



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

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1. INTRODUCTION

The Independent Expert

- 1.1. When an application is made to the High Court (“the Court”) for an order to sanction the transfer of long term insurance or reinsurance business from one insurer to another, the application is subject to Part VII of the Financial Services and Markets Act 2000 (“FSMA”) and must be approved by the Court under section 111. FSMA requires the application to be accompanied by a report on the terms of the Scheme by an independent expert.
- 1.2. I have been appointed by Pearl Assurance plc (“Pearl”) and National Provident Life Limited (“NPLL”) to report, pursuant to section 109 of FSMA, in the capacity of the Independent Expert, on the terms of the proposed 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.
- 1.3. In the remainder of this report (“my report”) I refer to this proposed scheme as “the Scheme”.
- 1.4. The Scheme will be presented to the Court for sanction under section 111 of FSMA.
- 1.5. In addition to the application to the Court to sanction the Scheme, a separate application to the Court is being made to amend the Demutualisation Scheme referred to in section 4, although such amendments will only be made if the Court grants orders in respect of both of the applications and the requirements in respect of various tax clearances have been met or waived.
- 1.6. The application to amend the terms of the Demutualisation Scheme is intended to be heard immediately prior to the hearing to sanction the Scheme.

The scope of my report

- 1.7. My terms of reference have been reviewed by the Financial Services Authority (“FSA”) and are set out in Appendix 1.
- 1.8. My report has been prepared under the terms of the guidance set out in Section 18 of the Supervision Manual contained in the FSA Handbook.
- 1.9. My report considers the consequences of the Scheme and the proposed amendments to the Demutualisation Scheme on the policyholders of Pearl and NPLL.
- 1.10. 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.
- 1.11. I am aware of the requirements regarding experts set out in Part 35 of the Civil Procedure Rules, this Practice Direction and the Protocol for Instruction of Experts to give Evidence in Civil Claims.
- 1.12. In assessing the impact of the Scheme and of the proposed amendments to the Demutualisation Scheme on the policyholders of Pearl and NPLL, and whether those policyholders are being treated fairly as a result of the implementation of the Scheme and the amendments to the Demutualisation Scheme, I have had regard to:
 - The effect of the Scheme and the amendments to the Demutualisation Scheme on the security of policyholder benefits and on the expectations of policyholders created by past practices employed, or statements made, by each company;
 - The Principles and Practices of Financial Management (“PPFM”) of each company; and
 - The reports of the With-Profits Actuary (“WPA”) and the Actuarial Function Holder (“AFH”) of each company.
- 1.13. As far as I am aware, there are no matters which I have not taken into account in undertaking my assessment of the Scheme and the proposed amendments to the Demutualisation Scheme and in preparing my report, but

which nonetheless should be drawn to the attention of policyholders in their consideration of the terms of the Scheme and the proposed amendments to the Demutualisation Scheme.

- 1.14. I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.
- 1.15. My report does not consider alternative schemes.
- 1.16. NPLL and Pearl have taken legal advice and have been advised that, as a matter of Jersey and Guernsey law, it will be necessary to undertake a separate Jersey scheme and a separate Guernsey scheme. The comments and conclusions contained in my report apply equally to the Pearl and NPLL business of policyholders who are resident in Jersey and Guernsey as they do to business written in the UK.

Qualifications and disclosures

- 1.17. I am a fellow of the Institute of Actuaries having qualified in 1973.
- 1.18. I am a principal of Milliman, Consultants & Actuaries ("Milliman") and I am based in its UK life insurance practice. My experience in the UK life insurance industry includes a number of Actuarial Function Holder, expert witness and reviewing actuary roles.
- 1.19. My appointment as the Independent Expert has been approved by the FSA in a letter dated 5th August 2009 to Pearl.
- 1.20. I hold no policies with, and have no financial interest in, Pearl or NPLL.
- 1.21. I have undertaken various roles as Independent Expert in the past, some for companies now part of the same group as Pearl and NPLL. These are covered in a statement of independence that was submitted to the FSA for review before my approval. This statement of independence is included in Appendix 1.
- 1.22. I do not believe that any of the above adversely affects my ability to act independently in my assessment of the Scheme or the proposed amendments to the Demutualisation Scheme.

Limitations

- 1.23. This report, and any extract or summary thereof has been prepared particularly for the use of the bodies or persons listed below:
 - The Court and the relevant Courts in Jersey and Guernsey;
 - The Directors and senior management of Pearl;
 - The Directors and senior management of NPLL;
 - The FSA or any other governmental department or agency having responsibility for the regulation of insurance companies in the UK;
 - The Jersey Financial Services Commission;
 - The Guernsey Financial Services Commission; and
 - The professional advisors of any of the above.
- 1.24. In preparing my report, I have had access to certain documentary evidence provided by Pearl and NPLL, the key elements of which are listed in Appendix 5. I have also had access to, and discussions with, senior management of Pearl and NPLL. In coming to my conclusions, I have relied upon the accuracy of the information which has been provided to me in written or verbal form, without independent verification.
- 1.25. This report must be considered in its entirety as individual sections, if considered in isolation, may be misleading. Draft versions of this report should not be relied upon for any purpose. I have provided a summary of my report

for inclusion in the policyholder circular and, other than this, no summary of my report may be made without my express consent.

- 1.26. This report has been prepared by Milliman on an agreed basis for Pearl in the context of the Scheme and the proposed amendments to the Demutualisation Scheme and must not be relied upon for any other purpose. No liability will be accepted by Milliman, or me, for any application of my report for a purpose for which it was not intended nor for the results of any misunderstanding by any user of any aspect of the report. In particular no liability will be accepted by Milliman or me under the terms of the Contracts (Rights of Third Parties) Act 1999.
- 1.27. The use of Milliman's name, trademarks or service marks, or reference to Milliman directly or indirectly in any media release, public announcement or public disclosure, including in any promotional or marketing materials, customer lists, referral lists, websites or business presentations is not authorised without Milliman's prior written consent for each such use or release, which consent shall be given in Milliman's sole discretion.

2. GENERAL CONSIDERATIONS OF THE INDEPENDENT EXPERT

Introduction

- 2.1. I have compiled my report in accordance with Chapter 18 of the Supervision Manual of the FSA Handbook.
- 2.2. Under FSMA, the concept of treating customers fairly (“TCF”) should be applied. In order to ensure that customers are treated fairly in the future it is necessary to establish the ways in which customers have been treated in the past. From the policyholders’ perspective, the successful implementation of the Scheme must be on the basis that their benefits and fair treatment are not materially adversely affected.
- 2.3. I need to consider the terms of the Scheme generally and how the different groups of policyholders are likely to be affected by the Scheme and, in particular:
 - The effect of the Scheme on the security of the policyholders’ contractual rights, including the likelihood and potential effects of the insolvency of the insurer; and
 - The likely effects of the Scheme on the benefit expectations of policyholders.
- 2.4. As described in section 4 of this report, two life companies are concerned in the Scheme, with different mixes of business within them.
- 2.5. The type of policy held by a policyholder will be a key determinant of the risks to which the policyholder is exposed. Other than this, the key determinants will be the characteristics of the company in which the policy is held – for example:
 - Size of company;
 - Amount of capital held, other calls on that capital and capital support currently available to the company;
 - Investment strategy;
 - Mix of business written;
 - Company strategy – e.g. open or closed, acquisitions strategy; and
 - Operational risks, reinsurance, governance, tax etc.
- 2.6. Some of these risks are company specific, for example risks arising from the particular mix of business written or the company strategy, and some are risks that are common to various different groups of policyholders across the companies subject to the Scheme.
- 2.7. In addition to the application to the Court to sanction the Scheme, a separate application to the Court is being made proposing amendments to a previous scheme from 1999 called the Demutualisation Scheme, although such amendments will only be made if the Court grants orders in respect of both of the applications. I give the background and context to the Demutualisation Scheme in section 4 of this report.
- 2.8. Under the terms of the Demutualisation Scheme, such amendments need to be made by a separate application to the Court and certification from an ‘independent actuary’ that the proposed amendments will not adversely affect the reasonable expectations of, or reduce the protections conferred by, the Demutualisation Scheme on NPLL policyholders is also required.
- 2.9. In this report I also consider the effects of the proposed amendments to the Demutualisation Scheme.

The structure of my report

- 2.10. Sections 3 and 4 of this report provide some background to the Pearl group and to the companies concerned in the Scheme and in section 5 I describe some post balance-sheet date capital injections that occurred primarily as a result of the recent acquisition of Pearl by Liberty Acquisition Holdings (International) Company (“Liberty”).

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- 2.11. In section 6 I summarise the key aspects of the proposed changes to the Demutualisation Scheme and in section 7 I summarise the key aspects of the Scheme.
 - 2.12. Section 8 covers some general issues around the governance of Pearl and NPLL.
 - 2.13. In section 9 I consider the issues facing the NPLL policyholders as a result of the proposed amendments to the Demutualisation Scheme.
 - 2.14. In the following sections I consider the issues facing the with-profits policyholders of the companies concerned in the Scheme (section 10) followed by the issues faced by the non-profit policyholders of the companies concerned in the Scheme (section 11).
 - 2.15. In section 12, I cover other more general issues relating to the Scheme, the proposed amendments to the Demutualisation Scheme and the management of the Pearl group.

Security of policyholder benefits

- 2.16. As part of my role as Independent Expert for this Scheme, I need to consider the security of policyholder benefits, that is the likelihood that policyholders will receive their benefits when due.
- 2.17. In considering and commenting upon policyholder security I shall consider primarily policyholders' guaranteed benefits and as appropriate their reasonable benefit expectations. The amount by which the long term fund assets exceed the long term fund liabilities (including the mathematical reserves) provides security for guaranteed benefits. Security is also provided by the margins for prudence in the assumptions used to calculate the long term business fund liabilities and by the shareholder capital.

Treating customers fairly ("TCF")

- 2.18. As Independent Expert for the Scheme I need also to consider the proposals in the context of the FSA's TCF regime and in particular the effect on policyholders' benefit expectations.
- 2.19. This involves consideration of areas where discretion is involved on behalf of the relevant insurance company with regard to charges applied to a policy and the benefits granted to the policyholder, and also to service standards applied.

The current regulatory regime

- 2.20. At the 2004 year end the FSA introduced a risk based capital framework under which companies are required to assess solvency under two regimes called Pillar I and Pillar II.
- 2.21. Pillar I is closely aligned to the statutory or regulatory measure of solvency of the previous regulatory regime where companies calculated their assets at broadly market value and their liabilities with allowance for prudence. Under Pillar I, reserves and capital requirements are calculated on a regulatory and on a realistic basis. Under the new regulatory regime, in addition to holding capital to cover these liabilities, companies must hold further amounts of capital to cover themselves against adverse deviations in future experience and one off shocks to investment performance. The overall capital requirement under the new Pillar I regime is called the Capital Resources Requirement ("CRR").
- 2.22. The Long-Term Insurance Capital Requirement ("LTICR"), the Resilience Capital Requirement ("RCR") and the With-Profits Insurance Capital Component ("WPICC") are elements of the CRR, specifically mentioned later in this report.
- 2.23. The capital that must be held under Pillar II is an amount set by the Individual Capital Assessment ("ICA"), which is the company's own assessment of its capital requirements. Pillar II is intended to provide a more realistic and complete view of the risks to which the company is exposed and to provide a framework within which the company should be managed in the future.

- 2.24. The FSA requires firms, when preparing their ICA, to identify the major risks they face and, where capital is appropriate to mitigate those risks, to quantify how much (and what type) of capital is appropriate. The FSA expects firms to conduct stress tests and scenario analyses in respect of each risk. These stress tests and scenario analyses, together with the assumptions used, should be documented and, along with the results, submitted to the FSA as the ICA. The company is not required to publish its Pillar II capital requirement.
- 2.25. The FSA will review the ICA and may prescribe an additional amount of capital that must be held by the firm in addition to the ICA. The total amount of Pillar II capital prescribed by the FSA is usually expressed as a percentage of the ICA capital, and is called Individual Capital Guidance ("ICG").
- 2.26. For the ICA, a firm will assess the amount of capital it needs to hold to remain able to meet its liabilities as they fall due in all but the most extreme circumstances. The FSA has indicated that ICG will be given taking into consideration capital resources consistent with a 99.5% confidence level that the firm will be able to meet its liabilities over a one year timeframe or, if appropriate to the firm's business, an equivalent lower confidence level over a longer timeframe.

3. BACKGROUND ON PEARL GROUP LIMITED

- 3.1. The Australian Mutual Provident Society (“AMPS”) merged with London Life Association in 1989 and acquired Pearl in 1990. In 1997 AMPS demutualised to create a holding company for all its insurance business called AMP Limited.
- 3.2. NPLL was established in 1999 by AMP Limited and commenced trading in January 2000 as part of arrangements relating to the demutualisation of National Provident Institution (“NPI”).
- 3.3. In December 2003, Pearl, NPLL, NPI Limited (“NPIL”) and London Life were de-merged from AMP Limited to become part of a new UK company called the Henderson Holding Group (“HHG”).
- 3.4. In April 2005, Sun Capital Partners and TDR Capital bought the Pearl, NPLL, NPIL and London Life businesses from HHG and these three companies became part of the newly formed Pearl Group Limited (“PGL”).
- 3.5. PGL was formed in 2004 for the purpose of purchasing and running closed UK life funds. It aimed to offer a solution to the growing problems and publicity surrounding closed life funds in the UK and was set up with the objective of ‘improving returns to policyholders of closed funds.’
- 3.6. PGL was at that stage owned by Sun Capital Partners and TDR Capital.
- 3.7. On 1st May 2008, PGL acquired the Resolution group of companies and currently consists of the following UK life insurance companies:
 - Pearl;
 - London Life;
 - NPLL;
 - NPIL;
 - Phoenix Life Limited (formerly owned by Resolution);
 - Phoenix and London Assurance Limited (formerly owned by Resolution); and
 - Phoenix Pensions Limited (formerly owned by Resolution).
- 3.8. In September 2009, PGL was acquired by Liberty Acquisition Holdings (International) Company (“Liberty”). Following this acquisition, Liberty was renamed Pearl Group and PGL was renamed Pearl Group Holdings (No 2) Limited.
- 3.9. As a result of the acquisition by Liberty there have been certain capital injections into the companies within PGL which are described in detail in section 5.

4. BACKGROUND ON COMPANIES CONCERNED IN THE SCHEME

Pearl

Background

- 4.1. The Pearl Loan Company was formed in 1857 and in 1862 the Pearl Life Assurance and Sick Benefit Society was formed. In 1864 the two companies merged to form The Pearl Life Assurance Loan and Investment Company Limited ("PLALIC").
- 4.2. PLALIC sold industrial branch business only until 1875 when it started to accept yearly premiums.
- 4.3. In 1874 the name was changed to Pearl Life Assurance Company Limited. The company made a number of acquisitions over the years and in 1914 the name was changed again to Pearl Assurance Company Limited. On 21st October 1981, the Company changed its name to Pearl Assurance plc ("Pearl") and re-registered as a public limited company. As at the date of this report Pearl is a public limited company.
- 4.4. In 1990, AMPS acquired Pearl and in 1997 set up a holding company for all its insurance business called AMP Limited.
- 4.5. In December 2003, Pearl, NPLL, NPIL and London Life were de-merged from AMP Limited to become part of a new UK company called HHG.
- 4.6. In April 2005, Sun Capital Partners and TDR Capital bought the Pearl, NPLL, NPIL and London Life businesses from HHG and these companies became part of the newly formed PGL.

Current fund structure

- 4.7. Pearl currently has a shareholders' fund ("Pearl SHF") and a long term business fund (the "Pearl LTF") subdivided into three sub-funds:
 - The Pearl With-Profits Fund (the "Pearl WPF");
 - The Pearl Pensions Non-Profit Fund (the "Pearl PNP Fund"); and
 - The Pearl Life Non-Profit Fund (the "Pearl LNP Fund").
- 4.8. All three have been closed to new business since 2003, with limited exceptions.
- 4.9. Pearl has written the following types of business:
 - Industrial Branch ("IB") and Ordinary Branch ("OB") life and pensions conventional with-profits business and OB unitised with-profits ("UWP") business;
 - Pensions non-profit business; and
 - Life non-profit business.
- 4.10. The table in Appendix 2 shows the financial position of Pearl as at 31st December 2008.

The Pacific Fund

- 4.11. The Pacific Fund is an attribution of surplus held in the Pearl WPF prior to 1965 which had not been distributed but to which, it was decided, the shareholders are partially entitled.
- 4.12. On 13th September 1996, the Secretary of State for Trade and Industry granted a Section 68 Order which allowed the Pacific Fund to be set up and which set out various conditions for its operation and altered the application of certain provisions of the Insurance Companies Act 1982 to Pearl accordingly. It is a condition of the Section 68 Order that this fund, which is now part of the Pearl LNP Fund, must be available not only to support the solvency of the Pearl WPF, but also to ensure that policyholders' reasonable benefit expectations are met. It is therefore

included in any investment strategy considerations. The fund is not available to support any with-profits business that is reinsured into Pearl.

The demutualisation of National Provident Institution (“NPI”)

- 4.13. NPI was established in 1835.
- 4.14. On 1st January 2000, NPI demutualised and was then acquired by AMP Limited. The demutualisation was effected via a transfer under Schedule 2C of the Insurance Companies Act 1982 (the “Demutualisation Scheme”). Simultaneously with the demutualisation, two new companies were formed; NPLL and NPIL.
- 4.15. Under the Demutualisation Scheme, the existing long term business assets and liabilities of NPI were transferred into the NPLL long term fund (the “NPLL Fund”). Subsequent new business was written in NPIL.
- 4.16. The NPLL Fund was closed to new business, with the exception of incremental business and certain new business issued under options in existing contracts.
- 4.17. The Demutualisation Scheme required the appointment of a committee, with responsibility for the management of the NPLL Fund. This committee is the NPLL Fund Supervisory Board.

Policy administration

- 4.18. Policy administration for NPLL is carried out by a service company within PGL.
- 4.19. The charges for this servicing are controlled by Schedule 4 of the Demutualisation Scheme, which sets out:
 - A list of per policy or per benefit acquisition, renewal, and termination expenses broken down by product type;
 - That charges are based on the numbers of policies or benefits in force each 1 July;
 - That the charging scale increases by RPI plus 1% each year. The extra 1% recognises that a part of the servicing costs are staff costs which escalate more quickly than RPI; and
 - That investment management charges are restricted to 0.1125% of funds under management.
- 4.20. The charges are determined as set out above for ten years from the implementation of the Demutualisation Scheme, i.e. until 1 January 2010.
- 4.21. After the ten year period, the charges cannot exceed those for similar services provided by third party companies and cannot significantly exceed the costs which NPLL would incur in undertaking the services itself.
- 4.22. Service standards at the time of the transfer were to be maintained, or (if better) to be those applicable to equivalent business elsewhere in the Group.
- 4.23. Any judgement calls regarding the charges to be applied after 2010 are the responsibility of the NPLL Fund Supervisory Board.

Taxation

- 4.24. Liabilities transferred to NPLL as a result of the demutualisation included taxation liabilities for the transferred business, including any arising as a result of the transfer.
- 4.25. The Demutualisation Scheme explicitly mentions that any taxation liabilities shall not be transferred to the shareholders' fund.
- 4.26. The NPLL Fund must be debited with taxation charges as if it were a mutual fund.

Membership Rights

- 4.27. Membership rights were cancelled in consequence of the Demutualisation Scheme and associated arrangements.
- 4.28. Members received compensation for their loss of membership rights in NPI. Any compensation unclaimed after six years would be forfeit and placed into the NPLL Fund.

The “Overcoat”

- 4.29. On the Demutualisation Scheme Effective Date AMP transferred £800 million to the NPLL shareholders’ fund, into an account called the “National Provident Life Capital Account” (the “Capital Account”). This capital support is known as the overcoat.
- 4.30. The Capital Account can be drawn down to the NPLL Fund if there is a deficit in the NPLL Fund to the amount needed to meet contractual and policyholders’ reasonable expectations of benefits in accordance with the Principles of Financial Management. The Demutualisation Scheme document highlights that PRE with respect to the security (but not amount) of benefits takes into account shareholder funds in NPLL.
- 4.31. The drawdown of capital from the Capital Account will occur via either a transfer of funds to the Transfer Capital Fund or via a contingent loan into the Loan Capital Fund. Both the Transfer Capital Fund and the Loan Capital Fund are sub-funds of the NPLL Fund.
- 4.32. The Demutualisation Scheme sets out that support charges are payable in respect of any such contingent loan. In any given year, the support charge is only payable if, after the payment of the support charge the NPLL Fund still has a non-negative regulatory surplus. In the event that the support charge is not able to be paid, it is deferred (and incurs interest) until such time as sufficient surplus has arisen to pay the accumulated charge.
- 4.33. In practice the entire overcoat is currently held in the Loan Capital Fund as a contingent loan. There is currently a moratorium period in respect of the interest payable on this loan but the support charges continue to be payable subject to the conditions described above. Payment of the 2007 and 2008 support charges has been deferred due to the financial condition of NPLL.

NPLL

- 4.34. NPLL was authorised in 1999 and was set up by AMP to accept the existing business of NPI. NPLL has been closed to new business since 2000. No new direct business is currently being written with the exception of incremental business and certain new business issued under options in existing contracts.
- 4.35. NPLL has a shareholders’ fund (the “NPLL SHF”) and a long term business fund with one sub-fund – the NPLL Fund. Within the NPLL Fund are two further sub-funds: the Transfer Capital Fund and the Loan Capital Fund.
- 4.36. With-profits policyholders are entitled to all of the distributable surplus arising in the NPLL Fund, and payouts are determined using asset shares as a guide.
- 4.37. The asset share of an insurance policy is a measure of the policy’s current value. It is calculated by increasing the premiums paid to date under the policy at the actual rate of return achieved on the assets, whilst making deductions for expenses incurred, tax and any charges levied by the company.
- 4.38. The definitions of asset share for the different product types of NPLL are given in Appendix 6.
- 4.39. The main products written in the NPLL Fund are:
- Self Employed Retirement Plan (“SERP”). This is a conventional with-profits (“CWP”) deferred annuity contract sold to the self employed. In return for regular and single premiums the product provides a guaranteed minimum level of annual income on retirement.
 - Unitised with-profits personal pension plans (“UWP PP”). These are personal pension plans sold to individuals since 1988. Contributions from policyholders purchase units at the rate applicable at that time.

Unit prices increase daily by the interim reversionary bonus rates which may be changed at any time until formally declared at the end of the year. Terminal bonus units may be added at any time. Series 1 policies offer a guaranteed minimum reversionary bonus of 4% per annum. If benefits are taken prior to age 65 a market value adjustment ("MVA") may be applied.

- Life With-Profits Bond. This is a single premium, UWP whole of life assurance contract.
- Profit Sharing Accounts ("PSA"). The PSA is effectively a CWP contract that pays out a sum assured on death or survival beyond a fixed term. The sum assured payable on survival to the pre-selected retirement date has a guaranteed minimum value.

4.40. Other products consist of:

- Other UWP products similar to the UWP PPP above. These include the Group Money Purchase, Free Standing AVC, Phased Retirement Account and Flexible Income Plan contracts.
- Other conventional business. For example conventional with-profits endowments, whole of life policies and some non-profit contracts.
- Deposit administration business. Under these policies premiums (net of charges) are credited to a deposit account that is increased with bonuses. The amount in the account is used to purchase pensions benefits.
- Capital Account business. The capital account is available to UWP policyholders as an investment choice and is invested in different assets compared to UWP and receives different bonus rates.

4.41. The level of guarantees attaching to the with-profits policies in the NPLL Fund is high and places a strain on the financial resources of NPLL in excess of the asset shares of the policies. The table in Appendix 2 shows the financial position as at 31st December 2008 for NPLL.

4.42. As at 31st December 2008 99.7% of the SERP policies had a guaranteed value above their asset share value. For the NPLL UWP business this percentage was approximately 91%. For SERP policies the excess of guaranteed value over the asset share was 127% in aggregate and for UWP policies the excess was 53%.

The Asset Share Charge Fund

4.43. Once the overcoat has been totally exhausted the cost of guarantees could be met from the Asset Share Charge Fund.

4.44. The charges that have already been made to the asset share of 2% in 2007 and 2008 are held in the Asset Share Charge Fund. These assets will be returned to asset shares if they are not needed to cover guarantees.

The Earmarked Portfolio

4.45. The Earmarked Portfolio consists of:

- A loan of the proceeds of the issue of subordinated unsecured notes of £65 million by the NPLL SHF in June 2006; and
- £55 million of assets drawn down from the NPLL SHF into the long term fund. This £55 million is made up of £10 million in 2004, £15 million in 2005 and £30 million in 2008.

4.46. The loan has interest payments of the investment return on the asset plus a 4.25% financing charge increasing by 0.5% per annum after 5 years. The value of the £55 million drawn down into the long term fund was £59.7 million as at 31st December 2008. There have been no changes to the Earmarked Portfolio in 2009 to date.

4.47. The Earmarked Portfolio exists to enhance the security of the NPLL policyholders but it is not a factor in their benefit expectations.

The Securitised Loan

- 4.48. NPI issued a securitisation loan on 16th April 1998. The face value of the loan was £260 million secured on the embedded value of most of the UWP and unit-linked business of NPI, creating the Mutual Securitisation plc vehicle. Under the original terms of the loan, £140 million is due for redemption by 2012 and £120 million is due for redemption by 2022.
- 4.49. Under the terms of the Demutualisation Scheme, all obligations of NPI with respect to the securitisation were transferred to, and assumed by, NPLL.
- 4.50. The surplus emerging on the business securitised is payable subject to the cap of a fixed schedule of payments.
- 4.51. As at 31 December 2008 the nominal amount outstanding on the Securitised Loan was £175 million.

Priority of Assets

- 4.52. In the event that there are insufficient assets allocated to the asset shares, the Capital Account, the Transfer Capital Fund and the Loan Capital Fund to cover the guarantees, then the next call would be on the Asset Share Charge Fund. If this still proves insufficient then assets from the Earmarked Portfolio and the NPLL SHF would be required.

Opal Re

- 4.53. Opal Re was established in 2007 with the main purpose of helping the PGL life companies to manage their long-tailed longevity risk. Opal Re is registered in Bermuda and is regulated by the Bermuda Monetary Authority. Opal Re currently has three separate treaties with Pearl, London Life and NPIL.
- 4.54. Pearl, NPIL and London Life each has a collateral account where Opal Re assets are held in respect of the reinsurance treaties. The assets held in each collateral account must be at least 102% of the best estimate liabilities. The asset and best estimate liability values are tracked every month and, at the end of each quarter, if the assets value is less than 102% of the best estimate liabilities, then Opal Re is required to inject further capital to this level.
- 4.55. The initial premium paid by each company to Opal Re was equal to the Pillar I (regulatory peak) reserves as at the end of 2006. This amount was paid to the collateral accounts and resulted in initial ratios of assets to best estimate liabilities of 103% - 105%.
- 4.56. Under Pillar I (regulatory peak) each life company holds a counterparty default provision in respect of Opal Re which reflects the shortfalls of the collateral accounts compared to the Pillar I (regulatory peak) reserves.

5. POST 31 DECEMBER 2008 FINANCIAL EVENTS

- 5.1. Since the FSA Returns and Report and Accounts for 31st December 2008 have been produced there have been some significant financial effects on Pearl and NPLL. These are:
- An injection of capital of £300 million into the Pearl SHF;
 - The transfer of £50 million of capital from the Pearl SHF to the NPLL SHF;
 - An injection of capital of £60 million into Opal Re;
 - A further capital injection into Pearl of £41m to replace a previously issued letter of credit in respect of Opal Re; and
 - The effecting of a reinsurance treaty ceding some of the longevity risk from the SERP policies to Pearl.
- 5.2. As at the 2008 year end Pearl held a counterparty default provision in respect of Opal Re. The injection of capital into Opal Re from Liberty results in a lower provision requirement for Pearl. After costs and an allocation of monies to London Life, the effect of the £60 million injection is restricted to a reduction of £52 million to the Pearl PNP Fund liabilities. The injection of capital by Liberty into Opal Re improves the excess capital available on both a Pillar I and a Pillar II basis.
- 5.3. As at the 2008 year end the assets of Pearl included a letter of credit from PGL in respect of Pearl's counterparty risk exposure to Opal Re. As at 31st December 2008, this letter of credit was included as an asset for Pillar I purposes but considered of no value for Pillar II. This has now been replaced by Pillar II admissible assets and further enhances the Pillar II position of Pearl.
- 5.4. In August 2009 NPLL and Pearl entered into a reinsurance agreement under which Pearl agreed to accept some of the longevity risk from the NPLL SERP policies. In the event that longevity experience turns out to be significantly higher than expected, Pearl will be called upon to cover the excess annuity payments. In the event that longevity is significantly lower than expected, NPLL will be required to pay some of the shortfall to Pearl. No premium was paid by NPLL to Pearl for this arrangement. This agreement has no effect on a Pillar I basis as it affects only the stress scenarios in the Pillar II ICA calculation. On a Pillar II basis the agreement has the effect of increasing the end 2008 capital resources (after the ICA) of NPLL by £19 million.
- 5.5. The capital enhancements referred to in paragraph 5.1 have considerable effects on the financial positions of Pearl and NPLL prior to the implementation of the Scheme.
- 5.6. As at the 31st December 2008 the events above would have had the effects on the financial positions of Pearl and NPLL on a Pillar I basis as shown below.

| | NPLL | | Pearl | |
|-------------------------|---------------|----------------|---------------|----------------|
| | Pre-injection | Post-injection | Pre-injection | Post-injection |
| Assets | 5,627 | 5,677 | 15,879 | 16,129 |
| Liabilities | 5,263 | 5,263 | 14,909 | 14,857 |
| Excess assets | 364 | 414 | 970 | 1,272 |
| CRR | 305 | 305 | 614 | 614 |
| Excess assets after CRR | 59 | 109 | 356 | 658 |
| Excess assets % | 1.1% | 2.1% | 2.4% | 4.4% |

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- 5.7. It should be noted that this table shows Pearl on a “standalone” basis and excludes the value of the NPLL excess assets.
- 5.8. The tables in Appendix 2 show more detail on the effect of the capital injections on Pearl and NPLL at a fund level.
- 5.9. The table above shows that the capital injections have considerably improved the financial soundness of both companies on a Pillar I basis.
- 5.10. On a Pillar II basis prior to the capital injections, as at 31st December 2008, the free capital of NPLL was 109% of its own ICA as adopted by the Board. Over the course of 2009 the Board of NPLL have been considering whether they should hold capital to cover a materially stronger ICA. The capital injections referred to above would enable NPLL to cover a materially stronger ICA.
- 5.11. Pearl has capital in excess of its Pillar II ICA after the capital injections.
- 5.12. During 2008 a Part VII Scheme was proposed by Pearl but never implemented (the “2008 Scheme”). The 2008 Scheme contained provisions to transfer the SERP business in a similar way to this Scheme and also contained provisions relating to the transfer of other business which are not included in this Scheme. I understand that the 2008 Scheme was withdrawn due to the uncertainties caused by the extremely volatile financial conditions in the second half of 2008 and the potential effect of these conditions on the financial strength of Pearl after the proposed transfers of business.
- 5.13. I have discussed the proposal to introduce the current Scheme with senior management of Pearl and with the Pearl and NPLL actuaries and I note the following:
- The 2008 year end solvency position is now known;
 - There have been capital injections and other enhancements to the capital position of Pearl on a Pillar I and Pillar II basis as described above; and,
 - The scope of the Scheme is narrower than that of the 2008 Scheme with overall less risk being assumed by Pearl.
- 5.14. I am therefore satisfied that the subsequent improvement in the financial condition of Pearl both before and after the Scheme means that the concerns that led to the withdrawal of the 2008 Scheme are no longer relevant.

6. THE PROPOSED AMENDMENTS TO THE DEMUTUALISATION SCHEME

Motivation for the amendments to the Demutualisation Scheme

6.1. The senior management of Pearl and NPLL have outlined the following reasons for the proposed amendments to the Demutualisation Scheme:

- To address the potential inequities in the implementation of the Demutualisation Scheme;
- To allow more directed and targeted management to both the SERP policies and the residual business. Currently the NPLL Fund cannot differentiate its strategy or hypothecate assets to separate groups of policyholders within the NPLL Fund;
- To treat all the customers of NPLL fairly; and
- To reduce customer complaints over time.

Summary of the proposed amendments to the Demutualisation Scheme

6.2. The proposed amendments to the Demutualisation Scheme are set out in Schedule 2 of the Scheme and can be grouped into the following categories:

- Changes to the credits and debits permitted between the NPLL funds;
- Changes to the Principles of Financial Management; and
- Additional provisions covering the establishment and maintenance of the Shareholders' Equalisation Fund.

6.3. I summarise each of these changes below.

Changes to the credits and debits permitted between the NPLL funds

6.4. The proposed amendments to the Demutualisation Scheme (paragraphs 27, 28, 36, 37 and 38) permit the transfer of money between the NPLL Fund, the NPLL Capital Account, the NPLL Transfer Capital Fund and the NPLL Loan Capital Fund and enable the assets of the NPLL Transfer Capital Fund to be transferred to Pearl pursuant to the Scheme.

Changes to the Principles of Financial Management

6.5. The proposed amendments to the Demutualisation Scheme will allow (paragraph 6 of Schedule 3), in the NPLL Fund:

- The allocation of returns to the respective funds based on a notional allocation of assets backing the relevant liabilities; and
- The hypothecation of different asset mixes (and therefore different returns) to different groups of policyholders.

6.6. The Principles of Financial Management will also be amended (paragraph 12 of Schedule 3) to recognise the setting up of the Shareholders' Equalisation Fund and that it:

- Will form part of policyholders' reasonable expectations ("PRE") regarding security of benefits; and
- Will not form part of PRE regarding benefit expectations of anything above asset share.

6.7. These are changes to the conditions laid down in the Demutualisation Scheme from 2000 and will be set out in the amended Demutualisation Scheme.

The Shareholders' Equalisation Fund ("SEF")

- 6.8. The amended Demutualisation Scheme will contain a new paragraph (paragraph 10A) which requires the establishment of the SEF within the NPLL Fund.
- 6.9. The amended Demutualisation Scheme will contain a new schedule (schedule 7) which contains provisions on the operation of the SEF and which puts restrictions on the amount of the SEF that can be released to the NPLL Loan Capital Fund, or otherwise as directed by Pearl, in each subsequent year. These percentages are shown in Appendix 4 and are the maximum release allowed.
- 6.10. Any such release can only occur to the extent that a Deficit (as defined in the Demutualisation Scheme) would not arise and to the extent that an investigation by the NPLL Actuary discloses sufficient surplus.
- 6.11. The SEF will rank alongside the Earmarked Portfolio within the NPLL Fund.
- 6.12. The investment return on the SEF will be retained within the SEF and it will bear its own investment expenses and tax.
- 6.13. The NPLL Board shall determine the investment policy of the SEF. Such investment policy shall take account of (but shall not be bound by) the advice of the NPLL Actuary.

7. THE PROPOSED SCHEME

Motivation for the Scheme

- 7.1. The senior management of Pearl and NPLL have outlined the following reasons for implementing the Scheme:
- To improve the financial position of NPLL;
 - To make it more likely for the investment strategy of the assets backing residual with-profits business in NPLL to be re-risked for potentially enhanced returns. This may be possible in the absence of the disproportionately onerous guarantee terms for the SERP business and the more restrictive investment strategy currently required;
 - To reduce the exposure of the residual with-profits business in NPLL to particular risks specific to the SERP portfolio;
 - To treat all the customers of NPLL and Pearl fairly; and
 - To reduce customer complaints over time.

Summary of the Scheme

- 7.2. Under the proposed Scheme the NPLL SERP policies will be transferred from the NPLL Fund to a newly created Pearl SERP Fund.
- 7.3. The Scheme is scheduled to be presented to the High Court on 20th January 2010. If it is approved by the High Court, then on 15th February 2010 (the "Transfer Date") the NPLL SERP business together with the assets attributed to this business will transfer from NPLL to Pearl. The Effective Date of the Scheme is expected to be 4th January 2010. .
- 7.4. The value of the assets to be transferred will be determined as at the Effective Date. The assets to be transferred on the Transfer Date will be based on estimates and adjustments can be made later to these amounts once an accurate calculation has been made. There will also be adjustments made in respect of amounts paid to or by NPLL in respect of the NPLL SERP business between the Effective Date and the Transfer Date.
- 7.5. The Effective Date has been set at a date prior to the Court hearing to simplify accounting treatment and the presentation of financial information for Pearl and NPLL.
- 7.6. I have discussed the fact that the Effective Date is prior to the Transfer Date with the senior management of Pearl and NPLL and I am not aware of any material adverse implications for policyholders.
- 7.7. For the Scheme to proceed orders approving both the Scheme and the proposed amendments to the Demutualisation Scheme must be granted.

Transferring Assets

- 7.8. The value of the assets to be transferred from NPLL to Pearl in respect of the SERP business will be determined as at the Effective Date by NPLL as the lower of:
- The amount that would be shown in a realistic balance sheet of the NPLL Fund prepared as at 31st December 2009 at lines 35, 36 and 41 of the Form 19 of the FSA Returns as they relate to the SERP business; and
 - The amount that would be shown in the regulatory valuation of the NPLL Fund prepared as at 31st December 2009, at column 9 of Form 51 of the FSA Returns, as they relate to the SERP business had the valuation been performed using the interest rate and expense assumptions specified in Appendix 9.4 of the FSA Returns and using the mortality and surrender assumptions specified in Appendix 9.4A of the FSA Returns.

- 7.9. In effect this means that the transfer will consist of:
- The value of the asset shares of the SERP business; and
 - The guarantee costs for the SERP business defined as the lower of:
 - The Pillar I peak 2 realistic value of the guarantee costs for the SERP business; and
 - The Pillar I peak 1 regulatory value of the guarantee costs using realistic (best estimate) assumptions for mortality and surrender rates expected in the future.
- 7.10. An additional amount will be transferred into the Pearl SERP Fund from the Pearl SHF to ensure that, at the Effective Date, the Pearl SERP Fund can meet its regulatory liabilities – i.e. the higher of its Pillar I regulatory peak and its Pillar I realistic peak liabilities.

Creation of the Pearl SERP Fund

- 7.11. Under the Scheme, a new sub-fund will be established in Pearl called the Pearl SERP Fund. On the Effective Date the SERP policies currently held in the NPLL Fund will be transferred to the Pearl SERP Fund.
- 7.12. The Pearl SERP Fund will include a SERP Loan Capital Fund and a SERP Transfer Capital Fund.
- 7.13. The total amount transferred from the NPLL Fund to the Pearl SERP Fund will be the value of the SERP asset shares from the NPLL asset share fund and the value of the guarantee costs as described above from the overcoat (which will by then be largely held within the NPLL Transfer Capital Fund) to the SERP Transfer Capital Fund. The transfer from the Pearl SHF described in paragraph 7.10 will also be held in the SERP Transfer Capital Fund.
- 7.14. The SERP policies will no longer be governed by the NPLL Fund Supervisory Board but will be run under the supervision of the Pearl With-Profits Committee (the “Pearl WPC”). The Pearl WPC will have its mandate revised to extend to the new Pearl SERP Fund and a new PPFM will be published to cover the SERP policies in Pearl.
- 7.15. The SERP policies will receive security from the assets of the Pearl SERP Fund and, if these should prove insufficient, the Pearl SHF. The SERP policies are therefore not entitled to benefit from the Pacific Fund other than in the extreme scenario of the Pearl SERP Fund and the Pearl SHF proving insufficient and the subsequent break down of the barriers between the different sub-funds of Pearl. As described in section 4, the Pacific Fund is a fund established from the inherited estate of Pearl and is to be used solely to benefit the existing Pearl policyholders.
- 7.16. The Scheme allows for a contingent loan to be made from the Pearl SHF to the Pearl SERP Fund in the event that the Pearl SERP Fund shows a deficit.
- 7.17. The Scheme allows that, when the value of the assets in the Pearl SERP Fund falls below £250 million (adjusted for changes in the RPI index), the Pearl Board has the right to stop administering the Pearl SERP Fund as a separate fund and allocate all the assets and liabilities to the Pearl PNP Fund. The details for conversion are set out in Schedule 4 of the Scheme and conversion of the SERP policies will not take place unless:
- The Pearl Board, or sub-committee thereof, has approved the proposals;
 - An independent expert has certified that the proposals are fair having regard to FSMA, the Scheme and the relevant PPFM; and
 - The FSA has approved the proposals or not objected to them within one month of being notified of the proposals.
- 7.18. In the event of closure of the Pearl SERP Fund, policyholders will not be entitled to all emerging surplus within the Pearl SERP Fund. Any excess surplus remaining in the fund once the requirement of meeting guarantees and the principle of paying out 100% of asset share has been met can be distributed to shareholders. Similarly, any shortfall arising in these funds would be met by shareholders.

Closure of the NPLL Fund

- 7.19. The Demutualisation Scheme allows that when the With-Profits Amount in the NPLL Fund falls below £500 million the NPLL Fund need not be maintained as a separate fund, subject to agreement from the Supervisory Board and the FSA.
- 7.20. This is not changed as a result of the proposed Scheme.

Administration

- 7.21. The administration of the policies will continue to be provided by the same administrators after the Scheme is implemented.

Costs of the Scheme

- 7.22. The cost of the Scheme and the application for the amendments to the Demutualisation Scheme will be split between the shareholder funds of Pearl and NPLL.

Tax

- 7.23. NPLL is currently taxed as a mutual life assurance company. I have been informed by the management of Pearl that there is no expectation of any changes to the tax position of the remaining NPLL or transferring SERP business as a result of the Scheme and they will continue to be subject to the same tax regime.
- 7.24. I have also been notified that the taxation of Pearl is expected to be materially unaffected by the Scheme and there will be no impact on the tax charged to policies.
- 7.25. All appropriate tax clearances will be applied for from the relevant authorities and I have been informed by the management of Pearl that these are expected to be received.

Excluded policies

- 7.26. An "Excluded Policy" is defined as any NPLL policy which:
- was written in an EEA state outside the UK and for which the FSA has not provided the certificate referred to in paragraph 4 of Schedule 12 to FSMA with respect to the relevant EEA state;
 - is not otherwise capable of being transferred pursuant to FSMA on the Effective Date or which the Court determines not to transfer by virtue of the Order; or
 - is a Guernsey or Jersey policy, for so long (if at all) as the relevant Guernsey/Jersey scheme has not been sanctioned and become effective.
- 7.27. Any policies that cannot be transferred as part of the proposed Scheme on the Effective Date will be reinsured into Pearl through an Excluded Policies reinsurance agreement and transferred if and when it is possible to do so.

Structure after the Scheme

Pearl

- 7.28. After the Scheme, Pearl will have the Pearl SHF and a long term business fund sub-divided into four sub-funds:
- The Pearl WPF;
 - The Pearl PNP Fund;
 - The Pearl LNP Fund; and

- The Pearl SERP Fund within which will be the Pearl SERP Transfer Capital Fund and the Pearl SERP Loan Capital Fund.

NPLL

- 7.29. The long term fund of NPLL contains some non-SERP, conventional with-profits policies which will stay within NPLL along with the UWP and non-profit policies after the transfer.
- 7.30. After the Scheme, NPLL will have the NPLL SHF and the reduced size NPLL Fund.

The Asset Share Charge Fund

- 7.31. The operation of the Asset Share Charge Fund will be unchanged by the Scheme. Charges made in the future to the asset shares of the policies remaining in NPLL will be held in the Asset Share Charge Fund together with those already held as collected to date from the asset shares of the NPLL policies.

Financial transactions to occur ahead of the transfer of SERP business

- 7.32. I have discussed with Pearl and NPLL management the various financial transactions and movements of capital that will take place prior to the Scheme taking effect.
- 7.33. At the time of writing this report I have seen the numbers for these various transactions based on the position as at 31st December 2008. The Effective Date for the Scheme is intended to be 4th January 2010 and the actual amounts being transferred will be based on the position as at the 31st December 2009.

The transfers under the Scheme – based on 2008 year end numbers

- 7.34. Based on the 31st December 2008 financials, the liabilities moving to Pearl on a regulatory Pillar I basis would have been £1,329 million. On a realistic Pillar I basis these same liabilities would have been £1,384 million consisting of asset shares of £684 million and guarantee costs etc of £694 million.
- 7.35. The assets moving from the NPLL Fund to the Pearl SERP Fund are as described in paragraph 7.13.
- 7.36. As at the 31st December 2008 the total transfer of assets from the NPLL Fund to the Pearl SERP Fund would have been £1,298 million consisting of asset shares of £684 million and assets to cover the guarantee costs (payable from the overcoat) of £614 million. This would have been below the liabilities required for the Pearl SERP Fund as described above and so, as described in paragraph 7.10, a transfer of £86 million would have been required from the Pearl SHF to the Pearl SERP Fund to ensure the Pillar I liabilities of £1,384 million were covered.
- 7.37. Before the transfer of assets from the overcoat to the Pearl SERP Fund can be effected by the Scheme, a reorganisation of the assets within the NPLL Fund and of the loan arrangements between Pearl, NPLH and NPLL must be undertaken. The result will be that, taking into account the restructure described above, immediately prior to the Effective Date, the overcoat will be held across the Transfer Capital Fund and the Loan Capital Fund. In terms of the financials as at 31st December 2008 this would have been approximately £ 614 million in the Transfer Capital Fund and £ 136 million in the Loan Capital Fund.
- 7.38. The overcoat was valued at £750 million as at 31st December 2008 and, based on the position as at 31st December 2008, as a result of the Scheme there would have been a reduction in the overcoat currently held in the NPLL Fund of £614 million to £136 million.

8. GOVERNANCE

Prior to the Scheme

- 8.1. PGL has different committees and boards to manage and govern the various subsidiary companies and funds within the group.

Pearl

- 8.2. The Pearl WPF is monitored by the Pearl WPC. The Pearl WPC is a governance structure which aims to fulfil the independent-input requirements of the FSA that the Board obtains independent review of its actions with respect to with-profits business.
- 8.3. The Pearl WPC must review any event or proposal which can have consequences for the PPFM. It will seek justification for any changes to the principles, including from a TCF perspective, but ultimate responsibility for changes lies with the Board.
- 8.4. The main areas of focus of the Pearl WPC are solvency, investment, fund management, bonus decisions, and PPFM-related customer communications. The Pearl WPC provides verification that processes followed are consistent with PPFM and that Board actions are consistent with PPFM. It may also comment on TCF issues but has no obligation to do so.
- 8.5. The Pearl WPC must have at least three members, of which at least two must be non-executive. The chair must be non-executive.

NPLL

- 8.6. The with-profits business of NPLL is monitored by the NPLL WPC although under the arrangements set out in the Demutualisation Scheme, a committee, known as the NPLL Fund Supervisory Board, must also be appointed and maintained.
- 8.7. The NPLL Fund Supervisory Board is responsible for the management of the NPLL Fund, in particular the investment and bonus policy. Its members are obliged to have regard solely to the interests and reasonable expectations of the NPLL policyholders, and must not comprise more than seven persons, of whom a majority are independent of any holding company of NPLL within the group. The chair of the NPLL Fund Supervisory Board must be one of the independent members.
- 8.8. The NPLL WPC reports to the NPLL Board and the NPLL Fund Supervisory Board.
- 8.9. The main areas of focus are solvency, investment, fund management, bonus decisions, and PPFM-related customer communications. The NPLL WPC is copied in on all Board papers and reports relevant to this focus. The NPLL WPC provides verification that processes followed are consistent with PPFM and that Board/Supervisory Board actions are consistent with the PPFM. It may also comment on TCF issues but has no obligation to do so.
- 8.10. The current membership of the NPLL WPC is the same as the NPLL Fund Supervisory Board with the same chair.

After the Scheme

- 8.11. The governance of the Pearl Group's life companies after the proposed Scheme will be managed in much the same way as is currently the case.
- 8.12. The movement of with-profits policies between funds will require the mandates of the various WPCs and the NPLL Fund Supervisory Board to be updated to cover the new structure.
- 8.13. The PPFM for each with-profit fund will be updated to reflect the Scheme.

Pearl

- 8.14. The Pearl WPC shall continue to cover business in Pearl as above.

Pearl SERP Fund

- 8.15. The Pearl SERP Fund is an additional with-profits fund to be created within Pearl.
- 8.16. The Pearl WPC will cover this fund in addition to its existing duties.

NPLL

- 8.17. The SERP policies transferring to Pearl will no longer be covered by the NPLL Fund Supervisory Board and NPLL WPC. The Pearl WPC shall bring these policies into its scope. The Pearl WPC performs a similar role to the NPLL Fund Supervisory Board but does not share the same levels of authority. Given the level of guarantees in the SERP business there is little discretion remaining in benefit levels and thus the change in governance should not impact on the SERP policyholders.
- 8.18. The NPLL Fund Supervisory Board will continue in its current form and role for policyholders remaining in NPLL.

Non-Profit business

- 8.19. The non-profit funds of Pearl are governed by the Pearl Board. Non-profit policies in NPLL are in the NPLL Fund and governed by the NPLL Fund Supervisory Board. Non-profit policies within a with-profits fund are governed by the relevant WPC.

The capital policies for Pearl and NPLL

- 8.20. New capital policies have been adopted by Pearl and NPLL following the Liberty acquisition. These policies are set as a fixed amount above the Pillar I and Pillar II capital requirements and are as follows:
- Pearl: The more onerous of:
 - £218 million in excess of its CRR; and
 - £249 million in excess of its ICA adjusted for any ICG.
 - NPLL: The more onerous of:
 - £44 million in excess of its CRR; and
 - £52 million in excess of its ICA adjusted for any ICG.
- 8.21. These policies were passed at the relevant Board meetings in September and were part of the Final Notice for Change in Control notice from the FSA dated 28th August 2009.
- 8.22. These capital policies will not be affected by the Scheme and after the implementation of the Scheme these capital policies will continue in their current form.

Conclusion

- 8.23. I am satisfied that the Scheme presents no change to the governance arrangements for the Pearl policyholders or the non-transferring NPLL policyholders, and, as stated above in paragraph 8.17, the governance changes made necessary by the Scheme will not have a material impact on the SERP policyholders.

9. THE EFFECT OF THE PROPOSED AMENDMENTS TO THE DEMUTUALISATION SCHEME

Introduction

- 9.1. The proposed amendments to the Demutualisation Scheme are set out above in section 6 of this report. In summary they are:
- Changes to the credits and debits permitted between the NPLL funds;
 - Changes to the Principles of Financial Management; and
 - Additional provisions covering the establishment and maintenance of the SEF.
- 9.2. As stated in section 1, the proposed amendments to the Demutualisation Scheme will only be made if the Court grants orders in respect of these amendments and in respect of the Scheme. I therefore consider the proposed changes to the Demutualisation Scheme, in particular those relating to the creation of the SEF, in the context of the Scheme being implemented. Therefore the proposed amendments are relevant only to the NPLL policyholders remaining in NPLL after the Scheme.
- 9.3. I summarise below the effects of the proposed amendments to the Demutualisation Scheme on the with-profits and non-profit policyholders of NPLL respectively.

Changes to the Demutualisation Scheme

- 9.4. Section 53 of the Demutualisation Scheme sets out the conditions necessary to be met in order to amend the Demutualisation Scheme. The liberty to amend the Demutualisation Scheme and the implementing Court order, as stated in paragraph 53.2 of the Demutualisation Scheme, exists only where the provisions of the Demutualisation Scheme prove “impossible, impractical or inequitable to implement”.
- 9.5. NPLL is closed to new business and, as shown by the tables in Appendix 2, is currently in a restricted financial position with limited excess capital. The levels of guarantees on the with-profits policies are, as described in section 4, significantly above the asset shares.
- 9.6. The overcoat that was set up to provide support and investment flexibility for the NPLL Fund is expected, with a high likelihood, to be largely used up to cover the cost of guarantees on the policies in the NPLL Fund. Furthermore, past legal advice has confirmed that the Demutualisation Scheme does not permit the hypothecation of different assets to different groups of policyholders and requires a common investment policy across virtually all products in the NPLL Fund.
- 9.7. All of these mean that the investment policy that can be used for the NPLL Fund is currently driven by the need to meet guaranteed benefits rather than provide support for investment flexibility to provide enhanced returns. These investment constraints mean that, in my opinion, it has become inequitable to implement certain provisions of the Demutualisation Scheme.
- 9.8. I therefore consider that the application to change the Demutualisation Scheme complies with the provisions of the Demutualisation Scheme subject to consent from the NPLL Supervisory Board.

The effect of the proposed amendments to the Demutualisation Scheme on the NPLL with-profits policyholders

The changes to the Principles of Financial Management

- 9.9. The proposed amendments to the Demutualisation Scheme introduce changes to the Principles of Financial Management of the non-transferring NPLL with-profits business:
- The possibility of different investment strategies being employed for different groups of policyholders; and

- The possibility of a notional portfolio being used to determine the returns for the policyholders.
- 9.10. Currently, under the terms of the Demutualisation Scheme, a common investment policy must be employed across all the different groups of NPLL policyholders. This includes the SERP, UWP and CWP policyholders and the different groups within these product types.
- 9.11. The transfer out of the SERP policies would enable the employment of an investment policy more in line with the non-transferring NPLL with-profits policyholders' original and current benefit expectations. Furthermore, the proposed amendments to the Demutualisation Scheme specifically permit the use of different investment policies for different groups of policyholders. Therefore it will be possible to better align the investment policy for the non-transferring NPLL with-profits policyholders with their benefit expectations.
- 9.12. I have discussed these with the NPLL with-profits actuary and it has been confirmed that the proposed changes to the Principles of Financial Management set out in the Demutualisation Scheme are intended to assist the long term management of the NPLL Fund and will only be considered if their use will preserve the fair treatment of policyholders. There are currently no plans to make use of the extra freedom conferred by these amendments to the Principles of Financial Management.
- 9.13. The NPLL with-profits actuary has indicated that in his view, due to the improved financial strength and the increased investment freedom available for the management of the NPLL Fund, it will be appropriate for a review of the investment strategy to take place after the Scheme. As a consequence he will be recommending to the NPLL Supervisory Board that they undertake such a review after the Scheme is implemented.
- 9.14. The NPLL WPA has described the two main criteria against which any such review should be judged. These are:
- Whether the security of the guaranteed benefits would be improved without any material adverse impact on policyholders' benefit expectations; and
 - Whether the benefit expectations of one group of policyholders would be improved without any material adverse impact on the benefit expectations of any other group and without any material reduction in the security of guaranteed benefits.
- 9.15. In the event of such a review the NPLL WPA will advise the NPLL Supervisory Board and the NPLL Board of these criteria.

The SEF

- 9.16. As stated in section 7.38 the implementation of the Scheme and the proposed amendments to the Demutualisation Scheme will result in a substantial decrease to the size of the overcoat remaining in NPLL to support the security of the business. Part of the overcoat will be transferred to the Pearl SERP Fund – an amount broadly covering the guarantee costs of the transferring SERP business which includes no allowance for the payment of any support charges to the NPLL SHF.
- 9.17. In the absence of the SEF, the NPLL shareholders would be disadvantaged by the Scheme because, although the assets would still be used to support the transferring SERP business and therefore remain unavailable to the NPLL shareholders, the NPLL shareholders would no longer receive the support charges (from the Pearl SERP Fund) in respect of these assets.
- 9.18. The SEF is created by the Scheme and the proposed amendments to the Demutualisation Scheme to compensate the NPLL shareholders for the loss of this future contingent income stream by the allocation of assets from the NPLL Fund to the SEF. Support charges payable by the NPLL Fund with respect to the SEF are paid from the SEF to the NPLL SHF and remain contingent on there being sufficient surplus available in the NPLL Fund.
- 9.19. The SEF is set up from the estate. In all reasonably foreseeable scenarios, the NPLL Fund estate will be used to pay guarantee costs on the NPLL business and financing costs. If the estate (including the overcoat) is exhausted before these guarantee costs and financing costs have been met in full, the remainder is met from the Asset Share Charge Fund (containing charges to asset share) followed by the Earmarked Portfolio and the NPLL SHF. Therefore the establishment of the SEF reduces the available estate and makes it more likely that charges will need to be made to asset shares of the NPLL Fund policies (compared to the position after the Scheme if

there was no SEF). The formula ensures that, in aggregate, the expected value of the charges after the Scheme will be lower than that prior to the Scheme.

- 9.20. The value of the assets allocated to the SEF will be calculated based on the formula set out in section 17 of the Scheme. The formula rolls forward the SEF calculated as at the 31st December 2009, in proportion to the change in guarantee, mortality and smoothing costs between the 31st December 2009 and the Effective Date.
- 9.21. The SEF formula is designed to compensate the shareholder for any loss of value resulting from the transfer and ensures that the expected aggregate level of future charges levied on policyholders' asset shares will be marginally lower after the Scheme than before. This will enhance the aggregate benefit expectations of those policyholders whose benefits are paid out on asset share and will have no impact on policyholders whose benefits are paid out at the guaranteed amount.
- 9.22. I understand that the NPLL Supervisory Board will monitor the charges as they are applied and will ensure all policyholders are treated fairly.
- 9.23. I am satisfied that the creation of the SEF is fair to the with-profits policyholders remaining in NPLL.

The effect of the proposed amendments to the Demutualisation Scheme on the non-profit policyholders

Introduction

- 9.24. As described in section 6, the key changes brought about by the proposed amendments to the Demutualisation Scheme for the NPLL non-profit policyholders remaining in NPLL result from:
- The changes to the flexibility available to manage the NPLL with-profits business remaining in NPLL and therefore to manage the investments in the NPLL Fund; and
 - The creation of the SEF within the NPLL Fund.
- 9.25. Therefore, the key issues to consider concern the possible impacts on the support available for the NPLL non-profit policyholders due to the proposed amendments to the Demutualisation Scheme.

Security of benefits

- 9.26. The non-profit policies remaining in NPLL after the transfer will continue to be supported by the NPLL Fund and the NPLL SHF.
- 9.27. Due to the flexibility granted to management in respect of notional asset allocations and differential investment policies there is a risk that, after the Effective Date, the assets backing the with-profits policies will be invested in riskier assets to increase the potential returns of the fund. Such a hypothecation strategy could expose the fund to increased investment risk which in turn requires more capital to be set aside.
- 9.28. The tables in Appendices 2 and 3 show that NPLL is expected to be financially stronger after the implementation of the Scheme and the proposed amendments to the Demutualisation Scheme. Taking account of the capital injections described in section 5, on a Pillar I basis as at 31st December 2008, NPLL would have had free capital of 8% of its liabilities and on a Pillar II basis free capital of 6% of its Pillar II liabilities. If the Scheme had been implemented on this date these figures would have been 11% (Pillar I) and 10% (Pillar II). The figures also show that NPLL is expected to have a higher absolute amount of capital available.
- 9.29. Therefore on both a Pillar I and a Pillar II basis the policyholders remaining in NPLL are in a better capitalised, financially stronger company after the implementation of the Scheme and the proposed amendments to the Demutualisation Scheme with an improved security of guaranteed benefits and an improved ability to withstand financial shocks.
- 9.30. The NPLL capital policy, as described in section 8, requires capital in excess of the regulatory minimum to be held at company level in the NPLL SHF. This capital policy will remain in place after the Effective Date.

- 9.31. Following discussions with the senior management of NPLL including the NPLL with-profits actuary, it has been confirmed that the proposed changes to the Principles of Financial Management set out in the Demutualisation Scheme are intended to assist the long term management of the NPLL Fund and will only be considered if their use will preserve the fair treatment of policyholders. There are currently no plans to make use of the extra freedom conferred by these amendments to the Principles of Financial Management although, as described above in paragraphs 9.11 to 9.15, the intention is to review the investment strategy after the Scheme is implemented subject to the preservation of the security of policyholder benefits.

The governance of the non-profit business after the Effective Date

- 9.32. The proposed amendments to the Demutualisation Scheme will have no effect on:
- The principles and practices used in the setting of discretionary charges;
 - The managers of the assets, asset/liability matching methodologies; or
 - The terms of the management services agreements with Pearl Group Services Limited.

Conclusion

- 9.33. As discussed above, NPLL is currently in an extremely restricted financial position, particularly as a result of the significant guarantees on the SERP business that are currently in the money and are likely to remain so for some considerable amount of time. These guarantees are having a particularly detrimental effect on the management of the remaining NPLL with-profits business and, as stated in paragraph 9.7, I believe it has become inequitable to implement certain provisions of the Demutualisation Scheme.
- 9.34. I therefore consider that the application to change the Demutualisation Scheme complies with the provisions of the Demutualisation Scheme subject to consent from the NPLL Supervisory Board.
- 9.35. The proposed amendments to the Demutualisation Scheme will make possible a better alignment of the investment policy for the non-transferring NPLL with-profits policyholders with their benefit expectations.
- 9.36. I am satisfied that the creation of the SEF is fair to the with-profits policyholders remaining in NPLL.
- 9.37. I am 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 with-profits and non-profit policyholders remaining in NPLL.

10. THE EFFECT OF THE SCHEME ON THE WITH-PROFITS POLICYHOLDERS

Introduction

- 10.1. In this section I consider the effect of the Scheme on the with-profits policyholders of the companies concerned in the Scheme. These with-profits policyholders can be divided into the following groups:
- NPLL SERP policyholders being transferred to Pearl;
 - NPLL with-profits policyholders remaining in NPLL; and
 - Policyholders of the Pearl WPF.
- 10.2. I consider these separate groups of policyholders in the context of the effect of the Scheme on the policyholders' security of benefits, with regards to treating customers fairly, and, in particular, on their benefit expectations.
- 10.3. For each group of with-profits policyholders, I set out a summary of the effects of the Scheme on the relevant group of policyholders. There then follows a list, and subsequent discussion, of the resulting issues for each group of with-profits policyholders.

NPLL SERP policyholders

Introduction

- 10.4. As described in section 7, under the Scheme, the SERP policyholders will be transferred to Pearl where they will be placed in a separate sub-fund of the Pearl LTF: the Pearl SERP Fund.
- 10.5. There are the following issues to consider under the changes the Scheme imposes on the NPLL SERP policyholders:
- SERP policyholders will no longer receive support from the NPLL UWP business;
 - SERP policyholders will be exposed to a different profile of risks in Pearl compared to NPLL;
 - The SERP business will receive external capital support from the Pearl SHF not, as currently, from the NPLL SHF; and
 - The Scheme changes the governance and management of the SERP business in that the NPLL Fund Supervisory Board will no longer have responsibility for the SERP business. Instead this will fall to the Pearl Board and the Pearl WPC.

Security of benefits

- 10.6. After the Scheme the transferring SERP policyholders will be in the Pearl SERP Fund, a sub-fund of the Pearl LTF separate from the existing Pearl business. Benefits of the transferring NPLL SERP policies that are currently guaranteed will remain guaranteed after the transfer.
- 10.7. Under the Scheme, assets equal to the statutory value of the SERP liabilities will be transferred into the Pearl SERP Fund from a combination of the NPLL Fund (asset shares plus a portion of the overcoat) and the Pearl SHF (the shortfall to make this up to the statutory liability value).
- 10.8. The security of the benefits of the transferring SERP policyholders will be provided, in the first instance, by the Pearl SERP Fund. If this should prove insufficient to meet the guaranteed benefits, support will be provided by the Pearl SHF.
- 10.9. In the extreme situation of this proving to be insufficient, the barriers between the different sub-funds of Pearl will break down and support could then be provided by the other sub-funds of Pearl.

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- 10.10. However, one must also consider that, in extreme circumstances, if the fund boundaries break down, support may be required from the Pearl SERP Fund to the other sub-funds of Pearl.
- 10.11. NPLL is currently in a weak financial position even taking into account the capital injections described in section 5 as can be seen in the tables in Appendix 2. Prior to the Scheme this weak financial position affects the security of the SERP business and the SERP business is exposed to the possibility of providing support for the other business in the NPLL Fund – the UWP business and the non-profit business.
- 10.12. There is currently no differential investment policy in the NPLL Fund in respect of the different types of with-profits business and, with the lower level of guarantees attached to the UWP business, the UWP business, in effect, supports the SERP business. In general, the SERP business currently provides little support for the UWP business.
- 10.13. After the transfer, as part of Pearl, the SERP policies will be in a ring-fenced fund and therefore exposed to the risks of that fund. In an extreme scenario and to the extent that the Pearl SERP Fund relies upon support from the Pearl SHF, the SERP business will be exposed to risks from the other business and the other funds in Pearl. Although the types of risk (for example, mortality and longevity risk) to which the business will be exposed are similar, the characteristics will be different due mainly to the different origins of the business, the different channels used to sell the business, the different demographics of the policyholders and the different financial strengths and therefore investment strategies of the two companies. For example, due mainly to its superior financial strength, Pearl currently has a larger exposure to market risk than NPLL.
- 10.14. Therefore, the implementation of the Scheme is expected to expose the NPLL SERP business to a wider range of risks.
- 10.15. The ratios in Appendices 2 and 3 are crude measures but show that Pearl is currently of similar financial strength to NPLL on Pillar I and the tables show further that Pearl has considerably more capital. On a Pillar I basis, using 2008 year end figures adjusted for the post balance sheet capital injections, NPLL has free capital of 8% of its total liabilities compared to 9% for Pearl and Pearl currently has over 3 times the excess capital after meeting its CRR.
- 10.16. Both the Pillar I and Pillar II calculations, to differing degrees, take account of the company's risk exposures. The Pillar I figures imply an improved coverage for the security of the guaranteed benefits and the Pillar II figures imply an improved ability to withstand extreme events.
- 10.17. On both a Pillar I and a Pillar II basis, there is projected to be a much higher absolute level of capital available in Pearl after the transfer than there is currently in NPLL.
- 10.18. Therefore, although there will be a change in the risk profile and in the range of risks to which the transferring SERP business is exposed, this is mitigated by the improvement in financial strength.
- 10.19. I am therefore satisfied that the Scheme will not have a materially adverse effect on the benefit security for the NPLL SERP policyholders.

Benefit expectations

- 10.20. NPLL SERP policies are with-profits policies that provide benefits in the form of an annuity. The benefit expectation of the policyholders retiring at or after age 60 is that the amount of annuity payable will be determined as the greater of:
- The guaranteed annuity payable under the policy (taking into account past additions of reversionary bonus); and
 - An annuity determined by converting the asset share of the policy into an annuity using immediate annuity rates current at the date benefits are taken.
- 10.21. No reversionary bonuses have been allocated since 2002 and the current PPFM states "it is ... expected that there will be no annual bonus declared for the foreseeable future". The NPLL PPFM has always stated this since it was introduced in 2004.
- 10.22. In this section I consider separately the following groups of policyholders:

- The group for whom the asset share is significantly less than the guaranteed amount of the policy and who hold policies to age 60;
- Other policyholders who hold their policies to age 60; and
- Those who surrender their policies prior to age 60.

10.23. I then cover the issues with respect to SERP policyholders who take an open market option on retirement and the governance arrangements for the SERP policyholders after the Scheme.

Policies with asset share significantly less than guaranteed amount

10.24. Although actually with-profits, the policies with asset share significantly less than the guaranteed amount currently have the characteristics of non-profit policies because, in any realistic circumstances, payout will be based on meeting these guarantees rather than investment returns. In particular:

- There are no equities backing the asset shares and only 7% of the asset shares are invested in property.
- As most of the assets are similar to fixed interest assets, a significant rise in value is only possible if interest rates fall significantly. Such a fall in interest rates would lead to an increase in the cost of annuities and therefore the larger asset share at maturity would be offset by the more expensive rate for the income it would be used to buy. The net result for the income achievable from the asset share would not be significant in the large majority of cases. The likelihood of such a change in interest rates leading to the retirement income for the policyholder being determined with reference to asset share, rather than the guaranteed annuity payable under the policy, is low.
- SERP policies were last sold in 1988 and therefore are at least 20 years old as at 31 December 2008. The average duration to retirement (age 60) of these policies is therefore significantly shorter than the time in force so far which implies that the potential upside to overall return from future high returns is low.

10.25. These characteristics imply that the amount received by the policyholder, and therefore the policyholders' total return, is little affected by future returns on property, equities or fixed interest investments, nor by significant changes in interest rates. In short, the return is close to being fixed or guaranteed and hence these policies are currently, effectively, non-profit.

10.26. In my opinion the benefit expectations of these policyholders are in line with guaranteed returns and they have no expectations of extra discretionary benefits being granted.

10.27. After the transfer to Pearl, the SERP policies will be in a separate fund in Pearl. Management will pass from the NPLL Fund Supervisory Board and the NPLL Board to the Pearl Board and the Pearl WPC and a new PPFM has been written for these policies to reflect the fact that they will be in the Pearl SERP Fund.

10.28. Pearl is required by the Scheme to manage this business in accordance with the new PPFM which I have examined and which in my opinion reflects the way these policies are currently managed.

10.29. I am therefore satisfied that the Scheme will not have a material effect on the benefit expectations of the transferring SERP policyholders with asset shares significantly lower than their guaranteed policy values.

Other SERP policyholders who retain their policies until age 60

10.30. The SERP policyholders with policies where the asset share is not significantly less than the guaranteed policy value have a higher likelihood of their returns being decided with reference to asset share rather than the guaranteed value of the policy and therefore more of the characteristics of with-profits policies.

10.31. As SERP policyholders, the same PPFM currently applies to this group of policyholders as to the group above – that is they also have no expectation of future annual bonus and their asset shares are part of the NPLL Fund and have a minimal equity/property component.

10.32. Currently, charges may be taken from the aggregate asset shares of the with-profits policies in the NPLL Fund, subject to certain restrictions, to assist in ensuring that the guaranteed benefits are met. Such a charge was

applied in 2007 and 2008 and policyholders' expectations should include the possibility that a further charge will be applied in the future.

- 10.33. The Pearl SERP Fund PPFM states that, "No charge will be made to asset shares in respect of guarantee costs or the costs associated with any other business risks". It should be noted also that the policyholders affected by the taking of such a charge would be limited to those receiving a payout determined by asset share. The number of such policyholders in the Pearl SERP Fund will be small and will decrease over time.
- 10.34. Viewed in the context of such a charge currently being taken, there will be an improvement in benefit expectations for this group of policyholders for whom the asset share could determine the benefit paid under the policy.
- 10.35. The investment policy in the Pearl SERP Fund may, after the Effective Date, be of a different risk profile than that of the current NPLL Fund. For those SERP policyholders with asset share currently above the guaranteed value of the policy, a more risky investment policy and more volatile returns (although potentially beneficial) would increase the likelihood of their terminal bonus (and hence policy value) being reduced. Therefore, in this respect, their benefit expectations could be harmed by the change to a higher risk investment policy.
- 10.36. However, for some policyholders, an increase in the risk level of the investment policy could increase the likelihood that a terminal bonus will be paid and therefore that their asset share will prove more valuable than the guaranteed policy. The switch to a lower risk investment policy could be viewed as against the interests of these policyholders.
- 10.37. As described in Section 5, the NPLL Fund is currently in a restricted financial position with limited excess capital. Therefore, the main driver of the investment policy for the NPLL Fund, in the absence of the Scheme, would be the protection of guaranteed benefits. In the future this would be likely to further inhibit exposure to equity and property and to lead to an investment policy of reducing risk.
- 10.38. I have discussed this with the NPLL AFH and WPA and senior NPLL management and I have reviewed the proposed new PPFM for the Pearl SERP Fund and I am satisfied that there will be no material change to the investment policy of the Pearl SERP Fund, compared to that of the NPLL Fund in the absence of the Scheme, as a result of the implementation of the Scheme.
- 10.39. The group of policies for whom the asset share is not significantly below the guaranteed value is relatively small and it is an obvious advantage that, after the Scheme, the asset shares will not be charged for guarantee costs.
- 10.40. I am therefore satisfied that the Scheme will not have a material effect on the benefit expectations of the other SERP policyholders who maintain their policies until age 60.

SERP policyholders who surrender their policy prior to age 60

- 10.41. After the Scheme, as currently, these policyholders will, broadly speaking, receive their asset share on surrender.
- 10.42. As discussed above, I do not expect the Scheme to lead to a material change to the investment policy for the assets backing the asset shares of the SERP policies. Also, asset shares will no longer be subject to charges to meet guaranteed values (as occurred in 2007 and 2008 with a 2% charge).
- 10.43. The Scheme is therefore not expected to have a material effect on the returns earned on the asset shares and so I am satisfied that the Scheme will not have a material effect on the benefit expectations of this group of policyholders.

SERP policyholders who take an open market option

- 10.44. The SERP policyholders have an open market option ("OMO") in which they can use the proceeds from their policy to purchase an annuity with another provider or receive a tax free cash amount on retirement. The calculation of the transfer value of the OMO and of the tax free cash amount is currently under the remit of the NPLL WPC and NPLL Fund Supervisory Board.
- 10.45. After the implementation of the Scheme this will be under the remit of the Pearl WPC. I have discussed this change with management and I am satisfied that the principles and practices used for the calculation by Pearl

and the Pearl WPC will be consistent with the current approach of the NPLL Fund Supervisory Board and with the NPLL PPFM. The proposed Pearl SERP Fund PPFM is consistent with the NPLL PPFM on this matter and both state that “the open market option and tax free cash values will represent a fair value of the annuity benefits given up”.

- 10.46. I am therefore satisfied that implementation of the Scheme will not have a materially adverse effect on the benefits received by SERP policyholders who opt to take an OMO and/or tax-free cash sum on retirement.

Governance of SERP policyholders

- 10.47. After the Scheme, the NPLL SERP policyholders will no longer be the responsibility of the NPLL Fund Supervisory Board. The SERP policyholders will be transferred into the Pearl SERP Fund, and, as part of Pearl, will be governed by the Pearl Board and the Pearl WPC.
- 10.48. I commented on the revised governance arrangements for the SERP policyholders in section 8.

Closure of the Pearl SERP Fund

- 10.49. The new Pearl SERP Fund will contain closure provisions as described in section 31 of the Scheme. Subject to certain conditions, as described in paragraph 7.17, when the fund falls below £250 million (adjusted for inflation), the Pearl Board may take the option to close the fund.
- 10.50. It should be noted that the majority of policies within the Pearl SERP Fund are effectively non-profit so conversion to non-profit will have little effect on the benefits.
- 10.51. I am satisfied that the closure provisions for the Pearl SERP Fund will not have a material effect on policyholders' benefit expectations and that the safeguards around closure (e.g. approval from the FSA) and the terms of conversion provide a suitable level of protection for policyholders' benefits.

Conclusion for SERP policyholders

- 10.52. In summary I am satisfied that the Scheme will not have a materially adverse effect on the security of benefits or on the benefit expectations of the SERP policyholders.

NPLL with-profits policyholders remaining in NPLL

Introduction

- 10.53. As described in section 7, under the Scheme the NPLL UWP policyholders will remain in the NPLL Fund after the Effective Date along with small amounts of CWP, CA and DA business. The SERP business will be transferred out.
- 10.54. There are the following key issues to consider under the changes that the Scheme imposes upon the non-transferring NPLL with-profits policyholders:
- The support currently received from the business and capital being transferred out (the SERP business and part of the 'overcoat') will no longer be available;
 - The non-transferring NPLL with-profits business will no longer be required to provide support for the SERP business;
 - The resulting fund will be reduced in size; and
 - The profile of risks to which the non-transferring NPLL with-profits business is exposed will be changed.

Security of benefits

- 10.55. Under the Scheme, assets representing a value (as described in more detail in section 7) of the transferring SERP liabilities will be transferred out of the NPLL Fund. These values will be agreed between the Pearl and NPLL actuaries and the bases used will be the relevant reserving bases as would be applied in FSA Returns submitted by NPLL as at the Effective Date.
- 10.56. After the transfer out of the SERP business, NPLL will be exposed to a different profile of risks, and may be exposed to a greater volatility of experience. Capital support from the portion of the overcoat transferred across to Pearl will be lost (although in practice it is not currently available to the business as it is required to support the guarantees on the transferring SERP business as discussed above), but, counteracting this, support will no longer need to be provided for the NPLL SERP business.
- 10.57. NPLL is currently in a restricted financial position and one of the key objectives of the Scheme is to strengthen NPLL. As discussed in section 5, as at 31st December 2008, NPLL covered its own ICA approved by the Board and with the post balance sheet date capital injections NPLL would be able to meet a materially stronger Pillar II capital requirement.
- 10.58. As shown in the tables in Appendices 2 and 3, NPLL would have an increased absolute level of capital available and these excess assets would represent higher percentages of total liabilities on both Pillar I and Pillar II bases. NPLL would therefore be considerably financially stronger after the Scheme and would be able to cover a materially stronger ICA.
- 10.59. The risks relating to the SERP policies will be removed from the NPLL Fund and this will reduce the risks to the security of the benefits of the remaining policies. The SERP policies have significant levels of guarantees and these have to be met by the assets within the NPLL Fund. The removal of the SERP business will leave the NPLL Fund with different risk exposures compared to the position before the Scheme. In particular there will be a reduction in the longevity risk exposure of the NPLL Fund and changes to the investment risk exposure.
- 10.60. The financial strength calculations take account of these changes in the NPLL Fund risk exposures and, as described above, show the NPLL Fund to be stronger after the Scheme.
- 10.61. Following discussions with the senior management of NPLL including the NPLL with-profits actuary, it has been confirmed that the proposed changes to the Principles of Financial Management set out in the Demutualisation Scheme are intended to assist the long term management of the NPLL Fund and will only be considered if their use will preserve the fair treatment of policyholders. There are currently no plans to make use of the extra freedom conferred by these amendments to the Principles of Financial Management although, as described above in paragraphs 9.11 to 9.15, the intention is to review the investment strategy after the Scheme is implemented subject to the preservation of the security of policyholder benefits.
- 10.62. I am therefore satisfied that the Scheme will not have a materially adverse effect on the benefit security for the non-transferring NPLL with-profits policyholders.

Benefit expectations

- 10.63. With a few exceptions, no reversionary bonuses have been allocated to the non-transferring NPLL with-profits policies since 2003. As is currently the case with the NPLL SERP policyholders, and as the current PPFM states "it is ... expected that there will be no annual bonus declared for the foreseeable future". The NPLL PPFM has always stated this since its inception in 2004.
- 10.64. In general, the non-transferring NPLL with-profits policyholders have lower guaranteed policy values than the transferring NPLL SERP policies. Therefore, in general, the investment strategy and other significant influences on the consequent return on the backing assets have a much greater effect on the benefit expectations of the non-transferring NPLL with-profits policyholders than on the benefit expectations of the SERP policyholders. Charges to asset share are also much more likely to have an effect on benefit expectations.
- 10.65. As commented above, after the Scheme, the solvency position of the NPLL Fund would be improved (both in percentage terms and in terms of absolute excess capital available) which should lead to a reduced requirement for restrictions to the investment policy for the assets backing the non-transferring NPLL with-profits policies.

- 10.66. Currently, under the terms of the Demutualisation Scheme, a common investment policy must be employed across all the different groups of NPLL policyholders. This includes the SERP, UWP and CWP policyholders and the different groups within these product types.
- 10.67. The transfer out of the SERP policies would enable the employment of an investment policy more in line with the non-transferring NPLL with-profits policyholders' original and current benefit expectations. Furthermore, the proposed amendments to the Demutualisation Scheme specifically permit the use of different investment policies for different groups of policyholders. Therefore it will be possible to better align the investment policy for the non-transferring NPLL with-profits policyholders with their benefit expectations.

Implications of not implementing the Scheme or the proposed amendments to Demutualisation Scheme

- 10.68. As described above and in section 4, it is currently the case that the non-transferring NPLL with-profits policyholders are effectively supporting the SERP business, are projected to receive low returns in the future, and are currently subject to charges to asset share.
- 10.69. After the Scheme takes effect and the Demutualisation Scheme is amended it may be possible to change the investment strategy of the NPLL Fund to be more in line with the non-transferring NPLL with-profits policyholders' original benefit expectations. This could be done by increasing the proportion of equity in the backing assets and/or by employing a differential investment policy for different groups of policyholders. In the absence of the Scheme and the proposed amendments to the Demutualisation Scheme these options are less likely to be allowable.
- 10.70. Although it is possible that charges may still be applied to asset share, it is projected that these will in future be lower than is currently the case.

Closure of the NPLL Fund

- 10.71. Section 33 of the Demutualisation Scheme sets out the provisions for the closure of the NPLL Fund. In summary, subject to certain conditions, when the "with-profits amount" drops below £500 million (the "closure limit"), adjusted for inflation from December 1999, the NPLL Fund may be closed. The "with-profits amount" is as defined in the Demutualisation Scheme but broadly speaking is equal to the value of the assets in the NPLL Fund less the non-profit and linked liabilities and less the value of the overcoat.
- 10.72. With the removal from the NPLL Fund of the SERP business there is a possibility that the closure of the NPLL Fund is brought forward significantly and therefore has an effect on the benefit expectations of the non-transferring NPLL Fund policyholders.
- 10.73. Prior to the transfer of the SERP business, the projected date at which the with-profits amount would fall below the inflated closure limit is 2022. Most of the SERP business is projected to have run-off by this date and the removal of the SERP business therefore has little effect on the date at which this closure limit is reached. After the transfer of the SERP business it is projected that the with-profits amount would fall below the inflated closure limit in 2021.
- 10.74. I am therefore satisfied that, as a result of the Scheme, there will not be a material change to the likely timing of future closure of the NPLL Fund in accordance with the closure provisions in the Demutualisation Scheme.

Conclusion for with-profits policyholders remaining in NPLL

- 10.75. In summary, after the Scheme:
- NPLL will be financially stronger both in percentage terms and in terms of the absolute excess capital available;
 - The non-transferring NPLL with-profits business will no longer be required to provide support for the SERP policyholders;

- The NPLL Fund has the potential for improved investment freedom as a result of the increased financial strength and the removal of the restrictions due to the requirements from the SERP business; and
 - The removal of the SERP business should enable the investment objectives of the NPLL Fund to be more closely aligned with the original and current benefit expectations of the non-transferring NPLL with-profits policyholders. This is further enhanced by the proposed changes to the Demutualisation Scheme.
- 10.76. I am therefore satisfied that the implementation of the Scheme will not materially adversely affect the security of the benefits of the with-profits policyholders remaining in NPLL and that the implementation of the Scheme will not have a materially adverse effect on the benefit expectations of the with-profits policyholders remaining in NPLL.
- 10.77. It is my view that the implementation of the Scheme is to the advantage of the NPLL with-profits policyholders remaining in NPLL when compared with the alternative of maintaining the status quo.

Pearl WPF policyholders

Introduction

- 10.78. As described in section 7, the Pearl WPF business remains in Pearl and therefore the key effects of the Scheme arise from the business being transferred into Pearl and the consequent effects on the security and benefit expectations of the Pearl WPF policyholders.
- 10.79. Therefore the key issues to consider are:
- The change in the risk profile of Pearl;
 - The change in the calls on the capital of Pearl; and
 - The circumstances under which the Pearl WPF may be called upon to support the business being transferred in.

Security of Benefits

- 10.80. The Pearl WPF will be unchanged as a result of the scheme – there will not be a change to the free capital of the fund nor to the risk profile within the Pearl WPF as a result of the proposed Scheme.
- 10.81. The transfer of the SERP policies into the Pearl SERP Fund will not impact the Pearl WPF policyholders directly as the Pearl SERP Fund will be a separate ring-fenced fund. However, the Pearl SERP Fund is an additional fund within Pearl and therefore another call on the capital support provided by the Pearl SHF. This adverse effect is shown in Appendix 3 as the free capital drops from 9% prior to the Scheme to 8% after the implementation of the Scheme.
- 10.82. As described above, there are limited bonus expectations for the SERP business and the majority of the SERP policies will behave like non-profit policies. There is therefore limited extra risk to Pearl WPF policyholders from the bonus expectations of the SERP policyholders.
- 10.83. The value of the guarantee costs associated with the transferring SERP policies will be transferred into the Pearl SERP Fund as described in section 7. These guarantee costs need to be met which exposes Pearl to additional risk, for example from longevity and persistency, and from the different underlying population/sales channels etc of the SERP business. Currently NPLL is a subsidiary of Pearl and therefore the Pearl policyholders are, to an extent, already exposed to these risks but only after exhaustion of the NPLL Fund and the NPLL SHF. After the Scheme, if the guarantee cost amount should prove to be insufficient, support will be provided by the Pearl SHF. It is only in an extreme scenario, where the Pearl SERP Fund and the Pearl SHF are exhausted, that there could be a threat to the security of the Pearl WPF policyholders' benefits from this additional risk exposure.
- 10.84. In summary, there will be additional risk exposure for the Pearl WPF but mitigating these adverse effects are:
- Pearl will be a larger company overall leading to a greater diversification amongst the various risks; and

- There will also be greater diversification within the various risk categories based on the different geographic regions, sales channels, policyholder demographics etc.

10.85. Given these, the minor nature of adverse effects, and the fact that as explained in paragraph 10.83 above, the Pearl policyholders are currently indirectly exposed to these risks, I am satisfied that the Scheme will not lead to a material reduction in the security of policyholder benefits for the policyholders of the Pearl WPF.

Benefit expectations

10.86. As described above, the Pearl WPF will be unchanged as a result of the scheme:

- There will be no change to the free capital of the Pearl WPF;
- There will be no change to the risk profile within the Pearl WPF;
- There will be no effect on the calculation of the asset shares of the Pearl WPF policies;
- The bonus expectations of the transferring SERP policies will have a limited effect on the returns for the Pearl WPF; and
- The additional risk exposures from the requirement to meet guarantee costs on the transferring SERP business will be met first by the Pearl SERP Fund (which includes an amount representing the value of the guarantee costs) and then by the Pearl SHF – only in extreme scenarios will the Pearl WPF be called upon.

10.87. Therefore, there is unlikely to be any material effect on the expected returns on the Pearl WPF policies.

10.88. The governance of the Pearl WPF will remain the responsibility of the Pearl WPC.

10.89. The servicing of the Pearl WPF policyholders will be carried out by the same company as prior to the Scheme and there are not expected to be any changes to the service standards as a result of the Scheme.

10.90. I am satisfied that implementation of the Scheme will not have a materially adverse effect on the benefit expectations or the fair treatment of the policyholders of the Pearl WPF.

Conclusion for Pearl WPF policyholders

10.91. In summary, I am satisfied that the Scheme will not have a materially adverse effect on the security of benefits or on the benefit expectations of the Pearl WPF policyholders.

11. THE EFFECT OF THE SCHEME ON THE NON-PROFIT POLICYHOLDERS

Introduction

- 11.1. In this section I consider the impact of the Scheme on the non-profit policyholders of the various companies concerned in the Scheme. These are:
- NPLL non-profit policyholders that will remain in NPLL under the terms of the Scheme;
 - Policyholders of the Pearl PNP Fund; and
 - Policyholders of the Pearl LNP Fund.
- 11.2. Before considering the effect of the Scheme on these different groups of policyholders, I consider some generic issues with the management of the non-profit business.

The governance of the non-profit business after the Effective Date

- 11.3. The Scheme will have no effect on:
- The principles and practices used in the setting of discretionary charges;
 - The managers of the assets, asset/liability matching methodologies; or
 - The terms of the management services agreements with Pearl Group Services Limited.

NPLL non-profit policyholders

Introduction

- 11.4. As described in section 7, the key changes brought about by the Scheme and the proposed amendments to the Demutualisation Scheme for the NPLL non-profit policyholders remaining in NPLL result from:
- The transfer out of the SERP business;
 - The changes to the flexibility available to manage the NPLL with-profits business remaining in NPLL and therefore to manage the investments in the NPLL Fund; and
 - The creation of the SEF within the NPLL Fund.
- 11.5. Therefore, the key issues to consider are:
- The support available, after the Scheme and the proposed amendments to the Demutualisation Scheme; and
 - The changed risk profile of NPLL after the transfer.

Security of benefits

- 11.6. The non-profit policies remaining in NPLL after the transfer will continue to be supported by the NPLL Fund and the NPLL SHF.
- 11.7. Due to the flexibility granted to management in respect of notional asset allocations and differential investment policies there is a risk that, after the Effective Date, the assets backing the with-profits policies will be invested in riskier assets to increase the potential returns of the fund. Such a hypothecation strategy could expose the fund to increased investment risk which in turn requires more capital to be set aside.

- 11.8. The tables in Appendices 2 and 3 show that NPLL is expected to be financially stronger after the implementation of the Scheme and the proposed amendments to the Demutualisation Scheme. Taking account of the capital injections described in section 5, on a Pillar I basis as at 31st December 2008, NPLL would have had free capital of 8% of its liabilities and on a Pillar II basis free capital of 6% of its Pillar II liabilities. If the Scheme had been implemented on this date these figures would have been 11% (Pillar I) and 10% (Pillar II). The figures also show that NPLL is expected to have a higher absolute amount of capital available.
- 11.9. The NPLL capital policy, as described in section 8, requires capital in excess of the regulatory minimum to be held at company level in the NPLL SHF. This capital policy will remain in place after the Effective Date.
- 11.10. The risks relating to the SERP policies will be removed from the NPLL Fund and this will reduce the risks to the security of the benefits of the remaining non-profit policies. The SERP policies have significant levels of guarantees and these have to be met by the assets within the NPLL Fund. The removal of the SERP business will leave the NPLL Fund with different risk exposures compared to the position before the Scheme. In particular there will be a reduction in the longevity risk exposure of the NPLL Fund and changes to the investment risk exposure.
- 11.11. The financial strength calculations take account of these changes in the NPLL Fund risk exposures and, as described above, show the NPLL Fund to be stronger after the Scheme.
- 11.12. Following discussions with the senior management of NPLL including the NPLL with-profits actuary, it has been confirmed that the proposed changes to the Principles of Financial Management set out in the Demutualisation Scheme are intended to assist the long term management of the NPLL Fund and will only be considered if their use will preserve the fair treatment of policyholders. There are currently no plans to make use of the extra freedom conferred by these amendments to the Principles of Financial Management although, as described above in paragraphs 9.11 to 9.15, the intention is to review the investment strategy after the Scheme is implemented subject to the preservation of the security of policyholder benefits.
- 11.13. I am satisfied that the Scheme will not have a materially adverse effect on the security of benefits for the NPLL non-profit policyholders remaining in NPLL.

Pearl non-profit policyholders

Introduction

- 11.14. As described in section 7, the Pearl non-profit business will remain in Pearl in the Pearl PNP Fund or in the Pearl LNP Fund as appropriate. Therefore the key effects of the Scheme arise from the business being transferred into the Pearl SERP Fund.
- 11.15. Therefore the key issues to consider are:
- The support available, after the Effective Date, to provide benefit security; and
 - The impact of the creation of the Pearl SERP Fund and transfer in of the NPLL SERP business.

Security of benefits

- 11.16. Support for the security of guaranteed benefits of the policyholders of the Pearl PNP Fund or the Pearl LNP Fund will continue to be provided by the Pearl SHF.
- 11.17. As shown in Appendices 2 and 3, Pearl will be financially strong after the Effective Date, albeit marginally less so than before. Based on 31st December 2008 numbers, on a Pillar I basis, after the implementation of the Scheme, Pearl would have excess assets of 8% of its total liabilities, and, on a Pillar II basis, free capital of 11% of its Pillar II liabilities.
- 11.18. The Pearl capital policy, as described in section 8, requires capital in excess of the regulatory minimum to be held at company level in the Pearl SHF. This capital policy will remain in place after the Effective Date.

- 11.19. The risk profile within Pearl will be different after the Scheme due to the transfer in of the SERP business. However, as discussed in paragraph 10.83, NPLL is a subsidiary of Pearl and therefore the Pearl policyholders are already indirectly exposed to these risks.
- 11.20. I am therefore satisfied that the Scheme will not have a materially adverse effect on the security of the benefits of the policyholders whose policies are currently in the Pearl non-profit funds.

Conclusion

- 11.21. I am satisfied that the Scheme and the proposed amendments to the Demutualisation Scheme will not lead to a material reduction in the security of the benefits of the non-profit policyholders of Pearl and NPLL.

12. OTHER CONSIDERATIONS DUE TO THE SCHEME AND THE AMENDMENTS TO THE DEMUTUALISATION SCHEME

Service standards

- 12.1. Pearl and NPLL each have agreements with Pearl Group Services Limited to provide their administrative services.
- 12.2. There will be no changes to this agreement except for where the company name has changed as a result of a transfer of business. There will be no changes to the service levels or standards as a result of the Scheme.
- 12.3. I am therefore satisfied that the Scheme will have no material effect on the service standards experienced by the Pearl or NPLL policyholders in accordance with treating customers fairly guidance.

Tax

- 12.4. Pearl and NPLL will apply for appropriate tax clearances from the relevant taxation authorities in respect of the Scheme and these are expected to be received.
- 12.5. The various financial transactions carried out prior to the Scheme, as described in section 6, will lead to the recognition of a loss for tax purposes. This may create a benefit for the NPLL shareholders.
- 12.6. I have spoken to Pearl and NPLL's tax specialists and management and they have assured me that neither the financial transactions described in section 7 nor the Scheme will lead to an increase in the tax charged to policyholders.

Expenses and charges

- 12.7. Pearl and NPLL currently have administration agreements with Pearl Group Services. The Scheme will not change the administrator or the level of service provided.
- 12.8. The expenses charged to NPLL are set out in the Demutualisation Scheme and are to be reviewed in 2010.
- 12.9. The Scheme will provide that the charges to the Pearl SERP Fund will continue indefinitely on the current basis and will be subject to a cap that any proportionate increase in these charges as applied to the SERP policies in the new Pearl SERP Fund will not be more than any proportionate increase in the same period applicable to policies that remain in NPLL.
- 12.10. Therefore, there should be no material increase in the expenses that could be charged to the SERP policies by Pearl compared to those that would have been charged by NPLL and I am satisfied that the SERP policyholders will not be materially adversely affected in respect of these expenses and charges.

Liberty

- 12.11. As discussed in section 3, Liberty has recently acquired PGL.
- 12.12. The acquisition is a recent development and the full implications are yet to be realised. It is possible that in future the group will wish to merge or transfer the long term funds within its life companies. However, any future merging or transferring of long term funds across the enlarged group will be subject to:
- FSMA;
 - Approval by the Court;
 - Non-objection by the FSA; and
 - A report by an Independent Expert.

12.13. For the avoidance of doubt, I have not seen any plans for a proposed restructuring involving Pearl or NPLL.

Group risk

12.14. I have discussed the impact of the Scheme on the other companies in PGL (now called Pearl Group Holdings (No 2) Limited with the senior management of Pearl and NPLL and I have been assured that the Scheme will have no material effect on the risk exposure of other companies in the group.

13. CONCLUSIONS

13.1. In summary, in my opinion:

- 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.

Mike Arnold

22 October 2009

FIA

APPENDIX 1 – TERMS OF REFERENCE AND STATEMENT OF INDEPENDENCE

Terms of reference

The following is an excerpt from my terms of reference agreed with Pearl and reviewed by the FSA.

Schedule 2

Scope of the work of the Independent Expert in relation to the Scheme

My report is to consider the terms of the Scheme generally and the effect which the Scheme will have on the holders of long term policies of each Company.

In particular my report will consider the following specific matters:

- The impact of the Scheme on the security of the different groups and generations of policyholders involved in the Scheme;
- A review of, and opinion on the fairness of, the terms that apply to any transfers of non-profit policies from with-profits funds to the extent that such transfers are included in the Scheme;
- A review of, and opinion on the fairness of, proposals to combine any with-profits funds to the extent that any such combinations are included in the Scheme (either as at the Effective Date or subsequently), and consideration of any further covenants or undertakings that may be required to ensure that each category of policyholder is treated fairly;
- A review of, and opinion on the fairness of, any mechanisms to be implemented at the same time as the Scheme, but not included in the Scheme, to provide financial support to any of the Companies' funds; and
- A review of the capital management policy to be adopted by the Companies following implementation of the Scheme.

My review and report will address generally the way in which the Companies have conducted their long term business but taking into account the particular circumstances of each class of business to be transferred. It will deal inter alia with the following aspects of each company:

- Memorandum, and the Articles of Association, at least insofar as these affect the rights, expectations and interests of policyholders;
- The terms of the policies issued by each Company;
- Promotional or marketing materials (including those documents issued under the Financial Services and Markets Act 2000 and previous compliance regimes) which would influence the reasonable expectations of policyholders;
- The existing and proposed internal working arrangements relating to the financial management of the long term business fund, including the operational and administrative arrangements which will apply to the policies to be transferred under the terms of the insurance scheme;
- The terms and conditions expected to be imposed by the Scheme to be presented to the Court, including the views expressed by the governing body or management of each company; and
- The terms of the previous Schemes of transfer concerning the policyholders of the Companies.

The above list is not intended to be exclusive to any other aspects which may be identified during the completion of the project and which are considered to be relevant.

I shall not be directly involved in the formulation of the proposed transfer although I should expect to give guidance during the evolution of the detailed proposals on those issues which concern me, or which I consider unsatisfactory.

Statement of independence

Pearl Group Services Limited (“PGS”) have proposed me to act as the independent expert in respect of a proposed scheme under Part VII of the Financial Services and Markets Act 2000 to transfer some of the long term insurance business of National Provident Life Limited (“NPLL”) to Pearl Assurance Limited (“Pearl”). This appointment requires approval by the Financial Services Authority and a statement of independence.

I am a Principal of Milliman Limited and I am based in its UK life insurance practice. I am a fellow of the Institute of Actuaries having qualified in 1973.

I hold no policies with, and have no financial interest in, Pearl or NPLL.

Milliman Limited has no connections with, and no financial interest in, Pearl or NPLL.

I have previously acted as Independent Expert in a number of other schemes to transfer long term insurance business including:

- The Part VII transfer of the long term business of Allianz Cornhill Insurance Plc to Britannic Unit Linked Assurance Limited in 2005.
- The Part VII transfer of the long term business of Pearl assurance (Unit Funds) Limited, Pearl Assurance (Unit Linked Pensions) Limited and London Life Linked Assurances Limited to NPI Limited in 2006.
- The Part VII transfer to transfer the long term business of Alba Life Limited, Britannic Assurance Plc, Britannic Retirement Solutions Limited, Britannic Unit Linked Assurance Limited, Century Life Plc and Phoenix Life and Pensions Limited to Phoenix Life Limited in 2006.

I am in the process of being engaged by NPLL as an independent expert witness in their litigation claim against PGS 2 Limited – see appendix.

I do not believe that any of the above adversely affects my ability to act independently in my assessment of the Scheme.

Mike Arnold

27th July 2009

Appendix – The expert witness role for NPLL.

The FSA has requested further information regarding the expert witness role for NPLL. This appendix to my statement of independence contains information to meet these FSA requests.

1. Description of my role and of the litigation.

The following is in Appendix 1 of Milliman's letter of engagement with NPLL under the heading "The services".

" Milliman will provide the services of a Fellow of the Institute of Actuaries or Faculty of Actuaries who holds a current Practising Certificate issued by the UK Actuarial Profession to act as Expert Witness for National Provident Life Limited ("NPLL") in their litigation against PGS 2 Limited ("PGS 2").

Specifically, the claim by NPLL relates to alleged failures and mistakes made by PGS 2 while performing its role as NPLL's manager. As a result of these alleged failures and mistakes, NPLL asserts that it made overpayments of approximately £18.4 million to certain policyholders in respect of their SERP policies between May 2003 and June 2005.

The expert witness is required to:

- Consider and report on the quantum of NPLL's claim against PGS 2; and
- From time to time, as required, consider and comment upon certain aspects of the conduct of PGS 2, including whether PGS 2 acted with the care and attention that could reasonably be expected of a management company.

Milliman's representative nominated for the role of expert witness is Mr Mike Arnold. "

2. Anticipated timeframes

The current timeframe is as follows:

- a. NPLL's expert evidence to be served on 4 September 2009.
- b. PGS 2's expert evidence to be served on 9 October 2009.
- c. Statement of areas of agreement/disagreement between experts to be filed at Court by 30 October 2009.

3. Why there is no impact on my independence.

I have spoken with both Lovells LLP (the legal firm representing NPLL in the litigation against PGS2 Limited) and Herbert Smith LLP (the legal firm representing PGS, Pearl and NPLL in the application to the Court for the proposed Scheme) regarding possible issues or concerns with my independence. Both sets of lawyers were comfortable that carrying out both roles would have no effect on my independence and in particular in relation to a role as Independent Expert for the NPLL restructure.

The litigation is for a relatively small amount (£18.4 million plus interest) and my fee is likely to be considerably less than that for the Independent Expert work for the NPLL restructure.

APPENDIX 2 – SELECTED FINANCIAL INFORMATION AS AT 31ST DECEMBER 2008

1. Pearl

| Pearl | 31 December 2008 | | | | | |
|-------------------------|---------------------------|-----------|------------|------------|-----|--------|
| £ million | | Pearl WPF | Pearl LNPF | Pearl PNPf | SHF | Total |
| Assets | | 11,867 | 232 | 3,243 | 786 | 16,129 |
| Liabilities | Conventional with-profits | 2,673 | 0 | 0 | 0 | 2,673 |
| net of reinsurance | Conventional non-profit | 166 | 55 | 439 | 0 | 660 |
| | Unitised with-profits | 3,927 | 0 | 0 | 0 | 3,927 |
| | Unit linked | 42 | 0 | 0 | 0 | 42 |
| | Index linked | 0 | 0 | 0 | 0 | 0 |
| | Sub total | 6,807 | 55 | 439 | 0 | 7,301 |
| | Cost of bonus | 15 | 0 | 0 | 0 | 15 |
| | Other | 4,435 | 24 | 2,747 | 334 | 7,540 |
| | Total liabilities | 11,258 | 79 | 3,186 | 334 | 14,857 |
| Excess Assets | | 610 | 154 | 57 | 452 | 1,272 |
| CRR | | | | | | 614 |
| Excess Assets after CRR | | | | | | 658 |

Notes:

1. The assets above include the injection of £250 million (net of the £50 million transferred to NPLL) following the acquisition by Liberty.
2. The effect of the Liberty injection of capital into Opal Re (£60 million) is taken account of by a reduction to the liabilities of the Pearl PNP Fund of £52 million.
3. The figures above do not include the 'look-through' value of the NPLL regulatory peak excess assets (£109 million including the £50 million injection).
4. The CRR above does not include the CRR of NPLL of £305 million.
5. Other than this the figures above are as in the 2008 year end FSA Returns.
6. Reconciliation to the Pearl report: $658 + 109 = 767$

2. NPLL

| NPLL | 31 December 2008 | | | |
|-------------------------|---------------------------|-----------|-----|-------|
| £ million | | NPLL Fund | SHF | Total |
| Assets | | 5,390 | 287 | 5,677 |
| Liabilities | Conventional with-profits | 1,871 | | 1,871 |
| net of reinsurance | Conventional non-profit | 148 | | 148 |
| | Unitised with-profits | 2,244 | | 2,244 |
| | Unit linked | 45 | | 45 |
| | Index linked | 1 | | 1 |
| | Sub total | 4,309 | 0 | 4,309 |
| | Cost of bonus | 2 | | 2 |
| | Other | 939 | 12 | 951 |
| | Total liabilities | 5,251 | 12 | 5,263 |
| Excess Assets | | 139 | 275 | 414 |
| CRR | | | | 305 |
| Excess Assets after CRR | | | | 109 |

Notes:

1. The assets above include the injection of £50 million following the acquisition by Liberty.
2. The above reconciles to table 6.4 of the NPLL report.

3. Solvency ratios for Pearl & NPLL prior to the transfer

| 31st December 2009 | Pearl | NPLL |
|-------------------------------------------------------------------------------|---------------|--------------|
| Assets | 16,129 | 5,677 |
| Reserves & Cost of Bonus | 7,317 | 4,312 |
| Other Liabilities | 7,540 | 951 |
| Total liabilities | 14,857 | 5,263 |
| Excess Assets | 1,272 | 414 |
| Pillar I excess assets as percentage of total liabilities | 9% | 8% |
| Pillar II capital resources as percentage of the Pillar II liabilities | 11% | 6% |

APPENDIX 3 – FINANCIAL POSITION POST-TRANSFER AS AT 31ST DECEMBER 2008

1. Pearl

| Pearl | 31 December 2008 | | | | | | |
|-------------------------|---------------------------|-----------|------------|------------|------------|-----|--------|
| £ million | | Pearl WPF | Pearl LNPF | Pearl PNPf | Pearl SERP | SHF | Total |
| Assets | | 11,867 | 232 | 3,243 | 1,384 | 700 | 17,427 |
| Liabilities | Conventional with-profits | 2,673 | 0 | 0 | 1,329 | | 4,002 |
| net of reinsurance | Conventional non-profit | 166 | 55 | 439 | | | 660 |
| | Unitised with-profits | 3,927 | 0 | 0 | | | 3,927 |
| | Unit linked | 42 | 0 | 0 | | | 42 |
| | Index linked | 0 | 0 | 0 | | | 0 |
| | Sub total | 6,807 | 55 | 439 | 1,329 | 0 | 8,630 |
| | Cost of bonus | 15 | 0 | 0 | | | 15 |
| | Other | 4,435 | 24 | 2,747 | | 334 | 7,540 |
| | Total liabilities | 11,258 | 79 | 3,186 | 1,329 | 334 | 16,186 |
| Excess Assets | | 610 | 154 | 57 | 55 | 366 | 1,241 |
| CRR | | | | | | | 742 |
| Excess Assets after CRR | | | | | | | 499 |

Notes:

1. The assets above include the injection of £250 million (net of the £50 million transferred to NPLL) following the acquisition by Liberty.
2. The effect of the Liberty injection of capital into Opal Re (£60 million) is taken account of by a reduction to the liabilities of the Pearl PNP Fund of £52 million.
3. The figures above do not include the 'look-through' value of the NPLL regulatory peak excess assets (£221 million including the £50 million injection).
4. The CRR above does not include the CRR of NPLL of £212 million.
5. Reconciliation to the Pearl report: $499 + 221 = 720$

The table above therefore presents a view of Pearl without taking account of excess capital in NPLL.

2. NPLL

| NPLL | 31 December 2008 | | | |
|-------------------------|---------------------------|-----------|-----|-------|
| £ million | | NPLL Fund | SHF | Total |
| Assets | | 4,092 | 287 | 4,379 |
| Liabilities | Conventional with-profits | 542 | | 542 |
| net of reinsurance | Conventional non-profit | 148 | | 148 |
| | Unitised with-profits | 2,244 | | 2,244 |
| | Unit linked | 45 | | 45 |
| | Index linked | 1 | | 1 |
| | Sub total | 2,980 | 0 | 2,980 |
| | Cost of bonus | 2 | | 2 |
| | Other | 939 | 12 | 951 |
| | Total liabilities | 3,922 | 12 | 3,934 |
| Excess Assets | | 170 | 275 | 445 |
| CRR | | | | 224 |
| Excess Assets after CRR | | | | 221 |

Notes:

1. The assets above include the injection of £50 million following the acquisition by Liberty.
2. The above reconciles to table 6.4 of the NPLL report.
3. Transfer of assets of £1,298 million.
4. Transfer of Pillar I (regulatory) liabilities of £1,329 million.

3. Solvency Ratios for Pearl & NPLL after the transfer

| 31st December 2009 | Pearl | NPLL |
|-------------------------------------------------------------------------------|---------------|--------------|
| Assets | 17,427 | 4,379 |
| Reserves & Cost of Bonus | 8,646 | 2,983 |
| Other Liabilities | 7,540 | 951 |
| Total liabilities | 16,186 | 3,934 |
| Excess Assets | 1,241 | 445 |
| Pillar I excess assets as percentage of total liabilities | 8% | 11% |
| Pillar II capital resources as percentage of the Pillar II liabilities | 11% | 10% |

APPENDIX 4 – RUN OFF OF THE SEF

| Calculation Date | Value Of Shareholder Equalisation Fund As Percentage of Opening Value Of The Fund |
|---------------------------------------------------|-----------------------------------------------------------------------------------|
| 31-Dec-10 | 93% |
| 31-Dec-11 | 86% |
| 31-Dec-12 | 80% |
| 31-Dec-13 | 74% |
| 31-Dec-14 | 69% |
| 31-Dec-15 | 64% |
| 31-Dec-16 | 59% |
| 31-Dec-17 | 54% |
| 31-Dec-18 | 49% |
| 31-Dec-19 | 44% |
| 31-Dec-20 | 39% |
| 31-Dec-21 | 34% |
| 31-Dec-22 | 29% |
| 31-Dec-23 | 24% |
| 31-Dec-24 | 19% |
| 31-Dec-25 | 14% |
| 31-Dec-26 | 9% |
| 31-Dec-27 | 4% |
| 31 December 2028 and subsequent Calculation Dates | 0% |

APPENDIX 5 – KEY SOURCES OF DATA

In writing this 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 | | |
| NPL end-2008 ICA Report | 07 NPL ICA report v23062009 (extract).pdf | 24/07/2009 |
| NPL ICA Cover Memo for the board | ICA cover - NPL v01.doc | 24/07/2009 |
| End-2008 ICA for NPLL | ICA report v 20072009_final.pdf | 30/07/2009 |
| Illustration of financial restructure - updated | NPL Restructure Contingent Loan Refinance v4 300709.ppt | 05/08/2009 |
| Description of financial restructure - updated | NPLL Financial Restructure 300709.doc | 05/08/2009 |
| NPLL - update of Pillar II position | Pillar2Figures_08_Q4_draftv2.doc | 06/08/2009 |
| Proposed new PPFM for NPLL | NPLL_PPFM_v10_excSERP_draft_030909_clean.doc | 08/09/2009 |
| Description of SEF | SEFDescriptiondtav3.pdf | 21/09/2009 |
| Update on Pillar 2 position | Pillar 2 position 08Q4 draft v4.pdf | 02/10/2009 |
| NPLL AFH WPA Report - updated | NPLL_AFHWPActuaryReport_Draft_9October2009.doc | 08/10/2009 |
| NPLL fund | NPLLSBinstrategypaper15192009_v2.pdf | 16/10/2009 |
| Pearl | | |
| Pearl end-2008 ICA Report | 05 Pearl ICA report 2008_12 (extract).pdf | 24/07/2009 |
| Pearl ICA Cover Memo for the board | ICA cover - Pearl Assurance v01.doc | 24/07/2009 |
| ICA Operational Risk Breakdown | 10 Pearl and Phoenix Operational Risk Results YE08.xls | 24/07/2009 |
| End-2008 ICA for Pearl | Pearl ICA report 2008_12v3.doc | 30/07/2009 |
| Proposed PPFM for Pearl SERP Fund | PPFM_Pearl_SERP_2010_draft_030909_clean.doc | 08/09/2009 |
| Update on Pillar 2 position | Note on Pearl Pillar 2 position v3.doc | 02/10/2009 |
| Pearl AFH WPA Report - updated | Pearl WPA and AFH Report 8 Oct 09.doc | 09/10/2009 |
| Scheme and Pearl Group | | |
| Comparison of 2009 scheme with 2008 scheme | Comparison - 2009 Scheme (v3) to 2008 Scheme.rtf | 21/07/2009 |
| High-level restructure timetable | Timetable as at 2009 07 23.xls | 24/07/2009 |
| Summary of Pearl & NPLL ICA Results | ICA Summary for July board v02 Pearl&NPL.xls | 24/07/2009 |
| FSA Letter regarding end-2007 ICA Review | Pearl Group ICAS Review Letter to J Moss 20090506.pdf | 24/07/2009 |
| Summary of ICA Results pre- and post- | PGL board - ICA summary v01 Pearl&NPL.ppt | 24/07/2009 |
| Overall Pearl/NPL Solvency Position 17 July | weekly update July 17 Pearl & NPLL.xls | 24/07/2009 |
| Summary of ICA methodology | 01 ICA pack summary and overlays v02.doc | 24/07/2009 |
| ICA Results for Pearl Group | 02-08 Summary for July board v02.xls | 24/07/2009 |
| Pearl Group ICA Methodology & Assumptions | 11 ICA Methodology 2008 draft v06.pdf | 24/07/2009 |
| Derivation of ICA Stresses | 11a Annex A - Derivation of stresses v04.pdf | 24/07/2009 |
| Approach to Operational Risk in the ICA | 11b Annex B - Assessment of Operational Risk v05.pdf | 24/07/2009 |
| ICA Correlation Assumptions | 11c Annex C - Correlation assumptions for 2008 v03.pdf | 24/07/2009 |
| Description of ICA non-linearity testing | 11d Annex D - Non-linearity 2008 draft v01.pdf | 24/07/2009 |
| Solvency figures as at 17 July | weekly update July 17 Pearl & NPLL.xls | 04/08/2009 |
| Letter approving Mike Arnold as independent expert | FSA letter of approval 2009-08-05-143145.pdf | 05/08/2009 |
| Summary of changes to demutualisation scheme | 2009 Demut Scheme - Summary of demutualisation scheme changes.doc | 05/08/2009 |

| | | |
|-------------------------------------------------|----------------------------------------------------------------|------------|
| Witness statement of Michael John Merrick | 2009 Demut Scheme - Witness statement.DOC | 05/08/2009 |
| Final notice of change in control | 5 Final Notice.pdf | 07/09/2009 |
| First witness statement of Michael John Merrick | 2009 Scheme - First witness statement (Directions Hearing).Doc | 11/09/2009 |
| Legal letter from Herbert Smith | document2009_10_02_160737.pdf | 02/10/2009 |
| Answers to FSA questions | Shareholder Equalisation fund 300909.doc | 07/10/2009 |
| Note on Distribution of Asset Share Charges | Distribution of Asset Share Charges draft1 FSA.pdf | 07/10/2009 |
| Scheme document | 2009 Scheme.doc | 22/10/2009 |

APPENDIX 6 – NPLL ASSET SHARE CALCULATIONS

The definitions of asset share for the different product types of NPLL are as follows:

- For Conventional With Profits (“CWP”) business:
 - The premiums paid;Less
 - The expenses (including commission and investment management charges) relevant to that business;
 - An appropriate allowance for mortality; and
 - A charge to cover some or all of the non-policy costs.Accumulated at the rates of investment return earned on the assets underlying the relevant business.
- For Deposit Administration (“DA”) business:
 - The premiums paid;Less
 - Expenses charged to the policy;
 - The fund-based charges applicable to that business, in the form of an annual management charge;
 - A charge to cover some or all of the non-policy costs.Accumulated at the rates of investment return earned on the assets underlying the relevant business.
- For Profit Sharing Accounts (“PSA”), UWP and Capital Account (“CA”):
 - The amount invested after initial charges;Less
 - The fund-based charges applicable to that business, in the form of an annual management charge;
 - A charge to cover some or all of the non-policy costs.Accumulated at the rates of investment return earned on the assets underlying the relevant business.

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