

PEARL ASSURANCE LIMITED

Company Registration Number 1419

DIRECTORS' REPORT AND FINANCIAL STATEMENTS for the year ended 31 December 2011

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PEARL ASSURANCE LIMITED

Contents	Page
Directors' report	2
Statement of Directors' responsibilities	6
Independent auditors' report to the members of Pearl Assurance Limited	7
Accounting policies	8
Statement of comprehensive income	15
Statement of financial position – equity and liabilities	16
Statement of financial position - assets	17
Statement of cash flows	18
Statement of changes in equity	19
Notes to the financial statements	20

Directors' report

The Directors present their Report and the Financial Statements of Pearl Assurance Limited ("the Company") for the year ended 31 December 2011

The Company is incorporated in the United Kingdom. Its registration number is 1419 and its registered office is 1, Wythall Green Way, Wythall, Birmingham B47 6WG

The financial statements of the Company have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRS") as they apply to the financial statements of the Company for the year ended 31 December 2011, and applied in accordance with the Companies Act 2006

Business review

Principal activities

The principal activity of the Company is the transaction of life assurance and pension business which is largely in run off

All business is written in the UK

Strategy

The strategy of the Phoenix Group, of which the Company is a member, is to be recognised as the best and most innovative manager of closed life assurance funds, to improve returns for policyholders and deliver value for owners

Corporate activity

At 31 December 2011, the outstanding balances on the loans to Pearl Group Holdings (No. 2) Limited ("PGH2"), the Company's immediate parent, was £603m (2010 £393m). The increase was due to a new loan of £200m issued in July 2011 and capitalised interest. At 31 December 2011, the total outstanding balances on loans from Phoenix Life Holdings Limited, was £250m (2010 £250m)

Business transacted

The Company maintains four long-term funds, together with its shareholder fund ("SHF"). The long-term funds comprise, a With-Profits fund ("WP") which operates on a 90/10 basis, a SERP WP fund operating on a 100/0 basis, a Life Non-Profit fund ("LNP"), and a Pension Non-Profit fund ("PNP"). In terms of policyholder liabilities, the WP fund is the largest with gross policyholder liabilities of £7,102m (2010 £7,035m) at the period end. The shareholder fund includes a small amount of general insurance business.

The Company writes a wide range of life and pensions business, predominantly on individual risks. Business written includes conventional life and pensions, unitised life and pensions and some unit-linked policies.

The WP fund transacts conventional and unitised with-profits business and the SERP fund transacts only conventional with-profits business. The LNP fund transacts term assurance and Permanent Health Insurance ("PHI") business as well as immediate and deferred annuities. The PNP fund transacts annuities and deferred annuities, the majority of which are reinsured to a fellow group entity, Opal Reassurance Limited ("Opal").

Reinsurance arrangements are in place with companies not in the Phoenix Group to cover some permanent health, critical illness and term assurance risks.

Policy administration is outsourced to Pearl Group Services Limited ("PGS"), a fellow group company. PGS has, in turn, outsourced all administration to Diligenta Limited. Under the agreements with PGS the majority of costs are levied on a per policy basis thereby mitigating the Company's expense risk. Asset management is primarily outsourced to Ignis Investment Services Limited, a fellow Group entity.

The gross premium income of the Company for the year was £350m (2010 £361m).

The total value of assets was £21,509m compared with £19,156m a year earlier.

The gross liabilities under insurance contracts at 31 December 2011 were £12,108m (2010 £11,466m).

There is a provision for the Company's shareholder fund to provide financial assistance to support the SERP fund. The result of the SERP fund impacts the value of the contingent loan liability and equity through the value of the support provided by the SHF. At 31 December 2011, the SHF has provided support of £143m (2010 £165m) to the SERP fund, on which an impairment of £41m (2010 £43m) has been recognised.

Results and dividends

The results of the Company for the year are shown in the statement of comprehensive income on page 15. The loss before owners' tax was £61m (2010 profit £79m).

Dividends totalling £35m were paid during the year (2010 £103m).

Principal risks and uncertainties

The Company is exposed to a number of financial risks arising from its underlying assets and liabilities, in particular from falls in financial markets, the change in interest rates, the widening of credit spreads and the risk of corporate defaults and insurance risk

The principal owners' risk exposures during the year relate to the NPFs and SERP WP fund and reflected the wide range of products. Life assurance, permanent health and critical illness contracts are affected by mortality and morbidity risks whilst pension business is adversely affected by improving annuitant longevity. Persistency and expense inflation risks apply to most products. The owners are also exposed to the risks of meeting policyholder guarantees in the with-profits fund. The funds also carry investment risk on holdings of fixed and variable rate income securities backing surplus assets in the fund and from investment performance associated with products carrying fund based charges. Risk exposures will reflect the wide range of business managed, with improving annuitant mortality being the principal risk. Market risk from investments of the NPF and SHF will be reduced because of the predominance of fixed and variable rate income securities and the extent of asset and liability matching.

The Company has a limited exposure to peripheral Eurozone debt, primarily within the WP funds, which has been actively reduced during the year. Management systems are in place to monitor credit exposures across counterparties, geographies and business lines.

The Company mitigates insurance risk through the use of internal risk measurement models, experience analyses, sensitivity analysis and stress testing. Mortality and morbidity risks are, in certain circumstances, mitigated by the use of reinsurance, although this exposes the Company to counterparty risk regarding the failure of the reinsurance party.

In addition, the Company faces operational risks. The outsourced policy administration arrangements which as noted above have been outsourced to Diligenta, are considered secure even in extreme stresses, specifically given the letter of credit and guarantee provided by Diligenta's parent undertaking Tata Consultancy Services.

As a result of the various transactions mentioned above, the Company is exposed to increased counterparty risk from PGH2 and Opal.

The Pearl WP fund is relatively strong financially and the risks, such as annuitant longevity and meeting policyholder guarantees, are unlikely to have a material adverse impact on the owners. The SERP WP fund is relatively weak and, as a result, the owner is exposed to insurance risk and to market and credit risk associated with its investments because the margin between the value of assets and the realistic value of policyholder liabilities is small. Further de-risking strategies are in place such as investment strategies matching fixed and variable rate income securities with liabilities, to mitigate risks associated with guarantees, the purchase of interest rate swaptions to mitigate risks of guaranteed annuity options, and selective reinsurance arrangements to mitigate mortality, morbidity and longevity risk.

Further information on financial risks is provided in the notes to the financial statements.

Key Performance Indicators ("KPIs")

The Company's performance is measured and monitored by the Board with particular regard paid to the following KPIs:

Customers

The Directors review various metrics in respect of Treating Customers Fairly ("TCF"), customer communication and complaints on a monthly basis. TCF is monitored through various TCF committees. All agreed service standards for the Company were met during the year.

There is also a With-Profits 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").

Capital resources

The aim of the Company is to maintain an appropriate margin of regulatory capital over capital resource requirements, both on a Pillar 1 and a Pillar 2 basis. As at 31 December 2011, the Company's free assets on a Pillar 1 basis were £565m (2010: £759m).

Profits after taxation and distributable reserves

For the year ended 31 December 2011 the Company reported a loss after taxation of £57m (2010: profit £92m). As at 31 December 2011, the Company had distributable reserves amounting to £40m (2010: £28m).

Cash flows

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

PEARL ASSURANCE LIMITED

Investment performance

The performance of the Company's invested assets is reviewed against pre-defined benchmarks by the Board, the Investment Management Committee and the Asset-Liability Management Committee ("ALCO")

Corporate governance

The Company, as part of a group wide framework, has established a governance framework for monitoring and overseeing strategy, conduct of business standards and operations of the business that includes

- a clearly stated corporate organisational structure, and written terms of reference for the Board and its committees, with appropriate delegated authorities,
- a Board Audit Committee, the members of which are non-executive Directors, which oversees internal control and financial reporting matters,
- a risk management function providing a second line of defence, independent of operations and with responsibility for monitoring and reporting of risk, and
- an internal audit function which provides independent, objective assurance over the complete control framework reporting to the Chairman of the Board Audit Committee and with direct access to all executive members, in particular the Chief Executive Officer

The Board has 5 non-executive members and 3 executive members

Future developments

The Company's long-term life assurance business is in gradual run off. The Company will continue to explore future business opportunities which help to secure future benefits for both policyholders and owners

Subject to approval by the FSA and the High Court, during 2012 the Company plans to transfer, under Part VII of the Financial Services and Markets Act 2000, all of the long-term business and the majority of the SHF of London Life Limited ("LLL") and some of the long-term business of National Provident Life Limited ("NPLL") for £nil consideration. It also plans to transfer the general insurance business of the Company to BA(GI) Limited, a fellow subsidiary, under Part VII of the Financial Services and Markets Act 2000

Going concern

The Directors' report summarises the Company's activities, its financial performance and financial position together with any factors likely to affect its future development. In addition, it discusses the principal risks and uncertainties it faces. Notes 32 and 33 to the financial statements summarise the Company's risk and capital management objectives and policies together with its financial risks

The Board has followed the United Kingdom Financial Reporting Council's "Going Concern and Liquidity Risk Guidance for Directors of UK Companies 2009" when performing their going concern assessment. As part of its comprehensive assessment of whether the Company is a going concern, the Board has undertaken a review of the valuation and liquidity of its investments as at the period end. The Board has also reviewed solvency and cash flow projections under normal and stressed conditions

As a result of this review, the Directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the financial statements

Directors

The names of those individuals who served as Directors of the Company during the year or who held office as at the date of signature of this report are as follows

A B Davidson	
J P Evans	(Chairman)
M J Merrick	
A Moss	
J C Park	
M D Ross	
W R Treen	
M N Urmston	
J J Yates	Resigned on 21 December 2011

Secretary

G A Watson acted as Secretary until 15 August 2011. Pearl Group Secretariat Services Limited were appointed as Secretary on 15 August 2011 and acted as Secretary for the rest of the year

Disclosure of indemnity

Qualifying third party indemnity arrangements (as defined in sections 234 of the Companies Act 2006) were in force for the benefit of the Directors of the Company during the year and remain in place at the date of approval of this report

PEARL ASSURANCE LIMITED

Disclosure of information to auditors

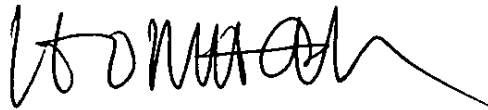
So far as each of the Directors is aware, there is no relevant audit information (as defined in the Companies Act 2006) of which the Company's auditors are unaware, and each of the Directors has taken all the steps that he/she ought to have taken as a Director to make himself/herself aware of any relevant audit information (as defined) and to establish that the Company's auditors are aware of that information

This confirmation is given and should be interpreted in accordance with the provisions of section 418(2) of the Companies Act 2006

Re-appointment of auditors

In accordance with section 487 of the Companies Act 2006, the Company's auditors, Ernst & Young LLP, will be deemed to have been re-appointed at the end of the period of 28 days following circulation of copies of these financial statements as no notice has been received from members pursuant to section 488 of the Companies Act 2006 prior to the end of the accounting reference period to which these financial statements relate

On behalf of the Board



L Nuttall
For and on behalf of Pearl Group Secretariat Services Limited
Company Secretary

20 March 2012

Statement of Directors' responsibilities

The Directors are responsible for preparing the Directors' Report and the Company financial statements ("the financial statements") in accordance with applicable United Kingdom law and regulations

Company law requires the Directors to prepare financial statements for each financial year. Under the law the Directors have elected to prepare those statements in accordance with International Financial Reporting Standards ('IFRS') as adopted by the European Union. Under company law, the Directors must not approve the financial statements unless they are satisfied that they present fairly the financial performance, financial position and cash flows of the Company for the accounting period. A fair presentation of the financial statements in accordance with IFRS requires the Directors to

- select suitable accounting policies in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and then apply them consistently,
- make judgements and accounting estimates that are reasonable and prudent,
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information,
- provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Company's financial position and financial performance,
- state that the Company has complied with applicable IFRSs, subject to any material departures disclosed and explained in the financial statements, and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence taking reasonable steps for the prevention and detection of fraud and other irregularities

PEARL ASSURANCE LIMITED

Independent auditors' report to the members of Pearl Assurance Limited

We have audited the financial statements of Pearl Assurance Limited for the year ended 31 December 2011 which comprise the accounting policies, the statement of comprehensive income, the statement of financial position, the statement of cash flows, the statement of changes in equity and the related notes 1 to 38. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards ("IFRS") as adopted by the European Union.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. 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 auditor

As explained more fully in the Statement of Directors' responsibilities set out on page 6, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the Directors, and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Directors' report and financial statements to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements

- give a true and fair view of the state of the Company's affairs as at 31 December 2011 and of its loss for the year then ended,
- have been properly prepared in accordance with IFRSs as adopted by the European Union, and
- have been prepared in accordance with the requirements of the Companies Act 2006.


Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us, or
- the financial statements are not in agreement with the accounting records and returns, or
- certain disclosures of Directors' remuneration specified by law are not made, or
- we have not received all the information and explanations we require for our audit.


James Lenton (Senior Statutory Auditor)
for and on behalf of Ernst & Young LLP, Statutory Auditor
London

March 2012

Accounting policies

(a) Basis of preparation

The financial statements have been prepared on a historical cost basis except for investment property and for those financial assets and financial liabilities that have been measured at fair value

The financial statements are separate financial statements and the exemption in section 401 of the Companies Act 2006 has been used not to present consolidated financial statements

Statement of compliance

The financial statements of the Company have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRS") as they apply to the financial statements of the Company for the year ended 31 December 2011, and applied in accordance with the Companies Act 2006

The financial statements are presented in sterling (£) rounded to the nearest £m except where otherwise stated

The Company presents its statement of financial position broadly in order of liquidity. An analysis regarding recovery or settlement more than twelve months after the period end is presented in the notes

Assets and liabilities are offset and the net amount reported in the statement of financial position only when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liability simultaneously. Income and expenses are not offset in the statement of comprehensive income unless required or permitted by an international financial reporting standard or interpretation, as specifically disclosed in the accounting policies of the Company

(b) Critical accounting estimates and judgements

The preparation of financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates

Critical accounting estimates are those which involve the most complex or subjective judgements or assessments. The areas of the Company's business that typically require such estimates are insurance contract liabilities, determination of the fair value of financial assets and liabilities, impairment tests for investments in subsidiaries and income taxes

Insurance contract liabilities

Insurance contract liability accounting is discussed in more detail in accounting policy (e) with further detail of the key assumptions made in determining insurance contract liabilities included in note 33

Fair value of financial assets and liabilities

The fair values of financial assets and liabilities are classified and accounted for as set out in accounting policies (n) and (f) respectively. Where possible, financial assets and liabilities are valued on the basis of listed market prices by reference to quoted market bid prices for assets and offer prices for liabilities, without any deduction for transaction costs. These are categorised as Level 1 financial instruments and do not involve estimates. If prices are not readily determinable, fair values are determined using valuation techniques including pricing models, discounted cash flow techniques or broker quotes. Financial instruments valued where valuation techniques are based on observable market data at the period end are categorised as Level 2 financial instruments. Financial instruments valued where valuation techniques are based on non-observable inputs are categorised as Level 3 financial instruments. Level 2 and Level 3 financial instruments therefore involve the use of estimates and note 27 provides further disclosures on fair value hierarchy and assumptions used to determine fair values

Impairment of investment in subsidiaries

Investments in subsidiaries are subject to impairment reviews as detailed in accounting policy (m). Impairments are measured at the difference between the carrying value of a particular asset and its recoverable amount. The recoverable amount is the higher of value in use or fair value less costs of disposal of the subsidiary estimated using applicable valuation techniques underpinned by IFRS net asset value or Embedded Value of the subsidiary

Income taxes

Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all the available evidence, it can be regarded as more likely than not that there will be suitable taxable profits against which the losses can be relieved. The UK taxation regime applies separate rules to trading and capital profits and losses. The distinction between temporary differences that arise from items of either a capital or trading nature may affect the recognition of deferred tax assets

The accounting policy for income taxes (both current and deferred taxes) is discussed in more detail in accounting policy (j)

(c) Foreign currency transactions

Assets and liabilities denominated in foreign currencies are translated into sterling at the closing rate at the period end. Income and expenses denominated in foreign currencies are translated at the prevailing rate at the date of the transaction. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies are recognised within fair value gains and losses as income or an expense in the statement of comprehensive income.

(d) 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.

Some insurance and investment contracts contain a Discretionary Participation Feature ("DPF"). This feature entitles the policyholder to additional discretionary benefits as a supplement to guaranteed benefits. Investment contracts with a DPF are recognised, measured and presented as insurance contracts. The Company classifies all contracts as insurance contracts.

(e) Insurance contracts and investment contracts with DPF

Under current IFRS requirements, insurance contracts and investment contracts with DPF are measured using accounting policies consistent with those previously adopted under United Kingdom Generally Accepted Accounting Principles ("UKGAAP"). Amounts recoverable from reinsurers are estimated in a manner consistent with the outstanding claims provision or settled claims associated with the reinsured policy.

Insurance liabilities

Insurance contract liabilities for non-participating business, other than unit-linked insurance contracts, are calculated on the basis of current data and assumptions using either a net premium or gross premium method. Where a gross premium method is used, the liability includes allowance for prudent lapses. Negative policy values are allowed for on individual policies.

- where there are no guaranteed surrender values, or
- in the periods where guaranteed surrender values do not apply even though guaranteed surrender values are applicable after a specified period of time.

The principle assumptions are given in note 33.

For participating business, the Company follows the provisions of the UK Accounting Standard Board's FRS 27 *Life Assurance*. The key aspects of the FRS27 are as follows:

- liabilities to policyholders arising from the with-profits business are stated at the amount of the realistic value of the liabilities, adjusted to exclude the owners' share of projected future bonuses,
- acquisition costs are not deferred, and
- reinsurance recoveries are measured on a basis that is consistent with the valuation of the liability to policyholders to which the reinsurance applies.

The realistic liability for any contract is equal to the sum of the with-profits bonus reserve and the cost of future policy-related liabilities.

The with-profits bonus reserve for an individual contract is determined by either a retrospective calculation of 'accumulated asset share' approach or by way of a prospective 'bonus reserve valuation' method.

The cost of future policy related liabilities is determined using a market consistent approach, mainly based on a stochastic model calibrated to market conditions at the end of the reporting period. Non market related assumptions (for example, persistency, mortality and expenses) are based on experience adjusted to take into account of future trends.

Where policyholders have valuable guarantees, options or promises in respect of the with-profits business, these costs are generally calculated using a stochastic model.

In calculating the realistic liabilities, account is taken of the future management actions consistent with those set out in the Principles and Practices of Financial Management (PPFM).

The principal assumptions are given in note 33.

Present value of future profits on non-participating business in the with-profits funds

For UK with-profits funds falling within the scope of FRS 27, an amount may be recognised for the present value of future profits ("PVFP") on non-participating business written in a with-profits fund where the determination of the realistic value of liabilities in that with-profits fund takes account, directly or indirectly, of this value.

PEARL ASSURANCE LIMITED

Where the value of future profits can be shown to be due to policyholders this amount is recognised as a reduction in the liability rather than as an intangible asset, and is then apportioned between the amounts that have been taken into account in the measurement of liabilities and other amounts which are shown as an adjustment to the unallocated surplus

The value of PVFP is determined in a manner consistent with realistic measurement of liabilities. In particular, the methodology and assumptions involve adjustments to reflect risk and uncertainty, are based on current estimates of future experience and current market yields and allow for market consistent valuation of any guarantees or options within the contracts. The value is also adjusted to remove the value of capital backing the non-profit business if this is included in the realistic calculation of PVFP

The principal assumptions used to calculate the PVFP are the same as those used in calculating the insurance contract liabilities given in note 33

Embedded derivatives

Embedded derivatives, including options to surrender insurance contracts, that meet the definition of insurance contracts or are closely related to the host insurance contract, are not separately measured. All other embedded derivatives are separated from the host contract and measured at fair value through profit or loss

Liability adequacy

At each reporting date, liability adequacy tests are performed to assess whether the insurance contract and investment contract with DPF liabilities are adequate. Current best estimates of future cash flows are compared to the carrying value of the liabilities. Any deficiency is charged as an expense to the statement of comprehensive income

The Company's accounting policies for insurance contracts meet the minimum specified requirements for liability adequacy testing under IFRS 4 *Insurance Contracts*, as they allow for current estimates of all contractual cash flows and of related cash flows such as claims handling costs. Cash flows resulting from embedded options and guarantees are also allowed for, with any deficiency being recognised as income or an expense in the statement of comprehensive income

Unallocated surplus

The unallocated surplus comprises the excess of the assets over the policyholder liabilities of the with-profits business. For the Company's with-profits funds, the amount included in the statement of financial position line item 'Unallocated surplus' represents amounts which have yet to be allocated to owners since the unallocated surplus attributable to policyholders has been included within liabilities under insurance contracts. The with-profits funds are closed to new business and as permitted by IFRS 4, the whole of the unallocated surplus has been classified as a liability (either within insurance contract liabilities or unallocated surplus)

If the realistic value of liabilities to policyholders exceeds the value of the assets in the with-profits fund (WPF), the unallocated surplus is valued at £nil and the amount of deficit reduces the fair value of the liability from the SHF to repay the capital support in the WPF detailed in note 32

(f) Financial liabilities

On initial recognition, financial liabilities are recognised when due and measured at the fair value of the consideration received less directly attributable transaction costs (with the exception of liabilities at fair value through profit or loss for which all transaction costs are expensed). Subsequent to initial recognition, financial liabilities (except for liabilities designated at fair value through profit or loss) are measured at amortised cost using the effective interest method

Financial liabilities are designated upon initial recognition at fair value through profit or loss when doing so results in more meaningful information because either

- it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases, or
- a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the Company's key management personnel

(g) Borrowings

Interest-bearing borrowings are recognised initially at fair value less any attributable transaction costs. The difference between initial costs and the redemption value is amortised as income or expense in the statement of comprehensive income over the period of the borrowing using the effective interest method

(h) Deposits from reinsurers

It is the Company's practice to obtain collateral to cover certain reinsurance transactions, usually in the form of cash or marketable securities. Where cash collateral is available to the Company for investment purposes it is

recognised as a 'financial asset' and the collateral repayable is recognised as 'deposits received from reinsurers' within the statement of financial position

Deposits received from reinsurers are measured at fair value through profit and loss as designated upon initial recognition

(i) Obligations for repayment of collateral received

It is the Company's practice to obtain collateral in stock lending and derivative transactions, usually in the form of cash or marketable securities. Where cash collateral is available to the Company for investment purposes, it is recognised as a 'financial asset' and the collateral repayable is recognised as 'obligations for repayment of collateral received' in the statement of financial position. The 'obligations for repayment of collateral received' are measured at amortised cost, which in the case of cash is equivalent to cost.

(j) Income tax

Income tax comprises current and deferred tax. Income tax is recognised as income or an expense in the statement of comprehensive income except to the extent that it relates to items recognised as other comprehensive income in the statement of comprehensive income, in which case it is recognised as other comprehensive income in that statement.

Current tax is the expected tax payable on the taxable income for the year, using tax rates and laws enacted or substantively enacted at the date of the statement of financial position together with adjustments to tax payable in respect of previous years.

Deferred tax is provided for on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not provided in respect of temporary differences arising from the initial recognition of goodwill and the initial recognition of assets or liabilities in a transaction that is not a business combination and that, at the time of the transaction, affects neither accounting nor taxable profit. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates and laws enacted or substantively enacted at the period end.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

The tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on owners' returns. This allocation is calculated based on an assessment of the effective rate of tax that is applicable to owners for the year.

(k) Investment property

Investment property is stated at fair value. Fair value is based on market values, being the estimated amount for which a property could be exchanged on the date of valuation between a willing buyer and a willing seller in an arm's length transaction. Gains and losses arising from the change in fair value are recognised as an income or expense in the statement of comprehensive income.

(l) Investments in associates and joint ventures

Investments in associates and joint ventures that are held for investment purposes are accounted for under IAS 39 *Financial Instruments: Recognition and Measurement* as permitted by IAS 28 *Interests in Associates* and IAS 31 *Interests in Joint Ventures*. These are measured at fair value through profit or loss. There are no investments in associates and joint ventures which are of a strategic nature.

(m) Investment in subsidiaries

At each reporting date, the Company assesses whether there are any indications of impairment. When indications of impairment exist, an impairment test is carried out by comparing the carrying value of the investment in the subsidiary with the estimate of the recoverable amount of the subsidiary. Impairments are recognised as income or an expense in the statement of comprehensive income in the period in which they occur.

Investments in shares in subsidiaries held for strategic purposes are carried in the statement of financial position at cost less impairment. Investments in shares in subsidiaries held for investment purposes are carried at fair value.

(n) Financial assets

Purchases and sales of financial assets are recognised on the trade date, which is the date that the Company commits to purchase or sell the asset.

Loans and deposits are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. These investments are initially recognised at cost, being the fair value of the consideration paid for the acquisition of the investment. All transaction costs directly attributable to the acquisition are also included.

PEARL ASSURANCE LIMITED

in the cost of the investment. Subsequent to initial recognition, these investments are carried at amortised cost, using the effective interest method.

Derivative financial instruments are classified as held for trading. They are recognised initially at fair value and subsequently are re-measured to fair value. Exchange-traded derivatives are valued at the published bid price, or, if these are not available, by using valuation techniques such as discounted cash flow models or option pricing models. The gain or loss on re-measurement to fair value is recognised as income or an expense in the statement of comprehensive income.

Equities, fixed and variable rate income securities and collective investment schemes are designated at fair value through profit or loss and accordingly are stated in the statement of financial position at fair value. They are designated at fair value through profit or loss because they are managed and evaluated on a fair value basis in accordance with the Company's stated risk management policies.

Impairment of financial assets

The Company assesses at each period end whether a financial asset or group of financial assets held at amortised cost is impaired. The Company first assesses whether objective evidence of impairment exists for financial assets. If it is determined that no objective evidence of impairment exists for an individually assessed financial asset, the asset is included in a group of financial assets with similar credit risk characteristics and that group of financial assets is collectively assessed for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in the collective assessment of impairment.

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 period end. 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 such as broker quotes, pricing models or discounted cash flow techniques. Where pricing models are used, inputs are based on market related data at the period end. Where discounted cash flow techniques are used, estimated future cash flows are based on contractual cash flows using current market conditions and market calibrated discount rates and interest rate assumptions for similar instruments.

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 receivables and 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.

Stock lending

Financial assets that are lent under the Company's stock lending programme do not qualify for derecognition from the statement of financial position as the Company retains substantially all the risks and rewards of the transferred assets.

Collateral

The Company receives and pledges collateral in the form of cash or non-cash assets in respect of stock lending transactions, derivative contracts and reinsurance arrangements in order to reduce the credit risk of these transactions. The amount and type of collateral required where the Company receives collateral depends on an assessment of the credit risk of the counterparty.

Collateral received in the form of cash, where the Company has contractual rights to receive the cash flows generated, is recognised as an asset in the statement of financial position with a corresponding liability for its repayment. Non-cash collateral received is not recognised in the statement of financial position, unless the counterparty defaults on its obligations under the relevant agreement.

Cash and non-cash collateral pledged where the Company retains the contractual rights to receive the cash flows generated is not derecognised from the statement of financial position, unless the Company defaults on its obligations under the relevant agreement, and therefore continues to be recognised in the statement of financial position within the appropriate asset classification.

(o) Reinsurance

The Company cedes insurance risk in the normal course of business. Reinsurance assets represent balances due from reinsurance companies. Reinsurers' share of insurance contract liabilities are dependent on expected claims and benefits arising under the related reinsured policies.

Reinsurance assets are reviewed for impairment at each reporting date or more frequently when an indication of impairment arises during the reporting year. Impairment occurs when there is objective evidence as a result of an event that occurred after initial recognition of the reinsurance asset that the Company may not receive all outstanding amounts due under the terms of the contract and the event has a reliably measurable impact on the amounts that the Company will receive from the reinsurer. The impairment charge is recorded as an expense in the statement of comprehensive income. The reinsurers' share of investment contract liabilities is measured on a basis that is consistent with the valuation of the liability to policyholders to which the reinsurance applies.

Gains or losses on purchasing reinsurance are recognised as an income or an expense in the statement of comprehensive income at the date of purchase and are not amortised. They are the difference between the premiums ceded to reinsurers and the related change in the reinsurers' share of insurance contract liabilities.

(p) Cash and cash equivalents

Cash and cash equivalents comprise cash balances and short-term deposits with an original maturity term of three months or less at the date of placement. Bank overdrafts that are repayable on demand and form an integral part of the Company's cash management are deducted from cash and cash equivalents for the purpose of the statement of cash flows.

(q) Leases

Where a significant element of the risks and rewards of title to the asset is retained by the lessor, such leases are classified as operating leases. Rental income from such leases is recognised as income in the statement of comprehensive income on a straight line basis over the period of the lease.

(r) Provisions and contingent liabilities

A provision is recognised when the Company has a present legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability. Where the Company has a present legal or constructive obligation but it is not probable that there will be an outflow of resources to settle the obligation or the amount cannot be reliably estimated, this is disclosed as a contingent liability.

(s) Dividends

Final dividends on ordinary shares are recognised as a liability and deducted from equity when they are approved by the Company's owners. Interim dividends are deducted from equity when they are paid.

Dividends for the year that are approved after the reporting period are dealt with as an event after the reporting period.

(t) Income recognition

Gross premiums

In respect of insurance contracts and investment contracts with DPF, premiums are accounted for on a receivable basis and exclude any taxes or duties based on premiums. Funds at retirement under individual pension contracts converted to annuities with the Company are, for accounting purposes, included in both claims incurred and premiums within gross premiums written.

Reinsurance premiums

Outward reinsurance premiums are accounted for on a payable basis.

Fee and commission income

Fee and commission income includes fund management based fees and other fees, which are recognised as the services are provided.

Net investment income

Net investment income comprises interest, dividends, rents receivable, fair value gains and losses on financial assets and investment property and impairment reversals and losses on loans and deposits and investments in subsidiaries.

Interest income is recognised as income in the statement of comprehensive income as it accrues using the effective interest method. Dividend income is recognised as income in the statement of comprehensive income on the date the right to receive payments is established, which in the case of listed securities is the ex-dividend date.

Rental income from investment property is recognised as income in the statement of comprehensive income on a straight-line basis over the term of the lease. Lease incentives granted are recognised as an integral part of the total rental income.

Fair value gains and losses on financial assets designated at fair value through profit or loss are recognised as income or an expense in the statement of comprehensive income. Realised gains and losses are the difference between the net sale proceeds and the original cost. Unrealised gains and losses are the difference between the valuation at the period end and their valuation at the previous period end or purchase price, if acquired during the year.

Other operating income

Other operating income comprises the general business result and other non-investment income which is recognised on an accruals basis.

(u) Benefits, claims and expenses recognition***Gross benefits and claims***

Claims on insurance contracts and investment contracts with DPF reflect the cost of all claims arising during the period, including policyholder bonuses allocated in anticipation of a bonus declaration. Claims payable on maturity are recognised when the claim becomes due for payment and claims payable on death are recognised on notification. Surrenders are accounted for at the earlier of the payment date or when the policy ceases to be included within insurance contract liabilities. 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.

Reinsurance claims

Reinsurance claims are recognised when the related gross insurance claim is recognised according to the terms of the relevant contract.

Finance costs

Interest payable is recognised as an expense in the statement of comprehensive income as it accrues and is calculated by using the effective interest method.

Transfers of business

Where the Company participates in a transfer of insurance business scheme under Part VII of the Financial Services Act 2000 and the ultimate shareholders remain the same, the transaction constitutes business combinations involving entities or businesses under common control. IFRS does not prescribe the treatment of such transfers. Accordingly, on initial recognition, the transferred assets and liabilities are measured at the carrying value in the transferring company and the resulting gain or loss is recognised as income or an expense in the statement of comprehensive income.

(v) Share capital and capital contributions***Ordinary share capital***

The Company has issued "A" and "B" ordinary shares which are classified as equity. Details of the relating entitlements are disclosed within note 10.

Capital contributions

Capital contributions received by the Company and which contain no agreement for their repayment are recognised directly in the statement of changes in equity as a distributable reserve.

(w) General business

The general insurance business has been closed to new business for a number of years and is in run off. The results are included within other operating income in the statement of comprehensive income. Provisions are 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 provision and subsequent settlement is included in the statement of comprehensive income in later years.

(x) Events after the reporting period

The financial statements are adjusted to reflect significant events that have a material effect on the financial results and that have occurred between the period end and the date when the financial statements are authorised for issue, provided they give evidence of conditions that existed at the period end. Events that are indicative of conditions that arise after the period end that do not result in an adjustment to the financial statements are disclosed.

PEARL ASSURANCE LIMITED

Statement of comprehensive income
for the year ended 31 December 2011

	Notes	2011 £m	2010 £m
Gross premiums written		350	361
Less premiums ceded to reinsurers		(4)	(3)
Net premiums written		346	358
Fees and commissions	2	8	6
Net investment income	3	1,322	1,326
Total revenue, net of reinsurance payable		1,676	1,690
Policyholder claims		(1,007)	(1,031)
Less reinsurance recoveries		205	214
Change in insurance contract liabilities		(642)	(301)
Change in reinsurers' share of insurance contract liabilities		147	(31)
Transfer from/(to) unallocated surplus	13	13	(86)
Net policyholder claims and benefits incurred		(1,284)	(1,235)
Administrative expenses	4	(133)	(85)
Other operating expenses	7	(250)	(278)
Total operating expenses		(1,667)	(1,598)
Profit before finance costs and tax		9	92
Finance costs	8	(27)	(15)
(Loss)/Profit for the year before tax		(18)	77
Tax attributable to policyholders' returns	9	(43)	2
(Loss)/Profit before tax attributable to owners		(61)	79
Tax (charge)/credit	9	(39)	15
Less tax attributable to policyholders' returns		43	(2)
Tax attributable to owners		4	13
(Loss)/Profit for the year attributable to owners		(57)	92
Other comprehensive income		-	-
Total comprehensive income for the year attributable to owners		(57)	92

PEARL ASSURANCE LIMITED

Statement of financial position – equity and liabilities
as at 31 December 2011

	Notes	2011 £m	2010 £m
EQUITY AND LIABILITIES			
Equity attributable to owners of the parent			
Share capital	10	342	342
Share premium		41	41
Capital contribution reserve		81	81
Retained earnings		547	639
Total equity		1,011	1,103
Liabilities			
Insurance contract liabilities			
Liabilities under insurance contracts	12	12,108	11,466
Unallocated surplus	13	281	294
		12,389	11,760
Financial liabilities			
Borrowings	14	250	250
Deposits received from reinsurers	15	2,526	2,415
Derivatives	16	1,083	618
Obligations for repayment of collateral received	17	4,008	2,775
	18	7,867	6,058
Provisions	19	15	16
Deferred tax	20	10	5
Payables related to direct insurance contracts	21	115	103
Current tax	20	31	-
Accruals and deferred income	22	7	7
Other payables	23	64	104
Total liabilities		20,498	18,053
Total equity and liabilities		21,509	19,156

PEARL ASSURANCE LIMITED

Statement of financial position – assets
as at 31 December 2011

	Notes	2011 £m	2010 £m
ASSETS			
Investment in subsidiaries	24	117	432
Investment property	25	42	45
Financial assets			
Loans and deposits	26	845	870
Derivatives	16	1,790	916
Equities		681	1,274
Fixed and variable rate income securities		9,070	8,287
Collective investment schemes		5,889	4,527
Deposits with cedants		24	26
	27	18,299	15,900
Deferred tax assets	20	29	45
Insurance assets			
Reinsurers' share of insurance contract liabilities	12	2,526	2,379
Reinsurance receivables		9	10
Insurance contract receivables		-	1
		2,535	2,390
Current tax	20	-	4
Prepayments and accrued income		110	121
Other receivables	29	30	89
Cash and cash equivalents	30	347	130
Total assets		21,509	19,156

On behalf of the Board



A Moss
Director
20 March 2012

PEARL ASSURANCE LIMITED

Statement of cash flows
for the year ended 31 December 2011

	Notes	2011 £m	2010 £m
Cash flows from operating activities			
Cash generated/(absorbed) by operations	31	358	(446)
Taxation recovered		7	31
Net cash flows from operating activities		<u>365</u>	<u>(415)</u>
Cash flows from investing activities			
Loan to Group companies		(200)	(65)
Dividends received from subsidiaries		75	-
Interest received from Group entities		13	23
Net cash flows from investing activities		<u>(112)</u>	<u>(42)</u>
Cash flows from financing activities			
Ordinary share dividends paid		(35)	(103)
Interest paid on subordinated liabilities		(1)	(2)
Net cash flows from financing activities		<u>(36)</u>	<u>(105)</u>
Net increase/(decrease) in cash and cash equivalents		217	(562)
Cash and cash equivalents at the beginning of the year		130	692
Cash and cash equivalents at the end of the year	30	<u>347</u>	<u>130</u>
Supplementary disclosures on cash flows from operating activities			
Interest received		504	381
Dividends received		75	88

PEARL ASSURANCE LIMITED

Statement of changes in equity
for the year ended 31 December 2011

	Share capital (note 10) £m	Share premium £m	Capital contribution reserve £m	Retained earnings £m	Total £m
At 1 January 2011	342	41	81	639	1,103
Loss for the year	-	-	-	(57)	(57)
Other comprehensive income for the year	-	-	-	-	-
Total comprehensive income for the year	-	-	-	(57)	(57)
Dividends paid on ordinary shares (note 11)	-	-	-	(35)	(35)
At 31 December 2011	342	41	81	547	1,011

Of the above, £40m (2010 £28m) is considered distributable

	Share capital (note 10) £m	Share premium £m	Capital contribution reserve £m	Retained earnings £m	Total £m
At 1 January 2010	342	41	81	650	1,114
Profit for the year	-	-	-	92	92
Other comprehensive income for the year	-	-	-	-	-
Total comprehensive income for the year	-	-	-	92	92
Dividends paid on ordinary shares (note 11)	-	-	-	(103)	(103)
At 31 December 2010	342	41	81	639	1,103

Notes to the financial statements

1 Financial information

The financial statements for the year ended 31 December 2011, set out on pages 8 to 48, were authorised by the Board of Directors for issue on 20 March 2012

In preparing the financial statements the Company has adopted the following standards, interpretations and amendments which have been issued by the International Accounting Standards Board ('IASB') and have been adopted for use by the EU. None of these have a material effect on the results of the Company

- IAS 32 *Financial Instruments Presentation* (Amendment) The amendment alters the definition of a financial liability in IAS 32 to enable entities to classify rights issues and certain options or warrants as equity instruments
- Annual improvements 2010 This makes a number of minor improvements to existing standards and interpretations

The IASB has issued the following standards, interpretations and amendments which, subject to adoption for use by the EU, apply from the dates shown. The Company has decided not to early adopt any of these standards, interpretations or amendments where this is permitted. The impact on the Company of adopting them is subject to evaluation

- IFRS 9 *Financial Instruments* (2015) These are the first two parts of a replacement standard for IAS 39 *Financial Instruments Recognition and Measurement* and deals with the classification and measurement of financial assets and financial liabilities, including some hybrid contracts
- Deferred tax Recovery of Underlying Assets (Amendments to IAS 12) (2012) This provides a practical approach to the measurement of deferred tax liabilities and assets when investment property is measured at fair value, according to whether the entity expects to recover an asset by using or selling it
- Disclosure – Transfer of Financial Assets (Amendments to IFRS 7) (2012) This revises the required disclosures to help users of financial statements evaluate the risk exposures relating to transfers of financial assets and the effect of those risks on an entity's financial position
- IFRS 13 *Fair Value Measurement* (2013) defines fair value and sets out in a single IFRS a framework for measuring fair value
- Presentation of Items of Other Comprehensive Income (Amendments to IAS 1) (2013) The amendment requires companies to group together items within other comprehensive income that may be reclassified to the profit or loss section of the statement of comprehensive income
- IAS 27 *Separate Financial Statements* (Revised) IAS 27 now only deals with the requirements for separate financial statements, which have been carried over largely unamended from IAS 27 Consolidated and Separate Financial Statements. Requirements for consolidated financial statements are now contained in IFRS 10 Consolidated Financial Statements
- Disclosures - Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7) (2013) The new disclosure requirements are intended to help users of financial statements better assess the effect or potential effect of offsetting arrangements on an entity's financial position
- Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32) (2014) The amendments address inconsistencies in current practice when applying the offsetting criteria in IAS 32

In addition, the following standards, interpretations and amendments have been issued but are not currently relevant to the Company

- IFRS 10 *Consolidated Financial Statements* (2013) provides a single consolidation model that identifies control as the basis for consolidation for all types of entities
- Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters (Amendments to IFRS 1) (2012)
- IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* (2013)
- IFRIC 14 *Prepayments of a Minimum Funding Requirement* (Amendment) The amendment permits a prepayment of future service costs in accordance with a minimum funding requirement to be recognised as a pension asset
- IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* Addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in its equity instruments being issued to extinguish all or part of the financial liability
- IFRS 11 *Joint Arrangements* (2013) establishes principles for financial reporting by parties to a joint arrangement
- IFRS 12 *Disclosure of Interests in Other Entities* (2013) combines, enhances and replaces the disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities
- IAS 19 *Employee Benefits* (Amendment) (2013) The IASB has issued numerous amendments to IAS 19. These range from fundamental changes like removing the corridor mechanism and the concept of expected returns on plan assets to simple clarifications and re-wording
- IAS 28 *Investments in Associates and Joint Ventures* (Revised) This standard supersedes IAS 28 Investments in Associates and prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures

PEARL ASSURANCE LIMITED

2 Fees and commissions

	2011 £m	2010 £m
Other fees	<u>8</u>	<u>6</u>

3 Net investment income

	2011 £m	2010 £m
Investment income		
Interest income on loans and deposits	27	15
Interest income on financial assets designated at fair value through profit or loss on initial recognition	478	358
Dividend income	135	151
Rental income	<u>3</u>	<u>2</u>
	<u>643</u>	<u>526</u>
Fair value gains/(losses)		
Financial assets at fair value through profit or loss		
Held for trading – derivatives	393	16
Designated upon initial recognition	487	799
Impairment on investments in subsidiaries	(198)	(16)
Investment property	<u>(3)</u>	<u>1</u>
	<u>679</u>	<u>800</u>
Net investment income	<u>1,322</u>	<u>1,326</u>

Interest income on loans and deposits includes interest receivable of £26m (2010 £14m) on loans to Group entities. Dividend income includes dividends from subsidiaries of £75m (2010 £88m)

4. Administrative expenses

	2011 £m	2010 £m
Outsourcing expenses	92	52
Investment management expenses and transaction costs	<u>41</u>	<u>33</u>
	<u>133</u>	<u>85</u>

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

5. Directors' remuneration

	2011 £000	2010 £000
Salaries and other short term benefits	<u>196</u>	<u>236</u>
Remuneration (executive and non-executive Directors' remuneration excluding pension contributions and awards under share option schemes and other long-term incentive schemes)	<u>196</u>	<u>236</u>
Post-employment benefits	-	2
Other long-term benefits	<u>109</u>	<u>131</u>
	<u>109</u>	<u>133</u>
Contributions to money purchase pension schemes	<u>7</u>	<u>2</u>

	2011 Number	2010 Number
Number of Directors accruing retirement benefits under		
- a defined benefit pension scheme	-	2
- a money purchase pension scheme	4	1

PEARL ASSURANCE LIMITED

	2011 £000	2010 £000
Highest paid Director's remuneration	<u>79</u>	<u>85</u>

The Directors are employed by Pearl Group Services Limited and Pearl Group Management Services Limited

For the purposes of this note an apportionment of the total remuneration paid to the Directors of the Company by the Phoenix Group has been made based on an estimate of the services rendered to the Company

6. Auditors' remuneration

The remuneration of the auditors of the Company, including their associates was £234,000 (2010 £286,000) No services were provided to associated pension schemes

	2011 £000	2010 £000
Audit of the financial statements	232	225
Other services supplied pursuant to legislation		
Audit related	<u>2</u>	<u>61</u>
	<u>234</u>	<u>286</u>

7. Other operating expenses

	2011 £m	2010 £m
Movement in deposits received from reinsurers	<u>250</u>	<u>278</u>

8 Finance costs

	2011 £m	2010 £m
Interest expense		
On borrowings at amortised cost	<u>27</u>	<u>15</u>
Attributable to		
- policyholders	23	13
- owners	<u>4</u>	<u>2</u>
	<u>27</u>	<u>15</u>

9. Tax credit/(charge)

Current year tax credit/(charge)

	2011 £m	2010 £m
Current tax		
UK Corporation tax	(33)	-
Adjustment in respect of prior years	<u>15</u>	<u>(1)</u>
	(18)	(1)
Deferred tax		
Reversal/(origination) of temporary differences		
On non-profit surpluses	5	(6)
Excess expenses	(2)	(32)
Capital allowances in excess of depreciation	-	3
Utilisation of tax losses	(23)	-
Tax losses arising in the current year carried forward	-	17
Losses on corporate restructuring not matched in accounts	-	33
Reduction in corporation tax rate	<u>(1)</u>	<u>1</u>
	(21)	16
Total tax credit/(charge)	<u>(39)</u>	<u>15</u>

PEARL ASSURANCE LIMITED

Attributable to

- policyholders

- owners

(43)	2
4	13
<u>(39)</u>	<u>15</u>

The Company, as a proxy for policyholders in the UK, is required to pay taxes on investment income and gains each year. Accordingly, the tax benefit or expense attributable to UK life assurance policyholder earnings is included in income tax expense. The tax (charge)/benefit attributable to policyholder earnings was £(43)m (2010 £2m).

Reconciliation of tax credit/(charge)

	2011 £m	2010 £m
Profit before tax	(18)	77
Policyholder tax credit/(charge)	(43)	2
Profit before the tax attributable to owners	<u>(61)</u>	<u>79</u>
Tax at standard UK rate of 26.5% (2010: 28%)	16	(22)
Net tax losses on corporate restructuring not matched in financial statements	-	33
Non-taxable income	20	25
Adjustment to current tax charge in respect of prior years	15	(1)
Adjustment to deferred tax charge in respect of prior periods	(6)	(13)
Tax losses not utilised	-	(7)
Recognition of tax assets not previously valued	11	-
Reduction in Corporation tax rates	(1)	1
Non-taxable impairment of subsidiary	(53)	-
Other	2	(3)
Owners' tax charge	<u>4</u>	<u>13</u>
Policyholder tax credit/(charge)	<u>(43)</u>	<u>2</u>
Total tax credit/(charge) for the year	<u>(39)</u>	<u>15</u>

10. Share capital

	2011 £m	2010 £m
Issued and fully paid		
42,169,489 (2010: 42,169,489) "A" ordinary shares of 5p each	2	2
340,001,000 (2010: 340,001,000) "B" ordinary shares of £1 each	<u>340</u>	<u>340</u>
	<u>342</u>	<u>342</u>

The holders of the "A" ordinary shares have no voting rights.

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, on a show of hands every holder of the "B" ordinary shares has one vote and on a poll, holders of the "B" ordinary shares have one vote for every share held.

The Company's Articles of Association contain a restriction on the number of shares that may be allotted.

PEARL ASSURANCE LIMITED

11 Dividends on ordinary shares

	2011 £m	2010 £m
Interim dividend for 2011 at 10.29p per share (2010 12.9p per share)	35	44
Second interim dividend for 2011 at nil p per share (2010 17.23p per share)	-	59
	<u>35</u>	<u>103</u>

12. Liabilities under insurance contracts

	Gross liabilities 2011 £m	Re- insurers' share 2011 £m	Gross liabilities 2010 £m	Re- insurers' share 2010 £m
Life assurance business				
Insurance contracts	8,945	2,526	8,201	2,379
Investment contracts with DPF	<u>3,163</u>	<u>-</u>	<u>3,265</u>	<u>-</u>
	<u>12,108</u>	<u>2,526</u>	<u>11,466</u>	<u>2,379</u>
Amounts due for settlement after 12 months	<u>11,225</u>	<u>2,526</u>	<u>7,478</u>	<u>2,174</u>

	Gross liabilities £m	Re- insurers' share £m
At 1 January 2011	11,466	2,379
Premiums	350	4
Claims	(1,007)	(205)
Other changes in liabilities	<u>1,299</u>	<u>348</u>
At 31 December 2011	<u>12,108</u>	<u>2,526</u>

	Gross liabilities £m	Re- insurers' share £m
At 1 January 2010	9,983	2,410
Part VII transfer scheme	1,182	-
Premiums	361	3
Claims	(1,031)	(214)
Other changes in liabilities	<u>971</u>	<u>180</u>
At 31 December 2010	<u>11,466</u>	<u>2,379</u>

As permitted by IFRS 7, the Company has not disclosed fair values for Investment contracts with a DPF as fair value ranges for the DPF cannot be reliably estimated. There is no active market for these instruments which will be settled with policyholders in the normal course of business.

13 Unallocated surplus

	2011 £m	2010 £m
At 1 January	294	208
Transfer (to)/from statement of comprehensive income	<u>(13)</u>	<u>86</u>
At 31 December	<u>281</u>	<u>294</u>

14. Borrowings

	2011 £m	2010 £m
Subordinated loan from fellow group company, Phoenix Life Holdings Limited ("PLHL")	<u>250</u>	<u>250</u>
Amounts due for settlement after 12 months	<u>250</u>	<u>250</u>

PEARL ASSURANCE LIMITED

The Company's shareholder fund received a subordinated loan facility of £250m from PLHL on 2 September 2009. This has been fully utilised and bears interest equal to the actual investment income earned on the £250m assets transferred. The interest is accrued and paid to PLHL on an annual basis. The maturity date of the loan is 2 September 2019. Repayment of any part of the loan earlier than the maturity date is conditional on the Company giving the FSA not less than six months notice in writing of the proposed early repayment and receiving written confirmation that the FSA does not object to such a repayment.

15. Deposits received from reinsurers

	2011	2010
	£m	£m
Carrying value		
At 31 December	<u>2,526</u>	<u>2,415</u>
Amount due for settlement after 12 months	<u>2,526</u>	<u>2,415</u>
Fair value		
At 31 December	<u>2,526</u>	<u>2,415</u>

With effect from 1 January 2007, the Company reassured certain pension annuities in payment to a fellow group Company, Opal Reassurance Limited ("Opal"). Under the terms of this reinsurance arrangement the Company holds assets in a collateral account over which Opal has a fixed charge.

Further information on the Company's collateral arrangements is provided in note 28.

16. Derivatives

The Company purchases derivative financial instruments in connection with the management of its insurance contract liabilities based on the principles of reduction of risk and efficient portfolio management.

The fair values of derivative financial instruments are as follows:

	2011	2011	2010	2010
	Assets	Liabilities	Assets	Liabilities
	£m	£m	£m	£m
Forward currency	29	20	25	36
Credit default options	28	1	2	11
Interest rate swaps	1,283	1,062	730	431
Swaptions	241	-	113	-
Inflation swaps	17	-	44	128
Total return bond swaps	192	-	2	12
	<u>1,790</u>	<u>1,083</u>	<u>916</u>	<u>618</u>

The amount recoverable after one year is £1,518m (2010: £800m). The amount payable after one year is £1,053m (2010: £510m).

The Company pledges and receives collateral in respect of its derivative positions. Further information is provided in note 28.

17. Obligations for repayment of collateral received

	2011	2010
	£m	£m
Carrying value		
At 31 December		
Stock lending collateral	3,031	2,420
Derivative collateral	<u>977</u>	<u>355</u>
	<u>4,008</u>	<u>2,775</u>
Amount due for settlement after 12 months	<u>831</u>	<u>310</u>
Fair value		
At 31 December	<u>4,008</u>	<u>2,775</u>

Further information on the Company's collateral arrangements is provided in note 28.

PEARL ASSURANCE LIMITED

18 Financial liabilities

	2011 £m	2010 £m
Carrying value		
Financial liabilities at fair value through profit or loss		
Deposits received from reinsurers	2,526	2,415
Held for trading – derivatives	1,083	618
Financial liabilities measured at amortised cost	<u>4,258</u>	<u>3,025</u>
	<u>7,867</u>	<u>6,058</u>
 Amount due for settlement after 12 months	 <u>4,660</u>	 <u>3,485</u>

The carrying value of the financial liabilities measured at amortised cost approximates to fair value

19. Provisions

	Leasehold properties £m
At 1 January 2011	16
Utilised during the year	(1)
At 31 December 2011	<u>15</u>

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 3.92% (2010 5.46%). The provision is expected to be utilised over the next 6 years (2010 7 years)

20 Tax assets and liabilities

	2011 £m	2010 £m
Current tax receivables	-	4
Net deferred tax assets	<u>29</u>	<u>45</u>
Total tax assets	<u>29</u>	<u>49</u>
 Current tax payables	 (31)	 -
Net deferred tax liabilities	<u>(10)</u>	<u>(5)</u>
Total tax liabilities	<u>(41)</u>	<u>(5)</u>

Deferred tax assets comprise

	2011 £m	2010 £m
Trading losses	28	51
Expenses and deferred acquisition costs carried forward	-	2
Accelerated capital allowances	<u>1</u>	<u>2</u>
Gross deferred tax assets	29	55
Less offset against deferred tax liabilities	<u>-</u>	<u>(10)</u>
Net deferred tax assets	<u>29</u>	<u>45</u>

Deferred tax liabilities comprise:

	2011 £m	2010 £m
Provisions and other temporary differences	<u>(10)</u>	<u>(15)</u>
Gross deferred tax liabilities	(10)	(15)
Less offset against deferred tax assets	<u>-</u>	<u>10</u>
Net deferred tax liabilities	<u>(10)</u>	<u>(5)</u>

PEARL ASSURANCE LIMITED

Movements in deferred tax assets/(liabilities) comprise:

	2011 £m	2010 £m
At 1 January	40	25
Amounts credited to the statement of comprehensive income	(21)	15
At 31 December	<u>19</u>	<u>40</u>

Deferred tax has been provided on the surpluses within the non-profit funds on the assumption that all such surpluses will eventually be distributed to owners

Deferred income tax assets are recognised for tax losses carried forward only to the extent that realisation of the related tax benefit is probable

	2011 £m	2010 £m
Deferred tax assets have not been recognised in respect of Capital losses	<u>41</u>	<u>39</u>

These can only be offset against future capital gains and have no expiry date

A gradual reduction in the UK corporation tax rate from 28% to 24% over four years was announced in the Emergency Budget of 22 June 2010 with a further 1% reduction being announced in the Budget of 23 March 2011. The Finance (No. 2) Act 2010 included the first of the 1% rate reductions with effect from April 2011, a further 1% reduction was substantively enacted on 29 March 2011 under the Provisional Collection of Taxes Act 1968 and a further 1% reduction (effective from April 2012) was included in Finance Act 2011. Further reductions are to be dealt with by future legislation. The benefit to the Company's net assets arising from the further 2% reduction of rate is estimated as £nil million in total and will be recognised as the legislation is substantively enacted.

On 23 March 2011, HMRC issued a technical note on "Solvency II and the Taxation of Insurance Companies", outlining changes to the taxation of UK insurance companies with effect from 2013. The Group has been actively involved in consulting with HMRC and HM Treasury on the detail of the new rules, including providing comments on proposed draft legislation, with the aim of ensuring that the Company's policyholders and shareholders are, as far as possible, not adversely affected by the changes.

The Group is still assessing the likely impact of the new rules (subject to the final legislation which will be introduced following the March 2012 Budget). The Group's view, at this stage, is that transition to the new rules is likely to result in the acceleration of some taxable profits (which will be recognised over a 10-year period under transitional provisions in the new rules), but this is not expected to have a material impact on its overall tax position.

21 Payables related to direct insurance contracts

	2011 £m	2010 £m
Payables related to direct insurance contracts	<u>115</u>	<u>103</u>
Amount due for settlement after 12 months	<u>39</u>	<u>40</u>

General insurance

Due to the historic diversity of issued general insurance policies and taking into account the legal and regulatory environment for hazardous risks, it is possible that additional claims could emerge from long tail unexpired risks albeit it is not possible to predict the quantum, location or timing of such occurrences.

The estimation of the provisions for the ultimate cost of claims for asbestos and environmental pollution is subject to a range of uncertainties that is generally greater than those encountered for other classes of insurance business and as a consequence of this uncertainty the eventual costs of settlement of outstanding claims and unexpired risks can vary substantially from the estimates.

The provision for the future claims payments has primarily been assessed in accordance with actuarial methods projecting the number and amount of claims separately. 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 certain 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 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.

PEARL ASSURANCE LIMITED

The average period before the undiscounted liability will be settled has been estimated at 11 years for 2011 and the provision has been discounted at 1.5% (2010: 1.9%) per annum

The overall effect is to reduce the gross and net claims outstanding financial liability for those classes of business referred to above at 31 December 2011 by £5m from £35m to £30m. The total amount of the investment return which corresponds to the unwinding of the discount is £nil

22. Accruals and deferred income

	2011 £m	2010 £m
Accruals	<u>7</u>	<u>7</u>
Amount due for settlement after 12 months	<u>-</u>	<u>-</u>

23. Other payables

	2011 £m	2010 £m
Investment broker balances	5	36
Other payables	<u>59</u>	<u>68</u>
	<u>64</u>	<u>104</u>
Amount due for settlement after 12 months	<u>-</u>	<u>-</u>

24. Investment in subsidiaries

	Investments in subsidiaries at cost £m	Investments in subsidiaries at fair value £m	Total £m
Cost or valuation			
At 1 January 2011	730	129	859
Disposal	-	(118)	(118)
Fair value gains	-	1	1
At 31 December 2011	<u>730</u>	<u>12</u>	<u>742</u>
Impairment			
At 1 January 2011	427	-	427
Impairment charge	198	-	198
At 31 December 2011	<u>625</u>	<u>-</u>	<u>625</u>
Carrying amount			
At 31 December 2011	<u>105</u>	<u>12</u>	<u>117</u>

The recoverable amount of investments in subsidiaries at cost is based on the value in use. This has been determined using the IFRS net asset value.

PEARL ASSURANCE LIMITED

	Investments in subsidiaries at cost £m	Investments in subsidiaries at fair value £m	Total £m
Cost or valuation			
At 1 January 2010	730	126	856
Fair value gains	-	3	3
At 31 December 2010	<u>730</u>	<u>129</u>	<u>859</u>
Impairment			
At 1 January 2010	411	-	411
Impairment charge	16	-	16
At 31 December 2010	<u>427</u>	<u>-</u>	<u>427</u>
Carrying amount			
At 31 December 2010	<u>303</u>	<u>129</u>	<u>432</u>

The principal subsidiaries of the Company are as follows

	Country of incorporation and principal place of operation	Class of shares held (wholly-owned unless otherwise indicated)
National Provident Life Limited (Insurance company)	UK	Ordinary shares of £1
National Provident Life Holdings Limited (Insurance holding company)	UK	Ordinary shares of £1

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 2011

During the year the investment in Dawberry Properties Limited (DPL) was exchanged for units in a collective investment scheme

The Company's subsidiary undertaking, National Provident Life Holdings ("NPLH"), has provided capital to National Provident Life Limited ("NPLL") 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 NPLL. The Company's valuation of its investment in NPLH includes the directors' best estimate of the amount of the contingent loan that will be recoverable from the long-term fund of NPLL, following settlement of policyholder claims. The contingent loan asset (£35m as at 31 December 2011, £38m as at 31 December 2010) is valued at an amount equal to the regulatory realistic contingent loan liability value within NPLL. The carrying value of the loan approximates to its fair value.

25 Investment property

	2011 £m	2010 £m
At 1 January	45	44
Fair value (losses)/gains	(3)	1
At 31 December	<u>42</u>	<u>45</u>

Investment property is stated at fair value and is independently valued in accordance with the Royal Institute of Chartered Surveyors' guidelines on the basis of the open market value of such properties.

Direct operating expenses (included within administrative expenses) in respect of investment properties that generated rental income during the year amounted to £nil (2010: £nil). The direct operating expenses arising from investment property that did not generate rental income during the year amounted to £1m (2010: £nil).

PEARL ASSURANCE LIMITED

26. Loans and deposits

	2011 £m	2010 £m
Loans to Group entities at amortised cost		
Loans to Pearl Group Holdings (No 2) Limited ("PGH2"), the Company's immediate parent	603	393
Loans to subsidiary companies	198	199
Loans to fellow subsidiaries	30	31
	<u>831</u>	<u>623</u>
Other loans and deposits	14	247
At 31 December	<u>845</u>	<u>870</u>

There are five loans to PGH2, two of which are repayable on 13 December 2013 and earn interest at a rate of 6 month LIBOR + 125bps, one is repayable on 31 December 2013 and earns interest at a rate of 6 month LIBOR + 250bps, one is repayable on 12 May 2015 and earns interest at a rate of 6 month LIBOR + 250bps and one is repayable on 31 December 2016 and earns interest at a rate of 6 month LIBOR + 125bps. There are three loans to subsidiaries, two of which are to National Provident Life Limited (NPLL) and one is to National Provident Life Holdings Limited (NPLH). One of the loans to NPLL is repayable on 30 June 2016 and earns interest at a fixed rate of 8.75% (9.25% from July 2011), and the other is repayable on 2 September 2019 and interest is calculated based on monthly returns. The loan to NPLH has no maturity date and earns interest at a rate of 12 month LIBOR + 125bps. There are four loans to fellow subsidiary companies PGH (LCA) Limited and PGH (LCB) Limited. Each of these has one loan that is repayable on 30 June 2016 and earns interest at a rate LIBOR + 125bps and one loan that is repayable on 02 September 2024 and earns interest at a rate LIBOR + 100bps.

There was a new loan issued to PGH2, the Company's immediate parent, of £200m in July 2011. There has been no other movement on loans to Group companies during the year other than interest capitalised on the loans to PGH2 of £10m (2010: £5m) and a reduction in the value of one of the loans to subsidiary companies of £1m (2010: £nil).

27. Financial assets and financial instrument fair value hierarchy

	2011 £m	2010 £m
Loans and deposits at amortised cost	845	870
Financial assets at fair value through profit or loss		
Investment in subsidiaries	12	129
Held for trading – derivatives	1,790	916
Designated upon initial recognition		
Equities	681	1,274
Fixed and variable rate income securities	9,070	8,287
Collective investment schemes	5,889	4,527
Deposits with cedants	24	26
	<u>18,311</u>	<u>16,029</u>
Amount recoverable after 12 months	<u>11,282</u>	<u>9,966</u>

The value of loans and deposits at amortised cost amounted to £845m (2010: £870m).

Determination of fair value and fair value hierarchy of financial instruments

Level 1 financial instruments The fair value of financial instruments traded in active markets (such as publicly traded securities and derivatives) is based on quoted market prices at the period end. The quoted market price used for financial assets is the current bid price on the trade date. If the bid price is unavailable a 'last traded' approach is adopted. For units in unit trusts and shares in open ended investment companies, fair value is by reference to published bid values.

Level 2 financial instruments The fair values of investments that are not traded in an active market are determined using valuation techniques with observable market inputs. The fair value of shares and other variable yield securities and of derivative financial instruments are estimated using pricing models, discounted cash flow techniques or broker quotes. Where pricing models are used, inputs are based on market related data at the period end. 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.

Level 3 financial instruments The Company's financial assets determined by valuation techniques using non observable inputs are based on a combination of independent third party evidence and internally developed

PEARL ASSURANCE LIMITED

models Third party evidence in the form of net asset valuation statements, are used in the valuation of the majority of indirect property, private equity and hedge funds Broker quotes are received for certain bonds where the market is considered to be inactive Internally developed models have been used in the valuation of a small number of investment vehicles which due to their nature and complexity have no external market Inputs into the internally developed models are based on market observable data where available

Fair value hierarchy of financial instruments measured at fair value

At 31 December 2011	Level 1 £m	Level 2 £m	Level 3 £m	Total fair value £m
Financial assets at fair value				
Investment in subsidiaries	-	-	12	12
Derivatives	-	1,771	19	1,790
Financial assets designated at fair value through profit or loss upon initial recognition				
Equities	3	-	678	681
Fixed and variable rate income securities	7,027	1,916	127	9,070
Collective investment schemes	5,065	151	673	5,889
Deposits with cedants	-	24	-	24
	12,095	2,091	1,478	15,664
Total financial assets at fair value	12,095	3,862	1,509	17,466
	Level 1 £m	Level 2 £m	Level 3 £m	Total fair value £m
Financial liabilities at fair value				
Derivatives	-	1,083	-	1,083
Financial liabilities designated at fair value through profit or loss upon initial recognition				
Deposits received from reinsurers	-	2,526	-	2,526
Total financial liabilities at fair value	-	3,609	-	3,609
At 31 December 2010	Level 1 £m	Level 2 £m	Level 3 £m	Total fair value £m
Financial assets at fair value				
Investment in subsidiaries	-	-	129	129
Derivatives	-	916	-	916
Financial assets designated at fair value through profit or loss upon initial recognition				
Equities	629	-	645	1,274
Fixed and variable rate income securities	7,448	485	354	8,287
Collective investment schemes	3,624	148	755	4,527
Deposits with cedants	-	26	-	26
	11,701	659	1,754	14,114
Total financial assets at fair value	11,701	1,575	1,883	15,159

PEARL ASSURANCE LIMITED

	Level 1 £m	Level 2 £m	Level 3 £m	Total fair value £m
Financial liabilities at fair value				
Derivatives	-	607	11	618
Financial liabilities designated at fair value through profit or loss upon initial recognition				
Deposits received from reinsurers	-	2,415	-	2,415
Total financial liabilities at fair value	-	3,022	11	3,033

Level 3 financial instrument sensitivities

At 31 December 2011, £1,478m (2010 £1,754m) of level 3 assets are invested in debt securities, indirect properties, private equity and hedge funds. Level 3 assets in private equity and hedge funds are valued using net asset statements provided by independent third parties. Whilst such valuations are sensitive to estimates, it is not possible to calculate the impact of a change in one or more assumptions to reasonably possible alternative assumption.

Fixed and variable rate income securities categorised as level 3 assets are valued using broker quotes. Although such valuations are sensitive to estimates, it is believed that changing one or more of the assumptions to reasonably possible alternative assumptions would not change the fair value significantly.

Included in level 3 assets is an investment in a property related structure of £66m (2010 £96m) which has been valued using a multi scenario discounted cash flow model. Under the optimistic scenario, the full value of the investment would increase by £35m (2010 £36m) and in the extreme stress scenario, the fair value would decrease by £38m (2010 £63m).

Significant transfers of financial instruments between level 1 and level 2

	From level 1 to level 2 £m	From level 2 to level 1 £m
At 31 December 2011		

Financial assets at fair value

Financial assets designated at fair value through profit or loss upon initial recognition

Fixed and variable rate income securities	631	143
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All the Group's level 2 assets have been valued using standard market pricing sources, which have not changed during 2011. However, following consultation with our investment managers and pricing providers, we have updated our criteria for an active market, particularly with reference to corporate bonds, and hence have classified some assets as level 2 where they may have been level 1 in previous reports.

	From level 1 to level 2 £m	From level 2 to level 1 £m
At 31 December 2010		

Financial assets at fair value

Financial assets designated at fair value through profit or loss upon initial recognition

Fixed and variable rate income securities	46	223
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2010 saw an improvement in the liquidity of the fixed and variable rate income securities market which has resulted in a number of securities moving from level 2 into level 1. There were however, a number of securities that moved from level 1 to 2 as a result of a downgrading in their credit rating. These securities were mainly in the financial sector with issuers such as banks and insurance companies.

PEARL ASSURANCE LIMITED

Movement in level 3 financial instruments measured at fair value

	At 1 Jan 2011 £m	Total gains/ (losses) in statement of comprehensive income £m	Purchases and sales £m	Transfers (to)/from level 1 and level 2 £m	At 31 Dec 2011 £m	Unrealised gains/ (losses) on assets held at end of year £m
Investment in subsidiaries	129	1	(118)	-	12	-
Derivatives	-	-	19	-	19	10
Financial assets designated at fair value through profit or loss upon initial recognition						
Equities	645	48	(9)	(6)	678	(12)
Fixed and variable rate income securities	354	(5)	(93)	(129)	127	(24)
Collective investment schemes	755	(63)	(19)	-	673	(10)
	<u>1,883</u>	<u>(19)</u>	<u>(220)</u>	<u>(135)</u>	<u>1,509</u>	<u>(36)</u>

	At 1 Jan 2011 £m	Total gains in statement of comprehensive income £m	Purchases and sales £m	Transfers (to)/from level 1 and level 2 £m	At 31 Dec 2011 £m	Unrealised gains on liabilities held at end of year £m
Financial liabilities designated at fair value through profit or loss upon initial recognition						
Derivatives	11	(11)	-	-	-	-

Gains and losses on Level 3 financial instruments are included as income or an expense in net investment income in the statement of comprehensive income. There were no gains or losses recognised in other comprehensive income.

	At 1 Jan 2010 £m	Total gains/ (losses) in statement of comprehensive income £m	Purchases and (sales) £m	Transfers from level 1 and level 2 £m	At 31 Dec 2010 £m	Unrealised gains/ (losses) on assets held at end of year £m
Investment in subsidiaries	126	3	-	-	129	-
Financial assets designated at fair value through profit or loss upon initial recognition						
Equities	690	54	(99)	-	645	(33)
Fixed and variable rate securities	375	6	26	(53)	354	(159)
Collective investment schemes	1,141	29	(270)	(145)	755	(161)
	<u>2,332</u>	<u>92</u>	<u>(343)</u>	<u>(198)</u>	<u>1,883</u>	<u>(353)</u>

	At 1 Jan 2010 £m	Total gains in statement of comprehensive income £m	Purchases and sales £m	Transfers from level 1 and level 2 £m	At 31 Dec 2010 £m	Unrealised gains on liabilities held at end of year £m
Financial liabilities designated at fair value through profit or loss upon initial recognition						
Derivatives	-	(4)	-	15	11	-

Gains and losses on Level 3 financial instruments are included as income or an expense in net investment income in the statement of comprehensive income. There were no gains or losses recognised in other comprehensive income.

28. Stock lending and collateral

The Company lends listed financial assets held in its investment portfolio to other institutions. The Company conducts its stock lending programme only with well-established, reputable institutions in accordance with established market conventions.

The financial assets do not qualify for derecognition as the Company retains all the risks and rewards of the transferred assets except for the voting rights. The carrying value of listed financial assets lent at 31 December 2011 that have not been derecognised amounted to fixed and variable income securities of £2,902m (2010 £2,320m).

It is the Company's practice to obtain collateral in stock lending transactions, usually in the form of cash or marketable securities.

Where the Company receives collateral in the form of marketable securities which it is not permitted to sell or re-pledge except in the case of default, it is not recognised in the statement of financial position. The fair value of financial assets accepted as collateral amounts to £nil (2010 £nil).

Where the Company receives collateral in the form of cash, it is recognised in the statement of financial position along with a corresponding liability to repay the amount of the collateral received, disclosed as 'Obligations for the repayment of collateral received'. The amount recognised as a financial asset and a financial liability at 31 December 2011 is £2,960m (2010 £2,331m) and £3,031m (2010 £2,420m) respectively.

The maximum exposure to credit risk in respect of stock lending transactions is £2,902m (2010 £2,320m) of which credit risk of £2,893m (2010 £2,320m) is mitigated through the use of collateral arrangements.

Collateral and pledges

Assets accepted

It is the Company's practice to obtain collateral to mitigate the counterparty risk related to over-the-counter ("OTC") derivatives and certain reinsurance transactions, usually in the form of cash or marketable securities.

Where the Company receives collateral in the form of marketable securities which it is not permitted to sell or re-pledge except in the case of default, it is not recognised in the statement of financial position. The fair value of financial assets accepted as collateral for OTC derivatives and reinsurance transactions but not recognised in the statement of financial position amounts to £nil and £nil respectively (2010 £nil and £nil).

Where the Company receives collateral on OTC derivatives and reinsurance transactions in the form of cash it is recognised in the statement of financial position along with a corresponding liability to repay the amount of the collateral received, disclosed as 'Obligations for the repayment of collateral received' and 'Deposits received from reinsurers' respectively. The amounts recognised as financial assets and financial liabilities from cash collateral received at 31 December 2011 are set out below.

Where the Company receives collateral on OTC derivatives and reinsurance transactions in the form of cash it is recognised in the statement of financial position along with a corresponding liability to repay the amount of the collateral received, disclosed as 'Obligations for the repayment of collateral received' and 'Deposits received from reinsurers' respectively. The amounts recognised as financial assets and financial liabilities from OTC derivatives are £977m (2010 £355m) and £977m (2010 £355m) respectively. The amounts recognised as financial assets and financial liabilities from reinsurance transactions are £2,523m (2010 £2,375m) and £2,526m (2010 £2,415m) respectively.

The maximum exposure to credit risk in respect of OTC derivative assets is £1,787m (2010 £915m) of which credit risk of £1,765m (2010 £859m) is mitigated by use of collateral arrangements.

Credit risk on exchange traded derivative assets of £3m (2010 £2m) is mitigated through regular margining and the protection offered by the exchange.

The maximum exposure to credit risk in respect of reinsurance assets is £2,523m (2010 £2,375m) and £2,525m (2010 £2,414m) of this is mitigated by use of collateral arrangements.

Assets pledged

Where the Group pledges collateral in the form of cash or marketable securities and retains all the risks and rewards of the transferred assets, they continue to be recognised in the statement of financial position. The value of assets pledged at 31 December 2011 in respect of OTC derivative liabilities of £nil amounted to £1,080 (2010 £nil).

PEARL ASSURANCE LIMITED

29 Other receivables

	2011 £m	2010 £m
Investment broker balances	1	15
Other receivables	29	74
	<u>30</u>	<u>89</u>
Amount recoverable after 12 months	<u>-</u>	<u>-</u>

The carrying value of other receivables approximates to their fair values

30. Cash and cash equivalents

	2011 £m	2010 £m
Bank and cash balances	28	4
Short-term deposits (including demand and time deposits)	319	126
	<u>347</u>	<u>130</u>

The carrying amounts approximate to fair value at the period end

31 Cash flows

Cash flows from operating activities

	2011 £m	2010 £m
Profit/(loss) for the year before tax	(18)	77
Non-cash movements in profit for the year before tax		
Fair value (gains)/losses		
Investment property	3	(1)
Financial assets	(880)	(815)
Impairment of subsidiaries	198	16
Change in unallocated surplus	(13)	86
Change in deposits received from reinsurers	111	(10)
Interest expense on borrowings	4	2
Interest income on loans	(10)	(14)
Changes in operating assets and liabilities		
Change in investment assets	(322)	(1,352)
Change in net derivative assets/(liabilities)	(409)	(79)
Change in reinsurance assets	(147)	35
Change in insurance contract liabilities	642	1,483
Change in other assets	82	(63)
Change in other liabilities	1,117	189
Cash generated/(absorbed) by operations	<u>358</u>	<u>(446)</u>

32. Capital management and capital statement

Capital Management Framework

The Company's Capital Management Framework is designed to achieve the following objectives

- provide appropriate security for policyholders and meet all regulatory capital requirements whilst not retaining unnecessary excess capital,
- ensure sufficient liquidity to meet obligations to policyholders and other creditors, and
- meet the dividend expectations of owners

The framework comprises a suite of capital management policies that govern the allocation of capital throughout the Company to achieve the framework objectives under a range of stress conditions. The policy suite is defined with reference to policyholder security, creditor obligations, owner dividend policy and regulatory capital requirements

PEARL ASSURANCE LIMITED

The capital policy is set by the Board and monitored each month at both the executive and Board level. The policies ensure sufficient liquidity to meet creditor and dividend obligations through the combination of cash buffers and cash flows. Volatility in the latter is monitored at the executive and Board level through stress and scenario testing. Where cash flow volatility is judged to be in excess of the Board's risk appetite, de-risking activities are undertaken.

The capital policy is set by the Board and monitored on a daily basis. These policies ensure there is sufficient capital to meet regulatory capital requirements under a range of stress conditions. The capital policy is managed according to the risk profile and financial strength of the Company.

Regulatory capital requirements

The Company must retain sufficient capital at all times to meet the regulatory capital requirements mandated by the FSA. In addition to EU-directive-based "Pillar 1" and Group capital requirements, the FSA has also stipulated a "Pillar 2" of risk-based capital requirements that have been implemented in the UK. The Company's actual capital requirement is based on whichever of the Pillar 1 or Pillar 2 requirement turns out to be more onerous. The Company generally holds an amount of capital that is greater than the minimum required amount to allow for adverse events in the future that may use capital and might otherwise cause the Company to fail the minimum level of regulatory capital test.

Pillar 1

With the exception of with-profits businesses, the regulatory capital requirement under Pillar 1 is the total amount held in respect of investment, expense and insurance risks (the "long-term insurance capital requirement" ("LTICR")) and any additional amounts required to cover the more onerous of two specified stress tests (the "resilience capital requirement" ("RCR")). The regulatory capital requirement is then deducted from the available capital resources to give the excess capital on a regulatory basis.

A further test is required under Pillar 1 in respect of with-profits funds which may result in an additional capital requirement referred to as the "with-profits insurance capital component" ("WPICC").

The table below sets out the Company's capital resources position at 31 December 2011 as reported in the annual returns to the FSA and compares this with the total equity attributable to owners of the Company as reported in the statement of financial position.

	2011 £m	2010 £m
Total equity attributable to owners	1,011	1,103
Differences in the valuation of assets and liabilities	727	632
Unallocated Surplus	281	294
Core tier one capital in related undertakings	11	(32)
Amounts deducted from technical provisions for discounting	(5)	(7)
Deductions in related undertakings	(23)	(42)
Other tier two instruments and lower tier two capital in related undertakings	250	250
Inadmissible assets other than intangibles and own shares	(21)	(46)
Asset values in excess of Pillar 1 counterparty limits	(311)	(142)
	<hr/>	<hr/>
Capital resources on a Pillar 1 Regulatory reporting basis	1,920	2,010

The Company has complied with externally imposed capital requirements during the year. At 31 December 2011, the amount of capital that the Company was required to hold was £1,356m (2010: £1,251m) and the excess capital over that required was £565m (2010: £759m).

Pillar 2

The Pillar 2 capital requirements are based on a self-assessment methodology, the Individual Capital Assessment ("ICA"). This methodology determines the capital requirement to ensure that the Company's realistic liabilities can be met in one year's time with a 99.5% confidence level, or in other words to be able to withstand a one in 200 year event. The FSA reviews the Company's ICA and may impose additional capital requirements if necessary in the form of Individual Capital Guidance ("ICG").

Group Capital Adequacy

In addition to the requirement to maintain individual capital resources in excess of its individual capital resources requirement, the Company is required to ensure that its capital resources are sufficient to maintain group capital resources in excess of the group capital resources requirement at all times. This is calculated at the level of the Company's highest EEA insurance parent undertaking, Phoenix Life Holdings Limited ("PLHL").

The group capital resources requirement is an aggregate of the individual capital resources requirements of each of the regulated entities within the Phoenix Group. Group capital resources are based on an aggregation of the capital resources of each of the regulated entities, net of the Phoenix Group's investment in them, and net of surplus assets held in the long-term funds of the regulated entities, but without making any deduction for counterparty exposures in excess of defined limits.

There are different forms and quality of capital that may be admitted to the calculation of group capital resources and there are also restrictions which limit lower quality capital to prescribed levels. Lower quality capital which exceeds these levels must be excluded from group capital resources, with a corresponding effect on the excess of group capital resources over group capital resources requirements.

Internal capital support to With Profits funds

As noted in the Directors' Report, there is a provision for the Company's SHF to provide financial assistance or support to the Company's SERP fund. At 31 December 2011 the SHF provided support in the form of a loan of £102m (2010: £122m).

33. Risk management

The Company is exposed to a number of risks in its business including those arising from underlying assets and liabilities. The Company complies with the Group approach to risk management which is described in the performance section of Phoenix Group Holdings annual report and accounts.

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 various 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 owners.

In pursuing these objectives, the Company deploys financial assets and incurs financial liabilities. Financial assets principally comprise investments in equity securities, fixed and variable income securities, property, collective investment schemes, derivatives, reinsurance, trade and other receivables and banking deposits. Financial liabilities comprise derivative liabilities, borrowings for financial purposes, and other payables.

Asset and Liability Management framework

The use of financial instruments naturally exposes the Company to the risks associated with them, chiefly market risk, credit risk and liquidity risk.

Responsibility for agreeing the financial risk profile rests with the Board, given advice from investment managers, internal committees and the actuarial function. In setting the risk profile, the Board will receive advice from the appointed investment managers and the actuarial function holder 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 actuarial function holder will also advise the extent to which the investment risk taken is consistent with the Company's commitment to treat customers fairly.

Derivatives are used in a number of the Company's funds, within policy guidelines agreed by the Board and overseen by the Investment Committee supported by the management oversight committee. Derivatives are primarily used for efficient portfolio management or for risk hedging purposes.

More details on the Company's exposure to financial risk are provided below.

The Company is also exposed to insurance risk. Life assurance risk arises through exposure to mortality, longevity and to variances between assumed and actual experience in factors such as persistency levels and management and administrative expenses. More details on the Company's exposure to insurance risk are provided below.

The Company's overall exposure to investment risk is monitored by appropriate committees which agree policies for managing each type of risk on an ongoing basis, essentially within the Asset and 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 under each type of contract. Separate portfolios of assets are maintained for with-profits business, which includes all of the Company's participating business, non-linked non-participating business and unit linked business held within the with-profits fund.

Financial risk analysis

Transactions in financial instruments may result in the Company assuming financial risks. This includes credit risk, market risk and liquidity risk. Each of these is described below, together with a summary of how the Company manages them.

PEARL ASSURANCE LIMITED

Credit risk

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. These obligations can relate to both recognised and unrecognised assets and liabilities.

There are two principal sources of credit risk for the Company

- Credit risk which results from direct investment activities, including investments in fixed and variable rate income securities, equities, derivatives, collective investment schemes, hedge funds and the placing of cash deposits, and
- Credit risk which results indirectly from activities undertaken in the normal course of business. Such activities include premium payments, outsourcing contracts, reinsurance, and the lending of securities.

The amount disclosed in the statement of financial position in respect of all financial assets, together with rights secured under unrecognised collateral arrangements represents the Company's maximum exposure to credit risk.

Credit risk is managed by the monitoring of aggregate Company exposures to individual counterparties and by appropriate credit risk diversification. The Company manages the level of credit risk it accepts through comprehensive credit risk tolerances. In certain cases, protection against exposure to particular credit risk types may be achieved through use of derivatives. The credit risk borne by the owners on with-profits policies is dependent on the extent to which the underlying insurance fund is relying on owners' support.

Quality of credit risk

An indication of the Company's exposure to credit risk is the quality of the investments and counterparties with which it transacts. The following table provides information regarding the aggregate credit exposure with external credit ratings.

At 31 December 2011

	AAA £m	AA £m	A £m	BBB £m	BB £m	B and below £m	Non rated £m	Total £m
Loans and deposits	-	-	-	-	-	-	845	845
Derivatives	-	-	1,650	-	-	-	140	1,790
Fixed and variable rate income securities	4,980	467	1,424	960	156	96	987	9,070
Deposits with ceding undertakings	-	-	-	-	-	-	24	24
Reinsurers' share of insurance contract liabilities	-	-	3	-	-	-	2,523	2,526
Cash and cash equivalents	-	-	347	-	-	-	-	347

At 31 December 2010

	AAA £m	AA £m	A £m	BBB £m	BB £m	B and below £m	Non rated £m	Total £m
Loans and deposits	-	-	-	-	-	-	870	870
Derivatives	-	550	353	-	-	-	13	916
Fixed and variable rate income securities	5,090	517	1,218	909	98	126	329	8,287
Deposits with ceding undertakings	-	-	-	-	-	-	26	26
Reinsurers' share of insurance contract liabilities	-	-	4	-	-	-	2,375	2,379
Cash and cash equivalents	-	130	-	-	-	-	-	130

Non-equity based derivatives are included in the credit risk table above and are subject to appropriate collateral arrangements.

Credit ratings have not been disclosed in the above tables for holdings in collective investment schemes. The credit quality of the underlying debt securities within these vehicles is managed by the safeguards built into the investment mandates for these vehicles.

It is also the Company's policy to maintain accurate and consistent internal risk ratings across its asset portfolio. This enables management to focus on the applicable risks and to compare credit exposures across all lines of business, geographical regions and products. The rating system is supported by a variety of financial analytics combined with market information to provide the main inputs for the measurement of counterparty risk. All internal risk ratings are tailored to the various categories of assets and are derived in accordance with the Company's

rating policy The attributable risk ratings are assessed and updated regularly and significant exposures and breaches are reported to the Board and to the Investment Committee

A further indicator of the quality of the Company's financial assets is the extent to which they are neither past due nor impaired The Company had no material assets which were impaired or past due (2010 £nil)

Concentration of credit risk

Concentration of credit risk might exist where the Company has significant exposure to an individual counterparty or a group of counterparties with similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic and other conditions The Company counterparty risk is monitored by the counterparty limits contained within the investment guidelines and investment management agreements, overlaid by regulatory requirements

The Company is also exposed to concentration risk outsourced service providers This is due to the nature of the outsourced service market The Company operates a policy to manage outsource service counterparty exposures and the impact from default is reviewed regularly by executive committees and measured through the ICA stress and scenario testing

Reinsurance

The Company is exposed to credit risk as a result of insurance risk transfer contracts with reinsurers This also gives rise to concentration of risk with individual reinsurers, due to the nature of the reinsurance market and the restricted range of reinsurers that have acceptable credit ratings The Company manages its exposure to reinsurance credit risk through the operation of a Reinsurance Policy and regular monitoring of exposures at the Reinsurance Management Committee The Company's largest reinsurance counterparty is Opal, a fellow group company, the reinsurance asset recoverable at 31 December 2011 was £2,523m (2010 £2,375m)

Collateral

The credit risk of the Company is mitigated, in certain circumstances, by entering into collateral agreements The amount and type of collateral required depends on an assessment of the credit risk of the counterparty Guidelines are implemented regarding the acceptability of types of collateral and the valuation parameters Collateral is mainly obtained for stock lending, certain reinsurance arrangements and to provide security against the maturity proceeds of derivative financial instruments Management monitors the market value of the collateral received, requests additional collateral when needed and performs an impairment valuation when impairment indicators exist and the asset is not fully secured Further details are given in notes 28 above

Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices Market risk comprises interest risk, currency risk and other price risk

The Company is mainly exposed to market risk as a result of

- the mismatch between liability profiles and the related asset investment portfolios,
- the investment of surplus assets including owners' reserves yet to be distributed, surplus assets within the long-term funds and assets held to meet regulatory capital and solvency requirements, and
- the income flow of management charges from the invested assets of the Company

The Company manages the levels of market risk that it accepts through the operation of an Investment Management policy and an approach to investment management that determines

- the constituents of market risk for the Company,
- the basis used to fair value financial assets and liabilities,
- the asset allocation and portfolio limit structure,
- diversification from benchmarks by type of instrument and geographical area,
- the net exposure limits by each counterparty or group of counterparties, geographical and industry segments,
- control over hedging activities,
- reporting of market risk exposures and activities, and
- monitoring of compliance with market risk policy and review of market risk policy for pertinence to the changing environment

All operations comply with regulatory requirements relating to the taking of market risk

Interest risk

Interest risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market 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

Interest risk is managed by matching assets and liabilities where practicable and by entering into derivative arrangements for hedging purposes where appropriate This is particularly the case for the non-profit funds For

with-profits business, some element of investment mismatching is permitted where it is consistent with the principles of treating customers fairly. The with-profits funds of the Company provide capital to allow such mismatching to be effected. In practice, the Company maintains an appropriate mix of fixed and variable rate income securities 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 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 in equity. It 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 to equity.

With-profits business and non-participating business within the with-profits funds are exposed to interest risk as guaranteed liabilities are valued relative to market interest rates and investments include fixed and variable rate interest securities and derivatives. For with-profits 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 these funds to the Company result is determined primarily by either the owners' share of the declared annual bonus or by the owners' interest in any change in value in the capital advanced to the Company's with-profits funds.

In the non-profit funds, policy liabilities are duration matched with primarily fixed and variable rate income 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 profit after tax in respect of a full financial year and in equity of £17m (2010: £13m). A decrease of 1% in interest rates, with all other variables held constant, would result in additional profit after tax in respect of a full financial year and an increase in equity of £25m (2010: £5m).

Price risk

The Company's price risk exposure relates to financial assets and liabilities whose values will fluctuate as a result of changes in market prices other than from interest rate and currency fluctuations. This is due to factors specific to individual instruments, their issuers or factors affecting all instruments traded in the market. Accordingly, the Company limits its exposure to any one counterparty in its investment portfolios and to any one foreign market.

The portfolio of marketable equity securities and property investments which is carried in the statement of financial position at fair value has exposure to price risk. The Company's objective in holding these assets is to earn higher long-term returns by investing in a diverse portfolio of high quality equities and properties. Portfolio characteristics are analysed regularly and price risks are actively managed in line with investment mandates. The Company's holdings are diversified across industries, and concentrations in any one company or industry are limited.

Equity and property price risk is primarily borne in respect of assets held in with-profits funds. For with-profits fund policyholders' future bonuses will be impacted by the investment returns achieved and hence the price risk. In addition some equity investments are held in respect of owners' funds. The Company as a whole is exposed to price risk fluctuations impacting the income flow of management charges from the invested assets of all funds.

Equity and property price risk is managed through the agreement and monitoring of financial risk profiles that are appropriate for maintaining adequate regulatory capital and treating customers fairly. This is largely achieved through asset class diversification.

The impact of non-government fixed and variable rate income securities and, *inter alia*, the change in market credit spreads during the year are fully reflected in the values shown in these financial statements. Similarly, the value of derivatives that the Company holds takes into account fully the changes in swap spreads.

The sensitivity analysis for equity and property price 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 to equity.

A 10% increase 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 in equity of £2m (2010: £2m). A 10% decrease 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 in equity of £2m (2010: £2m).

There is also an exposure to spread changes affecting the prices of corporate bonds and derivatives. This exposure applies to the with-profits fund, non-profit funds (where risks and rewards fall wholly to owners) and in owners' funds.

A 100 basis point widening of credit spreads, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full financial year and in equity of £8m (2010: £3m). A 100 basis point narrowing of credit spreads, with all other variables held constant, would result in an increase in the profit after tax in respect of a full financial year and in equity of £10m (2010: £9m).

Currency risk

The Company's principal transactions are carried out in sterling and therefore its exchange risk is limited principally to foreign operations

The Company's financial assets are primarily denominated in the same currencies as its insurance liabilities. Thus the main foreign exchange risk arises from recognised assets and liabilities denominated in currencies other than those in which insurance liabilities are expected to be settled and, indirectly, from the earnings of UK companies arising abroad

The with-profits funds have an exposure to overseas assets which is not driven by liability considerations. The purpose of this exposure is to reduce overall risk whilst maximising returns by diversification. This exposure is limited and managed through investment mandates which are subject to the oversight of the Investment Committees. Fluctuations in exchange rates from holdings in overseas assets are hedged against currency risks. Sensitivity of profit after tax and in equity to fluctuations in currency exchange rates is not considered significant at 31 December 2011 or 31 December 2010, since unhedged exposure to foreign currency was relatively low

Liquidity risk

Liquidity risk is defined as the failure of the Company to maintain adequate levels of financial resources to enable it to meet its obligations as they fall due. The Company has exposure to liquidity risk as a result of its inability to meet its short term cash flow requirements, and to meet its obligations to policy liabilities and the operating requirements of its subsidiaries

The Board has defined a number of governance objectives and principles and the liquidity risk framework is designed to ensure that

- liquidity risk is managed in a manner consistent with the Board's strategic objectives, risk appetite and Principles and Practices of Financial Management ("PPFM"),
- cash flows are appropriately managed and the reputation of the Company and the Phoenix Group are safeguarded, and
- appropriate information on liquidity risk is available to those making decisions

The Company's policy is to maintain sufficient liquid assets of suitable credit quality at all times and, where appropriate, to have access to borrowings so as to be able to meet all foreseeable current liabilities as they fall due in a cost-effective manner. Forecasts are prepared regularly to predict required liquidity levels over both the short and medium term allowing management to respond appropriately to changes in circumstances

Some of the Company's commercial property investments are held through a unit trust. This unit trust has the power to restrict and/or suspend withdrawals, which would, in turn, affect liquidity. To date, the unit trust has continued to process both investments and realisations in a normal manner and has not imposed any restrictions or delays

The Company's investments in the Ignis Fundamental Solutions Fund ("IFSF") and the Ignis Strategic Solutions Fund ("ISSF") are managed by Ignis Asset Management Limited, a fellow group company. The fund managers of the underlying funds have the power to impose gates on redemptions which can restrict available liquidity within the funds

The following table provides a maturity analysis showing the remaining contractual maturities of the Company's undiscounted financial liabilities and associated interest. The contractual maturities of liabilities under insurance contracts are included based on the estimated timing of the amounts recognised in the statement of financial position in accordance with the requirements of IFRS 4

At 31 December 2011

	1 year or less or on demand £m	1-5 years £m	Greater than 5 years £m	No fixed term £m	Total £m
Liabilities under insurance contracts	883	2,600	6,331	2,294	12,108
Borrowings	-	-	250	-	250
Deposits received from reinsurers	-	-	-	2,526	2,526
Derivatives	30	111	1,744	-	1,885
Obligations for repayment of collateral received	3,177	188	643	-	4,008
Payables related to direct insurance contracts	76	39	-	-	115
Accruals	7	-	-	-	7
Other payables	64	-	-	-	64

PEARL ASSURANCE LIMITED

At 31 December 2010

	1 year or less or on demand £m	1-5 years £m	Greater than 5 years £m	No fixed term £m	Total £m
Liabilities under insurance contracts	3,988	2,500	3,336	1,642	11,466
Borrowings	-	-	250	-	250
Derivatives	109	65	782	-	956
Deposits received from reinsurers	-	-	-	2,415	2,415
Obligations for repayment of collateral received	2,464	58	253	-	2,775
Payables related to direct insurance contracts	63	40	-	-	103
Accruals	7	-	-	-	7
Other payables	104	-	-	-	104

Insurance risk

Insurance risk refers to the risk that the frequency or severity of insured events may be worse than expected and includes expense risk. The Company's liabilities under insurance contracts are detailed in note 12 and include the following sources of insurance risk:

- Mortality – Higher than expected death claims on assurance products,
- Longevity – Lower than expected number of deaths experienced on annuity products or greater than expected improvements in life expectancy on immediate and deferred annuity products,
- Expenses – Policies cost more to administer than expected,
- Lapses – An adverse movement in either surrender rates or persistency rates on policies with guaranteed benefits leading to losses. This includes the risk of greater than expected policyholder option exercise rates giving rise to increased claims costs.

Objectives and policies for mitigating insurance risk

The Company uses several methods to assess and monitor insurance risk exposures both for individual types of risks insured and overall risks. These methods include internal risk measurement models, experience analyses, external data comparisons, sensitivity analyses, scenario analyses and stress testing. In addition to this, mortality, longevity and morbidity risks are in certain circumstances mitigated by the use of reinsurance.

The profitability of the run-off of the Company's closed long-term insurance business depends to a significant extent on the values of claims paid in the future relative to the assets accumulated to the date of claim. Typically, over the lifetime of a contract, premiums and investment returns exceed claim costs in the early years and it is necessary to set aside these amounts to meet future obligations. The amount of such future obligations is assessed on actuarial principles by reference to assumptions about the development of financial and insurance risks.

It is therefore necessary for the Board to make decisions, based on actuarial advice, which ensure an appropriate accumulation of assets relative to liabilities. These decisions include investment policy, bonus policy and, where discretion exists, the level of payments on early termination.

Sensitivities

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. Sometimes allowance must also be made for the effect on future assumptions of management or policyholder actions in certain economic scenarios. The most significant non-economic sensitivities arise from mortality, longevity and lapse risk.

A decrease of 5% in assurance mortality, with all other variables held constant, would result in an increase in the profit after tax in respect of a full year and an increase in equity of £2m (2010: £2m). An increase of 5% in assurance mortality, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full year and a decrease in equity of £2m (2010: £2m).

A decrease of 5% in annuitant longevity, with all other variables held constant, would result in an increase in the profit after tax in respect of a full year and an increase in equity of £21m (2010: £17m). An increase of 5% in annuitant longevity, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full year and a decrease in equity of £22m (2010: £17m).

A decrease of 25% in lapse rates, with all other variables held constant, would result in an increase in the profit after tax in respect of a full year and a decrease in equity of £1m (2010: £1m). An increase of 25% in lapse rates,

PEARL ASSURANCE LIMITED

with all other variables held constant, would result in a decrease in the profit after tax in respect of a full year and an increase in equity of £1m (2010 £1m)

Assumptions

Valuation of participating insurance and investment contracts

For participating business, which is with-profits business (insurance), the insurance contract liability is stated at the amount of the realistic value of the liabilities, adjusted to exclude the owners' share of future bonuses and the associated tax liability as required by FRS 27 "Life Assurance". This is a market consistent valuation, which involves placing a value on liabilities similar to the market value of assets with similar cash flow patterns

Valuation of non-participating insurance contracts

The non-participating insurance contract liabilities are determined using a gross premium valuation method

Process used to determine assumptions

For participating business the assumptions about future demographic trends are intended to be "best estimates". They are determined after considering the Company's recent experience and/or relevant industry data. Economic assumptions are market consistent.

For other business, demographic assumptions are derived by adding a prudent margin to best estimate assumptions. Economic assumptions are prudent estimates of the returns expected to be achieved on the assets backing the liabilities.

During the year a number of changes were made to assumptions to reflect changes in expected experience or to harmonise the approach across the Phoenix Group. The impact of material changes during the year were as follows:

	Increase/ (decrease) in insurance liabilities 2011 £m	Increase/ (decrease) in insurance liabilities 2010 £m
Change in longevity assumptions	(9)	(2)
Change in persistency assumptions	2	8
Change in expenses assumptions	3	-

Valuation interest rate

For participating business the liabilities are determined stochastically using an appropriate number of risk neutral scenarios produced by an economic scenario generator calibrated to market conditions and gilt yields as at the valuation date.

For non-participating business, assets are firstly hypothecated to classes of business being valued. The valuation interest rates for each block of business are based on the expected returns of the hypothecated assets. The yield is then adjusted to make allowance for credit risk, liquidity risk, reinvestment risk and investment management expenses.

Valuation interest rates for the non-participating business are typically

	2011	2010
Product		
Life non-profit non-linked	2.61%	3.57%
Pension non-profit non-linked	2.21%	3.77%
Life annuities	3.52%	3.98%
Term assurance	2.61%	3.57%
Pension annuities in payment	3.77%	4.16%
Deferred pension annuities	2.21%	3.77%
Index Linked Annuities	2.97%	3.95%

Expense inflation

Expenses are assumed to increase at the rate of increase in the Retail Price Index ("RPI") or Retail Price Index excluding mortgage payments ("RPIX") plus typical fixed margins in accordance with the various Management Service Agreements ("MSAs") the Company has in place with outsourced service providers. For with-profits business the rate of RPI inflation is determined within each stochastic scenario. For other business it is based on the Bank of England inflation spot curve. For MSAs with contractual increases set by reference to national average earnings inflation, this is approximated as RPI inflation plus 1%. In instances in which inflation risk is not mitigated, a further margin for adverse deviations may then be added to the rate of expense inflation.

PEARL ASSURANCE LIMITED

Mortality and longevity rates

Mortality rates are based on published tables, adjusted appropriately to take account of changes in the underlying population mortality since the table was published, company experience and forecast changes in future mortality. Where appropriate, a margin is added to assurance mortality rates to allow for adverse future deviations. Annuity mortality rates are adjusted to make allowance for future improvements in pensioner longevity. The mortality assumptions were varying proportions of the following published tables:

	Published Table 2011	Published Table 2010
Annuities in payment (UK – level)	Modified RMV00 Modified RFV00	Modified RMV00 Modified RFV00
Annuities in payment (UK – index linked)	Modified RMV00 Modified RFV00	Modified RMV00 Modified RFV00
Annuities in payment (Euro denominated)	-	-
Deferred Annuities (UK, in deferment)	AMC00 AFC00	AMC00 AFC00
Whole of life and endowments	AMC00 AFC00	AMC00 AFC00
Term assurance	AM80 AF80	AM80 AF80

A sample of the assumed future annual longevity improvement rates is shown below.

Females	2012	2022	2032	2042	2052
Age 60	1.84%	3.29%	3.18%	-	-
Age 70	2.65%	2.51%	2.79%	2.70%	-
Age 80	3.37%	2.41%	2.10%	2.18%	2.17%
Males	2012	2022	2032	2042	2052
Age 60	1.45%	2.48%	3.07%	-	-
Age 70	2.61%	1.80%	2.40%	2.69%	-
Age 80	3.63%	2.11%	1.77%	2.14%	2.17%

Lapse rates

The assumed rates for surrender and voluntary premium discontinuance in the participating business depend primarily on the length of time a policy has been in force. Withdrawal rates used in the valuation of with-profits policies are based on observed experience and adjusted when it is considered that future policyholder behaviour will be influenced by different considerations than in the past. In particular, it is assumed that withdrawal rates for unissued with-profits contracts will be higher on policy anniversaries on which Market Value Adjustments do not apply.

Policyholder options and guarantees

Some of the Company's products give potentially valuable guarantees, or give options to change policy benefits which can be exercised at the policyholders' discretion. These products are described below.

Most with-profits contracts give a guaranteed minimum payment on a specified date or range of dates or on death if before that date or dates. For pensions contracts, the specified date is the policyholder's chosen retirement date or a range of dates around that date. For endowment contracts, it is the maturity date of the contract. For with-profits bonds it is often a specified anniversary of commencement, in some cases with further dates thereafter. Annual bonuses when added to with-profits contracts usually increase the guaranteed amount.

There are guaranteed surrender values on a small number of older contracts.

Some pensions contracts include guaranteed annuity options (see deferred annuities below for details). The total amount provided in the with-profits funds in respect of the future costs of guaranteed annuity options are £1,221m (2010: £866m).

Discretionary participating bonus rate

The regular bonus rates assumed in each scenario are determined in accordance with the Company's PPFM. Final bonuses are assumed at a level such that maturity payments will equal asset shares subject to smoothing rules set out in the PPFM.

With-profits deferred annuities participate in profits only up to the date of retirement. At retirement, a guaranteed cash option allows the policyholder to commute the annuity benefit into cash on guaranteed terms.

PEARL ASSURANCE LIMITED

In common with other life companies in the UK 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, are included in liabilities arising under insurance contracts. The total amount provided in the with-profits funds in respect of the review and possible redress relating to pension policies, including associated costs, are £394m (2010 £329m)

Managing product risk

The following sections give an assessment of the risks associated with the Company's main life assurance products and the ways in which the Company manages those risks

The following tables provide a product analysis of the liabilities under insurance contracts and reinsurers' share of insurance contract liabilities within the statement of financial position

	2011 Gross		2011 Reinsurance	
	Insurance contracts £m	Investment contracts with DPF £m	Insurance contracts £m	Investment contracts with DPF £m
With-profits funds				
Pensions				
Deferred annuities – with guarantees	2,700	-	-	-
Immediate annuities	59	-	-	-
Unitised with-profits	-	2,716	-	-
Total pensions	2,759	2,716	-	-
Life				
Unitised with-profits	189	440	-	-
Life with-profits	1,000	-	-	-
Total life	1,189	440	-	-
Other	1,315	7	-	-
Non-profit funds				
Deferred annuities – without guarantees	13	-	-	-
Immediate annuities	3,630	-	2,529	-
Protection	39	-	(3)	-
	<u>8,945</u>	<u>3,163</u>	<u>2,526</u>	<u>-</u>
	2010 Gross		2010 Reinsurance	
	Insurance contracts £m	Investment contracts with DPF £m	Insurance contracts £m	Investment contracts with DPF £m
With-profits funds				
Pensions				
Deferred annuities – with guarantees	2,343	-	-	-
Immediate annuities	75	-	-	-
Unitised with-profits	-	2,785	-	-
Total pensions	2,418	2,785	-	-
Life				
Unitised with-profits	202	473	-	-
Life with-profits	1,143	-	-	-
Total life	1,345	473	-	-
Other	1,194	7	(7)	-
Non-profit funds				
Deferred annuities – without guarantees	12	-	-	-
Immediate annuities	3,202	-	2,383	-
Protection	30	-	3	-
	<u>8,201</u>	<u>3,265</u>	<u>2,379</u>	<u>-</u>

With-profits fund (Unitised and Traditional)

The Company operates two with-profits funds in which the with-profits policyholders benefit from a discretionary annual bonus (guaranteed once added in most cases) and a discretionary final bonus. Non-profit business is

also written in the with-profits funds and includes immediate annuities and deferred annuities with Guaranteed Annuity Rates ("GAR")

The investment strategy of each fund differs, but is broadly to invest in a mixture of fixed and variable rate income securities, equities and property and other asset classes in such proportions as is appropriate to the investment risk exposure of the fund and its capital resources

The Company has significant discretion regarding investment policy, bonus policy and early termination values. The process for exercising discretion in the management of the with-profits fund is set out in the PPFM for each with-profits fund and is overseen by with-profits committees. Advice is also taken from the with-profits actuary. Compliance with the PPFM is reviewed annually and reported to the FSA and policyholders.

The bonuses are designed to distribute to policyholders a fair share of the return on the assets in the with-profits funds together with other elements of the experience of the fund. The owners of the Company are entitled to receive one-ninth of the cost of bonuses declared for one fund and £nil for the other.

Unitised and traditional with-profits policies are exposed to equivalent risks, the main difference being that unitised with-profits policies purchase notional units in a with-profits fund whereas traditional with-profits policies do not. Benefit payments for unitised policies are then dependent on unit prices at the time of a claim, although charges may be applied. A unitised with-profits fund price is typically guaranteed not to fall and increases in line with any discretionary bonus payments over the course of one year.

Deferred annuities

Deferred annuity policies are written to provide either a cash benefit at retirement, which the policyholder can use to buy an annuity on the terms then applicable, or an annuity payable from retirement. The policies contain an element of guarantee expressed in the form that the contract is written in i.e. to provide cash or an annuity. Deferred annuity policies written to provide a cash benefit may also contain an option to convert the cash benefit to an annuity benefit on guaranteed terms, these are known as Guaranteed Annuity Rates ("GAR") policies.

During the last decade, interest rates and inflation have fallen and life expectancy has increased more rapidly than originally anticipated. Deferred annuity policies which are written to provide annuity benefits are managed in a similar manner to immediate annuities and are exposed to the same risks.

The guaranteed terms on GAR policies are more favourable than the annuity rates currently available in the market available for cash benefits.

The option provisions on GAR policies are particularly sensitive to downward movements in interest rates, increasing life expectancy and the proportion of customers exercising their option. Adverse movements in these factors could lead to a requirement to increase reserves which could adversely impact profit and potentially require additional capital. In order to address the interest rate risk (but not the risk of increasing life expectancy or changing customer behaviour with regard to exercise of the option), the Company has purchased derivatives that provide protection against an increase in liabilities and have thus reduced the sensitivity of profit to movements in interest rates.

The Company seeks to manage this risk in accordance with both the terms of the issued policies and the interests of customers, and has obtained external advice supporting the manner in which it operates the long-term funds in this respect.

Immediate annuities

This type of annuity is purchased with a single premium at the outset, and is paid to the policyholder for the remainder of their lifetime. Payments may also continue for the benefit of a surviving spouse or partner after the annuitant's death. Annuities may be level, or escalate at a fixed rate, or may escalate in line with a price index and may be payable for a minimum period irrespective of whether the policyholder remains alive.

The main risks associated with this product are longevity and investment risks. Longevity risk arises where the annuities are paid for the lifetime of the policyholder, and is managed through the initial pricing of the annuity and through reinsurance (appropriately collateralised) or transfer of existing liabilities. Annuities may also be a partial 'natural hedge' against losses incurred in protection business in the event of increased mortality (and vice versa) although the extent to which this occurs will depend on the similarity of the demographic profile of each book of business.

The pricing assumption for mortality risk is based on both historic internal information and externally generated information on mortality experience, including allowances for future mortality improvements. Pricing will also include a contingency margin for adverse deviations in assumptions.

Investment risk depends on the extent to which the annuity payments under the contracts have been matched by suitable assets which is managed under the ALM framework. Asset/liability modelling is used to monitor this position on a regular basis.

PEARL ASSURANCE LIMITED

Protection

These contracts are typically secured by the payment of a regular premium payable for a period of years providing benefits payable on certain events occurring within the period. The benefits may be a single lump sum or a series of payments and may be payable on death, serious illness or sickness.

The main risk associated with this product is the claims experience and this risk is managed through the initial pricing of the policy (based on actuarial principles), the use of reinsurance and a clear process for administering claims.

34. Operating leases

Operating lease rentals charged within administrative expenses amounted to £1m (2010 £1m)

The Company has commitments under non-cancellable operating leases as set out below

	2011 £m	2010 £m
Not later than one year	1	1
Later than one year and no later than five years	6	6
Later than five years	-	-
	<u>7</u>	<u>7</u>

These leases relate to closed offices on which rent is still payable

35 Commitments

	2011 £m	2010 £m
To subscribe to private equity funds and other unlisted assets	342	407
To purchase, construct or develop investment property	61	80

The Company has sufficient liquidity to settle these commitments if required

36 Related party transactions

The Company enters into transactions with related parties in its normal course of business. These are at arm's length on normal commercial terms.

Pearl Group Services Limited provides management services to the Company, in the form of staff and other services, under a management services agreement. The charge made to the Company for the year ended 31 December 2011 amounted to £92m (2010 £52m) and at the end of the year £nil (2010 £nil) remained outstanding.

Ignis Investment Services Limited, a fellow subsidiary and its subsidiaries provide investment management services to the Company in accordance with a number of investment management agreements. The charge made to the Company for the year ended 31 December 2011 amounted to £17m (2010 £24m) and at the end of the year £nil (2010 £nil) remained outstanding.

In the year ended 31 December 2011 the Company received dividends from NPLH of £75m (2010 £88m) and paid dividends to its immediate parent company of £35m (2010 £103m). In addition, the Company received interest on loans to its subsidiaries of £7m (2010 £15m), received interest on loans to its parent of £6m (2010 £6m), capitalised interest on loans to its parent of £10m (2010 £5m) and paid interest on loans from its parent of £4m (2010 £2m). The Company also received interest from another group company of £3m (2010 £nil).

At 31 December 2011, the Company held 540,612 (2010 512,645) ordinary shares in Phoenix Group Holdings, its ultimate parent company, which had a market value of £3m (2010 £3m).

Reinsurance transactions

	2011 £m	2010 £m
Reinsurance ceded to fellow subsidiaries		
Premiums	4	3
Claims	(2)	(7)
Share of reinsurance assets	<u>2,523</u>	<u>2,382</u>

PEARL ASSURANCE LIMITED

Amounts due to related parties

	2011 £m	2010 £m
Loans due to parent	250	250
Deposits received from reinsurers	2,525	2,414
Other amounts due to fellow subsidiaries	13	10
	<u>2788</u>	<u>2674</u>

Amounts due from related parties

	2011 £m	2010 £m
Loans due from parent	603	393
Other amounts due from parents	-	3
Loans due from subsidiary companies	198	199
Loans due from fellow subsidiaries	30	31
Other amounts due from subsidiaries	16	18
Other amounts due from fellow subsidiaries	27	2
	<u>874</u>	<u>646</u>

Key management compensation

The total compensation allocated to the Company and payable to employees classified as key management, which comprises the Directors, is disclosed in note 5

During the year to 31 December 2011, key management and other family members had no other transactions with the Company

Parent and ultimate parent entity

Information on the Company's parent and ultimate parent is given in note 38

37 Events after the reporting period

On 24 February 2012 the Company made a capital contribution of £50m to NP Life Holdings Limited, a subsidiary Company

On 7 March 2012, the Company made a second capital contribution of £50m to NP Life Holdings Limited, a subsidiary Company

38 Other information

The Company's principal place of business is the United Kingdom. The Company's immediate parent is Pearl Group Holdings (No 2) Limited and its ultimate parent is Phoenix Group Holdings, a company incorporated in the Cayman Islands and resident in Jersey. A copy of the financial statements of Phoenix Group Holdings can be obtained from the Company Secretary, 1st Floor, 32 Commercial Street, St Helier, Jersey, JE2 3RU