

SPRING 2015

EXAM ERM

**Enterprise Risk
Management**

CASE STUDY

ERM Case Study

Introduction and Recommendations

This case study presents information for six companies:

- Lyon Corporation (a holding company);
- Simple Life (a life insurance company);
- AHA Health (a health insurance company);
- Eureka Health (a health insurance company);
- Pryde P&C (a general, that is, property and casualty, insurance company);
- Helios (a non-US insurance company).

When you register for the ERM exam, you will select from one of six reading extensions. Information presented in this case study will be used in questions appearing on the one-hour extension-specific portion of the ERM exam. Please note that for those who are pursuing an FSA, the extension selected for this exam need not match the track selected for fellowship.

You are encouraged to read this case study in conjunction with the recommended study materials. This will help you become familiar with the information that is provided in this case study and assist you in putting syllabus readings in context. The case study should be read critically, with the understanding that it is meant to represent a hypothetical organization with some good policies and some flaws; it is not a representation of best practices.

All candidates are encouraged to read through the entire case study to gain an overview of the corporation, but, in particular, all candidates are responsible for the material in Section 1 of the case study.

In addition to Section 1:

- (a) Candidates who elect the Individual Life and Annuities Extension will answer questions based on Section 3. Simple Life Insurance Company, excluding the details of Section 3.14;
- (b) Candidates who elect the Group and Health Extension will answer questions based on Section 4. Health Insurance Companies, excluding the details of Section 4.15;
- (c) Candidates who elect the General Insurance Extension will answer questions based on Section 5. Pryde Property & Casualty;
- (d) Candidates who elect the Retirement Benefits Extension will answer questions based on information about the pension plans sponsored by Simple Life and AHA Health, specifically Sections 3.14, 4.14.3, and 4.15 (but such candidates should review all of Sections 3 and 4 to understand how the pension plans fit within the companies);
- (e) Candidates who elect the Investment Extension will answer questions based on investment information for Simple Life and the pension plans sponsored by Simple Life and AHA Health, specifically Sections 3.11 through 3.14 and Section 4.15 (but such

candidates should review all of Sections 3 and 4 to understand how the investments and the pension plans relate to the companies); and

- (f) Candidates who elect the General Corporate ERM Extension will answer questions based on the information presented for all six companies in Section 2.

It is important that you become familiar with the information presented in the case study that pertains to the extension-specific questions you will attempt in the exam. All candidates are expected to think about ERM holistically and how the issues identified in their respective extensions will affect the ERM processes of the organization as a whole.

Exam booklets will contain an exact copy of this case study. You will not be allowed to bring your copy of this case study into the exam room.

The following table of contents should assist you in locating information that is pertinent to your selected extension. As noted above, however, you are encouraged to become familiar with the entire case study.

This and the following pages contain tables for the standard normal distribution. These tables will be available with this case study at the examination and are for use in solving all problems on the examination, including those not related to the case study.

TABLES FOR THE STANDARD NORMAL DISTRIBUTION

Values of z for selected probabilities that $Z \leq z$.

Pr($Z \leq z$)	0.800	0.850	0.900	0.950	0.975	0.990	0.995
z	0.842	1.036	1.282	1.645	1.960	2.326	2.576

Table for $N(x)$ when $x \geq 0$. Use interpolation with these tables. For example, $N(0.6278) = N(0.62) + 0.78[N(0.63) - N(0.62)] = 0.7324 + 0.78(0.7357 - 0.7324) = 0.7350$.

x	0.00	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
0.0	0.5000	0.5040	0.5080	0.5120	0.5160	0.5199	0.5239	0.5279	0.5319	0.5359
0.1	0.5398	0.5438	0.5478	0.5517	0.5557	0.5596	0.5636	0.5675	0.5714	0.5753
0.2	0.5793	0.5832	0.5871	0.5910	0.5948	0.5987	0.6026	0.6064	0.6103	0.6141
0.3	0.6179	0.6217	0.6255	0.6293	0.6331	0.6368	0.6406	0.6443	0.6480	0.6517
0.4	0.6554	0.6591	0.6628	0.6664	0.6700	0.6736	0.6772	0.6808	0.6844	0.6879
0.5	0.6915	0.6950	0.6985	0.7019	0.7054	0.7088	0.7123	0.7157	0.7190	0.7224
0.6	0.7257	0.7291	0.7324	0.7357	0.7389	0.7422	0.7454	0.7486	0.7517	0.7549
0.7	0.7580	0.7611	0.7642	0.7673	0.7704	0.7734	0.7764	0.7794	0.7823	0.7852
0.8	0.7881	0.7910	0.7939	0.7967	0.7995	0.8023	0.8051	0.8078	0.8106	0.8133
0.9	0.8159	0.8186	0.8212	0.8238	0.8264	0.8289	0.8315	0.8340	0.8365	0.8389
1.0	0.8413	0.8438	0.8461	0.8485	0.8508	0.8531	0.8554	0.8577	0.8599	0.8621
1.1	0.8643	0.8665	0.8686	0.8708	0.8729	0.8749	0.8770	0.8790	0.8810	0.8830
1.2	0.8849	0.8869	0.8888	0.8907	0.8925	0.8944	0.8962	0.8980	0.8997	0.9015
1.3	0.9032	0.9049	0.9066	0.9082	0.9099	0.9115	0.9131	0.9147	0.9162	0.9177
1.4	0.9192	0.9207	0.9222	0.9236	0.9251	0.9265	0.9279	0.9292	0.9306	0.9319
1.5	0.9332	0.9345	0.9357	0.9370	0.9382	0.9394	0.9406	0.9418	0.9429	0.9441
1.6	0.9452	0.9463	0.9474	0.9484	0.9495	0.9505	0.9515	0.9525	0.9535	0.9545
1.7	0.9554	0.9564	0.9573	0.9582	0.9591	0.9599	0.9608	0.9616	0.9625	0.9633
1.8	0.9641	0.9649	0.9656	0.9664	0.9671	0.9678	0.9686	0.9693	0.9699	0.9706
1.9	0.9713	0.9719	0.9726	0.9732	0.9738	0.9744	0.9750	0.9756	0.9761	0.9767
2.0	0.9772	0.9778	0.9783	0.9788	0.9793	0.9798	0.9803	0.9808	0.9812	0.9817
2.1	0.9821	0.9826	0.9830	0.9834	0.9838	0.9842	0.9846	0.9850	0.9854	0.9857
2.2	0.9861	0.9864	0.9868	0.9871	0.9875	0.9878	0.9881	0.9884	0.9887	0.9890
2.3	0.9893	0.9896	0.9898	0.9901	0.9904	0.9906	0.9909	0.9911	0.9913	0.9916
2.4	0.9918	0.9920	0.9922	0.9925	0.9927	0.9929	0.9931	0.9932	0.9934	0.9936
2.5	0.9938	0.9940	0.9941	0.9943	0.9945	0.9946	0.9948	0.9949	0.9951	0.9952
2.6	0.9953	0.9955	0.9956	0.9957	0.9959	0.9960	0.9961	0.9962	0.9963	0.9964
2.7	0.9965	0.9966	0.9967	0.9968	0.9969	0.9970	0.9971	0.9972	0.9973	0.9974
2.8	0.9974	0.9975	0.9976	0.9977	0.9977	0.9978	0.9979	0.9979	0.9980	0.9981
2.9	0.9981	0.9982	0.9982	0.9983	0.9984	0.9984	0.9985	0.9985	0.9986	0.9986
3.0	0.9987	0.9987	0.9987	0.9988	0.9988	0.9989	0.9989	0.9989	0.9990	0.9990
3.1	0.9990	0.9991	0.9991	0.9991	0.9992	0.9992	0.9992	0.9992	0.9993	0.9993
3.2	0.9993	0.9993	0.9994	0.9994	0.9994	0.9994	0.9994	0.9995	0.9995	0.9995
3.3	0.9995	0.9995	0.9995	0.9996	0.9996	0.9996	0.9996	0.9996	0.9996	0.9997
3.4	0.9997	0.9997	0.9997	0.9997	0.9997	0.9997	0.9997	0.9997	0.9997	0.9998
3.5	0.9998	0.9998	0.9998	0.9998	0.9998	0.9998	0.9998	0.9998	0.9998	0.9998
3.6	0.9998	0.9998	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999
3.7	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999
3.8	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999	0.9999
3.9	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000

Table for $N(x)$ when $x \leq 0$. Use interpolation (entries are for the row value *minus* the column value). For example, $N(-0.1234) = N(-0.12) - 0.34[N(-0.12) - N(-0.13)] = 0.4522 - 0.34(0.4522 - 0.4483) = 0.4509$.

z	0.00	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
0.0	0.5000	0.4960	0.4920	0.4880	0.4840	0.4801	0.4761	0.4721	0.4681	0.4641
-0.1	0.4602	0.4562	0.4522	0.4483	0.4443	0.4404	0.4364	0.4325	0.4286	0.4247
-0.2	0.4207	0.4168	0.4129	0.4090	0.4052	0.4013	0.3974	0.3936	0.3897	0.3859
-0.3	0.3821	0.3783	0.3745	0.3707	0.3669	0.3632	0.3594	0.3557	0.3520	0.3483
-0.4	0.3446	0.3409	0.3372	0.3336	0.3300	0.3264	0.3228	0.3192	0.3156	0.3121
-0.5	0.3085	0.3050	0.3015	0.2981	0.2946	0.2912	0.2877	0.2843	0.2810	0.2776
-0.6	0.2743	0.2709	0.2676	0.2643	0.2611	0.2578	0.2546	0.2514	0.2483	0.2451
-0.7	0.2420	0.2389	0.2358	0.2327	0.2296	0.2266	0.2236	0.2206	0.2177	0.2148
-0.8	0.2119	0.2090	0.2061	0.2033	0.2005	0.1977	0.1949	0.1922	0.1894	0.1867
-0.9	0.1841	0.1814	0.1788	0.1762	0.1736	0.1711	0.1685	0.1660	0.1635	0.1611
-1.0	0.1587	0.1562	0.1539	0.1515	0.1492	0.1469	0.1446	0.1423	0.1401	0.1379
-1.1	0.1357	0.1335	0.1314	0.1292	0.1271	0.1251	0.1230	0.1210	0.1190	0.1170
-1.2	0.1151	0.1131	0.1112	0.1093	0.1075	0.1056	0.1038	0.1020	0.1003	0.0985
-1.3	0.0968	0.0951	0.0934	0.0918	0.0901	0.0885	0.0869	0.0853	0.0838	0.0823
-1.4	0.0808	0.0793	0.0778	0.0764	0.0749	0.0735	0.0721	0.0708	0.0694	0.0681
-1.5	0.0668	0.0655	0.0643	0.0630	0.0618	0.0606	0.0594	0.0582	0.0571	0.0559
-1.6	0.0548	0.0537	0.0526	0.0516	0.0505	0.0495	0.0485	0.0475	0.0465	0.0455
-1.7	0.0446	0.0436	0.0427	0.0418	0.0409	0.0401	0.0392	0.0384	0.0375	0.0367
-1.8	0.0359	0.0351	0.0344	0.0336	0.0329	0.0322	0.0314	0.0307	0.0301	0.0294
-1.9	0.0287	0.0281	0.0274	0.0268	0.0262	0.0256	0.0250	0.0244	0.0239	0.0233
-2.0	0.0228	0.0222	0.0217	0.0212	0.0207	0.0202	0.0197	0.0192	0.0188	0.0183
-2.1	0.0179	0.0174	0.0170	0.0166	0.0162	0.0158	0.0154	0.0150	0.0146	0.0143
-2.2	0.0139	0.0136	0.0132	0.0129	0.0125	0.0122	0.0119	0.0116	0.0113	0.0110
-2.3	0.0107	0.0104	0.0102	0.0099	0.0096	0.0094	0.0091	0.0089	0.0087	0.0084
-2.4	0.0082	0.0080	0.0078	0.0075	0.0073	0.0071	0.0069	0.0068	0.0066	0.0064
-2.5	0.0062	0.0060	0.0059	0.0057	0.0055	0.0054	0.0052	0.0051	0.0049	0.0048
-2.6	0.0047	0.0045	0.0044	0.0043	0.0041	0.0040	0.0039	0.0038	0.0037	0.0036
-2.7	0.0035	0.0034	0.0033	0.0032	0.0031	0.0030	0.0029	0.0028	0.0027	0.0026
-2.8	0.0026	0.0025	0.0024	0.0023	0.0023	0.0022	0.0021	0.0021	0.0020	0.0019
-2.9	0.0019	0.0018	0.0018	0.0017	0.0016	0.0016	0.0015	0.0015	0.0014	0.0014
-3.0	0.0013	0.0013	0.0013	0.0012	0.0012	0.0011	0.0011	0.0011	0.0010	0.0010
-3.1	0.0010	0.0009	0.0009	0.0009	0.0008	0.0008	0.0008	0.0008	0.0007	0.0007
-3.2	0.0007	0.0007	0.0006	0.0006	0.0006	0.0006	0.0006	0.0005	0.0005	0.0005
-3.3	0.0005	0.0005	0.0005	0.0004	0.0004	0.0004	0.0004	0.0004	0.0004	0.0003
-3.4	0.0003	0.0003	0.0003	0.0003	0.0003	0.0003	0.0003	0.0003	0.0003	0.0002
-3.5	0.0002	0.0002	0.0002	0.0002	0.0002	0.0002	0.0002	0.0002	0.0002	0.0002
-3.6	0.0002	0.0002	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001
-3.7	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001
-3.8	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001
-3.9	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

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1 Lyon Corporation

1.1 Overview

Lyon Corporation is a diversified U.S. public holding company with interests in financial services companies.

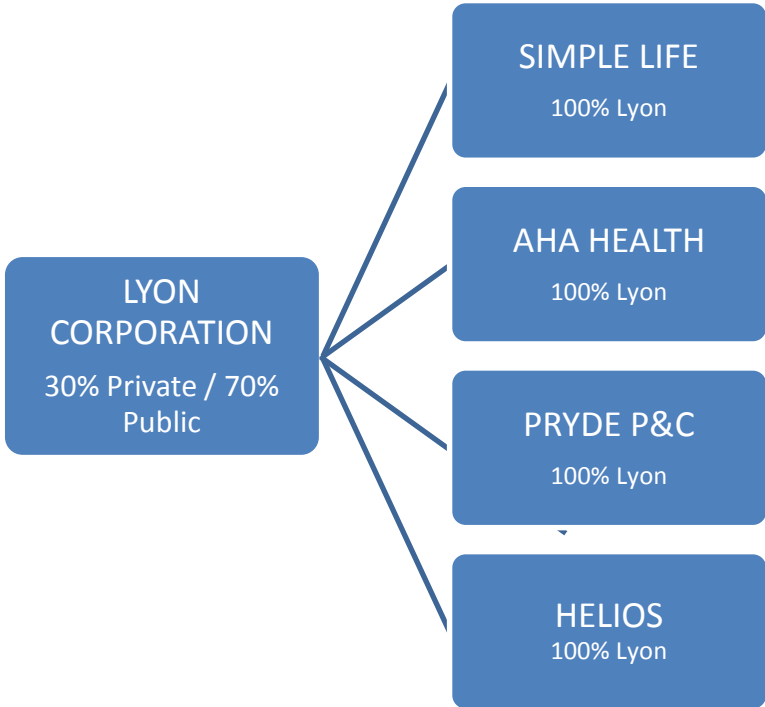
1.2 Mission Statement

Lyon Corporation is committed to enhancing shareholder value through the active management of long-term investments and responsible corporate citizenship. It is of the view that these objectives are best achieved and risks minimized through geographic diversification.

Lyon Corporation believes that the future belongs to corporations having a well-defined strategic vision anchored in strong core values. These principles guide the Corporation in all of its decisions.

1.3 Structure

Lyon Corporation is a public company (LCC: NYE and TSX) with a significant shareholder, Lyon Family, which owns about 30% of the outstanding shares. The holding company has the following structure:



Percentages denote equity interest and voting rights.

1.4 Simple Life

The Simple Life Insurance Company (SLIC) is a U.S. life insurance company located in Boston, Massachusetts, wholly owned by Lyon Corporation. SLIC has four lines of business: Universal Life (UL); Level Premium Term Insurance with three available level term periods: 10, 20 and 30 year; Single Premium Immediate Annuities (SPIA); and Variable Annuities with a Return of Premium (ROP) Guaranteed Minimum Death Benefit (GMDB) and an optional Guaranteed Minimum Accumulation Benefit (GMAB) or Guaranteed Minimum Withdrawal Benefit (GWAB). SLIC issues its products only in the United States.

SLIC provides basic life, health and disability benefits to its employees while they are employed by the company. These benefits do not continue after employees leave the company.

SLIC sponsors a company-paid final-average-earnings defined benefit pension plan for its employees.

1.5 AHA Health

AHA Health Insurance Company (AHA) is a large national insurer located in California with its home office in Los Angeles. AHA is wholly owned by Lyon Corporation. AHA sells individual and group health insurance and has a small block of long term care (LTC) business.

AHA Health provides basic life, health and disability benefits to its employees while they are employed by the company. These benefits do not continue after employees leave the company.

AHA Health sponsors a company-paid final-average-earnings defined benefit pension plan for its employees.

1.6 Pryde P&C

Pryde P&C is an Omaha, Nebraska-based U.S. writer with commercial and personal lines products that target a broad range of customers. In 2013, the split of premiums between commercial and personal lines is about 70%/30% respectively. Pryde is licensed in all 50 states. Its products are sold primarily through a career sales force led by sales directors responsible for selecting the product, managing the agency delivery system and serving the business in their territory. Pryde P&C is wholly owned by Lyon Corporation.

Pryde P&C provides basic life, health and disability benefits to its employees while they are employed by the company. These benefits do not continue after employees leave the company.

Pryde P&C does not sponsor any pension or savings plans for its employees.

1.7 Helios

Helios Life is located in Triangle City, Atlantis, a jurisdiction that uses the Euro as its currency. It is 100% owned by Lyon Corporation. Helios offers life insurance, disability insurance, and a combination illness/disability/life insurance product.

1.8 Lyon Board of Directors

The Lyon Board consists of 12 members, 4 of whom directly or indirectly represent the Lyon family interest. One of these four also serves as the Board Chairman of SLIC. There are six outside board members, four of whom are Chief Executive Officers or Board Chairmen in leading public companies in the United States or Canada. The other two board members are the Board Chairmen of AHA Health and Pryde P&C.

The following are the directors:

George Bell is the Chief Executive Officer of Rocket Aerospace Inc., the largest manufacturer of civil aircraft in the world.

Sarah Hanrahan is the Chief Executive Officer of Transworld Optics, a leading edge and global company in manufacturing of fiber optics.

Andrew Lyon is the Deputy Chairman of the Board and Co-Chief Executive Officer of Lyon Corporation.

Patrick Lyon is Co-Chief Executive Officer of Lyon Corporation.

R. Tomas Lyon III is Founder and Chairman of the Board of Lyon Corporation, and Chairman of the Executive Committee.

Jeremy Orr is a retired CEO and currently Chairman of Canada Aqua limited, the largest supplier of natural water in the Canadian marketplace.

Albert Montgomery is the Chairman, President and Chief Executive Officer of Northern Oil Sands Limited, one of Canada's largest oil sands company.

John Ritchie is a retired lawyer and a senior advisor to the Henderson & Henderson law firm.

Donald Rae is a retired businessperson, formerly CEO and Chairman of Rae Communications, Inc.

R. Tomas Lyon IV has been a director of Lyon Corporation since 1996. He was an insurance broker and President of Risky Life Insurance Company.

Dr. Jerry Graham is the Chairman and CEO of AHA Health.

Robert James is the Chairman and CEO of Pryde Property & Casualty Company.

1.8.1 Mandate of the Board

The mandate of the Board, which it discharges directly or through one of the five Board Committees, is to supervise the management of the business and affairs of the Corporation. Responsibilities include approval of strategic goals and objectives, review of operations, disclosure and communication policies, oversight of financial reporting and other internal

controls, corporate governance, Director orientation and education, senior management compensation and oversight, and Director nomination, compensation and assessment.

1.8.2 Executive Committee

The Executive Committee has and may exercise all or any of the powers vested in and exercisable by the Board, except approval of the annual strategic plan.

1.8.3 Audit Committee

The primary mandate of the Audit Committee is to review the financial statements of the Corporation and public disclosure documents containing financial information and to report on such review to the Board, to be satisfied that adequate procedures are in place for the review of the Corporation's public disclosure documents that contain financial information, to oversee the work and review the independence of the external auditors, and to review any evaluation of the Corporation's internal control over financial reporting.

1.8.4 Compensation Committee

The primary mandate of the Compensation Committee is to approve compensation policies and guidelines for employees of the Corporation, to approve compensation arrangements for executives of the Corporation, to recommend to the Board compensation arrangements for the Directors and for the Co-CEOs, to oversee the management of incentive compensation plans and equity compensation plans, and to review succession plans for senior management.

1.8.5 Related Party and Conduct Review Committee

The primary mandate of the Related Party and Conduct Review Committee is to recommend to the Board procedures for the consideration and approval of transactions with related parties of the Corporation and to review and, if deemed appropriate, to approve such transactions.

1.8.6 Governance and Nominating Committee

The primary mandate of the Governance and Nominating Committee is to oversee the Corporation's approach to governance issues, to recommend to the Board corporate governance practices consistent with the Corporation's commitment to high standards of corporate governance, to assess the effectiveness of the Board of Directors, of Committees of the Board and of the Directors, and to recommend to the Board candidates for election as Directors and for appointment to Board Committees.

1.8.7 Summary of Committee Memberships

The following table (where C = chairperson and M = member) summarizes committee memberships for Lyon’s Board of Directors:

	Executive	Audit	Compensation	Related Party and Conduct Review	Governance and Nominating
R. Tomas Lyon III	C				C
R. Tomas Lyon IV	M				M
Patrick Lyon	M			C	
Jeremy Orr	M		M		M
John Ritchie	M	M			M
George Bell		C		M	
Sarah Hanrahan		M	M		
Albert Montgomery		M		M	
Andrew Lyon			C		M
Donald Rae			M	M	

1.8.8 Code of Conduct and Business Ethics

The Board of Directors has adopted a Code of Business Conduct and Ethics to promote and maintain a culture of integrity throughout the Corporation. The Code is applicable to Directors, officers and employees of the Corporation.

1.9 Credit Rating

Lyon Corporation has a rating of A- (Super) from Kelly Ratings. The rating reflects the sufficient capital position of SLIC and Lyon’s overall positive financial results.

1.10 Oversight of Lyon Companies

Lyon Corporation, SLIC, AHA Health and Pryde P&C are each managed by an executive team (comprising the CEO, CFO, and COO and 4–6 other executives). Each CEO reports directly to his respective board. SLIC, AHA Health and Pryde P&C each have an independent Board of Directors.

The remainder of this document presents information about Lyon Corporation and the companies in which Lyon Corporation has a financial interest.

2 Lyon Corporation (Corporate) Functions and Oversight

Lyon Corporation functions as a holding company with four fully-owned subsidiaries: Simple Life Insurance Company (SLIC), AHA Health Insurance Company (AHA), Pryde Property and Casualty, and Helios Insurance Company. Lyon Corporation is publicly-owned, with 30% of the shares held by the Lyon family. The company has \$50 million in debt outstanding in the form of 20-year bonds issued in 2001 at 7.75% interest.

Lyon Corporation is in the process of developing a corporate level ERM function. Operational information provided to Corporate from the primary affiliated companies (SLIC, AHA, and Pryde) has been limited up until this time. However, the ERM department recently asked each affiliate to provide a summary description of its company, including product lines, outside relationships, risk assessments and concerns, and current business issues.

Lyon requires its subsidiaries to dividend excess capital up to the holding company. In turn, Lyon will consider providing capital contributions to subsidiaries that fall short of their capital requirements.

The documents that follow represent the first submissions from SLIC, AHA, and Pryde in response to Corporate's request.

2.1 SLIC Report to Corporate

2.1.1 SLIC -- Company Summary

The Simple Life Insurance Company (SLIC) is 100% owned by Lyon Corporation. R. Tomas Lyon III serves as Chairman of the Board, President and CEO.

SLIC is a life insurance company with four lines of business: Term Life, Universal Life, Single Premium Immediate Annuities, and Variable Annuities.

2.1.2 Capitalization and Investments

The company operates without any long-term debt except for two 15 year tenor Surplus Notes issues. \$50 million was issued at 9.5% in 2001 and \$35 million at 7.75% in 2006. The company strives to maintain a strong statutory risk based capital (RBC) ratio and to have an actual to required economic capital ratio of 110% or greater. Any surplus in excess of the larger of 400% of RBC and 110% of required economic capital is distributed to Lyon Corporation through a dividend annually at the end of the first quarter based on the year-end balance sheet. Surplus positions less than the maximum of 300% of RBC and 90% of required economic capital are addressed through a capital contribution from Lyon Corporation or the issuance of additional surplus notes.

The company's general account is invested primarily in fixed-income assets. Variable annuity fixed accounts are part of the general account; VA investment accounts are held in a separate (segregated) account and are managed by a third-party investment advisor.

Within the general account, there are separate investment portfolios for each of the four main product lines.

2.1.3 Risk Policies

Credit Risk: Fixed-income securities in the general account have exposure limits at individual obligor (issuer) and sector levels. For each portfolio, there are weighted average credit quality targets.

Market Risk: Semi-annually within the Term, UL and SPIA lines of business, the company measures the effective duration of the assets and liabilities. If the asset and liability durations are further apart than 0.5, the asset portfolio is rebalanced such that its new effective duration equals that of the liabilities.

The VA hedging program uses a dynamic approach updated for market factors monthly and for inforce changes quarterly. The key risk measures are delta and rho, and the program updates its equity and interest rate derivatives such that at least 80% of liability delta and rho are hedged. Vega is self-insured due to system complexity and the expense of implied volatility hedges. The VA liability delta and rho measures are estimated from an actuarial projection model using a home-grown computing platform.

Liquidity Risk: The liquidity policy requires SLIC to hold sufficient liquid assets to meet expected demands for cash in a unique liquidity stress-test scenario. The scenario focuses on a reputational liquidity crisis basis where markets continue to operate normally and the liquidity crunch affects only the company. The liquidity stress test anticipates situations where the company's ability to sell assets to meet cash needs from its liability products is hindered by the market taking advantage of the company during the crisis. In addition, testing periodically considers a systemic stress scenario where the entire market is not able to sell assets at a reasonable value. However, SLIC's liquidity policy does not require it to hold sufficient liquid assets to be able to meet cash demands in such a scenario, since it expects regulatory relief in a systemic crisis.

Operational Risk: The SLIC Chief Risk Officer will be responsible for collecting and disseminating risk information. A report will be prepared monthly and distributed to executive management.

2.1.4 SLIC Risk Management Committee

The committee meets on a regular quarterly basis during the year. Meetings focus on reviewing internal risk reports and interviews with key employees in finance, systems, and audit.

The committee recently recommended the hiring of a Chief Risk Officer (CRO), who will create and lead an independent Enterprise Risk Management (ERM) department. The CRO will be responsible for developing and implementing a comprehensive company-wide ERM program and serve as the risk liaison across various business segments to address significant emerging concerns.

It was determined by the Board that the Risk Management Committee will be redundant once the CRO is in place and has sufficient experience. Thus, the Risk Management Committee will be disbanded on the date the CRO becomes an officer of SLIC.

2.1.5 SLIC – Initial Product Report

2.1.5.1 Level Premium Term Insurance

Product Description: The term life insurance line has two series of products. The fully underwritten line offers three term periods: 10, 20 and 30 year. The simplified issue line offers a 10 year level term product. Both lines are convertible to the currently issued UL product during the level term period.

For both term insurance lines, SLIC makes use of reinsurance, the terms of which have been fairly consistent for many product generations. The fully underwritten line is coinsured at 60% and any single life issue over \$1 million is 100% facultatively reinsured. The simplified issue line is reinsured under YRT treaties to a pool of four reinsurers, each with an 8% quota share.

Market Position: Sales have been strong, due to competitive pricing, higher-than-average first year sales compensation, and a strong advertising campaign.

Experience: The fully underwritten line has shown improving mortality relative to pricing and lower-than-priced lapse rates. In contrast, the simplified issue line shows deteriorating mortality relative to pricing and higher-than-priced lapse rates.

SLIC Pricing department has implemented cutting edge approaches to assess mortality experience, including performing predictive modeling exercises to determine and better understand sensitivity to various independent variables (e.g., policy year, income, geography, etc.). In addition, SLIC participates in and uses Society of Actuaries industry studies to assess its relative experience. Its studies span the last five years of mortality incidence and are refreshed annually. Pricing systematically distributes the experience study report to other modeling areas, so their assumptions can be kept current.

SLIC's current annual lapse experience studies are based on the last five years of experience, but are being refined. Currently, studies exist for aggregate experience by issue age and policy year, but enhancements are planned to include splits for gender and underwriting risk class.

Based on the emerging experience results and increasing face amounts for these products, SLIC is re-evaluating its reinsurance agreements and retention limits.

2.1.5.2 Variable Annuity

Product Description: All Variable Annuity contracts provide a Return of Premium (ROP) GMDB. Partial withdrawals are available, with the GMDB reduced dollar for dollar by the amount of the withdrawal. The VA offers a collection of eight proprietary mutual fund choices (seven domestic and one foreign) and a fixed fund invested in the general account.

Two optional Guaranteed Living Benefits (GLBs) are offered, only one of which may be chosen for a single underlying contract: (i) a Guaranteed Minimum Accumulation Benefit (GMAB), which guarantees the contractholder's account value will not drop below the premium deposit (reduced by any withdrawals) as of the 10th year anniversary; or (ii) a Guaranteed Minimum Withdrawal Benefit (GMWB) that guarantees the contractholder the ability to withdraw 5% of the benefit base per year for life.

The most recent sales mix, as measured by account value, shows 30% without a GLB, 50% with a GMWB and 20% with a GMAB.

Market Position: Sales are flat compared to prior years, probably attributable to other competitors offering a wider range of funds and rider options. To avoid the lengthy and expensive market research and product development cycles, the Company has decided to be a "fast-follower" and copy successful designs it sees in the market place.

Over the prior year, National Bank has begun selling a product to compete with the GMAB written by the insurance industry. The product adds a guarantee on an S&P 500 mutual fund investment that promises return of principle for a 2% annual fee applied to the fund value. National Bank has numerous branches throughout the country and seems to have a strong marketing department.

Experience: Annual studies spanning the prior calendar year experience are used for the full surrenders, where experience is distributed across contract year. Pricing performs these studies and distributes them to other modeling groups upon request.

All SLIC VA modeling applications use industry mortality experience as published by a large actuarial consulting firm seven years ago.

Proposed Product Improvements: SLIC plans to add new fund families over the next six months. The new fund options will be available on existing and new VA GMAB or GMWB contracts as well as on new VA contracts with the new guaranteed benefit riders described below.

SLIC is considering an enhanced product called VA Plus, which provides the same benefits as the existing products but also includes a ratchet on the GLB and GMDB benefits. A ratchet provides that on every contract anniversary the benefit base is set equal to the greater of the account value and the prior year benefit base rolled up 5%.

SLIC will be fast-tracking the product development and implementation process, resulting in a very aggressive time schedule. As part of the implementation process, the administrative system needs additional programming to handle an increased slate of fund and rider offerings.

2.1.5.3 Universal Life

Product Description: When SLIC began selling Universal Life in 1995, the company sold a mix of various UL products, with 4% guarantees, which were common at that time. Some of those products remain in force.

The company's current universal life offerings consist of two different products:

The Saver Supreme product is designed to accumulate high cash surrender values relative to the death benefit over time. The Protector Plus product, with secondary guarantees, is designed for the consumer who wants death benefit protection at the lowest possible premium; it guarantees that the policy will stay in force if the specified premium is paid each year.

For both products, the credited rate on the accumulation fund is guaranteed to be never less than 3%. SLIC targets a 2% spread.

Market Position: Launch sales have been much lower than expected, but the company is anticipating that the 3% floor on investment returns will become more attractive and result in higher future sales. For the UL product, like the VA, the Company has decided that "fast-follower" is the preferred product development method for the near future.

Current Issues: The administrative system needs additional programming to handle some product features that are now available to the policyholder. To date these features selections have been tracked through electronic notes in the policy file.

Three of the Company's competitors in the UL market have recently formed an administrative services only company, called UL Admin Co, to administer their universal life contracts. UL Admin Co performs all of the UL administrative tasks for the three companies, such as policy administration, valuation, and cash flow and reserve projections for planning and risk purposes. In recognition of the expense savings achieved, the three companies have given an extra-contractual benefit to their policyholders by reducing their annual policy maintenance charge.

Experience: Policy issuance as a percentage of applications has been much lower than expected. Lapse rates in the first year are lower than anticipated in pricing. Recent mortality experience has been approximately equal to expected mortality, but SLIC has little exposure to date.

SLIC has not yet implemented a separate mortality study for its UL product. Instead, SLIC bases its UL mortality assumption for all modeling applications on the Term mortality experience studies, since both products have the same risk classes and underwriting criteria.

SLIC's lapse study on the UL product is fairly comprehensive, reflecting the surrender charge period and the dynamic impacts of crediting rates. It includes the last five years of lapse experience and is updated semi-annually by Pricing, which then systematically distributes these reports to all other modeling groups.

Due to the current low level of interest rates, the Company has revised the investment plan to be a mix of ten-year BBB corporate debt, high yielding sovereign paper of mixed maturity periods, and some exclusive opportunities in the private equity area.

Proposed New Product: SLIC is considering adding an Indexed UL product, a hot product in the current market. An Indexed UL product is a fixed UL product with an indexed account option.

The interest credits on the indexed account are based on the greater of the return on an index, such as the S&P 500, or zero. It is attractive to policyholders who want to participate in the future price appreciation in stocks in the S&P 500 without the risk of negative returns.

For the basic product SLIC would enter a swap agreement to exchange a specified investment income to a return on an S&P index with a zero floor and a specified cap, which would allow SLIC effectively to transfer out the embedded market risk. More sophisticated Indexed UL products could be offered in the future with multiple indexed accounts based on different indices or different time periods of index growth and indexed interest crediting.

To facilitate pricing and implementation, the features for the basic product are proposed to be similar to the current UL product with some exceptions. The product design actuaries have proposed that the UL investment portfolio support both the UL and the new Indexed UL products. The indexed interest would be hedged by purchasing the equivalent swap on the underlying index, initially the S&P 500.

2.1.5.4 Single Premium Immediate Annuity

Product Description: The product offered is a straight life annuity issued to ages 65 and above, with no death benefit.

Experience: Recent mortality experience has been approximately equal to expected but mortality improvement seems to be higher than expected.

SLIC's pricing mortality assumption is based on Pricing's annual experience study spanning the last two years of experience. Pricing makes this study available to the other modeling groups upon request. The mortality improvement assumption for all modeling applications is based on industry experience as released in a recent study performed by a large consulting firm.

Market Position: Recent sales have shown slow but steady growth. The product is selling well, but decreasing interest rates are a matter of concern. Traditionally, assets supporting this block have been investments in high quality long term corporate bonds and treasuries. However, in response to the recent economic environment and the uptick in mortality improvement, higher yielding exotic investments have been used recently to help meet the desired profit margin. These new investments include such assets as real estate, domestic private equity and emerging markets common equity.

2.2 AHA Report to Corporate

Lyon Corporation management has little experience in health insurance. As result, they have been content to allow the AHA management a great deal of autonomy. This arrangement has worked well in the past, and AHA was reluctant to provide a very thorough report to Lyon.

2.2.1 AHA – Company Summary

AHA Health Insurance Company (AHA) is a large national insurance company located in California with its home office in Los Angeles. AHA is wholly-owned by Lyon Corporation.

AHA sells individual and group health insurance in California and 14 other states. It is in both the small and large group markets in all states. In addition, AHA has a small block of long term care (LTC) business with policyholders located all over the country.

2.2.1.1 Operations

AHA negotiates with physician and hospital providers in each state in which it is licensed and continually monitors these provider networks. It has contracted with Networks 'R Us to use its provider networks when members need services outside of states in which it is licensed.

AHA has its own centralized medical management staff that administers its medical management policies consistently in all states in which it is licensed. AHA's staff continually reviews and revises policies to keep costs down and to keep up with the latest developments. Its vendors, Networks 'R Us, Carefree Rx, and Painless Dental, work with AHA to make sure their medical management policies do not conflict with those of AHA.

AHA has a claims system developed and maintained by a well-respected national vendor. AHA maintains a close relationship with this vendor to make sure that the system meets all of its needs.

AHA underwrites large group business coverage, using credibility rating. While the underwriting decision is systematically determined in most cases, the Senior Pricing Actuary makes the ultimate underwriting decision for the largest cases, relying on his extensive experience in the industry.

AHA's robust data collection process includes categorizing it in numerous different ways that allows all parts of the company to use the same database. Their data are used for actively monitoring claims experience, which results in up-to-date pricing and forecasting assumptions. In addition, their data is used for research and ad hoc financial analyses, group reporting, and financial reporting. In fact, the group reports have proved helpful in showing groups how to lower their costs.

2.2.1.2 Risk Management

AHA management believes the company can prosper by being aggressive and willing to take risks. The company does not have a named CRO, but has a risk committee with limited scope and authority. Various senior managers take on a CRO role as needed.

AHA's incentive compensation plan criteria include membership growth, profitability, and quality of care. AHA's plan covers management staff from top management to frontline management. The goal is to have all management focused on the key drivers of success.

2.2.1.3 Healthcare Reform & Other Regulatory Issues

AHA's staff have been following healthcare reform since its inception and have developed and updated detailed implementation plans. These include timelines and requirements for additional staff. The new staff members need to be hired in time to get at least 6 months of

training. At this time, the funds for the new staff have not been approved so hiring has been put on hold.

AHA is developing its strategy for the period after full implementation of the Affordable Care Act in 2014. The company's claim experience varies dramatically by state and market (Individual, Small Group and Large Group, and LTC). AHA must decide whether to pull out of certain markets, stay in the market and sell out of the Exchange, or remain in the market and sell through the Exchange.

2.2.1.4 Other Initiatives

AHA management is looking into purchasing Eureka, a health insurance company domiciled in New York. The driving force behind this acquisition is to help AHA enter a new market without having to build a lot of infrastructure. Initially, the Eureka management would remain in place to run the company and integration would proceed over several years. AHA management is putting together a due diligence team including staff from AHA finance, actuarial, marketing, and medical management.

2.2.2 AHA – Initial Product Report

Product Summary: AHA's individual and group health policies include comprehensive major medical coverage of hospital services, physician services, and prescription drugs. The plans have an average deductible under \$2,000 in all markets. In addition, the group policies include dental coverage. Dental is offered as a rider to the medical policies.

AHA negotiates physician and hospital contracts in each state in which it is licensed and has contracted with a provider network for services outside of states in which it is licensed. In addition, AHA has contracted with a nationwide drug plan to manage its prescription drug coverage and a dental administrator to manage its dental plans.

LTC: AHA is interested in hedging the risk arising from the small LTC block. A team from AHA's finance and actuarial areas plus the corporate finance and investment areas are meeting to determine next steps.

2.3 Pryde Report to Corporate

2.3.1 Pryde -- Company Summary

Pryde is an Omaha, Nebraska-based U.S. writer with commercial and personal lines products that target a broad market. In 2013, the split of premiums between commercial and personal lines is about 70%/30% respectively. Pryde is licensed in all 50 states and its products are sold primarily through a career sales force.

Pryde's business is spread throughout the United States, with its largest concentration in California (17% of premium), followed by Texas, Georgia, Florida, and Mississippi (each with 5% - 6% of premium).

2.3.1.1 Exited Markets

Beginning in 2008, Pryde's previous management team followed a growth and acquisition strategy and decentralization of its personal lines operations, which led to rate inadequacy and adverse loss reserve development.

Pryde experimented with production sources and customer segments with which management was unfamiliar. The new markets contained customer groups who were much more price-conscious and claims-conscious than Pryde's traditional customers. Pryde subsequently exited these segments because of higher than expected growth and poor operating results.

2.3.1.2 Risk and Capital Analysis

Pryde has approximately \$3.5 billion in assets and \$800 million in capital and surplus. Pryde retained Hawthorne Consulting in 2010 to aid the company in developing a "risk and capital" model to aid management in gauging the adequacy of overall capitalization of the company and allocating capital to lines of business.

Hawthorne recommended using a risk adjusted return on required capital (RAROC) approach and used VaR and TVaR to assess capital needs. Overall, Hawthorne's work showed that Pryde's current capital and surplus exceed the amount needed to support its businesses on a risk-adjusted basis.

2.3.2 Pryde – Initial Product Report

Commercial: The two major lines of commercial business written are:

- Commercial Multi-Peril("CMP")
- Workers Compensation

Personal: The two major personal lines of business written are:

- Personal Automobile
- Personal Property

Exposures and Reinsurance: The group's primary catastrophe exposure stems from both hurricanes and earthquakes. However, these exposures are mitigated through excess of loss reinsurance, as well as catastrophe protection that has enabled the group to improve its net catastrophe leverage to a very manageable level. As a result, the group's estimated net probable maximum losses (PML) stemming from a combined 250-year hurricane and a 250-year earthquake depicted in a PML analysis represents approximately 5% of capital and surplus, which is significantly less than the 10% limit set by the Chief Actuary years ago

Pryde maintains quota-share reinsurance and excess-of-loss reinsurance for property risks, and a working layer treaty reinsurance plus an aggregate excess of loss treaty for casualty risks.

2.4 Corporate Financial Statements

The current year financial statements are provided for Lyon Corporation on a consolidated basis, and multi-year summary statements are provided for each of the subsidiaries. 2012 and 2013 are actual results; 2014 – 2016 are projections.

2.4.1 Lyon Consolidated 2013 Statements

2013 FINANCIAL STATEMENTS	SLIC	AHA	Pryde	Helios	Holding*	Combined
Income Statement (000s)						
Premiums & Policy Fees	951,995	6,131,868	885,134	138,919	-	8,107,916
Investment Income	256,026	50,511	86,942	74,968	9,606	478,052
TOTAL REVENUE	1,208,020	6,182,379	972,076	213,887	9,606	8,585,968
Property and casualty losses and loss expense	-	-	855,778	-	-	855,778
Life, accident and health benefits	533,421	4,803,494	-	95,562	-	5,432,476
Other expenses	604,987	1,042,482	257,216	98,371	5,281	2,008,337
TOTAL EXPENSES	1,138,407	5,845,976	1,112,995	193,933	5,281	8,296,592
Income Before Income Tax	69,613	336,403	(140,919)	19,954	4,325	289,376
Income Tax	24,364	117,741	(35,230)	4,378	1,254	112,508
Net Income	45,248	218,662	(105,689)	15,576	3,070	176,868
Balance Sheet (000s)						
General account assets	4,861,829	2,852,370	3,470,568	1,318,552	183,151	12,686,472
Separate account assets	1,776,520	-	-	-	-	1,776,520
Total Assets	6,638,349	2,852,370	3,470,568	1,318,552	183,151	14,462,991
Property and casualty loss and other liabilities	-	-	2,660,922	-	-	2,660,922
Separate account liabilities	1,776,520	-	-	-	-	1,776,520
Future policy benefits and claims, other liabilities	4,239,751	1,024,022	-	1,164,527	-	6,428,299
Other liabilities	-	-	-	-	52,235	52,235
Total Liabilities	6,016,270	1,024,022	2,660,922	1,164,527	52,235	10,917,976
Surplus	622,079	1,828,348	809,647	154,025	130,916	3,545,016
Total Liabilities and Surplus	6,638,349	2,852,370	3,470,568	1,318,552	183,151	14,462,991
Economic Capital						
Required capital	427,738	1,623,795	961,104	141,781	15,092	3,169,510
Free capital	73,350	19,954	(15,591)	53,184	120,799	251,696
Available Capital	501,088	1,643,749	945,512	194,966	135,891	3,421,206

*Excluding investments in subsidiaries

2.4.2 SLIC Financial Statements

	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Premiums & Policy Fees	1,409,953	1,518,963	1,643,255	1,782,566	1,938,716
Ceded Premiums	(516,395)	(566,968)	(624,848)	(691,301)	(767,773)
Net Investment Income	244,880	256,026	272,300	289,389	306,489
Total Revenue	1,138,437	1,208,020	1,290,707	1,380,653	1,477,431
Surrender & Annuity Benefits	120,223	133,406	145,809	160,018	174,082
Death Benefits	686,645	749,625	816,438	898,947	994,185
Ceded Benefits	(313,195)	(349,610)	(382,219)	(424,317)	(473,625)
Increase in Net Reserves	284,100	313,186	342,146	368,740	396,591
Expenses	176,465	190,362	205,206	222,074	237,690
Net Transfers to/(from) Separate Account	117,173	101,439	92,733	83,124	72,518
Total Benefits & Expenses	1,071,412	1,138,407	1,220,112	1,308,586	1,401,441
Income Before Income Tax	67,025	69,613	70,595	72,068	75,991
Federal Income Tax	23,459	24,364	24,708	25,224	26,597
Net Income	43,567	45,248	45,887	46,844	49,394
Statutory Balance Sheet (000s)					
General account assets	4,517,756	4,861,829	5,219,286	5,627,632	6,023,616
Separate account assets	1,376,968	1,776,520	2,035,490	2,307,169	2,591,646
Total Assets	5,894,724	6,638,349	7,254,776	7,934,800	8,615,262
Net General Account Reserve Liabilities	3,926,564	4,239,751	4,581,896	4,950,636	5,347,227
Separate Account Liabilities	1,376,968	1,776,520	2,035,490	2,307,169	2,591,646
Total Liabilities	5,303,532	6,016,270	6,617,386	7,257,805	7,938,872
Surplus	591,192	622,079	637,390	676,995	676,390
Total Liabilities and Surplus	5,894,724	6,638,349	7,254,776	7,934,800	8,615,262
Economic Capital Balance Sheet (000s)					
Market Value of Assets	6,142,302	6,937,074	7,566,731	8,291,867	9,002,949
Economic Reserve	5,673,379	6,435,987	7,059,523	7,717,053	8,362,851
Required Economic Capital	413,238	427,738	454,518	487,880	524,502
Free Surplus	55,685	73,350	52,690	86,933	115,596
Total Liabilities and Surplus	6,142,302	6,937,074	7,566,731	8,291,867	9,002,949

2.4.3 AHA Financial Statements

TOTAL	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Premiums net	5,633,910	6,131,868	6,751,482	7,359,037	7,915,398
Health benefits	4,394,473	4,803,494	5,342,158	5,868,867	6,331,664
General expenses	963,620	1,042,482	1,087,044	1,030,441	1,070,014
Total Expenses	5,358,093	5,845,976	6,429,202	6,899,308	7,401,678
Investment Income	40,362	50,511	56,220	62,798	70,326
Income Before Income Tax	316,179	336,403	378,501	522,527	584,047
Federal Income Tax	110,663	117,741	132,475	182,884	204,416
Net Income	205,517	218,662	246,025	339,643	379,630

Statutory Balance Sheet (000s)

Total Assets	2,542,098	2,852,370	3,186,107	3,568,061	3,888,667
Liability for unpaid claims and claim adjustment expenses	605,645	674,505	742,663	809,494	870,694
Other Liabilities	326,767	349,516	384,834	419,465	451,178
Total Liabilities	932,412	1,024,022	1,127,498	1,228,959	1,321,872
Surplus	1,609,686	1,828,348	2,058,610	2,339,102	2,566,796
Total Liabilities and Surplus	2,542,098	2,852,370	3,186,107	3,568,061	3,888,667

Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate	-	-	-	-	-
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Economic Capital Balance Sheet (000s)

Market Value of Assets	2,623,446	2,952,203	3,291,249	3,689,375	4,024,771
Economic Reserve	1,188,193	1,308,454	1,444,921	1,578,973	1,702,536
Required Economic Capital	1,485,087	1,623,795	1,796,726	1,969,129	2,125,063
Free Surplus	(49,834)	19,954	49,602	141,274	197,172
Total Liabilities and Surplus	2,623,446	2,952,203	3,291,249	3,689,375	4,024,771

Additional Metrics

Enrollment (000s)					
Members	1,928	2,001	2,095	2,165	2,224
Member Months	21,253	22,258	23,088	23,975	24,743
Utilization (per 1,000 members)					
Physician Visits	4,520	4,374	4,389	4,395	4,396
Hospital Days	407	381	377	378	378

2.4.4 Pryde Financial Statements

	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Underwriting Income					
Premiums earned	941,046	885,134	874,321	897,483	921,264
Losses and loss adjustment expenses incurred	766,681	855,778	676,964	694,906	713,326
Expenses	274,508	257,216	251,018	257,692	264,544
Net Underwriting Gain (loss)	(100,143)	(227,861)	(53,661)	(55,114)	(56,606)
Investment Income	85,805	86,942	85,055	85,302	87,524
Income Before Income Tax	(14,338)	(140,919)	31,394	30,189	30,918
Federal Income Tax	(3,585)	(35,230)	7,848	7,547	7,729
Net Income	(10,754)	(105,689)	23,545	22,641	23,188

Statutory Balance Sheet (000s)

Total Assets	3,391,189	3,470,568	3,424,362	3,513,597	3,605,098
Losses and loss adjustment expenses	1,764,471	1,987,002	1,895,856	1,944,028	1,993,427
Unearned Premium	453,687	431,446	442,875	454,609	466,655
Other Liabilities	257,694	242,473	252,439	259,127	265,994
Total Liabilities	2,475,853	2,660,922	2,591,170	2,657,763	2,726,076
Surplus	915,336	809,647	833,192	855,834	879,022
Total Liabilities and Surplus	3,391,189	3,470,568	3,424,362	3,513,597	3,605,098

Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate	-	-	-	-	-
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Economic Capital Balance Sheet (000s)

Market Value of Assets	3,564,140	3,657,979	3,622,975	3,717,385	3,814,193
Economic Reserve	2,513,000	2,712,467	2,651,585	2,730,353	2,811,426
Required Economic Capital	1,020,698	961,104	971,266	998,756	1,027,024
Free Surplus	30,442	(15,591)	125	(11,724)	(24,257)
Total Liabilities and Surplus	3,564,140	3,657,979	3,622,975	3,717,385	3,814,193

2.5 Rating Agency Report

Lyon Corporation is preparing for a rating review by Kelly Rating Agency, an internationally recognized rating agency. Kelly has previously focused on its ratings of stand-alone insurance companies, such as SLIC and Pryde, but beginning last year required that insurance groups be rated at the corporate level. During its review last year, Kelly identified several issues that it expects Lyon to address before the next review, scheduled for later this year. Correspondence related to the prior review and Kelly's most recent rating report are provided starting on the following page.

Kelly Ratings & Analysis - When it comes to ratings, clearly you need Kelly

1 Kelly Drive, Capital City

ph 123/555-6500

February 10, 2014
R. Tomas Lyon III
Lyon Corporation

Dear Mr. Lyon:

It is time once again for Kelly Ratings & Analysis' annual review of Lyon Corporation. I will call you next week to set up a date. Ideally, Paula Silver, Director of our Financial Services Practice, and I would like to meet with Lyon Corporation sometime in early April. As in past years, we will come to your offices for a day of meetings with your senior management team. Count on the presentation from Lyon Corporation taking the first half of the meeting; the second half will be a free form Q&A with your management. We can finalize the agenda during next week's call.

Attached is Kelly's rating rationale from last year. Due to last year being the initial group-level review and the lack of available group financial data, the rationale was based primarily on our qualitative assessment of the group and its component companies. Please look through this document and make note of any aspects that you wish to discuss. In addition, we will need your 2013 financial information. I would like to receive that in advance of our meeting.

I want to remind you that, since last year was the first year for a group-level rating review, our Kelly Financial Wherewithal Rating™ (commonly known as the "Kelly Rating") was not publicly disclosed. It was intended to help you understand our group assessment criteria and how Lyon Corporation would be evaluated, so you would have an opportunity to improve any deficient processes before this year's public rating. The rating determined for Lyon Corporation last year was **A-**.

Evaluating implementation and effectiveness of insurers' ERM processes has become an increasingly important part of Kelly's evaluation and rating of insurer's financial strength. During this year's annual review, we would also like to start having more discussions with Lyon Corporation management on several aspects related to the risk management processes, such as ERM culture and policies, risk governance, risk control and mitigation processes, strategic risk management, as well as management of specific risks (e.g., ALM, credit risk, liquidity risk, operational risk).

Sincerely,

Otto Gold
Director, Financial Services Rating Bureau

LYON CORPORATION

2013 Kelly Financial Wherewithal Rating™ - Group Level

Based on our opinion of the company's financial strength, it is assigned a **Kelly Financial Wherewithal Rating™ of A-(Super)**. The company's Financial Size Category is Class VIII.

Rating Rationale

Rating Rationale: The rating for Lyon Corporation reflects the company's strong capital position, reasonable operating performance and the long-term stability of its management. However, profitability has not been as strong as its rating peers, and Lyon Corporation will continue to face challenges as a public company.

Rating History

No history – Initial Group Rating

Business Review

Lyon Corporation began operations in 1904. For most of its history, it has been controlled by the Lyon family. R. Tomas Lyon III is its fourth generation leader.

Lyon Corporation began as a life insurance company selling innovative term life insurance at very aggressive rates. That continues to be a hallmark of the company today.

The company began to broaden its scope in the 1990's by demutualizing and offering public stock. The Lyon Family originally maintained a majority ownership of the company, but has subsequently divested a substantial portion of its shares. The Lyon Corporation is now 30% privately held by the Lyon Family. A holding company structure was put in place. The original life insurance company became Simple Life (SLIC), owned 100% by Lyon Corporation. The Corporation also acquired a health insurance company, AHA Health, and a property and casualty company, Pryde P&C, early in 2000. Lyon Corporation became an international group in 2008 with the acquisition of Atlantis-based Helios Insurance Company. All of the subsidiaries are owned 100% by Lyon Corporation.

SLIC has significantly increased its product offerings beyond term insurance and now has a growing SPIA line of business, as well as universal life and variable annuities. However, all of the SLIC products face competitive pressures and likely will require updated features and pricing.

AHA has provided solid results and takes a proactive approach to the health market. Pryde has been a less positive addition to the Lyon Corporation, showing unfavorable results in recent years, particularly when Pryde management experimented with unfamiliar production sources and customer segments in the late 2000's. Losses eroded Pryde's capital position, but recent changes seem to be putting the subsidiary back on track.

Helios has shown steady profitability and has provided a reasonable means for Lyon Corporation to gain international experience on a small scale.

Investment operations have not performed especially well on a risk-adjusted basis and there is some concern if the low interest rate environment persists.

After several years of sluggish growth, Lyon Corporation has set some very aggressive growth targets for the future. The company appears to have the capital to fund this growth internally; however the plan to actually achieve sales at these levels remains unclear.

Earnings

Lyon Corporation's earnings have benefited over the years from solid product profitability in most lines of business. We expect product earnings to decline in the future as the company attempts to grow its business in a very competitive market. The current low interest rate environment will also continue to put pressure on earnings.

Profitability Analysis

(in millions of dollars)

Net Op Gain	2009	2010	2011	2012
SLIC	39.0	47.3	46.4	46.5
AHA	188.0	183.8	109.8	205.9
Pryde	35.1	14.6	-3.0	-10.4
Other	3.4	10.7	13.8	13.2
Total	265.6	256.4	167.0	255.2

Capitalization

Capital and surplus within the subsidiaries is quite strong, totaling \$3.5 billion. It appears that the company's excess capital could be deployed more effectively to increase earnings and returns for shareholders. The company's growth strategy may be a means to accomplish this, if implemented appropriately.

However, we note that Lyon Corporation has not made any significant efforts to measure capital requirements on a risk-adjusted basis. Therefore, it is difficult for Lyon Corporation to evaluate the appropriateness of its growth strategy or other potential strategic initiatives. We believe that this needs to be a future focus for corporate management if Lyon Corporation wishes to demonstrate that it is being run effectively.

We also note that the company continues to operate with minimal long-term debt. While this capital structure can be appropriate for a corporation, in our opinion, Lyon Corporation has not done any evaluation to justify that this is the best structure for the company.

Investments and Liquidity

Lyon Corporation maintains a conservative investment portfolio, based primarily on high-quality investment grade corporates and Treasuries. As a result, default experience in the fixed income portfolio has been very good and can be viewed as much better than insurance industry averages over the most recent years. The portfolio has also provided sufficient liquidity.

We understand that Lyon Corporation is exploring the possibility of moving to more aggressive portfolios for select lines of business by adding high yield and BBB debt securities, as well as equities. This is an area that Kelly will continue to monitor.

Officers

Chairman of the Board (Lyon Corporation); Chairman, President and CEO (SLIC) -- R. Tomas Lyon III

Deputy Chairman of the Board, Co-CEO (Lyon Corporation) – Andrew Lyon

Co-CEO (Lyon Corporation) – Patrick Lyon

Chairman and CEO (AHA Health) – Dr. Jerry Graham

Chairman and CEO (Pryde) – Robert James

2.6 Corporate ERM Department

In reaction to rating agency concerns and regulatory expectations, Lyon recently announced the creation of a formal Corporate ERM Department. The appointment of a Chief Risk Officer (CRO) is expected shortly.

The objectives of the Corporate ERM Department are:

- Establish a consistent ERM process among the Lyon Corporation companies
- Promote a strong risk culture within Lyon Corporation
- Develop a corporate-level Economic Capital modeling process
- Create a risk appetite statement and assess overall risk exposure in relation to risk appetite
- Develop a strategic risk profile in conjunction with the Corporate Strategic Planning Department

2.6.1 Economic Capital Modeling

The three affiliated companies have provided information on the status of economic capital modeling within their organizations.

2.6.1.1 SLIC

SLIC has implemented an internal economic capital model tailored to its own company-specific risks. The intent is to quantify the risks to the company's net equity (on a market-consistent basis) using a one-year 99.0% Value at Risk (VaR) measure. The model quantifies exposure to interest rate risk, equity price risk, and credit risk.

Interest rates are modeled stochastically using a single-factor model calibrated to monthly historical data for 10-year U.S. Treasury yields from 1994. Equity returns are modeled stochastically using a regime-switching lognormal distribution that is calibrated to thirty years of daily S&P 500 equity index returns.

For the VA and its GMAB and GMWB, the VaR is calculated with liabilities net of hedging assets and derivatives. Implied volatility is derived from current exchange-traded 10-year at-the-money equity floors. As an approximation, the test assumes expiring derivatives can be replaced with current at-the-money instruments.

For credit risk, the model assumes that existing investment grade fixed income assets are sold immediately if they fall below investment grade. Therefore, the company does not quantify the risk of credit default or loss given default. Credit risk is modeled through the stochastic simulation of credit ratings migration. The calibration uses ten years of historical data for corporate bond ratings migrations and yield spreads. Since the company has a general buy and hold investment strategy, credit spreads are only considered to be a risk factor if and when investment grade assets are downgraded below investment grade. SLIC calculates the risk of fluctuations in market value due to credit spread movements in the absence of ratings

downgrades, but excludes the results since its statutory surplus is based upon asset book value and it has a general buy and hold investment strategy.

The Company is currently considering a few methodologies to capture insurance risk, but has not implemented anything to date. A full-blown stochastic-on-stochastic analysis may be too much of a load on the existing computer infrastructure, so less onerous methodologies are being studied.

At this point, the Company does not have an operational risk model and, therefore, operational risk is estimated to be 10% of the fair value of liabilities, whose calculation excludes any provisions for this risk.

Procedurally, each risk is calculated for each line of business. Each risk is then summed for the company. The risks are then aggregated using a correlation matrix derived from the prior ten years of market movements. All negative correlations are floored at zero. Operational risks are assumed to have zero correlation with other factors. Diversification benefits are allocated back to the lines of business.

2.6.1.2 AHA

AHA uses an internal Economic Capital Model. The Model targets a total economic capital level that is calibrated to an AA financial strength. AHA defines the Model economic capital required as being the capital required to protect AHA's policyholders in order to meet all of their claims with a confidence level of 99.0 percent over a one-year time horizon. Diversification benefits are allocated back to the lines of business (LOBs).

2.6.1.3 Pryde

Pryde retained Hawthorne Consulting in 2010 to assist the company in developing an economic capital model that would aid management in gauging the adequacy of overall capitalization of the company and in allocating resultant capital to target lines of business or business segments. Pryde wishes to gauge the risk adjusted return on capital (RAROC) by segment to aid in its business planning for 2014 and beyond. In essence, Pryde's goal is to improve its ability to better manage capital and return.

Hawthorne recommended using the RAROC approach. This approach considers both how much Pryde is earning on the capital that is committed to the business and how much capital is needed to ensure that policyholders are paid in the event of a stress scenario.

Hawthorne estimated capital requirements for Pryde based on a 99.4% VaR risk metric. Economic capital assessment was based on a multi-step process beginning with a bottom-up analysis of individual risks.

Stand-alone capital was determined per the 99.4% VaR for each risk separately. The resulting total was reduced by about 15%, based on Hawthorne's estimate of correlation and diversification effects.

Pryde now uses an internal Economic Capital Model, which has evolved from Hawthorne’s work. The Model targets a total economic capital level that is calibrated to an AA financial strength. PRYDE defines the Model economic capital required as being the capital required to protect PRYDE’s policyholders in order to meet all of their claims with a confidence level of 99.0 percent over a one-year time horizon. Diversification benefits are allocated back to the LOBs.

2.6.2 Strategic Risk Analysis

2.6.2.1 Risk Appetite

In absence of a CRO, the Lyon Audit Committee had commenced work on developing a risk appetite statement for Lyon Corporation. The following is a draft risk appetite statement prepared by the Audit Committee for review by the Lyon Corporation Board.

Risk Appetite Statement (Draft)

Lyon recognizes that it will take on certain business risks in an informed and proactive manner, such that the level of risk is aligned with the potential business rewards. Lyon's risk management process is designed to facilitate management's regular review of current risk exposures against Lyon's risk appetite. Any risk with the potential to have a material impact on shareholder value will be included within the scope of the risk management process. The Board will, on a regular basis, review and approve Lyon's risk appetite.

The following table summarizes the Lyon Corporation's pain threshold at the holding company level.

Enterprise Risk Exposure Risk Appetite “Pain Point”	Likelihood *	Likelihood – Hard Limit **
Holding company earnings fall short of Annual Plan by more than 25%	10%	20%
Credit rating falls below A-	10%	20%
Group Capital Adequacy Ratio falls by 20%	10%	20%

* Probability of reaching the “pain point” in a given year.

** The maximum acceptable probability of reaching the “pain point” in a given year.

Risk Limits

The same risk appetite limits will be applied at the affiliate level. Each business unit will determine the risk limit for each business segment taking into account all risk categories applicable to the product lines.

2.6.2.2 Risk Culture

Lyon Corporation defines risk culture as the norms of behavior for employees in Corporate and the affiliates to accept or take risks within the prescribed risk limits, and the ability to identify, understand, discuss and act on the risk at the Corporate as well as affiliate levels. Once the ERM processes are fully established, Lyon Corporation expects that all employees will fully understand the ERM processes and have the conviction to openly discuss risk issues with their managers. Lyon expects to include risk competency in the compensation and reward framework.

2.6.2.3 Merger and Acquisition

Lyon Corporation does not currently pursue acquisitions at the Corporate level. It allows the affiliates to pursue potential acquisitions if they are supported by the affiliate business plan approved by the Lyon Board.

The Lyon Board has three overarching principles for approval of any acquisition identified by the affiliates:

1. The acquisition should be strategic to the affiliate.
2. The acquisition should provide clearly identifiable benefits.
3. The risks involved in the integration must be clearly identified, along with appropriate risk management responses to be taken.

Potential Acquisition

Currently, AHA has targeted Eureka Insurance Company (Eureka), a health insurance company, as a potential acquisition target. Eureka is domiciled in New York and is in the small and large group and LTC markets in the state of New York.

Eureka's products include comprehensive major medical coverage of hospital services, physician services, dental services, and prescription drugs. The average deductible for Eureka's plans is under \$2,000 in all markets. Dental is offered as a rider to medical.

Eureka has contracted with Networks 'R Us to use their provider networks for physician and hospital services. It also has contracts with Carefree Rx, a Prescription Benefit Management company (PBM), and Painless Dental to manage and administer their prescription drug and dental plans, respectively. In order to lower costs, it periodically puts its network contracts out to bid. While this may lower premiums it has been disruptive to members in the past.

Eureka uses the standard medical management from its vendors. The company has a medical management staff that coordinates with the vendors' medical managers to ensure that the vendors meet New York requirements and that their policies are consistent with the Eureka product language.

Due diligence related to the potential acquisition identified certain key issues that need closer review:

1. Determine whether the Eureka administration system, which is a home grown system, is compatible with AHA's system.
2. Ensure that the policy and claims reserves at Eureka are adequate and that the underlying assumptions and calculations are reasonable.
3. Understand why the broker and administrative costs are higher than expected.
4. Decide how to deal with human resource issues, for example, consolidating Eureka employees into the AHA pension plan.

3 Simple Life Insurance Company (SLIC)

The Simple Life Insurance Company (SLIC) is 100% owned by Lyon Corporation.

SLIC is a life insurance company with four lines of business: Term Life, Universal Life, Single Premium Immediate Annuities, and Variable Annuities.

The Company, founded as Term Life Insurance Company, made its name selling term life insurance, and this continues to be a hallmark of the company today. The Company is at a crossroads where competition has required significant compression of margins. The goal is to capture a portion of the asset build-up within the “baby boomer” generation as its members find that term insurance is insufficient for their needs and wish to change their desired insurance products. To reflect the expanded product offering, the Company was renamed and rebranded as Simple Life Insurance Company at the end of 2009.

3.1 Board of Directors

R. Tomas Lyon III- Chairman, President and CEO

Karl Palomino - former CFO, SLIC

Jeanne Holstein-Palomino - Philanthropist

Ivan X. Salmon - former Chief Legal Counsel, SLIC

Hermione Dauphin - former accounting partner for Dollars ‘R Us, former insurance regulator for Insurance Department of Illinois

3.2 Officers

R. Tomas Lyon III, Chairman of the Board, President, CEO

Henri Jay, EVP- Operations

Open, SVP & Chief Financial Officer

Mindy Wren, SVP & Chief Counsel

Odetta Bird, SVP- Variable Annuity

George Lyon, SVP- Universal Life

William Xu, SVP - Term Life

Danielle Wolfe - VP - Chief Marketing Officer

3.3 Capitalization

The company operates without any long-term debt except for two 15 year tenor Surplus Notes issues. \$50 million was issued at 9.5% in 2001 and \$35 million at 7.75% in 2006.

The company strives to maintain a strong capital position on both a statutory and an economic capital basis. Any surplus in excess of the larger of 400% of RBC or 110% of required economic capital is distributed to Lyon Corporation through a dividend annually at the end of the first quarter based on the year-end balance sheet. Surplus positions less than the maximum of 300% of RBC and 90% of required economic capital are addressed through a capital contribution from Lyon Corporation or the issuance of additional surplus notes.

Statutory capital is allocated to the LOBs as follows: Each reporting period the Financial Reporting Department calculates the required statutory capital for each of the four lines of business (LOB): Term, UL, VAs, and SPIAs. SLIC currently targets an RBC of 350%, an A+ capital level. At the end of each reporting period, each LOB holds exactly its required capital, which is achieved by the LOB transferring any excess statutory capital to the SLIC Corporate Account or by receiving a statutory capital contribution from the SLIC Corporate Account. Thus, the SLIC Corporate Account invests statutory capital in the LOB and each period either receives returns or makes further investments in the LOB.

3.4 Investment Policy and Strategy

The investment department manages the general account investments. The Chief Investment Officer (CIO) reports to the CFO. Investment policy and strategy is reviewed and approved by an internal management committee consisting of the CEO, CFO, CIO, and SVPs (or VPs) of its four main business lines. Internal management committee decisions are subject to review by the SLIC Board's investment committee. The internal management committee meets quarterly and is responsible for reviewing investment results and approving the use of new investment instruments. Day-to-day decision-making authority is delegated to the CIO, up to specified limits. The CIO may delegate approval authority to his or her subordinates. Transactions in excess of the CIO's approval limit require approval by the CEO and CFO.

The company's general account is invested primarily in fixed-income assets. Variable annuity investment accounts are held in a separate (segregated) account and are managed by a third-party investment advisor.

Within the general account, there are separate investment portfolios for each of the four main product lines and the Corporate Account.

3.5 Specified Risk Policies

3.5.1 Credit Risk

Fixed-income securities in the general account have exposure limits at individual obligor (issuer) and sector levels. Obligor-level limits vary according to asset type and credit quality, as determined by external rating agencies. The investment department monitors compliance of the exposure limits.

For each portfolio, there are weighted average credit quality targets. Portfolio credit quality is measured by converting each asset's external credit rating into a numerical score. Scores are a linear function of credit ratings (AAA = 1, AA = 2, etc.). Sub-category ratings (i.e., + or -) are ignored in the scale. The company prefers to maintain a score of 3.5 or better quality for each line of business.

3.5.2 Market Risk

Semi-annually within the term, UL and SPIA lines of business, the company measures the effective duration of the assets and liabilities. If the asset and liability durations are further apart than 0.5, the asset portfolio is rebalanced such that its new effective duration equals that of the liabilities.

The VA hedging program uses a dynamic approach updated for market factors monthly and for inforce changes quarterly. The key risk measures are delta and rho, and the program updates its equity and interest rate derivatives such that at least 80% of liability delta and rho are hedged. Vega is self-insured due to system complexity and the expense of implied volatility hedges. Reports are produced and hedges adjusted approximately six-weeks following each quarter end.

The VA liability delta and rho measures are estimated from an actuarial projection model using a home-grown computing platform. Actuarial assumptions are mostly updated annually, and are based on historical experience when possible, and pricing assumptions otherwise. The inforce contract data comes from an extract from the contract administration system, and are subsequently aggregated into modeling cells for computing efficiency. Model access and changes to it are controlled, while its documentation is routinely updated.

A modeling actuary from the valuation group prepares a quarterly report for the hedging group, who then passes along buy and sell instructions to their traders. After completing the transactions, the traders confirm the trades in a report to the hedging group.

3.5.3 Liquidity Risk

The liquidity policy requires SLIC to hold sufficient liquid assets to meet expected demands for cash in a unique liquidity stress-test scenario. The scenario focuses on a reputational liquidity crisis basis where markets continue to operate normally and the liquidity crunch affects only the company. The liquidity stress test anticipates situations where the company's ability to sell

assets to meet cash needs from its liability products is hindered by the market taking advantage of the company during the crisis. In addition, testing periodically considers a systemic stress scenario where the entire market is not able to sell assets at a reasonable value. However, SLIC's liquidity policy does not require it to hold sufficient liquid assets to be able to meet cash demands in such a scenario, since it expects regulatory relief in a systemic crisis.

3.5.4 Operational Risk

The CRO will be responsible for collecting and disseminating risk information. A report will be prepared monthly and distributed to executive management.

3.6 Economic Capital Model

SLIC has implemented an economic capital model tailored to its own company-specific risks. SLIC uses an internal economic capital model. The model targets a total economic capital level that is calibrated to an AA financial strength. SLIC defines the model economic capital required as being the capital required to protect SLIC's policyholders in order to meet all of their claims with a confidence level of 99.0 percent over a one-year time horizon.

The Statutory and Economic balance sheets are independent of each other. The amount of assets assigned to a line of business is based on the required capital, either on an economic basis or a statutory basis. That is, the assets backing the liabilities on an economic basis are not the same as the assets allocated on a statutory basis.

The intent of the economic capital model is to quantify the risks to the company's net equity (on a market-consistent basis) using a one-year 99.0% Value at Risk (VaR) measure. The model quantifies exposure to interest rate risk, equity price risk, and credit risk.

Interest rates are modeled stochastically using a single-factor model calibrated to monthly historical data for 10-year US Treasury yields from 1994. Equity returns are modeled stochastically using a regime-switching lognormal distribution that is calibrated to thirty years of daily S&P 500 equity index returns.

For the VA and its GMAB and GMWB, the VaR is calculated with liabilities net of hedging assets and derivatives. Implied volatility is derived from current exchange-traded 10-year at-the-money equity floors. As an approximation, the test assumes expiring derivatives can be replaced with current at-the-money instruments.

For credit risk, the model assumes that existing investment grade fixed income assets are sold immediately if they fall below investment grade. Therefore, the company does not quantify the risk of credit default or loss given default. Credit risk is modeled through the stochastic simulation of credit ratings migration. The calibration uses ten years of historical data for corporate bond ratings migrations and yield spreads. Since the company has a general buy and hold investment strategy, credit spreads are only considered to be a risk factor if and when investment grade assets are downgraded below investment grade. SLIC calculates the risk of fluctuations in market value due to credit spread movements in the absence of ratings

downgrades, but excludes the results since its statutory surplus is based upon asset book value and it has a general buy and hold investment strategy.

The Company is currently considering a few methodologies to capture insurance risk, but has not implemented anything to date. A full-blown stochastic-on-stochastic analysis may be too much of a load on the existing computer infrastructure, so less onerous methodologies are being studied.

At this point, the Company does not have an operational risk model and, therefore, operational risk is estimated to be 10% of the fair value of liabilities, whose calculation excludes any provisions for this risk.

Procedurally, each risk is calculated for each line of business. Each risk is then summed for the company. The risks are then aggregated using a correlation matrix derived from the prior ten years of market movements. All negative correlations are floored at zero. Operational risks are assumed to have zero correlation with other factors. Diversification benefits are allocated back to the lines of business.

Stress Testing

Stochastic testing is supplemented with deterministic scenario-based stress tests, performed annually. Each test is applied as an instantaneous shock to the economic conditions as of the valuation date. Interest rates have a floor of 0.10%.

3.7 Risk Management Committee

The committee meets regularly on a quarterly basis. Meetings focus on reviewing internal risk reports and interviews with key employees in finance, systems, and audit.

At its third quarter meeting, the committee unanimously recommended the hiring of a Chief Risk Officer (CRO), who will create and lead an independent Enterprise Risk Management (ERM) department. The CRO will be responsible for developing and implementing a comprehensive company-wide ERM program and serve as the risk liaison across various business segments to address significant emerging concerns. The committee also recommended that the CRO report on risk-related issues at its quarterly meeting.

However, during the debate of this recommendation with the Board, Mr. Lyon expressed the opinion that the Risk Management Committee would be redundant once the CRO started. His preference was that the CRO report to the EVP-Planning as someone with significant experience who knew the company well and could serve as a guide to the CRO. Mr. Lyon recommended that the new CRO become an officer of the company following three to five years of experience at the company. The Board concurred with Mr. Lyon and the Risk Management Committee will be disbanded on the date the CRO becomes an officer of SLIC.

3.8 Product Distribution:

The Company distributes its products through an independent brokerage system. The Company supplies marketing materials and product descriptions. Brokers are responsible for their own training. The Company has relied upon its distribution system to clarify and explain the change in name of the Company.

3.9 Product Descriptions

3.9.1 Level Premium Term Insurance

The term life insurance line has two series of products. The fully underwritten line, Secure Term, offers 10, 20, and 30 year level term plans. This product has three non-smoker rate classes and one smoker rate class. The simplified issue line, Simple Term, offers a 10 year level term product for up to \$1 million in face amount.

Both lines are renewable after the level term period with a sharply increasing annually renewable term premium schedule. They are also both convertible to the currently issued UL product during the level term period. Premiums are such that no cash surrender values are necessary.

Secure Term is coinsured at 60% to Trust Us Re. The treaty provides a 100% first year allowance with a 2% renewal allowance. Any single life issue over \$1 million is 100% facultatively reinsured.

Simple Term is reinsured under YRT treaties to a pool of four reinsurers, each with an 8% quota share. The YRT reinsurance premium rate for all four reinsurers is set to 105% of the pricing mortality. An initial allowance of 100% provides first year strain relief.

The SLIC Pricing department has implemented cutting edge approaches to assess mortality experience, including performing predictive modeling exercised to determine and better understand sensitivity to various independent variables (e.g., policy year, income, geography, etc.). In addition, SLIC participates in and uses Society of Actuaries industry studies to assess its relative experience. Its studies span the last five years of mortality incidence and are refreshed annually. Pricing systematically distributes the experience study report to other modeling areas, so their assumptions can be kept current.

SLIC's current annual lapse experience studies are based on the last five years of experience, but are being refined. Currently, studies exist for aggregate experience by issue age and policy year, but enhancements are planned to include splits for gender and underwriting risk class.

Current experience studies have shown Secure Term to have improving mortality relative to pricing and lower-than-priced lapse rates. In contrast, Simple Term shows deteriorating mortality relative to pricing and higher-than-priced lapse rates.

Based on the emerging experience results and increasing face amounts for these products, SLIC is re-evaluating its reinsurance agreements and retention limits.

Sales have been strong, due to competitive pricing, higher-than-average first year sales compensation, and a strong advertising campaign. Because the products are selling well and the Company sees limited downside risk in this simplistic product, the product pricing review will be postponed until next year.

3.9.2 Variable Annuity

Current Product: The Variable Annuity has a Return of Premium (ROP) GMDB. Partial withdrawals are permitted, with the GMDB reduced dollar for dollar by the amount of the withdrawal. The contract has a policy fee of \$100 per year if the account value is less than \$100,000; no policy fee if account value is \$100,000 or greater. The mortality and expense fee is 1% of the separate account investments.

The VA offers a collection of eight proprietary mutual fund choices (seven domestic and one foreign) and a fixed fund invested in the general account.

The sales force is compensated with a commission of 5% of the first year deposits.

The product has two optional guaranteed living benefits (GLB's), only one of which may be chosen for a single underlying contract. The Guaranteed Minimum Accumulation Benefit (GMAB) option guarantees the contractholder's account value will not drop below the premium deposit (reduced by any withdrawals) as of the 10th year anniversary. If the account value is below this value, it is "trued-up" to this value as of this date. The fee for this benefit is 0.5% per year of the account value during this 10 year protection period.

The Guaranteed Minimum Withdrawal Benefit (GMWB) option guarantees the contractholder the ability to withdraw 5% of the benefit base per year for life, regardless of whether the account value is sufficient to support these withdrawals. The benefit base equals net deposits rolled up at 5% per year for life. The fee for this rider is 1% per year of the benefit base. The most recent sales mix, as measured by account value, shows 30% without a GLB, 50% with a GMWB and 20% with a GMAB.

Sales are flat compared to prior years, probably attributable to other competitors offering a wider range of funds and rider options. To avoid the lengthy and expensive market research and product development cycles, the Company has decided to be a "fast-follower" and copy successful designs it sees in the market place.

Over the prior year, National Bank has begun selling a product to compete with GMABs written by the insurance industry. The product adds a guarantee on an S&P 500 mutual fund investment that promises return of principle for a 2% annual fee applied to the fund value. National Bank has numerous branches throughout the country and seems to have a strong marketing department.

Annual experience studies spanning the prior calendar year experience are used for the full surrenders, where experience is distributed across contract year. Pricing performs these studies and distributes them to other modeling groups upon request.

All SLIC VA modeling applications use industry mortality experience as published by a large actuarial consulting firm seven years ago.

Proposed Product Improvements: First, the marketing team believes that adding a wider range of investment fund options would attract new customers and help to retain existing clients. Therefore, the company plans to add new fund families over the next six months. The new fund options will be available on existing and new VA GMAB or GMWB contracts as well as on new VA contracts with the new guaranteed benefit riders described below.

Second, Marketing also believes additional guaranteed benefit riders similar to those that competitors have added over the past several years would boost sales. Therefore, the company is considering an enhanced product called VA Plus, which provides the same benefits as the existing products but also includes a ratchet on the GLB and GMDB benefits. The ratchet provides that on every contract anniversary the benefit base is set equal to the greater of the account value and the prior year benefit base rolled up 5%.

These riders are under development and are expected to be available in nine months.

SLIC will be fast-tracking the product development and implementation process, resulting in a very aggressive time schedule. As part of the implementation process, the administrative system needs additional programming to handle an increased slate of fund and rider offerings.

3.9.3 Universal Life

When SLIC began selling Universal Life in 1995, the company sold a mix of various UL products, with 4% guarantees, which were common at that time. Some of those products are still in force.

The company's current universal life offerings consist of two different products. Saver Supreme is designed as an accumulation product, whereas Protector Plus is a protection-oriented product with secondary guarantees.

The Saver Supreme product is designed to accumulate high cash surrender values relative to the death benefit over time. The Protector Plus product is designed for the consumer who wants death benefit protection at the lowest possible premium; it guarantees that the policy will stay in force if the specified premium is paid each year.

Key terms for both products are as follows:

- Fully underwritten
- Face Amount offered from \$25,000 to \$5,000,000
- Surrender charge is significant to start, grading down to zero in policy year 11
- Credited rate on the accumulation fund is guaranteed to be never less than 3%. Company targets a 2% spread.

Launch sales have been much lower than expected, but the company is anticipating that the 3% floor on investment returns will become more attractive and result in higher future sales. For the UL product, like the VA, the Company has decided that “fast-follower” is the preferred product development method for the near future.

The administrative system needs additional programming to handle some product features that are now available to the client. To date these features selections have been tracked through electronic notes in the policy file.

Three of the Company’s competitors in the UL market have recently formed an administrative services only company, called UL Admin Co, to administer their universal life contracts. UL Admin Co performs all of the UL administrative tasks for the three companies, such as policy administration, valuation, and cash flow and reserve projections for planning and risk purposes. In recognition of the expense savings achieved, the three companies have given an extra-contractual benefit to their policyholders by cutting their annual policy maintenance charge by \$30.

Policy issuance as a percentage of applications has been much lower than expected. Lapse rates in the first year are lower than anticipated in pricing. Recent mortality experience has been approximately equal to expected mortality, but SLIC has little exposure to date.

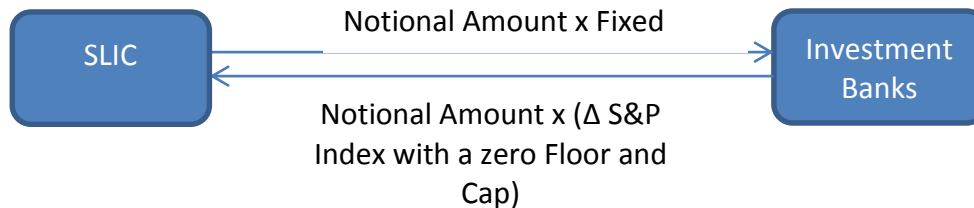
SLIC has not yet implemented a separate mortality study for its UL product. Instead, SLIC bases its UL mortality assumption for all modeling applications on the Term mortality experience studies, since both products have the same risk classes and underwriting criteria.

SLIC’s lapse study on the UL product is fairly comprehensive, reflecting the surrender charge period and the dynamic impacts of crediting rates. It includes the last five years of lapse experience and is updated semi-annually by Pricing, which then systematically distributes these reports to all other modeling groups.

Due to the current low level of interest rates, the Company has revised the investment plan to be a mix of ten-year BBB corporate debt, high yielding sovereign paper of mixed maturity periods, and some exclusive opportunities in the private equity area.

Proposed New Product: George Lyon, SVP - Universal Life is interested in diversifying SLIC’s UL product portfolio and increasing sales. Consistent with SLIC’s “fast-follower” product development method, Mr. Lyon asked the product development actuaries to investigate broadening SLIC’s UL product line by adding an Indexed UL product, a hot product in the current market. An Indexed UL product is a fixed UL product with an indexed account option. The interest credits on the indexed account are based on the greater of the return on an index, such as the S&P 500, or zero. It is attractive to policyholders who want to participate in the future price appreciation in stocks in the S&P 500 without the risk of negative returns. To the policyholder, the risk/return of an Indexed UL policy falls somewhere between the relatively low risk/low return of a UL policy and the relatively high risk/high return of a Variable UL policy.

For the basic product SLIC would enter a swap agreement to exchange a specified investment income to a return on an S&P index with a zero floor and a specified cap, which would allow SLIC effectively to transfer out the embedded market risk.



Lyon envisions that more sophisticated Indexed UL products could be offered in the future with multiple indexed accounts based on different indices or different time periods of index growth and indexed interest crediting.

In response to Mr. Lyon's request, the product development actuaries have developed a basic Indexed UL product. To facilitate pricing and implementation, the features are proposed to be the same as the current UL product with the following exceptions.

- To simplify hedging, the swap will be purchased on a quarterly basis for the aggregate premiums paid into the indexed account within the quarter;
- Premiums are assumed to be allocated 40% to the Fixed Account and 60% to the Indexed Account
- The Fixed Account has a minimum guaranteed crediting rate of 2% and a current crediting rate, declared annually, based on the net portfolio yield less a 2% expense charge;
- The Indexed Account credits interest annually based on the increase in the S&P 500 index, excluding dividends, up to a declared cap, which will be determined for each quarter, driven by swap prices. The declared cap and S&P index value in effect on the policy anniversary are used to determine the indexed interest credits in the following policy year. The minimum guaranteed cap is 2%. The minimum guaranteed crediting rate is 0% on the Indexed Account.

The product design actuaries have proposed that the UL investment portfolio support both the UL and the new Indexed UL products. The indexed interest would be hedged by purchasing the equivalent swap on the underlying index, initially the S&P 500.

3.9.4 Single Premium Immediate Annuity

The major product features and pricing characteristics of the only single premium immediate annuity that SLIC has ever sold include:

- Single Premium = 110% of present value of expected payments discounted at 4%
- Straight Life Annuity (no certain period)
- Issued to all ages 65 and over
- No death benefit
- Expected mortality equals 100% of the 2000 US Annuity Table with Projection Scale X
- Commission equals 5% of premium

Recent sales have shown slow but steady growth as interest rates have fallen. Through interviews with select brokers, SLIC has noticed an odd correlation - it seems many of the Company's annuitants have also taken out term life insurance contracts with "We-Serve-the-Healthy" Life in amounts equal to the annuity single premium.

Recent mortality experience has been approximately equal to expected but mortality improvement seems to be higher than expected.

SLIC's pricing mortality assumption is based on Pricing's annual experience study spanning the last two years of experience. Pricing makes this study available to the other modeling groups upon request. The mortality improvement assumption for all modeling applications is based on industry experience as released in a recent study performed by a large consulting firm.

The product is selling well, but decreasing interest rates are a matter of concern. Traditionally, assets supporting this block have been investments in high quality long term corporate bonds and treasuries. However, in response to the recent economic environment and the uptick in mortality improvement, higher yielding exotic investments have been used recently to help meet the desired profit margin. These new investments include such assets as real estate, domestic private equity and emerging markets common equity.

3.10 Financial Statements

Multi-year financial statements are provided for each of the product lines and for SLIC in total. 2012 and 2013 are actual results; 2014 – 2016 are projections.

TERM	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Premiums & Policy Fees	956,961	1,048,585	1,153,597	1,274,062	1,412,404
Ceded Premiums	(516,395)	(566,968)	(624,848)	(691,301)	(767,773)
Net Investment Income	94,777	98,581	104,546	112,674	122,981
Total Revenue	535,343	580,198	633,295	695,434	767,612
Surrender & Annuity Benefits	-	-	-	-	-
Death Benefits	582,119	641,381	697,082	768,600	851,974
Ceded Benefits	(313,195)	(349,610)	(382,219)	(424,317)	(473,625)
Increase in Net Reserves	121,274	142,319	163,352	185,574	208,928
Expenses	121,086	132,136	143,859	157,506	173,385
Net Transfers to/(from) Separate Account	0	0	0	0	0
Total Benefits & Expenses	511,283	566,226	622,073	687,363	760,662
Income Before Income Tax	24,059	13,972	11,222	8,072	6,950
Federal Income Tax	8,421	4,890	3,928	2,825	2,432
Net Income	15,639	9,082	7,294	5,247	4,517
Statutory Balance Sheet (000s)					
General account assets	1,573,961	1,729,391	1,907,299	2,109,740	2,337,773
Separate account assets	-	-	-	-	-
Total Assets	1,573,961	1,729,391	1,907,299	2,109,740	2,337,773
Net General Account Reserve Liabilities	1,441,829	1,584,148	1,747,499	1,933,074	2,142,001
Separate Account Liabilities	-	-	-	-	-
Total Liabilities	1,441,829	1,584,148	1,747,499	1,933,074	2,142,001
Surplus	132,132	145,243	159,800	176,666	195,772
Total Liabilities and Surplus	1,573,961	1,729,391	1,907,299	2,109,740	2,337,773
Additional Balance Sheet Information					
Surplus Transfer from/(to) Corporate	(5,109)	4,029	7,262	11,620	14,588

Economic Capital Balance Sheet (000s)

Market Value of Assets	908,151	991,810	1,087,021	1,194,981	1,315,970
Economic Reserve	785,797	857,024	938,407	1,030,328	1,133,119
Required Economic Capital	122,354	134,786	148,614	164,653	182,851
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	908,151	991,810	1,087,021	1,194,981	1,315,970

Additional EC Balance Sheet Information

Transfer from/(to) Corporate	(10,155)	(12,400)	(13,747)	(15,313)	(17,097)
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UNIVERSAL LIFE

2012 2013 2014 2015 2016

Statutory Income Statement (000s)

Premiums & Policy Fees	196,447	210,789	224,661	238,006	250,218
Ceded Premiums	-	-	-	-	-
Net Investment Income	98,364	100,580	106,946	112,809	118,635
Total Revenue	294,811	311,369	331,607	350,815	368,853

Surrender & Annuity Benefits	69,685	72,760	77,637	84,017	89,961
Death Benefits	81,322	81,413	88,217	93,561	98,890
Ceded Benefits	-	-	-	-	-
Increase in Net Reserves	88,393	96,600	104,349	108,249	112,483
Expenses	23,775	24,877	25,916	26,945	27,932
Net Transfers to/(from) Separate Account	-	-	-	-	-
Total Benefits & Expenses	263,176	275,649	296,119	312,772	329,267

Income Before Income Tax	31,636	35,720	35,488	38,043	39,586
Federal Income Tax	11,072	12,502	12,421	13,315	13,855
Net Income	20,563	23,218	23,067	24,728	25,731

Statutory Balance Sheet (000s)

General account assets	1,906,597	2,011,783	2,125,380	2,243,211	2,365,621
Separate account assets	-	-	-	-	-
Total Assets	1,906,597	2,011,783	2,125,380	2,243,211	2,365,621

Net General Account Reserve Liabilities	1,752,086	1,848,687	1,953,035	2,061,284	2,173,768
Separate Account Liabilities	-	-	-	-	-
Total Liabilities	1,752,086	1,848,687	1,953,035	2,061,284	2,173,768

Surplus	154,511	163,096	172,345	181,927	191,854
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Total Liabilities and Surplus	1,906,597	2,011,783	2,125,380	2,243,211	2,365,621
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Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate	(12,673)	(14,632)	(13,819)	(15,146)	(15,804)
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Economic Capital Balance Sheet (000s)

Market Value of Assets	2,402,840	2,539,417	2,689,005	2,846,688	3,017,630
Total Assets	2,402,840	2,539,417	2,689,005	2,846,688	3,017,630

Economic Reserve	2,230,406	2,092,713	2,218,648	2,351,925	2,497,659
Risk Margin	252,300	264,362	277,331	290,641	304,327
Required Economic Capital	172,434	182,342	193,026	204,122	215,643
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	2,402,840	2,539,417	2,689,005	2,846,688	3,017,630

Additional EC Balance Sheet Information

Transfer from/(to) Corporate	1,207	(3,647)	(3,571)	(3,470)	(3,342)
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VARIABLE ANNUITIES	2012	2013	2014	2015	2016
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Statutory Income Statement (000s)

Premiums & Policy Fees	234,076	236,581	241,442	246,388	251,419
Ceded Premiums	-	-	-	-	-
Net Investment Income	25,861	28,687	31,006	33,668	36,454
Total Revenue	259,937	265,268	272,449	280,056	287,873

Surrender & Annuity Benefits	35,458	44,355	50,663	57,272	64,171
Death Benefits	23,204	26,831	31,139	36,787	43,321
Ceded Benefits	-	-	-	-	-
Increase in Net Reserves	59,119	59,043	59,313	59,873	60,223
Expenses	12,678	12,863	13,166	13,470	13,775
Net Transfers to/(from) Separate Account	117,173	101,439	92,733	83,124	72,518
Total Benefits & Expenses	247,633	244,531	247,014	250,526	254,009

Income Before Income Tax	12,304	20,737	25,434	29,530	33,865
Federal Income Tax	4,306	7,258	8,902	10,336	11,853
Net Income	7,998	13,479	16,532	19,195	22,012

Statutory Balance Sheet (000s)

General account assets	607,258	657,558	718,343	782,125	846,408
Separate account assets	1,376,968	1,776,520	2,035,490	2,307,169	2,591,646
Total Assets	1,984,226	2,434,077	2,753,834	3,089,294	3,438,054

Net General Account Reserve Liabilities	519,107	578,150	637,463	697,336	757,559
Separate Account Liabilities	1,376,968	1,776,520	2,035,490	2,307,169	2,591,646
Total Liabilities	1,896,074	2,354,670	2,672,953	3,004,505	3,349,205

Surplus	88,152	79,408	80,880	84,789	88,849
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Total Liabilities and Surplus	1,984,226	2,434,077	2,753,834	3,089,294	3,438,054
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Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate	(4,857)	(22,223)	(15,060)	(15,286)	(17,952)
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Economic Capital Balance Sheet (000s)

Market Value of Assets	2,398,377	2,932,841	3,317,552	3,720,841	4,139,878
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Economic Reserve	2,297,355	2,841,681	3,224,540	3,623,165	4,037,347
Required Economic Capital	101,022	91,160	93,012	97,676	102,531
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	2,398,377	2,932,841	3,317,552	3,720,841	4,139,878

Additional EC Balance Sheet Information

Transfer from/(to) Corporate	(1,212)	(10,939)	(5,581)	(6,007)	(6,459)
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SPIA 2012 2013 2014 2015 2016

Statutory Income Statement (000s)

Premiums & Policy Fees	22,469	23,008	23,555	24,110	24,675
Ceded Premiums	-	-	-	-	-
Net Investment Income	14,051	15,804	16,638	17,594	18,551
Total Revenue	36,521	38,812	40,192	41,704	43,225
Surrender & Annuity Benefits	15,080	16,291	17,508	18,729	19,950
Death Benefits	-	-	-	-	-
Ceded Benefits	-	-	-	-	-
Increase in Net Reserves	15,314	15,223	15,132	15,043	14,957
Expenses	5,815	7,070	8,367	9,707	11,091
Net Transfers to/(from) Separate Account	-	-	-	-	-
Total Benefits & Expenses	36,210	38,584	41,008	43,479	45,998
Income Before Income Tax	311	227	(816)	(1,775)	(2,773)
Federal Income Tax	109	80	(285)	(621)	(971)
Net Income	202	148	(530)	(1,154)	(1,803)

Statutory Balance Sheet (000s)

General account assets	224,371	240,367	256,268	272,076	287,793
Separate account assets	-	-	-	-	-
Total Assets	224,371	240,367	256,268	272,076	287,793
Net General Account Reserve Liabilities	213,543	228,766	243,898	258,942	273,898
Separate Account Liabilities	-	-	-	-	-
Total Liabilities	213,543	228,766	243,898	258,942	273,898
Surplus	10,828	11,601	12,370	13,134	13,894
Total Liabilities and Surplus	224,371	240,367	256,268	272,076	287,793

Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate	575	626	1,299	1,918	2,563
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Economic Capital Balance Sheet (000s)

Market Value of Assets	283,798	304,969	326,144	347,323	368,510
Economic Reserve	273,121	293,507	313,897	334,294	354,698
Required Economic Capital	10,676	11,462	12,246	13,029	13,811
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	283,798	304,969	326,144	347,323	368,510

Additional EC Balance Sheet Information

Transfer from/(to) Corporate	(886)	(940)	(992)	(1,042)	(1,091)
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CORPORATE

2012 2013 2014 2015 2016

Statutory Income Statement (000s)

Premiums & Policy Fees	-	-	-	-	-
Ceded Premiums	-	-	-	-	-
Net Investment Income	11,826	12,374	13,165	12,644	9,868
Total Revenue	11,826	12,374	13,165	12,644	9,868
Surrender & Annuity Benefits	-	-	-	-	-
Death Benefits	-	-	-	-	-
Ceded Benefits	-	-	-	-	-
Increase in Net Reserves	-	-	-	-	-
Expenses	13,110	13,417	13,899	14,446	11,505
Net Transfers to/(from) Separate Account	-	-	-	-	-
Total Benefits & Expenses	13,110	13,417	13,899	14,446	11,505
Income Before Income Tax	(1,284)	(1,043)	(734)	(1,802)	(1,637)
Federal Income Tax	(450)	(365)	(257)	(631)	(573)
Net Income	(835)	(678)	(477)	(1,171)	(1,064)

Statutory Balance Sheet (000s)

General account assets	205,569	222,730	211,995	220,480	186,021
Separate account assets	-	-	-	-	-
Total Assets	205,569	222,730	211,995	220,480	186,021

Net General Account Reserve	-	-	-	-	-
Liabilities	-	-	-	-	-
Separate Account Liabilities	-	-	-	-	-
Total Liabilities	-	-	-	-	-

Surplus	205,569	222,730	211,995	220,480	186,021
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Total Liabilities and Surplus	205,569	222,730	211,995	220,480	186,021
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Additional Balance Sheet Information

Transfer from/(to) Lines	22,064	32,200	20,318	16,894	16,605
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Economic Capital Balance Sheet (000s)

Market Value of Assets	149,137	168,038	147,010	182,033	160,961
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Economic Reserve	86,700	86,700	86,700	86,700	35,700
Required Economic Capital	6,752	7,988	7,620	8,400	9,665
Free Surplus	55,685	73,350	52,690	86,933	115,596
Total Liabilities and Surplus	149,137	168,038	147,010	182,033	160,961

TOTAL	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Premiums & Policy Fees	1,409,953	1,518,963	1,643,255	1,782,566	1,938,716
Ceded Premiums	(516,395)	(566,968)	(624,848)	(691,301)	(767,773)
Net Investment Income	244,880	256,026	272,300	289,389	306,489
Total Revenue	1,138,437	1,208,020	1,290,707	1,380,653	1,477,431
Surrender & Annuity Benefits	120,223	133,406	145,809	160,018	174,082
Death Benefits	686,645	749,625	816,438	898,947	994,185
Ceded Benefits	(313,195)	(349,610)	(382,219)	(424,317)	(473,625)
Increase in Net Reserves	284,100	313,186	342,146	368,740	396,591
Expenses	176,465	190,362	205,206	222,074	237,690
Net Transfers to/(from) Separate Account	117,173	101,439	92,733	83,124	72,518
Total Benefits & Expenses	1,071,412	1,138,407	1,220,112	1,308,586	1,401,441
Income Before Income Tax	67,025	69,613	70,595	72,068	75,991
Federal Income Tax	23,459	24,364	24,708	25,224	26,597
Net Income	43,567	45,248	45,887	46,844	49,394

Statutory Balance Sheet (000s)

General account assets	4,517,756	4,861,829	5,219,286	5,627,632	6,023,616
Separate account assets	1,376,968	1,776,520	2,035,490	2,307,169	2,591,646
Total Assets	5,894,724	6,638,349	7,254,776	7,934,800	8,615,262
Net General Account Reserve Liabilities	3,926,564	4,239,751	4,581,896	4,950,636	5,347,227
Separate Account Liabilities	1,376,968	1,776,520	2,035,490	2,307,169	2,591,646
Total Liabilities	5,303,532	6,016,270	6,617,386	7,257,805	7,938,872
Surplus	591,192	622,079	637,390	676,995	676,390
Total Liabilities and Surplus	5,894,724	6,638,349	7,254,776	7,934,800	8,615,262

Economic Capital Balance Sheet (000s)

Market Value of Assets	6,142,302	6,937,074	7,566,731	8,291,867	9,002,949
Economic Reserve	5,673,379	6,435,987	7,059,523	7,717,053	8,362,851
Required Economic Capital	413,238	427,738	454,518	487,880	524,502
Free Surplus	55,685	73,350	52,690	86,933	115,596
Total Liabilities and Surplus	6,142,302	6,937,074	7,566,731	8,291,867	9,002,949

3.11 Portfolio Summary

The following is a breakdown by asset class of the market value of SLIC's general account investment portfolios (\$ million) as of 12/31/2013, excluding derivatives and variable annuity separate (segregated) accounts.

LOB	US Govt	US Corporate Investment Grade		US Corp Below Invest Grade	US Mortgage/ Asset-Backed Securities	Mortgages	Real Estate	Common Stock	Cash & Short-Term		Total
		Public	Private						Term	Other	
Term	65	606	172	33	372	343	-	-	66	65	1,720
UL	73	533	292	54	457	484	-	-	72	54	2,018
VA	27	323	62	26	93	72	-	-	34	6	643
SPIA	7	42	18	4	54	41	-	-	30	40	235
Corp	5	72	9	5	13	15	19	9	47	31	226
Total	176	1,575	553	122	989	955	19	9	249	196	4,842

Other asset portfolio characteristics by line of business are as follows:

	Average Duration	Average Book Yield	Average Quality*
Term	7.61	6.19%	3.02
UL	7.91	5.60%	3.53
VA	4.51	4.56%	3.06
SPIA	9.18	6.61%	3.29

*Quality Ratings: Aaa=1, Aa=2, A=3, Baa=4

3.12 Historical Market Data

In preparation for a review of its economic capital model assumptions, SLIC has compiled the following summary of historical index returns for various asset classes.

Summary of Monthly Index Returns, 3/31/1992 to 3/31/2012

	Barclays Capital U.S. Bond Indices						Equity Indices		
	Treasuries	Agencies	Mortgage Backed Securities	Corporate Investment Grade	Corporate High Yield	Aggregate	Long Treasuries	S&P 500	MSCI EAFE
Compound Annual Return	6.43%	6.24%	6.47%	7.15%	8.11%	6.63%	8.84%	8.55%	5.92%
Annualized Volatility	4.61%	3.68%	2.84%	5.59%	9.00%	3.73%	9.81%	15.05%	16.88%
Skewness	-0.22	-0.15	-0.06	-0.71	-1.17	-0.28	0.17	-0.69	-0.59
Kurtosis	4.00	4.22	4.89	7.56	12.54	3.93	4.96	4.22	4.29
Correlations									
Treasuries	1.00								
Agencies	0.95	1.00							
Mortgage Backed Securities	0.84	0.89	1.00						
Corporate Investment Grade	0.67	0.76	0.70	1.00					
Corporate High Yield	-0.10	0.05	0.10	0.54	1.00				
Aggregate	0.92	0.96	0.91	0.87	0.22	1.00			
Long Treasuries	0.94	0.86	0.75	0.64	-0.09	0.86	1.00		
S&P 500	-0.15	-0.05	0.02	0.27	0.62	0.06	-0.15	1.00	
MSCI EAFE	-0.18	-0.08	-0.03	0.29	0.62	0.04	-0.17	0.79	1.00
Bond Index Data as of 3/31/2012									
Duration	5.61	3.66	3.32	6.84	4.19	5.01	15.90		
Convexity	0.70	0.01	-2.02	0.91	0.00	-0.16	3.54		
Yield to Maturity	1.19%	1.26%	2.74%	3.41%	7.73%	2.23%	3.11%		
OAS to Treasuries	0.00%	0.36%	0.52%	1.76%	5.76%	0.64%	0.00%		

Source: Barclays Capital, Bloomberg

3.13 SLIC Disaster and Business Continuity Program

Each department within SLIC maintains a Business Continuity Policy (BCP) under the direction and advice of the Business Buoyancy Department (BBD). As part of this process, SLIC senior management has designated business continuity coordinators for each of their respective departments. These coordinators maintain and update business continuity plans, keep inventories of vital records and establish an appropriate record retention schedule. Each quarter, the business continuity coordinators are required to complete a check-box report to senior management to indicate that they have fulfilled their duties.

In addition to complying with the program developed by the BBD, each department is encouraged to institute and maintain a Risk Mitigation Policy (RMP) to help SLIC rebuild in the event of a catastrophe. The RMP includes development and maintenance of rebuild instructions and management succession instructions. The RMP is reviewed and updated on an annual basis.

Periodic disaster recovery exercises are performed where SLIC personnel (with the exception of senior management) are required to work from an offsite location. SLIC has contracted out this offsite service from a third-party, Disasters-R-Us™, that specializes in providing shared disaster recovery capabilities.

Although Disasters-R-Us™ is located a fair distance from SLIC and Disasters-R-Us™ contracts out the same equipment to multiple clients on a first-come, first-serve basis, SLIC senior management believed that the price was affordable.

Each year SLIC conducts a fire drill exercise where SLIC personnel (with the exception of senior management) are required to leave the building, meet at nearby pre-determined rallying points and wait for instructions. Those employees with SLIC-issued laptops are required to take their laptops with them, proceed to a nearby coffee shop, purchase a small coffee with the unlimited refill option and continue work by connecting to the coffee shop's Wi-Fi hotspot.

Each year, SLIC senior management participates in an offsite workshop to review all of the operating policies in the disaster and business continuity program as well as the effectiveness of the most recent disaster recovery and fire drill exercises.

3.14 SLIC Salaried Pension Plan

The following pages contain financial and demographic information about the SLIC Salaried Pension Plan, as well as information about the Statement of Funding Policies and Procedures for the Plan and the Statement of Investment Policies and Procedures for the Plan.

SLIC, through its Board of Directors, has delegated responsibility for the day-to-day management of the Plan to the Vice-President, Human Resources and the Chief Financial Officer. The CFO's focus is on financial reporting and cash contribution requirements, the VP HR is largely responsible for all other activities.

3.14.1 Pension Plan - Benefit Provisions and Financial Information

The information on the following pages enumerates the current provisions of the Pension Plan and provides certain historical financial information. Historical financial information is not available prior to January 1, 2009.

Extracts of Retirement Benefits Provisions and Financial Information

SLIC Salaried Pension Plan

Eligibility	Immediate
Vesting	100% after 5 years of plan membership
Normal Retirement Age	65
Early Retirement Age	55 with 5 years of plan membership
Best Average Earnings	Average earnings during 60 consecutive months of highest earnings
Earnings	Base Pay, excluding overtime and bonuses
Normal Retirement Benefit	2% of best average earnings times service years, subject to maximum
Accrued Benefit	Benefit calculated as under the normal retirement benefit formula using best average earnings and service as the valuation date
Early Retirement Benefit	Accrued benefit reduced by 0.25% per month that early retirement precedes age 62 for active participants and actuarial equivalent for terminated vested participants
Form of Benefit	If with spouse, 60% joint & survivor benefit; else single life annuity
Optional Forms of Benefit	None
Indexing	None
Termination Benefit	(1) Lump sum value equal to actuarial present value of accrued pension payable at age 65; or (2) Deferred pension
Pre-Retirement Death Benefit	Lump sum value equal to actuarial present value of accrued pension payable at age 65 to named beneficiary
Disability Benefit	Accrual of service while on long term disability and immediate pension without a reduction upon permanent and total disability

SLIC Salaried Pension Plan
Historical Actuarial Valuation Results

	2009	2010	2011	2012	2013
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Participant Summary - January 1

<i>Active Participants</i>					
(a) count	975	966	959	950	933
(b) average age	50.9	51.2	51.2	51.4	52
(c) average service	17.3	17.5	17.7	17.8	17.8
(d) average future working lifetime	11	11	11	11	11
(e) average plan earnings (prior year)	95,000	95,100	95,200	95,000	94,900
<i>Deferred Vested Participants</i>					
(a) count	-	-	-	-	-
<i>Pensioners (incl beneficiaries)</i>					
(a) count	915	915	916	916	921
(b) average age	74.2	74.2	73.9	73.5	73
(c) average annual benefit	47,500	47,600	47,700	47,700	47,500

Plan Assets (numbers in \$000's) *

<i>Change in Plan Assets during Prior Year:</i>					
Market Value of Assets at January 1 of prior year	-	664,572	679,902	486,055	584,132
Employer Contributions during prior year	-	14,800	16,664	66,946	46,599
Benefit Payments during prior year	-	(44,763)	(44,654)	(45,693)	(45,393)
Expenses during prior year	-	-	-	-	-
Investment return during prior year	-	45,293	(165,856)	76,824	58,886
Market Value of Assets at January 1 of current year	664,572	679,902	486,055	584,132	644,224
Rate of return during prior year	0%	7%	-25%	15%	10.1%
<i>Average Portfolio Mix During Prior Year:</i>					
(a) Domestic Large Cap Equities	0%	40%	39%	33%	36%
(b) Domestic Small Cap Equities	0%	20%	20%	15%	16%
(c) Domestic Fixed Income	0%	30%	30%	42%	39%
(d) International Equities	0%	4%	4%	5%	4%
(e) Real Estate	0%	4%	4%	2%	3%
(f) Cash	0%	2%	2%	3%	2%
(g) Total	0%	100%	100%	100%	100%
<i>Asset Class Returns during Prior Year:</i>					
(a) Domestic Large Cap Equities	0%	5%	-37%	26%	15%
(b) Domestic Small Cap Equities	0%	9%	-45%	28%	5%
(c) Domestic Fixed Income	0%	7%	5%	6%	7%
(d) International Equities	0%	16%	-6%	-17%	13%
(e) Real Estate	0%	6%	-63%	51%	29%
(f) Cash	0%	5%	2%	0%	0%

* numbers may not add due to rounding

SLIC Salaried Pension Plan
Historical Actuarial Valuation Results

2009 2010 2011 2012 2013

Actuarial Valuation - January 1 (numbers in \$000's) *

1. Actuarial Accrued Liability:					
(a) Active participants	256,032	278,310	279,745	288,114	298,850
(b) Deferred vested participants	-	-	-	-	-
(c) Pensioners	395,509	405,052	406,347	415,085	437,475
(d) Total	651,541	683,362	686,091	703,199	736,325
2. Actuarial Value of Assets					
	664,572	679,902	486,055	584,132	644,224
3. Unfunded Actuarial Accrued Liability: (1d)-(2)					
	(13,031)	3,460	200,036	119,067	92,101
4. Normal Cost (beg. Of year)					
	14,800	15,903	15,805	16,186	16,789
5. Change in Unfunded AAL during prior year:					
(a) Unfunded AAL at prior valuation date	-	(13,031)	3,460	200,036	119,067
(b) Adjustment for Interest	-	(880)	225	13,002	7,739
(c) Normal Cost w/interest less contributions	-	499	(268)	(52,290)	(30,875)
(d) (Gain)/Loss on investment	-	(1,446)	209,140	(44,539)	(20,878)
(e) (Gain)/Loss on salary increases less than expected	-	(17,013)	(17,797)	(18,771)	(19,031)
(f) (Gain)/Loss on assumption changes	-	27,971	0	7,876	30,342
(g) (Gain)/Loss on all other factors	-	7,358	5,276	13,753	5,737
(h) Unfunded AAL at current valuation date	(13,031)	3,460	200,036	119,067	92,101
6. Actuarial Basis					
(a) Interest	6.75%	6.50%	6.50%	6.50%	6.00%
(b) Salary scale	3.75%	4.00%	4.00%	4.00%	3.50%
(c) Consumer Price Index	3.00%	3.00%	3.00%	3.00%	2.50%
(d) Mortality	UP 1994 AA15	UP 1994 AA15	UP 1994 AA15	1994 Uninsured Pensioner Mortality - Generational	1994 Uninsured Pensioner Mortality - Generational
(e) Turnover			None		
(f) Retirement age			Age 62		
(g) Proportion married and age difference			80% married, husbands 3 years older than wives		
(h) Expenses			Assume all expenses paid by company		
(i) Asset Valuation Method			Market value of assets		
(j) Actuarial Cost Method			Projected unit credit		

* numbers may not add due to rounding

SLIC Salaried Pension Plan
Historical Actuarial Valuation Results

2009 2010 2011 2012 2013

Expense Valuation - January 1 (numbers in \$000's) *

<i>1. Reconciliation of funded status at valuation date:</i>					
(a) Accrued Benefit Obligation (ABO)	(629,971)	(603,007)	(623,057)	(657,031)	(688,835)
(b) Projected Benefit Obligation (PBO)	(730,433)	(703,251)	(726,773)	(767,023)	(802,888)
(c) Fair Value of Assets	664,572	679,902	486,055	584,132	644,224
(d) Funded Status: (b) + (c)	(65,861)	(23,349)	(240,718)	(182,891)	(158,664)
(e) Unamortized net actuarial gain)/loss	56,088	17,601	241,333	211,784	203,307
(f) Accrued benefit asset/(liability)	(9,773)	(5,748)	616	28,893	44,643
<i>2. Pension Expense:</i>					
(a) Service Cost (beg. of year)	17,759	16,645	17,313	18,558	19,249
(b) Interest Cost	41,734	43,598	43,274	43,866	41,971
(c) Expected return on assets	(48,719)	(49,943)	(37,251)	(43,855)	(45,138)
(d) Amortization of past service cost	-	-	-	-	-
(e) Amortization of net actuarial gain)/loss	-	-	15,332	12,280	11,183
(f) Pension Expense for year	10,774	10,300	38,669	30,849	27,266
<i>3. Actuarial Basis and Supplemental Data</i>					
(a) Discount rate	5.75%	6.25%	6.00%	5.75%	5.25%
(b) Return on assets	7.50%	7.50%	7.50%	7.50%	7.00%
(c) Salary scale	3.75%	3.50%	3.50%	3.50%	3.00%
(d) Consumer Price Index	3.00%	3.00%	3.00%	2.50%	2.50%
(e) Mortality	UP 1994 AA15	UP 1994 AA15	UP 1994 AA15	1994 Uninsured Pensioner Mortality - Generational	1994 Uninsured Pensioner Mortality - Generational
(f) Turnover			None		
(g) Proportion married and age difference		80% married, husbands 3 years older than wives			
(h) Retirement age			Age 62		
(i) Expenses		Assume all expenses paid by company			
(j) Asset Valuation Method		Market value of assets			
(k) Actuarial Cost Method		Projected unit credit			
(l) Employer contributions	14,800	16,664	66,946	46,599	46,599
(m) Benefit payments	(44,763)	(44,654)	(45,693)	(45,393)	(45,393)

* numbers may not add due to rounding

SLIC Salaried Pension Plan
Reconciliation of Plan Participants (2009 - 2013)

	Active	Pensioners/ Beneficiaries	Total
1. Participants as of January 1, 2009	975	915	1,890
- New Entrants/Rehires	9	-	9
- Terminated Nonvested	(3)	-	(3)
- Terminated Vested (Lump Sum Cashout)	(8)	-	(8)
- Retirement	(7)	7	-
- Death w/ Beneficiary	-	3	3
- Deaths	-	(10)	(10)
- Net change	(9)	-	(9)
2. Participants as of January 1, 2010	966	915	1,881
- New Entrants/Rehires	11	-	11
- Terminated Nonvested	(3)	-	(3)
- Terminated Vested (Lump Sum Cashout)	(7)	-	(7)
- Retirement	(8)	8	-
- Death w/ Beneficiary	-	3	3
- Deaths	-	(10)	(10)
- Net change	(7)	1	(6)
3. Participants as of January 1, 2011	959	916	1,875
- New Entrants/Rehires	9	-	9
- Terminated Nonvested	(3)	-	(3)
- Terminated Vested (Lump Sum Cashout)	(7)	-	(7)
- Retirement	(7)	7	-
- Death w/ Beneficiary	(1)	7	6
- Deaths	-	(14)	(14)
- Net change	(9)	-	(9)
4. Participants as of January 1, 2012	950	916	1,866
- New Entrants/Rehires	4	-	4
- Terminated Nonvested	(2)	-	(2)
- Terminated Vested (Lump Sum Cashout)	(7)	-	(7)
- Retirement	(11)	11	-
- Death w/ Beneficiary	(1)	7	6
- Deaths	-	(13)	(13)
- Net change	(17)	5	(12)
5. Participants as of January 1, 2013	933	921	1,854

**SLIC Salaried Pension Plan
Age/Svc/Earnings as of January
1, 2013**

		Service (Years)					
		< 5	5-10	10-15	15-20	>20	Totals
Age (Years)	< 25	# Participants	-	-	-	-	-
		Average Salary	-	-	-	-	-
	25-35	# Participants	7	45	-	-	52
		Average Salary	58,800	66,600	-	-	65,600
	35-45	# Participants	22	14	43	54	133
		Average Salary	59,500	82,900	87,700	95,400	85,700
	45-55	# Participants	4	20	48	149	369
		Average Salary	60,500	81,600	90,100	94,500	92,900
	55-65	# Participants	10	19	58	129	329
		Average Salary	55,000	80,200	85,100	92,400	102,400
	> 65	# Participants	6	10	6	14	50
		Average Salary	72,600	91,900	111,200	121,000	116,300
	Totals	# Participants	49	108	155	346	933
		Average Salary	60,200	76,200	88,400	94,900	95,000
		Avg Age	52.0				
		Avg Svc	17.8				
		Avg Salary	94,900				

Simple Life Salaried Pension Plan			
Interest Sensitivity and Cash Flows			
	Actives	Pensioners	Total
Rate	Liability	Liability	Liability
6.00%	298,849,923	437,475,000	736,324,923
5.50%	319,436,841	455,140,469	774,577,310
6.50%	280,175,145	420,993,205	701,168,350
Duration (5.5%)	13.1	7.8	10.0
Convexity (5.5%)	255.9	108.2	168.2
Five Years	Actives	Pensioners	Total
Ending Dec 31	Cash Flow	Cash Flow	Cash Flow
2017	55,930,427	200,566,677	256,497,104
2022	110,010,522	181,480,351	291,490,873
2027	134,057,420	151,888,965	285,946,385
2032	130,404,137	113,612,879	244,017,016
2037	118,132,501	71,987,503	190,120,004
2042	96,147,700	35,985,415	132,133,115
2047	66,944,859	13,308,120	80,252,979
2052	39,938,564	3,396,522	43,335,086
2057	20,656,666	537,413	21,194,079
2062	9,219,194	49,492	9,268,686
2067	3,364,241	2,365	3,366,606
2072	873,435	68	873,503
2077	124,446	0	124,446
2082	7,911	0	7,911
2087	132	0	132
2092	0	0	0

3.14.2 Statement of Funding Policies and Procedures -SLIC

The Company has prepared a Statement of Funding Policies and Procedures (“Statement”) to document the governance of the Plan. The Company has also prepared a Statement of Investment Policies and Procedures. Extracts of the Statement are provided below followed by a summary of the Statement contents.

3.14.2.1 Allocation of Responsibilities

SLIC, through its Board of Directors, has delegated responsibility for the day-to-day management of the Plan to the Vice-President, Human Resources and the Chief Financial Officer. The CFO’s focus is on financial reporting and cash contribution requirements, the VP HR is largely responsible for all other activities.

The Company has delegated the management of Plan funding as follows:

The Company, acting through Management, will:

- Establish, review and amend, as required, the Statement of Funding Policies and Procedures;
- Select the Pension Consultant and the Actuary;
- Review funding reports prepared by the Actuary regarding the funding of the Plan; and
- Be responsible for the assumption or delegation of any responsibilities not specifically mentioned.

The Pension Consultant and Actuary will:

- Assist, as required, the Company in the preparation of the Statement of Funding Policies and Procedures;
- Present to the Company, as required by the Statement of Funding Policies and Procedures, reviews and reports regarding the funding of the Plan; and
- Comment to the Company on any changes in plan design, contribution flow or pension legislation that may affect the funding of the Plan.

3.14.2.2 Funding Policy Principles

The Company is the primary risk bearer under the Plan. As a result, the funding objective of the Company is the accumulation of assets that will secure the Plan's benefits in respect of service already rendered. The accumulation of assets should be reasonable, without significant volatility or further recourse to the Company's assets.

The Company believes management of the Plan on a going concern basis is the most suitable means to achieve these objectives.

3.14.2.3 Management of Risks

The Company has adopted the following policies to mitigate their risks:

- Going-concern valuations are to be prepared using best estimate assumptions adjusted to include margins for adverse deviation. The Company will consult with the Pension Consultant and Actuary regarding the adoption of margins for adverse deviation.
- Emerging experience will differ from the assumptions made for going-concern purposes. The Pension Consultant and Actuary will monitor emerging experience and recommend revisions to the going-concern assumptions as appropriate.
- Plan provisions are managed to mitigate, to the extent possible, demographic and economic risks. Benefit improvements under the Plan will be made with due regard to the Plan's funded status.
- Investment activity will be carried out with due regard to the liability structure of the Fund, to the cash flow requirements of the Fund, and to the risks and rewards inherent in the defined benefit investments. The Statement of Investment Policies and Procedures documents the Company's policies regarding investment risk.

3.14.2.4 Funding Target

The funding target for the Plan is to have a funded ratio (assets divided by liabilities) of 100% on a going-concern basis.

3.14.2.5 Funding Risks

The Company bears the following funding risks:

- The Plan's demographic experience may differ from best-estimate assumptions. The Plan provides for subsidized early retirement provision and bears the risk of overutilization of the provision by the Plan membership.
- The Plan's economic experience may differ from best-estimate assumptions. In addition to investment risks, the Company bears the risks associated with providing a final average earnings benefit.
- The Plan's liabilities are debt-like in nature and have a long term to maturity. As a result of the current investment strategy and nature of the Plan's liabilities, there is the risk of an asset-liability mismatch.

* * * * *

The contents of the Statement follow:

- PURPOSE
- BACKGROUND, PLAN TYPE AND LIABILITIES
- ALLOCATION OF RESPONSIBILITIES
- FUNDING POLICY PRINCIPLES
- FUNDING RISKS
- MANAGEMENT OF RISKS
- FUNDING TARGET
- ELIMINATION OF DEFICITS
- UTILIZATION OF EXCESSES
- FREQUENCY OF VALUATIONS
- COMMUNICATION
- APPENDIX 1 – Summary of Roles
- APPENDIX 2 – Summary of Liabilities, Assets and Membership Data
- APPENDIX 3 – History of SFP&P Review and Amendments

3.14.2.6 Statement of Investment Policies and Procedures - Excerpts

Following are excerpts from the Statement of Investment Policies and Procedures for the SLIC Insurance Company's Pension Plan.

3.14.2.7 Investment Risk

- Investment risk is borne by the Company
- Going-concern surplus, subject to any legislative restrictions, can be applied against the Company's Normal Actuarial Cost

3.14.2.8 Allocation of Responsibilities

The Company, acting through Management, will:

- Establish, review and amend, as required, the Statement of Investment Policies and Procedures;
- Select one or more fund managers ("Fund Managers"), the Pension Consultant and the Actuary;
- Select the Custodian to hold pension fund assets;
- Review the performance of the Fund and the Fund Managers at least annually; and
- Be responsible for the assumption or delegation of any responsibilities not specifically mentioned.

The Fund Managers will:

- Manage the asset mix and select securities within each Investment Fund Option, subject to applicable legislation and the constraints set out in this Statement.

The Pension Consultant and Actuary will:

- Assist, as required, the Company in the preparation of the Statement of Investment Policies and Procedures; and
- Comment to the Company on any changes in plan design or contribution flow that may affect the investment of assets.

The Custodian will:

- Fulfil the regular duties required by law of the Custodian in accordance with the Plan;
- Participate in annual reviews of the Statement of Investment Policies and Procedures;
- Present to the Company, at least annually, reviews and reports of investment performance of the Fund Managers;
- Provide the Company with monthly updates on the performance of the Fund Managers;
- Provide the Company with information, on an ongoing basis, about changes at the Fund Managers that could affect investment performance;
- Present to the Company, at least annually, reviews and reports of all investment Fund assets and transactions for the period;
- Monitor actual investments as appropriate to ensure compliance with the Pension Benefits Act; and
- Rebalance the Plan portfolios as requested by the Company.

3.14.2.9 Investment Objectives

- to preserve the capital;
- to provide sufficient funds to meet payments as they become due; and
- to maintain sufficient assets over actuarial requirements to meet unforeseen liabilities.

3.14.2.10 Rate of Return Objectives

- to achieve an average annual rate of return, net of investment expenses, of at least the funding valuation rate of return (currently 6.0%) per year, measured over moving, four-year periods;
- to achieve top third performance, relative to the peer group of fund managers, measured over moving, four-year periods;
- to exceed the passive benchmark for the Pension Fund by 1.00% per annum, measured on a four-year moving average basis; and
- to achieve at least the increase in the Consumer Price Index plus 3%, on a four-year moving average basis.

3.14.2.11 Asset Allocation Guidelines

The following normal policy allocation, and associated range for strategic deviation at any time, has been adopted by the Company:

Percentages of Fund at Market Value	Normal	Minimum	Maximum
Domestic Equities	40%	30%	50%
International Equities	20%	15%	25%
Domestic Fixed Income	30%	15%	45%
Real Estate (Private)	4%	0%	8%
Private Equity	4%	0%	8%
Cash	2%	0%	4%

Within the ranges noted above, the Fund Managers may actively vary the asset mix in an effort to achieve the investment objectives of the Company.

3.14.2.12 Passive Management Objectives

The rate of return expected to be achieved through passive management of the assets in the Plan Fund will be based on the normal allocation of assets. The passive return shall be set equal to the sum of:

- 45.0% of the S&P 500 Index return for the year;
- 20.0% of the MSCI EAFE Index return for the year; and
- 35.0% of the Barclays Capital Aggregate Bond Index return for the year.

3.14.2.13 *Rebalancing*

The Company will direct the re-balancing of the assets in the component pooled funds, when it deems rebalancing to be appropriate.

3.14.2.14 *Related Party Transactions*

A Related Party is:

- (a) the Company, acting as Plan Administrator,
- (b) an officer, director or employee of the Company,
- (c) the funding agent or person responsible for investing the assets of the Plan, or any officer, director or employee thereof,
- (d) an association or trade union representing employees of the Company, or an officer or employee thereof,
- (e) an employer who participates in the Plan, or an employee, officer or director thereof,
- (f) the Plan Participant,
- (g) a person (including spouse or child) directly or indirectly holding more than 10% of the voting shares of the Company,
- (h) the spouse or child of (a) to (g),
- (i) an affiliate of the Company,
- (j) a corporation directly or indirectly controlled by a person in (a) to (h),
- (k) an entity in which a person in (a), (b), (e) or (g), has a substantial investment (where “substantial investment” means more than 25% of the ownership interests in an unincorporated entity, more than 10% of the voting rights of a corporation or more than 25% of the shareholders’ equity in a corporation) or,
- (l) an entity with substantial investment in the Company.

Related Parties excludes government or a financial institution holding Plan assets if not the administrator.

The Company, acting as Plan Administrator, shall not, directly or indirectly:

- lend the assets of the Plan to a Related Party or invest those assets in the securities of a Related Party; or
- enter into a transaction with a Related Party on behalf of the Plan, subject to a minimum limit of \$50,000 per transaction and a cumulative limit of \$250,000 in a Plan’s fiscal year.

Related Party transactions are acceptable provided they are necessary for the operation of the Plan and are purchased on terms and conditions that are at least as favourable for the Plan as are otherwise available.

3.14.2.15 Appendix - Economic Data

The investment consultant for SLIC's DB Plan has supplied the following economic data:

SLIC DB Plan	Market Value (\$000)	Duration	KRD 1 Yr	KRD 3 Yr	KRD 5 yr	KRD 10 Yr	KRD 20 Yr	KRD 30 Yr
Plan Actives	298,850	13.1	0.05	0.25	1.08	3.60	4.50	3.62
Plan Pensioners	437,475	7.8	0.20	0.52	1.35	2.85	2.22	0.66
Plan Total Liabilities	736,325	10.0	0.15	0.42	1.25	3.16	3.15	1.87

	Equity Indices		Barclay's Capital U.S. Bond Indices	
	S&P 500	MSCI EAFE	Aggregate	Aggregate 10+ Year Maturity
Expected Returns	6.50%	8.00%	2.30%	3.00%
Annualized Volatility	15.05%	16.88%	3.73%	10.02%
Duration	0.00	0.00	5.01	14.19
Skewness	-0.67	-0.77	-0.41	0.03
Kurtosis	4.22	4.51	4.82	5.56

Correlations	Equity Indices		Barclay's Capital U.S. Bond Indices	
	S&P 500	MSCI EAFE	Aggregate	Aggregate 10+ Year Maturity
S&P 500	1.00			
MSCI EAFE	0.79	1.00		
Aggregate	0.06	0.04	1.00	
Aggregate 10+ Year Maturity	-0.10	-0.05	0.90	1.00

SLIC DB PLAN: Top 10 Equity Holdings

Rank	Name	Beta	Rank	Name	Beta
1	General Electric	1.60	6	Caterpillar	2.00
2	Citigroup	0.99	7	Berkshire Hathaway	0.48
3	Exxon Mobil	0.49	8	Costco	0.79
4	Mead Johnson	0.75	9	Procter & Gamble	0.46
5	AT&T	0.60	10	Cisco Systems	1.18

SLIC DB Plan:

Portfolio Managers	Current	Expected	TE
US Fixed Income	% Allocation	Tracking Error	Volatility
Manager A	50%	1.2%	4%
Manager B	50%	2.0%	4%
Benchmark	0%	0%	0%
Portfolio Managers		Expected	TE
US Equity	% Allocation	Tracking Error	Volatility
Manager C	50%	3.6%	6%
Manager D	50%	2.4%	6%
Benchmark	0%	0%	0%

4 Health Insurance Companies

4.1 Background

AHA Health Insurance Company (AHA) is a large national insurance company located in California with its home office in Los Angeles. AHA is wholly owned by Lyon Corporation.

4.2 Employee Benefits

AHA Health provides basic life, health and disability benefits to its employees while they are employed by the company. These benefits do not continue after employees leave the company.

AHA Health sponsors a company-paid final-average-earnings defined benefit pension plan for its employees.

4.3 Product Lines

AHA sells individual and group insurance in California and 14 other states. It is in both the small and large group markets in all states. In addition, AHA has a small block of long term care (LTC) business with policyholders located all over the country.

4.4 Product Structure

AHA's policies include comprehensive major medical coverage of hospital services, physician services, and prescription drugs. The plans have an average deductible under \$2,000 in all markets. In addition, the group policies also include dental coverage. Dental is offered as a rider to the medical policies.

4.5 Provider Networks & Medical Management

AHA has staff that negotiates with physician and hospital providers in each state in which it is licensed and continually monitors these provider networks. It has contracted with Networks 'R Us to use its provider networks when members need services outside of states in which it is licensed. In addition, AHA has contracted with Carefree Rx, a nationwide drug plan, to manage and administer its prescription drug coverage. Finally, AHA has a contract with Painless Dental to manage and administer its dental plans.

AHA has its own centralized medical management staff that administers its medical management policies consistently in all states in which it is licensed. AHA's staff continually reviews and revises policies to keep costs down and to keep up with the latest developments. Its vendors, Networks 'R Us, Carefree Rx, and Painless Dental, work with AHA to make sure their medical management policies do not conflict with those of AHA.

4.6 Operations

AHA has a claims system developed and maintained by a well-respected national vendor. AHA maintains a close relationship with this vendor to make sure that the system meets all of its needs.

AHA underwrites large group business coverage, using credibility rating. While the underwriting decision is systematically determined in most cases, the Senior Pricing Actuary makes the ultimate underwriting decision for the largest cases, relying on his extensive experience in the industry.

AHA's robust data collection process includes categorizing it in numerous different ways that allows all parts of the company to use the same database. For example, Medical Management can use the corporate database to determine which of its initiatives have been successful. Their data are used for actively monitoring claims experience, which results in up-to-date pricing and forecasting assumptions. In addition, their data is used for research and ad hoc financial analyses, group reporting, and financial reporting. In fact, the group reports have proved helpful in showing groups how to lower their costs.

4.7 Management/Culture

Lyon Corporation management has little experience in health insurance. As result, they are content to allow the AHA management a great deal of autonomy and this arrangement has worked well in the past.

AHA's management tends to be aggressive and willing to take risks. The fact that their business is spread over a large membership base in 15 states may give them a sense of security. AHA does not currently and has never had a CRO. The company has a risk committee with limited scope and authority, and different senior managers take on a CRO role as needed.

The management team has a generous incentive plan. AHA's plan criteria include membership growth, profitability, and quality of care. AHA's plan covers management staff from top management to frontline management. The goal is to have all management focused on the key drivers of success.

4.8 Affordable Care Act & Other Regulatory Issues

AHA's staff has been following the Affordable Care Act since its inception. They have made all required system, product, underwriting, pricing, and administrative changes to be compliant with the Affordable Care Act. However, the funds for the new staff have not been approved so hiring has been put on hold. The pressure on profit margin from the Affordable Care Act minimum loss ratio rebates made it economically unfeasible to hire additional staff. Current AHA staff members have increased responsibilities to operate in a post-Affordable Care Act environment. This has put a strain on staff morale and performance.

AHA has recently started cancelling Individual policies that are not compliant with the Affordable Care Act (ACA). There have been some complaints from policyholders in all states. However, the most complaints have come from policyholders in Nevada, California, and Ohio. The company is concerned that they could see lapse rates as high as 50% in these Individual medical markets.

The company has developed new billing and claim systems to administer its new ACA compliant plans. The old billing, claim, underwriting, and rating systems are in the process of being retired. AHA has reduced staffing levels on the old systems and has not upgraded the software used for the old systems. As a result, service on the old administrative systems has started to deteriorate.

AHA has made an offer to early renew its entire small group block effective 12/1/13 with the current rate structure and plan designs. Therefore, there have not been any complaints from the small group policyholders.

Next year, AHA will undergo its triennial audit by the California Department of Insurance. Management anticipates that there will not be any problems but this audit entails a substantial effort from Finance, Internal Audit, Actuarial, and other areas.

4.9 Statutory and Economic Capital

Statutory Capital

Statutory capital is allocated to the LOBs as follows. Each reporting period the Financial Reporting Department calculates the required statutory capital for each of the four lines of business (LOB): LTC, Individual, Small Group and Large Group. AHA currently targets an RBC of 600%, an A+ capital level. At the end of each reporting period, each LOB holds exactly its required capital which is achieved by the LOB transferring any excess statutory capital to the Corporate LOB or by receiving a statutory capital contribution from Corporate. Thus, Corporate invests statutory capital in the LOB and each period either receives returns or makes further investments in the LOB. AHA invests in liquid, highly rated bonds with asset/liability matching to support their health and LTC liabilities. Their investment returns are sufficient to support their pricing.

Economic Capital

AHA uses an internal Economic Capital Model. The model targets a total economic capital level that is calibrated to an AA financial strength. AHA defines the model economic capital required as being the capital required to protect AHA's policyholders in order to meet all of their claims with a confidence level of 99.0 percent over a one-year time horizon. Diversification benefits are allocated back to the LOBs.

The Statutory and Economic Balance Sheets are independent of each other. The amount of assets assigned to a LOB is based on the required capital, either on an economic basis or a

statutory basis. That is, the assets backing the liabilities on an economic basis are not the same as the assets allocated on a statutory basis.

Surplus in excess of 700% of RBC (which is 117% of the 600% target) is distributed to Lyon Corporation through a dividend annually at the end of the first quarter based on the year-end balance sheet. Surplus positions less than 500% of RBC (which is 83% of the 600% target) result in a capital contribution from Lyon Corporation or the issuance of Surplus Notes.

4.10 Going Forward

The corporate CFO of AHA is interested in hedging the LTC risk and has called together a team from AHA's finance and actuarial areas plus the corporate finance and investment areas to see how to move ahead with this idea. It would seem that the timing on this initiative is very appropriate because the management of AHA is looking into purchasing a block of LTC business.

In addition, AHA is developing its strategy for the period after full implementation of the Affordable Care Act in 2014. AHA's claim experience varies by state and market (Individual, Small Group, Large Group, and LTC). AHA must decide whether to pull out of certain markets, stay in the market and sell out of the Exchange, or remain in the market and sell through the Exchange. Exchanges offer protection through premium stabilization (reinsurance and risk corridor) programs. However, any pricing error would be exploited very quickly for plans on the Exchange. A large volume of underpriced new business could be sold very quickly. Also, a rate increase would take months to implement given the new, time-consuming rate approval process.

Finally, AHA management is looking into purchasing Eureka Insurance Company (Eureka), a health insurance company domiciled in New York with its home office in Albany, NY. The driving force behind this potential acquisition is to help AHA enter a new market without having to build a lot of infrastructure. Initially, the Eureka management would remain in place to run the company and integration would proceed over several years. AHA management is putting together a due diligence team including staff from AHA finance, actuarial, marketing, and medical management.

4.11 Eureka Insurance Company

4.11.1 Employee Benefits

Eureka provides basic life, health and disability benefits to its employees while they are employed by the company. These benefits do not continue after employees leave the company.

Eureka does not sponsor any pension or savings plans for its employees.

4.11.2 Product Lines

Eureka is in the small and large group and LTC markets in the state of New York.

4.11.3 Product Structure

Eureka's products include LTC and comprehensive major medical coverage of hospital services, physician services, dental services, and prescription drugs. The average deductible for Eureka's plans is also under \$2,000 in all markets. Dental is offered as a rider to medical.

Eureka is not writing any new LTC business. The closed LTC block remains on Eureka's financial statements with a low average lapse rate.

4.11.4 Provider Networks & Medical Management

Eureka has contracted with Networks 'R Us to use its provider networks for physician and hospital services. It also has contracts with Carefree Rx, a Prescription Benefit Management company (PBM), and Painless Dental to manage and administer Eureka's prescription drug and dental plans, respectively. In order to lower costs, it periodically puts its network contracts out to bid. While this may lower premiums it has been disruptive to members in the past.

Eureka uses the standard medical management from its vendors. The company has medical management staff that coordinate with the vendors' medical managers to ensure that the vendors meet New York requirements and that their policies are consistent with the Eureka product language.

4.11.5 Operations

Eureka has a "home grown" claims system that has performed well over the years. However, modifications are difficult and take time which has resulted in payment errors. Their controls in many areas differ from those of AHA and some are drastically different.

Similar to AHA, Eureka underwrites large group business coverage, but its procedures are very different. The advent of healthcare reform will bring the underwriting processes of the two companies closer together. As with AHA, Eureka uses credibility rating but has different points for determining whether a group is fully credible.

Eureka stores its data mainly at the group level and uses categories that allow it to do some detailed reporting to groups, pricing, monthly financial reporting and, of course, statutory reporting.

4.11.6 Management/Culture

Compared to AHA, the management of Eureka appears to be more conservative. However, since their company covers the entire state of New York, they are adept at dealing in diverse markets (rural to cosmopolitan). As with AHA, the Eureka management team has a generous incentive plan but requirements for receiving incentive payments differ between the two companies. Finally, there are substantial cultural differences between the southern California AHA and the northeastern Eureka management teams.

Eureka does not have a CRO in place.

Eureka's incentive compensation plan only covers senior management and the incentives cover the direct responsibilities of each executive (e.g., the chief marketing officer is responsible for growth and the CFO is responsible for profitability). The goal of this plan is to make sure senior executives focus on their responsibilities and do not get sidetracked. Also, this type of plan ensures that management in the rest of the company does not make decisions directly affecting a given executive's area of the business.

4.11.7 Affordable Care Act & Other Regulatory Issues

The management of Eureka has implemented the Affordable Care Act similar to AHA, by using current staff. Eureka management determined that the pressure on margins as a result of the Affordable Care Act minimum loss ratio requirements made it economically unfeasible to hire additional staff. The morale and performance of current staff has deteriorated due to increased work responsibilities.

4.11.8 Statutory and Economic Capital

Statutory Capital

Eureka reports statutory results only at the level required by regulatory authorities and does not allocate capital back to the lines of business. Eureka invests in highly rated publicly traded bonds, private placements, and Commercial Mortgage-Backed Securities (CMBS) that are duration matched to its liabilities. The returns are adequate to support the pricing. However, the investments supporting its LTC liabilities are illiquid. An increase in LTC lapse rates would produce losses.

Economic Capital

Eureka has not yet developed an economic capital model.

4.12 AHA Financial Statements

Multi-year financial statements are provided for each of the product lines and for AHA in total. 2012 and 2013 are actual results; 2014 – 2016 are projections.

LTC	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Premiums net	540,517	605,379	678,024	759,387	850,514
Health benefits	178,371	202,802	228,833	258,192	289,175
General expenses	105,401	111,995	128,825	132,893	144,587
Total Expenses	283,771	314,797	357,658	391,084	433,762
Investment Income	3,583	4,462	4,976	5,573	6,241
Income Before Income Tax	260,328	295,044	325,342	373,876	422,993
Federal Income Tax	91,115	103,266	113,870	130,856	148,048
Net Income	169,214	191,779	211,472	243,019	274,946
Statutory Balance Sheet (000s)					
Total Assets	224,585	252,443	282,736	316,664	354,664
Liability for unpaid claims and claim adjustment expenses	58,106	66,592	74,583	83,533	93,557
Other Liabilities	31,350	34,507	38,647	43,285	48,479
Total Liabilities	89,456	101,098	113,230	126,818	142,036
Surplus	135,129	151,345	169,506	189,847	212,628
Total Liabilities and Surplus	224,585	252,443	282,736	316,664	354,664
Additional Balance Sheet Information					
Surplus Transfer from/(to) Corporate	(154,735)	(175,563)	(193,311)	(222,678)	(252,164)
Economic Capital Balance Sheet (000s)					
Market Value of Assets	220,758	248,926	279,589	314,027	352,704
Economic Reserve	95,628	108,478	121,949	137,090	154,109
Required Economic Capital	125,130	140,448	157,641	176,937	198,595
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	220,758	248,926	279,589	314,027	352,704

Additional Metrics

Enrollment (000s)					
Members	327	333	340	347	354
Member Months	3,528	3,631	3,738	3,847	3,960
Utilization (per 1,000 members)					
Physician Visits	2,088	3,049	3,049	3,049	3,049
Hospital Days	188	265	262	262	262

INDIVIDUAL

	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Premiums net	1,109,901	1,209,793	1,391,261	1,572,125	1,666,453
Health benefits	899,020	982,956	1,140,834	1,297,004	1,378,990
General expenses	205,332	211,714	246,949	259,401	266,632
Total Expenses	1,104,352	1,194,670	1,387,783	1,556,404	1,645,622
Investment Income	7,424	9,163	9,943	11,435	12,921
Income Before Income Tax	12,973	24,286	13,422	27,156	33,752
Federal Income Tax	4,541	8,500	4,698	9,505	11,813
Net Income	8,433	15,786	8,724	17,651	21,939

Statutory Balance Sheet (000s)

Total Assets	461,164	504,484	580,156	655,576	694,911
Liability for unpaid claims and claim adjustment expenses	119,314	133,077	153,039	172,934	183,310
Other Liabilities	64,374	68,958	79,302	89,611	94,988
Total Liabilities	183,689	202,035	232,341	262,545	278,298
Surplus	277,475	302,448	347,815	393,031	416,613
Total Liabilities and Surplus	461,164	504,484	580,156	655,576	694,911
Additional Balance Sheet Information					
Surplus Transfer from/(to) Corporate	19,065	9,187	36,643	27,565	1,643

Economic Capital Balance Sheet (000s)

Market Value of Assets	544,600	597,348	688,576	779,927	828,669
Economic Reserve	234,938	259,211	299,022	338,946	360,395
Required Economic Capital	309,663	338,137	389,553	440,981	468,273
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	544,600	597,348	688,576	779,927	828,669

Additional Metrics

Enrollment (000s)					
Members	269	277	305	320	326
Member Months	2,798	2,910	3,109	3,297	3,395
Utilization (per 1,000 members)					
Physician Visits	5,863	5,425	5,425	5,425	5,425
Hospital Days	528	472	467	467	467

SMALL GROUP

2012 2013 2014 2015 2016

Statutory Income Statement (000s)

Premiums net	1,452,552	1,583,282	1,757,443	1,898,038	2,049,881
Health benefits	1,191,093	1,294,333	1,449,890	1,575,372	1,716,775
General expenses	268,722	277,074	311,946	313,176	327,981
Total Expenses	1,459,815	1,571,407	1,761,836	1,888,548	2,044,756
Investment Income	9,894	11,992	13,013	14,445	15,600
Income Before Income Tax	2,631	23,867	8,619	23,935	20,725
Federal Income Tax	921	8,353	3,017	8,377	7,254
Net Income	1,710	15,513	5,603	15,558	13,471

Statutory Balance Sheet (000s)

Total Assets	603,535	660,228	732,854	791,482	854,800
Liability for unpaid claims and claim adjustment expenses	156,149	174,161	193,319	208,784	225,487
Other Liabilities	84,248	90,247	100,174	108,188	116,843
Total Liabilities	240,397	264,408	293,493	316,972	342,330
Surplus	363,138	395,820	439,361	474,510	512,470
Total Liabilities and Surplus	603,535	660,228	732,854	791,482	854,800

Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate	28,274	17,169	37,938	19,591	24,490
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Economic Capital Balance Sheet (000s)

Market Value of Assets	738,048	809,502	900,600	974,865	1,055,248
Economic Reserve	321,892	355,100	395,335	428,230	463,857
Required Economic Capital	416,156	454,402	505,265	546,635	591,391
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	738,048	809,502	900,600	974,865	1,055,248

Additional Metrics

Enrollment (000s)

Members	442	455	487	506	521
Member Months	4,770	4,958	5,159	5,416	5,631

Utilization (per 1,000 members)

Physician Visits	5,159	4,774	4,774	4,774	4,774
Hospital Days	464	415	411	411	411

LARGE GROUP

	2012	2013	2014	2015	2016
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Statutory Income Statement (000s)

Premiums net	2,530,940	2,733,415	2,924,754	3,129,487	3,348,551
Health benefits	2,125,989	2,323,403	2,522,600	2,738,301	2,946,725
General expenses	379,641	437,346	394,842	320,772	326,484
Total Expenses	2,505,630	2,760,749	2,917,442	3,059,073	3,273,208
Investment Income	17,398	20,895	22,466	24,039	25,721
Income Before Income Tax	42,708	(6,439)	29,778	94,452	101,064
Federal Income Tax	14,948	(2,254)	10,422	33,058	35,372
Net Income	27,760	(4,185)	19,356	61,394	65,692

Statutory Balance Sheet (000s)

Total Assets	1,051,605	1,139,834	1,219,622	1,304,996	1,396,346
Liability for unpaid claims and claim adjustment expenses	272,076	300,676	321,723	344,244	368,341
Other Liabilities	146,794	155,805	166,711	178,381	190,867
Total Liabilities	418,870	456,480	488,434	522,624	559,208
Surplus	632,735	683,354	731,188	782,372	837,138
Total Liabilities and Surplus	1,051,605	1,139,834	1,219,622	1,304,996	1,396,346
Additional Balance Sheet Information					
Surplus Transfer from/(to) Corporate	19,109	54,804	28,479	(10,211)	(10,925)

Economic Capital Balance Sheet (000s)

Market Value of Assets	1,159,612	1,260,818	1,352,491	1,450,821	1,556,289
Economic Reserve	535,735	585,664	628,614	674,708	724,174
Required Economic Capital	623,877	675,153	723,877	776,113	832,115
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	1,159,612	1,260,818	1,352,491	1,450,821	1,556,289

Additional Metrics

Enrollment (000s)					
Members	891	936	964	993	1,022
Member Months	10,157	10,759	11,082	11,414	11,757
Utilization (per 1,000 members)					
Physician Visits	4,690	4,340	4,340	4,340	4,340
Hospital Days	422	378	373	373	373

CORPORATE	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Premiums net	-	-	-	-	-
Health benefits	-	-	-	-	-
General expenses	4,525	4,353	4,483	4,199	4,329
Total Expenses	4,525	4,353	4,483	4,199	4,329
Investment Income	2,064	3,998	5,822	7,307	9,842
Income Before Income Tax	(2,461)	(355)	1,339	3,109	5,513
Federal Income Tax	(861)	(124)	469	1,088	1,930
Net Income	(1,600)	(231)	871	2,021	3,583

Statutory Balance Sheet (000s)

Total Assets	201,209	295,382	370,739	499,343	587,946
Liability for unpaid claims and claim adjustment expenses	-	-	-	-	-
Other Liabilities	-	-	-	-	-
Total Liabilities	-	-	-	-	-
Surplus	201,209	295,382	370,739	499,343	587,946
Total Liabilities and Surplus	201,209	295,382	370,739	499,343	587,946
Additional Balance Sheet Information					
Surplus Transfer from/(to) Corporate	88,287	94,403	90,251	185,733	236,957

Economic Capital Balance Sheet (000s)

Market Value of Assets	(39,573)	35,609	69,993	169,736	231,861
Economic Reserve	-	-	-	-	-
Required Economic Capital	10,262	15,655	20,391	28,463	34,689
Free Surplus	(49,834)	19,954	49,602	141,274	197,172
Total Liabilities and Surplus	(39,573)	35,609	69,993	169,736	231,861

TOTAL	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Premiums net	5,633,910	6,131,868	6,751,482	7,359,037	7,915,398
Health benefits	4,394,473	4,803,494	5,342,158	5,868,867	6,331,664
General expenses	963,620	1,042,482	1,087,044	1,030,441	1,070,014
Total Expenses	5,358,093	5,845,976	6,429,202	6,899,308	7,401,678
Investment Income	40,362	50,511	56,220	62,798	70,326
Income Before Income Tax	316,179	336,403	378,501	522,527	584,047
Federal Income Tax	110,663	117,741	132,475	182,884	204,416
Net Income	205,517	218,662	246,025	339,643	379,630

Statutory Balance Sheet (000s)

Total Assets	2,542,098	2,852,370	3,186,107	3,568,061	3,888,667
Liability for unpaid claims and claim adjustment expenses	605,645	674,505	742,663	809,494	870,694
Other Liabilities	326,767	349,516	384,834	419,465	451,178
Total Liabilities	932,412	1,024,022	1,127,498	1,228,959	1,321,872
Surplus	1,609,686	1,828,348	2,058,610	2,339,102	2,566,796
Total Liabilities and Surplus	2,542,098	2,852,370	3,186,107	3,568,061	3,888,667

Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate	-	-	-	-	-
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Economic Capital Balance Sheet (000s)

Market Value of Assets	2,623,446	2,952,203	3,291,249	3,689,375	4,024,771
Economic Reserve	1,188,193	1,308,454	1,444,921	1,578,973	1,702,536
Required Economic Capital	1,485,087	1,623,795	1,796,726	1,969,129	2,125,063
Free Surplus	(49,834)	19,954	49,602	141,274	197,172
Total Liabilities and Surplus	2,623,446	2,952,203	3,291,249	3,689,375	4,024,771

Additional Metrics

Enrollment (000s)					
Members	1,928	2,001	2,095	2,165	2,224
Member Months	21,253	22,258	23,088	23,975	24,743
Utilization (per 1,000 members)					
Physician Visits	4,520	4,374	4,389	4,395	4,396
Hospital Days	407	381	377	378	378

2013 AHA Transactions with Providers (in \$000s)

	Direct Medical Expense Payment
	<hr/>
<u>Capitation Payments</u>	
1 Medical groups	\$0
2 Intermediaries	\$260,306
3 All other providers	\$0
4 Total capitation payments	<hr/> \$260,306
<u>Other Payments</u>	
5 Fee-for-service	\$1,152,391
6 Contractual fee payments	\$3,390,797
7 Bonus/withhold arrangements: fee-for-service	\$0
8 Bonus/withhold arrangements: contractual fee payments	\$0
9 Non-contingent salaries	\$0
10 Aggregate cost arrangements	\$0
11 All other payments	\$0
12 Total other payments	<hr/> \$4,543,187
13 Total (line 4 + line 12)	<hr/> \$4,803,494

AHA Premiums, Enrollment, and Utilization

		Comprehensive Hospital & Medical			Long Term Care	Total
		Individual	Small Group	Large Group		
Total Members at the end of:						
1.	Prior Year	269,059	441,637	891,008	326,622	1,928,325
2.	First Quarter, Current Year	269,981	434,586	904,609	319,641	1,928,818
3.	Second Quarter, Current Year	274,740	441,236	914,417	324,701	1,955,094
4.	Third Quarter, Current Year	274,903	445,861	918,183	330,277	1,969,225
5.	Fourth Quarter, Current Year	277,130	454,886	935,558	333,155	2,000,729
6.	Current Year Member Months	2,909,868	4,958,253	10,758,917	3,631,385	22,258,424
Total Members Ambulatory Encounters for Year:						
7.	Physician	1,315,503	1,972,558	3,891,142	922,535	8,101,738
8.	Non-Physician	78,404	113,619	219,460	10,609,147	11,020,631
9.	Total	1,393,907	2,086,178	4,110,602	11,531,681	19,122,368
10.	Hospital Patient Days Incurred	51,740	68,273	122,435	20,390	262,838
11.	Number of Inpatient Admissions	12,255	17,642	32,135	2,115	64,147
Premiums, Written and Earned (in \$000s)						
12.	Health Premiums, Written	\$1,209,793	\$1,583,282	\$2,733,415	\$605,379	\$6,131,868
13.	Life Premiums, Direct	\$0	\$0	\$0	\$0	\$0
14.	Property & Casualty Premiums, Written	\$0	\$0	\$0	\$0	\$0
15.	Health Premiums, Earned	\$1,209,793	\$1,583,282	\$2,733,415	\$605,379	\$6,131,868
16.	Life Premiums, Earned	\$0	\$0	\$0	\$0	\$0
17.	Property & Casualty Premiums, Earned	\$0	\$0	\$0	\$0	\$0
Claims, Paid and Incurred (in \$000s)						
18.	Amount Paid for Provision of Health Care Services	\$969,194	\$1,276,321	\$2,294,803	\$194,316	\$4,734,634
19.	Amount Incurred for Provision of Health Care Services	\$982,956	\$1,294,333	\$2,323,403	\$202,802	\$4,803,494
Member Ambulatory Encounters for Year - Per 1,000						
7.	Physician	5,425	4,774	4,340	3,049	4,368
8.	Non-Physician	323	275	245	35,058	5,941
9.	Total	5,748	5,049	4,585	38,107	10,309
10.	Hospital Patient Days Incurred	213	165	137	67	142
11.	Number of Inpatient Admissions	51	43	36	7	35
Premiums, Written and Earned - PMPM						
12.	Health Premiums, Written	\$415.76	\$319.32	\$254.06	\$166.71	\$275.49
13.	Life Premiums, Direct	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
14.	Property & Casualty Premiums, Written	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
15.	Health Premiums, Earned	\$415.76	\$319.32	\$254.06	\$166.71	\$275.49
16.	Life Premiums, Earned	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
17.	Property & Casualty Premiums, Earned	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Claims, Paid and Incurred -PMPM						
18.	Amount Paid for Provision of Health Care Services	\$333.07	\$257.41	\$213.29	\$53.51	\$212.71
19.	Amount Incurred for Provision of Health Care Services	\$337.80	\$261.05	\$215.95	\$55.85	\$215.81

2013 AHA Experience by State

	NV	OR	WA	CA	IL	IN	NJ	MI
GROUP MEDICAL								
Small Group								
Direct Premium (in \$000s)	\$354,819	\$72,009	\$32,029	\$333,920	\$32,029	\$156,738	\$210,801	\$56,335
Direct Claims (in \$000s)	\$314,206	\$60,893	\$28,254	\$225,303	\$26,062	\$141,027	\$192,177	\$40,676
Direct Loss Ratio	88.6%	84.6%	88.2%	67.5%	81.4%	90.0%	91.2%	72.2%
Member Months	1,010,248	171,533	67,443	515,409	107,146	596,682	805,720	303,628
Earned Premium - PMPM	\$351.22	\$419.79	\$474.90	\$647.87	\$298.93	\$262.68	\$261.63	\$185.54
Incurred Claims - PMPM	\$311.02	\$354.99	\$418.93	\$437.13	\$243.24	\$236.35	\$238.52	\$133.97
Large Group								
Direct Premium (in \$000s)	\$544,276	\$99,621	\$57,366	\$876,439	\$372,179	\$63,242	\$456,409	\$121,448
Direct Claims (in \$000s)	\$456,442	\$93,213	\$36,383	\$748,709	\$291,966	\$60,137	\$402,017	\$106,142
Direct Loss Ratio	83.9%	93.6%	63.4%	85.4%	78.4%	95.1%	88.1%	87.4%
Member Months	2,191,676	286,438	169,195	3,044,310	1,600,783	266,709	1,792,747	694,243
Earned Premium - PMPM	\$248.34	\$347.79	\$339.05	\$287.89	\$232.50	\$237.12	\$254.59	\$174.94
Incurred Claims - PMPM	\$208.26	\$325.42	\$215.04	\$245.94	\$182.39	\$225.48	\$224.25	\$152.89
Total Group Medical								
Direct Premium (in \$000s)	\$899,095	\$171,629	\$89,395	\$1,210,359	\$404,208	\$219,980	\$667,210	\$177,783
Direct Claims (in \$000s)	\$770,647	\$154,105	\$64,637	\$974,011	\$318,028	\$201,164	\$594,194	\$146,818
Direct Loss Ratio	85.7%	89.8%	72.3%	80.5%	78.7%	91.4%	89.1%	82.6%
Member Months	3,201,924	457,971	236,639	3,559,719	1,707,929	863,390	2,598,467	997,871
Earned Premium - PMPM	\$280.80	\$374.76	\$377.77	\$340.02	\$236.67	\$254.79	\$256.77	\$178.16
Incurred Claims - PMPM	\$240.68	\$336.50	\$273.15	\$273.62	\$186.21	\$232.99	\$228.67	\$147.13
INDIVIDUAL MEDICAL								
Direct Premium (in \$000s)	\$271,135	\$54,983	\$24,517	\$255,123	\$24,517	\$119,639	\$161,113	\$43,030
Direct Claims (in \$000s)	\$248,483	\$46,308	\$21,405	\$161,294	\$19,777	\$107,087	\$145,978	\$30,992
Direct Loss Ratio	91.6%	84.2%	87.3%	63.2%	80.7%	89.5%	90.6%	72.0%
Member Months	592,889	100,669	39,581	302,479	62,881	350,176	472,856	178,191
Earned Premium - PMPM	\$457.31	\$546.17	\$619.42	\$843.44	\$389.90	\$341.65	\$340.72	\$241.48
Incurred Claims - PMPM	\$419.10	\$460.00	\$540.80	\$533.24	\$314.52	\$305.81	\$308.72	\$173.93

2013 AHA Experience by State (Continued)

	SC	TN	TX	OH	GA	KY	WI	Total
GROUP MEDICAL								
Small Group								
Direct Premium (in \$000s)	\$11,358	\$33,165	\$52,700	\$92,226	\$106,309	\$29,076	\$9,768	\$1,583,282
Direct Claims (in \$000s)	\$7,551	\$24,601	\$42,868	\$78,673	\$75,750	\$26,062	\$10,230	\$1,294,333
Direct Loss Ratio	66.5%	74.2%	81.3%	85.3%	71.3%	89.6%	104.7%	81.8%
Member Months	48,443	133,334	236,961	414,227	406,809	104,866	35,804	4,958,253
Earned Premium - PMPM	\$234.46	\$248.74	\$222.40	\$222.64	\$261.32	\$277.27	\$272.81	\$319.32
Incurred Claims - PMPM	\$155.87	\$184.50	\$180.91	\$189.93	\$186.21	\$248.53	\$285.72	\$261.05
Large Group								
Direct Premium (in \$000s)	\$26,864	\$840	\$10,634	\$13,712	\$46,732	\$23,506	\$20,148	\$2,733,415
Direct Claims (in \$000s)	\$31,572	\$301	\$6,014	\$13,230	\$43,299	\$15,335	\$18,643	\$2,323,403
Direct Loss Ratio	117.5%	35.8%	56.6%	96.5%	92.7%	65.2%	92.5%	85.0%
Member Months	124,816	5,306	50,337	81,088	228,552	124,358	98,358	10,758,917
Earned Premium - PMPM	\$215.23	\$158.21	\$211.25	\$169.10	\$204.47	\$189.02	\$204.84	\$254.06
Incurred Claims - PMPM	\$252.95	\$56.67	\$119.47	\$163.16	\$189.45	\$123.31	\$189.54	\$215.95
Total Group Medical								
Direct Premium (in \$000s)	\$38,222	\$34,004	\$63,334	\$105,937	\$153,042	\$52,582	\$29,916	\$4,316,696
Direct Claims (in \$000s)	\$39,123	\$24,901	\$48,882	\$91,903	\$119,049	\$41,397	\$28,873	\$3,617,735
Direct Loss Ratio	102.4%	73.2%	77.2%	86.8%	77.8%	78.7%	96.5%	83.8%
Member Months	173,259	138,640	287,297	495,316	635,361	229,224	134,161	15,717,170
Earned Premium - PMPM	\$220.61	\$245.27	\$220.45	\$213.88	\$240.87	\$229.39	\$222.98	\$274.65
Incurred Claims - PMPM	\$225.80	\$179.61	\$170.14	\$185.55	\$187.37	\$180.60	\$215.21	\$230.18
INDIVIDUAL MEDICAL								
Direct Premium (in \$000s)	\$8,728	\$25,351	\$40,195	\$70,438	\$81,224	\$22,238	\$7,561	\$1,209,793
Direct Claims (in \$000s)	\$5,668	\$18,752	\$32,500	\$59,694	\$57,523	\$19,777	\$7,718	\$982,956
Direct Loss Ratio	64.9%	74.0%	80.9%	84.7%	70.8%	88.9%	102.1%	81.3%
Member Months	28,429	78,250	139,066	243,098	238,744	61,542	21,017	2,909,868
Earned Premium - PMPM	\$307.02	\$323.98	\$289.03	\$289.75	\$340.21	\$361.34	\$359.75	\$415.76
Incurred Claims - PMPM	\$199.37	\$239.65	\$233.70	\$245.55	\$240.94	\$321.36	\$367.23	\$337.80

4.13 Eureka Financial Statements

Financial statements are provided for Eureka in total. 2012 and 2013 are actual results; 2014 is a projection.

TOTAL	2012	2013	2014
Income Statement (000s)			
Premiums net	483,094	486,852	490,803
Health benefits	403,169	399,569	405,772
General expenses	89,954	90,051	91,118
Total Expenses	493,123	489,620	496,890
Investment Income	2,520	2,572	2,724
Income Before Income Tax	(7,508)	(196)	(3,363)
Federal Income Tax	(2,628)	(69)	(1,177)
Net Income	(4,880)	(127)	(2,186)
Balance Sheet (000s)			
Total Assets	122,579	123,803	122,277
Liability for unpaid claims and claim adjustment expenses	51,933	53,554	53,988
Other Liabilities	28,019	27,751	27,976
Total Liabilities	79,952	81,304	81,964
Surplus	42,627	42,499	40,313
Total Liabilities and Surplus	122,579	123,803	122,277

2013 Eureka Transactions with Providers (in \$000s)

	<u>Direct Medical Expense Payment</u>
<u>Capitation Payments</u>	
1 Medical groups	\$0
2 Intermediaries	\$0
3 All other providers	\$0
4 Total capitation payments	\$0
<u>Other Payments</u>	
5 Fee-for-service	\$271,500
6 Contractual fee payments	\$121,985
7 Bonus/withhold arrangements: fee-for-service	\$152
8 Bonus/withhold arrangements: contractual fee payments	\$152
9 Non-contingent salaries	\$0
10 Aggregate cost arrangements	\$0
11 All other payments	\$5,780
12 Total other payments	\$399,569
13 Total (line 4 + line 12)	\$399,569

2013 Eureka Premiums, Enrollment, and Utilization

	<u>Comprehensive Hospital & Medical Group Policies</u>
Total Members at the end of:	
1. Prior Year	142,916
2. First Quarter, Current Year	144,014
3. Second Quarter, Current Year	146,552
4. Third Quarter, Current Year	146,639
5. Fourth Quarter, Current Year	147,827
6. Current Year Member Months	1,921,757
Total Members Ambulatory Encounters for Year:	
7. Physician	695,035
8. Non-Physician	39,200
9. Total	734,235
10. Hospital Patient Days Incurred	21,869
11. Number of Inpatient Admissions	5,740

Premiums, Written and Earned (in \$000s)

12. Health Premiums, Written	\$342,193
13. Life Premiums, Direct	\$0
14. Property & Casualty Premiums, Written	\$0
15. Health Premiums, Earned	\$342,193
16. Life Premiums, Earned	\$0
17. Property & Casualty Premiums, Earned	\$0

Claims, Paid and Incurred (in \$000s)

18. Amount Paid for Provision of Health Care Services	\$274,392
19. Amount Incurred for Provision of Health Care Services	\$274,439

Member Ambulatory Encounters for Year - Per 1,000

7. Physician	4,340
8. Non-Physician	245
9. Total	4,585
10. Hospital Patient Days Incurred	137
11. Number of Inpatient Admissions	36

Premiums, Written and Earned - PMPM

12. Health Premiums, Written	\$178.06
13. Life Premiums, Direct	\$0.00
14. Property & Casualty Premiums, Written	\$0.00
15. Health Premiums, Earned	\$178.06
16. Life Premiums, Earned	\$0.00
17. Property & Casualty Premiums, Earned	\$0.00

Claims, Paid and Incurred -PMPM

18. Amount Paid for Provision of Health Care Services	\$142.78
19. Amount Incurred for Provision of Health Care Services	\$142.81

2013 Eureka Experience by State**Total Group Medical**

	NY
Direct Premium (in \$000s)	\$342,193
Direct Claims (in \$000s)	\$274,439
Direct Loss Ratio	80.2%
Member Months	1,921,757
Earned Premium - PMPM	\$178.06
Incurred Claims - PMPM	\$142.81

4.14 Correspondence

The memos and emails on the following pages provide some information about AHA's activities. Some of the correspondence relates to a potential acquisition of a closed block of long term care business, while other correspondence relates to Eureka. There is also correspondence describing some of Eureka's health care reform activities.

4.14.1 Memorandum -Bigger Actuarial Consulting- LTC Acquisition

Date: April 30, 2013
Subject: LTC Acquisition
To: B. G. Bucks, CFO AHA
From: Joe Cool, FSA, MAAA

I have done a preliminary investigation of your acquisition target and have the following observations:

- This is a closed block of LTC business that is close to the same size as AHA's block of LTC.
- The block is administered using a home grown system and we need to make sure that it is compatible with the AHA system.
- Many of the products generate cash values.
- In addition to the purchase price, AHA will need to make sure that policy and claims reserves are adequate and that the assumptions underlying cash value calculations are reasonable.
- The current owner of the block has not filed for a rate increase since the inception of the product.

Please let me know how you would like to proceed.

4.14.2 AHA Internal Memorandum - Confidential- Eureka Acquisition

Date: May 15, 2013
Subject: Eureka Acquisition
To: B. G. Bucks, CFO AHA
From: G. O. Getter, MBA, Project Manager

I have been working with our consultant and broker on this project and I believe it is an important and exciting opportunity for our organization. Our consultant's actuaries and financial folks asked that I pass along several minor details that they have found while digging around in the publically available data and financials. They say they need to look at these areas more closely during due diligence.

- They think the medical loss ratio is low.
- Broker fees and administrative costs are a bit high.
- Low surplus backed by illiquid assets.

None of these items are insurmountable, especially considering our financial strength and marketing expertise. As a result, I do not see any deal breakers here.

Again, I cannot stress enough the fact that this is an important and exciting opportunity.

4.14.3 AHA Internal Memorandum - Confidential- Pension Plan Funding

Date: September 30, 2013
Subject: Pension Plan Funding
To: B. G. Bucks, CFO AHA
From: I. M. Caring, VP HR

As you know, AHA sponsors a company-paid final-average-earnings defined benefit pension plan for its employees, whereas Eureka does not sponsor any pension or savings plans for its employees.

Historically, assets in the AHA Salaried Pension Plan fund have been invested in the same manner as assets in the SLIC Salaried Pension Plan fund.

Reports from the AHA Salaried Pension Plan's actuary indicate that, over the past five years:

- (a) Unfunded actuarial liabilities have been somewhat volatile, ranging from approximately \$10.7 million to \$60.8 million (the most recent actuarial report indicated unfunded actuarial liabilities of \$23.7 million. Unfunded actuarial liabilities must be amortised, in accordance with government regulations, by cash contributions.
- (b) Pension expense, which is reported on the company's financial statements, has also been somewhat volatile, ranging from \$15.5 million to \$30.0 million. Pension Expense for the most recent fiscal year was \$28.3 million.

As mentioned above, Eureka does not sponsor any pension or savings plans for its employees. At this point, we have not had any discussions about how to deal with Eureka employees, should AHA decide to acquire Eureka.

4.14.4 AHA E-Mail- Underwriting Procedural Changes

Date: June 30, 2013
Subject: Underwriting Procedural Changes
To: B. G. Bucks, CFO AHA
From: Rick Averse, U/W Manager

As you know, the Underwriting staff is stretched pretty thin due to our involvement in new initiatives and the hold on hiring. As a result, we have come up with some ways to try to keep things moving without increasing our risk.

- The actuarial department will give us trend assumptions and benefit relativities. We will not accept this data from other sources. We are seeing a lot of new benefit designs so the actuaries will be doing more for us than in the past. Also, I have not spoken with them about this since I wanted your opinion and support first.
- We will use discretion on rating cases.
- During busy time, we will have marketing do field underwriting on some of our simpler cases. The marketing staff is very enthusiastic about this idea.

Please let me as soon as you can if we can move ahead. Thanks.

4.14.5 AHA E-Mail- New Claims Administration Update

Date: September 30, 2013

Subject: New Claims Administration System Update

To: B. G. Bucks, CFO AHA; Ace Ventura, FSA, AHA Valuation Actuary; Sal Bidness, AHA Chief Marketing Officer

From: Bob Smith, AHA VP Operations

Installation of the new claims system is going as well as can be expected. We have gotten a bit behind because some of the IT folks have been reassigned and our vendor found a software problem that will take a couple of weeks to fix.

I just wanted to remind all of you that the last time we performed maintenance on our system we were unable to pay claims for two weeks. As a result, I have approved overtime for the claims processors so that we can bring down our claims inventories as much as possible before we move to the new system. There will probably still be some delay in payments but we think we have minimized the impact.

We had hoped that we would be able to run dual systems so as not to disrupt our operations, but that will not be feasible.

Let me know if you have any questions.

4.14.6 E-Mail – Missing Data for Calculation of Risk Adjusters

Date: December 30, 2012
Subject: Data Needed for Calculation of Risk Adjusters
To: B. G. Bucks, CFO AHA
From: I. M. Concerned, FSA, AHA Pricing Actuary

As you know, there are several difficult challenges that we face as we work toward full implementation of the Affordable Care Act (ACA) in 2014. One of the most difficult challenges over the next year is training our network providers to code claims correctly to maximize our risk adjustment score. Beginning in 2014, a new risk adjustment program will become effective for our individual and small group business as required by ACA. Our network providers are currently not coding claims in such a way as to maximize our risk score. This miscoding could cost the company millions of dollars.

We need to start working on this project immediately.

4.14.7 Eureka E-Mail – Rate Filing

Date: December 10, 2012

Subject: New York State Small Group Rate Filing

To: M. N. Bags, CFO Eureka

From: Manny Risk, FSA, Eureka Pricing Actuary

Yesterday, you asked me about the progress of our latest small group rate filing with the New York Department of Financial Services (NYDFS). It has been slow going. NYDFS implemented a new rate filing process starting in 2011. Much more information is now required for each rate filing. Also, five months of lead time are required before the proposed effective date (i.e., we have to file in July for a January 1 effective date). It's much more difficult to implement rate increases than it was a few years ago.

However, we do have a good working relationship with the reviewing actuary. I'll keep negotiating with him to get the filing approved.

4.14.8 Eureka E-Mail – Sales Conference

Date: December 10, 2012

Subject: Sales Meeting with Brokers

To: B.G. Cheese, President Eureka

From: B.G. Sales, VP Eureka Marketing Department

Thank you for making time in your busy schedule to speak at the upcoming sales meeting with our brokers. They have always been good business partners in both the large and small group markets and they are very excited to continue selling our product after full implementation of ACA.

The brokers are very excited about the prospect of selling our small group product on the Exchange in 2014. They think that with our rates published on the Exchange for all to see, they can sell as much as \$50M per year.

As always, they are also interested in our commission rates post ACA implementation. They have heard that there are new fees and assessments going into effect in 2014, some of them related to participation on the Exchange. Naturally, they are concerned about how this might affect their commissions.

Again, thank you for agreeing to speak at the conference. Most of our brokers have a long-standing relationship with us and are willing to work with us through implementation of ACA.

4.14.9 Eureka E-Mail – ACA Product and Network Changes

Date: December 31, 2012

Subject: Product and Network changes needed for Affordable Care Act implementation

To: B.G. Cheese, President Eureka

From: Netta Work, VP Eureka Product Development and Networks

There are two issues related to implementation of ACA that we need to discuss. They affect our networks and our products.

- 1) Coverage of pediatric dental benefits in small group plans – starting in 2014, our small group plans must provide pediatric dental coverage. Currently, Networks 'R Us doesn't contain any pediatric dentists. We need pediatric dentists in our plans starting in 2014.
- 2) Accurate diagnosis codes for risk adjustment calculations – the new risk adjustment calculation for small group plans starting in 2014 requires accurate diagnosis codes on every claim. In the past, the doctors in Networks 'R us haven't always entered these codes accurately.
- 3) Accreditation needed for participation on the small group Exchange – we have decided to participate on the small group Exchange starting in 2014. Unfortunately, plans must be accredited by either the Utilization Review Accreditation commission (URAC) or the National Committee for Quality Assurance (NCQA). We are not accredited by either organization. We should start that process as soon as possible. It may take 18 months to become accredited.

Please let me know when you are available to discuss.

4.15 AHA Salaried Pension Plan

The following pages contain financial and demographic information about the AHA Salaried Pension Plan, as well as information about the Statement of Funding Policies and Procedures for the Plan and the Statement of Investment Policies and Procedures for the Plan.

AHA, through its Board of Directors, has delegated responsibility for the day-to-day management of the Plan to the Vice-President, Human Resources and the Chief Financial Officer. The CFO's focus is on financial reporting and cash contribution requirements, the VP HR is largely responsible for all other activities.

4.15.1 Pension Plan - Benefit Provisions and Financial Information

The information on the following pages enumerates the current provisions of the Pension Plan and provides certain historical financial information. Historical financial information is not available prior to January 1, 2009.

AHA Salaried Pension Plan

Eligibility	Immediate
Vesting	100% after 5 years of plan membership
Normal Retirement Age	65
Early Retirement Age	55 with 5 years of plan membership
Best Average Earnings	Average earnings during 60 consecutive months of highest earnings
Earnings	Base Pay, excluding overtime and bonuses
Normal Retirement Benefit	1% of best average earnings times service years, subject to maximum
Accrued Benefit	Benefit calculated as under the normal retirement benefit formula using best average earnings and service as the valuation date
Early Retirement Benefit	Accrued benefit reduced on an actuarial equivalent basis for all members
Form of Benefit	Single life annuity
Optional Forms of Benefit	None
Indexing	None
Termination Benefit	(1) Lump sum value equal to actuarial present value of accrued pension payable at age 65; or (2) Deferred pension
Pre-Retirement Death Benefit	Lump sum value equal to actuarial present value of accrued pension payable at age 65 to named beneficiary
Disability Benefit	Accrual of service while on long term disability and immediate pension without a reduction upon permanent and total disability

AHA Salaried Pension Plan
Historical Actuarial Valuation Results

2009 2010 2011 2012 2013

Participant Summary - January 1

<i>Active Participants</i>					
(a) count	3,759	4,197	5,017	4,826	5,027
(b) average age	37.8	37.9	39.2	40.3	40.6
(c) average service	7.5	6.9	6	6	5.9
(d) average future working lifetime	20	20	20	20	20
(e) average plan earnings (prior year)	61,800	63,400	72,900	75,000	80,500
<i>Deferred Vested Participants</i>					
(a) count	-	-	-	-	-
<i>Pensioners (incl beneficiaries)</i>					
(a) count	237	251	262	277	315
(b) average age	76.8	76.8	74.2	74.5	74.8
(c) average annual benefit	15,400	15,500	16,100	16,000	16,200

Plan Assets (numbers in \$000's) *

<i>Change in Plan Assets during Prior Year:</i>					
Market Value of Assets at January 1 of prior year	-	96,024	110,852	92,799	133,829
Employer Contributions during prior year	-	12,408	16,706	31,980	26,461
Benefit Payments during prior year	-	(4,550)	(5,791)	(7,218)	(5,532)
Expenses during prior year	-	-	-	-	-
Investment return during prior year	-	6,969	(28,969)	16,269	14,531
Market Value of Assets at January 1 of current year	96,024	110,852	92,799	133,829	169,289
Rate of return during prior year	0%	7%	-25%	15%	10.1%
<i>Average Portfolio Mix During Prior Year:</i>					
(a) Domestic Large Cap Equities	0%	40%	39%	33%	36%
(b) Domestic Small Cap Equities	0%	20%	20%	15%	16%
(c) Domestic Fixed Income	0%	30%	30%	42%	39%
(d) International Equities	0%	4%	4%	5%	4%
(e) Real Estate	0%	4%	4%	2%	3%
(f) Cash	0%	2%	2%	3%	2%
(g) Total	0%	100%	100%	100%	100%
<i>Asset Class Returns during Prior Year:</i>					
(a) Domestic Large Cap Equities	0%	5%	-37%	26%	15%
(b) Domestic Small Cap Equities	0%	9%	-45%	28%	5%
(c) Domestic Fixed Income	0%	7%	5%	6%	7%
(d) International Equities	0%	16%	-6%	-17%	13%
(e) Real Estate	0%	6%	-63%	51%	29%
(f) Cash	0%	5%	2%	0%	0%

* numbers may not add due to rounding

AHA Salaried Pension Plan
Historical Actuarial Valuation Results

2009 2010 2011 2012 2013

Actuarial Valuation - January 1 (numbers in \$000's) *

1. Actuarial Accrued Liability:					
(a) Active participants	76,035	92,741	114,322	121,670	144,470
(b) Deferred vested participants	-	-	-	-	-
(c) Pensioners	30,658	33,458	39,229	41,218	48,479
(d) Total	106,694	126,200	153,551	162,888	192,949
2. Actuarial Value of Assets					
	96,024	110,852	92,799	133,829	169,289
3. Unfunded Actuarial Accrued Liability: (1d)-(2)					
	10,669	15,347	60,753	29,059	23,660
4. Normal Cost (beg. Of year)					
	10,138	13,441	19,054	20,278	24,486
5. Change in Unfunded AAL during prior year:					
(a) Unfunded AAL at prior valuation date	-	10,669	15,347	60,753	29,059
(b) Adjustment for Interest	-	720	998	3,949	1,889
(c) Normal Cost w/interest less contributions	-	(2,005)	(2,935)	(12,727)	(5,725)
(d) (Gain)/Loss on investment	-	(223)	36,529	(9,432)	(5,152)
(e) (Gain)/Loss on salary increases less than expected	-	(908)	10,432	(1,310)	4,153
(f) (Gain)/Loss on assumption changes	-	9,875	0	7,656	1,697
(g) (Gain)/Loss on all other factors	-	(2,782)	381	(19,829)	(2,261)
(h) Unfunded AAL at current valuation date	10,669	15,347	60,753	29,059	23,660
6. Actuarial Basis					
(a) Interest	6.75%	6.50%	6.50%	6.50%	6.00%
(b) Salary scale	3.75%	4.00%	4.00%	4.00%	3.50%
(c) Consumer Price Index	3.00%	3.00%	3.00%	3.00%	2.50%
(d) Mortality	UP 1994 AA15	UP 1994 AA15	UP 1994 AA15	1994 Uninsured Pensioner Mortality - Generational	1994 Uninsured Pensioner Mortality - Generational
(e) Turnover			None		
(f) Retirement age			Age 65		
(g) Proportion married and age difference			Not Applicable		
(h) Expenses			Assume all expenses paid by company		
(i) Asset Valuation Method			Market value of assets		
(j) Actuarial Cost Method			Projected unit credit		

* numbers may not add due to rounding

AHA Salaried Pension Plan
Historical Actuarial Valuation Results

	2009	2010	2011	2012	2013
Expense Valuation - January 1 (numbers in \$000's) *					
<i>1. Reconciliation of funded status at valuation date:</i>					
(a) Accrued Benefit Obligation (ABO)	(97,661)	(93,740)	(130,024)	(137,815)	(152,350)
(b) Projected Benefit Obligation (PBO)	(130,116)	(126,200)	(175,847)	(186,598)	(206,454)
(c) Fair Value of Assets	96,024	110,852	92,799	133,829	169,289
(d) Funded Status: (b) + (c)	(34,091)	(15,347)	(83,048)	(52,769)	(37,165)
(e) Unamortized net actuarial gain/loss	42,093	20,299	90,715	62,417	45,445
(f) Accrued benefit asset/(liability)	8,002	4,951	7,667	9,647	8,280
<i>2. Pension Expense:</i>					
(a) Service Cost (beg. of year)	13,048	13,441	22,545	23,994	26,635
(b) Interest Cost	8,453	8,888	11,687	12,470	13,244
(c) Expected return on assets	(7,497)	(8,723)	(7,888)	(10,822)	(12,583)
(d) Amortization of past service cost	-	-	-	-	-
(e) Amortization of net actuarial (gain)/loss	1,454	384	3,657	2,188	1,240
(f) Pension Expense for year	15,459	13,990	30,000	27,829	28,536
<i>3. Actuarial Basis and Supplemental Data</i>					
(a) Discount rate	6.00%	6.50%	6.00%	6.00%	5.75%
(b) Return on assets	7.50%	7.50%	7.50%	7.50%	7.00%
(c) Salary scale	3.75%	3.50%	3.50%	3.50%	3.00%
(d) Consumer Price Index	3.00%	3.00%	3.00%	2.50%	2.50%
(e) Mortality	UP 1994 AA15	UP 1994 AA15	UP 1994 AA15	1994 Uninsured Pensioner Mortality - Generational	1994 Uninsured Pensioner Mortality - Generational
(f) Turnover			None		
(g) Proportion married and age difference			Not Applicable		
(h) Retirement age			Age 65		
(i) Expenses			Assume all expenses paid by company		
(j) Asset Valuation Method			Market value of assets		
(k) Actuarial Cost Method			Projected unit credit		
(l) Employer contributions	12,408	16,706	31,980	26,461	26,461
(m) Benefit payments	(4,550)	(5,791)	(7,218)	(5,532)	(5,532)

* numbers may not add due to rounding

AHA Salaried Pension Plan
Reconciliation of Plan Participants (2009 - 2013)

	Active	Pensioners/ Beneficiaries	Total
1. Participants as of January 1, 2009	3,759	237	3,996
- New Entrants/Rehires	617	-	617
- Terminated Nonvested	(73)	-	(73)
- Terminated Vested (Lump Sum Cashout)	(87)	-	(87)
- Retirement	(17)	17	-
- Death w/ Beneficiary	(2)	-	(2)
- Deaths	-	(3)	(3)
- Net change	438	14	452
2. Participants as of January 1, 2010	4,197	251	4,448
- New Entrants/Rehires	1,385	-	1,385
- Terminated Nonvested	(269)	-	(269)
- Terminated Vested (Lump Sum Cashout)	(285)	-	(285)
- Retirement	(11)	11	-
- Death w/ Beneficiary	-	3	3
- Deaths	-	(3)	(3)
- Net change	820	11	831
3. Participants as of January 1, 2011	5,017	262	5,279
- New Entrants/Rehires	271	-	271
- Terminated Nonvested	(269)	-	(269)
- Terminated Vested (Lump Sum Cashout)	(163)	-	(163)
- Retirement	(26)	26	-
- Death w/ Beneficiary	(4)	3	(1)
- Deaths	-	(14)	(14)
- Net change	(191)	15	(176)
4. Participants as of January 1, 2012	4,826	277	5,103
- New Entrants/Rehires	459	-	459
- Terminated Nonvested	(122)	-	(122)
- Terminated Vested (Lump Sum Cashout)	(88)	-	(88)
- Retirement	(44)	44	-
- Death w/ Beneficiary	(4)	2	(2)
- Deaths	-	(8)	(8)
- Net change	201	38	239
5. Participants as of January 1, 2013	5,027	315	5,342

**AHA Salaried Pension Plan
Age/Svc/Earnings as of January
1, 2013**

		Service (Years)						
		< 5	5-10	10-15	15-20	>20	Totals	
Age (Years)	< 25	# Participants	220	-	-	-	-	220
		Average Salary	36,000	-	-	-	-	36,000
	25-35	# Participants	1,125	536	12	-	-	1,673
		Average Salary	55,900	73,500	74,700	-	-	61,700
	35-45	# Participants	598	584	308	34	5	1,529
		Average Salary	79,000	88,400	101,700	98,100	141,100	87,800
	45-55	# Participants	408	263	86	66	68	891
		Average Salary	91,800	101,800	100,200	133,100	131,100	101,600
	55-65	# Participants	320	172	84	58	-	634
		Average Salary	95,100	105,000	85,100	96,000	-	96,500
	> 65	# Participants	72	8	-	-	-	80
		Average Salary	96,000	105,200	-	-	-	96,900
	Totals	# Participants	2,743	1,563	490	158	73	5,027
		Average Salary	70,300	87,500	97,900	111,900	131,800	80,500
		Avg Age	40.6					
		Avg Svc	5.9					
		Avg Salary	80,500					

AHA Pension Plan			
Interest Sensitivity and Cash Flows			
	Actives	Pensioners	Total
Rate	Liability	Liability	Liability
6.00%	144,470,323	48,478,500	192,948,823
5.50%	161,562,552	50,274,659	211,837,211
6.50%	129,537,476	46,794,590	176,332,066
Duration (5.5%)	22.2	7.2	18.4
Convexity (5.5%)	597.9	92.6	470.9
Five Years	Actives	Pensioners	Total
Ending Dec 31	Cash Flow	Cash Flow	Cash Flow
2017	3,664,621	23,878,862	27,543,483
2022	10,487,888	20,551,640	31,039,528
2027	36,101,345	16,216,539	52,317,885
2032	85,602,936	11,052,980	96,655,916
2037	112,201,991	6,132,117	118,334,109
2042	111,018,528	2,575,053	113,593,581
2047	101,999,865	770,824	102,770,689
2052	85,533,058	149,502	85,682,561
2057	61,302,312	17,194	61,319,506
2062	37,699,639	1,091	37,700,730
2067	20,053,305	36	20,053,341
2072	9,241,645	1	9,241,646
2077	3,536,911	0	3,536,911
2082	1,000,803	0	1,000,803
2087	164,549	0	164,549
2092	12,311	0	12,311

4.15.2 Statement of Funding Policies and Procedures - AHA Health

The Company has prepared a Statement of Funding Policies and Procedures (“Statement”) to document the governance of the Plan. The Company has also prepared a Statement of Investment Policies and Procedures. Extracts of the Statement are provided below followed by a summary of the Statement contents.

4.15.2.1 Allocation of Responsibilities

The Company has delegated the management of Plan funding as follows:

The Company, acting through Management, will:

- Establish, review and amend, as required, the Statement of Funding Policies and Procedures;
- Select the Pension Consultant and the Actuary;
- Review funding reports prepared by the Actuary regarding the funding of the Plan; and
- Be responsible for the assumption or delegation of any responsibilities not specifically mentioned.

The Pension Consultant and Actuary will:

- Assist, as required, the Company in the preparation of the Statement of Funding Policies and Procedures;
- Present to the Company, as required by the Statement of Funding Policies and Procedures, reviews and reports regarding the funding of the Plan; and
- Comment to the Company on any changes in plan design, contribution flow or pension legislation that may affect the funding of the Plan.

4.15.2.2 Funding Policy Principles

The Company is the primary risk bearer under the Plan. As a result, the funding objective of the Company is the accumulation of assets which will secure the Plan’s benefits in respect of service already rendered. The accumulation of assets should be reasonable, without significant volatility or further recourse to the Company’s assets.

The Company believes management of the Plan on a going concern basis is the most suitable means to achieve these objectives.

4.15.2.3 Management of Risks

The Company has adopted the following policies to mitigate their risks:

- Going-concern valuations are to be prepared using best estimate assumptions adjusted to include margins for adverse deviation. The Company will consult with the Pension Consultant and Actuary regarding the adoption of margins for adverse deviation.
- Emerging experience will differ from the assumptions made for going-concern purposes. The Pension Consultant and Actuary will monitor emerging experience and recommend

revisions to the going-concern assumptions as appropriate.

- Plan provisions are managed to mitigate, to the extent possible, demographic and economic risks. Benefit improvements under the Plan will be made with due regard to the Plan's funded status.
- Investment activity will be carried out with due regard to the liability structure of the Fund, to the cash flow requirements of the Fund, and to the risks and rewards inherent in the defined benefit investments. The Statement of Investment Policies and Procedures documents the Company's policies regarding investment risk.

4.15.2.4 Funding Target

The funding target for the Plan is to have a funded ratio (assets divided by liabilities) of 100% on a going-concern basis.

4.15.2.5 Funding Risks

- The Company bears the following funding risks:
- The Plan's demographic experience may differ from best-estimate assumptions.
- The Plan's economic experience may differ from best-estimate assumptions. In addition to investment risks, the Company bears the risks associated with providing a final average earnings benefit.
- The Plan's liabilities are debt-like in nature and have a long term to maturity. As a result of the current investment strategy and nature of the Plan's liabilities, there is the risk of an asset-liability mismatch.

* * * * *

The contents of the Statement follow:

- PURPOSE
- BACKGROUND, PLAN TYPE AND LIABILITIES
- ALLOCATION OF RESPONSIBILITIES
- FUNDING POLICY PRINCIPLES
- FUNDING RISKS
- MANAGEMENT OF RISKS
- FUNDING TARGET
- ELIMINATION OF DEFICITS
- UTILIZATION OF EXCESSES
- FREQUENCY OF VALUATIONS
- COMMUNICATION
- APPENDIX 1 – Summary of Roles
- APPENDIX 2 – Summary of Liabilities, Assets and Membership Data
- APPENDIX 3 – History of SFP&P Review and Amendments

4.15.3 Statement of Investment Policies and Procedures- Excerpts

Following are excerpts from the Statement of Investment Policies and Procedures for the AHA Health Insurance Company's Pension Plan.

4.15.3.1 Investment Risk

- Investment risk is borne by the Company
- Going-concern surplus, subject to any legislative restrictions, can be applied against the Company's Normal Actuarial Cost

4.15.3.2 Allocation of Responsibilities

The Company, acting through Management, will:

- Establish, review and amend, as required, the Statement of Investment Policies and Procedures;
- Select one or more fund managers ("Fund Managers"), the Pension Consultant and the Actuary;
- Select the Custodian to hold pension fund assets;
- Review the performance of the Fund and the Fund Managers at least annually; and
- Be responsible for the assumption or delegation of any responsibilities not specifically mentioned.

The Fund Managers will:

- Manage the asset mix and select securities within each Investment Fund Option, subject to applicable legislation and the constraints set out in this Statement.

The Pension Consultant and Actuary will:

- Assist, as required, the Company in the preparation of the Statement of Investment Policies and Procedures; and
- Comment to the Company on any changes in plan design or contribution flow that may affect the investment of assets.

The Custodian will:

- Fulfil the regular duties required by law of the Custodian in accordance with the Plan;
- Participate in annual reviews of the Statement of Investment Policies and Procedures;
- Present to the Company, at least annually, reviews and reports of investment performance of the Fund Managers;
- Provide the Company with monthly updates on the performance of the Fund Managers;
- Provide the Company with information, on an ongoing basis, about changes at the Fund Managers that could affect investment performance;
- Present to the Company, at least annually, reviews and reports of all investment Fund assets and transactions for the period;

- Monitor actual investments as appropriate to ensure compliance with the Pension Benefits Act; and
- Rebalance the Plan portfolios as requested by the Company.

4.15.3.3 Investment Objectives

- to preserve the capital;
- to provide sufficient funds to meet payments as they become due; and
- to maintain sufficient assets over actuarial requirements to meet unforeseen liabilities.

4.15.3.4 Rate of Return Objectives

- to achieve an average annual rate of return, net of investment expenses, of at least the funding valuation rate of return (currently 6.0%) per year, measured over moving, four-year periods;
- to achieve top third performance, relative to the peer group of fund managers, measured over moving, four-year periods;
- to exceed the passive benchmark for the Pension Fund by 1.00% per annum, measured on a four-year moving average basis; and
- to achieve at least the increase in the Consumer Price Index plus 3%, on a four-year moving average basis.

4.15.3.5 Asset Allocation Guidelines

The following normal policy allocation, and associated range for strategic deviation at any time, has been adopted by the Company:

Percentages of Fund at Market Value	Normal	Minimum	Maximum
Domestic Equities	40%	30%	50%
International Equities	20%	15%	25%
Domestic Fixed Income (duration of 5)	30%	15%	45%
Real Estate (Private)	4%	0%	8%
Private Equity	4%	0%	8%
Cash	2%	0%	4%

Within the ranges noted above, the Fund Managers may actively vary the asset mix in an effort to achieve the investment objectives of the Company.

4.15.3.6 Passive Management Objectives

The rate of return expected to be achieved through passive management of the assets in the Plan Fund will be based on the normal allocation of assets. The passive return shall be set equal to the sum of:

- 45.0% of the S&P 500 Index return for the year;
- 20.0% of the MSCI EAFE Index return for the year; and
- 35.0% of the Barclays Capital Aggregate Bond Index return for the year.

4.15.3.7 Rebalancing

The Company will direct the re-balancing of the assets in the component pooled funds, when it deems rebalancing to be appropriate.

4.15.3.8 Related Party Transactions

A Related Party is:

- (a) the Company, acting as Plan Administrator,
- (b) an officer, director or employee of the Company,
- (c) the funding agent or person responsible for investing the assets of the Plan, or any officer, director or employee thereof,
- (d) an association or trade union representing employees of the Company, or an officer or employee thereof,
- (e) an employer who participates in the Plan, or an employee, officer or director thereof,
- (f) the Plan Participant,
- (g) a person (including spouse or child) directly or indirectly holding more than 10% of the voting shares of the Company,
- (h) the spouse or child of (a) to (g),
- (i) an affiliate of the Company,
- (j) a corporation directly or indirectly controlled by a person in (a) to (h),
- (k) an entity in which a person in (a), (b), (e) or (g), has a substantial investment (where “substantial investment” means more than 25% of the ownership interests in an unincorporated entity, more than 10% of the voting rights of a corporation or more than 25% of the shareholders’ equity in a corporation) or,
- (l) an entity with substantial investment in the Company.

Related Parties excludes government or a financial institution holding Plan assets if not the administrator.

The Company, acting as Plan Administrator, shall not, directly or indirectly:

- lend the assets of the Plan to a Related Party or invest those assets in the securities of a Related Party; or
- enter into a transaction with a Related Party on behalf of the Plan, subject to a minimum limit of \$50,000 per transaction and a cumulative limit of \$250,000 in a Plan's fiscal year.

Related Party transactions are acceptable provided they are necessary for the operation of the Plan and are purchased on terms and conditions that are at least as favourable for the Plan as are otherwise available.

4.15.4 Appendix: Economic Data

The investment consultant for AHA's DB Plan has provided the following information:

AHA DB Plan	Market Value (\$000)	Duration	KRD 1 Yr	KRD 3 Yr	KRD 5 yr	KRD 10 Yr	KRD 20 Yr	KRD 30 Yr
Plan Actives	144,470	22.2	0.01	0.04	0.15	2.00	7.30	12.70
Plan Pensioners	48,479	7.2	0.20	0.55	1.40	2.75	1.90	0.40
Plan Total Liabilities	192,949	18.4	0.05	0.15	0.45	2.20	5.95	9.60

	Equity Indices		Barclay's Capital U.S. Bond Indices	
	S&P 500	MSCI EAFE	Aggregate	Aggregate 10+ Year Maturity
Expected Returns	6.50%	8.00%	2.30%	3.00%
Annualized Volatility	15.05%	16.88%	3.73%	10.02%
Duration	0.00	0.00	5.01	14.19
Skewness	-0.67	-0.77	-0.41	0.03
Kurtosis	4.22	4.51	4.82	5.56

Correlations	Equity Indices		Barclay's Capital U.S. Bond Indices	
	S&P 500	MSCI EAFE	Aggregate	Aggregate 10+ Year Maturity
S&P 500	1.00			
MSCI EAFE	0.79	1.00		
Aggregate	0.06	0.04	1.00	
Aggregate 10+ Year Maturity	-0.10	-0.05	0.90	1.00

AHA DB Plan:

Fixed Income Portfolio Managers	Current % Allocation	Expected Tracking Error	TE Volatility
Manager E	50%	1.50%	3%
Manager F	50%	2.00%	4%
Benchmark	0%	0%	0%
Equity Portfolio Managers	Current % Allocation	Expected Tracking Error	TE Volatility
Manager G	50%	4.00%	5%
Manager H	50%	3.50%	7%
Benchmark	0%	0%	0%

5 Pryde Property & Casualty

5.1 Overview

Pryde is an Omaha, Nebraska-based U.S. writer with commercial and personal lines of business, as follow:

- PERSONAL
 - Personal Auto
 - Personal Property
- COMMERCIAL
 - Commercial Multiple Peril
 - Workers Compensation

The split of premium between commercial and personal lines is about 70%/30% respectively. Pryde is licensed in all 50 states and its products are sold primarily through a sales force led by sales directors responsible for selecting the product, managing the agency delivery system and serving the business in their territory. The company has approximately \$3.5 billion in assets and \$800 million in Capital and Surplus.

5.2 Employee Benefits

Pryde provides basic life, health and disability benefits to its employees while they are employed by the company. These benefits do not continue after employees leave the company.

Pryde does not sponsor any pension or savings plans for its employees.

5.3 Production

Business is produced primarily through exclusive career agents on a national basis, with some additional business coming through independent agents and general agents. Pryde's strategy is centered on serving a broad range of customers in both personal and commercial lines of business. Customer service is rated highly as evidenced in consistently high customer retention levels.

5.4 Major Lines of Business

The major lines of business are commercial multiple peril ("CMP") and workers compensation ("WC") on the commercial side and personal automobile ("PA") and personal property ("PP") on the personal side.

Line	2013 Written Premium Direct	2013 Written Premium Net	2013 % of NPW	2013 Loss & LAE Ratio	12/31/13 Loss & LAE Reserves
Commercial MultiPeril	314,383	275,085	31.9	96.0	449,912
Workers Compensation	350,436	330,811	38.3	102.5	1,349,014
Personal Automobile	141,735	134,648	15.6	86.0	121,183
Personal Property	203,914	122,348	14.2	96.1	66,894
Totals	1,010,467	862,893	100.0	96.7	1,987,002

5.5 Regional Spread

Pryde's direct business is geographically spread throughout the United States with its largest state (California) representing 17% of total premium volume. The next largest states include Texas, (6.0%); Georgia (5.5 %); Florida(5.4%); Mississippi(5.3%); 46 other jurisdictions, (61.3%).

5.6 Exited Markets

Beginning in 2008, Pryde's previous management team followed a growth and acquisition strategy and decentralization of its personal lines operations, which led to rate inadequacy and adverse loss reserve development.

Pryde experimented with production sources and customer segments with which management was unfamiliar. The new markets contained customer groups who were much more price-conscious and claims-conscious than Pryde's traditional customers. Pryde subsequently exited these segments because of higher than expected growth and poor operating results.

5.7 Financial Statements

Multi-year financial statements are provided for each of the product lines and for Pryde in total. 2012 and 2013 are actual results; 2014 – 2016 are projections.

PERSONAL PROPERTY	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Underwriting Income					
Premiums earned	172,052	137,642	124,183	127,909	131,746
Losses and loss adjustment expenses incurred	139,362	132,205	96,863	99,769	102,762
Expenses	50,469	40,375	37,806	38,940	40,108
Net Underwriting Gain (loss)	(17,779)	(34,938)	(10,485)	(10,800)	(11,124)
Investment Income	9,704	8,916	7,607	6,883	7,090
Income Before Income Tax	(8,075)	(26,022)	(2,878)	(3,917)	(4,034)
Federal Income Tax	(2,019)	(6,506)	(719)	(979)	(1,009)
Net Income	(6,056)	(19,517)	(2,158)	(2,938)	(3,026)

Statutory Balance Sheet (000s)

Total Assets	366,710	309,725	280,232	288,639	297,299
Losses and loss adjustment expenses	62,713	66,894	48,432	49,884	51,381
Unearned Premium	76,468	61,174	63,009	64,900	66,847
Other Liabilities	43,434	34,380	35,915	36,993	38,103
Total Liabilities	182,614	162,448	147,356	151,777	156,330
Surplus	184,096	147,277	132,876	136,863	140,968
Total Liabilities and Surplus	366,710	309,725	280,232	288,639	297,299
Additional Balance Sheet Information					
Surplus Transfer from/(to) Corporate	12,117	(17,302)	(12,242)	6,924	7,132

Economic Capital Balance Sheet (000s)

Market Value of Assets	398,839	337,337	306,051	316,113	326,503
Economic Reserve	193,389	172,682	157,229	162,553	168,055
Required Economic Capital	205,451	164,655	148,821	153,560	158,449
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	398,839	337,337	306,051	316,113	326,503

**COMMERCIAL MULTIPLE PERIL
Statutory Income Statement
(000s)**

	2012	2013	2014	2015	2016
Underwriting Income					
Premiums earned	263,307	270,950	278,524	285,487	292,624
Losses and loss adjustment expenses incurred	213,279	260,112	208,893	214,115	219,468
Expenses	76,359	78,575	77,987	79,936	81,935
Net Underwriting Gain (loss)	(26,331)	(67,737)	(8,356)	(8,565)	(8,779)
Investment Income	21,164	21,366	23,548	23,121	23,699
Income Before Income Tax	(5,167)	(46,372)	15,193	14,556	14,920
Federal Income Tax	(1,292)	(11,593)	3,798	3,639	3,730
Net Income	(3,875)	(34,779)	11,394	10,917	11,190

Statutory Balance Sheet (000s)

Total Assets	878,771	958,734	941,325	964,858	988,979
Losses and loss adjustment expenses	383,901	449,912	417,786	428,230	438,936
Unearned Premium	133,407	137,543	140,981	144,506	148,118
Other Liabilities	75,775	77,299	80,359	82,368	84,427
Total Liabilities	593,084	664,754	639,126	655,105	671,482
Surplus	285,688	293,980	302,198	309,753	317,497
Total Liabilities and Surplus	878,771	958,734	941,325	964,858	988,979

Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate	10,849	43,071	(3,176)	(3,362)	(3,446)
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Economic Capital Balance Sheet (000s)

Market Value of Assets	925,820	1,010,885	997,520	1,025,698	1,054,661
Economic Reserve	598,421	673,395	649,992	668,862	688,269
Required Economic Capital	327,398	337,490	347,528	356,836	366,392
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	925,820	1,010,885	997,520	1,025,698	1,054,661

WORKERS COMPENSATION	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Underwriting Income					
Premiums earned	316,339	325,064	334,946	343,320	351,903
Losses and loss adjustment expenses incurred	262,561	333,190	264,608	271,223	278,003
Expenses	87,940	90,642	92,976	95,301	97,683
Net Underwriting Gain (loss)	(34,162)	(98,769)	(22,637)	(23,203)	(23,783)
Investment Income	43,959	47,458	47,755	48,948	50,172
Income Before Income Tax	9,797	(51,311)	25,117	25,745	26,389
Federal Income Tax	2,449	(12,828)	6,279	6,436	6,597
Net Income	7,348	(38,483)	18,838	19,309	19,792

Statutory Balance Sheet (000s)

Total Assets	1,767,189	1,951,944	1,944,260	1,992,867	2,042,688
Losses and loss adjustment expenses	1,181,526	1,349,014	1,323,038	1,356,114	1,390,017
Unearned Premium	159,658	165,406	169,541	173,779	178,124
Other Liabilities	90,686	92,958	96,638	99,054	101,531
Total Liabilities	1,431,869	1,607,377	1,589,217	1,628,947	1,669,671
Surplus	335,319	344,567	355,043	363,919	373,017
Total Liabilities and Surplus	1,767,189	1,951,944	1,944,260	1,992,867	2,042,688

Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate	174	47,732	(8,362)	(10,433)	(10,694)
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Economic Capital Balance Sheet (000s)

Market Value of Assets	1,776,287	1,970,997	1,969,417	2,025,896	2,083,968
Economic Reserve	1,459,075	1,644,347	1,632,126	1,679,445	1,728,110
Required Economic Capital	317,212	326,650	337,291	346,451	355,858
Free Surplus	-	-	-	-	-
Total Liabilities and Surplus	1,776,287	1,970,997	1,969,417	2,025,896	2,083,968

CORPORATE	2012	2013	2014	2015	2016
Statutory Income Statement (000s)					
Underwriting Income					
Premiums earned	-	-	-	-	-
Losses and loss adjustment expenses incurred	-	-	-	-	-
Expenses	833	685	643	661	678
Net Underwriting Gain (loss)	(833)	(685)	(643)	(661)	(678)
Investment Income	(2,000)	(1,637)	(2,904)	(2,536)	(2,589)
Income Before Income Tax	(2,833)	(2,322)	(3,547)	(3,196)	(3,267)
Federal Income Tax	(708)	(581)	(887)	(799)	(817)
Net Income	(2,125)	(1,742)	(2,661)	(2,397)	(2,450)
 Statutory Balance Sheet (000s)					
Total Assets	(67,334)	(118,231)	(103,241)	(105,406)	(107,687)
Losses and loss adjustment expenses	-	-	-	-	-
Unearned Premium	-	-	-	-	-
Other Liabilities	-	-	-	-	-
Total Liabilities	-	-	-	-	-
Surplus	(67,334)	(118,231)	(103,241)	(105,406)	(107,687)
Total Liabilities and Surplus	(67,334)	(118,231)	(103,241)	(105,406)	(107,687)
 Additional Balance Sheet Information					
Transfer from/(to) Lines	15,206	(49,156)	17,651	232	170
 Economic Capital Balance Sheet (000s)					
Market Value of Assets	25,998	(23,631)	(7,102)	(19,313)	(32,226)
Economic Reserve	-	-	-	-	-
Required Economic Capital	(4,444)	(8,040)	(7,227)	(7,589)	(7,969)
Free Surplus	30,442	(15,591)	125	(11,724)	(24,257)
Total Liabilities and Surplus	25,998	(23,631)	(7,102)	(19,313)	(32,226)

TOTAL 2012 2013 2014 2015 2016

Statutory Income Statement (000s)

Underwriting Income

Premiums earned	941,046	885,134	874,321	897,483	921,264
Losses and loss adjustment expenses incurred	766,681	855,778	676,964	694,906	713,326

Expenses 274,508 257,216 251,018 257,692 264,544

Net Underwriting Gain (loss) (100,143) (227,861) (53,661) (55,114) (56,606)

Investment Income 85,805 86,942 85,055 85,302 87,524

Income Before Income Tax (14,338) (140,919) 31,394 30,189 30,918

Federal Income Tax (3,585) (35,230) 7,848 7,547 7,729

Net Income (10,754) (105,689) 23,545 22,641 23,188

Statutory Balance Sheet (000s)

Total Assets 3,391,189 3,470,568 3,424,362 3,513,597 3,605,098

Losses and loss adjustment expenses 1,764,471 1,987,002 1,895,856 1,944,028 1,993,427

Unearned Premium 453,687 431,446 442,875 454,609 466,655

Other Liabilities 257,694 242,473 252,439 259,127 265,994

Total Liabilities 2,475,853 2,660,922 2,591,170 2,657,763 2,726,076

Surplus 915,336 809,647 833,192 855,834 879,022

Total Liabilities and Surplus 3,391,189 3,470,568 3,424,362 3,513,597 3,605,098

Additional Balance Sheet Information

Surplus Transfer from/(to) Corporate - - - - -

Economic Capital Balance Sheet (000s)

Market Value of Assets 3,564,140 3,657,979 3,622,975 3,717,385 3,814,193

Economic Reserve 2,513,000 2,712,467 2,651,585 2,730,353 2,811,426

Required Economic Capital 1,020,698 961,104 971,266 998,756 1,027,024

Free Surplus 30,442 (15,591) 125 (11,724) (24,257)

Total Liabilities and Surplus 3,564,140 3,657,979 3,622,975 3,717,385 3,814,193

5.8 Underwriting Results

Year	Net UW Income (\$000)	Expense Ratios			Total Exp.	Comb Ratio
		Loss& LAE	Net Comm	Other Exp.		
2009	-33,403	76.5	10.6	16.2	26.9	103.4
2010	-60,089	78.2	10.5	17.2	27.7	105.9
2011	-92,222	79.9	10.4	18.1	28.4	108.3
2012	-100,143	81.5	10.2	20.0	30.2	111.7
2013	-227,861	96.7	10.2	19.6	29.8	126.5
5-Yr Avg		82.5	10.4	18.2	28.6	111.2

Pryde has been challenged by adverse loss reserve development in recent years. In 2013, the company experienced a natural catastrophe loss.

	Original Loss Reserves	Developed Through 2013	Developed to Orig (%)
2008	1,301,526	1,518,881	16.7%
2009	1,425,693	1,562,559	9.6%
2010	1,561,466	1,712,928	9.7%
2011	1,684,697	1,844,743	9.5%
2012	1,764,471	1,923,273	9.0%
2013	1,987,002	1,987,002	

After reviewing experience for the most recent years, Pryde determined that reserves needed to be strengthened in 2013 and the company may need to strengthen reserves further in future years.

5.9 Investment Income

Pryde has generally produced favorable investment yield from a predominantly fixed income portfolio that has outperformed industry composite averages. Invested assets are comprised primarily of a bond portfolio diversified among corporate, tax-exempts, and U.S. Government Obligations. The company's stated investment strategy is simple: preserve capital while maintaining the predictability of return on investment without incurring undue risk. Hence, the strategy focuses on fixed income rate investments held for long term investment. Affiliated investments relate to Pryde Services, a wholly owned entity that provides services for Pryde Property & Casualty.

<u>Asset Class</u>	<u>Assets (000s)</u>
Long-term Bonds	1,300,702
Preferred stock	118,246
Common stock	141,895
Cash & short-term invest	153,719
Other non-affil inv asset	437,509
Investments in affiliates	212,842
Total invested assets	2,364,913

<u>Asset Class</u>	<u>% of Total Bonds</u>	<u>Mkt Val to Stmt Val(%)</u>	<u>Avg Maturity (Yrs)</u>	<u>Class 1 - 2 (%)</u>	<u>Class 3 - 6 (%)</u>	<u>Struc. Secur. (%)</u>	<u>Struc. Secur. (% of PHS)</u>
Governments	22.3	1.8	4.7	100.0
States, terr & poss	28.8	1.0	7.1	100.0	...	71.1	37.2
Corporates	48.9	1.6	5.7	98.5	1.5	6.5	5.8
Total all bonds	100.0	1.5	5.9	99.2	0.8	23.6	43.0

5.10 Catastrophe Exposure

The group's primary catastrophe exposure stems from both hurricanes and earthquakes. However, these exposures are mitigated through excess of loss reinsurance, as well as catastrophe protection that has enabled the group to improve its net catastrophe leverage to a very manageable level. As a result, the group's estimated net probable maximum losses (PML) stemming from a combined 250-year hurricane and a 250-year earthquake depicted in a PML analysis represents approximately 5% of capital and surplus, which is significantly less than the 10% limit set by the Chief Actuary years ago.

Along with the rest of the industry, Pryde experienced moderate catastrophe losses in both its personal and commercial property lines in 2013.

5.11 Reinsurance

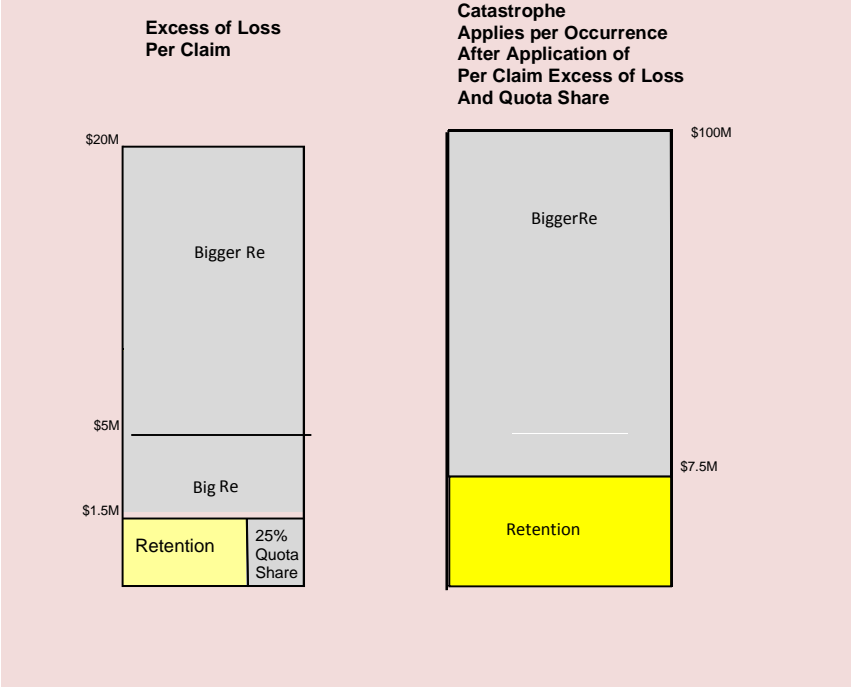
Pryde reinsures with high-quality reinsurers.

5.11.1 Property Risks

Pryde cedes 25% of the ground-up first \$1.5 million/claim via a quota-share reinsurance treaty with SHARE Re. In addition Pryde has a multi-line working layer excess-of loss reinsurance treaty with BIG Re, where Pryde cedes each \$3.5 million in excess of \$1.5 million per claim for property risks, subject to a \$7.5 million per occurrence aggregate limit. Protection is further supplemented with additional coverage provided by BIGGER Re:

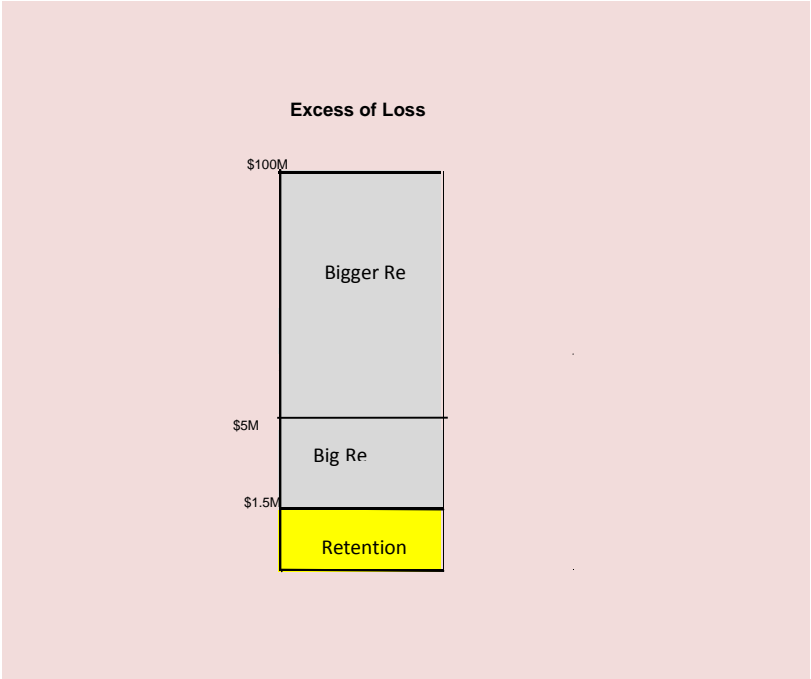
- Excess layer of \$15 million in excess of \$5 million per claim; and
- Property catastrophe cover for \$92.5 million in excess of \$7.5 million per Occurrence Aggregate Limit.

The diagram below depicts the coverage pictorially.



5.11.2 Casualty Risks

Working layer treaty reinsurance with Big Re includes one multi-line \$3.5 Million excess of \$1.5 Million for casualty risks and \$3.5 Million per occurrence. An additional excess of loss treaty with BIGGER Re covers losses in excess of \$5.0 Million, up to \$100 million.



5.12 Statutory Capital

Statutory capital is allocated to the LOBs as follows. Each reporting period the Financial Reporting Department calculates the required statutory capital for each of the four lines of business (LOB): Personal Auto, Personal Property, Commercial Multi-Peril, Commercial Workers Compensation. PRYDE currently targets an RBC of 350%, an A+ capital level. At the end of each reporting period, each LOB holds exactly its required capital which is achieved by the LOB transferring any excess statutory capital to the Corporate LOB or by receiving a statutory capital contribution from Corporate. Thus, Corporate invests statutory capital in the LOB and each period either receives returns or makes further investments in the LOB.

5.13 Total Available Capital

The proper assessment of an insurer's true financial strength requires appraisal of its total balance sheet on an integrated basis under a system that depends upon realistic values (economic values) and consistent treatment of both assets and liabilities, and that does not generate a hidden surplus or deficit. To convert the statutory capital figures to economic capital levels, adjustments are necessary. Statutory accounting principles deviate from economic valuations in several ways, including, but not limited to, the following:

- Acquisition Costs are not deferred
- Bonds in good standing are valued at amortized value--not market value
- Loss and loss adjustment expense reserves do not reflect the time value of money
- Carried statutory reserves do not reflect inherent reserve margins (e.g. carried reserves being redundant or deficient)

5.14 Rating Agency Review

A.M. Best's most recent rating for Pryde, determined in 2012, was an A-, reflecting the company's adequate capitalization and its nationally recognized position in its core business. Pryde's strong reputation and dedicated product and service capabilities have enabled it to sustain strong market penetration.

Partially offsetting these positive factors are the company's significant adverse reserve development on prior accident years, its dependence on reinsurance, and recent inconsistent operating results. A.M. Best remains concerned over the potential for additional adverse loss reserve development and its impact on near-term operating performance and overall capitalization.

Pryde's overall capitalization as measured by Best's Capital Adequacy Ratio (BCAR) is adequate for its A- rating.

5.15 Economic Capital Model

Pryde had retained Hawthorne Consulting in 2010 to aid the company in developing a "risk and capital" model that would aid management in gauging the adequacy of overall capitalization of

the company and in allocating resultant capital to target lines of business or niche business segments. Pryde wished to gauge the risk adjusted return on capital (RAROC) by segment to aid in its business planning for 2011 and beyond. In essence, Pryde's goal was to improve its ability to manage capital and return. Underlying this goal, Hawthorne advised on three underlying themes:

- Capital Productivity
- Capital Protection
- Capital Adequacy

Hawthorne's thought leadership focuses on the notion that there is a trade-off between having enough capital to minimize insurance company failures and having the minimum amount of capital so capital can be deployed. As such, Hawthorne recommended using the RAROC approach. In essence, this approach considers both how much Pryde is earning on the capital that is committed to the business and how much capital is needed to ensure that policyholders are paid in the event of a stress scenario. Hawthorne argues that RAROC addresses the aforementioned trade-off between capital productivity and capital adequacy. To set a target or requirement for the amount of capital that should be held by an insurance company or group requires a clear vision of the purposes for which capital is held. Effectively defined capital requirements serve several purposes, including, but not limited to:

- Providing funds so Pryde is able to honor its obligations during adverse contingent events.
- Motivating a company to avoid undesirable levels of risk
- Promoting a risk management culture to the extent that capital requirements are a function of actual economic risk

Economic capital should be what Pryde requires for ongoing operations and what it must hold in order to gain the necessary confidence of the marketplace, its policyholders, its investors, and its regulatory supervisors. The operations of Pryde, on the other hand, after the net effect of all the inherent risks, must yield a rate of return deemed reasonable by the providers of the insurer's capital.

Building on the work completed with Hawthorne and based on direction from the Lyon Corporate ERM Department, Pryde has developed an internal Economic Capital Model. The model targets a total economic capital level that is calibrated to an AA financial strength. Pryde defines the model economic capital required as being the capital required to protect Pryde's policyholders in order to meet all of their claims with a confidence level of 99.0 percent over a one-year time horizon. Diversification benefits are allocated back to the LOBs.

The Statutory and Economic Balance Sheets are independent of each other. The amount of assets assigned to a LOB is based on the required capital, either on an economic basis or a statutory basis. That is, the assets backing the liabilities on an economic basis are not the same as the assets allocated on a statutory basis and then valued on an economic basis.

Surplus in excess of 400% of RBC (which is 114% of the 350% target) is distributed to Lyon Corporation through a dividend annually at the end of the first quarter based on the year-end balance sheet. Surplus positions less than 300% of RBC (which is 86% of the 350% target) result in a capital contribution from Lyon Corporation or the issuance of surplus notes.

5.16 Appendix

- Consultant's Report - Executive Summary and Recommendations @9/30/10
- Consultant's Report - Background, Terminology, Considerations

5.16.1 Consultant's Report- Executive Summary 9/30/10

Pryde has asked Hawthorne to consult and help in developing a "risk and capital" model that would aid management in gauging the adequacy of overall capitalization of the company and in allocating capital to target line of business or niche business segments to aid in its business planning for 2011 and beyond.

In considering the trade-off between having enough capital to minimize insurance company failures and having the minimum amount of capital so capital can be deployed, Hawthorne recommends a risk adjusted return on required capital (RAROC) approach in measuring returns. This approach considers both how much Pryde is earning on the capital that is committed to the business and how much capital is needed to ensure that policyholders are paid in the event of a stress scenario.

Economic capital is the capital required to buffer the policyholder from default up to a target solvency or rating standard (e.g. A.M. Best's). We estimated capital requirements for Pryde based on a 99.4% VaR risk metric (i.e., capital needed to assure that there is only a 0.6% chance all of the capital will be depleted). This is consistent with an A+ rating.

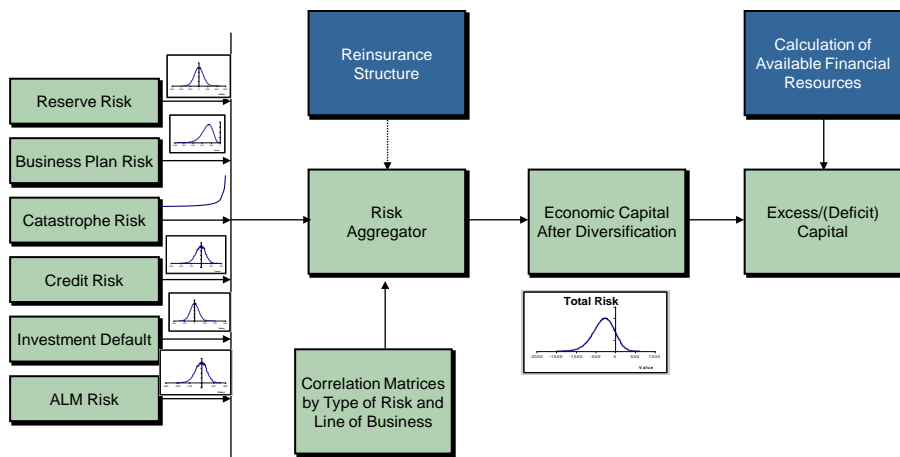
We used the following two risk metrics in gauging Pryde's Capital Needs:

- Value at Risk (VaR)
- Tail Value at Risk (TVaR)

Briefly, the "Value at Risk" (VaR) risk metric measures a percentile of a cumulative probability distribution (e.g., the 95th percentile of the distribution is the value for which there is a 5% probability of exceeding that value).

TVaR is similar to VaR risk metric but considers all possibilities beyond the above VaR threshold in that it reflects the average of all possible values beyond a defined percentile (e.g., TVaR 95% is the arithmetic average of all possible VaRs beyond the 95th percentile of the distribution).

Economic capital assessment was based on a multi-step process beginning with a bottom-up analysis of individual risks.



The first column below reflects how much stand-alone capital is needed per the 99.4% VaR for each risk separately. This totaled a sum of \$1,132.6M of economic capital. In consideration of correlation and diversification effects, this sum is reduced by 15.0% resulting in a total needed capital of approximately **\$962.4 Million**.

RISKTYPE	2010		
	STANDALONE ECONOMIC CAPITAL REQUIREMENTS	DIVERSIFIED CAPITAL AS A PERCENT OF STANDALONE	DIVERSIFIED ECONOMIC CAPITAL REQUIREMENTS
RESERVE	438.3	93.4%	409.4
BUSINESS PLAN	330.2	96.1%	317.3
CATASTROPHE	41.8	68.2%	28.5
CREDIT	138.3	93.7%	129.6
INVESTMENT	141.3	31.2%	44.1
ALM	42.7	78.6%	33.6
TOTAL	1,132.6	85.0%	962.4

5.16.1.1 Observations

Pryde's diversified economic capital requirement of \$962.4 Million, compared to the available economic capital of \$1,068.2 Million, places Pryde in a favorable capital position relative to the risk metrics utilized. Although one should note that the free surplus arises from diversification.

Further analysis should be performed on the relative performance of Pryde's four primary lines of business, to determine their marginal contributions to economic profit. We recommend the

development of a RAROC analysis to determine where Pryde can most effectively focus its resources.

Note –Our analysis considers business plan risk as the uncertainty of deviating from the business plan targets/baselines. Our detailed approach and assumptions are presented in the following sections of the report.

5.16.2 Consultant’s Report - Background, Terminology, Considerations

Prior to 2009, Pryde had experienced a significant reduction in its surplus position due primarily to a decline in underwriting performance from aggressive growth in non-core lines of business followed by significant loss reserve charges.

Pryde’s goal is to improve its ability to better manage capital and return. Underlying this goal, Hawthorne defines three underlying themes:

- Capital Productivity
- Capital Protection
- Capital Adequacy

5.16.2.1 Degree of Protection

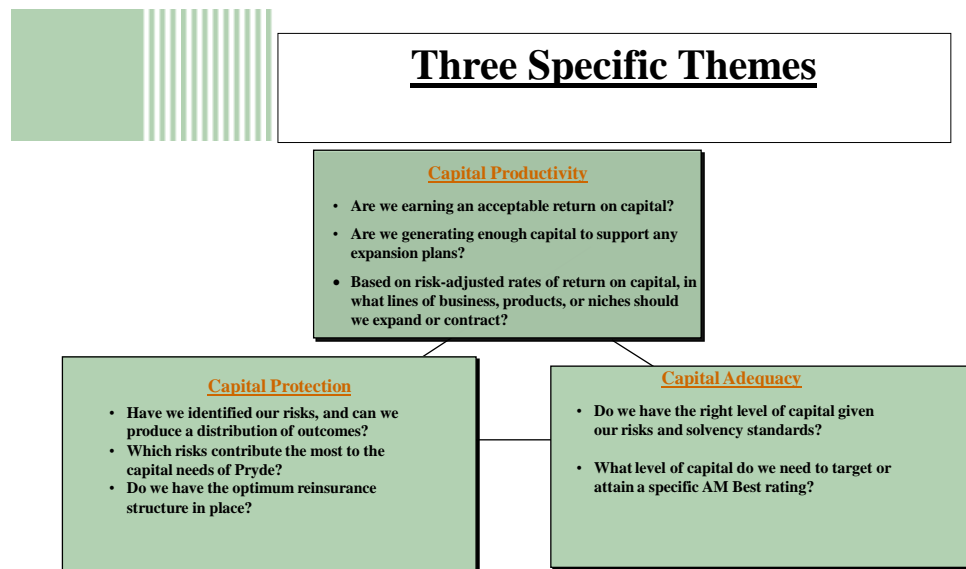
The strength of an insurer’s capital can be thought of as the probability that a company’s assets backing liabilities, together with capital, will be sufficient to satisfy all of its obligations to its policyholders. It should be noted that it is virtually impossible to have enough capital to totally prevent insurance company failures. Excess capital, while affording perhaps additional solvency protection, would impede capital investment in insurers because the additional cost of capital may not be compensated for in the pricing of the insurer’s policies. Hence excess capital has the potential to either raise the cost of insurance to a company’s policyholders or to prevent a market from existing. Insufficient capital, in comparison with that deemed necessary by modeling all of the appropriate risk factors at an adequate level of confidence, may result in inadequate pricing and will increase the exposure of the insurer, over time, to the risk of insolvency. Hence there is a constant trade-off between having enough capital to minimize insurance company failures and maintaining the minimum amount of capital so capital can be deployed effectively.

5.16.2.2 Time Horizon Considerations of Capital Needs

An insurer’s financial statements are usually prepared at the end of each fiscal year—a considerable task that requires significant preparation time. Often there is a significant delay of several months between the statement date and the actual finalizations of company financials. This aspect is also followed by the timing and implementation of business plan actions, which may be corrective or opportunistic with regards to company decision-making. In the meantime, during the decision-making phase, the company would continue to operate and conduct business. We suggest an appropriate time horizon for considering an insurer’s capital needs as one year from the evaluation date of the existing risk and return profile. This time horizon

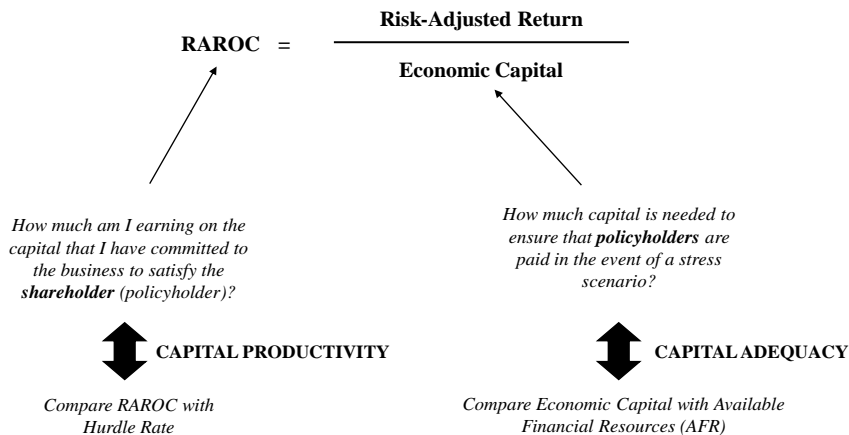
should not be confused with the full term of all of the assets and obligations of the insurer. The amount of required economic capital must be sufficient with a high level of confidence to meet all obligations for the time horizon as well as the present value at the end of the time horizon of the remaining future obligations.

In the course of this type of analysis, considerations should always be given to the notion that there is a trade-off between having enough capital to minimize insurance company failures and maintaining the minimum amount of capital so that capital can be deployed elsewhere, more effectively. As such, we recommend using a risk adjusted return on required capital (RAROC) approach in measuring returns. Our RAROC approach in essence considers both how much Pryde is earning on the capital that is committed to the business and how much capital is needed to ensure that policyholders are paid in the event of a stress scenario. Hence RAROC addresses the aforementioned trade-off between capital productivity and capital adequacy.

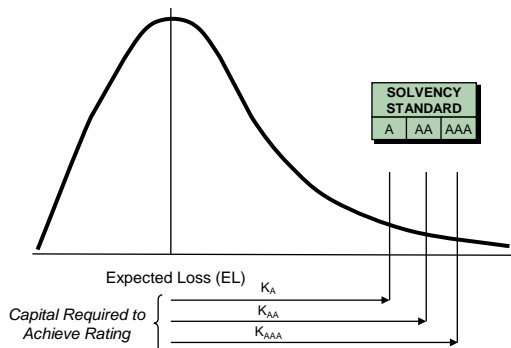


Risk Adjusted Return on Capital

An economic capital and RAROC framework provides the measures needed to better manage risk and return.



ECONOMIC CAPITAL IS DEFINED AS THE AMOUNT OF CAPITAL REQUIRED TO ACHIEVE A TARGET SOLVENCY STANDARD BASED UPON THE FIRM-WIDE LOSS DISTRIBUTION



- Economic capital is the capital required to buffer the policyholder from default up to a target solvency standard (and thus confidence interval)
- For the same risk profile, an institution targeting a better credit rating will need to hold more capital (AA institutions require more capital than single A)

5.16.2.3 Uncertainty vs. Volatility

It is generally accepted that uncertainty risk, the risk that models used to estimate claims or other relevant processes are mis-specified, (e.g., best point estimate of loss reserves) must be considered for the full remaining term of the insurance contracts. Uncertainty risk is widely believed to be non-diversifiable because it cannot be relatively reduced by increasing insured

portfolio size. On the other hand, some argue that volatility risk, the risk of random fluctuations in either the frequency or severity of contingent events, can be ignored in the long run, because these risks can be diversified away in the future. We believe that this notion is not universally true as some volatility risk cannot be diversified away. While true that in fully efficient markets volatility would not be valued in the calculation of the fair value of a set of projected future cash flows, insurance markets are relatively inefficient. Hence capital supports both types of risk; both volatility and uncertainty. We doubt that every risk can be classified as one or the other in practice, as many types of risk may have both systematic and diversifiable elements. Moreover, this distinction may also depend on insurer size and the characteristics of the markets in which it operates.

5.16.2.4 Consideration of Risk Transfer

Last but not least, total capitalization should also take into account risk transfer mechanisms that reduce the risks of the insurer, such as the purchase of reinsurance, hedging, and securitization. Although the role of reinsurance is to transfer underwriting and reserve risks, consideration should still be given to recoverable risk as previously defined. It is also important to analyze the risk transfer structure in any reinsurance contract. Finite risk deals, for example, are structured to provide financing by reinsurers with, at times, a minimal amount of risk transfer.

Hedging can be considered natural or constructed. Natural hedges occur when a company can offset risks in different lines of business. Financial hedges on the other hand, involving the use of derivative instruments, can offset certain financial guarantees with respect to interest rates and or equity markets.

5.16.2.5 Correlation and Diversification

Our risk-based approach to required capital treats each source of risk separately (e.g., initial capital amounts are determined in silos). Total Capitalization, however, needs to recognize the relationships among the various risk sources that can affect the company's operations. As such, total capitalization should reflect risk concentration, diversification, and interdependencies.