

2012/12/31

3196171

CLERICAL MEDICAL INVESTMENT GROUP LIMITED

DIRECTORS' REPORT AND FINANCIAL STATEMENTS

31 DECEMBER 2012



Member of Lloyds Banking Group plc

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COMPANY INFORMATION

Board of Directors

Lord Blackwell (Chairman)

Dr N M Bryson (Deputy Chairman)

M Christophers

M G Culmer

M A Fisher

J Goford

A M Parsons*

A M Peck

Drs C A C M Schrauwers

T E Strauss*

D J Walkden*

* denotes Executive Director

Company Secretary

C M Herd

Actuarial Function Holder

R McIntyre

Independent Auditors

PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Erskine House
68-73 Queen Street
Edinburgh
EH2 4NH

Registered Office

33 Old Broad Street
London
EC2N 1HZ

Company Registration Number

3196171

DIRECTORS' REPORT

Principal activities and review of business

The Directors present the audited financial statements of Clerical Medical Investment Group Limited ("the Company"). The Company is a limited liability company domiciled and incorporated in the United Kingdom. Details of the principal subsidiary undertakings are given in note 14.

The principal activity of the Company is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the UK and through non-UK branches. The Company offers a range of products such as annuities and investment type products principally through independent financial advisers. The Company also reinsures business with subsidiary undertakings and with insurance entities external to the Lloyds Banking Group plc ("LBG").

Single Integrated Insurance Business

In preparation for the introduction of the Solvency II regime the insurance entities within LBG's Insurance Division were restructured in 2011 to bring all relevant entities under Scottish Widows Group Limited ("SWG"). As a result SWG became the holding company for the entities within the single integrated insurance business and is the ultimate insurance undertaking for solvency purposes. All subsidiaries of SWG are now managed within an overall risk and capital management framework. The capital management framework will facilitate the monitoring and allocation of capital across the entities owned by SWG, including those within LBG. Further details on the approach to capital management are set out in note 32.

In future, 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. Although the implementation date for Solvency II within the European Union has been deferred, the structure will enable the business to operate effectively within the transitional arrangements that have been proposed.

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 2012 and future planned activity to invest in higher yielding illiquid assets is expected to deliver significant increased investment return to the Company, without increasing credit risk beyond risk appetite. During 2012 excess liquidity was invested in less liquid credit assets purchased from, or issued by, parties within LBG, including £510m asset backed securities and covered bonds. 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 32.

Gender Neutral Pricing

The European Court of Justice made a ruling on 1 March 2012 that the current insurance industry practice of pricing products differently for men and women, to reflect differing risk, would not be allowed from 21 December 2012. To comply with the ruling the Company introduced gender neutral pricing, affecting all new annuity and protection policy quotes, on 12 November 2012. Any annuity and protection policies quoted before this date and in place before 21 December 2012 are unaffected.

Retail Distribution Review

The Retail Distribution Review ("RDR") is an FSA initiative designed to increase consumer confidence in the advice they are given on investments and pensions, and came into effect on 1 January 2013. Financial advisers will meet higher standards of qualifications and agree charges for investment advice directly with the customer, instead of being paid by commission from the charges on investment products bought from the Company.

There remains significant uncertainty regarding market and consumer behaviour and the resultant impact on new business and retention which will only become clearer following implementation. It is expected that, as a result of RDR some independent financial advisers may choose to exit markets, therefore some customers may look to receive advice elsewhere. Accordingly, the Company is committed to providing a direct proposition to maintain a high quality of service to these customers, and has updated its range of products to deliver transparent and flexible charging solutions for advisers and their clients.

Taxation of life assurance companies

The Finance Act 2012 introduced a new UK tax regime for insurance companies which took effect from 1 January 2013. The new regime, together with current economic forecasts, has had a number of impacts on the deferred tax charge of the Company. This has resulted in an overall additional charge of £2m due to the inclusion of certain investments to the charge to tax under the new regime, and no impact from the revaluation of tax losses.

DIRECTORS' REPORT (continued)*Provision in relation to German insurance business litigation*

The Company has received a number of claims in the German courts, relating to policies issued by the Company but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. In its accounts for the year ended 31 December 2011 the Company recognised a provision of £175 million with respect to this litigation. Following decisions in July 2012 from the Federal Court of Justice ("FCJ") in Germany the Company has recognised a further provision of £150 million with respect to this litigation, increasing the total provision to £325 million.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions, and the implications with respect to the claims facing the Company. As a result the ultimate financial effect, which could be materially different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved. Further information in relation to the provision is set out in note 24.

Reinsurance changes between Clerical Medical Managed Funds ("CMMF") and Clerical Medical Investment Group ("CMIG")

On 30th November 2012, an existing unit-linked reinsurance arrangement from CMIG to CMMF was partially terminated. This arrangement resulted in the transfer of insurance liabilities and associated investments of £7,318m. In addition CMIG accepted CMMF's Self Invested Personal Pension reinsurance arrangement with Suffolk Life Annuities Limited.

On the same date, CMMF entered into new reinsurance agreements to reinsure directly written unit-linked liabilities and matching investments of £121m to CMIG. Both this and the partial termination had no resultant profit due to the transfers taking place for nil consideration. Further information in relation to the changes to this business are set out in note 3.

Recapture of reassured business by Halifax Life Limited (2011)

On 30 September 2011 Halifax Life Limited ("HLL"), a subsidiary of the Company, recaptured its portfolio of insurance business from CMMF. As a result of the significant reduction in its risks following the recapture, CMMF subsequently effected a capital reduction of ordinary share capital and paid a dividend of £184m to the Company. The Company's investment in CMMF was impaired by £194m following the receipt of the dividend.

Issue of subordinated debt

In June 2012 CMIG issued £250m of subordinated debt to Scottish Widows Group, a subsidiary of LBG. Further details of these financial instruments can be found in note 26.

Results and dividend

The result of the Company for the year ended 31 December 2012 is a loss after tax of £(54)m (2011: loss of £(10)m). The result reflects the recognition of an additional provision of £150m in relation to German insurance business litigation set out above, dividends received from CMMF of £50m (2011: £184m) and subsequent impairment of the Company's investment in CMMF of £(49)m (2011: £(194)m). The result also reflects market conditions over 2012. Whilst the Company experienced positive returns in the period on investments held, these were largely offset by changes in the value of insurance and investment contract liabilities. The Directors consider the result for the year to be satisfactory in light of these factors.

During the year, no interim dividends were paid (2011: £nil). The Directors recommend no dividend payment in respect of the year ended 31 December 2012.

Key performance indicators

Total premiums received from policyholders were £1,331m (2011: £1,447m). Of this, £905m (2011: £929m) was recognised in the statement of comprehensive income, with the remainder being subject to deposit accounting as set out in note 1(v).

Funds under management are £22.3bn (2011: £15.8bn) excluding cross holdings. The increase is mainly due to the reinsurance change explained above with £7.3bn of assets being transferred into CMIG.

DIRECTORS' REPORT (continued)

The Directors believe that the Company currently has adequate capital resources and will continue to do so in the foreseeable future. Further information on the capital position of the Company is given in note 32.

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 Financial Services Authority ("FSA") 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.

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 32.

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 32.

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 except for the German insurance business litigation, for which a provision has been established, as discussed earlier in this report and set out in note 24.

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:

R J M Bulloch	(appointed 01 January, resigned 31 December 2012)
D J Walkden	(appointed 01 January 2012)
Lord A P Leitch	(resigned 29 February 2012)
R Harris	(resigned 29 February 2012)
C A C M Schrauwers	(appointed 14 May 2012)
Lord Blackwell	(appointed 01 September 2012)
M A Fisher	(appointed 19 September 2012)
G N Stewart	(resigned 05 October 2012)
M G Culmer	(appointed 31 October 2012)
A M Parsons	(appointed 09 November 2012)

Particulars of the Directors' emoluments are set out in note 33.

All Directors have the benefit of a contract of indemnity, which is both a Qualifying Third Party Indemnity Provision and a Qualifying Pension Scheme Indemnity Provision. This was in force during the whole of the year. Directors no longer in office but who served on the Board at any time in the year had the benefit of this contract of indemnity during that period of service.

DIRECTORS' REPORT (continued)**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 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.

Policy and practice on payment of creditors

The Company follows the 'Prompt Payment Code' published by the Department for Business Innovation and Skills ("BIS"), regarding the making of payments to suppliers. A copy of the code and information about it may be obtained from the BIS website.

The Company's policy is to agree terms of payment with suppliers and these normally provide for settlement within 30 days after the date of the invoice, except where other arrangements have been negotiated. It is the policy of the Company to abide by agreed terms of payment, provided the supplier performs according to the terms of contract.

The processing of invoices from suppliers and settlement of trade creditors is undertaken by Scottish Widows Services Limited ("SWS") within the Scottish Widows Group. The number of days shown in this report, to comply with the provisions of the Companies Act 2006, is 13 days (2011: 14 days).

Statement of Directors' responsibilities

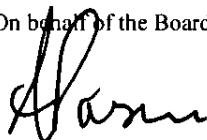
The Directors are responsible for preparing the Directors Report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have elected to prepare 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.

On behalf of the Board of Directors



A M Parsons
Director

21 March 2013

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF CLERICAL MEDICAL INVESTMENT GROUP LIMITED

We have audited the financial statements of Clerical Medical Investment Group Limited for the year ended 31 December 2012, which comprise of the Statement of Comprehensive Income, the Balance Sheet, the Statement of Cash Flows, the Statement of Changes in Equity and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of directors and auditors

As explained more fully in the statement of Directors' responsibilities set out on page 7, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

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.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the directors, and the overall presentation of the financial statements.

In addition, we read all the financial and non-financial information in the Directors' report and financial statements to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements

- give a true and fair view of the state of the Company's affairs as at 31 December 2012 and of its loss and cash flows for the year then ended,
- have been properly prepared in accordance with IFRSs as adopted by the European Union, and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

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

Matters on which we are required to report by exception

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

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



Karyn Lamont (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Edinburgh
21 March 2013

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2012

	Notes	2012 £ m	2011 £ m
Revenue			
Gross earned premiums		905	929
Premiums ceded to reinsurers		(40)	(26)
Premiums net of reinsurance		865	903
Fee and commission income	4	85	84
Investment income	5	556	969
Net gains on assets and liabilities at fair value through profit or loss	6	443	38
Total revenue		1,949	1,994
Expenses			
Gross claims and benefits paid		2,212	2,448
Claims recoveries from reinsurers		(29)	(12)
		2,183	2,436
Change in insurance contract and participating investment contract liabilities	22	(828)	(815)
Change in non-participating investment contract liabilities		924	(170)
Change in assets arising from reinsurance contracts		(804)	(7)
Change in unallocated surplus	23	(2)	(304)
		(710)	(1,296)
Operating expenses	7	558	767
Expenses for asset management services received		34	40
Finance costs	9	49	40
		641	847
Total expenses		2 114	1 987
(Loss)/profit before tax		(165)	7
Taxation credit/(charge)	10	111	(17)
Loss for the year		(54)	(10)
Other comprehensive income			
Movement in net investment hedge, net of tax		1	1
Currency translation differences, net of tax		(1)	(1)
Other comprehensive income		-	-
Total comprehensive income		(54)	(10)

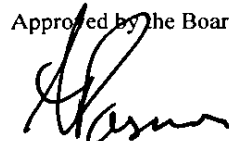
The notes set out on pages 13 to 65 are an integral part of these financial statements

BALANCE SHEET AS AT 31 DECEMBER 2012

	Notes	2012 £ m	2011 £ m
ASSETS			
Intangible assets including intangible insurance assets	11	148	183
Deferred costs	12	439	452
Deferred tax assets	13	24	1
Investment in subsidiaries	14	7,760	4,651
Investment properties	15	699	691
Assets arising from reinsurance contracts held	16	1,042	8,275
Current tax receivable	13	95	98
Prepayments		2	2
Derivative financial instruments	17	593	695
Loans and receivables	18	259	331
Investments at fair value through profit or loss	19	14,866	11,287
Cash and cash equivalents	20	243	197
Total assets		26,170	26,863
EQUITY AND LIABILITIES			
Capital and reserves attributable to Company's equity shareholder			
Share capital	21	70	70
Share premium		1	1
Retained earnings		1,330	1,384
Total equity		1,401	1,455
Liabilities			
Insurance contract and participating investment contract liabilities	22	14,993	15,821
Unallocated surplus	23	56	58
		15,049	15,879
Deferred tax liabilities	13	133	242
Current tax payables	13	28	17
Provisions for other liabilities and charges	24	289	171
Accruals and deferred income	25	27	23
Subordinated debt	26	846	595
Non-participating investment contract liabilities	27	7,862	7,723
Derivative financial instruments	17	267	286
Other financial liabilities	28	268	472
Total liabilities		24,769	25,408
Total liabilities and equity		26,170	26,863

The notes set out on pages 13 to 65 are an integral part of these financial statements

Approved by the Board on 21 March 2013



A M Parsons
Director

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2012

		2012	2011
	Notes	£ m	£ m
Cash flows from operating activities			
(Loss)/profit before tax		(165)	7
Adjusted for			
Amortisation and impairment of intangible assets including intangible insurance assets		35	19
Dividends received from subsidiary undertakings	5	(50)	(334)
Movement in deferred costs		13	18
Finance costs	9	49	40
Net decrease in operating assets and liabilities	29	170	(50)
Proceeds from issue of subordinated debt		(250)	-
Taxation paid		(7)	(34)
Net cash outflow from operating activities		(205)	(334)
Cash flows from investing activities			
Dividends received	5	50	334
Net cash inflows from investing activities		50	334
Cash flows from financing activities			
Proceeds from issue of subordinated debt	26	250	-
Finance costs paid	9	(49)	(40)
Net cash outflows from financing activities		201	(40)
Net increase/(decrease) in cash and cash equivalents		46	(40)
Cash and cash equivalents at the beginning of the year		197	237
Net cash and cash equivalents at the end of the year	20	243	197

The notes set out on pages 13 to 65 are an integral part of these financial statements

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2012

Notes	Issued share capital £ m	Share premium £ m	Retained earnings £ m	Total £ m
Balance as at 1 January 2011	70	1	1,394	1,465
Loss for the year and total comprehensive income for the year	-	-	(10)	(10)
Balance as at 31 December 2011	70	1	1,384	1,455
Loss for the year and total comprehensive income for the year	-	-	(54)	(54)
Balance as at 31 December 2012	70	1	1,330	1,401

Not all of the above amounts can be distributed to the equity shareholders since the Company is required to meet regulatory capital requirements. Further details are given in note 32.

The notes set out on pages 13 to 65 are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

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,
- (3) in respect of the Company's with profit fund liabilities, in accordance with Financial Reporting Standard ("FRS") 27 "Life Assurance" issued by the United Kingdom Accounting Standards Board, and
- (4) 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 of section 408 of the Companies Act 2006 and has not disclosed a statement of comprehensive income and related notes in respect of the Company

Standards and interpretations effective in 2012

A number of standards, amendments to and interpretations of published standards which have the potential to impact on the Company's financial statements have been issued and are mandatory for accounting periods beginning on or after 1 January 2012. Their relevance to the Company's financial statements is assessed at note 36

Details of those IFRSs pronouncements which will be relevant to the Company but which were not effective at 31 December 2012 and which have not been applied in preparing these financial statements are given in note 37

(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 IFRSs because they do not transfer significant insurance risk are classified as investment contracts. Such contracts are further analysed between those with discretionary participating features ("participating investment contracts") and without discretionary participating features ("non-participating investment contracts")

A participating investment contract gives investors a contractual right to receive, as a supplement to guaranteed benefits, additional discretionary benefits or bonuses that are likely to be a significant portion of the total contractual benefits, through participation in the surplus arising from the assets held in the fund

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012**1. Accounting policies (continued)**

The Company has the discretion within the constraints of the terms and conditions of the instrument to allocate part of this surplus to the policyholders and part to the Company's equity shareholders. Participating investment contracts are accounted for in the same manner as insurance contracts in accordance with the requirements of IFRS 4 'Insurance Contracts'.

Non-participating investment contracts are contracts that neither transfer significant insurance risk nor contains a discretionary participating feature.

Hybrid contracts

For certain investment contracts, the contract can be partly invested in units which contain a participating feature and partly without. Where the contract is split, part is allocated as a non-participating investment contract and part as a participating investment contract.

(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, 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.

All financial assets and financial liabilities are designated at fair value through profit or loss, with the exception of certain loans and receivables, subordinated liabilities, borrowings and other financial liabilities which are stated at amortised cost, (as discussed in policies (n), (u), (y) and (x) respectively) and derivatives (policy m). 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, derivatives and cash and to evaluate the Company's investments with reference to their fair values. For further details on the Company's fair value methodology see policy (j).

(d) Revenue recognition**Premium income**

Premiums received in respect of life insurance contracts and participating investment 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

Fee and commission income is recognised in the statement of comprehensive income in the period in which it is earned. Fee and commission received that relates to the provision of future services is deferred and recognised as the services are provided.

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. The liability is recognised in the balance sheet within accruals and deferred income until recognition criteria are met.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1 Accounting policies (continued)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 or collective investment vehicles distributions 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 on a straight line basis over the term of the lease. The cost of incentives are recognised as a reduction of total income over the term of the lease on a straight line basis.

(e) Expense recognitionClaims

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.

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 at policy (h). Subsequent amortisation of deferred costs is recognised as set out in policy (h).

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.

Finance costs

Interest expense for all interest-bearing financial instruments is recognised in the statement of comprehensive income as it accrues, within finance costs.

(f) Leases

Assets leased to or from third parties, including properties leased to tenants, are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee, all other leases are classified as operating leases. Operating lease rental income and expenditure are recognised on a straight-line basis over the life of the leases through the statement of comprehensive income, within investment income and operating expenses respectively.

Properties leased out to tenants under operating leases are included in investment properties in the balance sheet.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1 Accounting policies (continued)**(g) Intangible assets including intangible insurance assets****(i) Acquired value of in-force business**

Insurance and investment contracts acquired in business combinations are measured at fair value at the time of acquisition. This measurement includes the recognition of an acquired value of in-force ('acquired VIF') asset which reflects the present value of future cash flows expected from the business acquired. The asset is shown gross of attributable tax and a corresponding deferred tax liability has been established. Amortisation of the acquired VIF balance and related tax is carried out on a best estimate basis over the estimated life of the contracts. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the acquired VIF balance is tested for impairment at each reporting date. Such an asset is not recognised in respect of future profits on contracts written in the normal course of business.

(ii) Software development costs

Acquired computer software licences are capitalised on the basis of the cost incurred to acquire and to bring to use the specific software. These costs are amortised on a straight-line basis over the expected useful life of the software, not exceeding a period of five years. The amortisation charge for the year in respect of software licences and software development costs is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the assets is tested for impairment at each reporting date. Further information on the Company's impairment policy is set out at policy (p).

(h) Deferred costs**(i) Deferred acquisition costs**

The costs of acquiring new insurance contracts and participating investment contracts (excluding those assessed on a 'realistic basis' in accordance with FRS 27), 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 amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the asset is tested for impairment at each reporting date. Further information on the Company's impairment policy is set out at policy (p).

(ii) Deferred origination costs

Costs which are directly attributable and incremental to securing new non-participating investment contracts are capitalised. This asset is subsequently amortised over the estimated contractual lifetime of each policy on a straight-line basis 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 amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the asset is tested for impairment at each reporting date. Further information on the Company's impairment policy is set out at policy (p).

(i) Investment in subsidiaries

The Company owns a number of subsidiaries as set out in note 14. Certain subsidiaries do not form part of actively managed investment portfolios, and the risks and rewards of owning those subsidiaries primarily rest with the equity shareholders of the Company, including such investments where ownership of the subsidiary is split between the Company's long-term fund and its shareholder fund. Those subsidiaries are held initially at cost, being the fair value of the consideration given to acquire the holding, then subsequently at cost subject to impairment. Further information on the Company's impairment policy is set out at policy (p).

Certain subsidiaries, including holdings in collective investment vehicles (which includes OEICs) are held primarily as vehicles through which specific investments are held as part of the actively managed investment portfolios. These 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, subsidiaries which are managed as part of policyholder investment funds are carried at fair value and changes in their fair value are reflected in the statement of comprehensive income, within net gains and losses on assets at fair value through profit or loss.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)**(j) Investments at fair value through profit or loss**

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

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 cost, 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 collective investment vehicles (including OEICs and Unit Trusts) is determined as the last published price applicable to the vehicle 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 the Fair Value Pricing Committee on a monthly basis

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)*Property investments through special purpose vehicles*

The Company invests in a number of investment properties through holdings in special purpose vehicles ("SPVs"). SPVs are initially recognised at cost, being the fair value of the consideration given. After initial recognition, such assets are accounted for and measured at fair value, which equates to the relevant proportion of the published net asset value of the company. This valuation is based on open market valuations of the properties held by the SPVs, as provided at the reporting date by independent valuers.

Fair value methodology

All financial instruments carried at fair value 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. 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, open ended investment companies (OEICs) and 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 are not based on observable market data (unobservable inputs). 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 32.

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 (m).

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1 Accounting policies (continued)**(k) 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.

(l) Assets arising from reinsurance contracts held

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 the assets arising from reinsurance contracts held are classified as financial assets designated as fair value through profit or loss.

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 (p).

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 on the face of the statement of comprehensive income, through change in assets arising from reinsurance contracts held. These balances are subject to an annual impairment review. Further information on the Company's impairment policy is set out at policy (p).

(m) Derivative financial instrumentsClassification

Derivative financial instruments, including embedded derivatives, are held for trading, with the exception of derivatives which are designated as effective hedging instruments, which are held at fair value through profit or loss. 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

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 held for trading are recognised in the statement of comprehensive income, through net gains and losses on assets and liabilities at fair value through profit or loss.

Hedge accounting

In limited circumstances, derivatives are designated as fair value hedges. Hedge accounting allows one instrument, generally a derivative such as a swap, to be designated as a hedge of another instrument such as a loan.

Derivatives may only be designated as hedging instruments provided certain strict criteria are met. At the inception of a hedge, its terms must be clearly documented and there must be an expectation that the derivative will be highly effective in offsetting changes in the fair value of the hedged risk. The hedge documentation must also specify the methodology that will be used to measure effectiveness. Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the statement of comprehensive income, through net gains and losses on assets and liabilities at fair value through profit or loss, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

The effectiveness of the hedging relationship must be tested throughout its life. A hedge is regarded as highly effective if the change in fair value of the hedge instrument and the hedge item are negatively correlated within a range of 80% to 125%, either for the period since effectiveness was last tested or for the period since inception. Where the hedge is highly effective, the net impact on the statement of comprehensive income is minimised. If, at a reporting date, it is concluded that the hedge is no longer highly effective in achieving its objective, the hedge relationship is terminated. Should this happen, changes in the fair value of the hedged item are no longer recognised in the statement of comprehensive income and the adjustment that has been made to the carrying amount of the hedged item is amortised to the statement of comprehensive income over the period to maturity of the hedged item.

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the statement of comprehensive income, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the statement of comprehensive income. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the statement of comprehensive income using the effective interest method over the period to maturity.

Changes in the fair value of derivatives that qualify as a net investment hedge on foreign operations are taken to other comprehensive income when the hedge is deemed to be effective. The ineffective portion of any net investment hedge is recognised in the statement of comprehensive income immediately.

The fair values of derivative instruments used for hedging purposes are disclosed in note 17.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1 Accounting policies (continued)

All derivatives are presented as assets when their fair value is positive and as liabilities when their fair value is negative

(n) 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 as fair value through profit or loss at initial recognition

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 at policy (p).

(o) 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.

(p) ImpairmentFinancial 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 its value in use.

Non-financial assets

Assets that have an indefinite useful life, for example land, are not subject to depreciation or amortisation 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)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 flow 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

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.

(q) 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 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 tax arises from the 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 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 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 tax asset to be utilised. Deferred tax assets and liabilities are undiscounted.

Allocation of tax charge between equity shareholders 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.

(r) 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)**(s) Insurance contracts and participating investment 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 issues pension and 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 or participating investment contracts in the Company's With Profits Fund

Liabilities of the Company's With Profits Fund, including guarantees and options embedded within products written by that fund, are accounted for under the "realistic" method in accordance with the requirements of FRS 27. However, in contrast to the approach used for the FSA's realistic capital regime, projected transfers out of the fund into other funds of the Company are not treated as insurance liabilities, but are recorded in unallocated surplus. Changes in the value of these liabilities are recognised in the statement of comprehensive income through changes in insurance contract and participating investment contract liabilities.

Insurance contracts which are not unit-linked or in the Company's With Profits Fund

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 and participating investment contract liabilities.

Insurance contracts which are unit-linked

Allocated premiums in respect of unit-linked contracts that are life insurance contracts or participating investment 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. 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 and participating investment contract liabilities. 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.

Unallocated surplus

Any amounts in the With Profits Fund not yet determined as being due to policyholders or the equity shareholders and projected transfers out of the fund to other funds of the Company are recognised as an unallocated surplus which is shown separately from the other insurance liabilities.

Bonuses

Bonuses reflected in the statement of comprehensive income in a given year comprise:

- Unit price increases and new reversionary bonuses declared in respect of that year which are provided within the calculation of insurance contract and participating investment contract liabilities, and
- Terminal and interim bonuses paid out to policyholders on maturity and included within gross claims and benefits.

Receivables and payables

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)**(t) 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 a 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.

(u) Subordinated debt

Subordinated debt comprises dated and undated loan capital and is carried at amortised cost adjusted for any hedged interest rate risk. Interest payable is recognised in the statement of comprehensive income, through finance costs.

Dated subordinated debt is classified as a liability due to there being a contractual obligation for cash settlement.

The undated subordinated guaranteed bonds are classified as a liability on the basis of the existence of a capital disqualification event considered to be a genuine settlement provision in the context of current uncertainty surrounding the direction of future regulatory rule developments.

(v) Non-participating investment contracts

The Company's non-participating 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 by the value of corresponding unit-linked financial assets attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable. Investment income allocated to non-participating investment contracts is included in change in non-participating 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 non-participating investment contract liability.

Fee and commission income in relation to non-participating unit-linked investment business is presented within the statement of comprehensive income within fee and commission income.

(w) Liability adequacy test

At each reporting date, liability adequacy tests are performed to ensure the adequacy of the insurance and participating investment contract liabilities net of related deferred costs and acquired value of in-force business. 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.

(x) 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.

(y) Borrowings

Borrowings are recognised initially at fair value, being the issue proceeds net of transaction costs incurred. Borrowings are subsequently stated at amortised cost, any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the statement of comprehensive income through finance costs over the period of the borrowings using the effective interest rate applicable to the instrument. In practice, due to the nature of these balances, being bank overdrafts, the carrying value equates to the fair value of these liabilities as the borrowings are repayable on demand.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1 Accounting policies (continued)**(z) Foreign currency translation**

Each of the Company's operations measures items included in the financial statements using the currency of the primary economic environment in which it operates (the "functional currency"). The functional currency of the majority of the Company's operations is pounds sterling. The financial statements are presented in pounds sterling, rounded to the nearest million (£m), which is the Company's presentational 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 rates of exchange ruling at the time of the respective transactions. Any exchange differences are dealt with in that part of the statement of comprehensive income in which the underlying transaction is reported.

The results and financial position of the Company's foreign operations that have a functional currency different from the presentational currency are translated into the presentational currency as follows. The assets and liabilities of foreign operations are translated into sterling at foreign exchange rates ruling at the balance sheet date. The income and expenses of foreign operations are translated into sterling at average exchange rates, unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions. Foreign exchange differences arising on the translation of foreign operations are recognised in other comprehensive income.

(aa) 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 not recognised in financial liabilities on the balance sheet is legally segregated from the assets of the Company. 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

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 contract and participating investment contract liabilities

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

In accordance with FRS 27, the liabilities of the Company's With Profits Fund are calculated using a stochastic simulation model which values liabilities on a basis consistent with tradable market option contracts (a 'market-consistent' basis). The liabilities are sensitive to both investment market conditions and changes to a number of non-economic assumptions, such as the level of take-up of options inherent in the contracts, mortality rates and lapses prior to dates at which a guarantee would apply.

For insurance contracts outside the With Profits Fund, 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 in respect of annuity business written and levels of future expenses. Such assumptions are based on recent actual experience, supplemented by industry information where appropriate. No critical accounting estimates apply for participating investment contracts as the contract liabilities arising outside the With Profits Fund are almost entirely current unit values.

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 balances is given in note 31.

Sensitivities regarding changes to key assumptions in calculating insurance contract and participating investment contract liabilities are given in note 31.

(b) Intangible assets and intangible insurance assetsAcquired value of in-force business

Following the acquisition of Clerical Medical and General Life Assurance Society in 1996, the Company holds an asset representing the acquired VIF. The asset is calculated by projecting the future surpluses and other cash flows attributable to the Company arising from business written, excluding the value of future investment risk margins, discounted at an appropriate rate. The key assumptions used in estimating future surpluses relate to lapse rates and expenses.

The assumptions were determined on a best-estimate basis and, as above, were based on recent actual experience and industry information where appropriate. Amortisation of this balance and related tax is carried out on a best estimate basis over the estimated life of the contracts. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of this asset is tested for impairment at each reporting date. Further information on this asset is given in note 11.

(c) Deferred costs

For insurance contracts and participating investment contracts (excluding those assessed on a 'realistic basis' in accordance with FRS 27), 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 12.

The recognition of costs 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 2012**2 Critical accounting estimates and judgments in applying accounting policies (continued)****(d) 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 at notes 10 and 13.

(e) Provisions for other liabilities and charges

The Company has received a number of claims in the German courts, relating to policies issued by the Company but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. In its accounts for the year ended 31 December 2011 the Company recognised a provision of £175 million with respect to this litigation. Following decisions in July 2012 from the Federal Court of Justice ("FCJ") in Germany the Company has recognised a further provision of £150 million with respect to this litigation, increasing the total provision to £325 million.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions and the implications with respect to the claims facing the Company. As a result the ultimate financial effect, which could be materially different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved. Further information in relation to the provision is set out in note 24.

(f) 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 32.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

3 Termination of existing reinsurance arrangement between CMIG and CMMF and other reinsurance changes

On 30 November 2012, an existing unit-linked reinsurance arrangement from the Company to CMMF was partially terminated, with the property fund liabilities continuing to be reassured to CMMF. The recaptured business did not previously transfer reinsurance risk and so is not accounted for through the statement of comprehensive income. The recapture is accounted for directly in the balance sheet, with the derecognition of £7,197m of assets arising from reinsurance contracts held offset by the recognition of net assets, principally investments held at fair value through profit and loss.

The related CMMF Self Invested Personal Pension ("SIPP") reinsurance arrangement with Suffolk Life Annuities Limited was novated to the Company. The novation of this business to CMIG from CMMF resulted in the recognition of £47m of assets arising from reinsurance contracts held at fair value through profit and loss, offset by associated investment contract liabilities.

In addition, on the same date, CMMF entered into new reinsurance agreements to reinsure £121m of its directly written unit-linked non-participating investment contracts pension business to the Company. This new business has been accounted for in accordance with the accounting policy for non-participating investment contracts (v) with this not accounted for through the statement of comprehensive income, but accounted for directly in the balance sheet as adjustments to the non-participating investment contract liability.

These transactions referred to above had no impact on any gains or losses as the transfer took place for nil consideration.

4 Fee and commission income

	2012 £ m	2011 £ m
Fee income from reinsured business	77	78
Change in deferred income	2	5
Other	6	1
Total	85	84

5 Investment income

	2012 £ m	2011 £ m
Net income on investments designated at fair value through profit or loss	443	489
Interest (payable)/receivable on swap	(2)	2
Financial instruments at amortised cost		
Interest income on deposits	2	4
Interest income from group undertakings	3	-
Dividend income from subsidiary undertakings	50	334
Rental income on investment properties	51	56
Foreign currency translation differences	16	79
Other	(7)	5
Total	556	969

6. Net gains/(losses) on assets and liabilities at fair value through profit or loss

	2012 £ m	2011 £ m
Derivative financial instruments at fair value through profit or loss	(127)	37
Investments designated at fair value through profit or loss	669	108
Investment properties at fair value through profit or loss	(23)	(27)
Foreign exchange	(76)	(80)
Fair value hedge adjustment in respect of swap	-	6
Fair value hedge adjustment for change in value of subordinated debt	-	(6)
Total	443	38

The fair value hedge adjustments in the above table reflect gains and losses arising in respect of undated subordinated debt issued by the Company which forms part of a hedge relationship. Further information in respect of this subordinated debt is set out at note 26.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

7 Operating expenses

	2012 £ m	2011 £ m
Acquisition and origination costs in respect of insurance and investment contracts	52	64
Expenses for administration	260	297
	312	361
Provision in relation to German insurance business litigation	150	175
Change in deferred costs	13	18
Amortisation and impairment of acquired VIF	33	18
Amortisation of software development costs	1	1
Impairment of investment in subsidiaries	49	194
Total	558	767

An impairment charge of £49m has been recognised during the year (2011 £194m) against the carrying value of CMMF, a subsidiary undertaking, to reduce its carrying value to its net asset value as detailed in the Directors' report

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 (2011 nil). The employee costs, including pension costs and share-based payment costs, are included in the recharge noted above.

8 Auditors' remuneration

	2012 £000	2011 £000
Fees payable to the company's auditor for the audit of the company's annual financial statements	398	419
Fees payable to the company's auditor and its associates for other services		
Audit-related assurance services	420	430
Non-audit services	-	25
Total	818	874

Audit fees for 2012 and 2011 were borne by another company within the group and recharged to the company.

9 Finance costs

	2012 £ m	2011 £ m
Interest payable on swap	6	8
Interest on subordinated debt	43	32
Total	49	40

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

10. Taxation

(a) Analysis of tax credit/(charge)

	2012 £ m	2011 £ m
Current tax:		
UK corporation tax	(2)	51
Overseas tax	(2)	(6)
Adjustment in respect of prior years	(17)	6
Total current tax	(21)	51
Deferred tax		
Origination of temporary differences	113	(85)
Change in tax rate	7	17
Adjustment in respect of prior years	12	-
Total deferred tax	132	(68)
Total income tax credit/(charge)	111	(17)

The policyholder tax benefit or expense is included in income tax expense. Policyholder tax is a credit of £29m (2011 charge of £90m), including a prior year tax charge of £4m (2011 charge of £2m).

(b) Reconciliation of tax (charge)/credit

	2012 £ m	2011 £ m
(Loss)/profit before tax	(165)	7
Tax at 24.5% (2011: 26.5%)	40	(2)
Effects of		
Impairment of subsidiaries	(12)	(51)
UK tax basis for life insurance profits	45	-
Tax exempt income	14	89
Policyholder tax	22	(66)
Adjustment to tax charge in respect of prior years	(1)	8
Overseas tax	-	(6)
Change in tax rate	(4)	17
Other	7	(6)
Total	111	(17)

The standard rate of Corporation Tax in the UK changed from 26% to 24% with effect from 1 April 2012. Accordingly, the company's profits for this accounting period are taxed at an effective rate of 24.5%.

The Finance Act 2012 reduced the rate of corporation tax from 24% to 23% with effect from 1 April 2013. The impact of this reduction in tax rate, which is applicable to the calculation of deferred tax assets and liabilities at the reporting date, is reflected in the above table.

The Finance Act 2012 introduced changes to the taxation of life assurance companies with effect from 1 January (see Note 13). The impact of these changes on the calculation of deferred tax assets and liabilities at the reporting date is reflected in the above table.

11 Intangible assets including intangible insurance assets

		2012 £ m	2011 £ m
Acquired VIF	(a)	148	181
Software development costs	(b)	-	2
Total		148	183

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

11. Intangible assets including intangible insurance assets (continued)

(a) Acquired VIF

	2012 £ m	2011 £ m
<i>Cost</i>		
At 1 January and 31 December	651	651
<i>Accumulated amortisation and impairment</i>		
At 1 January	470	452
Amortisation during the year	33	18
At 31 December	503	470
<i>Carrying amount</i>		
At 31 December	148	181

Of the above total, £129m (2011 £148m) is expected to be recovered more than one year after the reporting date

(b) Software development costs

	2012 £ m	2011 £ m
<i>Cost</i>		
At 1 January	6	6
Disposals	(1)	-
At 31 December	5	6
<i>Accumulated amortisation</i>		
At 1 January	4	3
Amortisation charge for the year	1	1
At 31 December	5	4
<i>Carrying amount</i>		
At 31 December	-	2

Of the above total, nil (2011 £1m) is expected to be recovered more than one year after the reporting date

12. Deferred costs

		2012 £ m	2011 £ m
Deferred acquisition costs	(a)	302	285
Deferred origination costs	(b)	137	167
Total		439	452

(a) Deferred acquisition costs

	2012 £ m	2011 £ m
At 1 January	285	269
Amounts incurred during the period	80	81
Amortisation during the period	(63)	(65)
At 31 December	302	285

Of the above total, £242m (2011 £219m) is expected to be recovered more than one year after the reporting date

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

12. Deferred costs (continued)

(b) Deferred origination costs

	2012 £ m	2011 £ m
At 1 January	167	201
Amounts incurred during the period	1	2
Amortisation during the period	(31)	(36)
At 31 December	137	167

Of the above total, £124m (2011 £140m) is expected to be recovered more than one year after the reporting date

13. Tax assets and liabilities

	2012 £ m	2011 £ m
Current tax receivables	95	98
Deferred tax assets	24	1
Total tax assets	119	99
Current tax payables	28	17
Deferred tax liabilities	133	242
Total tax liabilities	161	259

Deferred tax assets include £24m (2011 £1m) that is expected to be recovered more than one year after the reporting date

Deferred tax liabilities include £140m (2011 £242m) that is expected to be settled more than one year after the reporting date

(a) Recognised deferred tax

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

	2012 £ m	2011 £ m
Deferred tax assets comprise		
Trade losses	13	-
Other	11	1
Total deferred tax assets	24	1
Deferred tax liabilities comprise		
Unrealised gains on investment assets	-	-
Deferred acquisition costs	99	111
Other insurance related items	-	56
Deferred tax on acquired VIF	34	75
Total deferred tax liabilities	133	242
Net deferred tax liabilities	109	241

The Finance Act 2012 reduced the rate of corporation tax from 24% to 23% with effect from 1 April 2013. The impact of this reduction in tax rate, which is applicable to the calculation of deferred tax assets and liabilities at the reporting date, is reflected in the above table.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

13 Tax assets and liabilities (continued)

The Finance Act 2012 introduced a new UK tax regime for insurance companies which took effect from 1 January 2013. The new regime, together with current economic forecasts, has had a number of impacts on the deferred tax charge of the Company. This has resulted in an overall additional charge of £2m, comprising £nil due to the revaluation of policyholder tax assets, £2m due to the inclusion of certain investments to the charge to tax under the new regime, and £nil due to the revaluation of tax losses.

The tax charge in the statement of comprehensive income relating to each of the above items is as follows:

	2012 £ m	2011 £ m
Trade losses	13	-
Unrealised gains on investment assets	-	15
Expenses deductible in future periods	-	(62)
Other deferred tax assets	-	-
Deferred costs	12	12
Other insurance items	66	(41)
Acquired value in force	41	8
Total deferred tax (charge)/credit	132	(68)

(b) Unrecognised deferred tax

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

Deferred tax assets have not been recognised in respect of unrelieved capital losses of £17m (2011 £25m), as there is insufficient certainty as to the availability of future profits.

Deferred tax assets have not been recognised in respect of excess expenses carried forward of £76m (2011 £63m), as there is insufficient certainty as to the availability of future profits.

The Company has a significant With Profits pension business. The business is subject to UK corporation tax on the basis of a notional return determined by UK taxation authorities. To the extent that the actual return from the business is less than the notional return, tax losses accumulate which may be carried forward and offset against excess returns in future years. The maximum potential value of these losses at 31 December 2012 was £285m (2011 £282m). No asset has been recognised in respect of these losses as it is unlikely that there will be excess returns in future years against which they can be offset.

14 Investment in subsidiaries

	2012 £ m	2011 £ m
At 1 January	4,651	1,998
Movements in holdings of subsidiaries at fair value	6	(38)
Movements in holdings of collective investment vehicles at fair value	3,152	2,885
Impairment of investment in subsidiaries carried at cost	(49)	(194)
At 31 December	7,760	4,651

Investments in subsidiaries held at cost are generally recoverable more than one year after the reporting date. Due to the nature of investments in collective investment vehicles (including OEICs), there is no fixed term associated with these investments.

An impairment charge of £49m has been recognised during the year (2011 £194m) against the carrying value of CMMF, a subsidiary undertaking, to reduce carrying value to its net asset value. Of the above total, £486m (2011 £535m) relates to subsidiaries carried at cost. Investments in subsidiaries held at cost are generally recoverable more than one year after the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

14. Investment in subsidiaries (continued)

The following are particulars of the Company's principal subsidiaries

Name	Class of Share or Stock	Percentage held	Country of Registration or Incorporation	Nature of Business
Clerical Medical Managed Funds Limited	Ordinary	100	England and Wales	Life Insurance
Halifax Life Limited	Ordinary	100	England and Wales	Life Insurance
Clerical Medical Forestry Limited	Ordinary	100	England and Wales	Investments
CM Venture Investments Limited	Ordinary	100	Isle of Man	Investments
Clerical Medical Non-Sterling Property Company S a r l	Ordinary	100	Luxembourg	Property Investments
St Andrew's Life Assurance Plc *	Ordinary	100	England	Life Insurance

* indirect holding

The Company also invests in a number of collective investment schemes including OEICs which have been classified as investments in subsidiaries as described in the accounting policies

The ability of regulated entities to pay cash dividends to the Company or repay loans or advances is restricted by regulatory solvency requirements as well as Companies Act distributable reserves requirements. The ability of non-regulated entities to pay cash dividends to the Company or repay loans or advances is restricted by Companies Act distributable reserves requirements

15. Investment properties

	2012 £ m	2011 £ m
At 1 January	691	868
Additions – new properties	25	-
Additions – subsequent expenditure on existing properties	16	17
Disposals	(7)	(167)
Net loss from change in fair values	(26)	(27)
At 31 December	699	691

The rental income arising from investment properties during the year amounted to £51m (2011 £56m), 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 £1m (2011 £5m)

Expenditure on investment properties which did not generate rental income was £1m (2011 £2m)

The investment properties are independently valued by CB Richard Ellis and Jones Lang LaSalle on at least a quarterly basis for the purpose of determining the open market value of the properties

The carrying value of investment properties under development is £20m (2011 £27m). The carrying value of land held for development purposes that has not yet been developed is £nil (2011 £3m)

Due to the nature of the above assets, there are no fixed terms associated with these investments

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

16 Assets arising from reinsurance contracts held

The Company's assets arising from reinsurance contracts held can be analysed between those classified as insurance contracts and those classified as financial assets designated at fair value through profit or loss as follows

	2012			2011		
	Classified as		Total	Classified as		Total
	Insurance contracts	Fair value through profit or loss		Insurance contracts	Fair value through profit or loss	
	£ m	£ m	£ m	£ m	£ m	£ m
At 1 January	284	7,991	8,275	116	9,406	9,522
Movement recognised through the statement of comprehensive income	(32)	836	804	168	(161)	7
Movement recognised directly through the balance sheet	-	(8,037)	(8,037)	-	(1,254)	(1,254)
At 31 December	252	790	1,042	284	7,991	8,275
Amounts in respect of insurance and participating investment contract liabilities	252	-	252	284	432	716
Amounts in respect of non-participating investment contract liabilities	-	790	790	-	7,559	7,559
	252	790	1,042	284	7,991	8,275

Assets arising from reinsurance contracts held include £923m (2011 £7,398m) that is expected to be settled more than one year after the reporting date

In previous years reinsurance contracts which did not transfer significant insurance risk were classified as insurance contracts where these were held in respect of insurance contract liabilities. In light of developing practice, these amounts (2012 Nil, 2011 £432m) are now classified as financial assets designated at fair value through income in accordance with the underlying reinsurance contracts. The associated premiums ceded to reinsurers (2012 £15m, 2011 £18m) and claims recovered from reinsurers (2012 £52m, 2011 £57m) have been reclassified accordingly within the statement of comprehensive income.

17 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. In addition, the Company has entered into a swap for the specific purpose of hedging movements in the fair value of certain subordinated debt, as described in note 26.

Swap contracts include interest and inflation rate swaps. An interest or inflation rate swap is an agreement between two parties to exchange fixed and variable rate interest payments, based upon interest or inflation 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

17 Derivative financial instruments (continued)

Details regarding derivative financial instruments are given in the following tables

	2012			2011		
	Contract Amount £ m	Fair value assets £ m	Fair value liabilities £ m	Contract Amount £ m	Fair value assets £ m	Fair value liabilities £ m
Derivative financial instruments held for trading						
Swap contracts	2,962	175	260	2,817	142	271
Option contracts	2,219	368	-	2,499	518	-
Index futures contracts	913	11	2	745	1	11
Forward foreign exchange contracts	1,351	9	5	427	4	3
Derivative financial instruments designated as fair value hedges	314	30	-	325	30	-
Derivative financial instruments designated as net investment hedge	284	-	-	49	-	1
Total	8,043	593	267	6,862	695	286

Derivative financial instrument assets include £521m (2011 £647m) that is expected to be recovered more than one year after the reporting date

Derivative financial instrument liabilities include £260m (2011 £271m) that is expected to be settled more than one year after the reporting date

The fair value hedge included in the above tables is an interest rate swap in respect of the interest payments relating to the subordinated debt issued by the Company. This instrument forms part of a hedge relationship with the subordinated debt issued.

The net investment hedge included in the table above is held in respect of the European branch of the Company. The hedge has been put in place to offset the currency exposure relating to the branch with changes in the fair value of the derivative being taken directly to equity.

18. Loans and receivables

	2012 £ m	2011 £ m
Insurance business		
Amounts receivable in respect of direct insurance business	15	12
Amounts receivable under reinsurance contracts	1	4
Other loans and receivables		
Accrued interest and rent	10	27
Amounts due from related parties	79	156
Other	154	132
Total	259	331

Of the above total, £52m (2011 £89m) is expected to be recovered more than one year after the reporting date

Amounts due from reinsurers represent reinsurance receivables where the Company has the right to cover losses on contracts provided to policyholders

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

18 Loans and receivables (continued)

The carrying amount of loans to related parties is a reasonable approximation of fair value

There is no significant concentration of credit risk with respect to loans and receivables. Further information in respect of credit risk, is given in note 32

19. Investments at fair value through profit or loss

	2012 £ m	2011 £ m
At fair value:		
Shares and other variable yield securities	8,317	5,531
Debt and other fixed/variable income securities	6,549	5,756
Total investments at fair value	14,866	11,287

Of the debt securities, £5,894m (2011 £5,189m) is expected to be recovered more than one year after the reporting date. Due to the nature of equity and other variable yield securities, there is no fixed term associated with these securities

20. Cash and cash equivalents

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

	2012 £ m	2011 £ m
Cash at bank	75	113
Short term deposits	168	84
Total	243	197

Cash and cash equivalents in the above table contains amounts of £241m (2011 £195m) which are held entirely within the long-term insurance funds of the Company. These balances are not therefore readily available for use by the Company

21. Share capital

	2012 £ m	2011 £ m
Allocated, called up and fully paid share capital:		
70,000,000 ordinary shares of £1 each	70	70

There have been no changes to share capital during the year ended 31 December 2012

22 Insurance contract and participating investment contract liabilities

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

	2012			2011		
	Gross £ m	Reinsurance £ m	Net £ m	Gross £ m	Reinsurance £ m	Net £ m
At 1 January	15,821	(716)	15,105	16,638	(600)	16,038
Provision in respect of new business	393	(112)	281	347	(110)	237
Changes in existing business provisions	(1,217)	3	(1,214)	(1,350)	4	(1,346)
Recapture of reinsurance	-	422	422	-	-	-
Assumption changes	(4)	151	147	186	(10)	176
At 31 December	14,993	(252)	14,741	15,821	(716)	15,105

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

22. Insurance contract and participating investment contract liabilities (continued)

On 30 November 2012 the Company partially terminated its unit-linked pension reinsurance agreement with CMMF. This resulted in the net reduction of assets arising from reinsurance contracts held in respect of insurance contracts of £422m, this offset by increases to other gross asset classes.

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 plc.

An analysis of the expected maturities of insurance contract and participating investment contract liabilities is given in note 32.

23. Unallocated surplus

An analysis of the change in unallocated surplus is as follows:

	2012 £ m	2011 £ m
At 1 January	58	362
Change recognised through the statement of comprehensive income	(2)	(304)
At 31 December	56	58

Of the above total, £56m (2011: £58m) is expected to be settled more than one year after the reporting date.

The With Profits fund commenced a distribution of the excess estate from 1 February 2010 by enhancing the level of future expected benefit payments.

24. Provisions for other liabilities and charges

	2012 German insurance business litigation £ m	2012 Other £m	2012 Total £ m	2011 Total £ m
Opening balance	170	1	171	2
Exchange and other adjustments	1	-	1	-
Charge for the year	150	-	150	175
Amount utilised in the period	(33)	-	(33)	(6)
Closing balance	288	1	289	171

Of the above total, £200m (2011: £130m) is expected to be applied more than one year after the reporting date.

Provision in relation to German insurance business litigation

The Company has received a number of claims in the German courts, relating to policies issued by the Company but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. In its accounts for the year ended 31 December 2011 the Company recognised a provision of £175 million with respect to this litigation. Following decisions in July 2012 from the Federal Court of Justice ("FCJ") in Germany the Company has recognised a further provision of £150 million with respect to this litigation, increasing the total provision to £325 million.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions, and the implications with respect to the claims facing the Company. As a result the ultimate financial effect, which could be materially different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved.

The Directors believe this provision represents an appropriate estimate of the financial impact based upon a series of assumptions, including the number and proportions of claims received from the respective populations of different classes of policies, the proportion upheld, and resulting legal and administration costs.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

24 Provisions for other liabilities and charges (continued)

The Company will re-evaluate the assumptions underlying its analysis at each reporting date as more information becomes available. As noted above, there is inherent uncertainty in making estimates, actual results in future periods may differ significantly from the amount provided.

Other

Other provisions include provisions held in respect of onerous leases on investment properties.

25 Accruals and deferred income

	2012 £ m	2011 £ m
Accrued expenses	9	4
Deferred income	7	10
Deferred revenue on investment property	11	9
Total	27	23

Of the above total, £16m (2011: £13m) is expected to be realised more than one year after the reporting date.

26 Subordinated debt

Clerical Medical Finance plc, a fellow group undertaking, issued debt externally and in turn loaned the proceeds to the Company on similar interest, repayment and subordination terms as those applicable to the external bonds. The bonds are guaranteed on a subordinated basis by the Company after the claims of the Company's senior creditors, including all policyholders.

On 1st June 2012 CMIG issued £250m of GBP LIBOR + 7.45% Subordinated Guaranteed Bonds maturing on 1 June 2042, to Scottish Widows Group Limited.

The carrying value shown in the balance sheet is as follows:

	2012 £ m	2011 £ m
Subordinated debt	794	544
Issue costs	9	9
	803	553
Accrued interest on subordinated debt	18	18
Fair value hedge adjustment	25	24
Total	846	595

The carrying value is calculated on an effective interest rate basis adjusted for foreign exchange movements, amortised issue costs and hedged interest rate risk. The 2012 carrying value includes a foreign exchange gain of £14m (2011: £14m).

The fair value of the subordinated debt is £870m (2011: £388m), calculated at the open market value using published bid prices at the reporting date and including £9m (2011: £9m) of amortised issue costs.

Details of the bonds issued and proceeds loaned to the Company are as follows:

Scottish Widows Group Limited

£250m of floating rate subordinated notes held by Scottish Widows Group Limited, issued by CMIG in June 2012. Redemption of the notes is due in 2042. However, the notes may be redeemed at an earlier date provided that certain conditions, including the provision of six months' written notice of the intention to redeem, are met. Interest is payable on an annual basis at a rate of 12 month LIBOR plus 7.45%. Repayment of the notes is subordinate to the claims of CMIG's senior creditors, including all policyholders.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

26 Subordinated debt (continued)Clerical Medical Finance plc

£51m of 7.375% undated Subordinated Guaranteed Bonds, the redemption of which is at the option of Clerical Medical Finance plc and is generally not allowable prior to 5 November 2019. The interest rate charged to the Company by Clerical Medical Finance plc is 7.61%.

€219m of 6.45% dated Subordinated Guaranteed Bonds maturing on 5 July 2023. Redemption of the bonds is at the option of Clerical Medical Finance plc and is generally not allowable prior to July 2013, after which time if the bond has not been redeemed floating rate interest is payable. The interest rate charged to the Company by Clerical Medical Finance plc is 6.555%.

€388m of 4.25% undated Subordinated Guaranteed Bonds. Redemption of the bonds is at the option of Clerical Medical Finance plc and is generally not allowable prior to 27 June 2015, after which time if the bond has not been redeemed floating rate interest is payable. The interest rate charged to the Company by Clerical Medical Finance plc is 4.27%. An interest rate swap has been put in place in respect of the €388m tranche of the subordinated debt, which is accounted for using hedge accounting, as set out in note 1(m).

27. Non-participating investment contract liabilities

An analysis of the change in net non-participating investment contract liabilities is as follows:

	Gross £ m	2012 Reinsurance £ m	Net £ m	Gross £ m	2011 Reinsurance £ m	Net £ m
At 1 January	7,723	(7,559)	164	9,160	(8,922)	238
Provision in respect of new business	37	(37)	-	44	(44)	-
Changes in existing business provisions	(66)	78	12	(1,481)	1,407	(74)
Transfer of business	168	6,728	6,896	-	-	-
At 31 December	7,862	(790)	7,072	7,723	(7,559)	164

On 30 November 2012 the Company partially terminated its unit-linked pension reinsurance agreement with CMMF and accepted the novation of CMMF's reinsurance arrangement with Suffolk Life Annuities Limited. These transactions resulted in the net reduction of assets arising from reinsurance contracts held in respect of non-participating investment contracts of £6,728m, this offset by increases to other gross asset classes and the recognition of an offsetting non-participating investment contract liability of £47m.

At the same time CMMF established new reinsurance agreements with the Company to reinsure £121m of directly written unit linked pension business. Further information in relation to the changes to this business are set out in note 3.

An analysis of the contractual and expected maturities of non-participating investment contract liabilities is given in note 32.

28 Other financial liabilities

	2012 £ m	2011 £ m
Insurance business		
Amounts payable in respect of direct insurance business	88	88
Other liabilities		
Due to related parties	84	79
Due to brokers	8	6
Social security and other taxes	1	3
Repurchase creditor	78	274
Other	9	22
Total	268	472

Of the above total, £78m (2011: £274m) is expected to be settled more than one year after the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

29. Increase/decrease in operating assets and liabilities

	2012 £ m	2011 £ m
(Increase)/decrease in operating assets:		
Investment properties	(8)	177
Investment in subsidiaries held in the long term insurance funds of the Company	(3,109)	(2,847)
Assets arising from reinsurance contracts held	7,233	1,247
Prepayments	-	12
Investments at fair value through profit or loss	(3,579)	3,835
Loans and receivables including insurance receivables	72	72
Derivative financial instruments	102	(194)
Net decrease in operating assets	711	2,302
Increase/(decrease) in operating liabilities:		
Insurance contract and participating investment contract liabilities	(828)	(817)
Unallocated surplus within insurance business	(2)	(304)
Subordinated debt	251	(7)
Non-participating investment contract liabilities	139	(1,437)
Derivative financial instruments	(19)	152
Other financial liabilities	(204)	(275)
Provision for other liabilities and charges	118	169
Accruals and deferred income	4	(27)
Net decrease in operating liabilities	(541)	(2,546)
Net decrease/(increase) in operating assets and liabilities	170	(244)

30. Dividends paid

	2012 £ m	2011 £ m
Total dividends paid on equity shares	-	-

No dividend was paid in 2012 or 2011

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

31. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities

Policyholder liabilities can be analysed into With Profit Fund liabilities and Non Profit Fund liabilities

(1) Processes used to determine key assumptions in respect of insurance and investment contracts**(a) Liabilities of the With Profits Fund calculated on a “realistic” basis**

The Company's With Profits Fund contains both insurance and participating investment contracts. In accordance with FRS 27 the liabilities of the With Profit Funds are accounted for using the 'realistic' capital regime of the FSA ('realistic' liabilities). The main components of the realistic liabilities are

- With Profits benefit reserves, i.e. the total asset shares for with-profits policies,
- the costs of options and guarantees,
- deductions levied against asset shares, and
- the impact of smoothing policy

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market consistent basis. The calculation of realistic liabilities uses best estimate assumptions of e.g. mortality, persistency and expenses.

The processes for determining the key assumptions are set out below, and remain unchanged from the prior year.

- Investment returns and discount rates

A stochastic economic scenario generator, which uses recognised asset models, provides future asset value and yield scenarios; these determine investment returns for each scenario. The economic scenario generator is calibrated to observable yield curves and option prices where possible. Nominal interest rates are modelled using a standard interest rate model, calibrated to risk-free yields. The risk-free yield is defined as the spot yields derived from the UK gilt yield curve. The liabilities are valued by discounting projected future cash flows using the risk free yield.

- Investment volatility

The volatility of future equity returns in excess of nominal interest rates has been calibrated to ten-year at-the-money-forward options on appropriate indices. The indices used are the FTSE-100, the EuroStoxx-50, and the S&P 500. For property, no observable prices exist and so volatility has been derived from analysis of historic data.

- Mortality

The mortality assumptions, including allowances for improvements in longevity for annuitants, are based on recent actual experience, industry tables and mortality rates implied by indicative reinsurance terms.

- Persistency

Persistency is a function of both the rate of policy termination and the rate at which policyholders stop paying regular premiums. The assumed levels of these rates are based on a combination of historical experience and management's views on future experience taking into consideration potential changes that may result from guarantees and options becoming more valuable under adverse market conditions.

- Maintenance expenses

Allowance is made for the charges applied to the With Profits Fund and these are, for conventional With Profits business, governed by the Scheme of Transfer.

- Guaranteed annuity option take-up rates

The guaranteed annuity option take-up rates are set with regard to the Company's recent actual experience, increased to reflect future uncertainties where the exercise of options by policyholders might increase liabilities.

(b) Liabilities of the Non Profit Fund

The Company's Non Profit Fund contains both insurance and non participating investment contracts.

(i) Insurance contracts

The insurance contract liabilities are determined on the basis of recognised actuarial methods and are consistent with the approach to be used for the FSA 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

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

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 FSA 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, particularly those for annuitants. 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 FSA 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 FSA 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

The mortality assumptions, including allowances for improvements in longevity for annuitants, 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. Improvements in female annuitant mortality are assumed to follow the CMI projection model from the Actuarial profession's mortality committee subject to a long term rate of improvement of 1.5% per annum (2011 CMI projection model with a long term improvement rate of 1.5%). Improvements in male annuitant mortality are assumed to follow the CMI projection model from the Actuarial profession's mortality committee subject to a long term rate of improvement of 1.5% per annum (2011 CMI projection model with a long term improvement rate of 1.5%).

- 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. 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.

(ii) Non-participating investment contracts

The non-participating investment contracts are unit-linked, and the liability is determined by the value of corresponding unit-linked financial assets attributed to the contract holders at the balance sheet date.

(2) Key assumptions

(a) With Profits Fund

Assumptions are set for the 'realistic' valuation of the Company's With Profits Fund. In addition, liabilities in respect of non-participating policies in the With Profits Fund were also accounted for on the regulatory assessment.

(i) Investment returns and discount rates

In the 'realistic' valuation of liabilities in calibrating the economic scenario generator, the risk-free yield curve is defined as the yield curve for UK gilts.

(ii) Investment volatility (realistic liabilities only)

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2012, the 10-year equity-implied-at-the-money assumption was set at 26.3% (27.2% as at 31 December 2011). The assumption for property volatility was 15% (31 December 2011: 15%). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 18% as at 31 December 2012 (31 December 2011: 19%).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

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

(iii) Mortality assumptions

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

		2012	2011
Assurances (excluding term assurances)			
Conventional With-Profits	Males	45% AMC00 Ultimate	50% AMC00 Ultimate
	Females	60% AFC00 Ultimate	60% AFC00 Ultimate
Unisex Assurances	Males	85% AMC00 Ultimate	90% AMC00 Ultimate
	Females	90% AFC00 Ultimate	95% AFC00 Ultimate
Annuities			
Self-employed / Personal Pensions	Males	96% PCMA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)	96% PCMA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)
	Females	94% PCFA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)	94% PCFA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)
Other Annuities in payment	Males	96% PCMA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)	96% PCMA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)
	Females	94% PCFA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)	94% PCFA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)
Deferred Annuities	Males	96% PCMA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)	96% PCMA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)
	Females	94% PCFA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)	94% PCFA00 (CMI 2011 - 1 25% minimum improvement rate from 2003)

With regard to the above tables

The Company's current longevity assumptions are based on CMI_2011 model which was started last year. The CMI intend to update the model on a regular basis but updates to the reporting basis are only made when a significant movement in rates has been observed.

The release of the CMI_2012 has been postponed to February 2013. This is to allow for the revised population estimates which will be published by the Office for National Statistics (ONS) following the 2011 Census. Therefore, it is proposed to continue to apply the CMI_2011 model projections in the year end basis.

(iv) Other assumptions

Deferred annuity contracts with a guaranteed-rate annuity option have been valued based upon an assumed rate of take-up of the guaranteed annuity option of 85% for the realistic assessment (85.0% assumed at 31 December 2011).

(b) Non Profit Funds

The principal assumptions underlying the calculation of the Non Profit Fund liabilities are given below

(i) Investment returns and discount rates

Class of business	2012 Interest rate (net) %	2011 Interest rate (net) %
Conventional Life business and non-unit reserves on linked business	0.51	0.57
Annuities in payment	2.23	2.54

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

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

(ii) Mortality assumptions

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

		2012	2011
Term Assurances			
	Males	51 75% TMC00 Select	57 50% TMC00 Select
	Females	57 5% TFC00 Select	63 25% TFC00 Select
Annuities			
Purchased (whole life)	Males	86 4% PCMA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)	86 4% PCMA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)
	Females	84 6% PCFA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)	84 6% PCFA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)
Self-employed / personal Pensions	Males	86 4% PCMA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)	86 4% PCMA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)
	Females	84 6% PCFA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)	84 6% PCFA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)
Other Annuities in payment	Males	86 4% PCMA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)	86 4% PCMA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)
	Females	84 6% PCFA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)	84 6% PCFA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)
Deferred annuities	Males	86 4% PCMA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)	86 4% PCMA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)
	Females	84 6% PCFA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)	84 6% PCFA00 (CMI 2011 - 1 5% minimum improvement rate from 2003)

With regard to the above tables

The Company's current longevity assumptions are based on CMI_2011 model which was started using last year. The CMI intend to update the model on a regular basis but it is expected that, but updates to the reporting basis are only made when a significant movement in rates has been observed.

The release of the CMI_2012 has been postponed to February 2013. This is to allow for the revised population estimates which will be published by the Office for National Statistics (ONS) following the 2011 Census. Therefore, it is proposed to continue to apply the CMI_2011 model projections in the year end basis.

Previous longevity assumptions have applied since end-2007. These were set following an in-house consideration of all of the available industry data and models. The results were then calibrated to fit the Interim Cohort Projections published by the CMI in 2002. These tables recognise a 'cohort' effect, an observable more rapid rate of improvement for annuitants born in a period centred around 1926.

The CMI 'medium' projections are now considered out of date by many longevity experts as they are based on insured pension scheme data up to 1999. Consequently, the number of life offices using these projections has decreased substantially in recent years and it is expected that this trend will continue.

In November 2009 the CMI published a new mortality projection model, denoted 'CMI_2009', as the CMI had become concerned about the continuing widespread use of the 'interim cohort' mortality projections. The model has been updated since its issue with the latest update in November 2011, denoted 'CMI_2011' to reflect the publication of England and Wales population data for calendar year 2010. We consider it more appropriate to use this new model than revisit the previous in-house work.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

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

(3) The effect of changes in key assumptions**(a) With Profits Fund**

There is no net impact on profit before tax of the changes in key assumptions within the With Profits Fund as any change in policyholder liabilities is offset by an equal and opposite movement in the unallocated surplus of the long-term business

(b) Non Profit Funds

Changes in certain key assumptions were made during 2012 with the following impacts on profit after tax

Variable	Impact on profit after tax 2012 £m	Impact on profit after tax 2011 £m
Mortality	(43)	51
Expenses	27	68
Inflation	13	44
Valuation interest rate & credit default rates	(47)	(150)

(4) Sensitivity analysis (in respect of insurance and participating investment contracts only)

The following table demonstrates the effect of changes in key assumptions on profit before tax assuming that the other assumptions remain unchanged. In practice this is unlikely to occur, and changes in some assumptions may be correlated. In all cases there is no net impact on profit before tax of changes in assumptions within the With Profits Fund as any change in policyholder liabilities is offset by an equal and opposite movement in the unallocated surplus of the long-term business

Variable	Change in variable	2012 Impact on profit after tax £ m	2011 Impact on profit after tax £m
Annuitant Mortality	5% reduction	(43)	(37)
Other Mortality	5% reduction	-	2
Lapses	10% reduction	(23)	(21)
Maintenance expenses	10% reduction	38	35
Interest rate – change in redemption yield ⁽¹⁾	0.25% reduction	(49)	(36)
Interest rates – change in valuation margin ⁽²⁾	0.25% reduction	(67)	(58)

(1) This interest rate sensitivity shows the impact of a 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.

(2) This interest rate sensitivity shows, for pensions annuity business, the impact of a change to the valuation rate of interest without a corresponding change to asset yields, this would increase the margin available to cover default and other risks.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32 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 UK and through non-UK branches. The Company offers a wide range of life insurance products such as annuities, pensions, whole life, term life and investment type products principally through independent financial advisers, the Lloyds Banking Group network and direct sales. The Company also reinsures business with subsidiary undertakings and with insurance entities external to the Company.

The Company assesses the relative costs and concentrations of each type of risk through the Individual Capital Assessment (ICA) and Solvency II capital assessments and 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. The Risk function provides oversight and challenge and forms 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.

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 are 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 Lloyds Banking Group and 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 take 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

The Board has defined the methodology for the management of risk appetite and approved appropriate limits. Limits are defined for the Group as a whole and for the individual risk components. The limits are defined in terms of the amount of capital required to be held to cover certain specified stressed scenarios.

Exposure to each type of risk is monitored against the prescribed limits and the results reported to the Board of the Company. Where the exposure to any risk exceeds a trigger amount, the Insurance Executive Committee must approve an action plan to reduce the exposure or the Insurance Board must approve a revised limit.

(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), with profits 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32 Risk management (continued)

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 number of ways, including risk appetite assessment and monitoring of capital resource requirements. In addition, the Principles and Practices of Financial Management (PPFM) set out the way in which the with-profits business is managed. 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 with profits business, subject to minimum guarantees, policyholders' benefits are influenced by the smoothed investment returns on assets held in the With Profits Fund. The smoothing cushions policyholders from daily fluctuations in investment markets. This process is managed in accordance with the published PPFM.

The Company bears financial risk in relation to the guaranteed benefits payable under these contracts. The amount of the guaranteed benefits increases as additional benefits are declared and allocated to policies.

For unit-linked business, policyholders' benefits are closely linked to the investment returns on the underlying 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 such as annuity 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 where the difference is material.

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The summary 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.

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 above 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 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 prices (equity and property risk), market interest rates (interest rate 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 held outwith 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 risk. This includes the suitable use of derivatives to minimize 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.
- With Profits funds are managed in line with the published PPFM. Benchmarks and minimum and maximum holdings in asset classes are specified to allow limited investment management discretion whilst ensuring adequate diversification.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32 Risk management (continued)

Variable rate bonds and associated additional swap transactions provide significant protection to the With Profits Fund from the effects of interest rate falls in respect of the cost of guaranteed annuity rates

An analysis of financial assets and financial liabilities at fair value through profit or loss according to their fair value hierarchy (as defined in note 1(c)) is given below

As at 31 December 2012

	Fair value hierarchy			
	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
Investment in subsidiaries*	7,183	91	-	7,274
Equity securities	8,056	-	261	8,317
Debt securities	2,907	3,132	510	6,549
Derivative financial assets	11	582	-	593
Assets arising from reinsurance contracts held	-	790	-	790
Total assets	18,157	4,595	771	23,523
Derivative financial liabilities	2	265	-	267
Non-participating investment contract liabilities	-	7,862	-	7,862
Total liabilities	2	8,127	-	8,129

As at 31 December 2011

	Fair value hierarchy			
	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
Investment in subsidiaries*	4,034	82	-	4,116
Equity securities	5,267	-	264	5,531
Debt securities	3,344	2,412	-	5,756
Derivative financial assets	1	694	-	695
Assets arising from reinsurance contracts held	-	7,991	-	7,991
Total assets	12,646	11,179	264	24,089
Derivative financial liabilities	11	275	-	286
Non-participating investment contract liabilities	-	7,723	-	7,723
Total liabilities	11	7,998	-	8,009

* Investment in subsidiaries exclude those held at cost of £486m (2011 £535m)

Of the debt securities classified as Level 2 above, £3,132m (2011 £2,412m) have been valued using a modelled price or based on a price from a single broker. The models used to derive these prices use only observable data and are therefore level 2 rather than level 3. The remaining assets are priced using prices obtained via a price vendor. This vendor obtains prices from a number of different market makers in corporate bonds and calculates a consensus price to give the best reflection of the market price on that day. On the basis that this price may not be based on actual trades and as information regarding the volume of individual trades is not readily available, these assets have been classified as level 2 rather than level 1.

Assets classified as Level 3 comprise private equity investments, property investment vehicles, certain loans, asset backed securities and covered bonds.

Private equity investments are valued using the financial statements of the underlying companies prepared by the general partners, adjusted for known cash flows since valuation and subject to a fair value review to take account of other relevant information. Property investment vehicles are valued based on the net asset value of the relevant company which incorporates surveyors' valuations of property. Whilst such valuations are sensitive to estimates, it is believed that changing one or more of the assumptions to reasonably possible alternative assumptions would not change the fair value significantly.

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 £1m or increase it by £1m.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32 Risk management (continued)

Whilst such valuations are sensitive to estimates it is believed that changing one or more of the assumptions to reasonably possible alternative assumptions would not change the fair value significantly

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)

	2012		2011	
	£m	£m	£m	£m
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
Balance at 1 January	264	-	321	-
Total net gains/(losses) recognised within net realised and net fair values gains on assets at fair value through profit or loss in the statement of comprehensive income	52	-	(32)	-
Purchases	537	-	4	-
Disposals	(82)	-	(29)	-
Balance at 31 December	771	-	264	-
Total gains/(losses) for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	52	-	(32)	-

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

The exposure of the Company's insurance and investment contract business to equity 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

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

	2012	2011
	£ m	£ m
Impact on profit after tax and equity at reporting date		
10% increase in equity prices	1	2
10% decrease in equity prices	(1)	(2)

(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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32 Risk management (continued)

The effect of changes in interest rates in respect of financial assets which back insurance contract liabilities is given in note 30. 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.

	2012 £ m	2011 £ m
Impact on profit after tax and equity at reporting date		
25 basis points increase in yield curves	49	36
25 basis points decrease in yield curves	(49)	(36)

(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 and the investments of the shareholder fund are in sterling or should be 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.

The nature of the Company's business involves the accepting of insurance risks which primarily relate to mortality, persistency and expenses. The Company underwrites 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
- Annuity products – where typically the policyholder is entitled to payments which cease upon death

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. The possibility of a pandemic, for example one arising from Swine Flu, is regarded as a potentially significant mortality risk.

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. For participating investment contracts the participating nature of these contracts results in a significant portion of the insurance risk being shared with the policyholder.

Insurance risk is also affected by the policyholders' right to pay reduced or no future premiums, to terminate the contract completely or to exercise a guaranteed annuity option. 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32 Risk management (continued)

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

The principal methods available to the Company to control or mitigate longevity and mortality 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 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 reinsurance arrangements 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 and participating investment contracts is given in note 31.

(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 and credit risk in respect of With Profits funds is largely borne by the policyholders. Consequently, the Company has no significant exposure to credit risk for those funds.

For non-linked funds 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 Lloyds Banking Group 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 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 receivables are assessed on a case by case basis, using a credit rating agency where appropriate.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32 Risk management (continued)

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

As at 31 December 2012

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Debt securities	6,549	4,221	742	1,007	570	9
Derivative financial instruments	593	-	-	563	30	-
Loans and receivables	259	40	11	140	14	54
Assets arising from reinsurance contracts held	1,042	-	-	254	35	753**
Cash and cash equivalents	243	-	-	233	3	7
Total	8,686	4,261	753	2,197	652	823

*Of which £571m is BBB rated

** Relates to the Company's subsidiary, CMMF

Amounts classified as 'not rated' in the above table are not rated by Standard and Poor's or an equivalent rating agency

As at 31 December 2011

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Debt securities	5,756	4,190	183	1,072	302	9
Derivative financial instruments	695	-	-	695	-	-
Loans and receivables	331	41	3	164	7	116
Assets arising from reinsurance contracts held	8,275	-	66	200	9	8,000**
Cash and cash equivalents	197	-	-	197	-	-
Total	15,254	4,231	252	2,328	318	8,125

*Of which £236m is BBB rated

** Relates to the Company's subsidiary, CMMF

Amounts classified as 'not rated' in the above table are not rated by Standard and 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 Financial Services Authority for regulatory reporting.

At 31 December 2012 and 31 December 2011, 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 8% (2011: 4%) of the Company's total assets, excluding with-profits and unit-linked funds where credit risk is matched by policyholder liabilities.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32 Risk management (continued)**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 Shareholder and With-Profits Investment Management Committee ("SAWPIM") Operational Banking Committee and Insurance Finance and Capital Committee

(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 all 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

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
- 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

	2012 £ m	2011 £ m
Investments at fair value through profit or loss	-	4
Cash and cash equivalents	37	62
Total	37	66

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32. Risk management (continued)

Collateral amounts held against derivatives are not recognised as assets. Assets with a fair value of £309m (2011: £454m) were accepted by the Company as collateral, of which £nil (2011: £nil) is permitted to be sold or repledged in the absence of default. The policy of the Company is not to repledge assets, and no collateral was sold or repledged by the Company during the year or in the prior year. The Company has an obligation to return these assets to the pledgor.

The Company enters into stocklending transactions. The SAWPIM is responsible for setting the parameters of stocklending and therefore changes to these 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.

All collateral held relates to fully performing assets.

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 Company enters into securities lending transactions whereby cash and securities are temporarily received or transferred as collateral. Assets and liabilities relating to such arrangements at 31 December are as follows:

	Asset		Related Liability	
	2012 £ m	2011 £ m	2012 £ m	2011 £ m
Equity Investments	6	73	17	51
Debt Investments	1,768	1,003	1,860	1,076
Assets subject to repurchase	1,774	1,076	1,877	1,127

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.

There were no collateral defaults in respect of stocklending during the year ended 31 December 2012 (2011: none) which required a call to be made on collateral.

Collateral pledged in respect of a repurchase agreement with HBOS Treasury continues to be recognised on the Company's balance sheet. The amount pledged was £78m (2011: £274m).

(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 2012

32 Risk management (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 quantify the liquidity risk exposure various stress tests are considered. At the start of 2012 liquidity risk was measured by comparing the projected outflow in the stress scenario for twelve months of surrenders and three months of maturities against the sum of liquid resources available. During 2012 a new liquidity risk appetite was introduced that required that in a one-in-ten year event the Company still has sufficient liquid assets to cover three times net cash flows (to policyholders, shareholders and debt holders). A further revision was made to the liquidity risk appetite in December 2012. 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, Company firm-specific stress scenarios, FSA market-wide scenarios, and FSA market wide scenarios with Insurance-specific overlays. The risk appetite sets a coverage benchmark of over 150%.

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

Annuity contracts

Assets are held which are specifically chosen to correspond to the expectation of timing of annuity payments. Gilts, corporate bonds, and, where required, derivatives are selected to reflect, the expected annuity payments as closely as possible and are regularly rebalanced to ensure that this remains the case in future.

With-profits contracts

For with-profits business, a portfolio of assets is held in line with investment mandates which will reflect policyholder expectations as set out in the published PPFM.

Liquidity is maintained within the portfolio via the holding of cash balances and a substantial number of highly liquid assets, principally gilts and bonds. Management also have the ability to sell less liquid assets at a reduced price if necessary, with any loss passed on to policyholder in line with policyholders' reasonable expectations. Losses are managed and mitigated by anticipating policyholder behaviour and sales of underlying assets within funds.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32. Risk management (continued)

Non-participating contracts

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 2012, there are £nil funds under management subject to deferral (2011 £nil).

For non-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 with the Insurance Liquidity Risk Policy and the wider LBG 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. Liquidity risk in respect of insurance and participating investment 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 non-participating 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.

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
Non-participating investment contract liabilities	7,862	-	7,862	-	-	-	-
Derivative financial instruments	267	-	3	4	-	6	254
Subordinated debt	846	388	-	-	35	142	946
Other financial liabilities	268	-	268	-	-	-	-
Total	9,243	388	8,133	4	35	148	1,200

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

As at 31 December 2011

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
Non-participating investment contract liabilities	7,723	-	7,723	-	-	-	-
Derivative financial instruments	286	-	2	13	-	-	271
Subordinated debt	595	396	-	-	12	50	268
Other financial liabilities	472	-	472	-	-	-	-
Total	9,076	396	8,197	13	12	50	539

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32. Risk management (continued)

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 2012

Maturity Analysis for insurance and investment contracts	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 contract and participating investment contract liabilities	14,993	159	325	1,404	4,744	8,361
Non-participating investment contract liabilities	7,862	73	144	637	2,470	4,538

As at 31 December 2011

Maturity Analysis for insurance and investment contracts	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 contract and participating investment contract liabilities	15,821	160	328	1,495	5,212	8,626
Non-participating investment contract liabilities	7,723	66	133	605	2,275	4,644

(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 IFCC

The Company is regulated by the FSA. The FSA specifies the minimum amount of capital that must be held by the Company in addition to their insurance liabilities

Under the FSA rules, the Company must hold assets in excess of the higher of

- (i) the Pillar 1 amount, which is calculated by applying fixed percentages of mathematical reserves and capital at risk, and
- (ii) the Pillar 2 amount, which is derived from an economic capital assessment undertaken by each regulated company, which is reviewed by the FSA

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 comply with the insurance capital requirements set out by the FSA in the UK,
- 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,
- 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, and
- to meet the requirements of the Scheme of Transfer

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32 Risk management (continued)

The capital management strategy is such that the single integrated insurance business (comprising SWG and its subsidiaries, including the Group) 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 solvency 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 and includes subordinated debt (note 26).

The table below sets out the regulatory capital and the required capital held at 31 December in each year on a Pillar 1 basis. The current year information is based upon the 2012 FSA returns.

	2012 £ m	2011 £ m
Regulatory capital held	2,584	2,658
Regulatory capital required	1,472	1,493

All minimum regulatory requirements were met during the year.

(d) 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 the theft of, or damage to the Group's assets, the loss, corruption, misuse or theft of the Group's information assets or threats or actual harm to the Group's people. This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

32. Risk management (continued)**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 divisional and 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 losses from change initiatives failing to deliver to requirements, budget or timescale, failing to implement change effectively or failing to realise desired benefits.

Political risk

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. A LBG Scottish Constitutional Change Steering Group, with cross-Group representation, has been set up to assess any potential impact for the business.

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.

(e) 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 laws, regulations or codes applicable.

A provision is held in respect of German litigation. This is discussed further in note 24.

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

33 Related party transactions

a) Ultimate parent and shareholding

The Company's immediate parent undertaking is Scottish Widows plc, a company registered in the United Kingdom

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

Scottish Widows plc is the parent undertaking of the smallest such group of undertakings. 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

The Company's immediate parent undertaking is Scottish Widows plc, a company registered in the United Kingdom. Clerical Medical Investment Group has taken advantage of the provisions of the Companies Act 2006 and has not produced consolidated financial statements

(b) Transactions and balances with related parties

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

Relationship	Transactions in the Year		Outstanding Balance at 31 December	
	2012 £m	2011 £m	2012 £m	2011 £m
Ultimate Parent undertaking:				
Investments and amounts receivable/(payable)	(5)	(8)	9	14
Commission and amounts payable	(1)	-	(1)	-
Parent undertakings:				
Reassurance and amounts receivable/(payable)	89	(3)	24	64
Subsidiary undertakings				
Expense recharges and amounts receivable/(payable)	(1)	(11)	(29)	(31)
Commission and amounts receivable	-	-	1	1
Reassurance and amounts receivable/(payable)	8,018	6	21	23
Loans receivable	(20)	(43)	29	49
Dividends received	50	334	-	-
Holding in OEICs	-	-	7,046	3,894
Other related parties				
Expense recharges and amounts receivable/(payable)	24	(34)	(8)	(32)
Bank charges receivable	-	(28)	-	-
Interest receivable	-	(3)	-	-
Cash and amounts receivable/(payable)	193	59	(79)	(271)
Reassurance and amounts receivable/(payable)	-	9	-	27
Management fees and amounts payable	2	(33)	(4)	(6)
Loans	(31)	(40)	11	42
Subordinated debt	(237)	19	(808)	(571)
Holding in OEICs	-	-	5,469	-
Debt securities	515	-	515	-

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

33. Related party transactions (continued)**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 are as follows

	2012 £ 000	2011 £ 000
Salaries and other short-term benefits	300	781
Post-employment benefits	13	15
Share-based payments	48	167
Total	361	963

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 to four Directors and key management personnel (2011: one) under defined benefit pension schemes. Ten Directors and key management personnel (2011: two) are paying into a defined contribution scheme.

Detail regarding the highest paid Director is as follows:

	2012 £000	2011 £000
Apportioned aggregate emoluments	42	157
Defined benefits pension scheme accrued benefit at 31 December	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. These have been disclosed in the LBG consolidated accounts.

HM Treasury

In January 2009, HM Treasury became a related party of the Company following its subscription for ordinary shares in Lloyds Banking Group plc, the Company's ultimate parent company, issued under a placing and open offer. HM Treasury held a 39 per cent (31 December 2011: 40 per cent) interest in Lloyds Banking Group's ordinary share capital and, consequently, HM Treasury remained a related party of the Company throughout 2012.

There were no material transactions between the Company and HM Treasury during the year (2011: none) that were not made in the ordinary course of business or that are unusual in their nature or conditions. In addition, the Company has 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.

34. Stocklending

The aggregate value of securities on loan by the Company is £1,774m (2011: £1,076m). Securities on loan are included in investments at fair value through profit or loss and no account is taken of collateral held. The aggregate value of collateral held is £1,877m (2011: £1,127m). Further detail in respect of collateral is provided in note 32.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

35 Operating leases

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

	2012 £ m	2011 £ m
Within one year	41	39
Between two and five years	145	157
Beyond five years	340	393
Total	526	589

The total future minimum rental payments payable under non-cancellable leases are as follows

	2012 £ m	2011 £ m
Within one year	7	11
Between two and five years	-	-
Beyond five years	-	-
Total	7	11

The total of contingent rents recognised as income during the year was £nil (2011 £nil). The total of contingent rents recognised as operating expenses during the year was £nil (2011 £nil). Generally the Company's operating leases are for terms of 15 years or more.

36. Standards and interpretations effective in 2012

The Company has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2012. None of these standards or amendments has had a material impact on these financial statements.

(i) Disclosures – Transfers of Financial Assets (Amendments to IFRS 7) Requires disclosure in respect of all transferred financial assets that are not derecognised in their entirety and transferred assets that are derecognised in their entirety but with which there is continuing involvement.

(ii) Deferred Tax – Recovery of Underlying Assets (Amendment to IAS 12) Introduces a rebuttable presumption that investment property measured at fair value is recovered entirely through sale and that deferred tax in respect of such investment property are recognised on that basis. The Company's existing practices are consistent with this Amendment.

Details of those IFRSs pronouncements which will be relevant to the Company but which were not effective at 31 December 2012 and which have not been applied in preparing these financial statements are given in note 37.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

37. 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 2012 and have not been applied in preparing these financial statements. Except as discussed below, the full impact of these accounting changes is being assessed by the Company.

Pronouncement	Nature of change	IASB effective date
Amendments to IAS 1 "Presentation of Financial Statements" – 'Presentation of Items of Other Comprehensive Income' ^{1,2}	Requires entities to group items presented in other comprehensive income on the basis of whether they are potentially reclassified to profit or loss subsequently	Annual periods beginning on or after 1 July 2012
Amendments to IFRS 7 "Financial Instruments Disclosures" – 'Disclosures-Offsetting Financial Assets and Financial Liabilities'	Requires 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	Annual periods beginning on or after 1 January 2013
IFRS 9 'Financial Instruments'	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.	Annual periods beginning on or after 1 January 2015
IFRS 10 "Consolidated Financial Statements"	Supersedes IAS 27 "Consolidated and Separate Financial Statements" and SIC-12 Consolidation "Special Purpose Entities" and establishes the principles for when an entity controls another entity and therefore is required to consolidate the other entity in group financial statements. The effect of applying this IFRS to the Company could result in a change in collective investment vehicles classified as investments in subsidiaries.	Annual periods beginning on or after 1 January 2013
IFRS 12 'Disclosure of Interests in Other Entities'	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.	Annual periods beginning on or after 1 January 2013
IFRS 13 'Fair Value Measurement'	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.	Annual periods beginning on or after 1 January 2013
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

¹ At the date of this report, these pronouncements are awaiting EU endorsement.

² IFRS 9 is the initial stage of the project to replace IAS 39. Future stages are expected to result in amendments to IFRS 9 to deal with changes to the impairment of financial assets measured at amortised cost and hedge accounting, as well as a reconsideration of classification and measurement. Until all stage of the replacement project are complete, it is not possible to determine the overall impact on the financial statements of the replacement of IAS 39.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012**38 Post Balance Sheet Events**

The proposed further reductions in the rate of corporation tax to 21 per cent by 1 April 2014 is expected to be enacted during 2013. The effect of this further change upon the Company's deferred tax balances cannot be reliably quantified at this stage. The proposed further reductions in the rate of corporation tax to 20 per cent by 1 April 2015 is expected to be enacted during 2014. The effect of this further change upon the Company's deferred tax balances cannot be reliably quantified at this stage.