

**SCOTTISH PROVIDENT LIMITED**  
**REPORT AND FINANCIAL STATEMENTS**

**31 DECEMBER 2009**

**INCORPORATED IN SCOTLAND**

Registration No. SC212709



## **Directors' report**

Company registration number: SC212709

The Directors present their annual report on the affairs of the Company, together with the financial statements and auditors' report, for the year ended 31 December 2009.

### **Business review**

#### ***Principal activities***

During the year the Company undertook no long term insurance business following the Part VII transfer detailed below. Following this transfer, the Company's principal activity has been the investment of surplus funds.

#### ***Change in ultimate parent undertaking***

On 2 September 2009, the shareholders of Pearl Group Limited (subsequently renamed Pearl Group Holdings (No.2) Limited) ("PGH2"), which at the time was the Company's ultimate parent undertaking, exchanged their interests in the Group for the issue of shares in Liberty Acquisitions Holdings (International) Company. Following this, Liberty Acquisitions Holdings (International) Company became the Company's ultimate parent undertaking and subsequently changed its name to Pearl Group. On 15 March 2010, Pearl Group changed its name to Phoenix Group Holdings.

Also on 2 September 2009, the Financial Services Authority lifted the Own Initiative Variation in Permission ("OIVoP") which it had placed on the PGH2 group in 2008.

#### ***Corporate developments***

Restructuring to simplify the legal and fund structures of the life insurance companies within the group has been taking place during the year. With effect from 1 January 2009, the long term business and part of the shareholders' funds of the Company were transferred to Phoenix Life Limited (PLL), a fellow group company, for £nil consideration in accordance with the terms of a scheme under Part VII of the Financial Services and Markets Act 2000 approved by the High Court on 30 January 2009.

Following the Part VII scheme, the Board of Directors approved a reduction in the Company's issued share capital to £1 on 25 March 2009. Further details of the Part VII scheme and capital reduction are set out at note 1.

Following the restructuring of the Company's operations, the Board submitted an application to the Financial Services Authority (FSA) requesting cancellation of the Company's authorisation to undertake long term business. This application was approved by the FSA on 11 December 2009, and from that date the Company was no longer authorised to transact long-term business.

#### ***Operational activities and key performance indicators***

The Board and management monitor business performance via a range of performance indicators, the key financial reporting items being profits in comparison to annual and quarterly targets and solvency in comparison to internal and external regulatory requirements. Details of the profit for the year are set out on page 12 and the Company's capital management process and capital resources are outlined at note 34.

#### ***Principal Risks***

Following the Part VII transfer referred to above, the Company's principal risks are solely in relation to the counterparty risk of default in relation to the loans granted to its immediate parent company, Pearl Life Holdings Limited ("PLH") or the underlying deposits within collective investment schemes held during the year.

#### ***Going concern***

The Directors' report summarises the activities of the Company, discusses the principal risks and uncertainties it faces and comments on material developments. Notes 33 and 34 to the financial statements summarise the Company's risk and capital management objectives and policies together with its financial risks.

After making enquiries and considering in detail the Company's individual regulatory capital requirements, together with the potential impact on these from issues arising elsewhere within the Group, 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' report continued**

### ***Future developments***

Following the transfer of the Company's long term business and its subsequent de-authorisation as an insurer, the Directors continue to review the future operations of the Company within the Phoenix Group.

### ***Dividends***

During the year, the Company paid an interim dividend of £7m (2008: £nil).

### ***Share Capital***

Details of the share capital structure of the Company are given in note 11 to the financial statements. Details of the capital restructuring undertaken during the year are set out in notes 11 and 12.

### ***Employee information***

Pearl Group Management Services Limited ("PGMS"), a fellow group company, provided services to the Company and accordingly the Company had no employees in the current or prior year. Employee policies and practices are managed on a group basis and are set out in the report and financial statements of the ultimate parent undertaking.

### ***Directors***

Except as shown, the Directors of the Company throughout the year were:

M Dale	(resigned 22 April 2009)
A B Davidson	(resigned 22 April 2009)
D G R Ferguson	(resigned 22 April 2009)
E J C Hawkes	(resigned as alternate director to H E M Osmond 22 April 2009)
K Luscombe	(resigned 23 December 2009)
M J Merrick	
J S Moss	
H E M Osmond	(resigned 22 April 2009)
I B Owen	(resigned 22 April 2009)
M D Ross	(resigned 22 April 2009)
J S B Smith	
L G Tamberlin	(resigned as alternate director to M Dale 22 April 2009)

Pearl Group Holdings (No. 2) Limited ("PGH2") has agreed to provide an Indemnity to certain persons associated with that company and its subsidiaries. These persons include nominated directors and secretaries of PGH2, directors and secretaries of subsidiary companies such as the Company together with alternate directors and approved persons, being persons in relation to whom the Financial Services Authority has given its approval under section 59 of the Financial Services and Markets Act 2000 ("FSMA") for the performance of a controlled function. This indemnity will cover all losses, costs and expenses incurred by an indemnified person incurred in the exercise, execution and discharge of his duties, or connected to the same, to the fullest extent permitted, consistent with the Companies Act 2006 and the FSA Rules. In addition, with effect from, and on, 1 March 2010, Impala has also agreed to provide an Indemnity to certain persons associated with the Company. These persons include the Company's directors, Secretary and approved persons. This indemnity will cover all losses, costs and expenses incurred by an indemnified person in the exercise, execution and discharge of his duties, or connected to the same, to the fullest extent permitted, consistent with the Companies Act 2006 and the FSA Rules. Both indemnities state that they do not apply to any loss suffered or incurred by an indemnified person to the extent that he is indemnified by any third party (including under any Directors & Officers liability insurance). Directors, alternate directors and company secretaries of Pearl Group Holdings (No. 1) Limited and former subsidiaries of that company (including members of the Scottish Provident Fund Supervisory Committee) may still benefit from the provisions of an earlier Deed of Indemnity entered into by that company.

## **Directors' report continued**

### ***Statement of Directors' responsibilities***

The Directors are responsible for preparing their report and financial statements. Company law requires the Directors to prepare such financial statements in accordance with the Companies Act 2006. The Directors have chosen to prepare financial statements for the Company in accordance with IFRS and Article 4 of the IAS Regulations.

International Accounting Standard 1 requires that financial statements present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's 'Framework for the Preparation and Presentation of Financial Statements'. In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable IFRS.

Directors are also required to:

- properly select and apply accounting policies;
- 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 entity's financial position and financial performance; and
- prepare the financial statements on a going concern basis unless, having assessed the ability of the Company to continue as a going concern, management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company, for safeguarding the assets, for taking reasonable steps for the prevention and detection of fraud and other irregularities and for the preparation of a Directors' report which complies with the requirements of the Companies Act 1985.

### ***Payment of suppliers***

In the forthcoming year, it is expected that goods and services will continue to be supplied to the Company by Pearl Group Management Services Limited. On this basis, Pearl Group Management Services Limited will continue to be responsible for agreeing terms and conditions under which business is to be transacted and for making suppliers aware of these before business is contracted. It is policy to ensure payments are made in accordance with legal and contractual obligations.

Details of payment policy and average creditor days are disclosed within the accounts of Pearl Group Management Services Limited.

### ***Reappointment 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 reappointed at the end of the period of 28 days following circulation of copies of these accounts 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 accounts relate.

## **Directors' report continued**

### ***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 they 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.

**By order of the Directors**

A handwritten signature in black ink, appearing to be 'G A Watson', with a long horizontal flourish extending to the right.

**G A Watson**

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

27 April 2010

Registered office: 301 St. Vincent Street, Glasgow, G2 5HN

## Independent auditors' report to the members of Scottish Provident Limited

We have audited the financial statements of Scottish Provident Limited for the year ended 31 December 2009, which comprise the Statement of Comprehensive Income, the Statement of Other Comprehensive Income, the Statement of Financial Position, the Statement of Cash Flows, and the related notes 1 to 37. These financial statements have been prepared under the accounting policies set out therein. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) 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 auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

### Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement set out on page 3, 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 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 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.

### 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 2009 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.

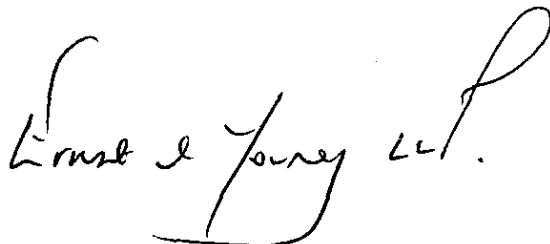
### Opinion on other matter prescribed by the Companies Act 2006

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.



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

29 April 2010

## Accounting policies continued

### (a) Basis of preparation

The financial statements have been prepared on the going concern basis. In adopting the going concern basis the following significant matters have been taken into consideration:

- A comprehensive review of the valuation and liquidity of investments at the balance sheet date;
- Solvency and cash flow projections under normal and stressed conditions; and
- Impact of failures of material reinsurers, service providers and investment managers.

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. These financial statements are presented in pounds sterling, rounded to the nearest £1m.

The financial statements have been prepared under the historical cost convention except as modified by the application of the following:

- financial instruments at fair value through income; and
- insurance liabilities.

The preparation of financial statements in conformity with IFRS requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of current events and actions, actual results ultimately may differ from those estimates.

In preparing the financial statements the Company has adopted the following standards, amendments and interpretations:

- *IAS 1 Presentation of Financial Statements (Revised)*. This revises and enhances the presentation of information in the financial statements.
- Improving disclosures about Financial Instruments (Amendments to IFRS 7). This requires enhanced disclosures about fair value measurements and liquidity risk.
- *IFRS 8 Operating Segments*. This converges International and US reporting requirements relating to segmental information.
- Annual Improvements 2008. This makes a number of improvements to existing standards.

The Company has taken advantage of the exemption provided for in the Companies Act 2006 (s401) and as such, the information presented in these financial statements relates to the Company only and not the consolidated position of the Group headed by the Company.

The International Accounting Standards Board (IASB) has issued the following standards, amendments and interpretations, which apply from the dates shown. The Company has decided, where permitted, not to adopt any of these standards, amendments or interpretations in advance of their implementation date. The impact of adopting them is not expected to have a material effect on the results of the Company.

- *IFRS 9 Financial Instruments (2013)*. IFRS 9 is the first phase of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and deals with the classification and measurement of financial assets, including some hybrid contracts.
- *IAS 24 Related Party Disclosures (2011)*. This amends the definition of a related party and clarifies its intended meaning.
- Annual improvements 2009 (2010). This makes a number of minor improvements to existing standards and interpretations.
- Embedded Derivatives (Amendments to IFRIC 9 and IAS 39) (2010). This clarifies the treatment of embedded derivatives.

## Accounting policies continued

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

- IAS 27 *Consolidated and Separate Financial Statements*. This revises the accounting treatment of dividends paid out of the pre-acquisition reserves of subsidiaries (2009)
- IAS 27 *Consolidated and Separate Financial Statements (Revised)* (2010). This revises the accounting for non-controlling interests and the loss of control of subsidiaries.
- IFRS 3 *Business Combinations (Revised)* (2010). This converges International and US reporting requirements relating to business combinations.
- IFRIC 17 *Distributions of Non-Cash Assets to Owners (2010)*. IFRIC 17 provides guidance on how an entity should account for distributions of non-cash assets to its owners, other than in limited circumstances.
- IFRIC 18 *Transfer of Assets from Customers* (2009)
- IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* (2011)
- Share-based Payment: Vesting conditions and cancellations (Amendments to IFRS 2). This results in an immediate acceleration of the expense that would otherwise have been recognized in future periods should an employee decide to stop contributing to the savings plan.
- Additional Exemptions for First Time Adopters (Amendments to IFRS 1) (2010)
- Group Cash-settled Share-based Payment Transactions (Amendments to IFRS 2) (2010)
- Classification of Rights Issues (Amendments to IAS 32) (2011)
- Prepayments of a Minimum Funding Requirement (Amendments to IFRIC 14) (2011)

A capital position statement has not been presented as this is disclosed in the financial statements of the ultimate parent company, Phoenix Group Holdings.

### (b) Critical accounting estimates and judgments

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 and investment contract liabilities, determination of the fair value for financial assets and liabilities, intangible assets and income taxes.

Insurance and investment contract liability accounting is discussed in more detail in notes (e) and (f) with further detail of the key assumptions made in determining insurance and investment contract liabilities included in note 16.

The fair values of financial assets are classified and accounted for in accordance with the policies set out in accounting policy (m). They are valued on the basis of listed market prices in so far as this is possible. If prices are not readily determinable, fair value is based either on internal valuation models or management estimates of amounts that could be realised under current market conditions.

Intangible assets are subject to regular impairment reviews as required. Impairments are measured as the difference between the cost of a particular asset and the current fair value or recoverable amount. Impairments are recorded in the income statement in the period they occur. The Company's policy in relation to impairment testing is detailed in accounting policy (k).

The accounting policy for income tax is detailed in accounting policy (i).

### (c) Foreign currency translation

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. 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 in the income statement.

Translation differences on debt securities and other monetary financial assets measured at fair value are included in foreign exchange gains and losses within net investment income. Translation differences on non-monetary items such as equities held for trading are reported as part of the fair value gain or loss.

Income statements and cash flows of foreign operations are translated into the Company's presentational currency at the appropriate rates prevailing during the year and their balance sheets are translated at the exchange rates ruling on 31 December. Exchange gains and losses arising from the translation of the functional currency results and financial position of foreign operations into the presentational currency of the company are reflected in the Statement of Recognised Income and Expense and treated as a separate component of equity.



## **Accounting policies continued**

### **(d) Classification of contracts**

The Company issues insurance contracts and investment contracts.

Insurance contracts are those contracts, which transfer significant insurance risk. As a general guideline, the Company defines as significant insurance risk the possibility of having to pay benefits on the occurrence of an insured event. Investment contracts are those contracts which carry no significant insurance risk.

A number of insurance and investment contracts contain a discretionary participation feature (DPF) which entitles the holder to receive, as a supplement to guaranteed benefits, additional benefits or bonuses that are likely to be a significant portion of the total contractual benefits and whose amount or timing is contractually at the discretion of the Company and based on the performance of specified assets. Contracts containing a DPF are also referred to as participating or with profit contracts.

For insurance contracts and investment contracts with DPF, the Company continues to use the Modified Statutory Solvency Basis (MSSB) of accounting, modified as necessary to comply with the requirements of IFRS. For contracts with DPF, this includes the adoption of FRS 27 'Life Assurance'. Investment contracts without DPF are accounted for as financial liabilities.

### **(e) Insurance contracts and investment contracts with DPF**

The significant accounting policies applied in relation to insurance contracts and investment contracts with DPF are:

#### **Premiums**

Premiums received in respect of insurance contracts and investment contracts with DPF are recognised as revenue when due and shown before deduction of commission. Reassurance premiums are charged when they become payable.

#### **Claims**

Death claims are recognised on receipt of notifications. Maturities and annuity payments are recorded when contractually due. Surrenders are recorded on the earlier of the date paid or date the policy benefit or part thereof ceases to be included within 'Liabilities under insurance contracts'. Claims on participating business include bonuses payable. Reinsurance recoveries are credited to match the relevant gross amounts.

#### **Fees and commissions**

Fee and charge income from services provided in respect of insurance contracts and investment contracts with DPF is recognised in the statement of comprehensive income within 'change in insurance contract liabilities' when the services are performed.

#### **Liabilities under insurance contracts**

Insurance liabilities are determined by the Directors on the advice of the Head of Actuarial Function following an annual investigation of the long-term business and reflect the value of related assets and the yield derived therefrom.

Insurance liabilities are calculated in accordance with reporting requirements under the Financial Services and Markets Act 2000 and Financial Services Authority (FSA) Prudential Sourcebook for Insurers.

Although the process for the establishment of insurance liabilities follows specified rules and guidelines, the provisions that result from the process are the subject of estimations. As a consequence, the eventual value of claims could vary from the amounts provided to cover future claims. The Company seeks to provide appropriate levels of contract liabilities taking known facts and experiences into account but nevertheless such liabilities remain uncertain.

Liabilities are calculated as follows:

\* Liabilities – insurance contracts without DPF which are not unit linked:

A liability for contractual benefits that are expected to be incurred in the future is recorded when the premium is recognised. The liabilities of the Company's non profit non linked funds are calculated by estimating the future cash flows over the duration of the in-force policies and discounting them back to the valuation date allowing for probabilities of insured event occurrence. The liability will vary with movements in interest rates and with the cost of life assurance and annuity benefits which reflect changes in mortality rates. Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs. For conventional life and pensions business, the gross premium valuation method has been used. This statutory solvency basis of valuation is then adjusted by eliminating the general contingency reserves and certain reserves required under insurance company regulations.

## **Accounting policies continued**

### **Liabilities under insurance contracts continued**

#### **\* Liabilities – insurance contracts without DPF which are unit linked:**

Allocated premiums in respect of unit linked contracts are recognised as liabilities. These liabilities are increased or reduced by the change in the relevant unit prices over the period and include any amounts necessary to compensate the Company for services to be performed over future periods. They are reduced by policy administration fees, mortality charges, surrender charges and any withdrawals. The mortality charges deducted in each period from the policyholders as a group are considered adequate to cover the total death benefit claims that are expected to occur over the term of the contracts.

#### **\* Liabilities – insurance and investment contracts with DPF:**

Liabilities of the Company's with profit fund, including guarantees and options embedded within products written by that fund, are stated at their realistic values in accordance with the FSA's realistic capital regime. The measurement of insurance liabilities is calculated using stochastic methods and therefore reflects both the intrinsic and time value of guarantees and options embedded within products. Economic assumptions are calibrated to observed current market prices.

#### **Liability adequacy test**

At each balance sheet date, liability adequacy tests are performed to ensure the adequacy of insurance contract and investment contract with DPF liabilities. In performing these tests, current best estimates of future contractual cash flows, claims handling and administration expenses, as well as investment income from the assets backing such liabilities are used. Any deficiency is immediately charged to income to establish an appropriate provision against these potential losses.

#### **Embedded derivatives**

Embedded derivative features contained within insurance contracts are accounted for at fair value and unrealised gains and losses arising on the embedded derivatives are reported in income. Where the risks and characteristics of embedded derivatives are not closely related to those of the host contract and the host contract is not carried at fair value the embedded derivatives are accounted for separately.

#### **Reinsurance**

The Company assumes and cedes reinsurance in the normal course of business. Reinsurance assets primarily include balances due from reinsurance companies for ceded insurance liabilities. Premiums on reinsurance assumed are recognised as revenue in the same manner as they would be if the reinsurance were considered direct business taking into account the product classification of the reinsured business. Amounts recoverable from or due to reinsurers are estimated in a manner consistent with the amounts associated with the reinsured policies and in accordance with the reinsurance contract. Premiums ceded and benefits reimbursed are presented on the income statement on a gross basis.

Contracts entered into by the Company with reinsurers under which the Company is compensated for losses on one or more contracts issued by the Company and that meet the classification requirements for insurance contracts are classified as reinsurance contracts held. Insurance contracts entered into by the Company under which the contract holder is another insurer (inwards reinsurance) are included with insurance contracts.

The benefits to which the Company expects to become entitled under its ceded reinsurance contracts are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers as well as longer-term receivables that are dependent on expected claims and benefits arising under the related reinsured insurance contracts.

Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured insurance contracts and in accordance with the terms of each reinsurance contract. Reinsurance payables are primarily premiums payable for reinsurance contracts and are recognised as an expense when due.

The Company regularly assesses its long-term reinsurance assets for impairment. A reinsurance asset is impaired if there is objective evidence that the Company may not receive all amounts due to it under the terms of the contract and that event has a reliably measurable impact on the amounts that the Company will receive from the reinsurer.

#### **Receivables and payables related to insurance contracts and investment contracts with DPF**

Receivables and payables are recognised when due. These include amounts due to and from agents, brokers and insurance contract holders.

#### **Unallocated surplus**

The unallocated surplus comprises the excess of the assets over the policyholder liabilities of the with profit business determined in accordance with FRS 27, in so far as it represents amounts which have yet to be allocated to equity holders.

## **Accounting policies continued**

### **(f) Investment contracts without DPF**

Receipts and payments on investment contracts without DPF are accounted for using deposit accounting, under which the amounts collected and paid out are recognised in the balance sheet as an adjustment to the liability to the policyholder. The significant accounting policies applied in relation to investment contracts without DPF are:

#### **Liabilities under investment contracts**

All of the Company's investment contracts without DPF are unit linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Company's unitised investment funds. The value of the unit linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable.

#### **Revenue from investment contracts**

Fee and charge income from investment management and other related services provided in respect of investment contracts without DPF is recognised in the accounting period in which the services are rendered and are included within 'change in investment contract liabilities' on the income statement. These services comprise an indeterminate number of acts over the life of individual contracts. For practical purposes, the Company recognises these fees on a straight-line basis over the estimated life of the contract.

### **(g) Net investment income**

Interest income and expense are recognised in the income statement for all interest bearing instruments on an accruals basis. Interest income includes coupons earned on fixed income financial assets. Dividend income is recognised in the income statement on the date the right to receive payment is established, which in the case of listed securities is the ex-dividend date.

Realised gains and losses on investments are calculated as the difference between net sales proceeds and original cost. Unrealised investment gains and losses are calculated as the difference between the valuation at the balance sheet date and their valuation at the last balance sheet date or purchase price, if acquired during the year.

Unrealised investment gains and losses include adjustments in respect of unrealised gains and losses recorded in prior years which have been realised during the year and are reported as realised gains and losses in the current income statement.

Outstanding derivative contracts, including forward foreign exchange contracts, are marked to market at the balance sheet date. Unrealised gains or losses thereon are included in the income statement as unrealised gains or losses on financial assets.

### **(h) Borrowings**

Interest bearing borrowings are recognised initially at fair value less any attributable transaction costs. The difference between initial cost and the redemption value is amortised through the income statement over the period of the borrowing using the effective interest rate method.

### **(i) Income tax**

The tax expense represents the sum of tax currently payable and deferred tax. The tax currently payable is based on income and gains arising in the accounting period and comprises both shareholder tax and tax payable on behalf of policyholders.

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets or liabilities using currently enacted tax rates.

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.

### **(j) Investments in subsidiaries**

Investments in subsidiary undertakings are carried in the balance sheet at cost less provision for impairment, if applicable. The carrying values of investments in subsidiaries are written down by the amount of any impairment in the underlying net assets of the subsidiary and the loss is recognised in the income statement in the period in which it occurs. A previously recognised impairment loss relating to an investment in a subsidiary may be reversed in part or in full when a change in circumstances leads to a change in the estimates used to determine the investment's recoverable amount. The carrying amount of the investment will only be increased up to the amount that it would have been had the original impairment not been recognised.

## **Accounting policies continued**

### **(k) Intangible assets**

Present value of acquired in-force business (PVIF)

When a portfolio of insurance contracts and/or investment contracts with DPF is acquired, whether directly from another insurance company or as part of a business combination, the difference between the fair value and the carrying amount of the insurance liabilities is recognised as the value of the acquired in-force business.

Subsequent to initial recognition, the intangible asset is carried at cost less accumulated amortisation and accumulated impairment losses. The intangible asset is amortised over the useful life of the acquired in-force policies during which future premiums are expected. Amortisation is recognised in the income statement as an expense.

An impairment review is performed at each reporting date or more frequently when an indication of impairment arises during the reporting year. When the recoverable amount is less than the carrying value, an impairment loss is recognised in the income statement. PVIF is also considered in the liability adequacy test for each reporting period.

PVIF is derecognised when the related contract is settled or disposed of.

### **(l) Loans and receivables**

Loans and receivables are valued initially at fair value, including transaction costs as relevant, and subsequently at amortised cost less impairment losses.

### **(m) Financial assets at fair value through income**

All invested financial assets were designated at fair value through income on the transition to IFRS as their performance is evaluated on a fair value basis in accordance with a documented investment strategy.

The fair values are determined by reference to quoted market bid prices or published bid prices. If quoted market prices or published prices are not available, fair values are determined or estimated by using various techniques, including but not limited to balance sheet analysis and comparison to similar quoted securities. Unlisted derivatives are valued on the basis of bid prices supplied by suitably qualified counterparties. The counterparties' valuation techniques rely on discounted cash flow models and option pricing models as appropriate.

Changes in fair value are recognised in the income statement in the period they occur.

Purchases and sales of financial assets at fair value through income are accounted for at trade date.

### **(n) Cash and cash equivalents**

Cash and cash equivalents comprise cash in hand, deposits held on call with banks and other short-term highly liquid investments with an original maturity term of 90 days or less. On the balance sheet, bank overdrafts with legal right of set off are included in cash and cash equivalents.

### **(o) Provisions**

Provisions (which do not include insurance liabilities) are recognised when the Company has a present obligation (legal or constructive) as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate of the amount of the obligation can be made.

Where the effect of the time value of money is material, the amount provided is the present value of the expenditures expected to be required to settle the obligation.

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.

### **(p) Dividends**

Dividends on ordinary shares are recognised in equity in the period in which they are declared.

### **(q) Offsetting financial assets and liabilities**

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention that expected future cash flows will be settled on a net basis.

## **Accounting policies continued**

### **(r) Segmental Reporting**

Business segments provide analysis of products or services that are subject to risks and returns that are different from those of other business segments. Geographical segments provide products or services within a particular geographic environment that is subject to risks and returns that are different from those of components operating in other geographical environments. The Company has only one business segment (life insurance) and one geographical segment (UK and Ireland); therefore, no segmental reporting is presented.

**Statement of comprehensive income for the year ended 31 December 2009**

	Notes	2009 £m	2008 £m
Gross premiums written		-	256
Less: premiums ceded to reinsurers		-	(254)
<b>Net premiums written</b>		-	2
Fees and commissions	2	-	5
Net investment income	3	43	(435)
<b>Total revenue, net of reinsurance payable</b>		43	(428)
Other operating income	4	-	1
<b>Net income</b>		43	(427)
Policyholder claims		-	839
Less: reinsurance recoveries		-	(105)
Change in insurance contract liabilities		-	(1,218)
Transfer (from)/to unallocated surplus	14	-	(52)
<b>Net policyholder claims and benefits incurred</b>		-	(536)
Change in investment contract liabilities		-	(61)
Acquisition costs	5	-	6
Administrative expenses	6	-	97
<b>Total operating expenses</b>		-	(494)
<b>Operating profit before financing costs and income taxes</b>		43	67
Financing costs	8	-	(15)
Loss on Part VII transfer	1	(389)	(11)
<b>(Loss)/profit for the year before income taxes</b>		(346)	41
Income taxes			
Policyholder tax		-	-
Shareholder tax		-	7
Tax on Part VII transfer		-	2
<b>Total tax expense</b>	10	-	9
<b>(Loss)/profit for the year attributable to equity holders</b>		(346)	32

All figures relate to discontinued operations.

**Statement of other comprehensive income for the year ended 31 December 2009**

	2009 £m	2008 £m
Foreign currency translation of branch	-	21
Current taxation arising on foreign currency translation of branch	-	(6)
<b>Net (expense)/income recognised directly in equity</b>	-	15
<b>(Loss)/profit for the year attributable to equity holders</b>	<b>(346)</b>	<b>32</b>
<b>Total recognised income/(expense) for the year attributable to equity holders</b>	<b>(346)</b>	<b>47</b>

**Statement of financial position as at 31 December 2009**

	Notes	2009 £m	2008 £m
<b>EQUITY AND LIABILITIES</b>			
<b>Equity</b>			
Share capital	11	-	1,765
Other reserves	12	-	222
Capital contribution reserves	12	-	178
Foreign currency translation reserve	12	-	17
Retained earnings		<u>1,063</u>	<u>(766)</u>
<b>Total equity attributable to equity holders of the Company</b>		<b>1,063</b>	<b>1,416</b>
<b>Liabilities</b>			
<b>Insurance contracts</b>			
Liabilities under insurance contracts	13	-	5,191
Unallocated surplus	14	-	42
		-	<u>5,233</u>
<b>Financial liabilities</b>			
Investment contracts	15	-	180
Borrowings	19	-	51
		-	<u>231</u>
Deferred tax	28	-	59
Reinsurance payables	17	-	8
Payables related to direct insurance contracts	18	-	34
Current tax	28	-	35
Trade and other payables	20	-	141
<b>Total liabilities</b>		<b>-</b>	<b>5,741</b>
<b>Total equity and liabilities</b>		<b><u>1,063</u></b>	<b><u>7,157</u></b>



**Statement of financial position as at 31 December 2009 continued**

	Notes	2009 £m	2008 £m
<b>ASSETS</b>			
Investments in subsidiaries	21	-	60
Intangible assets	22	-	272
Loans and receivables	23	1,063	1,037
Financial assets at fair value through income			
Equities		-	3
Fixed income securities		-	138
Collective investment schemes		-	4,256
		-	4,397
Insurance assets			
Reinsurers' share of insurance contract liabilities	13	-	1,186
Reinsurance receivables	26	-	4
Insurance contract receivables	27	-	2
		-	1,192
Deferred tax	28	-	13
Prepayments		-	6
Trade and other receivables	29	-	16
Cash and cash equivalents	30	-	164
<b>Total assets</b>		<b>1,063</b>	<b>7,157</b>

The financial statements were approved and authorised for issue by the Board of Directors on 27 April 2010 and were signed on its behalf by:



J S B Smith  
Director  
27 April 2010

**Statement of financial position as at 31 December 2009 continued**

	Notes	2009 £m	2008 £m
<b>ASSETS</b>			
Investments in subsidiaries	21	-	60
Intangible assets	22	-	272
Loans and receivables	23	1,063	1,037
Financial assets at fair value through income			
Equities		-	3
Fixed income securities		-	138
Collective investment schemes		-	4,256
		-	4,397
Insurance assets			
Reinsurers' share of insurance contract liabilities	13	-	1,186
Reinsurance receivables	26	-	4
Insurance contract receivables	27	-	2
		-	1,192
Deferred tax	28	-	13
Prepayments		-	6
Trade and other receivables	29	-	16
Cash and cash equivalents	30	-	164
<b>Total assets</b>		<b>1,063</b>	<b>7,157</b>

The financial statements were approved and authorised for issue by the Board of Directors on 27 April 2010 and were signed on its behalf by:

J S B Smith  
Director  
27 April 2010

**Statement of changes in equity for the year ended 31 December 2009**

	Share capital £m	Other Reserves £m	Capital contribution reserve £m	Foreign currency translation reserve £m	Retained earnings £m	Total £m
Balance at 1 January 2008	1,765	222	178	2	(798)	1,369
Arising in the period:						
Foreign currency translation of branch	-	-	-	15	-	15
Net income recognised directly in equity	-	-	-	15	-	15
Profit for the year	-	-	-	-	32	32
Total recognised income and expense for the year attributable to equity holders	-	-	-	15	32	47
Balance at 31 December 2008	1,765	222	178	17	(766)	1,416
Balance at 1 January 2009	1,765	222	178	17	(766)	1,416
Capital reduction (note 11,12)	(1,765)	(222)	(178)	(17)	2,182	-
Arising in the period:						
Dividend paid	-	-	-	-	(7)	(7)
Net loss recognised directly in equity	-	-	-	-	(7)	(7)
Loss for the year	-	-	-	-	(346)	(346)
Total recognised income and expense for the year attributable to equity holders	-	-	-	-	(353)	(353)
Balance at 31 December 2009	-	-	-	-	1,063	1,063

**Statement of cash flows for the year ended 31 December 2009**

	Notes	2009 £m	2008 £m
<b>Cash flows from operating activities</b>			
Net (decrease)/increase in operating assets and liabilities	31	(164)	262
Finance costs		-	(13)
Taxation paid		-	(52)
<b>Net cash flows from operating activities</b>		<b>(164)</b>	<b>197</b>
<b>Cash flows from investing activities</b>			
Loans granted to group undertakings		-	(181)
<b>Net cash flows from investing activities</b>		<b>-</b>	<b>(181)</b>
<b>Cash flows from financing activities</b>			
Repayment of borrowings		-	-
<b>Net cash flows from financing activities</b>		<b>-</b>	<b>-</b>
<b>Net (decrease)/increase in cash and cash equivalents</b>		<b>(164)</b>	<b>16</b>
<b>Cash and cash equivalents at the beginning of the year</b>		<b>164</b>	<b>148</b>
<b>Cash and cash equivalents at the end of the year</b>	30	<b>-</b>	<b>164</b>

Cash and cash equivalents comprise bank overdrafts and cash at bank and other short-term highly liquid investments with maturity of 90 days or less (note 30).

## Notes to the financial statements

### 1. Long term insurance funds transfer

As part of a programme of restructuring, with effect from 1 January 2009, the entire long term business and part of the shareholders' funds of the Company were transferred to PLL for £nil consideration in accordance with the terms of a scheme under Part VII of the Financial Services and Markets Act 2000 approved by the High Court on 30 January 2009. Policies in the special with profit fund will be converted to non profit and transferred to the new 'SPI with profit fund' in PLL. The assets and liabilities transferred and the consequent loss arising are set out below:

	2009
	£m
<b>Assets</b>	
Investments in subsidiaries	60
Intangible assets	272
Loans and receivables	17
Financial assets at fair value through income	
Equities	3
Fixed income securities	138
Collective investment schemes	4,249
Insurance assets	
Investment contracts	
Reinsurers' share of insurance contract liabilities	1,186
Reinsurance receivables	4
Insurance contract receivables	2
Deferred tax	13
Prepayments	6
Trade and other receivables	16
Cash and cash equivalents	164
	<b>6,130</b>
<b>Liabilities</b>	
Insurance contracts	
Liabilities under insurance contracts	5,191
Unallocated surplus	42
Financial liabilities	
Investment contracts	180
Borrowings	51
Deferred tax	59
Reinsurance payables	8
Payables related to direct insurance contracts	34
Current tax	35
Trade and other payables	141
	<b>5,741</b>
<b>Loss on transfer of net assets</b>	<b>389</b>

## Notes to the financial statements continued

### 1. Long term insurance funds transfer continued

On 29 December 2008, part of the long term business of the Company was transferred to The Royal London Mutual Insurance Society Limited (the Society) for £nil consideration in accordance with the terms of a scheme under Part VII of the Financial Services and Markets Act 2000 approved by the High Court on 4 December 2008 (the Scheme). The Scheme provides for the transfer of certain assets and liabilities, as set out below. As a result of the transfer, an additional asset has been generated and certain residual balances held have been impaired, as set out below.

The loss on transfer of net assets includes the release of the foreign currency translation reserve of £17m.

Details of the assets and liabilities transferred under the Scheme, the consequential generation of an asset, the impairment of residual assets and the loss arising are as follows:

	2008 £m
<b>Assets transferred</b>	
Reinsurers' share of insurance contract liabilities (note 13)	55
Reinsurance receivables	3
Insurance contract receivables	3
Trade and other receivables	2
Cash and cash equivalents	(1)
	<hr/> 62
<b>Liabilities transferred</b>	
Liabilities under Insurance Contracts (note 13)	48
Reinsurance payables	3
Payables related to direct insurance contracts	3
Trade and other payables	1
	<hr/> 55
<b>Net assets transferred</b>	<hr/> 7
<b>Asset generated</b>	
Loan (note 23)	5
<b>Assets impaired</b>	
Intangible assets (note 22)	9
<b>Loss on transfer</b>	<hr/> 11

## Notes to the financial statements continued

### 2. Fees and commissions

	2009 £m	2008 £m
Other fees	-	5

### 3. Net investment income

	2009 £m	2008 £m
Investment income :		
On items valued at fair value through income	-	240
On items valued at amortised cost	43	66
Fair value (losses) / gains	-	(741)
	43	(435)

### 4. Other operating income

	2009 £m	2008 £m
Other income	-	1

Other income in 2008 relates to income arising from an outstanding balance due from a fellow subsidiary.

### 5. Acquisition costs

	2009 £m	2008 £m
Acquisition costs paid	-	6

### 6. Administrative expenses

	2009 £m	2008 £m
Movement in acquired PVIF	-	55
Operating expenses	-	40
Management Fee (Ignis Investment Services Limited)	-	2
	-	97

The Company has no employees (2008: nil). All business administration services were provided to the Company by Pearl Group Management Services. Administration charges included in operating expenses amount to £nil (2008: £31m).

Operating expenses in 2008 are net of a £1m credit from Pearl Group Management Services Limited following finalisation of the Company's share of the pension scheme payments, as required under the terms of the Sale and Purchase Agreement between Resolution plc and Abbey National plc.

Operating expenses in 2008 include a charge from Pearl Group Management Services (Ireland) Limited of £5m in respect of the Company's Irish branch pension scheme.

## Notes to the financial statements continued

### 7. Auditors' remuneration

The remuneration (excluding VAT) of the auditors of the Company, including their associates, in respect of services supplied to the Company is as follows:

	2009 £	2008 £
Audit Services	10,000	245,000
Other Services	-	157,000
	<u>10,000</u>	<u>402,000</u>

These costs were met by Pearl Group Management Services Limited in 2009.

The remuneration included for other services in 2008 comprises:

	2009 £	2008 £
The auditing of accounts of associates of the Company pursuant to legislation	-	6,000
Other services pursuant to legislation – audit related	-	108,000
Other services	-	43,000
	<u>-</u>	<u>157,000</u>

### 8. Financing costs

	2009 £m	2008 £m
Interest expense:		
On items valued at fair value through income	-	15
	<u>-</u>	<u>15</u>

### 9. Directors' emoluments

The emoluments of Messrs M Dale, A B Davidson, D G R Ferguson, E J C Hawkes, M J Merrick, J S Moss, H E M Osmond, M D Ross and J S B Smith are disclosed in the financial statements of Pearl Group Holdings (No 2) Limited ("PGH2"), formerly Pearl Group Limited.

The aggregate emoluments of the remaining Directors of the Company were **£530,010** (2008: £381,094). Of this, **£52,069** (2008: £381,094) has been allocated to the Company.

The emoluments of the highest paid Director are disclosed in the financial statements of PGH2.

Retirement benefits are accruing for 0 (2008: 2) continuing Directors under defined contribution and defined benefit schemes. Annual bonuses are shown in the year in which they are earned.

During the year TDR Capital LLP, of whom Mr M Dale and Mr L G Tamberlin are designated members, received £812,500 (2008: £1,762,500) from Impala Holdings Limited as shareholder monitoring fees.



# Notes to the financial statements continued

## 10. Income taxes

### (a) Current year tax charge

	2009 £m	2008 £m
Current tax:		
UK Corporation tax	-	35
Overseas tax	-	3
	-	38
Adjustment in respect of prior years	-	1
	-	39
Deferred tax:		
Deferred tax on amortisation of VIF	-	(11)
On profit arising from the changes in assumptions used to determine insurance contract liabilities in accordance with PS06/14	-	(3)
Part VII transfer (note 1)	-	(2)
Overseas tax	-	(7)
Other	-	(7)
	-	(30)
Total income tax expense	-	9
Attributable to: policyholders	-	-
equity holders	-	9
	-	9

Unrecognised tax losses of previous years have been used to reduce current tax expense and deferred tax by £nil (2008: £nil) and £nil (2008: £nil) respectively.

### (b) Reconciliation of tax charge

	2009 £m	2008 £m
(Loss)/profit before tax	(346)	41
Tax at standard UK rate 28% (2008: 28.5%)	(97)	12
Untaxed income	-	(4)
Disallowable expenses	-	2
Adjustment to tax charge in respect of prior years	-	1
Loss arising on Part VII transfer not deductible for tax purposes	109	-
Group relief for nil payment	(12)	-
Impact of tax on acquired in-force amortisation at less than 28% (2008: 28.5%)	-	5
Overseas tax	-	(4)
Other	-	(3)
Total equity holders' tax charge for the year	-	9

## Notes to the financial statements continued

### 11. Share capital

	2009 £m	2008 £m
Issued and fully paid: 1 (2008: 1,765,000,002) ordinary shares at £1 each	-	1,765

The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Company. The ordinary shareholders are entitled to any residual assets on the winding up of the Company.

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

On 25 March 2009, in accordance with section 643 of the Companies Act 2006, the Directors approved a reduction in the Company's authorised share capital from £4,335,000,000, comprising 4,335,000,000 ordinary shares of £1 each, to £1, consisting of one ordinary share of £1, by the cancellation and extinction of all of the authorised but unissued ordinary shares and 1,765,000,001 of the issued ordinary shares registered in the name of Pearl Life Holdings Limited.

### 12. Other reserves

	2009 £m	2008 £m
Other reserves	-	222
Capital contribution reserve	-	178
Foreign currency translation reserve	-	17
	-	417

Other reserves arose on the date of demutualisation and were not distributable.

On 25 March 2009, in accordance with section 643 of the Companies Act 2006, the Directors approved the cancellation of the other reserves and the capital contribution reserve. The foreign currency translation reserve was released following the Part VII transfer.

### 13. Liabilities under insurance contracts

	Gross liabilities 2008 £m	Reinsurers' share 2008 £m
Insurance contracts	4,352	1,186
Investment contracts with DPF	839	-
	5,191	1,186
Amount due for settlement/recovery within 12 months	499	25
Amount due for settlement/recovery after 12 months	4,692	1,161

There are no liabilities under insurance contracts at 31 December 2009.

## Notes to the financial statements continued

### 13. Liabilities under insurance contracts continued

	Gross liabilities 2009 £m	Reinsurers' share 2009 £m
At 1 January 2009	5,191	1,186
Part VII transfer (note 1)	(5,191)	(1,186)
As at 31 December 2009	-	-

	Gross liabilities 2008 £m	Reinsurers' share 2008 £m
At 1 January 2008	5,976	967
Premiums	256	254
Claims	(839)	(105)
Other changes in liabilities	(430)	56
Foreign exchange adjustments	276	69
Part VII transfer (note 1)	(48)	(55)
As at 31 December 2008	5,191	1,186

### 14. Unallocated surplus

	2009 £m	2008 £m
As at 1 January	42	93
Transfer (to)/from income statement	-	(52)
Foreign exchange adjustments	-	1
Part VII transfer (note 1)	(42)	-
As at 31 December	-	42

### 15. Investment contract liabilities

	2009 £m	2008 £m
Investment contract liabilities	-	180
Amount due for settlement within 12 months	-	41
Amount due for settlement after 12 months	-	139

## Notes to the financial statements continued

### 16. Insurance and investment contract liabilities – assumptions and sensitivities

As per Note 1, all of the Company's insurance and investment contract liabilities were transferred to PLL in accordance with the Part VII scheme.

The valuation at 31 December 2008 was carried out as noted below.

#### (a) Assumptions

##### *Process used to determine 2008 assumptions*

For participating business written by realistic basis companies the demographic assumptions about future experience are intended to be "best estimates". These assumptions are determined after considering the companies' recent experience and/or relevant industry data. Economic assumptions are market consistent.

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

As outlined below, particular attention was given to the impact of deteriorating credit ratings on corporate bonds.

A number of changes were made to assumptions during the year to reflect changes in expected experience. No material changes were made to demographic assumptions, although future interest and expense inflation assumptions changed substantially in line with market conditions.

##### *Valuation interest rate*

For realistic basis companies, the liabilities are determined stochastically using an appropriate number of risk neutral scenarios produced by a proprietary economic scenario generator calibrated to market conditions and gilt yields as at the valuation date.

For funds not subject to realistic reporting, the method used to determine valuation interest rates generally follows the rules set out in section 1.2.33 of the Prudential Sourcebook for insurers. 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, reinvestment risk and investment management expenses. Valuation interest rates (after tax for life policies) were generally in the following ranges:

Life policies: 2.15% - 3.80%

Pension policies: 2.75% - 5.22%

As a consequence of deterioration in credit ratings on corporate bonds, a comparison of the credit ratings of assets held against actual credit spreads was undertaken and adjustments made to valuation interest rates where appropriate, resulting in a general reduction in rates.

Investment contracts with discretionary participation features are not measured at fair value, as there is currently no agreed definition of fair valuation for discretionary participation features under IFRS.

##### *Expense inflation*

Expenses are assumed to increase at the rate of increase in the RPI plus a fixed margin in accordance with the management service agreements (MSAs). For realistic basis business, the rate of RPI inflation is determined within each stochastic scenario; for other business it is assumed that RPI inflation is 2.54% per annum. 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 is then added to the rate of expense inflation.

##### *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. Annuitant mortality rates are adjusted to make allowance for future improvements in pensioner longevity.

## Notes to the financial statements continued

### 16. Insurance and investment contract liabilities – assumptions and sensitivities continued

#### *Lapse and surrender rates (persistence)*

The assumed rates for surrender and voluntary premium discontinuance depend on the length of time a policy has been in force and the type of business. Withdrawal rates used in the valuation of with profit 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 unitised with profit contracts will be higher on policy anniversaries on which market value adjustments do not apply. For protection business, lapse rates are based on recent observed experience with an appropriate prudent margin for adverse future deviations.

#### *Discretionary participating bonus rates*

For realistic basis companies, the regular bonus rates assumed in each scenario are determined in accordance with each company's Principles and Practices of Financial Management (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.

#### **(b) Sensitivities**

The table below indicates the stand-alone impact of certain key assumption changes to insurance and investment contracts.

Assumption changes for with profit contracts have no direct impact on profit or equity holders' funds. Consequently these do not feature in the table below.

	Change in assumption %	Impact on profit before equity holders' tax £m	Impact on equity holders funds £m
Fixed interest yield assumptions	-1%	(0.49)	(0.36)
Fixed interest yield assumptions	+1%	(10.21)	(7.35)
Equity and property values	-10%	(0.58)	(0.42)
Mortality assumptions for annuities	-5%	(0.04)	(0.03)
Credit Spread on Corporate Bonds	+1%	0.00	0.00

In reality, given the correlation between the assumptions, it is often not possible to demonstrate the effect of key assumptions whilst other assumptions remain unchanged. It should also be noted that in some instances these sensitivities are non-linear; consequently larger or smaller impacts should not be interpolated or extrapolated from these results.

### 17. Reinsurance payables

	2009 £m	2008 £m
Reinsurance payables	-	4
Due to fellow subsidiaries	-	4
	-	8
Amount due for settlement within 12 months	-	8

### 18. Payables related to direct insurance contracts

	2009 £m	2008 £m
Payables related to direct insurance contracts	-	34
Amount due for settlement within 12 months	-	34

## Notes to the financial statements continued

### 19. Borrowings

	2009 £m	2008 £m
Loan from subsidiary undertaking	-	51
Amount payable within 12 months	-	51

### 20. Trade and other payables

	2009 £m	2008 £m
Due to fellow subsidiaries	-	22
Due to subsidiary undertakings	-	10
Net collateral loan	-	27
Exchange Traded Futures	-	5
Other liabilities	-	77
	-	141
Amount due for settlement within 12 months	-	116
Amount due for settlement after 12 months	-	25

#### Net collateral loan

Collateral sums were deposited back to the Company by credit institutions in order to reduce the counterparty risk to the Company on particular assets held to back certain policyholder benefits. Interest on deposit back arrangements is payable on the amounts owed based on Sterling Overnight Index Average rates.

The table below provides analysis of the derivative assets and related collateral loans.

	2009 £m			2008 £m		
	Fair value assets	Collateral loan	Net fair value of liabilities	Fair value assets	Collateral loan	Net fair value of liabilities
OTC derivatives	-	-	-	244	(271)	(27)

### 21. Investments in subsidiaries

	£m
Cost at 31 December 2009	-
Cost at 31 December 2008	168
Carrying value at 31 December 2009	-
Carrying value at 31 December 2008	60

The subsidiary undertakings of the long-term fund in 2008 are stated below. All subsidiaries have share capital consisting solely of one class with the exception of South Glasgow Retail Park Ltd. which has 'A' ordinary and 'B' ordinary shares in issue.

Subsidiary	Nature of business	% of shares held	Country of incorporation
Phoenix SCP (Holdings) Limited – formerly Scottish Provident (Holdings) Ltd	Intermediate holding company	100	England
SPI Finance plc	Finance company	100	England
South Glasgow Retail Park Ltd	Property development	100	Scotland
Prolific Holdings Ltd	Investment holding company	100	England

## Notes to the financial statements continued

### 22. Intangible assets

#### PVIF

	2009 £m	2008 £m
At 1 January		
Cost	1,001	1,001
Accumulated amortisation and impairment	(729)	(665)
Net book amount	272	336
Year ended 31 December		
Opening net book amount	272	336
Movement in the period	-	(55)
Part VII transfer (note 1)	(272)	-
Impairment on Part VII transfer (note 1)	-	(9)
Net book amount	-	272
Amount recoverable within 12 months	-	27
Amount recoverable after 12 months	-	245

The PVIF is reported gross with related taxes included within deferred tax (note 28).

### 23. Loans and receivables

	2009 £m	2008 £m
Loan	-	5
Due from fellow subsidiaries	1,063	1,032
	1,063	1,037
Amount recoverable within 12 months	-	1
Amount recoverable after 12 months	1,063	1,036

The loan balance represents amounts receivable from the Society in connection with the Part VII transfer (note 1).

Amounts due from fellow subsidiaries relate to loans to be repaid in 2016. Interest is calculated at a rate of 12 month LIBOR + 100bps or 6 month LIBOR + 294bps.

### 24. Financial assets at fair value through income

	2009 £m	2008 £m
Financial Assets at fair value through income	-	4,397
Amount recoverable within 12 months	-	4,330
Amount recoverable after 12 months	-	67

## Notes to the financial statements continued

### 25. Financial assets at fair value hierarchy

#### (a) Financial assets

	2009 £m	2008 £m
Loans and receivables at amortised cost	1,063	1,037
Designated upon initial recognition:		
Equities	-	3
Fixed income securities	-	138
Collective investment schemes	-	4,256
	<b>1,063</b>	<b>5,434</b>
Amount recoverable within 12 months	-	4,331
Amount recoverable after 12 months	<b>1,063</b>	<b>1,103</b>

The fair values of loans and receivables at amortised cost are £1,063m (2008: £1,037m).

Included within loans and receivables at amortised cost are loans of **£1,063m** (2008: £1,032m) with related parties (note 32).

#### (b) Fair value hierarchy

There are no significant financial assets or liabilities designated at fair value through profit and loss at 31 December 2009.

**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 date. 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 instruments that are not traded in an active market are determined using valuation techniques where all significant inputs are market observable. 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 date. Where discounted cash flow techniques are used, future and contractual cash flows are based on current market positions, market calibrated discount rates and interest rate assumptions for similar instruments.

**Level 3 financial instruments.** The value of the Company's financial instruments determined by valuation techniques, where there remain significant unobservable inputs are based on a combination of independent third party evidence and internally developed models.

#### (c) Significant transfers of financial instruments between level 1 and level 2

There were no significant transfers of financial instruments between level 1 and level 2 in 2009.



## Notes to the financial statements continued

### 25. Financial assets at fair value hierarchy continued

#### (d) Movements in level 3 financial instruments measured at fair value

Financial Assets	At 1 January 2009 £m	Part VII transfer	At 31 December 2009 £m	Gains/ (losses) on assets held at end of year £m
Financial assets designated at fair value through income upon initial recognition:				
Fixed income securities	54	(54)	-	-
	<u>54</u>	<u>(54)</u>	<u>-</u>	<u>-</u>

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

#### (e) Sensitivity of level 3 financial instruments measured at fair value to changes in key assumption

Level 3 investments in debt securities and private equity have been valued using broker quotes or net asset statements provided by independent third parties. Whilst such valuations are sensitive to estimates, it is believed that changing one or more assumptions to reasonably possible alternative assumptions would not change the fair value significantly.

### 26. Reinsurance receivables

	2009 £m	2008 £m
Reinsurance receivables	-	4
Amount recoverable within 12 months	<u>-</u>	<u>4</u>

### 27. Insurance contract receivables

	2009 £m	2008 £m
Insurance contract receivables	-	2
Amount recoverable within 12 months	<u>-</u>	<u>2</u>

# Notes to the financial statements continued

## 28. Tax assets and liabilities

	2009 £m	2008 £m
Deferred tax assets	-	13
Total tax assets	-	13

	2009 £m	2008 £m
Current tax payables	-	35
Deferred tax liabilities	-	59
Total tax liabilities	-	94

Deferred tax assets comprise:

	2009 £m	2008 £m
Losses carried forward	-	13

Deferred tax liabilities comprise:

	2009 £m	2008 £m
PVIF	-	56
Other temporary differences	-	3
Total deferred tax liability	-	59

An amount of £nil (2008: £51m) of the deferred tax liability is expected to crystallise after 12 months.

Movements in deferred tax assets comprise:

	2009 £m	2008 £m
At 1 January	13	10
Part VII transfer (note 1)	(13)	-
Amounts released to the income statement	-	3
At 31 December	-	13

Movements in deferred tax liabilities comprise:

	2009 £m	2008 £m
At 1 January	59	86
Part VII transfer (note 1)	(59)	-
Amounts released to the income statement	-	(27)
At 31 December	-	59

Deferred income taxes are calculated on all temporary differences under the liability method using an effective tax rate of 28% (2008: 28%).

Deferred income tax assets are recognised for tax loss carry forwards only to the extent that realisation of the related tax benefit is probable.

The amount of tax loss carry forwards and tax credits at 31 December 2009 is £nil (2008: £253m). No deferred tax asset has been recognised in respect of these amounts.

## Notes to the financial statements continued

### 29. Trade and other receivables

	2009 £m	2008 £m
Due from fellow subsidiaries	-	13
Trade and other receivables	-	3
	<u>-</u>	<u>16</u>
Amount recoverable within 12 months	-	16

The majority of amounts due from fellow subsidiaries have been reclassified as loans and receivables in the current year, following changes in the terms of the loans (note 23).

### 30. Cash and cash equivalents

	2009 £m	2008 £m
Bank and cash balances	-	166
Bank overdrafts with legal right of set off	-	(2)
	<u>-</u>	<u>164</u>

All deposits are subject to fixed interest rates. The carrying amounts approximate to fair value at the balance sheet date.

### 31. Cash flows from operating activities

	2009 £m	2008 £m
(Loss)/Profit before tax for the year	(346)	41
Non-cash movements in profit before tax for the year:		
Part VII transfer (note 1) *	225	12
Gain on sale of financial assets at fair value through income	-	(4)
Fair value loss on financial assets at fair value through income	-	745
Impairment and amortisation of intangible assets	-	28
Net increase in working capital	<u>(43)</u>	<u>(560)</u>
Net (decrease)/increase in operating assets and liabilities	<u>(164)</u>	<u>262</u>

\* A bank overdraft of £1m was transferred as a result of the Part VII transfer in 2008 and is included within net increase in working capital.

## Notes to the financial statements continued

### 32. Related party transactions

	Notes	2009 £m	2008 £m
<b>Gross premiums written:</b>			
Scottish Mutual International Limited	(a)	-	1
<b>Premiums ceded to reinsurers:</b>			
Phoenix Pensions Limited	(b)	-	(207)
<b>Fees and commission:</b>			
Ignis Fund Managers Limited (formerly Resolution Fund Managers Limited)	(c)	-	1
Scottish Mutual Investment Managers Limited	(c)	-	2
<b>Investment income:</b>			
Scottish Mutual Investment Managers Limited	(d)	-	75
Ignis Fund Managers Limited (formerly Resolution Fund Managers Limited)	(d)	-	101
Pearl Life Holdings Limited (formerly Resolution Life Limited)	(e)	-	65
Ignis Investment Services Limited (formerly Resolution Investment Services Limited)	(d)	-	4
<b>Fair value gain/(losses):</b>			
Ignis Investment Services Limited (formerly Resolution Investment Services Limited)	(f)	-	4
Ignis Alternative Funds plc	(f)	-	(15)
Scottish Mutual Investment Managers Limited	(f)	-	(560)
Ignis Fund Managers Limited (formerly Resolution Fund Managers Limited)	(f)	-	(262)
<b>Reinsurance recoveries</b>			
Phoenix Pensions Limited	(g)	-	(36)
<b>Change in insurance contract liabilities</b>			
Scottish Mutual International Limited	(h)	-	(6)
Phoenix Pensions Limited	(i)	-	(305)
<b>Administrative expenses:</b>			
Pearl Group Management Services Limited (formerly Resolution Management Services Limited)	(j)	-	19
PGMS (Glasgow) Limited (formerly Resolution Management Services (Glasgow) Limited)	(j)	-	(1)
PGMS (Ireland) Limited (formerly Resolution Management Services (Ireland) Limited)	(j)	-	13
Ignis Investment Services Limited (formerly Resolution Investment Services Limited)	(j)	-	2
Scottish Mutual Assurance Limited	(k)	-	7
<b>Financing costs:</b>			
Prolific Holdings Limited	(l)	-	2

## Notes to the financial statements continued

### 32. Related party transactions continued

#### Notes:

- (a) Premiums include in 2008 £1m of net premiums reassured to Scottish Mutual International Limited.
- (b) Premiums ceded to reinsurers include in 2008 £207m of net premiums reassured to Phoenix Pensions Limited.
- (c) Represents rebate income for the relevant counterparty.
- (d) Represents franked and unfranked investment income received from relevant counterparty.
- (e) Represents interest receivable on loan to relevant counterparty.
- (f) Represents net unrealised/realised gain/(loss) in period with relevant counterparty.
- (g) Represents the reinsurers' share of claims.
- (h) Represents the movement in the asset to Scottish Mutual International Limited in relation to the reinsurance treaty between the two parties.
- (i) Represents the movement in the reinsurance asset with Phoenix Pensions Limited.
- (j) Management charges payable to relevant counterparty. PGMS (Ireland) Limited includes in 2008 £8m of management charges and £5m in relation to movement in pension deficit.
- (k) Represents amounts paid in respect of impairment of financial assets.
- (l) Represents interest payable on loan with Prolific Holdings Limited.

The Company enters into transactions with related parties in the normal course of business. Transactions are carried out on an arms length basis.

In addition, the Company has a related party relationship with its Directors and the Directors of its parent entities who are the key management personnel of the Company. Details of Directors' emoluments are set out at note 9.

## Notes to the financial statements continued

### 32. Related party transactions continued

The Company had the following outstanding balances with related parties at the year end, which are included in the balance sheet under the captions noted:

	Notes	2009 £m	2008 £m
<b>Loans and receivables</b>			
Pearl Life Holdings Limited (formerly Resolution Life Limited)	(a)	1,063	1,020
Impala Holdings Ltd	(a)	-	12
<b>Financial assets at fair value through income:</b>			
Scottish Mutual Investment Managers Limited	(b)	-	1,264
Ignis Alternative Funds plc	(b)	-	35
Ignis Fund Managers Limited (formerly Resolution Fund Managers Limited)	(b)	-	1,861
Ignis Investment Services Limited (formerly Resolution Investment Services Limited)	(b)	-	995
<b>Reinsurers' share of insurance contract liabilities:</b>			
Phoenix Pensions Limited	(c)	-	738
<b>Prepayments:</b>			
Ignis Investment Services Limited (formerly Resolution Investment Services Limited)	(e)	-	3
<b>Trade and other receivables:</b>			
Scottish Mutual Investment Managers Limited	(d)	-	11
Ignis Fund Managers Limited (formerly Resolution Fund Managers Limited)	(d)	-	2
<b>Liabilities under insurance contracts:</b>			
Scottish Mutual International Limited	(f)	-	14
<b>Borrowings:</b>			
Prolific Holdings Limited	(g)	-	51
<b>Reinsurance payables</b>			
Phoenix Pensions Limited	(h)	-	4
<b>Trade and other payables:</b>			
Scottish Mutual International Limited	(i)	-	1
PGMS (Ireland) Limited (formerly Resolution Management Services (Ireland) Limited)	(j)	-	3
South Glasgow Retail Park Limited	(k)	-	10
Pearl Group Management Services Limited (formerly Resolution Management Services Limited)	(n)	-	2
Scottish Mutual Assurance Limited	(o)	-	17

## Notes to the financial statements continued

### 32. Related party transactions continued

#### Notes:

- (a) Balance represents capital and accrued interest on loans
- (b) Balances represent the market value of investments held with the relevant counterparty.
- (c) Balance represents the reinsurance asset in relation to the reinsurance treaty between the two parties.
- (d) Balance represents debtor balances with relevant counterparty.
- (e) Balances represent an inter company prepayment of interest from relevant counterparty.
- (f) Balance represents the liability to Scottish Mutual International Limited in relation to the reinsurance treaty between the two parties.
- (g) Balance represents the loan with Prolific Holdings Limited including accrued interest of £2m.
- (h) Balance represents an inter company creditor with Phoenix Pensions Ltd.
- (i) Balance represents inter company creditor in relation to the reinsurance treaty between the two parties.
- (j) Balance represents an inter company creditor with PGMS (Ireland) Limited.
- (k) Balance represents an inter company creditor with South Glasgow Retail Park Ltd of £10m.
- (l) Balance in 2007 represents an inter company creditor with Ignis Fund Managers Limited.
- (m) Balance in 2007 represents an inter company creditor with Ignis Investment Services Limited.
- (n) Balance represents an inter company creditor with Pearl Group Management Services Limited.
- (o) Balance represents an inter company creditor of £17m.

### 33. Risk management policies

#### Management of insurance and financial risk

Following the Part VII transfer of all of the Company's long term business, with effect from 1 January 2009, the Company has only been exposed to financial risk in relation to the potential counterparty default on the loans to the immediate parent company, PLH, or the deposits within the collective schemes in which the Company had investments during 2009.

Prior to 1 January 2009, the Company's risk management policies were as noted below.

The Company has implemented processes and structures to support the effective management of risk. Board and Board sub-committee structures, membership and terms of reference have been implemented by PGL and have been adopted across the group. The Company's Directors are responsible for the system of risk management and internal control, including financial, operational and compliance controls and for reviewing its effectiveness. Due to the limitations that are inherent in any system of internal control, this system is designed to manage and control, rather than eliminate risk completely. In assessing these risks, the Directors take into account any benefits that may accrue from risk acceptance before making a commercial decision to ensure that risks are commensurate with the anticipated returns.

Risk within the group is overseen by the Risk Management function. The Risk Management function uses a hierarchy of Pearl Group-wide policy documents as the basis for its approach. Accompanying these, the Pearl Risk Management Framework sets out the high level arrangements for risk management, control and assurance within the Pearl Group. It is designed to provide a structured approach for identifying, monitoring and managing financial and non-financial risk within the Pearl Group.

The risk policy documents set out the nature and level of risks that are acceptable to PGL and its various businesses, and sets out the Board's tolerance for earnings volatility and possible losses. It provides a description of the types and quantum of risk that PGL is prepared to take as a result of its various business operations.

Risk management policies were similarly applied prior to 1 May 2008, when the Company's ultimate parent and controlling party was Resolution plc.

Contracts are split into three categories, the key risks of which are summarised as follows:

#### With profit fund

In the context of the Risk management policies note, the with profit fund includes the special with profit fund.

This fund takes controlled investment risk with the aim of enhancing policyholder investment returns. The fund aims to limit that risk, in line with the risk policies, to that supportable by the with profit fund's assets. The costs of guarantees are, in general, spread across the contracts in the fund, but there remains a risk that the shareholder may have to contribute capital to the fund in accordance with the terms of a memorandum of agreement to which the shareholder is party. However, derivative backed hedge assets are in place to protect against this risk.

## Notes to the financial statements continued

### 33. Risk management policies continued

For unitised with profit contracts, the Company receives an annual management charge, typically ranging between 0.5% and 1.5% per annum, so that the earnings risks to the shareholder are similar to unit linked contracts.

For traditional with profit contracts, which form the minority of the with profit fund business, the shareholder receives 1/9<sup>th</sup> of the cost of bonuses declared to policyholders as long as there is a distributable surplus within the fund.

#### Unit linked (Non profit fund)

In relation to unit linked contracts, the policyholders carry all investment risks, with any changes in underlying investments being reflected by an equal and opposite change in the related contract liabilities. The Company receives an annual management charge (AMC), typically ranging between 0.5% and 1.5% per annum of the net asset value of the underlying funds. As a result of this, AMC income can increase or decrease depending on price movements within each underlying unit linked contract.

#### Non linked (Non profit fund)

The risks relating to the non profit non linked contracts lie directly with the shareholder, in the event of assets not matching liabilities.

Further detail of the risks relevant to the above sub funds and contract types and how they are controlled is set out below.

#### (a) Insurance risk

Insurance risk is the possibility under any one insurance contract that the insured event occurs and the uncertainty of the amount of the resulting claim. It refers to the inherent uncertainties in insurance, including:

- the occurrence of any event specifically insured against;
- for long-term insurance business, adverse mortality, morbidity and persistency experience; and
- expense overruns relative to pricing or provisioning assumptions.

Those terms and conditions of insurance contracts that have a material effect on the Company's cash flows are as follows:

- fixed and guaranteed benefits for a fixed future premium;
- the option to pay reduced or no future premiums;
- the option to terminate the contract completely;
- the option to exercise a guaranteed annuity or cash option; and
- MVA free guarantees

The Company controls insurance risk through the following:

- the use of actuarial models to calculate premiums and monitor claims patterns. Past experience, as well as statistical methods, are used;
- issued guidelines for concluding insurance contracts and assuming insurance risks. In relation to life insurance, the Company concentrates on risks such as mortality, disability, illness and long-term care requirements;
- reinsurance of a large portion of the annuity business and, up to the point of the Part VII transfer to The Royal London Mutual Insurance Society Limited, protection business. Reassurance is also used to limit the Company's exposure to large single claims. When selecting a re-insurer, the Company only considers those companies that provide high security. In order to assess this, ratings information is used, both from the public domain or gathered through internal investigations;
- close monitoring of the management of assets and liabilities to attempt to match the expected pattern of claim payments with the maturity dates of assets;
- the use of underwriting with premium levels being set to reflect the calculated level of risk; and
- stress and scenario testing to monitor insurance risk as part of the Individual Capital Assessment required under the FSA realistic reporting regime. Each main category of insurance risk is subject to a detailed experience analysis to ensure that all assumptions are reasonable.



## Notes to the financial statements continued

### 33. Risk management policies continued

#### (i) Sensitivity analysis

The nature of the insurance business is such that a number of assumptions have been made in compiling the financial statements.

The table at note 16(b) provides a sensitivity analysis in relation to certain assumptions.

The Company's exposure to movements in equity markets is limited by the use of derivative backed hedges within the with profit funds. For unit linked contracts invested in equities, the investment risk is borne entirely by the contract holders. Accordingly the Company's results are less sensitive to movements in equity markets.

#### (ii) Concentrations of insurance risk

The table below presents an analysis of insured benefits across products for 2008.

2008	Liability values	
	Gross liabilities £m	Net of reinsurance £m
Property linked	535	535
Non profit annuity in payment	954	20
Traditional life non profit	79	32
Traditional pension non profit	220	15
Other non profit	38	38
With profit	3,365	3,365
Total	5,191	4,005

The values for 2009 are £nil – as a result of the Part VII transfer referred to above.

#### (b) Financial Risk

The Company is exposed to financial risk through its financial assets, financial liabilities, insurance assets and insurance liabilities.

The key financial risk is that the proceeds from its financial assets are not sufficient to fund the obligations arising from its insurance and investment contracts as they fall due. The most important components of this financial risk are market risk, credit risk and liquidity risk, as outlined in the following sections.

##### (i) 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 and comprises three types of risk: interest rate risk, price risk and currency risk. These risks impact on the Company depending on the nature of the contracts written, as follows:

## Notes to the financial statements continued

### 33. Risk management policies continued

#### Insurance and investment contracts with DPF

The main market risks inherent in these contracts are dependent upon the asset allocation of the with profit fund. The more the fund is invested in an asset class, the greater the risk attached to movements in the particular asset market.

The main market risks, reflecting the asset allocation, within the with profit fund are due to variations in:

- equity prices;
- interest rates and bond prices;
- corporate bond spreads;
- equity price volatility affecting the value of policy guarantees; and
- bond volatilities affecting the value of guaranteed annuity options and other guarantees.

There are currently no direct investments in property. Small values of property investments are held indirectly, in the unit linked funds, via Collective Investment Schemes (CISs). One of the CISs has divestment restrictions, potentially delaying redemption for up to six months if there is insufficient liquidity within the fund. There is currently sufficient cash in the fund to meet redemption levels.

#### Non linked insurance contracts without DPF

For conventional products without DPF, the contract benefits are guaranteed at outset, which implies a guaranteed rate of return (ignoring mortality risk). The Company bears the risk of the assets held failing to meet the value of liabilities.

The Company's non profit funds are invested in a mix of government bonds, corporate bonds and cash. Therefore, the main market risks within these funds are:

- variation in interest rates and bond prices; and
- variation in corporate bond spreads.

#### Unit linked insurance and investment contracts without DPF

For unit linked policies, the asset values determine the liabilities and the policyholder therefore bears all the market risk.

Fee income to the Company from unit linked policies is normally taken as a percentage of funds under management, which is determined by cash flows, including the rate of asset growth. Therefore, if markets fall the value of the fee income falls as the charges on the funds under management are reduced.

The level of market risk in the Company is monitored and a report on risk levels, including Risk Based Capital levels (both total risk and market risk), is provided regularly to the Executive Committee, the Finance, Risk and Capital Oversight Committee (FRCOC) and to the Asset and Liability Committee (ALCO).

A system of exposure limits is in place with clearly specified escalation procedures in the event of breaches. Risk positions against limits are included in the monthly reports to senior management. In the non profit fund, risk mitigation actions are likely to include adjusting asset profiles to more closely match liabilities. In relation to contracts with DPF, risk mitigation actions are likely to include switching the asset allocation into less risky assets or using derivatives to hedge positions.

Market risk can be further subdivided into the following components:

##### *Interest rate risk*

Interest rate risk is the risk that the value of future cash flows of a financial instrument will fluctuate because of changes in interest rates.

The Pearl Group interest rate risk policy requires the Company to manage interest rate risk by maintaining an appropriate mix of fixed and variable rate instruments. The policy also requires it to manage the maturity profile of these assets consistent with liabilities to policyholders.

## Notes to the financial statements continued

### 33. Risk management policies continued

#### *Currency risk*

The Company's transactions are principally carried out in pounds sterling, although some business is transacted in euros, primarily in relation to the Company's Irish branch.

The foreign currency denominated business is transacted in both the with profit fund and non profit fund and is in euros. The bulk of this is invested in euro-denominated assets held to match euro-denominated liabilities. A proportion of the with profit euro assets are included as part of the hedging programme. On a net basis, foreign currency mismatch exposure is not significant.

Limited foreign currency risk does arise within the with profit fund investment portfolios supporting the Company's insurance and investment operations, where assets are held that are denominated in a foreign currency. These positions are deliberately taken to obtain diversification benefits and exposures are generally low in proportion to total fund size.

The level of exposure in total and by currency is monitored daily.

#### *Price risk*

The Company's price risk exposure relates primarily to financial assets and liabilities whose values fluctuate as a result of changes to market prices other than from interest rate and currency fluctuations.

Equity price risk is primarily undertaken in respect of assets held in with profit or unit linked funds. For unit linked funds this risk is borne by policyholders as asset movements directly impact unit prices and hence policy values. For with profit fund policyholders' future bonuses will be impacted by price risk via investment returns achieved. However, the Company has entered into over the counter derivative contracts to provide financial protection against volatility in a range of embedded policy guarantees within the with profit fund.

There is also an exposure to credit spread changes affecting the prices of corporate bonds and derivatives. The exposure applies to the with profit fund, unit linked funds, the non profit fund and the shareholder fund.

The majority of the non profit fund is backed by debt instruments which are held to match the maturity profile of liabilities and as a result of this, price risk is minimised. The assets held in the shareholder fund that are exposed to price risk are primarily high rated short term liquid assets.

#### **(ii) Credit risk**

The Company has exposure to credit risk, which is the risk that a counterparty will be unable to pay amounts in full when due.

The Company recognises that credit risk in its life insurance business arises from:

- cash deposits;
- holdings of debt (principally corporate bonds);
- the impact of credit default on equity holdings;
- reinsurance contracts; and
- derivatives transactions.

The Company structures the levels of credit risk it accepts by placing limits on its exposure to a single counterparty, or groups of counterparties, thereby ensuring concentrations of credit risk are minimised. These limits and exposures are subject to ongoing monitoring and frequent review in the context of the exposure limits placed and changes in credit ratings and spreads.

## Notes to the financial statements continued

### 33. Risk management policies continued

The tables below show the rating of fair value of assets held by the Company, which are subject to credit risk. Only credit risk on assets where risk is borne by the shareholder is shown, therefore unit linked assets are excluded.

The credit risk borne by the shareholder on with profit policies is minimal. The bonuses to with profit policyholders are designed to distribute to policyholders a fair share of the return on the assets in the with profit funds together with other elements of the experience of the fund. With profit policies are managed such that bonuses distributed to the policyholder are smoothed by building and dissolving returns over the years.

The shareholders of the Company are entitled to receive one-ninth of the cost of bonuses declared for traditional with profit contracts, which form the minority of the with profit fund business. In exceptional circumstances support to the with profit fund may be provided by the non profit or shareholder funds. The process for exercising discretion in the management of the with profit funds is set out in the principles and practices of financial management ("PPFM") for the with profit fund and is overseen by the with profit committee.

#### Non Profit Non Linked & Shareholder funds

As at 31 December 2009	AAA	AA	A	BBB	BB & below	Not rated	Total
	£m	£m	£m	£m	£m	£m	£m
<b>Loans and receivables</b>	-	-	-	-	-	1,063	1,063
<b>Financial assets at fair value through income:</b>							
Derivative assets	-	-	-	-	-	-	-
Fixed interest securities	-	-	-	-	-	-	-
Loans and deposits	-	-	-	-	-	-	-
<b>Insurance assets:</b>		-	-	-	-	-	-
Reinsurers' share of insurance contract liabilities	-	-	-	-	-	-	-
Reinsurance receivables	-	-	-	-	-	-	-
Insurance contract receivables	-	-	-	-	-	-	-
<b>Prepayments</b>	-	-	-	-	-	-	-
<b>Trade and other receivables</b>	-	-	-	-	-	-	-
<b>Cash and cash equivalents</b>	-	-	-	-	-	-	-

# Notes to the financial statements continued

## 33. Risk management policies continued

### With Profit fund

As at 31 December 2009	AAA	AA	A	BBB	BB & below	Not rated	Total
	£m	£m	£m	£m	£m	£m	£m
Loans and receivables	-	-	-	-	-	-	-
Financial assets at fair value through income:							
Derivative assets	-	-	-	-	-	-	-
Fixed interest securities	-	-	-	-	-	-	-
Loans and deposits	-	-	-	-	-	-	-
Insurance assets:							
Reinsurers' share of insurance contract liabilities	-	-	-	-	-	-	-
Reinsurance receivables	-	-	-	-	-	-	-
Insurance contract receivables	-	-	-	-	-	-	-
Prepayments	-	-	-	-	-	-	-
Trade and other receivables	-	-	-	-	-	-	-
Cash and cash equivalents	-	-	-	-	-	-	-

### Non Profit Non Linked & Shareholder funds

As at 31 December 2008	AAA	AA	A	BBB	BB & below	Not rated	Total
	£m	£m	£m	£m	£m	£m	£m
Loans and receivables	-	-	-	-	-	1,037	1,037
Financial assets at fair value through income:							
Derivative assets	-	-	-	-	-	-	-
Fixed interest securities	99	-	1	-	-	-	100
Loans and deposits	14	8	1	-	-	3	26
Insurance assets:							
Reinsurers' share of insurance contract liabilities	-	26	415	-	-	714	1,155
Reinsurance receivables	-	4	-	-	-	-	4
Insurance contract receivables	-	-	-	-	-	-	-
Prepayments	1	-	-	-	-	-	1
Trade and other receivables	-	-	-	-	-	3	3
Cash and cash equivalents	81	23	10	-	-	104	218

## Notes to the financial statements continued

### 33. Risk management policies continued

#### With Profit fund

As at 31 December 2008	AAA	AA	A	BBB	BB & below	Not rated	Total
	£m	£m	£m	£m	£m	£m	£m
Loans and receivables	-	-	-	-	-	-	-
Financial assets at fair value through income:							
Derivative assets	-	-	-	-	-	-	-
Fixed interest securities	738	115	276	93	2	63	1,287
Loans and deposits	103	52	5	-	-	19	179
Insurance assets:							
Reinsurers' share of insurance contract liabilities	-	-	-	-	-	-	-
Reinsurance receivables	-	-	-	-	-	-	-
Insurance contract receivables	-	-	-	-	-	2	2
Prepayments	4	-	1	-	-	-	5
Trade and other receivables	-	-	-	-	-	-	-
Cash and cash equivalents	535	96	52	-	-	34	717

(Source of Credit Ratings – Standard & Poor's; Moody's)

Credit ratings have not been disclosed in the above table for equities. Whilst the Company is exposed to the impact of credit default on its equity holdings, this risk is not considered significant due to the spread of holdings.

Credit risk in relation to loans and deposits, fixed income securities and cash and cash equivalents have been assessed on a look through basis where the exposure to the securities is via collective investment vehicles.

#### (iii) Liquidity risk

Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities as they fall due.

The Company manages liquidity risk through a clearly articulated Liquidity Policy, Investment Guidelines and Investment Management Agreements. The group Liquidity Policy has the objectives of ensuring low probability of loss due to liquidity risk events, documentation of systems and controls of liquidity risk and cost-efficient control of liquidity risk.

The Company effects operational control of liquidity risk through clearly documented and frequently monitored treasury guidelines.

Liquidity controls in the Company are monitored on a daily basis and breaches are escalated as provided for in the Liquidity Policy. A report on liquidity risk levels is included in the monthly risk reports submitted to the ALCO and the FRCOC.

## Notes to the financial statements continued

### 33. Risk management policies continued

The tables below summarise the maturity profile of the financial liabilities and insurance contract liabilities of the Company. The basis of presentation is such that investment contracts and insurance contracts are on a discounted basis consistent with the balance sheet. All the remaining financial liabilities are shown on an undiscounted basis.

As at 31 December 2009	Up to 1 year	1-5 years	Greater than 5 years	Total
	£m	£m	£m	£m
Insurance contract liabilities	-	-	-	-
Investment contract liabilities *	-	-	-	-
Borrowings	-	-	-	-
Payables	-	-	-	-

As at 31 December 2008	Up to 1 year	1-5 years	Greater than 5 years	Total
	£m	£m	£m	£m
Insurance contract liabilities	499	1,445	3,247	5,191
Investment contract liabilities *	180	-	-	180
Borrowings	51	-	-	51
Payables	158	24	1	183

\* Investment contract policyholders have the option to terminate or transfer their contracts at any time and receive the surrender or transfer value of their policies. Although these liabilities are payable on demand, the Company does not expect these amounts to all be paid out within one year of the reporting date.

### 34. Capital management

The Company's policy was to maintain a strong and flexible capital base so as to retain a strong credit rating and satisfy regulatory requirements whilst still creating shareholder and policyholder value.

As noted in the Directors' Report, the Company was de-authorised in December 2009 and is no longer subject to any external capital requirements. Prior to de-authorisation, the Company's capital position was monitored in the context of both the Financial Services Authority's (FSA's) Pillar 1 and Pillar 2 financial resources requirements.

In respect of Pillar 1, the table below sets out the Company's capital resources position at 31 December 2008 as reported in the annual returns to the FSA and compares this with total equity available to equity holders of the Company as reported on the IFRS balance sheet at that date:

	2008 £m
Total equity attributable to equity holders of the Company on an IFRS basis	1,416
Differences in the valuation of assets and liabilities on a Pillar 1 regulatory basis	707
Unallocated surplus	42
Intangible assets	(216)
Asset values in excess of Pillar 1 market risk and counterparty limits	(980)
Inadmissible assets directly held	(14)
Capital resources on a Pillar 1 regulatory basis	955

In respect of Pillar 2, the group has developed a capital management framework using Individual Capital Assessment (ICA) principles for identifying the risks to which each of its business units and the group as a whole are exposed and quantifying their impact on capital. The ICA process estimates the level of capital the Company should retain to ensure that there is only an extremely small risk that the Company will be unable to meet its liabilities.

The capital required is calculated based on extreme but foreseeable risk events over a one year timeframe. Although the ICA process is an internal process, the FSA may use ICA information in discussing the target capital levels it believes the Company should have available on a Pillar 2 basis. The Company then holds a further capital buffer above this to ensure that it would be able to withstand a single stress event, whether that arose from market conditions or other causes, and have sufficient capital resources to still meet the capital requirements set by the FSA from internal resources.

## Notes to the financial statements continued

### 34. Capital management continued

The Company's capital position was monitored on both a Pillar 1 and Pillar 2 basis by the FRCOC and is reported to both the Executive Committee and the statutory Board. The FRCOC and Executive Committee monitor the Company's capital composition and position against the group targets which are regularly reviewed to ensure they remain appropriate to optimise value for the policyholders and shareholders. The level of required capital of the Company is the greater of:

- the amount of capital required to meet regulatory capital adequacy requirements (Pillar 1 and Pillar 2 regulatory bases); and
- the capital required under the Company's capital management policy.

There have been no material changes in the Company's management of capital during the period. The capital policy has been established by the Company and is not externally imposed. However, external approval from the FSA would be required before making any amendments to the policy.

Except as noted below, the Company has complied with all externally and internally imposed capital requirements throughout the period.

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 ultimate EEA insurance parent undertaking, Phoenix Life Holdings Limited ("PLH").

The group capital resources requirement is an aggregate of the individual capital resources requirements of each of the regulated entities within the PLH Group. Group capital resources are based on an aggregation of the capital resources of each of the regulated entities, net of the PLH 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. However, 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 Adequacy (GCA) requirements.

Following the technical breach of GCA requirements in 2008, the FSA issued an Own Initiative Variation of Permission (OIVoP) which, *inter alia*, required cash payments and asset transfers from regulated entities within the PGL Group to be disclosed to and approved by the FSA. This afforded the Company liquidity protection whilst the OIVoP remained in force. As noted in the Directors' Report, on 2 September 2009, the Financial Services Authority lifted the OIVoP.

The Company met its GCA requirements during the year.

### 35. Contingent liabilities

As a result of the Part VII transfer (see note 1), the Company had no contingent liabilities at 31 December 2009.

### 36. Commitments

There are no outstanding calls, uncalled liabilities or underwriting commitments on securities held as at 31 December 2009 (2008: nil).

### 37. Parent undertaking and controlling party

The Company's immediate parent company is Pearl Life Holdings Limited, registered in England and Wales. A copy of that company's financial statements can be obtained from 1 Wythall Green Way, Wythall, Birmingham B47 6WG.

Prior to 2 September 2009 the Company's ultimate parent undertaking was Pearl Group Holdings (No.2) Limited. Subsequent to this date, the ultimate parent undertaking became Pearl Group, which was subsequently renamed Phoenix Group Holdings whose registered office is c/o Maples Corporate Services Limited, PO Box 309, Ugland House, Grand Cayman, KY1-1104 Cayman Islands.

A copy of the accounts of Phoenix Group Holdings, which is the parent undertaking of the smallest and largest group to consolidate these financial statements, can be obtained from the Company Secretary, 1st Floor, 32 Commercial Street, St Helier, Jersey, JE2 3RU.