

# PHOENIX LIFE ASSURANCE LIMITED

Company Registration Number: 1419

STRATEGIC REPORT, DIRECTORS' REPORT AND  
FINANCIAL STATEMENTS  
for the year ended 31 December 2018

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## Strategic report

The Directors present the Strategic report, their Report and the financial statements of Phoenix Life Assurance Limited ("the Company") for the year ended 31 December 2018.

The financial statements of the Company for the year ended 31 December 2018 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRS") and applied in accordance with the Companies Act 2006.

## Business review

### Principal activities

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

All business is written in the UK.

### Strategy

The Company is a member of the Phoenix Group. The Phoenix Group is the largest specialist consolidator of heritage life assurance funds in Europe. Its main focus is on closed life fund consolidation, specialising in the acquisition and management of closed life insurance and pension funds. The Group seeks to use its expertise to deliver value for shareholders and improve returns for policyholders and customers, whilst continuing to be recognised as the leading solutions provider for the safe, innovative and profitable decommissioning of closed life funds in the UK.

### Financial Performance

The results of the Company for the year are shown in the Statement of comprehensive income on page 24. The profit before owners' tax was £98m (2017: £(23)m).

The Company has chosen to report a non-GAAP measure of performance, being operating profit. A reconciliation of operating profit to result attributable to owners is shown on page 25. Operating profit is considered to provide a comparable measure of the underlying performance of the business as it excludes the impact of short-term economic volatility and other one-off items.

The operating profit was £97m (2017: £25m). Operating profit includes expected returns including the owners' share of with-profits bonus of £42m (2017: £48m), changes in demographic assumptions of £49m (2017: £(15)m), demographic experience of £21m (2017: £(6)m), model and methodology changes of £(18)m (2017: £6m) and new business profits of £3m (2017: loss £(9)m).

The Company's solvency position is an important measure of financial strength. The estimated 31 December 2018 Solvency II own funds and excess of own funds over solvency capital requirement (unaudited) were £1,598m (2017: £1,955m) and £384m (2017: £365m) respectively.

### Corporate activity

On 16 April 2018 the Company repaid to Phoenix Life Holdings Limited ("PLHL") the tier 2 subordinated debt of £250m and received repayment of the outstanding group loan balance of £198m from Pearl Group Holdings (No. 2) Limited ("PGH2"), the Company's immediate parent.

The Company introduced the following measures during the year to improve customer outcomes:

- Capped ongoing product costs and charges at 1.5% for policies with a value over £5,000 invested in non-specialist funds; and
- Capped ongoing product costs and charges at 3% and removed exit charges on policies of less than £5,000.

On 29 November 2018, Phoenix Group announced the intention to move to a single, digitally enhanced outsourcer platform which will improve customer outcomes. A further 2 million of the Group's policies will be transferred to Diligenta Limited ("Diligenta") by 31 December 2021.

The financial impact of the above two items is discussed further in note 2.

### Business transacted

The Company has written a wide range of life and pensions business, predominantly on individual risks.

During the year, the Company has maintained four with-profits ("WP") funds of which the Pearl WP fund operates on a 90:10 basis and the SERP, LL WP and NPL WP funds operate on a 100:0 basis. The Company also maintains a portfolio of non-profit business ("NPFs") for which the profits accrue to the shareholder. In terms of policyholder liabilities, the Pearl WP fund is the largest with gross policyholder liabilities of £6,022m (2017: £6,686m) at the period end.

There are agreements in place for the Company to provide financial support to its WP funds, if necessary. At 31 December 2018, the support in the SERP fund is £755m (2017: £909m), the LL WP fund is £158m (2017: £191m) and the NPL WP fund is £388m (2017: £422m).

Reinsurance arrangements are in place with companies outside of the Phoenix Group to cover certain blocks of immediate and deferred annuities and some permanent health, critical illness and term assurance risks and annuities.

Unit-linked funds on policies written prior to 1 January 2000 and increments written on unit-linked policies from 1 January 2000 are fully reinsured to Phoenix Life Limited ("PLL"), a fellow group company.

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

Asset management is primarily outsourced to Ignis Investment Services Limited, a member of the Standard Life Aberdeen group.

Investment administration and custody services are primarily outsourced to HSBC Bank plc.

The gross premium income of the Company for the year was £232m (2017: £243m).

The total value of assets was £16,681m (2017: £18,710m).

The gross liabilities under insurance and investment contracts at 31 December 2018 were £14,782m (2017: £16,187m).

### ***Principal risks and uncertainties***

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

The principal owners' risk exposures during the year related to the NPFs, SERP, LL WP and NPL WP funds and reflect the wide range of products in the funds. Life assurance, permanent health and critical illness contracts are affected by mortality and morbidity risks whilst pension business is adversely affected by improving annuitant longevity. Persistency and expense inflation risks apply to most products. The owners are also exposed to the risks of meeting policyholder guarantees in the SERP, LL WP and NPL WP funds. The funds also carry investment risk on holdings of fixed and variable rate income securities backing surplus assets in the funds and from investment performance associated with products carrying fund based charges. A proportion of the business is unit-linked with the investment performance risk being carried by policyholders, although owners' profit is affected by fund based charges. Risk exposures will reflect the wide range of business managed, with market risks and improving annuitant mortality being the principal risk exposures. De-risking strategies are in place such as investment strategies matching fixed interest securities with liabilities and the purchase of interest rate swaptions to mitigate risks of guaranteed annuity options.

The Company undertakes regular monitoring activities in relation to market risk exposure, including upper target exposures in each asset class, cash flow forecasting and stress and scenario testing. In addition to this, the Company has reviewed and refined the swaps and swaptions it uses to manage residual interest rate exposures.

Assets held to meet obligations to policyholders include debt securities. The Company is exposed to deterioration in the actual or perceived creditworthiness or default of issuers of relevant debt securities. It is also exposed to trading counterparties failing to meet all or part of their obligations, such as reinsurers failing to meet obligations assumed under reinsurance arrangements. An increase in credit spreads on debt securities, particularly if it is accompanied by a higher level of actual or expected issuer defaults, could have a material adverse impact on the Company's financial condition.

The Company regularly monitors its counterparty exposure and has specific limits relating to counterparty credit ratings. Where possible, exposures are diversified through the use of a range of counterparty providers. All material reinsurance and derivative positions are appropriately collateralised and guaranteed.

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

The Company monitors insurance risk through the use of internal risk measurement models, experience analyses, sensitivity analysis and stress testing. Mortality, longevity and morbidity risks are, in certain circumstances,

mitigated by the use of reinsurance, although this exposes the Company to counterparty risk regarding the failure of the reinsurance party. Where significant, this counterparty exposure is mitigated by the Company holding collateral pledged by the reinsurer.

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

The Company operates the Phoenix Group's Risk Management Framework ("RMF") to ensure that risks are identified and managed effectively. Following the purchase of Standard Life Assurance Limited ("SLAL") by Phoenix Group, the RMF is being harmonised with SLAL's Enterprise Risk Management framework and the enhanced framework will be embedded in the business over 2019. Details of the harmonised framework are outlined in the Strategic Report in the Group's Annual Report and Accounts.

The Company closely manages the risk of failure to maintain sufficient capital to provide appropriate security for policyholders and meet all regulatory capital requirements mandated by the Solvency II Directive and the Prudential Regulation Authority ("PRA"). The Capital Management Framework is detailed in note 32.

#### *Operational risks*

In addition, the Company faces operational risks, including the performance of its third party arrangements, in particular its outsourced policy administration arrangements which, as noted above have been outsourced to PGS and subcontracted to Diligenta. A management service agreement is in place with PGS. The arrangement with Diligenta is considered secure even in extreme stresses; specifically given the letter of credit and guarantee provided by Diligenta's parent undertaking, Tata Consultancy Services.

#### *Regulatory and legislative landscape*

Changes in the regulatory and legislative landscape impacts the way the Company has engaged with its customers. The conduct-focused regulator has had a greater focus on customer outcomes. This may continue to challenge the existing approach and/or may result in remediation exercises where the Company cannot demonstrate that it met the expected customer outcomes in the eyes of the regulator. The Company puts considerable effort into managing relationships with its regulators such that it is able to maintain a forward view regarding potential changes in the regulatory landscape. The Company assesses the risks of regulatory change and the impact on its operations and lobbies where appropriate.

As progress is made towards the exit of the UK from the EU ('Brexit'), the Company is continuing to closely monitor developments to manage associated economic risks. There is significant uncertainty surrounding the arrangements post Brexit, in particular whether a transitional deal will be agreed or there will be a so called 'Hard' Brexit without a transitional deal. The Company regularly monitors and reviews the financial impacts of a range of 'Brexit-related' scenarios to enable it to consider potential mitigating actions. Note 33 includes analysis of various market risks, including sensitivity analysis. The Company has not written policies outside of the UK.

The Company continues to review data and consider proposals to ensure that product charges for customers remain appropriate.

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

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

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

##### *Customers*

The Directors review various metrics in respect of Treating Customers Fairly ("TCF"), customer communication and complaints on a monthly basis. TCF is monitored through various TCF committees and any exceptions are reported to the Board as appropriate.

There is also a With-Profits Committee, comprising mostly of independent members, to opine on issues of fairness to policyholders including ensuring policyholder monies are managed in accordance with the Company's Principles and Practices of Financial Management ("PPFM").

##### *Capital resources*

As at 31 December 2018 the Company's estimated Solvency II own funds and surplus (unaudited) were £1,598m (2017: £1,955m) and £384m (2017: £365m) respectively.

##### *Operating profit*

Operating Profit is a non-GAAP measure used by management and is considered a more representative measure of performance than IFRS profit or loss after tax as it provides long term performance information unaffected by

short-term economic volatility. For the year ended 31 December 2018, the Company reported an operating profit of £97m (2017: £25m).

*Profits after taxation*

For the year ended 31 December 2018, the Company reported a profit after taxation of £83m (2017: £(14)m).

*Distributable reserves*

As at 31 December 2018, the Company had distributable reserves amounting to £269m (2017: £146m).

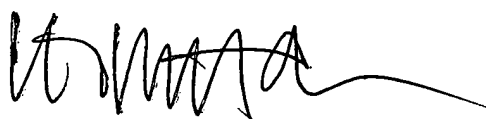
*Cash flows*

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

*Investment performance*

The performance of the Company's invested assets is reviewed against fund specific, pre-defined benchmarks by the Board, the Investment Committee and the Investment Management Committee ("IMC"), which is an internal management committee.

On behalf of the Board



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

26 February 2019

## Directors' report

Phoenix Life Assurance Limited ("the Company") is incorporated in England and Wales. Its registration number is 1419 and its registered office is 1 Wythall Green Way, Wythall, Birmingham, B47 6WG.

### **Corporate governance**

The Company, as part of a group wide framework, has established a governance framework for monitoring and overseeing strategy, operation of its business and compliance with applicable regulatory conduct standards that includes:

- a clear organisational structure with documented delegations of authority;
- matters reserved for the Board and written terms of reference for each of its committees;
- an Audit Committee, the members of which are all non-executive Directors, whose role is to monitor the overall integrity of the financial reporting by the Company and its subsidiaries, to review the overall effectiveness of the internal control and risk management systems of the Company and its subsidiaries, to monitor the overall effectiveness of the Internal Audit function of the Company and its subsidiaries and to oversee the relationship with the external auditors of the Company and its subsidiaries;
- a Risk Committee, whose membership is comprised of all the non-executive Directors of the Company, whose role is to advise the Board on risk appetite and tolerance in setting the future strategy, taking account of the Board's overall degree of risk aversion, the current financial situation of the Company and, drawing on assessment by the Audit Committee, the Company's capacity to manage and control risks within the agreed strategy; and
- the operation of a three lines of defence model with the Risk function providing risk oversight independent of management and the Internal Audit function providing independent verification of the adequacy and effectiveness of the internal controls and risk management processes in operation.

The Board is comprised of 7 non-executive Directors and 4 executive Directors.

### **Financial instruments**

Details of the Company's financial risk management objectives and policies in respect of its use of financial instruments are included in note 33 to the financial statements.

### **Future developments**

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

### **Going concern**

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

The Board has followed the UK Financial Reporting Council's "*Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks (April 2016)*" when performing their going concern assessment. To this end, the Board has undertaken a review of solvency, liquidity and cash flow projections under normal and stressed conditions.

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

**Directors**

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

A H Bowe	Appointed 31 August 2018
D R Cheeseman	
S A Clarke	
R D Houghton	Appointed 31 August 2018
J R Lister	
S D McInnes	Appointed 18 April 2018, resigned 31 August 2018
D S Miller	
A Moss	
J R Pears	Appointed 31 August 2018
N H Poyntz-Wright	
A W Snow	Resigned 15 March 2018
R K Thakrar	Appointed 23 July 2018
S C True	Resigned 9 March 2018
M N Urmston	(Chairman)

**Secretary**

Pearl Group Secretariat Services Limited acted as Secretary throughout the year.

**Disclosure of indemnity**

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

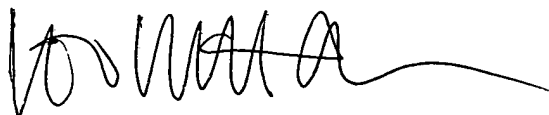
**Disclosure of information to auditor**

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 auditor is unaware, and each of the Directors has taken all the steps that they ought to have taken as a Director to make themselves aware of any relevant audit information (as defined) and to establish that the Company's auditor is aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of section 418(2) of the Companies Act 2006.

**Re-appointment of auditor**

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

On behalf of the Board



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

26 February 2019



**Statement of Directors' responsibilities**

The Directors are responsible for preparing the Strategic report, the Directors' report and the Company's financial statements ("the financial statements") in accordance with applicable United Kingdom law and regulations.

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

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

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

## Independent auditor's report to the members of Phoenix Life Assurance Limited

### Opinion

We have audited the financial statements of Phoenix Life Assurance Limited for the year ended 31 December 2018 which comprise the Statement of comprehensive income, the Pro-forma reconciliation of operating profit to result attributable to owners, the Statement of financial position, the Statement of cash flows, the Statement of changes in equity and the related notes 1 to 37 (except for the information in note 32 which is marked as unaudited), including a summary of significant accounting policies. 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.

In our opinion, the financial statements:

- give a true and fair view of the Company's affairs as at 31 December 2018 and of its profit 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.

### Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report below. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the Company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

### Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team. These matters were addressed in the context of our audit of the financial statements as a whole, and in our opinion thereon, and we do not provide a separate opinion on these matters.

### Valuation of insurance contract liabilities £13.0 billion, 2017 £14.1 billion

*Refer to the Critical accounting estimates (page 15); Accounting policy (e) and note 13 of the financial statements (page 36)*

We considered the valuation of insurance contract liabilities to be a significant risk for the Company. Specifically we considered the actuarial assumptions and modelling that are applied, as these involve complex and significant judgements about future events, both internal and external to the business for which small changes can result in a material impact to the resultant valuation. Additionally, the valuation process is conditional upon the accuracy and completeness of the data. We have split the risks relating to the valuation of insurance contract liabilities into the following component parts:

- Actuarial assumptions;
- Actuarial modelling; and
- Actuarial Data.

We assessed management's analysis of movements in insurance contract liabilities and obtained evidence to support large or unexpected movements. This provided important audit evidence over the valuation of insurance contract liabilities. Further additional audit procedures performed to respond to the specific risk areas are set out below:

Risk	Our response to the risk	Key observations communicated to the Audit Committee
<p><i>Actuarial assumptions</i></p> <p>Economic assumptions are set by management taking into account market conditions as at the valuation date. Non-economic assumptions such as future expenses, longevity and mortality are set based on past experience, market experience, market practice, regulations and expectations about future trends. Consequently, the economic assumptions are subject to uncertainty arising from macroeconomic events, such as Brexit.</p> <p>The assumptions that we consider to have the most significant impact are the base and trend longevity and persistency assumptions.</p> <p>These assumptions are used as inputs into a valuation model which uses standard actuarial methodologies.</p>	<p>To obtain sufficient audit evidence to conclude on the appropriateness of actuarial assumptions, we:</p> <ul style="list-style-type: none"> <li>• Obtained an understanding and tested the design and operating effectiveness of key controls over management's process for setting and updating actuarial assumptions;</li> <li>• Challenged and assessed whether the methodology and assumptions applied were appropriate based on our knowledge of the Company, industry standards and regulatory and financial reporting requirements;</li> <li>• Reviewed the results of management's experience analysis to assess whether these justified, the adopted assumptions and methodology, and checked that the assumptions used are consistent with this experience analysis;</li> <li>• in respect of longevity improvements we have evaluated the use of the chosen industry standard Continuous Mortality Investigation ('CMI') model and the parameters used to validate that it was appropriate relative to the industry;</li> <li>• benchmarked the demographic and economic assumptions against those of other comparable industry participants;</li> <li>• reviewed and assessed whether the disclosures in the financial statements, related to insurance contract liabilities, complied with the applicable financial reporting standards.</li> </ul>	<p>We determined that the actuarial assumptions used by management are reasonable based on the analysis of the experience to date, industry practice and the financial and regulatory requirements.</p>
<p><i>Actuarial modelling</i></p> <p>We consider the integrity and appropriateness of models to be critical to the overall valuation of insurance contract liabilities.</p> <p>Over £12.8 billion of the £13.0 billion of insurance contract liabilities are modelled using the actuarial modelling systems with the residual balance modelled outside these systems to cater for ancillary business. The key risk is therefore associated with the modelling systems but risks also exist in the calculation of amounts outside these systems.</p>	<p>To obtain sufficient audit evidence to conclude on actuarial models, including those models outside the core system, we:</p> <ul style="list-style-type: none"> <li>• obtained an understanding of the process and tested the design, implementation and operating effectiveness of key controls over management's process for model changes and key adjustments outside of the actuarial model during the year;</li> <li>• we challenged and evaluated the methodology, inputs and assumptions applied for model changes and out of model adjustments, on a sample basis, based on our knowledge of the Company,</li> </ul>	<p>We determined that the models used are appropriate, that changes to the models were implemented as intended and that controls over management's processes for modelling insurance contract liabilities outside of the actuarial modelling system were operating effectively.</p>

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Risk	Our response to the risk	Key observations communicated to the Audit Committee
	<p>industry standards and regulatory and financial reporting requirements;</p> <ul style="list-style-type: none"> <li>• reviewed the governance process around model changes and assessed the completeness of identified model changes by review of the relevant Board and Committee minutes;</li> <li>• assessed the results of the management's analysis of movements in insurance contract liabilities in order to corroborate the completeness of model changes.</li> </ul>	
<p><b>Actuarial Data</b></p> <p>The policy holder data is a key input into the valuation process. The valuation of insurance contract liabilities is therefore conditional upon the accuracy and completeness of the data used.</p>	<p>To obtain sufficient audit evidence to assess the integrity of actuarial data we:</p> <ul style="list-style-type: none"> <li>• For Outsourced Service Providers ('OSP') where we have placed reliance on the Service Organisation Controls ('SOC1') report, we have reviewed the SOC1 report and concluded on the design effectiveness of the relevant controls;</li> <li>• For OSPs where we do not receive a SOC1 we have obtained an understanding and performed direct testing of the operating effectiveness of the key controls;</li> <li>• confirmed that the actuarial model data extracts provided by the OSPs were those used as an input to the actuarial model;</li> <li>• obtained an understanding and tested the design and operating effectiveness of key input controls including information technology general controls, over management's data collection, extraction and validation process;</li> <li>• assessed the integrity of policy level data, performing corroborative testing on i) changes to static data during the period and ii) unusual trends and anomalies in the data, based on the product and our knowledge of the Company and industry standards;</li> <li>• assessed the appropriateness of management's grouping of data for input into the actuarial model; and</li> <li>• tested the reconciliations of premiums and claims information from the actuarial data extract to the general ledger, where applicable.</li> </ul>	<p>We determined based on our audit work that the policy holder data used for the actuarial model inputs are materially complete and accurate.</p>

In the prior year our auditors report included a key audit matter in relation to the valuation of complex and illiquid financial investments. In the current year, we do not consider this to be a key audit matter as the asset value has dropped from £45m to £37m and the net value on the balance sheet is immaterial.

## An overview of the scope of our audit

### Tailoring the scope

Our assessment of audit risk, our evaluation of materiality and our allocation of performance materiality determine our audit scope for the Company. This enables us to form an opinion on the financial statements. We take into account size, risk profile, the organisation of the Company and effectiveness of controls, including controls and changes in the business environment when assessing the level of work to be performed. All audit work was performed directly by the audit engagement team.

### Our application of materiality

We apply the concept of materiality in planning and performing the audit, in evaluating the effect of identified misstatements on the audit and in forming our audit opinion.

#### Materiality

*The magnitude of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users of the financial statements. Materiality provides a basis for determining the nature and extent of our audit procedures.*

We determined materiality for the Company to be £15.1 million (2017: £13.4 million), which is 2% (2017: 2%) of net assets. Whilst profit before tax or operating profit are common bases used across the life insurance industry, we believe that the use of net assets as the basis for assessing materiality is more appropriate given that the Company is a closed life assurance consolidator and as such net assets provides a more stable, long-term measure of value. We note also that net assets more closely correlates with key Company performance metrics such as Solvency II capital requirements and own funds. However, as these measures are non-GAAP measures, we consider net assets to be most appropriate.

During the course of our audit, we reassessed initial materiality and concluded that basis for materiality assessed at the planning stages of our audit remained appropriate.

#### Performance materiality

*The application of materiality at the individual account or balance level. It is set at an amount to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.*

On the basis of our risk assessments, together with our assessment of the Company's overall control environment, our judgement was that performance materiality was 50% (2017: 50%) of our planning materiality, namely £7.5million (2017: £6.7 million). We have set performance materiality at this percentage based on our assessment of the risk of misstatement.

#### Reporting threshold

*An amount below which identified misstatements are considered as being clearly trivial.*

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of £0.8 million (2017: £0.7 million), which is set at 5% of planning materiality, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in light of other relevant qualitative considerations in forming our opinion.

### Other information

The other information comprises the information included in the annual report set out on pages 2 to 8, other than the financial statements and our auditor's report thereon. The directors are responsible for the other information.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in this report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of the other information, we are required to report that fact.

We have nothing to report in this regard.

### **Opinions on other matters prescribed by the Companies Act 2006**

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and directors' report have been prepared in accordance with applicable legal requirements.

### **Matters on which we are required to report by exception**

In the light of the knowledge and understanding of the Company and its environment obtained in the course of the audit, we have not identified material misstatements in the strategic report or directors' report.

We have nothing to report in respect of the following matters in relation to which 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.

### **Responsibilities of directors**

As explained more fully in the Statement of Directors' responsibilities set out on page 8, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

### **Auditor's responsibilities for the audit of the financial statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

### ***Explanation as to what extent the audit was considered capable of detecting irregularities, including fraud***

The objectives of our audit:-

- in respect to fraud, are to identify and assess the risks of material misstatement of the financial statements due to fraud; to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and to respond appropriately to fraud or suspected fraud identified during the audit. However, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management; and
- in respect to irregularities, considered to be non-compliance with laws and regulations, are to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements ('direct laws and regulations'), and perform other audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements. We are not responsible for preventing non-compliance with laws and regulations and our audit procedures cannot be expected to detect non-compliance with all laws and regulations.

Our approach was as follows:

- We obtained a general understanding of the legal and regulatory frameworks that are applicable to the Company and determined that the direct laws and regulations related to elements of company law and tax legislation, and the financial reporting framework. Our considerations of other laws and regulations that may have a material effect on the financial statements included, permissions and supervisory requirements of the Prudential Regulation Authority ('PRA') and the Financial Conduct Authority ('FCA').

- We obtained a general understanding of how the Company is complying with those frameworks by making enquiries of management, internal audit, and those responsible for legal and compliance matters. We also reviewed correspondence between the Company and UK regulatory bodies; reviewed minutes of the Board and its Committees; and gained an understanding of the Company's approach to governance, demonstrated by the Board's approval of the Company's governance framework and the Board's review of the Company's risk management framework ('RMF') and internal control processes.
- For direct laws and regulations, we considered the extent of compliance with those laws and regulations as part of our procedures on the related financial statement items.
- For both direct and other laws and regulations our procedures involved: making enquiry of those charged with governance and senior management for their awareness of any non-compliance of laws or regulations, inquiring about the policies that have been established to prevent non-compliance with laws and regulations by officers and employees, inquiring about the Company's methods of enforcing and monitoring compliance with such policies, inspecting significant correspondence with the FCA and PRA.
- The Company operates in the insurance industry which is a highly regulated environment. As such the Senior Statutory Auditor considered the experience and expertise of the engagement team to ensure that the team had the appropriate competence and capabilities, which included the use of specialists where appropriate.
- We assessed the susceptibility of the Company's financial statements to material misstatement, including how fraud might occur by considering the controls that the Company has established to address risks identified by the entity, or that otherwise seek to prevent, deter or detect fraud. We also considered areas of significant judgement, including complex transactions, performance targets and economic or external pressures and the impact these have on the control environment. Where this risk was considered to be higher, we performed audit procedures to address each identified fraud risk. These procedures included testing manual journals and were designed to provide reasonable assurance that the financial statements were free from fraud or error.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at <https://www.frc.org.uk/auditorsresponsibilities>. This description forms part of our auditor's report.

#### Other matters we are required to address

- We were appointed by the Company on 17 July 1990 to audit the financial statements for the year ending 31 December 1990 and subsequent financial periods.
- The period of total uninterrupted engagement including previous renewals and reappointments is 29 years, covering the years ending 31 December 1990 to 31 December 2018.
- The non-audit services prohibited by the FRC's Ethical Standard were not provided to the Company and we remain independent of the Company in conducting the audit.
- The audit opinion is consistent with the additional report to the audit committee.

#### Use of our report

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.



Stuart Wilson (Senior statutory auditor)  
for and on behalf of Ernst & Young LLP, Statutory Auditor  
London  
1 March 2019

**Accounting policies****(a) Basis of preparation**

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

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

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

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

The financial statements are separate financial statements and the exemption in section 401 of the Companies Act 2006 has been used not to present consolidated financial statements. The results of the Company are consolidated into the accounts of the Company's ultimate parent, Phoenix Group Holdings plc, a company incorporated in England and Wales. A copy of the financial statements of Phoenix Group Holdings plc can be obtained from the Company Secretary, Juxon House, 100 St Paul's Churchyard, London, EC4M 8BU.

**Statement of compliance**

The financial statements of the Company have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRS") as they apply to the financial statements of the Company for the year ended 31 December 2018, and applied in accordance with the Companies Act 2006.

**(b) Critical accounting estimates and judgements**

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. Disclosures of judgements made by management in applying the Company's accounting policies include those that have the most significant effect on the amounts that are recognised in the Company's financial statements. Disclosures of estimates and associated assumptions include those that have a significant risk of resulting in a material change to the carrying value of assets and liabilities within the next year. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

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

**Operating profit**

Operating profit is the Company's non-GAAP measure of performance. The Company is required to make judgements as to the appropriate longer-term rates of investment return for the determination of operating profit, based on risk-free yields at the start of each financial year, and as to what constitutes an operating or non-operating item in accordance with the accounting policy detailed in (s).

**Insurance and investment contract liabilities**

Insurance and investment contract liability accounting is discussed in more detail in accounting policies (e) and (f) with further detail of the key assumptions made in determining insurance and investment contract liabilities included in note 33. Economic assumptions are set taking into account market conditions as at the valuation date. Non-economic assumptions, such as future expenses, longevity and mortality are set based on past experience, market practice, regulations and expectations about future trends.

The valuation of insurance contract liabilities is sensitive to the assumptions which have been applied in their calculation. Details of sensitivities arising from significant non-economic assumptions are detailed in note 33.

**Fair value of financial assets and liabilities**

The fair values of financial liabilities and assets are classified and accounted for as set out in accounting policies (g) and (n) respectively. Where possible, financial assets and liabilities are valued on the basis of listed market prices by reference to quoted market bid prices for assets and offer prices for liabilities, without any deduction for transaction costs. These are categorised as Level 1 financial instruments and do not involve estimates. If prices are not readily determinable, fair value is determined using valuation techniques including pricing models, discounted cash flow techniques or broker quotes. Financial instruments valued where valuation techniques are based on observable market data at the period end are categorised as Level 2 financial instruments. Financial instruments valued where valuation techniques are based on non-observable inputs are categorised as Level 3 financial instruments. Level 2 and Level 3 financial instruments therefore involve the use of estimates and note 26 provides further disclosures on fair value hierarchy and assumptions used to determine fair values.



In relation to the Level 3 financial instruments, sensitivity analysis is performed in respect of the key assumptions used in the valuation of these financial instruments. The details of this sensitivity analysis are included in note 26.

**Income taxes**

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

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

**(c) Foreign currency transactions**

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

**(d) Classification of contracts**

Contracts are classified as insurance contracts where the Company accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if a specified uncertain event adversely affects the policyholder.

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

Some insurance and investment contracts contain a discretionary participation feature ("DPF"). This feature entitles the policyholder to additional discretionary benefits as a supplement to guaranteed benefits. Investment contracts with a DPF are recognised, measured and presented as insurance contracts.

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

**Insurance liabilities**

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

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

For unit linked insurance contract liabilities the provision is based on the fund value, together with an allowance for any excess of future expenses over charges, where appropriate.

For participating business, the liabilities under insurance contracts and investment contracts with DPF are calculated in accordance with the following methodology:

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

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

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

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

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

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

The principal assumptions are given in note 33.

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

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

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

Where it is not possible to apportion the future profits on non-participating business to policyholders, the present value of future profits is recognised as an intangible asset and changes in its value are recorded as a separate item of income or an expense in the Statement of comprehensive income.

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

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

***Embedded derivatives***

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

***Liability adequacy***

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

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

***Unallocated surplus***

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

If the realistic value of liabilities to policyholders exceeds the value of the assets in any with-profits fund ("WPF"), the unallocated surplus is valued at £nil.

**(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 Statement of financial position as an adjustment to the liability to the policyholder.

The valuation of liabilities on unit-linked contracts is based on the fair value of the related assets and liabilities. The financial liability is measured based on the carrying value of the assets and liabilities that are held to back the contract. The liability is the sum of the unit-linked liabilities plus an additional amount to cover the present value of the excess of future policy costs over future charges.

Investment income attributable to, and the movements in the fair value of, investment contracts without DPF are included in the 'Change in investment contract liabilities' as income or an expense in the Statement of comprehensive income.

**(g) Financial liabilities**

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

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

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

**(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 as income or an expense in the Statement of comprehensive income over the period of the borrowing using the effective interest method.

Reversion loans are designated upon initial recognition at fair value through profit or loss and measured at fair value where doing so provides more meaningful information due to the reasons stated above in the financial liabilities accounting policy. Transaction costs relating to borrowings designated upon initial recognition at fair value through profit or loss are expensed as incurred.

**(i) Deposits from reinsurers**

It is the Company's practice to obtain collateral to cover certain reinsurance transactions, usually in the form of cash or marketable securities. Where cash collateral is available to the Company for investment purposes it is recognised as a 'financial asset' and the collateral repayable is recognised as 'deposits received from reinsurers' within the Statement of financial position.

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

**(j) Obligations for repayment of collateral received**

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

**(k) Income tax**

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

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

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

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

The tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on owners' returns. This allocation is calculated based on an assessment of the effective rate of tax that is applicable to owners for the year. Deferred tax assets and liabilities taxed at policyholder rates are not offset against deferred tax assets or liabilities taxed at shareholder rates due to restrictions in place in life tax legislation.

**(l) Investment property**

Investment property is stated at fair value. Fair value is the price that would be received to sell a property in an orderly transaction between market participants at the measurement date. Gains and losses arising from the change in fair value are recognised as income or an expense in the Statement of comprehensive income.

**(m) Investment in subsidiaries**

Investments in shares in subsidiaries held for strategic purposes are carried in the Statement of financial position at cost less impairment. At each reporting date for subsidiaries held at cost less impairment, the Company assesses whether there are any indications of impairment or reversal of impairment. When such indications exist, an impairment test is carried out by comparing the carrying value of the investment against the estimate of the recoverable amount, which represents the higher of value in use or fair value less costs of disposal. For investments in life insurance companies, the value in use will be calculated with reference to Solvency II eligible own funds and for other entities, IFRS net asset value. Impairments and reversal of impairments are recognised as income or an expense in the Statement of comprehensive income in the period in which they occur.

Investments in shares in subsidiaries held for investment purposes are carried at fair value through profit or loss. Investments in subsidiaries held for investment purposes include Open-ended Investments Companies ('OEICs'), unit trusts, Société d'Investissement à Capital Variable ('SICAVs') and private equity funds, which the Company is considered to control.

**(n) Financial assets**

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

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and only includes assets where a security has not been issued. These investments are initially recognised at cost, being the fair value of the consideration paid for the acquisition of the investment. All transaction costs directly attributable to the acquisition are also included in the cost of the investment. Subsequent to initial recognition, these investments are carried at amortised cost, using the effective interest method.

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

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

***Impairment of financial assets***

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

***Derecognition and offset of financial assets and liabilities***

A financial asset (or a part of a group of similar financial assets) is derecognised where:

- The rights to receive cash flows from the asset have expired;
- The Company retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a 'pass-through' arrangement; or
- The Company has transferred its rights to receive cash flows from the asset and has either transferred substantially all the risks and rewards of the asset or has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

Financial assets and liabilities are offset and the net amount reported in the statement of financial position only when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously. When financial assets and liabilities are offset any related interest income and expense is offset in the income statement.

**Fair value estimation**

The fair value of financial instruments traded in active markets such as publicly traded securities and derivatives are based on quoted market prices at the period end. The quoted market price used for financial assets is the current bid price on the trade date. The fair value of investments that are not traded in an active market is determined using valuation techniques such as broker quotes, pricing models or discounted cash flow techniques. Where pricing models are used, inputs are based on market related data at the period end. Where discounted cash flow techniques are used, estimated future cash flows are based on contractual cash flows using current market conditions and market calibrated discount rates and interest rate assumptions for similar instruments.

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

**Stock lending**

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

**Collateral**

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

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

Cash and non-cash collateral pledged where the Company retains the contractual rights to receive the cash flows generated is not derecognised from the Statement of financial position, unless the Company defaults on its obligations under the relevant agreement. Cash and non-cash collateral pledged, where the counterparty has contractual rights to receive the cash flows generated, is derecognised from the Statement of financial position and a corresponding receivable is recognised for its return.

**(o) Reinsurance****Reinsurance ceded**

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

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

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

**Reinsurance accepted**

The Company accepts insurance risk under reinsurance contracts. Amounts paid to cedants at the inception of reinsurance contracts in respect of future profits on certain blocks of business are recognised as a reinsurance asset. Changes in the value of the reinsurance assets created from the acceptance of reinsurance are recognised as an expense in the statement of comprehensive income, consistent with the expected emergence of the economic benefits from the underlying blocks of business.

At each reporting date, the Company assesses whether there are any indications of impairment. When indications of impairment exist, an impairment test is carried out by comparing the carrying value of the asset with the estimate of the recoverable amount. When the recoverable amount is less than the carrying value, an impairment charge is recognised as an expense in the Statement of comprehensive income. Reassurance assets are also considered in the liability adequacy test for each reporting period.

**(p) Cash and cash equivalents**

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

**(q) Leases**

Where a significant element of the risks and rewards of title to the asset is retained by the lessor, such leases are treated as operating leases. The assets held for use in such leases are included in investment property. Rental income from such leases is recognised as income in the Statement of comprehensive income on a straight line basis over the period of the lease.

**(r) Provisions and contingent liabilities**

A provision is recognised when the Company has a present legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

Where the Company has a present legal or constructive obligation but it is not probable that there will be an outflow of resources to settle the obligation or the amount cannot be reliably estimated, this is disclosed as a contingent liability.

A provision is recognised for onerous contracts in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs reflect the least net cost of exiting the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

**(s) Operating profit**

The Company has chosen to report a non-GAAP measure of performance, being operating profit. Operating profit is considered to provide a comparable measure of the underlying performance of the business as it excludes the impact of short-term economic volatility and other one-off items. This measure incorporates an expected return, including a longer term return on financial investments backing shareholder and policyholder funds over the period, with consistent allowance for the corresponding expected movements in liabilities. Annuity new business profits are included in operating profit using valuation assumptions consistent with the pricing of the business (including the Company's expected longer term asset allocation backing the business).

Operating profit includes the effect of variances in experience for non-economic items, such as mortality and expenses, and the effect of changes in non-economic assumptions. It also incorporates the impacts of significant management actions where such actions are consistent with the Company's core operating activities (for example, actuarial modelling enhancements and data reviews). Operating profit is reported net of policyholder finance charges and policyholder tax.

Operating profit excludes the impact of the following items:

- the difference between the actual and expected experience for economic items and the impacts of changes in economic assumptions on the valuation of liabilities;
- amortisation and impairments of intangible assets;
- finance costs attributable to owners;
- the financial impacts of mandatory regulatory change;
- integration, restructuring or other significant one-off projects; and
- any other items which, in the Directors' view, should be disclosed separately by virtue of their nature or incidence to enable a full understanding of the Company's financial performance.

Whilst the excluded items are important to an assessment of the financial performance of the Company, management considers that the presentation of the operating profit metric provides useful information for assessing the underlying performance of the Company on an ongoing basis.

The hedging strategy of the Company is calibrated to protect the regulatory capital position and cash generation capability, as opposed to the IFRS financial position. This can create additional volatility in the IFRS result which is excluded from the operating profit metric. In addition, significant non-recurring items are excluded where their nature is not reflective of the underlying performance of the business.

The Company therefore considers that operating profit provides a more representative indicator of the ability to generate cash available for distribution to shareholders. Accordingly, the measure is more closely aligned with the business model of the Company and how performance is managed by those charged with governance.

**(t) Dividends**

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

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

**(u) Income recognition**

**Gross premiums**

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

**Reinsurance premiums**

Outward reinsurance premiums are accounted for on a payable basis.

Reinsurance premiums include amounts receivable as refunds of premiums in cases where the Company cancels arrangements for the reinsurance of risk to another insurer.

**Fee and commission income**

Fee and commission income relates to the following:

- investment contract income – investment contract policyholders are charged for policy administration services, investment management services, surrenders and other contract fees. These fees are recognised as revenue over the period in which the related services are performed. If the fees are for services provided in future periods, then they are deferred and recognised over those periods. 'Front end' fees are charged on some non-participating investment contracts. Where the non-participating investment contract is measured at fair value, such fees which relate to the provision of investment management services are deferred and recognised as the services are provided; and
- other fees, which are recognised as the services are provided.

**Net investment income**

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

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

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

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

**(v) Benefits, claims and expenses recognition**

**Gross benefits and claims**

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

**Reinsurance claims**

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

**Finance costs**

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

**(w) Share capital and capital contributions**

***Ordinary share capital***

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

***Capital contributions***

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

**(x) Segmental reporting**

The Company has one reportable segment.

**(y) Events after the reporting period**

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



**Statement of comprehensive income**  
for the year ended 31 December 2018

	Notes	2018 £m	2017 £m
Gross premiums written		232	243
Less: premiums ceded to reinsurers		(4)	(22)
<b>Net premiums written</b>		<u>228</u>	<u>221</u>
Fees and commissions	3	21	21
Net investment income	4	(134)	604
<b>Total revenue, net of reinsurance payable</b>		<u>115</u>	<u>846</u>
<b>Net income</b>		<u>115</u>	<u>846</u>
Policyholder claims		(1,086)	(1,117)
Less: reinsurance recoveries		117	116
Change in insurance contract liabilities		1,156	477
Change in reinsurers' share of insurance contract liabilities		(149)	(196)
Transfer from unallocated surplus	14	21	14
<b>Net policyholder claims and benefits incurred</b>		<u>59</u>	<u>(706)</u>
Change in investment contract liabilities		101	(191)
Change in reinsurers' share of investment contract liabilities		(83)	141
Change in present value of future profits	22	-	5
Administrative expenses	5	(102)	(98)
<b>Total operating expenses</b>		<u>(25)</u>	<u>(849)</u>
<b>Profit / (Loss) before finance costs and tax</b>		<u>90</u>	<u>(3)</u>
Finance costs	8	(9)	(16)
<b>Profit / (Loss) for the year before tax</b>		<u>81</u>	<u>(19)</u>
Tax credit/(charge) attributable to policyholders' returns	9	17	(4)
<b>Profit / (Loss) before tax attributable to owners</b>		<u>98</u>	<u>(23)</u>
Tax credit	9	2	5
Plus: tax attributable to policyholders' returns		(17)	4
Tax (charge)/credit attributable to owners		(15)	9
<b>Profit / (Loss) for the year attributable to owners</b>		<u>83</u>	<u>(14)</u>
Other comprehensive income		-	-
<b>Total comprehensive income for the year attributable to owners</b>		<u>83</u>	<u>(14)</u>

**Pro-forma reconciliation of operating profit to result attributable to owners**  
for the year ended 31 December 2018

	Notes	2018 £m	2017 £m
<b>Operating profit</b>	<b>2</b>	<b>97</b>	<b>25</b>
Investment return variances and economic assumption changes on long-term business	2	3	(44)
Non-recurring items	2	(2)	(4)
<b>Profit / (Loss) before tax attributable to owners</b>		<b>98</b>	<b>(23)</b>
Tax (charge) / credit attributable to owners	9	(15)	9
<b>Profit / (Loss) for the year attributable to owners</b>		<b>83</b>	<b>(14)</b>

**Statement of financial position – equity and liabilities**  
as at 31 December 2018

	Notes	As at 31 December 2018 £m	As at 31 December 2017 £m
<b>EQUITY AND LIABILITIES</b>			
<b>Equity attributable to owners of the parent</b>			
Share capital	10	342	342
Share premium		41	41
Capital contribution reserve	11	97	97
Retained earnings		273	190
<b>Total equity</b>		<b>753</b>	<b>670</b>
<b>Liabilities</b>			
<b>Insurance contract liabilities</b>			
Liabilities under insurance contracts	13	12,971	14,127
Unallocated surplus	14	298	319
		<b>13,269</b>	<b>14,446</b>
<b>Financial liabilities</b>			
Investment contracts		1,811	2,060
Borrowings	15	83	350
Derivatives	16	327	543
Obligations for repayment of collateral received		298	494
	26	<b>2,519</b>	<b>3,447</b>
<b>Provisions</b>	17	<b>10</b>	<b>2</b>
<b>Deferred tax</b>	18	<b>6</b>	<b>19</b>
Reinsurance payables		9	9
Payables related to direct insurance contracts	19	88	74
Accruals and deferred income		9	10
Other payables	20	18	33
<b>Total liabilities</b>		<b>15,928</b>	<b>18,040</b>
<b>Total equity and liabilities</b>		<b>16,681</b>	<b>18,710</b>

**Statement of financial position - assets**  
as at 31 December 2018

		As at 31 December 2018 £m	As at 31 December 2017 £m
ASSETS	Notes		
Investment in subsidiaries	21	4,608	5,111
Intangible assets			
Present value of future profits	22	11	11
Investment property	23	37	45
Financial assets			
Loans and deposits	24	19	207
Derivatives	16	614	884
Equities		359	460
Fixed and variable rate income securities		3,898	4,346
Collective investment schemes		4,312	4,373
Reinsurers' share of investment contract liabilities	25	1,495	1,700
	26	10,697	11,970
Deferred tax assets	18	8	18
Insurance assets			
Reinsurers' share of insurance contract liabilities	13	1,063	1,212
Insurance contract receivables		1	1
		1,064	1,213
Current tax	18	6	4
Prepayments and accrued income	28	76	92
Other receivables	29	67	127
Cash and cash equivalents	30	107	119
<b>Total assets</b>		<b>16,681</b>	<b>18,710</b>

On behalf of the Board



D Cheeseman  
Director

26 February 2019

PHOENIX LIFE ASSURANCE LIMITED

**Statement of cash flows**  
for the year ended 31 December 2018

	Notes	2018 £m	2017 £m
<b>Cash flows from operating activities</b>			
Cash generated/(absorbed) by operations	31	75	(173)
Taxation paid		(5)	-
<b>Net cash flows from operating activities</b>		<u>70</u>	<u>(173)</u>
<b>Cash flows from investing activities</b>			
Loan repayment from group entity	24	198	96
<b>Net cash flows from investment activities</b>		<u>198</u>	<u>96</u>
<b>Cash flows from financing activities</b>			
Repayment of borrowings	15	(271)	(20)
Interest paid on subordinated loans		(9)	(17)
<b>Net cash flows from financing activities</b>		<u>(280)</u>	<u>(37)</u>
<b>Net decrease in cash and cash equivalents</b>		(12)	(114)
Cash and cash equivalents at the beginning of the year		119	233
<b>Cash and cash equivalents at the end of the year</b>	30	<u>107</u>	<u>119</u>
<b>Supplementary disclosures on cash flow from operating activities</b>			
Interest received		<u>131</u>	<u>155</u>
Dividends received		<u>113</u>	<u>111</u>

PHOENIX LIFE ASSURANCE LIMITED

**Statement of changes in equity**  
for the year ended 31 December 2018

	Share capital (note 10) £m	Share premium £m	Capital contribution reserve (note 11) £m	Retained earnings £m	Total £m
At 1 January 2018	342	41	97	190	670
Profit for the year	-	-	-	83	83
Other comprehensive income for the year	-	-	-	-	-
Total comprehensive income for the year	-	-	-	83	83
At 31 December 2018	342	41	97	273	753

Of the above, £269m (2017: £146m) is considered distributable.

	Share capital (note 10) £m	Share premium £m	Capital contribution reserve (note 11) £m	Retained earnings £m	Total £m
At 1 January 2017	342	41	97	279	759
Loss for the year	-	-	-	(14)	(14)
Other comprehensive income for the year	-	-	-	-	-
Total comprehensive income for the year	-	-	-	(14)	(14)
Dividends paid on ordinary shares (note 12)	-	-	-	(75)	(75)
At 31 December 2017	342	41	97	190	670

## Notes to the financial statements

### 1. Financial information

The financial statements for the year ended 31 December 2018, set out on pages 15 to 71, were authorised by the Board of directors for issue on 26 February 2019.

In preparing the financial statements, the Company has adopted the following standards and amendments which have been issued by the International Accounting Standards Board ('IASB') and have been adopted for use by the EU:

- **IFRS 15 Revenue from Contracts with Customers.** IFRS 15 establishes a single comprehensive framework for determining whether, how and when revenue is recognised. The standard does not apply to insurance contracts or financial instruments within the scope of IAS 39 Financial Instruments: Recognition and Measurement. The Company adopted IFRS 15 using the full retrospective method of adoption however the effect of adopting IFRS 15 has been minimal and has not resulted in any adjustment in either the current or prior period. There has been no change to the Company's accounting policies or to the basis of revenue recognition. As required by the standard, 'Disaggregation of Revenue' disclosures have been included in note 3 to the financial statements.
- **Amendments to IFRS 4 Insurance Contracts: Applying IFRS 9 Financial Instruments with IFRS 4.** The amendments address concerns arising from implementing the new financial instruments standard, IFRS 9, before implementing IFRS 17 Insurance Contracts, which replaces IFRS 4. The amendments introduce two options for entities issuing insurance contracts: a temporary exemption from applying IFRS 9 and an overlay approach. The Company has taken advantage of the temporary exemption granted to insurers in IFRS 4 from applying IFRS 9 until 1 January 2021 as a result of meeting the exemption criteria as at 31 December 2015. As required by IFRS 4, a number of disclosures have been included in note 26 to the financial statements to provide information to allow comparison with entities adopting the standard in 2018.

### New Accounting Pronouncements Not Yet Effective

The IASB has issued the following new standards, which apply from the dates shown. The Company has decided not to early adopt any of these standards where this is permitted. The impact on the Company of adopting these standards is subject to evaluation.

- **IFRS 17 Insurance contracts (2021 – recommended implementation date extended by the IASB to 2022).** Once effective, IFRS 17 will replace IFRS 4 (the current insurance contracts standard) and it is expected to significantly change the way the Company measures and reports its insurance contracts. The overall objective of the new standard is to provide an accounting model for insurance contracts that is more useful and consistent for users. The new standard uses three measurement approaches and the principles underlying these measurement approaches will significantly change the way the Company measures its insurance contracts and investment contracts with DPF. These changes will impact profit emergence patterns and add complexity to valuation processes, data requirements and assumption setting. During 2017 the Company commenced a project to perform an initial impact assessment of the standard on the Company and to produce a detailed implementation plan. Implementation activities during 2018 have included the development of detailed methodologies and policies and the identification of specific data and systems requirements. These activities will continue into 2019.
- **IFRS 9 Financial Instruments (2018 – Deferred to 2022).** Under IFRS 9, all financial assets will be measured either at amortised cost or fair value and the basis of classification will depend on the business model and the contractual cash flow characteristics of the financial assets. In relation to the impairment of financial assets, IFRS 9 requires the use of an expected credit loss model, as opposed to the incurred credit loss model required under IAS 39. The expected credit loss model requires the Company to account for expected credit losses and changes in those expected credit losses at each reporting date to reflect changes in credit risk since initial recognition.

The Company has taken advantage of the temporary exemption granted to insurers in IFRS 4 Insurance Contracts from applying IFRS 9 until 1 January 2021 (recommended deferral period extended by the IASB to 2022) as a result of meeting the exemption criteria as at 31 December 2015. As at this date the Company's activities were considered to be predominantly connected with insurance as the percentage of the total carrying amount of its liabilities connected with insurance relative to the total carrying amount of all its liabilities was greater than 90%. There have been no changes to the activities of the Company that require this assessment to be re-performed.

IFRS 9 will instead be implemented at the same time as the new insurance contracts standard (IFRS 17 Insurance Contracts) effective from 1 January 2021 (recommended deferral period extended by the IASB to 2022). The Company expects to continue to value the majority of its financial assets as at fair value through profit or loss on initial recognition, as these financial assets are managed on a fair value basis.

Other new or amended standards and interpretations issued by the IASB are not considered to have a significant impact on the Company's financial statements or accounting policies.

## 2. Operating Profit

### Calculation of the long-term investment return

The long-term nature of much of the Company's operations means that, for internal performance management, the effects of short-term economic volatility are treated as non-operating items. The Company focuses instead on an operating profit measure that incorporates an expected return on investments supporting its long-term business.

The expected return on investments for both owner and policyholder funds is based on opening economic assumptions applied to the funds under management at the beginning of the reporting period. Expected investment return assumptions are derived actively, based on risk-free yields at the start of each financial year.

The long-term risk-free rate used as a basis for deriving the long-term investment return is set by reference to a swap curve, plus 10bps (2017: swap curve plus 10bps). A risk premium of 350bps is added to the risk-free yield for equities (2017: 350bps), 250bps for properties (2017: 250bps), 150bps for other fixed interest assets (2017: 150bps) and 50bps for gilts (2017: 50bps).

The principal assumptions underlying the calculation of the long-term investment return are:

	2018 %	2017 %
Equities	5.2	5.0
Properties	4.2	4.0
Gilts	2.2	2.0
Other fixed interest	3.2	3.0

### Operating Profit / (Loss)

The operating profit of £97m (2017: £25m) includes the following:

- expected return on assets of £45m (2017: £48m);
- model and methodology changes of £(18)m (2017: £6m);
- updates to longevity assumptions and expense assumptions of £35m (2017: £62m) and £15m (2017: £14m) respectively; offset by updates to persistency assumptions of £(8)m (2017: £(98)m);
- experience variances of £24m (2017: £(14)m).

### Investment return variances

The investment return variances and economic assumption changes excluded from the long-term business operating profit largely arise due to differences in the IFRS reporting basis compared to the hedged Solvency II position, after allowance for risk capital.

### Non-recurring items

Non-recurring items in 2018 include:

- £(15)m net impact in respect of capping of product charges and removal of exit charges on certain policies
- £13m in respect of a strategic review of outsourcing relationships.

Non-recurring items in 2017 include:

- £(4)m net impact in respect of an increase in the workplace pension provision.



**3. Fees and commissions**

	2018 £m	2017 £m
Annual Management Charges	18	18
Non AMC Investment Contact Income	3	2
Total Investment Contract Income	21	20
Other	-	1
Total Fees and Commissions	21	21

Annual management charges are recognised in proportion to the Company's provision of investment management services. The percentage fee is specified in the policy documents. There are no remaining performance obligations as the revenue recognised corresponds to the value to the customer.

Non AMC investment contact income represents fees charged in the running of investment contracts including the provision of benefits.

Significant judgements are not required in determining the costs incurred to obtain or fulfil contracts with customers, and no amortisation is required, as income directly matches costs with management charges being applied on an ongoing (or pro-rata) basis.

**4. Net investment income**

	2018 £m	2017 £m
Investment income		
Interest income on loans and deposits	1	13
Interest income on financial assets designated at fair value through profit or loss on initial recognition	130	142
Dividend income	120	111
	251	266
Fair value gains/(losses)		
Financial assets and liabilities at fair value through profit or loss		
Held for trading – derivatives	(84)	10
Designated upon initial recognition	(170)	214
Investment in subsidiary (note 21)	(133)	121
Investment property (note 23)	2	(7)
	(385)	338
Net investment income	(134)	604

Interest income on loans and deposits includes interest receivable of £1m (2017: £13m) on loans to Group companies.

**5. Administrative expenses**

	2018 £m	2017 £m
Outsourcing expenses	81	72
Investment management expenses and transaction costs	21	26
	102	98

The Company has no employees. Administrative services are provided by Pearl Group Services Limited ("PGS"), a fellow group company.

**6. Directors' remuneration**

	2018 £000	2017 £000
Remuneration (executive and non-executive Directors' remuneration excluding pension contributions, awards under share option schemes and other long-term incentive schemes)	798	681
Share option schemes and other long-term benefits	215	262
Contributions to money purchase pension schemes	9	3
	2018 Number	2017 Number
Number of Directors accruing retirement benefits under:		
- a money purchase pension scheme	2	1
Number of Directors who had exercised share options during the year	4	4
	2018 £000	2017 £000
Highest paid Director's remuneration (apportionment)	272	286

The Executive Directors are employed by either Pearl Group Management Services Limited ("PGMS"), Pearl Group Services Limited ("PGS") or Standard Life Assets and Employee Services Limited ("SLAESL"). The Non-Executive Directors are not employed but provide their services via a letter of appointment. For the purposes of this note an apportionment of the total remuneration paid to the Directors of the Company by the Phoenix Group has been made based on an estimate of the services rendered to the Company.

**7. Auditor's remuneration**

The remuneration of the auditor of the Company, including their associates, was £331,000 (2017: £319,000). No services were provided to associated pension schemes.

Fees paid to Ernst & Young LLP for audit services to the Company and its associates are disclosed below:

	2018 £000	2017 £000
Audit of the Company's financial statements	331	319
	331	319

There were no non-audit services provided by Ernst & Young LLP during the year (2017: None).

**8. Finance costs**

	2018 £m	2017 £m
Interest expense		
On borrowings at amortised cost	9	16
Attributable to:		
- policyholders	6	6
- owners	3	10
	9	16

**9. Tax charge/(credit)**

**Current year tax credit**

	2018 £m	2017 £m
Current tax:		
UK Corporation tax	11	6
Adjustment in respect of prior years	(10)	(1)
Total current tax	1	5
Deferred tax:		
Origination and reversal of temporary differences	(3)	(9)
Change in the rate of UK corporation tax	-	(1)
Total deferred tax	(3)	(10)
Total tax credit for the year	(2)	(5)
Attributable to:		
- tax (credit)/charge attributable to policyholders' returns	(17)	4
- tax charge/(credit) attributable to owners	15	(9)
Total tax credit for the year	(2)	(5)

The Company, as a proxy for policyholders in the UK, is required to pay taxes on investment income and gains each year. Accordingly, the tax benefit or expense attributable to UK life assurance policyholder earnings is included in income tax expense. The tax benefit attributable to policyholder earnings was £17m (2017: £4m expense).

**Reconciliation of tax charge/(credit)**

	2018 £m	2017 £m
Profit /(loss) for the year before tax	81	(19)
Tax credit/(charge) attributable to policyholders' returns	17	(4)
Profit/(loss) before tax attributable to owners	98	(23)
Tax at standard UK rate of 19% (2017: 19.25%)	19	(4)
Non-taxable income & gains	(1)	-
Adjustment to owners' tax charge in respect of prior years	(1)	(5)
Profits taxed at rates other than 19%	(2)	-
Tax charge/(credit) attributable to owners	15	(9)
Tax (credit)/charge attributable to policyholders' returns	(17)	4
Total tax credit for the year	(2)	(5)

**10. Share capital**

	2018 £m	2017 £m
Issued and fully paid		
42,169,489 (2017: 42,169,489) "A" ordinary shares of 5p each	2	2
340,001,000 (2017: 340,001,000) "B" ordinary shares of £1 each	340	340
	<u>342</u>	<u>342</u>

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

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

The holders of the "B" shares are entitled to:

- a dividend equivalent to 99.999% of the profits of the Company which it may determine to distribute in respect of any financial year with the balance going to the holders of the "A" ordinary shares.
- on a return of capital, repayment in full of the capital paid up on the "B" ordinary shares and a further sum equal to 99.999% of the assets available for distribution to members with the balance of assets then going to the holders of the "A" ordinary shares.

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

**11. Capital contribution reserve**

	2018 £m	2017 £m
At 1 January and 31 December	97	97

The capital contribution has been treated as capital as there is no agreement for repayment. The reserve is considered distributable.

**12. Dividends on ordinary shares**

	2018 £m	2017 £m
Interim dividend for 2017 at 22.06p per share	-	75
	<u>-</u>	<u>75</u>

The interim dividend for 2017 was paid by way of a dividend in-specie of £75m settled by the partial transfer of a loan to PGH2.

**13. Liabilities under insurance contracts**

	Gross liabilities 2018 £m	Re-insurers' share 2018 £m	Gross liabilities 2017 £m	Re-insurers' share 2017 £m
Long term insurance business:				
Insurance contracts	7,852	1,063	8,597	1,212
Investment contracts with DPF	5,119	-	5,530	-
	<u>12,971</u>	<u>1,063</u>	<u>14,127</u>	<u>1,212</u>
Amounts due for settlement after 12 months	11,282	954	12,329	1,096

	Gross liabilities 2018 £m	Re-insurers' share 2018 £m	Gross liabilities 2017 £m	Re-insurers' share 2017 £m
At 1 January	14,127	1,212	14,604	1,408
Premiums	232	4	243	22
Claims	(1,086)	(117)	(1,117)	(116)
Other changes in liabilities	(302)	(36)	397	(102)
At 31 December	<u>12,971</u>	<u>1,063</u>	<u>14,127</u>	<u>1,212</u>

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

Other changes in liabilities principally comprise changes in economic and non-economic assumptions and experience.

**14. Unallocated surplus**

	2018 £m	2017 £m
At 1 January	319	333
Transfer (to) Statement of comprehensive income	(21)	(14)
At 31 December	<u>298</u>	<u>319</u>

**15. Borrowings**

	2018 £m	2017 £m
<b>Carrying value</b>		
Subordinated loan from fellow group company (note a)	-	250
Debenture loan - limited recourse bonds 2022 7.59% (note b)	47	59
Financial liabilities at fair value through profit or loss:		
Refinancing loan (note c)	36	41
	<u>83</u>	<u>350</u>
Amount due for settlement after 12 months	<u>71</u>	<u>339</u>

a) On 16 April 2018, the Company fully repaid the subordinated loan facility of £250m to Phoenix Life Holdings Limited ("PLHL") including accrued interest.

b) On 3 April 1998 National Provident Institution ("NPI") raised £260m of capital through the securitisation of embedded value on a block of existing unit-linked and unitised with-profit life and pension policies. The issue of £260m Limited Recourse Bonds was undertaken by the issuer, Mutual Securitisation plc. The proceeds raised by Mutual Securitisation plc were on lent to NPI.

The equity share capital of Mutual Securitisation plc is wholly owned by a charitable trust and is incorporated in the Republic of Ireland, and its results are consolidated into the accounts of Phoenix Group Holdings, the Company's ultimate parent undertaking. On 1 January 2000, all assets and liabilities of NPI were transferred to National Provident Life Limited ("NPLL"). As part of the Part VII transfer of NPLL on 30 June 2015 the loan was transferred to the Company.

The Bonds constitute direct and secured obligations of the issuer, payments under which are limited in recourse to margins emerging from the securitised block of business and from a collateral fund of £21m (2017: £26m). The collateral fund is included in cash and cash equivalents in the Statement of financial position.

The Class A2 £120m 7.5873% limited recourse bonds have an average remaining life of 1 year, maturing in 2022.

The carrying value of the bonds has been impaired as the expected future surplus emerging on the securitised business is insufficient to meet the scheduled interest and principal payments. The impairment is calculated by discounting expected future cash flows at the original effective rate of interest of the bonds, and has reduced by £1m in the year (2017: £1m).

During the year repayments of £12m (2017: £11m) of principal and £5m (2017: £5m) of accrued interest were made.

The remaining principal is £48m (2017: £60m).

c) With effect from 30 June 2015, following the NPLL Part VII transfer, the Company became party to a loan agreement with Santander UK plc ("Santander") which relates to the sale of Extra-Income Plan policies that Santander finances to the value of the associated property reversions. As part of the arrangement, Santander receive an amount calculated by reference to the movement in the Halifax House Price Index, and the Company has undertaken to indemnify Santander against profits or losses arising from mortality or surrender experience which differs from the basis used to calculate the reversion amount. Repayment will be on a policy-by-policy basis and is expected to occur over the next 10 to 20 years. The embedded derivative feature of the contract is unable to be separately measured from the host contract. As such the borrowing is designated as a liability at fair value through profit or loss. During the year, repayments totalling £9m (2017: £9m) were made. Note 23 contains details of the associated property reversions. It is expected that further repayments will occur within 12 months, broadly in line with the reduction in associated property reversions (note 23), although the value cannot be reliably estimated.

#### **Reconciliation of liabilities arising from financing activities**

The table below details changes in the Company's liabilities arising from financing activities, including both cash and non-cash changes. Liabilities arising from financing activities are those for which cash flows were, or future cash flows will be, classified in the Company's statement of cash flows as cash flows from financing activities.

	At 1 Jan 2018	Financing cash flows	Changes in fair value	At 31 Dec 2018
	£m	£m	£m	£m
Subordinated loan from fellow group company (note a)	250	(250)	-	-
Debenture loan - limited recourse bonds 2022 7.59% (note b)	59	(12)	-	47
Refinancing loan (note c)	41	(9)	4	36
	<u>350</u>	<u>(271)</u>	<u>4</u>	<u>83</u>

## 16. Derivatives

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

The fair values of derivative financial instruments are as follows:

	2018 Assets £m	2018 Liabilities £m	2017 Assets £m	2017 Liabilities £m
Forward currency	1	10	8	1
Credit default options	-	-	-	1
Interest rate swaps	572	312	752	532
Swaptions	24	-	109	-
Inflation swaps	14	3	12	3
Stock index futures	3	1	-	5
Total return bond swaps	-	1	1	-
Fixed interest futures	-	-	2	1
	<b>614</b>	<b>327</b>	<b>884</b>	<b>543</b>

The amount recoverable after one year is £609m (2017: £840m). The amount payable after one year is £316m (2017: £534m).

The Company pledges and receives collateral in respect of its derivative positions. Further information is provided in note 26.

## 17. Provisions

	Strategic review of outsourcing relationships £m	Leasehold properties £m	Unfunded pension and other £m	Total £m
At 1 January 2018	-	1	1	2
Additions in the year	8	-	-	8
Utilised during the year	-	-	-	-
At 31 December 2018	<b>8</b>	<b>1</b>	<b>1</b>	<b>10</b>

During 2018, Phoenix Group announced its intention to transition to a single, digitally enhanced outsourcer platform which will improve customer outcomes. Under this change, a further 2 million of the Group's policies will be transferred to Diligenta Limited ("Diligenta") by 31 December 2021.

A provision of £8m has been recognised for the Company's share of the expected cost of the migration, payable to PGMS.

**18. Tax assets and liabilities**

	2018 £m	2017 £m
<b>Current tax</b>		
Current tax recoverable	6	4
	<u>6</u>	<u>4</u>
<b>Deferred tax</b>		
The balances at 31 December comprises:		
Gross deferred tax assets	17	18
Less: offset against deferred tax liability	(9)	-
Net deferred tax assets	<u>8</u>	<u>18</u>
Gross deferred tax liabilities	(15)	(19)
Add: offset from deferred tax assets	9	-
Net deferred tax liabilities	<u>(6)</u>	<u>(19)</u>
<b>Net deferred tax asset/(liability)</b>	<u>2</u>	<u>(1)</u>

**Movement in deferred tax assets and liabilities**

Year ended 31 December 2018

	At 1 January £m	Recognised in the Statement of comprehensive income £m	At 31 December £m
Expenses and deferred acquisition costs carried forward	-	8	8
Trading losses	17	(9)	8
Accelerated capital allowances	1	-	1
IFRS transitional adjustments	(19)	4	(15)
	<u>(1)</u>	<u>3</u>	<u>2</u>

Year ended 31 December 2017

	At 1 January £m	Recognised in the Statement of comprehensive income £m	At 31 December £m
Trading losses	11	6	17
Accelerated capital allowances	1	-	1
IFRS transitional adjustments	(23)	4	(19)
	<u>(11)</u>	<u>10</u>	<u>(1)</u>

The Finance Act 2014 set the rate of corporation tax at 20% from 1 April 2015. The Finance (No. 2) Act 2015 announced a reduction in the rate from 20% to 19% from 1 April 2017, with a further reduction from 19% to 18% from 1 April 2020. The Finance Act 2016 which was substantively enacted on 15 September 2016 announced a further reduction in the rate from 18% to 17% from 1 April 2020. Consequently, a blended rate of tax has been used for the purposes of providing for deferred tax in these financial statements, where appropriate.



The Finance Act 2012 introduced new rules for the taxation of insurance companies, with effect from 1 January 2013. The deferred tax on the non-profit surplus has reversed and was replaced with IFRS transitional adjustments. The deferred tax on the transitional adjustments is being amortised over a 10 year period on a straight line basis commencing in 2013 and ending in 2022 as the IFRS tax transitional adjustment is brought into account in the current tax computations.

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

	2018 £m	2017 £m
Deferred tax assets have not been recognised in respect of:		
Capital losses*	20	14

\* These can only be recognised against future capital gains and have no expiry date.

**19. Payables related to direct insurance contracts**

	2018 £m	2017 £m
Payables related to direct insurance contracts	88	74
Amount due for settlement after 12 months	-	-

Payables related to direct insurance contracts includes balances for outstanding claims.

**20. Other payables**

	2018 £m	2017 £m
Investment broker balances	2	1
Other payables	16	32
	18	33
Amount due for settlement after 12 months	-	-

## 21. Investment in subsidiaries

The carrying value of the Investment in subsidiaries held at cost is £nil (2017: £nil). The cost of this was £894m (2017: £894m). There was no impairment in the year (2017: £nil).

Investments in subsidiaries held at fair value

	2018 £m	2017 £m
At 1 January	5,111	5,304
Additions	721	337
Disposals	(203)	(651)
Fair value losses / gains	(133)	121
Net transfers	(888)	-
At 31 December	4,608	5,111
	2018 £m	2017 £m
Total carrying value of investment in subsidiaries	4,608	5,111

As at 31 December, an analysis of OEIC's, Unit Trusts, SICAVs and private equity funds is carried out to assess the level of control to determine whether they are investments in subsidiaries, investment in associates or financial assets. Resulting transfers between investment in subsidiaries, investment in associates and financial assets are recognised at the opening value.

In 2018, £323m (2017: £nil) was transferred from collective investment schemes to investments in subsidiaries and £20m was transferred from equities to investments in subsidiaries. £1,231m (2017: £nil) was transferred from investments in subsidiaries to collective investment schemes.

The subsidiaries of the Company are as follows:

	Measurement basis	Country of incorporation and principal place of operation	Class of shares held (wholly-owned unless otherwise indicated)
London Life Trustees Limited (a)	Cost	England	Ordinary shares of £1
National Provident Life Limited * (a)	Cost	England	Ordinary shares of £1
NP Life Holdings Limited (a)	Cost	England	Ordinary shares of £1
NPI (Westgate) Limited (a)	Cost	England	Ordinary shares of £1
NPI (Printworks) Limited (a)	Cost	England	Ordinary shares of £1
Pearl (Barwell 2) limited (a)	Cost	England	Ordinary shares of £1
Pearl (Chiswick House) Limited (a)	Cost	England	Ordinary shares of £1
Pearl (Moor House 1) Limited (a)	Cost	England	Ordinary shares of £1
Pearl (Moor House 2) Limited (a)	Cost	England	Ordinary shares of £1
Pearl (Printworks) Limited (a)	Cost	England	Ordinary shares of £1
Pearl (Stockley Park) Limited (a)	Cost	England	Ordinary shares of £1
Pearl (WP) Investments LLC (b)	Fair value	USA	Limited Liability Company, 100%
Pearl Customer Care Limited (a)	Cost	England	Ordinary shares of £1
Pearl Trustees Limited (a)	Cost	England	Ordinary shares of £1
PUTM Bothwell Emerging Market Debt Unconstrained Fund (a) **	Fair value	England	Unit trust, 20.10%

	Measurement basis	Country of incorporation and principal place of operation	Class of shares held (wholly-owned unless otherwise indicated)
Phoenix ER2 Limited (a)	Cost	England	Ordinary shares of £1
The London Life Association Limited (a)	Cost	England	Ordinary shares of 50p
Ignis Strategic Solutions Funds plc - Fundamental Strategies Fund	Fair value	Ireland	OIEC, sub fund, 100.00%
Janus Henderson Institutional Short Duration Bond Fund **	Fair value	England	Unit trust, 99.97%
Janus Henderson Institutional Mainstream UK Equity Trust **	Fair value	England	Unit trust, 36.99%
PUTM Bothwell Floating Rate ABS Fund **	Fair value	England	Unit trust, 45.39%
PUTM Bothwell Global Credit Fund **	Fair value	England	Unit trust, 30.04%
PUTM Bothwell Asia Pacific (Excluding Japan) Fund **	Fair value	England	Unit trust, 20.13%
PUTM Bothwell Emerging Markets Equity Fund **	Fair value	England	Unit trust, 22.76%
PUTM Bothwell Institutional Credit Fund **	Fair value	England	Unit trust, 99.98%
PUTM Bothwell North America Fund **	Fair value	England	Unit trust, 20.96%
PUTM Bothwell Sub-Sovereign Bd B GBP Acc **	Fair value	England	Unit trust, 29.06%
PUTM Bothwell Tactical Asset Allocation Fund **	Fair value	England	Unit trust, 29.12%
Ignis Strategic Solutions Funds plc - Systematic Strategies Fund	Fair value	Ireland	OIEC, sub fund, 32.68%
ASI Phoenix Fund Financing SCSp (PLFF) (f)	Fair value	Luxembourg	Special Limited Partnership, 66.80%
Pearl Private Equity Fund LP	Fair value	Scotland	Limited Partnership, 100.00%
Pearl Strategic Credit Fund LP	Fair value	Scotland	Limited Partnership, 100.00%
Standard Life Investments Global SICAV - Emerging Market Debt Unconstrained	Fair value	Luxembourg	SICAV, 29.36%
Axial Fundamental Strategies (US Investments) LLC (b)	Fair value	USA	Limited Liability Company, 100.00%

\* is held via a subsidiary company, NP Life Holdings Limited.

\*\* All units invested in unit trusts are held in Authorised unit trusts

Alcobendas Entrust Limited was liquidated on 14 December 2018.

(a) The registered office of each of these subsidiaries is 1 Wythall Green Way, Wythall, Birmingham B47 6WG.

(b) The registered office of each of these subsidiaries is 2711 Centreville Road, Suite 400, Wilmington, DE\USA 19808.

(c) The registered office of each of these subsidiaries is 25-28 North Wall Quay, IFSC, Dublin 1, Ireland.

(d) The registered office of each of these subsidiaries is 201 Bishopsgate, London, EC2M 3AE.

(e) The registered office of each of these subsidiaries is 1 George Street, Edinburgh. EH2 2LL.

(f) The registered office of this subsidiary is 49, Avenue J.-F. Kennedy, L-1855 Luxembourg.

**22. Intangible assets – Present Value of Future Profits**

	2018 £m	2017 £m
<b>Carrying amount</b>		
At 1 January	11	6
Revaluation	-	5
At 31 December	<u>11</u>	<u>11</u>
 Amount recoverable after 12 months	 <u>11</u>	 <u>11</u>

The value of the present value of future profits ("PVFP") is determined using a basis consistent with the measurement of liabilities. The principal assumptions used to calculate the PVFP are the same as those used in calculating the insurance contract liabilities given in note 33.

**23. Investment property**

	2018 £m	2017 £m
At 1 January	45	73
Disposals	(10)	(21)
Fair value gains/(losses)	<u>2</u>	<u>(7)</u>
At 31 December	<u>37</u>	<u>45</u>
 Unrealised losses in the period on assets held at the end of the year	 <u>(5)</u>	 <u>(4)</u>

The property portfolio solely relates to £37m (2017: £45m) of residential property reversions arising from the sales of the NPI Extra Income Plan. Unrealised losses for the period of £5m include unwind of unrealised gains of £2m on disposals and losses on remaining property held.

The residential property reversions, interests in customers' properties that the Company will realise upon their death, are valued using a DCF model based on the Company's proportion of the current open market value, discounted for the lifetimes of the policyholders derived from published mortality tables. The open market value is measured by independent local property surveyors having appropriate recognised professional qualifications with reference to the condition of the property and local market conditions. The individual properties are valued triennially and indexed using regional house price indices to the balance sheet date. The discount rate is a risk-free rate appropriate for the duration of the asset, adjusted for the deferred possession rate of 3.6%. Assumptions are also made in the valuation for future growth in house prices based on a risk free rate. The residential property reversions have been substantially refinanced under the arrangements with Santander described in note 15 (c).

The fair value measurement of the investment properties has been categorised as a level 3 fair value based on the inputs to the valuation techniques used.

The key valuation sensitivities in respect of the residential property reversions are noted below:

- An increase of 1% in deferred possession rate would decrease the market value by £2m
- A decrease of 1% in deferred possession rate would increase the market value by £2m

Following the sale of investment properties held for rental purposes during 2017, the direct operating expenses in respect of investment properties that generated rental income during the year amounted to £Nil (2017: £24,000) and the direct operating expenses arising from investment property that did not generate rental income during the year amounted to £Nil (2017: £126,000).

**24. Loans and deposits**

	2018 £m	2017 £m
Loans to Group entities at amortised cost:		
Loans to PGH2 (a)	-	198
Loans to subsidiary company, Pearl (WP) Investments LLC	1	1
	<u>1</u>	<u>199</u>
Other loans and deposits at amortised cost, policy loans.	7	8
	<u>8</u>	<u>207</u>
Loans and deposits at fair value:		
Commercial real estate loans	11	-
At 31 December	<u>19</u>	<u>207</u>

(a) On 16 April 2018 PGH2 fully repaid the loan of £198m (including accrued interest) that was repayable on demand.

**25. Reinsurers' share of investment contract liabilities**

	2018 £m	2017 £m
Carrying value:		
At 31 December	<u>1,495</u>	<u>1,700</u>

The Company has treaties in place with Phoenix Life Limited ("PLL"), a fellow group company, to provide reinsurance in respect of liabilities that are linked to the performance of funds maintained by PLL.

**26. Financial instruments**

**IFRS 9 Financial Instruments (2021 – implementation date extended by the IASB to 2022)**

Under IFRS 9, all financial assets will be measured either at amortised cost or fair value and the basis of classification will depend on the business model and the contractual cash flow characteristics of the financial assets. In relation to the impairment of financial assets, IFRS 9 requires the use of an expected credit loss model, as opposed to the incurred credit loss model required under IAS 39. The expected credit loss model will require the Company to account for expected credit losses and changes in those expected credit losses at each reporting date to reflect changes in credit risk since initial recognition.

The Company has taken advantage of the temporary exemption granted to insurers in IFRS 4 Insurance Contracts from applying IFRS 9 until 1 January 2021 (recommended deferral period extended by IASB to 2022) as a result of meeting the exemption criteria as at 31 December 2015. As at this date the Company's activities were considered to be predominantly connected with insurance as the percentage of the total carrying amount of its liabilities in relation to insurance relative to the total carrying amount of all its liabilities was greater than 90%, with total liabilities being £17bn and liabilities connect to insurance being £17bn.

There have been no changes to the activities of the Company that require this assessment to be re-performed. IFRS 9 will instead be implemented at the same time as the new insurance contracts standard (IFRS 17 Insurance Contracts). The Company expects to continue to value the majority of its financial assets as at fair value through profit or loss on initial recognition, as they are managed and evaluated on a fair value basis.

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The table below separately identifies financial assets that are solely principal and interest (excluding those held for trading or managed on a fair value basis) and all other financial assets, measured at fair value through profit or loss.

	2018
Financial Instruments	Fair Value
	£m
Financial assets with contractual cash flows that are solely principal and interest ("SPPI") excluding those held for trading or managed on a fair value basis	8
All other financial assets that are fair value through profit or loss	13,801
<b>Total</b>	<b>13,809</b>

The financial assets with contractual cash flows that are solely principal and interest (SPPI) are loans and receivables of £8m.

The gain / (loss) in fair value of financial assets, during 2018, that are SPPI is £nil.

The (loss) in fair value, during 2018, of all other financial assets that are fair value through profit or loss is £(385)m.

The table below sets out a comparison of the carrying amounts and fair values of financial instruments as at 31 December 2018:

	<u>Carrying value</u>		
		Amounts recoverable after 12 months	
	Total £m	£m	Fair value £m
<b>Financial assets at 31 December 2018</b>			
Loans and deposits at amortised cost	8	8	8
Financial assets at fair value through profit or loss			
Held for trading - derivatives	614	609	614
Loans and deposits	11	11	11
Designated upon initial recognition			
Equities	359	-	359
Fixed and variable rate income securities	3,898	3,820	3,898
Collective investment schemes	4,312	-	4,312
Reinsurers share of investment contract liabilities	1,495	-	1,495
	<b>10,697</b>	<b>4,448</b>	<b>10,697</b>

	<u>Carrying value</u>		
		Amounts due for settlement after 12 months	
	Total £m	£m	Fair value £m
<b>Financial liabilities at 31 December 2018</b>			
Financial liabilities at fair value through profit or loss			
Held for trading - derivatives	327	316	327
Designated upon initial recognition			
Investment contracts	1,811	-	1,811
Borrowings	36	36	36
Financial liabilities measured at amortised cost			
Borrowings	47	35	49
Obligations for repayment of collateral received	298	-	-
	<b>2,519</b>	<b>387</b>	<b>2,223</b>

	<u>Carrying value</u>		
		Amounts recoverable after 12 months	Fair value
	Total £m	£m	£m
<b>Financial assets at 31 December 2017</b>			
Loans and deposits at amortised cost	207	207	207
Financial assets at fair value through profit or loss			
Held for trading - derivatives	884	840	884
Designated upon initial recognition			
Equities	460	-	460
Fixed and variable rate income securities	4,346	4,285	4,346
Collective investment schemes	4,373	-	4,373
Reinsurers share of investment contract liabilities	1,700	-	1,700
	<u>11,970</u>	<u>5,332</u>	<u>11,970</u>

	<u>Carrying value</u>		
		Amounts due for settlement after 12 months	Fair value
	Total £m	£m	£m
<b>Financial liabilities at 31 December 2017</b>			
Financial liabilities at fair value through profit or loss			
Held for trading - derivatives	543	534	543
Designated upon initial recognition			
Investment contracts	2,060	-	2,060
Borrowings	41	41	41
Financial liabilities measured at amortised cost			
Borrowings	309	297	316
Obligations for repayment of collateral received	494	-	-
	<u>3,447</u>	<u>872</u>	<u>2,960</u>

Obligations for repayment of collateral received of £298m (2017: £494m), have no expected settlement date. As the obligations relate to the repayment of collateral received in the form of cash, the liability is stated at the value of the consideration received and therefore no fair value has been disclosed.

#### Determination of fair value and fair value hierarchy of financial instruments

Level 1 financial instruments. The fair value of financial instruments traded in active markets (such as exchange traded securities and derivatives) is based on quoted market prices at the period end provided by recognised pricing services. Market depth and bid ask spreads are used to corroborate whether an active market exists for an instrument. Greater depth and narrower bid-ask spread indicates higher liquidity in the instrument and are classed as Level 1 inputs. For collective investment schemes, fair value is by reference to published bid prices.

Level 2 financial instruments. The fair values of financial instruments traded in active markets with less depth or wider bid-ask spreads which do not meet the classification as Level 1 inputs are classified as Level 2. The fair values of financial instruments not traded in active markets are determined using broker quotes or valuation techniques with observable market inputs. Financial instruments valued using broker quotes are classified as Level 2, only where there is a sufficient range of available quotes. The fair value of over the counter derivatives is estimated using pricing models or discounted cash flow techniques. Collective investments schemes where the underlying assets are not priced using active market prices are determined to be Level 2 instruments. Where pricing models are used, inputs are based on market related data at the period end. Where discounted cash flows are used, estimated future cash flows are based on management's best estimates and the discount rate used is a market related rate for a similar instrument.

Level 3 financial instruments. The Company's financial instruments determined by valuation techniques using non market observable inputs are based on a combination of independent third party evidence and internally developed models. In relation to investments in hedge funds and private equity investments, third party evidence in the form of net asset valuation statements are used as the basis for the valuation. Adjustments may be made to the net asset valuation where other evidence, for example recent sales of the underlying investments in the fund, indicates this is required. Securities that are valued using broker quotes which could not be corroborated across a sufficient range of quotes are considered as Level 3. For a small number of investment vehicles and debt securities, standard valuation models are used, with inputs that may not be fully market observable. Where possible and appropriate, inputs into such models are based on market observable data. The fair value of loans and some borrowings with no external market is determined by internally developed discounted cash flow models using a risk adjusted discount rate corroborated with external market data where possible.

For financial instruments that are recognised at fair value on a recurring basis, the Company determines whether transfers have occurred between levels in the hierarchy by re-assessing categorisation (based on the lowest level input that is significant to the fair value measurement as a whole) at the middle and end of each reporting period. Transfers identified are deemed to have taken place at the start of the reporting period.

Borrowings measured at amortised cost and categorised as Level 3 financial liabilities comprise the 7.59% limited recourse bonds.

#### Fair value hierarchy of financial instruments

The tables below separately identify financial instruments carried at fair value from those measured on another basis but for which fair value is disclosed.

At 31 December 2018

	Level 1 £m	Level 2 £m	Level 3 £m	Total fair value £m
<b>Investment in subsidiaries measured at fair value</b>	<b>4,025</b>	<b>348</b>	<b>235</b>	<b>4,608</b>

#### Financial assets measured at fair value

Derivatives	3	611	-	614
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Financial assets designated at fair value through profit or loss upon initial recognition

Equities	106	-	253	359
Fixed and variable rate income securities	3,678	113	107	3,898
Collective investment schemes	4,297	15	-	4,312
Reinsurers share of investment contract liabilities	-	1,495	-	1,495
Loans and deposits	-	-	11	11
<b>Total financial assets measured at fair value</b>	<b>8,084</b>	<b>2,234</b>	<b>371</b>	<b>10,689</b>

#### Financial assets for which fair values are disclosed

Loans and deposits at amortised cost	-	7	1	8
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<b>Total financial assets</b>	<b>8,084</b>	<b>2,241</b>	<b>372</b>	<b>10,697</b>
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Fair value hierarchy information for non-financial assets measured at fair value is included in note 23 for investment properties.



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	Level 1	Level 2	Level 3	Total fair value
	£m	£m	£m	£m
<b>Financial liabilities measured at fair value</b>				
Derivatives	1	326	-	327
<i>Financial liabilities designated at fair value through profit or loss upon initial recognition</i>				
Investment contract liabilities	-	1,811	-	1,811
Borrowings	-	-	36	36
<b>Total financial liabilities measured at fair value</b>	<b>1</b>	<b>2,137</b>	<b>36</b>	<b>2,174</b>
<b>Financial liabilities for which fair values are disclosed</b>				
Borrowings at amortised cost	-	-	49	49
<b>Total financial liabilities</b>	<b>1</b>	<b>2,137</b>	<b>85</b>	<b>2,223</b>
At 31 December 2017				
	Level 1	Level 2	Level 3	Total fair value
	£m	£m	£m	£m
<b>Investment in Subsidiaries measured at fair value</b>	<b>4,911</b>	<b>-</b>	<b>200</b>	<b>5,111</b>
<b>Financial assets measured at fair value</b>				
Derivatives	2	882	-	884
<i>Financial assets designated at fair value through profit or loss upon initial recognition</i>				
Equities	116	-	344	460
Fixed and variable rate income securities	4,151	97	98	4,346
Collective investment schemes	4,358	15	-	4,373
Reinsurers' share of investment contract liabilities	-	1,700	-	1,700
<b>Total financial assets measured at fair value</b>	<b>8,627</b>	<b>2,694</b>	<b>442</b>	<b>11,763</b>
<b>Financial assets for which fair values are disclosed</b>				
Loans and deposits at amortised cost	-	8	199	207
<b>Total financial assets</b>	<b>8,627</b>	<b>2,702</b>	<b>641</b>	<b>11,970</b>

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	Level 1	Level 2	Level 3	Total fair value
	£m	£m	£m	£m
<b>Financial liabilities measured at fair value</b>				
Derivatives	7	536	-	543
Financial liabilities designated at fair value through profit or loss upon initial recognition				
Investment contract liabilities	-	2,060	-	2,060
Borrowings	-	-	41	41
<b>Total financial liabilities measured at fair value</b>	<b>7</b>	<b>2,596</b>	<b>41</b>	<b>2,644</b>
<b>Financial liabilities for which fair values are disclosed</b>				
Borrowings at amortised cost	-	-	316	316
<b>Total financial liabilities</b>	<b>7</b>	<b>2,596</b>	<b>357</b>	<b>2,960</b>

**Level 3 financial instrument sensitivities**

Included within loans and deposits are commercial real estate loans with a fair value of £11m (2017: £nil). The loans are valued using a discounted cash flow model. The discount rate is made up of a risk-free curve and a spread. The spread is derived from a basket of comparable securities. The valuations are sensitive to movements in this spread – an increase of 35bps would decrease the value by less than £1m and a decrease of 35bps would increase the value by less than £1m.

Included within fixed and variable rate income securities are investments in local authority loans with a value of £76m (2017: £72m). The loans are valued using a discounted cash flow model. The discount rate is made up of a risk-free rate and a spread. The spread is derived from a basket of comparable securities. The valuations are sensitive to movements in this spread – an increase of 35bps would decrease the value by £4m (2017: £3m) and a decrease of 35bps would increase the value by £5m (2017: £4m).

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

Other level 3 investments in indirect property, equities (including private equity) and collective investment schemes (including hedge funds) are valued using net asset statements provided by independent third parties, and therefore no sensitivity analysis has been prepared.

Borrowings measured at fair value and categorised as Level 3 financial liabilities comprise the property reversion loans, measured using an internally developed model. The key valuation sensitivities in respect of these loans are noted below:

- An increase in the discount rate of 1% would decrease the fair value by £1m (2017: £1m).
- A decrease in the discount rate of 1% would decrease the fair value by £nil (2017: £1m).
- An increase of 1% in house price inflation would decrease the fair value by £nil (2017: £1m).
- A decrease of 1% in house price inflation would decrease the fair value by £1m (2017: £1m).

**Significant transfers of financial instruments between level 1 and level 2**

	From level 1 to level 2 £m	From level 2 to level 1 £m
At 31 December 2018		

**Financial assets at fair value**

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

Fixed and variable rate income securities	19	36
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Consistent with 2017, all the Company's Level 1 and Level 2 assets have been valued using standard market pricing sources.

The application of the Company's fair value hierarchy classification methodology at an individual security level, in particular observations with regard to measures of market depth and bid-ask spreads, have resulted in an overall net movement of financial assets from level 2 to level 1 in the period.

	From level 1 to level 2 £m	From level 2 to level 1 £m
At 31 December 2017		

**Financial assets at fair value**

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

Fixed and variable rate income securities	-	40
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**Movement in level 3 financial instruments measured at fair value**

	At 1 January 2018 £m	Total gains/ (losses) in Statement of comprehensive income £m	Purchases £m	Sales £m	Transfers to level 1 and level 2 £m	At 31 December 2018 £m	Unrealised gains/ (losses) in the period on assets held at end of year £m
Investment in subsidiaries	200	8	22	(16)	20	234	20
Financial assets designated at fair value through profit or loss upon initial recognition							
Equities	344	50	0	(121)	(20)	253	50
Fixed and variable rate income securities	98	(3)	16	(2)	(2)	107	(3)
Loans and deposits	-	-	11	-	-	11	-
	642	55	49	(139)	(2)	605	67

	At 1 January 2018 £m	Total losses in Statement of comprehensive income £m	Additions £m	Settlements £m	Transfers (to)/ from level 1 and level 2 £m	At 31 December 2018 £m	Unrealised losses in the period on liabilities held at end of year £m
Financial liabilities designated at fair value through profit or loss upon initial recognition							
Borrowings	41	4	-	(9)	-	36	4

PHOENIX LIFE ASSURANCE LIMITED

	At 1 January 2017	Total gains/ (losses) in Statement of comprehensive income	Purchases	Sales	At 31 December 2017	Unrealised gains/ (losses) in the period on assets held at end of year
	£m	£m	£m	£m	£m	£m
Investment in subsidiaries	290	(3)	54	(141)	200	(5)
Financial assets designated at fair value through profit or loss upon initial recognition						
Equities	413	22	20	(111)	344	23
Fixed and variable rate income securities	17	4	84	(7)	98	4
Collective investment schemes	-	-	(51)	51	-	-
	720	23	107	(208)	642	22

	At 1 January 2017	Total losses in Statement of comprehensive income	Part VII transfer	Settlements	At 31 December 2017	Unrealised losses in the period on liabilities held at end of year
	£m	£m	£m	£m	£m	£m
Financial liabilities designated at fair value through profit or loss upon initial recognition						
Borrowings	58	(8)	-	(9)	41	9

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

**Financial instrument collateral arrangements**  
**Offsetting financial assets and financial liabilities**

The Company has no financial assets and financial liabilities that have been offset in the Statement of financial position as at 31 December 2018 (2017: none).

The table below contains disclosures related to financial assets and financial liabilities recognised in the Statement of financial position that are subject to enforceable master netting arrangements or similar agreements. Such agreements do not meet the criteria for offsetting in the Statement of financial position as the Company has no current legally enforceable right to offset recognised financial instruments. Furthermore, certain related assets received as collateral under the netting arrangements will not be recognised in the Statement of financial position as the Company does not have permission to sell or re-pledge, except in the case of default. Details of the Company's collateral arrangements in respect of these recognised assets and liabilities are provided below.

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**At 31 December 2018**

**Financial assets**

Related amounts not offset

	Gross and net amounts of recognised financial assets £m	Financial instruments received as collateral £m	Cash received as collateral £m	Derivative liabilities £m	Net amount £m
OTC Derivatives	611	127	298	169	17
Exchange traded derivatives	3	-	3	-	-
Stock lending	985	1,052	-	-	(67)
<b>Total</b>	<b>1,599</b>	<b>1,179</b>	<b>301</b>	<b>169</b>	<b>(50)</b>

Stock lending assets lent are held on balance sheet within Fixed and variable rate income securities.

**Financial liabilities**

Related amounts not offset

	Gross and net amounts of recognised financial liabilities £m	Financial instruments pledged as collateral £m	Cash pledged as collateral £m	Derivative assets £m	Net amount £m
OTC Derivatives	326	141	18	169	(2)
Exchange traded derivatives	1	-	1	-	-
<b>Total</b>	<b>327</b>	<b>141</b>	<b>19</b>	<b>169</b>	<b>(2)</b>

**At 31 December 2017**

**Financial assets**

Related amounts not offset

	Gross and net amounts of recognised financial assets £m	Financial instruments received as collateral £m	Cash received as collateral £m	Derivative liabilities £m	Net amount £m
OTC Derivatives	882	172	494	208	8
Exchange traded derivatives	2	-	-	2	-
Stock lending	235	251	-	-	(16)
<b>Total</b>	<b>1,119</b>	<b>423</b>	<b>494</b>	<b>210</b>	<b>(8)</b>

**Financial liabilities**

	Related amounts not offset				
	Gross and net amounts of recognised financial liabilities £m	Financial instruments pledged as collateral £m	Cash pledged as collateral £m	Derivative assets £m	Net amount £m
OTC Derivatives	536	265	70	208	(7)
Exchange traded derivatives	6	-	4	2	-
<b>Total</b>	<b>542</b>	<b>265</b>	<b>74</b>	<b>210</b>	<b>(7)</b>

**Derivative and reinsurance collateral arrangements**

**Assets accepted**

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

Where the Company receives collateral in the form of marketable financial instruments which it is not permitted to sell or re-pledge except in the case of default, it is not recognised in the Statement of financial position. The fair value of financial assets accepted as collateral for OTC derivatives and reinsurance transactions but not recognised in the Statement of financial position amounts to £127m and £1,123m respectively (2017: £172m and £1,212m).

Where the Company receives collateral on OTC derivatives and reinsurance transactions in the form of cash it is recognised in the Statement of financial position along with a corresponding liability to repay the amount of the collateral received, disclosed as 'Obligations for the repayment of collateral received' and 'Deposits received from reinsurers' respectively. The amounts recognised as financial assets and financial liabilities from cash collateral received at 31 December 2018 are set out below.

	OTC derivatives	
	2018 £m	2017 £m
Financial assets	298	494
Financial liabilities	298	494

The maximum exposure to credit risk in respect of OTC derivative assets is £611m (2017: £882m) of which credit risk of £590m (2017: £867m) is mitigated by use of collateral arrangements (which are settled net after taking account of any OTC derivative liabilities owed to the counterparty).

Credit risk on exchange traded derivative assets of £3m (2017: £2m) is mitigated through regular margining and the protection offered by the exchange.

The maximum exposure to credit risk in respect of reinsurance assets is £1,063m (2017: £1,212m) and £1,022m (2017: £1,212m) of this is mitigated by use of collateral arrangements.

**Assets pledged**

The Company pledges collateral in respect of its OTC derivative liabilities.

Where the Company pledges collateral in the form of cash or marketable financial instruments and retains all the risks and rewards of the transferred assets, it continues to be recognised in the Statement of financial position. Cash collateral pledged where the counterparty retains the risks and rewards is derecognised from the Statement of financial position and a corresponding receivable is recognised for its return. The value of assets pledged at 31 December 2018 in respect of OTC derivative liabilities of £326m (2017: £536m) amounted to £159m (2017: £335m).

### **Stock lending collateral arrangements**

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

The financial assets do not qualify for derecognition as the Company retains all the risks and rewards of the transferred assets except for voting rights. The carrying value of listed financial assets lent at 31 December 2018 that have not been derecognised amounted to £985m (2017: £235m).

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

Where the Company receives collateral in the form of marketable financial instruments which it is not permitted to sell or re-pledge except in the case of default, such collateral is not recognised in the statement of financial position. The fair value of financial assets accepted as such collateral amounted to £1,052m (2017: £251m).

The maximum exposure to credit risk in respect of stock lending transactions is £985m (2017: £235m) and this is fully mitigated through the use of collateral arrangements.

## **27. Structured Entities**

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only, and the relevant activities are directed by means of contractual arrangements. A structured entity often has some or all of the following features or attributes: (a) restricted activities; (b) a narrow and well-defined objective, such as to provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors; (c) insufficient equity to permit the structured entity to finance its activities without subordinated financial support; and (d) financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches).

The Company has determined that all of its investments in collective investment schemes are structured entities. In addition, a number of debt security structures and private equity funds have been identified as structured entities. The Company has assessed that it has interests in structured entities as shown below:

- Unit trusts
- OEICs
- SICAVs
- Private Equity Funds (PEFs)
- Liquidity funds
- Asset-backed securities
- Collateralised Debt Obligation (CDOs)
- Other debt structures

The Company's holdings in the above investments are subject to the terms and conditions of the respective fund's prospectus and are susceptible to market price risk arising from uncertainties about future values. The Company holds redeemable shares and units in each of the funds. The funds are managed by asset managers who apply various investment strategies to accomplish their respective investment objectives. All of the funds are managed by asset managers who are compensated by the respective funds for their services. Such compensation generally consists of an asset-based fee and a performance-based incentive fee and is reflected in the valuation of each fund.

### **Interests in structured entities**

The Company does not provide financial or other support in relation to structured entities.

The Company's interests in structured entities are held at fair value through profit or loss. Any change in fair value is included in the Statement of comprehensive income in 'net investment income'.

A summary of the Company's interests in structured entities is included below. These are analysed by the nature of the investment and financial asset categorisation. The structured entities are presented within financial assets in the Statement of financial position except where the Company considers it has control and therefore has classified them as investments in subsidiaries (£4,608m (2017: £5,103m)).

	Carrying value of financial assets 2018 £m	Carrying value of financial assets 2017 £m
Equities	285	342
Collective investment schemes		
Equities	1,402	1,518
Bonds	3,373	3,265
Property	15	15
Short-term liquidity	3,350	4,285
Fund of funds	183	187
Diversified	198	200
Total collective investment schemes	8,521	9,470
Fixed and variable rate income securities		
Asset backed securities	139	155
	<u>8,945</u>	<u>9,967</u>

Collective investment schemes have been analysed by reference to the predominant asset class the structure is investing in. Where there is no predominant class, investments are allocated to the classification 'Diversified'.

The Company's maximum exposure to loss to the interests presented above is the carrying amount of the Company's investments. Once the Company has disposed of its shares or units in a fund, it ceases to be exposed to any risk from that fund.

Details of commitments to subscribe to private equity funds are included in note 34.

## 28. Prepayments and accrued income

	2018 £m	2017 £m
Prepayments	43	44
Accrued Income	33	48
	<u>76</u>	<u>92</u>
Amount recoverable after 12 months	<u>40</u>	<u>42</u>

## 29. Other receivables

	2018 £m	2017 £m
Collateral pledged	18	70
Initial margins on cleared derivatives	31	30
Other receivables	18	27
	<u>67</u>	<u>127</u>
Amount recoverable after 12 months	<u>-</u>	<u>-</u>



**30. Cash and cash equivalents**

	2018 £m	2017 £m
Bank and cash balances	107	119
	<u>107</u>	<u>119</u>

Included in bank and cash balances is collateral of £21m (2017: £26m) held in respect of the liabilities arising on the limited recourse bonds included in note 15.

**31. Cash flows**

***Cash flows from operating activities***

	2018 £m	2017 £m
Profit / (loss) for the year before tax	81	(19)
Non-cash movements in profit / (loss) for the year before tax		
Fair value (gains)/losses on:		
Investment property	(2)	7
Financial assets	254	(345)
Investments in subsidiaries	133	(121)
Change in PVFP	-	(5)
Change in unallocated surplus	(21)	(14)
Interest expense on borrowings	1	1
Interest income on loans	(1)	(13)
Changes in operating assets and liabilities		
Change in investment assets	440	111
Change in net derivative assets/(liabilities)	(32)	3
Change in obligation for repayment of collateral received	(196)	19
Change in reinsurance assets	354	194
Change in insurance contract and investment contract liabilities	(1,405)	(455)
Change in borrowings	4	(9)
Change in provisions	8	-
Change in other assets	459	511
Change in other liabilities	(2)	(38)
Cash generated/(absorbed) by operations	<u>75</u>	<u>(173)</u>

**32. Capital management**

**Capital Management Framework**

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

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

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

**Own Funds and SCR**

Following the implementation of the Solvency II Directive effective from 1 January 2016, the Company's capital is managed on a Solvency II basis. A Solvency II capital assessment involves valuation in line with Solvency II principles of the Company's own funds and a risk-based assessment of the Company's Solvency Capital Requirement ("SCR"). Solvency II surplus is the excess of Eligible Own Funds over the SCR.

Basic Own Funds represent the excess of assets over liabilities from the Solvency II balance sheet adjusted to add back any relevant subordinated liabilities that meet the criteria to be treated as capital items. The Basic Own Funds are classified into three Tiers based on permanency and loss absorbency (Tier 1 being the highest quality and Tier 3 the lowest). Limits are imposed on the amount of each tier that can be held to cover the SCR.

Surplus funds in the with-profit funds are restricted and can only be included in Eligible Own Funds up to the value of the SCR they are used to support.

The Company has obtained PRA approval to calculate the SCR using an Internal Model. This model has been calibrated to ensure that the Company's liabilities could be met in one year's time with a 99.5% confidence level, or in other words to be able to withstand a 1 in 200 year event.

The estimated Solvency II surplus position (unaudited) at 31 December 2018 is presented in the Strategic report on page 4.

#### **Capital policy**

The capital policy is set by the Board and ensures there is sufficient capital to cover the SCR under stress conditions. It is monitored weekly by management and is reported each month at an executive and Board level.

The policy also ensures sufficient liquidity to meet creditor and dividend obligations. Volatility in the latter is monitored at the executive and Board level through stress and scenario testing. Where cash flow volatility is judged to be in excess of the Board's risk appetite, de-risking activities are undertaken.

The Company has made no significant changes, from previous years, to its policies and processes for its capital structure.

#### **Internal capital support to with-profits funds**

As noted in the Strategic report, there are arrangements for the Company to provide financial support to the Company's with-profit ("WP") funds. At 31 December 2018, the Company provided support of £755m (2017: £909m) to the SERP WP fund, on which an impairment of £706m (2017: £855m) has been recognised. Support was also provided to the LL WP fund of £158m (2017: £191m) with an impairment recognised of £142m (2017: £166m). Support was also provided to the NPL WP fund of £388m (2017: £422m) with an impairment recognised of £308m (2017: £340m).

### **33. Risk management**

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

As noted in the 'Principal risks and uncertainties' section of the Strategic Report, the Company is closely monitoring developments to ensure that it can continue to service existing non-UK policyholders after the UK's exit from the EU. The Company regularly monitors and reviews the operational and financial impacts of a range of 'Brexit-related' scenarios to enable it to consider potential mitigating actions.

#### **Risk and capital management objectives**

The risk management objectives and policies of the Company are based on the requirement to protect the Company's regulatory capital position, thereby safeguarding policyholders' guaranteed benefits whilst also ensuring the Company can meet various cash flow requirements. Subject to this, the Company seeks to use available capital to achieve increased investment returns, balancing risk and reward, to generate additional value for policyholders and owners.

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

#### **Financial risk and the asset liability management framework**

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

Responsibility for agreeing the financial risk profile rests with the Board, as advised by investment managers, internal committees and the actuarial function. In setting the risk profile, the Board will receive advice from the appointed investment managers, the With-Profit Actuary and the Chief Actuary as to the potential implications of that risk profile on the probability of both realistic insolvency and of failing to meet the regulatory minimum capital requirement. The Chief Actuary will also advise the extent to which the investment risk assumed is consistent with the Company's commitment to treat customers fairly.

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

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

The Company is also exposed to insurance risk. Life insurance risk arises through exposure to mortality, longevity and to other variances between assumed and actual experience. These variances can also arise on persistency levels and management and administrative expenses. More details on the Company's exposure to insurance risk is provided below.

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

The Company operates the Phoenix Group's Risk Management Framework ("RMF") to ensure that risks are identified and managed effectively. Following the purchase of Standard Life Assurance Limited ("SLAL") by Phoenix Group, the RMF is being harmonised with SLAL's Enterprise Risk Management framework and the enhanced framework will be embedded in the business over 2019. Details of the harmonised framework are outlined in the Strategic Report in the Group's Annual Report and Accounts.

#### **Financial risk analysis**

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

#### **Credit risk**

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

There are two principal sources of credit risk for the Company:

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

The amount disclosed in the Statement of financial position in respect of all financial assets, together with rights secured under unrecognised collateral arrangements, and excluding those that back unit-linked liabilities, represents the Company's maximum exposure to credit risk.

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

### Quality of credit assets

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

#### 2018

	AAA £m	AA £m	A £m	BBB £m	BB £m	Internally Rated £m	Non rated £m	Unit- linked £m	Total £m
Loans and deposits	-	-	-	-	-	11	8	-	19
Derivatives	-	1	504	84	-	-	25	-	614
Fixed and variable rate income securities	178	2,542	538	292	-	261	87	-	3,898
Reinsurers' share of investment contract liabilities	-	-	-	-	-	-	-	1,495	1,495
Reinsurers' share of insurance contract liabilities	-	1,063	-	-	-	-	-	-	1,063
Cash and cash equivalents	-	24	25	58	-	-	-	-	107

#### 2017

	AAA £m	AA £m	A £m	BBB £m	BB £m	Internally Rated £m	Non rated £m	Unit- linked £m	Total £m
Loans and deposits	-	-	-	-	-	-	207	-	207
Derivatives	-	13	696	167	-	-	8	-	884
Fixed and variable rate income securities	231	2,913	731	318	1	98	54	-	4,346
Reinsurers' share of investment contract liabilities	-	-	-	-	-	-	-	1,700	1,700
Reinsurers' share of insurance contract liabilities	-	1,212	-	-	-	-	-	-	1,212
Cash and cash equivalents	-	107	12	-	-	-	-	-	119

As noted above for financial assets that do not have credit ratings assigned by external ratings the Group assigns internal ratings for use in management and monitoring credit risk. £11m (2017: £nil) of AAA, £57m (2017: £78m) of AA, £145m (2017: £20m) of A, £48m (2017: £nil) of BBB, fixed and variable rate income securities are internally rated.

Also included in the above are £11m (2017: £nil) of loans and deposits which are internally rated as A.

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

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

The Company maintains accurate and consistent risk ratings across its asset portfolio. This enables management to focus on the applicable risks and to compare credit exposures across all lines of business, geographical regions and products. The rating system is supported by a variety of financial analytics combined with market information to provide the main inputs for the measurement of counterparty risk. All risk ratings are tailored to the various categories of assets and are assessed and updated regularly. Significant exposures and breaches are reported to the Board and to the Investment Committee.

The Company operates an Internal Credit Rating Committee to monitor and control oversight of externally rated and internally rated assets. A variety of methods are used to validate the appropriateness of credit assessment from external institutions and fund managers. Internally rated assets are those that do not have a public rating from an external credit assessment institution. This Committee reviews the policies, processes and practices to ensure the appropriateness of the internal ratings assigned to asset classes.

The impact of non-government fixed and variable rate income securities and, inter alia, the change in market credit spreads during the year are fully reflected in the values shown in these financial statements. Credit spreads are

the excess of corporate bond yields over gilt yields to reflect the higher level of risk. Similarly, the value of derivatives that the Company holds takes into account fully the changes in swap spreads. This exposure applies to with-profits funds, unit-linked funds, non-profit funds (where risks and rewards fall wholly to owners) and in owners' funds.

A 100 basis point widening of credit spreads, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full financial year and in equity of £35m (2017: £38m).

A 100 basis point narrowing of credit spreads, with all other variables held constant, would result in an increase in the profit after tax in respect of a full financial year and in equity of £21m (2017: £38m).

A further indicator of the quality of the Company's financial assets is the extent to which they are neither past due nor impaired. The Company had no material assets which were impaired or past due (2017: £nil).

#### Concentration of credit risk

Concentration of credit risk might exist where the Company has significant exposure to an individual counterparty or a group of counterparties with similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic and other conditions. The Company's counterparty risk is monitored by the counterparty limits contained within the investment guidelines and investment management agreements, overlaid by regulatory requirements and the monitoring of aggregate counterparty exposures across the Company. Counterparty risk in respect of OTC derivative counterparties is monitored using a Potential Future Value ("PFE") exposure metric.

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

#### Reinsurance

The Company is exposed to credit risk as a result of insurance risk transfer contracts with reinsurers. This also gives rise to concentration of risk with individual reinsurers, due to the nature of the reinsurance market and the restricted range of reinsurers that have acceptable credit ratings. The Company manages its exposure to reinsurance credit risk through the operation of a Credit Risk Policy, collateralisation where appropriate, and regular monitoring of exposures at the Reinsurance Management Committee.

#### Collateral

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

Further details on collateral held are given in note 26 above.

#### Market risk

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

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

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

The Company manages the levels of market risk that it accepts through the operation of a Market Risk Policy and an approach to investment management that determines:

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

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

#### ***Interest rate risk***

Interest rate risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate relative to the respective liability due to the impact of changes in market interest rates on the value of interest-bearing assets and on the value of future guarantees provided under certain contracts of insurance.

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

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

With-profits business and non-participating business within the with-profits funds are exposed to interest rate risk as guaranteed liabilities are valued relative to market interest rates and investments include fixed and variable rate income securities and derivatives. For with-profits business the profit or loss arising from mismatches between such assets and liabilities is largely offset by increased or reduced discretionary policyholder benefits. The contribution of these funds to the Company result is determined primarily by either the owners' share of the declared annual bonus or by the owners' interest in any change in value in the capital advanced to the Company's with-profits funds.

In the non-profit fund, policy liabilities' sensitivity to interest rates are matched with fixed and variable rate income securities, which limits the sensitivity to changes in interest rates.

An increase of 1% in interest rates, with all other variables held constant, would result in a decrease in profit after tax in respect of a full financial year and a decrease in equity of £54m (2017: £32m). A decrease of 1% in interest rates, with all other variables held constant, would result in an increase in profit after tax in respect of a full financial year and in equity of £118m (2017: £83m).

#### ***Equity, property and inflation risk***

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

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

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

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

The sensitivity analysis for equity and property price risk illustrates how a change in the fair value of equities and properties affects the Company result. It takes into account the effect of such changes in equity and property prices on all assets and liabilities that contribute to the Company's reported profit after tax and to equity.

A 10% decrease in equity/property prices, with all other variables held constant, would result in an increase in the profit after tax in respect of a full financial year and in equity of £7m (2017: £10m).

A 10% increase in equity/property prices, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full financial year and in equity of £7m (2017: £10m).

#### **Currency risk**

Certain with-profits funds have an exposure to overseas assets which is not driven by liability considerations. The purpose of this exposure is to reduce overall risk whilst maximising returns by diversification. This exposure is limited and managed through investment mandates which are subject to the oversight of the Investment Committees.

Sensitivity of profit after tax and in equity to fluctuations in currency exchange rates is not considered significant at 31 December 2018 or 31 December 2017, since unhedged exposure to foreign currency was relatively low.

#### **Financial soundness risk**

Financial soundness risk is a broad risk category encompassing capital management risk, tax risk and liquidity and funding risk.

Capital management risk is defined as the failure of the Company to maintain sufficient capital to provide appropriate security for policyholders and meet all regulatory capital requirements whilst not retaining unnecessary capital. The Company has exposure to capital management risk through the regulatory capital requirements mandated by the PRA.

Tax risk is defined as the risk of financial or reputational loss arising from a lack of liquidity, funding or capital due to an unforeseen tax cost, or by the inappropriate reporting and disclosure of information in relation to taxation. The Company has exposure to tax risk through the annual statutory and regulatory reporting and through the processing of policyholder tax requirements. Tax risk is managed by maintaining an appropriately-staffed tax team who have the qualifications and experience to make judgements on tax issues, augmented by advice from external specialists where required. The Company has a formal tax risk policy, which sets out its risk appetite in relation to specific aspects of tax risk, and which details the controls the Company has in place to manage those risks. These controls are subject to a regular review process. The Finance Bill published in September 2017 confirmed mitigation against the proposed reform of the rules relating to the loss absorbing capacity of deferred tax.

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

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

- liquidity risk is managed in a manner consistent with the Boards' strategic objectives, risk appetite and PPFM;
- cash flows are appropriately managed and the reputation of the Company and the Phoenix Group are safeguarded; and
- appropriate information on liquidity risk is available to those making decisions.

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

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

**2018**

	1 year or less or on demand £m	1-5 years £m	Greater than 5 years £m	No fixed term £m	Total £m
Liabilities under insurance contracts	1,690	4,104	7,177	-	12,971
Investment contracts	1,811	-	-	-	1,811
Borrowings	16	41	1	36	94
Derivatives	11	31	391	-	433
Obligations for repayment of collateral received	298	-	-	-	298
Reinsurance payables	9	-	-	-	9
Payables related to direct insurance contracts	88	-	-	-	88
Accruals and deferred income	9	-	-	-	9
Other payables	18	-	-	-	18

**2017**

	1 year or less or on demand £m	1-5 years £m	Greater than 5 years £m	No fixed term £m	Total £m
Liabilities under insurance contracts	1,798	4,337	7,992	-	14,127
Investment contracts	2,060	-	-	-	2,060
Borrowings	17	307	-	41	365
Derivatives	8	84	594	-	686
Obligations for repayment of collateral received	494	-	-	-	494
Reinsurance payables	9	-	-	-	9
Payables related to direct insurance contracts	74	-	-	-	74
Accruals and deferred income	10	-	-	-	10
Other payables	33	-	-	-	33

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

A significant proportion of the Company's financial assets are held in gilts, cash, supranationals and investment grade securities which the Company considers sufficient to meet the liabilities as they fall due.

**Unit-linked contracts**

For unit-linked contracts the Company matches all the liabilities with assets in the portfolio on which the unit prices are based. With the exception of reinsurance exposures on certain lines of unit-linked business there is therefore no interest, price, currency or credit risk for the Company on these contracts.

In extreme circumstances, the Company could be exposed to liquidity risk in its unit-linked funds. This could occur where a high volume of surrenders coincides with a tightening of liquidity in a unit-linked fund to the point where assets of that fund have to be sold to meet those withdrawals. Where the fund affected consists of property, it can take several months to complete a sale and this would impede the proper operation of the fund. In these situations, the Company considers its risk to be low since there are steps that can be taken first within the funds themselves both to ensure the fair treatment of all investors in those funds and to protect the Company's own risk exposure.



**Insurance risk**

Insurance risk refers to the risk that the frequency or severity of insured events may be worse than expected and includes expense risk. The Company's liabilities under insurance contracts are detailed in note 13 and include the following sources of insurance risk:

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

**Objectives and policies for mitigating insurance risk**

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

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

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

**Sensitivities**

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

A decrease of 5% in assurance mortality, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full year and a decrease in equity of £2m (2017: £2m).

An increase of 5% in assurance mortality, with all other variables held constant, would result in an increase in the profit after tax in respect of a full year and an increase in equity of £2m (2017: £2m).

A decrease of 5% in annuitant longevity, with all other variables held constant, would result in an increase in the profit after tax in respect of a full year and an increase in equity of £46m (2017: £47m).

An increase of 5% in annuitant longevity, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full year and a decrease in equity of £46m (2017: £48m).

A decrease of 10% in lapse rates, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full year and a decrease in equity of £29m (2017 : £37m).

An increase of 10% in lapse rates, with all other variables held constant, would result in an increase in the profit after tax in respect of a full year and an increase in equity of £29m (2017 : £29m).

**Assumptions****Valuation of participating insurance and investment contracts**

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

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

**Valuation of non-participating insurance contracts**

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

#### Process used to determine assumptions

The approach to the valuation of insurance contracts in the financial statements is as follows:

- In determining the discount rate to be applied when calculating participating and non-participating insurance contract liabilities, the Company uses a swap curve plus 10bps.
- For non-participating insurance contract liabilities, the Company makes an explicit adjustment to the risk-free rate to adjust for illiquidity in respect of assets backing illiquid liabilities.
- For both participating and non-participating insurance contract liabilities, the Company sets assumptions at management's best estimates and recognises an explicit margin for demographic risks.

During the year a number of changes were made to assumptions to reflect changes in expected experience. The impact of material changes during the year were as follows:

	Increase/ (Decrease) in insurance liabilities 2018 £m	Increase/ (Decrease) in insurance liabilities 2017 £m
Change in mortality assumptions	(5)	-
Change in longevity assumptions	(35)	(62)
Change in persistency assumptions	8	98
Change in expenses assumptions	(15)	(14)
Change in other assumptions	(2)	(7)

#### Expense inflation

Expenses are assumed to increase at the rate of increase in the Retail Price Index ("RPI") or Retail Price Index excluding mortgage payments ("RPIX") plus typical fixed margins in accordance with the various Management Service Agreements ("MSAs") the Company has in place with outsourced service providers. For with-profits business the rate of RPI inflation is determined within each stochastic scenario. For other business it is based on the Bank of England inflation spot curve. For MSAs with contractual increases set by reference to national average earnings inflation, this is approximated as RPI inflation plus 1%.

#### 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.

The mortality assumptions were varying proportions of the following published tables:

	Published Table 2018	Published Table 2017
Annuities in payment (UK – level)	112% RMV00 116% RFV00	110% RMV00 114% RFV00
Annuities in payment (UK – index linked)	112% PCMA00 116% PCFA00	110% RMV00 114% RFV00
Deferred annuities (UK, in deferment)	88% AM00 88% AF00 112% RMV00 116% RFV00	88% AM00 88% AF00 110% RMV00 114% RFV00
Whole of life and endowments	A67-70	A67-70
Term assurances	AM80 AF80 A67-70	AM80 AF80 A67-70

#### Lapse rates

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

#### Policyholder options and guarantees

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

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

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

Some pension contracts include guaranteed annuity options (see deferred annuities below for details). The total amount provided in the with-profits funds in respect of the future costs of guaranteed annuity options are £1,120m (2017: £1,257m).

#### Discretionary participating bonus rate

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

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

In common with other life companies in the UK which have written pension transfer and opt-out business, the Company has set up provisions for redress relating to personal pension policies. These provisions, which have been calculated from data derived from detailed file reviews of specific cases, are included in liabilities arising under insurance contracts. The total amount provided in the with-profits funds in respect of redress relating to pension policies, including associated costs, are £289m (2017: £324m).

**Managing product risk**

The following sections give an assessment of the risks associated with the Company's main life assurance products and the ways in which the Company manages those risks. The following tables provide a product analysis of the liabilities under insurance contracts and reinsurers' share of insurance contract liabilities within the Statement of financial position.

**2018**

	Gross		Reinsurance	
	Insurance contracts	Investment contracts with DPF	Insurance contracts	Investment contracts with DPF
	£m	£m	£m	£m
With-profits funds:				
Pensions:				
Deferred annuities – with guarantees	2,340	69	-	-
Deferred annuities – without guarantees	3	-	-	-
Immediate annuities	98	-	-	-
Unitised with-profits	1,390	4,643	-	-
Total pensions	3,831	4,712	-	-
Life:				
Unitised with-profits	182	407	-	-
Life with-profits	673	-	-	-
Total life	855	407	-	-
Other	455	-	-	-
Non-profit funds:				
Deferred annuities – without guarantees	(5)	-	-	-
Immediate annuities	2,707	-	1,074	-
Protection	(21)	-	(13)	-
Unit Linked	31	-	2	-
Other	(1)	-	-	-
	7,852	5,119	1,063	-

**2017**

	Gross		Reinsurance	
	Insurance contracts	Investment contracts with DPF	Insurance contracts	Investment contracts with DPF
	£m	£m	£m	£m
With-profits funds:				
Pensions:				
Deferred annuities – with guarantees	2,594	78	-	-
Deferred annuities – without guarantees	3	-	-	-
Immediate annuities	110	-	-	-
Unitised with-profits	1,475	5,007	-	-
Total pensions	4,182	5,085	-	-
Life:				
Unitised with-profits	187	444	-	-
Life with-profits	848	-	-	-
Total life	1,035	444	-	-
Other	498	-	-	-
Non-profit funds:				
Deferred annuities – without guarantees	(9)	-	-	-
Immediate annuities	2,869	-	1,221	-
Protection	(13)	-	(12)	-
Unit Linked	34	1	2	-
Other	1	-	1	-
	8,597	5,530	1,212	-

**With-profits fund (Unitised and Traditional)**

The Company operates a number of with-profits funds in which the with-profits policyholders benefit from a discretionary annual bonus (guaranteed once added in most cases) and a discretionary final bonus. Non-profit business is also written in some of the with-profits funds and some of the funds may include investment contracts, immediate annuities and deferred annuities with Guaranteed Annuity Rates ("GAR").

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

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

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

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

**Deferred annuities**

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

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

The guaranteed terms on GAR policies are more favourable than the annuity rates currently available in the market available for cash benefits. The guaranteed terms on GCO policies are currently not valuable.

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

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

**Immediate annuities**

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

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

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

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

### Protection

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

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

### Other risks

#### Customer risk

Manufacturer customer treatment risk is the risk arising from the design or management of products, or from the failure to meet or exceed reasonable customer expectations, taking account of regulatory requirements.

There are eight key risk areas for Customer Treatment Risk which are aligned to the areas of focus in the Phoenix Group Customer Strategy. Common causes of Customer Treatment risks are:

- Failure to have in place an appropriate culture, structures, governance and frameworks across the Group to drive ethical and responsible behaviours, attitudes and decision making focussed on customer interests and outcomes.
- Failure to understand our customers' experience, behaviours and needs and act in their interests ensuring they are treated fairly, in line with our strategic objectives, and supported in making good financial decisions.
- Inappropriate conduct or failing to act with integrity informed by an understanding of how our actions could influence our customers' choices and behaviour.
- Failing to understand situations which may give rise to customer vulnerability, or to identify and respond to indications that customers are potentially vulnerable.
- Poor customer treatment or experience (including poor advice) as a result of, but not limited to, inability to satisfy agreed and suitable levels of service (including in the handling of customer complaints). This also includes acting outside of customer instructions, and failing to observe customer confidentiality.
- Failure to provide customers with the information they need to make informed decisions about their policy in a way which is clear, accurate and appropriately considers areas in which behavioural bias could arise.
- Failure to ensure that products we manufacture and offer to our customers are subject to robust assessments to ensure they are suitable for the target market.
- Failure to ensure that products offered to our customers by our affinity partners are subject to robust due diligence.
- Failure to ensure that our products remain appropriate and deliver promised outcomes throughout the lifetime of the customer relationship in a manner consistent with the Phoenix culture and current legislative and regulatory requirements.
- Volatile and/or poor fund performance.

Typical impacts for this type of loss event will include compensatory / ex gratia payments, or penalty payments resultant from breaching customer instructions for investments and increased resource requirements in order to provide rectification.

The Company's overall aim, in line with our Customer Strategy, is to deliver a service to our customers which meet their needs, offering enhancements in agreed key areas and ensuring that we treat all customers fairly. This aim takes account of proportionality, such that actions taken should not have a disproportionate impact on other stakeholders. For example, there may be instances where undertaking initiatives, to redress detriment to one group of customers, could result in a detrimental impact to another group of customers.

#### Operational risk

Operational risk is the risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people related or external events.

The framework for identifying and managing operational risks comprises the following elements:

- Culture: clearly articulated values and behaviours, where risk management is part of what we do..
- Organisational structure: the Company's organisational structure supports strong operational risk management.
- Governance: appropriate governance arrangements to manage / oversee operational risk are in place to ensure that business is planned, executed, controlled and monitored in an efficient manner.
- Identification: the Company seeks to ensure that all material operational risks are identified and captured through the components of the operational risk framework.
- Control Environment: the Company seeks to operate a strong control environment, where tolerance of operational risk within the business is subject to appropriate and proportionate levels of control.
- Assessment: operational risks are assessed to determine the potential impact on the business given the effectiveness of the controls in place and for determining the resulting capital required to be held.

- **Monitoring & Management:** Information: regular monitoring and reporting is undertaken to support the management of operational risks within agreed parameters, which through alignment to the Company's governance structure, will support visibility of information, and hence to inform decision makers and drive appropriate action.

Operational risk arises due to failures in one or more of the following aspects of our business:

- **Processes and Systems:** inputs, processing and output; infrastructure and organisation, including facilities, networks, hardware, software, communications and their interfaces.
- **People:** the people required within the Company and our outsourcers to operate / interface with, our processes and systems.
- **External:** the identification, assessment, monitoring and reporting of external occurrences that could adversely impact the operations of the Company.

It is accepted that it is neither possible, appropriate nor cost effective to completely eliminate operational risks from the business as operational risk is inherent in any operating environment particularly given the regulatory framework under which the Company operates. As such the Company will tolerate a degree of operational risk within the business in areas subject to appropriate and proportionate levels of control around the identification, management and reporting of such risks.

#### 34. Commitments

	2018 £m	2017 £m
To subscribe to private equity funds and other unquoted assets	118	141

#### 35. Related party transactions

The Company enters into transactions with related parties in its normal course of business. These are at arms length on normal commercial terms apart from transfers of long-term business.

PGS provide management services to the Company, in the form of staff and other services, under a management services agreement. The charge made to the Company for the year ended 31 December 2018 amounted to £68m (2017: £67m) and at the end of the year £4m (2017: £4m) was payable.

Included within provisions (note 17) is an amount payable to PGMS at 31 December 2018 of £8m (2017: £nil).

Phoenix Unit Trust Managers Limited, a fellow group subsidiary, provide investment management services to the Company, under an investment management agreement. The charge made to the Company for the year ended 31 December 2018 amounted to £3m (2017: £6m) and at the end of the year £2m (2017: £3m) was payable.

On 6 December 2017 the Company paid a dividend in-specie of £75m to PGH2, settled by the transfer of part of the £273m interest bearing loan balance. A new loan agreement was set up for the remaining £198m. On 16 April 2018 this loan was repaid in full to PGH2 and the Company repaid to Phoenix Life Holdings Limited ("PLHL") the tier 2 subordinated debt of £250m.

On 31 August 2018, the Group acquired 100% of the issued share capital of Standard Life Assurance Limited, Standard Life Pensions Fund Limited, Standard Life International Designated Activity Company, Vebnet (Holdings) Limited, Vebnet Limited, Standard Life Lifetime Mortgages Limited, Standard Life Assets and Employee Services Limited and Standard Life Investment Funds Limited from Standard Life Aberdeen plc ("SLA").

As part of the consideration, SLA took a 19.99% equity stake in the enlarged Phoenix Group, and therefore became a related party of the Company from that date. Subsequent to 31 August 2018, the Company incurred £3m of investment management fees with SLA, and at the end of the year £5m was payable.

On 30 September 2018, the Company repaid £12m (2017: £11m) of the limited recourse bonds to Mutual Securitisation plc, the results of which are consolidated into the accounts of Phoenix Group Holdings, the Company's ultimate parent undertaking. The principal outstanding at 31 December 2018 was £48m (2017: £60m). Interest of £4m (2017: £5m) was charged during the year of which £1m (2017: £1m) remains outstanding at the end of the year.

During 2017 PGH2, repaid in full an interest-bearing loan of £96m to the Company.

There was no interest capitalised by the Company on loans to its parent this year (2017: £13m). The Company also paid interest on loans from its parent of £3m (2017: £10m).

In the year ended 31 December 2017, there was an interim dividend in-specie for £2m paid by Alcobendas Entrust Limited to the Company.

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PHOENIX LIFE ASSURANCE LIMITED

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**Reinsurance transactions**

	2018 £m	2017 £m
Reinsurance accepted from fellow subsidiaries:		
Claims	(12)	(20)
Reinsurance ceded to fellow subsidiaries:		
Annual management charges receivable from group companies	15	16
Reinsurers' share of investment contract liabilities	1,495	1,700

**Amounts due to related parties**

	2018 £m	2017 £m
Subordinated loan due to Phoenix Life Holdings Limited	-	250
Other amounts due to fellow subsidiaries	5	15
	5	265

**Amounts due from related parties**

	2018 £m	2017 £m
Loans due from parent	-	198
Loans due from subsidiary companies	1	1
	1	199

**Key management compensation**

The compensation payable to employees classified as key management, which comprises the Directors, is disclosed in note 6. During the year to 31 December 2018, key management personnel and their close family members contributed £nil (2017: nil) to Pensions and Savings products sold by the Group. At 31 December 2018, the total value of key management personnel's investments in Group Pensions and Savings products was £262k (2017: nil).

**Parent and ultimate parent entity**

Information on the Company's immediate parent and ultimate parent is given in note 37.

**36. Contingent liabilities**

In the normal course of business, the Company is exposed to certain legal issues, which involve litigation and arbitration. At year end, the Company has a number of contingent liabilities, none of which are considered by the Directors to be material.

**37. Other information**

The Company is a private limited company registered in England. Its registration number is 1419 and its registered office is 1 Wythall Green Way, Wythall, Birmingham B47 6WG. Its principal place of business is the United Kingdom.

The Company's immediate parent is Pearl Group Holdings (No. 2) Limited and its ultimate parent is Phoenix Group Holdings plc, a company incorporated in England and Wales. A copy of the financial statements of Phoenix Group Holdings plc can be obtained from the Company Secretary, Juxon House, 100 St Paul's Churchyard, London, EC4M 8BU