3196171

CLERICAL MEDICAL INVESTMENT GROUP LIMITED

DIRECTORS' REPORT

AND

FINANCIAL STATEMENTS

31 DECEMBER 2010

Member of Lloyds Banking Group plc

CONTENTS

COMPANY INFORMATION

Board of Directors

Lord A P Leitch (Chairman)

Dr N M Bryson
M Christophers
J Goford
A G Kane (Deputy Chairman) *
P D Loney *
K Luscombe *
A M Peck

* denotes Executive Director

Secretary

C M Herd

Actuarial Function

R McIntyre

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 and incorporated in the United Kingdom

The principal activity of the Company is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the UK and through non-UK branches The Company offers a range of products such as annuities and investment type products principally through independent financial advisers The Company also reinsures business with subsidiary undertakings and with insurance entities external to the Lloyds Banking Group plc ("the Group") This includes the majority of its existing pensions linked business, which is reinsured to its subsidiary Clerical Medical Managed Funds Limited ("CMMF")

Review of historical transactions affecting the with profit fund (2010)

A project to review historical transactions between the Company's with profit fund and non profit fund was brought to a conclusion within the year The overall impact of the project was a net transfer of £110 2m to the with profit fund, primarily in respect of the reassessment of historical annual management charges

Redemption of subordinated debt (2010)

On 14 December 2010, the Company's subsidiary Clerical Medical Managed Funds Limited (CMMF) redeemed and cancelled £100m of subordinated debt previously issued to the Company resulting in no gain or loss to either company

Results and dividend

The result of the Company for the year ended 31 December 2010 is a loss after tax of £158m (2009 loss of £288m) and this has been transferred to reserves The result reflects the loss resulting from the net transfer of £110m to the with profit fund and, while positive market conditions led to net realised and unrealised gains in respect of investments held by the Company, as the majority of assets back policyholder liabilities this was offset by an increase in the value of insurance and investment contract liabilities The Directors consider the result for the year to be satisfactory in light of these factors

During the year, no dividends were paid (2009 £nil) The Directors expect to recommend payment of a dividend of £nil in respect of the year ended 31 December 2010 in due course

Key performance indicators

Total insurance premiums received from policyholders were £1,748m (2009 £1,979m) Of this, £1,060m (2009 £914m) was recognised in the statement of comprehensive income, with the remainder being subject to deposit accounting as set out in note 1(v) The fall in the level of premiums over 2010 principally reflects the closure to new pensions contracts on 1 July 2009

Funds under management are approximately £17 1bn (2009 £16 7bn)

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 33

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 the Group The development, performance and position of this Division are discussed in the Group's annual report, which does not form part of this report The Group's annual report also includes information for the Insurance Division on a European Embedded Value basis

Future outlook

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

Principal risks and uncertainties

The management of the business and the execution of the Company's strategy are subject to a number of risks The financial risk management objectives and policies of the Company and the exposure to market, insurance, credit and financial soundness risk are set out in note 33

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 risk management objectives and policies of the Company in respect of financial and prudential regulatory reporting risk are also set out in note 33

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

B Duffin (Resigned 18 March 2010)
P D Loney (Appointed 25 March 2010)
J Van Der Wielen (Resigned 25 March 2010)
T A Leonard (Resigned 5 April 2010)
K Luscombe (Appointed 6 April 2010)
Lord A P Leitch (Appointed 27 April 2010)
Dr N M Bryson (Appointed 27 April 2010)
J Goford (Appointed 27 April 2010)

Particulars of the Directors' emoluments are set out in note 34

Three (2009 two) of the Directors have entered into individual contracts of indemnity with the Group which constitute "qualifying pension scheme indemnity provisions" for the purposes of the Companies Act 2006 Two of these contracts were in force during the whole of the financial year and one came into force during the year All contracts remain in force The contracts are available for inspection at the registered office of Lloyds Banking Group plc Details of the registered office are given in note 34

All of the Directors (2009 two) have the benefit of a contract of indemnity which constitutes a "qualifying third party indemnity provision" For two of these Directors, contracts were in force for the whole of the financial year For the remaining Directors, a contract came into force during the financial year The contract remains in force and is available for inspection at the registered office of Lloyds Banking Group plc Details of the registered office are given in note 34

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

Re-appointment of auditors

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 14 days (2009 20 days)

DIRECTORS' REPORT (continued)

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

On behalf of the Board of Directors

Catriona M Herd

C M Herd

28 March 2011

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 2010, which comprise of the Statement of Comprehensive Income, the Balance Sheet, the Statement of Cash Flow, 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 and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors

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

Scope of the audit of the financial statements

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

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 2010 and of its loss and cash flows for the year then ended,
- have been properly prepared in accordance with IFRSs as adopted by the European Union, and
- have been prepared in accordance with the requirements of the Companies Act 2006

Opinion on other matter prescribed by the Companies Act 2006

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

Matters on which we are required to report by exception

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

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

Joanne Leeson (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Bristol
28 March 2011

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2010

	Notes	2010 £ m	2009 £ m
Revenue			
Gross earned premiums		1,060	914
Premiums ceded to reinsurers		(27)	1,762
Premiums net of reinsurance		**1,033**	**2,676**
Fee and commission income	3	79	78
Investment income	4	657	703
Net realised gains on assets and liabilities at fair value though income	5	184	13
Net fair value gains/(losses) on assets and liabilities at fair value through income	6	391	(44)
Other income		-	37
Total revenue		**2,344**	**3,463**
Expenses			
Gross claims and benefits		1,988	1,831
Claims recoveries from reinsurers		(54)	(186)
		1,934	**1,645**
Change in insurance contract and participating investment contract liabilities	22	299	(569)
Change in non-participating investment contract liabilities		1,202	950
Change in reinsurers' share of liabilities		(1,105)	845
Change in unallocated surplus	23	(308)	201
		88	**1,427**
Operating expenses	7	377	561
Expenses for asset management services received		45	76
Finance costs	9	36	79
		458	**716**
Total expenses		**2,480**	**3,788**
Loss before tax		**(136)**	**(325)**
Taxation (charge)/credit	10	(22)	37
Loss for the year		**(158)**	**(288)**
Other comprehensive income			
Movement in net investment hedges, net of tax		2	(2)
Currency translation differences, net of tax		(2)	9
Other comprehensive income		**-**	**7**
Total comprehensive income		**(158)**	**(281)**

The notes set out on pages 12 to 58 are an integral part of these financial statements

BALANCE SHEET AS AT 31 DECEMBER 2010

	Notes	2010 £ m	2009 £ m
ASSETS			
Intangible assets	11	202	221
Deferred costs	12	470	475
Deferred tax assets	13	63	73
Investment in subsidiaries	14	1,998	963
Property	15	-	6
Investment properties	16	868	945
Reinsurers' share of insurance contract and participating investment contract liabilities	22	600	522
Prepayments		14	2
Current tax receivable	13	74	29
Financial assets			
Reinsurers' share of non-participating investment contract liabilities	27	8,922	8,474
Derivative financial instruments	17	501	531
Loans and receivables	18	403	539
Investments at fair value through income	19	15,122	16,594
Cash and cash equivalents	20	237	356
Total assets		**29,474**	**29,730**
EQUITY AND LIABILITIES			
Capital and reserves attributable to Company's equity shareholder			
Share capital	21	70	70
Share premium	21	1	1
Retained earnings		1,394	1,552
Total equity		**1,465**	**1,623**
Liabilities			
Insurance contract and participating investment contract liabilities	22	16,638	16,339
Unallocated surplus	23	362	670
		17,000	**17,009**
Deferred tax liabilities	13	236	221
Current tax payables	13	78	39
Provisions for other liabilities and charges	24	2	2
Accruals and deferred income	25	50	39
Financial liabilities			
Subordinated debt	26	602	610
Non-participating investment contract liabilities	27	9,160	8,685
Derivative financial instruments	17	134	103
Other financial liabilities	28	747	1,383
Borrowings	29	-	16
Total liabilities		**28,009**	**28,107**
Total liabilities and equity		**29,474**	**29,730**

Approved by the Board on 28 March 2011

K Luscombe
Director

The notes set out on pages 12 to 58 are an integral part of these financial statements

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2010

	Notes	2010 £ m	2009 £ m
Cash flows from operating activities			
Loss before tax		(136)	(325)
Adjusted for			
Dividends and loan interest received from subsidiary undertakings		-	(1)
Impairment of property	15	-	3
Gain on disposal of property		-	-
Impairment of subsidiary undertakings owned by the shareholder fund		-	111
Amortisation and impairment of intangible assets	11	19	49
Movement in deferred costs	12	5	3
Finance costs	9	36	79
Other comprehensive income relating to monetary items		-	7
Foreign exchange on intangible assets		-	-
Net decrease in operating assets and liabilities	30	12	354
Taxation (paid)/received		(3)	18
Net cash (outflows)/inflows from operating activities		(67)	298
Cash flows from investing activities			
Purchase of property	15	-	-
Proceeds from sale of property		-	-
Additions to intangible assets	11	-	-
Dividends and loan interest received from subsidiary undertakings		-	1
Net cash inflows from investing activities		-	1
Cash flows from financing activities			
Dividends paid	31	-	-
Finance costs paid	9	(36)	(79)
Net cash outflows from financing activities		(36)	(79)
Net (decrease)/increase in cash and cash equivalents		(103)	220
Cash and cash equivalents at the beginning of the year		340	120
Net cash and cash equivalents at the end of the year	20	237	340

The notes set out on pages 12 to 58 are an integral part of these financial statements

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2010

	Notes	Issued share capital £ m	Share premium £ m	Retained earnings £ m	Total £ m
Balance as at 1 January 2009		70	1	1,833	1,904
Total comprehensive income for the year		-	-	(281)	(281)
Balance as at 31 December 2009		70	1	1,552	1,623
Total comprehensive income for the year		-	-	(158)	(158)
Balance as at 31 December 2010		70	1	1,394	1,465

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 33

The notes set out on pages 12 to 58 are an integral part of these financial statements

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

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 participating investment contract 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 2010

The Company has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2010 None of these standards or amendments has had a material impact on these financial statements

(i) IAS 27 *Consolidated and Separate Financial Statements* Requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control, any remaining interest in an investee is re-measured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1. Accounting policies (continued)

(ii) Amendment to IAS 39 *Financial Instruments Recognition and Measurement – 'Eligible Hedged Items'* Clarifies how the principles underlying hedge accounting should be applied in particular situations

(iii) *Improvements to IFRSs* (issued April 2009) Sets out minor amendments to IFRS standards as part of the annual improvements process

Details of those IFRS pronouncements which will be relevant to the Company but which were not effective at 31 December 2010 and which have not been applied in preparing these financial statements are given in note 37

(b) Product classification

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

Insurance contracts

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

Investment contracts

Any long term contracts not considered to be insurance contracts under IFRSs because they do not transfer significant insurance risk are classified as investment contracts Such contracts are further analysed between those with discretionary participating features ("participating investment contracts") and without discretionary participating features ("non-participating investment contracts")

A participating investment contract gives investors a contractual right to receive, as a supplement to guaranteed benefits, additional discretionary benefits or bonuses that are likely to be a significant portion of the total contractual benefits, through participation in the surplus arising from the assets held in the fund The Company has the discretion within the constraints of the terms and conditions of the instrument to allocate part of this surplus to the policyholders and part to the Company's equity shareholders Participating investment contracts are accounted for in the same manner as insurance contracts in accordance with the requirements of IFRS 4 "Insurance Contracts"

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

Hybrid contracts

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

(c) Financial assets and financial liabilities

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

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

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 (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, investment property and cash and to evaluate the Company's investments with reference to their fair values

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1 Accounting policies (continued)

Fair value methodology

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

(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 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 for the inputs to any valuation models) Unobservable inputs reflect the assumptions the Company considers that market participants would use in pricing the asset or liability, for example certain private equity investments held by the Company

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

Further analysis of the Company's instruments held at fair value is set out at note 33

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 fair value gains and losses on assets and liabilities at fair value through income On disposal, those transaction costs become realised and are expensed through the statement of comprehensive income, within net realised gains/ (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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1 Accounting policies (continued)

(d) Revenue recognition

Premium income

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

Fee and commission income

Fee and commission income 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

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 on an accruals basis, within investment income, when the right to receive payment is established The cost of incentives are recognised as a reduction of total income over the term of the lease on a straight line basis

(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 and claims recoveries are recognised through the relevant lines in the statement of comprehensive income Claims also include interest paid on the late payment of claims This is recognised when incurred

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1 Accounting policies (continued)

(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 cash flows expected from the business acquired The asset is shown gross of attributable tax and a corresponding deferred tax liability has been established Amortisation of the acquired VIF balance and related tax is carried out on a best estimate basis over the estimated life of the contracts The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses The carrying value of the acquired VIF balance is tested for impairment at each reporting date 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

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 participating investment contracts (excluding those assessed on a 'realistic basis' in accordance with FRS 27), which are incurred during a financial period but which relate to subsequent financial periods, are deferred to the extent that they are recoverable out of future revenue margins The deferred acquisition cost asset is amortised over the lifetime of the related contracts based on the pattern of margins arising from these contracts unless there is evidence to support an alternative recognition basis Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned

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

(ii) Deferred origination costs

Costs which are directly attributable and incremental to securing new non-participating investment contracts are capitalised. This asset is subsequently amortised over the estimated contractual lifetime of each policy on a straight-line basis unless there is evidence to support an alternative recognition basis Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned The carrying value of the asset is tested for impairment at each reporting date 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)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1 Accounting policies (continued)

In addition, certain subsidiaries are held primarily as vehicles through which specific investments are held as part of the actively managed investment portfolios These subsidiaries hold assets which are designated at fair value through 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 Further information is set out at policy (c)

Recognition

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

Measurement

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 similar arm's length transactions and reference to other instruments that are substantially the same, making maximum use of market inputs and relying as little as possible on entity-specific inputs The following paragraphs detail the valuation techniques specific to quoted 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 final pricing point on the reporting date Prices are provided by vendors such as Reuters or Bloomberg or by direct reference to the Stock Exchange For quoted debt security investments, bid prices at the final pricing point on the reporting date are obtained from index providers who obtain prices from a number of leading brokers, investment banks and market makers Where no independent price is available, a valuation technique is used to determine fair value The technique uses a spread over a comparable term gilt as the best estimate of fair value Spreads are calculated by reference to the wider market movement in credit spreads, the way in which the security is structured, other assets issued by the issuer or other assets with similar characteristics

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

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

Unquoted investments

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

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 or investments in subsidiaries, dependent on the extent to which control is deemed to be exercisable over those sub-funds

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1 Accounting policies (continued)

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

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

Property investments through special purpose vehicles

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

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

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 or liability 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 and liability 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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1. Accounting policies (continued)

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

Reinsurers' share of insurance contract and participating investment contract liabilities

Contracts entered into by the Company with reinsurers under which the Company is compensated for losses on one or more contracts issued by the Company and that meet the classification requirements for insurance contracts are classified as reinsurance contracts held

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 recoverables that are dependent on the expected claims and benefits arising under the related reinsured contracts (recognised within reinsurers' share of insurance and participating investment contract liabilities) Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment

Premiums ceded and claims reimbursed are recognised when due and disclosed separately on the face of the statement of comprehensive income Changes in the reinsurance assets are recognised on the face of the statement of comprehensive income through change in reinsurers' share of liabilities

Reinsurers' share of non- participating investment contract liabilities

Amounts due from reinsurers in respect of non-participating investment contracts are designated as fair value through income as the amount recoverable relates wholly to non-participating investment contract liabilities which are recognised at fair value These contracts do not meet the definition of a reinsurance contract under IFRS Where this is the case the amounts recoverable have been recognised as a financial asset within reinsurers' share of non-participating investment contract liabilities in the case of longer term receivables and within loans and receivables in the case of short-term balances Changes in these assets are recognised on the face of the statement of comprehensive income through change in reinsurers' share of liabilities

(m) Derivative financial instruments

<u>Classification</u>

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

<u>Recognition</u>

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

<u>Measurement</u>

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

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

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

Data from a primary source will initially be used in valuing derivatives However, tolerance checks are also performed between valuations derived from different sources in order to validate the calculated valuations, detect any potential discrepancies and, if appropriate, select a secondary or tertiary price for use in the valuation instead If, as a result of this process, a value other than one obtained from a primary valuation source were to be used to value a derivative, this would be

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1. **Accounting policies (continued)**

approved by the Derivative and Counterparty Risks 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 held for trading 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 methodology that will be used to measure effectiveness Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the statement of comprehensive income, through net gains and losses on assets 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 are designated and qualify as fair value hedges are recorded in the statement of comprehensive income, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the statement of comprehensive income The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the statement of comprehensive income using the effective interest method over the period to maturity

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

(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 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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1 Accounting policies (continued)

(p) Impairment

Financial assets

The carrying value of all financial assets held at amortised cost is reviewed for impairment whenever events or circumstances indicate that the carrying amount may not be recoverable The identification of impairment and the determination of recoverable amounts is an inherently uncertain process involving various assumptions and factors, including the financial condition of the counterparty, expected future cash flows, observable fair prices and expected net selling prices

In order to determine whether financial assets are impaired, all financial assets for which the fair value has fallen below the recoverable amount (assessed using cost price and the factors above) 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
(iv) observable data indicating that there is a measurable decrease in the estimated future cash flow from a group of assets since the initial recognition of those assets, even where the decrease cannot yet be identified with the individual assets of the Company, including
  - adverse changes in the payment status of issuers or debtors, or
  - national or local economic conditions that correlate with defaults on the assets in the Company

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

(q) Taxes

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

Current tax

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1. **Accounting policies (continued)**

Deferred tax

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes at the reporting date However, if the deferred tax arises from 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 tax assets are only recognised to the extent that it is probable that future taxable profits will be available against which the temporary differences, carry-forward of unused tax assets and unused tax losses can be utilised

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

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 participating investment contracts**

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

Insurance contracts and participating investment contracts in the Company's With Profits Fund

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

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

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

Insurance contracts which are unit-linked

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1. Accounting policies (continued)

Unallocated surplus

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

Bonuses

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

- Unit price increases and new reversionary bonuses declared in respect of that year which are provided within the calculation of insurance contract and participating investment contract liabilities,
- 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

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

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

(u) Subordinated debt

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

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) Non-participating investment contracts

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

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

(w) Liability adequacy test

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

1. Accounting policies (continued)

(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

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 foreign operations are recognised in other comprehensive income

(aa) Collateral

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

2. Critical accounting estimates and judgments in applying accounting policies

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

(a) Insurance contract and participating investment contract liabilities

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

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

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 32

Sensitivities regarding changes to key assumptions in calculating insurance contract and participating investment contract liabilities are given in note 32

(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

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 amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses The carrying value of this asset is tested for impairment at each reporting date Further information on this asset is given in note 11

(c) Deferred costs

For insurance contracts and participating investment contracts (excluding those assessed on a 'realistic basis' in accordance with FRS 27), acquisition costs which are incurred during a financial period but which relate to subsequent financial periods are deferred to the extent that they are recoverable out of future revenue margins All other costs are recognised as expenses when incurred The calculation of the deferred acquisition cost asset and its pattern of amortisation requires estimation of both the expected pattern of receipt of future revenue margins and the period that the business is expected to remain in force Further information on this asset is given in note 12

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

(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

	2010 £ m	2009 £ m
Fee income from reinsured business	79	76
Change in deferred income	-	2
Total	79	78

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

4. Investment income

	2010 £m	2009 £m
Investments at fair value through income		
Interest income on investments	275	179
Dividend income	234	248
Interest payable on swap	(9)	20
Dividend income from subsidiary undertakings	-	35
Financial instruments at amortised cost		
Interest income on deposits	9	4
Interest income from group undertakings	3	2
Interest income from loans to subsidiary undertakings	-	1
Rental income on investment properties	62	98
Foreign currency translation differences	82	114
Other	1	2
Total	657	703

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

	2010 £m	2009 £m
Derivative financial instruments at fair value through income	(53)	(87)
Investments at fair value through income		
Equity securities	116	58
Debt securities	126	32
Investment properties at fair value through income	(3)	18
Foreign exchange	(2)	(8)
Total	184	13

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

	2010 £m	2009 £m
Derivative financial instruments at fair value through income	(58)	(501)
Investments at fair value through income		
Equity securities (including investment in subsidiaries)	433	1,098
Debt securities	49	(259)
Investment properties at fair value through income	77	(99)
Foreign exchange	(110)	(283)
Fair value gain on derivative hedging instrument	9	12
Fair value loss on hedged loan	(9)	(12)
Total	391	(44)

7. Operating expenses

	2010 £m	2009 £m
Acquisition and origination costs in respect of insurance and investment contracts	59	120
Expenses for administration	294	267
	353	387
Change in deferred costs	5	2
Amortisation and impairment of acquired VIF	18	48
Amortisation of software development costs	1	1
Impairment of investment in subsidiaries	-	123
Total	377	561

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

7 Operating expenses (continued)

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

The Company had no direct employees during the year (2009 nil) The employee costs, including pension costs and share-based payment costs, are included in the recharge noted above

8. Auditors' remuneration

	2010 £m	2009 £m
Fees payable for the audit of the Company's current year annual report	0 4	0 6
Fees payable for other services		
Other services provided pursuant to legislation	0 2	0 1
Total audit fees	0 6	0 7
Other services - audit related	0 6	0 5
Total other audit fees	0 6	0 5
Total	1 2	1 2

Audit fees for 2009 and 2010 were borne by another company within the group and recharged to the company

9 Finance costs

	2010 £ m	2009 £ m
Interest on borrowings	-	9
Interest payable on swap	6	14
Interest on subordinated debt	30	56
Total	36	79

In 2009 finance costs of £2m reported under "Other interest" were in respect of interest paid on late payment of claims This has been reclassified to "Gross claims and benefits" on the statement of comprehensive income to improve presentation

10. Taxation

(a) Analysis of tax (charge)/credit

	2010 £ m	2009 £ m
Current tax		
UK corporation tax	1	8
Overseas tax	2	(5)
Adjustment in respect of prior years	1	(2)
Total current tax	4	1
Deferred tax:		
Origination of temporary differences	(37)	89
Change in tax rate	7	-
Adjustment in respect of prior years	4	(53)
Total deferred tax	(26)	36
Total income tax (charge)/credit	(22)	37

The policyholder tax benefit or expense is included in income tax expense Policyholder tax is a charge of £54m (2009 credit of £31m), including a prior year tax charge of £8m (2009 charge of £4m)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

10. Taxation (continued)

(b) Reconciliation of tax (charge)/credit

	2010 £m	2009 £m
Loss before tax	(136)	(325)
Tax at 28% (2009. 28%)	38	91
Effects of	-	-
Tax exempt income	-	-
Disallowable expenses	-	(31)
Policyholder tax	(41)	30
Adjustment to tax charge in respect of prior years	6	(52)
Overseas tax	2	1
Change in tax rate	7	-
Other	(34)	(2)
Total	(22)	37

11 Intangible assets

		2010 £m	2009 £m
Acquired VIF	(a)	199	217
Software development costs	(b)	3	4
Total		202	221

(a) Acquired VIF

	2010 £m	2009 £m
Cost		
At 1 January and 31 December	651	651
Accumulated amortisation and impairment		
At 1 January	434	386
Amortisation during the year	18	23
Impairment	-	25
At 31 December	452	434
Carrying amount		
At 31 December	199	217

Of the above total, £181m (2009 £201m) is expected to be recovered more than one year after the reporting date

(b) Software development costs

	2010 £m	2009 £m
Cost		
At 1 January and 31 December	6	6
Accumulated amortisation		
At 1 January	2	1
Amortisation charge for the year	1	1
At 31 December	3	2
Carrying amount		
At 31 December	3	4

Of the above total, £2m (2009 £3m) is expected to be recovered more than one year after the reporting date

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

12. Deferred costs

		2010 £ m	2009 £ m
Deferred acquisition costs	(a)	269	236
Deferred origination costs	(b)	201	239
Total		470	475

(a) Deferred acquisition costs

	2010 £ m	2009 £ m
At 1 January	236	227
Amounts incurred during the period	77	69
Amortisation during the period	(44)	(60)
At 31 December	269	236

Of the above total, £215m (2009 £197m) is expected to be recovered more than one year after the reporting date

(b) Deferred origination costs

	2010 £ m	2009 £ m
At 1 January	239	251
Amounts incurred during the period	2	18
Amortisation during the period	(40)	(29)
Foreign exchange	-	(1)
At 31 December	201	239

Of the above total, £173m (2009 £199m) is expected to be recovered more than one year after the reporting date

13 Tax assets and liabilities

	2010 £ m	2009 £ m
Current tax receivables	74	29
Deferred tax assets	63	73
Total tax assets	137	102
Current tax payables	78	39
Deferred tax liabilities	236	221
Total tax liabilities	314	260

Deferred tax assets include £63m (2009 £73m) that is expected to be recovered more than one year after the reporting date

Deferred tax liabilities include £236m (2009 £221m) 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 2010

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

	2010 £ m	2009 £ m
Deferred tax assets comprise:		
Unrealised losses on investment assets	-	42
Expenses deductible in future periods	62	31
Other	1	-
Total deferred tax assets	63	73
Deferred tax liabilities comprise:		
Unrealised gains on investment assets	15	-
Deferred costs	123	127
Other insurance related items	15	36
Deferred tax on acquired VIF	83	58
Total deferred tax liabilities	236	221
Net deferred tax liabilities	173	148

Deferred tax assets and liabilities are not discounted Included in the deferred tax balance is an asset of £62m (2009 £31m) 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 Finance (No 2) Act 2010 reduced the rate of corporation tax from 28% to 27% with effect from 1 April 2011 The impact of this reduction in tax rate, which is applicable to the calculation of deferred tax assets and liabilities at the reporting date, is reflected in the above table

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

	2010 £ m	2009 £ m
Unrealised gains on investment assets	(57)	5
Expenses deductible in future periods	31	(12)
Other deferred tax assets	1	1
Deferred costs	3	(2)
Other insurance items	21	25
Accelerated capital allowances	-	-
Acquired value in force	(25)	(53)
Total deferred tax (charge)/credit	(26)	36

Deferred tax assets have not been recognised in respect of unrelieved capital losses of £nil (2009 £4m), as there is insufficient certainty as to the availability of future profits

At the end of 2010 the Group has a deductible temporary difference relating to taxable profits of £911m (2009 £nil) for which no asset has been recognised as the Group intend to make these losses available to fellow Group Undertakings to the Company for no payment

14 Investment in subsidiaries

	2010 £ m	2009 £ m
At 1 January	963	1,115
Movements in holdings of subsidiaries at fair value	25	26
Movements in holdings of OEICS at fair value	1,010	-
Disposals of holdings in subsidiaries	-	(55)
Impairment of holdings in subsidiaries	-	(123)
At 31 December	1,998	963

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

14. Investment in subsidiaries (continued)

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

The Company invests in a number of OEICs which have been classified as investments in subsidiaries as described in note 1(h) These holdings were previously disclosed within Investments at fair value through income as equity

The following are particulars of the Company's principal subsidiaries

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

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

	2010 £ m	2009 £ m
Cost		
At 1 January	9	78
Disposals	-	-
Transfer to investment properties	(9)	(69)
At 31 December	-	9
Accumulated depreciation		
At 1 January	3	-
Impairment charge for the year	-	3
Transfer to investment properties	(3)	-
At 31 December	-	3
Carrying amount		
At 31 December	-	6

16. Investment properties

	2010 £ m	2009 £ m
At 1 January	945	1,214
Additions – subsequent expenditure on existing properties	22	70
Disposals	(182)	(309)
Transfer from property	6	69
Net gain/(loss) from change in fair values	77	(99)
At 31 December	868	945

The rental income arising from investment properties during the year amounted to £62m (2009 £98m), 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 £12m (2009 £33m)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

16. Investment properties (continued)

Expenditure on investment properties which did not generate rental income was £20m (2009 £50m)

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 £122m (2009 £77m) The carrying value of land held for development purposes that has not yet been developed is £23m (2009 £11m)

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

	2010			2009		
	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	1,105	8	45	1,740	16	79
Option contracts	4,618	462	75	3,110	497	2
Index futures contracts	603	1	7	809	1	17
Forward foreign exchange contracts	639	5	7	441	4	3
Derivative financial instruments designated as fair value hedges	334	23	-	345	13	-
Derivative financial instruments designated as net investment hedge	86	2	-	90	-	2
Total	7,385	501	134	6,535	531	103

Derivative financial instrument assets include £468m (2009 £262m) that is expected to be recovered more than one year after the reporting date

Derivative financial instrument liabilities include £117m (2009 £nil) that is expected to be settled more than one year after the reporting date

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

17. Derivative financial instruments (continued)

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 £nil (2009 £388m) was accepted by the Company in assets that it is permitted to sell or repledge even in the absence of default of the owner of the collateral 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

	2010 £ m	2009 £ m
Insurance business		
Amounts receivable in respect of direct insurance business	7	46
Other loans and receivables		
Accrued interest and rent	36	12
Amounts due from related parties	224	345
Other	136	136
Total	403	539

Of the above total, £148m (2009 £258m) is expected to be recovered more than one year after the reporting date

Of the above balances, £148m (2009 £258m) 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 33

19. Investments at fair value through income

	2010 £ m	2009 £ m
At fair value:		
Shares and other variable yield securities		
Listed	2,556	2,364
Unlisted	6,342	8,149
	8,898	10,513
Debt and other fixed/variable income securities	6,224	6,081
Total investments at fair value	15,122	16,594

Of the total debt securities above £4,029m (2009 £3,611m) are listed government bonds

Of the debt securities, £5,537m (2009 £4,349m) 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

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

	Asset		Related Liability	
	2010 £ m	2009* £ m	2010 £ m	2009* £ m
Equity Investments	23	-	11	-
Debt Investments	60	-	76	1
Assets subject to repurchase	83	-	87	1

*No securities lending transactions were in place at 31 December 2009

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

20. Cash and cash equivalents

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

	2010 £ m	2009 £ m
Cash at bank	127	114
Short term deposits	110	242
	237	356
Bank overdraft (note 29)	-	(16)
Total	237	340

Cash and cash equivalents in the above table contains amounts of £233m (2009 £222m) 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

	2010 £ m	2009 £ m
Authorised share capital:		
150,000,000 ordinary shares of £1 each	150	150
Allotted, called up and fully paid share capital.		
70,000,000 ordinary shares of £1 each	70	70

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 £1m 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 2010

22. Insurance contract and participating investment contract liabilities

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

	2010			2009		
	Gross £ m	Reinsurance £ m	Net £ m	Gross £ m	Reinsurance £ m	Net £ m
At 1 January	16,339	(522)	15,817	16,908	(2,270)	14,638
New business	324	(30)	294	299	(144)	155
Change in existing business	148	(101)	47	(1,064)	-	(1,064)
Recapture of reinsurance	-	-	-	-	2,040	2,040
Assumption changes	(173)	53	(120)	196	(148)	48
At 31 December	16,638	(600)	16,038	16,339	(522)	15,817

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 £2,040m shown in the above table, with a corresponding increase in premiums of £1,928m in respect of the recapture, resulting in a net profit impact of £(112m)

An analysis of the contractual and expected maturities of insurance contract and participating investment contract liabilities is given in note 33

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

23. Unallocated surplus

An analysis of the change in unallocated surplus is as follows

	2010 £ m	2009 £ m
At 1 January	670	469
Change recognised through the statement of comprehensive income	(308)	201
At 31 December	362	670

Of the above total, £362m (2009 £670m) is expected to be settled more than one year after the reporting date

24. Provisions for other liabilities and charges

At 31 December 2010 a provision of £2m (2009 £2m) was held in respect onerous leases on investment properties

During the ordinary course of business the Company is at times subject to threatened or actual legal proceedings both in the UK and overseas All such material cases are periodically reassessed, with the assistance of external professional advisors where appropriate, to determine the likelihood of the Company incurring a liability In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed to properly assess the merits of the case and no provisions are held against such cases

Contingent liability - litigation in relation to insurance branch business in Germany

The Company is involved in legal claims in the German courts, the majority of which are commenced by policyholders who purchased policies from independent German brokers as part of a geared arrangement, principally during the late 1990s and early 2000s There are currently several hundred cases pending The Company is defending all cases vigorously The legal process is still in its early stages and while the Company has won the vast majority of decisions in the District Courts, many cases are appealed

In many cases, the potential financial liability is not known, since claimants often commence proceedings for indemnification or a declaration rather than a specified monetary sum However, none of the currently commenced individual cases is considered to be financially significant In relation to the potential aggregated financial effect, it is not possible to make a reliable estimate As stated above, the quantum of the individual cases is not known, and in addition, German courts are not obligated to apply consistent principles of precedent, so the effect of a particular decision cannot be used to reliably predict the outcomes of other individual cases

The Company is actively identifying its rights and opportunities for reimbursement should it be found to be liable, which may include legal proceedings or contractual claims against third parties

25. Accruals and deferred income

	2010 £ m	2009 £ m
Accrued expenses	9	10
Deferred income	15	15
Deferred revenue on investment property	26	14
Total	50	39

Of the above total, £36m (2009 £13m) is expected to be settled more than one year after the reporting date

26 Subordinated debt

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

26 Subordinated debt (continued)

The carrying value shown in the balance sheet is as follows

	2010 £ m	2009 £ m
Subordinated debt	558	575
Issue costs	9	8
	567	583
Accrued interest on subordinated debt	17	18
Fair value hedge adjustment	18	9
Total	602	610

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 2010 carrying value includes a foreign exchange gain of £18m (2009 £9m)

The fair value of the subordinated debt is £490m (2009 £444m), calculated at the open market value using published bid prices at the reporting date and including £9m (2009 £8m) of amortised issue costs

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

£51m of 7 375% undated Subordinated Guaranteed Bonds, the redemption of which is at the option of Clerical Medical Finance plc and is generally not allowable prior to 5 November 2019 The interest rate charged to the Company by Clerical Medical Finance plc is 7 61%

€219m of 6 45% dated Subordinated Guaranteed Bonds maturing on 5 July 2023 Redemption of the bonds is at the option of Clerical Medical Finance plc and is generally not allowable prior to July 2013, after which time if the bond has not been redeemed floating rate interest is payable The interest rate charged to the Company by Clerical Medical Finance plc is 6 555%

€388m of 4 25% undated Subordinated Guaranteed Bonds Redemption of the bonds is at the option of Clerical Medical Finance plc and is generally not allowable prior to 27 June 2015, after which time if the bond has not been redeemed floating rate interest is payable The interest rate charged to the Company by Clerical Medical Finance plc is 4 27% An interest rate swap has been put in place in respect of the €388m tranche of the subordinated debt, which is accounted for using hedge accounting, as set out in note 1(m)

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

Tranche	Original issue	Amount redeemed	Outstanding at 31 December 2010
7 375%, originally issued November 1999/December 2000	£200m	£149m	£51m
6 45%, originally issued July 2001	€400m	€181m	€219m
4 25%, originally issued June 2005	€750m	€362m	€388m

The loan between Clerical Medical Finance plc 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

27. Non-participating investment contract liabilities

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

	2010 Gross £ m	2010 Reinsurance £ m	2010 Net £ m	2009 Gross £ m	2009 Reinsurance £ m	2009 Net £ m
At 1 January	8,685	(8,474)	211	7,761	(7,457)	304
New business	59	(59)	-	466	(466)	-
Change in existing business	416	(389)	27	458	(551)	(93)
At 31 December	9,160	(8,922)	238	8,685	(8,474)	211

An analysis of the contractual and expected maturities of non-participating investment contract liabilities is given in note 33

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

28. Other financial liabilities

	2010 £ m	2009 £ m
Insurance business		
Amounts payable in respect of direct insurance business	94	78
Other liabilities		
Due to related parties	68	367
Due to brokers	1	3
Social security and other taxes	2	2
Repurchase creditor	551	536
Collateral liability	-	388
Other	31	9
Total	747	1,383

Of the above total, £551m (2009 £nil) is expected to be settled more than one year after the reporting date

29. Borrowings

	2010 £ m	2009 £ m
Bank overdrafts	-	16
Total	-	16

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

30. Decrease in operating assets and liabilities

	2010 £ m	2009 £ m
(Increase)/decrease in operating assets		
Investment properties	77	269
Investment in subsidiaries held in the long term insurance funds of the Company	(1,035)	42
Property transferred to investment properties	6	69
Reinsurers' share of insurance contract and participating investment contract liabilities	(78)	1,749
Prepayments	(12)	1
Financial assets		
Investments	1,472	(1,515)
Loans and receivables including insurance receivables	136	147
Reinsurers' share of non-participating investment contract liabilities	(448)	(1,010)
Derivative financial instruments	30	131
Net decrease/(increase) in operating assets	**148**	**(117)**
Increase/(decrease) in operating liabilities:		
Insurance contract and participating investment contract liabilities	299	(569)
Unallocated surplus within insurance business	(308)	201
Financial liabilities		
Subordinated debt	(8)	(707)
Non-participating investment contract liabilities	475	916
Derivative financial instruments	31	(28)
Other financial liabilities	(636)	666
Provision for other liabilities and charges	-	(1)
Accruals and deferred income	11	(7)
Net (decrease)/increase in operating liabilities	**(136)**	**471**
Net decrease in operating assets and liabilities	**12**	**354**

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

31. Dividends paid

	2010 £ m	2009 £ m
Total dividends paid on equity shares	-	-

No dividend was paid in 2010 or 2009

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

Policyholder liabilities can be analysed into With Profit Fund liabilities and Non Profit Fund liabilities 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 Fund 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) Liabilities of the With Profits Fund 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 value and yield scenarios, these determine investment returns for each scenario The economic scenario generator is calibrated to observable yield curves and option prices where possible Nominal interest rates are modelled using a standard interest rate model, calibrated to risk-free yields The risk-free yield is defined as the spot yields derived from the UK gilt yield curve The liabilities are valued by discounting projected future cash flows using the risk free yield

- Investment volatility

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

- Mortality

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

- Persistency

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

- Maintenance expenses

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

- Guaranteed annuity option take-up rates

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

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

(b) Liabilities of the Non Profit Funds

(i) Insurance contracts

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

The liabilities will vary with movements in interest rates (this applies in particular to the cost of guaranteed benefits payable in the future) and with movements in the cost of life assurance and annuity benefits for which future mortality is uncertain
Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs Generally, assumptions used to value the liabilities contain a margin for adverse deviation and are determined as required by FSA rules This margin for adverse deviation is based on management's judgment and reflects management's views on the inherent level of uncertainty The assumptions to which the liabilities are most sensitive are the interest rates used to discount the cash flows and the mortality assumptions, particularly those for annuitants The key assumptions used in the measurement of the Non Profit Fund liabilities are

- **Interest rates**

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

- **Mortality**

  The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Company's actual experience where this provides a reliable basis, and relevant industry data otherwise, and includes a margin for adverse deviation Improvements in female annuitant mortality are assumed to follow the medium cohort projection from the Actuarial profession's mortality committee subject to a minimum rate of improvement of 1 5% per annum Improvements in male annuitant mortality are assumed to follow the long cohort projection from the Actuarial profession's mortality committee subject to a minimum rate of improvement of 1 5% per annum

- **Maintenance expenses**

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

- **Persistency rates**

  Prudent lapse rate assumptions have been used for term assurance business Whether a lapse rate is prudent broadly depends on whether the policy liability is negative or positive Thus for each policy a high lapse rate is assumed where the projected liability is negative and a low lapse rate is assumed where the projected liability is positive

(ii) Non-participating investment contracts

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

(2) Key assumptions

(a) With Profits Fund

Assumptions are given for the "realistic" valuation In addition, liabilities in respect of non-participating 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 UK gilts

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

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

The following interest rates are assumed in the regulatory valuation of non-participating policies in the With Profits Fund

Class of business	2010 Interest Rate (Net)	2009 Interest Rate (Net)
Annuities in Payment	2 91%	2 59%
Deferred Annuities	2 91%	2 59%

(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 2010, the 10 year-equity-implied-at-the-money assumption was set at 26 1% (26 6% as at 31 December 2009) The assumption for property volatility was 15% (31 December 2009 15%) The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 15% as at 31 December 2009 (31 December 2009 15%)

(iii) Mortality assumptions

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

		2010	2009
Assurances (excluding term assurances)			
Conventional With-Profits	Males	50% AMC00 Ultimate	55% AMC00 Ultimate
	Females	60% AFC00 Ultimate	60% AFC00 Ultimate
Unitised Assurances	Males	90% AMC00 Select	95% AMC00 Select
	Females	95% AFC00 Select	100% AFC00 Select
Annuities			
Self-employed / Personal Pensions	Males	81%PCMA00 75%lc (1 5%minimum improvement rate from 2003)	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)
	Females	86%PCFA00 75%lc (1 5%minimum improvement rate from 2003)	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)
Other Annuities in payment	Males	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)
	Females	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)
Deferred Annuities	Males	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)
	Females	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)

With regard to the above tables

'lc' denotes that explicit provision for future mortality improvement is made by applying the 'Long Cohort' projection factors from the Actuarial profession's Continuous Mortality Investigation for the period starting on 31 December 2002 to the 2000 base tables (adjusted as above) 75%mc means 75% of the 'Medium Cohort' projection factors are used If a percentage is shown in brackets this is a minimum annual improvement rate for all future years and ages

(iv) Other assumptions

Deferred annuity contracts with a guaranteed-rate annuity option have been valued based upon an assumed rate of take-up of the guaranteed annuity option of 95 0% for the realistic assessment (95 0% assumed at 31 December 2009)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

32 Insurance and investment contract liabilities – assumptions, change 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	2010 Interest rate (net) %	2009 Interest rate (net) %
Conventional Life business and non-unit reserves on linked business	1 48	2 10
Annuities in payment	3 34	3 67

(ii) Mortality assumptions

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

		2010	2009
Term Assurances			
	Males	57 50% TMC00 Select	63 25% TMC00 Select
	Females	63 25% TFC00 Select	69 00% TFC00 Select
Annuities			
Purchased (whole life)	Males	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)
	Females	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)
Self-employed / personal Pensions	Males	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)
	Females	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)
Other Annuities in payment	Males	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)
	Females	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)
Deferred annuities	Males	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)	81%PCMA00 75%lc (1 5% minimum improvement rate from 2003)
	Females	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)	86%PCFA00 75%lc (1 5% minimum improvement rate from 2003)

With regard to the above tables

'lc' denotes that explicit provision for future mortality improvement is made by applying the 'Long Cohort' projection factors from the Actuarial profession's Continuous Mortality Investigation for the period starting on 31 December 2002 to the 2000 base tables (adjusted as above) 75%mc means 75% of the 'Medium Cohort' projection factors are used If a percentage is shown in brackets this is a minimum annual improvement rate for all future years and ages

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

(3) The effect of changes in key assumptions

(a) With Profits Fund

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

(b) Non Profit Funds

Changes in certain key assumptions were made during 2010 with the following impacts on profit after tax

Variable	Impact on profit after tax 2010 £m	Impact on profit after tax 2009 £m
Mortality	8	(70)
Expenses	(41)	(17)
Inflation	18	(18)

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

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

Variable	Change in variable	2010 Impact on profit after tax £ m	2009 Impact on profit after tax £m
Annuitant Mortality	5% reduction	(35)	(27)
Other Mortality	5% reduction	3	6
Lapses	10% reduction	(12)	(6)
Maintenance expenses	10% reduction	26	16
Interest rate – change in redemption yield (1)	0 25% reduction	(26)	(9)
Interest rates – change in valuation margin (2)	0 25% reduction	(65)	(46)

(1) This interest rate sensitivity shows the impact of a 0 25 per cent movement in gilt yields and all of the consequential impacts on key economic assumptions including the investment returns, the valuation rates of interest and values of assets backing the business in question This excludes any impact on assets not backing the liabilities
(2) This interest rate sensitivity shows, for pensions annuity business, the impact of a change to the valuation rate of interest without a corresponding change to asset yields, this would increase the margin available to cover default and other risks

33 Risk management

The principal activity of the Company is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the UK The Company offers a wide range of life insurance products such as annuities, pensions, whole life, term life and investment type products principally through independent financial advisers The Company also reinsures business with subsidiary undertakings and with insurance entities external to the Company This includes the majority of its existing pensions linked business, which is reinsured to its subsidiary, CMMF

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 and the LP&I Executive Committee

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

(a) Governance framework

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33 Risk management (continued)

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 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 Audit Committee and the Board that risks within the Company are recognised, monitored and managed within acceptable parameters

An enterprise-wide risk management framework for the identification, assessment, measurement and management of risk is in place The framework is in line with Lloyds Banking Group's risk management principles and covers the full spectrum of risks that the Company are exposed to Under this framework, risks are categorised according to an approved Lloyds Banking Group risk language which has been adopted across the Company This covers the principal 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 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 and LP&I risk policies Responsibility for the management of all other risks resides with the Board of the Company who have delegated their authority to the LP&I Executive Committee

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

(b) Risk appetite

The Company has defined the methodology for the management of risk appetite and has approved 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 prescribed limits and the results of these tests are reported to the Board of the Company Where the exposure to any risk exceeds a trigger amount, the LP&I Executive Committee must approve an action plan to reduce the exposure or the Company's Board must approve a revised limit

(c) Financial risks

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

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

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

The Company manages these risks in a numbers of ways, including risk appetite assessment and monitoring of capital resource requirements 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, provided

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33. Risk management (continued)

that there is appropriate matching of assets and liabilities within these funds However, any change in the market value of these funds will have an indirect impact on the Company through the collection of annual management and other fund related charges As markets rise or fall, these charges rise or fall correspondingly

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

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

The following tables analyse the carrying amount of assets and liabilities, with financial assets and financial liabilities being presented according to their IAS 39 classification and IFRS 4 classification

	2010 £ m	2009 £ m
Financial assets		
Cash and cash equivalents	237	356
At fair value through income		
Investments at fair value through income		
- equity securities	8,898	10,513
- debt securities	6,224	6,081
Derivative financial instruments	501	531
Reinsurers' share of non-participating investment contracts liabilities	8,922	8,474
At amortised cost		
Loans and receivables	403	539
Reinsurers' share of insurance contract and participating investment contract liabilities	600	522
	25,785	27,016
Other assets		
Current tax receivable	74	29
Investment in subsidiaries	1,998	963
Investment properties	868	945
Property	-	6
Prepayments	14	2
Deferred tax assets	63	73
Deferred costs	470	475
Intangible assets	202	221
	3,689	2,714
Total assets	29,474	29,730
Financial liabilities		
At fair value through income		
Non-participating investment contract liabilities	9,160	8,685
Derivative financial instruments	134	103
At amortised cost		
Subordinated debt	602	610
Other financial liabilities	747	1,383
Borrowings	-	16
	10,643	10,797
Other liabilities		
Insurance contract and participating investment contract liabilities	16,638	16,339
Current tax payables	78	39
Accruals and deferred income	50	39
Provisions for other liabilities and charges	2	2
Deferred tax liabilities	236	221
Unallocated surplus	362	670
	17,366	17,310
Total liabilities	28,009	28,107

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33. Risk management (continued)

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

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

(1) Market risk

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

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

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

- Assets held in shareholder funds are invested in money market funds, gilts and investment grade bonds to match regulatory capital requirements The balance of the shareholder fund assets is managed in line with the policies of the Lloyds Banking Group to optimise shareholder return and risk This includes the suitable use of derivatives to minimize shareholder risk
- Unit-linked assets are invested in accordance with the nature of the fund mandates
- Conventional non-profit liabilities are "close matched" as far as possible in relation to currency, nature and duration
- With Profits liabilities are managed in line with the published PPFM Benchmarks and minimum and maximum holdings in asset classes are specified to allow limited investment management discretion whilst ensuring adequate diversification 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 their fair value hierarchy (as defined in note 1(c)) is given below

As at 31 December 2010

		Fair value hierarchy		
	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
Equity securities	8,577	-	321	8,898
Debt securities	3,464	2,760	-	6,224
Derivative financial assets	1	500	-	501
Reinsurers' share of non-participating investment contracts liabilities	-	8,922	-	8,922
Total assets	**12,042**	**12,182**	**321**	**24,545**
Derivative financial liabilities	7	127	-	134
Non-participating investment contract liabilities	-	9,160	-	9,160
Total liabilities	**7**	**9,287**	**-**	**9,294**

As at 31 December 2009

		Fair value hierarchy		
	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
Equity securities	10,120	104	289	10,513
Debt securities	3,503	2,578	-	6,081
Derivative financial assets	1	530	-	531
Reinsurers' share of non-participating investment contracts liabilities	-	8,474	-	8,474
Total assets	**13,624**	**11,686**	**289**	**25,599**
Derivative financial liabilities	29	74	-	103
Non-participating investment contract liabilities	-	8,685	-	8,685
Total liabilities	**29**	**8,759**	**-**	**8,788**

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33. Risk management (continued)

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)

Assets classified as level 3 comprise private equity investments and property investment vehicles Private equity investments are valued using the financial statements of the underlying companies prepared by the general partners, adjusted for known cash flows since valuation and subject to a fair value review to take account of other relevant information Property investment vehicles are valued based on the net asset value of the relevant company which incorporates surveyors' valuations of property

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

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

	2010		2009	
	£m	£m	£m	£m
	Assets	*Liabilities*	*Assets*	*Liabilities*
Balance at 1 January	289	-	414	-
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	48	-	(96)	-
Purchases	133	-	23	-
Disposals	(149)		(52)	-
Balance at 31 December	321		289	
Total gains and losses for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	45	-	(91)	-

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

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

(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

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

Impact on profit after tax and equity at reporting date	2010 £ m	2009 £ m
10% increase in equity prices	2	3
10% decrease in equity prices	(2)	(3)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33. Risk management (continued)

(ii) Interest rate risk

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

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

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

The effect of changes in interest rates in respect of financial assets which back insurance contract liabilities is given in note 32 The effect on the Company of changes in the value of investments held in respect of investment contract liabilities due to fluctuations in market interest rates is negligible as any changes will be offset by movements in the corresponding liability The sensitivity analysis below illustrates how the fair value of future cash flows in respect of interest-bearing financial assets, net of offsetting movements in insurance and investment contract liabilities, will fluctuate because of changes in market interest rates at the reporting date

Impact on profit after tax and equity at reporting date	2010 £ m	2009 £ m
25 basis points increase in yield curves	26	9
25 basis points decrease in yield curves	(26)	(9)

(iii) Foreign exchange risk

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

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

(2) Insurance risk

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

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

The Company principally writes the following types of life insurance contracts

- Life assurance – where the life of the policyholder is insured against death or permanent disability, usually for pre-determined amounts
- Annuity products – where typically the policyholder is entitled to payments which cease upon death

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33 Risk management (continued)

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 The nature of participating 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 and participating investment contract liabilities

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

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

Rates of mortality are investigated annually based on the Company's recent experience and future mortality assumptions are set using the latest population data available The 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 These initiatives are aimed both at the point of sale and through direct contact with existing policyholders eg through annual statement information packs

Further information on assumptions, changes in assumptions and sensitivities in respect of insurance and participating investment contracts is given in note 32

(3) Credit risk

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

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

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

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

Shareholder funds are managed in line with the LP&I Credit Risk Policy and the wider Lloyds Banking Group Credit Risk Policy and the principles are the same as those outlined above in respect of non-linked funds

Reinsurance is primarily used to reduce insurance risk However, it is also sought for other reasons such as improving profitability, reducing capital requirements and obtaining technical support In addition, reinsurance is also used to offer Investment Fund Links which we are unable to provide through other means The Company's reinsurance strategy is to

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33. **Risk management (continued)**

reduce the volatility of profits through the use of reinsurance whilst managing the insurance and credit risk within the constraints of the risk appetite limits

The Company has reinsurance on some lines of business where mortality risk exceeds set retention limits This does not, however, discharge the Company's liability as primary insurer If a reinsurer fails to pay a claim for any reason, the Company remains liable for the payment to the policyholder All new material reinsurance treaties are subject to Board approval and 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 three consecutive months and the policyholder has not provided further information in respect of the non-payment of premiums

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

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

	2010 £ m	2009 £ m
At fair value through income		
Debt securities at fair value	6,224	6,081
Derivative financial instruments at fair value	501	531
At amortised cost		
Loans and receivables at amortised cost	403	539
Reinsurers' share of insurance contract and participating investment contract liabilities	600	522
Reinsurers' share of non-participating investment contract liabilities	8,922	8,474
Cash and cash equivalents	237	356
Total assets bearing credit risk	**16,887**	**16,503**

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

As at 31 December 2010

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Debt securities	6,224	4,595	415	724	475	15
Derivative financial instruments	501	163	309	29	-	-
Loans and receivables	403	46	5	141	12	199
Reinsurers' share of insurance and participating investment contract liabilities	600	-	56	47	-	497
Reinsurers' share of non-participating investment contract liabilities**	8,922	-	-	-	-	8,922
Cash and cash equivalents	237	-	31	197	-	9
Total	**16,887**	**4,804**	**816**	**1,138**	**487**	**9,642**

*Of which £487m is BBB rated
** Relates to the Company's subsidiary, CMMF

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33 Risk management (continued)

As at 31 December 2009

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Debt securities	6,081	4,331	291	870	558	31
Derivative financial instruments	531	-	4	504	10	13
Loans and receivables	539	-	-	-	-	539
Reinsurers' share of insurance and participating investment contract liabilities	522	-	-	-	-	522
Reinsurers' share of non-participating investment contract liabilities**	8,474	-	-	-	-	8,474
Cash and cash equivalents	356	95	254	7	-	-
Total	**16,503**	**4,426**	**549**	**1,381**	**568**	**9,579**

*Of which £483m is BBB rated
** Relates to the Company's subsidiary, CMMF

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

(i) Concentration risk

Credit concentration risk

Credit concentration risk relates to the inadequate diversification of credit risk

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

At 31 December 2010 and 31 December 2009, the Company did not have any significant concentration of credit risk with a single counterparty or group of counterparties where limits applied With the exception of Government bonds and UCITS funds, the largest aggregated counterparty exposure is approximately 2% (2009 1 8%) of the Company's total assets, excluding with-profits and unit-linked funds where credit risk is matched by policyholder liabilities

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

Liquidity concentration risk

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

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

This is supplemented by active liquidity management in the Company, to ensure that even under stress conditions the Company has sufficient liquidity as required to meet its obligations This is delegated by the Board to and monitored through the LP&I Shareholder and With-Profits Investment Management Committee ("SAWPIMC"), Operational Banking Committee and Capital Working Group

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33. **Risk management (continued)**

(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 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 fund mandates The aggregate uncollateralised exposure to any one counterparty must not exceed limits specified in the fund mandates 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 life companies, funds and transactions, should not exceed £10m

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

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

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

	2010 £ m	2009 £ m
Cash and cash equivalents	76	388
Total	76	388

The Company has the right to recall any collateral pledged provided that this is replaced with alternative acceptable assets No account is taken of collateral held The policy of the Company is not to repledge assets No collateral (2009 £nil) was sold during the year At 31 December 2010, assets with a fair value of £nil (2009 £nil) were available to the Company to sell even in the absence of default by the counterparty None of these assets were past due or impaired at 31 December 2010 or 31 December 2009 In the event of default, assets received as collateral are sold

Collateral held in respect of OTC derivatives at 31 December 2010 had a fair value of £416m (2009 £61m)

All collateral held relates to fully performing assets

Collateral in respect of stocklending

The Company enters into stocklending transactions The LP&I SAWPIMC is responsible for setting the parameters of stocklending and therefore changes to these parameters The accepted collateral can include cash, equities, certain bonds and money market instruments On a daily basis, the fair value of collateral is compared to the fair value of stock on loan The value of collateral must always exceed the value of stock on loan Further information in respect of collateral relating to stocklending is given in note 35

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

The policy requires all lending to be undertaken via a 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 LP&I SAWPIMC will set counterparty limits for the re-investment of such balances Additionally, the LP&I SAWPIMC will set limits on the maximum amount of any stock that may be lent and the markets in which lending can take place

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33 Risk management (continued)

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

There were no collateral defaults in respect of stocklending during the year ended 31 December 2010 (2009 none) which required a call to be made on collateral

Collateral pledged in respect of a repurchase agreement with HBOS Treasury continues to be recognised on the Company's balance sheet

(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

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

In order to quantify the liquidity risk exposure, various stress tests are considered Liquidity risk is measured by comparing the projected outflow in the stress scenario for the following month against the sum of liquid resources available In conducting this assessment, no account is taken of future policyholder inflows The company had coverage of at least 100% at 31 December 2010 (2009 100%) in all stress scenarios considered

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

Annuity contracts

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

With-profits contracts

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33. Risk management (continued)

Non-participating contracts

For unit-linked products, portfolios are invested in accordance with unit fund mandates Deferral clauses are included in policyholder contracts to give time, when necessary, to realise linked assets without being a forced seller As at 31 December 2010, there are no funds under management subject to deferral

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 LP&I Liquidity Risk Policy and the wider Lloyds Banking Group Funding and Liquidity Risk Policy

The following tables indicate the timing of the contractual cash flows arising from the Company's financial liabilities, as required by IFRS 7 Liquidity risk in respect of insurance and participating investment contract liabilities has been analysed based on the expected pattern of maturities as permitted by IFRS 4 rather than by contractual maturity A maturity analysis of non-participating investment contracts based on expected contract maturities is also given as it is considered that this analysis provides additional useful information in respect of the liquidity risk relating to contracts written by the Company

As at 31 December 2010

Liabilities	Carrying amount*	Contractual cash flows (undiscounted)					
		No stated maturity	Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m	£ m
Non-participating investment contract liabilities	9,160	-	9,160	-	-	-	-
Derivative financial instruments	134	-	2	12	3	18	99
Subordinated debt	602	390	-	-	8	44	228
Borrowings	-	-	-	-	-	-	-
Other financial liabilities	747	-	747	-	-		-
Total	**10,643**	**390**	**9,909**	**12**	**11**	**62**	**327**

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

As at 31 December 2009

Liabilities	Carrying amount*	Contractual cash flows (undiscounted)					
		No stated maturity	Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m	£ m
Non-participating investment contract liabilities	8,685	-	8,685	-	-	-	-
Derivative financial instruments	103	-	2	20	3	25	53
Subordinated debt	610	409	-	-	8	49	238
Borrowings	16	-	16	-	-	-	-
Other financial liabilities	1,383	-	1,383	-	-	-	-
Total	**10,797**	**409**	**10,086**	**20**	**11**	**74**	**291**

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33 Risk management (continued)

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

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

As at 31 December 2010

Maturity Analysis for insurance and investment contracts	Total £ m	Less than 1 month £ m	1-3 months £ m	3-12 months £ m	1-5 years £ m	More than 5 years £ m
Insurance contract and participating investment contract liabilities	16,638	157	320	1,489	5,585	9,087
Non-participating investment contract liabilities	9,160	97	194	872	3,054	4,943

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 participating investment contract liabilities	16,339	153	278	1,312	5,796	8,800
Non-participating investment contract liabilities	8,685	89	141	763	3,230	4,462

(iii) Capital risk

Capital risk is defined as the risk that

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

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

Within the LP&I business unit, capital risk is actively monitored by the LP&I Capital Working Group

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

(i) the Pillar 1 amount, which is calculated by applying fixed percentages of mathematical reserves and capital at risk, and

(ii) the Pillar 2 amount, which is derived from an economic capital assessment undertaken by each regulated company, which is reviewed by the FSA

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

The Company's objectives when managing capital are

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

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 shareholder, return capital to the shareholder, issue new shares or sell assets

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

33 Risk management (continued)

The Company's capital comprises all components of equity, movements in which are set out in the statement of changes in equity and includes subordinated debt (note 26)

The table below sets out the regulatory capital and the required capital held at 31 December in each year on a Pillar 1 basis The current year information is, in general, an estimate that will be updated once the FSA returns for the year are finalised

	2010 £ m	2009 £ m
Regulatory capital held	3,199	2,624
Regulatory capital required	1,582	996

All minimum regulatory requirements were met during the year

(d) Legal and prudential regulatory risks

The Company also faces a number of legal and prudential 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

34. Related party transactions

(a) Ultimate parent and shareholding

The Company's immediate parent undertaking is HBOS Financial Services Limited, a company registered in the UK 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 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 2010

34. Related party transactions (continued)

(b) Transactions and balances with related parties

Transactions between the Company and other companies in the Lloyds Banking Group

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

	Transactions in the Year		Outstanding Balance at 31 December	
	2010 £m	2009 £m	2010 £m	2009 £m
Relationship				
Ultimate Parent undertaking:				
Investments and amounts receivable/(payable)	(8)	30	22	30
Parent undertakings				
Expense recharges and amounts payable	(158)	(449)	(2)	(272)
Subsidiary undertakings				
Expense recharges and amounts receivable/(payable)	(692)	23	(20)	42
Commission and amounts receivable	1			
Reassurance and amounts receivable/(payable)	815	161	39	121
Loans receivable	3	3	57	31
Sub Debt	(100)	-	-	100
Other related parties:				
Expense recharges and amounts receivable/(payable)	(19)	(3)	(24)	3
Cash and amounts receivable/(payable)	(42)	(67)	(541)	14
Reassurance and amounts receivable/(payable)	5	(17)	18	(17)
Management fees and amounts payable	(37)	(13)	(4)	(6)
Loans	(16)	(1)	95	106
Sub Debt	17	(575)	(590)	(672)
Total	(231)	(908)	(950)	(520)

Transactions between the Company and key management personnel

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

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

	2010 £ 000	2009 £ 000
Salaries and other short-term benefits	535	346
Post-employment benefits	11	34
Share-based payments	97	46
Total	643	426

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

Retirement benefits are accruing to two Directors (2009 two) under defined benefit pension schemes No directors (2009 none) are paying into a defined contribution scheme

The highest paid director's emoluments were not required to be disclosed for the year ended 31 December 2010 as they fell below the appropriate threshold

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

34. Related party transactions (continued)

HM Treasury

In January 2009, HM Treasury became a related party of the Company following its subscription for ordinary shares in Lloyds Banking Group plc, the Company's ultimate parent company, issued under a placing and open offer As at 31 December 2010, HM Treasury held a 41 per cent (2009 43 per cent) interest in Lloyds Banking Group's ordinary share capital and, consequently, HM Treasury remained a related party of the Company throughout 2010

There were no material transactions between the Company and HM Treasury during the year (2009 none) that were not made in the ordinary course of business or that are unusual in their nature or conditions In addition, the Company has entered into transactions with HM Treasury on an arm's length basis including, but not exclusively in relation to, the payment of corporation tax, employment tax, and value added tax Owing to the volume and diversity, such transactions are not disclosed

35. Stocklending

The aggregate value of securities on loan by the Company is £83m (2009 £nil) 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 £87m (2009 £1m) This collateral is in the form of high quality bonds and cash Further detail in respect of collateral is provided in note 33

36. Capital commitments

The Company had contracted for, but not paid for, £44m (2009 £23m) development expenses for investment property at the balance sheet date These amounts are not recognised in the financial statements

37. Future accounting developments

The following pronouncements will be relevant to the Company but were not effective at 31 December 2010 and have not been applied in preparing these financial statements The full impact of these accounting changes is being assessed by the Company The initial view is that none of these pronouncements are expected to cause any material adjustments to reported numbers in the financial statements

Pronouncement	Nature of change	IASB effective date
Improvements to IFRSs (issued May 2010)	Sets out minor amendments to IFRS standards as part of the annual improvements process	Dealt with on a standard by standard basis but not earlier than annual periods beginning on or after 1 July 2010
IAS 24 *Related Party Disclosures*(1)	Simplifies the definition of a related party and provides a partial exemption from the disclosure requirements for government related entities	Annual periods beginning on or after 1 January 2011
Amendment to IAS 32 *Financial Instruments Presentation – 'Classification of Rights Issues'*	Requires rights issues denominated in a currency other than the functional currency of the issuer to be classified as equity regardless of the currency in which the exercise price is denominated	Annual periods beginning on or after 1 February 2010
IFRS 9 *Financial Instruments Classification and Measurement*(1)	Replaces those parts of IAS 39 *'Financial Instruments Recognition and Measurement'* relating to the classification, measurement and derecognition of financial assets and liabilities It requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instrument. The available-for-sale financial asset and held-to-maturity investment categories in the existing IAS 39 will be eliminated The requirements for financial liabilities and derecognition are broadly unchanged from IAS 39 IFRS 9 is the initial stage of the project to replace IAS 39 Future stages are expected to result in amendments to IFRS 9 to deal with changes to the impairment of financial assets measured at amortised cost and hedge accounting Until all stages of the replacement project are complete, it is not possible to determine the overall impact on the financial statements of the replacement of IAS 39	Annual periods beginning on or after 1 January 2013

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

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

38 Post balance sheet events

An opt-out clause to the European Union ("EU") Gender Directive has permitted insurers to take gender into account as a risk factor when pricing contracts In March 2011 the European Court of Justice ("ECJ"), ruling on a test case, deemed that the opt-out infringes fundamental European rights for equal treatment of men and women Under the ruling, the ECJ requires the UK Government to amend domestic regulation on or before 21 December 2012 to reflect the ruling It is anticipated that such changes will alter the future market and prices for insurance products to a significant extent The potential impact on the Company is being assessed Any financial impact is uncertain until such time as the ruling is formally adopted into UK domestic legislation and the current uncertainty on retrospection is clarified

As outlined in note 13, the Finance Act (No 2) 2010 reduced the rate of corporation tax from 28% to 27% with effect from 1 April 2011 The Chancellor's Budget, announced on 23 March 2011, further reduced the rate of corporation tax to 26% with effect from 1 April 2011 The reduction to 26% is not estimated to have a significant effect on deferred tax assets and liabilities as at 31 December 2010 and will be reflected in the financial statements for the year ended 31 December 2011 The Chancellor also announced that the tax rate would fall to 23% by 2014 The impact of these proposed changes cannot be reliably estimated