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**Supplementary report of the Independent Expert on the transfer of some of the long term business of National Provident Life Limited to Pearl Assurance Plc.**

Prepared by:

**Mike Arnold FIA**

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## 1. INTRODUCTION

- 1.1. I have been appointed by Pearl Assurance plc (“Pearl”) and National Provident Life Limited (“NPLL”) to report, pursuant to section 109 of the Financial Services and Markets Act 2000 (“FSMA”), in the capacity of the Independent Expert, on the terms of the proposed scheme (“the Scheme”) providing for the transfer of certain long term business of NPLL to Pearl. Pearl Group Services will be responsible for payment of fees incurred by me in my capacity as Independent Expert for the proposed scheme.
- 1.2. The Scheme will be presented to the Court for sanction under section 111 of FSMA.
- 1.3. This report is supplementary to my report entitled ‘Report of the Independent Expert on the transfer of some of the long term business of National Provident Life Limited to Pearl Assurance Plc.’ (“my report”) dated 22<sup>nd</sup> October 2009.
- 1.4. This supplementary report should be read alongside my report which considers the consequences of the Scheme and the proposed amendments to the Demutualisation Scheme on the policyholders of Pearl and NPLL.
- 1.5. All the terms and conditions described in section 1 of my report apply equally to this supplementary report. All definitions and abbreviations used in my report apply also to this supplementary report.
- 1.6. My appointment as Independent Expert has been approved by the Financial Services Authority (“FSA”) and the FSA approved the form of my report.
- 1.7. In reporting on the Scheme as the Independent Expert, I recognise that I owe a duty to the Court and the Royal Courts of Jersey and Guernsey to assist these courts on matters within my expertise. This duty overrides any obligation to Pearl. I confirm that I have complied with this duty.
- 1.8. I am aware of the requirements regarding experts set out in Part 35 of the Civil Procedure Rules, the Practice Direction and the Protocol for Instruction of Experts to give Evidence in Civil Claims.
- 1.9. The comments and conclusions contained in my report and in this supplementary report apply equally to the business written by Pearl and NPLL in Jersey and Guernsey as they do to business written in the UK.
- 1.10. This supplementary report must be considered in its entirety and alongside my report. Individual sections, if considered in isolation, may be misleading. Draft versions of this report should not be relied upon for any purpose.

## 2. THE SCOPE OF THIS SUPPLEMENTARY REPORT

- 2.1. This supplementary report has been written to address some specific issues and questions that have arisen since my report was written.
- 2.2. In particular, in this supplementary report, I consider the effects on the conclusions in my report of the following:
- The updated financial position of NPLL and Pearl before and after the implementation of the Scheme based on estimated figures as at 31<sup>st</sup> December 2009.
  - Scheme related changes.
  - Issues raised by policyholders since the distribution of information to NPLL policyholders regarding the Scheme.

### 3. REVISED FINANCIAL POSITIONS AS AT 31<sup>ST</sup> DECEMBER 2009

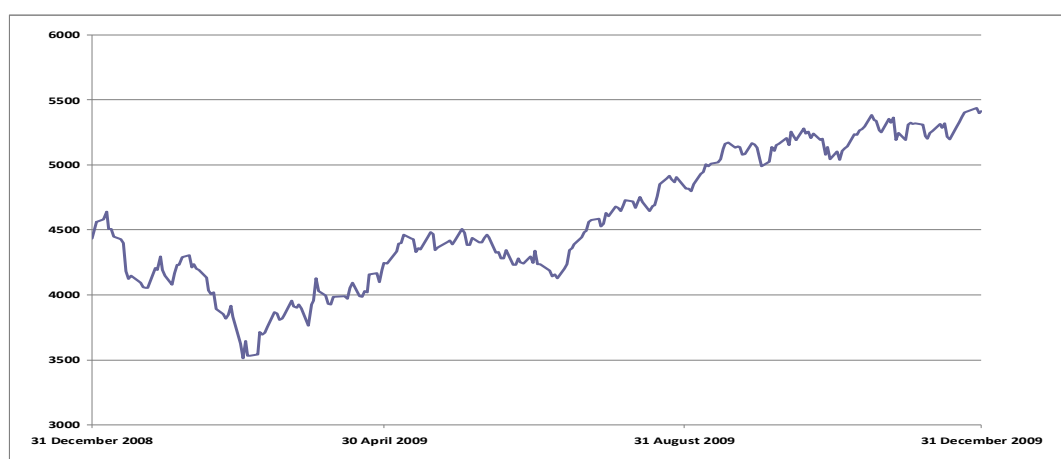
#### Introduction

- 3.1. The figures in my report allowed for certain post balance sheet events but were generally based on the financial returns as at 31<sup>st</sup> December 2008. In this supplementary report there is an update of the financial position of Pearl and NPLL as at 31<sup>st</sup> December 2009 both before and after the implementation of the Scheme.
- 3.2. The figures as at 31<sup>st</sup> December 2009 have been provided to me by the senior management of NPLL and Pearl and I have relied upon them without independent verification. Unlike the 2008 year end figures, on which my report was based, these 2009 year end figures have not been externally audited. My analysis has therefore focussed on the change in the estimated financial position as at 31<sup>st</sup> December 2009 due to the implementation of the Scheme.
- 3.3. Selected financials from 31<sup>st</sup> December 2008 are included in this supplementary report in Appendix 1 and comparable estimated financials as at 31<sup>st</sup> December 2009 are included in Appendix 2.

#### Changes in economic conditions during 2009

- 3.4. The table below summarises some key statistics showing the change in financial conditions over 2009 and the graph below shows the FTSE 100 level over 2009.

Date	Yield	
	31/12/2008	31/12/2009
FTSE UK Gilt Index - 10yr Gilt Yield	3.39%	4.07%
FTSE UK Gilt Index - 15yr Gilt Yield	3.71%	4.40%
UK Official Interest Rate	2.00%	0.50%
iBoxx AA Over 10 Year Stocks	7.15%	5.56%
RPI	0.90%	0.30%
15 year AAA spread	0.55%	0.35%
15 year AA spread	2.65%	1.02%



3.5. As can be seen from the above, market conditions have generally improved over 2009. Particular features that I comment on or use in discussions later in this supplementary report are:

- Gilt yields have increased over the year;
- Corporate bond spreads have narrowed; and
- Equities have increased in value over the year.

### Changes to assumptions over 2009

3.6. During 2009 the Actuarial Function Holders (“AFHs”) of Pearl and NPLL completed analyses of the non-economic experience of the Pearl and NPLL businesses – in particular the mortality and persistency experience. After reviewing the results of these investigations, the AFHs of Pearl and NPLL recommended to their respective Boards that the regulatory basis should be strengthened. Both Boards approved these recommendations which led to an increase in the regulatory liabilities for Pearl and NPLL.

### Explanation of changes between 31 December 2008 and 31 December 2009

3.7. There have been some material changes in the numbers within the financial statements of Pearl and NPLL in 2009. I have discussed these changes with the senior management of both Pearl and NPLL and high level explanations are set out below.

#### *Pearl*

3.8. Appendices 1 and 2 of this supplementary report show that the assets and liabilities of Pearl have decreased over 2009. However, during 2009, the excess assets of Pearl after the Capital Resources Requirement (“CRR”) have increased from £658 million to £710 million.

3.9. This change in excess assets can be explained, in broad terms, by the following three causes:

- The Long Term Insurance Capital Requirement (“LTICR”) decreased broadly in line with the reserves;
- The investment returns during 2009 for the Pearl SHF; and
- Investment returns on the non-profit business assets were partially counterbalanced by strengthening of the non-profit reserves but there was an overall increase in the surplus on the Pearl NPF.

#### *NPLL*

3.10. During 2009 the excess assets of NPLL after the CRR increased from £109 million to £141 million. However, this is due to two counteracting movements:

- A decrease in the excess assets before the CRR; and
- A decrease in the CRR made up of decreases in its two components:
  - The LTICR decreased broadly in line with the reserves; and
  - The With Profits Insurance Capital Component (“WPICC”) decreased to zero.

3.11. As discussed above, during 2009 there was a general narrowing of credit spreads on most corporate bonds, an increase in gilt yields, and a general increase in equity values. On the asset side, these factors would tend to lead to a decrease in fixed interest asset values and an increase in equity asset values. As NPLL has more of the former, overall there was a decrease in asset values.

3.12. On the liability side, one would expect these factors to also decrease liability values. On a realistic basis little credit was taken for the excess yield on corporate bonds so the main effect on the realistic liabilities was due to the increase in gilt yields. On a regulatory basis where the non-credit risk part of the excess yield is taken into

account, the narrowing of spreads counteracted the increase in the gilt yields over the year. Therefore the change in market conditions over 2009 led to a larger increase in the realistic surplus than in the regulatory surplus. This reduced the WPICC.

- 3.13. On the regulatory basis the improved market conditions have been counteracted by the strengthening of the regulatory valuation basis described above so that there was actually a decrease in the regulatory surplus over the year (as shown in Appendix 1 and 2 – excess assets before the CRR).
- 3.14. During 2009, the narrowing of credit spreads has led to a reduction in the WPICC such that, at the 2009 year end, it is zero in both the pre and post Scheme positions. Therefore the only component of the CRR that changes due to the implementation of the Scheme is the LTICR. This was not the case at 31<sup>st</sup> December 2008 when both the LTICR and the WPICC decreased on implementation of the Scheme.

### Effect of the Scheme based on 2009 Pillar I financials

- 3.15. Based on the estimated financials as at 31<sup>st</sup> December 2009, the relative financial positions of Pearl and NPLL before and after the proposed Scheme are similar to those discussed in my report.

#### *Pearl*

- 3.16. As shown in the appendices, the financial position of Pearl has improved since the end of 2008. Both the assets and liabilities of Pearl have decreased over 2009 but the Pillar I excess assets before and after the CRR have increased.
- 3.17. As shown in Appendix 2, based on 31<sup>st</sup> December 2009 estimated financials, Pearl would meet its Pillar I capital requirements after the Scheme is implemented. As a result of the Scheme, Pearl would suffer only a small reduction in the excess assets after the CRR and in the excess assets as a percentage of liabilities.

#### *NPLL*

- 3.18. The figures in Appendix 2 show that, based on the estimated figures as at 31<sup>st</sup> December 2009, implementation of the proposed Scheme would have improved the financial position of NPLL in terms of both the absolute amount of capital available and the excess assets as a percentage of total liabilities. This was also the case based on the financials as at 31<sup>st</sup> December 2008 as noted in my report.
- 3.19. Although both sets of figures show that the Scheme leads to an improvement in the financial position of NPLL, the difference based on the estimated figures as at 31<sup>st</sup> December 2009 is less pronounced. As highlighted in my report, the Pillar I excess assets after the CRR increase by £112 million based on the 31<sup>st</sup> December 2008 financials. The corresponding amount as at 31<sup>st</sup> December 2009 is estimated to be £62 million. This can be derived from the figures in Appendix 2 as the difference between the excess assets after the CRR before the implementation of the Scheme (£141 million) and after the Scheme is implemented (£203 million). However the change in the excess assets as a percentage of the total liabilities as a result of the Scheme is similar based on the financials at the two dates. This percentage increased from 8% to 11% based on the 31<sup>st</sup> December 2008 financials and from 7% to 10% based on the estimated 31<sup>st</sup> December 2009 financials.

### Changes in the Pillar II financials

- 3.20. As shown in my report, based on 2008 year end Pillar II financials, the Scheme leads to an improvement to the NPLL Pillar II position and has an immaterial effect on the Pearl Pillar II position.
- 3.21. Estimates of the Pillar II position as at 31<sup>st</sup> December 2009 indicate an improvement in the Pillar II capital in excess of the ICA for both Pearl and NPLL during 2009.
- 3.22. Estimates of the Pillar II position as at 31<sup>st</sup> December 2009 assuming the Scheme had been implemented, indicate, like the 2008 year end projections, that NPLL will have an improved Pillar II position and that there will be an immaterial effect on Pearl's Pillar II position.

- 3.23. The improvement for NPLL is not as pronounced as that shown in my report based on 31<sup>st</sup> December 2008 figures. The narrowing of credit spreads during 2009 has brought the value of the transferring SERP liabilities under Pillar II closer to the value of the transferring assets (as defined in the Scheme and as described in section 7 of my report). Therefore, the Scheme has a lower overall impact on the Pillar II capital position after the narrowing of credit spreads (as at the end of 2009) than it does before (as at the end of 2008).

### Conclusion

- 3.24. Therefore, as discussed above, based on the estimated 31<sup>st</sup> December 2009 financials, both Pearl and NPLL are expected to meet their Pillar I and Pillar II capital requirements after the Scheme is implemented. On both a Pillar I and Pillar II basis, implementation of the Scheme is projected to improve the position of NPLL and to make an insignificant difference to the position of Pearl.
- 3.25. I am therefore satisfied that:
- The level of capital support and therefore the security of policyholder benefits after the Scheme is implemented will not be materially adversely affected for either the Pearl or the NPLL policyholders;
  - The benefit expectations of the existing Pearl with-profits policyholders will, as discussed in my report (paragraphs 10.78 to 10.91), not be materially adversely affected;
  - The benefit expectations of the non-transferring NPLL with-profits policyholders will, as discussed in my report (paragraphs 10.53 to 10.77), not be materially adversely affected; and
  - The benefit expectations of the NPLL SERP with-profits policyholders will, as discussed in my report (paragraphs 10.4 to 10.52), not be materially adversely affected.
- 3.26. I am therefore satisfied that the changed economic conditions at the end of 2009 (relative to the end of 2008) will have no effect on the conclusions in my report.

## 4. SCHEME RELATED CHANGES

### Introduction

4.1. The changes to the Scheme since the production of my Report are:

- The Scheme has been amended so that £85 million of the amount of the NPLL SERP guarantee costs transferred will not be allocated to the Pearl SERP Transfer Capital fund. A consequential amendment has also been made to Schedule 4 to the Scheme to make it clear that any part of this £85 million that has not been used to meet guarantee costs will be taken into account in the determination of the surplus, if the SERP policies are converted to non-profit in the circumstances set out in the Scheme.
- The proposed amendment to the Principles of Financial Management set out in the Demutualisation Scheme of NPLL, which will permit hypothecation in NPLL has been changed to require the FSA to be notified and consulted, and their non-objection confirmed in writing, before any changes made possible by this amendment are implemented in practice.
- Schedule 4 to the Scheme contains the principles for the calculation of the surplus to be distributed in the event of the conversion of SERP policies from with-profits to non-profit policies. This Schedule has been changed to require the FSA to be notified and consulted, and their non-objection confirmed in writing, before any proposals resulting from this Schedule are implemented in practice.

4.2. In addition, following correspondence and discussions with the FSA, the NPLL Board made a commitment to introduce, before 30<sup>th</sup> September 2010, a limit on the total charges made to NPLL Fund asset shares in respect of guarantee costs. This limit will be applied on a per policy basis.

4.3. I cover these four points below.

### £85 million not transferred to the Pearl SERP Transfer Capital Fund

4.4. The NPLL SERP guarantee costs transferring represent part of the 'overcoat' (section 4 of my report) currently held in the NPLL Fund. After the transfer, this £85 million will not form part of the policyholder asset shares and will be called upon to meet guarantee costs before the Pearl SERP Transfer Capital Fund. Therefore, any of this £85 million not used to pay guarantee costs would now be distributed to policyholders of the Pearl SERP Fund rather than to the Pearl shareholder.

4.5. This change to the Scheme has a possible benefit for NPLL SERP policyholders although, based on projections carried out by senior management of Pearl and NPLL, it is extremely unlikely that it will have any effect at all as it will almost certainly be required to meet guarantee costs.

4.6. This change does not affect the non-transferring NPLL policyholders as the amount transferred out of the NPLL Fund is unchanged and therefore as stated in my report (paragraph 10.77) I remain satisfied that the implementation of the Scheme is to the advantage of the non-transferring NPLL policyholders when compared with the alternative of maintaining the status quo.

4.7. I am satisfied that £85 million is an appropriate amount, as it ensures that, as compared to their potential interests currently in the NPLL Fund, this proposed change to the Scheme will not have an adverse effect on:

- The interests of the transferring SERP policyholders in the Pearl SERP Fund; or
- The interests of the non-transferring NPLL policyholders in the NPLL Fund.

### **FSA non-objection to hypothecation**

- 4.8. As discussed in my report (section 6) one of the proposed changes to the Demutualisation Scheme is to allow NPLL to award returns to different groups of NPLL Fund policyholders with respect to different hypothetical allocations of assets.
- 4.9. Requiring FSA non-objection for such a hypothecation could only disadvantage policyholders if the possibility exists that the FSA would try to prevent NPLL from carrying out a hypothecation that is allowable under the amended Demutualisation Scheme and that would be to the advantage of policyholders.
- 4.10. I am confident that the FSA would not object to such a hypothecation. As stated in paragraph 10.61 of my report, I am confident that NPLL would not seek to implement a hypothecation that would not preserve the fair treatment of policyholders.
- 4.11. This change does not therefore affect the conclusions in my report.

### **FSA non-objection to proposals under Schedule 4 to the Scheme**

- 4.12. Requiring FSA non-objection for a proposal to convert the SERP policies into non-profit policies could only disadvantage SERP policyholders if the possibility exists that the FSA would try to prevent such a conversion that is allowable under Schedule 4 to the Scheme and that would be to the advantage of policyholders.
- 4.13. I am confident that the FSA would not seek to prevent such a conversion.
- 4.14. This change does not therefore affect the conclusions in my report.

### **Limit on asset share charges in respect of guarantee costs**

- 4.15. The limit on asset share charges will apply only in the NPLL Fund and the intention is to set a limit on charges whether or not the Scheme is implemented. If the Scheme is implemented the transferring SERP policyholders will not be subject to charges to asset share in respect of guarantee costs and therefore this would have no effect on the transferring SERP policyholders.
- 4.16. The imposition of a limit on the total charges that can be applied to asset shares in respect of guarantee costs will provide an additional benefit for any policyholders for whom this limit would otherwise be exceeded. Therefore this limit provides an additional safeguard on the level of future charges that can be applied to the asset shares of policyholders who remain in the NPLL Fund for a considerable amount of time after the limit is imposed.

### **Conclusion**

- 4.17. I am therefore satisfied that these Scheme related changes will have no effect on the conclusions in my report.

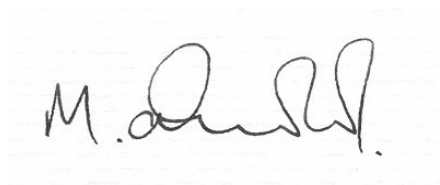
## **5. ISSUES RAISED BY POLICYHOLDERS**

- 5.1. I have reviewed the responses received from policyholders relating to the Scheme and the proposed amendments to the Demutualisation Scheme.
- 5.2. I am satisfied that there are no issues raised by policyholders in connection with the Scheme and the proposed amendments to the Demutualisation Scheme that would change the conclusions in my report.

## 6. CONCLUSIONS

6.1. In summary, I remain satisfied that:

- The proposed amendments to the Demutualisation Scheme will not adversely affect the reasonable expectations of, or reduce the protections conferred by the Demutualisation Scheme on, the NPLL policyholders remaining in NPLL;
- The security of the benefits of the policyholders of Pearl and NPLL will not be materially adversely affected by the implementation of the Scheme on the Effective Date or the proposed amendments to the Demutualisation Scheme;
- The benefit expectations of the with-profits policyholders of Pearl and NPLL will not be materially adversely affected by the implementation of the Scheme on the Effective Date or the proposed amendments to the Demutualisation Scheme;
- The Scheme and the proposed amendments to the Demutualisation Scheme will not have a materially adverse effect on the service standards experienced by the policyholders of Pearl and NPLL in accordance with TCF guidance.

A handwritten signature in black ink on a light blue grid background. The signature is cursive and appears to read 'M. Arnold'.

Mike Arnold, FIA

28<sup>th</sup> January 2010

## APPENDIX 1 – SELECTED FINANCIAL INFORMATION AS AT 31<sup>st</sup> DECEMBER 2008

### Before the Scheme

The table below shows the Pillar I financial position of Pearl and NPLL before the implementation of the proposed Scheme. These figures are as shown in Appendix 2 of my report.

31 December 2008 £ million	Pearl	NPLL
<b>Assets</b>	<b>16,129</b>	<b>5,677</b>
Reserves & Cost of Bonus	7,317	4,312
Other Liabilities	7,540	951
<b>Total liabilities</b>	<b>14,857</b>	<b>5,263</b>
<b>Excess Assets</b>	<b>1,272</b>	<b>414</b>
<b>CRR</b>	<b>614</b>	<b>305</b>
<b>Excess assets after CRR</b>	<b>658</b>	<b>109</b>
<b>Pillar I excess assets as a percentage of total liabilities</b>	<b>9%</b>	<b>8%</b>

### After the Scheme

The table below shows the Pillar I financial position of Pearl and NPLL after the implementation of the proposed Scheme. These figures are as shown in Appendix 2 of my report.

31 December 2008 £ million	Pearl	NPLL
<b>Assets</b>	<b>17,427</b>	<b>4,379</b>
Reserves & Cost of Bonus	8,646	2,983
Other Liabilities	7,540	951
<b>Total liabilities</b>	<b>16,186</b>	<b>3,934</b>
<b>Excess Assets</b>	<b>1,241</b>	<b>445</b>
<b>CRR</b>	<b>742</b>	<b>224</b>
<b>Excess assets after CRR</b>	<b>499</b>	<b>221</b>
<b>Pillar I excess assets as a percentage of total liabilities</b>	<b>8%</b>	<b>11%</b>

## APPENDIX 2 – SELECTED FINANCIAL INFORMATION AS AT 31<sup>ST</sup> DECEMBER 2009

### Before the Scheme

The table below shows the estimated Pillar I financial position of Pearl and NPLL before the implementation of the proposed Scheme.

31 December 2009 £ million	Pearl	NPLL
<b>Assets</b>	<b>14,146</b>	<b>5,174</b>
Reserves & Cost of Bonus	6,762	4,829
Other Liabilities	6,002	0
<b>Total liabilities</b>	<b>12,764</b>	<b>4,829</b>
<b>Excess Assets</b>	<b>1,382</b>	<b>345</b>
<b>CRR</b>	<b>672</b>	<b>204</b>
<b>Excess assets after CRR</b>	<b>710</b>	<b>141</b>
<b>Pillar I excess assets as a percentage of total liabilities</b>	<b>11%</b>	<b>7%</b>

Notes:

1. The figures for Pearl do not include the 'look-through' value of the NPLL Pillar I excess assets of £141 million
2. The Pearl CRR above does not include the NPLL CRR of £204 million.
3. In its FSA Returns, Pearl 'looks through' to NPLL and includes NPLL as an asset of Pearl. On this basis, the Pearl figures would be as follows (all figures in £ million):

Total excess assets:	1,382 + 345	=	1,727
Total CRR:	672 + 204	=	876
Total excess assets after CRR		=	851

### After the Scheme

The table below shows the estimated Pillar I financial position of Pearl and NPLL after the implementation of the proposed Scheme.

31 December 2009	Pearl	NPLL
£ million		
<b>Assets</b>	<b>15,374</b>	<b>3,967</b>
Reserves & Cost of Bonus	8,011	3,601
Other Liabilities	6,002	0
<b>Total liabilities</b>	<b>14,013</b>	<b>3,601</b>
<b>Excess Assets</b>	<b>1,361</b>	<b>366</b>
<b>CRR</b>	<b>727</b>	<b>163</b>
<b>Excess assets after CRR</b>	<b>634</b>	<b>203</b>
<b>Pillar I excess assets as a percentage of total liabilities</b>	<b>10%</b>	<b>10%</b>

Notes:

1. The figures for Pearl do not include the 'look-through' value of the NPLL Pillar I excess assets of £203 million
2. The Pearl CRR above does not include the NPLL CRR of £163 million.
3. In its FSA Returns, Pearl 'looks through' to NPLL and includes NPLL as an asset of Pearl. On this basis, the Pearl figures would be as follows (all figures in £ million):

Total excess assets:	1,361 + 366	=	1,727
Total CRR:	727 + 163	=	890
Total excess assets after CRR		=	837

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## APPENDIX 3 – KEY SOURCES OF DATA

In writing this supplementary report, I relied upon the accuracy of certain documents and spreadsheets provided by Pearl. These included, but were not limited to the following:

Description	Filename	Date received
NPLL AFH and WPA Report	NPLL AFH Supp Report Final Signed.pdf	28/01/2010
Pearl AFH and WPA Report	Pearl AFH Supp Report Final Signed.pdf	28/01/2010
Pillar II financials	Pillar 2 analysis dec09 v2.xls	18/01/2010
PillarII financials - note for NPLL	Note on NPLL Restructure Scheme & Pillar 2 position 31 Dec 09 v2.doc	18/01/2010
Amended Scheme document	2009 Scheme - FINAL.doc	28/01/2010
Amended Demutualisation Scheme	2009 Amended Demutualisation Scheme (Clean) - FINAL.doc	28/01/2010