NPI National Provident Life Limited

A Guide to How We Manage Our With-Profits Fund

Aims of this guide

This guide is a summary of how we manage the with-profits fund.

Why this guide is important

You have a with-profits policy and as a result your money is invested in National Provident Life's with-profits fund. This guide is a summary of how we manage the with-profits fund and how that affects your policy.

Some of our policies allow you to invest in more than one type of fund and to switch between funds. This guide refers only to that part of your policy invested in the with-profits fund.

You may want to read this document with your annual statement. Keep it safe with your policy, as you may want to refer to both of them in future. Don't worry if you have mislaid your policy, you can complete a declaration when you claim against it. Please contact us in writing if you have lost your policy and need to confirm the terms and conditions.

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1. Introduction to the Principles and Practices of Financial Management (PPFM)

What is the PPFM?

The PPFM explains in detail how we manage the with-profits fund. The PPFM is quite a long, detailed and complex document so this shorter guide is designed to explain the most important points. If you want to see the full PPFM, you can get a copy from our website (www.npi.co.uk) or by writing to us.

What are the Principles of Financial Management?

The principles are the basis by which we manage the with-profits fund. These are high-level statements that describe our long term approach. We don't expect to change the principles often.

The key drivers of the principles are:

- We aim to treat all customers fairly.
- We will manage our business in a lawful and financially sound manner.
- We aim to manage the with-profits fund so we can pay all guaranteed benefits.

We do not intend to change our approach to managing the with-profits fund. However, there are some circumstances when we might need to do so, for example to:

- Protect the financial position of the fund in adverse circumstances.
- Ensure we comply with any changes in taxation or regulatory requirements.
- Deal with unforeseen events that have a significant impact on the with-profits fund.

We will tell you at least three months in advance if material changes are being made to the principles.

What are the Practices of Financial Management?

Practices are more specific statements. They give more detail of how we are currently managing the with-profits fund. The practices may change more often as we respond to, for example, how the economy is performing, changes in the life assurance industry or to regulatory requirements.

We will inform you in writing at the next available opportunity of any material changes to the practices.

Governance arrangements

The responsibility for the management of the with-profits fund rests with the Board of National Provident Life Limited.

The High Court Scheme, which approved National Provident Institution's demutualisation in 1999 and the transfer of its business to National Provident Life, required the establishment of a Supervisory Board. The majority of its members are independent of the company's shareholders, and the Supervisory Board is focussed on protecting policyholders' interests.

The Supervisory Board also acts as a separate with-profits committee and provides independent verification that the processes followed are consistent with the PPFM and that decisions taken by the Board have followed due process and are consistent with the PPFM. They may also comment on matters relating to our commitment to treating customers fairly.

Each year we will produce an annual report for with-profits policyholders stating whether, throughout the previous year, we believe we have complied with our obligations relating to the PPFM. Attached to that report will be a separate report from the with-profits actuary.

You can obtain a copy of the latest report from our website (www.npi.co.uk) or by writing to us.

2. What is a with-profits policy?

A with-profits policy is usually a long term investment, typically for 10 years or more. With-profits policies provide some guarantees of a minimum payout and some protection against the ups and downs of the investment market. Any profits resulting from the investments are used to add bonuses to policies, after first providing for any guaranteed benefits. There are different types of with-profits policies.

You will have one or more of the five main types of with-profits policy:

- Conventional With-Profits
- Unitised With-Profits (including Portfolio Bond)
- Deposit Administration
- Capital Account
- Profit Sharing Account

We invest the Portfolio Bond business through the Pearl Assurance Limited with-profits fund. All other business is invested within our with-profits fund.

3. How does the with-profits fund work?

Premiums from all with-profits policyholders are pooled together in the with-profits fund and invested. Historically, these investments would have included shares (often called equities), fixed interest investments (such as government bonds and corporate bonds), cash deposits and property. However, we now have very little invested in shares (see section 5). The performance of these investments contributes to the value of your with-profits policy.

4. How is the value of your policy calculated?

The value of your policy will depend on a number of factors including:

- The type of policy you have (see section 2).
- The number and amount of the premiums you have paid.
- The investment performance of the assets backing your part of the with-profits fund (see section 5).
- The charges and/or expenses deducted from your policy (see section 11).
- The level of any guaranteed benefits (see section 6).
- The extent to which your policy is cushioned from some of the ups and downs in the investment market (see section 9).

When your make a claim against your policy, we compare the value of the policy's 'asset share' with the value of any guaranteed benefits. We aim to pay you whichever value is higher.

What is an 'asset share'?

'Asset share' is a term used to describe your policy's share of the with-profits fund.

Put simply, asset share is the money you have paid in, plus the investment return it has earned, less the expenses charged.

Asset share =
- the total of all the premiums you have paid
  plus
- the investment returns
  minus
- expenses and charges made to your policy.

In most cases, it is impractical to calculate the asset share for every individual policy in a fund. In these cases, we calculate the asset share by looking at sample policies rather than individual policies.

Whether you cash in your policy or hold it to maturity, it is our target to pay on average asset share - unless guaranteed values are higher. Individual payments may vary in a range about this target.

5. The with-profits fund and how we invest it

We review our investment strategy regularly. This means taking into account a range of factors such as:

- The financial position of the fund.
- The value of guarantees already given to policyholders.
- How much we need to keep in cash or in investments that can be easily sold, in order to meet claims in the near future.

We aim to maximise the returns for policyholders but we must bear in mind future commitments to pay out on policies. We need to ensure we do not have to sell investments to meet these commitments at a time when their values are low. This is known as matching assets (investments) with liabilities (commitments to pay out on policies).

There were significant falls in the stock market from 2000 through to 2003 and, during this time, we sold our equity investments. This was done in order to safeguard our ability to pay the guaranteed amounts promised on policies.

Since that time, the with-profits fund has mostly been invested in fixed interest investments.

The fund may use 'derivatives' (for example, the right to buy or sell securities at a pre-agreed price on a specific date) as an efficient way of quickly changing the investments in the fund and/or to reduce risks. We may also invest some of the fund in 'alternative investments'. These alternative investments will include a wider range of assets, including specialist funds where the aim is to reduce the variations in investment returns and improve the overall return to the fund.

For Deposit Administration and Capital Account policies, approximately three-quarters of the assets backing them will be invested in fixed interest investments, with the balance invested in property or equity type investments.

The other classes of business (excluding Portfolio Bonds) are currently mostly backed by fixed interest investments. We will inform you if this changes in the future.

As mentioned earlier, Portfolio Bonds are invested in the Pearl Assurance with-profits fund. You can get a copy of their equivalent to this guide from their website (www.pearl.co.uk) or by writing to us.

6. Guarantees

Your policy may guarantee to pay a certain amount at specific times in the future. The details will be set out in your policy document.

Typically, we would pay guaranteed amounts:

- At a fixed maturity date for endowment life policies.
- Over a range of retirement dates or ages for pension policies.
- If regular withdrawals are made from single premium investment policies.
- On the death of the life assured before any of the above dates.

Where guarantees apply on more than one occasion, the amount guaranteed will usually vary and will be described in your policy. Any payments made at other times are not guaranteed.

Why guarantees are important

In general, guarantees were set assuming a lower level of investment return than we expected to earn on the fund. In the past, this allowed us some flexibility to invest in assets which were expected to offer better long term returns but whose values could fluctuate in the short term.

We aim to pay out values reflecting actual returns. However, when investment returns are poor you are protected and will, as a minimum, receive any guaranteed benefits.

7. Bonuses

There are two types of bonuses that may be added to your policy.

Regular (annual) bonuses

When considering whether to add further regular (annual) bonuses, we look at a number of factors including:

- The performance of the fund – both short term and long term.
- The current financial position of the fund and how this is likely to change in the future.
- The level of guaranteed benefits compared to the asset shares.

As a result, the rate of regular bonus may vary and it may be nil.

Once added, regular bonuses increase the guaranteed amount payable on that policy and cannot be taken away, providing the policy is held to a date when a guarantee applies.

We set most bonuses annually at the end of each year to which they apply. At the same time, we also set bonus rates for the following year (the interim rates) for those policies where a claim is made before the next annual bonus rate is set.

We do not expect to declare an annual bonus, nor allocate interim bonus, for Conventional

With-Profits and Profit Sharing Account Policies in the foreseeable future. The same applies to Unitised With-Profits Policies except where the policy terms and conditions provide for a guaranteed minimum annual bonus rate.

For Unitised With-Profits Policies which have a guaranteed minimum annual bonus rate, we allocate bonuses daily but at the guaranteed rate. Your policy document will tell you if your policy has a guaranteed minimum bonus rate.

For Capital Account and Deposit Administration Policies we also allocate bonuses daily at the interim rate. The interim rates are based on the expected return over the coming year on the assets underlying these policies, plus or minus an adjustment as necessary to bring policy values closer to asset share.

We aim to be consistent when making bonus payments and will try not to vary the amount of regular bonuses on Capital Account and Deposit Administration Policies too much from year to year.

For Portfolio Bonds which, as explained earlier, are invested in the Pearl Assurance with-profits fund, the rate of any annual bonus payable is determined by the Pearl Board. We then normally confirm any bonus rate declared by Pearl as the rates to be applied to these policies

Final bonuses

To make up any shortfall between guaranteed benefits and the actual performance of the fund, a final bonus may be added to the guaranteed benefits when you make a claim on your policy (but not on Deposit Administration or Capital Account Policies).

Final bonuses are set with the aim that, on average, the total policy payout will equal asset share (see section 4). Final bonuses are typically reviewed every six months, but can be changed more frequently if economic conditions change significantly.

Final bonuses are not guaranteed and may be small or nothing depending on the performance of the fund.

8. How we decide how much you get if you end your policy early

If you end your policy at a date when the guarantees don't apply, for example by cashing in your policy or, in the case of pension plans, transferring your accumulated pension fund to another pension provider, we work out how much to pay you bearing in mind that we must be fair to all policyholders, those who stay, as well as those leaving. On average, we aim to pay to each policyholder their asset share.

Conventional With-Profits and Profit Sharing Account Policies – We work out the amount to pay by taking into account the premiums paid, the investment returns earned and the charges and expenses.

Deposit Administration Policies – The payment would normally be the value of the member's deposit account, less any surrender charge applicable.

Unitised With-Profits and Capital Account Policies – We work out the value by multiplying the number of units allocated to your policy by the current unit price. We may need to reduce the amount payable by applying a Market Value Reduction (MVR). Alternatively, for Unitised With-Profits Policies only, we may increase this amount by adding a final bonus.

There may also be a surrender charge payable under some policies.

What is a Market Value Reduction (MVR)?

An MVR, also known as a Market Value Adjustment (MVA), is a reduction that may be made to the amount payable under a Unitised With-Profits or Capital Account Policy when you leave the with-profits fund at a date when the guarantees don't apply. It may be used to reduce the amount paid out when the current value of a policy (calculated as described above) is greater than the asset share.

The size of any MVR imposed will change from time to time, depending, in the main, on the performance of the assets in the with-profits fund.

The times when we can and cannot apply an MVR to your policy depend on the type of policy you have and are set out in your policy document. For example, we cannot apply an MVR to a payment made on death nor, in some cases, at certain retirement ages.

9. How with-profits policies can cushion you from some of the ups and downs of the investment market

Our with-profits fund is now mostly invested in fixed interest assets and property. Although the values of these assets generally fluctuate less than shares they can, and do, change on a daily basis.

We aim to cushion with-profits policyholders from some of the ups and downs in the value of the investments to some extent.

We do not change the rates of final bonus very frequently and, to a limited degree, we hold back some of the performance in the good years to use when returns are low - this is known as smoothing.

Changes in the level of final bonuses may not directly correspond with changes in asset shares.

When investment conditions decline for long periods, payouts to policyholders will correspondingly fall – we cannot fully protect policyholders from significant changes in investment returns over an extended period of time. However, as described in section 6, the guaranteed benefits are the minimum we will pay and this guarantee can prove valuable in such circumstances.

10. How we manage exposure to risk

The with-profits fund is now closed to new business but is still exposed to a number of risks as a result of product design, for example, providing guarantees to policyholders, past selling and marketing practices, interest rate and market fluctuations and population changes e.g. how long people are living.

The fund, and our business, will be managed in such a way as to minimise existing risks in order to safeguard our ability to pay the guaranteed amounts promised on policies.

11. Charges and expenses

Expenses include any commission payable, the costs of administering the policies and managing the fund. Charges include the costs of servincing the loans made to the policyholder fund by the shareholder.

Administration and investment management are provided by a service company and investment managers respectively. Service company fees and investment management fees are deducted from asset shares.

Until 31 December 2009, all costs for administration were based on the scale of charges set out in the High Court Scheme governing National Provident Life Ltd – increased by 1% above the rate of inflation each year. The cost of investment management is also based on the scale of charges established by the High Court Scheme.

From 1 January 2010, the High Court Scheme requires that the expenses agreed with the service company and the investment manager should be no higher than the market rate for those services.

For some policy types, explicit charges are set out in your policy document. We have the right to change some of these charges. For example, policy fees may increase each year in line with a specified index such as the Retail Price Index.

It may be necessary in some circumstances to make an additional charge to asset shares to ensure that the guaranteed benefits of all policies can be met. Any additional charge will normally be limited to 2% in any 12 month period. Any monies taken in this way but not subsequently used to meet guaranteed benefits will be refunded to the asset shares of the remaining policies.

12. What is the ‘estate’?

Some life companies have what is known as an inherited ‘estate’. This is money, or surplus, built up over the years which provides working capital for the fund and supports its operation. This surplus is built up from profits that are not needed to meet the fund’s current and future liabilities to policyholders.

National Provident Life now has virtually no estate and what remains is expected to be required to pay future charges and the cost of meeting guaranteed benefits. It is because of this that the additional charge to asset shares mentioned above may be necessary.

The Scheme Capital Account

This is a loan originally made by the former owner, AMP Ltd, to National Provident Life at the time of NPI’s demutualisation. This loan is available to help the company meet its regulatory capital requirements. It can also be used to help pay guaranteed benefits promised to policyholders. Pearl Assurance Limited now owns this loan and is entitled to the investment return on the loan, plus an annual charge. It is unlikely that this loan will be repaid to Pearl in full, as we expect most of it will be required to pay guaranteed benefits.

13. Equity between policyholders and shareholders

When the business was transferred to National Provident Life following National Provident Institution’s demutualisation, the High Court Scheme required that the fund continue to operate as if it were a mutual company. The scheme strictly limits payments that can be made to shareholders. For example, when you receive a bonus, there is no associated payment to shareholders as happens in many other companies.

14. How to find out more

You can get a more detailed technical description of how we manage our with-profits fund in our PPFM. You or your adviser can obtain a copy from our website (www.npi.co.uk) or by writing to us.

None of the contents of this document form any part of, or vary, the terms or conditions of any policy issued or to be issued by National Provident Life. In the event of any inconsistency between the contents of this document and any policy, the terms and conditions of the policy prevail. Life policies are legal contracts and cannot be altered without the agreement of the policyholder.

This document is not a comprehensive explanation of either the management of the with-profits business of National Provident Life or of every matter which may affect the business. In addition, no part of this document should be read as a recommendation to policyholders or potential policyholders or their advisers in relation to the effecting or maintaining a with-profits policy. Anyone considering whether to effect or maintain a with-profits policy with National Provident Life, or any company within the same group, should seek independent financial advice.

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

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