# PEARL ASSURANCE PUBLIC LIMITED COMPANY

**(FORMERLY PEARL ASSURANCE LIMITED)**

**Company Registration Number: 1419**

## REPORT AND ACCOUNTS

For the year ended 31 December 2007

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Registered Office

The Pearl Centre
Lynch Wood
Peterborough
PE2 6FY

Company Registration No 1419

## BOARD OF DIRECTORS

I D Cormack
T Cross-Brown
J R Cusins
M Dale
J P Evans
A K Gupta
J S Moss
H E M Osmond
M D Ross
J S B Smith
W R Treen

**Company Secretary**
G A Watson

## DIRECTORS' REPORT

The directors have pleasure in presenting the Report and Accounts of Pearl Assurance Public Limited Company (formerly Pearl Assurance Limited) ("the Company") for the year ended 31 December 2007

### Principal activities

The principal activity of the Company is the transaction of various classes of insurance business, covering annuities, pensions, savings, investment products, industrial branch business and protection policies This will continue to be the main activity for the foreseeable future The Company has approximately 2 5m (2006 2 7m) policies in force and £13 9bn (2006 £13 5bn) of assets under management The Company has ceased to write new business but continues to accept premiums on in-force business and to manage the ongoing business

### Strategy

The strategy of the Pearl Group of which the Company is a member is to be recognised as the best and most innovative manager of closed life assurance funds enabling increased value and better payouts for its policyholders

### Principal risks and uncertainties

The risk management objectives and policies of the Company are firstly to protect the Company's regulatory capital requirements, thereby safeguarding policyholders' guaranteed benefits whilst also ensuring the Company's ability to meet cash flow requirements Subject to the above, the Company seeks to use available capital in pursuing investment opportunities that meet agreed return hurdles for risk taken in order to achieve increased investment returns, generating potential additional value for policyholders and shareholders

*Insurance risk*

Insurance risk in the Company arises through exposure to both increased mortality and longevity and to variances between assumed and actual experience in such factors as persistency levels and various management and administrative expenses The Company manages these risks by holding prudent reserves based on assumptions that reflect past experience and anticipated future trends Effective 1 January 2007, the Company substantially mitigated mortality and longevity risk by reassuring its pension non-profit annuity in payment liabilities to an external reassurer (see material developments below)

*Financial instruments risks*

The main risks arising from financial instruments are
- asset valuation risk, since reductions in the value of assets through market fluctuation will restrict assets available to fund long term fund obligations and may in extreme circumstances require shareholder funds to be transferred to cover any shortfalls,
- interest rate risk, since movements in interest rates will impact the value of future guarantees and the value of fixed interest securities relative to the value of the related liabilities,
- liquidity risk, arising from either the inability to close out a particular position at or near the previous market price as well as from having insufficient liquid assets to meet payment obligations,
- foreign exchange risk, arising from fluctuations in the value of amounts denominated in foreign currencies, and
- credit risk, arising from the default of the counterparty to a particular financial asset, or from a reinsurer's inability to meet the obligations assumed under its reinsurance arrangements

The Company's exposure to all these risks is monitored by appropriate committees, primarily by the Asset, Liability and Investment Management Committee and the Financial Risk Committee, which agree policies for managing each of these risks on an ongoing basis Derivatives are used to mitigate the impact of these risks where appropriate During the period the Company continued to invest in developing its specialised asset and liability matching capabilities which has resulted in improved deployment of the Company's capital resources

**DIRECTORS' REPORT (CONTINUED)**

**Material developments**

During 2007 the Company acquired a 20 13% interest in Resolution plc, being 138,205,822 ordinary shares At 31 December, the market value of this investment was £983m and the Company recognised a gain of £77m through the profit and loss account in relation to this investment Resolution plc is subject to an acquisition offer by Impala Holdings Limited, a 75% subsidiary of Pearl Group Limited (see post balance sheet events below)

Effective 1 January 2007 the Company entered into a reassurance arrangement in respect of specified pension annuities in payment policies with Opal Reassurance Limited, an external reassurer A premium of £2,735m was payable by the Company but has been withheld and placed in a collateral account in order to mitigate counterparty exposure The Company has therefore retained legal ownership of all assets and will continue to hold these assets on its balance sheet The reassurer has a fixed charge over the assets The key benefit of the transaction was the derisking of the Company's business by effectively divesting the investment and mortality risk to the reassurer

In November 2007 the existing reassurance agreement between the Company and NPI Limited ("NPI") in respect of Unitised With Profit ("UWP") and Capital Account Pensions business was amended with effect from 1 July 2007

Axial Investment Management Limited ("Axial") entered into an Investment Services Agreement with the Company, effective 1 July 2007, whereby Axial will act as investment managers to invest, re-invest and manage designated assets on behalf of the Company

In the second half of 2007, State Street Bank and Trust Company were appointed as a strategic partner to the Company to provide custody and accounting, securities lending, transition management and associated services for the Axial managed assets of the Company Transition from the previous provider has been completed during the year

In January 2007 the Company announced the distribution of the Company's with profit fund estate to policyholders, commencing in July 2007 through enhancement to asset shares

**Change of name**

On the 19 April 2007, the Company re-registered as a public limited company under section 53 of the Companies Act 1985 with the Company name changing from Pearl Assurance Limited to Pearl Assurance Public Limited Company

**Performance during 2007**

The results for the Company show a profit before exceptional items and taxation of £69m (2006 £87m) This result reflects a profit before tax of £45m from the long term funds of the Company, and a profit before tax of £24m from the Company's shareholder assets The return of £24m on the Company's shareholder assets principally comprises recurring investment return of £34m and a gain of £77m in respect of the holding in Resolution largely offset by a non-recurring loss from its investment in its subsidiary NP Life Holdings Limited ("NPLH") The long term profit reflects the emergence of recurring profits from the release of margins as policies run off together with a number of one off items These non-recurring items include a net loss arising on the reassurance of UWP business from NPI to the Company's pension non profit fund

**Dividends**

The directors have paid and declared dividends of £118m during the year (2006 £244m)

**Position as at 31 December 2007**

The net assets of the Company at 31 December 2007 were £1,199m (2006 £1,202m) The decrease in the year reflects the total recognised gains and losses arising in 2007 of £58m and the receipt of a £57m capital contribution from PGL offset by payment of dividends of £118m during the year

**DIRECTORS' REPORT (CONTINUED)**

**Key Performance Indicators ("KPIs")**

The Company's performance is measured and monitored by the Board with reference to the following KPIs

Customers

The directors review various metrics in respect of treating customers fairly, customer communication and complaints on a monthly basis All agreed service standards for the Company were met during the period

There is a with-profit committee comprising independent and executive members to opine on issues of fairness to policyholders including ensuring policyholder monies are managed in accordance with the Company's Principles and Practices of Financial Management (PPFM)

Regulatory capital

The aim of the Company is to ensure that at all times it has an appropriate level of excess regulatory capital over its capital resource requirements, both on a Pillar 1 and a Pillar 2 basis As at 31 December 2007, the Company's free assets on a Pillar 1 basis were £515m (2006 £733m)

Profit after taxation and distributable reserves

The profits and distributable reserves of the Company are closely managed to ensure that surplus capital can be released over time to PGL as the business runs off

During 2007 the Company reported profit after taxation of £58m (2006 £115m) As at 31 December 2007, the Company had retained profits of £816m (2006 £819m), of which at least £223m (2006 £245m) was considered to be distributable

Cashflows

Policyholder and shareholder cash flows are monitored closely by the business to ensure all liabilities can be met as they fall due

**Post balance sheet events**

On 16 November 2007, the Boards of PGL and Resolution plc ("Resolution") announced that they had agreed the terms of a recommended cash acquisition by Impala Holdings Limited ("Impala"), a 75% subsidiary of PGL, of the entire issued and to be issued share capital of Resolution plc This acquisition is to be by way of a Court sanctioned scheme of arrangement under section 425 of the Companies Act (the "Scheme") Resolution shareholders were sent a copy of the Scheme document setting out the terms of this acquisition on 12 December 2007 On 9 January 2008, shareholders voted in favour of accepting Impala's acquisition offer at an extraordinary general meeting of Resolution and also at a meeting convened by order of the Court Impala is currently awaiting regulatory clearance from the FSA and the satisfaction of all conditions precedent, and anticipate that the acquisition will be effective in the second quarter of 2008 The holdings of the Company will be transferred to Impala at fair value, on completion

**Directors and their interests**

The names of the directors as at the date of this report are set out on page 2 There are no directors' interests requiring disclosure under the Companies Act 1985

**DIRECTORS' REPORT (CONTINUED)**

**Disclosure of indemnity**

It has been resolved, by amendment of Company Articles, to provide an Indemnity to certain persons associated with the Company These persons include the Company's directors and secretary, and approved persons, being persons in relation to whom the Financial Services Authority has given its approval under section 59 of the Financial Services and Markets Act 2000 ("FSMA") for the performance of a controlled function This indemnity will cover all losses, costs and expenses incurred by an indemnified person in the exercise, execution and discharge of his duties, or connected to the same, to the fullest extent permitted, consistent with the Companies Act 1985

**Audit information**

So far as each person who was a director at the date of approving this report is aware, there is no relevant audit information, being information needed by the auditor in connection with preparing its report, of which the auditor is unaware Having made enquiries of fellow directors and the Company's auditor, each director has taken all the steps that he is obliged to take as a director in order to make himself aware of any relevant audit information and to establish that the auditor is aware of that information

**Auditors**

Ernst & Young LLP have intimated their willingness to continue in office and a resolution that they be re-appointed by the directors will be proposed at the Annual General Meeting

By order of the Board of Directors

G A Watson
Company Secretary

20 March 2008

**STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ACCOUNTS**

The directors are responsible for preparing the annual report and accounts in accordance with applicable law and regulations

Company law requires the directors to prepare accounts for each financial year Under that law the directors have elected to prepare the accounts in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law) The accounts are required by law to give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period In preparing those accounts, the directors are required to

- select suitable accounting policies and apply them consistently,
- make judgements and estimates that are reasonable and prudent,
- state whether applicable United Kingdom Accounting Standards have been followed, subject to any material departures disclosed and explained in the accounts, and
- prepare the accounts on the going concern basis unless it is inappropriate to presume that the Company will continue in business

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the accounts comply with the Companies Act 1985 They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website Legislation in the United Kingdom governing the preparation and dissemination of accounts may differ from legislation in other jurisdictions

## INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF PEARL ASSURANCE PLC

We have audited the Company's accounts (the 'financial statements') of Pearl Assurance Public Limited Company, for the year ended 31 December 2007 which comprise the Profit and Loss Account, the Balance Sheet and the related notes 1 to 31 These financial statements have been prepared under the accounting policies set out therein

This report is made solely to the Company's members, as a body, in accordance with Section 235 of the Companies Act 1985 Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed

**Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland)

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985 We also report to you whether in our opinion the information given in the Directors' report is consistent with the financial statements

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed

We read the Directors' report and consider the implications for our report if we become aware of any apparent misstatements within it

**Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements

**Opinion**

In our opinion

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Company's affairs as at 31 December 2007 and of its profit for the year then ended,
- the financial statements have been properly prepared in accordance with the Companies Act 1985, and
- the information given in the Directors' report is consistent with the financial statements

Ernst & Young LLP
Registered auditor
London
20 March 2008

## PROFIT AND LOSS ACCOUNT
### Technical account for long-term business
For the year ended 31 December 2007

| | Notes | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|---|
| Gross premiums written | 3 1 | 254 | 319 |
| Outward reinsurance premiums | 3 1 | (2,738) | (4) |
| **Earned premiums, net of reinsurance** | 3 1 | (2,484) | 315 |
| Investment income | 4 | 610 | 1,035 |
| Other technical income | 5 | - | 1 |
| **Total technical income** | | (1,874) | 1,351 |
| Gross and net claims paid | | (1,071) | (1,501) |
| Change in the gross and net provision for claims (note 20) | | 4 | 1 |
| **Claims incurred, net of reinsurance** | | (1,067) | (1,500) |
| Change in gross long term business provision | | | |
| - Change in insurance contracts (note 19) | | 59 | 557 |
| - Change in investment contracts with discretionary participation features (note 19) | | 379 | 253 |
| Change in reinsurers' share | | 2,729 | (9) |
| **Change in technical provisions, net of reinsurance** | | 3,167 | 801 |
| Net operating expenses | 1 1 | (55) | (75) |
| Investment expenses and charges | 4 | (40) | (38) |
| Unrealised losses on investments | 4 | (107) | (363) |
| Other technical charges | 1 2 | (79) | - |
| Taxation credit/(charge) attributable to the long term business | 6 1 | 47 | (30) |
| Transfer from/(to) the fund for future appropriations | 18 | 39 | (76) |
| | | (195) | (582) |
| **Balance on the technical account – long term business** | 3 6 | 31 | 70 |

All activities relate to continuing operations

## PROFIT AND LOSS ACCOUNT
### Non-technical account
For the year ended 31 December 2007

| | Notes | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|---|
| **Balance on the long term business technical account** | | | |
| Continuing operations | 3 6 | 31 | 70 |
| Taxation attributable to balance on long term business technical account | 6 1 | 14 | 30 |
| **Shareholders pre-tax profit from long term business** | | 45 | 100 |
| Investment income | 4 | 30 | 29 |
| Unrealised gains on investments | 4 | 7 | 146 |
| Investment expenses and charges | 4 | (17) | (190) |
| Other income | | 4 | 5 |
| Other charges | 1 2 | - | (3) |
| **Profit on ordinary activities before exceptional items and taxation** | | 69 | 87 |
| **Non-operating exceptional items** | | | |
| Profit on disposals | 8 | - | 64 |
| **Profit on ordinary activities before taxation** | | 69 | 151 |
| Taxation charge on profit on ordinary activities | 6 1 | (11) | (36) |
| **Profit on ordinary activities after taxation** | | 58 | 115 |

## STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

There are no recognised gains and losses for 2007 and 2006 other than the profit on ordinary activities shown above

## BALANCE SHEET
**Assets**
At 31 December 2007

| | Notes | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|---|
| **Investments** | | | |
| Land and buildings | 10 | 114 | 127 |
| Investments in group undertakings and participating interests | 11 | 732 | 734 |
| Other financial investments | 12 | 13,282 | 13,031 |
| Deposits with ceding undertakings | | 36 | 39 |
| | | 14,164 | 13,931 |
| **Reinsurers' share of technical provisions** | | | |
| Policyholder liabilities (note 19) | | 2,740 | 11 |
| Claims outstanding | | 15 | 185 |
| | | 2,755 | 196 |
| **Debtors** | | | |
| Debtors arising out of direct insurance operations | 14 1 | 5 | 8 |
| Other debtors | 14 2 | 74 | 68 |
| | | 79 | 76 |
| **Other assets** | | | |
| Cash at bank and in hand | | 219 | 133 |
| **Prepayments and accrued income** | | | |
| Accrued interest and rent | | 131 | 150 |
| Other prepayments and accrued income | | 9 | 5 |
| | | 140 | 155 |
| **Total assets** | | 17,357 | 14,491 |

**BALANCE SHEET**
**Liabilities**
At 31 December 2007

| | Notes | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|---|
| **Capital and reserves** | | | |
| Called up share capital | 15 | 342 | 342 |
| Share premium account | 16 | 41 | 41 |
| Profit and loss account | 16 | 816 | 819 |
| **Shareholders' funds attributable to equity interests** | 17 | 1,199 | 1,202 |
| **Fund for future appropriations** | 18 | 306 | 345 |
| **Gross technical provisions** | | | |
| Long term business provision | | | |
| - Insurance contracts (note 19) | | 7,607 | 7,666 |
| - Investment contracts with discretionary participation features (note 19) | | 4,368 | 4,747 |
| Claims outstanding | 20 | 105 | 276 |
| | | 12,080 | 12,689 |
| **Financial liabilities** | | | |
| Derivative liabilities | 13 | 190 | 55 |
| **Provisions for other risks** | | | |
| Deferred taxation | 6 3 | 16 | 37 |
| Other provisions | 21 | 24 | 31 |
| | | 40 | 68 |
| **Deposits received from reinsurers** | 12 2 | 2,584 | - |
| **Creditors** | | | |
| Other creditors including taxation and social security | 23 | 951 | 123 |
| **Accruals and deferred income** | | 7 | 9 |
| **Total liabilities** | | 17,357 | 14,491 |

The accounts were approved by the Board of Directors on 20 March 2008 and signed on its behalf by

Director

## ACCOUNTING POLICIES

**Basis of preparation**

The accounts have been prepared in accordance with the special provisions for insurance companies of section 255 of, and Schedule 9A to the Companies Act 1985, except as noted for investment properties (see accounting policy below) The accounts have been prepared in accordance with applicable UK accounting standards and under historical cost accounting rules, modified to include the revaluation of investments, and comply with the UK Statement of Recommended Practice for Insurance Business (SORP) issued by the Association of British Insurers in December 2005 and amended in December 2006

The Company has adopted the requirements of FRS 29 "Financial Instruments Disclosures" and the amendment to FRS 26 "Financial Instruments measurement recognition and derecognition" in its current accounts The adoption of the amendment to FRS 26 has had no impact on the results of the Company

The accounts present information about the Company as an individual undertaking as it is exempt from the obligation to prepare group accounts under section 228 of the Companies Act 1985

**General business**

*Basis of accounting*

Provision has been made for obligations that have been incurred that are not expected to be covered by the future profits of the operation, including the expected future investment return on the related assets and their disposal The result of the general insurance business is included within other technical income in the technical account for long-term business

*Claims*

Full provision is made for the estimated cost of claims, including claims incurred but not reported, after taking into account handling costs, anticipated inflation and settlement trends Any difference between the estimated provisions and subsequent settlement are dealt with in the technical accounts of later years

**Classification of contracts**

Contracts under which the Company accepts significant insurance risk are classified as insurance contracts Contracts under which the transfer of insurance risk to the Company from the policyholder is not significant are classified as investment contracts The Company classifies all contracts as insurance contracts

**Insurance contracts and investment contracts with discretionary participation features (DPF)**

*Premiums*

Long term insurance contract premiums, investment contracts with DPF and annuity considerations are credited when they become due, which for single premium business is the date from which the policy is effective For regular premium contracts, receivables are recorded at the date when payments are due Reinsurance premiums are charged when they are payable

Funds at retirement under individual pension contracts left with the Company are classified as new business single premiums and for accounting purposes are included in both claims incurred and as single premiums within gross premiums written

*Claims*

Claims payable on maturity on insurance contracts and investment contracts with DPF are recognised when the claim becomes due for payment and on death are accounted for on notification Surrenders are accounted for at the earlier of the payment date or when the policy ceases to be included within the long-term business provision Where claims are payable and the contract remains in force, the claim instalment is accounted for when due for payment Claims payable include the costs of settlement

**ACCOUNTING POLICIES (CONTINUED)**

**Insurance contracts and investment contracts with discretionary participation features (DPF) (continued)**

*Long-term business provision for insurance contracts and investment contracts with DPF*

Participating business

The provision for participating, or with profits business is calculated initially to comply with the requirements of the Financial Services Authority's realistic capital regime, as set out in chapter 1 3 of the Prudential Sourcebook for Insurers The results are then adjusted to exclude the shareholders' share of future bonuses and the associated tax liability and to deduct amounts recognised for the present value of future profits on non-participating business written in the with profits fund The principal assumptions are given in note 19

Non participating business

The long-term business provision for non participating non linked business is calculated initially to comply with the requirements under the Prudential Sourcebook for Insurers using a gross premium valuation method or a method at least as prudent as the gross premium method The provision is adjusted where necessary to remove excessively prudent margins required for statutory solvency purposes by eliminating the undistributed surplus carried forward together with general contingency reserves and reserves required under the Prudential Sourcebook for Insurers

The provision includes allowance for prudent lapses and also allows policies with no guaranteed surrender values and policies where guaranteed surrender values only become applicable after a specified period of time, in the periods where they do not have guaranteed surrender values, to have negative values The principal assumptions are given in note 19

*Profit recognition and the fund for future appropriations*

The Company has adopted the modified statutory solvency basis approach in the determination of profit on non participating business

Surpluses arising from the Company's participating business, as a result of the annual actuarial valuations of the related assets and liabilities, are subject to appropriation by the directors to participating policyholders by way of bonuses and to shareholders, which determines the shareholder profit reported in respect of participating business The shareholders' share of the appropriated surplus determines the profit reported in respect of participating business All surplus in other business is attributable to shareholders and included in profit

In accordance with Guidance Note 45, issued by the Institute of Actuaries in December 2005 (GN 45), since the Company is a closed with-profits business, the whole of the estate would be expected to be distributed to the policyholders over time and to be shown as a liability and not as a working capital This would result in the working capital calculated in accordance with the FSA's realistic capital regime being recorded as zero

Any unappropriated surplus is therefore attributed between policyholder and shareholder and in accordance with GN 45 the liability in respect of the policyholders' share of the estate is included in the long term business provision, resulting in the fund for future appropriations comprising the shareholder share of the estate and other shareholder items only

*Present value of future profits (PVFP) on non-participating business in the with-profit fund*

In determining the realistic value of liabilities for with profits contracts the value of future profits on non participating business written in the with profits fund is taken into account Although not separately identifiable, the fund for future appropriation includes the excess of the value of those future profits that are taken into account in calculating the realistic liabilities The future profits on the non participating business is apportioned as a deduction between the amount relating to the policy holder liabilities and the amount relating to the fund for future appropriation

*Non-distributable reserves*

Within the Company's 0 100 long term fund is an earmarked segment known as the Pacific fund The assets of the Pacific fund are formally attributed to shareholders with the agreement of the Financial Services Authority The net assets of the Pacific fund are considered non-distributable

**ACCOUNTING POLICIES (CONTINUED)**

**Investment income, realised and unrealised gains and losses on investments**

Dividends are included as investment income on the date that the right to receive payment has been established Interest income is recognised as the interest accrues using the effective yield method Rental income on investment properties is accounted for on a straight line basis over the lease term on ongoing leases

Gains and losses (both realised and unrealised) on financial assets designated as at fair value through profit or loss are recognised in the profit and loss account

Realised gains and losses on investments are calculated as the difference between the net sales proceeds and original cost Unrealised gains and losses on investments represent the difference between the valuation of investments at the balance sheet date and their original cost, or if they have been previously revalued, the valuation at the last balance sheet date The movement in unrealised gains and losses recognised in the period also includes the reversal of unrealised gains and losses recognised in earlier accounting periods in respect of investment disposals in the current period

**Land and Buildings**

Included within land and buildings is investment property, which is property held to earn rentals and/or for capital appreciation, is initially measured at cost including all transaction costs and is subsequently stated at its fair value at the balance sheet date Gains or losses arising from changes in the fair value of investment property are included in the profit and loss account in the period in which they arise

Investment properties are derecognised when they have either been disposed of or when the investment property is permanently withdrawn from use and no future benefit is expected from its disposal Any gains or losses on the derecognition of an investment property are recognised in the profit and loss account in the year of derecognition

In accordance with SSAP19 "Investment Properties", no depreciation is provided on land and buildings This is a departure of the Companies Act 1985 which require all properties to be depreciated However, these properties are held solely for investment purposes and management consider that systematic depreciation would be inappropriate Depreciation is only one of the factors reflected in the annual valuation of properties and the amounts which might otherwise have been shown cannot reasonably be separately identified or quantified The accounting policy adopted is therefore necessary for the accounts to give a true and fair view

**Financial Instruments**

*Financial Assets*

Interests in associated undertakings and joint ventures attributable to the long term business and which affect or establish policyholders' rights or otherwise held as part of the Company's investment portfolio, are accounted for as investments in group undertakings and participating interests

Equity investments in subsidiary undertakings, associated undertakings and joint ventures are stated at directors' valuation

Investment in loans to group undertakings are stated at amortised cost

Debt securities, equity securities and holdings in authorised collective investment schemes are designated as at fair value through profit and loss in accordance with the documented risk strategy of the group and are measured at subsequent reporting dates at fair value Gains and losses arising from changes in fair value are included in the profit or loss account for the period

*Financial liabilities*

Financial liabilities are stated at amortised cost Amortised cost is calculated by taking into account any issue costs, and any discount or premium on settlement Any difference between the proceeds net of transaction costs and the redemption value is recognised in the profit and loss account over the period of the financial liability using the effective interest method

**ACCOUNTING POLICIES (CONTINUED)**

**Financial Instruments (continued)**

*Derivative Financial Instruments*

The Company uses derivative financial instruments to mitigate against market, liquidity and credit risk

Derivative financial instruments are classified as held for trading and carried at fair value as assets or liabilities Fair values are based on quoted market prices or determined using valuation techniques Changes in fair values are recognised in the profit and loss account Derivative financial instruments include swaps, swaptions, futures, forwards and option contracts, all of which derive their value mainly from the underlying interest rates, foreign exchange rates, equity and debt instruments

*Fair value estimation*

The fair value of financial instruments traded in active markets such as publicly traded securities and derivatives, are based on quoted market prices at the balance sheet date The quoted market price used for financial assets is the current bid price on the trade date The fair value of investments that are not traded in an active market is determined using valuation techniques Regular way purchases and sales of financial assets are accounted for at trade date The fair value of shares and other variable yield securities and of derivative financial instruments, are estimated using pricing models or discounted cash flow techniques Where pricing models are used, inputs are based on market related data at the balance sheet date Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate used is a market related rate for a similar instrument

For units in unit trusts and shares in open ended investment companies, fair value is by reference to published bid-values The fair value of floating rate and overnight deposits with credit institutions is their carrying value The fair value of fixed-interest bearing deposits is estimated using discounted cash flow techniques

**Taxation**

The Company recognises deferred tax assets and liabilities on a discounted basis to reflect the time value of money A discount rate has been selected that reflects the yield on government bonds which have a maturity date similar to the likely average period for assets upon which deferred tax liabilities and assets arise Deferred tax is recognised in respect of all timing differences that have originated but not reversed by the balance sheet date with the exception of deferred tax assets which are recognised only to the extent that the directors consider that it is more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted Deferred tax on changes in the fair value of investments is recognised in the profit and loss account

Expenses and assets are recognised net of the amount of VAT except where this tax is not wholly recoverable, in which case the VAT is recognised as part of the cost of acquisition of the asset or as part of the expense item Receivables and payables are stated with the amount of VAT included The net amount of VAT recoverable from, or payable to the taxation authority is included as part of receivables or payables in the balance sheet

The transfer from the long term business account to the non-technical account is grossed up at the longer term effective rate of corporation tax

**Foreign currencies**

Transactions in currencies other than the functional currency of the Company are recorded at the rate appropriate at the time of accounting for the transaction Currency balances at the year end are converted at the year end spot rate For monetary assets and liabilities within the long-term funds the resulting exchange adjustments are included within the technical account For assets and liabilities held outside of the long-term funds any resulting exchange adjustments are taken to the non-technical account

**ACCOUNTING POLICIES (CONTINUED)**

**Cash flow statement**

The Company has taken advantage of the exemption given by FRS 1 (revised 1996) to subsidiary undertakings where 90% or more of the voting rights are controlled within the group, by not preparing a cash flow statement Details of the ultimate holding company are given in note 29 on the accounts

## NOTES TO THE ACCOUNTS

### 1. Net operating expenses and other charges

*1 1 Net operating expenses*

| | Technical account Long term business 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Administration expenses | 55 | 75 |
| | 55 | 75 |

*1 2 Other technical charges and other charges*

| | Technical account Long term business | | Non technical account | |
|---|---|---|---|---|
| | 31 Dec 07 £m | 31 Dec 06 £m | 31 Dec 07 £m | 31 Dec 06 £m |
| Movement in deposits received from reinsurers | 79 | - | - | - |
| Other charges | - | - | - | 3 |
| | 79 | - | - | 3 |

*1 3 Auditors' remuneration*

| | 31 Dec 07 £'000 | 31 Dec 06 £'000 |
|---|---|---|
| Fees payable to the Company's auditor for the audit of the Company's annual accounts | 223 | 270 |
| Fees payable to the Company's auditor for other services | | |
| Other services pursuant to legislation | 59 | 71 |
| Other services relating to tax | 4 | 7 |
| | 286 | 348 |

*1 4 Employee information*

The Company has no employees Staff are provided by Pearl Group Services Limited

### 2. Segmental information - Operating profit and net assets

The Company's activities consist solely of the provision of insurance of various types Almost all business is written in the United Kingdom in respect of continuing operations

**NOTES TO THE ACCOUNTS (CONTINUED)**

**3. Segmental information – Long term business**

Almost all business is written in the United Kingdom in respect of continuing operations

*3 1 Analysis of earned premiums, net of reinsurance*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Direct insurance | 270 | 311 |
| Reinsurance inwards | (16) | 8 |
| Gross written premiums | 254 | 319 |
| Reinsurance outwards | (2,738) | (4) |
| | (2,484) | 315 |
| Life business | 110 | 142 |
| Annuity business | 2 | 2 |
| Pension business | (2,596) | 171 |
| | (2,484) | 315 |

In November 2007, the existing reassurance agreement between the Company and NPI Limited in respect of Unitised With Profit and Capital Account Pensions business was amended with effect from 1 July 2007 and a reassurance premium of £23m was paid to NPI Limited

Effective 1 January 2007, the Company reassured certain pension non–profit annuities in payment liabilities to Opal Reassurance Limited, an external reassurer The initial premium for the reassurance of this business is included in outward reinsurance premiums

*3 2 Analysis of gross premiums written by way of direct insurance*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Regular premiums | 190 | 234 |
| Single premiums | 80 | 77 |
| | 270 | 311 |
| Non participating contracts | 110 | 112 |
| Participating contracts | 160 | 199 |
| | 270 | 311 |

Industrial branch premiums of £9m (2006 £12m) are classified as regular premium participating life business in the above analysis

**NOTES TO THE ACCOUNTS (CONTINUED)**

**3 Segmental information – Long term business (continued)**

*3 3 Analysis of new gross written premiums*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Direct insurance | 80 | 77 |
| Reinsurance inwards | (17) | 7 |
| | 63 | 84 |
| Annuity business | 1 | 1 |
| Pension business | 62 | 83 |
| | 63 | 84 |

*3 4 New business annual premium equivalent*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Annual premium equivalent | 8 | 8 |

*3 5 Analysis of new gross written premiums written by way of direct insurance*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Single premiums | 80 | 77 |
| | 80 | 77 |
| Non participating contracts | 80 | 77 |
| | 80 | 77 |

In classifying new business premiums, the basis of recognition adopted is as follows

- incremental increases on existing policies are classified as new business premiums,
- rebates from the Department of Social Security are classified as new single premiums, and
- funds at retirement under individual pension contracts left with the Company are classified as new business single premiums and for accounting purposes are included in both claims incurred and as single premiums within gross written premiums

## NOTES TO THE ACCOUNTS (CONTINUED)

### 3. Segmental information – Long term business (continued)

*3 6 Analysis of balance on technical account*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Life and annuity business – participating | 10 | 2 |
| Life and annuity business – non participating | (3) | 41 |
| Pension business – participating | 6 | 1 |
| Pension business – non participating | (9) | 28 |
| Shareholders' attributable assets | 27 | (3) |
| General insurance | - | 1 |
| **Balance on technical account – long-term business** | 31 | 70 |

*3 7 Reinsurance balance*

The reinsurance balance amounted to a credit to the long-term business technical account at 31 December 2007 of £54m (2006 £17m debit)

### 4 Investment return

| | Technical account Long term business | | Non-technical account | |
|---|---|---|---|---|
| | 31 Dec 07 £m | 31 Dec 06 £m | 31 Dec 07 £m | 31 Dec 06 £m |
| Income from loans and receivable at amortised cost | 13 | 10 | 6 | 6 |
| Income from financial assets at fair value through profit and loss | 553 | 586 | 24 | 23 |
| Income from other financial investments | 566 | 596 | 30 | 29 |
| (Expense)/Income from participating interests | (1) | 2 | - | - |
| Income from land and buildings | 5 | 8 | - | - |
| Gains on realisation of investments | 40 | 429 | - | - |
| **Investment Income** | 610 | 1,035 | 30 | 29 |
| **Unrealised gains** | - | - | 7 | 146 |
| Investment management expenses and charges | (38) | (34) | - | - |
| Losses on realisation of investments | - | - | (2) | (189) |
| Interest expense on financial liabilities at amortised costs | (2) | (4) | (15) | (1) |
| **Investment expenses and charges** | (40) | (38) | (17) | (190) |
| **Unrealised losses** | (107) | (363) | - | - |
| **Total investment return** | 463 | 634 | 20 | (15) |

**NOTES TO THE ACCOUNTS (CONTINUED)**

## 4 Investment return (continued)

Net gains/(losses) on financial assets at fair value through profit or loss Included in total investment return are

| | Technical account Long-term business | | Non-technical account | |
|---|---|---|---|---|
| | 31 Dec 07 £m | 31 Dec 06 £m | 31 Dec 07 £m | 31 Dec 06 £m |
| Assets designated upon initial recognition | (112) | 36 | 100 | (2) |
| Assets held for trading | 65 | (40) | (24) | 1 |
| | (47) | (4) | 76 | (1) |

Interest expenses for financial liabilities not at fair value through profit and loss comprises

| | | Technical account Long-term business | | Non-technical account | |
|---|---|---|---|---|---|
| | Note | 31 Dec 07 £m | 31 Dec 06 £m | 31 Dec 07 £m | 31 Dec 06 £m |
| Investment contracts with DPF | | 175 | 346 | - | - |
| Other creditors | | - | - | 14 | - |
| | | 175 | 346 | 14 | - |

The interest expense in respect of investment contracts with DPF is calculated as the increase in the realistic liability for those contracts not attributable to amounts received from, or paid to, policyholders and is presented within the long term business technical account under the heading "Change in long-term business provision"

## 5. Other income

*Other technical income*

| | Technical account Long-term business | |
|---|---|---|
| | 31 Dec 07 £m | 31 Dec 06 £m |
| General Insurance | - | 1 |
| | - | 1 |

**NOTES TO THE ACCOUNTS (CONTINUED)**

## 6. Taxation

*6 1 Profit and loss account*

| | Technical account Long term business | | Non-technical account | |
|---|---|---|---|---|
| | 31 Dec 07 £m | 31 Dec 06 £m | 31 Dec 07 £m | 31 Dec 06 £m |
| **United Kingdom corporation taxation** | | | | |
| Current tax (credit)/charge for the year | (1) | 23 | - | 5 |
| Adjustments for previous years | (25) | (15) | (3) | 1 |
| | (26) | 8 | (3) | 6 |
| Tax attributable to shareholders | - | - | 14 | 30 |
| **Total current taxation (credit)/charge** | (26) | 8 | 11 | 36 |
| **Deferred taxation** | | | | |
| Origination and reversal of timing differences | (21) | 23 | - | - |
| Decrease in discount | - | (1) | - | - |
| **Total charged to deferred taxation** | (21) | 22 | - | - |
| **Total tax (credit)/charge** | (47) | 30 | 11 | 36 |

After taking into account reliefs to which the Company is entitled, UK corporation tax on taxable profits attributable to shareholders has been accounted for at the rate of 30% The tax rate for life policyholders is 20%

*6 2 Factors affecting tax charge for year*

The tax assessed in the year is lower than the standard rate of corporation tax in the UK and the differences are explained below

The standard rate of tax has been determined by using the UK rate enacted for the year for which the profits will be taxed

**NOTES TO THE ACCOUNTS (CONTINUED)**

**6. Taxation (continued)**

*6 2 Factors affecting tax charge for year (continued)*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Profit on ordinary activities before taxation | 69 | 151 |
| Profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 30% | 21 | 45 |
| Effects of | | |
| Permanent differences | - | 1 |
| Non-taxable income | (3) | (3) |
| Prior year adjustments | (3) | 1 |
| Non-taxable book losses on sales/revaluations of subsidiaries and associates | (4) | (6) |
| Losses received from group company for no consideration | - | (2) |
| Current taxation charge for the period | 11 | 36 |

*6 3 Analysis of deferred tax*

The components of the net deferred tax liability are as follows

| | Liability provided 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Unrealised gains in investments | 14 | 38 |
| Deferred acquisition costs | (2) | (7) |
| Capital allowances | 1 | 8 |
| Other short term timing differences | 4 | (1) |
| Total undiscounted | 17 | 38 |
| Total on a discounted basis | 16 | 37 |

Reconciliation of movements in deferred tax

| | £m |
|---|---|
| At 31 December 2006 | 37 |
| Credit for the year | |
| Technical account – long term business | (21) |
| At 31 December 2007 | 16 |

**NOTES TO THE ACCOUNTS (CONTINUED)**

## 7. Dividends

Interim ordinary paid dividends

| | 31 Dec 07<br>£m | 31 Dec 06<br>£m |
|---|---|---|
| 34 88p per "B" ordinary £1 share (2006 71 76p per "B" ordinary £1 share) | 118 | 244 |

## 8. Exceptional items

The non-operating exceptional items have arisen from the following disposals

| | 31 Dec 07<br>£m | 31 Dec 06<br>£m |
|---|---|---|
| Sale of subsidiaries | - | 9 |
| General Insurance | - | 55 |
| | - | 64 |

On 1 July 2006, the Company sold the entire issued share capital of subsidiaries Pearl Assurance (Unit Funds) Limited (PAUF) and Pearl Assurance (Unit Linked Pensions) Limited (PAULP) to PGL From that date, the Company ceased to be the immediate parent undertaking of PAUF and PAULP The consideration of £139m comprised a £43m loan from PGL and the assumption by PGL of loan liabilities of the Company of £96m A profit of £9m arose on this transaction

Agreement was reached with Lloyds TSB on 20 July 2006 for the transfer by the Company of the rights to renew existing General Insurance policies and to market General Insurance products to the customers of the Company using the Company's brand A net upfront profit of £55m arose on this transaction The tax effect in the non-technical accounting relating to this non-operating exceptional item is a tax charge of £17m

## NOTES TO THE ACCOUNTS (CONTINUED)

### 9 Directors' emoluments

| | 31 Dec 07 £ | 31 Dec 06 £ |
|---|---|---|
| Emoluments (excluding pension contributions and awards under share option schemes and other long-term incentive schemes) | 2,334,229 | 4,224,960 |
| Contributions to money purchase pension schemes | 11,865 | 224,788 |
| Directors' and past directors' retirement benefits in excess of entitlements | 4,507 | 4,331 |

| | 31 Dec 07 Number | 31 Dec 06 Number |
|---|---|---|
| Number of directors who | | |
| - are members of a defined benefit pension scheme | 1 | 1 |
| - are members of a money purchase pension scheme | 1 | 2 |

| | 31 Dec 07 £ | 31 Dec 06 £ |
|---|---|---|
| Highest paid director's remuneration | | |
| Aggregate amount of emoluments and awards under long term incentive schemes (excluding pension contributions, share options gains and share awards arising from long-term incentive schemes) | 622,306 | 1,071,828 |
| Contributions to money purchase schemes | - | 11,324 |

**NOTES TO THE ACCOUNTS (CONTINUED)**

**10. Land and buildings**

| | Freehold £m | Long Leasehold £m | Total £m |
|---|---|---|---|
| At 1 January 2007 | 91 | 36 | 127 |
| Deficit on revaluation | (6) | (7) | (13) |
| At 31 December 2007 | 85 | 29 | 114 |
| Land and buildings at cost | | | |
| At 31 December 2007 | 71 | 35 | 106 |
| At 31 December 2006 | 71 | 35 | 106 |

All investment properties held by the Company were valued as at 31 December 2007, by qualified professional valuers working for the companies DTZ Debenham Tie Leung, CB Richard Ellis Limited or Atisreal The investment properties were valued on the basis of market value The properties in owner occupation for the purposes of the Company's business were valued on the basis of existing use value All valuers are Chartered Surveyors being members of the Royal Institution of Chartered Surveyors (RICS) All valuations were carried out in accordance with the RICS Appraisal and Valuation Manual

Other than for leasehold properties where the lease has less than twenty years unexpired term, no provision is made for depreciation of investment properties

**NOTES TO THE ACCOUNTS (CONTINUED)**

**11. Investments in group undertakings and participating interests**

| | Group Undertakings | | Participating Interests | Total |
|---|---|---|---|---|
| | Shares £m | Loans £m | Shares £m | £m |
| **Market Value** | | | | |
| At 1 January 2007 | 412 | 282 | 40 | 734 |
| Additions | 149 | 5 | 10 | 164 |
| Disposals | - | (73) | - | (73) |
| Distributions | (21) | - | (1) | (22) |
| Deficit on revaluation | (71) | - | - | (71) |
| At 31 December 2007 | 469 | 214 | 49 | 732 |
| **Cost** | | | | |
| At 31 December 2007 | 176 | 214 | 38 | 428 |
| At 31 December 2006 | 27 | 282 | 28 | 337 |

Included within shares in group undertakings is a contingent loan valued at £134m (2006 £216m) provided indirectly to National Provident Life Limited (see note 26)

The remaining principal subsidiaries and associated undertakings of the Company are disclosed within note 27

**NOTES TO THE ACCOUNTS (CONTINUED)**

## 12. Other financial investments

*12 1 Other financial investments*

The Company's other financial assets are classified in the balance sheet as other financial investments and are summarised by measurement category as follows

| | 31 Dec 07 Carrying Value £m | 31 Dec 07 Cost £m | 31 Dec 06 Carrying Value £m | 31 Dec 06 Cost £m |
|---|---|---|---|---|
| At fair value through profit and loss | | | | |
| Designated upon initial recognition | 12,890 | 12,045 | 12,763 | 11,938 |
| Derivative financial instruments held for trading | 303 | 42 | 178 | 48 |
| Loans and receivables at amortised cost | 89 | 89 | 90 | 90 |
| Total other financial investments | 13,282 | 12,176 | 13,031 | 12,076 |

The other financial investments of the Company can be further analysed as

| | Note | 31 Dec 07 Carrying Value £m | 31 Dec 07 Cost £m | 31 Dec 06 Carrying Value £m | 31 Dec 06 Cost £m |
|---|---|---|---|---|---|
| Share and other variable yield securities and units in unit trusts | | 5,935 | 5,056 | 4,105 | 3,261 |
| Debt securities and other fixed income securities | | 6,823 | 6,857 | 8,505 | 8,524 |
| Loans and receivables at amortised cost | | 89 | 89 | 90 | 90 |
| Deposits with credit institutions | | 132 | 132 | 153 | 153 |
| Derivative assets | 13 | 303 | 42 | 178 | 48 |
| | | 13,282 | 12,176 | 13,031 | 12,076 |
| Listed investments included above | | 11,075 | 10,500 | 12,999 | 12,044 |

The fair value of financial instruments traded in active markets, such as publicly traded securities and derivatives, are based on quoted market prices at the balance sheet date The quoted market price used for financial assets is the current bid price on the trade date For units in unit trusts and shares in open ended investment companies, fair value is by reference to published bid-values The fair value of floating rate and overnight deposits with credit institutions is their carrying value The fair value of fixed-interest bearing deposits is estimated using discounted cash flow techniques The fair value of investments that are not traded in an active market is determined using valuation techniques The fair value of shares and other variable yield securities and of derivative financial instruments, are estimated using pricing models or discounted cash flow techniques Where pricing models are used, inputs are based on market related data at the balance sheet data Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate used is a market related rate for a similar instrument

**NOTES TO THE ACCOUNTS (CONTINUED)**

**12 Other financial investments (continued)**

*12 1 Other financial investments (continued)*

The amount of unrealised gains/(losses) relating to the change in fair value of financial investments determined using valuation techniques other than quoted market prices is £22m (2006 £138m) in the long-term business technical profit and loss account and £6m (2006 (£12m)) in the non-technical profit and loss account

*12 2 Collateral*

*12 2 1 Premium withheld from reinsurers*

Effective 1 January 2007, the Company reassured certain pension annuities in payment to an external reassurer Under the terms of this reassurance arrangement the Company holds assets in a collateral account over which the external reassurer has a fixed charge

The fair value of the assets thus held is £2,584m (2006 £nil)

*12 2 2 Stock lending*

Under the Company's stock lending programme, collateral is received to the value of at least 102% of the stocks lent

The fair value of the collateral received is £2,601m (2006 £3,002m)

**13. Derivatives**

The Company purchases derivative financial instruments in the connection with the management of its insurance contract and investment contract liabilities

The fair values of derivative financial instruments are as follows

| | Derivative assets 31 Dec 07 £m | Derivative assets 31 Dec 06 £m | Derivative liabilities 31 Dec 07 £m | Derivative liabilities 31 Dec 06 £m |
|---|---|---|---|---|
| Forward currency | 17 | 2 | 86 | 6 |
| Credit default swaps | 25 | 2 | 6 | 4 |
| Interest rate swaps | 197 | 26 | 81 | 45 |
| Swaptions | 46 | 63 | - | - |
| Inflation swaps | 8 | 85 | - | - |
| Equity options | 9 | - | 9 | - |
| Total return bond swaps | 1 | - | 8 | - |
| | 303 | 178 | 190 | 55 |

Derivative assets are disclosed in the Company's balance sheet within "Other financial investments"

**NOTES TO THE ACCOUNTS (CONTINUED)**

**14. Debtors**

*14 1 Debtors arising out of direct insurance operations*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Amounts owed by policyholders | 5 | 8 |

All debtors are expected to be recovered within 12 months The carrying value amount of these assets is a reasonable approximation of their fair value

*14 2 Other debtors*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Outstanding sale of investments | 10 | 17 |
| Amounts owed by group undertakings | 21 | 10 |
| Taxation recoverable | 1 | 1 |
| Other debtors | 42 | 40 |
| | 74 | 68 |

All debtors are expected to be recovered within 12 months The carrying value amount of these assets is a reasonable approximation of their fair value

**15. Share capital**

*15 1 Share Capital authorised*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| 51,000,000 'A' ordinary equity shares of 5p each | 3 | 3 |
| 757,001,000 'B' ordinary equity shares of £1 each | 757 | 757 |
| | 760 | 760 |

*15 2 Share capital allotted*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Allotted, called up and fully paid equity shares | | |
| 42,169,489 'A' ordinary shares of 5p each | 2 | 2 |
| 340,001,000 'B' ordinary shares of £1 each | 340 | 340 |
| | 342 | 342 |

The holders of the "B" shares are entitled to

- a dividend equivalent to 99 999% of the profits of the Company which it may determine to distribute in respect of any financial year with the balance going to the holders of the "A" ordinary shares
- on a return of capital, repayment in full of the capital paid up on the "B" ordinary shares and a further sum equal to 99 999% of the assets available for distribution to members with the balance of assets then going to the holders of the "A" ordinary shares

At a General Meeting, every holder of the "B" ordinary shares shall have one vote and one poll vote for every share of which he is the holder The holders of the "A" ordinary shares shall have no voting rights

**NOTES TO THE ACCOUNTS (CONTINUED)**

## 16. Reserves

| | Share Premium £m | Profit and Loss account £m |
|---|---|---|
| At 1 January 2007 | 41 | 819 |
| Profit after taxation | - | 58 |
| Dividends (note 7) | - | (118) |
| Capital contribution | - | 57 |
| At 31 December 2007 | 41 | 816 |

In December 2007, the Company received from its parent undertaking PGL a £57m capital contribution

Of the £816m profit and loss account reserve at least £223m (2006 £245m) is considered distributable

## 17. Reconciliation of movement in shareholders' funds

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Shareholders' funds at 1 January | 1,202 | 1,317 |
| Opening balance sheet adjustments | - | 14 |
| Shareholders' funds at 1 January as restated | 1,202 | 1,331 |
| Profit after taxation | 58 | 115 |
| Dividends (note 7) | (118) | (244) |
| Capital contribution | 57 | - |
| Shareholders' funds at 31 December | 1,199 | 1,202 |

## 18 Fund for future appropriations

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| At 1 January | 345 | 269 |
| Transfer (to)/from the technical account | (39) | 76 |
| At 31 December | 306 | 345 |

The Company's with-profit fund is closed to new business In accordance with the principles established by FRS 27 Life Assurance and Guidance Note 45, the whole of the unappropriated surplus attributable to policyholders has been included in the long-term business provision As a result, the fund for future appropriation represents the shareholders' share of the inherited estate and other shareholder items only

**NOTES TO THE ACCOUNTS (CONTINUED)**

**19. Policyholder liabilities**

Material judgement is required in calculating the policyholder liabilities In particular there is discretion over the assumptions used The variance of actual experience from that assumed may result in such liabilities differing from the provisions made for them In calculating the realistic liabilities, account has also been taken of future management actions consistent with those set out in the Principles and Practices of Financial Management (PPFM) The most significant of these is that bonus rates in the with profit fund are assumed to change as markets change to target asset shares subject to guarantees and smoothing constraints

The Company is subject to a number of inherent risks that impact the value of policy liabilities, including interest rate risk, market fluctuations and demographic changes If interest rates fall, the impact of discounting on the policyholder liabilities will reduce, resulting in an increased provision Similarly, if annuitant mortality were assumed to increase, then the policyholder liabilities in respect of annuities would increase, whilst that in respect of assurances would decrease Where policies have been sold that include options, provision is made to allow for assumed policyholder behaviour, however, where that behaviour differs from expectations there will be a corresponding change in the provisions required

Liabilities may also arise in respect of claims relating to the interpretation of such contracts, or the circumstances in which policyholders have entered into them The extent of such liabilities is influenced by the actions and requirements of the FSA, the Ombudsman rulings, by industry compensation and by court judgements

Assumptions are set by reference to publicly available market data and then validated to ensure that the current assumptions continue to reflect actual experience

For participating business, the policyholder liabilities is calculated in accordance with the FSA's realistic capital regime, adjusted to exclude the shareholder's share of the future bonuses, the shareholders' share of the estate and the associated tax liability as required by FRS27 "Life Assurance" Non participating liabilities are valued using a gross premium method allowing for a prudent level of discontinuances

The present value of future profits on non-participating business written in the with profit fund, offset against the long-term business provided and not recognised as an asset as at 31 December 2007 was £42m (2006 £14m)

*19 1 Participating business*

For participating business, a market consistent valuation is used to calculate the long term business provision This involves placing a value on liabilities similar to the market value of assets with similar cash flow patterns The key assumptions used in this valuation are set out in the tables below

**Interest rates**

The risk free interest rates assumed are

| Year | 1 | 5 | 10 | 15 | 20 | 25 | 30 | 35 | 40 |
|---|---|---|---|---|---|---|---|---|---|
| 31 Dec 07 | 4 65% | 4 62% | 4 70% | 4 68% | 4 60% | 4 45% | 4 29% | 4 16% | 4 06% |
| 31 Dec 06 | 5 42% | 5 15% | 4 83% | 4 71% | 4 48% | 4 25% | 4 10% | 3 98% | 3 89% |

**NOTES TO THE ACCOUNTS (CONTINUED)**

**19. Policyholder liabilities (continued)**

*19 1 Participating business (continued)*

**Other assumptions**

Best estimate assumptions are set for inflation, mortality and expenses

| | 31 December 2007 | 31 December 2006 |
|---|---|---|
| Inflation | | |
| Retail price inflation | 3 2% | 3 2% |
| Expense inflation (direct business)+ | 3 2% | 3 4% |
| Earnings inflation | 4 2% | 4 7% |

+ NPI reinsurance expense inflation is 4 2% (2006 4 2%)

| | | |
|---|---|---|
| Asset mix for assets backing asset shares at the valuation date | | |
| Gilts and cash | 20 8% | 25 8% |
| Corporate bonds | 28 9% | 24 2% |
| Equities | 33 1% | 35 5% |
| Property | 17 2% | 14 5% |

| | | |
|---|---|---|
| Mortality rate | | |
| Conventional Life Business | 75% AM/F80 Ultimate | 75% AM/F80 Ultimate |
| Conventional Pensions Business | 75% AM/F80 Ultimate | 75% AM/F80 Ultimate |
| Conventional Industrial Branch Business | 60% ELT 14 Male | 60% ELT 14 Male |
| Non Unitised Accumulating Pensions Business | 75% AM/F80 Ultimate | 75% AM/F80 Ultimate |
| Direct Unitised Accumulating Life Business++ | 75% AM/F80 Ultimate | 75% AM/F80 Ultimate |
| Direct Unitised Accumulating Pensions Business | 75% AM/F80 Ultimate | 75% AM/F80 Ultimate |
| Direct Unitised Accumulating Other Business | 75% AM/F80 Ultimate | 75% AM/F80 Ultimate |
| Reassurance Accepted Unitised Life Business | 95% AM/F92 Ultimate | 95% AM/F92 Ultimate |
| Guaranteed Annuity Option/Pensions Misselling (post retirement) | Males 105 0% RMV00 Females 107 5% RFV00 maximum of 85% of the average of medium and long cohort improvements with a floor of 3% if aged 60 or less reducing linearly down to 0% aged 110 | Males 117 5% RMV92 Females 107 5% RFV92 maximum of 75% of the average of medium and long cohort improvements or CMIR17 improvements or 1% |

++ Business other than Homebuyer

**Persistency - Lapses / Surrenders / Paid Up Rates**

A review of persistency is carried out annually The review is based on a trend analysis of persistency, the results of which are then applied to existing assumptions Assumptions are adjusted where necessary to reflect more recent experience as evidenced in the persistency trend analysis, or to reflect expected future trends as a result of anticipated future events

**NOTES TO THE ACCOUNTS (CONTINUED)**

**19. Policyholder liabilities (continued)**

*19 1 Participating Business (continued)*

**Options and guarantees**

Some products give potentially valuable guarantees or policyholders the option to change policy benefits These can be exercised at the policyholders' discretion For example, some pension contracts include guaranteed annuity options where the policyholder can choose to take policy benefits in the form of an annuity based on guaranteed conversion rates There are also further contractual guarantees, primarily arising from sum assured and reversionary bonuses on conventional with profits business and the guaranteed cash amount and reversionary bonuses on the deferred annuities business

In accordance with the FSA's rules and FRS27 the measurement of financial options and guarantees is achieved through stochastic modelling which aims to reproduce the market cost of similar financial instruments The total amount provided in respect of the future costs of guaranteed annuity options is £339m (2006 £366m) and in respect of other guarantees is £249m (2006 £268m)

In common with other life companies in the United Kingdom which have written pension transfer and opt out business, the Company has set up provisions for the review and possible redress relating to personal pension policies These provisions, which have been calculated from data derived from detailed file reviews of specific cases and using a certainty equivalent approach, which give a result very similar to a market consistent valuation, are included in the policyholder liabilities The total amount provided in respect of the review and possible redress relating to pension policies, including associated costs, is £349m (2006 £420m)

The directors are of the opinion that the provisions are consistent with the principles of treating customers fairly

**Provision for bonuses**

The total cost of bonuses attributable to the accounting period, being amounts representing an allocation of surplus for the year is £169m (2006 £138m)

**Other specific matters**

The Financial Services Authority carried out a review of low-cost mortgage endowments in 1999 As a result all such mortgage endowment policyholders were provided with information on the performance of their policy The Company took action to ameliorate the financial impact on those policyholders who were most impacted by the reduction in expected future investment returns Provision has been made in these accounts for the expected costs of the action taken and to meet the potential costs arising from any complaints associated with low-cost mortgage endowments The total amount provided is £83m (2006 £79m)

*19 2 Non participating business*

Effective 1 January 2007, the Company entered into a reassurance arrangement under which the Company reassured its pension non-profit annuity in payment liabilities From this date, the reassurer bears substantially all the risks and rewards of the pension non-profit annuity in payment business

Under the terms of the reassurance arrangement entered into with the reassurer, the Company has a contingent liability relating to the increase in the treaty best estimate reserves resulting from mortality improvements The maximum liability under the arrangement is £46m at 31 December 2007

In order to protect the policyholders from large counterparty exposures, the initial premium payable, has been withheld and placed in a collateral account and the reassuer holds a fixed charge over the assets The balance due to the reassurer at 31 December 2007 of £2,584m is shown within "Deposits received from reinsurers"

**NOTES TO THE ACCOUNTS (CONTINUED)**

**19. Policyholder lıabilitıes (continued)**

*19 2 Non partıcıpatıng busıness (contınued)*

For non partıcıpatıng busıness, valuatıon assumptıons have been determıned ın accordance wıth the rules relatıng to the valuatıon of lıabılıtıes as publıshed by the Fınancıal Servıces Authorıty ın ıts Prudentıal Sourcebook for Insurers The key assumptıons used ın thıs valuatıon are set out ın the tables below

| | 31 Dec 07 | 31 Dec 06 |
|---|---|---|
| Interest rate | | |
| Pensıon busıness | | |
| Dırect annuıtıes ın payment | 4 78% | 4 83% |
| Reınsured ın annuıtıes ın payment | 4 78% | 4 88% |
| Lıfe busıness | | |
| Yearly renewable Term Assurance (Smoker/Non-Smoker) | 4 37% | 4 71% |
| **Mortalıty rate** | | |
| Pensıon busıness | | |
| Dırect annuıtıes ın payment | 97 5/100% RMV00/RFV00 maxımum of 85% of the average of medıum and long cohort ımprovements wıth a floor of 3% ıf aged 60 or less reducıng lınearly down to 0% aged 110 | 110/100% RMV92/RFV92 wıth maxımum of 75% of average of medıum and long cohort ımprovements or CMIR17 ımprovements or 1% |
| Reınsured ın annuıtıes ın payment (Natıonal Provıdent Lıfe Lımıted) | 107 5/107 5% RMV92/RFV92 Wıth maxımum of the average of medıum and long cohort) ımprovements wıth a floor of 3% ıf aged 60 or less reducıng lınearly down to 0% aged 110 | 105/105% RMV92/RFV92 wıth maxımum of the average of medıum and long cohort ımprovements or 1% |
| Reınsured ın annuıtıes ın payment (London Lıfe Lımıted) | 90/85% PMA00/PFA00 maxımum of the average of medıum and long cohort ımprovements wıth a floor of 3% ıf aged 60 or less reducıng lınearly down to 0% aged 110 | |
| Lıfe busıness | | |
| Yearly Renewable Term Assurance (Non-Smoker) | 60% AM/F80 Ultımate | 60% AM/F80 Ultımate |
| Yearly Renewable Term Assurance (Smoker) | 120% AM/F80 Ultımate | 120% AM/F80 Ultımate |
| **Lapse rate** | | |
| Lıfe busıness | | |
| Yearly Renewable Term Assurance (Smoker/Non-Smoker) | 7 5% Lapse rates for these polıcıes are varıable for the first 7 years of polıcy duratıon convergıng to 7 5% thereafter | 8 75% Lapse rates for these polıcıes are varıable for the first 7 years of polıcy duratıon convergıng to 8 75% thereafter |

**NOTES TO THE ACCOUNTS (CONTINUED)**

**19. Policyholder liabilities (continued)**

*19 2 Non participating business (continued)*

**Options and guarantees**

Some contracts written in the non-participating fund include options and guarantees Since this fund is not subject to the FSA's realistic capital regime, provision for these options and guarantees has been calculated using a deterministic approach However, these provisions do not differ materially from a provision based on a market consistent stochastic model

**20. Claims outstanding**

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| General business | 42 | 209 |
| Life business | 63 | 67 |
| | 105 | 276 |

Effective 31 December 2007 the novation of the general insurance Monarch liabilities was completed The novation removes the Company's liability as a first layer reinsurer up to the US$500m finite reinsurance protection that the Company purchased in 1997 Under the novation the Company's obligation to maintain the gross liability and corresponding reinsurance asset on the balance sheet is removed and this has consequently resulted in the release of £165m gross reserves

The technical provisions for the future claims payments have primarily been assessed using chain ladder methods Where there is a notable exposure to long term asbestos, pollution and health hazard liabilities, external independent actuaries provide best estimate benchmarks An appropriate prudential margin is applied to all lines of business as it is recognised that the estimation of certain future claims payments is an inherently uncertain exercise and future experience could be more adverse

In calculating the technical provisions in respect of long term UK Industrial disease business the future investment income on the assets held to cover the related provisions has been taken into account by discounting future cash flows The average period before the liability will be settled has been estimated at 9 0 years for 2007 (2006 8 4 years) and the provision has been discounted at an interest rate of 3 5% (2006 3 5%)

The overall effect is to reduce the gross and net technical provisions for those classes of business referred to above at 31 December 2007 by £12m from £35m to £23m (2006 by £8m from £28m to £20m) The total amount of the investment return which corresponds to the unwinding of the discount is £1m (2006 £1m)

**21. Provisions**

| | Leasehold Properties £m | Other £m | Total £m |
|---|---|---|---|
| At 1 January 2007 | 20 | 11 | 31 |
| Amounts utilised | (2) | (8) | (10) |
| Increase in provision | (1) | 3 | 2 |
| Unwind of discount | 1 | - | 1 |
| At 31 December 2007 | 18 | 6 | 24 |

**NOTES TO THE ACCOUNTS (CONTINUED)**

**21 Provisions (continued)**

The leasehold properties provision has been made for amounts in respect of the excess of lease rentals and other payments on properties that are currently vacant or expected to become vacant over the amounts to be recovered from subletting these properties on a discounted basis at 7 1% (2006 7 3%) The provision is expected to be utilised over the next 10 years

As at 31 December 2007 other provisions relate to IB deferred policyholder payments of £1m (2006 £1m), litigation expenses on property of £3m (2006 £3m) and dilapidation expenses on property of £2m (2006, £3m) These provisions are expected to be utilised respectively over the next 15 years, 1 year and 1 year respectively

**22. Financial liabilities at amortised cost**

| | Notes | Carrying value 31 Dec 07 £m | Carrying value 31 Dec 06 £m | Fair value 31 Dec 07 £m | Fair value 31 Dec 06 £m |
|---|---|---|---|---|---|
| Deposits received from reinsurers | 12 2 1 | 2,584 | - | 2,584 | - |
| Other creditors including taxation and social security | 23 | 951 | 123 | 951 | 123 |
| | | 3,535 | 123 | 3,535 | 123 |

**23. Other creditors including taxation and social security**

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Outstanding purchase of investments | 854 | 13 |
| Amount owed to group undertakings | 6 | 27 |
| Corporation tax | 26 | 7 |
| Other creditors | 65 | 76 |
| | 951 | 123 |

**24. Assets of the long term business fund**

The total amount of assets relating to the long term business fund is £15,489m (2006 £13,222m)

**25. Capital commitments and contingent liabilities**

*25 1 Capital commitments and contingent liabilities*

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Other capital commitments for settlement after 31 December | 202 | 49 |
| Securities commitments | 647 | 228 |

Securities commitments comprise commitments of the Company to subscribe to private equity funds and other unlisted assets

The following contingent liabilities existed as at 31 December 2007

a) in the normal course of business, the Company is exposed to certain legal issues, which involve litigation and arbitration and

**NOTES TO THE ACCOUNTS (CONTINUED)**

**25. Capital commitments and contingent liabilities (continued)**

*25 1 Capital commitments and contingent liabilities (continued)*

b) in the normal course of business, the Company enters into various types of investment contracts that can give rise to contingent liabilities These include foreign exchange contracts, financial futures, interest rate derivatives and exchange traded options These contracts are entered into in the normal management of the investment portfolio

*25 2 Annual commitments under non-cancellable land and building operating leases*

The obligations under non-cancellable land and building operating leases fall due

| | 31 Dec 07<br>£m | 31 Dec 06<br>£m |
|---|---|---|
| Within one year | 1 | 1 |
| In the second to fifth years inclusive | 6 | 6 |
| In more than five years | 5 | 5 |
| | 12 | 12 |

**26. Contingent loan**

The Company's subsidiary undertaking, NP Life Holdings Limited, has provided capital to National Provident Life Limited in the form of a contingent loan The assets backing the loan are used to provide additional regulatory capital for the long term fund of National Provident Life Limited The Company's valuation of its investment in NP Life Holdings Limited includes the best estimate of the directors of the amount of the contingent loan that will be recoverable from the long term fund of National Provident Life Limited, following settlement of policyholder claims (£134m as at 31 December 2007, £216m as at 31 December 2006) The contingent loan asset is valued at an amount equal to the FRS27 realistic contingent loan liability within National Provident Life Limited The carrying value of the loan is equal to the fair value

The Company's total investment in NP Life Holdings Limited is valued at £389m (2006 £482m)

**NOTES TO THE ACCOUNTS (CONTINUED)**

## 27. Subsidiary and associated undertakings

The principal subsidiaries and associated undertakings of the Company are as follows

| | Country of Incorporation and principal place of operation | Class of shares held (wholly owned unless otherwise indicated) |
|---|---|---|
| **a) Insurance companies** | | |
| National Provident Life Limited | UK | Ordinary shares of £1 |
| **b) Non Insurance companies** | | |
| NP Life Holdings Limited | UK | Ordinary shares of £1 |
| **c) Associated undertakings** | | |
| Henderson UK Shop Fund (property fund) | Jersey | 26% |
| Henderson French Property Fund BV (property fund) | Netherlands | 41% |
| Drago Real Estate Partners Limited (close-ended investment company) | Guernsey | 24 7% Ordinary shares of €0 01 |
| **d) Joint Ventures** | | |
| Tesco Property Limited Partnership (property partnership) | UK+ | 50% |

+Held by a subsidiary undertaking

The information disclosed above is only in respect of those undertakings which principally affect the figures shown in the Company's accounts and are undertakings of the Company as at 31 December 2007

## 28. Related party transactions

The Company has taken advantage of the exemption given by FRS8 to subsidiary undertakings, 90% or more of whose voting rights are controlled within the group, by not disclosing information on related party transactions with entities that are part of the PGL Group of companies

As Axial Investment Management Limited with whom the Company has an investment management agreement is only 50 5% controlled within the group, the transactions between the Company and Axial Investment Management Limited are disclosed below

| | 31 Dec 07 £m |
|---|---|
| Investment management expenses | 9 |

Balances with Axial Investment Management Limited are as follows

| | 31 Dec 07 £m |
|---|---|
| Other creditors | 2 |

One life policy is held by one key management member of the Company, the sum assured under this policy is £60,000 (2006 £60,000)

**NOTES TO THE ACCOUNTS (CONTINUED)**

**28. Related party transactions (continued)**

During the year Sun Capital Partners Limited, of whom H E M Osmond is a director and TDR Capital LLP, of whom M Dale is a designated member received £622,306 (2006 £597,610) and £5,601,112 (2006 £1,795,220) respectively as shareholder monitoring fees and investment management fees

On 15 May 2007, the Company became a holder of £56,700,000 of a £905,000,000 syndicated loan facility made available jointly to Sun Capital Investment Limited and Hera Investments One Limited who jointly own the issued share capital of PGL, the Company's ultimate parent undertaking During the year interest receivable of £2,500,000 has been recognised and cash receipts for interest and capital of £2,000,000 and £1,900,000 respectively have been received in relation to the Company's element of the loan The total balance of capital and interest outstanding at 31 December 2007 is £55,300,000

On 4 July 2007, the Company purchased 79,522 shares in Drago Real Estate Partners Limited for consideration of €8,379,190 44,695 of these shares were purchased for €4,709,470 from directors of Sun Capital Partners Limited including H E M Osmond

On 20 November 2007, the Company purchased 16,200,000 shares in Sant Topco Holdings BV, a property investment portfolio holding company, for consideration of €121,000,000 financed in part through loans of €100,346,000 of which €99,298,000 were from directors of Sun Capital Partners Limited including H E M Osmond, TDR Capital LLP, of whom M Dale is a designated member, Drago Real Estate Partners Limited and London Life Limited These loans were all interest free and were settled with shares of Sant Topco Holdings BV Following this intermediary step, the Company has retained a holding of 17 1% in Sant Topco Holdings BV

**29. Parent undertakings**

The Company's immediate and ultimate parent undertaking is Pearl Group Limited whose registered office is The Pearl Centre, Lynch Wood, Peterborough, PE2 6FY A copy of PGL accounts can be obtained from the registered office

**30. Risk Management**

*30 1 Risk and capital management objectives and policies*

The risk management objectives and policies of the Company are based on the requirement to protect the Company's regulatory capital position, thereby safeguarding policyholders' guaranteed benefits whilst also ensuring the Company can meet its different cash flow requirements Subject to the above, the Company seeks to use available capital in pursuing investment opportunities that meet agreed return hurdles for risk taken in order to achieve increased investment returns, generating additional value for policyholders and shareholders

In pursuing these goals, the Company deploys financial assets and incurs financial liabilities Financial assets principally comprise investments in equity securities, fixed interest investments, derivatives, trade and other receivables and banking deposits Financial liabilities comprise investment contracts, borrowings for financing purposes, trade and other payables

The use of financial instruments naturally exposes the Company to the risks associated with them, chiefly, market risk, credit risk and liquidity risk The Company's risk management policy establishes a framework for setting the financial risk profile for the life Company and reporting on financial risk exposure Responsibility for agreeing the financial risk profile rests with the Board of the Company, given advice from investment managers, internal risk committees and the Head of actuarial function In setting the risk profile, the Board of the Company will receive advice from the appointed investment managers and the actuary as to the potential implications of that risk profile with regard to the probability of both realistic insolvency and of failing to meet the regulatory minimum capital requirement The actuary will also advise the extent to which the investment risk taken is consistent with the Company's commitment to treat customers fairly

**NOTES TO THE ACCOUNTS (CONTINUED)**

**30. Risk Management (continued)**

*30 1 Risk and capital management objectives and policies (continued)*

Derivatives are used in a number of the Company's funds, within policy guidelines agreed by the Board of the Company and overseen by the Asset, Liability and Investment Management Committee ("ALIMCo") and the Financial Risk Committee Derivatives are primarily used for efficient portfolio management or for risk hedging purposes

More detail on the Company's exposure to financial risk is provided in 30 4 below

The Company is also exposed to insurance risk arising from its life assurance business Life insurance risk in the Company arises through its exposure to mortality and to variances between assumed and actual experience in factors such as persistency levels and management and administrative expenses

The Company's overall exposure to risk is monitored by appropriate committees, primarily by the ALIMCo and the Financial Risk Committee, which agree policies for managing each type of risk on an ongoing basis, essentially within the Company's Asset Liability Management ("ALM") framework that has been developed to achieve investment returns in excess of amounts due in respect of insurance contracts The effectiveness of the Company's ALM relies on close matching of assets and liabilities arising from insurance contracts, taking into account the types of benefits payable to policyholders Separate portfolios of assets are maintained for with-profits business, which includes all of the Company's participating business and non participating business

A further tool used by management is the regulatory requirement for the Company to carry out an Individual Capital Assessment (ICA) in accordance with the FSA's General Prudential Sourcebook The intention of the ICA is to estimate how much capital is required to reduce the risk of insolvency to a remote degree of probability The ICA framework developed by the Company identifies the risks to which it is exposed and quantified their impact on economic capital The results are used to formulate an appropriate management response in the form of risk mitigation, where this is necessary

During the period the Company continued to invest in developing its specialised asset and liability matching capabilities, which is focused on delivering more effective deployment of capital resources

*30 2 The Capital Statement*

The Company's capital consists of

| | 31 Dec 07 £m | 31 Dec 06 £m |
|---|---|---|
| Called up share capital | 342 | 342 |
| Share premium account | 41 | 41 |
| Profit and loss account | 816 | 819 |
| Fund for future appropriations | 306 | 345 |
| | 1,505 | 1,547 |

Since the Company is subject to FSA capital rules, capital is managed principally on a regulatory basis This means that the Company's objectives for management of capital are set by reference to its regulatory capital resources and its regulatory capital requirements Both of these are calculated according to the rules and guidance established by the FSA The Company's objective is to maintain an excess of regulatory capital resources over regulatory capital requirement at all times This objective is met by monthly monitoring of the Company's capital position together with appraisal of capital management opportunities by committees established for these purposes

**NOTES TO THE ACCOUNTS (CONTINUED)**

**30 Risk Management (continued)**

*30 2 The Capital Statement (continued)*

The adjustments to capital from a statutory to a regulatory basis are set out in the table below

**2007**

| | Statutory Capital £m | Adjustments onto a regulatory basis £m | Regulatory capital £m |
|---|---|---|---|
| Called up share capital | 342 | - | 342 |
| Share premium | 41 | - | 41 |
| Profit and loss account | 816 | (479) | 337 |
| Fund for future appropriations | 306 | 1,178 | 1,484 |
| | 1,505 | 699 | 2,204 |

**2006**

| | Statutory Capital £m | Adjustments onto a regulatory basis £m | Regulatory Capital £m |
|---|---|---|---|
| Called up share capital | 342 | - | 342 |
| Share premium | 41 | - | 41 |
| Profit and loss account | 819 | (259) | 560 |
| Fund for future appropriations | 345 | 1,189 | 1,534 |
| | 1,547 | 930 | 2,477 |

The regulatory adjustments are principally in respect of assets and liabilities where the valuation under the regulatory basis is different from the statutory basis

The regulatory capital requirement comprises amounts held in respect of expense, investment and insurance risks, called the Long-Term Insurance Capital Requirement

*Realistic basis*

The Company's with-profits fund is subject to the FSA's realistic capital regime, under which liabilities to policyholders include both declared bonuses and the constructive obligation for future bonuses not yet declared Under FRS 27 "Life Assurance" a further adjustment is made to exclude amounts, if any, attributable to shareholders in respect of future bonuses Hence liabilities included in the balance sheet for the with profits funds do not include the amount representing the shareholders' share of future bonuses

For the Company's with-profits fund, a further test is required which compares realistic excess capital with excess capital calculated on a regulatory basis Where the realistic excess capital is less than that calculated on a regulatory basis, additional capital must be held, known as the with-profits insurance capital component ("WPICC") to cover the difference between both calculations and this is added to the regulatory peak The realistic excess capital is calculated as the difference between the with-profits fund's realistic assets and realistic liabilities with a further deduction, known as the risk capital margin ("RCM") to cover prescribed stress tests

**NOTES TO THE ACCOUNTS (CONTINUED)**

**30. Risk Management (continued)**

*30 2 The Capital Statement (continued)*

The Company has complied with externally imposed capital requirements during the period At 31 December, the amount of capital that the Company was required to hold was £1,689m (2006 £1,744m) and the excess capital over that required to be held was £515m (2006 £733m)

*30 3 Insurance risk*

Sensitivity analysis

Insurance liabilities are sensitive to changes in risk variables, such as prevailing market interest rates, currency rates and equity prices, since these variations alter the value of the financial assets held to meet obligations arising from insurance contracts and changes in investment conditions also have an impact on the value of insurance liabilities themselves Additionally, insurance liabilities are sensitive to the assumptions which have been applied in their calculation, such as mortality and persistency rates Sometimes allowance must also be made for the effect on future assumptions of management or policyholder actions in certain economic scenarios This could lead to changes in assumed asset mix, or future bonus rates The most significant sensitivities arise from the following three sources

*Market risk*

If market conditions vary adversely from the assumed investment return and interest rates, then liabilities will increase Where this increase is not offset by a corresponding change in asset values, there will be an overall reduction in available capital

*Mortality risk*

Mortality risk arises from differences between anticipated and actual volumes of deaths on assurance business or improvements in longevity for annuity business For annuity contracts, an improvement in mortality leads to an increase in reserves and a reduction in capital For term assurances, an improvement in mortality has a converse effect

*Persistency*

Persistency risk arises where assumed levels of withdrawals diverge from actual experience Where there are too few lapses and the policy provides a guarantee at a future point in time, the Company will need to provide for the cost of those additional guarantees, or have a suitable hedge Where there are higher than assumed lapses and there are onerous surrender values, this will lead to financial loss and a potential weakening of the capital position When considering assumptions for persistency, thought needs to be given to the assumed behaviour of policyholders in relation to guarantees and options

*30 4 Financial risk analysis*

*30 4 1 Credit risk*

Exposure to credit risk arises from counterparties failing to meet all or part of their obligations, from a reinsurer's inability to meet the obligations assumed under its reinsurance arrangements or changes to the market value of assets caused by changes in perception of the creditworthiness of counterparties The maximum exposure is equal to the carrying amount of those assets

Credit risk is managed by monitoring of aggregate Company exposures to individual counterparties and by appropriate credit risk diversification In certain cases, protection against exposure to particular credit risk types may be achieved through use of derivatives

**NOTES TO THE ACCOUNTS (CONTINUED)**

**30. Risk Management (continued)**

*30 4 Financial risk analysis (continued)*

*30 4 1 Credit risk (continued)*

An indication of the Company's exposure to credit risk is the quality of the investments and counterparties with which it transacts The Company is most exposed to credit risk on debt and other fixed income securities Debt and other fixed income securities mainly comprise government bonds and corporate bonds Given the nature of government bonds the credit risk associated with these is considered negligible and the Company therefore focuses on monitoring the quality of its corporate bonds

The following table provides information regarding the aggregate credit exposure, for debt securities and other fixed interest securities with external credit ratings, of the Company

**2007**

| | AAA | AA | A | BBB | BB | B | CCC | Non Rated | Carrying Value £m |
|---|---|---|---|---|---|---|---|---|---|
| Debt securities and other fixed income securities | 52 6% | 5 1% | 11 4% | 14 3% | 4 3% | 5 7% | 0 6% | 6 0% | 6,823 |

**2006**

| | AAA | AA | A | BBB | BB | B | CCC | Non Rated | Carrying Value £m |
|---|---|---|---|---|---|---|---|---|---|
| Debt securities and other fixed income securities | 54 9% | 6 2% | 15 0% | 11 3% | 2 9% | 5 5% | - | 4 2% | 8,505 |

The majority of over the counter derivatives are only entered into with approved counterparties, unless specific approval has been obtained by the ALIMCo and by the Financial Risk Committee, thus reducing credit risk on these instruments

With regard to deposits with credit institutions, Company practice is to hold cash and deposits with financial institutions and in money market funds that have a rating of A1, P1 or higher

The Company is exposed to concentrations of risk with individual reinsurers, due to the nature of the reinsurance market The Company's largest reassurance exposure at 31 December 2007 was to Opal Reassurance Limited, and the reassurance asset recoverable was £2,732m (2006 £nil) In order to mitigate the credit risk arising from this exposure and to protect policyholders, the terms of the reassurance arrangement provides that the initial premium payable has been withheld and placed in collateral accounts The Company operates a policy to manage its reinsurance counterparty risk and the impact from reinsurer default if measured regularly

**NOTES TO THE ACCOUNTS (CONTINUED)**

**30 Risk Management (continued)**

*30 4 Financial risk analysis (continued)*

*30 4 1 Credit risk (continued)*

The following table gives information regarding the ageing of financial assets that are past due but not impaired and the carrying value of financial assets that have been impaired

**2007**

| | Neither past due nor impaired | 0-30 days | 30-90 days | >90 days | Impaired | Carrying value |
|---|---|---|---|---|---|---|
| | | | | | | £m |
| Debt securities and other fixed income securities | 100 0% | - | - | - | - | 6,823 |
| Deposits with credit institutions | 100 0% | - | - | - | - | 132 |
| Derivative assets | 100 0% | - | - | - | - | 303 |
| Loans and receivables at amortised cost | 100 0% | - | - | - | - | 303 |
| Debtors | 93 8% | 1 0% | 0 9% | 4 3% | - | 79 |
| Accrued interest and rent | 94 9% | 2 5% | 1 0% | 1 6% | - | 131 |
| Cash at bank and in hand | 100 0% | - | - | - | - | 219 |

**2006**

| | Neither past due nor impaired | 0-30 days | 30-90 days | >90 days | Impaired | Carrying value |
|---|---|---|---|---|---|---|
| | | | | | | £m |
| Debt securities and other fixed income securities | 100 0% | - | - | - | - | 8,505 |
| Deposits with credit institutions | 100 0% | - | - | - | - | 153 |
| Derivative assets | 100 0% | - | - | - | - | 178 |
| Loans and receivables at amortised cost | 100 0% | - | - | - | - | 372 |
| Debtors | 84 2% | 5 3% | 2 6% | 5 3% | 2 6% | 76 |
| Accrued interest and rent | 90 5% | 4 6% | 2 3% | 2 6% | - | 150 |
| Cash at bank and in hand | 100 0% | - | - | - | - | 133 |

There were no material financial assets that would have been past due or impaired had the terms not been renegotiated

*30 4 2 Market Risk*

Market risk is the risk of adverse financial impact due to fluctuations in the fair values or future cash flows of financial instruments whether arising from changes to interest rates, equity prices, property prices or foreign currency exchange rates

*Interest Rate Risk*

Interest rate risk is the risk that the Company will sustain losses through adverse movements in interest rates due to the effect such movements have on the value of interest-bearing assets and on the value of future guarantees provided under certain contracts of insurance

**NOTES TO THE ACCOUNTS (CONTINUED)**

**30 Risk Management (continued)**

*30 4 Financial risk analysis (continued)*

*30 4 2 Market risk (continued)*

Interest rate risk is managed by matching assets and liabilities where practicable and by entering into swap arrangements where appropriate This is particularly the case for the non participating funds For participating business, some element of investment mismatching is permitted where it is consistent with the principles of treating customers fairly The with-profits fund of the Company provides capital to allow such mismatching to be effected In practice, the Company maintains an appropriate mix of fixed and variable rate instruments according to the underlying insurance contracts and will review this at regular intervals to ensure that overall exposure is kept within the risk profile agreed for each particular fund This also requires the maturity profile of these assets to be managed in line with the liabilities to policyholders

The sensitivity analysis for interest rate risk indicates how changes in the fair value or future cash flows of a financial instrument arising from changes in market interest rates at the reporting date result in a change in profit after tax and shareholder equity The analysis takes into account the effect of such changes in market interest rates on all assets and liabilities that contribute to the Company's reported profit after tax and shareholder equity

With-profit business and non profit business within the with-profits fund are exposed to interest rate risk as guaranteed liabilities are valued relative to market interest rates and investments include fixed interest stocks and derivatives For with-profit business the profit or loss arising from mismatches between such assets and liabilities is largely offset by increased or reduced discretionary policyholder benefits The contribution of this fund to the Company result is determined primarily by the shareholders' share of the declared annual bonus

In the non participating funds, policy liabilities are duration matched with primarily fixed interest securities, with the result that sensitivity to changes in interest rates is very low

An increase of 1% in interest rates, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full financial year and decrease in shareholder equity of £69m (2006 £12m) A decrease of 1% in interest rates, with all other variables held constant, would result in an additional profit after tax in respect of a full financial year and an increase in shareholder equity of £84m (2006 £6m)

*Equity and property price risk*

Equity and property price risk is the risk that a reduction in the value of equities or property assets through market fluctuation will restrict assets available to fund long-term fund obligations, which could create liquidity risk and may also require shareholder funds to be transferred to cover any shortfalls The Company is exposed to equity price risk as a result of its holdings in equity investments and to property price risk as a result of its holdings of investment properties, either directly or indirectly via intermediate investment structures

Equity and property price risk is managed through the agreement and monitoring of financial risk profiles that are appropriate for the Company's life funds in respect of maintaining adequate regulatory capital and treating customers fairly This is largely achieved through asset class diversification

The sensitivity analysis for equity and property risk illustrates how a change in the fair value of equities and properties affects the Company result It takes into account the effect of such changes in equity and property prices on all assets and liabilities that contribute to the Company's reported profit after tax and shareholder equity Equity and property investments are principally used as investments of the Company's with profits fund The contribution of this fund to the Company result is determined primarily by the shareholders' share of the declared annual bonus

**NOTES TO THE ACCOUNTS (CONTINUED)**

**30 Risk Management (continued)**

*30 4 Financial risk analysis (continued)*

*30 4 2 Market risk (continued)*

A 10% decrease in equity/property prices, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full financial year and a decrease in shareholder equity of £91m (2006 £34m) A 10% increase in equity/property prices, with all other variables held constant, would result in an increase in the profit after tax in respect of a full financial year and an increase in shareholder equity of £96m (2006 £20m)

*Currency Risk*

Currency risk arises from financial assets and financial liabilities denominated in foreign currencies There is a risk that the Company will suffer losses through adverse movements in currency exchange rates

Foreign currency risk is managed through appropriate monitoring and use of forward contracts to mitigate risk where this is beneficial

Sensitivity of profit and shareholders' equity to fluctuations in currency exchange rates is not considered significant at 31 December 2007, since unhedged exposure to foreign currency was relatively low

*30 4 3 Liquidity Risk*

Liquidity risk arises from either the inability to close out a particular position at or near the previous market price as well as from having insufficient liquid assets to meet payment obligations

Financial markets have seen significant volatility during the latter half of the financial year as evidenced by the widening of credit spreads and the fall in the demand in the commercial property market A very substantial proportion of the Company's assets are invested in listed securities such that liquidity risk is not a major issue The Company has some appetite for illiquid assets, mainly within the with-profits fund, where there is appropriate compensation for the risk taken and where the matching liabilities are equally illiquid Overall liquidity risk is low

Liquidity risk is managed by the Company through the monitoring of current assets to ensure there are sufficient readily realisable assets within the funds to settle liabilities as they fall due

The following table provides a maturity analysis showing the remaining contractual maturities of the Company's undiscounted financial liabilities

**2007**

| | 1 year or less or on demand | 1-5 years | 5-10 years | 10-15 years | 15-20 years | Greater than 20 years | No fixed term | Total |
|---|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m | £m |
| Derivative liabilities | 104 | 17 | 9 | 6 | 9 | 209 | - | 354 |
| Investment contracts with discretionary participation features, included in long -term business provision | 452 | 1,340 | 1,460 | 1,181 | 1,026 | 1,775 | - | 7,234 |
| Other creditors including taxation and social security | 942 | 5 | 4 | - | - | - | - | 951 |

## NOTES TO THE ACCOUNTS (CONTINUED)

### 30 Risk Management (continued)

*30 4 Financial risk analysis (continued)*

*30 4 3 Liquidity risk (continued)*

**2006**

| | 1 year or less or on demand | 1-5 years | 5-10 years | 10-15 years | 15-20 years | Greater than 20 years | No fixed term | Total |
|---|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m | £m |
| Derivative liabilities | - | 19 | 16 | 3 | 2 | 132 | - | 172 |
| Investment contracts with discretionary participation features, included in long- term business provision | 550 | 1,484 | 1,582 | 1,226 | 1,057 | 1,447 | - | 7,346 |
| Other creditors including taxation and social security | 113 | 5 | 5 | - | - | - | - | 123 |

### 31. Post balance sheet events

On 16 November 2007, the Boards of PGL and Resolution plc ("Resolution") announced that they had agreed the terms of a recommended cash acquisition by Impala Holdings Limited ("Impala"), a 75% subsidiary of PGL, of the entire issued and to be issued share capital of Resolution This acquisition is to be by way of a Court sanctioned scheme of arrangement under section 425 of the Companies Act Resolution shareholders were sent a copy of the Scheme document setting out the terms of this acquisition on 12 December 2007 On 9 January 2008, shareholders voted in favour of accepting Impala's acquisition offer at an extraordinary general meeting of Resolution and also at a meeting convened by order of the Court Impala is currently awaiting regulatory clearance from the FSA and the satisfaction of all conditions precedent, and anticipate that the acquisition will be effective in the second quarter of 2008 The holdings of the Company will be transferred to Impala at fair value, on completion