CLERICAL MEDICAL INVESTMENT GROUP LIMITED

ANNUAL REPORT

AND

FINANCIAL STATEMENTS

31 DECEMBER 2014

Member of Lloyds Banking Group plc

CONTENTS

COMPANY INFORMATION

Board of Directors

N E T Prettejohn (Chairman)

Dr N M Bryson (Deputy Chairman)

M Christophers
M G Culmer
A M Parsons*
T E Strauss*
V Maru
C J Thornton*
R L M Wohanka
D J S Oldfield
J E M Curtis
J F Hylands

* denotes Executive Director

Company Secretary

J M Jolly

Actuarial Function Holder

R J McIntyre

Independent Auditors

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

Registered Office

33 Old Broad Street
London
EC2N 1HZ

Company Registration Number

3196171

STRATEGIC REPORT

The Directors present their strategic report on Clerical Medical Investment Group Limited ("the Company", "CMIG") for the year ended 31 December 2014.

The Company contributes to the Life Insurance results within the Lloyds Banking Group plc ("LBG") Insurance Division. Insurance is a core but significantly under-served need for millions of individual and commercial customers in the UK. The market is set for strong growth driven by changing demographics but since setting out our strategy the pace of external change has accelerated, creating short-term market disruption and opportunities for growth.

The Scottish Widows brand was relaunched this year to both the consumer and intermediary audience. This significant investment demonstrates our continued commitment to be a leader in the life planning and retirement market. The campaign message was "Life feels better when you have a plan" and focussed on how Scottish Widows will help both corporate and individual customers to secure the life they want tomorrow, by ensuring that they have a plan that is going to meet their needs. Having peace of mind today, means they can get on with living life to the full.

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

- Result for the year;
- Funds under management;
- Capital resources;
- Liquidity position; and
- Other sources.

Key performance indicators

Result for the year

The result of the Company for the year ended 31 December 2014 is a loss before tax of £8m (2013: profit of £337m). The result reflects market conditions over 2014, the recognition of an additional provision of £120m (2013: £75m) in relation to German insurance business litigation set out below, together with provisions totalling £30m in relation to the sale of LBG's European insurance business, £10m (2013: £nil) of dividends received from the Company's subsidiary Clerical Medical Ventures Investments Limited and £nil (2013: £160m) dividends received from the Company's subsidiary Halifax Life Limited, during 2014 the Company received interim dividends of £nil (2013: £100m) from its subsidiary Halifax Life Limited. Whilst the Company experienced positive returns in the period on investments held, these were largely offset by changes in the value of insurance and investment contract liabilities. The Directors consider the result for the year to be satisfactory in light of these factors.

Funds under management

Funds under management relating to policyholder liabilities were £22.9bn (2013: £21.9bn), the movement reflecting net flows from policyholders and investment return for the period.

Capital Resources

The Directors believe that the Company currently has adequate capital resources and will continue to do so in the foreseeable future. On a Pillar 1 basis the regulatory surplus of the Company in excess of capital requirements is £1,517m (2013: £1,395m). On a Pillar 1 basis the regulatory surplus attributable to the shareholder, excluding the regulatory surplus attributable to the with profits funds, is £1,293m (2013: £1,334m).

Liquidity

The Company regularly monitors its liquidity position, to ensure that, even under stressed conditions, the Company has sufficient liquidity to meet its obligations and remains within approved risk appetite.

STRATEGIC REPORT (continued)

Other sources

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

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

Review of the business

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

Investment strategy

As part of its efficient balance sheet management, the Company is focused on investments that improve risk adjusted returns and provide more diversification of assets to match its liabilities. In particular, the Company continues to identify investment opportunities in long term, higher yielding illiquid assets available within LBG and developing the Company's capability to originate new loan assets, leveraging the capabilities of LBG as appropriate. This is expected to continue to deliver significant increased investment return to the Company without increasing credit risk beyond the Group's risk appetite.

During 2014 the Company acquired illiquid credit assets from, or issued by, parties within LBG totalling £625m (2013: £1.8bn) secured on social housing, education finance and infrastructure projects. All assets were acquired at their fair value from LBG parties. Further details on the credit risk and fair value measurement of these assets can be found in note 30.

Litigation in relation to insurance branch business in Germany

The Company has received a number of claims in the German courts, relating to policies issued by the Company but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. Following decisions in July 2012 from the Federal Court of Justice in Germany the Company recognised provisions totalling £397 million in 2012 and 2013. Volumes of claims have not decreased as quickly as expected and as a result the Company has recognised a further £120 million during 2014 bringing the total provision to £517 million. The remaining unutilised provision as at 31 December 2014 is £197 million.

The validity of the claims facing the Company depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will only be known once all relevant claims have been resolved.

This provision requires significant judgement by the Company's management in determining appropriate assumptions, including the number of claims received, the proportion upheld, and resulting legal and administration costs. Assuming that all other assumptions remain unchanged, if in the longer term the level of claims was ten percentage points higher (lower) than estimated then the cost would increase (decrease) by approximately £6m; and if uphold rates were ten percentage points higher (lower) than estimated then the cost would increase (decrease) by approximately £35m.

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

Outlook

In 2015, LBG Insurance intends to seek sanction from the High Court with relation to an insurance business transfer scheme (the Scheme) under the provisions of Part VII of the Financial Services and Markets Act (2000). The Scheme proposes to transfer all of the long term business in LBG Insurance (including all assets, liabilities, rights and responsibilities) to a single Insurance entity, however the full impact of the transfer on this Company is yet to be determined and approved. The reorganisation provides the Group with a more robust solvency capital position, simplifies Solvency II reporting and will result in the emergence of cost synergies due to a reduction in the number of legal operating entities.

STRATEGIC REPORT (continued)

Principal risks and uncertainties

The management of the business and the execution of the Company's strategy are subject to a number of risks. The financial risk management objectives and policies of the Company and the exposure to market, insurance, credit, financial soundness, conduct, operational and political risk and uncertainties are set out in note 30.

In addition, the Company are also exposed to financial and prudential regulatory reporting risk, in particular the risk of reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial reporting or over prudential regulatory reporting and financial reporting fraud. The financial and risk management objectives and policies of the Company in respect of financial and prudential regulatory reporting risk are also set out in note 30.

The Company, like other insurers, is subject to legal proceedings in the normal course of business. Whilst it is not practicable to forecast or determine the final results of all pending or threatened legal proceedings, management does not believe that such proceedings, including litigation, will have a material effect on the results and financial position of the Company except for the German insurance business litigation, for which a provision has been established, as discussed earlier in this report and set out in note 23.

On behalf of the Board of Directors

A M Parsons
Director
26 March 2015

DIRECTORS' REPORT

Principal activities and review of business

The Directors present the audited financial statements of the Company. The Company is a limited liability company domiciled and incorporated in the United Kingdom. Details of the principal subsidiary undertakings are given in note 13.

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 LBG.

Results and dividend

The result of the Company for the year ended 31 December 2014 is a profit after tax of £6m (2013: profit of £317m). The result reflects market conditions over 2014, the recognition of an additional provision of £120m (2013: £75m) in relation to German insurance business litigation set out above, a new onerous contracts provision of £30m in relation to the change in administration of the Company's European business, £10m (2013: £nil) of dividends received from the Company's subsidiary Clerical Medical Ventures Investments Limited and £nil (2013: £160m) dividends received from the Company's subsidiary Halifax Life Limited. Whilst the Company experienced positive returns in the period on investments held, these were largely offset by changes in the value of insurance and investment contract liabilities. The Directors consider the result for the year to be satisfactory in light of these factors.

No interim dividend was paid during the year (2013: £nil). The Directors do not recommend the payment of a final dividend (2013: £nil). Further information on the results of the Company is provided in the Strategic Report.

Post balance sheet events

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

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:

Lord Blackwell	(resigned 23 June 2014)
M A Fisher	(resigned 22 April 2014)
Drs C A C M Schrauwers	(resigned 18 November 2014)
J Goford	(resigned 13 February 2015)
N E T Prettejohn	(appointed 23 June 2014)
D J S Oldfield	(appointed 18 July 2014)
J E M Curtis	(appointed 11 November 2014)
J F Hylands	(appointed 19 March 2015)

Particulars of the Directors' emoluments are set out in note 31.

Directors' indemnities

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

Disclosure of information to auditors

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

DIRECTORS' REPORT (continued)

Corporate governance statement

In accordance with the Financial Services Authority's Disclosure and Transparency Rule("DTR") 7.2.1, the disclosures required by DTR 7.2.5R are within note 30 to the accounts and are therefore incorporated into this report by reference.

Political contributions

During the year, the Company made no political contributions (2013: £nil).

Statement of Directors' responsibilities

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

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

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

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

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

On behalf of the Board of Directors

A M Parsons
Director
26 March 2015

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

Report on the financial statements

Our opinion

In our opinion, Clerical Medical Investment Group Limited's financial statements (the "financial statements"):

- give a true and fair view of the state of the Company's affairs as at 31 December 2014 and of its profit and cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

What we have audited

The financial statements for the year ended 31 December 2014, which are prepared by Clerical Medical Investment Group Limited, comprise:

- Balance Sheet as at 31 December 2014;
- Statement of Comprehensive Income for the year then ended;
- Statement of Cash Flows for the year then ended;
- Statement of Changes in Equity for the year ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in the preparation of the financial statements is applicable law and IFRSs as adopted by the European Union.

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

Opinion on other matter prescribed by the Companies Act 2006

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

Other matters on which we are required to report by exception

Adequacy of accounting records and information and explanations received

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

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

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

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

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

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

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

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

What an audit of financial statements involves

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

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

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

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

In addition, we read all the financial and non-financial information in the Annual Report and Financial Statements to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Joanne Leeson (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Bristol
26 March 2015

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2014

	Notes	December 2014 £ m	December 2013 £ m
Revenue			
Gross earned premiums		697	916
Premiums ceded to reinsurers		(41)	(43)
Premiums net of reinsurance		656	873
Fee and commission income	3	75	69
Investment income	4	596	802
Net gains on assets and liabilities at fair value through profit or loss	5	825	1,257
Total revenue		2,152	3,001
Expenses			
Gross claims and benefits paid		1,730	2,164
Claims recoveries from reinsurers		(41)	(39)
		1,689	2,125
Change in liabilities arising from insurance contracts and participating investment contracts	21	(247)	(707)
Change in liabilities arising from non-participating investment contracts		407	912
Change in assets arising from reinsurance contracts held	15	(146)	(141)
Change in unallocated surplus	22	(5)	-
		9	64
Operating expenses	6	386	390
Expenses for asset management services received		34	34
Finance costs	8	42	51
		462	475
Total expenses		2,160	2,664
(Loss)/profit before tax		(8)	337
Taxation credit/(charge)	9	14	(20)
Profit for the year		6	317
Other comprehensive income			
Items that may be reclassified to profit or loss			
Movement in net investment hedge, net of tax		6	-
Currency translation differences, net of tax		(2)	-
Other comprehensive income, net of tax		4	-
Total comprehensive income		10	317

The notes set out on pages 15 to 65 are an integral part of these financial statements.

BALANCE SHEET AS AT 31 DECEMBER 2014

	Notes	December 2014 £ m	December 2013 £ m
ASSETS			
Intangible assets including intangible insurance assets	10	109	129
Deferred costs	11	331	376
Deferred tax assets	12	8	9
Investment in subsidiaries	13	486	486
Investment properties	14	536	593
Assets arising from reinsurance contracts held	15	1,004	1,020
Current tax receivable	12	27	10
Prepayments		2	2
Derivative financial instruments	16	727	305
Loans and receivables	17	749	829
Investments at fair value through profit or loss	18	20,384	21,440
Cash and cash equivalents	19	381	154
Total assets		24,744	25,353
EQUITY AND LIABILITIES			
Capital and reserves attributable to Company's equity shareholder			
Share capital	20	70	70
Share premium		1	1
Retained earnings		1,657	1,647
Total equity		1,728	1,718
Liabilities			
Insurance contracts and participating investment contract liabilities	21	14,039	14,286
Unallocated surplus	22	51	56
		14,090	14,342
Deferred tax liabilities	12	87	100
Current tax payables	12	44	36
Provisions for other liabilities and charges	23	227	274
Accruals and deferred income	24	19	18
Subordinated debt	25	628	658
Non participating investment contract liabilities	26	7,230	7,718
Derivative financial instruments	16	485	218
Other financial liabilities	27	206	271
Total liabilities		23,016	23,635
Total liabilities and equity		24,744	25,353

The notes set out on pages 15 to 65 are an integral part of these financial statements.

The financial statements on pages 11 to 65 were approved by the Board on 26 March 2015.

A M Parsons
Director

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2014

	Notes	2014 £ m	2013 £ m
Cash flows from operating activities			
(Loss)/Profit before tax		(8)	337
Adjusted for:			
Amortisation and impairment of intangible assets including intangible insurance assets		20	19
Dividends received from subsidiary undertakings	4	(10)	(160)
Finance costs	8	42	51
Net movement of loans to related parties	17	73	525
Repayment of subordinated debt	25	19	171
Net decrease/(increase) in operating assets and liabilities	28	218	(500)
Taxation (paid)/received		(3)	55
Net cash inflows from operating activities		351	498
Cash flows from investing activities			
Dividends received	4	10	160
Net cash inflows from investing activities		10	160
Cash flows from financing activities			
Amounts paid on redemption of subordinated debt	25	(19)	(171)
Net movement of loans to related parties	17	(73)	(525)
Finance costs paid	8	(42)	(51)
Net cash outflows from financing activities		(134)	(747)
Net increase/(decrease) in cash and cash equivalents		227	(89)
Cash and cash equivalents at the beginning of the year		154	243
Cash and cash equivalents at the end of the year	19	381	154

The notes set out on pages 15 to 65 are an integral part of these financial statements.

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2014

	Issued share capital £ m	Share premium £ m	Retained earnings £ m	Total £ m
Balance as at 1 January 2013	70	1	1,330	1,401
Profit for the year	-	-	317	317
Total comprehensive income for the year	-	-	-	-
Balance as at 31 December 2013	70	1	1,647	1,718
Profit for the year	-	-	6	6
Total comprehensive income for the year	-	-	4	4
Balance as at 31 December 2014	70	1	1,657	1,728

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 30.

The notes set out on pages 15 to 65 are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies

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

(a) Basis of preparation

The financial statements of the Company have been prepared:

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

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

(3) in respect of the Company's with profit fund liabilities, in accordance with Financial Reporting Standard ("FRS") 27 "Life Assurance" issued by the United Kingdom Accounting Standards Board; and

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

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

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

The Company has taken advantage of the provisions of the Companies Act 2006 and has not produced consolidated financial statements.

Standards and interpretations effective in 2014

A number of standards, amendments to and interpretations of published standards which have the potential to impact on the Company's financial statements have been issued and are mandatory for accounting periods beginning on or after 1 January 2014. Their relevance to the Company's financial statements is assessed at note 33.

Details of standards and interpretations in issue but which have not been adopted early are set out at note 34.

(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 and without a discretionary participation feature ("DPF"). Contracts containing a DPF are referred to as participating investment contracts and those without a DPF as non participating investment contracts.

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

Non participating investment contracts are contracts that neither transfer significant insurance risk nor contain a DPF.

Hybrid contracts

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

(c) Financial assets and financial liabilities

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

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

All financial assets and financial liabilities are designated at fair value through profit or loss, with the exception of certain loans and receivables, subordinated liabilities, other financial liabilities and borrowings which are stated at amortised cost, (as described in policies (n), (v), (y) and (z) respectively) and derivatives (policy m). The classification depends on the purpose for which the financial assets and financial liabilities were acquired. Certain financial assets and financial liabilities, whose default accounting treatment would be to record these balances at amortised cost, are instead designated at fair value through profit or loss as they are held to match insurance and investment contract liabilities linked to the changes in fair value of these assets and liabilities, thereby reducing measurement inconsistencies, and reflecting the fact that these are managed and their performance evaluated on a fair value basis. Information on these balances is provided internally on a fair value basis to the Company's key management. The Company's investment strategy is to invest in equity and debt securities, loans, investment property, derivatives and cash and to evaluate the Company's investments with reference to their fair values. For further details on the Company's fair value methodology see policy (o).

(d) Fair value methodology

All assets and liabilities carried at fair value, or for which a fair value measurement is disclosed, are categorised into a "fair value hierarchy" as follows:

(i) Level 1

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

(ii) Level 2

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

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

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

1. **Accounting policies (continued)**

(iii) Level 3

Valued using inputs for the asset or liability that include significant unobservable inputs (inputs not based on observable market data). Unobservable inputs may have been used to measure fair value where observable inputs are not available. This approach allows for situations in which there is little, if any, market activity for the asset or liability at the measurement date (or market information for the inputs to any valuation models). Unobservable inputs reflect the assumptions the Company considers that market participants would use in pricing the asset or liability, for example 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 30.

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

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

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

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

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

(e) **Revenue recognition**

Premium income

Premiums received in respect of life insurance contracts 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

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. **Accounting policies (continued)**

Investment income

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

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

Rental income in respect of investment properties is recognised on a straight line basis over the term of the lease. The cost of incentives are recognised as a reduction of total income over the term of the lease on a straight line basis.

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

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

(f) Expense recognition

Claims

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

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

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.

(g) Leases

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

(h) Intangible assets including intangible insurance assets

(i) Acquired value of in-force business

Insurance and investment contracts acquired in business combinations are initially measured at fair value at the time of acquisition and subsequently held at amortised cost The initial fair value 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 or when there is an earlier indication of impairment (further information on the Company's impairment policy is set out at policy (q)). Such an asset is not recognised in respect of future profits on contracts written in the normal course of business.

(ii) Software development costs

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

(i) Deferred costs

(i) Deferred acquisition costs

The costs of acquiring new insurance contracts and participating investment contracts (excluding those assessed on a realistic basis in accordance with FRS 27), which are incurred during a financial period but which relate to subsequent financial periods, are deferred to the extent that they are recoverable out of future revenue margins. The deferred acquisition cost asset is amortised over the lifetime of the related contracts based on the pattern of margins arising from these contracts unless there is evidence to support an alternative recognition basis. Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the asset is tested for impairment at each reporting date. Further information on the Company's impairment policy is set out at policy (q).

(ii) Deferred origination costs

Costs which are directly attributable and incremental to securing new non participating investment contracts are capitalised. This asset is subsequently amortised over the estimated contractual lifetime of each policy on a straight-line basis unless there is evidence to support an alternative recognition basis. Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the asset is tested for impairment at each reporting date. Further information on the Company's impairment policy is set out at policy (q).

(j) Investment in subsidiaries

The Company owns a number of subsidiaries as set out in note 13. Certain subsidiaries do not form part of actively managed investment portfolios, and the risks and rewards of owning those subsidiaries primarily rest with the equity shareholders of the Company, including such investments where ownership of the subsidiary is split between the Company's long-term fund and its shareholder fund. Those subsidiaries are held initially at cost, being the fair value of the consideration given to acquire the holding, then subsequently at cost subject to impairment. Further information on the Company's impairment policy is set out at policy (q).

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

(k) Investment properties

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

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

(l) Assets arising from reinsurance contracts held

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

Assets arising from reinsurance contracts held – classified as insurance contracts

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

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

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

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

(m) Derivative financial instruments

Classification

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

Recognition

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

Measurement

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

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

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

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

For exchange traded contracts, the value is based on the quoted bid price at close of business where the contract is an asset held. Where the contract is a liability held the value is based on the quoted offer price at close of business.

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

Hedge accounting

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

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

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

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

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

The fair values of derivative instruments used for hedging purposes are disclosed in note 16.

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

(n) Loans and receivables

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

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

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

(o) Investments at fair value through profit or loss

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

Classification

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

Recognition

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

Measurement

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

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

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

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

The fair value of holdings in collective investment vehicles (including OEICs and Unit Trusts) is determined as the last published price applicable to the vehicle at the reporting date.

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

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

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

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

Structured entities

The Company invests in structured entities arising from investments in investment properties held through limited partnerships. The limited partnership 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 limited partnership, as provided at the reporting date by independent valuers.

The Company holds investments in structured entities arising from investments in collective investment vehicles. Collective investment vehicles are carried at fair value.

(p) 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.

(q) Impairment

Financial assets

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

Non-financial assets

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

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

Impairment process

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

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

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

(r) Taxes

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

Current tax

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

Deferred tax

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

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

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

Allocation of tax charge between shareholder and policyholders

The tax expense in the statement of comprehensive income is analysed between policyholder and shareholder tax. This allocation is based on the definition of policyholders' share and shareholders' share of taxable profit under current UK tax rules.

(s) Share capital

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

Dividends payable

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

(t) Insurance contracts and participating investment contracts

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

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

Liabilities of the Company's With Profits Funds, including guarantees and options embedded within products written by the funds, are accounted for under the realistic method in accordance with the requirements of FRS 27. However, in contrast to the approach used for the PRA's realistic capital regime, projected transfers out of the funds 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 contracts and participating investment contract liabilities.

Liabilities for non participating insurance contracts in the Company's With Profits Funds are measured using the traditional regulatory assessment. The movement in this balance is recognised in the statement of comprehensive income, through changes in insurance and participating investment contract liabilities.

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

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

Insurance contracts which are unit-linked

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

Unallocated surplus

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

Bonuses

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

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

(u) Provisions for other liabilities and charges

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

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.

(v) Subordinated debt

Subordinated debts comprise dated and undated loan capital. They are recognised initially at fair value, being the issue proceeds net of transaction costs incurred. Subordinated debts 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 liabilities using the effective interest rate applicable to the instrument. Both dated and undated subordinated debts are adjusted for hedged interest rate risk. Changes in the resulting value of these subordinated debts are accounted for as set out at policy (z). 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.

(w) Non participating investment contracts

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

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

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

(x) 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.

(y) 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.

(z) Borrowings

Borrowings are recognised initially at fair value, being the issue proceeds net of transaction costs incurred. In practice, due to the nature of these balances, being bank overdrafts, the carrying value equates to the fair value of these liabilities as the borrowings are repayable on demand.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

1. Accounting policies (continued)

(aa) 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 presentation currency.

Monetary items denominated in foreign currencies are translated into sterling at the exchange rates ruling at the reporting date. Non-monetary items denominated in foreign currencies that are measured at fair value are translated at the exchange rates ruling at the date when the current fair value is determined. Non-monetary items denominated in foreign currencies that are measured at historical cost are translated at the exchange rates ruling at the date of the transaction. Revenue transactions and those relating to the acquisition and realisation of investments have been translated at rates of exchange ruling at the time of the respective transactions. Any exchange differences are dealt with in that part of the statement of comprehensive income in which the underlying transaction is reported.

The results and financial position of the Company's foreign operations that have a functional currency different from the presentation 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.

(ab) Collateral

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

2. Critical accounting estimates and judgments in applying accounting policies

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

(a) Insurance contracts and participating investment contract liabilities

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

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

For insurance contracts outside the With Profits Fund, the liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses, credit default and mortality. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets. The most critical non-economic assumptions are mortality rates in respect of annuity business written and levels of future expenses. Such assumptions are based on recent actual experience, supplemented by industry information where appropriate. No critical accounting estimates apply for participating investment contracts as the contract liabilities arising outside the With Profits Fund are almost entirely current unit values.

At each reporting date, the estimates and assumptions referred to above are reassessed for adequacy and changes will be reflected in adjustments to the liability, through the statement of comprehensive income. Further information on these assumptions is given in note 29.

Sensitivities regarding changes to key assumptions in calculating insurance contracts and participating investment contract liabilities are given in note 29.

(b) Intangible assets and intangible insurance 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 arising on the acquisition of the Company was 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 related to lapse rates and expenses. The assumptions were determined on a best-estimate basis and, as above, were based on recent actual experience and industry information where appropriate.

Amortisation of these balances and the related deferred 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 10.

(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 year but which relate to subsequent financial years 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 11.

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

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

(d) Taxation

The Company recognises current and deferred tax assets in line with IAS 12 "Income Taxes". In recognising these assets, management takes into account the likely impact of tax issues that are subject to ongoing discussion with HM Revenue and Customs (HMRC) 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 9 and 12.

(e) Fair value of financial instruments

In accordance with IFRS 7, the Company categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques. These valuation techniques involve management judgement and estimates, the extent of which depends on the complexity of the instrument and the availability of market observable information. Further details of these valuations are described in note 30.

(f) Provisions for other liabilities and charges

German Litigation

The Company has received a number of claims in the German courts, relating to policies issued by the Company but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. Following decisions in July 2012 from the Federal Court of Justice in Germany the Company recognised provisions totalling £397 million in 2012 and 2013. Volumes of claims have not decreased as quickly as expected and as a result the Company has recognised a further £120 million during 2014 bringing the total provision to £517 million. The remaining unutilised provision as at 31 December 2014 is £197 million.

The validity of the claims facing the Company depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will only be known once all relevant claims have been resolved.

The Directors believe this provision represents an appropriate estimate of the financial impact based upon a series of assumptions, including the number of claims received from the respective populations of different classes of policies, the proportion upheld, and resulting legal and administration costs. Further information in relation to the provision is set out in note 23.

European Business Restructure

In August 2013 LBG sold Heidelberger Leben ("HLE") to Cinven Partners and German financial group Hannover Re ("the purchasers"). The Company's management have estimated that separation costs of £12m and transaction costs of £3m will be incurred as the result of this agreement.

In addition, the Company is committed over a 10 year period to pay a minimum of £13m to the purchasers for the provision of back office services in relation to the Company's European business. This commitment results in the recognition of an onerous contracts provision for £13m.

As the Company is committed to these future costs, a provision has been recognised with the charge to the Statement of Comprehensive Income being recognised within operating expenses.

Further information in relation to the provision is set out in note 23.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

3. Fee and commission income

	2014	2013
	£ m	£ m
Fund management and policy admin fees	69	67
Change in deferred income	1	2
Other	5	-
Total	75	69

4. Investment income

	2014	2013
	£ m	£ m
Net income on investments designated at fair value through profit or loss	499	541
Interest receivable on swap	14	5
Financial instruments at amortised cost		
Interest income on deposits	-	2
Interest income from group undertakings	7	4
Dividend income from subsidiary undertakings	10	160
Rental income on investment properties	45	55
Foreign currency translation differences	18	25
Other	3	10
Total	596	802

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

	2014	2013
	£ m	£ m
Derivative financial instruments at fair value through profit or loss	142	(203)
Investments designated at fair value through profit or loss	613	1,444
Investment properties at fair value through profit or loss	77	20
Foreign exchange	(7)	(4)
Total	825	1,257

6. Operating expenses

	2014	2013
	£ m	£ m
Acquisition and origination costs in respect of insurance and investment contracts	15	21
Expenses for administration	175	183
	190	204
Provision in relation to German insurance business litigation[1]	121	75
Provision in relation to restructuring of European business[1]	11	28
Change in deferred costs	44	64
Amortisation and impairment of acquired VIF	20	19
Total	386	390

[1] Further information on provisions is set out in note 23.

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 nil direct employees during the year (2013: nil). The employee costs, including pension costs and share-based payment costs, are included in the recharge noted above.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

7. Auditors' remuneration

	2014 £000	2013 £000
Fees payable to the Company's auditor for the audit of the company's annual financial statements	393	396
Fees payable to the Company's auditor and its associates for other services:		
Audit-related assurance services	401	405
Total	794	801

Audit fees for 2014 and 2013 were borne by another company within the group and recharged to the Company.

8. Finance costs

	2014 £ m	2013 £ m
Interest payable on swap	4	5
Interest on subordinated debt	38	46
Total	42	51

9. Taxation

(a) Analysis of tax credit/(charge)

	2014 £ m	2013 £ m
Current tax:		
UK corporation tax	1	(36)
Adjustment in respect of prior years	1	(2)
Total current tax	2	(38)
Deferred tax:		
Origination of temporary differences	12	7
Change in tax rate	-	12
Adjustment in respect of prior years	-	(1)
Total deferred tax	12	18
Total income tax credit/(charge)	14	(20)

The policyholder tax benefit or expense is included in income tax expense. Policyholder tax is a charge of £nil (2013: credit of £5m), including a prior year tax charge of £nil (2013: charge of £5m).

(b) Reconciliation of tax (charge)/credit

	2014 £ m	2013 £ m
(Loss)/profit before tax	(8)	337
Tax at 21.5% (2013: 23.25%)	2	(78)
Effects of:		
Impairment of subsidiaries	-	-
UK tax basis for life insurance profits	-	-
Tax exempt income	12	49
Policyholder tax	-	1
Adjustment to tax charge in respect of prior years	1	(3)
Change in tax rate	-	12
Other	(1)	(1)
Total	14	(20)

The standard rate of Corporation Tax in the UK changed from 23% to 21% with effect from 1 April 2014. Accordingly, the company's profits for this accounting period are taxed at an effective rate of 21.5%.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

10. Intangible assets including intangible insurance assets

Acquired VIF

	2014 £ m	2013 £ m
Cost		
At 1 January and 31 December	651	651
Accumulated amortisation and impairment		
At 1 January	522	503
Amortisation during the year	20	19
At 31 December	542	522
Carrying amount		
At 31 December	109	129

Of the above total, £95m (2013: £109m) is expected to be recovered more than one year after the reporting date.

11. Deferred costs

	2014 £ m	2013 £ m
Deferred acquisition costs (a)	243	266
Deferred origination costs (b)	88	110
Total	331	376

(a) Deferred acquisition costs

	2014 £ m	2013 £ m
At 1 January	266	302
Amounts incurred during the period	7	11
Amortisation during the period	(30)	(47)
At 31 December	243	266

Of the above total, £213m (2013: £224m) is expected to be recovered more than one year after the reporting date.

(b) Deferred origination costs

	2014 £ m	2013 £ m
At 1 January	110	137
Amounts incurred during the period	2	1
Amortisation during the period	(24)	(28)
At 31 December	88	110

Of the above total, £71m (2013: £90m) is expected to be recovered more than one year after the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

12. Tax assets and liabilities

	2014 £ m	2013 £ m
Current tax receivables	27	10
Deferred tax assets	8	9
Total tax assets	35	19
Current tax payables	44	36
Deferred tax liabilities	87	100
Total tax liabilities	131	136

The current tax balances in the above table include £34m payable (2013: £33m receivable) in respect of group relief for corporation tax which is payable to other companies within LBG.

Deferred tax assets include £7m (2013: £8m) that is expected to be recovered more than one year after the reporting date.

Deferred tax liabilities include £74m (2013: £79m) that is expected to be settled more than one year after the reporting date.

(a) Recognised deferred tax

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

	2014 £ m	2013 £ m
Deferred tax assets comprise:		
Transitional Adjustments on introduction of new life tax regime	8	9
Total deferred tax assets	8	9
Deferred tax liabilities comprise:		
Deferred acquisition costs	65	74
Deferred tax on acquired VIF	22	26
Total deferred tax liabilities	87	100
Net deferred tax liabilities	79	91

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

	2014 £ m	2013 £ m
Trade losses	-	(13)
Deferred costs	9	25
Transitional Adjustments on introduction of new life tax regime	(1)	(2)
Acquired value in force	4	8
Total deferred tax credit	12	18

(b) Unrecognised deferred tax

Deferred tax assets for trading losses, expenses deductible in future periods and accelerated capital losses are recognised on the basis of future profit projections, which show sufficient future taxable profits to utilise these assets. The deferred tax assets not recognised are not subject to any expiry date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

12. Tax assets and liabilities (continued)

Deferred tax assets have not been recognised in respect of excess expenses carried forward of £65m (2013: £99m), as there is insufficient certainty as to the availability of future profits.

13. Investment in subsidiaries

	2014 £ m	2013 £ m
At 1 January	486	486
At 31 December	486	486

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

No impairment charges have been made on subsidiaries held at cost during the year (2013: £nil).

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[2]	Ordinary	100	England and Wales	Investments
CM Venture Investments Limited[2]	Ordinary	100	Isle of Man	Investments
Clerical Medical Non-Sterling Property Company S.a.r.l[2]	Ordinary	100	Luxembourg	Property Investments
St Andrew's Life Assurance Plc[1]	Ordinary	100	England	Life Insurance

[1] Indirect holding.
[2] The above table includes investments in subsidiaries that are held at fair value that are classified as investments at fair value through profit or loss as described in the accounting policies (note 1 (j)), for further information see note 18.

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

14. Investment properties

	2014 £ m	2013 £ m
At 1 January	593	699
Additions – new properties	-	6
Additions – subsequent expenditure on existing properties	23	18
Disposals	(157)	(156)
Net gain from change in fair values	77	26
At 31 December	536	593

The rental income arising from investment properties during the year amounted to £42m (2013: £55m), 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 £6m (2013: £7m).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

14. Investment Properties (continued)

Expenditure on investment properties which did not generate rental income was £nil (2013: £1m).

The investment properties are independently valued by DTZ on at least a quarterly basis for the purpose of determining the open market value of the properties. The carrying value of investment properties under development is £2m (2013: £12m). The carrying value of land held for development purposes that has not yet been developed is £19m (2013: £13m).

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

15. Assets arising from reinsurance contracts held

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

	2014			2013		
	Reinsurance contracts £ m	Classified as Fair value through profit or loss £ m	Total £ m	Reinsurance contracts £ m	Classified as Fair value through profit or loss £ m	Total £ m
At 1 January	264	756	1,020	252	790	1,042
Movement recognised through the statement of comprehensive income	(44)	190	146	12	129	141
Movement recognised directly through the balance sheet	-	(162)	(162)	-	(163)	(163)
At 31 December	220	784	1,004	264	756	1,020
Amounts in respect of insurance and participating investment contract liabilities	220	-	220	264	-	264
Amounts in respect of non participating investment contract liabilities	-	784	784	-	756	756
At 31 December	220	784	1,004	264	756	1,020

Assets arising from reinsurance contracts held include £891m (2013: £905m) that is expected to be settled more than one year after the reporting date.

16. Derivative financial instruments

In the normal course of business, the Company enters into swap contracts, option contracts, index futures contracts and forward foreign exchange contracts. All such contracts are undertaken either for efficient portfolio management purposes or for the purpose of matching contractual liabilities. In addition, the Company has entered into a swap for the specific purpose of hedging movements in the fair value of certain subordinated debt, as described in note 25.

Swap contracts include currency, interest and inflation rate swaps. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. An interest or inflation rate swap is an agreement between two parties to exchange fixed and variable rate interest payments, based upon interest or inflation rates defined in the contract, without the exchange of the underlying principal amount.

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

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

16. Derivative financial instruments (continued)

Details regarding derivative financial instruments are given in the following tables:

	2014 Contract Amount £ m	2014 Fair value assets £ m	2014 Fair value liabilities £ m	2013 Contract Amount £ m	2013 Fair value assets £ m	2013 Fair value liabilities £ m
Derivative financial instruments held for trading:						
Swap contracts	3,527	249	(225)	2,056	17	(61)
Option contracts	4,493	462	(239)	4,236	234	(126)
Index futures contracts	344	1	(12)	288	4	(8)
Forward foreign exchange contracts	926	4	(9)	3,339	29	(23)
Derivative financial instruments designated as fair value hedges	303	11	-	323	21	-
Total	9,593	727	(485)	10,242	305	(218)

Derivative financial instrument assets include £694m (2013: £245m) that is expected to be recovered more than one year after the reporting date.

Derivative financial instrument liabilities include £447m (2013: £112m) 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 liabilities issued by the Company. This instrument forms part of a hedge relationship with the subordinated liabilities issued.

Details of collateral accepted and pledged in respect of derivative financial instruments are given in note 30.

17. Loans and receivables

	2014 £ m	2013 £ m
Amounts receivable in respect of direct insurance business	9	91
Accrued interest and rent	11	11
Amounts due from related parties	665	592
Other	64	135
Total	749	829

Of the above total, £640m (2013: £568m) is expected to be recovered more than one year after the reporting date.

On the 25 January 2013 the Company issued a £200m loan to Scottish Widows plc ("SW plc"). Interest on the loan is payable on an annual basis at a rate of 3 month LIBOR. The loan is unsecured and is repayable one year after written notice is given to SW plc by the Company.

On the 17th December 2013 the Company issued a £350m loan to Scottish Widows plc ("the borrower"), an LBG subsidiary. Interest on the loan is payable on an annual basis at a rate of 3 month LIBOR plus 0.3%. The loan is repayable on demand within 13 months of written notice being given to the borrower, with the borrower having the option to repay the whole or part of the loan amount at any time. On the same date the borrower entered into a collateral arrangement with the Company.
Further information on the Company's collateral in respect of loans to related parties is set out in note 30.

On the 24th June 2014 the £350m loan with Scottish Widows plc was increased by £75m to a total £425m. No changes to the terms and conditions of the loan were made.

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 30.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

18. Investments at fair value through profit or loss

	2014 £ m	2013 £ m
At fair value:		
Shares and other variable yield securities	17,463	15,858
Debt and other fixed/variable income securities	2,921	5,582
Total investments at fair value	20,384	21,440

Included within shares and other variable yield securities are shares in subsidiary undertakings of £7,541m (2013: £7,063m) which are held at fair value through profit or loss.

Of the debt securities £2,904m (2013: £5,295m) is expected to be recovered more than one year after the reporting date. Due to the nature equity securities there is no fixed term associated with these securities.

Of the above debt securities, £1,125m (2013: £526m) was acquired from a related party. All transactions were completed at arm's length.

Interests in unconsolidated structured entities

Included within investments at fair value through profit or loss are investments in unconsolidated structured entities of £17,262m (2013: £15,741m) arising from investments in collective investment vehicles and limited partnerships.

The collective investment vehicles and limited partnerships are primarily financed by investments from investors in the vehicles. The investments are carried at fair value and the Company's maximum exposure to loss is equal to the carrying value of the investment. However, investments in collective investment vehicles and limited partnerships are primarily held to match policyholder liabilities and the majority of the risk from a change in the value of the Company's investment is matched by a change in policyholder liabilities. At 31 December 2014, the total net assets of unconsolidated collective investment vehicles and limited partnerships in which the Company held a beneficial interest was £200,860m (2013: 258,261m). During the year the Company has not provided any non-contractual financial or other support to these unconsolidated collective investment vehicles and limited partnerships.

19. Cash and cash equivalents

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

	2014 £ m	2013 £ m
Cash at bank	195	103
Short term deposits	186	51
Total	381	154

Cash and cash equivalents in the above table contains amounts of £381m (2013: £154m) 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.

20. Share capital

	2014 £ m	2013 £ m
Allocated, called up and fully paid share capital:		
70,000,000 ordinary shares of £1 each	70	70

There have been no changes to share capital during the year ended 31 December 2014.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

21. Insurance contracts and participating investment contract liabilities

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

	2014			2013		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
	£ m	£ m	£ m	£ m	£ m	£ m
At 1 January	14,286	(264)	14,022	14,993	(252)	14,741
Provision in respect of new business	137	-	137	171	-	171
Changes in existing business provisions	(616)	5	(611)	(558)	13	(545)
Assumption changes	232	39	271	(320)	(25)	(345)
At 31 December	14,039	(220)	13,819	14,286	(264)	14,022

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

An analysis of the expected maturities of insurance contracts and participating investment contract liabilities is given in note 30.

22. Unallocated surplus

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

	2014	2013
	£ m	£ m
At 1 January	56	56
Change recognised through the statement of comprehensive income	(5)	-
At 31 December	51	56

Of the above total, £45m (2013: £49m) is expected to be settled more than one year after the reporting date.

23. Provisions for other liabilities and charges

	2014 German insurance business litigation	2014 European business restructure	2014 Total	2013 Total
	£ m	£ m	£ m	£ m
At 1 January	246	28	274	289
Charge for the year	120	12	132	103
Amount utilised in the year	(169)	(10)	(179)	(118)
At 31 December	197	30	227	274

Of the above total, £114m (2013: £137m) is expected to be applied more than one year after the reporting date.

Provision in relation to German insurance business litigation

The Company has received a number of claims in the German courts, relating to policies issued by the Company but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. Following decisions in July 2012 from the Federal Court of Justice in Germany the Company recognised provisions totalling £397 million in 2012 and 2013. Volumes of claims have not decreased as quickly as expected and as a result the Company has recognised a further £120 million during 2014 bringing the total provision to £517 million. The remaining unutilised provision as at 31 December 2014 is £197 million (2013: £246m).

23. Provisions for other liabilities and charges (continued)

The validity of the claims facing the Company depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will only be known once all relevant claims have been resolved.

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

European business restructure

As previously disclosed, In August 2013 LBG sold Heidelberger Leben ("HLE") to Cinven Partners and German financial group Hannover Re ("the purchasers"). The Company's management have estimated that separation costs of £12m and transaction costs of £3m will be incurred as the result of this agreement. Whilst the separation activity remains in progress there are uncertainties as to the ultimate financial effect, which will only be known once separation activity has been completed.

In addition, the Company is committed over a 10 year period to pay a minimum of £13m to the purchasers for the provision of back office services in relation to the Company's European business. This commitment results in the recognition of an onerous contracts provision for £13m.

As the Company is committed to these future costs a provisions have been recognised with the charge to the Statement of Comprehensive Income being recognised within operating expenses.

24. Accruals and deferred income

	2014 £ m	2013 £ m
Accrued expenses	5	1
Deferred income	14	17
Total	19	18

Of the above total, £10m (2013: £8m) is expected to be realised more than one year after the reporting date.

25. Subordinated debt

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

On 5th July 2013 Clerical Medical Finance plc, a subsidiary of LBG, exercised its option to redeem €219m of 6.45% dated Subordinated Guaranteed Bonds, the proceeds of which had been loaned to the Company on similar interest and repayment terms. The sterling value of this redemption was £189m. Prior to repayment the Company repaid in full a corresponding amount to Clerical Medical Finance plc with the use of available surplus liquidity. Further information on the Company's credit risk is available in note 30.

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

	2014 £ m	2013 £ m
Subordinated debt	604	623
Issue costs	9	10
	613	633
Accrued interest on subordinated debt	10	10
Fair value hedge adjustment	5	15
Total	628	658

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 2014 carrying value includes a foreign exchange gain of £20m (2013: £17m).

The fair value of the subordinated debt is £609m (2013: £756m), calculated at the open market value using published bid prices at the reporting date and including £9m (2013: £10m) of amortised issue costs.

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

Scottish Widows plc

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

Clerical Medical Finance plc

£53m 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%.

€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). It is proposed that the €388m of 4.25% undated Subordinated Guaranteed Bonds be redeemed in 2015.

26. Non participating investment contract liabilities

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

	2014 Gross £ m	 Reinsurance £ m	 Net £ m	2013 Gross £ m	 Reinsurance £ m	 Net £ m
At 1 January	7,718	(756)	6,962	7,862	(790)	7,072
Provision in respect of new business	31	-	31	37	-	37
Changes in existing business provisions	(519)	(28)	(547)	(181)	34	(147)
At 31 December	7,230	(784)	6,446	7,718	(756)	6,962

An analysis of the contractual and expected maturities of non participating investment contract liabilities is given in note 30.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

27. Other financial liabilities

	2014 £ m	2013 £ m
Amounts payable in respect of direct insurance business	85	79
Due to related parties	28	48
Due to brokers	-	43
Social security and other taxes	2	2
Repurchase creditor	88	74
Other	3	25
Total	206	271

Of the above total, £nil (2013: £nil) is expected to be settled more than one year after the reporting date.

28. (Increase)/decrease in operating assets and liabilities

	2014 £ m	2013 £ m
(Increase)/decrease in operating assets:		
Deferred costs	45	63
Investment properties	57	106
Assets arising from reinsurance contracts held	16	22
Investments at fair value through profit or loss	1,056	700
Loans and receivables	80	(570)
Derivative financial instruments	(422)	288
Net decrease in operating assets	832	609
Increase/(decrease) in operating liabilities:		
Insurance contracts and participating investment contract liabilities	(247)	(707)
Unallocated surplus within insurance business	(5)	-
Subordinated debt	(30)	(188)
Non participating investment contract liabilities	(488)	(144)
Derivative financial instruments	267	(49)
Other financial liabilities	(65)	3
Provision for other liabilities and charges	(47)	(15)
Accruals and deferred income	1	(9)
Net (decrease) in operating liabilities	(614)	(1,109)
Net decrease/(increase) in operating assets and liabilities	218	(500)

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

Policyholder liabilities can be analysed into With Profits Fund liabilities and non participating fund liabilities. In accordance with FRS 27, the liabilities of the With Profits Funds are accounted for using the realistic capital regime of the PRA (realistic liabilities). All non participating 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. In accordance with FRS 27, the liabilities of the With Profit Funds are accounted for using the realistic capital regime of the PRA (realistic liabilities). The main components of the realistic liabilities are:

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

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

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 swap curve less a deduction for credit risk. The liabilities are valued by discounting projected future cash flows using the risk free yield.

- **Investment volatility**

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

- **Mortality**

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

- **Persistency**

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

- **Maintenance expenses**

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

- **Guaranteed annuity option take-up rates**

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

(b) Liabilities of the Non Profit Fund

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

(i) Insurance contracts

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

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

- Interest rates

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

- Mortality and morbidity

  The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and includes a margin for adverse deviation. The assumptions have additional margins over the With Profits Fund assumptions, as required by PRA regulations. Improvements in female annuitant mortality are assumed to follow the CMI 2012 projection for females from the Actuarial profession's mortality committee with a long term rate of improvement of 1.75% per annum. Similarly improvements in male annuitant mortality are assumed to follow the CMI 2012 projection for males from the Actuarial Profession's mortality committee with a long term rate of improvement of 2.0% 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. Whether a lapse rate is prudent broadly depends on whether the policy liability is negative or positive at any point in its life. Thus for each policy a high lapse rate is assumed where the projected liability is negative and a low lapse rate is assumed where the projected liability is positive.

(ii) Non participating investment contracts

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

(2) Key assumptions

(a) With Profits Fund

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

(i) Investment returns and discount rates

In the realistic valuation of liabilities in calibrating the economic scenario generator, the risk-free yield curve is defined as the UK swap yield curve less a deduction for credit risk. In 2012 this was based on the UK government gilt curve.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

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

(ii) Investment volatility (realistic liabilities only)

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2014, the 10 year-equity-implied-at-the-money assumption was set at 22.3% (22.1% as at 31 December 2013). The assumption for property volatility was 13.1% (31 December 2013: 15%). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 29% as at 31 December 2014 (31 December 2013: 18%).

(iii) Mortality assumptions

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

		2014	2013
Assurances (excluding term assurances)			
Conventional With-Profits	Males	40% AMC00 Ultimate	50% AMC00 Ultimate
	Females	55% AFC00 Ultimate	55% AFC00 Ultimate
Unitised Assurances	Males	80% AMC00 Ultimate	85% AMC00 Ultimate
	Females	85% AFC00 Ultimate	90% AFC00 Ultimate
Annuities			
Self-employed / Personal Pensions	Males	96% PCMA00 (CMI 2012- 1.75%long term improvement rate from 2003)	96% PCMA00 (CMI 2011- 1.5%long term improvement rate from 2003)
	Females	98% PCFA00 (CMI 2012 – 1.5%long term improvement rate from 2003)	94% PCFA00 (CMI 2011 – 1.25%long term improvement rate from 2003)
Other Annuities in payment	Males	96% PCMA00 (CMI 2012- 1.75%long term improvement rate from 2003)	96% PCMA00 (CMI 2011- 1.5%long term improvement rate from 2003)
	Females	98% PCFA00 (CMI 2012 - 1.5%long term improvement rate from 2003)	94% PCFA00 (CMI 2011 - 1.25%long term improvement rate from 2003)
Deferred Annuities	Males	96% PCMA00 (CMI 2012- 1.75%long term improvement rate from 2003)	96% PCMA00 (CMI 2011- 1.5%long term improvement rate from 2003)
	Females	98% PCFA00 (CMI 2012 - 1.5%long term improvement rate from 2003)	94% PCFA00 (CMI 2011 - 1.25%long term improvement rate from 2003)

With regard to the above tables:

'CMI_2012_M_ 1.75%' denotes that future improvement factors, which are applied from 31 December 2002, are taken from CMI 2012 tables for males, with a long term improvement rate of 1.75% per annum. Similarly 'CMI_2012_F_1.5 %' tables are used for females. CMI_2012 denotes that explicit provision for future mortality improvement is made by applying the 2012 version of Continuous Mortality Investigation mortality projection model released in September 2012.

(iv) Other assumptions

Deferred annuity contracts with a guaranteed-rate annuity option have been valued based upon an assumed rate of take-up of the guaranteed annuity option of 85 % for the realistic assessment (85% assumed at 31 December 2013).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

29. 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	2014 Interest rate (net) %	2013 Interest rate (net) %
SW Protection Business Reinsured in CMIG	0.81	1.58
Conventional Life business and non-unit reserves on life linked business	0.81	1.26
Annuities in payment	2.95	3.67
Conventional Pensions Business and non-unit reserves on pensions linked business	1.01	1.58

(ii) Mortality assumptions

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

		2014	2013
Term Assurances			
	Males	40.25% TMC00 Select	46% TMC00 Select
	Females	51.75% TFC00 Select	51.75% TFC00 Select
Annuities			
Purchased (whole life)	Males	86.4% PCMA00 (CMI 2011- 2.00%long term improvement rate from 2003)	86.4% PCMA00 (CMI 2011- 1.75%long term improvement rate from 2003)
	Females	88.2% PCFA00 (CMI 2011 - 1.75%long term improvement rate from 2003)	84.6% PCFA00 (CMI 2011 - 1.5%long term improvement rate from 2003)
Self-employed / personal Pensions	Males	86.4% PCMA00 (CMI 2011- 2.00%long term improvement rate from 2003)	86.4% PCMA00 (CMI 2011- 1.75%long term improvement rate from 2003)
	Females	88.2% PCFA00 (CMI 2011 - 1.75%long term improvement rate from 2003)	84.6% PCFA00 (CMI 2011 - 1.5%long term improvement rate from 2003)
Other Annuities in payment	Males	86.4% PCMA00 (CMI 2011- 2.00%long term improvement rate from 2003)	86.4% PCMA00 (CMI 2011- 1.75%long term improvement rate from 2003)
	Females	88.2% PCFA00 (CMI 2011 - 1.75%long term improvement rate from 2003)	84.6% PCFA00 (CMI 2011 - 1.5%long term improvement rate from 2003)
Deferred annuities	Males	86.4% PCMA00 (CMI 2011- 2.00%long term improvement rate from 2003)	86.4% PCMA00 (CMI 2011- 1.75%long term improvement rate from 2003)
	Females	88.2% PCFA00 (CMI 2011 - 1.75%long term improvement rate from 2003)	84.6% PCFA00 (CMI 2011 - 1.5%long term improvement rate from 2003)

With regard to the above tables:

CMI_2012_M_2.00% denotes that future improvement factors, which are applied from 31 December 2002, are taken from CMI 2012 tables for males, with a long term improvement rate of 2.00%. Similarly CMI_2012_F_1.75% tables are used for females.

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

The CMI have indicated that they will be making some significant changes to this model in 2014 and so there is potential for a change in shape and/or size of the improvements in the short term. Without knowing the size of these impacts, it is prudent to delay updating the improvements until the next review. A more granular analysis of our own annuity book is available from the Longevitas model and this may shape how the rates are set.

CMI 2013 improvements were, on the whole, slower than expected and would have led to an increase in IFRS profit. Hence, leaving rates unchanged is the more prudent option.

(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 2014 with the following impacts on profit after tax:

Variable	Impact on profit after tax 2014 £m	Impact on profit after tax 2013 £m
Mortality	(5)	21
Expenses	19	(34)
Inflation	53	(37)
Lapses	4	1.4
Valuation interest rate & credit default rates	(19)	174

(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	2014 Impact on profit after tax £ m	2013 Impact on profit after tax £m
Annuitant Mortality	5% reduction	(44)	(38)
Other Mortality	5% reduction	1	3
Lapses	10% reduction	(17)	(16)
Maintenance & Investment Expenses	10% reduction	46	47
Interest rate – change in redemption yield (1)	0.25% reduction	(41)	(37)
Interest rates – change in valuation margin (2)	0.25% reduction	(69)	(59)

(1) This interest rate sensitivity shows the impact of a 0.25 per cent movement in gilt yields and all of the consequential impacts on key economic assumptions including the investment returns, the valuation rates of interest and values of assets backing the business in question. This excludes any impact on assets not backing the liabilities.

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management

The principal activity of the Company is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the UK and through non-UK branches. The Company is largely closed to new business, but continues to offer a wide range of life insurance products such as annuities, pensions, whole life, term life and investment type products principally through independent financial advisers, the Lloyds Banking Group network and direct sales. The Company also reinsures business with subsidiary undertakings and with insurance entities external to the Company.

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

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

(a) Governance framework

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

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

The approach to risk management aims to ensure that there is effective independent checking or "oversight" of key decisions through the operation of a "three lines of defence" model. The first line of defence is line management, who have direct accountability for risk decisions. The Risk function provides oversight and challenge and form the second line of defence.

Internal Audit constitutes the third line of defence, whose objective is to provide the required independent assurance to the Audit Committee and the Board that risks within the Company are recognised, monitored and managed within acceptable parameters.

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

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

(b) Risk appetite

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

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

(c) Financial risks

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

30. Risk management (continued)

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

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

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

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

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

(1) Market risk

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

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

30. Risk management (continued)

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

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

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

As at 31 December 2014

		Fair value hierarchy		
	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
Investment properties	-	-	536	536
Investments at fair value through profit and loss	17,475	1,363	1,545	20,383
Derivative financial assets	4	723	-	727
Assets arising from reinsurance contracts held	-	784	-	784
Total assets	17,479	2,870	2,081	22,430
Derivative financial liabilities	22	463	-	485
Non participating investment contract liabilities	-	7,230	-	7,230
Total liabilities	22	7,693	-	7,715

As at 31 December 2013

		Fair value hierarchy		
	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
Investment properties	-	-	593	593
Investments at fair value through profit and loss	17,540	2,892	1,008	21,440
Derivative financial assets	27	278	-	305
Assets arising from reinsurance contracts held	-	756	-	756
Total assets	17,567	3,926	1,601	23,094
Derivative financial liabilities	36	182	-	218
Non participating investment contract liabilities	-	7,718	-	7,718
Total liabilities	36	7,900	-	7,936

The derivative securities classified as Level 2 above have been valued using a tri-party pricing model as determined by the Pricing Source Agreement between Aberdeen Asset Management ("AAM") and State Street. Prices are sourced from external sources, counterparties, and the Investment Manager (AAM). Where the primary value is within tolerance of the secondary value, the primary value will be utilised.

If the primary and secondary values are out of tolerance, then the primary value will be validated against the tertiary value. If it is within tolerance the primary value will be applied. If primary and tertiary values are out with tolerance, then the secondary value is validated against the tertiary value. If secondary and tertiary values are within tolerance, then the secondary value is applied. If they are out of tolerance then the investment manager is notified to allow them to make the final pricing decision.

Assets classified as Level 3 comprise private equity investments, property investment vehicles, asset backed securities, social housing, infrastructure and education loans.

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. Investment property is independently valued as described in note 14. Valuations are based on observable market prices for similar properties. Adjustments are applied, if necessary, for specific characteristics of the property, such as the nature, location or condition of the specific asset. If such information is not available alternative valuation methods such as discounted cash flow analysis or recent prices in less active markets are used.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management (continued)

Where any significant adjustments to observable market prices are required, the property would be classified as level 3. 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.

Loans classified as level 3 are valued using a discounted cash flow model. The discount rate comprises market observable interest rates, a risk margin that reflects credit scores that are calibrated to observed ratings and credit spreads on bonds issued within the same sector, and an incremental liquidity premium that is estimated by reference to historical spreads at origination on similar loans where available and established measures of market liquidity. An expected value approach, based on historical data, is applied to options embedded in the loans. The effect of applying reasonably possible alternative assumptions to the value of these loans would be to decrease the fair value by £51m or increase it by £54m.

Asset backed securities and covered bonds classified as level 3 are not actively traded, and are valued using a discounted cash flow model. The valuation incorporates credit risk spreads, which are generally based on observable spreads on similar securities, plus a liquidity premium. Assumptions are made about the expected life of the securities, reflecting prepayment behaviour. The effect of applying reasonably possible alternative assumptions to the value of these asset backed securities would be to decrease the fair value by £(1)m or increase it by £1m.

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).

	2014		2013	
	£ m	£ m	£ m	£ m
	Assets	*Liabilities*	*Assets*	*Liabilities*
At 1 January	1,601	-	1,697	-
Total net gains recognised within net realised and net fair values gains on assets at fair value through profit or loss in the statement of comprehensive income	58	-	52	-
Transfers in	9	-	38	-
Transfers out	-	-	(514)	-
Purchases	678	-	560	-
Disposals	(265)	-	(232)	-
At 31 December	2,081	-	1,601	-
Total gains for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	29	-	52	-

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management (continued)

(i) Equity and property risk

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

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

Impact on profit after tax and equity at reporting date	2014 £ m	2013 £ m
30% decrease in equity prices	(4)	(2)
10% increase in equity prices	1	1
10% decrease in equity prices	(1)	(1)

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

Impact on profit after tax and equity at reporting date	2014 £ m	2013 £ m
25 basis points increase in yield curves	41	37
25 basis points decrease in yield curves	(41)	(37)

(iii) Foreign exchange risk

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

- The Company's principal transactions are carried out in pounds sterling;
- The Company's financial assets are primarily denominated in the same currencies as its insurance and investment contract liabilities; and
- Other than shareholder funds, all non-linked investments of the non-profit funds and the investments of the shareholder fund are in sterling or 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.

30. Risk management (continued)

(2) Insurance risk

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

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

The Company principally writes the following types of life insurance contracts:

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

For contracts where death is the insured risk, the most significant factors that could increase the overall level of claims are epidemics or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected. The possibility of a pandemic, for example one arising from Swine Flu, is regarded as a potentially significant mortality risk.

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

For contracts with fixed and guaranteed benefits and fixed future premiums, there are no mitigating terms and conditions that significantly reduce the insurance risk accepted. For participating investment contracts the participating nature of these contracts results in a significant portion of the insurance risk being shared with the policyholder.

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

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

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

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

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

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

Further information on assumptions, changes in assumptions and sensitivities in respect of insurance and participating investment contracts is given in note 29.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management (continued)

(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. Loan assets held in the annuity portfolio, that have been purchased from LBG as part of the Company's investment strategy to invest in higher yielding illiquid assets, are monitored by LBG using established robust processes and controls.

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

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

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

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

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

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

As at 31 December 2014

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Debt securities	2,921	574	765	1,385	195	2
Derivative financial instruments	727	-	-	703	24	-
Loans and receivables	749	5	13	704	6	21
Assets arising from reinsurance contracts held	1,004	-	-	222	31	751**
Cash and cash equivalents	381	-	258	113	10	-
Total	5,782	579	1,036	3,127	266	774

*Of which £260m is BBB rated.
** Relates to the Company's subsidiary, CMMF.

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management (continued)

As at 31 December 2013

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower* £ m	Not rated £ m
Debt securities	5,582	599	3,046	1,393	527	17
Derivative financial instruments	305	-	-	267	38	-
Loans and receivables	829	12	38	762	13	4
Assets arising from reinsurance contracts held	1,020	-	-	266	37	717**
Cash and cash equivalents	154	-	54	100	-	-
Total	7,890	611	3,138	2,788	615	738

* Of which £532m is BBB rated.
** Relates to the Company's subsidiary, CMMF.

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

(i) Concentration risk

Credit concentration risk

Credit concentration risk relates to the inadequate diversification of credit risk.

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

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

At 31 December 2014 and 31 December 2013, 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% (2013: 2%) of the Company's total assets, excluding with-profits and unit-linked funds where credit risk is matched by policyholder liabilities.

Liquidity concentration risk

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

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

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

(ii) Collateral management

Collateral in respect of derivatives

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management (continued)

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

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

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

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

- Sovereign government debt of developed economies;
- Supranational debt denominated in eligible currencies;
- Corporate bonds denominated in eligible currencies;
- Equities denominated in eligible currencies; and
- Cash (this is received and invested in the AAM 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:

	2014 £ m	2013 £ m
Investments at fair value through profit or loss	33	36
Cash and cash equivalents	75	5
Total	108	41

The Company has the right to recall any collateral pledged provided that this is replaced with alternative acceptable assets. Collateral pledged continues to be recognised on the Company's balance sheet.

Collateral amounts held against derivatives are not recognised as assets. Assets with a fair value of £384m (2013: £154m) were accepted by the Company as collateral, of which £nil (2013: nil) is permitted to be sold or repledged in the absence of default. The policy of the Company is not to repledge assets, and no collateral was sold or repledged by the Company during the year or in the prior year. The Company has an obligation to return these assets to the pledgor.

All collateral held relates to fully performing assets.

Collateral in respect of loans to related parties

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

Collateral amounts held are not recognised as assets. At 31 December 2014, collateral with a fair value of £569m (2013: £482m) was available to Company to sell or repledge in the absence of default by the counterparty. The policy of the Company is not to repledge assets, and no collateral (2013: £nil) was sold or repledged during the year. The Company have an obligation to return these assets to the pledgor.

Collateral in respect of stocklending

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management (continued)

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

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

The aggregate value of securities on loan by the Company is £111m (2013: £1,233m). Securities on loan are included in investments at fair value through profit or loss and no account is taken of collateral held. The aggregate value of collateral held is £118m (2013: £1,300m).

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 2014 (2013: none) which required a call to be made on collateral.

Collateral pledged in respect of a repurchase agreement with HBOS Treasury continues to be recognised on the Company's balance sheet. The amount pledged was £88m (2013: £74m).

(iii) Offsetting

The following table shows the potential effect of netting arrangements:

As at 31 December 2014

				Related amounts where set off not permitted in the balance sheet		
	Gross amounts of assets / liabilities	Amounts set off in the balance sheet	Net amounts presented in the balance sheet	Financial instruments	Collateral	Potential net amounts if offset of related amounts permitted
	£ m	£ m	£ m	£ m	£ m	£ m
Financial assets						
Derivatives	727	-	727	(338)	(349)	40
Financial liabilities						
Derivatives	(485)	-	(485)	338	106	(41)

As at 31 December 2013

				Related amounts where set off not permitted in the balance sheet		
	Gross amounts of assets / liabilities	Amounts set off in the balance sheet	Net amounts presented in the balance sheet	Financial instruments	Collateral	Potential net amounts if offset of related amounts permitted
	£ m	£ m	£ m	£ m	£ m	£ m
Financial assets						
Derivatives	251	-	251	(109)	(144)	(2)
Financial liabilities						
Derivatives	(188)	-	(188)	109	45	(34)

The value of net amounts presented in the balance sheet for derivatives comprises those derivatives held by the Company that are subject to master netting arrangements. Total derivatives presented in the balance sheet are shown in note 16.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management (continued)

(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 has established a system of internal controls, the objective of which is to provide reasonable assurance that transactions are recorded and undertaken in accordance with delegated authorities that permit the preparation and disclosure of financial statements, regulatory reporting and tax returns in accordance with IFRSs, statutory and regulatory requirements.

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

(ii) Liquidity risk

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

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

In order to measure liquidity risk exposure the Company's liquidity is assessed in a stress scenario. Liquidity risk is actively managed and monitored to ensure that, even under stress conditions, the Company has sufficient liquidity to meet its obligations and remains within approved risk appetite. Liquidity risk appetite considers two time periods; three month stressed outflows are required to be covered by primary liquid assets; and one year stressed outflows are required to be covered by primary and secondary liquid assets, after taking account of management actions. Primary liquid assets are gilts or cash, and secondary liquid assets are tradable non-primary assets.

Liquidity risk is managed in line with the Insurance Liquidity Risk Policy and the wider LBG Funding and Liquidity Policy.

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

Annuity contracts

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

With-profits contracts

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

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

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 2014, there are £nil funds under management subject to deferral (2013 £nil).

30. Risk management (continued)

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 2014

Liabilities		Contractual cash flows (undiscounted)					
	Carrying amount[1] (discounted) £ m	No stated maturity £ m	Less than 1 month £ m	1-3 months £ m	3-12 months £ m	1-5 years £ m	More than 5 years £ m
Non participating investment contract liabilities	7,230	-	7,230	-	-	-	-
Derivative financial instruments	485	-	-	22	16	133	314
Subordinated debt	628	356	-	-	21	95	678
Other financial liabilities	206	-	118	-	88	-	-
Total	8,549	356	7,348	22	125	228	992

[1]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 2013

Liabilities		Contractual cash flows (undiscounted)					
	Carrying amount (discounted) £ m	No stated maturity £ m	Less than 1 month £ m	1-3 months £ m	3-12 months £ m	1-5 years £ m	More than 5 years £ m
Non participating investment contract liabilities	7,718	-	7,718	-	-	-	-
Derivative financial instruments	218	-	-	97	6	104	11
Subordinated debt	658	386	-	-	21	93	678
Other financial liabilities	271	-	197	-	74	-	-
Total	8,865	386	7,915	97	101	197	689

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 on the following page:

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management (continued)

As at 31 December 2014

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 contracts and participating investment contract liabilities	14,039	122	239	1,083	4,142	8,453
Non participating investment contract liabilities	7,230	71	136	630	2,512	3,881

As at 31 December 2013

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 contracts and participating investment contract liabilities	14,286	102	261	1,139	4,292	8,492
Non participating investment contract liabilities	7,718	76	147	665	2,631	4,199

(iii) Capital risk

Capital risk is defined as the risk that:

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

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

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

Under the PRA 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 PRA.

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.

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

The Company's objectives when managing capital are:

- to have sufficient capital to safeguard the Company's ability to continue as a going concern so that it can continue to provide returns for the shareholder and benefits for other stakeholders;
- to comply with the insurance capital requirements set out by the PRA in the UK;
- 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 capital management strategy is such that the single integrated insurance business (comprising Scottish Widows Group ("SWG") and its subsidiaries, including the Company) will hold capital in line with the stated risk appetite for the business, which is to be able to withstand a one in ten year stress event without breaching the capital requirements. At SWG level it is intended that all surplus capital above that required to absorb a one in ten year stress event will be distributed to LBG.

30. 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 25).

The table below sets out the regulatory capital and the required capital held at 31 December in each year on a Pillar 1 basis. The current year information is based upon the 2014 PRA returns.

As at 31 December

	2014 £ m	2013 £ m
Regulatory capital held	3,212	3,150
Regulatory capital required	(1,695)	(1,755)
Regulatory capital surplus	1,517	1,395

All minimum regulatory requirements were met during the year.

(d) Operational risk

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

There are a number of categories of operational risk:

Conduct risk

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

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

People risk

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

Financial crime and security risk

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

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

Organisational infrastructure and change risk

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

30. Risk management (continued)

Political risk

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

Supplier management risk

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

IT Systems risk

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

The Directors have approved a risk framework and monitor the effective operation of this across the Company.

(e) Legal and regulatory risks

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

A provision is held in respect of German litigation. This is discussed further in note 23.

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

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

The Company monitor and manage all legal and regulatory risks closely and have regulator interaction with the regulators.

31. Related party transactions

a) Ultimate parent and shareholding

The immediate parent undertaking is Scottish Widows plc.

The parent undertaking which is the parent undertaking of the smallest group to consolidate these financial statements is Scottish Widows plc. Copies of the consolidated annual report and accounts of Scottish Widows plc may be obtained from Insurance Secretariat, 69 Morrison Street, Edinburgh EH3 8YF.

The ultimate parent undertaking and controlling party is Lloyds Banking Group plc, which is the parent undertaking of the largest group to consolidate these financial statements. Copies of the consolidated annual report and accounts of Lloyds Banking Group plc may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com.

Clerical Medical Investment Group Limited has taken advantage of the provisions of the Companies Act 2006 and has not produced consolidated financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

31. 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	
	2014	2013	2014	2013
	£ m	£ m	£ m	£ m
Relationship				
Ultimate Parent undertaking:				
Invested assets	-	-	-	18
Parent undertakings:				
Invested assets	-	-	-	2
Reassurance and amounts receivable/(payable)	66	93	6	9
Loans receivable	5	-	627	550
Subordinated debt	(21)	(17)	(262)	(262)
Subsidiary undertakings:				
Expense recharges and amounts receivable/(payable)	(1)	-	(11)	-
Commission and amounts receivable	-	4	5	-
Reassurance and amounts receivable/(payable)	-	4	(8)	56
Loans receivable	-	2	-	3
Dividends received	10	160	-	-
Holding in OEICs	-	-	7,250	7,063
Other related parties:				
Invested assets	2	-	36	46
Derivative financial assets	88	-	111	-
Derivative financial liabilities	-	-	(22)	-
Expense recharges and amounts receivable/(payable)	(68)	(47)	(107)	(59)
Holding In OEICs	-	-	7,648	6,289
Management fees and amounts payable	(13)	(17)	(4)	(6)
Interest payable	(17)	-	8	-
Cash and amounts receivable/(payable)	-	10	-	(84)
Reassurance and amounts receivable/(payable)	-	(7)	(5)	(5)
Commission and amounts payable/receivable	(2)	(1)	2	-
Loans to other related parties	-	-	14	(5)
Subordinated debt	(10)	(30)	(366)	(381)

Transactions between the Company and key management personnel

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

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

Key management compensation:

	2014	2013
	£000	£000
Salaries and other short-term benefits	334	317
Post-employment benefits	7	9
Share-based payments	98	80
Total	439	406

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

31. Related party transactions (continued)

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 one Director and key management personnel (2013: one) under defined benefit pension schemes. Eleven Directors and key management personnel (2013: Fifteen) are paying into a defined contribution scheme.

Detail regarding the highest paid Director is as follows:

	2014 £000	2013 £000
Apportioned aggregate emoluments	96	50
Defined benefits pension scheme accrued benefit at 31 December	-	2

The highest paid Director exercised share options during the year and was granted shares in respect of qualifying service during the year. This was also the case in the prior year. These have been disclosed in the LBG consolidated accounts.

HM Treasury

In January 2009, HM Treasury became a related party of the Company following its subscription for ordinary shares in Lloyds Banking Group plc, the Company's ultimate parent company, issued under a placing and open offer HM Treasury held a 24.9 per cent (31 December 2013: 32.7 per cent) interest in Lloyds Banking Group's ordinary share capital and, consequently, HM Treasury remained a related party of the Company throughout 2014.

There were no material transactions between the Company and HM Treasury during the year (2013: 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.

32. Operating leases

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

	2014 £ m	2013 £ m
Within one year	37	41
Between two and five years	101	136
Beyond five years	214	341
Total	352	518

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

	2014 £ m	2013 £ m
Within one year	1	1
Between two and five years	3	3
Beyond five years	168	162
Total	172	166

The total of contingent rents recognised as income during the year was £nil (2013: £nil). The total of contingent rents recognised as operating expenses during the year was £1m (2013: £nil). Generally the Company's operating leases are for terms of 15 years or more.

33. Capital commitments

The Company has given an undertaking to provide capital commitments of £553,706,192 in relation to private equity investments. The total amount drawn down as at 31 December 2014 was £449,579,044. The remainder of the funds committed can be drawn down as required.

The Company has contracted for, but not paid for, £6m (2013: £nil) of development expenses for investment property.

34. Standards and interpretations effective in 2014

The Company has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2014.

(i) IFRIC 21 "Levies"

This interpretation clarifies that the obligating event that gives rise to a liability to pay a government levy is the activity that triggers the payment of the levy as set out in the relevant legislation and that operating in a future period, irrespective of the difficulties involved in exiting a market, does not create a constructive obligation to pay a levy. The interpretation has not had a material impact on the financial statements.

(ii) Amendments to IAS 32 "Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities"

The amendments to IAS 32 clarify the requirements for offsetting financial instruments and address inconsistencies identified in applying the offsetting criteria used in the standard. This amendment has not had a material impact on the financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

35. Future accounting developments

The following pronouncements may have a significant effect on the Company's financial statements but are not applicable for the year ending 31 December 2014 and have not been applied in preparing these financial statements. Except as discussed below, the full impact of these accounting changes is being assessed by the Company.

Pronouncement	Nature of change	IASB effective date
IFRS 9 "Financial Instruments" [1]	Replace those parts of IAS 39: 'Financial Instruments: Recognition and Measurement' relating to the classification, measurement and derecognition of financial assets and liabilities. IFRS 9 requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instrument, and eliminates the available-for-sale financial asset and held-to-maturity investment categories in IAS 39. The requirements for derecognition are broadly unchanged from IAS 39. The standard also retains most of the IAS 39 requirements for financial liabilities except for those designated at fair value through profit or loss whereby the part of the fair value change attributable to the entity's own credit risk is recorded in other comprehensive income. The hedge accounting requirements are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39.	Annual periods beginning on or after 1 January 2018
IFRS 15 "Revenue from Contracts with Customers" [1]	Replaces IAS 18 "Revenue" and IAS 11 "Construction Contracts". IFRS 15 establishes principles for reporting useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Revenue is recognised at an amount that reflects the consideration to which the entity expects to be entitled in exchange for goods and services. Financial instruments, leases and insurance contracts are out of scope and so this standard is not expected to have a significant impact on the financial results or position of the Company.	Annual periods beginning on or after 1 January 2017

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