ST ANDREW'S LIFE ASSURANCE PLC

ANNUAL REPORT

AND

FINANCIAL STATEMENTS

31 DECEMBER 2013

Member of Lloyds Banking Group plc

CONTENTS

COMPANY INFORMATION

Board of Directors

Lord Blackwell (Chairman)

Dr N M Bryson (Deputy Chairman)
M Christophers
M G Culmer
M A Fisher
J Goford
V Maru
A M Parsons*
Drs C A C M Schrauwers
T E Strauss*
C J Thornton*
R L M Wohanka

* denotes Executive Director

Company Secretary

C M Herd

Actuarial Function Holder

R McIntyre

Independent Auditors

PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
31 Great George Street,
Bristol,
BS1 5QD

Registered Office

33 Old Broad Street
London
EC2N 1HZ

Company Registration Number

03104670

STRATEGIC REPORT

The Directors present their strategic report on St Andrew's Life Assurance Plc ("the Company") for the year ended 31 December 2013

The Company contributes to the Life Insurance result within the Lloyds Banking Group ("LBG") Insurance division, focusing on protecting today and securing tomorrow for our customers The nation's demographics are changing, with people living longer, retiring later and working into retirement It's a future that many customers are not prepared for

Our strategy to help our customers 'Secure Tomorrow' is geared to meeting the needs of our changing society by

- Being customer centric,
- Having a clear market focus, and
- Leveraging our unique Group advantage

As part of the LBG Insurance Division strategy the Company has been closed to new business apart from increments into existing contracts with the remaining focus on the retention and servicing of existing customers Accordingly, the Company is focussed on ensuring policyholder obligations are met at the same time ensuring the company is managed to maximise capital efficiency and returns for its shareholder and the LBG Insurance division To support this, the Company is focussed on the following key performance indicators

- Result for the year,
- Funds under management,
- Regulatory capital in excess of internal buffers, and
- Liquidity position

Result for the year

The result of the Company for the year ended 31 December 2013 is a profit before tax of £119m (2012 £114m)

The result reflects market conditions in the year The Directors consider the result for the year to be satisfactory in light of these factors

Key performance indicators

Funds under management

Funds under management relating to policyholder liabilities were £10 6bn (2012 £10 7bn), the movement reflecting net flows from policyholders and investment return for the period

Capital Resources

The Directors believe that the Company currently has adequate capital resources and will continue to do so in the foreseeable future On a Pillar 1 basis the regulatory surplus of the Company in excess of capital requirements is £494m (2012 £458m) On a Pillar 1 basis the regulatory surplus attributable to the shareholder is £494m (2012 £458m)

Solvency II

Our business model as a Single Integrated Insurance Business positions us to maximise the capital benefits from risk diversification available under the Prudential Regulation Authority ("PRA") Individual Capital Assessment Plus (ICA plus) regime and ultimately Solvency II When Solvency II is fully implemented, it is expected that the Insurance Division of LBG will be able to recognise the capital diversification benefits which will flow from the management of capital and risk within this overall structure The implementation date for Solvency II within the European Union has been deferred until 1 January 2016, although some transitional measures to demonstrate preparedness will apply during 2015

The Company's preparations on Solvency II are continuing, although the Single Integrated Insurance Business structure will enable the business to operate effectively within the transitional arrangements that have been proposed The Company has already embedded Solvency II into its way of working and takes this into account when considering capital requirements The Company has developed a Risk Management Framework, with the Own Risk and Solvency Assessment a central feature to this framework

Further information on the capital position of the Company is given in note 25

STRATEGIC REPORT (continued)

Liquidity

The Company regularly monitors its liquidity position, which includes stressed outflows that are based on the most severe of several scenarios Company specific stress scenarios, PRA market-wide scenarios, and PRA market wide scenarios with Insurance-specific overlays A liquidity risk appetite coverage ratio of over 150% is rated green

Other Sources

The Company also forms part of LBG's Insurance Division The development, performance and position of the Insurance Division are presented within LBG's annual report, which does not form part of this report

The Directors consider that the above are the key performance indicators which are appropriate to the principal activity of the Company These, together with other metrics which cover customer, operational measures and capital, are included in the balanced scorecard which is used to measure all aspects of the performance of the business In addition, the Directors are of the opinion that the information contained in the Company's PRA returns on capital resources and requirements and regular actuarial reports, in conjunction with the information presented in the financial statements as a whole, provide the management information necessary for the Directors to understand the development, performance and position of the business of the Company Along with fellow direct and indirect subsidiaries of the ultimate insurance parent undertaking, the Company is included in the calculation of the Scottish Widows Group capital surplus This is calculated in accordance with the Insurance Groups Directive, and is reported in the LBG annual report

Review of the business

In addition to the progress made against the strategic initiatives summarised earlier there are other areas that are worthy of note and these are described below Decisions taken in the areas described below and in pursuit of our strategy are considered within our Risk and Capital Management Framework and brought to life for the Board through the Own Risks and Solvency Assessment (ORSA) completed annually

Investment strategy

The Company continues to practise efficient balance sheet management with a focus on investment and liquidity management opportunities This includes leveraging wider LBG skills and capabilities where it is appropriate to do so Activity completed in 2013 and future planned activity to invest in higher yielding illiquid assets is expected to continue to deliver significant increased investment return to the Company, without increasing credit risk beyond the Company's risk appetite During 2013 the Company continued to invest excess liquidity in less liquid credit assets purchased from, or issued by, parties within LBG including £185m of loans secured on asset backed securities and mortgage backed securities All assets were acquired at their fair value Further details on the credit risk and fair value measurement of these assets can be found in note 25

Loans issued to related parties during the year

On the 17 December 2013 the Company issued a £150m loan to Scottish Widows plc ("the borrower"), a LBG subsidiary Interest on the loan is payable on an annual basis at a rate of 3 month LIBOR plus 0 3% The loan is repayable on demand within 13 months of written notice being given to the borrower, with the borrower having the option to prepay the whole or part of the amount loan at any time Further information on loans to related parties is set out in note 26 On the same date the borrower entered into a collateral arrangement with the Company Further information on the Company's collateral in respect of loans to related parties is set out in note 25

Outlook

The Directors consider that the Company's principal activities will continue unchanged in the foreseeable future

Principal risks and uncertainties

The management of the business and the execution of the Company's strategy are subject to a number of risks The financial risk management objectives and policies of the Company and the exposure to market, insurance, credit, financial soundness, conduct, operational and political risk and uncertainties are set out in note 25

In addition, the Company is also exposed to financial and prudential regulatory reporting risk, in particular the risk of reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial reporting or over prudential regulatory reporting and financial reporting fraud The financial and risk management objectives and policies of the Company in respect of financial and prudential regulatory reporting risk are also set out in note 25

STRATEGIC REPORT (continued)

The Company, like other insurers, is subject to legal proceedings in the normal course of business Whilst it is not practicable to forecast or determine the final results of all pending or threatened legal proceedings, management does not believe that such proceedings, including litigation, will have a material effect on the results and financial position of the Company

On behalf of the Board of Directors

A M Parsons
Director
20 March 2014

DIRECTORS' REPORT

Principal activities and review of business

The Directors present the audited financial statements of the Company The Company is a limited liability Company domiciled and incorporated in the United Kingdom

The principal activity of the Company is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the UK The Company manages a wide range of life insurance products such as protection type products including whole life and investment type products through the LBG network The Company also reinsures business with other LBG companies and with insurance entities external to the Group

From 31 October 2013 the Company stopped selling the Over 50s Guaranteed Life Plan product, which was the only protection product still open to new business However it continues to receive increments on some existing protection contracts

Results and dividend

The result of the Company for the year ended 31 December 2013 is a profit after tax of £127m (2012 profit after tax of £100m) and this has been transferred to reserves The result reflects market conditions over 2013 Significant net gains arose in respect of investments held by the Company The Directors consider the result for the year to be satisfactory in light of these factors

Interim dividends totalling £100m (2012 £nil) were paid in the year The Directors do not expect to recommend payment of a final dividend in respect of the year ended 31 December 2013

Directors

The names of the current Directors are listed on page 3 Changes in directorships during the year (and since the end of the year) are as follows

D J Walkden	(resigned 1 June 2013)
A M Peck	(resigned 31 May 2013)
R L M Wohanka	(appointed 1 June 2013)
V Maru	(appointed 18 June 2013)
C J Thornton	(appointed 1 June 2013)

Particulars of the Directors' emoluments are set out in note 26

LBG has granted to the Directors of the Company a deed of indemnity through deed poll which constituted 'qualifying third party indemnity provisions' for the purposes of the Companies Act 2006 The deed was in force during the whole of the financial year and at the date of approval of the financial statements Directors no longer in office but who served on the Board of the Company at any time in the financial year had the benefit of this contract of indemnity during that period of service The indemnity remains in force for the duration of a Director's period of office The deed indemnifies the Directors to the maximum extent permitted by law The Deed for existing Directors is available for inspection at the registered office of LBG In addition, LBG has in place appropriate Directors and Officers Liability Insurance cover which was in place throughout the financial year

Disclosure of information to auditors

Each person who is a Director at the date of approval of this report confirms that, so far as the Director is aware, there is no relevant audit information of which the Company's auditors are unaware and each Director has taken all the steps that he ought to have taken as a Director in order to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information This confirmation is given, and should be interpreted in accordance with, the provisions of the Companies Act 2006

Employees

LBG is committed to providing employment practices and policies which recognise the diversity of the workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief In the UK, LBG belongs to the major employer groups campaigning for equality for all staff, including Employers' Forum on Disability, Employers' Forum on Age and Stonewall LBG is also represented on the Board of Race for Opportunity and the Equal Opportunities Commission Involvement with these organisations enables LBG to identify and implement best practice for staff

Employees are kept closely involved in major changes affecting them through such measures as team meetings, briefings, internal communications and opinion surveys These meetings, briefings and internal communications also serve to achieve a common awareness of the financial and economic factors that affect the performance of the Company There are well established procedures, including regular meetings with recognised unions, to ensure that the views of employees are taken into account in reaching decisions Schemes offering share options or the acquisition of shares are available for most staff, to encourage their financial involvement in LBG

DIRECTORS' REPORT (continued)

Political Contributions

During the year, the Company made no political contributions (2012 £nil)

Statement of Directors' Responsibilities

The Directors are responsible for preparing the Strategic Report, Directors' Report and the financial statements in accordance with applicable law and regulations

Company law requires the Directors' to prepare financial statements for each financial year Under that law the Directors have prepared the financial statements in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union Under Company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period In preparing these financial statements, the Directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgements and accounting estimates that are reasonable and prudent,
- state whether applicable IFRSs as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements, and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business

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

Each of the Directors whose names are listed on page 3 confirms that, to the best of their knowledge

- the Company financial statements, which have been prepared in accordance with IFRSs as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and profit of the Company, and
- the Directors' Report on pages 7 to 8 and the Strategic Report on pages 4 to 6 includes a fair review of the development and performance of the business and the position of the Group and Company, together with a description of the principal risks and uncertainties that it faces

On behalf of the Board of Directors

A M Parsons
Director
20 March 2014

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF ST ANDREW'S LIFE ASSURANCE PLC

Report on the financial statements

Our opinion

In our opinion the financial statements

- give a true and fair view of the state of the Company's affairs as at 31 December 2013 and of its profit and cash flows for the year then ended,
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, and
- have been prepared in accordance with the requirements of the Companies Act 2006

This opinion is to be read in the context of what we say below

What we have audited

The financial statements for the year ended 31 December 2013, which are prepared by St Andrew's Life Assurance plc, comprise

- the statement of comprehensive income,
- the balance sheet,
- the statement of cash flows,
- the statement of changes in equity, and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information

The financial reporting framework that has been applied in their preparation comprises applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates In making such estimates, they have made assumptions and considered future events

What an audit of financial statements involves

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) (ISAs (UK & Ireland)) An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error This includes an assessment of

- whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed,
- the reasonableness of significant accounting estimates made by the directors, and
- the overall presentation of the financial statements

In addition, we read all the financial and non-financial information in the Annual Report and Financial Statements 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

Opinion on matter prescribed by the Companies Act 2006

In our opinion 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

Other matters on which we are required to report by exception

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

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF ST ANDREW'S LIFE ASSURANCE PLC (continued)

Directors' remuneration

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

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

As explained more fully in the Statement of Directors' Responsibilities on page 8, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view

Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and ISAs (UK & 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 Company's member 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

Joanne Leeson (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Bristol

20 March 2014

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2013

	Note	2013 £ m	2012 £ m
Revenue			
Gross earned premiums		147	373
Premiums ceded to reinsurers		(37)	(41)
Premiums net of reinsurance		110	332
Fee and commissions income	4	1	2
Investment income	5	327	350
Net gains on assets and liabilities at fair value though profit or loss	6	737	459
Total revenue		1,175	1,143
Expenses			
Gross claims and benefits paid		1,136	1,340
Claims recoveries from reinsurers		(32)	(29)
		1,104	1,311
Change in insurance contract liabilities		(131)	(384)
Change in investment contract liabilities		-	1
Change in assets arising from reinsurance contracts held	13	3	(10)
		(128)	(393)
Operating expenses	7	49	77
Expenses for asset management services received		31	34
		80	111
Total expenses		1,056	1,029
Profit before tax		119	114
Taxation credit/(charge)	9	8	(14)
Profit for the year		**127**	**100**

There are no items of comprehensive income which have not already been presented in arriving at the profit for the year Accordingly, the profit for the year is the same as total comprehensive income for the year

The notes set out on pages 15 to 53 are an integral part of these financial statements

BALANCE SHEET AS AT 31 DECEMBER 2013

	Note	31 December 2013 £ m	31 December 2012[1] £ m
ASSETS			
Deferred acquisition costs	10	130	145
Deferred tax assets	11	46	44
Investment properties	12	132	138
Current tax receivables	11	46	30
Assets arising from reinsurance contracts held	13	115	144
Derivative financial instruments	14	68	102
Loans and receivables	15	246	89
Investments at fair value through profit or loss	16	10,273	10,552
Cash and cash equivalents	17	33	54
Total assets		**11,089**	**11,298**
EQUITY AND LIABILITIES			
Capital and reserves attributable to Company's equity shareholder			
Share capital	18	360	360
Retained earnings		381	354
Total equity		741	714
Liabilities			
Insurance contract liabilities	19	10,076	10,207
Deferred tax liabilities	11	26	33
Current tax payables	11	5	41
Investment contract liabilities	20	9	9
Derivative financial instruments	14	24	4
Other financial liabilities	21	208	290
Total liabilities		10,348	10,584
Total liabilities and equity		**11,089**	**11,298**

The notes set out on pages 15 to 53 are an integral part of these financial statements

[1] Reflects the implementation of IFRS 10 as set out in note 16

The financial statements on pages 11 to 53 were approved by the Board on 20 March 2014

A M Parsons
Director
20 March 2014

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2013

	Note	2013 £ m	2012 £ m
Cash flows from operating activities			
Profit before tax		119	114
Adjusted for			
Movement in deferred acquisition costs	10	15	36
Net increase in operating assets and liabilities	22	(2)	(149)
Taxation paid		(53)	(10)
Net cash inflows/(outflows) from operating activities		79	(9)
Cash flows from financing activities			
Dividends paid	23	(100)	-
Net cash flows from financing activities		(100)	-
Net decrease in cash and cash equivalents		(21)	(9)
Cash and cash equivalents at the beginning of the year		54	63
Cash and cash equivalents at the end of the year	17	33	54

The notes set out on pages 15 to 53 are an integral part of these financial statements

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2013

	Note	Issued share capital £ m	Retained earnings £ m	Total equity £ m
Balance at 1 January 2012		**360**	**254**	**614**
Total comprehensive income for the year		-	100	100
Dividends paid	23	-	-	-
Balance as at 31 December 2012		**360**	**354**	**714**
Total comprehensive income for the year		-	127	127
Dividends paid	23	-	(100)	(100)
Balance as at 31 December 2013		**360**	**381**	**741**

Not all of the above amounts can be distributed to the equity shareholder since the Company is required to meet regulatory capital requirements Further details are given in note 25

The notes set out on pages 15 to 53 are an integral part of these financial statements

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013

1 Accounting policies

The accounting policies adopted in the preparation of the financial statements, which have been consistently applied to all periods presented in these financial statements unless stated otherwise, are set out below

(a) Basis of preparation

The financial statements of the Company have been prepared

(1) in accordance with the International Accounting Standards ("IASs") and International Financial Reporting Standards ("IFRSs") issued by the International Accounting Standards Board and the Standards and Interpretations ("SICs") and International Financial Reporting Interpretations ("IFRICs") issued by its International Financial Reporting Interpretations Committee, as endorsed by the European Union,

(2) in accordance with those parts of the Companies Act 2006 applicable to companies reporting under IFRSs, and

(3) under the historical cost convention, as modified by the revaluation of investment properties and certain financial assets and financial liabilities at fair value through profit or loss, as set out in the relevant accounting policies

The Directors are satisfied that the Company has adequate resources to continue in business for the foreseeable future Accordingly, the financial statements of the Company have been prepared on a going concern basis

In accordance with IAS 1 "Presentation of Financial Statements", assets and liabilities in the balance sheet are presented in accordance with management's estimated order of liquidity Analysis of the assets and liabilities of the Company into amounts expected to be received or settled within 12 months after the reporting date (current) and more than 12 months after the reporting date (non-current) is presented in the notes

The Company has taken advantage of the provisions under section 400 of the Companies Act 2006 and has not produced consolidated financial statements These financial statements present information about the Company as an individual undertaking and not about its group

(b) Product classification

The Company issues contracts that transfer insurance risk or financial risk or both

Insurance contracts

Insurance contracts are those contracts which transfer significant insurance risk Such contracts may also transfer financial risk As a general guideline, the Company defines as significant insurance risk the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur Once a contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly over time

Investment contracts

Any long term contracts not considered to be insurance contracts under IFRS because they do not transfer significant insurance risk are classified as investment contracts

Non participating contracts are contracts that neither transfer significant insurance risk nor give investors a contractual right to receive, as a supplement to guaranteed benefits, additional discretionary benefits or bonuses

The Company does not have any participating investment contracts Items termed as investment contracts below therefore refer only to non participating investment contracts

(c) Financial assets and financial liabilities

Management determines the classification of its financial assets and financial liabilities at initial recognition Management's policies for the recognition of specific financial assets and financial liabilities, as identified on the balance sheet, are set out under the relevant accounting policies

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Company has transferred substantially all of the risks and rewards of ownership Financial liabilities are derecognised only when the obligation specified in the contract is discharged, cancelled or expires

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

1 Accounting policies (continued)

(c) Financial assets and financial liabilities (continued)

All financial assets and financial liabilities are designated at fair value through profit or loss, with the exception of certain loans and receivables (policy (l)), other financial liabilities (policy (v)) which are stated at amortised cost, and derivatives as described further in policy (k) The classification depends on the purpose for which the financial assets and financial liabilities were acquired

Certain financial assets and financial liabilities, whose default accounting treatment would be to record these balances at amortised cost, are instead designated at fair value through profit or loss as they are held to match insurance and investment contract liabilities linked to the changes in fair value of these assets and liabilities, thereby reducing measurement inconsistencies, and reflecting the fact that these are managed and their performance evaluated on a fair value basis Information on these balances is provided internally on a fair value basis to the Company's key management The Company's investment strategy is to invest in equity and debt securities, loans, investment property and cash and to evaluate the Company's investments with reference to their fair values

(d) Fair value methodology

All financial instruments carried at fair value, or for which a fair value measurement is disclosed are categorised into a "fair value hierarchy" as follows

(i) Level 1

Valued using quoted prices (unadjusted) in active markets for identical assets and liabilities to those being valued Additionally, this includes OEIC investments An active market is one in which arm's length transactions in the instrument occur with both sufficient frequency and volume to provide pricing information on an ongoing basis Examples include listed equities, listed debt securities, OEICS, unit trusts traded in active markets and exchange traded derivatives such as futures

(ii) Level 2

Valued using inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices) If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability Level 2 inputs include the following

- Quoted prices for similar (but not identical) instruments in active markets,
- Quoted prices for identical or similar instruments in markets that are not active, where prices are not current, or price quotations vary substantially either over time or among market makers,
- Inputs other than quoted prices that are observable for the instrument (for example, interest rates and yield curves observable at commonly quoted intervals and default rates),
- Inputs that are derived principally from, or corroborated by observable market data by correlation or other means

Examples of these are securities measured using discounted cash flow models based on market observable swap yields and listed debt or equity securities in a market that is inactive

(iii) Level 3

Valued using inputs for the asset or liability that include significant unobservable inputs (inputs not based on observable market data) Unobservable inputs may have been used to measure fair value where observable inputs are not available This approach allows for situations in which there is little, if any, market activity for the asset or liability at the measurement date (or market information for the inputs to any valuation models) Unobservable inputs reflect the assumptions the Company considers that market participants would use in pricing the asset or liability, for example certain private equity investments held by the Company

Where estimates are used, these are based on a combination of independent third-party evidence and internally developed models, calibrated to market observable data where possible

Further analysis of the Company's instruments held at fair value is set out at note 25

The Company's management, through a fair value pricing committee, review information on the fair value of the Company's financial assets and financial liabilities and the sensitivities to these values on a regular basis

No assets are classified as held-to-maturity or available-for-sale Derivative assets (other than a derivative which is a designated and effective hedging instrument) are classified as held for trading With the exception of derivative liabilities, no liabilities are classified as held for trading Further information on derivatives is set out at policy (k)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

1 Accounting policies (continued)

(d) Fair value methodology (continued)

Transaction costs incidental to the acquisition of a financial asset are expensed through the statement of comprehensive income, within net gains and losses on assets and liabilities at fair value through profit or loss

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet only when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously

Transfers between different levels of the fair value hierarchy are deemed to have occurred at the next reporting date after the change in circumstances that caused the transfer

(e) Revenue recognition

Premium income

Premiums received in respect of life insurance contracts are recognised as revenue when they become payable by the policyholder and are shown before deduction of commission Premiums ceded to reinsurers are recognised when the related gross premiums are recognised Gross and ceded premiums are recorded through the relevant lines in the statement of comprehensive income

Fee and commission income

The Company receives ongoing investment management fees which are recognised as revenue as the services are provided

The Company also receives initial investment management fees in the form of an adjustment, or charge, to the amount invested These fees are in respect of services rendered in conjunction with the issue and management of investment contracts where the Company actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the contract These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Company defers these fees and recognises them on a straight-line basis over the estimated lives of the contracts unless there is evidence to support an alternative recognition basis Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned The income is recognised through the statement of comprehensive income, within fee and commission income

Net gains and losses on assets and liabilities at fair value through profit or loss

Net gains and losses on assets and liabilities at fair value through profit or loss includes both realised and unrealised gains and losses Movements are recognised in the statement of comprehensive income in the period in which they arise

Investment income

Interest income for all interest-bearing financial instruments is recognised in the statement of comprehensive income as it accrues within investment income

Dividends receivable in respect of listed shares and collective investment vehicles are recognised on the date that these are quoted ex-dividend, other dividend income is recognised when received All dividends received are recognised through the statement of comprehensive income, within investment income

Rental income in respect of investment properties is recognised in the statement of comprehensive income on a straight line basis, within investment income, when the right to receive payment is established The cost of incentives are recognised as a reduction of total income over the term of the lease on a straight line basis

(f) Expense recognition

Claims

Claims are recorded as an expense on the earlier of the maturity date or the date on which the claim is notified Claims recoveries from reinsurers are recognised when the related claims are recognised Claims and claims recoveries are recognised through the relevant lines in the statement of comprehensive income Claims handling costs and interest on late claims are also included in claims This is recognised when incurred

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

1 Accounting policies (continued)

(f) Expense recognition (continued)

Operating expenses

Commission paid in respect of the business written by the Company is recognised through the statement of comprehensive income, within operating expenses Where certain criteria are met, commission and other acquisition costs may be deferred The circumstances under which such costs are deferred are set out in policy (g)

Other operating expenses are recognised in the statement of comprehensive income as incurred, within operating expenses

Expenses for asset management services received

Expenses for asset management services received are recognised in the statement of comprehensive income as they accrue, within expenses for asset management services received

(g) Deferred acquisition costs

The costs of acquiring new insurance contracts which are incurred during a financial period but which relate to subsequent financial periods, are deferred to the extent that they are recoverable out of future revenue margins The deferred acquisition cost asset is amortised over the lifetime of the related contracts based on the pattern of margins arising from these contracts unless there is evidence to support an alternative recognition basis Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned

The carrying value of the asset is tested for impairment at each reporting date The change in the value of deferred acquisition costs for the year is recognised through the statement of comprehensive income, within operating expenses Further information on the Company's impairment policy is set out in policy (o)

(h) Investment in subsidiaries

Certain subsidiaries, including holdings in mutual investment funds, (which includes OEICs) are held primarily as vehicles through which specific investments are held as part of the actively managed investment portfolios Those subsidiaries hold assets which are designated at fair value through profit or loss in accordance with IAS 39 "Financial Instruments Recognition and Measurement" and primarily match policyholder liabilities Accordingly, these subsidiaries which are managed in this manner are carried at fair value and presented within investments at fair value through profit or loss (see policy (m)) Changes in their fair value are reflected in the statement of comprehensive income, within net gains and losses on assets and liabilities at fair value through profit or loss

(i) Investment properties

Investment properties comprise freehold and long leasehold land and buildings, which are held either to earn rental income or for capital appreciation or both are initially measured at cost, being the fair value of the consideration given, including directly attributable transaction costs Subsequently, on a periodic basis and at each reporting date, such properties are carried at fair value as assessed by qualified external appraisers who have recent experience in the relevant location and the category of properties being valued Fair value is based on active market prices, adjusted if necessary for any difference in the nature, location or condition of the specific asset If this information is not available, alternative valuation methods such as discounted cash flow analysis or recent prices in less active markets are used Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value

Gains or losses arising from changes in the fair values of investment properties are recognised in the statement of comprehensive income in the period in which they arise, within net gains and losses on assets and liabilities at fair value through profit or loss

(j) Reinsurance

The Company cedes reinsurance in the normal course of business Where the reinsurance contract transfers significant insurance risk to the reinsurer, the assets arising from reinsurance contracts held are classified as insurance contracts Where the reinsurance contract does not transfer significant insurance risk to the reinsurer for the assets arising from reinsurance contracts held are classified as a financial asset designated as fair value through profit or loss

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

1. Accounting policies (continued)

(j) Reinsurance (continued)

Assets arising from reinsurance contracts held – classified as insurance contracts

These assets are recognised within assets arising from reinsurance contracts held Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the underlying contracts and in accordance with the terms of each reinsurance contract These balances are subject to an annual impairment review Further information on the Company's impairment policy is set out at policy (o)

Premiums ceded and claims reimbursed are recognised when due and disclosed separately on the face of the statement of comprehensive income Changes in these assets are recognised on the face of the statement of comprehensive income, through change in assets arising from reinsurance contracts held

Assets arising from reinsurance contracts held – at fair value through profit or loss

Amounts due from reinsurers in respect of contracts that do not transfer significant insurance risk to the reinsurer are designated as fair value through profit or loss as this ensures consistency of valuation with the underlying liabilities These contracts, whilst legally reinsurance contracts, do not meet the definition of a reinsurance contract under IFRSs Where this is the case, the amounts recoverable have been recognised as a financial asset within assets arising from reinsurance contracts held Changes in these assets are recognised directly through the balance sheet These balances are subject to an annual impairment review Further information on the Company's impairment policy is set out at policy (o)

(k) Derivative financial instruments

Classification

Derivative financial instruments, including embedded derivatives, are held for trading, with the exception of derivatives which are designated as effective hedging instruments of which the Company has none Derivatives held for trading are used for the purposes of efficient portfolio management or to match contractual liabilities

Recognition

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently remeasured at their fair value

Measurement

The best evidence of the fair value of a derivative at initial recognition is the transaction price unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument

Fair values are obtained from quoted market prices in active markets, including recent market transactions For over-the-counter ("OTC") derivatives, the value is derived from a hierarchy of valuation sources, as follows

- primary source – an independent valuation source
- secondary source – generally, this would be the counterparty valuation
- tertiary source – generally, this would be the fund manager valuation

Data from a primary source will initially be used in valuing derivatives However, tolerance checks are also performed between valuations derived from different sources in order to validate the calculated valuations, detect any potential discrepancies and, if appropriate, select a secondary or tertiary price for use in the valuation instead If, as a result of this process, the primary, secondary and tertiary values for an instrument are not within tolerance then the valuation is referred to the relevant authority within Insurance Finance to agree a final pricing decision

For exchange traded contracts, the value is based on the quoted bid price at close of business where the contract is an asset held or liability to be issued Where the contract is an asset to be acquired or liability held, the value is based on the quoted offer price at close of business

Changes in the fair value of derivatives are recognised in the statement of comprehensive income, through net gains and losses on assets and liabilities at fair value through profit or loss

(l) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and that are not designated at fair value through profit or loss at initial recognition

1 Accounting policies (continued)

(l) Loans and receivables (continued)

Loans and receivables are initially recognised at fair value less directly attributable transaction costs and subsequently measured at amortised cost, subject to impairment With the exception of certain long-term loans made to related parties, in practice, the carrying value of these balances equates to the fair value due to the short-term nature of the amounts included within loans and receivables

A charge for impairment in respect of loans and receivables would be made in the statement of comprehensive income when there is objective evidence that the Company will not be able to collect all amounts due according to their original terms The impairment charge would be recognised through operating expenses in that part of the statement of comprehensive income Receivables arising from insurance contracts are also classified in this category and are reviewed for impairment as part of the impairment review of loans and receivables Such amounts are reflected through the statement of comprehensive income within gross premiums written and claims recoveries from reinsurers Further information on the Company's impairment policy is set out in policy (o)

(m) Investments at fair value through profit or loss

Investments at fair value through profit or loss comprise debt and equity securities

Classification

A financial asset is classified in this category at inception if acquired principally for the purpose of selling in the short-term, if it forms part of a portfolio of financial assets in which there is evidence of short-term profit-taking, or if designated as such

Recognition

Purchases and sales of financial assets are recognised on the trade date i e the date the Company commits to purchase the asset from, or deliver the asset to, the counterparty Investments are initially recognised at fair value, being the fair value of the consideration given, and are subsequently remeasured at fair value

Measurement

The fair values of investments are based on current bid prices If the market for a financial asset is not active, and also for unlisted securities, the Company establishes fair value by using valuation techniques These include the use of similar arm's length transactions and reference to other instruments that are substantially the same, making maximum use of market inputs and relying as little as possible on entity-specific inputs

For equity investments that are quoted and actively traded in organised financial markets, fair value is determined by reference to Stock Exchange quoted market bid prices at the final pricing point on the reporting date Prices are provided by vendors such as Reuters or Bloomberg or by direct reference to the Stock Exchange

For quoted debt security investments, bid prices at the final pricing point on the reporting date are obtained from index providers who obtain prices from a number of leading brokers, investment banks and market makers Where no independent price is available, a valuation technique is used to determine fair value The technique uses a spread over a comparable term gilt as the best estimate of fair value Spreads are calculated by reference to the wider market movement in credit spreads, the way in which the security is structured, other assets issued by the issuer or other assets with similar characteristics

For corporate bonds, the Company's management perform a comparison of information received from the index provider used against other available price sources on a monthly basis to ensure that prices can be supported by market data

The fair value of holdings in OEICs and Unit Trusts is determined as the last published price applicable to the OEIC sub-fund or the Unit Trust at the reporting date

In addition to the measurement policies, investment asset prices are reviewed weekly to identify those assets where the price has not moved for at least six days This review provides an initial indication that the market for each identified asset may be inactive These assets are then reviewed by management who may identify an alternative price source for assets which in their view are still actively traded On conclusion that a particular asset is illiquid, management will identify an alternative valuation technique by deciding whether an appropriate price can be obtained from a recognised independent broker Where this is the case, the broker will be approved as a price source for the asset A price will then be obtained from the broker on a monthly basis A review of all illiquid assets and prices obtained or calculated is conducted by a Fair Value Pricing Committee on a monthly basis

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

1. Accounting policies (continued)

(m) Investments at fair value through profit or loss (continued)

For equity investments such as private equity, fair value is determined by reference to the most recent valuation, adjusted for any cash movements or other relevant information since the last valuation point, which is likely to be up to one quarter prior to the reporting date

In order to ensure that a fair value is recognised for unquoted or illiquid debt securities, the primary price source is an external broker valuation If available, a further external broker valuation is sought as a secondary valuation source in order to validate the primary source A formal review is then carried out which challenges the external valuation and includes consideration of the impact of any relevant movements in underlying variables such as

- underlying movements in the relevant markets, for example credit spreads,
- how current transactions are being priced in the market,
- how the security is structured, and
- any supporting quantitative analysis as appropriate, for example with reference to Bloomberg or internal models

(n) Cash and cash equivalents

Cash and cash equivalents includes cash at bank, short-term highly liquid investments with original maturities of three months or less (excluding such investments as otherwise meet this definition but which are held for investment purposes rather than for the purposes of meeting short-term cash commitments) and bank overdrafts where a legal right of set-off exists

(o) Impairment

Financial assets

The carrying value of all financial assets held at amortised cost is reviewed for impairment whenever events or circumstances indicate that the carrying amount may not be recoverable The identification of impairment and the determination of recoverable amounts is an inherently uncertain process involving various assumptions and factors, including the financial condition of the counterparty, expected future cash flows, observable fair prices and expected net selling prices An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its estimated recoverable amount The recoverable amount is the higher of an asset's fair value less costs to sell and the present value of estimated future cash flows discounted at the asset's original effective interest rate

Non-financial assets

Assets that have an indefinite useful life are not subject to amortisation or depreciation and are tested annually for impairment Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable

An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its estimated recoverable amount The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows

If there is objective evidence that an impairment loss has occurred, the amount of the loss is charged to the relevant line in the statement of comprehensive income in the period in which it occurs Non-financial assets for which impairment was recognised in prior periods are reviewed for possible reversal of the impairment at each reporting date

Impairment process

Objective evidence that an asset or group of assets is impaired includes observable data that comes to the attention of the Company about the following events

(i) significant financial difficulty of the issuer or debtor,
(ii) a breach of contract,
(iii) the disappearance of an active market for that asset because of financial difficulties, or
(iv) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of assets since the initial recognition of those assets, even where the decrease cannot yet be identified with the individual assets of the Company, including
   - adverse changes in the payment status of issuers or debtors, or
   - national or local economic conditions that correlate with defaults on the assets in the Company

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

1 Accounting policies (continued)

(o) Impairment (continued)

The Company first assesses whether objective evidence of impairment exists individually for assets that are individually significant If the Company determines that no objective evidence of impairment exists for an individually assessed asset, whether significant or not, it includes the asset in a group of assets with similar credit risk characteristics and collectively assesses them for impairment Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the issuer's ability to pay all amounts due under the contractual terms of the debt instrument being evaluated Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment

(p) Taxes

Tax on the profit or loss for the year is recognised in the statement of comprehensive income within taxation and comprises current and deferred tax

Current tax

Current tax is the expected tax payable on the taxable income for the period, using tax rates and legislation enacted or substantively enacted at the reporting date, together with adjustments to estimates made in prior years

Deferred tax

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes at the reporting date However, if the deferred income tax arises from initial recognition of an asset or liability in a transaction other than a business combination that, at the time of the transaction affects neither accounting nor taxable profit or loss, it is not accounted for The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates and legislation enacted or substantively enacted at the reporting date

Deferred income tax assets are only recognised to the extent that it is probable that future taxable profits will be available against which the temporary differences, carry-forward of unused tax assets and unused tax losses can be utilised

The carrying amount of deferred income tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the deferred income tax asset to be utilised

Allocation of tax charge between equity shareholder and policyholders

The tax expense in the statement of comprehensive income is analysed between policyholder and shareholder tax This allocation is based on an assessment of the rates of tax which will be applied to the returns under current UK tax rules

(q) Share capital

Shares are classified as equity when there is no obligation to transfer cash or other assets Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax

Dividends payable

Dividends payable on ordinary shares are recognised in equity in the period in which they are approved

(r) Insurance contracts

The Company issues life insurance contracts to protect customers from the consequences of events (such as death, critical illness or disability) that would affect the ability of the customer or their dependants to maintain their current level of income and also annuity contracts Guaranteed claims paid on occurrence of the specified insured event are either fixed or linked to the extent of the economic loss suffered by the policyholder

Insurance contracts which are not unit-linked

The liability is calculated by estimating the future cash flows over the duration of in-force policies and discounting them back to the valuation date, allowing for probabilities of occurrence The liability will vary with movements in interest rates and with the cost of life assurance and annuity benefits where future mortality is uncertain Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs Changes in the value of these liabilities are recognised in the statement of comprehensive income through changes in insurance contract liabilities

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

1 Accounting policies (continued)

(r) Insurance contracts (continued)

Insurance contracts which are unit-linked

Allocated premiums in respect of unit-linked insurance contracts are recognised as liabilities These liabilities are increased or reduced by the change in the unit prices and are reduced by policy administration fees, mortality and surrender charges and any withdrawals Where the mortality charges deducted in each period from the policyholders as a group are not considered adequate to cover the expected total death benefit claims in excess of the contract account balances in each period, additional liabilities are established for these claims Similarly, where deductions made for policy administration are not considered adequate to cover policy administration costs, additional liabilities are established Revenue consists of fees deducted for mortality, policy administration and surrender charges Interest or changes in the unit prices credited to the account balances incurred in the period are charged as expenses in the statement of comprehensive income, through changes in insurance contract liabilities as appropriate Benefit claims in excess of the account balances incurred in the period are charged as expenses in the statement of comprehensive income, through gross claims and benefits paid

(s) Provisions for other liabilities and charges

Provisions are recognised when the Company has a present legal or constructive obligation as a result of past events, when it is probable that the obligation will result in an outflow of resources to settle the obligation and when a reliable estimate of the amount of the obligation can be made If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessment of the time value of money and, where appropriate, the risks specific to the liability

The Company recognises provision for onerous contracts when the expected benefits to be derived from contracts are less than the unavoidable costs of meeting the obligations under the contracts

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably Contingent liabilities are not recognised in the financial statements but are disclosed unless the likelihood of possible obligations arising is remote

(t) Investment contracts

The Company's investment contracts are primarily unit-linked These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Company's unitised investment funds The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the reporting date Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable Investment income allocated to investment contracts is included in change in investment contract liabilities

Deposits and withdrawals are not accounted for through the statement of comprehensive income but are accounted for directly in the balance sheet as adjustments to the investment contract liability

Fee and commission income in relation to unit-linked investment business is presented within the Statement of Comprehensive Income within fee and commissions income

(u) Liability adequacy test

At each reporting date, liability adequacy tests are performed to ensure the adequacy of the insurance contract liabilities net of related deferred costs In performing these tests, current best estimates of future contractual cash flows, claims handling and policy administration expenses, as well as investment income from assets backing such liabilities, are used Any deficiency is immediately charged to the statement of comprehensive income, initially by writing off the relevant assets and subsequently by establishing a provision for losses arising from the liability adequacy tests

(v) Other financial liabilities

Other financial liabilities are initially recognised at fair value less directly attributable transaction costs and subsequently measured at amortised cost In practice, the carrying value of these balances equates to the fair value due to the short-term nature of the amounts included within other financial liabilities

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

1. Accounting policies (continued)

(w) Foreign currency translation

Items included in the financial statements of the Company are measured using the currency of the primary economic environment in which the entity operates (the "functional currency") The financial statements are presented in pounds sterling, rounded to the nearest million ("£ m"), which is the Company's presentation and functional currency

Monetary items denominated in foreign currencies are translated into sterling at the exchange rates ruling at the reporting date Non-monetary items denominated in foreign currencies that are measured at fair value are translated at the exchange rates ruling at the date when the current fair value is determined Non-monetary items denominated in foreign currencies that are measured at historical cost are translated at the exchange rates ruling at the date of the transaction Revenue transactions and those relating to the acquisition and realisation of investments have been translated at average rates of exchange (unless this is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case revenue transactions are translated at the dates of the transactions) Any exchange differences are dealt with in that part of the statement of comprehensive income in which the underlying transaction is reported

(x) Collateral

The Company receives or pledges collateral in the form of cash or securities in respect of derivative transactions it undertakes The Company also receives collateral in the form of securities in respect of stock lending agreements, repurchase agreements and certain loans made to related parties Collateral received is recognised as an asset on the balance sheet when the risks and rewards of ownership are substantially transferred to the Company A corresponding liability for repayment of collateral is recognised in financial liabilities Collateral received that is legally segregated from the assets of the Company, is not recognised on the balance sheet Collateral pledged continues to be recognised as an asset on the balance sheet unless the risks and rewards have been substantially transferred to the counterparty

2 Critical accounting estimates and judgments in applying accounting policies

The Company's management makes estimates and judgments that affect the reported amount of assets and liabilities Estimates and judgments are continually evaluated and based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected

(a) Insurance contracts

The estimation of the ultimate liability arising from insurance contracts which are not unit-linked is the Company's most critical accounting estimate

For insurance contracts, the liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses, credit default and mortality Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets The most critical non-economic assumptions are mortality rates, lapse rates and levels of future expenses Such assumptions are based on recent actual experience, supplemented by industry information where appropriate

At each reporting date, the estimates and assumptions referred to above are reassessed for adequacy and changes will be reflected in adjustments to the liability through the statement of comprehensive income Further information on these assumptions is given in note 24

Sensitivities regarding changes to key assumptions in calculating insurance contract and participating investment contract liabilities are given in note 24

(b) Deferred acquisition costs

For insurance contracts and participating investment contracts (excluding those assessed on a realistic basis in accordance with FRS27) acquisition costs which are incurred during a financial period but which relate to subsequent financial periods are deferred to the extent that they are recoverable out of future revenue margins All other costs are recognised as expenses when incurred The calculation of the deferred acquisition cost asset and its pattern of amortisation requires estimation of both the expected pattern of receipt of future revenue margins and the period that the business is expected to remain in force Further information on this asset is given in note 10

The recognition of costs and income in respect of non-participating investment contracts is governed by IAS 18 "Revenue" Under this standard, directly attributable and incremental costs to securing new business are capitalised and are then subsequently amortised over the period of the provision of the investment management services Estimation is required of the period that the business is expected to remain in force and prudent assumptions are required for contracts which do not have a fixed maturity date

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

2 Critical accounting estimates and judgments in applying accounting policies (continued)

(c) Taxation

The Company recognises current and deferred tax assets in line with IAS 12 "Income Taxes" In recognising these assets, management takes into account the likely impact of tax issues that are subject to ongoing discussion with HM Revenue and Customs and other tax authorities With regard to the Company's deferred tax assets, a significant feature is the management judgment applied in determining the timing, sensitivities and probability of them reversing This judgment is based on tax forecasts reflecting new business assumptions, sensitivities and proposed management actions Further information in relation to the Company's current and deferred tax assets is set out in notes 9 and 11

(d) Fair value of financial instruments

In accordance with IFRS 7, the Company categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques These valuation techniques involve management judgement and estimates, the extent of which depends on the complexity of the instrument and the availability of market observable information Further details of these valuations are described in note 25

3 Transfer of Insurance Business from Halifax Non – Trading One Limited to the Company

On 11 October 2012, the Irish High Court in Dublin made an order sanctioning a scheme to transfer insurance business under Assurance Companies Act 1909, the Insurance Act 1989 and the European Communities (Life Assurance) Framework Regulations 1994 (as amended) (the Irish equivalent of what in the UK would be called a "Part VII transfer") The effective date for the transfer was 31 October 2012 and that transaction transferred part of the life assurance and permanent health elements of PPI business underwritten by HNTO (together with all liabilities relating to that business and admissible assets to match the liabilities of that business) to the Company with an approximate value of £13 million

4. Fee and commissions income

	2013 £ m	2012 £ m
Fund management and policy administration fees	1	2
Total	**1**	**2**

5 Investment income

	2013 £ m	2012 £ m
Investments at fair value through profit or loss		
Interest income on investments	59	74
Dividend income	255	264
Rental income on investment properties	10	11
Other	3	1
Total	**327**	**350**

6 Net gains on assets and liabilities at fair value through profit or loss

	2013 £ m	2012 £ m
Derivative financial instruments at fair value through profit or loss	(50)	(35)
Investments at fair value through profit or loss	791	504
Investment properties at fair value through profit or loss	(4)	(10)
Total	**737**	**459**

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

7 Operating expenses

	2013 £ m	2012 £ m
Acquisition and origination costs in respect of insurance and investment contracts	12	14
Expenses for administration	22	27
	34	41
Change in deferred acquisition costs	15	36
Total	**49**	**77**

The administration of the Company is undertaken by other group companies A recharge is levied from these undertakings to the Company in respect of those costs incurred on behalf of the Company

The Company had no direct employees during the year (2012 nil) The employee costs, including pension costs and share-based payment costs, are included in the recharges noted above

8 Auditors' remuneration

	2013 £'000	2012 £'000
Fees payable to the Company's auditor for the audit of the Company's annual financial statements	102	104
Fees payable to the Company's auditor and its associates for other services		
Audit related assurance services	123	123
Total	**225**	**227**

Audit fees for 2013 and 2012 were borne by another company within the group and recharged to the Company

9. Taxation

(a) Current year tax charge

	2013 £ m	2012 £ m
Current tax		
UK corporation tax	(1)	(5)
Adjustment in respect of prior years	1	-
Total current tax	-	(5)
Deferred tax		
Origination/(reversal) of temporary differences	10	(12)
Adjustment in respect of prior years	(7)	-
Change in tax rate	5	3
Total deferred tax	8	(9)
Total income tax credit/(charge)	**8**	**(14)**

The policyholder tax benefit or expense is included in income tax expense Policyholder tax is a credit of £7m (2012 charge of £23m), including a prior year tax credit of £1m (2012 nil)

The Finance Act 2013 was substantively enacted on 2 July 2013 The Act reduces the rate of corporation tax to 21 per cent with effect from 1 April 2014 and 20 per cent with effect from 1 April 2015 The impact of the corporation tax reductions to 21 and 20 per cent are reflected in the above table

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

9 Taxation (continued)

(b) Reconciliation of tax credit/(charge)

	2013 £ m	2012 £ m
Profit before tax	119	114
Tax at 23 25% (2012 24 5%)	(28)	(28)
Effects of		
Deferred tax assets not recognised	1	-
Dividend income not taxable	31	28
Policyholder tax	5	(17)
Change in tax rate	5	-
Adjustment in respect of prior years	(6)	3
Total	**8**	**(14)**

The standard rate of corporation tax in the UK changed from 24% to 23% with effect from 1 April 2013 Accordingly the Company's profits for this accounting period are taxed at an effective rate of 23 25%

10. Deferred acquisition costs

	2013 £ m	2012 £ m
At 1 January	145	181
Amounts incurred during the year	-	10
Amortisation during the year	(15)	(46)
At 31 December	**130**	**145**

Of the above total, £116m (2012 £111m) is expected to be recovered more than one year after the reporting date

11. Tax assets and liabilities

	2013 £ m	2012 £ m
Current tax receivables	46	30
Deferred tax assets	46	44
Total tax assets	**92**	**74**
Current tax payables	5	41
Deferred tax liabilities	26	33
Total tax liabilities	**31**	**74**

The current tax balances in the above table include £5m (2012 £31m) in respect of group relief for corporation tax which is payable to other companies within LBG

Of the deferred tax assets included in the above table, £32m (2012 £19m) is expected to be realised within one year of the reporting date

Of the deferred tax liabilities included in the above table, £3m (2012 £7m) is expected to be settled within one year of the reporting date

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

11. Tax assets and liabilities (continued)

(a) Recognised deferred tax

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax payables and when the deferred income taxes relate to the same fiscal authority The amounts are as follows

	2013 £ m	2012 £ m
Deferred tax assets comprise		
Expenses deductible in future periods	46	38
Other insurance related items	-	6
Total deferred tax assets	**46**	**44**
Deferred tax liabilities comprise		
Deferred acquisition costs	26	33
Total deferred tax liabilities	**26**	**33**
Net deferred tax assets	**20**	**11**

The deferred tax credit/(charge) in the income statement relating to each of the above items is as follows

	2013 £ m	2012 £ m
Expenses deductible in future periods	8	(17)
Deferred acquisition costs	7	12
Other insurance items	(7)	(4)
Total deferred tax charge	**8**	**(9)**

(b) Unrecognised deferred tax

Deferred tax assets have not been recognised in respect of unrelieved capital losses of £3m (2012 £133m), as there is insufficient certainty as to the availability of future profits In addition, the Company has an unrecognised deferred tax asset in respect of other losses of £nil (2012 (£4m))

12 Investment properties

	2013 £ m	2012 £ m
At 1 January	138	153
Additions – new properties	43	17
Additions – subsequent expenditure on existing properties	2	-
Disposals	(47)	(22)
Net loss from change in fair values	(4)	(10)
At 31 December	**132**	**138**

Investment property in the above table contains amounts of £132m (2012 £138m) which is held entirely within the long-term insurance funds of the Group These balances are not therefore readily available for use by the Group

Rental income arising from investment properties during the year amounted to £10m (2012 £11m), which is included in investment income Direct operating expenses (included within operating expenses) arising in respect of such investment properties during the year amounted to £nil (2012 £nil)

Expenditure on investment properties which did not generate rental income was £nil (2012 £nil) The carrying value of investment properties under development is £nil (2012 £nil)

The investment properties are independently valued by Colliers CRE on at least a quarterly basis for the purpose of determining the open market value of the properties

Due to the nature of the above assets, there is no fixed term associated with these investments

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

12. Investment Properties (continued)

Operating lease receipts and payments represent rental receivable and payable by the Company for certain of its properties Generally the Company's operating leases are for terms of 15 years or more

13 Assets arising from reinsurance contracts held

	2013 Insurance	2013 Classified as Fair value through profit or loss	2013 Total	2012 Insurance	2012 Classified as Fair value through profit or loss	2012 Total
	£ m	£ m	£ m	£ m	£ m	£ m
At 1 January	82	62	144	70	81	151
Movement recognised through the statement of comprehensive income	(3)	-	(3)	12	(2)	10
Movement recognised directly through the balance sheet	-	(26)	(26)	-	(17)	(17)
At 31 December	79	36	115	82	62	144
Amounts in respect of insurance contract liabilities	79	36	115	82	62	144
At 31 December	**79**	**36**	**115**	**82**	**62**	**144**

Assets arising from reinsurance contracts held include £103m (2012 £129m) that is expected to be settled more than one year after the reporting date

14 Derivative financial instruments

In the normal course of business, the Company enters into swap contracts, option contracts, index futures contracts and forward foreign exchange contracts All such contracts are undertaken either for efficient portfolio management purposes or for the purpose of matching contractual liabilities

Swap contracts include interest rate swaps An interest rate swap is an agreement between two parties to exchange fixed and variable interest rate payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amount

Option contracts include index and single equity options Such options represent a contract sold by one party to another party offering the right, but not the obligation, to buy or sell a financial asset at an agreed price on a specified future date or within a specified period of time

Index futures contracts are used to hedge the investment portfolio against adverse movements in underlying markets or effecting policy switches between markets without the need to trade the underlying securities Futures may also be used for the purposes of efficient portfolio management provided that their substance would otherwise be permitted as a series of direct transactions

Forward foreign exchange contracts are an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate

Details regarding derivative financial instruments are given in the following tables

	2013 Contract Amount	2013 Fair value asset	2013 Fair value liabilities	2012 Contract Amount	2012 Fair value asset	2012 Fair value liabilities
	£ m	£ m	£ m	£ m	£ m	£ m
Derivative financial instruments held for trading						
Swap contracts	1,098	12	1	1,401	42	3
Option contracts	990	51	20	384	58	-
Index futures contracts	103	2	1	732	2	1
Forward foreign exchange contracts	257	3	2	165	-	-
Total	**2,448**	**68**	**24**	**2,682**	**102**	**4**

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

14. Derivative financial instruments (continued)

Derivative financial instrument assets include £50m (2012 £91m) that is expected to be recovered more than one year after the reporting date

Derivative financial instrument liabilities include £20m (2012 £2m) that is expected to be settled more than one year after the reporting date

The amount of £36m (2012 £33m) was accepted by the Company in assets that it is permitted to sell or repledge even in the absence of default of the owner of the collateral The Company has an obligation to return these assets to the pledgor

Details of collateral accepted and pledged in respect of derivative financial instruments are given in note 25

15 Loans and receivables

	2013 £ m	2012 £ m
Accrued interest and rent	11	42
Amounts due from related parties	33	12
Loan to related parties	150	-
Collateral asset	28	1
Other	24	34
Total	**246**	**89**

Of the above total, £178m (2012 £1m) is expected to be recovered more than one year after the reporting date

£150m (2012 £nil) of the above balances are interest bearing The carrying amount of loans to related parties is a reasonable approximation of fair value

Amounts receivable under reinsurance contracts represent reinsurance receivables where the Company has the right to recover losses on contracts provided to policyholders

On the 17 December 2013 the Company issued a £150m loan to Scottish Widows plc ("the borrower"), a LBG subsidiary Interest on the loan is payable on an annual basis at a rate of 3 month LIBOR plus 0 3% The loan is repayable on demand within 13 months of written notice being given to the borrower, with the borrower having the option to prepay the whole or part of the amount loan at any time On the same date the borrower entered into a collateral arrangement with the Company Further information on the Company's collateral in respect of loans to related parties is set out in note 26

Further information in respect of credit risk is given in note 25

16 Investments at fair value through profit or loss

	2013 £ m	2012 £ m
At fair value		
Shares and other variable yield securities	8,868	8,960
Debt and other fixed/variable income securities	1,405	1,592
Total investments at fair value	**10,273**	**10,552**

In order to improve presentation, investments in subsidiaries held at fair value in the Company have been reclassified from investments in subsidiaries to investments at fair value through profit or loss for both the current and the preceding year The table below shows the values reclassified

	As at 31 December 2012 £ m	As at 1 January 2012 £ m
Investment in subsidiaries	(1,953)	(2,006)
Investments at fair value through profit and loss	1,953	2,006
Total	-	-

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

16 Investments at fair value through profit or loss (continued)

Included within shares and other variable yield securities are shares in subsidiary undertakings of £3,958m (2012 £1,953m, 2012 restated £2,368m) which are held at fair value through profit or loss The value of subsidiary undertakings has been restated to reflect the implementation of IFRS 10 as set out in note 28

Of the total shares and other variable yield securities, liquidity funds amount to £1,248 m (2012 £1,880m)

Of the total debt and other fixed/variable income securities above, £1,207 m (2012 £1,377m) are listed government bonds

Of the debt and other fixed/variable income securities, £1,224 m (2012 £1,380m) is expected to be recovered more than one year after the reporting date Due to the nature of shares and other variable yield securities, there is no fixed term associated with these securities

Interests in unconsolidated structured entities

Included within investments at fair value through profit or loss are investments in unconsolidated structured entities of £8,445m arising from investments in collective investment vehicles and limited partnerships

The collective investment vehicles and limited partnerships are primarily financed by investments from investors in the vehicles The investments are carried at fair value and the Company's maximum exposure to loss is equal to the carrying value of the investment However, investments in collective investment vehicles and limited partnerships are primarily held to match policyholder liabilities and the majority of the risk from a change in the value of the Company's investment is matched by a change in policyholder liabilities At 31 December 2013, the total net assets of unconsolidated collective investment vehicles and limited partnerships in which the Company held a beneficial interest was £114,514m During the year the Company has not provided any non-contractual financial or other support to these unconsolidated collective investment vehicles and limited partnerships

LBG's asset management businesses sponsors a range of collective investment vehicles and limited partnerships where it acts as the decision maker over the investment activities and markets the funds under one of LBG s brands The Company earns fees from managing the investments of these funds The investment management fees that the Company earned from these sponsored unconsolidated collective investment vehicles and limited partnerships, including those in which the Company held no interest at 31 December 2013, was £nil The carrying value of assets transferred to those funds during the year was £nil

17. Cash and cash equivalents

Cash and cash equivalents for use in the statement of cash flows include the following

	2013 £ m	2012 £ m
Cash at bank	3	5
Short term deposits	30	49
Total	**33**	**54**

Cash and cash equivalents in the above table contains amounts of £33m (2012 £54m) which are held entirely within the non profit fund of the Company These balances are not therefore readily available for use by the Company

18. Share capital

	2013 £ m	2012 £ m
Allotted, called up and fully paid share capital		
360,000,000 ordinary shares of £1 each	360	360

There were no changes in ordinary share capital during the year

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

19 Insurance contract liabilities

An analysis of the change in insurance contract liabilities and reinsurers' share of insurance contract liabilities is as follows

	2013			2012		
	£ m Gross	£ m Reinsurance	£ m Net	£ m Gross	£ m Reinsurance	£ m Net
At 1 January	10,207	(144)	10,063	10,591	(151)	10,440
Provision in respect of new business	26	-	26	233	-	233
Changes in existing business	(139)	21	(118)	(608)	19	(589)
Assumption changes	(18)	8	(10)	(20)	(12)	(32)
Transfer of business	-	-	-	11	-	11
At 31 December	10,076	(115)	9,961	10,207	(144)	10,063

On 31 October 2012 the Company acquired part of the life assurance and permanent health elements of PPI business underwritten by HNTO under an effective Part VII transfer (Assurance Companies Act 1909, the Insurance Act 1989 and the European Communities (Life Assurance) Framework Regulations 1994) Further information in relation to the acquisition of this business is set out in note 3

As the Company is wholly owned by an entity which prepares group financial statements, the Company has taken advantage of the provisions contained in FRS 27 and has not presented a capital position statement and supporting disclosures Information in which the Company is included is given in the financial statements of Lloyds Banking Group

An analysis of the expected maturities of insurance contract liabilities is given in note 25

20 Investment contract liabilities

An analysis of the change in net investment contract liabilities is as follows

	2013			2012		
	£ m Gross	£ m Reinsurance	£ m Net	£ m Gross	£ m Reinsurance	£ m Net
At 1 January	9	-	9	9	-	9
Changes in existing business provisions	-	-	-	-	-	-
At 31 December	9	-	9	9	-	9

An analysis of the expected maturities of investment contract liabilities is given in note 25

21. Other financial liabilities

	2013 £ m	2012 £ m
Amounts payable in respect of direct insurance business	1	1
Claims outstanding	86	95
Amounts payable on reinsurance contracts	3	11
Due to related parties	21	82
Due to brokers	30	60
Collateral liability	33	33
Other	34	8
Total	208	290

Of the above total, £33m (2012 £33m) is expected to be settled more than one year after the reporting date

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

22. Net decrease in operating assets and liabilities

	2013 £ m	2012[1] £ m
(Increase)/decrease in operating assets		
Investment property	6	15
Assets arising from reinsurance contracts held	29	7
Investments at fair value through profit or loss	279	128
Loans and receivables	(157)	(26)
Derivative financial instruments	34	88
Net decrease in operating assets	191	212
Increase/(decrease) in operating liabilities		
Insurance contract liabilities	(131)	(384)
Derivative financial instruments	20	(12)
Other financial liabilities	(82)	35
Net decrease in operating liabilities	(193)	(361)
Net decrease in operating assets and liabilities	**(2)**	**(149)**

[1] Reflects the implementation of IFRS 10 as set out in note 16

23. Dividends paid

	2013 £ m	2012 £ m
Total dividends paid on equity shares	100	-

The dividend paid in the year amounted to 27 78 pence per share

24 Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities

All policyholder liabilities are non-profit fund liabilities

(i) Insurance contracts

The insurance contract liabilities are determined on the basis of recognised actuarial methods and consistently with the approach to be used for the PRA returns The methods used involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting these cash flows back to the valuation date allowing for probabilities of occurrence

The liabilities will vary with movements in interest rates (this applies in particular to the cost of guaranteed benefits payable in the future) and with movements in the cost of life assurance and annuity benefits for which future mortality is uncertain

Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs Generally, assumptions used to value the liabilities contain a margin for adverse deviation and are determined as required by PRA rules This margin for adverse deviation is based on management's judgment and reflects management's views on the inherent level of uncertainty The assumptions to which the liabilities are most sensitive are the interest rates used to discount the cash flows and the mortality assumptions The key assumptions used in the measurement of the Non Profit Fund liabilities are

- Interest rates

  The rates used are derived consistently with the approach to be used for the PRA returns These limit the rates of interest that can be used by reference to a number of factors including the dividend and earnings yields on equities, rental income, and redemption yields on fixed interest assets at the valuation date Margins for risk are allowed for in the assumed interest rates These are derived from the limits contained in the PRA Rules, including reductions made to the available yields to allow for default risk based upon the credit rating of each stock, and an over-riding restriction which limits the yield from investments in property by reference to the yield from appropriate long-term gilts

- Mortality and morbidity

  The mortality and morbidity assumptions are set with regard to the Company's actual experience where this provides a reliable basis, and relevant industry data otherwise, and includes a margin for adverse deviation

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

24 Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

(i) Insurance contracts (continued)

- Maintenance expenses

Allowance is explicitly made for future policy costs Expense loadings are determined by reference to an internal analysis of current and expected future expense levels, plus a margin for adverse deviations Explicit allowance is made for future expense inflation from the valuation date No allowance is made for any expected reductions in expense levels that have not occurred at the valuation date

- Persistency rates

Prudent lapse rate assumptions have been used for term assurance business Whether a lapse rate is prudent broadly depends on whether the policy liability is negative or positive at any point in its life Thus for each policy a high lapse rate is assumed where the projected liability is negative and a low lapse rate is assumed where the projected liability is positive Prudent lapse rate assumptions have been used for investment bond business As the liabilities on bonds are non-negative, a low lapse rate is assumed

(ii) Investment contracts

These contracts are unit-linked The liability is determined by the value of corresponding unit-linked financial assets attributed to the contract holders at the balance sheet date

(1) Key assumptions

The principal assumptions underlying the calculation of the insurance contract liabilities are given below

(i) Investment returns and discount rates

Class of business	2013 Interest rate (net) %	2012 Interest rate (net) %
Conventional Life business	1 26	0 51
Non-unit reserves on linked business	1 26	0 51

(ii) Mortality assumptions

The mortality assumptions for the main classes of business are as follows

Term Assurances	2013	2012
Males		
Smoker	92% TMS00Select	103 5% TMS00Select
Non-Smoker	109 25% TMN00Select	103 5% TMN00Select
Females		
Smoker	109 25% TFS00Select	115% TFS00Select
Non-Smoker	109 25% TFN00Select	109 25% TFN00Select

Investment Bonds	2013	2012
Males	71 5% AMC00U	77% AMC00U
Females	93 5% AFC00U	93 5% AFC00U

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

24 Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

(2) The effect of changes in key assumptions

Changes in certain key assumptions were made during 2013 with the following impacts on profit after tax

Variable	Impact on profit after tax and equity for the year	
	2013 £m	2012 £m
Expenses	(1)	22
Inflation	(10)	6
Interest rates	13	(1)

(3) Sensitivity analysis (in respect of insurance contracts only)

The following table demonstrates the effect of changes in key assumptions on profit after tax assuming that the other assumptions remain unchanged In practice this is unlikely to occur, and changes in some assumptions may be correlated

Variable	Change in variable	Impact on profit after tax and equity for the year	
		2013 £ m	2012 £ m
Mortality	5% reduction	6	6
Lapses	10% reduction	(5)	(5)
Maintenance expenses	10% reduction	9	10
Interest rate – change in redemption yield (1)	0 25% reduction	(2)	(1)

(1) This interest rate sensitivity shows the impact of 0 25 per cent movement in gilt yields and all of the consequential impacts on key economic assumptions including the investment returns, the valuation rates of interest and values of assets backing the business in question This excludes any impact on assets not backing the liabilities

25 Risk management

The principal activity of the Company is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the United Kingdom The Company offers a wide range of life insurance products such as whole life and investment type products through the Lloyds Banking Group network and direct sales The Company also reinsures business with insurance entities external to the Group

The Company assesses the relative costs and concentrations of each type of risk through the Individual Capital Assessment ("ICA") material issues are escalated to the Insurance Risk Committee and the Insurance Executive Committee

This note summarises these risks and the way in which the Company manages them

(a) Governance framework

The Company is part of Lloyds Banking Group, which has established a risk management function with responsibility for implementing the Lloyds Banking Group risk management framework within the Company

Responsibility for the setting and management of risk appetite and risk policy resides with the Board who manage risks in line with LBG and Insurance risk policies The Board has delegated operational implementation to the Insurance Executive Committee

The approach to risk management aims to ensure that there is effective independent checking or "oversight" of key decisions through the operation of a "three lines of defence" model The first line of defence is line management, who have direct accountability for risk decisions Risk provide oversight and challenge and form the second line of defence Internal Audit constitutes the third line of defence, whose objective is to provide the required independent assurance to the Audit Committee and the Board that risks within the Company are recognised, monitored and managed within acceptable parameters

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25. Risk management (continued)

An enterprise-wide risk management framework for the identification, assessment, measurement and management of risk is in place The framework is in line with Lloyds Banking Group's risk management principles and covers the full spectrum of risks that the Company is exposed to Under this framework, risks are categorised according to an approved Lloyds Banking Group risk language which has been adopted across the Company This covers the principal risks faced by the Company, including the exposures to market, insurance, credit, financial soundness and operational risk The performance of the Company, its continuing ability to write business and the strategic management of the business depend on its ability to manage these risks

Policy owners, identified from appropriate areas across the business, are responsible for drafting the Insurance risk policies, for ensuring that they remain up-to-date and for facilitating any changes These policies are subject to at least an annual review, or earlier if deemed necessary Limits are prescribed within which those responsible for the day to day management of the Company can make decisions Line management are required to follow prescribed reporting procedures to the bodies responsible for monitoring compliance with policy and controlling the risks

(b) Risk appetite

Risk Appetite is the amount and type of risk that the Board is prepared to seek, accept or tolerate and is fully aligned to LBG Strategy The Board has defined the methodology for the management of Risk Appetite and approved a set of Risk Appetite Statements that cover Financial Risks (Strategic, Solvency and Capital, Earnings and Liquidity), Operational Risks, People and Risk Culture, Conduct Risks and Regulatory Risks The Risk Appetite Statements set limits for exposures to the key risks faced by the business

Experience against Risk Appetite is reported monthly to the Insurance Risk Committee, quarterly to the Insurance Risk Oversight Committee, to the LBG Group Risk Committee and to the LBG Board Risk Committee, and bi-annually to the Insurance Board Copies are also supplied regularly to Insurance's regulators as part of the close and continuous relationship Reporting focuses on ensuring, and demonstrating to the Insurance Board, and their delegate the Insurance Risk Oversight Committee, that Insurance is run in line with approves Risk Appetite Any breaches of Risk Appetite require clear plans and timescales for resolution

(c) Financial risks

The Company writes a variety of insurance and investment contracts which are subject to a variety of financial risks, as set out below Contracts can be either single or regular premium and conventional (non-profit) or unit-linked in nature

The Company is exposed to a range of financial risks through its financial assets, financial liabilities, reinsurance assets and insurance and investment contract liabilities In particular, the key financial risk is that long-term investment proceeds are not sufficient to fund the obligations arising from its insurance and investment contracts The most important components of financial risk are market, insurance, credit and financial soundness risk

The market risks that the Company primarily faces due to the nature of its investments and liabilities are interest rate, equity, foreign exchange and property risk

The Company manages these risks in a numbers of ways, including risk appetite assessment and monitoring of capital resource requirements The Company also uses financial instruments (including derivatives) as part of its business activities and to reduce its own exposure to market risk and credit risk

For unit-linked business, policyholders' benefits are closely linked to the investment returns on the underlying internal funds In the short term, profit and equity are therefore largely unaffected by investment returns on assets in internal unit-linked funds as any gains or losses will be largely offset by changes in the corresponding insurance and investment contract liabilities, provided that there is appropriate matching of assets and liabilities within these funds However, any change in the market value of these funds will have an indirect impact on the Company through the collection of annual management and other fund related charges As markets rise or fall, the value of these charges rises or falls correspondingly

For non-participating business, other than unit-linked business, the principal market risk is interest rate risk, which arises because assets and liabilities may exhibit differing changes in market value as a result of changes in interest rates Asset and liability matching is used to mitigate the impact of changes in interest rates

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost The summary of significant accounting policies (note 1) describes how the classes of financial instruments are measured and how income and expenses, including fair value gains and losses, are recognised

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25. Risk management (continued)

The timing of the unwind of the deferred tax assets and liabilities is dependent on the timing of the unwind of the temporary timing differences, arising between the tax bases of the assets and liabilities and their carrying amounts for financial reporting purposes, to which these balances relate

A maturity analysis of the financial liabilities set out in the later tables is given in the financial soundness risk section of this note

The sensitivity analyses given throughout this note are based on a change in an assumption while holding all other assumptions constant In practice, this is unlikely to occur as changes in some of the assumptions may be correlated, for example changes in interest rates and changes in market values The sensitivity analysis presented also represents, in accordance with the requirements of IFRS 7, management's assessment of a reasonably possible alternative in respect of each sensitivity, rather than worst case scenario positions

1. Market risk

Market risk is the risk of reductions in earnings and/or value, through financial or reputational loss, from unfavourable market movements This risk typically arises from fluctuations in market interest rates (interest rate risk), market prices (equity and property risk), and foreign exchange rates (foreign exchange risk), whether such changes are caused by factors specific to the individual instrument or its issuer or factors affecting all instruments traded in the market

Investment holdings within the Company are diversified across markets and, within markets, across sectors Holdings of individual assets are diversified to minimise specific risk and large individual exposures are monitored closely For assets heldout with unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid

Market risk policy is dependent on the nature of the funds in question, and can be broadly summarised as follows

- Assets held in shareholder funds are invested in money market funds, gilts and investment grade bonds to match regulatory capital requirements The balance of the shareholder fund assets is managed in line with the policies of the Lloyds Banking Group to optimise shareholder return and minimise risk This includes suitable use of derivatives to minimise shareholder risk
- Unit-linked assets are invested in accordance with the nature of the fund mandates
- Conventional non-profit liabilities are "close matched" as far as possible in relation to currency, nature and duration

Below is an analysis of assets and liabilities at fair value through profit or loss and assets and liabilities for which a fair value is required to be disclosed, according to their fair value hierarchy (as defined in note 1 (d))

As at 31 December 2013

	Fair value hierarchy Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	-	-	132	132
Equity securities, debt securities and holdings in OEICS	10,075	53	145	10,273
Derivative financial assets	5	63	-	68
Total	10,080	116	277	10,473
Derivative financial liabilities	3	21	-	24
Investment contract liabilities	-	9	-	9
Total	3	30	-	33

As at 31 December 2012

	Fair value hierarchy Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	-	-	138	138
Equity securities, debt securities and holdings in OEICS	10,324	28	200	10,552
Derivative financial assets	2	100	-	102
Total	10,326	128	338	10,792
Derivative financial liabilities	-	4	-	4
Investment contract liabilities	-	9	-	9
Total	-	13	-	13

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25 Risk management (continued)

1 Market risk (continued)

The derivative securities classified as Level 2 above have been valued using a tri-party pricing model as determined by the Pricing Source Agreement between Scottish Widows Investment Partnership ("SWIP") and State Street Prices are sourced from external sources, counterparties, and the Investment Manager Where the primary value is within tolerance of the secondary value, the primary value will be utilised If the primary and secondary values are out of tolerance, then the primary value will be validated against the tertiary value If it is within tolerance the primary value will be applied If primary and tertiary values are outwith tolerance, then the secondary value is validated against the tertiary value If secondary and tertiary values are within tolerance, then the secondary value is applied If they are out of tolerance then the investment manager is notified to allow them to make the final pricing decision

Assets classified as level 3 comprise asset backed securities, investment property and covered bonds

Investment property is independently valued as described in note 12 Valuations are based on observable market prices for similar properties Adjustments are applied, if necessary, for specific characteristics of the property, such as the nature, location or condition of the specific asset If such information is not available alternative valuation methods such as discount cash flows analysis or recent prices in less active markets Where any significant adjustments to observable market prices are required, the property would be classified as level 3

Asset backed securities and covered bonds classified as level 3 are not actively traded, and are valued using a discounted cash flow model The valuation incorporates credit risk spreads, which are generally based on observable spreads on similar securities, plus a liquidity premium Assumptions are made about the expected life of the securities, reflecting prepayment behaviour The effect of applying reasonably possible alternative assumptions to the value of these asset backed securities and covered bonds would be to decrease the fair value by £3m or increase it by £3m

The table below shows movements in the assets and liabilities measured at fair value based on valuation techniques for which any significant input is not based on observable market data (level 3 only)

	2013		2012	
	£m	£m	£m	£m
	Assets	*Liabilities*	*Assets*	*Liabilities*
Balance at 1 January	338	-	153	-
Total net gains/(losses) recognised within net gains/(losses) on assets and liabilities at fair value though profit or loss in the statement of comprehensive income	(17)	-	(12)	-
Purchases	81	-	219	-
Disposals	(125)	-	(22)	-
Balance at 31 December	277	-	338	-
Total unrealised gains/(losses) for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	(17)	-	(2)	-

Total gains or losses for the period included in the statement of comprehensive income, as well as total gains or losses relating to assets and liabilities held at the reporting date, are presented in the statement of comprehensive income, through net gains/losses on assets and liabilities at fair value through profit or loss

(i) Equity risk and property risk

The exposure of the Company's insurance and investment contract business to equity and property risk relates to financial assets and financial liabilities whose values will fluctuate as a result of changes in market prices other than from interest and foreign exchange fluctuations This is due to factors specific to individual instruments, their issuers or factors affecting all instruments traded in the market Accordingly, the Company monitors exposure limits both to any one counterparty and any one market

There is no material sensitivity due to fluctuations in market prices at the reporting date to the fair value of future cash flows in respect of properties, net of offsetting movements in insurance and investment contract liabilities

The table below shows the sensitivity in respect of equities

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25. Risk management (continued)

1 Market risk (continued)

Impact on profit after tax and equity at reporting date	2013 £ m	2012 £ m
10% (2012 10%) increase in equity prices	(4)	(4)
10% (2012 10%) decrease in equity prices	4	4

(ii) Interest rate risk

Interest rate risk is the risk that the value of future cash flows of a financial instrument will fluctuate because of changes in interest rates and the shape of the yield curve Interest rate risk in respect of the Company's insurance and investment contracts arises when there is a mismatch in duration or yield between liabilities and the assets backing those liabilities

The Company's interest rate risk policy requires that the maturity profile of interest-bearing financial assets is appropriately matched to the guaranteed elements of the financial liabilities

A fall in market interest rates will result in a lower yield on the assets supporting guaranteed investment returns payable to policyholders This investment return guarantee risk is managed by matching assets to liabilities as closely as possible An increase in market interest rates will result in a reduction in the value of assets subject to fixed rates of interest which may result in losses if, as a result of an increase in the level of surrenders, the corresponding fixed income securities have to be sold

The effect of changes in interest rates in respect of financial assets which back insurance contract liabilities is given in note 25 The effect on the Company of changes in the value of investments held in respect of investment contract liabilities due to fluctuations in market interest rates is negligible as any changes will be offset by movements in the corresponding liability

The sensitivity analysis below illustrates how the fair value of future cash flows in respect of interest-bearing financial assets, net of offsetting movements in insurance and investment contract liabilities, will fluctuate because of changes in market interest rates at the reporting date

Impact on profit after tax and equity at reporting date	2013 £ m	2012 £ m
25 basis points (2012 25 basis points) increase in yield curves	2	1
25 basis points (2012 25 basis points) decrease in yield curves	(2)	(1)

(iii) Foreign exchange risk

Foreign exchange risk relates to the effects of movements in exchange markets including changes in exchange rates The overall risk to the Company is minimal due to the following

- The Company's principal transactions are carried out in pounds sterling,
- The Company's financial assets are primarily denominated in the same currencies as its insurance and investment contract liabilities, and
- Other than shareholder funds, all non-linked investments of the non-profit funds are in sterling or are currency matched The effect on the Company of changes in the value of investments held in respect of investment contract liabilities due to fluctuations in foreign exchange rates is negligible as any changes will be offset by movements in the corresponding liability

2. Insurance risk

Insurance risk is the risk of reductions in earnings and/or value through financial or reputational loss due to fluctuations in the timing, frequency and severity of insured events and to fluctuations in the timing and amount of claim settlements The principal risk the Company faces under insurance contracts is that the actual claims and benefit payments exceed the amounts expected at the time of determining the insurance liabilities

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25 Risk management (continued)

2 Insurance risk (continued)

The nature of the Company's business involves the accepting of insurance risks which primarily relate to mortality, morbidity, persistency and expenses The Company underwrites new business policies to ensure an appropriate premium is charged for the risk or that the risk is declined

The Company principally writes the following types of life insurance contracts

- Life assurance – where the life of the policyholder is insured against death or permanent disability, usually for pre-determined amounts
- Morbidity products – where the policyholder is insured against the risk of contracting a defined illness

For contracts where death is the insured risk, the most significant factors that could increase the overall level of claims are epidemics or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected

For contracts where survival is the insured risk, the most significant factor is continued improvement in medical science and social conditions that would increase longevity

For contracts with fixed and guaranteed benefits and fixed future premiums, there are no mitigating terms and conditions that significantly reduce the insurance risk accepted

Insurance risk is also affected by the policyholders' right to pay reduced or no future premiums or to terminate the contract completely As a result, the amount of insurance risk is also subject to policyholder behaviour On the assumption that policyholders will make decisions that are in their best interests, overall insurance risk will generally be aggravated by policyholder behaviour For example, it is likely that policyholders whose health has deteriorated significantly will be less inclined to terminate contracts insuring death benefits than those policyholders who remain in good health

The Company has taken account of the expected impact of policyholder behaviour in setting the assumptions used to measure insurance and investment contract liabilities

The principal methods available to the Company to control or mitigate mortality and morbidity risk are through the following processes

- Underwriting (the process to ensure that new insurance proposals are properly assessed),
- Pricing-to-risk (new insurance proposals would usually be priced in accordance with the underwriting assessment),
- Claims management,
- Product design,
- Policy wording, and
- The use of reinsurance and other risk mitigation techniques

Rates of mortality and morbidity are investigated annually based on the Company's recent experience and future mortality assumptions are set using the latest population data available Where they exist, the reassurance arrangements of the Company are reviewed at least annually

Persistency risk is the risk associated with the ability to retain long-term business and the ability to renew short-term business The Company aims to reduce its exposure to persistency risk by undertaking various initiatives to promote customer loyalty These initiatives are aimed both at the point of sale and through direct contact with existing policyholders, for example, through annual statement information packs

Further information on assumptions, changes in assumptions and sensitivities in respect of insurance contracts is given in note 24

3. Credit risk

Credit risk is the risk of reductions in earnings and/or value, through financial or reputational loss, as a result of the failure of the party with whom the Company has contracted to meet its obligations

Investment counterparty default risk arises primarily from holding invested assets to meet liabilities, and reinsurer default credit risk primarily arises from exposure to reinsurers

Credit risk in respect of unit-linked funds is borne by the policyholders Consequently, the Company has no significant exposure to credit risk for those funds

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25. Risk management (continued)

3 Credit risk (continued)

For non-linked fund investments, limits on the exposure to a single entity are specified and monitored Bond exposures are managed through credit rating bands and maximum exposures to individual assets and sectors are set Assets are restricted to securities in a specified list of countries, and limits applicable to property portfolios are set to prevent concentration of exposure to single tenants and single buildings

Shareholder funds are managed in line with the Insurance Credit Risk Policy and the wider LBG Credit Risk Policy and the principles are the same as those outlined above in respect of non-linked funds

Reinsurance is primarily used to reduce insurance risk However, it is also sought for other reasons such as improving profitability, reducing capital requirements and obtaining technical support In addition, reinsurance is also used to offer Investment Fund Links which we are unable to provide through other means The Company's reinsurance strategy is to reduce the volatility of profits through the use of reinsurance whilst managing the insurance and credit risk within the constraints of the risk appetite limits

The Company has reinsurance on some lines of business where mortality or morbidity risk exceeds set retention limits This does not, however, discharge the Company's liability as primary insurer If a reinsurer fails to pay a claim for any reason, the Company remains liable for the payment to the policyholder All new material reinsurance treaties are subject to Board approval and reinsurance arrangements are reviewed annually to ensure that the reinsurance strategy is being achieved

Policies are treated as lapsed when payments from the policyholder have not been received for three consecutive months and the policyholder has not provided further information in respect of the non-payment of premiums

Exposure to other trade debtors is assessed on a case by case basis, using a credit rating agency where appropriate

The tables below analyse financial assets subject to credit risk using Standard & Poor's rating or equivalent

As at 31 December 2013

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Debt securities	1,405	143	1,212	43	7	-
Derivative financial instruments	68	-	-	46	22	-
Loans and receivables	246	-	11	227	-	8
Reinsurers' share of insurance contract liabilities	115	-	79	-	-	36
Cash and cash equivalents	33	-	25	7	1	-
Total	1,867	143	1,327	323	30	44

*Of which £30 m is BBB rated

Amounts classified as "not rated" are not rated by Standard & Poor's or an equivalent rating agency The 'not rated' reinsurers' share of insurance contract liabilities relate to a Company within LBG

As at 31 December 2012

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Debt securities	1,592	1,573	9	3	7	-
Derivative financial instruments	102	-	-	102	-	-
Loans and receivables	89	12	-	20	-	57
Reinsurers' share of insurance contract liabilities	144	-	68	15	-	61
Cash and cash equivalents	54	-	-	54	-	-
Total	1,981	1,585	77	194	7	118

*Of which £7m is BBB rated

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25 **Risk management (continued)**

3 Credit risk (continued)

Amounts classified as "not rated" within loans and receivables and assets arising from reinsurance contracts held include £nil (2012 £nil) due from other Group companies which are not rated by Standard & Poor's or an equivalent rating agency

(i) Concentration risk

Credit concentration risk

Credit concentration risk relates to the inadequate diversification of credit risk

The Company requires strict control limits on the derivative positions held by each fund as set out in the Insurance Derivatives Risk Policy ("DRP")

Credit risk is managed through the setting and regular review of counterparty credit and concentration limits on asset types which are considered more likely to lead to a concentration of credit risk For other asset types, such as UK government securities or investments in funds falling under the UCITS Directive, no limits are prescribed as the risk of credit concentration is deemed to be immaterial This policy supports the approach mandated by the Prudential Regulation Authority for regulatory reporting

At 31 December 2013 and 31 December 2012, the Company did not have any significant concentration of credit risk with a single counterparty or group of counterparties where limits applied With the exception of Government bonds and UCITS funds, the largest aggregated counterparty exposure is approximately 2% (2012 6%) of the Company's total assets, excluding unit-linked funds where credit risk is matched by policyholder liabilities

Liquidity concentration risk

Liquidity concentration risk arises where the Company is unable to meet its obligations as they fall due or do so only at an excessive cost, due to over-concentration of investments in particular financial assets or classes of financial asset

As most of the Company's invested assets are diversified across a range of marketable equity and debt securities in line with the investment options offered to policyholders it is unlikely that a material concentration of liquidity concentration could arise

This is supplemented by active liquidity management in the Company, to ensure that even under stress conditions the Company has sufficient liquidity as required to meet its obligations This is delegated by the Board to and monitored through the Insurance Risk Committee ("IRC"), Insurance Shareholder Investment Management Committee ("ISIM") and Banking and Liquidity Operating Committee ("BLOC")

(ii) Collateral management

Collateral in respect of derivatives

The Company requires strict control limits on net open derivative positions, namely the difference between purchase and sale contracts, by both amount and term The amount subject to credit risk at any one time is limited to the current fair value of instruments that are favourable to the Company (that is, assets), which in relation to derivatives is only a fraction of the contract or notional values used to express the volume of instruments outstanding For derivative asset positions, the value of collateral held is at least equal to the value of the asset held on the balance sheet

The requirement for collateralisation of OTC derivatives, including the levels at which collateral is required and the types of asset that are deemed to be acceptable collateral, are set out in a Credit Support Annex ("CSA") A CSA is a bilateral legal agreement which, once signed, forms part of the International Swaps and Derivatives Association ("ISDA") agreement between the Company and the counterparty

A CSA must be completed for OTC derivatives as part of the contracts for such transactions The CSA will require collateralisation where any net exposure to a counterparty exceeds the OTC counterparty limit, which must be established in accordance with the DRP The aggregate uncollateralised exposure to any one counterparty must not exceed limits specified in the DRP Where derivative counterparties are related, the aggregate net exposure is considered for the purposes of applying these limits

The aggregate exposure to any one counterparty, net of any collateralisation, across all life companies, funds and transactions, should not exceed £10m

Collateralisation is the pledging or receiving of assets as a guarantee against the fulfilment of a future obligation, normally through a cash transfer or asset delivery

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25 Risk management (continued)

3 Credit risk (continued)

Acceptable collateral is defined in each instance and must take into account the quality and appropriateness of the proposed collateral as well as being acceptable to the entity receiving the collateral Collateral may include the following

- Sovereign government debt of developed economies,
- Supranational debt denominated in eligible currencies,
- Corporate bonds denominated in eligible currencies
- Equities denominated in eligible currencies, and
- Cash (this is received and invested in the SWIP Global Liquidity Fund)

Assets with the following carrying amounts have been pledged in accordance with the terms of the relevant CSAs entered into in respect of various OTC derivative contracts

	2013 £ m	2012 £ m
Cash and cash equivalents	-	1
Total	-	1

The Company has the right to recall any collateral pledged provided that this is replaced with alternative acceptable assets Collateral pledged continues to be recognised on the Company's balance sheet Collateral amounts held are not recognised as assets The policy of the Company is not to repledge assets No collateral (2012 £nil) was sold during the year At 31 December 2013, assets with a fair value of £36m (2012 £33m) were available to the Company to sell even in the absence of default by the counterparty None of these assets were past due or impaired at 31 December 2013 or 31 December 2012 In the event of default, assets received as collateral are sold

Collateral held in respect of OTC derivatives at 31 December 2013 had a fair value of £36m (2012 £89m)

All collateral held relates to fully performing assets

Collateral in respect of loans to related parties

The Company has made loans to related parties against which collateral is held The collateral includes asset backed securities and covered bonds with a fair value of at least 130% of the cash lent

Collateral amounts held are not recognised as assets At 31 December 2013, collateral with a fair value of £207m (2012 £nil) was available to the Company to sell or repledge in the absence of default by the counterparty The policy of the Company is not to repledge assets, and no collateral (2012 £nil) was sold or repledged during the year The Company have an obligation to return these assets to the pledgor

Collateral in respect of stocklending

The Company enters into stocklending transactions The Insurance Investment Strategy Committee (IISC) and its sub-committee Investment Management Operational Review Committee (IMOR) are responsible for setting the parameters of stocklending and therefore changes to those parameters The accepted collateral can include cash, equities, certain bonds and money market instruments On a daily basis, the fair value of collateral is compared to the fair value of stock on loan The value of collateral must always exceed the value of stock on loan

Stocklending is permitted in accordance with the Insurance Stocklending Policy All stocklending takes place on an open/call basis, enabling the loan to be recalled at any time within the standard settlement terms of the market concerned

The policy requires all lending to be undertaken via a fully indemnified programme (where the agent of the programme provides an indemnification against borrower and collateral default)

Additionally, IMOR will set limits on the maximum amount of any security that may be lent and the markets in which lending can take place

The policy requires acceptable collateral to be pledged to at least the value of securities lent and sets specific parameters over what qualifies as acceptable collateral

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25. Risk management (continued)

3. Credit risk (continued)

The aggregate value of securities on loan by the Company is £944m (2012 £1,025m) Securities on loan are included in investments at fair value through profit or loss and no account is taken of collateral held The aggregate fair value of collateral held is £994m (2012 £1,071m) for the Company

There were no collateral defaults in respect of stocklending during the year ended 31 December 2013 (2012 none) which required a call to be made on collateral

iii) Offsetting

The following table shows the potential effect of netting arrangements

As at 31 December 2013

	Gross amounts of assets / liabilities £ m	Amounts set off in the balance sheet £ m	Net amounts presented in the balance sheet £ m	Related amounts where set off not permitted in the balance sheet: Financial instruments £ m	Related amounts where set off not permitted in the balance sheet: Cash Collateral £ m	Potential net amounts if offset of related amounts permitted £ m
Financial assets						
Derivatives	62	-	62	(20)	(36)	6
Financial liabilities						
Derivatives	(21)	-	(21)	20	-	1

As at 31 December 2012

	Gross amounts of assets / liabilities £ m	Amounts set off in the balance sheet £ m	Net amounts presented in the balance sheet £ m	Related amounts where set off not permitted in the balance sheet: Financial instruments £ m	Related amounts where set off not permitted in the balance sheet: Cash Collateral £ m	Potential net amounts if offset of related amounts permitted £ m
Financial assets						
Derivatives	100	-	100	-	(88)	12
Financial liabilities						
Derivatives	(3)	-	(3)	-	-	(3)

4. Financial soundness risk

Financial soundness risk covers the risk of financial failure, reputational loss or loss of earnings and/or value arising from a lack of liquidity, funding or capital and/or the inappropriate recording, reporting or disclosure of financial, taxation and regulatory information

(i) Financial and prudential regulatory reporting, tax and disclosure risks

The Company is exposed to the risk that policies and procedures are not sufficient to maintain adequate books and records to support statutory, regulatory and tax reporting and to prevent and detect financial reporting fraud

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25 Risk management (continued)

4. Financial soundness risk (continued)

The Company has developed procedures to ensure that compliance with both current and potential future requirements are understood and that policies are aligned to its risk appetite The Company has established a system of internal controls, the objective of which is to provide reasonable assurance that transactions are recorded and undertaken in accordance with delegated authorities that permit the preparation and disclosure of financial statements, regulatory reporting and tax returns in accordance with IFRSs, statutory and regulatory requirements

The Company undertakes a programme of work designed to support an annual assessment of the effectiveness of internal controls over financial reporting, to identify tax liabilities and to assess emerging legislation and regulation

(ii) Liquidity risk

Liquidity risk is the risk that the Company will encounter difficulty in raising funds to meet its financial commitments as they fall due, or can secure them only at an excessive cost Liquidity risk may result from either the inability to sell financial assets quickly at their fair values, or from an insurance liability falling due for payment earlier than expected, or from the inability to generate cash inflows as anticipated

Liquidity risk has been analysed as arising from payments to policyholders (including those where payment is at the discretion of the policyholder) and non policyholder related activity (such as investment purchases and the payment of shareholder expenses)

In order to measure liquidity risk exposure the Company's liquidity is assessed in a stress scenario A new liquidity risk appetite statement was approved in January 2013 The new appetite considers two time periods, a three month stressed outflow is required to be covered by primary liquid assets, and a one year stressed outflow is required to be covered by primary and secondary liquid assets, after taking account of management actions Primary liquid assets are gilts or cash, and secondary liquid assets are tradable non-primary assets Stressed outflows are based on the most severe of several scenarios

Group firm-specific stress scenarios, PRA market-wide scenarios, and PRA market wide scenarios with Insurance-specific overlays A liquidity risk appetite coverage ratio of over 150% is rated green

Liquidity risk in respect of each of the major product areas is primarily mitigated as follows

Non-participating funds

For unit-linked products, portfolios are invested in accordance with unit fund mandates Deferral clauses are included in policyholder contracts to give time, when necessary, to realise linked assets without being a forced seller As at 31 December 2013, there are no funds under management subject to deferral

For non unit-linked products, investments are mostly held in gilts with minimal liquidity risk Investments are arranged to minimise the possibility of being a distressed seller whilst at the same time investing to meet policyholder obligations This is achieved by anticipating policyholder behaviour and sales of underlying assets within funds

Shareholder funds

For shareholder funds, liquidity risk is managed in line with the Insurance Liquidity Risk Policy and the wider Lloyds Banking Group Funding and Liquidity Risk Policy

The following tables indicate the timing of the contractual cash flows arising from the Company's financial liabilities, as required by IFRS 7 The table is based on the undiscounted cash flows of financial liabilities based on the earliest date on which the Company is obliged to pay The table includes both interest and principal cash flows

Liquidity risk in respect of insurance contract liabilities has been analysed based on the expected pattern of maturities as permitted by IFRS 4 rather than by contractual maturity A maturity analysis of investment contracts based on expected contract maturities is also given as it is considered that this analysis provides additional useful information in respect of the liquidity risk relating to contracts written by the Company

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25 Risk management (continued)

4. Financial soundness risk (continued)

As at 31 December 2013

Liabilities	Carrying amount*	Contractual cash flows (undiscounted)					
		No stated maturity	Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m	£ m
Investment contract liabilities	9	-	9	-	-	-	-
Derivative financial instruments	24	-	-	3	1	5	15
Other financial liabilities	208	145	30	-	-	33	-
Total	241	145	39	3	1	38	15

As at 31 December 2012

Liabilities	Carrying amount*	Contractual cash flows (undiscounted)					
		No stated maturity	Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m	£ m
Investment contract liabilities	9	-	9	-	-	-	-
Derivative financial instruments	4	-	-	1	-	3	-
Other financial liabilities	290	-	257	-	-	33	-
Total	303	-	266	1	-	36	-

*The carrying amount is presented on a discounted basis In accordance with IFRS 7, the contractual cash flows are presented on an undiscounted basis

The contractual cash flow analysis set out above has been based on the earliest possible contractual date, regardless of the surrender penalties that might apply and has not been adjusted to take account of such penalties

An analysis of the contractual cash flows in respect of insurance and investment contract liabilities by expected contract maturity, on a discounted basis, is shown below

As at 31 December 2013

Maturity Analysis for insurance and investment contract liabilities	Total	Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m
Insurance contracts	10,076	91	186	817	2,822	6,160
Investment contracts	9	-	-	1	3	5

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25 Risk management (continued)

4 Financial soundness risk (continued)

As at 31 December 2012

Maturity Analysis for insurance and investment contract liabilities	Total £ m	Less than 1 month £ m	1-3 months £ m	3-12 months £ m	1-5 years £ m	More than 5 years £ m
Insurance contracts	10,207	90	195	750	3,098	6,074
Investment contracts	9	-	-	1	3	5

(iii) Capital risk

Capital risk is defined as the risk that

- the Company has insufficient capital to meet its regulatory capital requirements,
- the Company has insufficient capital to provide a stable resource to absorb all losses up to a confidence level defined in the risk appetite,
- the Company loses reputational status by having capital that is regarded as inappropriate, either in quantity, type or distribution, and/or
- the capital structure is inefficient

Within the Insurance Division, capital risk is actively monitored by the Insurance Finance Committee

The business of the Company is regulated by the PRA and the FCA (Financial Conduct Authority) The PRA specifies the minimum amount of capital that must be held by the Company in addition to its insurance liabilities

Under the PRA rules, each insurance Company must hold assets in excess of the higher of

- the Pillar 1 amount, which is calculated by applying fixed percentages of mathematical reserves and capital at risk, and
- the Pillar 2 amount, which is derived from an economic capital assessment undertaken by each regulated Company, which is reviewed by the PRA

In addition capital requirements and capital available under Solvency II are estimated in order to ensure that Solvency II capital requirements will be met when Solvency II is introduced

The minimum required capital must be maintained at all times throughout the year These capital requirements and the capital available to meet them are regularly estimated in order to ensure that capital maintenance requirements are being met

The Company's objectives when managing capital are

- to have sufficient capital to safeguard the Company's ability to continue as a going concern so that it can continue to provide returns for the shareholder and benefits for other stakeholders,
- to comply with the insurance capital requirements set out by the PRA in the UK, and
- and when capital is needed, to require an adequate return to the shareholder by pricing insurance and investment contracts according to the level of risk associated with the business written

The capital management strategy is such that the single integrated insurance business (comprising SWG and its subsidiaries, including the Company) will hold capital in line with the stated risk appetite for the business, which is to be able to withstand a one in ten year stress event without breaching the capital requirements At SWG level it is intended that all surplus capital above that required to absorb a one in ten year stress event will be distributed to LBG

The Company's capital comprises all components of equity, movements in which are set out in the statement of changes in equity

The table below sets out the regulatory capital and the required capital held at 31 December in each year on a Pillar 1 basis

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

25 Risk management (continued)

4. Financial soundness risk (continued)

	2013 £ m	2012 £ m
Regulatory capital held	591	558
Regulatory capital required	(97)	(100)
Regulatory Surplus	**494**	**458**

All minimum regulatory requirements were met during the year

5. Operational risk

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

There are a number of categories of operational risk

Conduct risk

The risk of regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer outcomes Associated risks include poor product design and development, customer advice, customer service and customer complaint handling

Customer treatment and how LBG as a whole manages its customer relationships affects all aspects of the Company's operations and is closely aligned with achievement of LBG's strategic vision to be the best bank for customers There remains a high level of scrutiny regarding the treatment of customers by financial institutions from regulatory bodies, the press and politicians

People risk

The risk of reductions in earnings and/or value through financial or reputational loss arising from ineffectively leading colleagues responsibly and proficiently, managing people resource, supporting and developing colleague talent, or meeting regulatory obligations related to our people

Financial crime and security risk

Financial crime risk covers the risk of reduction in earnings and/or value, through financial or reputational loss, associated with financial crime and failure to comply with related regulatory obligations, these losses may include censure, fines or the cost of litigation This includes risks associated with fraud and bribery, and obligations related to money laundering, sanctions and counter terrorism

Security risk relates to the risk of reductions in earnings and/or value, through financial or reputational loss, resulting from theft of or damage to the Company's assets, the loss, corruption, misuse or theft of the Company's information assets or threats or actual harm to the Company's people This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events

Organisational infrastructure and change risk

Organisational infrastructure risk covers the risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor internally facing business processes at a Company, divisional or Company level Organisational infrastructure in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise Change risk comprises the risk of potential loss from change initiatives failing to deliver to requirements, budget or timescale, failing to implement change effectively or failing to realise desired benefits

Political risks and uncertainties

Political risk is the risk of reductions in earnings and/or value through financial loss from a changing political environment In the absence of a definitive, agreed and fully-implemented solution to the Eurozone crisis there continues to be some risk that ongoing economic uncertainty in Europe and the availability of credit could cause a return to recession in the UK and Ireland

A Scottish Independence referendum is due to be held in 2014 The impact of a 'yes' vote in favour of Scottish independence is uncertain The outcome could have a material impact on compliance costs, the tax position, and cost of funding for

25 Risk management (continued)

5 Operational risk (continued)

the Company Key mitigating actions include monitoring and assessment of the potential impact on the Company's business and impact on customers of a vote in favour of Scottish independence

Supplier management risk

The risk of reductions in earnings and/or value through financial or reputational loss from services with outsourced partners or third party suppliers

IT Systems risk

The risk of reductions in earnings and/or value through financial or reputational loss resulting from the failure to develop, deliver or maintain effective IT solutions

6 Legal and regulatory risks

Legal and regulatory risk is the risk of reductions in earnings and/or value, through financial or reputational loss, from failing to comply with the applicable laws, regulations or codes

The volume of actual and expected regulatory change remains high where work is ongoing to review, assess and embed new regulatory requirements into day-to-day operational and business practices across the Company

Regulators are interested in protecting the rights of the policyholders and ensuring that the Company is satisfactorily managing affairs for the benefit of the policyholders Regulators are also keen to ensure that the Company maintains appropriate solvency levels to meet unforeseen liabilities arising from reasonably foreseeable economic shocks or natural disasters As such, the Company is subject to regulatory requirements which prescribe and impose certain restrictive provisions

26 Related party transactions

(a) Ultimate parent and shareholding

The Company's immediate parent undertaking is Halifax Life Limited, a Company registered in the United Kingdom Halifax Life Limited has taken advantage of the provisions of the Companies Act 2006 and has not produced consolidated financial statements

The Company s ultimate parent Company and ultimate controlling party is Lloyds Banking Group plc, which is also the parent undertaking of the largest group of undertakings for which group financial statements are drawn up and of which the Company is a member

Scottish Widows plc is the parent undertaking of the smallest group of undertakings for which group financial statements are drawn up and of which the Company is a member

Copies of the Scottish Widows plc financial statements in which the Company are consolidated can be obtained from the Company Secretary's Department, 69 Morrison Street, Edinburgh, EH3 8YF

Copies of the Lloyds Banking Group plc financial statements in which the Company is consolidated can be obtained from the Group Secretary's Department, Lloyds Banking Group plc, 25 Gresham Street, London, EC2V 7HN

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

26 Related party transactions (continued)

(b) Transactions between the Company and other companies in the Lloyds Banking Group

The Company has entered into the following transactions with other related parties during the year and holds the following balances with other related parties at the end of the year

	Transactions in the Year		Outstanding Balances at 31 December	
	2013 £m	2012 £m	2013 £m	2012[1] £m
Relationship				
Ultimate Parent Undertaking				
Investments and amounts receivable	-	(153)	-	1
Parent undertakings				
Reinsurance and amounts receivable	(27)	17	36	62
Dividends paid	(100)	-	-	-
Subsidiary undertakings				
Holdings in OEICs	-	-	3,958	2,368
Other Related Parties				
Holdings in OEICs	-	-	3,832	4,514
Loans receivable	-	-	150	-
Commission and amounts receivable/(payable)	7	(1)	25	5
Cash and amounts receivable/(payable)	(2)	(26)	2	5
Debt securities	13	197	184	197
Expense recharges and amounts payable	(19)	(10)	(14)	(70)
Management fees and amounts payable	-	(1)	2	(1)

[1] Reflects the implementation of IFRS 10 as set out in note 28

Transactions between the Company and key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Company which, for the Company, are the Executive Directors

Transactions between the key management personnel of the Company and parties related to them as defined by IAS 24 "*Related Party Disclosures*" are as follows

Key management compensation

	2013 £'000	2012 £'000
Salaries and other short-term benefits	320	302
Post-employment benefits	9	13
Share-based Payments	80	48
Total	409	363

Certain members of key management in the Company, including the highest paid Director, provide services to other companies within the Lloyds Banking Group In such cases for the purposes of this note, figures have been included based on an apportionment to the Company of the total compensation earned

Retirement benefits are accruing for nil Directors and key management personnel (2012 four) under defined benefit pension schemes Six Directors and key management personnel (2012 nine) are paying into a defined contribution scheme

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

26 Related party transactions (continued)

Detail regarding the highest paid Director is as follows

	2013 £000	2012 £000
Apportioned aggregate emoluments	50	42
Defined benefits pension scheme accrued benefit at 31 December	2	2

The highest paid Director exercised share options during the year and was granted shares in respect of qualifying service during the year This was also the case in the prior year

HM Treasury

In January 2009, HM Treasury became a related party of the Company following its subscription for ordinary shares in Lloyds Banking Group, the Company's ultimate parent company, issued under a placing and open offer As at 31 December 2013, HM Treasury held a 32 7 per cent (2012 39 2 per cent) interest in LBG's ordinary share capital and, consequently, HM Treasury remained a related party of the Company throughout 2013

There were no material transactions between the Company and HM Treasury during the year (2012 £Nil) that were not made in the ordinary course of business or that are unusual in their nature or conditions In addition, the Company have entered into transactions with HM Treasury on an arm's length basis including, but not exclusively in relation to, the payment of corporation tax, employment tax and value added tax Owing to the volume and diversity, such transactions are not disclosed

27. Operating Lease

The total future minimum rental payments receivable under non-cancellable leases, including subleases, are as follows

	2013 £ m	2012 £ m
Within one year	9	11
Between two and five years	36	42
Beyond five years	108	98
Total	153	151

Nil contingent rents were recognised as income during the year (2012 £nil) No contingent rents were recognised as operating expenses during the year (2012 £nil) Generally the Company's operating leases are for terms of 15 years or more

28. Standards and interpretations effective in 2013

(a) Nature of change

The Company has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2013

(i) IFRS 10 "Consolidated Financial Statements"

IFRS 10 supersedes IAS 27 "Consolidated and Separate Financial Statements" and SIC-12 Consolidation "Special Purpose Entities" and establishes the principles for when the Company controls another entity and therefore is required to consolidate the other entity in the Company's financial statements Under IFRS 10, the Company controls an entity when it is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through the exercise of power

On adoption of IFRS 10, the Company changed its accounting policy for determining whether it has control over collective investment vehicles and limited partnerships This resulted in collective investment vehicles that were not previously viewed as subsidiaries being subsidiaries, and collective investment vehicles that were previously subsidiaries being derecognised as such

The Company has applied IFRS 10 retrospectively and restated its comparatives in accordance with the transitional provisions included in the standard These provisions require the Company to re-assess its control conclusions as at 1 January 2013 and restate its comparative information, applying the revised assessment in 2012 to the extent that the relevant investments were held in that year The impact of the restatement is set out in note 16 The Company has taken advantage of

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

28 Standards and interpretations effective in 2013 (continued)

the transitional provision in IFRS 10, as amended in June 2012, and has not disclosed the financial impact of adopting IFRS 10 on the current reporting period

(ii) IFRS 12 "Disclosure of Interests in Other Entities"

IFRS 12 requires an entity to disclose information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows These changes relate only to disclosure and have had no overall impact on the financial results or position of the Company The standard has resulted in an increase in disclosure, in particular on structured entities The Company has interests in structured entities arising from investment in collective investment vehicles The Company has expanded the disclosures about interests in unconsolidated structured entities to reflect the new disclosure requirements, as set out in note 16

(iii) IFRS 13 "Fair Value Measurement"

IFRS 13 defines fair value, sets out a framework for measuring fair value and requires disclosures about fair value measurements It applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements This standard has not had a material impact on the financial statements The Company has expanded the disclosures about the fair value measurement of non financial assets and liabilities to reflect the new disclosure requirements, as set out in note 25

(iv) Amendments to IFRS 7 "Financial Instruments: Disclosures" – 'Offsetting Financial Assets and Financial Liabilities'

The amendments to IFRS 7 require an entity to disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's balance sheet These changes relate only to disclosure and have had no overall impact on the financial results or position of the Company The Company has expanded the disclosures about offsetting financial assets and financial liabilities, as set out in note 25

(v) Amendments to IAS 1 "Presentation of Financial Statements" – 'Presentation of Items of Other Comprehensive Income'

The amendments to IAS 1 require entities to group items presented in other comprehensive income on the basis of whether they are potentially reclassified to profit or loss subsequently These changes relate only to presentation and have had no overall impact on the financial results or position of the Company The Company has amended the presentation of other comprehensive income to reflect the new requirements

Details of those IFRSs pronouncements which will be relevant to the Company but which were not effective at 31 December 2013 and which have not been applied in preparing these financial statements are given in note 29

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2013 (continued)

29 Future accounting developments

The following pronouncements may have a significant effect on the Company's financial statements but are not applicable for the year ending 31 December 2013 and have not been applied in preparing these financial statements Except as disclosed below, the full impact of these accounting changes is being assessed by the Company

Pronouncement	Nature of change	IASB effective date
IFRS 9 "Financial Instruments" [1 2]	Replace those parts of IAS 39 Financial Instruments Recognition and Measurement' relating to the classification, measurement and derecognition of financial assets and liabilities IFRS 9 requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instrument, and eliminates the available-for-sale financial asset and held-to-maturity investment categories in IAS 39 The requirements for financial liabilities and derecognition are broadly unchanged from IAS 39	Not yet determined
Amendments to IAS 32 "Financial Instruments Presentation" – 'Offsetting Financial Assets and Financial Liabilities'	Inserts application guidance to address inconsistencies identified in applying the offsetting criteria used in the standard Some gross settlement systems may qualify for offsetting where they exhibit certain characteristics akin to net settlement	Annual periods beginning on or after 1 January 2014
IFRIC 21 'Levies" [1]	Clarifies that the obligating event that gives rise to a liability to pay a government levy is the activity that triggers the payment of the levy as set out in the relevant legislation An entity does not have a constructive obligation to pay a levy that will be triggered by operating in a future period	Annual periods beginning on or after 1 January 2014

[1] At the date of this report, these pronouncements are awaiting EU endorsement
[2] IFRS 9 is the standard which will replace IAS 39 Future changes to IFRS 9 are expected dealing with the impairment of financial assets measured at amortised cost, which will be based on expected rather than incurred credit losses, and limited amendments to classification and measurement which include the introduction of a third measurement category, fair value through other comprehensive income Until the standard is complete, it is not possible to determine the overall impact of the standard

30. Post Balance Sheet Events

No significant post balance sheet events have been identified affecting the Company's financial statements