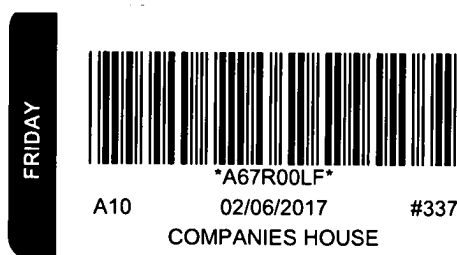


# Equitable Life

**Equitable Life Assurance Society**

**Recreating Value for Policyholders**

Company number 37038



**ANNUAL REPORT AND ACCOUNTS  
FOR THE YEAR ENDED 31 DECEMBER 2016**

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# Chairman's statement

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## The Society's Chairman, Ian Brimecome, on behalf of the Board

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### Dear Members

Following a year full of unprecedented economic and political turbulence, we are pleased to say that we have been able to maintain the 35% capital distribution payable to with-profits policyholders.

### Falling interest rates

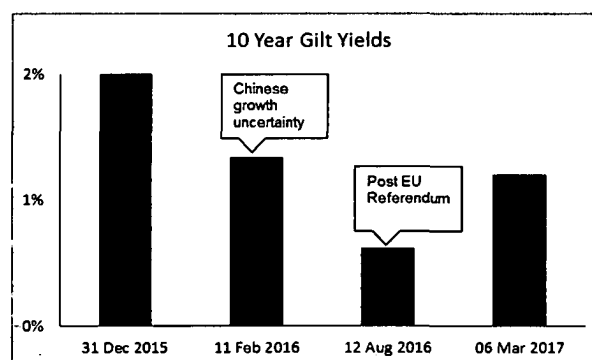
When interest rates fell very sharply last year in February and then again in August following the Brexit vote, I have to say that we did not feel quite so confident in our ability to maintain capital distribution. Our reasoning is straightforward. The greatest risk that the Society faces is policyholders deferring retirement at a time when interest rates are very low. This combination of factors was exactly what took place in 2016.

Many of our with-profits policies have a built-in guarantee of 3.5% pa. We have invested our assets to be sure that we can pay these guarantees, based on when we think policyholders will retire. The Society is exposed to the risk that policyholders stay longer than we expect when we are not able to earn that 3.5% pa return. Consequently, we are required to hold back capital to cover that risk.

In early 2016, as Chinese growth prospects materially reduced, worldwide financial markets tumbled. The flight of cash from company shares to government securities such as UK gilts was very marked and, in consequence, interest rates fell significantly.

Then, in August 2016 following the Brexit vote, the Bank of England cut overnight interest rates by half.

For the Society, the most important interest rate warning indicator is the level of ten year gilt yields. The graph below shows all too clearly the dramatic changes since the end of 2015.



If ten year gilt yields fall below 0.5% and policyholders defer their retirement, capital distribution of 35% becomes very much more difficult to support under the new regulations introduced in 2016, known as Solvency II.

### Mitigating interest rate risk

In the light of last year's market turbulence, we considered carefully what could be done to bring rather more stability to capital distribution. Our most significant step was to seek approval from our regulators for a more gradual transition to the new solvency regulations. We are pleased to say that this application was successful. This means that the amount of additional capital required under Solvency II can be phased in over 16 years. In this very low interest rate environment, such phasing does a great deal to remove the pressure for a reduction in capital distribution.

# Chairman's statement continued

## Recreating policyholder value

The Equitable Life is a closed mutual in run-off. Solvency regulations are not designed with that sort of organisation in mind. Our driving force is to get capital back into your hands. This is very different to an organisation open to new business which needs to hold capital back to support future growth. We would very much wish to be able to make a greater capital distribution to policyholders when they leave, ever mindful that policyholders who might remain for longer periods do not end up getting a lower amount. This is no simple balancing act but, rather, goes to the heart of whether our strategy is really being successful.

Recreating policyholder value remains our mission. We are determined to distribute all of the Society's capital among with-profits policyholders as fairly and as soon as possible. This strategy has served us well since it was launched in 2010. Seven years on, I provide a current perspective of what "as fairly and as soon as possible" means today and in a post-Brexit world. This will act as a guide to the next steps in our strategic thinking.

## As fairly as possible

Every day, we have to make decisions that we must judge to be fair. Yet, by its very nature, fairness is a subjective concept. We therefore give a great deal of thought to the considerations that should underpin fair outcomes for policyholders. For example, proposals must be logical and capable of being communicated so that they are understood. Furthermore, any proposal should provide consistency from policyholder to policyholder and, where that is not feasible, there needs to be a good explanation as to why not.

Perfect fairness may be something that is desirable, but it is unattainable. Our use of "as fairly as possible" recognises this and, in coming forward with proposals, the Board acknowledges that there will necessarily be gradations of fairness, so long as overall there is a greater degree of fairness.

## As soon as possible

The total capital that we hold in case things go wrong is c£1bn; some 20% of the assets we manage on behalf of with-profits policyholders. A material proportion of that capital is held because the solvency regulations stipulate the amount. For a normal company, one which is expecting to grow, that would be entirely sensible. But Equitable is not a normal company. We are in run-off.

Given the considerable volatility of 2016, the obvious question is what confidence do we have about capital distribution in the future. To help here, we evaluate the impact of many different future scenarios which allow for the possibility of events such as stock market collapses or mass policy surrenders.

In the majority of scenarios, capital distribution rises somewhat over the next ten years or so and there is a small chance that it could rise considerably. More worryingly, there are events that could cause the capital distribution to be reduced to zero, such as the very low interest rates experienced in 2016.

Low interest rates have been something that we have had to face up to for a number of years now. Having said that, no one forecast that they would fall to such levels. An important consequence of low interest rates is high asset values. That brings with it our greatest strategic challenge: how to give you credit for those high asset values which will inevitably reduce in the years ahead if interest rates rise.

A simple example will bring the previous paragraphs to life. Consider you have a policy with a current value of £10,000 of which £7,500 is guaranteed in any circumstance. If you wish to cash in your policy right now, the Society can pay you £13,500, being the £10,000 current policy value plus the capital distribution of 35% referred to above (as it is higher than your guaranteed amount). However, the actual fund potentially available in regard to your policy is c£15,000, but the regulations require us to retain £1,500 to cover financial shocks that would affect our ability to pay other policyholders.

So, policyholders are faced with a choice. The only amount that is certain is the guarantee (£7,500). The capital distribution is currently 35% and we are looking at ways of improving it but, if the future does not turn out as we hope, there is the potential to lose at least £3,500 (35% of £10,000). Or policyholders can wait in the hope that the £15,000 will eventually become payable.

In 2017, we intend to investigate deeply our options to address the challenge of low interest rates and, in particular, we shall explore how we can make more certain the 35% uplift currently paid to policyholders when they retire. We will also explore what can trigger payment of the £1,500 balance referred to in my example above.

# Chairman's statement continued

## Policyholder retirements

While a greater number of policyholders cashed in their benefits in 2016 than had been seen for some years, there is nevertheless a clear underlying trend for policyholders to defer taking their benefits until after the retirement date that we had been assuming.

We can speculate as to what might be at the heart of this phenomenon. It could simply be policyholders working for longer; it could be that policyholders' savings with the Equitable are a small part of their investment and are treated as rainy day money; it could be that the relative returns on Equitable policies over recent years have been rather better than may have been expected. The fact is we do not know. If we did know, we could predict better your likely intentions; and we would be able to manage your savings optimally. In particular, we would more likely be able to pay out a higher level of capital distribution more quickly.

We learned in 2016 that the prospect of a reduction in the 35% capital distribution is something that policyholders would prefer to avoid, particularly if they are intending to cash in their policies in the next year or two. This is entirely understandable. The trouble with economic shocks is that they are just that, and sometimes it is simply not possible to give any notice of the consequence on your savings.

## Listening to policyholders

In order to help guide us in our decision making, we seek many means to find out what policyholders think. Focus groups can be very helpful in helping us design communications which you understand. Your insightful questions at our Annual General Meeting inevitably give us great pause for reflection. The Equitable Members Action Group can be relied on always to give a penetrating perspective. This sort of direct feedback is immensely valuable and we are grateful to policyholders who give up their time to assist. We listen carefully and, while we are unable to meet the wish of every policyholder, we do listen.

We also write to thousands of policyholders every year asking them to give very specific feedback on a small number of questions. One such question is whether or not policyholders consider the Society to be going in the right direction. In 2016, there was a notable increase in the number of policyholders who were no longer as sure as they had been. We are certain that this change of sentiment reflected the content of last September's letter where we warned that the capital distribution might have to be suspended.

Following our successful application for a more gradual transition to the new solvency regulations, we wrote to policyholders in January to express our greater confidence in maintaining the 35% capital distribution. We followed up this letter with a new survey and there has been a substantial increase in policyholders saying that they think that the Equitable is moving in the right direction.

## The Society's costs

The Society's cost base continues on a strong downwards path. In 2016, net operating expenses were £37m, down from £43m in 2015. Similarly, business-as-usual costs reduced to £24m, down from £26m in 2015. A significant reason for this reduction was that we managed down staff numbers by more than 70 to 242. Essential to the success of the Society is a motivated and engaged workforce, so staff reductions at the level experienced have to be managed well. We put great store on being open with our staff on what run-off means, staying true to the Society's values of delivering for policyholders, transparency, fairness and affordability.

In the latest staff survey at the end of 2016, the vast majority clearly understood their role in recreating value for policyholders and agreed that Equitable is a good place to work. The Board would like to thank all our staff for their contribution and commitment to delivering policyholder value.

## Facing the future

We welcome Lord Finkelstein to the Board as a non-executive Director. Daniel Finkelstein's wide experience will bring a welcome new perspective to the Equitable. As the Society develops the next phase of its strategy to distribute capital to with-profits policyholders as fairly and as soon as possible, Daniel's wisdom and insight will be of unique importance.

We began 2016 facing turbulent markets at exactly the same time as a change in the solvency regime. We successfully navigated those very choppy waters, and we begin 2017 confident that we can continue to find ways to recreate value for our policyholders.



Ian Brimecome  
Chairman

20 March 2017

# Strategic report

The Equitable Life Assurance Society is a mutual company owned by its members. The Society no longer writes any new business and is therefore in run-off. We manage some £7bn of assets on behalf of: approximately 141,000 individual with-profits policyholders; 143,000 with-profits policyholders in company pension schemes; and 123,000 unit-linked policyholders. The vast majority are expected to take their benefits over the next 20 years.

The Society's business model remains straightforward. The Society's mission in run-off is exclusively to serve the best interests of our existing policyholders.

This report explains the Society's strategy, linking it to the principal risks and our key performance indicators.

## The Society's strategy

The Society's aim is to recreate policyholder value by distributing all of the capital among with-profits policyholders as fairly and as soon as possible.

To achieve this, we carefully manage solvency to enable capital distribution and only then seek to maximise investment return, all the while providing a value-for-money cost base.

Over the last few years, we have taken material steps to reduce or eliminate key risks, thereby reducing the Society's capital requirements. In July 2013, we eradicated our staff pension liabilities, thereby enabling an increase in capital distribution from 12.5% to 25%. In March 2015, we successfully bought back the unit-linked business from Halifax Life. This has enabled us to, once again, take full responsibility for the management of this business for the benefit of not just with-profits policyholders but also those with a unit-linked policy.

Then, in the same month, we sold £0.9bn of annuities to Canada Life, which subsequently transferred in 2016. These transactions significantly reduced the Society's risks and, therefore, its capital requirements, and were material to the Board's decision to increase capital distribution to 35%.

## Our approach to capital distribution

Every year, the Board assesses the impact of its risk reduction programme and decides whether an adjustment in capital distribution is warranted. To help inform the Board, extensive reviews of the capital required under a wide range of possible future economic conditions are undertaken.

In 2016, the Board felt able to maintain capital distribution at 35% notwithstanding the political and economic volatility. The Chairman warned in his 2015 statement that these conditions could lead to a reduction in capital distribution and, twice during the year, as conditions deteriorated, we wrote to policyholders explaining the risk, and its implications for capital distribution.

We are required to hold capital against the risk that policyholders defer taking their benefits when long-term interest rates are low. The new regulatory regime, Solvency II, required us to hold even more capital to address this risk.

Dramatic reductions in ten year interest rates, throughout 2016 and particularly following the EU Referendum, led to falls in our solvency coverage. Throughout the year, we considered various risk mitigation options to maintain the 35%. The most material action, as outlined in the Chairman's statement, was to apply to our regulator for a more gradual transition to the amount of capital we need to hold under Solvency II.

The application was approved at the end of 2016 and provides an underpinning to the 35%. However, the existence of the guarantees means that the combined risks of low interest rates and policyholder deferrals are a constant threat to our good management of the Society.

The Board is firm in its belief that, when policyholders leave, they should leave with a fair share of capital. The key here is that there should be proper balance between those policyholders who leave over the next few years and those who remain well beyond that. So long as there is sufficient capital to support the latter, earlier leavers should not be denied a fair capital distribution for the sake of higher investment returns to those policyholders who remain.

As the Chairman wrote in his statement, we intend to investigate how we can address the challenge of low interest rates and establish whether we can build a path towards a higher level of distribution.

## Carefully managing solvency

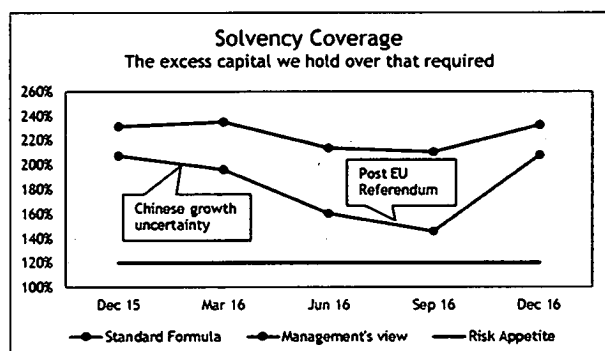
Company solvency levels are regulated by the Prudential Regulation Authority ("PRA"). There is a further regulator, the Financial Conduct Authority ("FCA"), that pays particular attention to fairness to policyholders. Our decision to maintain the capital distribution of 35% has been made following consultation with both regulators.

## Strategic report continued

Under the Solvency II regime, it is necessary to assess our capital using two different measures. Both require us to hold more capital than in previous years. The first measure, known as the Standard Formula, adopts a generic rules-based approach. It is this measure that is particularly sensitive to the interest rate reductions discussed in the Chairman's statement. This is because the rules dictate that extra capital has to be held (referred to as the Risk Margin), which increases in size as interest rates fall.

In addition to the Standard Formula measure, we also calculate solvency based on our view of the risks that directly impact the Society. This measure of solvency is very similar to that reported over the last few years using the concept of Economic Capital described in the next section. We commonly refer to this as Management's view of the capital required.

This latter measure does not lead to the volatile movements in coverage seen under the first measure as we match policy payments to income from assets. This means that, when interest rates fall, the liabilities increase in line with our assets. Importantly, we cannot match assets to the Risk Margin, thereby leaving us exposed to interest rate movements under the Standard Formula measure. This is illustrated in the graph below.



The Board has defined a risk appetite such that the Society should hold capital at least 120% of that required in the two measures described above. Were the ratio to fall below 120%, capital distribution would likely be reduced. In arriving at the amount of capital we can distribute, we ensure we have sufficient capital to cover both measures.

As was discussed in the Chairman's statement, the interest rate reductions in 2016 caused the Standard Formula coverage levels to fall during 2016 before our mitigating actions took effect. Year-end coverage was very similar to the levels at

the start of the year. This can also be seen in the graph above.

### Capital management

The amount of capital we hold is the excess of assets over policy liabilities. This measure, known as Excess Assets, has improved since 2015, driven by: changes in valuation assumptions; our cost reductions; unit-linked charge increases; and an accounting gain from the derivatives held to mitigate the impact of low interest rates. Given the continuing political and market uncertainty, the Board does not consider it prudent to treat the gain from derivatives as distributable, as it may yet be needed to provide further protection against the risk of low interest rates combined with policyholders deferring their retirement.

Management's view of the amount of capital required is called Economic Capital. Here, we consider the impact on the Society's capital under extreme conditions; events that could occur once in every 200 years resulting from, among other things, insurance risk, credit risk, market risk and operational risk.

Accounting rules do not allow these extreme events to be included as liabilities in the Financial statements, but the capital required to support them is, nevertheless, the equivalent of non-distributable reserves. We are required to hold this Economic Capital to protect policyholders and, therefore, it has to be deducted from Excess Assets to arrive at the Surplus.

The impact of the new solvency regulations has been, as expected, to increase Economic Capital. We have taken action in recent years to ensure that our Excess Assets have risen so that the impact on our Surplus is largely mitigated.

Excess Assets and Economic Capital interact as follows:

	2016	2015
	£m	£m
Excess Assets		
- the amount of capital we hold	1,005	793
Economic Capital		
- the amount of capital we require	(423)	(197)
<b>Surplus</b>	<b>582</b>	<b>596</b>

The Surplus is the difference between the capital held and the capital required. When policyholders leave, they receive the capital distribution

# Strategic report continued

prevailing at the time. In 2016, this amounted to £93m which is funded by the Excess Assets.

Our accounting policy has been amended to reflect the impact on liabilities caused by the new solvency regulations. The prior year figures above have been adjusted accordingly. The liabilities in the Financial statements are prepared using the Management View approach described above.

## Investment return

The Society's investment strategy is to effectively manage solvency and, only then, to maximise return. Key to this strategy is our policy of matching payments to income from assets. This means that, as interest rates rise or fall, the Society's ability to pay benefits is much less affected. In order to assess when policy payments will occur, judgement is required regarding future policyholder behaviour.

This strategy necessarily leads to a relatively conservative investment approach. The Society's portfolio consists primarily of British government securities (gilts), corporate bonds, and cash. During the last few years, the Society has all but eliminated its holdings in capital intensive equities and property.

Given our strategy, the investment return needs to be seen in context of the increased capital distribution resulting from investing in relatively low risk assets. Consequently, the return is likely to be lower than from a portfolio invested in equities and property. However, and this is critical, capital distribution can be significantly higher.

While it is impossible to fully mitigate the risk of credit defaults or the widening of credit spreads due to market turbulence, the Board believes that our low risk investment portfolio will provide better protection than an alternate one which carries higher risk.

The return on investments in 2016 was 10.6%. As a result of our matching policy, the Society's liabilities have risen by an equivalent amount to the assets. Consequently, the part of the return arising from the change in asset values has been deducted (8.5%) in order to arrive at the fund performance which, in 2016, was 2.1% before charges of 1.5%.

In considering an appropriate increase to policy values, we are informed more by the underlying long-term sustainable rate of return, secured when contributions were originally invested, than by the in-year performance. The underlying return is of the order of 2% pa after deduction of charges.

The Board has decided therefore that, for 2016, policy values will increase at 2% pa for UK with-profits pension policies (1.6% pa for life assurance policies where tax is deducted).

Interest rates have been falling for many years and since 2009 have repeatedly found new lows. As a result, where policyholders postpone taking retirement benefits, we have to reinvest assets at the interest rates prevailing at the time. Therefore, if policyholders continue to defer taking their benefits, the underlying rate of return of 2% is likely to become unsustainable at some point.

## Unit-linked business

In 2016, we made two significant changes to the unit-linked business. In April 2016, we increased the annual management charge from 0.5% to an average of 0.72%, much nearer market norms. The charges now cover the costs of running the business. We have also reduced the number of funds under management from 107 to 30 to ensure that policyholders are mainly invested in large liquid funds which will also help improve investment performance. In consequence of these important steps in regard to unit-linked policies, Excess Assets have increased by c£35m. As a result, this business has become less of a capital strain to with-profits policyholders.

## Predicting the future

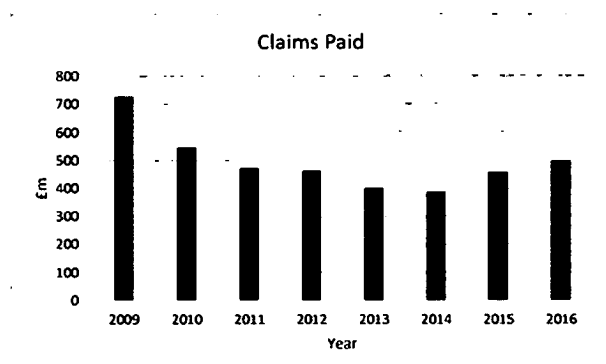
Every year, the Board reviews how much capital will be required and how much is likely to be available for distribution under a wide range of possible future economic conditions. The most likely outcomes result in capital distribution rising over the next ten years, assuming policyholders continue the retirement patterns of the past.

However, more and more policyholders are choosing to remain with the Society past their expected retirement date. In a low interest rate environment, this increases the capital strain of the guarantees. The potential for this trend to continue represents the most significant risk faced by the Society.



# Strategic report continued

In regard to those policyholders who have left the Society, the trend in the value of claims is shown in the graph below.

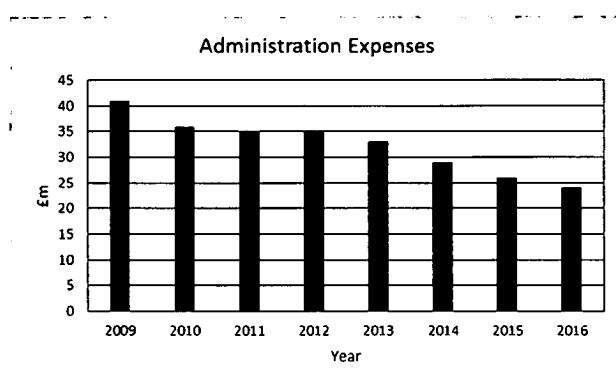


The reduction in the annual value of claims from 2009 to 2014 has coincided with a period of low interest rates and higher capital distribution. In 2016, following reductions in our solvency coverage, we wrote to policyholders explaining that the 35% capital distribution was at risk. This was followed by an increase in claims in the last quarter of the year, which are now reverting to the levels of 2015.

We were successful in addressing the challenges in 2016 but, as long as the guarantees remain, there will always be a risk that capital distribution will, at some point, have to be reduced. Hence, our current investigation, to establish whether we can provide greater certainty to the distribution.

## Providing the best value-for-money cost base

We consider value for money to be where administrative expenses reduce in line with the run-off of policies as policyholders retire. During 2016, the reduction in policies was approximately 30,000; an 8% fall over 2015. Administrative expenses fell by c8% from £26m to £24m.



We also incur costs through the need for one-off projects. Success for such spend is to reap the benefits of the projects, which are often critical to enabling capital distribution. A good example is the sale of the annuity book.

Total costs in 2016 have fallen to £37m, from £43m in 2015. Particularly noteworthy is that costs are down from £115m in 2009.

Reducing administrative expenses in line with policy run-off requires efficiency savings to be made, which more than mitigate upward pressures on the cost base such as inflation. In any given year, it is not always possible to achieve this due to, for example, the exit of a group pension scheme.

However, over time, the associated costs are managed downwards. As the table below shows, we have been able to reduce expenses faster than policy numbers.

% reduction between 2009 and 2016

Administrative expenses	40
Policy numbers	35

The main areas of saving continue to be from the Lean Manufacturing techniques first introduced in 2011, and the Society's cost reduction programme known as Simplification. Lean Manufacturing promotes continuous improvement and operational excellence within the business.

The Simplification programme has succeeded in reducing costs by an annualised £5.6m by removing complexity, renegotiating third-party tariffs, and aligning the cost base more directly to policy run-off. In addition, following a review of our product offerings, we decided to withdraw from the loss-making administration service provided to Group Final Salary schemes. As a result of the programme, staff numbers, including contractors, fell from 318 in December 2015 to 242 by the end of 2016. The benefits of the programme have led to an improvement of £18m in our forecast of future expenses.

The Society currently levies a charge of 1% pa on with-profits assets to cover the costs of running the business. Our Lean Manufacturing and Simplification work has been fundamental to keeping costs within that 1% in recent years.

We have also built up a cost reserve which, together with the 1% expense charge, is intended

# Strategic report continued

to provide sufficient funds to meet the Society's future costs.

In setting targets to deliver a value-for-money cost base, the Board is mindful of the need to have in place strong controls. In this respect, the Society operates a robust and comprehensive risk management framework described on page 20. Service to policyholders is monitored very regularly and, throughout 2016, we have performed within the standards agreed by the Board.

Following successful completion of the main risk reduction initiatives, exceptional project expenditure during 2016 of £4m remains significantly lower than in previous years.

## The perspective of policyholders

We place great store on what policyholders think. Every year, we seek the views of a representative sample of policyholders through questionnaires and focus groups.

In our most recent survey, it is very pleasing to know that almost all policyholders who had engaged with our staff felt that they had responded positively.

This confirms our view that staff take great pride in providing a trusted and valued service.

## Principal risks

The Society operates a comprehensive risk management framework through which it identifies, monitors and reports on the principal risks to its strategic objectives. They are managed within a risk appetite set by the Board, who also ensures that adequate capital is held against these risks.

Simply stated, the more risk the Society takes in managing its business, the more capital it needs to hold in case things go wrong. Hence, the Board's focus on reducing these risks.

While individual risks are important, the Board also considers certain combinations of risks. This is particularly relevant in turbulent market conditions. For example, falling interest rates combined with policyholders deferring benefits is a particularly onerous combination. If these risks were to materialise in an economic environment of credit defaults and a divergence of swap and gilt yields, then this would put at risk the current level of capital distribution.

To mitigate the risk of policyholders taking their benefits beyond their expected retirement date, we will continue our research into the factors that might give rise to this deferral.

The main risks relevant to the Society are described below.

### Insurance risk

Insurance risk refers to fluctuations in the timing, frequency and severity of insured events relative to the expectations of the Society at the time of underwriting.

The most material insurance risk is in regard to retirements and transfers not being in line with estimates.

To mitigate this risk, the Society holds a series of derivatives called swaptions. When interest rates reduce, the value of the swaptions rises, offsetting the increase in Economic Capital that might arise as a result of policyholders deferring retirement. When interest rates rise, the value of the swaptions will fall but will be offset by a reduction in Economic Capital, leading to minimal change in overall Surplus.

When interest rates fall to very low levels, as they did in 2016, the value of the swaptions far exceeds the required level of protection. Management took advantage of these extraordinary circumstances to adjust the derivatives and release the excess value, thereby realising an accounting gain of £95m.

The second material insurance risk is in regard to expenses not reducing in line with policyholder run-off. The risk reduced during 2016 following the success of the Society's Simplification programme.

### Liquidity risk

This is the risk that the Society is unable to meet short-term cash flow requirements, particularly those in respect of policyholders taking their benefits.

The Society continues to hold high levels of liquid assets in order to provide protection against the scenario of policyholders who have passed their earliest contractual date deciding to take their benefits immediately.

The impact of such an event would be approximately £1.3bn, and liquid assets significantly in excess of this amount are held in mitigation.

# Strategic report continued

## Credit risk

Credit risk refers to where a counterparty fails to pay amounts in full when due. The main credit risks faced by the Society are:

- (i) The risk of default on its portfolio of fixed-interest securities, especially corporate bonds; and
- (ii) The risk of default by any of its reinsurers.

The Society seeks to limit exposure to credit risk by setting robust selection criteria and exposure limits covering factors such as counterparty financial strength. The Society monitors performance so that appropriate management actions can be taken to pre-empt loss from default events. No defaults occurred in 2016.

The major reinsurance treaties are with a company in Lloyds Banking Group. At £0.4bn, these exposures are much reduced following the unit-linked transaction discussed on page 50.

## Market risk

- (i) Interest rates: the risk that interest rate changes have a financial impact through any mismatching of assets and liabilities. The Society closely matches the expected income from assets to the expected outgoings from policy maturities. The more closely we are matched, the less capital is required against interest rate movements.

During 2016, there were two adjustments to asset duration following the year-end and half-year liability valuations. The adjustments had the impact of further strengthening cash flow matching.

- (ii) Spread risk: changes in the value of corporate bonds relative to gilts could have a financial impact on our capital calculations. As long as policyholders do not change their behaviour, we will hold the bonds until they mature so any capital strain is of a temporary nature. The Society invests in a diversified portfolio of high-quality corporate bonds, thereby reducing the potential exposure.

- (iii) Swap basis risk: Solvency II requires liabilities to be valued using swap rates, whereas our assets are primarily gilts and bonds. In 2016, there was some divergence of swap rates from gilt rates, which impacted our Solvency II coverage. We have

accepted this risk and do not hedge against it.

## Operational risk

Operational risk is the potential for loss to result from inadequate or failed internal processes and systems, human error or from external events. The main sources of operational risk for the Society are:

- (i) Those related to delivery of services to our policyholders;
- (ii) The delivery of services to the Society by significant third party suppliers; and
- (iii) Risks in executing strategic projects.

The management controls designed to mitigate these risks have succeeded in keeping losses to a bare minimum. There have been no material changes to operational risk in the year.

Having said that, cyber attacks on companies are a growing threat. These could lead to loss of policyholder data, operational disruption, and reputational damage. Working closely with suppliers, the Board regularly assesses the threat level in the UK, along with the Society's defences against various potential attacks. Management also conducts simulations to ensure that the Society is as prepared as it can be.

## Regulatory risk

Regulatory risk is the risk to capital and reputation associated with a failure to identify or comply with regulatory requirements and expectations. We put great store in having an open and cooperative relationship so that our regulators fully understand our run-off strategy and how we are performing against our objectives. We have arrangements in place to identify new regulatory developments, implement changes to meet these requirements, and monitor ongoing compliance.

## Key performance indicators

Key performance indicators are used by the Board to show the extent to which the strategies designed to recreate policyholder value are achieving the desired outcome. The most important indicators are shown in the table below.

% of policy value	2015-17	2014	2011
Capital distribution	35	25	12.5
Policy value increase	2	2	2
Financial Adjustment	0	0	5

## Strategic report continued

The Board's strategy of capital distribution has clearly led to increases in policyholder value.


We estimate that, as a result of capital distribution, approximately 97 out of 100 individual with-profits policyholders taking their benefits receive a payout greater than the policy guarantee.

### Conclusion

The Board is confident that it can deliver run-off with capital distribution most likely increasing gradually over time. Notwithstanding that, we will determine in 2017 whether there are means of materially reducing the risk of any reduction in capital distribution as well as identifying alternatives to run-off which could release capital earlier.



Chris Wiscarson  
Chief Executive



Simon Small  
Finance Director

20 March 2017

# Board of Directors

## **Ian Brimecome (b)(c)**

Chairman

Ian Brimecome was appointed Chairman in September 2009. He joined the Board in January 2007 and is Chairman of the Nominations Committee. Ian is Chairman of Axa UK plc, Tokio Marine Kiln Group Ltd, Tokio Marine North America, Delphi Financial Group and HCC Holdings. He is also Executive Chairman International of Tokio Marine Holdings, Deputy Chairman of Tokio Marine Asia and a non-executive Director of Edelweiss Tokio Life. Ian has more than 30 years of experience of the financial services industry in a wide variety of roles and has advised on more than 100 merger and acquisition transactions in the insurance and asset management industries in more than 20 countries.

## **Keith Nicholson (a)(b)(c)**

Deputy Chair and Senior Independent Director

Keith Nicholson joined the Board in August 2009. He was appointed Deputy Chairman on 1 July 2012 and chairs the Audit and Risk Committee. Keith left KPMG in 2009 after more than 30 years with the firm. He has a wealth of experience with financial services companies covering audit and advisory roles. These included FTSE 100 companies in the UK and non-UK multinationals. Keith is Chairman of Liberty Specialty Markets. He is also the Senior Independent Director of JRP Group plc.

## **Chris Wiscarson**

Chief Executive

Chris Wiscarson was appointed Chief Executive in September 2009. Before that, he was a member of the Group Executive Committee at Lloyds Banking Group. He started his career with Equitable Life, before moving to South Africa in 1979. In 1986, he returned to England to take up the position of Chief Executive of Save & Prosper Insurance. In 1990, he joined the Lloyds Banking Group, where he held a number of senior roles including Finance Director of the Lloyds Abbey Life Group, then Chief Executive of Lloyds TSB Life. At the beginning of 2000, he was appointed the Director responsible for the non-UK businesses in the Lloyds TSB Group before taking up the position of Group Integration Director.

## **Simon Small**

Finance Director

Simon Small joined the Society as Finance Director in July 2012. He is responsible for the Society's Finance, IT Change, Company Secretariat and Investment functions, and takes a lead role in capital and strategic planning. Simon, a qualified accountant, has particular expertise in the financial and administrative aspects of operations and IT. He had previously worked at Lloyds Banking Group for over 20 years, latterly as the Finance Director to the team responsible for delivering the synergy benefits in the merger of Lloyds TSB and HBOS. Simon's expertise includes deal negotiation, restructuring company finances and delivering efficiency savings.

## Board of Directors continued

### **Penny Avis (a)**

Penny Avis joined the Board in January 2015. A Chartered Accountant, Penny is a former Deloitte corporate finance partner with wide-ranging merger and acquisition and accounting experience. Penny was an elected non-executive Board member at Deloitte UK LLP responsible for oversight of executive management and acted as a mentor to partner-track directors. Prior to Deloitte, Penny worked for PwC and Arthur Andersen. She is also a non-executive Director at Envestors Ltd, a private corporate finance business, Cifas, the UK's fraud prevention service and city law firm, Howard Kennedy.

### **Daniel Finkelstein**

Daniel Finkelstein, Lord Finkelstein OBE, joined the Board on 17 March 2017. A journalist and Conservative politician, Daniel has been a columnist on *The Times* since 2001 and is a former executive editor, Chief Leader Writer and comment editor. He is a former chairman of Policy Exchange Ltd, a political think tank, and has been a political adviser to the Conservative Party and to the Social Democratic Party. He was a non-executive Director at the *Jewish Chronicle* between 2011 and 2013. Daniel holds an honorary Doctor of Science degree from City University.

### **Ian Gibson (a)**

Ian Gibson joined the Board in August 2013. Ian retired from Legal & General in 2007 after more than 35 years with the organisation. He is a qualified actuary and has extensive experience of managing and advising on with-profits funds. After retiring from Legal & General, Ian worked as an actuarial consultant providing advice on, among other things, Solvency II and life fund transfers. He has also served on the Supervision Committee of the Life Board of the Institute and Faculty of Actuaries.

### **Cathryn Riley (a)(b)(c)**

Cathryn Riley joined the Board in August 2009. She chairs the Society's Remuneration Committee. In a wide-ranging career covering customer services, IT, operations, human resources and general management, Cathryn has worked for British Coal, British Airways, Coopers & Lybrand, BUPA and latterly Aviva plc where she was Group Chief Operations Officer and a member of the company Executive Committee. She is Chairman of AA Insurance Services Ltd and a non-executive Director of International Personal Finance plc, ACE Underwriting Agencies Ltd, ACE European Group Ltd and Chubb Insurance Company of Europe.

### **Key to membership of principal Board Committees**

- (a) Audit and Risk
- (b) Remuneration
- (c) Nomination

# Directors' report

## Principal activities

The principal activity of the Society during 2016 remained the transaction of life assurance and pension business in the form of guaranteed, participating and unit-linked contracts, predominantly in the UK. The Society closed to new business on 8 December 2000. The Financial statements of the Society are shown on pages 44 to 79. The operations of the Society are described in the Chairman's statement and the Strategic report, which includes reference to certain key performance indicators. The Directors' remuneration report and details of the governance arrangements of the Society are given in the Corporate governance statement on pages 16 to 36.

## Directors

The Directors shown on the previous pages were Directors throughout the year with the exception of Daniel Finkelstein, who was appointed on 17 March 2017.

All the Society's Directors will retire at the Annual General Meeting ("AGM") and offer themselves for re-election.

## Directors' indemnities

The Society maintains directors' and officers' liability insurance, which gives appropriate cover for any legal action brought against its Directors. The Society has also provided an indemnity for each of its Directors, which is a qualifying third party indemnity provision for the purposes of section 234 of the Companies Act 2006.

## Principal risks

The Strategic report sets down the Society's principal risks and its arrangements for managing these and holding capital against them.

## Directors' responsibilities in respect of the Financial statements

The Companies Act 2006 requires the Directors to prepare Financial statements for each financial year which give a true and fair view of the state of affairs of the Society and of the result of the Society for that period. In preparing those Financial statements, the Directors are required to:

- Select suitable accounting policies and then apply them consistently;
- Make judgements and estimates that are reasonable and prudent;

- State whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the Financial statements;
- Prepare the Financial statements on the going concern basis unless it is inappropriate to presume that the Society will continue in business; and
- Consider whether the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the information necessary for members to assess the Society's performance, business model and strategy.

The Directors have complied with the above requirements. The Directors are responsible for keeping proper accounting records, which disclose with reasonable accuracy at any time the financial position of the Society, and enable them to ensure that the Financial statements comply with the Companies Act 2006, as described above. They also have a general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Society and to prevent and detect fraud and other irregularities.

The Financial statements are published on the Society's website. The maintenance and integrity of this website is the responsibility of the Directors. Legislation in the UK governing the preparation and dissemination of Financial statements may differ from the legislation in other jurisdictions.

## Statement of disclosure of information to auditors

The Directors have taken all the steps that they ought to have taken in order to make themselves cognisant of any relevant audit information and to establish that the Society's auditors are aware of that information. To the best of their knowledge, Directors consider there is no relevant audit information which has not been brought to the attention of the Society's auditors.

## Long-term viability statement

In accordance with the 2016 UK Corporate Governance Code, the Board has assessed the prospects of the Society over a period longer than the 12 months required under the going concern provisions.

For a number of years, a model has been used by the Board to assess the financial viability of the Society. The model projects the solvency position

## Directors' report continued

of the Society under 500 different economic scenarios, to determine the affordability of capital distribution. It has been designed and built and is used under approved guidelines and reflects the Solvency II regime.

The model has a number of assumptions and limitations. During 2016, the most important limitation was addressed by improving how changes in policyholder behaviour and other insurance related risks are modelled.

In addition, the Board also reviews the results of stress testing and sensitivity analysis of key variables, to ascertain what combination of events could cause solvency to fall below risk appetite. This has enabled the Board to conduct a robust assessment of the principal risks facing the Society.

While the model can project over the entire run-off period, the Board believes that it is more appropriate to consider a three-year time frame for the purposes of the viability statement. This matches the period covering the Society's Business Plan, which is approved annually at the December Board meeting. Greater confidence can be placed on shorter-term projections, because the model results are less exposed to uncertainties inherent in any longer time frame.

Based on the above analysis, the Board has assessed the Society's prospects with reference to the principal risks, strategy and risk appetite as set out in the Strategic report. Consequently, the Board is confident of its ability to manage adverse scenarios that may arise, recognising in some scenarios that reductions to policyholder payments would be required. The Board, therefore, has a reasonable expectation that the Society will be able to continue in operation and meet its liabilities as they fall due over the period to 31 December 2019.

### The Board's conclusions on information to members

Having taken advice from the Audit and Risk Committee, the Board considers that the Annual Report and Accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary for the Society's members to assess the Society's performance, business model and strategy.

### Employees

Employees of the Society have been regularly informed, and consulted, on matters of concern to them. The Society is an equal opportunities employer. All employment applications, training opportunities, career development and promotion are fully considered with regard to an individual's particular aptitudes and abilities. As a mutual company, the Society has no employee share scheme.

### Auditors

PricewaterhouseCoopers LLP have expressed their willingness to continue in office, and a resolution will be proposed at the AGM.

### Signed by order of the Board



Jean Fleet  
Company Secretary

20 March 2017



# Corporate governance statement

## 1. Statement from the Chairman

The Society aims to meet the highest standards in corporate governance and voluntarily adopts the relevant provisions of the 2016 UK Corporate Governance Code ("UKCGC"). The Board is responsible to the Society's members for good corporate governance and applies high standards to ensure that this is achieved.

I would like to give my personal confirmation of the importance the Board attaches to ensuring continuing good performance of the Board, its Committees and individual Directors. More information on the processes for carrying out the reviews is given below.

This report summarises the Society's governance arrangements, including reports on each of the Board Committees. Personal statements from the Chair of the Audit and Risk Committee and the Chair of the Remuneration Committee are also included below.

## 2. Governance by Directors

### The Board

The Board meets regularly to lead, control and monitor the overall performance of the Society. The Board's principal functions are: to determine the strategy and policies of the Society; to set out guidelines within which the business is managed;

and to review business performance. The Board considers and decides on all major matters of Society corporate strategy and ensures that the strategy is consistent with its appetite for risk. There is a formal schedule of matters reserved for the Board's decision. Members of senior management supply the Board with appropriate and timely information and are available to attend meetings and answer questions. Authority is delegated to the Chief Executive for implementing strategy and managing the Society.

The roles of Chairman and Chief Executive are separated and the Chairman has primary responsibility for the effective functioning of the Board.

### Board Committees

The Board formally delegates certain specific responsibilities to the four Board Committees described elsewhere in this report. The Terms of Reference of the Committees are available on the Society's website, [www.equitable.co.uk](http://www.equitable.co.uk), or on request.

### Board and Committee meetings

Details of the number of meetings of the Board and Board Committees, and attendance by Directors are set out in the following table.

	Board	With-Profits Committee	Audit and Risk Committee	Nominations Committee	Remuneration Committee
Number of meetings during 2016	9	8	7	1	3
Attendance by Directors					
Ian Brimecome <sup>1</sup>	9	8	-	1	2
Keith Nicholson	9	8	7	1	3
Chris Wiscarson	9	8	-	-	-
Simon Small	9	8	-	-	-
Penny Avis	9	8	7	-	-
Ian Gibson	9	8	7	-	-
Cathryn Riley	9	8	7	1	3

Pages 12 and 13 show details of Committee membership.

Note:

<sup>1</sup> The Chairman could not attend the Remuneration Committee meeting on 8 December 2016. He had reviewed the agenda papers and given his views to the Chair of the Committee. The Committee was quorate in his absence.

# Corporate governance statement continued

## Taking advice

The Board and its Committees are able to take advice from professional advisers to assist them in assessing the business of the Society. Each Director has access to the Company Secretary.

Subject to defined procedures, Directors may also obtain independent professional advice, at the Society's expense, about any matter concerning the Society relevant to their duties.

## Directors

The Board had two executive Directors who served throughout 2016: the Chief Executive and the Finance Director. There are six non-executive Directors on the Board. Daniel Finkelstein was appointed a non-executive Director on 17 March 2017.

The Chairman and the Deputy Chairman are elected by the Board. The current Board members are described on pages 12 and 13.

The Board reviews the independence of the non-executive Directors and has concluded that Penny Avis, Daniel Finkelstein, Ian Gibson, Keith Nicholson and Cathryn Riley should be considered to be independent.

The Directors' remuneration report on pages 25 to 36 explains the basis of remuneration of the executive and non-executive Directors.

## Performance evaluation

The Board reviews its own performance and that of its Committees each year. In 2014 and 2015, this was achieved by the Board reviewing responses to a questionnaire completed by Directors and agreeing relevant actions. In 2016, we commissioned the Board's independent advisor, Nicholas Wells, to carry out a full review of the Society's Board and its Committees. This took into account the guidance in the UKCGC that an evaluation of the Board of FTSE 350 companies should be externally facilitated every three years.

The scope was to review the effectiveness of the Board as a unit, examine its structures and processes, assess the contribution made individually and collectively by Directors, and report on adherence to corporate governance best practice. The review was conducted through attendance at Board and Committee meetings, individual meetings with Directors and other senior management, and examination of relevant agendas, papers and minutes.

The review found that:

- The Board's structures and processes are well understood by Directors and are effective;
- Matters reserved for the Board are clear and appropriate;
- Board meetings are chaired well with all Directors' views being sought as each point is covered;
- The Board has an appropriate mix of skills, experience and knowledge;
- The Board owns and sets the strategy and determines risk appetite;
- Board Committee membership is appropriate; and
- Board Committees operate under appropriate terms of reference and report back to the Board in a timely manner.

The principal recommendations were as follows:

- Following confirmation of the Society's values, beliefs and behaviours, relevant management information in the form of a 'culture dashboard' should be provided to Board; and
- During 2017, the Board should agree the tests to be applied to help assess fair outcomes for policyholders.

Steps are underway to implement these recommendations.

Typically, non-executive Directors spend at least 20 days on work for the Society each year, including attendance at Board and Board Committee meetings. Directors regularly visit our offices in Aylesbury to spend time with our staff to understand better the key risks and controls of running our business.

With assistance from the Nominations Committee, the Board reviews the performance of individual Directors annually. The non-executive Directors meet under the leadership of the Senior Independent Director to review the performance of the Chairman. In conducting these reviews, the Board has regard to the guidance on performance evaluation accompanying the UKCGC. The Board recognised that, in accordance with the Code, any term beyond six years for a non-executive Director should be subject to particularly rigorous review and should take into account the need for progressive refreshing of the Board.

In the light of the reviews referred to above, the Board considers it has the appropriate balance of

# Corporate governance statement continued

skills and experience to meet the requirements of the Society's business. The diverse experience, skills and independent perspective of the Directors provide effective review of and challenge to the Society's activities.

Board succession plans were reviewed during 2016. Consideration was given to the ongoing skills and experience needed to meet the Society's strategic objectives, and to the timing of future Board appointments. At the 2017 Annual General Meeting ("AGM"), members will be asked to approve an increase in the maximum limit of the aggregate of Directors' fees. This will allow for the appropriate expertise and experience to be added to the Board as we seek to meet the next phase of our strategy of recreating policyholder value.

## Appointments to the Board

Directors must retire and seek re-election at the first AGM following appointment. The Society's Articles require one third of the Directors who are subject to retirement by rotation to retire at each AGM and also that all Directors must submit themselves for re-election by rotation at an AGM at least every three years. All the Society's Directors will retire and offer themselves for re-election at the 2017 AGM.

The ongoing suitability of Directors is subject to annual review by the Board, as advised by the Nominations Committee. The Board's policy on remuneration is set out in the Directors' remuneration report.

## 3. Management of the Society

The Executive team meets weekly to manage business activities. Papers are prepared and presented to the Board and its Committees by the Executive team. The Executive team comprises: the Chief Executive; the Finance Director; the Risk Director; the Chief Actuary; the Head of Human Resources; and two Senior Managers, Customer Service.

The Chief Actuary, Martin Sinkinson, advises on the Society's ability to meet obligations to policyholders. He identifies and assesses the risks that could have a material impact on meeting these objectives as well as the capital needed to support the business. He also advises the Board on the methods and assumptions to be used for the assessment of the value of the Society's liabilities, and reports on the results. The Society is also required to appoint a With-Profits Actuary, who advises the Board on key aspects of the discretion to be exercised affecting with-profits business,

including the fair treatment of and communication with with-profits policyholders, and advice on bonus rates. Louise Eldred is the With-Profits Actuary.

The Board has responsibility for investment strategy, investment policy and appointing investment managers. These responsibilities are discharged through the Society's Asset and Liability Committee, which is chaired by the Finance Director. The Committee takes advice from the Chief Actuary and the Chief Investment Officer, and regularly liaises with the investment advisers to oversee day-to-day investment matters.

The Finance Director is the executive responsible for: the Society's Finance, IT Change, Company Secretariat and Investment functions; and our unit-linked business. He is also responsible for corporate strategy development and monitors progress against targets.

Monthly management information in respect of financial performance, fair treatment of policyholders, complaints handling, risk management, compliance and investment performance is prepared and reviewed by senior management, the Executive team and the Board.

Each year, the Society prepares a three-year business plan and budget to assist in the monitoring of results, assets, liabilities and investment performance. Actual performance against these plans is actively monitored and, where appropriate, corrective action is agreed and implemented.

The Senior Managers, Customer Service, Mark Francis and Louise Parbat, are responsible for ensuring that we meet the day-to-day needs of policyholders.

The Risk Director, Dave Pearce, is responsible for: providing the framework of risk policies; processes and approaches to be followed by staff; and for reporting to the Audit and Risk Committee and the Board on the key risks facing the Society and how those risks are controlled and managed.

The Head of Human Resources, Carol Whitehead, is responsible for establishing appropriate standards of: recruitment; staff performance review; union relations; and staff communications.

# Corporate governance statement continued

## 4. Culture

Culture in financial firms has moved towards the top of the agenda for regulators and consumers. We define culture as a system of values, beliefs and behaviours that influence how work gets done in an organisation. The Society's culture must underpin its strategy and business model, and be aligned to our purpose. Furthermore, performance management through objective setting and regular performance reviews, and the reward of staff through the discretionary annual bonus scheme, must be aligned with our strategy and purpose. The Society has been working to a clear set of values over the past few years. The values are a regular source of reference and are fundamental to good decision making. During 2016, the beliefs and behaviours necessary to deliver our strategy in line with those values have been set down. A statement of values, beliefs and behaviours was endorsed by the Board in December 2016. The Board will monitor the Society's culture using a dashboard of indicators.

### Our purpose

To recreate policyholder value by distributing capital to with-profits policyholders as fairly and as quickly as possible.

### Our values

- Delivering for our policyholders
- Transparency
- Fairness
- Affordability

### Our beliefs

- Recreating policyholder value is the lens through which to determine the Society's strategy;
- The Society sees regulation as a good and necessary requirement, and its role is to work with regulators without adversity;
- The Society's risk appetite should underpin decision making;
- It is important to maintain a strong control environment;
- Good enough communication is not good enough; and
- Seek opportunity for feedback and act on it.

### Our behaviours

- Integrity
- Take ownership
- Can-do approach
- Keep it simple
- Supportive

## 5. Internal controls and risk management

The Directors are ultimately responsible for the Society's system of internal control and for reviewing management's arrangements for ensuring its effectiveness, including the effectiveness of controls over outsourced activities. This system is designed to manage rather than eliminate the risk of failure to achieve business objectives. The system can only provide reasonable, rather than absolute, assurance against material loss or misstatement. The Directors seek to ensure that the Society mitigates its exposure to risks consistent with its strategy. They also take into consideration the materiality of the risks to be managed and the cost-effectiveness of the relevant aspects of internal control.

The introduction of Solvency II from 1 January 2016 brought with it new requirements for governance, including internal controls and risk management, capital management and financial reporting. The Society took steps to ensure that appropriate processes, capabilities and controls were in place to ensure that these new requirements were met. Compliance and internal audit reviews have provided assurance that the Society is complying with Solvency II.

On behalf of the Board, the Audit and Risk Committee has reviewed the effectiveness of the risk management and internal control systems for the year ended 31 December 2016, taking into account matters arising up to the date of this report.

The review demonstrated that the Society has in place a comprehensive set of risk management and internal control arrangements. These include the identification, assessment, measurement, monitoring, reporting and management of risks. The review also confirmed that the Society is compliant with the Systems of Governance requirements under Solvency II. There have been no material changes to the Society's Systems of Governance in 2016.

A programme of internal audits and compliance monitoring takes place to provide assurance that the Society's controls are fit for purpose and that regulatory requirements are being met. No material control issues arose in 2016 and there were no material risk events or breaches during the year. If significant failings or control deficiencies were to be identified, the Committee would confirm whether or not appropriate remedial action had been taken. The review concluded that the

# Corporate governance statement continued

Society's risk management and internal control systems are operating effectively.

The principal components of the Society's system of internal control are detailed below.

Ultimate responsibility for the oversight of the management of risk rests with the Board who has adopted the widely recognised 'three lines of defence' governance model, under which primary responsibility for day-to-day risk management and compliance rests with business areas. Oversight and challenge is provided by the Risk and Compliance function as the second line of defence, and independent assurance is provided by Internal Audit as the third line of defence.

## Control environment

The Society is committed to the highest standards of business ethics and conduct, and seeks to maintain these standards across all of its operations. The Society regularly reviews its governance arrangements and guiding principles to ensure that these remain appropriate for its business.

An appropriate organisational structure for planning, executing, controlling and monitoring business operations is in place in order to achieve the Society's objectives. The structure is reviewed and updated on a regular basis, taking into account the different priorities of the Society's business, to ensure that it provides clear responsibilities and control for key areas. Separate functions have been established for Risk Management, Compliance and Internal Audit.

## Risk management

The Audit and Risk Committee has delegated authority from the Board for reviewing the Society's internal control and risk management systems, and for monitoring performance against the Board's risk appetite.

The Risk Director is responsible for ensuring that there is an effective and well-documented enterprise-wide risk management framework, including:

- A risk and control self-assessment process no less frequently than half-yearly, which requires senior management to attest to the risks and associated controls in place within their area of the business;
- Risk management policies for all principal risk categories. Material changes to these policies are approved by the Board;
- The agreement by the Board of risk appetite statements which are closely

linked to the achievement of the Society's strategic objectives, and key risk indicators for monitoring against risk appetite;

- A robust and consistent approach across the Society for risk identification and risk assessment; and
- Detailed monitoring, review and reporting on material risks, including to the principal management and risk committees.

The Risk Management Framework is designed to meet the requirements and standards set by the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA"), and under the new Solvency II requirements which applied from 1 January 2016.

The Strategic report sets out the principal risks faced by the Society.

## Monitoring and other assurance activities

Assurance is provided to the Audit and Risk Committee and the Board on the effectiveness of the key controls through:

- Review and recommendation to the Audit and Risk Committee of the Annual Assurance plan by the Executive Committee;
- Regular reporting by Internal Audit on findings from audits and other assurance reviews, and the management actions to address the findings;
- Annual review of effectiveness of key internal controls by the Executive team and the Audit and Risk Committee;
- Reporting on the regulatory environment and associated regulatory risks by the Society's Risk Director;
- Review of emerging risks, their implications for the Society, and identification of appropriate mitigating actions by the Risk Director;
- Reports received from the Society's Risk and Compliance functions on specific elements of risk and their management; and
- The work of independent advisers commissioned to report on specific aspects of internal control.

The Audit and Risk Committee monitors the status of actions to improve the effectiveness of the system of internal control.

## Internal Audit

The Society's Internal Audit team provides assurance over the operation of governance, risk

# Corporate governance statement continued

management and the system of internal control. This team draws on technical audit support from a specialist third party.

The programme of internal audit reviews is based on the Society's risk profile, independently assessed by Internal Audit and reviewed by the Audit and Risk Committee. The delivery of the Internal Audit plan and the activities to report and track audit findings are reported to, and reviewed by, the Executive Committee and the Audit and Risk Committee.

## 6. Governance Advisory Arrangement

Since April 2015, pension providers operating workplace pension plans must have an Independent Governance Committee or a Governance Advisory Arrangement ("GAA"), whose principal function is to:

- Act solely in the interests of the members of those pension plans; and
- Assess the 'value for money' delivered by the pension plans to those members.

PTL provide the Society's GAA for our workplace pension plans, which were all grouped personal pension plans at commencement. The GAA is required to produce an annual report on a number of matters, including an assessment of the value delivered by these pension plans. A copy of their latest report will be made available on our website. In the report, they conclude that our grouped personal pension plans "represent reasonable to good value for money, taking into account the benefits offered to policyholders."

## 7. Policyholder communications

The Board is committed to open communications with policyholders. We continue to simplify our processes and written material, dispensing with jargon as much as possible.

In April 2016, the Annual Report and Accounts was published on our website. Copies were provided to those who had requested to receive a paper version. Notice of the 2016 AGM was sent to all Members of the Society together with the Chairman's statement and other information from the Annual Report and Accounts.

Also in April 2016, Annual Statements were issued to all with-profits and unit-linked policyholders.

The Chief Executive wrote to policyholders in April 2016 to advise that the Board had decided to maintain capital distribution at 35%. With turbulent markets and political uncertainties, we considered

we should make policyholders aware that it was not unthinkable that capital distribution may have to reduce. Following further falls in interest rates after the European Referendum, we deemed it appropriate to write again in September about the possibility that capital distribution may have to be reduced or suspended.

In October, quantitative research was undertaken among a large group of policyholders. As the Chairman comments in his report, there was a notable increase in the number of policyholders who were no longer as sure as they had been that the Society is going in the right direction. We are certain that this change of sentiment reflected the content of the letter sent in September.

A further letter was issued in January 2017, expressing our greater confidence in maintaining capital distribution at 35% following a successful application for a more gradual transition to new solvency regulations. In the survey issued following this letter, there was a marked increase in the number of policyholders who consider that the Society is moving in the right direction.

In December 2015, details of changes to fund charges and our plans for simplifying the range of funds available were sent to unit-linked policyholders. During 2016, we wrote to policyholders affected by the closure of funds with details of alternative investment options.

At the AGM, members of the Board are available to answer questions. Separate resolutions are proposed on each issue so that they can be given proper consideration. Resolutions are dealt with on a show of hands unless a poll is called. The Society counts all proxy votes and indicates the level of proxies lodged on each resolution, after it has been dealt with on a show of hands. The proxy form specifically provides for members to be able to abstain on a resolution or resolutions if they wish.

The Society produces a document setting out its Principles and Practices of Financial Management. In 2016, there were no changes to the principles. There were some changes to the practices. There is also a simplified version of this document: "A guide to how we manage the with-profits fund". The latest versions of these are available on the Society's website, together with information about with-profits bonus rates. Any material changes in these documents are drawn to the attention of policyholders.

Each year, reports are produced by the Board and by the With-Profits Actuary on how the with-profits fund has been managed. These documents are

# Corporate governance statement continued

available on the Society's website and on request for members without Internet access.

## 8. UK Modern Slavery Act 2015

Given the nature of the Society's business, we do not consider that there is a significant risk of slavery or human trafficking within the company or its supply chain. A 'right to work' check is undertaken for all staff as part of the recruitment process. We pay staff above the National Living Wage. We treat staff fairly in accordance with our policies and procedures.

At least annually, we require our material third-party suppliers to attest that they comply with the requirements of the UK Modern Slavery Act 2015 and, in particular, to confirm that there is no modern slavery or human trafficking in their operations or those of their subcontractors. The annual attestations provided since the legislation came into force have confirmed compliance with the Act.

## 9. Board Committees

### The Audit and Risk Committee

#### Statement from the Audit and Risk Committee Chair

The Board's approach to governance means that the Audit and Risk Committee has an efficient and effective oversight of both the risk and control frameworks of the Society as well as taking responsibility for both internal and external audit. The Committee continues to ensure that an appropriate balance of discussion between risk and audit takes place at its meetings throughout the year.

While the Board has delegated oversight in relation to risk matters to the Committee, there are still occasions when it is more appropriate for detailed discussions on risks relating to specific events or transactions to be considered by both the Committee and the Board. Such matters in the last year included the risks around: market volatility; Brexit; cyber security; and capital distribution.

The Committee continued to invite to its meetings members of the Executive team and other senior managers as appropriate so that they provide their reports at first hand. It enabled them to hear and respond to the constructive challenges made by members of the Committee, who draw on their own experience and wider industry knowledge. This approach results in the Committee reaching agreement on appropriate outcomes for the Society. In addition, we held meetings separately

with each of the Finance Director, the Risk Director, the Chief Actuary and the Head of Internal Audit without any other executives present. There were no issues or concerns raised by them in regard to discharging their responsibilities.

The Committee meets with Marcus Hine, our PricewaterhouseCoopers ("PwC") LLP Audit Partner, in private session once a year. This session informs the Committee in its consideration of the Annual Report and Accounts. There were no matters arising that the Committee had to follow up with the Executive prior to making its recommendations to the Board on the Annual Report and Accounts.

The report that follows gives a high-level overview of the matters covered during the year.



Keith Nicholson  
Chair, Audit and Risk Committee

20 March 2017

### Audit and Risk Committee report

Throughout 2016, the Committee comprised: Keith Nicholson (Chair); Penny Avis; Ian Gibson; and Cathryn Riley. All members of the Committee are non-executive Directors.

The Committee met seven times in 2016. Two of those meetings were solely in regard to the review and approval of documentation in connection with the Society's application for a more gradual transition to new solvency regulations. The other five meetings paid particular attention to the Society's:

- Fair, balanced and understandable financial reporting;
- Compliance with the UKCGC;
- Risk management systems, risk appetite and the identification and management of key risks;
- Arrangements for ensuring compliance with regulatory requirements, in particular, the implementation of processes to meet Solvency II requirements;
- Control environment;
- Internal and external audit processes;
- Resourcing of the Risk, Compliance and Internal Audit functions as the business runs off;
- Business continuity arrangements; and
- Procedures for handling allegations from whistle-blowers.

# Corporate governance statement continued

The Committee assisted the Board in fulfilling its responsibilities in regard to the Society's Financial statements and Annual Regulatory Returns to the PRA. The Committee Chairman reported to the Board meeting that followed each Audit and Risk Committee meeting, with the minutes of the meetings being subsequently circulated to the Board.

At the meeting in September 2016, Internal Audit prepared a draft Assurance plan, for review and challenge by the Committee. The final plan reflecting the outcome of the review and challenge was approved at the December 2016 meeting.

An external assessment of the Internal Audit team was performed during 2016. That assessment concluded that Internal Audit demonstrated a good level of adherence with the Institute of Internal Audit standards. The review identified some opportunities to further strengthen the Society's internal audit processes, including the development of an overall 'assurance map'.

Reports were provided by the Risk Director throughout the year on the management and identification of risks. The Committee reviewed and discussed the risk assessments, the risk appetite statements and the mitigating actions prior to submission to Board for approval. Matters considered by the Committee included:

- Cyber security: this is an increasing threat and the Committee received assurance on the effectiveness of the Society's controls and the plans in place for dealing with potential attacks;
- The implications of the UK exit from the European Union;
- The implications of continued market volatility and policyholder behaviour on the Society's capital distribution strategy; and
- The application to the PRA for the Society to utilise transitional arrangements in implementing Solvency II capital requirements.

In relation to the Financial statements for 2016, the following significant issues were considered by the Committee:

- The methodologies and assumptions used in the valuation of the Society's liabilities. The Committee's review focused on the methodology and data underlying the principal assumptions of policyholder behaviour and expenses;

- During 2016, the Committee and the Board regularly reviewed: policyholder behaviour in light of the pension reforms implemented in April 2015; market volatility; and Brexit. We continue to develop our understanding of the influences that cause policyholders to take their benefits. The Committee considered carefully policyholder behaviour assumptions for 2016. We agreed with management's recommendation (made to the Board following the review by the Committee) that the retirement age at which benefits are taken should be increased to reflect recent experience of policyholder deferrals, and that surrender rates should be increased to reflect recent non-contractual termination rates;
- The Committee reviewed the assumptions recommended by management in applying the budgeted expenses approved by the Board to the valuation of the liabilities. The Committee considered the run-off plans of management in concluding the approach recommended by management; and
- The valuation of the Society's invested assets. Reports from the Finance Director were submitted to the Committee providing information on the valuation processes followed for invested assets, including how these provided a fair value.

The Committee considered whether the Annual Report and Accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary for members to assess the Society's performance, business model and strategy and how these judgements were reached.

In arriving at their conclusion, the Committee reviewed the Board and Audit and Risk Committee papers and minutes to satisfy itself that the Annual Report and Accounts did meet these criteria and could be recommended to the Board for approval.

The Committee kept the relationship between the Society and its external auditors under review and considered their independence, including the extent, if any, of their fees from non-audit services. As part of the review, the Committee obtained confirmation that, in PwC's opinion, their independence as auditors had not been compromised. The Committee approved the terms of engagement and the remuneration to be paid to the external auditors in respect of audit services.



# Corporate governance statement continued

The Society's general principle is that our external auditors should not provide non audit-related services for the Society. In 2016, the exceptions to this were in relation to the provision of: regular regulatory updates in relation to policies sold in Germany; a software validation tool in connection with our submissions under Solvency II regulations; and assurance activities in regard to the Society's application for a more gradual transition to new solvency regulations. The costs for these services are significantly lower than the audit fees.

The Audit and Risk Committee has primary responsibility for recommending to the Board the appointment, reappointment and removal of the external auditors. In considering this, the Committee takes into account the firm's independence and whether it would be appropriate to invite tenders for the role of external auditors.

PwC have acted as the Society's external auditors since 2001. The Committee reviewed the appointment of external auditors during 2012 as there was a mandatory rotation of the Audit Partner at PwC during 2013. In recommending the reappointment of PwC as the Society's external auditors, and not making the role subject to tender at that time, the Committee considered the need for continuity of experience in the external auditor, in particular, during periods of significant change. The Board agreed the Committee's recommendation that the appointment of the external auditor should be reviewed in autumn 2017 as Marcus Hine will be rotating off the external audit at the conclusion of the 2017 audit.

The Committee reviewed the effectiveness of the external audit process at its meeting on 16 March 2017, utilising input from the Chair and the Finance Director. The Committee concluded that PwC's performance had been effective, and recommended to the Board that they be reappointed for 2017.

The UKCGC states that the Board should satisfy itself that at least one member of an Audit Committee has recent and relevant financial experience. The Board has agreed that Keith Nicholson should be regarded as the member having recent and relevant financial experience. The Board considers that the Committee as a whole has the skills, expertise and experience relevant for the Society's circumstances.

The UKCGC states that no one other than the Committee Chair and members should be entitled to be present at a meeting of an Audit Committee, but others may attend at the invitation of the

Committee. The Audit and Risk Committee has indicated that any Director may attend its meetings if he or she wishes.

The Committee undertakes an annual review of its effectiveness by means of the completion of a questionnaire by members of the Committee and senior management who regularly attend meetings. The most recent review was undertaken in February 2017.

## The With-Profits Committee

The Committee considers matters affecting with-profits policyholders such that the interests of all, or, where relevant, specific groups of, policyholders are appropriately considered. Its primary objective is to ensure the fair treatment of with-profits policies, having due regard to:

- Appropriate risk and capital management;
- Fair payouts when benefits are taken;
- Appropriate investment strategies for the Society's fund;
- Clear and timely policyholder communications; and
- Any issues that with-profits policyholders might reasonably expect the Committee to consider.

Details of how this is achieved are documented in the Society's Principles and Practices of Financial Management and 'Guide to how we manage the with-profits fund' published on our website. The Committee is responsible for the maintenance of these documents.

The Committee works closely with, and obtains the opinion and advice of, the Society's With-Profits Actuary. It advises the Board on matters affecting with-profits policyholders.

In 2016, the Board carried out the duties of the With-Profits Committee. In order to ensure appropriate focus is given to these duties, the With-Profits Committee meets as part of Board Meetings at which there are with-profits items.

These arrangements have been in place for some years, and they will be reviewed in 2017 to establish whether they remain fit for purpose.

## The Nominations Committee

During 2016, the Nominations Committee comprised three non-executive Directors: Ian Brimecome (Chair); Keith Nicholson; and Cathryn Riley. The Committee assists the Board in ensuring that the Society meets the relevant principles and provisions of the UKCGC.

# Corporate governance statement continued

The UKCGC states that the Board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.

In relation to the Committee's review of the appropriateness and suitability of Board members, Directors are required to provide feedback to the Chairman both on their own performance and that of their colleagues.

The feedback was discussed at the March Nominations Committee meeting, following which the Chairman provided specific feedback to each Board member.

UKCGC principles also specify that there should be a formal, rigorous and transparent procedure for the appointment of new directors to the Board.

During 2016, the Society undertook a search for a new non-executive Director. As reported in the Chairman's statement, this search resulted in the appointment of Lord Finkelstein to the Board on 17 March 2017. The Board did not consider the use of an external search consultancy was necessary to assist with this appointment.

On joining the Board, new Directors receive an extensive bespoke induction programme. Meetings take place with Directors and senior management to share and explain the Society's internal and external reports on important aspects of its business.

The Board is committed to appropriate diversity, including gender diversity. The Board's clearly stated intention in its 2013 Annual Report and Accounts was to have at least two women Directors. This we have achieved.

It is our intention to have a leadership team that brings different skills and perspectives as well as different experiences and backgrounds. By the end of 2015, we had achieved our aim to have an equal number of women and men in senior management positions and this balance has been maintained. At the end of 2016, the Society's workforce comprised 69% women and 31% men. Currently, two of the seven members of the Executive team are women, as is the With-Profits Actuary, the Head of Legal Services and the Company Secretary.

We make specific comparisons of the salaries paid to men and women, grade by grade, and we do not consider there is gender bias.

## Directors' remuneration report

### Statement from the Remuneration Committee Chair

Executive remuneration has never been subject to the degree of scrutiny that it receives today. A constant theme with which I agree wholeheartedly is a strong link between pay and performance.

Investors, politicians and the media are unremitting in expressing strong views on what they expect from boards in setting executive remuneration. The Remuneration Committee remains very mindful, in carrying out its duties, of both this wider external environment and the views of policyholders.

Turning to performance in 2016, notwithstanding the unprecedented volatility in 2016, we are pleased to have been able to maintain the 35% capital distribution payable to with-profits policyholders. Other important factors in the Committee's assessment of performance include the continued reduction in the size of the Society's cost base seen in 2016 and the maintenance of good levels of staff morale, as evidenced by the staff survey.

In May 2016, we put before you a new remuneration policy and this received 91% approval. Key elements of this policy are:

- One bonus scheme with removal of the separate Long-Term Incentive Plan;
- Published performance measures;
- 50% of the sum awarded as bonus is deferred for up to three years; and
- The entire bonus is subject to clawback, and the deferred portion is subject to malus.

The Committee has applied the new policy in determining the remuneration of our executive Directors for 2016. Our driving force is to ensure that executive pay fairly and effectively rewards good performance for the year immediately past. Additionally, the Committee has a clear eye to do what is necessary to secure the future success of the Society. The Society remains a substantial business and it is essential to have the right people running it, and they must be paid properly.

# Corporate governance statement continued

## Review of 2016

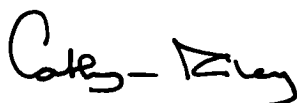
During 2016, the Committee made the following decisions, details of which are set out in the Directors' remuneration report:

- Assessing executive Director performance against the 2016 targets, explained in more detail below;
- Approving the 2017 performance targets;
- Agreeing to make no change to the Chief Executive's and Finance Director's base salaries in the 2016 year-end pay review;
- Meeting newly introduced remuneration requirements under Solvency II; and
- Reviewing senior management succession.

The Chief Executive performed strongly in 2016. His leadership of the Society through that very challenging year was steady and assured, costs continue to be well controlled, staff numbers have reduced substantially while good levels of morale have been maintained. As has been the position in previous years, the Remuneration Committee agreed with the Chief Executive that again no bonus would be payable.

The Finance Director, S A Small, is eligible for a bonus of up to 80% of annual base salary. In 2016, Mr Small performed well. His achievements of further cost reduction, implementation of Solvency II and the simplification of the Society were of a high standard and played a major part in the continued successful implementation of the Society's strategy. The Committee considered that his performance merited a bonus of 60% of base salary (£137,700). Of this, £68,850 is deferred and is payable over the next three years, subject to malus.

My commitment last year was that the new policy would not lead to greater levels of overall remuneration through the back door. We have met this commitment.



Cathryn Riley  
Chair, Remuneration Committee

20 March 2017

## Definitions

### Base salary

Fixed amount; reviewed annually and paid monthly in twelve equal instalments.

### Bonus

The annual discretionary bonus rewards achievement of key deliverables in the relevant financial year. The maximum possible bonus is expressed as a percentage of base salary.

### Long-Term Incentive Plan

The Long-Term Incentive Plan ("LTIP"), introduced in 2012, expired in 2015. There is no replacement.

### Clawback

Clawback allows for the recovery of sums already paid to executive Directors. Clawback applies to bonus and LTIP awarded after 1 January 2015, for a period of two years following award in any of the following circumstances: a misstatement of the Society's Financial statements deemed material by the Remuneration Committee; or a failure of risk management deemed material by the Remuneration Committee; or gross misconduct by the executive Director.

### Malus

Malus allows for the forfeiture of bonus in the deferred period before it has been paid to the executive Director in any of the following circumstances: a restatement of the Society's Financial statements as a result of an error; or failure by the executive Director to comply with the rules, policies or procedures of the Society, or those of our regulators, deemed to be significant by the Remuneration Committee; or any adverse post-implementation review findings relating to a project or task, deemed to be significant by the Remuneration Committee, for which the executive Director is accountable; or dismissal of the executive Director.

## About the Remuneration Committee

The Remuneration Committee is responsible for recommending remuneration policy to the Board. The Committee comprises three non-executive Directors: Cathryn Riley, Ian Brimecome and Keith Nicholson. The Committee reviews remuneration policy annually and sets the terms of employment and remuneration of executive Directors.

The Committee operates to the standards set out in the UKCGC and by the Association of British Insurers ("ABI").

## Corporate governance statement continued

The Committee's formal annual review of its approach and processes found them to be appropriate and effective.

During 2016, the Society received remuneration survey information from Willis Towers Watson. This survey is an important reference source in understanding the levels of remuneration within the UK insurance sector.

In considering matters relating to Directors' remuneration the Society received advice and services from the following:

Firm	Services	Fees, excl. VAT £000
Tidden Services Ltd	Expert analysis	31
Willis Towers Watson Ltd	Remuneration survey	3
Ashurst LLP	Legal advice	2
Hogan Lovells International LLP	Legal advice	2
Deloitte LLP	Remuneration advice	1
<b>Total</b>		<b>39</b>

In 2016, these firms provided other services to the Society additional to those provided to the Remuneration Committee.

# Corporate governance statement continued

## Annual report on remuneration

Decisions in regard to executive Director remuneration in 2016 have been made in accordance with the Directors' remuneration policy approved by members on 23 May 2016 and effective from 1 January 2016. The total emoluments of the Directors were as follows:

### Executive Directors' emoluments

	Salary		Performance related bonus		Benefits		LTIP		Total	
	2016 £	2015 £	2016 £	2015 £	2016 £	2015 £	2016 £	2015 £	2016 £	2015 £
C M Wiscarson	450,000	450,000	-	-	123,062	105,020	-	-	573,062	555,020
S A Small	229,500	229,500	137,700	114,750	71,667	68,229	-	135,000	438,867	547,479
<b>Total</b>	<b>679,500</b>	<b>679,500</b>	<b>137,700</b>	<b>114,750</b>	<b>194,729</b>	<b>173,249</b>	<b>-</b>	<b>135,000</b>	<b>1,011,929</b>	<b>1,102,499</b>

#### Note:

London is the principal place of work for executive Directors. When they are required to travel to the Society's Aylesbury office, the associated costs are covered by the Society. The Society pays the tax on these benefits. The amount in 2016 for C M Wiscarson was £33,591 (2015: £23,436) and for S A Small £43,982 (2015: £40,245), and these sums are included under Benefits above.

Executive Directors' emoluments have been audited by PricewaterhouseCoopers LLP.

### Relative importance of spend on pay

A reduction in the number of the Society's employees has led to spend on pay reducing to £14m (2015: £16m). The table below compares spend on pay to the amount of capital distribution enhancing policy values of £878m (2015: £976m). Total spend on pay is very small compared with capital distribution enhancing policy values. While executive Director pay has remained stable at £1m, it has increased to 8.0% of all employee remuneration (2015: 7.7%) as a consequence of the reduction in employee numbers.

	2016 £m	2015 £m
Remuneration of executive Directors	1	1
Remuneration of employees other than executive Directors	11	12
Other including social security and pension costs	2	3
<b>Total spend on pay</b>	<b>14</b>	<b>16</b>
Capital distribution enhancing policy values	878	976
Total spend on pay as a percentage of capital distribution enhancing policy values	1.6%	1.6%
Remuneration of executive Directors as a percentage of remuneration of all employees	8.0%	7.7%

### Benefits

As the Society does not provide an occupational pension scheme for Directors, C M Wiscarson and S A Small have no accrued pension entitlements (2015: no accrued pension entitlements). Other benefits relate to travel, premiums for medical insurance, permanent health insurance, life assurance and payments in lieu of pension contributions.

# Corporate governance statement continued

## Performance-related bonus

The performance of C M Wiscarson against his objectives was as follows:

Objective	Measure	Performance
Policyholders	Issue payments to policyholders within agreed timescales	Achieved
	Percentage of positive with-profits policyholder views regarding the direction of the Society less percentage of negative views to be greater than 50%	September 2016: 37% February 2017: 53%
	Establish new policyholder behaviour forecasting methodology	Achieved
Financial	Solvency ratios to be within agreed limits	Achieved
	Expense levels (i.e. Society's costs) not to exceed budget	Exceeded
Risk	Manage risk within agreed appetite: key risk indicators in place, monitored and action taken	Achieved
	Embed Solvency II	Achieved
Projects	Complete strategic projects to time, cost and quality	Exceeded
	Deliver the 2016 unit-linked business plan	Exceeded
	Deliver target cost savings through Simplification	Exceeded
People	Staff survey positive scores to exceed 70% on all questions	Achieved

The Chief Executive performed strongly in 2016. His leadership of the Society through that very challenging year was steady and assured, costs continue to be well controlled, staff numbers have reduced substantially while good levels of morale have been maintained. As has been the position in previous years, the Remuneration Committee agreed with the Chief Executive that again no bonus be payable.

The remuneration of the Society's Chief Executive since 2009 has been as follows:

Year	Chief Executive	Chief Executive's total remuneration	Annual bonus as % of maximum opportunity	Long-term vesting as % of maximum opportunity
2016	C M Wiscarson	£573,062	0%	0%
2015	C M Wiscarson	£555,020	0%	0%
2014	C M Wiscarson	£550,669	0%	0%
2013	C M Wiscarson	£551,712	0%	0%
2012	C M Wiscarson	£540,896	0%	0%
2011	C M Wiscarson	£533,788	0%	0%
2010	C M Wiscarson	£537,623	0%	0%
2009*	C M Wiscarson	£177,472	0%	0%
2009*	C G Thomson	£1,388,153	85%	100%

\* C G Thomson resigned on 26 August 2009 and C M Wiscarson became Chief Executive from 2 September 2009.

# Corporate governance statement continued

The remuneration of the Chief Executive increased by 3% compared with 2015 solely as a result of the increase in the cost of insurance and travel benefits. The cost of two insurance premiums increased as they are age related, and 25 additional return journeys were made to Aylesbury, which was appropriate in view of the amount of change in the business.

The performance of S A Small against his objectives was as follows:

Objective	Measure	Performance
Policyholders		
Investment strategy	Deliver strategy	Achieved
Policyholder views regarding direction of the Society	Percentage of positive with-profits policyholder views regarding the direction of the Society less percentage of negative views to be greater than 50%	September 2016: 37% February 2017: 53%
Financial		
Solvency ratios within agreed limits	ORSA and SCR above 150%	Achieved
Provide best value-for-money cost base	Not to exceed 100% of budget for Society and not to exceed 100% of budget for Finance, IT and Company Secretariat; Board agree to executable plans to stay within the 1% charge over the plan period	Exceeded
Simplification	Deliver target cost savings	Exceeded
Risk		
Manage risk within appetite and policy	No risk events or audit findings indicative of a systemic failure of the Enterprise Risk Management Framework	Achieved
Effective third party management	Set and deliver against supplier scorecards	Achieved
Solvency II	Solvency II embedded such that programme can be closed and work becomes business as usual	Exceeded
IT key performance indicators	Hours lost are <7 per person and 85% of changes are delivered on time on budget while meeting target feedback scores	Achieved
Projects		
Unit linked	Deliver the unit-linked 2016 business plan including fund rationalisation and revised charge structure	Exceeded
Other	Deliver the 2016 strategy-driven action plan and prepare updated strategy for Board review	Achieved
People		
	Finance staff survey positive scores >70% for each question	Achieved
	Structuring of Finance and IT so they are more closely aligned to the run-off profile, delivered to plan and budget	Achieved

The Finance Director, S A Small, is eligible for a bonus of up to 80% of annual base salary. In 2016, Mr Small performed well. His achievements of further cost reduction, implementation of Solvency II and the Simplification of the Society were of a high standard and played a major part in the continued successful implementation of the Society's strategy. The Committee considered that S A Small's performance merited a bonus of 60% of base salary (£137,700). Of this, £68,850 is deferred and is payable over the next three years, subject to malus.

# Corporate governance statement continued

## Performance targets for 2017

The 2017 balanced scorecard set for C M Wiscarson is as follows:

Objective	Measure	Performance required
Policyholders	Payments to policyholders	Issue within agreed timescales
	With-profits policyholder views regarding direction of the Society	Percentage of positive views less percentage of negative views to be greater than 50%
	Policyholder behaviour research	Use to enhance service proposition
Financial	Solvency ratios	Ratios to be within agreed limits
	Expense levels	Not to exceed budget
Risk	Manage risk within agreed appetite	Key risk indicators in place, monitored and action taken
	Solvency II	On time reporting; internal assessment confirms compliance
Projects	Strategic projects	Complete projects to time, cost and quality
	Simplification	Deliver target 2017 cost savings
People	Staff survey	Positive scores to exceed 70% on all questions

The 2017 balanced scorecard set for S A Small is as follows:

Objective	Measure	Performance required
Policyholders	Investment management	Deliver agreed approach
	With-profits policyholder views regarding direction of the Society	Percentage of positive views less percentage of negative views to be greater than 50%
Financial	Solvency ratios	Ratios to be within agreed limits
	Expense levels	Not to exceed budget
Risk	Third party management	Set and deliver against supplier scorecards
	Solvency II	On time reporting; internal assessment confirms compliance
	IT key performance indicators	Achieve service targets
Projects	Strategic projects	Complete sponsored projects to time, cost and quality
	Simplification	Deliver target 2017 cost savings
People	Staff survey	Positive scores to exceed 70% on all questions



# Corporate governance statement continued

## 2017 pay award

It is the Society's practice to review basic salaries for all staff towards the end of each financial year, taking into account affordability, changes in pay within the insurance sector and the external economic environment. In 2016, following such review, it was decided to award a 2% increase in basic annual salary, from January 2017 (January 2016: 2%). No increase was applied to the salaries of the Chief Executive and the Finance Director.

## Payments made to non-executive Directors

Total payments to non-executive Directors are set out below. No other payments were made.

Non-executive Directors	2016 £	2015 £
I Brimecome, Chairman	150,000	140,000
Other non-executive Directors		
P J Avis*	50,000	43,154
I A Gibson	50,000	45,000
K Nicholson	60,000	55,000
C Riley	50,000	45,000
Total for non-executive Directors	360,000	328,154

\* P J Avis was appointed on 16 January 2015.

The above payments have been audited by PricewaterhouseCoopers LLP.

## Consideration of member views

The proxy votes received, excluding abstentions, in respect of the Directors' remuneration report at the Society's AGM held on 23 May 2016, were as follows:

	2016		2015	
For	47,578	(91%)	59,990	(94%)
Against	4,529	(9%)	3,867	(6%)

# Corporate governance statement continued

## Executive Directors' remuneration policy

### Base salary

#### Purpose and link to strategy

Fixed amount to attract and retain executives of suitably high calibre to manage the Board's strategic plans and lead the Society.

#### Value

Chief Executive: £450,000 pa  
Finance Director: £229,500 pa

Reflects the individual's skills and experience.

Reviewed annually with changes, if applicable, usually effective from 1 January. Promotion or an increase in responsibility could lead to a higher increase than that made to other staff at the Society.

Total remuneration is referenced to Willis Towers Watson survey data. We may pay higher salaries and total remuneration for strongly performing individuals or to attract and retain executives of the right calibre.

#### Operation

Paid monthly in twelve equal instalments.

#### Performance metrics

None, although overall performance of the individual is considered by the Committee when setting and reviewing salary annually.

### Benefits

#### Purpose and link to strategy

The Society does not provide an occupational pension scheme for Directors. A cash allowance is provided in lieu.

The Society also pays the premiums on behalf of Directors relating to private medical insurance, income protection and life assurance, particulars of which may be obtained from the Company Secretary. The Committee may alter benefits from time to time and, where this occurs, an explanation will be provided in the subsequent annual Directors' remuneration report.

London is the principal place of work for executive Directors. When Directors are required to travel to the Society's Aylesbury office, the associated costs are covered by the Society.

#### Maximum potential value

Cash allowance in lieu of pension: Chief Executive: £70,000 pa; other executive Directors: 10% of base annual salary.

Insurance premiums vary year by year. The current annual cost is shown in the executive Directors' emoluments table. The costs of travel to Aylesbury vary year by year in line with business needs.

#### Operation

The cash allowance in lieu of pension is paid monthly in twelve equal instalments.

The costs of travel to Aylesbury are taxable benefits, and paid by the Society on a 'grossed up' basis.

#### Performance metrics

None.

# Corporate governance statement continued

## Discretionary annual bonus

### Purpose and link to strategy

Rewards achievement of key deliverables in the relevant financial year.

### Maximum potential value

80% of base salary.

For the remainder of his employment with the Society the current Chief Executive is eligible for consideration for a bonus of up to 25% of his basic salary for exceptional performance.

### Operation

Performance is monitored throughout the year, and a formal assessment is presented to the Remuneration Committee at the half year and year end.

Where performance is on target, typically 75% of the maximum bonus is paid but, in some circumstances, it may be lower. Where performance is assessed as exceeded, bonus of up to the maximum is payable. Where performance does not reach on target level, no bonus is payable.

50% of the sum awarded is deferred, and subject to malus, with the deferred amount being paid in equal instalments on the three anniversaries following initial payment.

Up to 100% of the gross sum is subject to clawback.

### Performance metrics

A scorecard is agreed each year setting out specific performance objectives. Objectives are determined so that the interests of bonus scheme participants and of policyholders are aligned. In particular, there is a strong focus on ensuring that executives act in ways that achieve business stability through, for example, treating customers fairly and prudently managing risk.

In addition to the discretionary annual bonus, in the event of a corporate transaction, the Society may introduce a retention bonus arrangement, linked to value created, to ensure executive Directors remain with the Society during a period of uncertainty. It is not possible to set out the terms of such an arrangement in advance as they would arise from the specific circumstances at the time. Disclosure would follow in the Directors' remuneration report in the year following the establishment of such an arrangement.

# Corporate governance statement continued

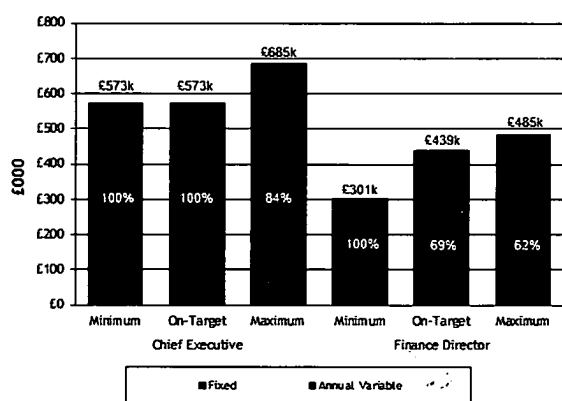
## Application of the remuneration policy

We estimate that the level of remuneration received by each of the two executive Directors for the 2016 financial year will be, indicatively, at three different levels of performance:

1. Minimum: where only fixed pay (salary, benefits and cash in lieu of pension) is payable and no bonus accrues;
2. On target: fixed pay plus, annual discretionary bonus at on target level; and
3. Maximum: fixed pay plus maximum bonus.

The chart below shows the value and composition of the remuneration package of the Chief Executive and Finance Director under the three levels of performance described above.

Illustration of the application of the remuneration policy in 2017



The basis of calculation and key assumptions used to compile the chart are:

- Salary, benefits in kind and cash in lieu of pension, as described in the remuneration policy table, are shown at the estimated cash cost to the Society;
- On-target bonus reflects the position where the corporate and personal metrics in the scorecard are achieved; and
- Maximum bonus reflects the position where overall performance is exceeded and represents the amount at which the bonus payment is capped.

## Approach to recruitment of Directors

The remuneration components for new Directors would be the same as those for existing Directors; that is: base salary; discretionary annual bonus with a maximum opportunity of 80% of base salary; 10% of base salary cash payment in lieu of a pension contribution; and payment of medical insurance, income protection and life assurance premiums.

Exceptionally, the Remuneration Committee may make a payment towards the cost of relocation. The specific individual circumstances of the joining Director will be the basis for determining whether any such costs will be met.

As a consequence of joining the Society, new Directors may lose the right to payments from their previous employer. While we would not compensate a Director for this upon arrival, we may choose to recognise such loss through the discretionary annual bonus, should performance justify this. We may also similarly recognise preparation by the Director in readiness for joining the Society.

## Payment for loss of office

The notice period for the Chief Executive is twelve months and, for other executive Directors, six months. These time periods have been put in place to safeguard the Society, in recognition that it typically takes several months to appoint successors to these positions.

The Society has the right to terminate any executive Director's employment by making a payment in lieu of the whole or unexpired part of the notice period.

Executive Directors are not eligible for a redundancy payment. Termination payments will be calculated on the following basis:

- Base salary due in respect of the notice period remaining;
- Benefits in respect of the same period; and
- Discretionary annual bonus relating to the period worked. For example, a 'good leaver' with a leaving date halfway through the financial year could receive a bonus relating to half a year's work. A good leaver is defined as an individual ceasing to hold office or employment with the Society by reason of death, injury, ill health, redundancy or retirement.

## Service contracts

There are no obligations on the Society in the Directors' service contracts which could give rise to, or impact on, remuneration payments or payments for loss of office which are not disclosed elsewhere in this report. No legacy matters arise from previous contracts. The contracts are available for inspection at the Society's registered office.

# Corporate governance statement continued

## Use of discretion

The Committee has discretion to increase base salary. This would typically take place at the time of the annual pay rise, on promotion, or following an increase in responsibility.

The Remuneration Committee exercises discretion regarding payments under the discretionary annual bonus up to the maxima disclosed in this report, and in determining whether a Director ceasing employment is defined as a good leaver.

Such discretion is necessary not only to evaluate the annual bonus but also to reduce payments where appropriate. Such flexibility is considered to be in the best interests of the Society and, other than in respect of increases to base salary and the discretionary annual bonus scheme, is only exercised exceptionally.

## Directors' remuneration in the context of pay and employment in the Society

The Society applies the same remuneration principles to all staff, ensuring there is alignment with business strategy throughout the Society. As well as salary, pension and other benefits, staff have the opportunity to receive a discretionary annual bonus.

The Remuneration Committee takes into account any annual pay increase for Society staff when determining the levels of increases for Directors.

## Succession planning

The Society identifies and prepares successors capable of filling senior management positions to ensure continuity of management, and this work is subject to twice-yearly review by the Remuneration Committee. This approach has proven effective when addressing changes at executive level.

The relatively small size of the Society means that it is not always possible to fill senior positions internally. Options include identifying external candidates or the use of contractors in specialist functions such as Risk and Finance. In some cases, responsibilities can be passed to other senior managers, rather than making a replacement appointment.

## Non-executive Director remuneration policy

Non-executive Directors receive only fees and are not eligible to receive benefits, pension or any annual or long-term incentives. Non-executive Directors' remuneration, other than that for the Chairman, is set by the Board. The Chairman's remuneration is set by the Remuneration Committee.

Fees are set by reference to market data, and the Board has discretion to increase fees periodically. Fees were increased from 1 January 2016, the first such increase for non-executive Directors since 2012, and for the Chairman since 2013.

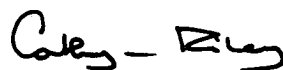
Fees for the non-executive Directors are as follows:

	Annual fee	Effective from
Chairman	£150,000	1 January 2016
Senior Independent Director and Chair of Audit and Risk Committee	£60,000	1 January 2016
Other non-executive Directors including Chair of Remuneration Committee	£50,000	1 January 2016

There is a one-month notice period under non-executive Directors' service agreements.

## Approval

This report was approved by the Board of Directors on 20 March 2017 and signed on its behalf by:



Cathryn Riley  
Chair, Remuneration Committee

## 10. Statement of compliance with the UK Corporate Governance Code

The Board considers that the Society has applied the relevant principles of the UK Corporate Governance Code. The Society complied with the Code and associated guidance throughout the year, other than that the Remuneration Committee should consist of at least three non-executive Directors. The Board believes it is sufficient that two independent non-executive Directors together with the Society's non-Executive Chairman are members of the Committee.

Signed on behalf of the Society's Board of Directors



Ian Brimecome  
Chairman

20 March 2017

# Independent Auditor's report to the members of The Equitable Life Assurance Society

Assurance Society

## Report on the Financial statements

### Our opinion

In our opinion, The Equitable Life Assurance Society's Financial statements (the "Financial statements"):

- Give a true and fair view of the state of the Society's affairs as at 31 December 2016 and of its result for the year then ended;
- Have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- Have been prepared in accordance with the requirements of the Companies Act 2006.

### What we have audited

The Financial statements, included within the Annual Report and Accounts (the "Annual Report"), comprise:

- The Balance sheet as at 31 December 2016;
- The Statement of comprehensive income for the year then ended; and
- The Notes on the Financial statements, which include a summary of significant accounting policies and other explanatory information.

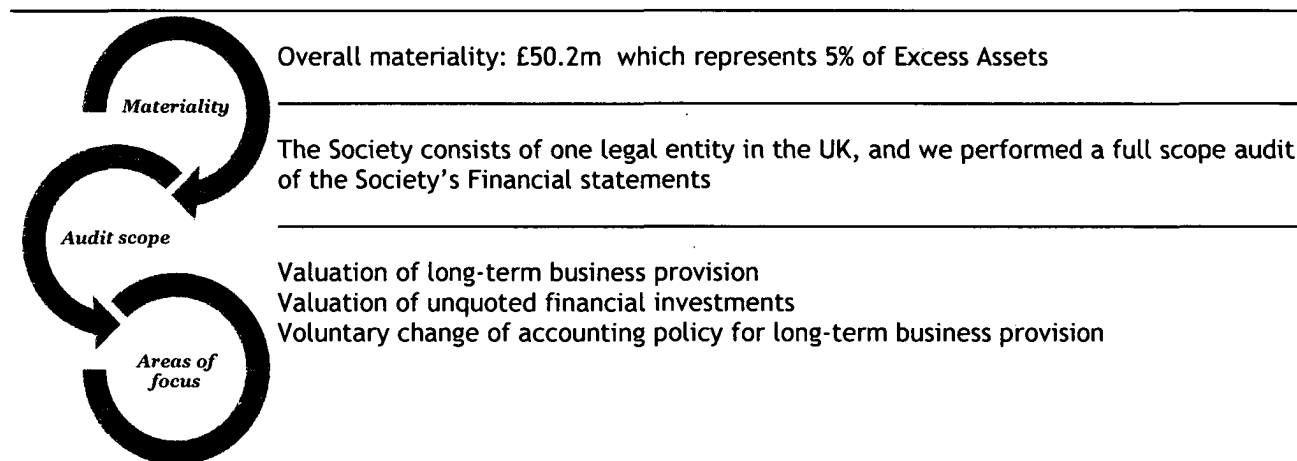
The financial reporting framework that has been applied in the preparation of the Financial statements is United Kingdom Accounting Standards comprising FRS 102 "The Financial Reporting Standard applicable in the UK and Republic of Ireland" and applicable law (United Kingdom Generally Accepted Accounting Practice).

### Our audit approach

#### Context

The Society is a closed life assurance fund and our audit is set against the context of its continued run-off. Its primary objective is to maintain a solvent run-off in order to be able to fairly distribute its Excess Assets to its members over time. No significant strategic transactions have been undertaken during the year.

#### Overview



### The scope of our audit and our areas of focus

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK and Ireland)").

We designed our audit by determining materiality and assessing the risks of material misstatement in the Financial statements. In particular, we looked at where the Directors made subjective judgements, for example, in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. As in all of our audits, we also addressed the risk of management

# Independent Auditors' report

## to the members of The Equitable Life Assurance Society continued

override of internal controls, including evaluating whether there was evidence of bias by the Directors that represented a risk of material misstatement due to fraud.

The risks of material misstatement that had the greatest effect on our audit, including the allocation of our resources and effort, are identified as 'Areas of focus' in the table below. We have also set out how we tailored our audit to address these specific areas in order to provide an opinion on the Financial statements as a whole, and any comments we make on the results of our procedures should be read in this context. This is not a complete list of all risks identified by our audit.

Area of focus	How our audit addressed the area of focus
<p><b>Valuation of long-term business provision</b></p> <p>We focused on the Directors' assessment of the valuation of the long-term business provision of £5,042m at 31 December 2016 for settlement of future benefits because it involves complex and subjective judgements about future events, both internal and external to the business, for which small changes can result in significant impacts to the valuation of the long-term business provision (see Note 13). Those assumptions to which the long-term business provision is most sensitive include future administrative expenses and persistency (being the rate at which policies are retained over time), including how the Guaranteed Investment Return ("GIR") affects policyholder behaviour, particularly with respect to persistency.</p>	<p>We assessed the Directors' valuation of the long-term business provision by:</p> <ul style="list-style-type: none"> <li>• Testing the Society's internal controls over assumption setting, including: <ul style="list-style-type: none"> <li>◦ Assessing the effectiveness of the process by which the assumptions were set, including the degree of rigour, challenge and oversight provided by senior management and the Directors; and</li> <li>◦ Examining evidence that shows there was adequate authorisation and explanation for changing assumptions, and the input of assumptions into valuation models;</li> </ul> </li> <li>• Testing the appropriateness of the assumptions used in the calculation of the long-term business provision, including: <ul style="list-style-type: none"> <li>◦ Testing that the assumptions, including the reasons for any changes, were supportable based on observed experience over previous periods; and</li> <li>◦ Assessing the reasonableness of future administrative expense forecasts against the Society's strategic business plans and evaluating the accuracy of previous forecasts against actual expenditure;</li> </ul> </li> <li>• Testing the consistency of data used in the valuation with the Society's books and records; and</li> <li>• Comparing the methods used by the Directors in establishing their valuation against recognised actuarial practices.</li> </ul> <p>We performed sensitivity analyses on the impact of change in policyholder persistency assumptions on the long-term business provision and used this information to set our own independent expectation to be able to conclude that the impact from the change in assumptions is appropriate.</p> <p>We found that the Directors' process was rigorous. The valuation assumptions are inherently subjective; however, we considered, based on the results of our testing, that the assumptions used were appropriate in the context of the Society's products.</p>

# Independent Auditors' report

to the members of The Equitable Life Assurance Society continued

Area of focus	How our audit addressed the area of focus
<p><b>Valuation of unquoted financial investments</b>  The Society uses derivative investments to hedge the risk of movement in the GIR liability, and the investment portfolio includes a material amount of unquoted financial investments (see Note 11). These investments were valued using significant non-observable inputs, sometimes involving the use of complex valuation models, and their valuation is therefore inherently uncertain. These investments represent approximately 3% of the total invested assets on the Society's Balance sheet.</p>	<p>We examined the basis on which the Directors and the Society's investment manager determined the fair valuation of these financial investments, and, where valuation models were used, we checked that the Directors/management had appropriate oversight over the development and use of those models.</p> <p>We examined the work performed by management to obtain prices for the Society's investments from independent sources to corroborate those provided by its external investment manager and found that no discrepancies were identified.</p> <p>We tested the valuation of a sample of unquoted financial investments by comparing the valuation applied by the Directors to independent pricing sources or our independent valuation models as appropriate.</p> <p>In performing this testing we did not identify any material misstatements in the valuation of unquoted financial investments.</p>
<p><b>Voluntary change of accounting policy for the long-term business provision</b>  The Society has voluntarily changed its accounting policy for the valuation of the long-term business provision, as disclosed in Note 1b. We focused on this change because it is significant to the preparation of the Society's Financial statements.</p>	<p>We assessed whether the changes made to the Society's accounting policy satisfy the criteria for a voluntary change set out by UK GAAP accounting standards. We found the new policy to be materially compliant with UK GAAP.</p> <p>We also tested the application of this policy in the preparation of the Financial statements, including the restatement of the 2015 Balance sheet, and the disclosures made in the Society's Financial statements in respect of this change. We did not identify any material misstatements in this testing.</p>

## How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the Financial statements as a whole, taking into account the geographic structure of the Society, the accounting processes and controls, and the industry in which the Society operates.

The Society consists of a single legal entity and one closed life assurance fund operating out of a single location. The Society outsources its investment management and administration function and hosting of IT infrastructure to third parties.

In order to gain appropriate audit evidence we performed a combination of testing the Society's internal controls over financial reporting and testing transactions and balances to supporting evidence. In respect of the outsourced investment management and administration service providers we were able to gain appropriate audit evidence through a combination of evaluating the providers' published assurance reports on internal control and testing controls operated by the Society that monitor the procedures carried out by the service providers. In respect of the outsourced IT service provider we were able to gain appropriate audit evidence by



# Independent Auditors' report

to the members of The Equitable Life Assurance Society continued

testing internal controls operated by the Society over IT systems and processes. This gave us the evidence we needed for our opinion on the Society's Financial statements as a whole.

## Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and on the Financial statements as a whole.

Based on our professional judgement, we determined materiality for the Financial statements as a whole as follows:

Overall materiality	£50.2m (2015: £39.1m)
How we determined it	5% of Excess Assets
Rationale for benchmark applied	Consistent with the prior year, since the Society does not report a profit or loss, we believe that Excess Assets is the most appropriate benchmark on which to base materiality, as it represents the amount available to meet liabilities in excess of those provided for at the balance sheet date, as well as to increase payouts to policyholders in the future.

We agreed with the Audit and Risk Committee that we would report to them misstatements identified during our audit above £2.5m (2015: £1.9m) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

## Going concern

The Directors have voluntarily complied with Listing Rule 9.8.6(R)(3)(a) of the Financial Conduct Authority ("FCA"), and have provided a statement in relation to going concern, set out on page 47, required for companies with a premium listing on the London Stock Exchange.

The Directors have requested that we review the statement on going concern as if the Society were a premium listed company. We have nothing to report, having performed our review.

The Directors have chosen to voluntarily report how they have applied the UK Corporate Governance Code (the "Code") as if the Society were a premium listed company. Under ISAs (UK and Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to the Directors' statement about whether they considered it appropriate to adopt the going concern basis in preparing the Financial statements. We have nothing material to add or to draw attention to.

As noted in the Directors' report, the Directors have concluded that it is appropriate to adopt the going concern basis in preparing the Financial statements. The going concern basis presumes that the Society has adequate resources to remain in operation, and that the Directors intend it to do so, for at least one year from the date the Financial statements were signed. As part of our audit, we have concluded that the Directors' use of the going concern basis is appropriate. However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the Society's ability to continue as a going concern.

# Independent Auditors' report

to the members of The Equitable Life Assurance Society continued

## Other required reporting

### Consistency of other information and compliance with applicable requirements

Companies Act 2006 reporting

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 the Directors' report have been prepared in accordance with applicable legal requirements.

In addition, in light of the knowledge and understanding of the Society and its environment obtained in the course of the audit, we are required to report if we have identified any material misstatements in the Strategic report and the Directors' report. We have nothing to report in this respect.

ISAs (UK and Ireland) reporting	
As a result of the Directors' voluntary reporting on how they have applied the Code, under ISAs (UK and Ireland) we are required to report to you if, in our opinion:	
<ul style="list-style-type: none"><li>• Information in the Annual Report is:<ul style="list-style-type: none"><li>◦ Materially inconsistent with the information in the audited Financial statements; or</li><li>◦ Apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Society acquired in the course of performing our audit; or</li><li>◦ Otherwise misleading.</li></ul></li></ul>	We have no exceptions to report.
<ul style="list-style-type: none"><li>• The statement given by the Directors on page 14, in accordance with provision C.1.1 of the Code, that they consider the Annual Report taken as a whole to be fair, balanced and understandable and provides the information necessary for members to assess the Society's position and performance, business model and strategy, is materially inconsistent with our knowledge of the Society acquired in the course of performing our audit.</li></ul>	We have no exceptions to report.
<ul style="list-style-type: none"><li>• The section of the Annual Report on pages 22 to 24, as required by provision C.3.8 of the Code describing the work of the Audit and Risk Committee does not appropriately address matters communicated by us to the Audit and Risk Committee.</li></ul>	We have no exceptions to report.

# Independent Auditors' report

to the members of The Equitable Life Assurance Society continued

**The Directors' assessment of the prospects of the Society and of the principal risks that would threaten the solvency or liquidity of the Society**

As a result of the Directors' voluntary reporting on how they have applied the Code, we are required under ISAs (UK and Ireland) to report to you if we have anything material to add or to draw attention to in relation to:	
<ul style="list-style-type: none"><li>• The Directors' confirmation the Annual Report, in accordance with provision C.2.1 of the Code that they have carried out a robust assessment of the principal risks facing the Society, including those that would threaten its business model, future performance, solvency or liquidity.</li></ul>	We have nothing material to add or to draw attention to.
<ul style="list-style-type: none"><li>• The disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated.</li></ul>	We have nothing material to add or to draw attention to.
<ul style="list-style-type: none"><li>• The Directors' explanation in the Annual Report, in accordance with provision C.2.2 of the Code, as to how they have assessed the prospects of the Society, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Society will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.</li></ul>	We have nothing material to add or to draw attention to.
The Directors have voluntarily complied with Listing Rule 9.8.6(R)(3) of the Financial Conduct Authority and have provided a statement that they have carried out a robust assessment of the principal risks facing the Society and a statement in relation to the longer-term viability of the Society, set out on pages 14 and 15. The Directors have requested that we review these statements as if the Society were a premium listed company. Our review was substantially less in scope than an audit and only consisted of: making enquiries and considering the Directors' process supporting their statements; checking that the statements are in alignment with the relevant provisions of the Code; and considering whether the statements are consistent with the knowledge acquired by us in the course of performing our audit. We have nothing to report, having performed our review.	

**Adequacy of accounting records and information and explanations received**

Under the Companies Act 2006, we are required to report to you if, in our opinion:

- We have not received all the information and explanations we require for our audit; or
- 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.

We have no exceptions to report arising from this responsibility.

## Directors' remuneration

Under the Companies Act 2006, we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

# Independent Auditors' report

to the members of The Equitable Life Assurance Society continued

## Other voluntary reporting

### Matter on which we have agreed to report by exception

#### Corporate governance statement

The Society voluntarily prepares a Corporate governance statement in accordance with the provisions of the UK Corporate Governance Code. The Directors have requested that we review the parts of the Corporate governance statement relating to the ten further provisions of the UK Corporate Governance Code specified for auditor review by the Listing Rules of the Financial Conduct Authority, as if the Society were a premium listed company. We have nothing to report having performed our review.

## Responsibilities for the Financial statements and the audit

### Our responsibilities and those of the Directors

As explained more fully in the Directors' responsibilities in respect of the Financial statements, the Directors are responsible for the preparation of the Financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the Financial statements in accordance with applicable law and ISAs (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Society's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

### What an audit of Financial statements involves

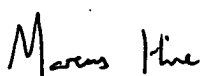
An audit involves obtaining evidence about the amounts and disclosures in the Financial statements sufficient to give reasonable assurance that the Financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- Whether the accounting policies are appropriate to the Society's circumstances and have been consistently applied and adequately disclosed;
- The reasonableness of significant accounting estimates made by the Directors; and
- The overall presentation of the Financial statements.

We primarily focus our work in these areas by assessing the Directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the Financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited Financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. With respect to the Strategic report and Directors' report, we consider whether those reports include the disclosures required by applicable legal requirements



Marcus Hine (Senior Statutory Auditor)  
for and on behalf of PricewaterhouseCoopers LLP  
Chartered Accountants and Statutory Auditors, London  
20 March 2017

# Statement of comprehensive income

For the year ended 31 December 2016

## Technical account – long-term business

	Notes	2016		2015 Restated	
		£m	£m	£m	£m
<b>Earned premiums, net of reinsurance</b>					
Gross premiums written	4		1	16	
Annuity business reinsurance initial premium	3		-	(850)	
Insurance business element of buy-back	3		-	180	
Other outward reinsurance premiums	3		(5)	(6)	
			(4)	(660)	
Investment income	5		391	308	
Unrealised gains on investments	5		386	-	
Other technical income	9		6	22	
<b>Total technical income</b>			<b>779</b>	<b>(330)</b>	
<b>Claims incurred, net of reinsurance</b>					
Claims paid – gross amount	6		498	459	
Reinsurers' share			(29)	(71)	
			469	388	
<b>Changes in other technical provisions, net of reinsurance - restated</b>					
Long-term business provision – gross amount	13d		(843)	(447)	
Reinsurers' share	13d		829	(824)	
			(14)	(1,271)	
Technical provisions for linked liabilities – gross amount	13d		234	28	
Reinsurers' share	13d		(5)	80	
			229	108	
<b>Net operating expenses</b>	7		29	35	
<b>Other technical charges</b>	9		57	34	
Investment expenses including interest	5		6	7	
Unrealised loss on investments	5		-	369	
Taxation attributable to the long-term business	10		3	-	
			95	445	
<b>Total technical charges</b>			<b>779</b>	<b>(330)</b>	
<b>Balance on the Technical Account</b>			-	-	
<b>Total comprehensive income for the year</b>			-	-	

The restatement of 2015 relates to a change of accounting policy for technical provisions for non-profit policies, as explained in Note 1b.

The results for 2016 and 2015 are not consolidated, as explained in Note 1a. All amounts relate to continuing operations. The Notes on pages 47 to 79 form an integral part of these Financial statements.

# Balance sheet as at 31 December 2016

## Assets

	Notes	2016 £m	2015 Restated £m
<b>Investments</b>			
Investments in Group undertakings	11a	30	26
Shares and other variable yield securities and units in unit trusts	11a	84	88
Debt and other fixed-income securities	11a	4,222	5,083
Deposits and other investments	11a	393	328
		<b>4,729</b>	<b>5,525</b>
<b>Assets held to cover linked liabilities</b>	11b	<b>1,846</b>	<b>1,788</b>
Reinsurers' share of technical provisions - restated			
Long-term business provision	13c,d	397	1,226
Technical provisions for linked liabilities	13c,d	12	33
		<b>409</b>	<b>1,259</b>
<b>Debtors</b>			
Debtors arising out of direct insurance operations	12	1	3
Debtors arising out of reinsurance operations	12	2	6
Other debtors	12	13	5
		<b>16</b>	<b>14</b>
<b>Other assets</b>			
Cash at bank and in hand		6	10
<b>Prepayments and accrued income</b>			
Accrued interest and rent		39	53
Other prepayments and accrued income		2	3
		<b>41</b>	<b>56</b>
<b>Total assets</b>		<b>7,047</b>	<b>8,652</b>

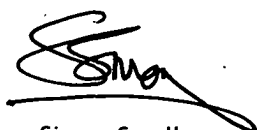
The Notes on pages 47 to 79 form an integral part of these Financial statements.

## Balance sheet as at 31 December 2016 continued

### Liabilities

	Notes	2016 £m	2015 Restated £m
<b>Technical provisions - restated</b>			
Long-term business technical provision - gross amount	13a,d	5,042	5,885
Technical provisions for linked liabilities	13b,d	1,858	1,821
		<b>6,900</b>	<b>7,706</b>
<b>Creditors</b>			
Creditors arising out of direct insurance operations	16	25	23
Deposit received from reinsurer - secured	3,16	-	796
Amounts owed to credit institutions	16	6	3
Other creditors including taxation and social security	16	108	112
		<b>139</b>	<b>934</b>
Accruals and deferred income		<b>8</b>	<b>12</b>
<b>Total liabilities</b>		<b>7,047</b>	<b>8,652</b>

These Financial statements were approved by the Board on 20 March 2017 and were signed on its behalf by:



Simon Small  
Finance Director

The Equitable Life Assurance Society registered company number 37038

The Notes on pages 47 to 79 form an integral part of these Financial statements.

The Society is a mutual company with no equity holders and so has not presented a Statement of changes in equity.

# Notes on the Financial statements

## 1. Accounting policies

### a. Statement of compliance

The Equitable Life Assurance Society is a UK private unlimited life assurance company without share capital.

The Society's registered office is at 20-22 Bedford Row, London, WC1R 4JS. The policyholder administration office is at Walton Street, Aylesbury, Buckinghamshire, HP21 7QW.

The Financial statements have been prepared in compliance with United Kingdom Accounting Standards, including 'The Financial Reporting Standard applicable in the United Kingdom and the Republic of Ireland' ("FRS 102"), 'Insurance Contracts' ("FRS 103") and the Companies Act 2006, under the provision of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410).

The Society does not have subsidiary companies that require consolidation, and these Financial statements represent the results and position of the Society only.

The Directors have considered the appropriateness of the going concern basis used in the preparation of these Financial statements, having regard to the ability of the Society to be able to meet its liabilities as and when they fall due, and the adequacy of available assets to meet liabilities. In the opinion of the Directors, the going concern basis adopted in the preparation of these Financial statements continues to be appropriate.

### b. Change in accounting policies

The Directors have reviewed the accounting policies. Following the introduction of Solvency II, the Directors have decided the accounting policy for insurance contract liabilities, should be based on the Solvency II valuation, with the following adjustments to align to FRS103 requirements:

- A risk-free discount rate derived from gilt yields;
- Mortality and longevity assumptions include a margin to reflect the uncertainty in future experience;
- The exclusion of the Solvency II transitional deductions, the Transitional Measures on Technical Provisions;
- The exclusion of the Solvency II Risk Margin; and
- The exclusion of the Solvency II allowance for counterparty default risk.

The new policy is unchanged for most of the Society's business. However, for non-profit policies, including index-linked policies, the new accounting policy removes the 10% prudence margin from expected future expenses and changes the discount rate from one based on assets held to one based on gilt yields. Therefore, the new policy represents a change of accounting policy for non-profit policies.

The Statement of comprehensive income and the Balance sheet have been restated for non-profit policies. The change impacts gross and reinsured technical provisions. The overall impact of the changes on Excess Assets is an increase of £10m and is analysed in Note 13d.

The new policy is more reliable than, and at least as relevant as, our previous accounting policy as it:

- Aligns with Solvency II principles;
- Is consistent with management's view of the financial position of the Society;
- Contains appropriate levels of prudence; and
- Avoids the reduction of relevance and reliability inherent in continuing with a policy based on a historical and now unmaintained regulatory basis.

The Directors are satisfied that all other accounting policies are appropriate and, as such, there are no changes in other accounting policies from the prior year.

### c. Contract classification

The Society has classified its Long Term Assurance business in accordance with FRS 103. Insurance contracts are contracts that transfer significant insurance risk. Investment contracts are those contracts where no significant insurance risk is transferred. Investment contracts that contain a discretionary participation feature entitling the policyholder to receive additional bonuses or benefits, such as with-profits contracts, are classified as investment contracts with discretionary participation feature. Those investment contracts that do not have this feature are classified as investment contracts without discretionary participation feature, and are almost entirely unit-linked contracts.

Hybrid policies that include both discretionary participation feature and unit-linked components have been unbundled and the two components have been accounted for separately.



# Notes on the Financial statements continued

## 1. Accounting policies (continued)

### c. Contract classification (continued)

Reinsurance contracts have been classified in the same manner as direct contracts, with those reinsurance contracts which do not transfer significant insurance risk classified as financial assets.

A major treaty with Lloyds Banking Group ("LBG"), reinsures non-profit business, and until March 2015 also reinsured unit-linked business. Some of the underlying policies reinsured by the treaty are classified as insurance and others as investment. Rather than classifying the reinsurance treaty as a whole, the underlying policies have been considered and the reinsurance classified accordingly. The reinsurance of annuities with Canada Life from 1 January 2015 until the Part VII transfer in 2016 has been classified as insurance business. Changes in reinsurance arrangements in 2015 are described in Note 3.

### d. Insurance contracts and investment contracts with discretionary participation feature

#### Earned premiums

Premiums earned are accounted for on a cash basis, in respect of single premium business and recurrent single premium pension business, and on an accruals basis in respect of all other business.

All pension policies contain an open market option under which, in lieu of the benefits that must be taken on retirement, the equivalent lump sum can be transferred to another provider. All such lump sums, arising from policies within the Society, are included in 'Claims paid'.

#### Claims

Death claims are recorded on the basis of notifications received. Retirements at the option of policyholders and surrenders are recorded when notified; contractual retirements, maturities and annuity payments are recorded when due. Claims on with-profits business include bonuses payable, which in turn include capital distribution amounts. Claims payable include interest and direct costs of settlement.

#### Reinsurance contracts

Outward reinsurance premiums are recognised when payable. Reinsurance recoveries are credited to match the relevant gross claims.

#### Liabilities

Liabilities for insurance contracts and investment contracts with discretionary participation feature are measured as described in section j.

### e. Investment contracts without discretionary participation feature

Unit-linked investment contracts classified as investment without discretionary participation feature are classified as financial instruments and so have been accounted for using the principles of deposit accounting. Policyholders' deposits and withdrawals are not included in premiums and claims in the Technical Account, but are accounted for directly in the Balance sheet as adjustments to technical provisions. Fees receivable from investment contracts without discretionary participation feature are reported in 'Other technical income'.

Liabilities for contracts classified as investment without discretionary participation feature are measured on an amortised cost basis. The amortised cost of these financial liabilities is equivalent to the amount payable on demand without penalty.

### f. Investment return

Investment return comprises all investment income, realised gains and losses, and movements in unrealised gains and losses, net of investment expenses, including interest payable on financial liabilities.

Investment income, including interest income from fixed-interest investments, is accrued up to the balance sheet date. Other income is recognised when it becomes payable.

Realised gains and losses on investments are calculated as the difference between net sales proceeds and the original cost.

Unrealised gains and losses on investments represent the difference between the valuation of investments at the balance sheet date and their purchase price or, if they have been previously valued, their valuation at the last balance sheet date. The movement in unrealised gains and losses recognised in the year also includes the reversal of unrealised gains and losses recognised in earlier accounting periods in respect of investment disposals in the current period.

# Notes on the Financial statements continued

## 1. Accounting policies (continued)

### g. Valuation of investments

All financial assets are initially recognised at cost, being the fair value at the date of acquisition. Subsequently, all financial assets are valued at fair value. Where possible, fair value is based on market observable data, which is used to determine a bid market valuation. Where market observable data is not available or is inadequate it will be supplemented by broker or dealer quotations, the market values of another instrument that is substantially the same or other appropriate valuation techniques.

A financial asset is recognised when the Society commits to purchase the asset, and is derecognised when the contractual right to receive cash flows expires or when the asset is transferred.

The Society's derivatives are interest rate swaptions, futures and forward contracts. Hedge accounting has not been used for these instruments. Collateral received to back derivative positions is recognised in the Balance sheet if the Society is exposed to the risk and rewards of ownership. Collateral received as cash is reinvested in cash equivalents and is recognised, along with a corresponding liability in 'Other creditors'. There is potential for collateral received in other forms, for example, gilts. This was not the case at the balance sheet date. Such collateral would not be recorded on the Balance sheet, but would be disclosed in Note 15c.

Securities lent, where substantially all the risks and rewards of ownership remain with the Society, are retained on the Balance sheet at their current value. Collateral received in respect of securities lent is not recorded on the Balance sheet.

### h. Investments in Group undertakings

Investments in Group undertakings are carried at fair value, being net asset value. Changes in carrying value are reported in the Technical Account.

### i. Impairment policy

The Society reviews the carrying value of its assets (other than those held at fair value) at each balance sheet date. If the carrying value of a financial asset is impaired, the carrying value is reduced through a charge to the Technical Account. Impairment is only recognised if the loss event has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

### j. Technical provisions - long-term business provision and provision for linked liabilities

The long-term business provision is determined for the Society, following an investigation of the long-term funds, and is calculated in accordance with the regulations contained in the Prudential Regulation Authority ("PRA") Rulebook, with certain adjustments to align to FRS103 requirements. The investigation is carried out as at 31 December. All long-term business technical provisions are determined in accordance with the Solvency II regulatory valuation adjusted to:

- Use discount rates derived from gilt yield curves;
- Calibrate economic models to government bond yield curves;
- Remove the impact of Transitional Measures on Technical Provisions;
- Remove the allowance for reinsurer default risk;
- Remove the Risk Margin; and
- Add a margin to best estimate mortality and longevity assumptions to ensure sufficient prudence.

All other inputs and assumptions are the same as those used in the Solvency II regulatory valuation of liabilities.

Liabilities include guaranteed bonuses and an estimate of non-guaranteed benefits, including future discretionary increases to policy values, and provision for any guaranteed values which are in excess of policy values. With-profits policy liabilities do not include an allowance for capital distribution.

With-profits technical provisions include an amount representing the excess of assets over other valuation liabilities. This amount is referred to as Excess Assets in these Financial statements and is a key measure of the Society's capital, as described in the Strategic report.

The Society's investment contracts without discretionary participation feature consist almost entirely of unit-linked contracts. The liability in respect of unit-linked contracts is equal to the value of assets to which the contracts are linked, and is included in 'Technical provisions' in the Balance sheet.

# Notes on the Financial statements continued

## 1. Accounting policies (continued)

### k. Taxation

The charge for taxation in the Technical Account is based on the method of assessing taxation for long-term funds. Provision has been made for deferred tax assets and liabilities using the liability method on all material timing differences, including revaluation gains and losses on investments recognised in the Technical Account. Deferred tax is calculated at the rates at which it is expected that the tax will arise and has not been discounted. A deferred tax asset is only recognised to the extent that recovery is probable at a later date.

### l. Foreign currency translation

Monetary assets and liabilities in foreign currencies are expressed in pounds sterling at the exchange rates ruling at the balance sheet date. Income and expense transactions have been translated at rates of exchange ruling at the time of the transactions.

### m. Segmental reporting

In the opinion of the Directors, the Society operates in one business segment, being that of long-term insurance business.

## 2. Statement of critical accounting judgements and sources of estimation uncertainty

The preparation of Financial statements requires management to make judgements in the process of applying the Society's accounting policies. The preparation of Financial statements also requires the use of estimates and assumptions. These are based on management's best knowledge of current circumstances and expectation of future events. Actual results may differ from those estimates.

Significant in the Financial statements are:

- The classification of contracts as investment or insurance, as described in Note 1c;
- The choice of measurement model of invested assets. As described in Note 1g, the Society values all invested assets according to the fair value model; and
- The methodologies and assumptions made in valuing technical provisions, as described in Note 13f-g. Areas of significant focus in 2016 were the review of assumptions about future policyholder behaviour and expenses.

## 3. Reinsurance

### a. Reinsurance with LBG

From 2001 to 2014, the majority of the Society's unit-linked and non-profit business was reinsured with companies in LBG.

Premiums and deposits received from policyholders in respect of reinsured business are forwarded to LBG. LBG reimburse the Society for any claims and withdrawals the Society has paid to policyholders in respect of reinsured business. Under the terms of the reinsurance contracts with LBG, if the Society were to become insolvent, or reasonably likely to become insolvent in the opinion of the reinsurer's board, LBG can then make payments directly to policyholders whose policies have been reinsured.

In 2014 the Society entered into a contract to buy back £1.9bn of previously reinsured unit-linked business. £1.7bn of the recaptured business relates to investment business and so is not reflected within reinsurance premiums in the 2015 Technical Account. The balance of £180m is recorded within reinsurance premiums. The 2014 contract was conditional on transferring the assets to the Society, which occurred in March 2015, and the Society now directly manages the assets backing the majority of unit-linked policies. The insurance and expense risk associated with the recaptured business has returned to the Society and the concentration of counterparty risk with LBG has significantly reduced.

The remaining reinsurance contracts with LBG represent the Society's largest reinsurance arrangement and create an asset on the Balance sheet of £409m; being the entitlement for the Society to recover from LBG the claims paid under reinsured business (Note 13c). In the event of the insolvency of the reinsurer, the Society would be liable for any shortfall between the obligations under the policies and the amounts recovered.

# Notes on the Financial statements continued

## 3. Reinsurance (continued)

### b. Annuity reinsurance with Canada Life

On 2 March 2015, the Society entered into an agreement with Canada Life to reassure the non-profit annuity business, under which Canada Life bore substantially all the risks and rewards of this business with effect from 1 January 2015. The initial premium of £850m for the reinsurance is included in 'Outward reinsurance premiums' in 2015.

In order to protect policyholders from counterparty credit risk, the initial premium was deposited back with the Society. This deposit was held in assets with a similar investment mix to that previously held by the Society. Canada Life held a secured charge over these assets (reported in Non-linked investments in Note 11). The investment returns from the secured assets were attributed to Canada Life, and payments in respect of related annuity payments deducted from the deposited assets.

Following the completion of a High Court process, the non-profit and unit-linked annuity business was novated to Canada Life on 19 February 2016 as a Part VII transfer under the Financial Services and Markets Act 2000. On completion of the transfer, the reinsurance agreement was terminated and the assets held on deposit transferred to Canada Life.

The impact of the reinsurance in 2015 is shown in Note 13c (Reinsurers' share of technical provisions) and Note 16 (Deposit received from reinsurer - secured). The Part VII transfer in 2016 is shown in Note 13d (Movement in technical provisions) and Note 9 (Other technical income and charges).

### c. Other outward reinsurance

The Society has several other outward reinsurance contracts under which relatively small volumes of business are reinsured. Additional contracts were effected in 2016 so that almost all mortality risk is now reinsured.

## 4. Earned premiums

Premiums received in respect of investment contracts without discretionary participation feature are not included in the Technical Account or in the table below, as stated in Note 1e. The total of these deposits received in 2016 was £50m and represents linked pension business (2015: £57m). New premium deposits were £nil (2015: £33m).

Premium income included in the Technical Account is analysed in the table below.

	2016 £m	2015 £m
<b>Analyses of gross premiums:</b>		
Individual premiums	-	16
Premiums under group contracts	1	-
	1	16
Regular premiums	1	15
Single premiums	-	1
	1	16
Premiums from non-profit contracts	7	9
Premiums from with-profits contracts	(6)	6
Premiums from linked contracts	-	1
	1	16
Premiums from life business	9	11
Premiums from pension business	(8)	5
	1	16
Premiums from UK business	-	14
Premiums from overseas business	1	2
	1	16

UK regular with-profits premiums in 2016 include c£8m of premiums received, reduced by c£14m of premiums that policyholders switched out of with-profits into unit-linked contracts. Linked premiums are included in deposits recorded in 'Technical provisions' in the Balance sheet.

### Classification of new business

The Society closed to new business on 8 December 2000. The Society only recognises new business premiums and deposits where it is contractually obliged to do so. There was no new premium income in the year (2015: less than £1m).

Annual equivalent premiums in respect of new business received during the year were £nil (2015: £nil). New premiums in respect of reinsured business during the year were £nil (2015: £nil).

# Notes on the Financial statements continued

## 5. Total investment return

	2016 £m	2015 £m
<b>a. Total investment return</b>		
Investment income comprises income from:		
Other investments	180	198
Net gains on realisation of investments	211	110
<b>Investment income and net realised gains</b>	<b>391</b>	<b>308</b>
 Investment expenses including interest comprise:		
Investment management expenses	(6)	(7)
 Unrealised gains/(losses) on investments	<b>386</b>	<b>(369)</b>
<b>Investment return on assets at fair value through the Profit and Loss Account</b>	<b>771</b>	<b>(68)</b>

During 2016, there was political and economic uncertainty that caused volatility in investment markets. Overall, yields fell and equity markets rose, leading to a significant unrealised gain on investments. Realised gains include £95m from a restrike of the swaption portfolio. Investment income fell, reflecting the transfer of c£820m of assets to Canada Life in February 2016.

The gross return on with-profits assets and the adjustments made to the return on invested assets to derive the return net of charges are shown in the table below and are discussed in the Strategic report.

	2016 %	2015 %
Return on investments	10.6	0.2
Adjusted for:		
Movements affecting liabilities	(8.5)	1.3
Expenses	(1.0)	(1.0)
Guarantees	(0.5)	(0.5)
Tax and changes in provision	-	-
<b>Return net of charges</b>	<b>0.6</b>	<b>-</b>

### b. Interest income and expense not included in the investment return

Contracts classified as investment with discretionary participation feature are measured at amortised cost. The interest income and expense in respect of such contracts is included within the Technical Account under the heading 'Change in long-term business provision'.

# Notes on the Financial statements continued

## 6. Claims incurred

	2016 £m	2015 £m
Claims paid - gross claims	498	459
Investment contract claims which are deposit accounted for and therefore not included in the Technical Account	232	176

The increase in the value of claims paid reflects increased economic uncertainty in 2016, prompting some policyholders to take their benefits. Claims paid include claims handling expenses of £2m (2015: £1m). Included in the above payments are capital distribution amounts and attributable final and interim bonuses for the Society of £112m (2015: £83m).

## 7. Net operating expenses

a. Net operating expenses	2016 £m	2015 £m
Administration expenses	24	26
Costs of strategic initiatives	4	5
Redundancies	1	4
<b>Total net operating expenses</b>	<b>29</b>	<b>35</b>
Investment management expenses (Note 5a)	6	7
Claims handling expenses (Note 6)	2	1
<b>Total costs</b>	<b>37</b>	<b>43</b>

Administration expenses have fallen in 2016 as a result of efficiency savings from fewer back office support staff and smaller office space. Administration expenses include lease costs of less than £1m (2015: <£1m). Costs of strategic initiatives include those associated with the delivery of the Canada Life annuity sale, ongoing activity relating to simplifying business processes and reducing the number of unit-linked funds we operate. The increase in claims handling expenses is aligned to the higher level of claims experienced in 2016.

### b. Services from auditors

PricewaterhouseCoopers LLP ("PwC") is one of a number of professional firms that undertake advisory work for the Society. Where PwC has been engaged to perform such work, in circumstances where it is to the Society's advantage that it does so, the Society's regular commitments procedures are followed, and the Audit and Risk Committee reviews them to ensure that auditor independence is preserved.

During the year, the Society received the following services from the Society's auditor:

	2016 £m	2015 £m
Fees payable for the audit of the Society's statutory Financial statements	0.3	0.3
Fees payable for the audit of the Society's regulatory return	0.3	0.2
Fees payable to the Society's auditor for other services:		
Principally arising from non-audit work related to implementation of Solvency II	0.1	0.2
	<b>0.7</b>	<b>0.7</b>

Note: The Society's subsidiary, Equitable Private Equity Holdings Limited ("EPEHL") is audited by PwC and was paid £5k for audit services in 2016 (2015: £8k).

# Notes on the Financial statements continued

## 8. Directors and employees

	2016 £m	2015 £m
<b>a. Staff costs</b>		
Wages and salaries	12	13
Social security costs	1	2
Pension costs	1	1
	<b>14</b>	<b>16</b>

Wages and salaries decreased in 2016 largely due to the reduction in staff numbers. The monthly average number of employees employed by the Society during the year, including executive Directors, required to be disclosed in accordance with the Companies Act 2006, was 260 (2015: 305). Staff numbers reduced during 2016 due to efficiencies made in the year and the closure of Group Final Salary scheme administration. The Society engages the services of a number of contractors. The total staff number at the end of 2016 including contractors was 242 (2015: 318).

Throughout 2016, a group personal pension plan with Legal & General has been made available to employees. With effect from 1 July 2014, staff have been automatically enrolled in this scheme in line with Workplace Pensions legislation. Pension costs represent the employer contribution to this plan and are based on a percentage of salary.

### b. Emoluments of Directors

Full details of Directors' emoluments, pensions and interests, as required by the Companies Act 2006, are included in the Directors' remuneration report, within the Corporate governance statement.

# Notes on the Financial statements continued

## 9. Other technical income and charges

Other technical income of £6m (2015: £22m) includes rebates received from unit-linked Open Ended Investment Company ("OEIC") fund managers (£5m; 2015: £9m). In 2015, it also included £10m investment return on assets over which Canada Life held a secured charge. The corresponding return in 2016 was an investment loss of £30m, which is therefore reported in 'Other technical charges'.

Other technical charges in 2016 include £27m for the transfer of unit-linked annuities that were not part of the reinsurance arrangement, to Canada Life, and £30m investment loss on assets over which Canada Life held a secured charge. Other technical charges in 2015 of £34m represent the payment to LBG in connection with buying back unit-linked business, and some associated non-profit business.

## 10. Taxation

	2016 £m	2015 £m
Investment return for the year (Note 5)	771	(68)
Other technical income	6	22
Other technical charges	(57)	(34)
Net operating expenses	(29)	(35)
<b>Net income</b>	<b>691</b>	<b>(115)</b>
Of which attributable to UK life business	15	(2)
Current corporation tax charge at 20%	3	-
<b>Total charge</b>	<b>3</b>	<b>-</b>

The UK corporation tax charge is provided at 20% (2015: 20%), computed in accordance with the rules applicable to life assurance companies, whereby the fund is required to meet the tax liabilities on investment income and gains attributable to UK life business policyholders, but no tax is charged on the profits or investment returns attributable to pension business or policies written for overseas residents. The 2016 result is a tax charge of £3m, reflecting the investment return earned in the year, partially offset by previously unused tax losses.

The Society has £2m of unused tax losses (2015: £9.3m) from realised losses on the disposal of investments. A deferred taxation asset has not been recognised in this regard due to uncertainty of recovery.



# Notes on the Financial statements continued

## 11. Investments

	Cost		Current Value	
	2016 £m	2015 £m	2016 £m	2015 £m
<b>a. Non-linked investments held at fair value through the Profit and Loss Account</b>				
Investments in Group undertakings				
Shares	21	21	30	26
Shares and other variable yield securities and units in unit trusts				
Shares and units in unit trusts	35	51	8	9
Other variable yield securities	125	113	76	79
	160	164	84	88
Debt and other fixed-income securities				
Short-term gilts	537	566	533	564
Gilts, index-linked and government approved bonds	2,373	3,018	2,684	3,202
Corporate bonds	979	1,292	1,005	1,317
	3,889	4,876	4,222	5,083
Deposits and other investments	393	328	393	328
	4,463	5,389	4,729	5,526
<b>b. Linked investments held at fair value through the Profit and Loss Account</b>				
Shares and units in unit trusts	1,661	1,809	1,840	1,733
Deposits and other investments	6	55	6	55
	1,667	1,864	1,846	1,788
<b>Total value of investments</b>	<b>6,130</b>	<b>7,253</b>	<b>6,575</b>	<b>7,313</b>

The Society's group undertaking is a majority investment in Equitable Private Equity Holdings Limited ("EPEHL"), a Guernsey registered company. EPEHL's investment is Knightsbridge Integrated Holdings V L.P., which invests in North American equity and venture capital projects. EPEHL made a loss in 2016 of £42,000 (\$52,000) (2015: £31,000 (\$45,000)) and its total net asset value is £30m (\$37m) (2015: £26m (\$37m)).

Other variable yield securities comprise interest rate swaption derivatives, valued on a mark-to-model basis.

Debt and other fixed-income securities includes listed investments of £4,222m (2015: £5,082m) at fair value.

During the year, the Society has undertaken stock lending. This is not reflected on the Balance sheet because the beneficial ownership of assets lent remains with the Society. At the balance sheet date, investments of £643m (2015: £347m) were lent in the normal course of business to authorised money brokers on a secured basis, and investments of £667m (2015: £357m) were received as collateral from brokers. Income earned on stock lending during the year, net of fees paid, was £0.2m (2015: £0.2m). Collateral received from brokers is UK government bonds and is not less than 102% of the market value of borrowed fixed-income securities.

# Notes on the Financial statements continued

## 11. Investments (continued)

The reinsurance agreement with Canada Life described in Note 3 included the reinsurance of non-profit annuities with a deposit back arrangement. The value of assets deposited with the Society, as at the 2015 balance sheet date, was £796m. These assets are included in the table above. The charge over deposit assets was released after the transfer of assets to Canada Life under the Part VII Transfer on 19 February 2016.

The Society closely monitors the valuation of assets in markets that have become less liquid. Determining whether a market is active requires the exercise of judgement and is determined based upon the facts and circumstances of the market for the instrument being measured. Where it is determined that there is no active market, fair value is established using a valuation technique. Such valuation techniques use market observable data wherever possible, including prices obtained via pricing services, dealer quoted prices or models such as net asset value.

For fixed-income securities for which there is no active market, the fair value is based on prices obtained from pricing services or dealer price quotations. Such valuations are based on market observable data, including transaction prices, dealer bids and quoted market prices for securities with similar credit, maturity and yield characteristics.

### c. Fair value hierarchies

(i) In accordance with FRS 102, investments carried at fair value have been categorised into a fair value hierarchy:

#### ***Assets valued at quoted market prices from active markets ("Level 1")***

Inputs to Level 1 fair values are unadjusted quoted prices in active markets for identical assets.

#### ***Prices substantially based on market observable inputs ("Level 2")***

Inputs to Level 2 fair values are inputs other than quoted prices included within Level 1 that are observable for the asset either directly or indirectly. Level 2 inputs include the following:

- Quoted prices for similar (i.e. not identical) assets in active markets; and
- Quoted prices for identical or similar assets in markets that are not active, the prices are not current, or price quotations vary substantially either over time or among market makers, or in which little information is released publicly.

#### ***Prices based on unobservable inputs where observable inputs are not available ("Level 3")***

Inputs to Level 3 fair values are unobservable inputs for the asset, for example, assets valued by a model or securities for which no recent market observable price is available.

The Society holds interest rate swaptions, which are valued based on an industry recognised model, which is calibrated to market observable data where possible. Significant inputs to this model include interest rate curves and interest rate volatility. The sensitivity of the model to changes in assumptions has been assessed and indicates that changing one or more of the assumptions to reasonably possible alternative assumptions would not significantly change the fair value of financial assets.

# Notes on the Financial statements continued

## 11. Investments (continued)

### c. Fair value hierarchies (continued)

(ii) Analysis of investments according to fair value hierarchy:

31 December 2016

	Level 1	Level 2	Level 3	Total fair value
Asset category	£m	£m	£m	£m
Investments in Group undertakings	-	-	30	30
Shares and units in unit trusts	1,845	-	2	1,847
Other variable yield securities	-	-	76	76
Debt securities and other fixed-income securities	3,142	995	85	4,222
Deposits and other investments	400	-	-	400
<b>Total invested assets</b>	<b>5,387</b>	<b>995</b>	<b>193</b>	<b>6,575</b>
<b>Total invested assets</b>	<b>82%</b>	<b>15%</b>	<b>3%</b>	<b>100%</b>

31 December 2015

	Level 1	Level 2	Level 3	Total fair value
Asset category	£m	£m	£m	£m
Investments in Group undertakings	-	-	26	26
Shares and units in unit trusts	1,733	-	9	1,742
Other variable yield securities	-	-	79	79
Debt securities and other fixed-income securities	3,630	1,292	161	5,083
Deposits and other investments	383	-	-	383
<b>Total invested assets</b>	<b>5,746</b>	<b>1,292</b>	<b>275</b>	<b>7,313</b>
<b>Total invested assets</b>	<b>78%</b>	<b>18%</b>	<b>4%</b>	<b>100%</b>

The distribution of assets between the levels has remained broadly stable over the year.

## 12. Debtors

	2016 £m	2015 £m
<b>Debtors arising out of direct insurance</b>		
Amounts owed by policyholders	1	3
<b>Debtors arising out of reinsurance</b>	2	6
<b>Other debtors</b>		
Corporation tax asset	2	-
Debtors other than Group and related companies	11	5
	<b>16</b>	<b>14</b>

The carrying values of these items equate closely to fair values and are expected to be realised within a year of the balance sheet date.

## Notes on the Financial statements continued

### 13. Technical provisions

a. Gross long-term business technical provisions	2016 £m	2015 Restated £m	2015 As reported £m
<b>Non-profit technical provisions - restated</b>			
Non-profit insurance technical provisions	383	924	1,031
Non-profit investment technical provisions	-	-	(12)
Index-linked annuities	15	308	316
	<b>398</b>	<b>1,232</b>	<b>1,335</b>
<b>With-profits technical provisions</b>			
With-profits insurance technical provisions			
Policy values	126	145	145
Cost of guaranteed annuity option	7	5	5
Cost of investment guarantees	67	70	70
Future charges	(9)	(24)	(24)
	<b>191</b>	<b>196</b>	<b>196</b>
With-profits investment technical provisions			
Policy values	2,384	2,643	2,643
Cost of investment guarantees	1,057	1,016	1,016
Future charges	(175)	(201)	(201)
	<b>3,266</b>	<b>3,458</b>	<b>3,458</b>
Other long-term liabilities - restated	182	206	234
Excess Assets - restated	1,005	793	783
<b>Total with-profits technical provisions</b>	<b>4,644</b>	<b>4,653</b>	<b>4,671</b>
<b>Total long-term business technical provisions</b>	<b>5,042</b>	<b>5,885</b>	<b>6,006</b>

### b. Gross linked liabilities

	2016 £m	2015 £m
Other linked insurance liabilities	120	141
Other linked investment liabilities	1,738	1,680
<b>Total linked liabilities</b>	<b>1,858</b>	<b>1,821</b>

# Notes on the Financial statements continued

## 13. Technical provisions (continued)

### c. Reinsurers' share of technical provisions: insurance and investment contracts

	2016 £m	2015 Restated £m	2015 As reported £m
Non-profit insurance technical provisions - restated	382	918	1,025
Non-profit investment technical provisions - restated	-	-	6
Index-linked annuities - restated	15	308	316
	397	1,226	1,347
Unit linked investment liabilities	12	33	33
<b>Total reinsurers' share</b>	<b>409</b>	<b>1,259</b>	<b>1,380</b>

### d. Movement in technical provisions

The impact of the changes to the accounting policy for technical provisions on the opening and closing positions for 2015 are shown in the following tables, along with the movements in the current year.

	Gross technical provisions					
	With- profits £m	Index- linked £m	Non- profit £m	Excess Assets £m	Sub- total £m	Linked £m
2015 opening positions as reported	4,187	323	1,124	797	6,431	1,912
Restatement of opening position	2	(9)	(133)	41	(99)	-
<b>2015 opening positions restated</b>	<b>4,189</b>	<b>314</b>	<b>991</b>	<b>838</b>	<b>6,332</b>	<b>1,912</b>
Net deposits and withdrawals	-	-	-	-	-	(119)
Change in Technical Account as reported	(299)	(7)	(105)	(14)	(425)	28
Restatement of movement in 2015	(30)	1	38	(31)	(22)	-
<b>Restated 2015 closing position</b>	<b>3,860</b>	<b>308</b>	<b>924</b>	<b>793</b>	<b>5,885</b>	<b>1,821</b>
Change arising from new deposits <sup>1</sup>	-	-	-	-	-	35
Change arising from withdrawals <sup>1</sup>	-	-	-	-	-	(232)
Annuity transfer to Canada Life	-	(294)	(458)	-	(752)	-
Other change in Technical Account	(221)	1	(83)	212	(91)	234
<b>2016 Closing positions</b>	<b>3,639</b>	<b>15</b>	<b>383</b>	<b>1,005</b>	<b>5,042</b>	<b>1,858</b>

# Notes on the Financial statements continued

## 13. Technical provisions (continued)

### d. Movement in technical provisions (continued)

	Reinsured technical provisions				
	With- profits £m	Index- linked £m	Non- profit £m	Sub total £m	Linked £m
2015 opening positions as reported	-	13	488	501	1,912
Accounting policy change	-	-	(99)	(99)	-
<b>2015 opening positions restated</b>		<b>13</b>	<b>389</b>	<b>402</b>	<b>1,912</b>
Net deposits and withdrawals	-	-	-	-	(1,799)
Change reported in Technical Account	-	303	543	846	(80)
Accounting policy change	-	(8)	(14)	(22)	-
<b>Restated 2015 closing position</b>	-	<b>308</b>	<b>918</b>	<b>1,226</b>	<b>33</b>
Change arising from new deposits <sup>1</sup>	-	-	-	-	(20)
Change arising from withdrawals <sup>1</sup>	-	-	-	-	(6)
Annuity transfer to Canada Life	-	(294)	(458)	(752)	-
Other change in Technical Account	-	1	(78)	(77)	5
<b>2016 Closing positions</b>	-	<b>15</b>	<b>382</b>	<b>397</b>	<b>12</b>

Note:

<sup>1</sup> Premiums (Note 4) and claims (Note 6) in respect of investment contracts without discretionary participation feature are not included in the Technical Account but are reported as deposits to and withdrawals from technical provisions.

# Notes on the Financial statements continued

## 13. Technical provisions (continued)

### d. Movement in technical provisions (continued)

Analysis of impact of restatement	With- profits £m	Index- linked £m	Non- profit £m	Excess Assets £m	Sub total £m
<b>Restatement of gross technical provision</b>					
2015 opening position	2	(9)	(133)	41	(99)
Change in 2015	(30)	1	38	(31)	(22)
<b>Restatement of reinsured technical provisions</b>					
2015 opening position	-	-	99	-	99
Change in 2015	-	8	14	-	22
<b>2015 closing position restatement</b>	<b>(28)</b>	<b>-</b>	<b>18</b>	<b>10</b>	<b>-</b>
<b>Key driver of change</b>					
Net present value of future expenses and charges in respect of unit-linked and non-profit business, previously reported in Other long-term liabilities	(19)	-	19	-	-
The present value of non-profit business represents the release of margins from Solvency I based non-profit technical provisions. These margins do not exist under new accounting policy	(9)	-	-	9	-
Impact of change in mortality and discount rate assumptions	-	-	(1)	1	-
<b>2015 closing position restatement</b>	<b>(28)</b>	<b>-</b>	<b>18</b>	<b>10</b>	<b>-</b>

The impact of the new accounting policy on 2016 Excess Assets is immaterial, as the majority of non-profit business transferred to Canada Life in February 2016, and the residual business is almost fully reinsured. The impact on individual Balance sheet line items is to decrease gross and reinsured long-term business technical provisions by c£20m each.

# Notes on the Financial statements continued

## 13. Technical provisions (continued)

### e. Movement in Excess Assets

The principal movements in the Excess Assets during the year are shown in the following table.

	2016 £m	2015 £m	2016 Key movements
<b>Opening Excess Assets</b>	<b>793</b>	<b>797</b>	
Investment performance net of changes in policy values	173	(24)	Includes gains on swaptions and impact of changes in credit spreads
Variance in expenses experience and assumptions	51	9	Reflects increased variability of future expenses
Unit-linked buy back from LBG	-	(26)	
Annuity reinsurance	-	77	
Changes in valuation experience and assumptions	86	11	Reflects deferral of retirements and increase in assumed level of surrenders
Capital distribution within claims payments	(93)	(66)	Increase reflects higher level of claims
Change in accounting policy	-	10	
Other movements	(5)	5	
<b>Closing Excess Assets</b>	<b>1,005</b>	<b>793</b>	

### f. Valuation inputs and assumptions

#### (i) Factors affecting a number of components of technical provisions

Factors such as economic assumptions, policyholder retirement rates, surrenders and mortality experience affect a number of the above components.

#### *Economic assumptions*

In order to produce valuations of the cost of guarantees, future charges and the impact of early surrenders, an economic model is required to generate projections of policy values in many different economic scenarios. The valuation involves constructing 5,000 scenarios, aggregating the results under each scenario and then calculating the average liability. In each scenario, policy values are assumed to change in line with the projected return on with-profits assets net of charges.

The economic model used by the Society in the valuation was supplied by Moody's Analytics. The model used is market consistent and has been calibrated to government bond yield curves at the valuation date, and this determines the risk-free rates used in the projections. For all with-profits policies and other policies written in sterling, discount rates are taken from UK government bond yield curves. Discount rates from equivalent local government bond yield curves are used for other than with-profits policies written in other currencies.

The effect of the change in yield curves from 2015 to 2016 was to increase the Excess Assets by £7m (2015: decrease £1m). Assumptions are also required for the volatility of the asset values for different asset categories. Bond volatilities vary by term and duration and are calibrated to those implied by swaption volatilities obtained from market sources. For equity values, the model produces a ten year volatility of 24% (2015: 23%).

#### *Retirements*

For the majority of Recurrent Single Premium ("RSP") contracts, benefits can be taken on contractual terms at a range of ages. For example, benefits from Retirement Annuity policies can be taken at any age from age 60, whereas benefits from Group Pension policies are expected to be taken at each scheme's normal retirement age. This date is referred to as the Earliest Contractual Date ("ECD"). A proportion of policyholders take their benefits before and a proportion after the earliest expected retirement date.



# Notes on the Financial statements continued

## 13. Technical provisions (continued)

### f. Valuation inputs and assumptions (continued)

#### (i) Factors affecting a number of components of technical provisions (continued)

An investigation of the actual retirement ages for the Society's with-profits policyholders, analysed by type of contract, has been carried out, based on experience between 2012 and 2016. The results of that investigation have been used to establish the expected proportion of policyholders of a particular age that will retire each year, for each type of product. The results are converted to best estimate retirement rates using judgement about future retirement patterns. A corresponding investigation of unit-linked policyholders has also been carried out and used to set retirement rates. The investigation shows a trend towards people retiring later, and this has been reflected in the assumptions for the year. The effect of the change in retirement assumptions in the year has resulted in a decrease in Excess Assets of £20m (2015: no change).

#### *Surrenders*

An investigation of the actual surrender rates for the Society's with-profits and unit-linked business, analysed by type of contract, has been carried out based on experience between 2012 and 2016. The results of that investigation have led to a material increase in the level of assumed surrender rates for the valuation. The effect of the change in the surrender rates has resulted in an increase in the Excess Assets of £88m (2015: £1m).

#### *Mortality*

The Society's valuation has been carried out using published mortality tables and an investigation into the Society's actual mortality experience. The Society continues to make allowance for future improvements in the longevity of annuitants. The mortality assumptions are detailed in the tables below.

Mortality assumptions by class of business	2016	2015
Non-profit and index-linked annuities in payment		
Basic Life and General Annuity business	82.5% PNML08 cmi2015 (U=2016)* for males 80.0% PNFL08 cmi2015 (U=2016)* for females	80.0% IML00 cmi2011 (U=2015)* for males 77.5% IFL00 cmi2011 (U=2015)* for females
Pension business	82.5% PNML08 cmi2015 (U=2016)* for males 80.0% PNFL08 cmi2015 (U=2016)* for females	80.0% PNML00 cmi2011 (U=2015)* for males 65.0% PNFLA00 cmi2011 (U=2015)* for females
Temporary assurances	62.5% TMC00 for males 75.0% TFC00 for females	62.5% TMC00 for males 82.5% TFC00 for females
Other Life and Pension business		
Conventional business: non-profit and with-profits	85.0% AMC00 ultimate for males 85.0% AFC00 ultimate for females	90.0% AMC00 ultimate for males 92.5% AFC00 ultimate for females
Recurrent Single Premium business: with-profits and unit-linked	52.5% AMC00 ultimate for males 57.5% AFC00 ultimate for females	72.5% AMC00 ultimate for males 80.0% AFC00 ultimate for females

Note:

\* The allowance for future mortality improvements is based on the mortality improvements as per cmi2015 tables (with a long-term improvement rate of 1.5% pa for males; 1.25% pa for females).

# Notes on the Financial statements continued

## 13. Technical provisions (continued)

### f. Valuation inputs and assumptions (continued)

#### (i) Factors affecting a number of components of technical provisions (continued)

The changes in mortality assumptions in the year have reduced Excess Assets by £4m (2015: reduced by £2m).

#### (ii) Cost of options and guarantees

Financial options represent the value of the option within a small number of Conventional With-Profits ("CWP") policies to take their benefits in annuity form. The options are valued at £7m (2015: £5m) and are included in policyholder liabilities.

Guarantees are features of with-profits life assurance contracts that confer potentially valuable benefits to policyholders. They expose the Society to two types of risk: insurance (such as mortality and morbidity) and financial (such as market prices and interest rates). The value of a guarantee comprises two elements: the intrinsic value and the time value. The intrinsic value is the amount that would be payable if the guarantee was exercised immediately. The time value is the additional value that reflects the possibility of the intrinsic value increasing in future, before the expiry of guarantee. The intrinsic and time values of all guarantees are included in policyholder liabilities.

All the Society's material guarantees are valued on a market-consistent basis using the economic model and assumptions, as described in section (i) above.

The Society has in issue two principal types of with-profits policy: RSP policies and CWP policies. These policies represented 98% and 2%, respectively, of the total policy values at 31 December 2016 (98% and 2% of the total policy values at 31 December 2015). For the majority of RSP policies issued before 1 July 1996, each premium (after charges) secures a Guaranteed Investment Return ("GIR"), typically at the rate of 3.5% pa. For the majority of RSP policies issued after 1 July 1996, the GIR is nil%. For CWP policies, guarantees are payable at specified dates or on the occurrence of specified events.

The guarantees in respect of the Society's with-profits business relate to a guarantee on contractual termination (for example, on retirement, maturity, death or on payment of an annuity). The terms of the guarantee vary by contract. For the Society's RSP contracts where there is a GIR, the value of that guaranteed return is assessed based on assumed retirement ages of policyholders. Certain policies also contain a guaranteed minimum level of pension as part of the condition of the original transfer of state benefits to the policy.

For CWP business, there is a guarantee that the amount payable on death or at maturity (where appropriate) will not be less than the sum assured and any declared reversionary bonuses.

For policies where the guaranteed value at contractual termination exceeds the policy value at that date, the excess would be paid, and estimates of such excess form part of the Technical Provisions (Note 13a). In calculating the amount payable to policyholders, account is taken of any management actions such as making changes to policy values in response to changes in market conditions. The cost of these guarantees has increased from £1,086m in 2015 to £1,124m at 31 December 2016, principally as a result of falling government bond yields.

There is inherent uncertainty in calculating the cost of these guarantees, as the value depends on future economic conditions, policyholder actions (such as early or late retirement and surrenders) and mortality. In calculating the value of the guarantees, account has been taken of actual experience to date, in addition to industry benchmarks and trends. Information on retirement, surrender and mortality assumptions is included in section (i) above. For economic assumptions, prices for relevant quoted and non-quoted derivatives are used to confirm market consistency.

# Notes on the Financial statements continued

## 13. Technical provisions (continued)

### g. Other long-term liabilities

Technical provisions include amounts in respect of specific provisions so that the total of the Society's technical provisions properly reflect our best estimate of the liabilities held.

The analysis below combines all expense provisions together. In prior years, in accordance with the previous regulatory regime, some elements were included in non-profit technical provisions.

Other long-term liabilities	2016 £m	2015 £m
Policy administration costs.		
With-profits	38	42
Non-profit and index-linked	5	5
Unit-linked	34	34
Investment management and administration costs	59	60
Other administration and support costs	337	350
Present value of total future expenses	473	491
1% with-profits expense charge	(185)	(211)
Unit-linked annual management charge	(114)	(79)
Administration cost recovery from reinsurer	(4)	(5)
	(303)	(295)
Regular expense provision	170	196
Exceptional expense provision	12	10
<b>Other long-term liabilities</b>	<b>182</b>	<b>206</b>

The future administration and support costs of the Society are estimated as part of our business planning process. An assessment of each expense category is undertaken to estimate the extent to which they can reasonably be expected to reduce in line with the run-off of the business. Future administration and support costs are increased in line with expected inflation.

Future investment management and investment administration expenses are based on the terms agreed with the third parties that provide these services, and projections of the value of investments under management.

Assumptions for retirements, surrenders and mortality affect the estimation of future costs of running the business, and are described in section (i) above.

Future expenses are met from a charge of 1% (2015: 1%) deducted from the return passed on to with-profits policyholders and annual management charges on unit-linked funds ranging from 0.5% pa to 1.0% pa (2015: 0.5% pa). Allowance is made for the recovery of administration expenses under reinsurance agreements with LBG.

The resultant expected cash flows are discounted at a risk-free gilt rate to determine the regular expense provision of £170m (2015: £196m). This provision is intended to provide sufficient reserves to enable the Society to meet future costs while maintaining a stable expense charge as the business declines.

The exceptional expense provision represents the anticipated additional exceptional expenses of £12m (2015: £10m) over future years.

# Notes on the Financial statements continued

## 14. Regulatory valuation capital statement

### a. Analysis of capital

Throughout 2016, the Society was subject to the capital requirements of the Solvency II regime. This note presents the capital position of the Society, as reported in the Society's Solvency and Financial Condition Report, available to view on the Society's website in late May 2017. This view of the capital position is a different view of capital than the Society's own assessment, which, subject to risk appetites, underpins strategic decisions and is referred to in the Strategic report as the "management view". This is also a change from 2015, when the Society was regulated under the Solvency I regime (Note 14e).

As part of regulatory valuation reporting, each life assurance company must retain sufficient capital to meet capital requirements, as specified in the PRA Rulebook. Each life assurance company calculates the available capital resources, known as Own Funds. The Society's Own Funds are the value of the assets less the value of the liabilities calculated using the Solvency II Solvency Formula, which includes a Risk Margin. Each company is required to hold a minimum level of capital known as the Solvency Capital Requirement ("SCR"). The Society has defined a risk appetite such that the Society should hold capital at least 120% of SCR.

The Society complied with all Solvency II capital requirements throughout the current year and Solvency I requirements throughout the prior year.

	2016 £m
Excess assets per Financial statements	1,005
Estimated adjustments to Standard Formula basis	(172)
Estimated Standard Formula Own Funds	833

### b. Movement in available capital resources

The available capital resources for the Society amount to £833m. The table below shows the effect of movements in the total amount of available capital of the Society during the year.

Movement in Own Funds	2016 £m
At 1 January	612
Investment performance net of changes in policy values	150
Other valuation assumptions changes	81
Variance in expenses experience and assumptions	26
Change in Risk Margin	(45)
Capital distribution within claims payments	(93)
Transitional Measures on Technical Provisions ("TMTP") <sup>1</sup>	107
Other movements	(5)
At 31 December	833

Note

<sup>1</sup> Calculation of TMTP was not audited by PricewaterhouseCoopers LLP

# Notes on the Financial statements continued

## 14. Regulatory valuation capital statement (continued)

### c. Restrictions on available capital resources

It is the Society's aim to manage its business in a sound and prudent manner for the benefit of all policyholders. The Society closed to new business in 2000 and new policies are only issued where there is a regulatory or contractual obligation to do so. The Society has no shareholders and all surpluses and deficits belong to the with-profits policyholders. The Society seeks to ensure that it can meet its contractual obligations to both policyholders and creditors as they fall due. Any new distributions of surplus will be made in non-guaranteed form.

### d. Sensitivity to market conditions of liabilities and components of available capital

The sensitivity of the capital position is monitored through monthly solvency estimates reported to the Executive Committee, the Board and the PRA, and a twice yearly solvency sensitivity analysis is reported to the Asset and Liability Committee. The available capital resources are sensitive to both market conditions and changes to a number of non-economic assumptions that affect the valuation of the liabilities of the fund.

The Society's available capital is sensitive to low interest rates. The Society's investment policy of matching assets and liabilities, and the swaption portfolio, held to mitigate the impact of policyholders with 3.5% GIR deferring retirement in low interest rate environments, reduce the impact of low interest rates on policy liabilities (Note 15d). However, the Risk Margin, being the cost of holding capital against insurance risk, increases markedly when interest rates are low.

The available capital resources are also sensitive to changes in swap rates. Solvency II requires liabilities to be valued using swap rates, whereas our assets are primarily gilts and bonds. In 2016, there was a divergence of swap rates from gilt and bond yields, meaning the value of liabilities increased by more than the value of assets. The valuation strain is temporary as the Society's assets are held to maturity and produce cash flows to meet our liabilities as they become payable. The impact of such a change in swap rates as compared to gilt and bond yields is partially mitigated by the Volatility Adjustment. This makes an adjustment to the Solvency II discount rates for a proportion of the return earned on a reference portfolio of investments that includes gilts and corporate bonds.

Defaults on fixed-interest assets directly reduce the available capital resources, as does any increase in non policy-related provisions.

The PRA has approved the Society's application for TMTP. These are a transitional reduction in technical provisions, helping to mitigate the impact of the Risk Margin on available capital. TMTPs reduce annually until 2031, with the first reduction on 1 January 2017.

The principal non-economic assumptions are the level of future retirement rates, future expenses, future surrender rates and the level of future mortality rates.

### e. Capital statement for prior year

Until 31 December 2015, the Society was regulated under the previous PRA regime, known as Solvency I. Each life assurance company had to retain sufficient capital to meet the capital requirements, as specified in the PRA Handbook of Rules and Guidance. Each life assurance company calculated the available capital resources as the value of the assets less the value of the liabilities on a regulatory valuation basis, as specified in the PRA Handbook of Rules and Guidance. Each company was required to hold a minimum level of capital known as the Capital Resource Requirement ("CRR").

The CRR comprised the Long-Term Insurance Capital Requirement ("LTICR") and, if required, an additional element of capital required so as to reduce the surplus capital to be no more than the surplus on a realistic valuation basis. This additional amount of capital was added to the CRR, and was referred to as the With-Profits Insurance Capital Component ("WPICC"). However, for the Society as a closed mutual with-profits fund, the PRA required that all capital was anticipated to be distributed to policyholders, leaving a nil balance of surplus capital on a realistic valuation basis. To achieve this, the WPICC for the Society was therefore the difference between the available capital resources and the LTICR, leaving a nil balance of excess capital resources.

## 14. Regulatory valuation capital statement (continued)

### e. Capital statement for prior year (continued)

The capital statement in respect of the Society at 31 December 2015 is set out below.

	2015 £m
Available capital resources	542
Long-Term Insurance Capital Requirement (LTICR)	(191)
With-Profits Insurance Capital Component (WPICC)	(351)
Total regulatory Capital Resource Requirement (CRR)	(542)
Excess of available capital resources over CRR	-

The movement in the total amount of available capital through 2015 is set out below.

	2015 £m
Movement in available capital resources	
At 1 January	486
Investment return and interest rate movements	1
Other valuation assumptions	(8)
Expense reductions	16
Strategic projects	66
Other movements	(19)
At 31 December	542

## 15. Management of risk

### a. Risk management framework

As described in the Strategic report, risk management is central to the Society's strategy. The Corporate governance statement describes the Society's comprehensive risk management framework and the Strategic report describes the principal risks faced by the Society, which are:

- Insurance risk;
- Credit risk;
- Market risk;
- Operational risk;
- Liquidity risk; and
- Regulatory risk.

There have been no material changes to the measures used to assess these risks over the reporting period. The Society uses scenario testing to model the impact of these risks, individually and in aggregate, under stress conditions on the adequacy of our financial resources and the capital we need to hold.

The potential impacts of financial risks on the Balance sheet are discussed further below.

## 15. Management of risk (continued)

### b. Insurance risk

Insurance risk is the risk that the actual timing, frequency and severity of insured events differ from that assumed in policy valuations.

For the Society, insurance risk consists of expense risk and the following elements relating to the timing of insured events:

- Longevity risk;
- Mortality risk; and
- Persistency risk.

#### (i) Expense risk

##### *Description*

The Balance sheet includes amounts representing the expected value of all future expenses of administration and investment management net of charges made to policy values to pay for these costs. Expense risk is the risk that expenses are higher than those assumed.

The main sources of risk are:

- The assumed future cost base of the business is higher than expected;
- Future inflation of expenses is higher than anticipated; and
- The value of future charges deducted from unit-linked policies is lower than expected.

##### *Management of risk*

As explained in the Strategic report, the Society actively manages its costs down, so that business-as-usual costs fall in line with policy run-off. Furthermore, the Society maintains, and regularly reviews, a set of actions it can take to directly control expenses in severe business scenarios.

Most of the Society's expenses are expected to be linked in some way to UK price inflation. To mitigate the risk of higher than expected rates of inflation, the Society holds a portfolio of index-linked assets in order to match the inflation-linked nature of expenses.

##### *Sensitivity*

The exceptional expense provision is described in Note 13g. The following table shows the sensitivity to reasonably possible scenarios.

Sensitivity scenario	Mitigated by	Net impact on Excess Assets	
		2016 £m	2015 £m
5% increase in assumed level of expenses		(22)	(21)
1% increase in assumed rate of UK price inflation	Impact of index-linked portfolio	13	18

The increase in the level of charges and the rationalisation of the range of unit-linked funds have reduced the Society's exposure to expense risk. The active management of expenses using Lean Manufacturing and Simplification techniques continues to be a key focus for the Society.

#### (ii) Timing of insured events risk

##### *Description*

Annuity benefits are payable only while policyholders survive. Liabilities in respect of these policies are based on current expectations of future survival rates. Longevity risk is the risk that policyholders live longer than currently expected, giving rise to the payment of more benefits than currently reserved for. Exposure to this risk reduced following the reinsurance of substantially all of the Society annuities to Canada Life in 2015 and their subsequent transfer on 19 February 2016.

## 15. Management of risk (continued)

### b. Insurance risk (continued)

#### (ii) Timing of insured events risk (continued)

The Society's mortality risk exposure arises principally on non-profit assurance policies. Assurance benefits are payable only when the policyholder dies. Liabilities in respect of these policies are based on current

expectations of future survival rates. Mortality risk is the risk that policyholders die sooner than currently expected, giving rise to the payment of more death benefits than currently reserved for. A further exposure to mortality risk exists on CWP policies, but, as stated in Note 13, these represent only 2% of with-profits policy values.

Persistency risk is the risk that the timing at which policyholders choose to take their benefits differs from the timing expected. If future experience is different than expected, it can lead to an increase in the cost of the guarantees within policies.

#### *Management of risk*

The Society is closed to new business and does not take on new insurance risk. The Society reviews its recent claims experience and combines it with industry-wide data (standard tables of mortality rates) and industry standard models of future annuitant mortality improvement rates in order to derive expectations about future timing of policyholder claims.

All deferred annuities and most assurances are reinsured. The taking-on of additional longevity risk has been eliminated by providing retiring pension policyholders with a Canada Life annuity illustration and emphasising their option to seek annuities in the open market.

The Society regularly reviews options for removing or reducing the level of risk via transactions such as reinsurance or transfer of business.

#### *Sensitivity*

The assumptions made for the timing of insured events and the impact of changes to those assumptions are disclosed in Note 13. The following table shows the sensitivities to reasonably possible future changes.

	Annuitant mortality Decrease 10%	Assured lives mortality Increase 10%	With-profits surrender rates Decrease 1% pa	With-profits retirement rates Decrease <sup>1</sup>	With-profits retirement rates Increase <sup>1</sup>
Impact on Excess Assets	£m	£m	£m	£m	£m
2016	(3)	(1)	(51)	(38)	39
2015	(4)	(2)	(54)	(21)	22

Note:

<sup>1</sup> A change in retirement rates that is approximately equal to policyholders changing retirement by an average of one year.

The risk of with-profits policyholders surrendering less frequently and deferring retirement beyond those assumed are significant due to the impact on the cost of guarantees. The interaction of this with interest rates is discussed under 'Interest rate risk'.

#### **c. Credit risk**

##### *Description*

Credit risk is the risk that a counterparty will fail to pay amounts in full when due. The main credit risks faced by the Society are:

- The risk of default on its portfolio of fixed-interest investments, especially corporate bonds; and
- The risk of default by any of its reinsurers.

## **15. Management of risk (continued)**

### **c. Credit risk (continued)**

#### *Management of risk*

Credit risk is monitored by the Society's Asset and Liability Committee. The Society manages its exposure to default on its portfolio of fixed-interest investments through:

- Its policy of only investing in assets of high credit quality;
- Carefully selecting individual investments; and
- Limiting concentrations with any one counterparty.



There have been no material changes to the Society's exposure to credit risk in 2016. Exposure to credit risk associated with all the Society's financial assets is summarised below, according to the middle rating of the external credit ratings supplied by Moody, Standard & Poor, and Fitch. This analysis has been changed from the lowest of the external credit ratings in order to align to Solvency II, and the rating for 2015 has been restated.

2016 Credit ratings	AAA £m	AA £m	A £m	BBB £m	Other £m	Total £m
Debt and other fixed-income securities	141	3,201	397	463	20	4,222
Deposits and other investments	374	-	19	-	-	393
Cash at bank and in hand	-	-	-	6	-	6
Other financial assets	3	20	6	9	19	57
Reinsurers' share of technical provisions and liabilities (Note 13c)	-	-	409	-	-	409
	<b>518</b>	<b>3,221</b>	<b>831</b>	<b>478</b>	<b>39</b>	<b>5,087</b>

2015 - restated Credit ratings	AAA £m	AA £m	A £m	BBB £m	Other £m	Total £m
Debt and other fixed-income securities	292	3,646	623	507	15	5,083
Deposits and other investments	306	-	22	-	-	328
Cash at bank and in hand	-	-	10	-	-	10
Other financial assets	7	27	9	9	18	70
Reinsurers' share of technical provisions and liabilities (Note 13c)	-	-	1,259	-	-	1,259
	<b>605</b>	<b>3,673</b>	<b>1,923</b>	<b>516</b>	<b>33</b>	<b>6,750</b>

Other financial assets comprise Debtors and Prepayments and accrued income.

The potential credit risk exposure from default by swaption counterparties is mitigated by the receiving of collateral. Collateral of £81m (2015: £89m) has been received in cash, and has been invested in assets similar in nature to cash. The value of these assets at the year end was £81m and is included in 'Deposits and other investments' in Note 11a.

The potential credit risk exposure from default by futures counterparties is mitigated by daily settlement of variation payments and through trading on a regulated futures exchange. None of the changes in the value of derivatives has been driven by changes in the credit rating of counterparties.

At the reporting date, no material financial assets were past due nor impaired (2015: £nil). The Society has not experienced nor expects any significant losses from non-performance by any counterparties.

With regard to reinsurance, steps are taken wherever possible, to limit counterparty risk. The major reinsurance treaties are a company in LBG. Because reinsurance does not remove the primary liability of the

## 15. Management of risk (continued)

### c. Credit risk (continued)

Society to its policyholders, the credit rating of LBG and certain of its group companies are monitored closely in order to manage the risk.

On 2 March 2015, the Society reassured substantially all annuity business with Canada Life. In order to protect policyholders from counterparty credit risk, the initial premium was deposited back with the Society. This deposit was held in assets with a similar investment mix to that previously held by the Society. Canada Life held a secured charge over these assets. The credit risk exposure to Canada Life was fully mitigated. On 19 February 2016, the reinsurance was terminated, and the policies and secured assets transferred to Canada Life, thereby removing the risk (Note 3).

### *Sensitivity*

The largest single credit risk exposure amounts to £409m for business reinsured with companies in LBG (2015: £416m restated). In the event of the insolvency of the reinsurer, if not honoured by the LBG parent company, the Society would be liable for any shortfall between the obligations under the policies and the amounts recovered. The Society holds a further £12m (2015: £4m) of investments (credit rating A) with LBG.

After LBG, the next largest single credit exposure is £37m, relating to an investment in Bayerische Motoren Werke AV ("BMW").

### **d. Market risk**

#### *Description*

Market risk is the risk of adverse changes in asset values or values of future cash flows of investments. This can arise from fluctuations in interest rates, equity, property and corporate bond prices, and foreign currency exchange rates. The main responsibility for monitoring these risks lies with the Society's Asset and Liability Committee.

In line with the Society's investment policy, with-profits investments are mainly in fixed-interest securities, as follows:

UK with-profits assets mix	2016	2015
	%	%
Gilts	56	55
Corporate bonds	22	24
Short-term gilts and cash	20	19
Other	2	2
	100	100

In adverse investment conditions, the Society could make appropriate reductions to with-profits policy values and apply financial adjustments to surrenders. These actions mitigate market risk, but do not remove the risk entirely for with-profits policies because the value of assets could still fall short of the value of guarantees within policies.

Market risk is considered further by looking at its four elements:

- i) Interest rate risk;
- ii) Equity and property price risk;
- iii) Corporate bond spread risk; and
- iv) Currency risk.

## **15. Management of risk (continued)**

### **d. Market risk**

#### **i) Interest rate risk**

##### *Description*

Long-term liabilities fluctuate in value because of changes in interest rates. Interest rate risk is the risk that these fluctuations are not fully matched by changes in investment values.

As mentioned under Insurance risk above, there is a further risk for the Society in respect of GIR on with-profits RSP policies, which are typically 3.5% pa. In the current low interest rate environment, the cost of providing these guarantees would increase if interest rates fall further, if policyholders defer their retirement beyond the dates assumed or if both scenarios occurred together.

#### *Management of risk*

The Society operates an investment policy so that assets and liabilities are matched. Specifically, the Society holds fixed-interest gilts and corporate bonds to produce income and redemption proceeds that closely match the expected outgoings from with-profits policies and non-profit policies each year. Index-linked gilts are held to match the expected outgoings from regular expenses. The more closely we are matched, the smaller the impact of changes in interest rates.

The Society monitors the exposure to changes in interest rates through periodic reviews of the asset and liability matching position.

To mitigate the impact of with-profits policyholders with a 3.5% pa GIR deferring retirement when interest rates fall, the Society holds a series of derivatives called swaptions that increase in value when interest rates fall. The effectiveness of the swaption portfolio is reviewed periodically to ensure that it provides adequate protection against a fall in interest rates.

#### **Sensitivity**

The following table shows the sensitivity to reasonably possible scenarios, and illustrates the success of the swaption portfolio in mitigating the risk of with-profits policyholders deferring their retirement if interest rates fall.

Scenario	Interest rates, at all terms	Relative assumption for 3.5% pa GIR policyholder retirement	Asset basis	Impact on Excess Assets	
				2016 £m	2015 £m
Fall by 0.5% pa	No change	Excluding swaptions		33	16
Fall by 0.5% pa	Defer retirement by 1 year	Excluding swaptions		(19)	(16)
Fall by 0.5% pa	Defer retirement by 1 year	Including swaptions		14	14
Rise by 0.5% pa	No change	Excluding swaptions		(28)	(17)
Rise by 0.5% pa	No change	Including swaptions		(48)	(38)

#### **ii) Equity and property price risk**

##### **Description**

The Society's assets do not include property investments. This is, therefore, not a significant source of risk.

The Society's with-profits assets do not include material equity investments. Equity price risk is the risk that falls in equity values reduce the value of with-profits assets.

The Society is also exposed to the risk that falls in equity prices reduce the value of the charge for expenses levied on unit-linked business.

## **15. Management of risk (continued)**

### **d. Market risk (continued)**

#### **ii) Equity and property price risk (continued)**

##### **Management of risk**

The society has little appetite to invest in equity due to its high capital requirement. The Society holds almost no equity investments and so this is not a significant source of risk to the with-profits business.

#### **Sensitivity**

The following table shows the sensitivity to reasonably possible scenarios, and illustrates the very low exposure to equity price risk.

With-profits asset value impact	
	2016 £m
	2015 £m

Equity prices decrease by 10%	(8)	(6)
-------------------------------	-----	-----

### iii) Corporate bond spread risk

#### *Description*

The risk of default on fixed-interest securities has been discussed under 'Credit risk'. There is a further risk that fluctuations in the market prices of corporate bonds relative to the market price of British government bonds (gilts), known as spread, are not fully matched by changes in technical provisions. This gives rise to volatility in reported Excess Assets values.

#### *Management of risk*

Corporate bond spread risk is managed through the investment policy, whereby the Society invests in a diversified portfolio of high-quality corporate bonds. The Society's corporate bond holdings typically have terms of less than eight years, which are less sensitive to changes in spread than longer dated bonds. The duration of gilt holdings ensures that policy liabilities remain matched.

The reinsurance and subsequent transfer of annuities to Canada Life has removed the exposure to bond spread risk from assets backing those policies.

#### *Sensitivity*

The following table shows the sensitivity to reasonably possible scenarios, and illustrates the reduction of risk exposure during the year.

Scenario	Impact on Excess Assets	
	2016 £m	2015 £m
Change in corporate bond spreads		
Rise 0.5% pa	(17)	(21)
Fall 0.5% pa	18	23

### iv) Currency risk

#### *Description*

Currency risk is the risk that changes in foreign currency exchange rates impact the value of investments and that the changes are not fully matched by changes in long-term liabilities.

#### *Management of risk*

The Society's principal liabilities are defined in pounds sterling, and its exposure to the risk of movements in foreign exchange rates is limited.

The Society's financial assets are primarily denominated in the same currencies as its liabilities, which mitigates the foreign exchange rate risk for any overseas operations. The main foreign exchange risk arises from recognised assets denominated in currencies other than those in which insurance and investment liabilities

## **15. Management of risk (continued)**

### **d. Market risk (continued)**

#### iii) Currency risk (continued)

are expected to be settled. The Society invests in a US dollar forward exchange contract to mitigate the most significant exposure to currency risk, and so has very low sensitivity to currency risk.

The Society is exposed to the risk that movements in foreign exchange rates reduce the value of charges levied on unit-linked business.

#### *Sensitivity*

The impact of a change of 10% in foreign exchange rates at the reporting date would have changed the Excess Assets by £4m (2015: £2m) after allowing for the mitigating impact of the US dollar forward exchange contract.

### **e. Liquidity risk**

#### *Description*

Liquidity risk is the risk of the Society failing to meet cash flow requirements as they become due.

### *Management of risk*

Monitoring of this risk is undertaken by the Asset and Liability Committee.

The Society holds highly liquid assets in excess of short-term cash flow requirements and so has a very low exposure to short-term liquidity risk.

Assets backing linked liabilities are mostly invested in UK-listed OEICs. In the unlikely event that OEIC fund managers suspend trading, the Society would be exposed to liquidity risk. The Society has sufficient liquid assets to meet cash flow requirements on linked policies. In extreme scenarios, the Society can defer paying unit-linked claims for up to one month and, in respect of property-linked funds, for up to six months.

Over the longer term, the Society monitors its forecast liquidity position for with-profits business by estimating the expected cash outflows and purchasing assets with similar durations to meet these obligations. The sensitivity of these outflows to changes in policyholder behaviour is also monitored. Large volumes of surrenders or policyholders taking their benefits earlier than expected can cause the forced sale of illiquid assets at impaired values. If this disadvantages continuing customers, the Financial Adjustment to policy values can be varied in order to maintain fairness.

There were no material changes to the Society's exposure to liquidity risk over the prior year.

### *Sensitivity*

The Society's investment strategy and reinsurance arrangements mean that it has a very low exposure to liquidity risk. Even in a scenario such as corporate bonds becoming illiquid 76% of investment assets held backing insurance and investment liabilities are held in liquid assets such as gilts and cash, which can normally be quickly realised.

Unit-linked contracts, with the exception of unit-linked annuities, can be terminated at any time, resulting in a cash flow in the category '0-1 year'. The value of unit-linked policies, net of reinsurance, that could be terminated at 31 December 2016 is £1.8bn.

With-profits policies with an ECD prior to 31 December 2016 have a contractual value no lower than total guaranteed benefits, and equalled £1.3bn at 31 December 2016 (2015: £1.4bn). The liquid assets previously referred to include £3.6bn to back with-profits policies (2015: £3.5bn). This is more than sufficient to meet the value of these guaranteed with-profits benefits.

## 15. Management of risk (continued)

### e. Liquidity risk (continued)

As noted in Note 13f (i), the majority of RSP benefits can be taken on contractual terms at a range of ages. The following table details the cash flows using retirement assumptions based on recent experience, that vary between different product types.

2016	0-1 year	2-5 years	6-10 years	11 years and over	No term	Total	Carrying value
<b>Estimated cash flows (undiscounted)</b>	£m	£m	£m	£m	£m	£m	£m
Unit-linked investment contracts	150	497	471	740	-	1,858	1,738
With-profits investment contracts	234	864	972	1,462	-	3,532	3,266
Other financial liabilities (Creditors)	139	-	-	-	-	139	139
<b>Total financial liabilities</b>	<b>523</b>	<b>1,361</b>	<b>1,443</b>	<b>2,202</b>		<b>5,529</b>	<b>5,143</b>
Of which reinsured	(1)	(4)	(3)	(4)	-	(12)	(12)
<b>Total net financial liabilities</b>	<b>522</b>	<b>1,357</b>	<b>1,440</b>	<b>2,198</b>	<b>-</b>	<b>5,517</b>	<b>5,131</b>
Net insurance liabilities	47	118	64	103	-	332	312
Other long-term liabilities	25	5	29	180	-	239	182
Excess Assets					1,005	1,005	1,005
<b>Total net liabilities</b>	<b>594</b>	<b>1,480</b>	<b>1,533</b>	<b>2,481</b>	<b>1,005</b>	<b>7,093</b>	<b>6,630</b>

2015 - Restated	0-1 year	2-5 years	6-10 years	11 years and over	No term	Total	Carrying value
<b>Estimated cash flows (undiscounted)</b>	£m	£m	£m	£m	£m	£m	£m
Unit-linked investment contracts	139	497	508	849	-	1,993	1,680
With-profits investment contracts	281	637	1,320	1,676	-	3,914	3,458
Other financial liabilities (Creditors)	934	-	-	-	-	934	934
<b>Total financial liabilities</b>	<b>1,354</b>	<b>1,134</b>	<b>1,828</b>	<b>2,525</b>	<b>-</b>	<b>6,841</b>	<b>6,072</b>
Of which reinsured	(4)	(13)	(11)	(11)	-	(39)	(33)
<b>Total net financial liabilities</b>	<b>1,350</b>	<b>1,121</b>	<b>1,817</b>	<b>2,514</b>	<b>-</b>	<b>6,802</b>	<b>6,039</b>
Net insurance liabilities	76	122	76	99		373	343
Other long-term liabilities	5	11	38	271		325	206
Excess Assets	-	-	-	-	793	793	793
<b>Total net liabilities</b>	<b>1,431</b>	<b>1,254</b>	<b>1,931</b>	<b>2,884</b>	<b>793</b>	<b>8,293</b>	<b>7,381</b>

## 16. Creditors

2016	2015
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	£m	£m
Creditors arising out of direct insurance operations	25	23
Deposit received from reinsurer - secured	-	796
Amounts owed to credit institutions	6	3
Other creditors including taxation and social security		
Balances with Group undertakings	25	19
Derivatives positions		
Obligation to return swaptions variation margin to Morgan Stanley and Goldman Sachs	81	89
Forward US\$/GBP exchange contract <sup>1</sup>	-	-
Other creditors	2	4
<b>Total creditors</b>	<b>139</b>	<b>934</b>

Note:

<sup>1</sup> The fair value of the forward US dollar and sterling currency exchange contract was £0.1m liability (2015: £0.4m liability). If the Balance sheet position is held to maturity in March 2017 the Society will be obliged to pay \$13.4m and will receive £10.7m.

## 17. Subsidiary and associated undertakings

	Share class	2016		2015	
		Percentage held	Current value £m	Percentage held	Current value £m
Subsidiary companies					
Equitable Private Equity Holdings Ltd Regency Court, Glatigny Esplanade, St Peter Port, Guernsey, GYJ 3AP					
	Ordinary USD 1	100%	-	100%	-
	Preference USD 1	100%	30	100%	26
Basinghall Street Investments Ltd 20-22 Bedford Row, London, WC1R 4JS					
	Ordinary GBP 1	100%	-	100%	-
Significant holdings - equity shares					
Putnam Private Equity LN	Ireland			22.73%	1
Pantheon Europe Fund First Floor, Dorey Court, Admiral Park, St Peter Port Guernsey GY1 6HJ		24.76%		24.76%	1
Permira UK Fund IV	Guernsey			27.27%	-
Significant holdings - limited partnership interest					
Emerging Euro LP	USA			22.22%	1

Basinghall Street Investments Ltd was removed from the register of companies on 3 January 2017.

Investments in subsidiary companies are held directly by the Society. None of the above holdings are regarded by the Directors as associated undertakings, as the Society does not exert significant influence. None of the holdings materially affects the results or net assets of the Society. These investments are included in the Balance sheet at current value, which is based upon the Society's share of relevant net assets.

## 18. Related party transactions

There were no material related party transactions during 2016 (2015: £nil).

## 19. Commitments

The Society has no material operating lease commitments.

Commitments in respect of uncalled capital on private equity fund interests, not provided for in the Financial statements, amounted to £7m (2015: £6m) for the Society.



# Additional information for members

## Capital distribution and the cost of guarantees

Within the annual valuation, we do not make an allowance for future capital distribution. It is instructive, however, to assess the working capital of the fund under the alternative assumptions shown below: the first assuming no capital distribution, as per the Financial statements; the second assuming capital distribution remains at 35% for the remainder of the lifetime of the business; and the third assuming capital distribution increases each year from 35% in 2015 at a constant rate, which aims to pay out all the capital over the lifetime of the business.

	Capital Distribution		
	Nil%	35% unchanged	35% increasing
	£m	£m	£m
<b>Total with-profits assets</b>	<b>4,791</b>	<b>4,791</b>	<b>4,791</b>
less:			
Technical provisions			
Policy values	2,510	2,510	2,510
Cost of guaranteed annuity option	7	7	7
Cost of guarantees	1,124	567	130
Future charges	(184)	(95)	(95)
Future capital distributions	-	1,473	1,910
Other long-term liabilities	182	182	182
Other liabilities	147	147	147
<b>Working capital for fund (Excess Assets)</b>	<b>1,005</b>	<b>-</b>	<b>-</b>

Under the heading 'Future capital distributions', it can be seen that the majority of available capital is expected to be distributed with the Claims Enhancement Factor at 35%, with approximately £400m available for future increases. As discussed in the Chairman's statement, the Society is exploring how to make more certain the 35% uplift currently paid to policyholders when they retire.

## Headline historical data

	2016	2015	2014
Gross claims paid			
Reported in Technical account	£498m	£459m	£386m
Withdrawals from investment contracts	£232m	£176m	£139m
	£730m	£635m	£525m
Number of policyholders			
With-profits individual	141,000	152,000	164,000
With-profits in company schemes	143,000	157,000	170,000
Unit-linked	123,000	134,000	144,000
Annuity holders			30,000
Total number of policyholders <sup>1</sup>	328,000	358,000	416,000
Fall in year	30,000	58,000	14,000

Note

<sup>1</sup> individual policyholders may be included in more than one of the categories, but will be included only once in the total.