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CLERICAL MEDICAL INVESTMENT GROUP LIMITED

REPORT OF THE DIRECTORS

AND

FINANCIAL STATEMENTS

31 DECEMBER 2009

Member of Lloyds Banking Group plc

CONTENTS

COMPANY INFORMATION

Board of Directors

M Christophers
A G Kane*
T A Leonard*
P D Loney*
A M Peck
J Van Der Wielen*

* denotes Executive Director

Secretary

S Mayer

Actuarial Function Holder

P Turnbull

Auditors

PricewaterhouseCoopers LLP
31 Great George Street
Bristol
BS1 5QD

Registered Office

33 Old Broad Street
London
EC2N 1HZ

Company Registration Number

3196171

DIRECTORS' REPORT

Principal activity and review of business

The Directors present the financial statements of Clerical Medical Investment Group Limited ("the Company") The Company is a limited liability company domiciled in the United Kingdom

The principal activity of the Company is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the United Kingdom 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 This includes the majority of its existing pensions linked business, which is reinsured to its subsidiary, Clerical Medical Managed Funds Limited ("CMMF")

With effect from 20 January 2009, the Company began to accept reinsured protection business from Scottish Widows plc, another life company within Lloyds Banking Group plc As a result of this transaction, gross premiums have increased by £81 5m and loss before tax has increased by £38 3m

From 1 July 2009, the Company ceased writing new pension contracts However it continues to receive increments on existing contracts

On 27th July 2009, Clerical Medical Finance plc, a fellow subsidiary undertaking, redeemed and cancelled part of its subordinated debt, the proceeds of which are loaned to the Company as described in note 25 The loan between Clerical Medical Finance plc and the Company was redeemed in the same ratio to that of the external redemption, resulting in no gain or loss to the Company

On 31 December 2009, the Company recaptured its portfolio of annuity business reinsured to its subsidiary undertaking, Clerical Medical Managed Funds Limited This resulted in the de-recognition of reinsurance assets of £2 0bn and a negative profit impact of £112 2m, being the consideration paid for the recaptured business

Results and dividend

The result of the Company for the year ended 31 December 2009 is a loss after tax of £287 5m (2008 profit of £261 9m) and this has been transferred to reserves

During the year, no dividends were paid (2008 £610m) The Directors do not recommend the payment of a dividend in respect of the year ended 31 December 2009

Key performance indicators

Total gross premiums received from policyholders were £1,978 6m (2008 £2,809 3m) Of this, £914 0m (2008 £784 2m) was recognised in the statement of comprehensive income with the remainder being subject to deposit accounting

Funds under management are approximately £16 7bn (2008 £15 4bn)

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 Directors consider that the above key performance indicators are appropriate to the principal activity of the Company In addition, the Directors are of the opinion that the Financial Services Authority's (FSA) returns capital resource requirement information 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

The Company also forms part of the Insurance Division of Lloyds Banking Group plc The development, performance and position of this Division are discussed in the Group's annual report, which does not form part of this report

Future outlook

The Directors consider that the Company's 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 and financial soundness risk are set out in note 32

DIRECTORS' REPORT (continued)

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 regulatory 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

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

A G Kane (Appointed 4 March 2009)
J Van Der Wielen (Appointed 4 March 2009)
S Colsell (Resigned 23 March 2009)
J Dawson (Resigned 23 March 2009)
R Devey (Resigned 23 March 2009)
P Gale (Resigned 31 December 2009)
B Duffin (Resigned 18 March 2010)
P D Loney (Appointed 25 March 2010)

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

Disclosure of information to auditors

Each Director confirms that, as far as they are aware, there is no relevant audit information of which the Company's auditors are unaware Relevant information is defined as "information needed by the Company's auditors in connection with preparing their report"

Each Director has taken all the steps that he ought to have taken in his duty as a Director in order to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information

This confirmation is given, and should be interpreted in accordance with, the provisions of section 418 of the Companies Act 2006

Change of auditors

Following the resignation of KPMG on 30 April 2009, PricewaterhouseCoopers LLP were appointed as auditors of the company with effect from the same date by resolution of the members dated 30 April 2009

Pursuant to section 487 of the Companies Act 2006, auditors duly appointed by the members of the company shall, subject to any resolution to the contrary, be deemed to be reappointed for the next financial year and PricewaterhouseCoopers LLP will therefore continue in office

Policy and practice on payment of creditors

The Company follows "The Better Payment Practice 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, No1 Victoria Street, London, SW1H 0ET

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 a separate company within the Lloyds Banking Group The number of days shown in this report, to comply with the provisions of the Companies Act 2006, is 20 days (2008 19 days)

On behalf of the Board of Directors

Sally Mayer
25 March 2010

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,
- 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

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 2009 which comprise 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 6, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors

This report, including the opinions, has been prepared for and only for the Company's member asa 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 financial statements

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

Opinion on financial statements

In our opinion the financial statements

- give a true and fair view of the state of the Company's affairs as at 31 December 2009 and of the Company's loss and cash flows for the year then ended,
- have been properly prepared in accordance with IFRSs as adopted by the European Union,
- have been properly prepared in accordance with the requirements of the Companies Act 2006

Opinion on other matters 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 by the Company, 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

Clare Thompson (Senior Statutory Auditor)
For and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Bristol
25 March 2010

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2009

	Notes	2009 £ m	2008 (Restated) £ m
Revenue			
Gross earned premiums		914 0	784 2
Premiums ceded to reinsurers	22	1,761 7	(155 2)
Premiums net of reinsurance		**2,675 7**	**629 0**
Fee and commission income	3	77 6	78 4
Investment income	4	703 1	746 5
Net realised gains on assets and liabilities at fair value though income	5	13 1	785 2
Net fair value losses on assets and liabilities at fair value through income	6	(44 0)	(2,023 3)
Other income		37 5	-
Total revenue		**3,463 0**	**215 8**
Expenses			
Gross claims and benefits		1,828 4	930 0
Claims recoveries from reinsurers		(185 6)	(201 5)
		1,642 8	728 5
Change in insurance contract and investment contract with DPF liabilities		(568 6)	2,211 4
Change in investment contract without DPF liabilities		949 5	(2,984 7)
Change in reinsurers' share of liabilities	22	844 4	765 4
Change in unallocated surplus	23	201 2	(1,028 2)
		1,426 5	(1,036 1)
Operating expenses	7	561 3	401 6
Expenses for asset management services received		76 1	52 9
Finance costs	9	80 4	103 1
		717 8	557 6
Total expenses		**3,787 1**	**250 0**
Loss before tax		**(324 1)**	**(34.2)**
Taxation credit	10	36 6	296 1
(Loss)/profit for the year		**(287 5)**	**261 9**
Other comprehensive income			
Movement in net investment hedges		(2 4)	-
Currency translation differences		9 4	(9 0)
Other comprehensive income		**7 0**	**(9 0)**
Total comprehensive income		**(280.5)**	**252 9**

The notes set out on pages 12 to 65 are an integral part of these financial statements

The 2008 comparatives have been restated as explained in note 38 with no overall impact on either profit or net assets

BALANCE SHEET AS AT 31 DECEMBER 2009

	Notes	2009 £ m	2008 (Restated) £ m	1 Jan 2008 (Restated) £ m
ASSETS				
Intangible assets	11	221 1	270 8	294 0
Deferred costs	12	474 9	477 9	413 1
Deferred tax assets	13	73 0	67 0	20 5
Investment in subsidiaries	14	963 4	1,114 7	935 9
Property	15	6 0	77 4	161 4
Investment properties	16	945 4	1,214 3	1,963 5
Reinsurers' share of insurance contract and investment contract with DPF liabilities	22	521 5	2,270 4	2,294 2
Prepayments and accrued income		1 8	2 4	17 3
Current tax receivable	13	29 0	7 8	105 7
Financial assets				
Reinsurers' share of investment contract without DPF liabilities	26	8,473 6	7,456 5	8,805 1
Derivative financial instruments	17	531 3	662 3	57 2
Loans and receivables	18	538 7	686 1	626 9
Investments at fair value through income	19	16,594 0	15,079 2	17,272 4
Cash and cash equivalents	20	356 6	289 3	267 8
Total assets		**29,730.3**	**29,676 1**	**33,235 0**
EQUITY AND LIABILITIES				
Capital and reserves attributable to Company's equity shareholders				
Share capital	21	70 0	70 0	1,629 0
Share premium	21	1 0	1 0	1 0
Retained earnings		1,552 2	1,832 7	630 8
Total equity		**1,623 2**	**1,903.7**	**2,260.8**
Liabilities				
Insurance contract and investment contract with DPF liabilities	22	16,339 4	16,908 0	15,215 5
Unallocated surplus	23	670 4	469 2	1,497 4
		17,009 8	17,377 2	16,712 9
Deferred tax liabilities	13	220 7	250 5	409 5
Current tax payables	13	38 5	-	-
Provisions for other liabilities and charges		1 6	2 2	1 9
Accruals and deferred income	24	39 3	46 6	51 3
Financial liabilities				
Subordinated debt	25	609 7	1,316 3	1,014 8
Investment contract without DPF liabilities	26	8,684 9	7,761 0	12,424 3
Derivative financial instruments	17	102 8	131 1	37 9
Other liabilities	27	1,383 8	718 5	270 2
Borrowings	28	16 0	169 0	51 4
Total liabilities		**28,107 1**	**27,772 4**	**30,974 2**
Total liabilities and equity		**29,730 3**	**29,676 1**	**33,235 0**

Approved by the Board on 25 March 2010

T A Leonard
Director

The notes set out on pages 12 to 65 are an integral part of these financial statements

The 2008 comparatives have been restated as explained in note 38 with no overall impact on either profit or net assets

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2009

	Notes	2009 £ m	2008 (Restated) £ m
Cash flows from operating activities			
Loss before tax		(324 1)	(34 2)
Adjusted for			
Dividends and loan interest received from subsidiary undertakings		(0 9)	(64 9)
Impairment of property	15	2 8	-
Gain on disposal of property		-	(15 5)
Impairment of subsidiary undertakings owned by the shareholder fund		109 5	-
Amortisation and impairment of intangible assets	11	49 5	28 3
Movement in deferred costs	12	3 0	(64 8)
Finance costs	9	80 4	103 1
Other comprehensive income relating to monetary items		7 0	(9 0)
Foreign exchange on intangible assets		0 3	-
Net decrease in operating assets and liabilities	29	354 3	377 4
Taxation received		18 1	188 5
Net cash flows from operating activities		299 9	508 9
Cash flows from investing activities			
Purchase of property	15	-	(20 4)
Proceeds from sale of property		-	68 7
Additions to intangible assets	11	(0 1)	(5 1)
Dividends and loan interest received from subsidiary undertakings		0 9	64 9
Net cash flows from investing activities		0 8	108 1
Cash flows from financing activities			
Dividends paid	30	-	(610 0)
Finance costs paid	9	(80 4)	(103 1)
Net cash flows from financing activities		(80 4)	(713 1)
Net increase in cash and cash equivalents		220 3	(96 1)
Cash and cash equivalents at the beginning of the year		120 3	216 4
Net cash and cash equivalents at the end of the year	20	340 6	120 3

The notes set out on pages 12 to 65 are an integral part of these financial statements

The 2008 comparatives have been restated to reflect the reclassifications explained in note 38

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2009

	Notes	Issued share capital £ m	Share premium £ m	Retained earnings £ m	Total £ m
Balance as at 1 January 2008		1,629 0	1 0	630 8	2,260 8
Total comprehensive income for the year		-	-	252 9	252 9
Dividends paid	30	-	-	(610 0)	(610 0)
Reduction of Issued Share Capital under Section 641 of the Companies Act 2006		(1,559 0)	-	1,559 0	-
Balance as at 31 December 2008		70 0	1 0	1,832 7	1,903 7
Total comprehensive income for the year		-	-	(280 5)	(280 5)
Balance as at 31 December 2009		70 0	1 0	1,552 2	1,623 2

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 12 to 65 are an integral part of these financial statements

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies

Summary of significant accounting policies

The Company has identified the accounting policies that are most significant to its business operations and the understanding of its results

The financial statements comprise the statement of comprehensive income, the balance sheet, the statement of cash flows, the statement of changes in equity and the related notes The preparation of the financial statements necessitates the use of estimates and assumptions in applying the accounting policies set out on pages 12 to 24 The accounting policies which relate to insurance contract and investment contract with DPF liabilities (policy s), intangible assets (policy f), the ascertainment of fair values of financial assets and financial liabilities (policy c) and the determination of impairment losses (policy p) are those which involve the most complex or subjective decisions or assessments These estimates and assumptions affect the reported amounts of assets and liabilities, contingent or otherwise, at the reporting date, as well as affecting the reported income and expenses for the year

In each case, the determination of these is fundamental to the financial results and position of the Company, and requires management to make complex judgments based on information and financial data that may change in future periods Although the estimates are based on management's best knowledge of current facts as at the reporting date, the actual outcome may differ from those estimates

The significant accounting policies adopted in the preparation of the financial statements, which have been consistently applied to all periods presented in these financial statements, 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 income, 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 is exempt by virtue of IAS 27 Consolidated and Separate Financial Statements from the requirement to prepare group Financial Statements These Financial Statements present information about the Company as an individual undertaking and not about its group

Standards and interpretations effective in 2009

A number of standards, amendments to and interpretations of published standards which have the potential to impact on the Company's operations have been issued and are mandatory for accounting periods beginning on or after 1 January 2009 Their relevance to the Company's operations is assessed at note 36

Details of standards and interpretations in issue but which have not been adopted early are set out at note 37

(b) Product classification

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies (continued)

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 and without a discretionary participation feature ("DPF")

A DPF is a contractual right that gives investors the 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 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 Investment contracts with DPF are accounted for in the same manner as insurance contracts in accordance with the requirements of IFRS 4 "Insurance Contracts"

Investment contracts without DPF are contracts that neither transfer significant insurance risk nor contain a DPF

Hybrid contracts

For certain investment contracts, the contract can be partly invested in units which contain a DPF and partly without Where the contract is split, part is allocated as an investment contract and part as an investment contract with DPF

(c) Financial assets and financial liabilities

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

Financial assets are derecognised when the rights to receive cashflows 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 income, with the exception of certain loans and receivables (policy n), borrowings (policy y) and other financial liabilities (policy x) which are stated at amortised cost, and derivatives, as described further in 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 income 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 and to evaluate the Company's investments with reference to their fair values

Fair value methodology

The Company has adopted the amended IFRS 7 Financial Instruments Disclosures' from 1 January 2009

Further information on the impact on the Company of the adoption of this amendment is set out in note 36

All financial instruments carried at fair value are categorised into a "fair value hierarchy as follows

(i) Level 1

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, quoted unit trusts traded in active markets and exchange traded derivatives such as futures

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 **Accounting policies (continued)**

(ii) Level 2

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, investment property measured using market observable information, and listed debt or equity securities in a market that is inactive

(iii) Level 3

Inputs for the asset or liability 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 forthe 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 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

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 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 realised gains and losses on assets and liabilities at fair value through income

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

(d) Revenue recognition

Premium income

Premiums received in respect of life insurance contracts and investment contracts with DPF 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 includes deferred income in respect of future charges and amounts received as charges in respect of reinsured unit linked business where, due to the reinsurance, the corresponding adjustment to unit linked investment contract liabilities is included within the income statement of the reinsuring company

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies (continued)

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 Open Ended Investment Company (OEIC) 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 in the statement of comprehensive income, within investment income, when the right to receive payment is established

(e) Expense recognition

Claims

Claims are recorded as an expense on the earlier of the maturity date or the date on which the claim is notified Claims recoveries from reinsurers are recognised when the related claims are recognised Claims are recognised through the relevant lines in the statement of comprehensive income

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 (g) Subsequent amortisation of deferred costs is recognised as set out in policy (g)

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

Expenses for asset management services received

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

Finance costs

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

Dividends payable

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

(f) Intangible assets

(i) Acquired value of in-force business

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 cashflows 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 Further information on the Company's impairment policy is set out at policy (p)

(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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies (continued)

Costs that are directly associated with the production of identifiable and unique software products controlled by the Company, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets, subject to de minimis limits Direct costs include the software development team's employee costs and an appropriate portion of relevant overheads All other costs associated with developing or maintaining computer software programmes are recognised through the statement of comprehensive income as an expense as incurred, within operating expenses

Computer software development costs recognised as assets are amortised using the straight-line method over their expected useful lives, not exceeding a period of five years Subsequent expenditure is only capitalised when it increases the expected future economic benefits of the specific asset to which it relates

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)

(g) Deferred costs

(i) Deferred acquisition costs

The costs of acquiring new insurance contracts and investment contracts with DPF 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 At each reporting date the asset is reviewed and is impaired where it is no longer expected to be recoverable out of future margins on the related insurance contracts and investment contracts with DPF The change in the value of deferred acquisition costs for the year is recognised through the statement of comprehensive income, within operating expenses

(ii) Deferred origination costs

Costs which are directly attributable and incremental to securing new investment contracts without DPF 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 costs associated with contracts are incurred At each reporting date the recoverability of the asset is reviewed and the asset is impaired if projected future margins from the related investment contracts without DPF are less than the carrying value of the deferred costs The change in the value of deferred origination costs for the year is recognised through the statement of comprehensive income, within operating expenses

(h) Investment in subsidiaries

The Company owns a variety of subsidiaries Certain subsidiaries trade with a view to making a profit, and the risks and rewards of owning those subsidiaries primarily rest with the equity shareholders of the Company 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)

In addition, certain subsidiaries are held primarily as vehicles through which specific investments are held as part of the actively managed investment portfolios Those subsidiaries hold assets which are designated at fair value through income 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 income

(i) Investments at fair value through income

Investments at fair value through income comprise debt and equity securities

Classification

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

Recognition

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1. Accounting policies (continued)

Measurement

Quoted investments

The fair values of quoted 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 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 The following paragraphs detail the valuation techniques specific to equity and debt securities

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 close of business 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 close of business on the reporting date are obtained from data vendors 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

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 three 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 pricesource 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 A review of all illiquid assets and prices obtained or calculated is conducted by the Fair Value Operations Group

Unquoted investments

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 variablessuch 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 referenceto Bloomberg or internal models

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

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

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 fair value through income, 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 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 and adjusted where this is required to ensure compliance with IFRS

Net realised gains and losses on assets and liabilities at fair value through income

Realised gains and losses on assets and liabilities are calculated as the difference between net sale proceeds and the original cost and are recognised in the statement of comprehensive income in the period in which they arise, within net realised gains and losses on assets and liabilities at fair value through income

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies (continued)

Net fair value gains and losses on assets and liabilities at fair value through income

Unrealised gains and losses on assets and liabilities are calculated as the difference between the current valuation of the asset at the reporting date and the original cost Movements in unrealised gains and losses arising are recognised in the statement of comprehensive income in the period in which they arise, within net fair value gains and losses on assets and liabilities at fair value through income The movement in the unrealised gains and losses recognised in the year also includes the reversal of unrealised gains and losses recognised in earlier accounting periods in respect of asset disposals in the current period

(j) Property

All property (other than investment property) is stated at cost less accumulated depreciation and any impairment in value Subsequent costs are included in an asset's carrying value only when it is probable that future economic benefits related to the asset will flow to the Company and such costs can be measured reliably

Depreciation of property is calculated on a straight-line basis to allocate the difference between the cost and the estimated residual value over the estimated useful lives of these assets The depreciation charge is recognised through the statement of comprehensive income, within other operating expenses

The periods generally applicable are

- Buildings 40 years

Land is considered to have an indefinite useful life and is therefore not depreciated

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each reporting date

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable In the event that an asset's carrying amount is determined to be greater than the recoverable amount, it is written down immediately Further information on the Company's impairment policy is set out at policy (p)

(k) Investment properties

Investment properties, which are held either to earn rental income or for capital appreciation, or both, are initially measured at fair value, being the fair value of the consideration given, including directly attributable transaction costs Subsequently, on a quarterly basis and at each reporting date, such properties are carried at fair value as assessed by qualified external appraisers 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 at fair value through income

(l) Reinsurance assets

The Company cedes reinsurance in the normal course of business Reinsurance assets, which are measured on a basis consistent with the related insurance contract liabilities, include balances due from both insurance and reinsurance companies for ceded insurance liabilities Premiums ceded and claims reimbursed are disclosed separately on the face of the statement of comprehensive income The benefits to which the Company is entitled under its reinsurance contracts held are recognised as reinsurance assets These assets consist of short-term balances due from reinsurers (recognised within loans and receivables), as well as longer term receivables that are dependent on the expected claims benefits arising under the related reinsured insurance contracts (recognised within reinsurers' share of insurance contract liabilities)

Amounts due from reinsurers in respect of investment contracts are designated as fair value through income as the amount recoverable relates wholly to investment contract liabilities which are recognised at fair value

The change in reinsurers' share of liabilities on the face of the statement of comprehensive income represents the movement during the year in all amounts recoverable from reinsurers

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies (continued)

(m) Derivative financial instruments

Classification

Derivative financial instruments, including embedded derivatives, are held for trading, with the exception of derivatives which are designated and effective hedging instruments, which are held at fair value Derivatives held for trading are used for the purposes of efficient portfolio management or to match contractual liabilities

Recognition

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

Measurement

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

Fair values are obtained from quoted market prices in active markets, including recent market transactions For over-the-counter ("OTC") derivatives, the fund manager valuation is used

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, a value other than one obtained from a primary valuation source were to be used to value a derivative, this would be approved by the Fair Value Committee

For exchange traded contracts, the value is based on the quoted bid price at close of business

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

Hedge accounting

The Company designates certain derivatives as fair value hedges or a hedge of a net investment in a foreign operation 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 methodobgy 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 at fair value through income, 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 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 income statement immediately

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies (continued)

(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

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 accrued interest and rent receivable These are accounted for at fair value, reflecting the amounts receivable at the year end 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 in that part of the statement of comprehensive income in which the original transaction was reported 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) Impairment

Financial assets

The carrying value of all financial assets 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

In order to determine whether financial assets are impaired, all financial assets for which the fair value has fallen below cost price either by a significant amount or for a prolonged period of time are individually reviewed A distinction is made between negative revaluations due to general market fluctuations and due to issuer-specific developments The impairment review focuses on issuer-specific developments regarding financial condition and future prospects, taking into account the intent and ability to hold the securities under the Company's long term investment strategy

Non-financial assets

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

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

If there is objective evidence that an impairment loss has occurred, the amount of the loss is charged to the relevant line in the statement of comprehensive income in the period in which it occurs

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies (continued)

(iv) observable data indicating that there is a measurable decrease in the estimated future cashflow 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 cashflows 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 enacted or substantively enacted at the reporting date, together with adjustments to estimates made in prior years

Deferred income tax

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

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

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

Allocation of tax charge between equity 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

(s) Insurance contracts and investment contracts with DPF

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 **Accounting policies (continued)**

Insurance contracts or investment contracts with DPF 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 investment contract with DPF liabilities

Insurance contracts or investment contracts with DPF 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 investment contract with DPF liabilities

Insurance contracts or investment contracts with DPF which are unit-linked

Allocated premiums in respect of unit-linked contracts that are either life insurance contracts or investment contracts with DPF 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 The mortality charges deducted in each period from the policyholders as a group are considered adequate to cover the expected total death benefit claims in excess of the contract account balances in each period and hence no additional liability is 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 investment contract with DPF 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 investment contract with DPF liabilities,
- 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

(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 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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies (continued)

(u) Subordinated debt

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

The 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) Investment contracts without DPF

The Company issues investment contracts without fixed terms (unit-linked) In accordance with industry practice, these contracts are accounted for as financial liabilities, the values of which are contractually linked to the fair values of financial assets within the Company's unitised investment funds The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the policyholders at the reporting date The value of the liabilities is never less than the amount payable on surrender, discounted for the required notice period where applicable

The best evidence of the fair value of these financial liabilities at initial recognition is the transaction price unless the fair value of that instrument is evidenced by comparison with other observable market transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets Any profit arising on initial measurement of these investment contracts is deferred as a liability for the future investment management services that the Company will render to each policyholder The deferred income balance is recognised over the estimated lives of the contracts, in line with the provision of investment management services unless there is evidence to support an alternative recognition basis

The element of premiums and claims in respect of investment contracts without DPF which is invested or withdrawn on behalf of the policyholder is excluded from the statement of comprehensive income, with all movements in the policyholder liability and related assets being recorded in the balance sheet, within investment contract liabilities Changes in the value of the investment contract liabilities relating to the changes in the value of backing assets are recognised through the statement of comprehensive income, within change in investment contract liabilities

(w) Liability adequacy test

At each reporting date, liability adequacy tests are performed to ensure the adequacy of the insurance and investment contract with DPF 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 aprovision 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

(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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 Accounting policies (continued)

Assets and liabilities denominated in foreign currencies are translated into sterling at the exchange rates ruling at the reporting date Revenue transactions and those relating to the acquisition and realisation of investments have been translated at average rates of exchange (unless this is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates in which case revenue transactions are translated at the dates of the transactions) Exchange differences are dealt with in that part of the statement of comprehensive income in which the underlying transaction is reported, with the exception of differences arising from hedges of net investments in foreign operations, which are recognised in other comprehensive income

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 a 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 Derivative collateral pledged or received is recognised as a liability or asset on the balance sheet Derivative collateral that has been received in the form of cash is invested in a cash or cash equivalent investment vehicle which provides immediate liquidity Income from collateral is used to pay the interest obligations to the counterparty

The Company also receives collateral in the form of securities in respect of stock lending agreements Collateral received against stock lent is not recorded on the balance sheet but is appropriately segregated from the assets of the Company

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 investment contract with DPF liabilities

The estimation of the ultimate liability arising from insurance 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

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 Further information on these balances is given in note 31

Sensitivities regarding changes to key assumptions in calculating insurance contract liabilities are given in note 31

(b) Intangible assets

Acquired 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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

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

The assumptions are determined on a best-estimate basis and, as above, are 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 recognised charge for the year is recognised through the income statement, 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 investment contracts with DPF (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 investment contracts without DPF 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

(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

3 Fee and commission income

	2009 £ m	2008 £ m
Fee income from reinsured business	75 8	77 7
Change in deferred income	1 8	0 7
Total	77 6	78 4

4 Investment income

	2009 £ m	2008 £ m
Investments at fair value through income		
Interest income on investments	179 0	193 0
Dividend income	247 8	407 3
Interest receivable on swap	20 0	28 5
Dividend income from subsidiary undertakings	34 5	-
Financial instruments at amortised cost		
Interest income on deposits	4 3	5 6
Interest income from group undertakings	2 1	12 5
Dividend income from subsidiary undertakings	-	60 0
Interest income from loans to subsidiary undertakings	0 9	4 9
Gain on disposal of property	-	15 5
Rental income on investment properties	98 2	113 3
Foreign currency translation differences	114 1	(118 3)
Other	2 2	24 2
Total	703 1	746 5

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

5 Net realised gains/(losses) on assets and liabilities at fair value through income

	2009 £ m	2008 £ m
Derivative financial instruments at fair value through income	(86 9)	330 4
Investments at fair value through income		
Equity securities	57 6	322 3
Debt securities	31 5	30 5
Investment properties at fair value through income	18 4	94 8
Foreign exchange	(7 5)	7 2
Total	13 1	785 2

6 Net fair value gains/(losses) on assets and liabilities at fair value through income

	2009 £ m	2008 £ m
Derivative financial instruments at fair value through income	(500 6)	110 7
Investments at fair value through income		
Equity securities	1,067 4	(2,912 0)
Debt securities	(259 2)	204 9
Investment properties at fair value through income	(99 3)	(661 5)
Gains in holdings of subsidiaries at fair value	31 1	211 8
Foreign exchange	(283 7)	1,023 0
Fair value gain on derivative hedging instrument	12 2	41 0
Fair value (loss) on hedged loan	(11 9)	(41 2)
Total	(44 0)	(2,023 3)

7 Operating expenses

	2009 £ m	2008 £ m
Acquisition and origination costs in respect of insurance and investment contracts	119 8	89 5
Expenses for administration	267 1	311 9
	386 9	401 4
Change in deferred costs	1 9	(61 1)
Amortisation and impairment of acquired VIF	48 4	27 4
Amortisation of software development costs	1 1	0 9
Impairment of investment in subsidiaries	123 0	33 0
Total	561 3	401 6

The administration of the Company is undertaken by HBOS plc A recharge is levied from this undertaking to the Company in respect of those costs incurred on behalf of the Company

The Company had no direct employees during the year (2008 nil) The employee costs, including pension costs and share-based payment costs, are included in the recharge from HBOS plc noted above

8 Auditors' remuneration

	2009 £ m	2008 £ m
Fees payable for the audit of the statutory accounts for the Company	0 6	0 6
Fees payable for the audit of Lloyds Banking Group plc reporting returns for the Company	0 5	-
Fees payable for the audit of HBOS plc reporting returns for the Company	-	0 2
Fees payable for services provided pursuant to legislation	0 1	0 1
Total	1 2	0 9

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

9 Finance costs

	2009 £ m	2008 £ m
Interest on borrowings	8 9	3 3
Interest payable on swap	14 2	36 9
Interest on subordinated debt	55 6	62 5
Other interest	1 7	0 4
Total	80 4	103 1

10 Taxation

(a) Analysis of tax credit

	2009 £ m	2008 £ m
Current tax:		
UK corporation tax	7 8	(50 5)
Overseas tax	(5 0)	0 5
Adjustment in respect of prior years	(2 0)	140 6
Total current tax	0 8	90 6
Deferred tax:		
Origination of temporary differences	89 4	206 3
Adjustment in respect of prior years	(53 6)	(0 8)
Total deferred tax	35 8	205 5
Total income tax credit	36 6	296 1

The policyholder tax benefit or expense is included in income tax expense Policyholder tax is a credit of £30 8m (2008 credit of £172 8m), including a prior year tax charge of £3 8m (2008 charge of £3 8m)

(b) Reconciliation of tax credit

	2009 £ m	2008 £ m
Loss before tax	(324 1)	(34 2)
Tax at 28% (2008 28 5%)	90 7	9 7
Effects of		
Tax exempt income	-	17 2
Disallowable expenses	(30 7)	-
Policyholder tax	29 7	123 6
Adjustment to tax charge in respect of prior years	(51 8)	142 6
Overseas tax	1 4	2 4
Other	(2 7)	0 6
Total	36 6	296 1

The Finance Act 2007 reduced the rate of corporation tax from 30% to 28% with effect from 1 April 2008 The impact of this reduction in tax rate, which resulted in a weighted average rate of 28 5% being applied to the profit for the prior year, is reflected in the above table

11. Intangible assets

		2009 £ m	2008 £ m
Acquired VIF	(a)	217 3	265 7
Software development costs	(b)	3 8	5 1
Total		221 1	270 8

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

11 Intangible assets (continued)

(a) Acquired VIF

	2009 £ m	2008 £ m
Cost		
At 1 January and 31 December	651 4	651 4
Accumulated amortisation and impairment		
At 1 January	385 7	358 3
Amortisation during the year	23 0	27 4
Impairment	25 4	-
At 31 December	434 1	385 7
Carrying amount		
At 31 December	217 3	265 7

Of the above total, £201 2m (2008 £242 7m) is expected to be recovered more than one year after the reporting date

(b) Software development costs

	2009 £ m	2008 £ m
Cost		
At 1 January	6 0	0 9
Additions	0 1	5 1
At 31 December	6 1	6 0
Accumulated amortisation		
At 1 January	0 9	-
Amortisation charge for the year	1 1	0 9
At 31 December	2 0	0 9
Foreign exchange		
At 1 January	-	-
Incurred in the year	0 3	-
At 31 December	0 3	-
Carrying amount		
At 31 December	3 8	5 1

Of the above total, £2 6m (2008 £4 2m) is expected to be recovered more than one year after the reporting date

12. Deferred costs

		2009 £ m	2008 £ m
Deferred acquisition costs	(a)	236 1	226 5
Deferred origination costs	(b)	238 8	251 4
Total		474 9	477 9

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

12 Deferred costs (continued)

(a) Deferred acquisition costs

	2009 £ m	2008 £ m
At 1 January	226 5	100 3
Amounts incurred during the period	69 9	52 3
Amortisation during the period	(60 3)	(50 4)
Transfers (note 12 (b))	-	124 3
At 31 December	236 1	226 5

During the year to 31 December 2008, changes were made to certain investment bonds with additional life cover being added In accordance with IFRS 4 'Insurance Contracts', this resulted in these products transferring from being accounted for as investment contracts without DPF to insurance contracts, which resulted in a £124 3m increase in deferred acquisition costs, with a corresponding reduction in deferred origination costs

Of the above total, £197 2m (2008 £190 2m) is expected to be recovered more than one year after the reporting date

(b) Deferred origination costs

	2009 £ m	2008 £ m
At 1 January	251 4	312 8
Amounts incurred during the period	17 8	116 8
Amortisation during the period	(29 4)	(57 7)
Transfers (note 12 (a))	-	(124 3)
Foreign exchange	(1 0)	3 8
At 31 December	238 8	251 4

Of the above total, £199 4m (2008 £211 2m) is expected to be recovered more than one year after the reporting date

13 Tax assets and liabilities

	2009 £ m	2008 £ m
Current tax receivables	29 0	7 8
Deferred tax assets	73 0	67 0
Total tax assets	102 0	74 8
Current tax payables	38 5	-
Deferred tax liabilities	220 7	250 5
Total tax liabilities	259 2	250 5

Deferred tax assets include £73 0m (2008 £67 0m) that is expected to be recovered more than one year after the reporting date

Deferred tax liabilities include £220 7m (2008 £250 5m) that is expected to be settled more than one year after the reporting date

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

13 Tax assets and liabilities (continued)

Recognised deferred tax

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

	2009 £ m	2008 £ m
Deferred tax assets comprise·		
Unrealised losses on investment assets	42 0	47 3
Expenses deductible in future periods	31 0	19 0
Other	-	0 7
Total deferred tax assets	73 0	67 0
Deferred tax liabilities comprise		
Deferred costs	126 8	129 2
Other insurance related items	36 2	10 5
Deferred tax on acquired VIF	57 7	110 8
Total deferred tax liabilities	220 7	250 5
Net deferred tax liabilities	147 7	183 5

Included in the deferred tax balance is an asset of £31 0m (2008 £19 0m) in respect of expenses incurred by the Company that will be deductible in future periods Projections indicate that these expenses will be offset against future income and gains

The tax credit in the income statement relating to each of the above items is as follows

	2009 £ m	2008 £ m
Unrealised gains on investment assets	(5 3)	235 2
Expenses deductible in future periods	12 0	(0 5)
Other deferred tax assets	(0 7)	-
Deferred costs	2 4	(18 2)
Other insurance items	(25 7)	(16 2)
Accelerated capital allowances	-	(0 3)
Acquired value in force	53 1	5 5
Total deferred tax credit	35 8	205 5

Deferred tax assets have not been recognised in respect of unrelieved capital losses of £3 9m (2008 £3 9m), as there is insufficient certainty as to the availability of future profits

14. Investment in subsidiaries

	2009 £ m	2008 £ m
At 1 January	1,114 7	935 9
Movements in holdings of subsidiaries at fair value	26 2	211 8
Disposals of holdings in subsidiaries	(54 5)	-
Impairment of holdings in subsidiaries	(123 0)	(33 0)
At 31 December	963 4	1,114 7

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

14 Investment in subsidiaries (continued)

Investments in subsidiaries held at cost are generally recoverable more than one year after the reporting date

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 0	England and Wales	Life Insurance
Halifax Life Limited	Ordinary	100 0	England and Wales	Life Insurance
Clerical Medical Forestry Limited	Ordinary	100 0	England and Wales	Life Insurance
CM Venture Investments Limited	Ordinary	100 0	Isle of Man	Investments
Non-Sterling Property Fund	Ordinary	100 0	Luxembourg	Property Investments

The subsidiary Lands Improvement Holdings Limited was sold on 22 November 2009, resulting in a pre-tax profit on disposal of £24 7m

The ability of regulated entities to pay cash dividends to the Company or repay loans or advances is restricted by regulatory solvency 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 Property

	2009 £ m	2008 £ m
Cost		
At 1 January	77 4	161 4
Additions	-	20 4
Disposals	-	(53 2)
Transfer to investment properties	(68 6)	(51 2)
At 31 December	8 8	77 4
Accumulated depreciation		
At 1 January	-	-
Impairment charge for the year	2 8	-
At 31 December	2 8	-
Carrying amount		
At 31 December	6 0	77 4

The above assets are generally recoverable more than one year after the reporting date

16. Investment properties

	2009 £ m	2008 £ m
At 1 January	1,214 3	1,963 5
Additions – new properties	-	32 8
Additions – subsequent expenditure on existing properties	70 7	31 1
Disposals	(308 9)	(202 8)
Transfer from property	68 6	51 2
Net loss from change in fair values	(99 3)	(661 5)
At 31 December	945 4	1,214 3

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

16. **Investment properties (continued)**

The rental income arising from investment properties during the year amounted to £98 3m (2008 £113 4m), 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 £33 0m (2008 £13 0m)

Expenditure on investment properties which did not generate rental income was £49 6m (2008 £21 7m)

The investment properties are independently valued by CBRE, DTZ 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 properties under development is £77 4m (2008 £49 4m) The carrying value of land held for development purposes that has not yet been developed is £10 5m (2008 £19 2m)

Investment properties are generally recoverable more than one year after the reporting date

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

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

Details regarding derivative financial instruments are given in the following tables

	2009			2008		
	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	1,739 7	16 0	79 3	1,391 7	60 2	33 0
Option contracts	3,110 4	496 7	1 7	1,981 0	489 0	2 4
Index futures contracts	808 8	1 3	16 6	3,040 7	52 0	66 1
Forward foreign exchange contracts	440 8	4 0	3 4	620 1	53 0	29 6
Derivative financial instruments designated as fair value hedges	344 9	13 3	-	716 3	8 1	-
Derivative financial instruments designated as net investment hedge	90 1	-	1 8	-	-	-
Total	6,534 7	531 3	102 8	7,749 8	662 3	131 1

Derivative financial instrument assets include £262 3m (2008 £37 0m) that is expected to be recovered more than one year after the reporting date

None of the derivative financial instrument liabilities are expected to be settled more than one year after the reporting date (2008 £7 1m)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

17. Derivative financial instruments (continued)

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

The amount of £387 9m (2008 £147 4m) was accepted by the Company in assets that it is permitted to sell or repledge in the absence of default of the owner of the collateral No collateral was sold or repledged during the year or in the prior year The Company has an obligation to return these assets to the pledgor

18 Loans and receivables

	2009 £ m	2008 £ m
Insurance business		
Amounts receivable in respect of direct insurance business	46 2	4 9
Other loans and receivables		
Accrued interest and rent	11 6	15 6
Amounts due from related parties	344 6	512 6
Others	136 3	153 0
Total	538 7	686 1

Of the above total, £257 6m (2008 £188 8m) is expected to be recovered more than one year after the reporting date

Of the above balances, £257 6m (2008 £188 8m) are interest bearing Interest on these balances is shown in other investment income in note 4

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 income

	2009 £ m	2008 £ m
At fair value		
Shares and other variable yield securities		
Listed	2,364 5	2,318 8
Unlisted	8,149 0	8,019 7
	10,513 5	10,338 5
Debt and other fixed/variable income securities	6,080 5	4,740 7
Total investments at fair value	16,594 0	15,079 2

Of the total debt securities above, £3,611 1m (2008 £2,492 7m) are listed government bonds

Of the debt securities, £4,348 5m (2008 £5,612 0m) is expected to be recovered more than one year after the reporting date Due to the nature of equity securities and investments in pooled investment funds, there is no fixed term associated with these securities

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

20 Cash and cash equivalents

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

	2009 £ m	2008 £ m
Cash at bank	114 0	265 9
Short term deposits	242 6	23 4
	356 6	289 3
Bank overdraft (note 28)	(16 0)	(169 0)
Total	340 6	120 3

Cash and cash equivalents in the above table contains amounts of £221 7m (2008 £94 0m) 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 and share premium

	2009 £ m	2008 £ m
Authorised share capital		
150,000,000 ordinary shares of £1 each	150 0	150 0
Allotted, called up and fully paid share capital:		
70,000,000 ordinary shares of £1 each	70 0	70 0

In December 2001, the Company issued 159,000,000 ordinary shares of £1 each at a premium of 0 63 pence, giving rise to a share premium account of £1 0m All shares are fully paid, there are no rights, preferences or restrictions attached to the shares

There have been no changes to share capital during the year ended 31 December 2009 On 1 October 2008, the directors passed a special resolution, supported by a solvency statement under Section 641 of the Companies Act 2006, to reduce the Company's authorised share capital from 1,709,000,000 ordinary shares of £1 each to 150,000,000 shares of £1 each The resolution, together with the solvency statement, was registered by Companies House on 9 October 2008 and therefore the reduction in share capital became effective as of that date

22 Insurance contract and investment contract with DPF liabilities

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

	2009			2008		
	Gross £ m	Reinsurance £ m	Net £ m	Gross £ m	Reinsurance £ m	Net £ m
At 1 January	16,908 0	(2,270 4)	14,637 6	15,215 5	(2,294 2)	12,921 3
New business	299 2	(142 7)	156 5	307 1	(113 2)	193 9
Change in existing business	(1,063 8)	(0 2)	(1,064 0)	(1,265 5)	133 4	(1,132 1)
Transfer in	-	-	-	2,602 8	-	2,602 8
Recapture of reinsurance	-	2,040 2	2,040 2	-	-	-
Assumption changes	196 0	(148 4)	47 6	48 1	3 6	51 7
At 31 December	16,339 4	(521 5)	15,817 9	16,908 0	(2,270 4)	14 637 6

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

On 31 December 2009, the Company recaptured its portfolio of annuity business from its subsidiary Clerical Medical Managed Funds Limited This resulted in the transfer in of liabilities of £2,040 2m shown in the above table, with a corresponding increase in premiums of £1,928 0m in respect of the recapture, resulting in a net profit impact of £(112 2m) The transfer in during 2008 relates to products transferred from being accounted as investment contracts to insurance contracts due to additional life cover being added to certain investment bonds

An analysis of the contractual and expected maturities of insurance contract and investment contract with DPF liabilities is given in note 32

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

23. Unallocated surplus

An analysis of the change in unallocated surplus is as follows

	2009 £ m	2008 £ m
At 1 January	469 2	1,497 4
Change recognised through the statement of comprehensive income	201 2	(1,028 2)
At 31 December	670 4	469 2

Due to nature of this balance, no recovery is expected in the next 12 months

24. Accruals and deferred income

	2009 £ m	2008 £ m
Accrued expenses	9 8	8 2
Deferred income	15 3	18 3
Deferred revenue on investment property	14 2	20 1
Total	39 3	46 6

Of the above total, £12 9m (2008 £15 3m) is expected to be settled more than one year after the reporting date

25. Subordinated debt

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

In June 2005 Clerical Medical Finance plc issued €750m of 4 25% undated Subordinated Guaranteed Bonds (current sterling value still in issue £343 3m) 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%

In July 2001 Clerical Medical Finance plc issued €400m of 6 45% dated Subordinated Guaranteed Bonds maturing on 5 July 2023 (current sterling value still in issue £192 5m) 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 5 56%

Previously Clerical Medical Finance plc issued £200 0m of 7 38% undated Subordinated Guaranteed Bonds (current sterling value still in issue £48 0m), the redemption of which is at the option of Clerical Medical Finance plc and is generally not allowable prior to 5 November 2019 The first tranche of £150 0m was issued in November 1999 and the remainder in December 2000 The interest rate charged to the Company by Clerical Medical Finance plc for the first tranche is 7 61% and 7 30% for the second tranche

On 27th July 2009 Clerical Medical Finance Ltd redeemed and cancelled its subordinated debt as follows

Tranche	Original issue	Amount redeemed	Outstanding at 31 December 2009
4 25%, issued June 2005	€750m	€362m	€388m
6 45%, issued July 2001	€400m	€181m	€219m
7 38%, issued Nov 2009 / Dec 2000	£200m	£149m	€51m

The loan between Clerical Medical Finance Ltd and the Company was redeemed at carrying value in the same ratio to that of the external redemption, resulting in no gain or loss to the Company

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

25 Subordinated debt (continued)

The fair value together with the carrying amount shown in the balance sheet is as follows

	2009 £ m	£ m	2008 £ m	£ m
	Carrying value	*Fair value*	*Carrying value*	*Fair value*
Subordinated debt	575 1	454 2	1,282 0	799 1
Accrued interest on subordinated debt	25 9	-	37 5	-
Fair value hedge adjustment	8 7	-	(3 2)	-
Total	609 7	454 2	1,316 3	799 1

The fair value of the subordinated guaranteed bonds is their open market value and has been calculated using published bid prices at the reporting date 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 2009 carrying value includes a foreign exchange gain of £89 6m (2008 loss of 260 4m)

An interest rate swap has been put in place in respect of the €750m tranche of the subordinated debt, which is accounted for using hedge accounting, as set out in note 1 (m)

26 Investment contract without DPF liabilities

An analysis of the change in net investment contract without DPF liabilities is as follows

	2009 Gross £ m	Reinsurance £ m	Net £ m	2008 Gross £ m	Reinsurance £ m	Net £ m
At 1 January	7,761 0	(7,456 5)	304 5	12,424 3	(8,805 1)	3,619 2
New business	466 4	(466 3)	0 1	418 1	(285 1)	133 0
Change in existing business	457 5	(550 8)	(93 3)	(2,438 4)	1,633 7	(804 7)
Transfer out (Note 22)	-	-	-	(2,643 0)	-	(2,643 0)
At 31 December	8,684 9	(8,473 6)	211 3	7,761 0	(7,456 5)	304 5

An analysis of the contractual and expected maturities of investment contract without DPF liabilities is given in note 32

Under the fair value methodology, all investment contract without DPF liabilities are categorised as Level 2

27. Other financial liabilities

	2009 £ m	2008 £ m
Insurance business		
Amounts payable in respect of direct insurance business	77 8	84 6
Other liabilities		
Due to related parties	366 8	79 0
Due to brokers	3 1	4 5
Trade payables	0 3	0 1
Social security and other taxes	2 4	27 5
Repurchase creditor	536 4	349 2
Collateral liability	387 9	134 1
Other	9 1	39 5
Total	1,383 8	718 5

Of the above total, £nil (2008 £nil) is expected to be settled more than one year after the reporting date

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

28. Borrowings

	2009 £ m	2008 £ m
Bank overdrafts	16 0	169 0
Total	16 0	169 0

The fair value of the balances set out above is not materially different to the carrying value due to the short-term nature of these balances

29. Decrease in operating assets and liabilities

	2009 £ m	2008 £ m
(Increase)/decrease in operating assets		
Investment properties	268 9	749 2
Investment in subsidiaries held in the long term insurance funds of the Company	41 8	(178 8)
Property transferred to investment properties	68 6	51 2
Reinsurers' share of insurance contract and investment contract with DPF liabilities	1,748 9	23 8
Prepayments and accrued income	0 6	14 9
Financial assets		
Investments	(1,514 8)	2,193 2
Loans and receivables including insurance receivables	147 4	(59 2)
Reinsurers' share of investment contract without DPF liabilities	(1,009 6)	1,338 9
Derivative financial instruments	131 0	(560 8)
Net (increase)/decrease in operating assets	**(117 2)**	**3,572.4**
Increase/(decrease) in operating liabilities:		
Insurance contract and investment contract with DPF liabilities	(568 6)	1,692 5
Unallocated surplus within insurance business	201 2	(1,028 2)
Financial liabilities		
Subordinated debt	(706 6)	257 2
Investment contract without DPF liabilities	916 4	(4,653 6)
Derivative financial instruments	(28 3)	93 2
Other financial liabilities	665 3	448 3
Provision for other liabilities and charges	(0 6)	0 3
Accruals and deferred income	(7 3)	(4 7)
Net increase/(decrease) in operating liabilities	**471.5**	**(3,195.0)**
Net decrease in operating assets and liabilities	**354.3**	**377 4**

30. Dividends paid

	2009 £ m	2008 £ m
Total dividends paid on equity shares	-	610 0

No dividend was paid in 2009, the dividend paid in 2008 amounted to 871 4 pence per share

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

31 Insurance contract and investment contract with DPF liabilities – assumptions, changes in assumptions and sensitivities

Policyholder liabilities can be analysed into With-Profits Fund liabilities and Non-Profit Fund liabilities In accordance with FRS 27, the liabilities of the With Profit Fund are accounted for using the "realistic" capital regime of the FSA ("realistic" liabilities) All Non-Profit liabilities are accounted for using a traditional prospective actuarial discounted cash flow methodology

(1) Processes used to determine key assumptions in respect of insurance and investment contracts

(a) With-Profits Fund - Insurance contracts and investment contracts with DPF calculated on a "realistic" basis

The Company's With-Profits Fund contains both insurance and participating investment contracts 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 returns 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 relevant government yield curve The volatility of future equity returns in excess of nominal interest rates has been calibrated to 10 year at-the-money options on the relevant equity indices, with volatility assumed to vary with both the term and the price of the option For property, no observable prices exist and so volatility has been derived from the volatility of a portfolio of equity and zero coupon bonds The liabilities are valued by discounting projected future cashflows using the risk free yield

- **Investment volatility**

  Investment volatility is derived from implied volatility of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices

- **Mortality**

  The mortality assumptions, including allowances for improvements in longevity for annuitants, are based on recent actual experience where this is significant and relevant industry data otherwise

- **Persistency**

  Persistency is a function of both the rate of policy termination, the rate at which policyholders switch from with-profits 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 including those governed by the Scheme of Transfer

- **Guaranteed annuity take-up rates**

  Certain pension contracts contain guaranteed annuity options that allow the policyholder to take an annuity benefit on retirement at annuity rates that were guaranteed at the outset of the contract For contracts that contain such options key assumptions in determining the cost of the options are economic conditions in which the option has value, mortality rates and take up rates of the options

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

31 Insurance contract and investment contract with DPF liabilities – assumptions, changes in assumptions and sensitivities (continued)

(b) Non-Profit Funds - Insurance contracts and investment contracts with DPF

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

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

Assumptions are made in respect of all material factors affecting future cashflows, 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 cashflows 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 and morbidity**

  The mortality and morbidity 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

- **Maintenance expenses**

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

- **Persistency rates**

  Prudent lapse rate assumptions have been used for term assurance business Whether a lapse rate is prudent broadly depends on whether the policy is negative or positive at any point in its life, thus for each product a high lapse rate is assumed where the projected liability is negative or a low lapse rate is assumed at points where the projected liability is positive

(2) Key assumptions

(a) With-Profits Fund

Assumptions are given for the "realistic" valuation In addition, liabilities in respect of Non-Profit policies in the With-Profits Fund were also accounted for on the traditional regulatory assessment

(i) Investment returns and discount rates

In the "realistic" valuation of liabilities in calibrating the economic scenario generator, the risk-free yields curve is defined as the yields curve for relevant government bonds

Class of business	2009 Interest Rate (Net)	2008 Interest Rate (Net)
Annuities in Payment	2 59%	2 6%
Deferred Annuities	2 59%	2 6%

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

31 Insurance contract and investment contract with DPF liabilities – assumptions, changes in assumptions and sensitivities (continued)

(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 2009, the UK 10 year-equity at-the-money assumption was set at 26 6 per cent (33 7 per cent as at 31 December 2008) The assumption for UK property volatility was 17 per cent (31 December 2008 21 per cent) The volatility of UK interest rates has been calibrated to the implied volatility of UK swaptions which was broadly 15 per cent as at 31 December 2009 (31 December 2008 17 per cent)

(iii) Mortality assumptions

The key mortality assumption is that for annuities used in the calculation of the cost of guarantee annuity options

Annuities		2009	2008
Annuities when in payment	Males	90% PCMA00(100%mc)_1 25%	90% PCMA00(100%mc)_1 5%
	Females	95% PCFA00(75%mc)_1 25%	95% PCFA00(75%mc)_1 0%

(iv) Lapse assumptions

The long-term lapse assumptions for the main classes of business are detailed below

2009

Product group		Average surrender / paid-up rate for the policy years (% pa) 1-5	6-10	11-15	16-20
CWP endowment	surrender	2 5%	2 5%	3 0%	2 5%
UWP savings endowment	surrender	3 4%	7 5%	7 3%	5 0%
UWP bond	surrender	17 4%	13 0%	16 4%	18 3%
CWP pension	surrender	4 8%	4 8%	3 9%	3 5%
UWP individual pension regular premium	surrender	9 0%	7 7%	6 1%	4 0%
UWP individual pension single premium	surrender	9 1%	7 5%	5 0%	3 8%

2008

Product group		Average surrender / paid-up rate for the policy years (% pa) 1-5	6-10	11-15	16-20
CWP endowment	surrender	2 5%	2 5%	3 0%	2 0%
UWP savings endowment	surrender	2 6%	5 8%	6 0%	5 0%
UWP bond	surrender	16 0%	15 1%	17 1%	18 8%
CWP pension	surrender	3 0%	3 0%	3 0%	3 0%
UWP individual pension regular premium	Surrender	7 4%	6 9%	5 8%	5 3%
UWP pension single premium	surrender	9 2%	7 7%	5 0%	4 0%

(v) Other assumptions

Deferred annuity contracts with a guaranteed annuity option have been valued based upon an assumed rate of take-up of the guaranteed annuity option of 95 0% for the realistic assessment (95 0% assumed at 31 December 2008)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

31 Insurance contract and investment contract with DPF liabilities – assumptions, changes in assumptions and sensitivities (continued)

(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	2009 Interest rate (net) %	2008 Interest rate (net) %
Conventional Life business and non-unit reserves on linked business	2 10	1 94
Annuities in payment	3 67	3 85

(ii) Mortality assumptions

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

Products		2009	2008
Conventional Business			
Life Savings (WP & NP)	Male/Female	60 5% AMC00 / 66% AFC00	55% AM92 Ult / 66% AF92 Ult
Pensions (WP & NP)	Male/Female	33% AMC00 / 33% AFC00	22% AM92 Ult / 22% AF92 Ult
Life Term Assurance	Male/Female	63 3% TMC00 / 69% TFC00	49 5% AM92 Ult/44% AF92 Ult
Annuities			
Pensions	Male/Female	81% PCMA00 LC_1 5 (0 3)/ 86% PCFA00_75% MC_1 5(0 3)	85% PCMA00(mc) minimum 1 5% improvement/90% PCFA00 (75%mc) with minimum 1% improvement
Purchased Life (excl ILD)	Male/Female	81% PCMA00 LC_1 5 (0 3)/ 86% PCFA00_75% MC_1 5(0 3)	85% PCMA00(mc) minimum 1 5% improvement/90% PCFA00 (75%mc) with minimum 1% improvement

For deferred annuities in deferment, an explicit provision for future improvement has been made by assuming mortality in deferment reduces at a rate of 4% pa from the valuation date through deferment

(iii) Lapse assumptions

2009

Product Group		Average lapse-surrender-paid up rate (% pa) for the policy years 1-5	6-10	10-15	16-20	20+
Unit Linked Life Single Premium	surrender	4 25%	4 75%	3 75%	3 25%	3 25%
Unit Linked Individual Pensions Regular Premium	surrender	3 73%	4 32%	3 72%	2 34%	2 34%
Unit Linked Executive Pensions Regular Premium	surrender	7 80%	7 80%	7 80%	7 80%	7 80%
Unit Linked Individual Pensions Single Premium	surrender	4 90%	4 50%	3 60%	2 70%	2 70%
Unit Linked & unitised with-Profits group pensions regular premium	surrender	3 41%	4 50%	4 05%	4 05%	4 05%
Unit Linked & unitised with-Profits Group Money Purchase regular premium	surrender	6 75%	6 75%	6 75%	6 75%	6 75%
Conventional Life Savings	surrender	1 50%	1 50%	1 80%	1 50%	1 20%

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

31 Insurance contract and investment contract with DPF liabilities – assumptions, changes in assumptions and sensitivities (continued)

2008

Product Group		Average surrender / paid-up rate for the policy years (% pa)				
		1-5	6-10	10-15	16-20	20+
Unit Linked Life Single Premium	surrender	1 55%	2 70%	1 88%	1 63%	1 63%
Unit Linked Individual Pensions Regular Premium (non-pupped policies)	surrender	2 65%	3 05%	2 75%	2 50%	2 50%
Unit Linked Executive Pensions Regular Premium (non-pupped policies)	surrender	5 50%	5 50%	5 50%	5 50%	5 50%
Unit Linked Individual Pensions Single Premium	surrender	4 10%	4 00%	3 00%	2 50%	2 50%
Unit Linked & unitised with-Profits group pensions regular premium	surrender	4 02%	6 66%	6 00%	6 00%	6 00%
Unit Linked & unitised with-Profits Group Money Purchase regular premium	surrender	8 70%	8 70%	8 70%	8 70%	8 70%
Conventional Life Savings	surrender	1 63%	1 63%	1 95%	1 30%	1 30%

(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 2009 with the following impacts on profit before tax

	2009 £m	2008 £m
Variable		
Mortality	(69 8)	34 9
Expenses	(16 8)	(2 3)

(4) Sensitivity analysis

(a) With-Profits Fund

In all cases there is no impact on profit before tax 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

The following table demonstrates the effect of changes in key assumptions on profit before tax assuming that the other assumptions remain unchanged, in respect of Insurance contracts without DPF and Insurance and Investment contracts with DPF In practice this is unlikely to occur, and changes in some assumptions may be correlated

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

31 **Insurance contract and investment contract with DPF liabilities – assumptions, changes in assumptions and sensitivities (continued)**

Variable	Change in variable	2009 £ m	2008 £ m
Annuitant Mortality	5% reduction	(36 8)	(27 5)
Other Mortality	5% reduction	7 6	10 1
Lapses	10% reduction	(8 3)	(4 8)
Maintenance expenses	10% reduction	22 8	21 1
Interest rate – change in redemption yield (1)	0 25% reduction	(11 9)	(10 5)
Interest rates – change in valuation margin (2)	0 25% reduction	(63 5)	(49 2)

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 risk discount rate, 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

32 **Risk management**

The Company issues contracts that transfer insurance and financial risk or both This note summarises these risks and the way in which the Company manages them

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

(a) Governance framework

The Company is part of the Insurance Division of Lloyds Banking Group plc This Division has established a risk management function with responsibility for implementing the Lloyds Banking Group plc risk management framework within the Company

The approach to risk management ensures that there is effective independent checking or 'oversight" of key decisions through the operation of a "three lines of defence" model The first line of defence is line management, who have direct accountability for risk decisions Risk management provide oversight and challenge and form the second line of defence Internal Audit constitutes the third line of defence, which provides the required independent assurance to 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 plc's risk management principles and covers the full spectrum of risks that the Company exposed to Under this framework, risks are categorised according to an approved Lloyds Banking Group plc risk language which has been adopted across the Company This covers the principal financial risks faced by the Company, including the exposures to market, insurance, credit and financial soundness 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

Lloyds Banking Group plc retains primary responsibility for the management of investment risks arising in respect of the shareholder funds within the Company These funds are managed in line with the Lloyds Banking Group plc and Clerical Medical risk policies Responsibility for the management of all other risks resides with the Board of each Group company who have delegated their authority to the Clerical Halifax Executive Committee

Policy owners, identified from appropriate areas across the business, are responsible for drafting the Lloyds Banking Group plc and Clerical Medical 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 each Group 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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32. Risk management (continued)

(b) Risk appetite

The Company has defined the methodology for the management of risk appetite and has set appropriate limits Where appropriate for each life company and risk component, 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 of these tests are reported to senior management

(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

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

The Company manages these risks in a numbers 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 internal funds In the short term, profit and equity are therefore largely unaffected by investment returns on assets in internal unit-linked funds as any gains or losses will be largely offset by changes in the corresponding insurance and investment contract liabilities 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, these charges rise or fall correspondingly

For Non-Profit 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 significant exposure exists

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32 Risk management (continued)

The following tables analyse the carrying amount of assets and liabilities, with financial assets and financial liabilities being presented according to their IAS 39 classification

	2009 £ m	2008 £ m
Financial assets		
Cash and cash equivalents	356 6	289 3
At fair value through income		
Investments at fair value through income		
- equity securities	10,513 5	10,338 5
- debt securities	6,080 5	4,740 7
Derivative financial instruments	531 3	662 3
Reinsurers' share of investment contracts without DPF liabilities	8,473 6	7,456 5
At amortised cost		
Loans and receivables	538 7	686 1
Reinsurers' share of insurance contract and investment contract with DPF liabilities	521 5	2,270 4
	27,015.7	**26,443.8**
Other assets		
Current tax receivable	29 0	7 8
Investment in subsidiaries	963 4	1,114 7
Investment properties at fair value	945 4	1,214 3
Property	6 0	77 4
Prepayments and accrued income	1 8	2 4
Deferred tax assets	73 0	67 0
Deferred costs	474 9	477 9
Intangible assets	221 1	270 8
	2,714 6	**3,232 3**
Total assets	**29,730 3**	**29,676 1**
Financial liabilities		
Insurance contract and investment contract with DPF liabilities	16,339 4	16,908 0
At fair value through income		
Investment contract without DPF liabilities	8,684 9	7,761 0
Derivative financial instruments	102 8	131 1
At amortised cost		
Subordinated debt	609 7	1,316 3
Other financial liabilities	1,383 8	718 5
Borrowings	16 0	169 0
	27,136 6	**27,003 9**
Other liabilities		
Current tax payables	38 5	-
Accruals and deferred income	39 3	46 6
Provisions for other liabilities and charges	1 6	2 2
Deferred tax liabilities	220 7	250 5
Unallocated surplus	670 4	469 2
	970 5	**768 5**
Total liabilities	**28,107 1**	**27,772 4**

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 liquidity risk section of this note

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32. Risk management (continued)

(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 in line with the policy of Lloyds Banking Group plc to optimise shareholder risk and return
- Unit-linked assets are invested in accordance with the nature of the fund mandates
- Conventional non-profit annuity liabilities are "close matched" as far as possible in relation to nature and duration
- With Profits liabilities are managed in line with the relevant Company's PPFM Benchmarks and minimum and maximum holdings in asset classes are specified to allow limited investment management discretion whilst ensuring adequate diversification 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 income according to fair value hierarchy (as defined in note 1 (c)) is given below

	Fair value hierarchy Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Equity securities	10,119 8	105 0	288 7	10,513 5
Debt securities	3,502 9	2,577 6	-	6,080 5
Derivative financial assets	1 3	530 0	-	531 3
Reinsurers' share of investment contracts without DPF liabilities	-	8,473 6	-	8,473 6
Total assets	**13,624.0**	**11,686 2**	**288 7**	**25,598.9**
Derivative financial liabilities	28 9	73 9	-	102 8
Investment contract without DPF liabilities	-	8,684 9	-	8,684 9
Total liabilities	**28 9**	**8,758.8**	**-**	**8,787 7**

There were no significant transfers between Level 1 and Level 2 during the year The table below shows movements in the assets measured at fair value based on valuation techniques for which any significant input is not based on observable market data (Level 3 only)

	Equity Securities £m
Balance at 1 January 2009	414 1
Total net gains or losses recognised within net realised and net fair values gains on assets at fair value through income in the statement of comprehensive income	(95 5)
Additions	22 5
Disposals	(52 4)
Balance at 31 December 2009	**288 7**
Total gains and losses for the period included in the statement of comprehensive income for assets held at 31 December 2009	**(90 9)**

In accordance with the transitional provisions of the amendment to IFRS 7 which introduced the above reconciliation, no comparative data has been provided

The sensitivity analyses given throughout this note are based on a change in an assumption while holding all other assumptions constant In practice, it is unlikely that isolated movements would occur as changes in some of the assumptions may be correlated, for example changes in interest rates and changes in equity The sensitivity analysis presented represents a reasonably possible change in a single factor

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32 **Risk management (continued)**

(i) Equity and property risk

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

The sensitivity analysis below illustrates the impact on profit and shareholder equity of changes in equity and property process, net of offsetting movements in insurance and investment contract liabilities, at the reporting date

	2009 £ m	2008 £ m
10% increase in equity prices	4 1	4 1
10% decrease in equity prices	(4 1)	(4 1)
10% increase in property prices	0 3	1 6
10% decrease in property prices	(0 3)	(1 6)

(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

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 annuity liabilities as closely as possible An increase in market interest rates will result in a reduction in the value of assets subject to fixed rates of interest which may result in losses if, as a result of an increase in the level of surrenders, the corresponding fixed income securities have to be sold

The effect of changes in interest rates in respect of financial assets which back insurance contract liabilities is given in note 31 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 the impact on profit and shareholder equity of changes in interest rate yields on interest-bearing financial assets, net of offsetting movements in insurance and investment contract liabilities, at the reporting date

	2009 £ m	2008 £ m
25 basis points increase in yield curves	11 9	6 8
25 basis points decrease in yield curves	(11 9)	(6 8)

The prior year sensitivity set out above has been amended to present the profit and equity impact of the stated change in interest rates on the same basis as the current year calculation

32. Risk management (continued)

(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 majority of the Company's principal transactions are carried out in pounds sterling A small proportion of the overall Company's business is administered through the Maastricht branch business where transactions are predominantly carried out in Euros, the net investment in this business is hedged as described in note 17
- The Company's Non-Profit property linked insurance and investment contract liabilities are exactly matched,
- Currency risk relating to Tier 2 Euro-denominated subordinated debt is economically hedged through the use of a forward contract and other Euro-denominated assets, and
- Guarantee costs for With-Profits business are hedged using sterling, euro and dollar derivatives to match the currency risk within the guarantee costs

(2) <u>Insurance risk</u>

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/underwritten events and to fluctuations in the timing and amount of claim settlements This includes fluctuations in profits due to customer behaviour 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, morbidity, persistency and expenses

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
- Morbidity products – where the policyholder is insured against the risk of contracting a defined illness

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

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

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32. Risk management (continued)

Rates of mortality and morbidity are investigated annually based on the Company's recent experience and future mortality assumptions are set using the latest population data available Each Company's 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 through revising the commission structure on future product developments and undertaking various initiatives to promote customer loyalty

Further information on assumptions, changes in assumptions and sensitivities in respect of insurance contract and investment contract with DPF liabilities is given in note 31

(3) <u>Credit risk</u>

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 we have contracted to meet its obligations (both on and off balance sheet)

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 The tables in this section reflect the credit risk on assets held within these funds, but do not take account of the offsetting reduction in liabilities to unit-linked and with-profit policyholders that would be expected in the event of default

For non-linked funds investments, limits on the exposure to a single entity are specified and monitored Bond exposures are managed through maximum exposures to individual assets and sectors 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 wider Lloyds Banking Group plc Credit Risk Policy and the principles are the same as those outlined above in respect of non-linked funds

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

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

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32 Risk management (continued)

The following table sets out details of those assets which bear credit risk

	2009 £ m	2008 £ m
At fair value through income		
Liquidity funds classed as equity	2,194 2	2,063 4
Debt securities at fair value	6,080 5	4,740 7
Derivative financial instruments at fair value	531 3	662 3
At amortised cost		
Loans and receivables at amortised cost	538 7	686 1
Reinsurers' share of insurance contract and investment contract with DPF liabilities	521 5	2,270 4
Reinsurers' share of investment contract without DPF liabilities	8,473 6	7,456 5
Cash and cash equivalents	356 6	289 3
Total assets bearing credit risk	**18,696 4**	**18,168.7**

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

As at 31 December 2009

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Liquidity funds classed as equity	2,194 2	2,194 2	-	-	-	-
Debt securities	6,080 5	4,330 5	291 0	870 2	558 3	30 5
Derivative financial instruments	531 3	-	4 0	503 9	10 1	13 3
Loans and receivables	538 7	-	-	-	-	538 7
Reinsurers' share of insurance contract and investment contract with DPF liabilities	521 5	-	-	-	-	521 5
Reinsurers' share of investment contract without DPF liabilities	8,473 6	-	-	-	-	8,473 6
Cash and cash equivalents	356 6	94 9	254 4	7 3	-	-
Total	**18,696 4**	**6,619 6**	**549 4**	**1,381.4**	**568 4**	**9,577 6**

*Of which £483 4m is BBB rated

As at 31 December 2008

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Liquidity funds classed as equity	2,063 4	2,063 4	-	-	-	-
Debt securities	4,740 7	2,777 1	315 9	1,120 1	495 3	32 3
Derivative financial instruments	662 3	24 5	86 2	436 0	107 5	8 1
Loans and receivables	686 1	-	-	-	-	686 1
Reinsurers' share of insurance contract and investment contract with DPF liabilities	2,270 4	-	-	-	-	2,270 4
Reinsurers' share of investment contract without DPF liabilities	7,456 5	-	-	-	-	7,456 5
Cash and cash equivalents	289 3	142 1	125 8	21 4	-	-
Total	**18,168.7**	**5,007.1**	**527.9**	**1,577.5**	**602 8**	**10,453.4**

*Of which £540 4m is BBB rated

Assets classified as "not rated" in the above tables are not rated by Standard and Poor's or an equivalent rating agency

No assets were past due but not impaired at the reporting date (2008 £nil) There were no impaired assets at 31 December 2009 or 31 December 2008 No terms in respect of financial assets had been renegotiated at 31 December 2009 or 31 December 2008

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32 Risk management (continued)

Counterparty limits are governed by the fund mandates in place for the underlying funds within the Company Each mandate sets out the permitted asset types within each fund with a minimum and maximum permitted holding by asset type, and within each asset type there are further restrictions set down by credit rating of the assets held Counterparty limits are set out within those by asset types according to the credit rating of the instruments held – these vary by mandate according to the stated fund objective in the Mandate

The portfolio of mandates is reviewed at least annually and is designed to set a counterparty risk threshold that is lower than those required for FSA reporting

(i) Concentration risk

Credit concentration risk relates to the inadequate diversification of credit risk This risk is managed through compliance with the fund mandates in place for those funds As previously stated, defaults on unit-linked and with-profits funds would be matched by an offsetting reduction in liabilities to unit-linked and with-profits policyholders

Each mandate sets out the permitted asset types within each fund with a minimum and maximum permitted holding by asset type, and within each asset type there are further restrictions set down by credit rating of the assets held Counterparty limits are set out within those by asset types according to the credit rating of the instruments held – these vary by mandate according to the stated fund objective

The portfolio of mandates is reviewed at least annually and within the non-profit and shareholder funds is designed to set counterparty risk thresholds that are lower than those required for FSA reporting

The only assets permitted to be held with no limit on concentration risk in any fund mandate are UK Treasury securities These are unlimited, with holdings at 31 December 2009 being £3 6bn (2008 £2 5bn), of which £3 0bn (2008 £2 4bn) was held in unit-linked and with-profit funds

The largest exposures to which counterparty limits are applied in the fund mandates are to the range of Insight liquidity funds These AAA rated funds have UCITS status and a diverse portfolio of investments Exposure across these liquidity funds totalled £2 9bn (2008 £3 3bn), of which £1 8bn (2008 £2 4bn) was held in unit-linked and with-profit funds

Other than UK Treasury securities and liquidity fund investments, the Company did not have any significant concentration of credit risk with a single counterparty or group of counterparties where limits applied at 31 December 2009 or 31 December 2008 The next largest exposure at 31 December 2009, without taking into account collateral held or other credit enhancements, was to HSBC Bank plc totalling £304 0m (2008 JP Morgan Chase & Co totalling £225 0m) and this represented 1 8% of the investments held (2008 1 3%) £284m of the exposure to HSBC Bank plc was held in the unit-linked and with-profit funds

The Company maintains strict control limits on the derivative positions held by each fund as set out in the Insurance Division Derivatives Policy

(ii) Collateral management

Collateral in respect of OTC derivatives

The requirement for collateralisation, 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 over the counter ("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 Insurance Division's Risk Policy The aggregate uncollateralised exposure to any one counterparty must not exceed limits specified in the Insurance Division's Derivative Policy Where derivative counterparties are related, the aggregate net exposure is considered for the purposes of applying these limits

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

The aggregate exposure, net of any collateralisation, to any one counterparty, across all funds and transactions, should not exceed £225m

Collateral is pledged or received in cash and cash equivalents

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32 Risk management (continued)

Cash and cash equivalents as set out below have been pledged in accordance with the terms of the relevant CSAs entered into in respect of various OTC derivative contracts

	2009 £ m	2008 £ m
Cash and cash equivalents	387 9	341 1
Total	**387.9**	**341 1**

The Company has the right to invest cash received in short term investments such as Liquidity Funds to generate higher returns

Collateral in respect of securities lending

The Company enters into securities lending transactions The Board is responsible for setting the parameters of securities lending 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

Securities lending is permitted in accordance with the Insurance Division Credit Risk Policy on securities lending All securities lending 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 partial indemnified programme (where the operator of the programme provides an indemnification against borrower and collateral default) The partial programme does not cover the re-investment of outright cash and therefore the policy specifies that the Insurance Investment Control Committee ("IICC") will set counterparty limits for the re-investment of same

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

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

There were no collateral defaults in respect of securities lending during the year ended 31 December 2009 which required a call to be made on collateral During 2008 possession was taken of collateral held on securities lending transactions with Lehman Brothers, following the collapse of that company The fair value of the collateral obtained comprised of £171 9m cash There was no material impact on profit before tax relating to the recovery

(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

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 maintains a system of internal controls, consistently applied, providing 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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32. Risk management (continued)

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)

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 match the expectation of timing of annuity payments Gilts and corporate bonds are selected to reflect, as closely as possible, the expected annuity payments and are regularly rebalanced to ensure that no liquidity risk arises in the 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 a substantial number of highly liquid assets, principally gilts and bonds (Corporate Bonds have not proved liquid of late), and by requiring the fund manager to hold six months future expected cashflow in liquid assets at any one time 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

In order to quantify the liquidity risk exposure, various stress tests are considered Liquidity risk is measured for each company by comparing the projected outflow in the stress scenario for the following month against the sum of liquid resources available

Non-Profit funds

For unit-linked products, portfolios are invested in accordance with unit fund mandates Deferral clauses are included in policyholder contracts to give time, when necessary, to realise linked assets without being a forced seller As at 31 December 2009, there are no funds under management subject to deferral

A manager's box is also held to mitigate the risk of normal disinvestments in the course of business A disinvesting policyholder receives the closing price on the date of surrender This price can be affected by the level of disinvestment thereby deferring the liquidity risk to the policyholder

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 Lloyds Banking Group Funding and Liquidity Risk Policy

The following tables indicate the timing of the contractual cashflows arising from the Company's financial liabilities, as required by IFRS 7 Liquidity risk in respect of insurance contract and investment contract with DPF liabilities has been analysed based on the expected pattern of maturities as permitted by IFRS 4 "Insurance Contracts" rather by contractual maturity A maturity analysis of investment contracts without DPF based on expected contract maturities is also given as it is considered that this analysis provides additional useful information in respect of the liquidity risk relating to contracts written by the Company

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32 Risk management (continued)

The following tables indicate the timing of the contractual cashflows arising from the Company's financial liabilities, as required by IFRS 7

As at 31 December 2009

Liabilities	Carrying amount*	Contractual cashflows (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
Investment contract without DPF liabilities	8,684 9	-	8,684 9	-	-	-	-
Derivative financial instruments	102 8	-	2 0	19 8	2 8	25 1	53 1
Subordinated debt	609 7	409 0	-	-	8 2	49 3	238 3
Borrowings	16 0	-	16 0	-	-	-	-
Other financial liabilities	1,383 8	-	1,383 8	-	-	-	-
Total	**10,797 2**	**409 0**	**10,086.7**	**19.8**	**11 0**	**74 4**	**291.4**

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

As at 31 December 2008

Liabilities	Carrying amount*	Contractual cashflows (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
Investment contract without DPF liabilities	7,761 0	-	7,761 0	-	-	-	-
Derivative financial instruments	131 1	-	16 0	79 5	1 3	6 1	28 2
Subordinated debt	1,316 3	926 2	-	-	14 0	105 4	544 4
Borrowings	169 0	-	169 0	-	-	-	-
Other financial liabilities	718 5	-	718 5	-	-	-	-
Total	**10,095 9**	**926 2**	**8,664.5**	**79 5**	**15.3**	**111 5**	**572 6**

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

The contractual cashflow 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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32. Risk management (continued)

An analysis of insurance contract and investment contract without DPF liabilities by expected contract maturity, on a discounted basis, is shown below

As at 31 December 2009

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 investment contract with DPF liabilities	16,339 4	152 8	277 8	1,312 1	5,796 6	8,800 1
Investment contract without DPF liabilities	8,684 9	89 4	140 7	762 5	3,230 2	4,462 1

As at 31 December 2008

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 investment contract with DPF liabilities	16,908 0	177 0	335 9	1,351 9	6,106 5	8 936 7
Investment contract without DPF liabilities	7,761 0	92 1	143 9	594 7	2,723 2	4,207 1

(iii) Capital risk

Capital risk is defined as the risk that

- the Company, or one of its separately regulated subsidiaries, 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

The business of several of the companies within the Company is regulated by the FSA The FSA specifies theminimum amount of capital that must be held by each of the regulated companies within the Company in addition to their insurance liabilities Under the FSA rules, each insurance company within the Company must hold assets in excess of the higher of

(i) the Pillar 1 amount, which is calculated by applying fixed percentages to premiums and claims, 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 The fair value surplus is 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 further capital to safeguard the Company's ability to continue as a going concern so that it can continue to provide returns for the equity shareholders and benefits for other stakeholders,
- when capital is needed, to require an adequate return to the equity shareholders 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

The Company manages the capital structure and makes adjustments to reflect changes in economic conditions and the risk characteristics of the underlying assets In order to maintain or adjust the capital structure, the Company may adjust the amount of dividends paid to the equity shareholders, return capital to the equity shareholders, issue new shares or sell assets

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 25)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

32 Risk management (continued)

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, in general, an estimate that will be updated once the FSA returns for the year are finalised

	2009 £ m	2008 £ m
Regulatory capital held	2,624	3,558
Regulatory required capital	996	1,603

All minimum regulatory requirements were met during the year

(iv) Legal and regulatory risks

The Company also faces a number of legal and regulatory risks, reflecting the volume and pace of change within the UK This impacts the Company both operationally, in terms of costs of compliance and uncertainty about regulatory expectations, and strategically, through pressure on key earnings streams The latter could potentially result in major changes to business and pricing models, particularly in the UK retail market Business planning processes continue to reflect change to the regulatory environment

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

33 Related party transactions

(a) Ultimate parent and shareholding

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

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

HBOS plc is the parent undertaking of the smallest such group of undertakings Copies of the Lloyds Banking Group plc financial statements in which the Group and Company are consolidated can be obtained from the Group Secretary's Department, Lloyds Banking Group plc, 25 Gresham Street, London, EC2V 7HN

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

33 Related party transactions (continued)

(b) Transactions and balances with related parties

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

Counterparty	Transaction type	Relationship	2009 £ m	2008 £ m
HBOS Insurance & Investment Group	Recharges	Fellow group undertaking	(0 7)	-
	Other receivables (recharges)	Fellow group undertaking	(0 7)	0 5
HBOS Financial Services Ltd	Other payables	Parent undertaking	(266 0)	13 2
	Recharges		(382 3)	(137 8)
Halifax Plc	Other payables	Fellow group undertaking	(4 8)	(4 1)
	Recharges		(66 1)	(1 0)
Lloyds Banking Group Plc	Investment transactions	Ultimate parent undertaking	29 6	-
	Investments		29 6	-
Clerical Medical International Holdings BV	Other receivables	Fellow group undertaking	-	20 2
	Recharges		-	0 6
CMI Insurance Company Ltd	Other receivables	Fellow group undertaking	-	5 6
CMI Insurance Luxembourg SA	Loans	Fellow group undertaking	103 0	202 1
	Loans granted during the year		-	152 9
	Recharges		-	1 8
Halifax Fund Management Ltd	Recharges	Fellow group undertaking	0 9	-
Clerical Medical PEP Managers	Other payables	Subsidiary undertaking	(0 3)	-
P E G Investment Company Ltd	Other payables	Subsidiary undertaking	(0 1)	-
HBOS Investment Fund Managers Ltd	Loans	Fellow group undertaking	2 6	3 5
	Loans granted during the year		(0 8)	3 5
	Other payables		-	(0 1)
	Recharges		-	(0 1)
HECM Customer Services Ltd	Other receivables	Fellow group undertaking	-	0 5
	Factoring collections		(2 0)	31 4
	Other receivables		-	(1 9)
	Factoring		2 0	(29 9)
	Other payables		-	3 8
	Recharges		(3 9)	(2 7)
	Other payables		0 6	-
Bank of Scotland Ltd	Cash at bank	Fellow group undertaking	14 1	80 7
	Cash at bank transactions		(66 6)	57 9
	Other payables		-	(13 9)
	Recharges		-	(175 7)
CMI Financial Services Ltd	Other receivables	Fellow group undertaking	-	0 3
	Marketing recharge		-	4 8
Insight Investment Services Ltd	Other receivables	Fellow group undertaking	-	1 8
	Investment charges		-	11 2
Clerical Medical Finance Plc	Loan transactions	Fellow group undertaking	671 8	(62 7)
	Interest		31 5	60 5
	Loans and interest payable		(606 9)	(1,320 0)
CME Financial Services BV	Other payables	Fellow group undertaking	-	(18 3)
	Recharges		-	(64 5)
Clerical Medical European Financial Services	Other payables	Fellow group undertaking	-	-
	Recharges		(32 9)	-
CMI Financial Management Services Ltd	Other payables	Fellow group undertaking	0 2	(0 1)
	Recharges		2 3	(0 3)
Heidelberger Leben Co	Other payables	Fellow group undertaking	-	(0 2)
	Recharges		-	(1 1)
Insight Investment Management Ltd	Other payables	Fellow group undertaking	-	(7 2)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

33. Related party transactions (continued)

	Investment charges		(35 9)	(82 3)
Invista Real Estate Investment Management	Other payables	Fellow group undertaking	(0 6)	(5 0)
	Investment charges		(8 2)	(13 6)
Clerical Medical Managed Funds Ltd	Loans	Subsidiary undertaking	100 0	100 0
	Other receivables		(9 8)	64 1
	Reassurance		158 3	110 6
	Other receivables		120 7	31 2
	Stocklending		0 4	30 6
	Other payables		-	(4 0)
	Other receivables		51 8	-
	Movement in other receivables		55 7	-
	Reassurance		2 7	(0 7)
Clerical Medical Venture Investments	Loans	Fellow group undertaking	54 6	55 9
	Loans granted during the year		(1 4)	(7 1)
Halifax Life Ltd	Other receivables	Subsidiary undertaking	-	15 6
	Commission		-	2 0
	Loans receivable		-	(0 3)
	Loans		-	51 2
Clerical Medical Forestry	Loans payable	Subsidiary undertaking	(23 7)	(28 2)
	Loans		4 5	(34 1)
Clerical Medical Properties	Loans payable	Subsidiary undertaking	-	(0 9)
Scottish Widows plc	Other payables	Fellow group undertaking	(16 9)	-
	Reassurance		(16 9)	-
Scottish Widows Investment Partnership Ltd	Other payables	Fellow group undertaking	(5 0)	-
	Investment charges		(5 0)	-

On 13 January 2009, HM Treasury subscribed for 2,597 million shares in Lloyds Banking Group plc, the Company's ultimate parent company On 16 January 2009, Lloyds Banking Group acquired HBOS plc in an all share acquisition which, together with the shares subscribed for on 13 January 2009, gave HM Treasury a 43 38 per cent interest in Lloyds Banking Group's ordinary share capital and, consequently, HM Treasury became a related party of the Company from this date

Transactions between the Company and key management

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

Key management compensation

	2009 £	2008 £
Salaries and other short-term benefits	345,684	288,658
Pension contributions and entitlements	34,332	40,521
Other long-term benefits	46,279	42,103
Total	426,295	371,282

Certain members of key management in the Company, including the highest paid director, provide services to other companies within Lloyds Banking Group plc 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

Directors sit on several boards and their benefits are allocated to a company depending on the proportion of their time that they spend as a director of that company

Retirement benefits are accruing to two Directors (2008 three) under defined benefit pension schemes No directors (2008 none) are paying into a defined contribution scheme

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

33 Related party transactions (continued)

Life assurance contracts

	Number of key management personnel	2009 £000
Valuation as at 1 January 2009 or date of appointment, if later	1	26 7
Premiums paid/amounts invested during the year	1	0 1
Total sum insured/value of investment at 31 December 2009	1	26 8

Detail regarding the highest paid director is as follows

	2009 £	2008 £
Apportioned aggregate emoluments	-	148,250
Pension contributions and entitlements	-	21,210

The highest paid director's emoluments were not required to be disclosed for the year ended 31 December 2009 as they fell below the appropriate threshold

34 Stocklending

The aggregate value of securities on loan by the Company is £nil (2008 £1,856 9m) Securities on loan are included in investments at fair value through income and no account is taken of collateral held The aggregate value of collateral held is £1 3m (2008 £2,035 6m) This collateral is in the form of high quality bonds and cash. Further detail in respect of collateral is provided in note 32

35. Capital commitments

The Company had contracted for, but not paid for, £22 8m (2008 £64 0m) of capital expenditure in respect of investment property at the balance sheet date These amounts are not recognised in the financial statements

36 Standards and interpretations effective in 2009

The following standards, amendments to and interpretations of published standards which have the potential to impact on the Company's operations have been issued and are mandatory for the year ended 31 December 2009 Their relevance to the Company's operations is assessed below

- Amendment to IAS 23 ' Borrowing Costs' This standard requires that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should form part of the cost of that asset Other borrowing costs should be recognised as an expense The amendment removes the previously allowable alternative treatment of immediately recognising as an expense borrowing costs that relate to assets that take a substantial period of time to get ready for use or sale Adoption of this standard has had no impact on the financial results or position of the Company as the alternative treatment previously allowed under IAS 23 was not adopted

- Amendment to IAS 1 "Presentation of Financial Statements' This standard sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content All changes in equity in respect of transactions with shareholders in their capacity as shareholders are required to be presented separately from changes in equity arising from transactions with other parties ("non-owner'), in a statement of changes in equity All non-owner changes in equity (comprehensive income) are required to be presented in one statement of comprehensive income or in two statements (an income statement and a statement of comprehensive income) The changes required on adoption of this standard relate only to presentation and disclosure and have therefore had no overall impact on the financial results or position of the Company other than to rename the income statement as the statement of comprehensive income and the cash flow statement as the statement of cash flows IAS 1 has been further amended by an amendment to IAS 32, details of which are set out in later in this section

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

36 Standards and interpretations effective in 2009 (continued)

- Amendments to IAS 1 "Presentation of Financial Statements" and IAS 32 'Financial Instruments Presentation" The amendments are relevant to entities that have issued financial instruments that are (i) puttable financial instruments (instruments which allow the holder to require the issuer to redeem the instruments for cash), or (ii) instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation Under the revised IAS 32, subject to extensive detailed criteria being met, such instruments will be classified as equity whereas, prior to these amendments, they would have been classified as financial liabilities The amendments will require reclassifications from or to equity when the specified criteria are no longer met, or when they are subsequently met IAS 1 has been amended to require disclosure of (i) summary quantitative date about the amount classified as equity, (ii) the entity's objectives, policies and processes for redeeming the instruments, and (iii) the expected cash outflow on redemption and how this has been calculated in respect of a puttable financial instrument which has been classified within equity These amendments have not yet been endorsed by the EU but adoption would have had no impact on the financial results or position of the Company

- Improvements to International Financial Reporting Standards 2008 (majority of changes effective for accounting periods beginning on or after 1 January 2009) – this is the first standard published under the IASBs annual improvements process, which is intended to deal with non-urgent, minor amendments to standards The standard includes 35 amendments and is split into two parts (i) amendments that result in accounting changes for presentation, recognition or measurement purposes, and (ii) amendments that are terminology or editorial changes only Adoption of this standard has resulted in a change of disclosure in the Company financial statements for property under construction or development for future use This is now treated as Investment Property since it is within the scope of IAS 40 as a result of the Improvements to International Financial Reporting Standards 2008 It was previously treated as Property, Plant and Equipment since it was within the scope of IAS 16 Other than that, adoption of this standard has had only a minor impact on some of the disclosures given in the Company financial statements

- Amendments to IAS 39 'Financial Instruments Recognition and Measurement" and IFRS 7 "Financial Instruments Disclosures" The amendments allow IFRS reporters to reclassify financial instruments in the same manner as currently permitted under US generally accepted accounting practice The changes to IAS 39 permit an entity to reclassify non-derivative financial assets falling within the scope of IAS 39 out of the fair value through profit and loss ("FVTPL") and available for sale categories in limited circumstances Adoption of these amendments has had no impact on the financial results or position of the Company or Company as no financial assets falling within the scope of these amendments are held

- Amendments to IAS 39 "Financial Instruments Recognition and Measurement" and IFRIC 9 "Reassessment of embedded derivatives" This amendment clarifies the consequences if the fair value of an embedded derivative that would have to be separated from its host contract cannot be measured reliably These amendments have not yet been endorsed by the EU but adoption of these amendments would have had no impact on the financial results or position of the Company or Company

- Amendment to IAS 27 "Consolidated and Separate Financial Statements' (effective for accounting periods beginning on or after 1 January 2009) The amendment removes the definition of the "cost method under IAS 27, thereby removing the distinction between pre- and post-acquisition profits in an entity's separate financial statements All dividends from a subsidiary, jointly controlled entity or associate can therefore be recognised directly in the statement of comprehensive income Previously, dividends paid out of pre-acquisition profits were set against the carrying value of the investment in the balance sheet However, an entity must now consider whether the payment of such dividends results in impairment of the relevant investment IAS 27 has also been amended to effectively allow the cost of an investment in a subsidiary, in limited reorganisations, to be based on the previous carrying amount of the subsidiary rather than its fair value Adoption of these amendments has had no impact on the financial results or position of the Company Generally, due to the capital constraints applicable to the entity's subsidiaries which are carried at cost, dividends are not paid out of pre-acquisition reserves so no impairment losses would be expected to arise in respect of the payment of dividends from these entities No reorganisations have been carried out which meet the amended conditions set out in IAS 27 These amendments have not yet been endorsed by the EU

- Amendment to IFRS 7 "Financial Instruments Disclosures" (effective for accounting periods beginning on or after 1 January 2009) The amendments introduce enhanced disclosures about fair value measurement and liquidity risk For fair value measurements, a three level hierarchy has been introduced A financial instrument should be classified into one of these levels in its entirety, with the appropriate level in the hierarchy being determined on the basis of the lowest level input that is "significant" to the fair value measurement Adoption of these amendments has resulted in additional quantitative disclosure being provided in the relevant notes The amendments in respect of liquidity risk clarify the scope of items to be included in the maturity analyses required by IFRS 7 by changing the definition of liquidity risk to include only financial liabilities that are settled by delivering cash or another financial instrument The amendments also clarify that a hybrid contract that is a financial liability should not be separated into a host contract as related embedded derivative for the purpose of the maturity analysis Adoption of these amendments has had no impact on the liquidity risk disclosures provided by the Company

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

37 Standards and interpretations in issue but not adopted early

The following standards, amendments to and interpretations of published standards have been issued and will be relevant to the Company's operations but have not been adopted early by the Company

- Amendment to IAS 27 "Consolidated and Separate Financial Statements" (effective for accounting periods beginning on or after 1 July 2009) The standard requires that any changes in the parent's ownership of a subsidiary after control is obtained that do not result in a loss of control should be accounted for as transactions with shareholders in their capacity as shareholders As a result, any gains or losses arising from such transactions would be taken directly to equity rather than being recognised through the statement of comprehensive income The standard also specifies the accounting required when control of an entity is lost Adoption of this standard will only be required in respect of any future changes in the control of entities accounted for by the Company in accordance with IAS 27 Currently, such transactions are generally accounted for under IAS 39, as set out at policy (h)

- Amendment to IAS 39 "Financial Instruments Recognition and Measurement" (effective for accounting periods beginning on or after 1 July 2009) This amendment clarifies how the principles that determine whether a hedged risk or portion of cash flows is eligible for hedge designation should be applied in particular situations Adoption of this amendment will have no impact on the financial results or position of the Company or Company This amendment has not yet been endorsed by the EU

- Improvements to International Financial Reporting Standards 2009 (majority of changes effective for accounting periods beginning on or after 1 January 2010) This is the second standard published under the IASBs annual improvements process, which is intended to deal with non-urgent, minor amendments to standards The standard includes amendments to 12 standards Adoption of this standard has had no impact on financial results, financial position or disclosures given in the Company and Company financial statements This standard has not yet been endorsed by the EU

- Amendment to IAS 24 "Related Party Disclosures (effective for accounting periods beginning on or after 1 January 2011) This revised standard simplifies the disclosure requirements for entities that are controlled, jointly controlled or significantly influenced by a government and clarifies the definition of a related party A partial exemption is provided from the disclosure requirements of IAS 24 for government-related entities, meaning that there is no need to disclose related party transactions and outstanding balances (including commitments) with (i) a government that has control, joint control or significant influence over the reporting entity, and (ii) an other entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the related entity The amendment also simplifies the definition of a related party, clarifies its intended meaning and eliminates a number of inconsistencies Adoption of this amendment will have no impact on the financial results, financial position or disclosures given in the financial statements This amendment has not yet been endorsed by the EU

- IFRS 9 "Financial Instruments Part 1 Classification and Measurement" (effective for accounting periods beginning on or after 1 January 2013) IFRS 9 replaces those parts of IAS 39 relating to the classification and measurement of financial assets Under IFRS 9, only two measurement categories are available being fair value through profit or loss and amortised cost Previously, categories of available-for-sale and held-to-maturity were also available The decision on classification is made at initial recognition and will depend on an entity's business model for managing its financial instruments and the contractual cash flow characteristics of the financial instruments An instrument is subsequently measured at amortised cost only if it is a debt instrument and (i) the objective of the entity's business model is to hold the asset to collect the contractual cash flows, and (ii) the asset's contractual cash flows represent only payments of principal and interest All other debt instruments are to be measured at fair value through profit or loss All equity instruments are to be subsequently measured at fair value Gains and losses in respect of equity instruments held for trading will be recognised through the income statement For other equity instruments, it will be possible to make an irrevocable election at initial recognition to recognise realised and unrealised fair value gains and losses directly in equity through the statement of comprehensive income It will not be possible to recycle gains and losses in respect of such investments to the income statement although dividend income associated with such instruments will be recognised in the income statement rather than being taken directly to equity Adoption of this standard, which has not yet been endorsed by the EU, is not expected to have any impact on the financial results or position of the Company

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

38 Prior year reclassifications

The following table sets out the balance sheets as at 31 December 2008 and the income statement for the year ended 31 December 2008 as presented in the 2008 financial statements of the Group with reclassifications made to present these statements on a basis consistent with the presentation practices adopted within Lloyds Banking Group

Balance Sheet as at 31 December 2008

	As previously presented £m	Balance sheet reclassifications £ m	Restated £ m
ASSETS			
Intangible Assets	270 8	-	270 8
Property	77 4	-	77 4
Deferred costs	477 9	-	477 9
Deferred tax assets (Note 1)	-	67 0	67 0
Investment in subsidiaries (Note 2)	2,027 4	(912 7)	1,114 7
Investment properties (Note 2)	1,491 2	(276 9)	1,214 3
Reinsurers' share of insurance contract and investment contract with DPF liabilities (Note 3)	-	2,270 4	2,270 4
Reinsurance assets (Note 3)	9,734 4	(9,734 4)	-
Prepayment and accrued income (Note 4)	41 4	(39 0)	2 4
Current tax receivable	7 8	-	7 8
Financial assets			
Reinsurers' share of investment contract without DPF liabilities (Note 3)	-	7,456 5	7,456 5
Derivative financial instruments	665 5	(3 2)	662 3
Loans and receivables (Note 4)	-	686 1	686 1
Equity investments (Note 5)	5,174 9	(5,174 9)	-
Debt investments (Note 5)	8,580 6	(8,580 6)	-
Investments at fair value through income (Note 5)	-	15,079 2	15,079 2
Insurance Receivables (Note 4)	4 9	(4 9)	-
Other receivables (Note 4)	642 2	(642 2)	-
Cash and cash equivalents	289 3	-	289 3
Total assets	**29,485 7**	**190 4**	**29,676 1**
EQUITY AND LIABILITIES			
Capital and reserves attributable to Company's equity shareholders			
Share capital	70 0	-	70 0
Share premium	1 0	-	1 0
Retained earnings	1,832 7	-	1,832 7
Total equity	1,903 7	-	**1,903 7**
Liabilities			
Insurance contract and investment contract with DPF liabilities (Note 6)	10,742 0	6,166 0	16,908 0
Unallocated surplus	469 2	-	469 2
	11,211 2	6,166 0	17,377 2
Deferred tax liabilities (Note 1)	183 5	67 0	250 5
Current tax payables	-	-	-
Provisions for other liabilities and charges	-	2 2	2 2
Accruals and deferred income (Note 7)	26 5	20 1	46 6
Financial liabilities			
Subordinated debt	1,319 5	(3 2)	1,316 3
Investment contract without DPF liabilities (Note 6)	13,934 5	(6,173 5)	7,761 0
Derivative financial instruments	131 1	-	131 1
Other liabilities (Note 7)	541 3	177 2	718 5
Borrowings	169 0	-	169 0
Other insurance financial liabilities (Note 7)	65 4	(65 4)	-
Total liabilities	**27,582.0**	**190 4**	**27,772.4**
Total liabilities and equity	**29,485.7**	**190 4**	**29,676.1**

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

38 Prior year reclassifications (continued)

The significant balance sheet reclassifications (none of which require re-measurement of an asset or liability) are in relation to

1 – the reclassification from Deferred tax liabilities to Deferred tax assets

2 - the reclassification of Investments in subsidiaries and Investment properties as Investments at fair value through income

3 – the reclassification of Reinsurance assets to Reinsurers' share of insurance contract and investment contract with DPF liabilities and Reinsurers' share of investment contract without DPF liabilities

4 - the reclassification of Other receivables, Insurance receivables and Prepayments and accrued income as Loans and receivables within financial assets

5 - the reclassification of Equity investments and Debt investments as Investments at fair value through income, and the reclassification of Debt investments as Other financial liabilities

6 – the reclassification of Investment contract with DPF liabilities as Insurance contract and investment contract with DPF liabilities

7 – the reclassification of Other liabilities as Accruals and deferred income and the reclassification of Other insurance financial liabilities and Debt securities as Other liabilities

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

38. Prior year reclassifications (continued)

Balance Sheet as at 1 January 2008

	As previously presented £m	Balance sheet reclassifications £ m	Restated £ m
ASSETS			
Intangible Assets	294 0	-	294 0
Property	161 4	-	161 4
Deferred costs	413 1	-	413 1
Deferred tax assets (Note 1)	-	20 5	20 5
Investment in subsidiaries (Note 2)	6,159 2	(5,223 3)	935 9
Investment properties (Note 2)	2,274 1	(310 6)	1,963 5
Reinsurers' share of insurance contract and investment contract with DPF liabilities (Note 3)	-	2,294 2	2,294 2
Reinsurance assets (Note 3)	11,097 1	(11,097 1)	-
Prepayment and accrued income	36 7	(19 4)	17 3
Current tax receivable	105 7	-	105 7
Financial assets			
Reinsurers' share of investment contract without DPF liabilities (Note 3)	-	8,805 1	8,805 1
Derivative financial instruments	101 5	(44 3)	57 2
Loans and receivables (Note 4)	-	626 9	626 9
Equity investments (Note 5)	5,962 9	(5,962 9)	-
Debt investments (Note 5)	5,775 6	(5,775 6)	-
Investments at fair value through income (Note 5)	-	17,272 4	17,272 4
Insurance Receivables	49 5	(49 5)	-
Other receivables (Note 4)	558 0	(558 0)	-
Cash and cash equivalents	267 8	-	267 8
Total assets	**33,256 6**	**(21 6)**	**33,235 0**
EQUITY AND LIABILITIES			
Capital and reserves attributable to Company's equity shareholders			
Share capital	1,629 0	-	1,629 0
Share premium	1 0	-	1 0
Other reserves	2 6	(2 6)	-
Retained earnings	628 2	2 6	630 8
Total equity	**2,260.8**	**-**	**2,260 8**
Liabilities			
Insurance contract and investment contract with DPF liabilities (Note 6)	8,012 1	7,203 4	15,215 5
Unallocated surplus	1,497 4	-	1 497 4
	9,509 5	7,203 4	16,712 9
Deferred tax liabilities (Note 1)	389 0	20 5	409 5
Current tax payables	-	-	-
Provisions for other liabilities and charges	-	1 9	1 9
Accruals and deferred income (Note 7)	28 2	23 1	51 3
Financial liabilities			
Subordinated debt	1,059 1	(44 3)	1,014 8
Investment contract without DPF liabilities (Note 6)	19,625 5	(7,201 2)	12,424 3
Derivative financial instruments	37 9	-	37 9
Other liabilities (Note 7)	196 1	74 1	270 2
Borrowings	51 4	-	51 4
Other insurance financial liabilities (Note 7)	99 1	(99 1)	-
Total liabilities	**30,995 8**	**(21.6)**	**30,974 2**
Total liabilities and equity	**33,256.6**	**(21.6)**	**33,235.0**

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

38 Prior year reclassifications (continued)

The significant balance sheet reclassifications (none of which require re-measurement of an asset or liability) are the same as those as at 31 December 2008 described above this table

Income Statement for the year ended 31 December 2008

	As previously presented £m	Reclassifications £ m	2008 (Restated) £ m
Revenue			
Gross earned premiums	784 9	(0 7)	784 2
Premiums ceded to reinsurers	(155 2)	-	(155 2)
Premiums net of reinsurance	629 7	(0 7)	629 0
Fee and commission income	77 9	0 5	78 4
Finance income (Note 8)	46 0	(46 0)	-
Investment income (Note 8)	1,932 0	(1,185 5)	746 5
Net realised gains/(losses) on assets and liabilities at fair value though income (Note 9)	662 1	123 1	785 2
Net fair value gains/(losses) on assets and liabilities at fair value through income (Note 9)	(3,191 9)	1,168 6	(2,023 3)
Income from shares in group undertakings (Note 9)	60 0	(60 0)	-
Total revenue	215 8	-	215 8
Expenses			
Gross claims and benefits	930 0	-	930 0
Claims recoveries from reinsurers	(201 5)	-	(201 5)
	728 5	-	728 5
Change in insurance contract and investment contract with DPF liabilities (Note 10)	3,248 8	(1,037 4)	2,211 4
Change in investment contract without DPF liabilities (Note 10)	(3 280 5)	295 8	(2,984 7)
Change in reinsurers' share of liabilities	23 8	741 6	765 4
Change in unallocated surplus	(1,028 2)	-	(1,028 2)
	(1,036 1)	-	(1,036 1)
Operating expenses (Note 11)	360 7	40 9	401 6
Expenses for asset management services received (Note 11)	-	52 9	52 9
Fee and commission expenses (Note 11)	93 8	(93 8)	-
Finance costs	103 1	-	103 1
	557 6	-	557 6
Total expenses	250 0	-	250 0
Loss before tax	(34 2)	-	(34 2)
Taxation credit	296 1	-	296 1
Profit for the year	**261 9**	-	**261 9**

The significant income statement reclassifications are in relation to

8 – the reclassification of interest on swap contracts and interest from group undertakings from Finance income to Investment income

9 – the reclassification from Income from shares in group undertakings, Net realised gains/(losses) on assets and liabilities at fair value though income and Net fair value gains/(losses) on assets and liabilities at fair value through income to Investment income

10 – the reclassification of the Change in investment contract with DPF liabilities from Change in investment contract without DPF liabilities

11 – the reclassification of Expenses for asset management services received from Operating expenses and Fee and commission expenses to Expenses for asset management services received