

NPI

National Provident Life Limited Principles and practices of **financial management**

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Contents

<i>Section</i>	<i>Page</i>
Introduction	3
Disclaimer	5
A Methods used to determine payouts	5
B Setting annual bonus rates	8
C The approach to setting final bonuses	8
D Smoothing of payouts	9
E Investment strategy	10
F Business risks	11
G Charges and expenses	12
H The estate	13
I Use of the Scheme Capital Account	13
J New business	14
K Equity between policyholders and shareholders	15
L Portfolio Bonds	15
Appendix 1 Classes of business	17
Appendix 2 Glossary	18
The glossary defines a number of terms which are italicised in the text.	

Introduction

Company structure

NP Life was established in 1999 to take over the existing business of *NPI* subsequent to *NPI*'s demutualisation and its acquisition by AMP Limited on 1 January 2000. The *High Court Scheme* approving *NPI*'s demutualisation provided the framework within which *NP Life* operates, which has a significant impact on the principles and practices set out in this document.

As from 15 December 2003, *NP Life* became part of a group of companies headed by HHG plc, which consisted primarily of Henderson Global Investors (an investment management company), Pearl Assurance Limited, London Life Limited, *NPI Limited*, *NP Life* and HHG Services Limited, an administration company. The HHG group came from a demerger of the UK companies in the AMP group from the Australasian business of AMP.

As from April 2005, Phoenix Group acquired the life companies and service company from HHG plc. *NP Life* is now part of the Phoenix group of companies.

The demutualisation arrangements

NP Life does not write new business other than increments and new members to existing group schemes and most of these are reassured to *NPI Limited*. In addition, all unit-linked business (other than Unilink policies) is reassured to *NPI Limited*. Both these reassurance arrangements are provided for by the *High Court Scheme*. The amounts that may be allocated to the *NP Life Fund* for administration and investment management costs are prescribed by the Scheme. Investment management and administration are outsourced, administration is undertaken by Pearl Group Services Limited.

The *estate* of *NP Life* vested in the *eligible with-profits policyholders* as a result of the demutualisation and was to be distributed to them as their policies became claims, to the extent this was consistent with the sound and prudent management of *NP Life*. AMP provided £800 million of capital support (the *Scheme Capital Account*) to *NP Life*. The *Scheme Capital Account* was originally part of the *Shareholder Fund* of *NP Life*, but could be drawn down into the *NP Life Fund* subject to certain conditions. It was intended to provide some increased investment freedom for *NP Life* and to be repayable

subject to certain conditions. It is not repayable to the extent that it is necessary to meet *guarantee costs* when the *estate* of *NP Life* is exhausted. Subject to this, payouts are set as far as possible excluding assets in the *Scheme Capital Account*. Further details of the *Scheme Capital Account* are provided in Section I.

Subsequent events

Largely because of the falls in equity prices during 2000 to 2003, the *Scheme Capital Account* was gradually drawn down from the *Shareholder Fund* into the *NP Life Fund* and the equity holdings were reduced. All the *Scheme Capital Account* has now been drawn down from the *Shareholder Fund* into the *NP Life Fund* and is held in the *Scheme Capital Fund*. In early 2003, *NP Life* sold the remaining equity investments (bar a very minimal amount of unquoted investments) of the *NP Life Fund* and reinvested the proceeds in fixed interest investments. The levels of payouts on with-profits policies have reduced significantly reflecting the reduced value of the assets backing the with-profits policies and, in many cases, payouts are now equal to the benefits guaranteed under the policy terms. The *estate* of *NP Life* is now expected to be used entirely to meet the *guarantee costs* and other costs which are chargeable to it. Therefore, there is currently no distribution of the *estate* to *eligible with-profits policyholders*, nor is there likely to be for the foreseeable future. *Annual bonus rates* have generally been reduced to zero except where a minimum level has been guaranteed, and are likely to remain zero for the foreseeable future.

In each year since 2007, a 2% charge has been taken from *asset shares* because the *estate* was expected to be required to meet *guarantee costs* and other costs which are chargeable to it, and since it was also likely that the *Scheme Capital Fund* would be required to meet *guarantee costs*. These charges are to help meet *guarantee costs* and are held in the *Asset Share Charge Fund*.

The shareholder has also provided further support, in the form of the *Earmarked Portfolio*. The *Earmarked Portfolio* provides security for policyholders in that it is available to meet *guarantee costs* if the *estate*, the *Asset Share Charge Fund* and the *Scheme Capital Fund* are all exhausted. Other than this, it is not taken into account in determining payouts.

On 15 February 2010, all Self Employed Retirement Plans then in force were transferred from *NP Life* to Pearl Assurance Limited under a scheme approved by the High Court

on 5 February 2010. The financial effect of the transfer was backdated to 4 January 2010. As part of this scheme, the part of *NP Life's* assets representing this transferred business and including much of the *Scheme Capital Fund* was also transferred to Pearl Assurance Ltd. Also, as part of this scheme and an associated amendment to the *High Court Scheme*, a *Shareholder Equalisation Fund* was established with assets from the *estate*. The *Shareholder Equalisation Fund* has been established to help offset the loss in value for shareholders that will result from the transfer (due mainly to the loss of financing costs on the part of the *Scheme Capital Fund* that was transferred to Pearl Assurance Limited). The *Shareholder Equalisation Fund* is to be paid to the shareholder on an agreed schedule subject to such payments not endangering the *Financial Position of the Office*. It may be used to meet *guarantee costs* when other sources to meet those costs (except the *Earmarked Portfolio*) are exhausted.

Therefore, *guarantee costs* are currently met from the *estate* in the first instance. Once this is exhausted, they will be met in turn from the *Scheme Capital Fund*, the *Asset Share Charge Fund*, the *Shareholder Equalisation Fund* and the *Earmarked Portfolio*.

Fund structure

NP Life has only one long term fund (the *NP Life Fund*) which includes both with-profits and non-profit business. It holds the assets backing the *Scheme Capital Fund*, the *Shareholder Equalisation Fund* and the *Earmarked Portfolio* in separate sub-funds. Also, for investment purposes only, it subdivides the remaining fund into a number of sub-funds so that it has appropriate investments backing the various classes of non-profit business and other liabilities, and its with-profits business. The Investment section (section E) sets out the investment strategy for the part of the fund explicitly invested to back its with-profits liabilities.

Purpose of the Principles and Practices of Financial Management (PPFM)

This statement of *PPFM* describes the principles and practices that *NP Life* applies when managing its with-profits business. This document is designed to enable policyholders of *NP Life* to better understand the way in which it manages its with-profits business. *NP Life* will also produce an annual report available to policyholders on its compliance with its *PPFM*.

Principles

The principles provide a high level description of the standards adopted by *NP Life* in managing the *NP Life Fund* and describe the business model used by *NP Life* in meeting its duties to policyholders and in responding to long term changes in the business and economic environment. Principles are intended to be enduring, but *NP Life* may change them from time to time, in which case three months written notice will be given to current with-profits policyholders before any material change is made (in the absence of a waiver of this requirement by the Financial Services Authority).

Practices

The practices provide a more detailed description of how *NP Life* intends to manage the *NP Life Fund* and respond to changes in the business and economic environment in the short term. The aim is that the practices provide sufficient detail for a knowledgeable observer to understand the material risks and rewards from effecting or maintaining a with-profits policy with *NP Life*. *NP Life* may change its practices without advance notice but policyholders will be notified of such changes. Notification may be given after the change has been made but will be within a reasonable time period from the effective date of the change.

These principles and practices apply to all of *NP Life's* with-profits business, other than Portfolio Bond business. A separate section (Section L) on Portfolio Bonds is included below but most information on that product is given in the Pearl *PPFM*. Where necessary, a distinction is drawn between the different types of with-profits business other than Portfolio Bond. In most cases, the distinctions are between five classes of with-profits business, which are:

- Conventional With-Profits (CWP)
- Unitised With-Profits (UWP)
- Deposit Administration (DA)
- Capital Account (CA)
- Profit Sharing Account (PSA)

These classes of business are described in Appendix 1. There is no with-profits business (other than Portfolio Bond) not covered by these classes.

Disclaimer

None of the contents of this document form part of, or vary, the terms or conditions of any policy issued or to be issued by *NP Life*. In the event of any inconsistency between the contents of this document and any policy, the terms and conditions of the policy prevail.

This document is intended to assist knowledgeable observers to understand the way in which the with-profits business of *NP Life* is conducted and the material risks and rewards involved in effecting or maintaining a with-profits policy with *NP Life*. It is not a comprehensive explanation either of the management of the with-profits business of *NP Life* or of every matter which may affect that business. In addition, no part of the document should be read as a recommendation to policyholders or potential policyholders or their advisers in relation to the effecting or maintaining of a with-profits policy. Accordingly, any person considering whether to effect or maintain a with-profits policy with *NP Life* should seek independent financial advice.

Statements in this document in relation to the risks and rewards involved in effecting and maintaining a with-profits policy with *NP Life* are by their nature forward-looking statements that are subject to a variety of uncertainties. Readers of this document should read such forward-looking statements in that context.

The contents of this document may change as the circumstances of *NP Life* and the business environment change. The document may also change to reflect changes made by *NP Life* to the management of the with-profits business.

Readers of this document should read the whole document. Reading only selected sections or paragraphs in isolation may result in a misleading impression of the way in which the with-profits business of *NP Life* is conducted and the material risks and rewards involved in effecting and maintaining a with-profits policy with *NP Life*. The principles set out in this document and their associated practices should in particular be read together.

A. Methods used to Determine Payouts

Principles

- PA.1 In accordance with the *High Court Scheme* governing *NP Life*, the total payout on with-profits policies is based on *asset shares*, subject to smoothing (see section D below), plus for *eligible with-profits policyholders*, a share of any *distributable free estate* of *NP Life*. The total payout on with-profits policies is, however, not less than the value of the guaranteed benefits.
- PA.2 Payouts are set with the intention that all policyholders will be treated fairly and of distributing equitably all the assets of the *NP Life Fund*, including all future surpluses but as far as possible excluding assets in the *Scheme Capital Fund*, *Earmarked Portfolio* and *Shareholder Equalisation Fund*.
- PA.3 *Asset share* techniques are used as a guide to determining payouts on CWP, PSA and UWP business. The *asset share* techniques provide a guide to the levels of *final bonus* or, for UWP and CA business, Market Value Reduction (*MVR*) that may apply.
- PA.4 *Asset share* techniques are also used as a guide to determining payouts on DA and CA business, primarily to determine the *annual bonus rate*.
- PA.5 *Asset share* techniques are used for all significant lines of business. For some minor lines of business, the results of the major line of business most similar to the minor line are used as a guide to setting payouts.
- PA.6 A requirement of the *High Court Scheme* is that *asset shares* are calculated from the *asset shares* determined at 1 January 2000 using the methods in use by *NPI* at 31 December 1998, accumulated by reference to the subsequent financial position, performance and experience of the *NP Life Fund*.
- PA.7 The *Supervisory Board* may decide that the investment return for any identified group of policies may be determined from the returns on assets notionally hypothecated to that group of policies (whether or not the *NP Life Fund* holds those hypothecated assets), rather than the return on the

actual assets backing the with-profits business as a whole. Any hypothecation will be subject to the principle that it will only be considered if it preserves the fair treatment of policyholders overall.

- PA.8 Approximations are only used where it is made necessary by, for example, insufficient data or systems constraints.
- PA.9 Significant changes to the methods and data used to determine payouts require the approval of the *Supervisory Board*. Changes to historical data are only likely to be made if they are found to be incorrect.

Practices

CA.1 Payouts are determined using the results of the *asset share* calculations, subject to *NP Life's* smoothing practices, with a minimum payout of the guaranteed benefits.

CA.2 *Asset shares* are:

- i) for CWP business, the premiums paid, for DA business the premiums paid less expenses charged to the policy and for PSA, UWP and CA the amount invested after initial charges;
- less
- ii) for CWP business, the expenses (including commission and investment management charges) relevant to that business;
- iii) for DA, PSA, UWP and CA business, the fund-based charges applicable to that business, in the form of an annual management charge;
- iv) for CWP business, an appropriate allowance for mortality;
- v) for all business, a charge to cover some or all of the *non-policy costs*; and
- vi) for all or some of the classes of business, a charge to cover *guarantee costs* (which may be negative if it is appropriate to rebate any of the previously taken charges);

accumulated at the rates of investment return earned on the assets underlying the relevant business as described in CA.6 below.

For life business, an appropriate allowance for tax on the investment returns and tax relief on expenses is made.

CA.3 For CWP, payouts are based on *asset shares* calculated for a sample policy commencing in each previous *terminal bonus period* and becoming payable in the current calendar year. For PSA, UWP, and CA business, payouts are based on a sample investment in each previous *terminal bonus period* and becoming payable in the current year. Consequently, for UWP, PSA or CA business, a regular premium policy may have numerous rates of *final bonus* and / or *MVR* applicable in the calculation of the amount payable reflecting the investments made in different *terminal bonus periods*, and a single premium policy will have a separate rate of *final bonus* or *MVR* in respect of each single premium paid.

CA.4 *Asset shares* are calculated as at the mid-point of the financial year of claim. Estimates of investment returns are used where the investment return for the year of claim and the previous year is not known at the date of calculation. The actual rates of investment returns (determined in accordance with CA.6) are used in any subsequent calculation of *asset shares* once the actual investment returns have been determined.

CA.5 The methodology used to determine payouts is documented by papers submitted to, and approved by, the *Supervisory Board*. Investment returns, expenses and charges are documented by internal memoranda.

CA.6 The investment return for DA and CA business is determined from the return on assets notionally backing that business. For the other classes of business, the investment return is determined from the return on the assets backing with-profits business, excluding those assets notionally backing the DA and CA business. The investment return for CWP, PSA, UWP and CA business, less an appropriate allowance for tax in respect of life business, is then increased / reduced by the charge in respect of past smoothing costs in accordance with CD.2 below.

- CA.7 The investment management expenses used in *asset share* calculations for CWP business are based since 1 January 2000 on the charges payable by *NP Life* under its service agreement with its investment managers. The maintenance expenses used in *asset share* calculations for CWP business are based since 1 January 2000 on the charges payable by *NP Life* under its service agreement with Pearl Group Services Limited but, from 14 December 2006, the then current level of expenses will be inflated at the fixed rate of 4.07% per annum. For years prior to 2000, both investment management and maintenance expenses are based on the results of internal expense apportionment investigations. For UWP, PSA, DA and CA business, expenses are not directly attributable to *asset shares* and charges in the form of an annual management charge are taken instead.
- CA.8 The mortality rates used for CWP *asset shares* are based on *NP Life's* recent experience.
- CA.9 The amount of tax chargeable to policies in the *asset share* calculations is intended to be a reasonable approximation to that actually payable by the company in respect of its with-profits business. A notional amount of tax is determined as if the *NP Life Fund* had constituted the whole long-term fund of a separate mutual life assurance company. Any difference between this notional amount of tax and that taken into account in the calculation of *asset shares* is treated as *non-policy costs*. Any difference between the tax actually payable and the notional amount is payable by or to the shareholder.
- CA.10 *Guarantee costs* are required by the *High Court Scheme* to be met by the surplus assets in the *NP Life Fund* in excess of those allocated to *asset shares* or, if there are no surplus assets, the *Scheme Capital Fund*. If the *Scheme Capital Fund* is not expected to cover all remaining *guarantee costs* then a charge to *asset shares* may be made as described under CA.11.
- CA.11 In any 12 month period, any charge made to *asset shares* in respect of the costs of meeting guaranteed benefits will normally be limited to 2%. However, if it is considered necessary, to enable *NP Life* to continue to meet the principle set out in PA.1 of paying at least the value of guaranteed benefits on all policies, a higher charge may be applied. The amount of any charges in respect of the costs of meeting guaranteed benefits will be maintained in the *Asset Share Charge Fund*, a separate sub-fund of the with-profits fund, until it is either required to meet *guarantee costs* or until the financial position has improved sufficiently to enable the charges to be allocated back to the then remaining *asset shares*. In determining which classes of business to deduct charges in respect of the costs of meeting guaranteed benefits from, or rebate them to, principle PA.2 will be the guiding principle.
- CA.12 For certain mortgage endowment policies, the *NPI Promise* applies which will mean an extra amount is payable at maturity if the payout falls below the amount of mortgage the policy was originally targeted to repay, subject to certain conditions being met. The cost of this Promise forms part of the *non-policy costs*.
- CA.13 Except where payment of a contractual benefit results in a higher amount, and except where the amount cannot be reasonably compared with a calculated *asset share*, the target ranges for policy claim payouts are:
- a) 80% to 120% of unsmoothed *asset share* in respect of UWP, PSA and CA business; or
 - b) 80% to 140% of unsmoothed *asset share* in respect of CWP.
- These ranges apply to both maturity payments and surrender payments for these classes of business. It is expected that at least 90% of cases would fall within these target ranges. Payouts on DA business are not set by reference to *asset shares*.
- CA.14 These ranges have been determined and will be monitored by reference to specimen with-profits policies of the appropriate classes of business.

B. Setting annual bonus rates

Principles

- PB.1 In accordance with the *High Court Scheme*, *annual bonuses* are set disregarding the existence of the *Scheme Capital Account*, *Scheme Capital Fund* and *Shareholder Equalisation Fund*. They are also set disregarding the *Earmarked Portfolio*.
- PB.2 Due to the *Financial Position of the Office*, the strategy is to keep any increase in guaranteed benefits to a minimum by declaring as little *annual bonus* as possible. For CWP business, it is therefore expected that there will be no *annual bonus* declared for the foreseeable future. For UWP business, it is similarly expected that there will be no *annual bonus* declared for the foreseeable future, except where the policy terms and conditions provide for a minimum rate.
- PB.3 For DA and CA business the *annual bonus rate* reflects the current investment return on the assets notionally backing this business plus or minus a smoothing adjustment.
- PB.4 To protect the *Financial Position of the Office*, *NP Life* may deem it necessary to change the *interim annual bonus rate* for DA and CA business at any time, and to reduce the *interim annual bonus rate*, possibly to zero, and to declare at the year end a rate different from the interim rate.
- PB.5 As *NP Life* is closed to new business, it is not expected that any new series of bonus rates will be necessary.

Practices

- CB.1 *Annual bonus rates* and *interim annual bonus rates* for the following year are normally declared annually at 31 December, but *interim annual bonus rates* may be changed at any time.
- CB.2 *Annual bonus rates* on DA and CA business would not normally be expected to change by more than 1.5% per annum, but may change by more, in particular if the *Supervisory Board* deems it necessary to protect the *Financial Position of the Office*.
- CB.3 For DA and CA business the *interim annual bonus rate* is set at the start of each calendar year at a

level consistent with the expected return on the underlying assets minus the annual management charge, plus or minus an adjustment designed to bring the nominal value of the business more closely into line with the *asset shares*. In normal circumstances, the rate of *annual bonus* declared at the year end would be the same as this interim rate.

C. The approach to setting final bonuses

Principles

- PC.1 *Final bonuses* are set with the intention of distributing equitably between its policyholders all the assets of the *NP Life Fund*, including all future surpluses but as far as possible excluding assets in the *Scheme Capital Account*, *Scheme Capital Fund*, *Earmarked Portfolio* and *Shareholder Equalisation Fund*.
- PC.2 For maturities and retirements under CWP, PSA and UWP business, and deaths and transfers under PSA and UWP business, *final bonuses* are normally set so that the total payout is targeted on *asset share*, subject to smoothing (see section D below), plus any distribution of the *estate*. The policyholder will receive not less than the value of the guaranteed benefits under the relevant policy.
- PC.3 No *final bonus* is normally payable on DA and CA business.

Practices

- CC.1 *Final bonuses* are normally reviewed twice each year at 30 June and 31 December, but may be changed without notice at any time that *NP Life* determines. Such an interim change would normally either be because economic conditions have changed leading to a larger than expected gap between the levels of payouts and the underlying *asset shares*, or if the *Supervisory Board* deems it necessary to protect the *Financial Position of the Office*.
- CC.2 For each class of policy, *final bonus* rates and *MVRs*, if applicable, would normally be the same for each *terminal bonus period* whatever the cause of claim (e.g. retirement, death, transfer, switch), except where the policy conditions guarantee a benefit higher than that based on *asset share* for certain

claim types. For UWP and CA business, *MVRs* do not apply on some claims (e.g. deaths, some retirements) as specified in the policy conditions.

CC.3 For UWP business, for each *terminal bonus period*, either an *MVR* or a *final bonus* will apply. There will not be both at the same time.

CC.4 *Final bonuses* are currently set so the payout in total (but excluding any distribution of the *estate*) is targeted on 100% of the *asset share* but the amount payable may differ from 100% of the *asset share*:

- i) because of the impact of the smoothing rules;
- ii) if the *Supervisory Board* deems it necessary to protect the *Financial Position of the Office*;
- iii) because, for CWP business, the surrender basis approximates on average to *asset share*, so the amount payable on any particular policy may be more or less than the amount targeted.

CC.5 For With-Profits Endowment Assurance and With-Profits Whole Life Assurance policies, there is no separate scale of *final bonus* for surrenders, but the surrender value includes a proportion of the *final bonus* that would be payable were the policy then maturing.

D. Smoothing of payouts

Principles

PD.1 Payouts are usually smoothed so as to avoid excessive differences in payouts on similar policies over short periods of time.

PD.2 It is intended that smoothing will be cost neutral over time. If necessary, payouts will be amended to help ensure that the cost of smoothing does tend towards zero, and any outstanding smoothing account balances (see CD.1 below) can reasonably be expected to be reduced to zero within a limited period.

PD.3 *MVRs* for UWP and CA business are based on *asset shares* (and, for UWP, result from the same calculation methods as *final bonuses*), and thus reflect changes in underlying asset values.

PD.4 *NP Life* may change the way it smoothes payouts at any time or may cease to smooth payouts if the *Supervisory Board* deems it necessary to protect the *Financial Position of the Office*. In such circumstances, it may also adopt a different approach to smoothing by claim type.

PD.5 The basis for surrender values of CWP business is reviewed from time to time so that surrender values remain broadly consistent with the targeted level of payouts.

Practices

CD.1 A smoothing account is maintained to which the difference between the payouts (excluding any increase due to payment of guaranteed benefits) and the *asset shares* is credited (if positive) or debited (if negative). This smoothing account will be reduced (increased) towards zero by reducing (increasing) the investment return credited to *asset shares* and crediting (debiting) the smoothing account with the resultant change in *asset shares*. The smoothing account is accumulated each year at the rate of return in accordance with PA.6 above.

CD.2 The reductions (increases) in investment return each year are generally calculated to cover one half of the then current smoothing account balance but a higher fraction may be used if the *Supervisory Board* deems it necessary to protect the *Financial Position of the Office*.

CD.3 For CWP, PSA and UWP business, payouts are normally determined using *asset shares* under which the investment return credited in the year of claim reflects actual investment returns where known, and where returns have to be estimated is set equal to the Bank of England base rate one month prior to the date on which payouts are set, less 0.25%. This applies to all generations of policyholders.

CD.4 *MVRs* for UWP are calculated in the same way as rates of *final bonus* and rounded similarly. This is generally to the nearest 0.1%. *MVRs* for CA business are calculated using *asset shares* determined as described above for UWP business.

CD.5 *MVRs* do not apply to payments by way of *regular income payments* under policies such as

With-Profits Bonds and Flexible Income Plans. Any resulting costs in excess of *asset shares* form part of the *guarantee costs*.

- CD.6 For With-Profits Endowment Assurance and With-Profits Whole Life Assurance policies, the surrender basis is intended to pay on average the same percentage of *asset shares* as for maturity claims. The same scale of *final bonus* applies to surrender as to maturity claims, but only a proportion depending on sex, age attained and outstanding term is included in the surrender value.

- PE.5 The investment policy in respect of the *Scheme Capital Account*, *Scheme Capital Fund*, *Earmarked Portfolio* and *Shareholder Equalisation Fund* is determined by the *NP Life* Board of Directors. Such investment policy shall take account of (but shall not be bound by) the advice of the *Actuary*, and shall have regard to the need for the investments to be suitable for the purpose to which they will be put.
- PE.6 The only assets outside of the *NP Life Fund* that are relied upon to maintain the investment strategy are the assets of the *Scheme Capital Account*.

E. Investment strategy

Principles

- PE.1 The investment strategy for all the assets in the *NP Life Fund* takes into account the liabilities of *NP Life* under its policies and other liabilities. The primary requirement is to maintain the *Financial Position of the Office* at a level agreed by the *Supervisory Board* and protect existing guaranteed benefits. The need to meet, as far as possible, policyholders' reasonable expectations on levels of payouts in excess of guaranteed benefits is secondary to this.
- PE.2 Due to the *Financial Position of the Office*, the investment strategy for the *NP Life Fund* for the foreseeable future for CWP, PSA and UWP business is focused on the need to maintain the security of policyholders' guaranteed benefits. For DA and CA business, the asset strategy is primarily fixed interest securities, in line with statements made to those policyholders.
- PE.3 Derivatives may be used to implement investment policy ahead of physical sales and purchases of assets. Derivatives are also used to match certain policy liabilities or to provide protection against increases in policy liabilities.
- PE.4 The maximum counterparty risk is that agreed with the investment manager from time to time, but will in no event be more than that permitted by the valuation regulations, unless expressly authorised by the *Supervisory Board*.

Practices

- CE.1 The investment strategy for the with-profits fund is reviewed formally at least once a year. The *Supervisory Board* sets the investment strategy for the with-profits fund, and approves the investment mandate. The investment mandate specifies what proportion of the fund is to be invested in each of the asset classes, within agreed tolerances, and sets out within each asset class the restrictions on holdings of any particular asset or group of assets, and the acceptable levels of credit risk. For non-governmental fixed interest investments (other than bonds held as part of the property portfolio), the minimum acceptable credit rating at the date of purchase is A-. If the credit rating subsequently falls below this level, the holding would, subject to the investment manager's advice, normally be sold.
- CE.2 The aim is to seek to maximise the return available by investing in a range of gilt and non-gilt fixed interest securities and to consider riskier investments such as property and equity to the extent that their potentially greater returns would be beneficial to policyholders, provided that the variability in their market value could not potentially cause the *Financial Position of the Office* to significantly deteriorate.
- CE.3 The investments are selected to provide a reasonably close match to the liabilities on a realistic basis, but also having regard to the statutory solvency position of the Office.

- CF.3 Investment management has been outsourced to investment managers and administration services have been outsourced to Pearl Group Services Limited. There is a risk that the investment managers and / or Pearl Group Services Limited fail to provide adequate service or cease to trade.
- CF.4 There is a risk that the charges for administering the business could increase substantially after 2009 when the current agreements on cost levels expire. This could result in reduced payouts to policyholders, and could cause the *Financial Position of the Office* to seriously deteriorate.
- CF.5 Many of the in-force policies contain options for new policies, options over the date at which benefits are payable, and the format of the benefits. There is therefore a risk that the options could be exercised in a way that increases *guarantee costs*. There is also a risk that many policies will surrender or transfer away, reducing the expected value of future profits on those policies to the *estate* and potentially reducing the fund at a rate that may give rise to liquidity issues. There is also a risk that policies with valuable guarantees lapse at a lower rate than expected, thus increasing *guarantee costs*. These risks are monitored so that action may be taken, where appropriate and practical, to minimise the risk to the Office.
- CF.6 There is a risk that the level of *guarantee costs* could rise (e.g. as a result of investment returns being below the rates guaranteed in policy benefits) to the point where the *estate*, the *Scheme Capital Fund*, the *Asset Share Charge Fund*, the *Shareholder Equalisation Fund* and the *Earmarked Portfolio* were exhausted.
- CF.7 There is a risk that the level of outgoings from the fund exceeded the income at a time when the sale of assets was not practical. This could mean that *NP Life* would be unable to meet its payments to policyholders as they fall due.
- CF.8 The investment in non-gilt fixed interest securities carries a risk of default by the issuers of those assets.
- CF.9 There is a risk that mortality of assured lives increases substantially resulting in more payments of death benefits than expected.

- CF.10 The financing arrangements that currently give rise to *non-policy costs* are the securitised loan issued in 1998, £65 million of the *Earmarked Portfolio* issued in 2006 on which a financing charge of 4.25% per annum is payable, and the contingent loan on which a financing charge of 1.75% per annum is payable.
- CF.11 The subordinated debt issued in 2006 will be dealt with in accordance with principle PF.5.

G. Charges and expenses

Principles

- PG.1 Under the terms of the *High Court Scheme*, until the end of 2009:
- a) the per policy expenses incurred in policy administration were determined from the levels set out in that Scheme, increased each year by RPI plus 1%; and
 - b) investment management fees were fixed as a monthly charge equivalent to 0.1125% per annum of the average value of the funds under management, excluding any assets of the *Scheme Capital Account* and *Scheme Capital Fund*.

The *High Court Scheme* provides that, thereafter, the charges will be no higher than those chargeable for similar services made by third party administrators.

- PG.2 The charges and expenses attributable to the fund other than the per policy administration and investment form part of the *non-policy costs*.
- PG.3 For CWP business, *asset shares* allow for the expenses of administration, plus the commission payable under *NP Life's* normal terms. The investment return credited to CWP business is reduced by the investment management fee. For DA, UWP, PSA and CA business, *asset shares* are debited with charges in the form of an annual management charge which includes the investment management fee.
- PG.4 It is not expected that the levels of annual management charge made for DA, UWP, PSA and CA business would change unless:

a) the policy administration expenses and / or investment management fees increased significantly, particularly if they increased to the extent that they were greater than the amount of income generated by the annual management charges; or

b) the *estate* and the *Scheme Capital Fund* were both exhausted.

Any such change would only be prospective.

PG.5 All direct costs of investment are borne by the fund and act to reduce the investment return.

Practices

CG.1 Any apportionment of charges and expenses between with-profits and other business is normally only in respect of policies which are invested partially in with-profits and partially in non-profit and / or unit linked investments. Any such apportionment will normally be made on the basis of the value of the policy held in those investments or the amounts of premium to be invested in the various funds.

CG.2 All expenses charged to the fund are charged at cost. As the investment management fees charged to the *NP Life Fund* are currently lower than those specified in PG.1, the fund is charged those lower costs.

CG.3 The outsourcing agreements with Pearl Group Services Limited may be terminated at any time by them subject to one year's notice or by *NP Life*, subject to three months' notice. The agreements may also be terminated in the event of either party becoming insolvent or wound up. Similar arrangements apply to agreements with the investment managers, although the time periods may vary.

CG.4 The current level of annual management charge applicable to *asset shares* for DA, UWP, and CA business is generally 1.0% per annum, but charges applicable to some policies are different. For PSA business, the annual management charge is currently 0.85% per annum. Higher charges apply to initial units. The difference between the charges made to *asset shares* for DA, UWP, PSA and CA business and the expenses charged to the company by its investment managers and Pearl Group Services Limited are dealt with as *non-policy costs*.

H. The estate

Principles

PH.1 As a consequence of *NPI's* demutualisation, the *distributable free estate* is to be applied solely and exclusively in the provision of benefits to the *eligible with-profits policyholders* as set out in the *High Court Scheme*. The *distributable free estate* is to be distributed to the *eligible with-profits policyholders* in an equitable manner, subject to the distribution being prudent and with the intention that all of the *distributable free estate* will be distributed. It is unlikely there will be any *distributable free estate* for the foreseeable future.

PH.2 The *estate* may be used to meet any losses incurred by the company as a result of business risk, to provide a buffer against adverse experience, to pay for the *NPI Promise*, to meet *guarantee costs* as they arise and to meet any other costs necessary to ensure that payouts meet the reasonable expectations of policyholders.

Practices

CH.1 There is no distribution of the *estate* at present nor is there likely to be for the foreseeable future since it is likely that all of it will be needed to meet future *guarantee costs* and other charges for which it is liable.

CH.2 The investment strategy for the *estate* is the same as the strategy for the with-profits fund.

I. Use of the Scheme Capital Account

Principles

PI.1 The *Scheme Capital Account* and *Scheme Capital Fund* is a loan from the shareholder and the shareholder is entitled to the investment earnings net of expenses on the assets comprising the Account, plus a support charge of 1.75% per annum. The *Scheme Capital Account* is normally repayable as the average value of the with-profits amount (approximately the average over the preceding 12 months of *NP Life's* with-profit liabilities) decreases. Repayments and investment earnings are only payable to the extent that there is sufficient of the *Scheme Capital Account* to cover the payments.

PI.2 At any time that the *Actuary* deems there to be a deficit as defined in the *High Court Scheme*, sufficient of the *Scheme Capital Account* to cover the deficit shall be drawn down into the *Scheme Capital Fund* within the *NP Life Fund* as provided for in the *High Court Scheme*. No more than sufficient to cover the deficit from time to time may be kept in the *NP Life Fund* and any excess shall be returned to the *Shareholder Fund*.

PI.3 Generally, a deficit exists when and to the extent that, in the opinion of the *Actuary*, the value of the assets (to the extent that regulations allow them to be counted) in the *NP Life Fund* falls short of the greater of:

- a) the liabilities of the fund calculated in accordance with the relevant regulations; and
- b) the amount determined by the *Actuary* as necessary to continue to meet the reasonable expectations of policyholders and to manage the fund in a manner consistent with the *High Court Scheme*.

The full circumstances in which the *Scheme Capital Account* may be drawn down from the *Shareholder Fund* into the *Scheme Capital Fund* within the *NP Life Fund* of the company are detailed in the *High Court Scheme*.

PI.4 The *Scheme Capital Fund* is not repayable to the extent that it is necessary to meet *guarantee costs*. Subject to this, payouts are set as far as possible excluding assets in the *Scheme Capital Account* and *Scheme Capital Fund*.

Practices

CI.1 In determining whether a deficit exists, policyholders' reasonable expectations include that there should be sufficient assets in the *NP Life Fund* of the company to meet all claims as they fall due under all reasonably foreseeable circumstances. In addition, they include there being sufficient assets in the fund to meet regulatory capital requirements under all reasonably foreseeable circumstances.

CI.2 The support charge of 1.75% per annum payable on the *Scheme Capital Account* and the *Scheme*

Capital Fund forms part of the *non-policy costs*. Payment of the support charge is deferred if the annual statutory valuation does not reveal a surplus since the previous valuation. Any payment of the support charge that is deferred accrues interest at 3-month LIBOR until repaid.

CI.3 Prior to 2004, payment of the support charge from the *Scheme Capital Fund* was subject to a deficit test, and amounts due in respect of 2002 and 2003 were thereby deferred.

For the period to 31 December 2014, the following provisions apply:

- a) No support charge shall accrue;
- b) No further interest shall accrue on the *Scheme Capital Account* or the *Scheme Capital Fund*, any investment return in that period being for the benefit of the *NP Life Fund*; and
- c) In each year up to and including 2014, an amount of investment return equal to the support charge for that year shall be paid to the shareholder.

J. New business

Principles

PJ.1 In accordance with the conditions in the *High Court Scheme*, *NP Life* only accepts new business in the form of increments to existing policies, new policies arising out of rights under existing policies, and new members to existing group schemes. Most *incremental business* is reassured to *NPI Limited* on terms which prevent strain arising in *NP Life*.

Practices

CJ.1 The amount of new business being accepted is minimal. The only *incremental business* accepted which is not reassured to *NPI Limited* is investments in PSA under Executive Pension Plans.

K. Equity between policyholders and shareholders

Principles

PK.1 As a consequence of *NPI's* demutualisation, *NPI's* business as a mutual company was transferred into *NP Life*. The terms of the transfer are such that the *NP Life Fund* continues to operate as if it were a mutual company and the *eligible with-profits policyholders* remain entitled to 100% of the profits and losses arising on business written prior to demutualisation. The shareholder is entitled to any profits or losses arising on *incremental business* written since 1 January 2000 and reassured into *NPI Limited*. Any changes to this would require the approval of the High Court.

Practices

CK.1 The terms of the reassurance of *incremental business* provide for all profits or losses arising on that business to emerge in *NPI Limited*, and not in *NP Life*.

CK.2 Subject to certain minimum requirements being satisfied regarding the *Financial Position of the Office*, the *Earmarked Portfolio* and *Shareholder Equalisation Fund* are repayable to shareholders. The only other payments that can be made from *NP Life* to its shareholders are those in accordance with the *High Court Scheme* in respect of the *Scheme Capital Account* and *Scheme Capital Fund*. No deduction is made from *asset shares* in respect of the cost of shareholder transfers.

L. Portfolio Bonds

Portfolio Bonds are single premium bonds written by *NPI* in the second half of 1999. There are options for unit linked and unitised with-profits investment under the bond and policyholders may switch between the two. The unitised with-profits investment is reassured on original terms to Pearl Assurance plc (Pearl).

The *Pearl PPFM* gives most of the appropriate information in respect of unitised with-profits investment under Portfolio Bond business.

It is the sub-headings of '**Ordinary Branch (OB) Reinsured Business**' in the *Pearl PPFM* that provide the specific information relevant to Portfolio Bonds.

In addition, it is however relevant to note particular issues in respect of charges and expenses, business risk and the *estate* for *NP Life* affecting these policies.

Charges and expenses

Principles

L.1 The per policy expenses incurred in policy administration were agreed with Pearl Group Services Limited at the date of introduction of Portfolio Bonds and are subsequently increased each year. Investment management fees in respect of its investments are agreed by Pearl with its investment managers from time to time.

L.2 Expenses are not directly chargeable to policies – policies are subject to charges as set out in product terms, and the equivalent of an annual management charge is deducted from *asset shares*. Those charges are expected to at least cover the total costs, including commission, of all aspects of administering that business. The equivalent annual management charges are inclusive of the investment management fees.

L.3 It is not expected that the level of equivalent annual management charge would change unless:

a) the policy administration expenses and / or investment management fees increased to the extent that they were greater than the amount of income generated by the policy charges, including the annual management charges, less the normal commission payable;

b) the policies became unprofitable for any other reason.

Any such change would not be applied retrospectively.

L.4 All direct costs of investment are borne by the Pearl fund and act to reduce the investment return.

Practices

- L.5 The increase in charges made by Pearl Group Services Limited each year is a percentage equal to RPI plus 1%, until 2009. The *High Court Scheme* provides that thereafter the charges will be no higher than those chargeable for similar services made by third party administrators.

- L.6 Any apportionment of charges and expenses between with-profits and other business is normally only in respect of Portfolio Bonds which are invested partially in with-profits and partially in unit linked investments. Any such apportionment will normally be made on the basis of funds held.

Business risks

- L.7 It should be noted that Portfolio Bond business is not normally exposed to the profits or losses arising from Pearl's direct written business and it is therefore mainly the investment-related business risks and the risks to Pearl's solvency position that are relevant for Portfolio Bonds.

- L.8 In addition, reference should be made to Section F above for risks that may cause the *Financial Position of the Office* to seriously deteriorate. In the event that *NP Life* were to become insolvent, Portfolio Bond policyholders would share in any reduction in policy payouts along with other *NP Life* policyholders – the reinsurance to Pearl is an asset of the *NP Life Fund*, and is not directly attributable to the Portfolio Bond policyholders.

The estate

- L.9 Portfolio Bond policyholders have no rights to share in the *distributable free estate* of either *NP Life* or Pearl.

Appendix 1: Classes of Business

CWP Conventional with-profits business is characterised by the promise of a fixed benefit at a future date, or on death, in return for an agreed series of premium payments. Bonuses declared are added to the fixed benefit, as is any *final bonus* payable. *Final bonus* rates vary by the date the policy commenced.

CWP contracts include:

- With-Profits Endowment Assurance
- With-Profits Whole Life Assurance
- Flexible Mortgage Plans and Low Cost Mortgage Plans which are a combination of With-Profits Endowment Assurance and Non-Profit Term Assurance

UWP Unitised with-profits business is characterised by each investment in with-profits buying a number of units at the date of the investment. There is no guarantee on what those units may be worth at a future date, other than the unit price cannot fall. *Annual bonuses* are declared either in the form of additional units, or by an increase in the unit price, or a combination of both.

A *final bonus* may be added on claim, but where asset values are lower than the value of units, an *MVR* may be applied in some circumstances. *Final bonus* and *MVR* rates vary by the date on which the investment into the with-profits fund is made so, on a regular premium policy, multiple rates of *final bonus* (or *MVR*) may apply.

The contracts under which UWP is available include:

- With-Profits Bond
- Personal Pension Plan (both individual and group)
- Flexible Income Plan
- Group Money Purchase
- Group Investment Account
- Free Standing Additional Voluntary Contribution
- Phased Retirement Account

DA Deposit Administration business is a form of with-profits pension business backed primarily by fixed interest assets, where all the return is given through the *annual bonus rate* and there is no *final bonus*.

DA contracts include:

- Capital Pension Plan
- Visible Growth Fund
- Cash Accumulation Plans

CA Capital Account is similar to DA business but each investment into the Account purchases units, to which *annual bonuses* are added either by additional units or by an increase in unit price. The underlying investment strategy is the same, and CA and DA business normally share the same bonus rates. However on transfers, switches or early retirements, an *MVR* may apply to CA business, with the rates of *MVR* varying by date of investment into CA.

The contracts under which CA is available include:

- Personal Pension Plan (both individual and group)
- Flexible Income Plan
- Group Money Purchase
- Group Investment Account
- Free Standing Additional Voluntary Contribution
- Phased Retirement Account
- Executive Pension Plan
- Pension Transfer Plan

PSA Profit Sharing Account is a form of with-profits business under Executive Pension Plan and Pension Transfer Plan that is a hybrid between CWP and UWP. The contracts are priced and look like a unit linked investment and each investment buys either units in a unit linked fund or units in CA or, under PSA, a fixed benefit payable from normal retirement date. Bonuses are added to the fixed benefit(s), thus making it similar to CWP.

Appendix 2: Glossary

Actuary

This means the With-Profit Actuary of the company.

Alternative Investments

Investments typically made within a series of specialised funds set up with the aim of enhancing returns whilst reducing investment risk and fluctuations in returns. The specialist funds will use a range of investment managers in order to diversify their exposure to both individual managers and to the risks of the underlying portfolios. The investment managers will invest in a wide range of financial instruments (such as shares, fixed interest securities, cash and derivatives) to achieve their investment objectives. Selection and management of the investment managers will be subject to particularly detailed and continuous assessment in order to minimise the potential for adverse investment outcomes.

Annual bonus

An addition to the guaranteed benefits under a with-profits policy arising from a declaration by the *Supervisory Board* (or prior to demutualisation the *NPI Board*) of a distribution of surplus in that format to relevant policies. Once declared, *annual bonuses* become an addition to the benefits guaranteed under the policies to which they attach. Consequently, they increase the reserves *NP Life* has to hold in respect of its guaranteed liabilities.

Annual bonus rate

Annual bonuses are distributed as a percentage of the sum assured or sum assured plus existing *annual bonuses* for CWP and PSA business, or the bid value of the units held for UWP or CA business, or the nominal value of the deposit account under DA business. The *annual bonus rate* means that percentage rate, which varies by policy type.

Asset share(s)

The amount determined in CA.2 above.

Asset Share Charge Fund

A separate sub-fund of the with-profits fund as described in CA.11 above.

Distributable free estate

That part of the *estate* that the *Supervisory Board* declares to be distributable to *eligible with-profits policyholders*, taking into account the amount of the *estate* and all likely

costs charges and other debits to it, and the need to maintain the *Financial Position of the Office*.

Earmarked Portfolio

The portfolio of assets representing monies transferred into the *NP Life Fund* by the shareholder to support the fund.

Eligible with-profits policyholder(s)

The holder of a with-profits policy written by *NPI* that was in force (or was treated by *NPI* as having been in force) continuously from prior to 2 October 1999 until 1 January 2000.

Estate

The amount by which the assets of the *NP Life Fund*, excluding the *Scheme Capital Fund*, the *Asset Share Charge Fund*, the *Shareholder Equalisation Fund* and the *Earmarked Portfolio*, exceed the *asset shares*.

Final bonus

A bonus payable on claim to increase the guaranteed benefits, as increased by any *interim annual bonus rate* that is applicable, to the level determined in accordance with Section C above.

Financial Position of the Office

The financial strength of *NP Life* as measured by the regulatory solvency requirements, and / or an assessment of its financial strength on a realistic basis as determined by the *Actuary*.

Guarantee cost(s)

The amount by which the value of the guaranteed benefits under any policy which becomes a claim exceeds the value of the payout that would have been made had the benefit not been guaranteed.

High Court Scheme

The Scheme approved by the High Court under Section 2C of the Insurance Companies Act 1982 on 5 October 1999, governing the demutualisation of *NPI* and the operation of *NP Life* thereafter and amended on 5 February 2010 with the approval of the High Court.

Incremental business

Any new policy, increment to an existing policy or new member to a group scheme written by *NP Life* on or after 1 January 2000.

Interim annual bonus rate

A rate of bonus announced by the *Supervisory Board* applying to policies becoming claims in anticipation of a surplus arising during the financial year out of which they expect to declare an *annual bonus* and designed to give claims a fair share of the profits of *NP Life* that would have been distributed as *annual bonus* for the part year starting at the beginning of the financial year of claim and ending on the claim date.

MVR

A Market Value Reduction, referred to in most *NPI* and *NP Life* documents as a Market Value Adjustment (MVA). This acts like a negative *final bonus* to reduce payouts on UWP and CA business when the value of the underlying assets are less than the value of the units including declared annual and interim bonuses. *MVRs* do not apply to all claims, and the claims they do apply to are set out in the relevant policy documents.

Non-policy costs

Non-policy costs are those costs which the *NP Life Fund* bears including all amounts that would be expected to be covered by surplus assets to the extent that the expected costs exceed surplus assets but excluding:

- a) the amounts charged by Pearl Group Services Limited and its investment managers under *NP Life's* service agreements with those companies; and
- b) any *guarantee costs*.

NPI

National Provident Institution, a mutual life insurance company established in 1835 and demutualised at the beginning of 2000.

NPI Limited

A proprietary life assurance company established in 1999 which commenced writing new business in 2000.

NPI Promise

This applies only to certain mortgage endowment policyholders who have been notified of their eligibility for this Promise. The Promise states:

" *NP Life* promises that the maturity proceeds (of the *mortgage endowment policy*) will not be less than the

target amount that the mortgage endowment policy was originally intended to repay provided that the average investment return achieved on the underlying assets between 1 April 2001 and the maturity date of your policy compounded annually and after allowing for investment expenses and tax is at least 6%. In the event that the fund return averages less than 6% per annum over the relevant period, *NP Life* will pay the amount that would have been payable had the investment returns averaged exactly 6% per annum, but no more than the shortfall".

The *NPI Promise* is subject to certain conditions being met, principally that the policy continues in force unaltered to its maturity date and all premiums are paid when due.

NP Life

National Provident Life Limited.

NP Life Fund

The long term business fund of *NP Life*, held to cover policy and related liabilities.

Pearl PPFM

The Principles and Practices of Financial Management produced by Pearl Assurance plc in respect of its with-profits business. This may be obtained from Pearl Assurance plc, Lynch Wood, Peterborough PE2 6FY, or from their website at www.pearl.co.uk.

PPFM

The Principles and Practices of Financial Management for *NP Life*.

Regular income payments

The right under some policies to have units encashed on a regular basis to provide a fixed sum at each encashment date.

Scheme Capital Account

Money held in the *Shareholder Fund* of the company as the Capital Account as defined in the *High Court Scheme*, effectively a loan by the shareholder to *NP Life*, repayable subject to certain conditions.

Scheme Capital Fund

Money held in the *NP Life Fund* that has been drawn down from the *Scheme Capital Account*.

Shareholder Equalisation Fund

The fund established under the terms of the *High Court Scheme* as amended on 5 February 2010.

Shareholder Fund

The property and liabilities of *NP Life* other than those attributable to or represented by the *NP Life Fund*.

Supervisory Board

The Board set up by the *High Court Scheme* to be responsible for, amongst other things, the investment and bonus policy of *NP Life*, and to protect policyholders' interests. The majority of this Board, including the chairman, have to be independent of the shareholder.

Terminal bonus period

A terminal bonus period is generally a calendar year in which a CWP policy commenced or an investment in PSA, UWP or CA was made, but may be a shorter period, and is mostly a quarter year in respect of With-Profits Bonds.

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