SCOTTISH WIDOWS LIMITED

ANNUAL REPORT

AND

FINANCIAL STATEMENTS

31 DECEMBER 2017

Member of Lloyds Banking Group plc

CONTENTS

COMPANY INFORMATION

Board of Directors

N E T Prettejohn (Chairman)

S J O'Connor
M G Culmer
M Harris*
C J G Moulder
A M Blance
R L M Wohanka
J E M Curtis
J F Hylands
K A Cook
A Lorenzo*

* denotes Executive Director

Company Secretary

J M Jolly

Independent Auditors

PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
2 Glass Wharf
Bristol
BS2 0FR

Registered Office

25 Gresham Street
London
EC2V 7HN

Company Registration Number

03196171

GROUP STRATEGIC REPORT

The Directors present their strategic report on Scottish Widows Limited ("the Company") and its subsidiary undertakings (together referred to as "the Group") for the year ended 31 December 2017. The Company is limited by share capital.

The Group contributes to the results of the Insurance Division of Lloyds Banking Group ("LBG"). Scottish Widows was founded in 1815, and since then we have been focused on helping customers protect themselves today whilst preparing for a secure financial future. Our objective is to be the best insurance and retirement savings business for customers; providing simple, trusted, value for money products accessible through our customers' preferred channels.

The external business environment is changing rapidly, driven by regulations, technology and customer preferences, and legislative changes. Increased regulatory intervention is changing the way customers are saving for and accessing their savings for retirement. Rapid adoption of digital across Insurance is changing market dynamics with customers increasingly turning to these channels. Customer engagement is evolving from a fairly static relationship to more dynamic, service-oriented engagement.

We have evolved our strategy in response to changing customer needs and prioritised investment on four core markets, where we see the opportunity to deliver sustainable growth by taking advantage of strong macro-trends.

For Life and Pensions, the Group will become the "Go To Group" for Retirement for both personal and commercial customers, capturing the structural growth opportunity created by an ageing UK population as well as political and regulatory interventions (for example in relation to pensions freedom).

- In **Protection,** we will continue to rebuild direct relationships through a multi-channel, multi-brand engagement model and build scale within the intermediary channel

- In **Workplace Pensions,** we will increase capacity to build a scale and efficient business that serves our growing customer base, providing a better employer experience and improved member engagement. Additionally, we can build on banking relationships to selectively win new schemes in target segments

- In **Retirement,** we can capitalise on our unique opportunity of being part of the wider LBG and are looking to invest in the Retirement Account proposition to further build on an already strong presence and help franchise customers navigate their retirement journey, offering simple, value-for-money products

- In **Bulk Annuities**, we have now competed successfully for varying sizes of schemes, enabling employers to de-risk their defined benefit pension schemes. We will continue to grow our share of this profitable market, whilst building on wider LBG experience in asset origination

We will respond to margin pressures by **building scale**, further **reducing our cost base** and **simplifying our IT landscape** to reduce complexity and to improve agility.

Our Insurance Strategy will create a scalable and efficient business and deliver value for money propositions for our customers that are aligned to clear and growing customer needs.

LBG aspires to conduct business in a way that values and respects the human rights of all the stakeholders we work with. LBG complies with all relevant legislation, including the UK Modern Slavery Act.

Principal activities

The principal activity of the Group is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the United Kingdom. The Group also has freedom of services overseas, which write a relatively small amount of business, principally in Germany. The Group offers a wide range of life insurance products such as annuities, pensions, whole life, term life and investment type products through independent financial advisors, the LBG network and direct sales. The Group also reinsures business with insurance entities external to the Group.

Result for the Year

The result for the year ended 31 December 2017 is a Group profit after tax of £899m (2016: £173m). The result reflects positive assumption changes primarily from the mortality assumption basis as well as a reduction in expenses during the year largely due to no increase in the German Insurance Business litigation provision.

The Directors consider the result to be satisfactory in light of these factors.

GROUP STRATEGIC REPORT (CONTINUED)

Britain leaving the European Union

The Group has already considered many of the potential implications following the UK's vote to leave the European Union and continues to manage related developments to assess, and if possible mitigate any impact to its customers, colleagues and products – as well as legal, regulatory, tax, finance and capital implications.

Fair Treatment of Long-Standing Customers in the Life Insurance Sector

The Financial Conduct Authority ("FCA") has referred a number of firms, including the Company, to its enforcement division after publishing its thematic review on fair treatment of long-standing customers in the life insurance sector on 2 March 2016. The FCA is investigating the behaviour around disclosing exit and paid-up charges to customers after December 2008. The FCA have stated that no conclusion has been reached as to whether there have been any breaches of regulatory requirements and the commencement of investigations should not be taken to indicate they will necessarily result in a penalty being imposed or that redress will be payable. No provision is held in respect of this review at this time. This investigation is ongoing and it is currently not possible to make a reliable assessment of the liability, if any, that may result from the investigation.

Key performance indicators

Funds under management

Funds under management relating to policyholder liabilities were £124.4bn (2016: £121.3bn). The movement reflects net flows from policyholders and investment return for the period.

Solvency II

Our business model maximises the capital benefits from risk diversification available under Solvency II, the use of our Internal Model to calculate our Solvency Capital Requirement and the use of the Matching Adjustment, which has a beneficial impact on the level of regulatory capital we hold in relation to annuities business.

Solvency II came into force on 1 January 2016. Through preparation for Solvency II in previous years, the Group had already embedded Solvency II into decision making and when taking account of capital requirements. As agreed with the Prudential Regulation Authority ("PRA"), in May 2017 the wider insurance division submitted a single Own Risk and Solvency Assessment ("ORSA") for 2016 covering the group headed by Scottish Widows Group Limited, and the assessment of own risks and solvency needs of the Company is therefore covered by that assessment. The ORSA report for 2017 will be submitted to the PRA by March 2018.

The Directors believe that the Company currently has adequate capital resources and will continue to do so in the foreseeable future. On a Solvency II basis the estimated regulatory surplus of the Company in excess of capital requirements is £2.3bn (2016: £2.2bn).

The estimated Solvency II ratio for the insurance division of 160 per cent (2016: pre dividend position: 160 per cent) represents the shareholder view of Solvency II surplus. During 2017, benefits arose from positive market movements, earnings, the Major Model Change and year-end assumption changes, offset by negative impacts from new business strain and increased capital requirements for policyholder tax charges. In addition, the Company paid dividends of £600m in February 2017 and a further £50m dividend in July 2017 (2016: £250m). A £1,913m dividend was paid in June 2017 with corresponding intercompany loan repayments received from the Company's parent undertaking. Further information on the capital position of the Company is given in note 37.

During the year, the Group has successfully delivered Solvency II reporting in respect of full annual quantitative reporting for 31 December 2016, as well as the first narrative reporting required by Solvency II. The Regular Supervisory Report ("RSR") was privately reported to the PRA in May 2017. The Company has a waiver from the PRA exempting it from preparing a single Solvency and Financial Condition Report ("SFCR") and instead the Company reported publicly through a group SFCR for Scottish Widows Group Limited that was published in June 2017.

GROUP STRATEGIC REPORT (CONTINUED)

Key performance indicators (continued)

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 remain within the approved risk appetite. As at 31 December 2017, the Company (excluding the matched annuity portfolio, which is fully matched for liquidity purposes) had liquidity coverage of 168% (2016: 146%). Liquidity methodology and reporting has been updated to ensure compliance with Solvency II.

Present value of new business premiums ("PVNBP")

Life and pensions sales (PVNBP) for the year were £9,951m (2016: £8,919m). PVNBP increased 12 per cent driven by 29 per cent increase across workplace, planning and retirement and protection, partly offset by lower bulk annuity sales where we have maintained a strong pricing discipline whilst actively quoting in a very competitive market.

Other Sources where KPIs are presented

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

The Directors consider that the above are the key performance indicators which are appropriate to the principal activity of the Group. 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 Solvency II reporting 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 and the Group.

Review of the business

In addition to the progress made against the strategic initiatives summarised earlier there are other areas that are worthy of note and these are described below. Decisions taken in the areas described below and in pursuit of our strategy are brought to the Board for due consideration and approval.

Outsourcing of long-standing customer administration platform

On 19 September 2017, the Group entered into a long-term strategic partnership with Diligenta, to create an industry-leading policy administration service for our customers with long-standing products. The main benefit to our customers is that this new outsourcing arrangement will provide a service platform with digital capabilities so, over time, our customers with long-standing products can manage their policies with the Group in a simpler and more efficient way and the Group can respond better to their changing needs.

As a result of this outsourcing partnership, in the region of 1,000 roles whose work is transferring have TUPE transferred to Diligenta to continue to service our customers on 1 March 2018. The Group expects to realise benefits through savings through the reduction of ongoing costs, across both insurance and investment products, by moving to a single administration platform. The in-scope products are those either closed to new business or no longer actively marketed.

The Group and Company has recognised the impact of this contract through the reserving assumptions which form part of the insurance contract liabilities from the date of signing the outsourcing contract with Diligenta. This has resulted in a net increase to reserves of £89m for the year ended 31 December 2017.

GROUP STRATEGIC REPORT (CONTINUED)

Review of the business (continued)

Acquisition of Zurich UK Workplace Pensions and Savings Business

On 12 October 2017, the Group entered into an agreement to acquire the UK workplace pensions and savings business from the Zurich Group. The acquisition will enable the Group to accelerate the development of its financial planning and retirement business and will bring around £21bn of assets under administration once finalised.

The savings business will be acquired by Scottish Widows Administration Services Limited, a subsidiary undertaking, with the transfer expected to complete in early 2018, following confirmation of regulatory permissions. The Company will also acquire the pensions business. The transfer of the pensions business will be pursuant to an insurance business transfer scheme, under Part VII of the Financial Services and Markets Act 2000, and will require court approval. The pensions business transfer is therefore likely to complete at a later date. Consideration will be payable at completion for both transfers. The agreement allows for further contingent consideration to be paid at a date up to 12 months later than completion.

Investment strategy

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

During 2017, the Group continued to acquire illiquid credit assets from, or issued by, parties within LBG totalling £450m (2016: £1,223m). All assets were acquired at their fair value. The Group also originated new loans during the year totalling £352m (2016: £272m) and committed to lend a further £245m (2016: £nil). These credit assets are secured on Social Housing, Infrastructure, Education and Commercial Real Estate portfolios. Further details on the credit risk and fair value measurement of these assets can be found in note 37.

Bulk Annuities

We have continued to support corporate customers in de-risking their balance sheets, with the successful completion of a further eight (2016: four) bulk annuity transactions, bringing in £0.65bn (2016: £1.5bn) of liabilities from third party pension schemes.

Longevity Reinsurance

On 22 December 2017 the Group entered into a longevity reinsurance deal with The Prudential Insurance Company of America to cede risk on its annuity book of business. Under the reinsurance contracts, the Group has committed to pay fixed cash flows to the reinsurer for each policy covered and in exchange will receive from the reinsurer cash flows that are linked to the actual longevity of the underlying policies. The deal covers the full term of the underlying policies and estimated premiums, for the year ended 31 December 2017, are £26m.

Litigation in relation to insurance business in Germany

The Group continues to receive claims in Germany from customers relating to policies issued by the Company, under its former name of Clerical Medical Investment Group Limited. The German industry-wide issue regarding notification of contractual 'cooling off' periods has continued to lead to similar numbers of claims in 2017 as 2016. The total provision made to 31 December 2017 remains at £639m (2016: £639m). Settlement experience has improved and therefore only £30m was utilised in the year ended 31 December 2017 (2016: £50m) the remaining unutilised provision as at 31 December 2017 is £138m (2016: £168m).

The validity of the claims facing the Group 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 be known only once all relevant claims have been resolved.

GROUP STRATEGIC REPORT (CONTINUED)

Review of the business (continued)

Disposal of subsidiary

As part of LBG's implementation of the ring-fencing requirements, the Group has agreed to transfer ownership of a subsidiary undertaking, Scottish Widows Services Limited ("SWSL"), to Lloyds Bank plc, a subsidiary of LBG. The disposal is due to take place during 2018 and, as such, the Group has accounted for the operations of SWSL as discontinued operations. The assets and liabilities of SWSL have been reclassified in the balance sheet as assets and related liabilities held for sale and the result for SWSL for 2017 and 2016 has been reclassified in the statement of comprehensive income as discontinued operations.

Outlook

The Directors consider that the Group and Company's principal activities will continue to be unchanged in the foreseeable future.

Principal risks and uncertainties

During the ordinary course of business the Group is subject to complaints and threatened or actual legal proceedings (including class or group action claims) brought by or on behalf of current or former employees, customers, investors or other third parties, as well as legal and regulatory reviews, challenges, investigations and enforcement actions, both in the United Kingdom and overseas.

All such material matters are periodically reassessed, with the assistance of external professional advisors where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed to properly assess the situation, and no provisions are held in relation to such matters. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

On behalf of the Board of Directors

M Harris
Director
22 March 2018

DIRECTORS' REPORT

The Directors present the audited consolidated financial statements of the Company and the Group. The Company is a limited liability company, domiciled and incorporated in the United Kingdom. The Company also has freedom of services overseas, which write a relatively small amount of business, principally in Germany. Details of all the subsidiary undertakings are given in note 15.

Results and dividend

The result for the year ended 31 December 2017 is a Group profit after tax of £899m (2016: £173m). The result reflects positive assumption changes primarily from the mortality assumption basis as well as a reduction in expenses during the year largely due to stability in the German Insurance Business litigation. The Directors consider the result for the year to be satisfactory in light of these factors. Further information on the results of the Group, and future prospects of the business, are provided in the Group Strategic Report.

During the year, £2,563m interim dividends (2016: £250m) were paid. The Directors recommend no payment of a final dividend in respect of the year ended 31 December 2017 (2016: £nil). Details of dividends paid during the year are given in note 35.

Post balance sheet events

An interim dividend of £540m in respect of the year ending 31 December 2018 was declared on 08 February 2018 and paid to Scottish Widows Group Limited on 14 February 2018.

On 15 February 2018, the Group gave notice to Standard Life Aberdeen to terminate its partnership agreements with Aberdeen Asset Management and to review their long-term asset management arrangements to ensure they remain up-to-date and that customers continue to receive good service and investment performance. There are no immediate changes for customers. Following completion of the review, the Group anticipates implementing the new arrangements by the end of June 2019. The Group will work with Standard Life Aberdeen to ensure no disruption to performance or service in the interim.

On 20 February 2018, the LBG Board approved proposals on restructuring its legal entity framework, business and operating model in line with its Ring-fencing programme to ensure compliance in advance of the 1 January 2019 implementation date. This includes the sale of SWSL, during 2018, for a value equivalent to its net asset value at the time of sale to Lloyds Bank plc along with obligations relating to the Scottish Widows Retirement Benefit Scheme ("SWRBS"). This is in line with the Group's Shared Services model under which the Insurance sub-group will transfer its employees into the Ring-Fenced Bank. The Company is expected to pay SWSL a risk premium as part of a tri-partite agreement under which Lloyds Bank plc will take on the role of principal employer and guarantor of SWRBS.

On 26 February 2018, Scottish Widows Administration Services Limited ("SWAS") issued £75m of ordinary share capital to the Company.

Directors

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

M Christophers	(resigned 15 May 2017)
S J O'Connor	(appointed 01 June 2017)
C J G Moulder	(appointed 12 June 2017)
V Maru	(resigned 14 September 2017)

Particulars of the Directors' emoluments are set out in note 38.

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 or from the date of appointment in respect of the directors who joined the board of the Company during the financial year. 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.

DIRECTORS' REPORT (continued)

Disclosure of information to auditors

Each person who is a Director at the date of approval of this report confirms that, so far as the Director is aware, there is no relevant audit information of which the Company's auditors are unaware and each Director has taken all the steps that he ought to have taken as a Director 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.

Future developments

Future developments are detailed within the Group Strategic Report and also in note 41.

Employees

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

LBG encourages and gives full and fair consideration to job applications from people with a disability and are unbiased in the way it assesses, selects, appoints, trains and promotes people. LBG encourages job applications from those with a disability and continues to run a work experience programme with Remploy to support people with disabilities wanting to enter the workplace.

LBG is committed to continuing the employment of, and for arranging appropriate training for, employees of the company who have become disabled persons during the period when they were employed by the company.

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

Political contributions

During the year, the Group made no political contributions (2016: £nil).

Corporate governance

In accordance with the Financial Conduct Authority's Disclosure and Transparency Rule ("DTR") 7.2.1, the disclosures required by DTR 7.2.5R are within note 37 to the accounts and are therefore incorporated into this report by reference.

Going concern

The going concern of the Company and the Group is dependent on successfully maintaining adequate levels of capital and liquidity. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have considered a number of key dependencies which are set out in the risk management section under principal risks and uncertainties: funding and liquidity pages 94 to 97 and capital position on pages 97 and 98 and additionally have considered projections (including stress testing) for the Group's capital and funding position. Having consulted on these, the Directors conclude that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Hedging and financial risk management

Disclosures relating to hedge accounting are included within note 1 and note 19 to the accounts, disclosures relating to financial risk management are included in note 37 to the accounts and are therefore incorporated into this report by reference.

Statement of Directors' responsibilities

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

DIRECTORS' REPORT (continued)

Statement of Directors' responsibilities (continued)

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the Group and Company 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 Group and Company and of the profit or loss of the Group and Company for that period.

In preparing the financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- 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;
- make judgements and accounting estimates that are reasonable and prudent; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and parent company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group and Company's transactions and disclose with reasonable accuracy at any time the financial position of the Group and Company and enable them to ensure that the financial statements comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

The Directors are also responsible for safeguarding the assets of the Group and Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

In the case of each Director in office at the date the Directors' Report is approved:

- so far as the director is aware, there is no relevant audit information of which the Group and Company's auditors are unaware; and
- they have taken all the steps that they ought to have taken as a Director in order to make themselves aware of any relevant audit information and to establish that the Group and Company's auditors are aware of that information.

A copy of the financial statements is placed on our website www.scottishwidows.co.uk. The Directors are responsible for the maintenance and integrity of the Group and Company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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

- the Group and Company financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit of the Group and Company; and
- the strategic report on pages 4 to 8, and the Directors' Report on pages 9 to 11 include a fair review of the development and performance of the business and the position of the Group and Company, together with a description of the principal risks and uncertainties that it faces.

On behalf of the Board of Directors

M Harris
Director
22 March 2018

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF SCOTTISH WIDOWS LIMITED

Report on the audit of the financial statements

Opinion

In our opinion, Scottish Widows Limited's Group financial statements and Company financial statements (the "financial statements"):

- give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2017 and of the Group's profit and the Group's and the Company's cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union and, as regards the Company's financial statements, as applied in accordance with the provisions of the Companies Act 2006; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements, included within the Annual Report and Financial Statements (the "Annual Report"), which comprise: the Group and Company balance sheets as at 31 December 2017; the consolidated statement of comprehensive income, the Group and Company statements of cash flows, the Group and Company statements of changes in equity for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

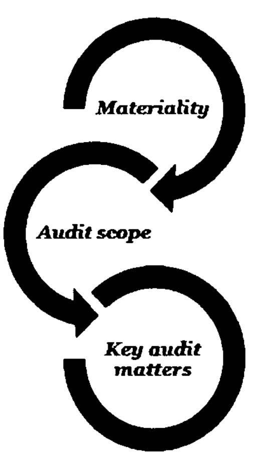
We remained independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the Company.

Other than those disclosed in note 9 to the financial statements, we have provided no non-audit services to the Group or the Company in the period from 1 January 2017 to 31 December 2017.

Our audit approach

Overview



Overall Group materiality of £58.6 million has been based on 1% of average net assets over the last 3 years. Overall Company materiality has been capped at £55.7 million to reflect its allocation of materiality for the purpose of the Group audit.

The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment, the financial significance of components and other qualitative factors (including history of misstatement through fraud or error).

We performed audit procedures over 14 components we considered financially significant in the context of the Group (full scope audit) and over 4 components specific audit procedures were performed on certain account balances and transactions. We also performed other procedures including testing entity level controls and analytical review procedures to mitigate the risk of material misstatement in the insignificant components. Procedures were also performed at the group level over the group consolidation process.

The areas of focus for our audit which involved the greatest allocation of our resources and effort were:

- Determination of significant actuarial assumptions for liabilities (Group and Company).
- Provisions relating to conduct of business practices (Group and Company).
- Valuation of illiquid financial instruments (Group and Company).

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF SCOTTISH WIDOWS LIMITED (continued)

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

We gained an understanding of the legal and regulatory framework applicable to the Group and the industry in which it operates, and considered the risk of acts by the Group which were contrary to applicable laws and regulations, including fraud. We designed audit procedures to respond to the risk, recognising that the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion. We designed audit procedures that focused on the risk of non-compliance related to insurance industry regulations and financial conduct issues. Our tests included review of complaints and correspondence with the regulators and substantive testing of the significant conduct provisions in relation to past sales of insurance products. There are inherent limitations in the audit procedures described above and the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it. We did not identify any key audit matters relating to irregularities, including fraud. As in all of our audits we also addressed the risk of management override of internal controls, including testing journals and evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.

Key audit matters

Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. This is not a complete list of all risks identified by our audit.

Key audit matter	How our audit addressed the key audit matter
Determination of significant actuarial assumptions for liabilities - Group and Company The Directors' determination of certain assumptions for the valuation of life insurance contract liabilities involves complex judgements about future events, both internal and external to the business. Changes in assumptions can result in material impacts to the valuation of the liabilities. The methodology used can also have a material impact on the valuation of the insurance contract liabilities. As part of our consideration of assumptions, we gave specific focus to annuitant mortality (longevity), maintenance expenses and credit default as being significant, because of the sensitivity of the Group and Company's profit to changes in these assumptions and the level of judgement involved in setting these assumptions.	We understood and tested key controls and governance around the processes for setting economic and non-economic assumptions. We found that the key controls for the setting of assumptions, including those operating over the experience analysis data relating to the significant assumptions, where applicable, were designed and implemented effectively. Therefore we are able to place reliance on these controls for the purposes of our financial statement audit. We engaged our actuarial specialists to assess the reasonableness of the actuarial assumptions, including the consideration and challenge of management's rationale for the judgements applied and any reliance placed on industry information. Our audit work in respect of determining the actuarial assumptions for the life insurance contract liabilities included: • Assessing the key changes in the assumptions against regulatory and reporting requirements and industry standards; • obtaining audit evidence in respect of the key controls over the key actuarial models, data collection and analysis and the assumptions setting processes used by management, evaluating their design and implementation and testing their operating effectiveness; and • benchmarking management's assumptions in the UK against the largest life insurers in the UK which were included in PwC's independent benchmarking survey. This allowed us to compare the assumptions used relative to those used by the Group's industry peers. For annuitant mortality assumptions, we evaluated the choice of the industry standard Continuous Mortality Investigation ('CMI') model, and its parameterisation and outputs against wider market data from benchmarking and regulatory feedback.

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF SCOTTISH WIDOWS LIMITED (continued)

<table>
<tr><th>Key audit matter</th><th>How our audit addressed the key audit matter</th></tr>
<tr><td></td><td>For annuitant mortality (longevity), we have assessed the appropriateness of how management's internal experience and industry data are used in setting future assumptions around longevity experience and future longevity trends and compared resulting life expectancies to benchmarking data.

For maintenance expenses, we assessed the appropriateness of the judgements around costs deemed to be non-attributable to insurance business and the resulting per-policy costs assumptions.

We have also reviewed the adjustments required to reflect the impact of the recently completed administration outsourcing agreement.

For credit default, we assessed the appropriateness of the methodology, including modifications made, against our knowledge and experience of the regulatory requirements and of the industry.

Our audit work in respect of methodologies used in the valuation of life insurance contract liabilities included challenging management's methodology, focusing on changes to methodology in the year, by applying our industry knowledge and experience to compare whether the methodology and/or changes are in compliance with recognised actuarial practices and regulatory and reporting requirements.

Based on the results of our audit work we concluded that the data, methodology and assumptions used by management were reasonable.</td></tr>
<tr><td>Provisions relating to the conduct of business practices - Group and Company

Matters relating to conduct of business practices, including in other EU countries, and specifically the Group and Company's anticipated customer redress payments, operational costs and regulatory fines continue to be significant.

Given the number and volume of products sold by the Group and Company historically, and the continued regulatory and public focus on the financial services industry, there is a continuing risk that conduct matters will emerge. Therefore, there is a financial reporting risk that such emerging risks and exposures are not appropriately identified and provided for in the financial statements.

Similarly, there is a risk that these known and emerging risks are not appropriately accounted for or disclosed in the financial statements. For the known issues that have been provided for, we focus our work on the key assumptions including volume of future complaints and related redress costs as these are key judgemental inputs into the measurement of provisions.</td><td>We understood and tested the key controls and management's processes for:

• Identifying emerging conduct risk exposures and assessing whether provisions or disclosures were necessary; and

• the calculation and review of conduct provisions including governance processes and approvals of model assumptions and outputs.

We found these key controls were designed, implemented and operated effectively and therefore we determined that we could place reliance on these key controls for the purposes of our audit.

We performed the following procedures around the completeness of provisions recognised:

• We met with management to understand the emerging and potential issues that they had identified. We independently assessed emerging and potential areas where exposures might have arisen based upon our knowledge and experience of emerging industry issues and the regulatory environment. We used this to challenge the completeness of the issues identified by management and whether a provision or contingent liability was required in the financial statements;

• we understood customer complaints received, and assessed the trends. We used this analysis to understand whether there were indicators of more systemic issues being present for which provisions or disclosures may have needed to be made in the financial statements;

• we read the Group and Company's correspondence with</td></tr>
</table>

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF SCOTTISH WIDOWS LIMITED (continued)

Key audit matter	How our audit addressed the key audit matter
	the Financial Conduct Authority and Prudential Regulation Authority. We met on a trilateral basis with the Financial Conduct Authority (at a Lloyds Banking Group level), Prudential Regulation Authority and the Chair of the Audit Committee. We also met on a bilateral basis with the Prudential Regulation Authority; • we read the minutes of key governance meetings including those of the Board, and of various management committees, as well as attending the Insurance Audit Committee; • we also understood the key activities of the Conduct and Compliance function to evaluate how risks are escalated and addressed by management; and • we have used knowledge of the insurance industry to ensure that management are evaluating risks and potential provisions consistently with others in the sector. No additional material conduct issues that would require financial statement disclosure or provision were identified as a result of the audit work performed. We performed the following procedures around the measurement of provisions recognised: • Challenged the assumptions set by management and used within the provision to supporting evidence, including regulatory communications; • assessed the assumptions used, including against a range of possible factors identified by management, and discussed with lawyers where appropriate; • compared future expectations with past experience; and • assessed the sensitivities disclosed within the Annual Report and Financial Statements. We are satisfied that the models and assumptions used are appropriate for a best estimate provision for year-end reporting within a reasonable range, given current evidence available at this time.
Valuation of illiquid financial instruments - Group and Company The Group and Company continue to expand their significant portfolio of illiquid investment securities, which require specific judgements to form the valuation. The majority of these assets have been originated within the wider Lloyds Banking Group and subsequently purchased by the Group and Company. The portfolio includes infrastructure, social housing, education and commercial real estate loans, equity release mortgages, and agricultural loans. The determination of the illiquid asset valuations remains a highly judgemental area which is a significant risk area due to the magnitude and the complexity of the valuation models used and requires the use of judgement by the Directors and/or the involvement of valuation experts. Valuations also require the use of judgement over the discount rates applied to the future contractual cash flows, particularly in respect of the credit risk of the borrowers.	We used our valuations experts to review the valuation models used to value each of these asset types. This included: • an assessment of the appropriateness of the valuation methodologies; • a review of the application of the approved valuation methodologies in the valuation models used; and • an assessment of the reasonableness of the fair value of the assets, with reference to market information. Our audit work in respect of the valuation of infrastructure, social housing, education, commercial real estate and agricultural loans included evaluating the assumptions over the credit risk of the borrowers used in formulating the discount rate for the future cash flows against our own expectations for similar borrowers. Our audit work in respect of the valuation of equity release mortgages included evaluating the assumptions over mortality and notional interest rates used in formulating the discount rate for the future cash flows against our own expectations. We determined that the assumptions used, and the resultant valuations of the complex financial instruments were within ranges that we consider to be acceptable.

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF SCOTTISH WIDOWS LIMITED (continued)

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the Group and the Company, the accounting processes and controls, and the industry in which they operate.

The Group is structured as one main life insurance company (Scottish Widows Limited), the Company, and 22 smaller subsidiary entities including the main service entity (Scottish Widows Services Limited) and a company that acts as the Authorised Corporate Director for the management of individual savings accounts (ISAs) and Open Ended Investment Company (OEIC) sub-funds (Scottish Widows Unit Trust Managers Limited). The financial statements are a consolidation of these reporting units.

Any components which were considered individually financially significant in the context of the Group's consolidated financial statements were considered full scope components. We then considered the individual financial significance of other components in relation to primary statement account balances. In doing this we also considered the presence of any significant audit risks and other qualitative factors (including history of misstatements through fraud or error). Any component which was not already included as a full scope audit component but was identified as being individually financially significant in respect of one of more primary statement account balances was subject to specific audit procedures over those account balances.

Inconsequential components (defined as components which did not represent a reasonable possibility of a risk of material misstatement either individually or in aggregate and are also financially insignificant) were eliminated from further consideration for specific audit procedures although they were subject to group level analytical review procedures.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the Group and Company financial statements as a whole as follows:

Overall materiality*	£58.6 million (Group); £55.7 million (Company)
How we determined it	1% of average net assets over the last 3 years.
Rationale for benchmark applied	We believe that net assets is the most appropriate benchmark for company and group materiality because the management of Scottish Widows Limited group is focused on managing capital held under Solvency II reporting; capital management to release internal dividends up to Lloyds Bank plc; the value of funds under management; and the liquidity of the business and its ability to meet the daily requirements of its policyholders, making net assets the most appropriate measure given it is akin to solvency. In order to smooth the impact of market movements impacting assets and variations in the annual level of capital distributions to Lloyds Bank plc, we will take an average of net assets over the last 3 years to better reflect the underlying position of the Group and Company. Company materiality has been capped at £55.7 million to reflect its allocation of materiality for the purpose of the Group audit.

* Movements in unit linked assets (£102.1 billion at 31 December 2017) have an equal and opposite movement in unit linked liabilities and therefore a specific materiality can be applied for any unit linked balance sheet risk. We have determined the unit linked materiality on a benchmark of 0.5% of total unit linked assets for the Group (£510.5 million).

For each component in the scope of our group audit, we allocated a materiality that is less than our overall group materiality. The range of materiality allocated across components was between £13 million and £81 million. Certain components were audited to a local statutory audit materiality that was also less than our overall group materiality.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £3.2 million (Group and Company) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF SCOTTISH WIDOWS LIMITED (continued)

Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which ISAs (UK) require us to report to you when:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the Group's and Company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's and Company's ability to continue as a going concern.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic Report and Directors' Report, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, ISAs (UK) require us also to report certain opinions and matters as described below.

Strategic Report and Directors' Report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Directors' Report for the year ended 31 December 2017 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the Group and Company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Directors' Report.

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of Directors' Responsibilities set out on pages 10-11, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the Company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or the Company or to cease operations, or have no realistic alternative but to do so.

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF SCOTTISH WIDOWS LIMITED (continued)

Auditors' responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report

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.

Other required reporting

Companies Act 2006 exception reporting

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 by the Company, or returns adequate for our audit have not been received from branches not visited by us; or
- certain disclosures of directors' remuneration specified by law are not made; or
- the Company financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the Audit Committee, we were appointed by the directors on 12 January 2009 to audit the financial statements for the year ended 31 December 2009 and subsequent financial periods. The period of total uninterrupted engagement is 9 years, covering the years ended 31 December 2009 to 31 December 2017.

~~Stephanie Bruce (Senior Statutory Auditor)~~
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
22 March 2018

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2017

	Note	2017 £m	2016 £m
		Group	*Group*
Revenue			
Gross earned premiums	3	7,358	7,381
Premiums ceded to reinsurers		(167)	(148)
Premiums net of reinsurance		7,191	7,233
Fee and commission income	4	291	323
Investment income	5	3,842	3,797
Net gains on assets and liabilities at fair value through profit or loss	6	6,771	12,718
Other operating income	7	97	82
Total revenue		18,192	24,153
Expenses			
Gross claims and benefits paid		(8,871)	(8,646)
Claims recoveries from reinsurers		153	125
		(8,718)	(8,521)
Change in liabilities arising from insurance contracts and participating investment contracts	24	(9,135)	(14,115)
Change in liabilities arising from non-participating investment contracts		2,830	704
Change in assets arising from reinsurance contracts held	18	939	1,602
Change in unallocated surplus	25	(152)	60
		(5,518)	(11,749)
Net profit attributable to external interests in collective investment vehicles		(1,433)	(2,023)
Operating expenses	8	(1,066)	(1,399)
Expenses for asset management services received		(203)	(123)
Finance costs	10	(80)	(79)
		(2,782)	(3,624)
Total expenses		(17,018)	(23,894)
Profit before tax – continuing operations		1,174	259
Taxation charge	11	(222)	(150)
Profit after tax – continuing operations		952	109
(Loss)/profit after tax – discontinued operations	43	(53)	64
Profit for the year		899	173
Other comprehensive income / (expense)			
Items that will not subsequently be reclassified to profit or loss			
Remeasurements of retirement benefit obligations, net of tax due to discontinued operations	11(c)	53	(62)
		53	(62)
Items that may subsequently be reclassified to profit or loss			
Currency translation differences		6	15
		6	15
Other comprehensive income / (expense), net of tax		59	(47)
Total comprehensive income for the year		958	126
Total comprehensive income arising from continuing operations		958	124
Total comprehensive income arising from discontinued operations		-	2
Total comprehensive income for the year		958	126

The notes set out on pages 23 to 107 are an integral part of these financial statements.

BALANCE SHEETS AS AT 31 DECEMBER 2017

	Note	31 December 2017 £m Group	31 December 2017 £m Company	31 December 2016 £m Group	31 December 2016 £m Company
ASSETS					
Intangible assets including insurance intangible assets	12	69	69	241	81
Deferred costs	13	1,656	1,637	1,689	1,672
Deferred tax assets	14	-	-	94	45
Investment in subsidiaries	15	-	392	-	428
Tangible fixed assets	16	13	-	15	-
Investment properties	17	3,640	189	3,643	178
Assets arising from reinsurance contracts held	18	8,377	8,377	7,387	7,387
Prepayments		39	27	63	26
Derivative financial instruments	19	3,465	3,424	3,800	3,719
Loans and receivables	20	4,037	2,868	6,227	5,162
Assets classified as held for sale	43	702	14	-	-
Investments at fair value through profit or loss	21	123,377	113,441	118,303	108,330
Cash and cash equivalents	22	1,932	1,063	2,207	1,291
Total assets		147,307	131,501	143,669	128,319
EQUITY AND LIABILITIES					
Capital and reserves attributable to the Group's equity shareholder					
Share capital	23	70	70	70	70
Share premium		1	1	1	1
Retained profits		4,682	4,837	6,265	6,398
Total equity		4,753	4,908	6,336	6,469
Liabilities					
Insurance contracts and participating investment contract liabilities	24	102,916	102,916	93,799	93,799
Unallocated surplus	25	380	380	228	228
		103,296	103,296	94,027	94,027
Future profits on non-participating business in the With Profits Funds	26	(43)	(43)	(47)	(47)
Current tax liabilities	14	174	154	66	48
Deferred tax liabilities	14	355	355	440	440
Provisions for other liabilities and charges	27	227	225	267	258
Accruals and deferred income	29	49	30	139	26
Subordinated debt	30	1,795	1,836	1,819	1,848
Non-participating investment contract liabilities	31	15,447	15,447	20,112	20,112
Derivative financial instruments	19	3,147	3,058	3,008	2,930
Other financial liabilities	32	3,005	2,233	3,153	2,204
External interests in collective investment vehicles		14,485	-	14,207	-
Borrowings	33	10	2	12	4
Retirement benefit obligations	28(a)	-	-	130	-
Liabilities directly associated with assets classified as held for sale	43	607	-	-	-
Total liabilities		142,554	126,593	137,333	121,850
Total equity and liabilities		147,307	131,501	143,669	128,319

The notes set out on pages 23 to 107 are an integral part of these financial statements.

The financial statements on pages 19 to 107 were approved by the Board on 22 March 2018.

M Harris
Director

STATEMENTS OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2017

	Note	2017 £m Group	2017 £m Company	2016 £m Group	2016 £m Company
Cash flows from operating activities					
Profit before tax[1]		1,110	1,127	346	138
Adjusted for:					
Depreciation of tangible fixed assets	16	1	-	1	-
Amortisation of intangible assets	12	48	12	50	14
Finance costs	10	80	79	79	81
Impairment in investment in subsidiary	15	-	22	-	-
Dividends received		-	(113)	-	(25)
Net decrease / (increase) in operating assets and liabilities	34	1,334	1,235	(5,761)	480
Retirement benefit obligations	28	67	-	(77)	-
Impact of the Insurance Business Transfer Scheme		22	13	-	-
Currency translation differences		6	-	15	9
Taxation (paid) / received		(153)	(72)	(106)	20
Net cash flows generated from / (used in) operating activities		2,515	2,303	(5,453)	717
Cash flows from investing activities					
Addition of intangible assets	12	(46)	-	(49)	-
Dividends received		-	113	-	25
Net cash flows (used in) / generated from investing activities		(46)	113	(49)	25
Cash flows from financing activities					
Dividends paid	35	(2,563)	(2,563)	(250)	(250)
Finance costs paid	10	(80)	(79)	(79)	(81)
Net cash flows used in financing activities		(2,643)	(2,642)	(329)	(331)
Net (decrease) / increase in cash and cash equivalents		(174)	(226)	(5,831)	411
Cash and cash equivalents at the beginning of the year		2,195	1,287	8,026	876
Net cash and cash equivalents at the end of the year[2]	22	2,021	1,061	2,195	1,287

[1] Group profit before tax comprises £1,174m in respect of continuing operations and a group loss before tax of £(64)m in respect of discontinued operations (2016: Group profit before tax of £259m in respect of continuing operations and £81m in respect of discontinued operations).

[2] Group net cash and cash equivalents at the end of the year comprises £1,922m in respect of continuing operations and £99m in respect of discontinued operations (2016: Group cash and cash equivalents of £1,916m in respect of continuing operations and £279m in respect of discontinued operations).

The notes set out on pages 23 to 107 are an integral part of these financial statements.

Discontinued operations

The impact of the Group's discontinued operations on the above cash flow statement is as follows:

	2017 £m Group	2016 £m Group
Net cash flows (used in) / generated from operating activities	(134)	17
Net cash flows used in investing activities	(46)	(49)
Net decrease in cash and cash equivalents	(180)	(32)

STATEMENTS OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2017

Group

	Share capital £m	Share premium £m	Retained profits £m	Total equity £m
Balance as at 1 January 2016	70	1	6,414	6,485
Profit for the year	-	-	173	173
Other comprehensive income				
Remeasurement of retirement benefit obligations/assets, net of tax due to discontinued operations	-	-	(62)	(62)
Currency translation	-	-	15	15
Total comprehensive income for the year	-	-	126	126
Fair value movement	-	-	(25)	(25)
Dividend	-	-	(250)	(250)
Balance as at 31 December 2016	70	1	6,265	6,336
Profit for the year	-	-	899	899
Other comprehensive income				
Remeasurement of retirement benefit obligations/assets, net of tax due to discontinued operations	-	-	53	53
Currency translation	-	-	6	6
Total comprehensive income for the year	-	-	958	958
Impact of the Insurance Business Transfer Scheme	-	-	22	22
Dividend	-	-	(2,563)	(2,563)
Balance as at 31 December 2017	70	1	4,682	4,753

Company

	Share capital £m	Share premium £m	Retained profits £m	Total equity £m
Balance as at 1 January 2016	70	1	6,573	6,644
Profit for the year	-	-	66	66
Other comprehensive income for the year	-	-	9	9
Dividend	-	-	(250)	(250)
Balance as at 31 December 2016	70	1	6,398	6,469
Total comprehensive income for the year	-	-	989	989
Impact of the Insurance Business Transfer Scheme	-	-	13	13
Dividend	-	-	(2,563)	(2,563)
Balance as at 31 December 2017	70	1	4,837	4,908

Not all of the above amounts can be distributed to the equity holder since the Company is required to meet regulatory capital requirements. Further details are given in note 37.

The notes set out on pages 23 to 107 are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

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 Group and Company have been prepared:

(1) in accordance with the International Accounting Standards ("IASs") and IFRSs issued by the International Accounting Standards Board and the Standards and Interpretations ("SICs") and International Financial Reporting Interpretations issued by its IFRS Interpretations Committee ("IFRS IC"), 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 Group's and Company's With Profits Funds liabilities, in accordance with Financial Reporting Standard ("FRS") 103 "Insurance Contracts" 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 Group and Company have adequate resources to continue in business for the foreseeable future. Accordingly, the financial statements of the Group and 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 Group and 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 Group has taken advantage of the provisions of section 408 of the Companies Act 2006 and has not disclosed a statement of comprehensive income and related notes in respect of the Company.

Standards and interpretations effective in 2017

The Group has adopted the following amendments to standards which became effective for the reporting period commencing 1 January 2017; "Recognition of Deferred Tax Assets for Unrealised Losses – Amendments to IAS 12", and "Disclosure initiative – amendments to IAS 7".

The amendments to IAS 7 require disclosure of changes in liabilities arising from financing activities. These disclosures are included in Note 30. No comparative information is required in the year the amendments are first applied.

Details of standards and interpretations in issue but which have not been adopted early are set out at note 41.

(b) Basis of consolidation

The assets, liabilities and results of Group undertakings (including structured entities) are included on the basis of financial statements made up to the reporting date. Group undertakings include all entities controlled by the Group. The Group controls an entity when it has power over the entity, is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through the exercise of power. This generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of substantive rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity and the Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to any of these elements.

Collective investment vehicles and limited partnerships ("investment vehicles") where the Group has control, in part through its long-term funds, are consolidated. Control arises where the Group has substantive rights to remove the external decision maker of the investment vehicle, and has a significant exposure to variable returns from the beneficial interest it holds in the investment vehicle. Where a subsidiary or related party of the Group acts as the decision maker of an investment vehicle the Group considers a number of factors in determining whether it acts as principal and therefore controls the investment vehicle including: an assessment of the scope of the Group's decision making authority over the investment vehicle; the rights held by other parties including substantive removal rights without cause over the Group acting as decision maker; the remuneration to which the Group is entitled in its capacity as decision maker; and the Group's exposure to variable returns from the beneficial interest it holds in the investment vehicle.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(b) Basis of consolidation (continued)

Consolidation can be appropriate in circumstances where the Group has less than a majority beneficial interest. Where a collective investment vehicle is consolidated the interest of parties other than the Group are reported within liabilities as external interests in collective investment vehicles. Where a limited partnership is consolidated the non-controlling interest is reported in equity. Group undertakings are fully consolidated from the date on which the ability to exercise control is transferred to the Group and cease to be consolidated from the date on which the ability to exercise control ceases.

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Changes in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary is derecognised and any investment retained in the former subsidiary is remeasured to its fair value; the gain or loss that is recognised in profit or loss on the partial disposal of the subsidiary includes the gain or loss on the remeasurement of the retained interest.

Intragroup transactions, balances and gains and losses on transactions between Group companies have been eliminated.

All the financial statements included are uniformly prepared in conformity with IFRSs and the Group's accounting policies and have adopted consistent accounting policies as at 31 December 2017.

(c) Product classification

The Group 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 Group 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 Group 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 Group's shareholder. Participating investment contracts are accounted for in the same manner as insurance contracts in accordance with the requirements of IFRS 4 "Insurance Contracts".

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

Hybrid contracts

For certain investment contracts within Scottish Widows heritage, the contract can be partly invested in units which contain a DPF and partly in units without. Where switching levels for similar contracts are deemed to be significant, new investment contracts which contain an option to switch into investment contracts with DPF have been classified as participating investment contracts. Where the switching levels are not deemed to be significant, a new contract is split, with units containing a DPF being allocated as a participating investment contract and the units without a DPF as a non-participating investment contract. Investment contracts which were in force when IFRS was implemented in 2005 were classified according to the switching levels observed at the time and retain their original classification. For certain investment contracts, the contract can be partly invested in units which contain a DPF and partly without. Where the contract is split, part is allocated as a non-participating investment contract and part as a participating investment contract.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(d) Financial assets and financial liabilities

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

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group 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 debt, other financial liabilities and borrowings, which are stated at amortised cost (as described in policies (q), (z), (ac) and (ae) respectively). 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 Group's key management. The Group's investment strategy is to invest in equity and debt securities, loans, investment property, derivatives and cash and to evaluate the Group's investments with reference to their fair values. For further details on the Group's fair value methodology see policy (e).

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.

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, both in the normal course of business and in the event of default, and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously.

(e) 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 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. **Accounting policies (continued)**

(e) **Fair value methodology (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 Group considers that market participants would use in pricing the asset or liability, for example private equity investments held by the Group and 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 Group's and Company's instruments held at fair value is set out at note 37. The Group's management, through a fair value pricing committee, review information on the fair value of the Group's financial assets and financial liabilities and the sensitivities to these values on a regular basis.

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.

(f) **Revenue recognition**

Premiums

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

The Group 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 Group 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 Group 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.

Investment income

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

Dividends receivable in respect of listed shares and collective investment vehicles are recognised on the date that these are quoted ex-dividend; other dividend income is recognised when the right to receive the dividend is established. 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 costs 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(f) Revenue recognition (continued)

Other operating income

Other income recognised in the statement of comprehensive income comprises recharges of costs incurred in respect of several LBG subsidiaries which are not consolidated in these financial statements. Income is recognised as the related expenses are incurred.

Within other operating income are rebates of annual management charges from external fund managers. The annual management charges are taken directly from the external investment funds and therefore not reported within Expenses for asset management services received. Rebates are recognised when they are earned.

(g) Accruals and deferred income

For non-participating investment contracts, the recognition of income is governed by IAS 18. Income received for services to be provided in future periods is deferred and recognised in the statement of comprehensive income as the service is provided. As above, 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. Further information on this liability is given in note 31.

(h) 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 Group 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 (k).

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.

(i) 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.

(j) Intangible assets including insurance intangible assets

(i) Acquired value of in-force business

Insurance and investment contracts acquired in business combinations (other than business combinations falling within policy (ah)) 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(j) Intangible assets including insurance intangible assets (continued)

(i) Acquired value of in-force business (continued)

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 Group's impairment policy is set out at policy (t)). Such an asset is not recognised in respect of future profits on contracts written in the normal course of business.

(ii) Software development costs

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

Computer software development costs recognised as assets are valued at cost and amortised using the straight-line method over their expected useful lives, not exceeding a period of seven years. Subsequent expenditure is only capitalised when it increases the expected future economic benefits of the specific asset to which it relates. The amortisation charge for the year in respect of software licences and software development costs is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the assets is tested for impairment at each reporting date. Further information on the Group's impairment policy is set out at policy (t).

(k) 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 103), 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 Group's impairment policy is set out at policy (t).

(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 Group's impairment policy is set out at policy (t).

(l) Investment in subsidiaries

The Company owns a number of subsidiaries as set out in note 15. Certain subsidiaries do not form part of actively managed investment portfolios and the risks and rewards of owning those subsidiaries primarily rest with the shareholder of the Company, including such investments where ownership of the subsidiary is split between the Company's long-term fund and its shareholder fund. These 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 Group's impairment policy is set out at policy (t).

Certain subsidiaries, including holdings in collective investment vehicles, are held primarily as vehicles through which specific investments are held as part of the actively managed investment portfolios. These subsidiaries hold assets which are designated at fair value through profit or loss in accordance with IAS 39 "Financial Instruments: Recognition and Measurement" and primarily match policyholder liabilities. Accordingly, subsidiaries which are managed as part of policyholder investment funds are carried at fair value and presented within investments at fair value through profit or loss in the Company (see policy r).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(l) Investment in subsidiaries (continued)

Changes in their fair value are reflected in the statement of comprehensive income, within net gains and losses on assets and liabilities at fair value through profit or loss.

(m) Tangible fixed assets

All property (other than investment property) and equipment is stated at cost less accumulated depreciation and any impairment in value. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for its intended use. Subsequent costs are included in an asset's carrying value only when it is probable that future economic benefits related to the asset will flow to the Group and such costs can be measured reliably.

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

The periods generally applicable are:

• Buildings	40 years
• Fixtures and fittings	15 years
• Computer equipment	3 years
• Other equipment	5 years
• Furnishings	10 years

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

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

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than the recoverable amount, it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

(n) 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, being the open market value, as assessed by qualified external appraisers who have recent experience in the relevant location and the category of properties being valued. If this information is not available, alternative valuation methods such as discounted cash flow analysis or recent prices 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.

Service charge income and expense are disclosed separately within the relevant note.

(o) Assets arising from reinsurance contracts held

The Group 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 a financial asset 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 Group's impairment policy is set out at policy (t).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(o) Assets arising from reinsurance contracts held (continued)

Assets arising from reinsurance contracts held – classified as insurance contracts (continued)

Changes in these assets are recognised on the face of the statement of comprehensive income, through change in assets arising from reinsurance contracts held.

Premiums ceded and claims reimbursed are recognised when corresponding insurance premium assumed and claims incurred. These items are disclosed separately on the face of the statement of comprehensive income.

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. Further information on the Group's impairment policy is set out at policy (t).

(p) 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 re-measured at their fair value.

Measurement

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

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

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

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 ask price at close of business.

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

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(p) Derivative financial instruments (continued)

Hedge accounting (continued)

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 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 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 19.

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

(q) 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 Group 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 Group's impairment policy is set out at policy (t).

(r) Investments at fair value through profit or loss

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

Classification

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

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

Recognition

Purchases and sales of financial assets are recognised on the trade date, i.e. the date the Group 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 Group 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 security 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.

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.

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.

Structured entities

The Group invests in structured entities arising from investments in investment properties held through limited partnerships. Some of these limited partnerships are consolidated, as set out at policy (b). The unconsolidated limited partnerships 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 Group holds investments in structured entities arising from investments in collective investment vehicles, carried at fair value. Some of these structured entities are consolidated, as set out at policy (b). Unconsolidated collective investment vehicles are carried at fair value.

(s) *Cash and cash equivalents*

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(t) 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 that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date.

Impairment process

Objective evidence that an asset or group of assets is impaired includes observable data that comes to the attention of the Group and 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 Group or Company, including:

- adverse changes in the payment status of issuers or receivables; or
- national or local economic conditions that correlate with defaults on the assets in the Group or Company.

The Group first assesses whether objective evidence of impairment exists individually for assets that are individually significant. If the Group 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.

(u) 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(u) Taxes (continued)

Deferred tax

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

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

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

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.

(v) 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.

(w) Insurance contracts and participating investment contracts

The Group 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 Group's With Profits Funds

Liabilities of the Group'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 103. Projected transfers out of the funds into other funds of the Group 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 change in liabilities in insurance contracts and participating investment contract liabilities.

Liabilities for non-participating insurance contracts in the Group's With Profits Funds are measured using an assessment that uses the pre Solvency II traditional regulatory assessment. In addition, the realistic value of future profits on those contracts is recognised as an offset to the corresponding liabilities in the balance sheet, as future profits on non-participating business in the With Profits Funds. The movement in this balance is recognised in the statement of comprehensive income, through change in liabilities arising from insurance contracts and participating investment contracts.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(w) Insurance contracts and participating investment contracts (continued)

Insurance contracts which are neither unit-linked nor in the Group's With Profits Funds

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 change arising from 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. Non-unit reserves are also established for expected future expenses not covered by future margins, inadequacy of benefit charges to cover benefit claims, and inadequacy of guarantee charges to cover guarantees. 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 liabilities arising from insurance contracts and participating investment contracts. 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 Funds not yet determined as being due to policyholders or the equity holder and projected transfers out of the funds to other funds of the Group are recognised as an unallocated surplus which is shown separately from the other insurance liabilities.

Bonuses

Bonuses 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 liabilities arising from insurance and participating investment contracts;
- Terminal and interim bonuses paid out to policyholders on maturity and included within gross claims and benefits paid.

(x) Retirement benefit obligations

Scottish Widows Services Limited assumes the role of principal employer for the Scottish Widows Retirement Benefit Scheme ("SWRBS") pension scheme within the Group. Individuals employed by the Group may be members of the SWRBS or of other pension schemes administered by LBG. All schemes are funded through payments to trustee-administered funds, determined, in the case of the defined benefit arrangements, by periodic actuarial calculations.

The Group contributes to both defined benefit and defined contribution elements of the pension schemes in question. A defined benefit plan is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and pensionable salary. A defined contribution plan is a pension plan under which the Group pays fixed contributions; there is no legal or constructive obligation to provide a specific benefit outcome.

Scottish Widows Retirement Benefit Scheme

A full actuarial valuation of this defined benefit scheme is carried out at least every three years with interim reviews in the intervening years; the valuation is updated to 31 December each year by a qualified actuary. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method by an independent, qualified actuary appointed by LBG.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(x) Retirement benefit obligations (continued)

Scottish Widows Retirement Benefit Scheme (continued)

The amount recognised in the balance sheet in respect of the defined benefit element of the pension scheme is the present value of the defined benefit obligation at the reporting date less the fair value of plan assets. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates equivalent to the market yields at the reporting date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid and that have terms to maturity that are approximate to the terms of the related pension asset/liability.

A surplus is only recognised to the extent that it is recoverable through a right to make reduced contributions in the future or to receive a refund from the scheme. The Group recognises any change in the effect of the surplus that can be recognised in other comprehensive income within remeasurements of the retirement benefit asset.

The Group recognises in profit or loss the current service cost of providing pension benefits and the net interest on the net defined benefit obligation. The current service cost is recognised within operating expenses.

The net interest on the net defined benefit obligation is recognised within finance costs, and is determined by applying the discount rate used to measure the net defined benefit obligation at the beginning of the period to the net defined benefit obligation at that date, taking account of changes in the net defined benefit obligation during the period as a result of contributions and benefit payments.

Past service costs are changes in the defined benefit obligation arising from plan amendments or curtailments and are recognised immediately in profit or loss, within operating expenses, when the plan amendment or curtailment occurs. The Group recognises the gain or loss on a settlement of the defined benefit obligation immediately in profit or loss when the settlement occurs.

The Group recognises in other comprehensive income, within remeasurements of the retirement benefit obligations, actuarial gains and losses arising from experience adjustments and changes in the actuarial assumptions, and the return on plan assets excluding the net interest on the net defined benefit obligation that is recognised in profit or loss.

Defined contribution schemes

Contributions made by the Group to defined contribution arrangements, including Your Tomorrow, are recognised in the statement of comprehensive income as an employee benefit expense when they are due, within operating expenses.

(y) Provisions for other liabilities and charges

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

The Group 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.

(z) Subordinated debt

Subordinated debt comprises dated and undated loan capital. They are recognised initially at fair value, being the issue proceeds net of transaction costs incurred. Subordinated debt is 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 debt is adjusted for hedged interest rate risk. Changes in the resulting value of this subordinated debt is accounted for as set out at policy (r). 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(aa) Non-participating investment contracts

The Group'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 Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the reporting date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable. Investment income allocated to non-participating investment contracts is presented within investment income, with corresponding movements being 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 liability arising from non-participating investment contracts.

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.

(ab) Liability adequacy test

At each reporting date, liability adequacy tests are performed to ensure the adequacy of the insurance contracts and participating investment contract liabilities net of related deferred costs and acquired VIF. 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.

(ac) 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.

(ad) External interests in collective investment vehicles

External interests in collective investment vehicles which are accounted for by the Group as investments in subsidiaries as set out at policy (l) above are initially recognised, and subsequently stated, at fair value. The fair value of holdings in these funds is determined at the valuation point applicable to the collective investment vehicles at the reporting date as set out under policy (r) above. Changes in the fair value of this balance are recognised in the statement of comprehensive income, through net profit attributable to external interests in collective investment vehicles.

(ae) 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.

(af) Foreign currency translation

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

Monetary items denominated in foreign currencies are translated into sterling at the exchange rates ruling at the reporting date. Non-monetary items denominated in foreign currencies that are measured at fair value are translated at the exchange rates ruling at the date when the current fair value is determined. Non-monetary items denominated in foreign currencies that are measured at historical cost are translated at the exchange rates ruling at the date of the transaction. Revenue transactions and those relating to the acquisition and realisation of investments have been translated at 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 Group's foreign operations that have a functional currency different from the presentational currency are translated into sterling at foreign exchange rates ruling at the balance sheet date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. Accounting policies (continued)

(af) Foreign currency translation (continued)

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.

(ag) Collateral

The Group receives or pledges collateral in the form of cash or securities in respect of derivative transactions it undertakes. The Group 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 Group. A corresponding liability for repayment of collateral is recognised in financial liabilities. Collateral received that is not recognised on the balance sheet is legally segregated from the assets of the Group. 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.

(ah) Discontinued operations

Non-current assets are classified as held for sale if the Group will recover the carrying amount principally through a sale transaction rather than through continuing use and a sale is considered highly probable. Non-current assets classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. Assets and liabilities classified as held for sale are shown separately on the face of the balance sheet.

A discontinued operation is a cash generating unit or a group of cash generating units that has been disposed of or is classified as held for sale, and (a) represents a separate major line of business or geographical area of operations, (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or (c) is a subsidiary acquired exclusively with a view to resale. The results after tax of discontinued operations are shown as a single line item on the face of the statement of comprehensive income. The prior year comparatives in the statement of comprehensive income and related notes have also been restated to reflect the impact of this change. See note 43 for further detail.

In order to fairly reflect the results and financial position of the Group's continuing operations and its discontinued operations, transactions that the continuing operations have with the discontinued operations are reported on the relevant line in the Group's statement of comprehensive income or balance sheet, with the matching transaction similarly reported in the discontinued operations statement of comprehensive income or balance sheet within the disposal entity. All such transactions fully eliminate within the Group's statutory consolidation and there is no net impact on profit before tax or equity.

2. Critical accounting estimates and judgments in applying accounting policies

The Group'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.

Critical accounting estimates

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

(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 Group's most critical accounting estimate.

In accordance with FRS 103, the liabilities of the Group's With Profits Funds are calculated using stochastic simulation models which value liabilities on a basis consistent with tradable market option contracts (a "market-consistent" basis). The liabilities are sensitive to both investment market conditions and changes to a number of non-economic assumptions, such as the level of take-up of options inherent in the contracts, mortality rates and lapses prior to dates at which a guarantee would apply.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

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

(a) Insurance contracts and participating investment contract liabilities (continued)

For insurance contracts outside the With Profits Funds, 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 for annuity business are set with reference to the risk adjusted yields on the underlying assets and for non-annuity business with reference to cash yields. 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 of the With Profits Funds 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 36.

Sensitivities regarding changes to key assumptions in calculating liabilities arising from insurance contracts and participating investment contracts are also given in note 36.

(b) Intangible assets including insurance intangible assets

Acquired value of in-force business

Following the acquisition of General Life Assurance Society by Clerical Medical in 1996, the Group holds an asset representing the acquired VIF.

The asset arising on the acquisition was calculated by projecting the future surpluses and other cash flows attributable 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 this balance 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 12.

(c) Deferred costs

For insurance contracts and participating investment contracts (excluding those assessed on a realistic basis in accordance with FRS 103) acquisition costs which are incurred during a financial period but which relate to subsequent financial periods are deferred to the extent that they are recoverable out of future revenue margins. All other costs are recognised as expenses when incurred. The calculation of the deferred acquisition cost asset and its pattern of amortisation requires estimation of both the expected pattern of receipt of future revenue margins and the period that the business is expected to remain in force. Further information on this asset is given in note 13.

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

(d) Retirement benefit obligations

The majority of the Group's employees are members of the SWRBS, although some employees are members of certain LBG Schemes. All schemes provide defined benefits and/or defined contribution benefits to the members of those schemes.

The risks associated with the LBG Schemes are shared among various entities under common control of LBG. The service company, which is consolidated into the Group, holds a defined benefit obligation which represents 100% of the SWRBS pension scheme due to the service company being principal employer and scheme guarantor. Further information on these liabilities including associated estimates and sensitivities is given in note 28.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

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

(e) Fair value of financial instruments

In accordance with IFRS 7, the Group 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 judgment 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 judgment 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 37.

(f) Provisions for other liabilities and charges

The Group continues to receive claims in Germany from customers relating to policies issued by the Company, under its former name of Clerical Medical Investment Group Limited but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s.

The German industry-wide issue regarding notification of contractual 'cooling off' periods has continued to lead to a similar number of claims in 2017 as 2016. The total provision made to 31 December 2017 is £639m (2016: £639m); Settlement experience has improved and therefore only £30m was utilised in the year ended 31 December 2017 (2016: £50m), the remaining unutilised provision as at 31 December 2017 is £138m (2016: £168m).

The validity of the claims facing the Group 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 27.

Critical judgments

The Directors use judgment in the process of applying the Group's accounting policies. The following judgements have the most significant effect on the amounts recognised in the consolidated financial statements.

(g) Taxation

The Group 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 any tax issues that are subject to ongoing discussion with HM Revenue and Customs and other tax authorities. With regard to the Group's and Company's deferred tax assets, a significant feature is the management judgment applied in determining the timing, sensitivities and probability of them crystallising. This judgment is based on tax forecasts reflecting new business assumptions, sensitivities and proposed management actions. Further information in relation to the Group's and Company's current and deferred tax assets is set out in notes 11 and 14.

3. Segmental analysis

In the opinion of the Directors, the Group operates in a single business segment, being the provision of long-term insurance and investment contracts, and therefore the following specific disclosure requirements under IFRS 8 "Operating Segments" are required. The table below provides a summary of the gross premiums written within the single business segment:

Group	2017 £m	2016 £m
Regular premiums	2,935	2,962
Single premiums	4,423	4,419
Total	7,358	7,381

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

3. Segmental analysis (continued)

Further, a summary of the gross premiums written by the segment's main product types is shown below

Group	2017 £m	2016 £m
Bulk Annuities	644	1,477
Corporate pensions	3,497	3,147
Individual pensions	426	445
Retirement income	508	565
Protection	429	479
Investments	246	212
Retirement account	1,608	1,075
Reduction in premiums from reinsurance recapture	-	(19)
Total	7,358	7,381

Of the above gross written premiums, £126m (2016: £130m) relates to the European business with the remaining written in the UK.

4. Fee and commission income

Group	2017 £m	2016 £m
Fund management and policy administration fees	283	308
Change in deferred income	8	15
Total	291	323

5. Investment income

Group	2017 £m	2016 £m
Net income on investments designated at fair value through profit or loss	3,579	3,446
Financial instruments at amortised cost		
Interest income on LBG group loans	33	51
Rental income on investment properties	204	219
Service charge income	14	19
Foreign currency translation differences	(5)	44
Other	17	18
Total	3,842	3,797

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

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

Group	2017 £m	2016 £m
Derivative financial instruments at fair value through profit or loss	25	501
Investments designated at fair value through profit or loss	6,350	12,388
Investment properties at fair value through profit or loss	232	(89)
Fair value hedge adjustment in respect of swap	17	(154)
Foreign exchange	147	72
Total	6,771	12,718

7. Other operating income

Included within the Group is a service company which incurs costs on behalf of several subsidiary undertakings of LBG which are not consolidated into these financial statements. This service company is now shown within assets classified as held for sale as a discontinued operation with the prior year comparative restated. See note 43 for further details.

Group	2017 £m	2016 £m
External rebates	77	79
Other	20	3
Total	97	82

8. Operating expenses

Group	2017 £m	2016 £m
Acquisition and origination costs in respect of insurance and investment contracts	148	138
Expenses for administration	737	778
	885	916
Provision in relation to German insurance business litigation	-	94
Fees and commissions payable	117	56
Change in deferred costs	33	77
Service charge expense	15	20
Amortisation of acquired VIF	12	14
Other	4	222
Total	1,066	1,399

All staff costs are reported within a service company that is now shown within assets classified as held for sale as a discontinued operation with the prior year comparative restated. See note 43 for further details.

The following staff and other employee related costs are reported within the service company as operating expenses.

	2017 £m	2016 £m
Wages and salaries	114	121
Share based payments	23	22
Social security costs	17	18
Other pension costs – defined contribution plan	14	15
Service costs – defined benefit plan	22	14
Total	190	190

During the year ended 31 December 2017 and 2016 the Group received charges from Scottish Widows Services Limited ("SWSL") relating to share-based payment schemes, all of which are equity settled.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

8. Operating expenses (continued)

The monthly average number of employees directly employed by the Group is as follows:

	2017	2016
UK	2,506	2,692
Total	2,506	2,692

9. Auditors' remuneration

Group	2017 £000	2016 £000
Fees payable to the Group's auditors for the audit of the Company's annual financial statements and the consolidation	2,745	2,671
Fees payable to the Group's auditor and its associates for other services:		
Audit of subsidiaries	1,011	653
Audit-related assurance services	818	1,684
Tax advisory	-	50
Total fees payable	4,574	5,058

During the year, the audit fee in respect of pension schemes of £34,500 (2016: £46,800) is borne by the Company.

10. Finance costs

Group	2017 £m	2016 £m
Interest on swaps	(23)	(20)
Interest on subordinated debt	96	93
Other	7	6
Total	80	79

11. Taxation charge

(a) Current year tax charge

Group	2017 £m	2016 £m
Current tax:		
UK corporation tax	263	76
Adjustment in respect of prior years	-	3
Total current tax	263	79
Deferred tax:		
(Reversal) / origination of temporary differences	(31)	77
Change in tax rate	(2)	(13)
Adjustment in respect of prior years	(8)	7
Total deferred tax	(41)	71
Total income tax charge	222	150

The policyholder tax benefit or expense is included in the income tax charge. Policyholder tax is a charge of £73m (2016: charge of £191m), including a prior year tax charge of £nil (2016: charge of £nil).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

11. Taxation charge (continued)

(b) Reconciliation of tax charge

Group	2017 £m	2016 £m
Profit before tax	1,174	259
Tax at 19.25% (2016: 20%)	226	52
Effects of:		
Tax exempt income	(53)	(58)
Non-deductible policyholder tax [1]	59	153
Adjustment in respect of prior years	(8)	10
Disallowable expenses	1	2
Change in tax rate	(2)	(13)
Other	(1)	4
Total	222	150

[1] In 2017 this includes a £nil (2016: £122m) write down of the deferred tax asset held within the life business, reflecting the Group's utilisation estimate which has been restricted by the current economic environment.

The Finance (No. 2) Act 2015 reduced the rate of Corporation Tax from 20% to 19% with effect from 1 April 2017 and Finance Act 2016 further reduced the rate of Corporation Tax from 19% to 17% with effect from 1 April 2020. The impact of these reductions in tax rate, which are applicable to the calculation of deferred tax assets and liabilities at the reporting date, are reflected in the above table.

(c) Tax recognised in other comprehensive income / (expense)

Group	2017			2016		
	Before tax £m	**Tax expense £m**	**After tax £m**	**Before tax £m**	**Tax expense £m**	**After tax £m**
Remeasurements of retirement benefit obligations / assets due to discontinued operations	67	(14)	53	(77)	15	(62)
Total	67	(14)	53	(77)	15	(62)

Further analysis of the remeasurements of retirement benefit obligations / assets in the above table is set out in note 28.

12. Intangible assets including insurance intangible assets

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Acquired VIF	69	69	81	81
Software development costs	-	-	160	-
Total	69	69	241	81

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

12. Intangible assets including insurance intangible assets (continued)

Group

	2017 Acquired VIF £m	2017 Software development costs £m	2017 Total £m	2016 Acquired VIF £m	2016 Software development costs £m	2016 Total £m
Cost						
At 1 January	651	282	933	651	307	958
Additions	-	46	46	-	49	49
Disposals/Write-downs of impaired assets	-	(53)	(53)	-	(74)	(74)
Transferred to assets held for sale	-	(275)	(275)	-	-	-
At 31 December	651	-	651	651	282	933
Accumulated amortisation and impairment						
At 1 January	(570)	(122)	(692)	(556)	(157)	(713)
Amortisation during the year	(12)	(36)	(48)	(14)	(36)	(50)
Amortisation on disposals/write-downs of impaired assets	-	51	51	-	71	71
Transferred to assets held for sale	-	107	107	-	-	-
At 31 December	(582)	-	(582)	(570)	(122)	(692)
Carrying amount						
At 31 December	69	-	69	81	160	241

Company

	2017 Acquired VIF £m	2017 Total £m	2016 Acquired VIF £m	2016 Total £m
Cost				
At 1 January	651	651	651	651
At 31 December	651	651	651	651
Accumulated amortisation and impairment				
At 1 January	(570)	(570)	(556)	(556)
Amortisation during the year	(12)	(12)	(14)	(14)
At 31 December	(582)	(582)	(570)	(570)
Carrying amount				
At 31 December	69	69	81	81

Of the above total for acquired VIF, £62m (2016: £69m) is expected to be recovered more than one year after the reporting date. The remaining amortisation period is 10 years (2016: 11 years).

As detailed in note 43, the software development costs have been moved to assets held for sale as part of the transfer of Scottish Widows Services Limited to discontinued operations. Software development costs of £136m (2016: £124m) are expected to be amortised more than one year after the reporting date.

13. Deferred costs

		2017 £m *Group*	2017 £m *Company*	2016 £m *Group*	2016 £m *Company*
Deferred acquisition costs	(a)	1,485	1,485	1,495	1,495
Deferred origination costs	(b)	171	152	194	177
Total		1,656	1,637	1,689	1,672

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

13. Deferred costs (continued)

(a) Deferred acquisition costs

	2017		2016	
	£m	£m	£m	£m
	Group	Company	Group	Company
At 1 January	1,495	1,495	1,513	1,513
Amounts incurred during the year	124	124	119	119
Amortisation during the year	(134)	(134)	(137)	(137)
At 31 December	1,485	1,485	1,495	1,495

Of the above total, £1,349m for Group and Company (2016: £1,365m for Group and Company) is expected to be recovered more than one year after the reporting date.

(b) Deferred origination costs

	2017		2016	
	£m	£m	£m	£m
	Group	Company	Group	Company
At 1 January	194	177	253	228
Amounts incurred during the year	2	1	1	1
Amortisation during the year	(25)	(26)	(60)	(52)
At 31 December	171	152	194	177

Of the above total, £123m for Group and £111m for Company (2016: £155m for Group and £144m for Company) is expected to be recovered more than one year after the reporting date.

14. Tax assets and liabilities

	2017		2016	
	£m	£m	£m	£m
	Group	Company	Group	Company
Deferred tax assets	-	-	94	45
Total tax assets	-	-	94	45
Current tax liabilities	174	154	66	48
Deferred tax liabilities	355	355	440	440
Total tax liabilities	529	509	506	488

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. Of the deferred tax assets included in the above table, £nil for Group and Company (2016: £25m for Group and £22m for Company) is expected to be realised within one year of the reporting date.

Under current tax law there is no expiry date for UK trading losses not yet utilised, although since Finance (No. 2) Act 2017 carried forward losses can only be used against 50 percent of taxable profits arising after 1 April 2017. This restriction in utilisation is not expected to have a material impact on the Group.

Of the deferred tax liabilities included in the above table, £38m for Group and Company (2016: £66m for Group and Company) is expected to be settled within one year of 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 taxes relate to the same fiscal authority.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

14. Tax assets and liabilities (continued)

(a) Recognised deferred tax (continued)

The amounts are as follows:

	2017		2016	
	£m	£m	£m	£m
	Group	Company	Group	Company
Deferred tax assets comprise:				
Trading losses	22	22	43	43
Expenses deductible in future periods	116	116	-	-
Pension and other post retirement obligations	-	-	29	-
Accelerated capital allowances	1	1	22	2
Total deferred tax assets	139	139	94	45
Deferred tax liabilities comprise:				
Unrealised gains on investment assets	116	116	-	-
Deferred acquisition costs	173	173	194	194
Transitional adjustments on introduction of new life tax regime	193	193	231	231
Deferred tax on acquired VIF	12	12	15	15
Total deferred tax liabilities	494	494	440	440
Net deferred tax liabilities	355	355	346	395

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.

Of the deferred tax assets and liabilities balances shown in the above table, £(155)m for Group and Company (2016: £(192)m for Group and Company), relating to 'transitional adjustments on introduction of new life tax regime' are expected to be settled more than one year after the reporting date.

Finance (No. 2) Act 2015 reduced the rate of Corporation Tax from 20% to 19% with effect from 1 April 2017 and Finance Act 2016 reduced the rate of Corporation Tax from 19% to 17% with effect from 1 April 2020. The impact of these reductions in tax rate, which are applicable to the calculation of deferred tax assets and liabilities at the reporting date, is reflected in the above table.

The tax charge/(credit) in the statement of comprehensive income relating to each item is as follows:

	2017	2016
	£m	£m
	Group	Group
Trading losses	21	28
Expenses deductible in future periods	-	122
Deferred acquisition costs	(21)	(31)
Deferred tax on acquired VIF	(3)	(3)
Transitional adjustments on introduction of new life tax regime	(37)	(46)
Total deferred tax (credit) / charge	(40)	71

(b) Unrecognised deferred tax

Deferred tax assets are recognised for tax loss carry forwards only to the extent that realisation of the related tax benefit is probable. The deferred tax assets not recognised are not subject to any expiry date.

Deferred tax assets have not been recognised in respect of excess expenses carried forward of £208m (2016: £379m) as there is insufficient certainty as to the availability of future profits.

The 2017 Autumn Budget announced that indexation relief on capital gains would be frozen from 1 January 2018 which, if enacted at the balance sheet date, would have resulted in the recognition of an estimated £30m of the deferred tax asset currently not recognised.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

15. Investment in subsidiaries

Company	2017 £m	2016 £m
At 1 January	428	428
Impairment of investment in subsidiaries	(22)	-
Transferred to assets held for sale	(14)	-
At 31 December	392	428

The investment held for sale is shown separately on the face of the balance sheet.

All entities detailed overleaf are wholly-owned, directly or indirectly, and transact insurance or reinsurance business, investment management activities or services in connection therewith, unless otherwise stated. Following are particulars of the Company's subsidiaries and associates:

Bedfont Lakes Business Park (No.2) LP	(3)
Celsius European Lux 2 SARL	(2)
Clerical Medical (Dartford Number 3) Limited	(3)
Clerical Medical (Dartford Number 2) Limited	(3)
Clerical Medical Forestry Limited*	(3)
Clerical Medical Managed Funds Limited	(3)
Clerical Medical Non Sterling Property SARL	(4)
Clerical Medical Non Sterling Arts FSA	(5)
Clerical Medical Non Sterling Arts LSA	(5)
Clerical Medical Non Sterling Guadalix Holdco BV	(6)
Clerical Medical Non Sterling Guadalix Propco SL	(7)
Clerical Medical Non Sterling Megapark Holdco BV	(6)
Clerical Medical Non Sterling Megapark Propco SA	(7)
Clerical Medical Properties Limited	(3)
CM Venture Investments Limited	(8)
Dalkeith Corporation	(9)
Delancey Arnold UK Limited (50%) *	(10)
Delancey Rolls UK Limited (50%) *	(10)
Fontview Limited	(3)
France Industrial Premises Holding	(11)
General Reversionary and Investment Company (80%)	(3)
The Great Wigmore Partnership (G.P.) Limited (50%)	(12)
The Great Wigmore Partnership (50%)	(12)
Great Wigmore Property Limited (50%)	(12)
Halifax Life Limited	(13)
Industrial Real Estate (General Partner) Limited	(14)
Industrial Real Estate Limited Partnership	(14)
Industrial Real Estate Nominee Limited	(14)
Newfont Limited *	(3)
Oystercatcher LP	(3)
Oystercatcher Nominees Limited	(3)
Oystercatcher Residential Limited	(3)
Rolls Development UK Limited (50%) *	(10)
SARL Coliseum	(15)
SARL Fonciere de Rives	(15)
SARL HIRAM	(15)
SAS Compagnie Fonciere de France	(15)
SCI Astoria Invest	(15)
SCI de l'Horloge	(15)
SCI Equinoxe	(15)
SCI Mercury Invest	(15)
SCI Millenium AP1	(15)
SCI Norli	(15)
SCI Rambeateau CFF	(15)
Scottish Widows Active Management Fund	(1)
Scottish Widows Administration Services Limited	(16)
Scottish Widows Fund and Life Assurance Society	(17)
Scottish Widows Industrial Properties Europe BV	(18)
Scottish Widows Pension Trustees Limited	(19)
Scottish Widows (Port Hamilton) Limited	(17)
Scottish Widows Property Management Limited	(17)
Scottish Widows Services Limited	(1)
Scottish Widows Trustees Limited	(17)
Scottish Widows Unit Trust Managers Limited	(20)
St Andrew's Life Assurance plc	(3)
Starfort Limited *	(3)
Saint Michel Holding Company No 1	(11)
Saint Michel Investment Property	(11)
Saint Witz II Holding Company No 1	(11)
Saint Witz II Investment Property	(11)
SWAMF (GP) Limited	(3)
SWAMF Nominee (1) Limited	(3)
SWAMF Nominee (2) Limited	(3)
SW No 1 Limited	(19)
Thistle Investments (AMC) Limited	(21)
Thistle Investments (ERM) Limited	(21)
Waverley Fund II Investor LLC	(9)
Waverley Fund III Investor LLC	(9)

* In liquidation

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

15. Investment in subsidiaries (continued)

The investments in subsidiaries included above are generally recoverable more than one year after the reporting date.

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.

Registered office addresses

(1) 69 Morrison Street, Edinburgh, Midlothian, EH3 8YF
(2) Centre Orchimont, 36 Rangwee, L-2412, Luxembourg
(3) 33 Old Broad Street, London, EC2N 1HZ
(4) Citco REIF Services, 20 Rue de Poste, L-2346, Luxembourg
(5) Avenue Louise 331-333, 1050 Brussels, Belgium
(6) Naritaweg 165, 1043 BW, Amsterdam, Netherlands
(7) Calle Pinar 7, 5Olzquierda, 28006, Madrid, Spain
(8) RL360 House, Cooil Road, Douglas, Isle of Man, IM2 2SP
(9) Corporation Service Company, Suite 400, 2711 Centre Road, Wilmington, DE 19805, United States
(10) 4th Floor 4 Victoria Street, St. Albans, Hertfordshire, AL1 3TF
(11) SAB Formalities, 23 Rue de Roule, Paris, 75001, France
(12) 33 Cavendish Square, London, WIG 0PW
(13) Trinity Road, Halifax, West Yorkshire, HX1 2RG
(14) 21 St Thomas Street, Bristol, BS1 6JS
(15) 8 Avenue Hoche, 75008, Paris, France
(16) 25 Gresham Street, London, EC2V 7HN
(17) 15 Dalkeith Road, Edinburgh, EH16 5BU
(18) Weena 340, 3012 NJ, Rotterdam, Netherlands
(19) Port Hamilton, 69 Morrison Street, Edinburgh, EH3 8YF
(20) Charlton Place, Andover, Hampshire, SP10 1RE
(21) 35 Great St. Helen's, London, EC3A 6AP

Collective investment vehicles and limited partnerships ("investment vehicles") where the Group has control, in part through its long term funds, are consolidated as set out in policy 1(b).

The table overleaf lists collective investment vehicles and limited partnerships which are considered to be related undertakings due to the Group holding of 20% or more.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

15. Investment in subsidiaries (continued)

Name Of Umbrella And Undertaking	% Held
HBOS International Investment Funds ICVC (i)	
North American Fund	96.49%
Far Eastern Fund	81.71%
European Fund	94.19%
International Growth Fund	53.63%
Japanese Fund	95.80%
HBOS Specialised Investment Funds ICVC (i)	
Cautious Managed Fund	52.61%
Ethical Fund	83.59%
Fund Of Investment Trusts	40.57%
Smaller Companies Fund	66.86%
Special Situations Fund	51.67%
HBOS UK Investment Funds ICVC (i)	
UK Equity Income Fund	62.43%
UK Growth Fund	62.36%
U.K. FTSE All-Share Index Tracking Fund	58.47%
HBOS Actively Managed Portfolio Funds ICVC (i)	
Diversified Return Fund	94.47%
Absolute Return Fund	92.49%
Dynamic Return Fund	96.56%
HBOS Property Investment Funds ICVC (i)	
UK Property Fund	40.50%
Scottish Widows Tracker And Specialist Investment Funds ICVC (ii)	
UK All Share Tracker Fund	92.70%
International Bond Fund	32.96%
UK Tracker Fund	47.44%
UK Fixed Interest Tracker Fund	96.28%
Emerging Markets Fund	89.40%
UK Index-Linked Tracker Fund	50.89%
UK Smaller Companies Fund	28.56%
Overseas Fixed Interest Tracker Fund	94.23%
Scottish Widows UK And Income Investment Funds ICVC (ii)	
UK Corporate Bond Fund	62.79%
UK Growth Fund	62.02%
Gilt Fund	95.99%
High Income Bond Fund	25.77%
Strategic Income Fund	63.23%
Environmental Investor Fund	69.89%
Ethical Fund	73.65%
Scottish Widows Overseas Growth Investment Funds ICVC (ii)	
Global Growth Fund	54.22%
European Growth Fund	90.07%
American Growth Fund	87.81%
Pacific Growth Fund	76.54%
Japan Growth Fund	98.62%
Scottish Widows Managed Investment Funds ICVC (ii)	
International Equity Tracker Fund	77.65%
Balanced Portfolio Fund	82.19%
Progressive Portfolio Fund	72.76%
Cautious Portfolio Fund	60.17%
Cash Fund	99.06%
Opportunities Portfolio Fund	92.18%

Name Of Umbrella And Undertaking	% Held
Multi-Manager ICVC (ii)	
Multi Manager UK Equity Growth Fund	82.23%
Multi Manager UK Equity Income Fund	29.30%
Multi Manager UK Equity Focus Fund	21.50%
Scottish Widows Investment Solutions Funds ICVC (ii)	
Balanced Solution	45.76%
Cautious Solution	37.40%
Discovery Solution	45.42%
Strategic Solution	55.13%
Dynamic Solution	57.85%
Defensive Solution	68.08%
Adventurous Solution	76.79%
European (Ex UK) Equity Fund	96.77%
Asia Pacific (Ex Japan) Equity Fund	95.74%
Japan Equities Fund	94.71%
US Equities Fund	99.71%
Fundamental Index UK Equity Fund	85.30%
Fundamental Index Global Equity Fund	96.68%
Fundamental Index Emerging Markets Equity Fund	95.50%
Fundamental Low Volatility Index Global Equity	98.39%
Fundamental Low Volatility Index Emerging Markets Equity	96.17%
Fundamental Low Volatility Index UK Equity	91.85%
Scottish Widows Income And Growth Funds ICVC (ii)	
Balanced Growth Fund	27.17%
UK Index Linked Gilt Fund	100.00%
Corporate Bond PPF Fund	100.00%
SW Corporate Bond Tracker	100.00%
Scottish Widows GTAA 1	84.39%
Corporate Bond 1 Fund	100.00%
Adventurous Growth Fund	71.69%
Investment Portfolio ICVC (ii)	
IPS Growth	22.01%
ACS Pooled Property	
Scottish Widows Pooled Property ACS Fund	99.87%
Scottish Widows Pooled Property ACS Fund 2	99.78%
Universe, The CMI Global Network (iii)	
CMIG GA 70 Flexible	100.00%
CMIG GA 80 Flexible	100.00%
CMIG GA 90 Flexible	100.00%
CMIG Focus Euro Bond	99.96%
European Enhanced Equity	100.00%
CMIG Access 80%	100.00%
Continental Euro Equity	97.56%
UK Equity	73.76%
US Enhanced Equity	87.67%
Japan Enhanced Equity	93.57%
Pacific Enhanced Basin	78.82%
Euro Bond	69.14%
US Bond	93.52%
US Currency Reserve	76.15%
Euro Currency Reserve	98.70%
Euro Cautious	90.89%

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

15. Investment in subsidiaries (continued)

Name Of Umbrella And Undertaking	% Held
Aberdeen Liquidity Fund (Lux) (iv)	
Aberdeen Liquidity Fund (Lux) - Sterling Fund	47.26%
Aberdeen Liquidity Fund (Lux) - Euro Fund	20.88%
Aberdeen Liquidity Fund (Lux) - Ultra Short Duration Sterling Fund	48.85%
Aberdeen Investment ICVC (v)	
Aberdeen Global High Yield Bond Fund	24.25%
Aberdeen European Property Share Fund	56.79%
Aberdeen Sterling Opportunistic Corporate Bond Fund	34.58%
Aberdeen Sterling Bond Fund	77.36%
Aberdeen Investment ICVC II (v)	
Aberdeen Global Corporate Bond Tracker Fund	97.86%
Aberdeen Investment ICVC III (v)	
Aberdeen Global Emerging Markets Quantitative Equity Fund	70.62%
BNY Mellon Investments Funds ICVC (vi)	
Insight Global Multi-Strategy Fund	43.84%
Insight Global Absolute Return Fund	73.62%
Newton Multi-Asset Growth Fund	29.15%
Newton UK Opportunities Fund	42.36%
Newton UK Income Fund	27.38%
Insight Investment Funds-Of-Funds II ICVC (vii)	
Absolute Insight Fund	61.29%
Invesco Perpetual Far Eastern Investment Series (viii)	
Invesco Perpetual Asian Equity Income Fund	24.38%

Name Of Umbrella And Undertaking	% Held
Russell Investment Company Plc (ix)	
Russell Euro Fixed Income Fund	29.73%
Russell Sterling Bond Fund	38.48%
Russell U.S. Bond Fund	48.73%
UBS Investment Funds ICVC (x)	
UBS Global Optimal Fund	25.42%
UBS UK Opportunities Fund	44.79%
LDI Solutions Plus Plc (xi)	
IIFIG Government Liquidity Fund	21.81%
The TM Levitas Funds (xii)	
TM Levitas A Fund	21.56%
TM Levitas B Fund	26.39%
Aberdeen Private Equity Fund Of Funds (2007) Plc (xiii)	96.08%
SWIP European Balanced Property Fund (xiv)	84.64%
SSGA UK Equity Tracker Fund (xv)	92.43%
SSGA Europe (Ex UK) (xv)	96.10%
SSGA Asia Pacific Tracker Fund (xv)	86.64%
SSGA North American Equity Fund (xv)	100.00%
Blackrock Balanced Growth Portfolio Fund (xvi)	42.06%
Blackrock UK Smaller Companies Fund (xvi)	23.09%
Schroder Gilt And Fixed Interest Fund (xvii)	23.75%
HLE Active Managed Portfolio Konservativ (xviii)	32.65%
HLE Active Managed Portfolio Dynamisch (xviii)	53.98%
HLE Active Managed Portfolio Ausgewogen (xviii)	58.43%

Principle Place of Business:

(i) Trinity Road, Halifax, West Yorkshire, HX1 2RG
(ii) 15 Dalkeith Road Edinburgh EH16 5WL
(iii) 106, Route D'arlon, L-8210 Mamer, Grand Duchy Of Luxembourg
(iv) 35a, Avenue John F. Kennedy, L-1855 Luxembourg, Grand Duchy Of Luxembourg
(v) 1 Bread Street, Bow Bells House, London EC4M 9HH
(vi) Bny Mellon Centre, 160 Queen Victoria Street, London EC4V 4LA
(vii) 160 Queen Victoria Street, London EC4V 4LA
(viii) Perpetual Park, Perpetual Park Drive, Henley-On-Thames, Oxfordshire RG9 1HH
(ix) 78 Sir John Rogerson's Quay, Dublin 2, Ireland
(x) 21 Lombard Street, London, EC3V 9AH
(xi) 32 Molesworth Street, Dublin 2, Ireland
(xii) Exchange Building, St. John's Street, Chichester, West Sussex PO19 1UP
(xiii) 39/40 Upper Mount Street, Dublin 2, Ireland
(xiv) 80, Route D'esch, L-1470 Luxembourg
(xv) 20 Churchill Place, Canary Wharf, London E14 5HJ
(xvi) 12 Throgmorton Avenue, London EC2N 2DL
(xvii) 31 Gresham Street, London, EC2V 7QA
(xviii) 2, Boulevard Konrad Adenauer, L-1115 Luxemburg

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

15. Investment in subsidiaries (continued)

Principle Place of Business (continued):

On the 15 July 2016 the Aberdeen Global Liquidity Fund ("GLF") was transferred into the Aberdeen Liquidity Fund (Lux) ("ALF"). At 31 December 2016 the Group's ultimate parent company held a controlling interest in the ALF and therefore under IFRS 10 the ALF was consolidated.

As at 31 December 2017 the Group's ultimate parent company no longer holds a controlling interest in the ALF with the percentage ownership falling below 50% and therefore the ALF is no longer consolidated.

16. Tangible fixed assets

Land and buildings	2017 £m *Group*	2016 £m *Group*
Cost		
At 1 January	25	27
Disposals	(2)	(2)
At 31 December	23	25
Accumulated depreciation		
At 1 January	(10)	(10)
Depreciation charge for the year	(1)	(1)
Disposals/Write-offs	1	1
At 31 December	(10)	(10)
Carrying amount		
At 1 January	15	17
At 31 December	13	15

The valuation of the land and buildings for the purposes of impairment testing was undertaken by Jones Lang LaSalle. The fair value of the land and buildings is not significantly different from the carrying value. The above assets are generally recoverable more than one year after the reporting date.

17. Investment properties

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	3,643	178	4,228	315
Additions – new properties	60	1	187	-
Additions – subsequent expenditure on existing properties	125	-	93	4
Disposals	(420)	-	(776)	(143)
Net gain/(loss) from change in fair values	232	10	(89)	2
At 31 December	3,640	189	3,643	178

In 2016, £44m of property assets held within Group funds were transferred to an Authorised Contractual Scheme ("ACS") in exchange for cash. This was in order to better support ongoing liquidity and portfolio management objectives. No property assets were transferred during 2017.

Rental income arising from investment properties during the year, included in investment income, amounted to: Group £204m (2016: £219m) and Company £11m (2016: £16m). Direct operating expenses (included within operating expenses) arising in respect of such investment properties during the year amounted to: Group £26m (2016: £29m) and Company £nil (2016: £3m).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

17. Investment properties (continued)

Expenditure on investment properties which did not generate rental income was: Group £nil (2016: £nil) and Company £nil (2016: £nil). The carrying value of land held for development in Group is £28m (2016: £34m) and Company is £nil (2016: £nil). The carrying value of investment property under development in Group is £54m (2016: £61m) and Company is £nil (2016: £nil).

Due to the nature of the above assets, there is no fixed term associated with these investments. The investment properties are independently valued by Cushman Wakefield, Savills, and Knight Frank, on at least a quarterly basis for the purpose of determining the open market value of the properties.

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

18. Assets arising from reinsurance contracts held

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:

Group and Company	2017			2016		
	Re-insurance contracts	Classified as Fair value through profit or loss	Total	Re-insurance contracts	Classified as Fair value through profit or loss	Total
	£m	£m	£m	£m	£m	£m
At 1 January	704	6,683	7,387	636	7,760	8,396
Movement recognised through the statement of comprehensive income	(139)	1,078	939	68	1,534	1,602
Collapse of reinsurance arrangement recognised directly through the balance sheet	-	-	-	-	(2,301)	(2,301)
Other movements recognised directly through the balance sheet	-	51	51	-	(310)	(310)
At 31 December	565	7,812	8,377	704	6,683	7,387
Amounts in respect of liabilities arising from insurance and participating investment contracts	565	7,416	7,981	704	6,366	7,070
Amounts in respect of liabilities arising from non-participating investment contracts	-	396	396	-	317	317
Total	565	7,812	8,377	704	6,683	7,387

Assets arising from reinsurance contracts held include £7,734m for Group and Company (2016: £6,835m for Group and Company) that is expected to be settled more than one year after the reporting date.

In 2016, a tranche of externally reinsured assets of £2,301m was collapsed and subsequently reinvested in directly held assets. As these contracts are accounted for as investment contracts, this movement was recognised directly to the balance sheet. There was no such transaction in 2017.

19. Derivative financial instruments

In the normal course of business, the Group and 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 30.

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

19. Derivative financial instruments (continued)

Index futures contracts are used to hedge the investment portfolio against adverse movements in underlying markets or effecting policy switches between markets without the need to trade the underlying securities. Futures may also be used for the purposes of efficient portfolio management provided that their substance would otherwise be permitted as a series of direct transactions. Forward foreign exchange contracts are an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate.

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

Group		2017			2016	
	Contract Amount £m	**Fair value assets £m**	**Fair value liabilities £m**	**Contract Amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Derivative financial instruments held for trading:						
Swap contracts	33,445	2,454	(2,289)	31,744	2,586	(2,263)
Option contracts	16,245	650	(761)	32,409	799	(626)
Index futures contracts	6,758	62	(60)	6,171	63	(29)
Forward foreign exchange contracts	5,981	23	(37)	7,557	59	(90)
Derivative financial instruments designated as fair value hedges	1,500	276	-	1,500	293	-
Total	63,929	3,465	(3,147)	79,381	3,800	(3,008)

Company		2017			2016	
	Contract Amount £m	**Fair value assets £m**	**Fair value liabilities £m**	**Contract Amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Derivative financial instruments held for trading:						
Swap contracts	33,141	2,454	(2,282)	31,459	2,577	(2,260)
Option contracts	14,439	644	(728)	31,080	793	(615)
Index futures contracts	3,748	37	(37)	2,620	25	(18)
Forward foreign exchange contracts	2,662	13	(11)	3,193	30	(37)
Derivative financial instruments designated as fair value hedges	1,500	276	-	1,500	294	-
Total	55,490	3,424	(3,058)	69,852	3,719	(2,930)

Derivative financial instrument fair value assets include £3,150m for Group and £3,149m for Company (2016: £3,430m for Group and £3,421m for Company) that is expected to be recovered more than one year after the reporting date.

Derivative financial instrument fair value liabilities include £2,498m for Group and £2,490m for Company (2016: £2,537m for Group and £2,535m for Company) that is expected to be settled more than one year after the reporting date.

The fair value hedges included in the above tables represent interest rate swaps in respect of the interest payments relating to subordinated debt issued by the Group. These instruments form part of hedge relationships with the subordinated debt issued.

Details of collateral accepted and pledged in respect of derivative financial instruments are given in note 37.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

20. Loans and receivables

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Accrued income, dividend and rent	524	162	515	144
Loans to related parties	1,753	1,752	3,796	3,796
Other amounts due from related parties	140	167	199	199
Amounts receivable from direct insurance business	182	182	209	209
Reverse repurchase asset and collateral asset	988	345	883	459
Other	450	260	625	355
Total	4,037	2,868	6,227	5,162

Of the above total, £348m for Group and for Company (2016: £425m for Group and for Company) is expected to be recovered more than one year after the reporting date. The carrying amount of loans to related parties is a reasonable approximation of fair value.

As a result of the reclassification of the subsidiary SWSL to assets and liabilities held for sale there has been a reduction in loans and receivables for the Group in 2017. See note 43 for further detail.

Reverse repurchase assets relate to cash collateral received and reinvested under derivatives and stock lending programmes.

Within loans and receivables, the largest credit concentration is with Lloyds Bank Plc of £1,400m (2016: Scottish Widows Group Ltd of £2,271m). Further information in respect of credit risk, including collateral held against loans to related parties, is given in note 37.

21. Investments at fair value through profit or loss

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Shares and other variable yield securities	84,533	93,873	77,219	89,446
Debt and other fixed/variable income securities	38,844	19,568	41,084	18,884
Total investments at fair value	123,377	113,441	118,303	108,330

Of the debt securities £37,224m for Group and £19,306m for Company (2016: £38,029m for Group and £18,625m for Company) is expected to be recovered more than one year after the reporting date. Due to the nature of shares and other variable yield securities there is no fixed term associated with these securities. Included within the Company's shares and other variable yield securities are shares in subsidiary undertakings of £68,479m (2016: £64,218m), which are held at fair value through profit or loss.

During 2017, the Group acquired illiquid credit assets from, or issued by, parties within LBG totalling £450m (2016: £1,223m). The Group also originated loans during the year totalling £352m (2016: £272m) and committed to lend a further £245m (2016: £nil). These credit assets are secured on Social Housing, Infrastructure, Education and Commercial Real Estate portfolios. The Group also holds credit assets secured on Equity Release Mortgages and Agricultural Mortgages.

All assets acquired from LBG were acquired at their fair value and further details on the credit risk and fair value measurement of these assets can be found in note 37.

Structured entities are consolidated when the Group has control in accordance with the consolidation policy set out in note 1(b). In 2016, £44m of property assets held within the Group funds were transferred to an Authorised Contractual Scheme ("ACS"), in order to better support ongoing liquidity and portfolio management objectives. No property assets were transferred during 2017.

Of the total debt securities included above £4,775m for Group (2016: £4,391m) and £4,774m for Company (2016: £4,175m) is secured on real estate. Of the debt securities above, £6,759m (2016: £6,340m) for Group and £6,834m (2016: £6,387m) for Company was acquired from a related party. All transactions were completed at arm's length.

Within shares and other variable yield securities are cash funds of £271m for Group and £270m for Company (2016: £230m for Group and £221m for Company) representing collateral received and reinvested in relation to derivatives contracts and stocklending programmes, further details is given in note 37.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

21. Investments at fair value through profit or loss (continued)

Interests in unconsolidated structured entities

Included within investments at fair value through profit or loss are investments in unconsolidated structured entities for Group of £27.4bn (2016: £24.8bn) 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 Group'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 Group's investment is matched by a change in policyholder liabilities. At 31 December 2017, the total net assets of unconsolidated collective investment vehicles and limited partnerships in which the Group held a beneficial interest were £2,338bn (2016: £1,869bn). During the year the Group has not provided any non-contractual financial or other support to these unconsolidated collective investment vehicles and limited partnerships (2016: none).

Interests in unconsolidated structured entities (continued)

The Group sponsors a range of collective investment vehicles and limited partnerships where it acts as the decision maker over the investment activities and markets the funds under one of LBG's brands. The Group earns fees from managing the investments of these funds. The investment management fees that the Group earned from these sponsored unconsolidated collective investment vehicles and limited partnerships, including those in which the Group held no interest at 31 December 2017, was £103m (2016: £160m).

Interests in consolidated structured entities

The Group consolidates a number of structured entities, in accordance with the consolidation policy set out in note 1(b).

In 2015 the Company fully assumed a guarantee granted by SW Funding plc, a fellow group undertaking. The guarantee concerns a contractual arrangement with State Street Trustees Limited (SSTL), which acts as the Depositary of a consolidated structured entity, the Scottish Widows Property Authorised Contractual Scheme (SWACS). Under the terms of the contractual arrangement, the Company has indemnified SSTL against all losses suffered or incurred by SSTL arising out of or in relation to the scheme property of the SWACS, which consists of real property and for which SSTL is the legal owner. During the year, no losses have arisen and the Company has made no payment under this contractual arrangement (2016: none).

During the year, the Group has not provided any non-contractual financial support to consolidated structured entities and has no current intention of providing such support (2016: none).

22. Cash and cash equivalents

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

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Cash at bank	1,651	795	1,806	1,028
Short term deposits	281	268	401	263
Cash at bank	1,932	1,063	2,207	1,291
Less: bank overdrafts (note 33)	(10)	(2)	(12)	(4)
Total	1,922	1,061	2,195	1,287

As a result of the reclassification of the subsidiary SWSL to assets and liabilities held for sale there has been a reduction in cash and cash equivalents for the Group in 2017. See note 43 for further detail.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

23. Share capital

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Issued and fully paid share capital:				
70,000,000 (2016: 70,000,000) ordinary shares of £1 each	70	70	70	70
Total	70	70	70	70

24. Insurance contracts and participating investment contract liabilities

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

Group and Company		2017			2016	
	£m	£m	£m	£m	£m	£m
	Gross	*Reinsurance*	*Net*	*Gross*	*Reinsurance*	*Net*
At 1 January	93,799	(7,071)	86,728	79,716	(8,114)	71,602
New business	4,197	(21)	4,176	4,450	(15)	4,435
Changes in existing business	773	(941)	(168)	4,477	1,072	5,549
Assumption changes	(316)	52	(264)	1,571	(14)	1,557
Change in classification	4,463	-	4,463	3,585	-	3,585
At 31 December	102,916	(7,981)	94,935	93,799	(7,071)	86,728

An analysis of the expected maturities of liabilities arising from insurance contracts and participating investment contracts is given in note 37. The portfolio is subject to a number of risks as set out in note 37.

During the year, a new death benefit was added to certain legacy pension contracts to align terms with other pension products. The addition of this benefit has changed the classification of these contracts from investment contracts to insurance contracts, as the contracts now transfer significant insurance risk. This has led to an increase in insurance contracts and participating investment contracts of £4,463m. In 2016, death benefit was added to other legacy pension contracts resulting in an increase in insurance contracts and participating investment contracts of £3,585m.

On 19 September 2017, the Group entered in to an outsourcing contract with Diligenta, which is designed to deliver reduced maintenance costs for insurance and investment business. The impact of this contract has been recognised through insurance contract liability reserves this year. This has resulted in a net increase to reserves of £89m.

25. Unallocated surplus

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

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	228	228	288	288
Change recognised through the statement of comprehensive income	152	152	(60)	(60)
At 31 December	380	380	228	228

Of the above total, £324m for Group and Company (2016: £192m for Group and Company) is expected to be settled more than one year after the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

26. Future profits on non-participating business in the With Profits Funds

An analysis of the change in future profits on non-participating business in the Scottish Widows With Profits Fund is as follows:

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	47	47	79	79
Change recognised through the statement of comprehensive income	(4)	(4)	(32)	(32)
At 31 December	43	43	47	47

£42m for Group and Company (2016: £46m for Group and Company) is expected to be recovered more than one year after the reporting date.

27. Provisions for other liabilities and charges

Group	2017 German insurance business litigation £m	2017 Other £m	2017 Total £m	2016 German insurance business litigation £m	2016 Other £m	2016 Total £m
At 1 January	168	99	267	124	76	200
Increase in the year	-	52	52	94	93	187
Amount utilised in the period	(30)	(62)	(92)	(50)	(70)	(120)
At 31 December	138	89	227	168	99	267

Company	2017 German insurance business litigation £m	2017 Other £m	2017 Total £m	2016 German insurance business litigation £m	2016 Other £m	2016 Total £m
At 1 January	168	90	258	124	62	186
Increase in the year	-	52	52	94	86	180
Amount utilised in the period	(30)	(55)	(85)	(50)	(58)	(108)
At 31 December	138	87	225	168	90	258

Of the above total, £102m for Group and Company (2016: £130m for Group and Company) is expected to be settled more than one year after the reporting date.

Customer claims in relation to insurance business in Germany

The Group continues to receive claims in Germany from customers relating to policies issued by the Company, under its former name of Clerical Medical Investment Group Limited. The German industry-wide issue regarding notification of contractual 'cooling off' periods has continued to lead to a similar number of claims in 2016 and 2017. The total provision made to 31 December 2017 is £639m (2016: £639m). Settlement experience has improved and therefore only £30m was utilised in the year ended 31 December 2017 (2016: £50m); the remaining unutilised provision as at 31 December 2017 is £138m (31 December 2016: £168m).

The validity of the claims facing the Group 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. Claims received to date represent 5% of the relevant total policy population. Key metrics and sensitivities are highlighted in the table below:

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

27. Provisions for other liabilities and charges (continued)

Sensitivities	Actuals to date	Anticipated Future	Sensitivity
Number of claims	11,500	9,200	1,000 = £9m
Average uphold rate per claim	69%	54%	10% = £15m
Average redress per upheld claim	£51,500	£13,000	£1,000 = £6m
Administrative expenses	£143m	£23m	1 case = £1,300

The actuals to date include claims that have been received and provided for but not yet resolved. For future claims the anticipated average uphold rate, redress per upheld claim and administrative and legal expenses are consistent with the actual experience seen over the 12 months prior to the reporting date. This recent experience is more favourable compared with previous years due to time barring of more onerous types of claim and because most claims are now settled without recourse to litigation.

Contingent liabilities

Tax authorities

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities. This includes open matters where HMRC adopt a different interpretation and application of tax law which might lead to additional tax. A number of Group companies have an open matter in relation to a claim for group relief of losses incurred in a former Irish banking subsidiary of LBG, which ceased trading on 31 December 2010. In the second half of 2013 HMRC informed LBG that their interpretation of the UK rules, permitting the offset of such losses, denies these claims; if HMRC's position is found to be correct, management estimate that this would result in an increase in the Group's current tax liability of approximately £20m (including interest). LBG does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due on the Group.

Fair Treatment of Long-Standing Customers in the Life Insurance Sector

The FCA has referred a number of firms, including the Company, to its enforcement division after publishing its thematic review on fair treatment of long-standing customers in the life insurance sector on 2 March 2016. The FCA is investigating the behaviour around disclosing exit and paid-up charges to customers after December 2008. The FCA have stated that no conclusion has been reached as to whether there have been any breaches of regulatory requirements and the commencement of investigations should not be taken to indicate they will necessarily result in a penalty being imposed or that redress will be payable. No provision is held in respect of this review at this time. This investigation is ongoing and it is currently not possible to make a reliable assessment of the liability, if any, that may result from the investigation.

Outsourcing of long-standing customer administration platform

The outsourcing contract signed with Diligenta on 19 September 2017 provides for certain future payments which are contingent on contractual milestones being achieved. Further, there are provisions whereby the Group has agreed to reimburse Diligenta for any severance costs, if and when a restructuring programme is initiated by Diligenta in relation to those employees transferring on 1 March 2018. At 31 December 2017, no conditions exist for such payments to be made, and as such these are regarded as contingent in nature. A proportion of these costs (£16m) have been recognised already in insurance contract liabilities. The remainder relating the share of these future payments by investment business, will be expensed as incurred in future periods.

Other legal actions and regulatory matters

During the ordinary course of business the Group is subject to complaints and threatened or actual legal proceedings (including class or group action claims) brought by or on behalf of current or former employees, customers, investors or other third parties, as well as legal and regulatory reviews, challenges, investigations and enforcement actions, both in the United Kingdom and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisors where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed to properly assess the situation, and no provisions are held in relation to such matters. However, the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

28. Retirement benefit obligations

Scottish Widows Services Limited ("SWSL") is the principal employer of the Scottish Widows Retirement Benefit Scheme ("SWRBS") pension scheme. The Group's employees may be members of the SWRBS, which provides mainly defined benefits, or members of LBG Schemes, which provide defined benefits and/or defined contribution benefits to the members of those schemes.

(a) Scottish Widows Retirement Benefits Scheme

(i) Characteristics of the SWRBS

The SWRBS is a funded scheme in the UK, operated as a separate legal entity under trust law by Scottish Widows Pension Trustees Limited (the Trustee) in compliance with the Pensions Act 2004. A valuation exercise is carried out for the scheme at least every three years, whereby scheme assets are measured at market value and liabilities (technical provisions) are measured using prudent assumptions. If a deficit is identified a recovery plan is agreed between the Company and the Trustee and sent to the Pensions Regulator for review. The Group has not provided for these deficit contributions as the future economic benefits arising from these contributions are expected to be available to the Group.

The latest full valuation of the SWRBS was carried out as at 1 July 2016 and showed a deficit of £388m when comparing assets with technical provisions liabilities. The recovery plan provides for the Group to pay deficit contributions of £9m each month from January 2018 to June 2021. These deficit contributions are in addition to the regular contributions to meet the cost of benefits accruing over each year and the administration expenses of running the scheme.

The Group is required to pay contributions to fund its obligations. The Group has paid contributions of £13m (2016: £14m) to the SWRBS in 2017. Employee contributions made during the year were £nil (2016: £nil). The Group currently expects to pay contributions totalling £120m in 2018.

As a result of the reclassification of the subsidiary SWSL to assets and liabilities held for sale there has been a reduction in pension benefit obligations for the Group in 2017. See note 43 for further detail.

The technical provisions liabilities differ from the liabilities assessed under IAS19, with technical provisions typically being more prudent. The IAS19 liabilities disclosed in note 43 have been calculated by and independent, qualified actuary appointed by LBG.

The responsibility for the governance of the SWRBS lies with the Pension Trustees. The SWRBS is managed by a Trustee Board (the Trustee) whose role is to ensure that the SWRBS is administered in accordance with the SWRBS rules and relevant legislation, and to safeguard the assets in the best interests of all members and beneficiaries. The Trustee is solely responsible for setting investment policy and for agreeing funding requirements with the employer through the triennial valuation process. The Board of Trustees must be composed of representatives of the Group and plan participants in accordance with the SWRBS's regulations.

(ii) Amounts in the Financial Statements of the SWRBS

The amounts recognised in the Group's balance sheet are as follows:

	2017 £m	2016 £m
Fair value of scheme assets	1,171	1,259
Present value of defined benefit obligations	(1,248)	(1,389)
Transferred to liabilities held for sale	77	-
Liability recognised in the balance sheet	-	(130)

The following tables present a further analysis of the amounts recognised in the Group's balance sheet:

	2017 £m	2016 £m
Net amount recognised in the balance sheet		
At 1 January	(130)	(50)
Service cost	(22)	(14)
Net interest on net defined benefit asset	(4)	(2)
Remeasurement effects recognised in other comprehensive income	67	(77)
Employer contributions	13	14
Administration costs incurred during the period	(1)	(1)
Transferred to liabilities held for sale	77	-
At 31 December	-	(130)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

28. Retirement benefit obligations (continued)

(ii) Amounts in the Financial Statements of the SWRBS (continued)

	2017 £m	2016 £m
Movements in the defined benefit obligation		
At 1 January	1,389	1,161
Current service cost	15	14
Interest expense	37	43
Remeasurements:		
Actuarial losses – experience	(11)	(81)
Actuarial losses – demographic assumptions	(53)	(7)
Actuarial gains – financial assumptions	42	338
Benefits paid	(177)	(79)
Past service cost – curtailments	6	-
At 31 December	1,248	1,389

The following tables provide an analysis of the SWRBS assets:

	2017 £m	2016 £m
Changes in the fair value of scheme assets		
At 1 January	1,259	1,111
Return on plan assets excluding amounts included in interest income	44	173
Interest income	34	41
Employer contributions	12	14
Benefits paid	(177)	(79)
Administrative costs paid	(1)	(1)
At 31 December	1,171	1,259

	2017			2016		
	Fair value of assets with quoted prices £m	Fair value of assets with unquoted prices £m	Total £m	Fair value of assets with quoted prices £m	Fair value of assets with unquoted prices £m	Total £m
Debt instruments	462	-	462	465	-	465
Pooled investment vehicles	132	540	672	-	759	759
Derivatives	37	-	37	25	-	25
Money market instruments, derivatives cash and other assets and liabilities	3	(3)	-	-	10	10
Total fair value of scheme assets	634	537	1,171	490	769	1,259

Improvements in the granularity of the data received have resulted in improved classification of the above categories and comparatives have been updated to reflect this.

An analysis of the SWRBS' debt securities is provided below:

2017	Total £m	AAA £m	AA £m	A £m	BB or lower £m	BBB or lower £m	Not rated £m
Government bonds	155	-	155	-	-	-	-
Index linked government bonds	307	-	307	-	-	-	-
Total fair value of scheme assets	462	-	462	-	-	-	-

2016	Total £m	AAA £m	AA £m	A £m	BB or lower £m	BBB or lower £m	Not rated £m
Government bonds	132	-	132	-	-	-	-
Index linked government bonds	333	-	333	-	-	-	-
Total fair value of scheme assets	465	-	465	-	-	-	-

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

28. Retirement benefit obligations (continued)

(ii) Amounts in the Financial Statements of the SWRBS (continued)

The SWRBS' collective investment vehicles comprise:

	2017 £m	2016 £m
Non-UK equity investment funds	243	243
Corporate bond funds	100	251
Private equity funds	4	6
Property partnerships and unit trusts	124	114
Emerging market equity funds	81	52
Multi strategy alternative credit funds	120	93
At 31 December	672	759

Improvements in the granularity of the data received have resulted in improved classification of the above categories and comparatives have been updated to reflect this.

The expense recognised in the Statement of Comprehensive Income for the year ended 31 December comprises:

	2017 £m	2016 £m
Current service cost	15	14
Past service cost - curtailments	6	-
Net interest amount	4	2
Plan administration costs incurred in the year	1	1
Net expense recognised	26	17

The principal actuarial and financial assumptions used in valuations of the SWRBS were as follows:

	2017 %	2016 %
Discount rate	2.59	2.76
Rate of inflation		
Retail Prices Index	3.20	3.23
Consumer Price Index	2.15	2.18
Rate of salary increases	0.00	0.00

	2017 Years	2016 Years
Life expectancy for member aged 60, on the valuation date:		
Men	27.3	28.0
Women	29.5	30.4
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	28.4	29.3
Women	30.7	31.8

Risk exposure of SWRBS

The Group is exposed to the following risks in relation to the SWRBS scheme:

Inflation rate risk: The SWRBS's benefit obligations are linked to inflation both in deferment and once in payment. Higher inflation will lead to higher liabilities although this will be partially offset by holdings of inflation-linked gilts and, in most cases caps on the level of inflationary increases are in place to protect against extreme inflation.

Interest rate risk: The defined benefit obligation is determined using a discount rate derived from yields on AA-rated corporate bonds. A decrease in corporate bond yields will increase plan liabilities although this will be partially offset by an increase in the value of bond holdings and derivatives.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

28. Retirement benefit obligations (continued)

(ii) Amounts in the Financial Statements of the SWRBS (continued)

Longevity risk: The SWRBS obligations are to provide benefits for the life of the members so increases in life expectancy will result in an increase in the plans' liabilities.

Investment risk: SWRBS assets are invested in a diversified portfolio of debt securities, equities and other return-seeking assets. If the assets underperform the discount rate used to calculate the defined benefit obligation, it will reduce the surplus or increase the deficit. Volatility in asset values and the discount rate will lead to volatility in the net pension liability on the Group's balance sheet and in other comprehensive income. To a lesser extent this will also lead to volatility in the IAS 19 pension expense in the Group's statement of comprehensive income.

The ultimate cost of the defined benefit obligations will depend upon actual future events rather than the assumptions made. The assumptions made are unlikely to be borne out in practice and as such the cost may be higher or lower than expected.

(iii) Amount, timing and uncertainty of future cash flows

Sensitivity analysis

The effect of reasonably possible changes in key assumptions on the value of SWRBS liabilities and the resulting pension charge in the Group's statement of comprehensive income and on the net defined benefit pension scheme asset is set out below. The sensitivities provided assume that all other assumptions and the value of the SWRBS' assets remaining unchanged, and are not intended to represent changes that are at the extremes of possibility. The calculations are approximate in nature and full detailed calculations could lead to a different result. It is unlikely that isolated changes to individual assumptions will be experienced in practice. Due to the correlation of assumptions, aggregating the effects of these isolated changes may not be a reasonable estimate of the actual effect of simultaneous changes in multiple assumptions.

Effect of reasonably possible alternative assumptions	**Increase / (decrease) in the statement of comprehensive income charge**		**Increase / (decrease) in the net defined benefit pension scheme liability**	
	2017	**2016**	**2017**	**2016**
	£m	**£m**	**£m**	**£m**
Central basis	(14)	(21)	(77)	(130)
Inflation:				
Increase of 0.1%	(15)	(22)	(101)	(156)
Decrease of 0.1%	(13)	(19)	(54)	(103)
Discount rate:				
Increase of 0.1%	(13)	(19)	(50)	(99)
Decrease of 0.1%	(15)	(22)	(106)	(162)
Expected life expectancy of members:				
Increase of one year	(16)	(22)	(138)	(183)
Decrease of one year	(12)	(19)	(20)	(80)

Sensitivity analysis method and assumptions

The inflation assumption sensitivity applies to both the assumed rate of increase in the Consumer Prices Index (CPI) and the Retail Prices Index (RPI). The assumed pension increases before and after retirement are linked to inflation (either CPI or RPI) subject to certain minimum and maximum limits. The inflation assumption sensitivity allows for a corresponding impact of changing the inflation assumption as the assumed pension increases both before and after retirement. This has no impact on the salary increase assumption as the rate at which pensionable salaries can increase is capped at 0% per annum.

The sensitivity analysis does not include the impact of any possible change in the rate of salary increases as pensionable salaries have been materially frozen since 2 April 2014.

The life expectancy assumption has been applied by allowing for an increase/decrease in life expectation from age 60 of one year, based upon the approximate weighted average age for each scheme. Whilst this is an approximate approach and will not give the same result as a one year increase in life expectancy at every age, it provides an appropriate indication of the potential impact on the schemes from changes in life expectancy.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

28. Retirement benefit obligations (continued)

(iii) Amount, timing and uncertainty of future cash flows (continued)

Sensitivity analysis method and assumptions (continued)

There was no change in the methods and assumptions used in preparing the sensitivity analysis from the prior year.

Asset-liability matching strategies

The SWRBS investment strategy is determined by the Trustee of the SWRBS in consultation with SWSL. It is regularly reviewed and developed. A principal element of the strategy is to hold matching assets, primarily index-linked gilts, in respect of the liabilities of the SWRBS represented by pensions in payment and a proportion of deferred pension liabilities. The objective is to reduce the volatility of the SWRBS funding position caused by changes in market expectations of interest rates and inflation and the assets are structured to take into account the profile of the SWRBS liabilities. Credit default swaps and corporate bonds provide a credit overlay to these matching assets, which in total comprise approximately 60% (2016: 58.9%) of the SWRBS assets. The remaining assets are invested in diversified return-seeking assets including equities (both listed and private) and property.

Maturity profile of defined benefit obligation

The weighted average duration of the defined benefit pension obligation is 25 years (2016: 25 years).

(a) Guarantee to the trustees of SWRBS

SWL provides a guarantee to the trustees of SWRBS to explicitly cover the minimum legal funding obligations imposed on SWSL by Sections 75 and 75A of the Pensions Act 1995 and under the rules of the scheme. As a result, the Group will be liable to its proportionate share of the deficit in the SWRBS at the relevant time (calculated as the cost of securing benefits with an insurer) in the event that SWRBS is wound up; the employer becomes insolvent; or an employer ceases to employ active members of SWRBS at a time when another employer continues to do so, but the associated debt is not apportioned to another employer.

(b) Defined contribution schemes

The SWRBS also includes a defined contribution section; most of the members have now transferred to the Your Tomorrow defined contribution section of the LBG Pension Scheme No. 1. During the year ended 31 December 2017, the charge to the Group's statement of comprehensive income in respect of the SWRBS was £14m (2016: £15m), representing the contributions payable by SWSL in accordance with the scheme's rules. There were no outstanding or prepaid contributions at 31 December 2017 (2016: none).

(c) Amounts recognised in other comprehensive income for total defined benefit schemes

Remeasurement effects recognised in other comprehensive income for the year ended 31 December are reconciled to the analyses of amounts recognised in the group balance sheet as follows:

Group	2017			2016		
	Before tax £m	Tax expense £m	After tax £m	Before tax £m	Tax credit £m	After tax £m
SWRBS	67	(14)	53	(77)	15	(62)
Total	67	(14)	53	(77)	15	(62)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

29. Accruals and deferred income

	2017 £m	2017 £m	2016 £m	2016 £m
	Group	*Company*	*Group*	*Company*
Accrued expenses	11	10	98	3
Deferred income	38	20	41	23
Total	49	30	139	26

Of the above total, £30m for Group and £18m for Company (2016: £17m for Group and Company) is expected to be settled more than one year after the reporting date. As a result of the reclassification of the subsidiary SWSL to assets and liabilities held for sale there has been a reduction in accruals and deferred income for the Group in 2017. See note 43 for further detail.

30. Subordinated debt

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

	2017 £m	2017 £m	2016 £m	2016 £m
	Group	*Company*	*Group*	*Company*
Subordinated debt	1,518	1,559	1,525	1,555
Issue costs	(15)	(15)	(16)	(16)
	1,503	1,544	1,509	1,539
Accrued interest on subordinated debt	50	50	50	50
Fair value hedge adjustment	242	242	260	259
Total	1,795	1,836	1,819	1,848

Movements in the carrying value are as follows:

	£m	£m
	Group	*Company*
At 1 January 2017	1,819	1,848
Changes in fair value	(29)	(17)
Other non-cash movements	5	5
At 31 December 2017	1,795	1,836

£1,500m of fixed rate subordinated notes were issued by the Company in April 2013, at a discount of £13m. Redemption is due in 2023 for £850m of the notes, and in 2043 for the remaining £650m. Interest is payable on a quarterly basis at a rate of 5.5% on the former and 7% on the latter. Repayment of the notes is subordinate to the claims of the Company's senior creditors, including all policyholders. The interest rate risk of the notes is managed using a derivative which is accounted for using hedge accounting, as set out in note 1(p).

In addition, subordinated debt of the Company includes £51m of 7.375% undated Subordinated Guaranteed Bonds held by Clerical Medical Finance plc, 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%.

The fair values of the subordinated debt of the Group and Company are as follows:

Group	2017 £m	2017 £m	2016 £m	2016 £m
	Carrying value	*Fair value*	*Carrying value*	*Fair value*
Undated subordinated debt	59	56	55	51
Dated subordinated debt	1,736	1,655	1,764	1,764
Total	1,795	1,711	1,819	1,815

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

30. Subordinated debt (continued)

Company	2017 £m Carrying value	2017 £m Fair value	2016 £m Carrying value	2016 £m Fair value
Undated subordinated debt	59	56	56	51
Dated subordinated debt	1,777	1,696	1,792	1,792
Total	1,836	1,752	1,848	1,843

The fair value of undated subordinated debt has been calculated using published bid prices at the reporting date. The fair value of dated subordinated debt has been assessed by management with reference to published prices.

31. Non-participating investment contract liabilities

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

Group and Company	2017 Gross £m	2017 Reinsurance £m	2017 Net £m	2016 Gross £m	2016 Reinsurance £m	2016 Net £m
At 1 January	20,112	(317)	19,795	22,759	(282)	22,477
New business	608	-	608	560	-	560
Changes in existing business	(813)	(79)	(892)	371	(35)	336
Change in classification	(4,460)	-	(4,460)	(3,578)	-	(3,578)
At 31 December	15,447	(396)	15,051	20,112	(317)	19,795

An analysis of the contractual and expected maturities of liabilities arising from non-participating investment contracts is given in note 37.

During the year, a new death benefit was added to certain legacy pension contracts to align terms with other pension products. The addition of this benefit has changed the classification of these products from investment contracts to insurance contracts, as the products now transfer significant insurance risk. This has led to a decrease in non-participating investment contract liabilities of £4,460m. In 2016, death benefit was added to other legacy pension contracts resulting in a decrease in non-participating investment contract liabilities of £3,578m.

32. Other financial liabilities

	2017 £m Group	2017 £m Company	2016 £m Group	2016 £m Company
Amounts payable in respect of direct insurance business	565	565	512	512
Amounts payable on reinsurance contracts	5	5	25	25
Due to related parties	933	981	1,221	1,099
Due to brokers	108	83	258	42
Collateral liability	925	283	696	263
Other	469	316	441	263
Total	3,005	2,233	3,153	2,204

Of the above total, £nil for Group and £nil for Company (2016: £nil for Group and £nil for Company) is expected to be settled more than one year after the reporting date.

As a result of the reclassification of the subsidiary SWSL to assets and liabilities held for sale there has been a reduction in other financial liabilities in the Group for 2017. See note 43 for further detail.

The Group and Company has recognised assets and liabilities in relation to cash collateral received and reinvested in relation to derivatives contracts and stock lending programme. The liability is recognised as Collateral Liability within Other financial liabilities and the reinvestment assets as Reverse Repurchase Assets, within Loans and Receivables and liquidity funds within Investments at fair value through profit or loss.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

33. Borrowings

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Bank overdrafts	10	2	12	4
Total	10	2	12	4

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

34. Net decrease / (increase) in operating assets and liabilities

	2017		2016	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Net (Increase) / decrease in operating assets:				
Deferred costs	33	35	77	69
Investment properties	3	(11)	585	137
Assets arising from reinsurance contracts held	(990)	(990)	1,009	1,009
Tangible fixed assets	2	-	2	-
Prepayments	24	(1)	(28)	4
Financial assets:				
Derivative financial instruments	335	295	(1,736)	(1,733)
Loans and receivables	1,801	2,294	621	(277)
Investments at fair value through profit or loss	(5,074)	(5,111)	(15,160)	(11,346)
Net increase in operating assets	(3,866)	(3,489)	(14,630)	(12,137)
Increase/ (decrease) in operating liabilities:				
Insurance contracts and participating investment contract liabilities	9,117	9,117	14,083	14,083
Future profits on non-participating business in the With Profits Funds	4	4	32	32
Unallocated surplus	152	152	(60)	(60)
Retirement benefit obligations	(53)	-	80	-
Provisions for other liabilities and charges	(40)	(33)	67	72
Accruals and deferred income	3	4	28	(5)
Financial liabilities:				
Subordinated debt	(24)	(12)	148	160
Non-participating investment contract liabilities	(4,665)	(4,665)	(2,647)	(2,647)
Derivative financial instruments	139	128	1,151	1,139
Other financial liabilities	289	29	(1,331)	(157)
External interest in collective investment vehicles	278	-	(2,682)	-
Net increase in operating liabilities	5,200	4,724	8,869	12,617
Net decrease / (increase) in operating assets and liabilities	1,334	1,235	(5,761)	480

35. Dividends paid

	2017	2016
	£m	£m
Total dividends paid on equity shares	2,563	250

The Company paid dividends of £600m in February 2017 and a further £50m dividend in July 2017 (2016: £250m). A £1,913m dividend was paid in June 2017 with corresponding intercompany loan repayments received from the Company's parent undertaking.

The dividend paid in the year amounted to £36.61 per share (2016: £3.57 per share).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – 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 103, 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 Funds calculated on a realistic basis

The Group and Company has With Profits Funds containing both insurance and participating investment contracts. The main components of the realistic liabilities are: with profits benefit reserves (i.e. the total asset shares for with profits policies); the costs of options and guarantees; deductions levied against asset shares and the impact of smoothing policy.

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

The processes for determining the key assumptions are set out below, and unless otherwise stated, 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 yield derived from the UK swap yield 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 at-the-money-forward options of up to 10 years term 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 and morbidity assumptions, including allowances for improvements in longevity for annuitants, are based on recent actual experience, industry tables and projection models, internal research and 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 Funds and these are, for conventional with profits business, governed by the relevant Schemes 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-participating funds

(i) Insurance contracts and participating investment contracts

The liabilities of the Group and Company are determined on the basis of recognised actuarial methods. 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

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. 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-participating fund liabilities are:

Interest rates

The method used to derive the interest rates limits 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, include 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. Improvements in female annuitant mortality are assumed to follow the CMI_2016 mortality projection model for females from the Actuarial profession's Continuous Mortality Investigation with a long term rate of improvement of 2.05% per annum and a higher smoothing parameter. Similarly improvements in male annuitant mortality are assumed to follow the CMI_2016 mortality projection model for males from the Actuarial Profession's Continuous Mortality Investigation with a long term rate of improvement of 2.25% per annum and a higher smoothing parameter.

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.

For business covered by the Diligenta outsourcing contract the impact from this on maintenance costs is allowed for along with a prudent estimate of the associated costs required to deliver the guaranteed financial benefits from the contract.

Persistency rates

Prudent lapse rate assumptions have been used for term assurance business and other business categories. 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 at points where the projected liability is negative and a low lapse rate is assumed at points where the projected liability is positive.

(ii) Non-participating investment contracts

These contracts are unit-linked, and the liability is determined as the value of the units allocated to the contracts plus an allowance for other amounts not reflected in the unit value.

(2) Key assumptions

(a) With Profits Funds

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

(i) Investment returns and discount rates

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(a) With Profits Funds (continued)

Class of business	Interest rate (net) 2017 %	Interest rate (net) 2016 %
Annuities in Payment	1.50	1.50
Deferred Annuities	1.30	1.40

(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 2017, the 10 year-equity-implied-at-the-money assumption was 20.9% (23.9% as at 31 December 2016). The assumption for property volatility at 31 December 2017 was 12.7% (31 December 2016: 12.7%). The volatility of interest rates has been calibrated to the absolute implied volatility of Swaptions. This is broadly 0.63% as at 31 December 2017 (0.73% at 31 December 2016), based on an average of the at-the-money surface.

(iii) Mortality assumptions

The mortality assumptions for the main classes of business are set with regard to recent Group experience and general industry trends, all of which are adjusted for smoker status and age / sex specific factors. The mortality tables used in the valuation are summarised below:

SW With Profits Fund

		2017	2016
Assurances (excluding term assurances)			
Conventional With Profits	Males		
	Smoker	68% AMS00 Ultimate	68% AMS00 Ultimate
	Non-smoker	68% AMN00 Ultimate	68% AMN00 Ultimate
	Unknown	60% AMC00 Ultimate	60% AMC00 Ultimate
	Females		
	Smoker	68% AFS00 Ultimate	68% AFS00 Ultimate
	Non-smoker	80% AFN00 Ultimate	80% AFN00 Ultimate
	Unknown	65% AFC00 Ultimate	65% AFC00 Ultimate
Unitised Assurances	Males	36% AMC00 Ultimate	42% AMC00 Ultimate
	Females	59% AFC00 Ultimate	59% AFC00 Ultimate
Annuities			
Purchased (whole life)	Males	Bespoke mortality tables CMI_2016_M [2.00%] T80-110	95% IML00 Ultimate CMI_2014_M_[2.00%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [1.80%] T80-110	80% IFL00 Ultimate CMI_2014_F_[1.80%] T80-110
Self-employed / Personal Pensions	Males	Bespoke mortality tables CMI_2016_M [2.00%] T80-110	81% RMV00 Ultimate CMI_2014_M_[2.00%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [1.80%] T80-110	88% RFV00 Ultimate CMI_2014_F_[1.80%] T80-110

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(a) With Profits Funds (continued)

(iii) Mortality assumptions (continued)

Other Annuities in payment	Males	Bespoke mortality tables CMI_2016_M [2.00%] T80-110	90%-101% PCMA00 Ultimate CMI_2014_M_[2.00%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [1.80%] T80-110	73-77% PCFA00 Ultimate CMI_2014_F_ [1.80%] T80-110
Deferred Annuities	Males	65% AMC00 Ultimate CMI_2016_M [2.00%] T80-110	66% AMC00 Ultimate CMI_2014_M_[2.00%] T80-110
	Females	68% AFC00 Ultimate CMI_2016_F [1.80%] T80-110	77% AFC00 Ultimate CMI_2014_F_[1.80%] T80-110

With regard to the above and subsequent tables:

T80-110 means that the long term rate of mortality improvements in the CMI mortality projections model tapers linearly to zero between ages 80 and 110. A smoothing parameter higher than the default parameter was used in CMI_2016.

CMIG With Profits Fund

		2017	2016
Assurances (excluding term assurances)			
Conventional With Profits	Males Females	35% AMC00 Ultimate 50% AFC00 Ultimate	35% AMC00 Ultimate 57% AFC00 Ultimate
Unitised Assurances	Males Females	80% AMC00 Ultimate 80% AFC00 Ultimate	77% AMC00 Ultimate 82% AFC00 Ultimate
Annuities			
Self-employed / Personal Pensions	Males	Bespoke mortality tables CMI_2016_M [2.00%] T80-110	99% PCMA00 CMI_2014 M [2.00%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [1.80%] T80-110	103% PCFA00 CMI_2014 F [1.80%] T80-110
Deferred Annuities	Males	Bespoke mortality tables CMI_2016_M [2.00%] T80-110	99% PCMA00 CMI_2014 M [2.00%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [1.80%] T80-110	103% PCFA00 CMI_2014 F-[1.80%] T80-110

With regard to the above and subsequent tables:

T80-110 means that the long term rate of mortality improvements in the CMI mortality projections model tapers linearly to zero between ages 80 and 110. A smoothing parameter higher than the default parameter was used in CMI_2016.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(a) With Profits Funds (continued)

(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 2016).

(b) Non-participating funds

The principal assumptions underlying the calculation of each of the business transferred in from Group companies in respect of non-participating fund liabilities are given below.

(i) Investment returns and discount rates

Formerly Scottish Widows plc **Class of business**	**Interest rate (net)** **2017** **%**	 **2016** **%**
Conventional Life business and non-unit reserves on linked life business (pre-2013)	0.50	0.47
Conventional Life business and non-unit reserves on linked life business (post-2013)	0.62	0.59
Non-unit reserves on linked pension business (Retirement account, solutions and stakeholder)	0.62	0.59
Conventional pensions business and non-unit reserves on other linked pensions business	0.62	0.59
Annuities in payment	2.23	2.26

Formerly Clerical Medical Investment Group Ltd **Class of business**	**Interest rate (net)** **2017** **%**	 **2016** **%**
Conventional Life business and non-unit reserves on linked life business	0.50	0.29
Formerly SW Protection business	0.50	0.47
Conventional pensions business and non-unit reserves on other linked pensions business	0.62	0.36
Annuities in payment	2.23	2.26

Formerly Halifax Life Limited **Class of business**	**Interest rate (net)** **2017** **%**	 **2016** **%**
Non-unit reserves on linked pension business	0.62	0.36
ELAS reassured annuities in payment	2.23	2.26
Annuities in payment	2.23	2.26

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(b) Non-participating funds (continued)

(ii) Investment returns and discount rates (continued)

Formerly St Andrew's Life Assurance plc Class of business	Interest rate (net) 2017 %	 2016 %
Conventional Life business	0.50	0.30
Non-unit reserves on linked life business	0.50	0.36

(ii) Mortality assumptions

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

Formerly Scottish Widows plc

		2017	2016
Protection for Life	Males		
	Smoker	89% ADJTMS00 Select	96% TMS00 (5) Select
	Non smoker	84% ADJTMN00 Select	89% TMN00 (5) Select
	Females		
	Smoker	88% ADJTFS00 Select	91% TFS00 (5) Select
	Non smoker	87% ADJTFN00 Select	92% TFN00 (5) Select
Term Assurances			
	Males		
	Smoker	77% TMS00 Select	80 – 107% TMS00 (5) Select
	Non smoker	67% TMN00 Select	78 – 133% TMN00 (5) Select
	Unknown	67% TMN00 Select	78% TMN00 (5) Select to 132% TMC00 (5) Select
	Females		
	Smoker	79% TFS00 Select	72 – 121% TFS00 (5) Select
	Non smoker	84% TFN00 Select	69 – 125% TFN00 (5) Select
	Unknown	84% TFN00 Select	69% TFN00 (5) Select to 125% TFC00 (5) Select
Unitised Pensions (Solutions, Stakeholder)	Males	53% AMC00 Ultimate	51% AMC00 Ultimate
	Females	51% AFC00 Ultimate	51% AFC00 Ultimate
Retirement Account	Males	66% AM92 Ultimate	66% AM92 Ultimate
	Females	55% AF92 Ultimate	55% AF92 Ultimate
Transferred from Lloyds Bank	Males		
	Smoker	56% AMS00 Ultimate	75% AMS00 Ultimate
	Non smoker	72% AMN00 Ultimate	94% AMN00 Ultimate
	Unknown	72% AMN00 Ultimate	94% AMN00 Ultimate
	Females		
	Smoker	62% AFS00 Ultimate	88% AFS00 Ultimate
	Non smoker	70% AFN00 Ultimate	88% AFN00 Ultimate
	Unknown	70% AFN00 Ultimate	88% AFN00 Ultimate

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(b) Non-participating funds (continued)

(iii) Mortality assumptions (continued)

		2017	2016
Annuities			
Purchased (whole life)	Males	Bespoke mortality tables CMI_2016_M [2.25%]	86% IML00 Ultimate CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	72% IFL00 Ultimate CMI _2014_F [2.05%] T80-110
Self-employed/ personal pensions	Males	Bespoke mortality tables CMI_2016_M [2.25%]	85% RMV00 Ultimate CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	99% RFV00 Ultimate CMI _2014_F [2.05%] T80-110
Other Annuities in payment	Males	Bespoke mortality tables CMI_2016_M [2.25%]	94 - 112% PCMA00 Ultimate CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	82 - 95% PCFA00 Ultimate CMI _2014_F [2.05%] T80-110
Executive Pensions	Males	Bespoke mortality tables CMI_2016_M [2.25%]	94% PCMA00 Ultimate CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	82% PCFA00 Ultimate CMI _2014_F [2.05%] T80-110
Group scheme annuities	Males	Bespoke mortality tables CMI_2016_M [2.25%]	106% PCMA00 Ultimate CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	87% PCFA00 Ultimate CMI _2014_F [2.05%] T80-110
Transferred from Lloyds TSB	Males	Bespoke mortality tables CMI_2016_M [2.25%]	112% PCMA00 Ultimate CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	95% PCFA00 Ultimate CMI _2014_F [2.05%] T80-110

Under the mortality assumptions adopted for personal/ self-employed business a male aged 65 will live on average for 24 years.

		2017	2016
Deferred Annuities			
	Males	59% AMC00 Ultimate CMI_2016_M [2.25%]	59% AMC00 Ultimate CMI _2014_M [2.25%] T80-110
	Females	61% AFC00 Ultimate CMI_2016_F [2.05%]	69% AFC00 Ultimate CMI _2014_F [2.05%] T80-110

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(b) Non-participating funds (continued)

(iii) Mortality assumptions (continued)

T80-110 means that the long term rate of mortality improvements in the CMI mortality projections model tapers linearly to zero between ages 80 and 110. A smoothing parameter higher than the default parameter was used in CMI_2016.

Formerly Clerical Medical Investment Group Ltd

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

		2017	2016
Term Assurances	Males	29% TMC00 Ultimate	29% TMC00 Ultimate
	Females	40% TFC00 Ultimate	41% TFC00 Ultimate
Annuities Purchased (whole life)	Males	Bespoke mortality tables CMI_2016_M [2.25%]	89% PCMA00 CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	93% PCFA00 CMI _2014_F [2.05%] T80-110
Self-employed/ personal pensions	Males	Bespoke mortality tables CMI_2016_M [2.25%]	89% PCMA00 CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	93% PCFA00 CMI _2014_F [2.05%] T80-110
Other Annuities in payment	Males	Bespoke mortality tables CMI_2016_M [2.25%]	89% PCMA00 CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	93% PCFA00 CMI _2014_F [2.05%] T80-110
Deferred annuities	Males	Bespoke mortality tables CMI_2016_M [2.25%]	89% PCMA00 CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	93% PCFA00 CMI _2014_F [2.05%] T80-110

T80-110 means that the long term rate of mortality improvements in the CMI mortality projections model tapers linearly to zero between ages 80 and 110. A smoothing parameter higher than the default parameter was used in CMI_2016.

Under the mortality assumptions adopted for personal/ self-employed business a male aged 65 will live on average for 24 years.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(b) Non-participating funds (continued)

(iii) Mortality assumptions (continued)

Formerly Halifax Life Limited

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

		2017	2016
UL Individual Pensions Regular Premium	Males	54% AMC00 Ultimate	47% AMC00 Ultimate
	Females	54% AFC00 Ultimate	50% AFC00 Ultimate
UL Individual Pensions Single Premium	Males	54% AMC00 Ultimate	47% AMC00 Ultimate
	Females	54% AFC00 Ultimate	50% AFC00 Ultimate
UL Group Pension	Males	72% AMC00 Ultimate	85% AMC00 Ultimate
	Females	68% AFC00 Ultimate	83% AFC00 Ultimate
Pension Annuities	Males	Bespoke mortality tables CMI_2016_M [2.25%]	89% PCMA00 CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	93% PCFA00 CMI _2014_F [2.05%] T80-110
Deferred Annuities	Males	Bespoke mortality tables CMI_2016_M [2.25%]	89% PCMA00 CMI _2014_M [2.25%] T80-110
	Females	Bespoke mortality tables CMI_2016_F [2.05%]	93% PCFA00 CMI _2014_F [2.05%] T80-110

T80-110 means that the long term rate of mortality improvements in the CMI mortality projections model tapers linearly to zero between ages 80 and 110. A smoothing parameter higher than the default parameter was used in CMI_2016.

Formerly St Andrew's Life Assurance plc

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

		2017	2016
Term Assurances	Males		
	Smoker	98% TMS00 Select	98% TMS00Select
	Non-Smoker	98% TMN00 Select	90% TMN00Select
	Females		
	Smoker	104% TFS00 Select	109% TFS00Select
	Non-Smoker	104% TFN00 Select	109% TFN00Select
Investment Bonds	Males	72% AMC00 Ultimate	72% AMC00Ultimate
	Females	94% AFC00 Ultimate	94% AFC00Ultimate

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

36. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(3) The effect of changes in key assumptions

(a) With Profits Funds

There is no net impact on profit before tax of the changes in key assumptions within the With Profits Funds 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-participating funds

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

Variable	Impact on profit after tax 2017 £m *Group*	2017 £m *Company*	2016 £m *Group*	2016 £m *Company*
Mortality	213	213	250	250
Expenses	10	10	(126)	(126)
Lapses	(15)	(15)	(18)	(18)
Valuation interest rate	34	34	26	26
Inflation	33	33	(108)	(108)

The expense line includes the impact of the Diligenta outsourcing contract.

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

(a) With Profits Funds

There is no net impact on profit before tax of the changes in key assumptions within the With Profits Funds 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-participating funds

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

Variable	Change in variable	Impact on profit after tax 2017 £m *Group*	2017 £m *Company*	2016 £m *Group*	2016 £m *Company*
Annuitant Mortality	5% reduction	(193)	(193)	(243)	(243)
Non-annuitant Mortality	5% reduction	8	8	8	8
Lapses	10% reduction	(50)	(50)	(41)	(41)
Future maintenance expenses and investment expenses	10% reduction	136	136	162	162
Interest rate – change in redemption yield (1)	0.25% reduction	(16)	(16)	(80)	(80)
Interest rate – change in valuation margin(2)	0.25% reduction	(356)	(356)	(372)	(372)

(1) This interest rate sensitivity shows the impact of a 0.25% 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.

(2) This interest rate sensitivity shows, for 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 2017

37. Risk management

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

The Group assesses the relative costs and concentrations of each type of risk 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 Group manages them.

(a) Governance framework

The Group is part of LBG, which has established a risk management function with responsibility for implementing the LBG risk management framework (with appropriate Insurance focus) within the Group.

This enterprise-wide risk management framework for the identification, assessment, measurement and management of risk covers the full spectrum of risks that the Group and Company are exposed to, with risks categorised according to an approved LBG risk language. This covers the principal risks faced by the Group, including the exposures to market, insurance, credit, capital, liquidity, regulatory & legal, conduct, people, governance, operational and financial reporting risks. The performance of the Group, its continuing ability to write business and the strategic management of the business depend on its ability to manage these risks.

Responsibility for setting and managing risk appetite and risk policy resides with the Board. Risks are managed in line with LBG and Insurance risk policies. The Board has delegated certain risk matters to the Insurance Risk Oversight Committee with operational implementation assigned to the Insurance and Wealth Risk Committee.

The risk management approach aims to ensure effective independent checking or "oversight" of key decisions by operating 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 is the second line of defence. Internal Audit, the third line of defence, provide independent assurance to the Audit Committee and the Board that risks are recognised, monitored and managed within acceptable parameters.

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

(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 Group and LBG strategy. The Board has defined a framework for the management of risk and approved a set of risk appetite statements that cover financial risks (earnings, capital, insurance, credit, market and liquidity), operational risks, people, conduct risks, regulatory & legal risks, financial reporting and governance risks. The risk appetite statements set limits for exposures to the key risks faced by the business. Risk appetite is reviewed at least annually by the Board. Executive owned Tier 2 and Tier 3 limits sit beneath Board owned risk appetite (Tier 1) and are managed and governed within the Insurance business.

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

(c) Financial risks

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

The Group is exposed to a range of financial risks through its financial assets, financial liabilities, assets arising from reinsurance contracts and liabilities arising from insurance and investment contracts. 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, capital and liquidity risk.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

The Group 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 ("PPFMs") set out the way in which the with profits business is managed. The Group 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 Funds. The smoothing cushions policyholders from daily fluctuations in investment markets. This process is managed in accordance with the published PPFMs.

The financial risks arising from providing minimum guaranteed benefits are borne in the With Profits Funds, but the Group bears financial risk in relation to the possibility that in extreme market conditions the With Profits Funds might be unable to bear the full costs of the guarantees. 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 Group and 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, 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) 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 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 defined as the risk that unfavourable market movements (including changes in and increased volatility of interest rates, market-implied inflation rates, credit spreads and prices for bonds, foreign exchange rates, equity, property and commodity prices and other instruments) lead to reductions in earnings and/or value.

Investment holdings within the Group 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 with unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

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

- Assets held in shareholder funds are invested in money market funds, gilts, loans and investment grade bonds to match regulatory capital requirements. The balance of the shareholder fund assets is managed in line with the policies of LBG to optimise shareholder risk and return. This includes suitable use of derivatives to minimise shareholder risk.
- Unit-linked assets are invested in accordance with the nature of the fund mandates.
- Conventional non-profit liabilities are "close matched" as far as possible in relation to currency, nature and duration.
- With Profits Funds are managed in line with the published PPFMs. Benchmarks and minimum and maximum holdings in asset classes are specified to allow limited investment management discretion whilst ensuring adequate diversification. Swaps and swaptions provide significant protection to the With Profits Funds from the effects of interest rate falls in respect of the cost of guaranteed annuity rates.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

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 (e)).

Group As at 31 December 2017

	Fair value hierarchy Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	-	-	3,640	3,640
Assets arising from reinsurance contracts held at fair value through profit or loss	-	7,812	-	7,812
Equity securities	83,661	-	872	84,533
Debt securities	10,675	20,507	7,662	38,844
Derivative financial assets	244	3,160	61	3,465
Total assets	94,580	31,479	12,235	138,294
Derivative financial liabilities	585	2,562	-	3,147
Liabilities arising from non-participating investment contracts	-	15,447	-	15,447
Subordinated debt	-	1,795	-	1,795
Total liabilities	585	19,804	-	20,389

Company As at 31 December 2017

	Fair value hierarchy Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	-	-	189	189
Assets arising from reinsurance contracts held at fair value through profit or loss	-	7,812	-	7,812
Equity securities	92,908	142	823	93,873
Debt securities	4,917	6,968	7,683	19,568
Derivative financial assets	214	3,149	61	3,424
Total assets	98,039	18,071	8,756	124,866
Derivative financial liabilities	530	2,528	-	3,058
Liabilities arising from non-participating investment contracts	-	15,447	-	15,447
Subordinated debt	-	1,836	-	1,836
Total liabilities	530	19,811	-	20,341

Group As at 31 December 2016

	Fair value hierarchy Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	-	-	3,643	3,643
Assets arising from reinsurance contracts held at fair value through profit or loss	-	6,683	-	6,683
Equity securities	76,289	13	917	77,219
Debt securities	13,185	20,968	6,931	41,084
Derivative financial assets	267	3,489	44	3,800
Total assets	89,741	31,153	11,535	132,429
Derivative financial liabilities	355	2,653	-	3,008
Liabilities arising from non-participating investment contracts	-	20,112	-	20,112
Subordinated debt	-	1,819	-	1,819
Total liabilities	355	24,584	-	24,939

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

Company As at 31 December 2016

	Fair value hierarchy Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	-	-	178	178
Assets arising from reinsurance contracts held at fair value through profit or loss	-	6,683	-	6,683
Equity securities	88,327	210	909	89,446
Debt securities	5,354	6,601	6,929	18,884
Derivative financial assets	224	3,452	43	3,719
Total assets	93,905	16,946	8,059	118,910
Derivative financial liabilities	332	2,598	-	2,930
Liabilities arising from non-participating investment contracts	-	20,112	-	20,112
Subordinated debt	-	1,848	-	1,848
Total liabilities	332	24,558	-	24,890

Assets arising from reinsurance contracts held at fair value through profit and loss are valued using the published price for the funds invested in. Participating investment contracts are not included above, on the basis that fair value and carrying value would not be materially different.

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 Standard Investments and State Street. Prices are sourced from external sources, counterparties, and the Investment Manager (Aberdeen Standard Investments). Further detail on valuation is given in note 1(p).

Assets classified as Level 3 comprise private equity investments and property investment vehicles within equity securities, investment properties, certain loans assets, certain asset backed securities and equity release mortgages within debt securities and a prepayment hedge within derivative financial assets.

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 17. 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. 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.

The following valuation methods and sensitivity of valuation assumptions are applied to both the Group and the Company.

Loan assets
Loans classified as Level 3 within debt securities are valued using a discounted cash flow model. The discount rate comprises market observable interest rates, a risk margin that reflect loan credit ratings and calibrated to weighted average life on borrower level using sector bond spread curves for each rating, and an incremental illiquidity premium that is estimated by reference to historical spreads at origination on similar loans where available and established measures of market liquidity. Libor tenor and base rate options are valued stochastically using expected value approach, where simulated market data is based on historical market information. Prepayment options are valued using a monthly time step binomial tree approach.

Unobservable inputs in the valuation model include an Illiquidity premium (2017 spreads: 18.5bps to 51.5bps) and Inferred spreads (2017 spreads: 126bps to 236bps). The effect of applying reasonably possible alternative assumptions to the value of these loans would be to decrease the fair value by £235m (2016: £304m) or increase it by £276m (2016: £315m). There are no material interdependencies between the above assumptions.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

Equity release mortgages – ERM SPV

A portfolio of Equity Released Mortgages is securitised through a Special Purpose Vehicle into a Senior Note (A Note) and a Junior Note (B Note). These notes are classified as Level 3 within debt securities.

The equity release mortgages are valued using a discounted cash flow approach. Decrements (mortality, voluntary early repayment, entry into long-term care) are used to determine the incidence of cash flows. The discount rate is based on a risk free rate plus a spread to compensate for the risks associated with the loans which is determined on a portfolio level. There is a No Negative Equity Guarantee on the mortgages which is valued with a time-dependent Black-Scholes model.

Unobservable inputs in the valuation model include gross interest rate on mortgages 4.90% to 6.20% (2016: 5.75% to 7.25%), spread over risk-free (over swap) 3.44% to 3.78% (2016: 4.03% to 4.57%), residential property volatility and value 3.6% to 16.4% (2016: 3.6% to 16.4%), voluntary early repayment rate 6.26% to 9.08% (2016: 6.26% to 9.08%), delay in settlement of loan 3 months to 26 months (2016: 3 months to 26 months), property valuation haircut -5% to -10% (2016: -5% to -10%), and expected equity return 8% to 12% (2016: 8% to 12%). The effect of applying the aforementioned reasonably possible alternative assumptions in line with the ranges disclosed above would decrease the fair value by £5m (2016: £12m) or increase it by £14m (2016: £7m). There are no material interdependencies between the above assumptions.

Prepayment hedge

Level 3 derivatives include a bespoke prepayment hedge executed to mitigate prepayment risk within debt securities. An expected value approach based on historical data using a stochastic process is applied to value the derivative. Unobservable inputs include asset swap spreads (2017 weighted averages: 142bps to 250bps). The effect of applying a reasonably possible alternative assumption to the value of this asset would be to decrease the fair value by £14m (2016: £27m) or increase it by £16m (2016: £24m).

AgFe RESDF

The AgFe UK Real Estate Senior Debt Fund (known as AgFe RESDF) is a limited partnership set up and managed by AgFe. The asset is classified as a Level 3 asset and is included within equity securities. The fund holds a portfolio of underlying commercial real estate loans and is administered by Langham Hall. The AgFe RESDF fund consists of 10 senior loans which are marked-to-model valued using a discounted cash flow approach. The single source of valuation uncertainty for these loans is concerned with property values 7.5% to 12.5% (2016 stresses: 7.5% to 12.5%). The effect of applying reasonably possible alternative assumptions to the value of these loans would be to decrease the fair value by £8.2m (2016: £10.5m) or increase it by £0.8m (2016: £0.2m).

Agricultural Loans – AMC SPV

A portfolio of agricultural loans is securitised through a Special Purpose Vehicle into a Senior Note (A Note) and a Junior Note (E Note). These notes are classified as Level 3 within debt securities. The underlying agricultural loans are valued using a discounted cash flow approach. The discount rate comprises market observable interest rates, a risk margin that reflect underlying loan credit ratings, an incremental illiquidity premium as well as a prepayment cost of capital premium.

Unobservable inputs in the Agriculture valuation model include: Illiquidity premium (2017 spreads: 18.5bps to 51.5bps), Inferred spreads (2017 spreads: 134bps to 210bps) and prepayment rates (2017 rates: 78.35% to 121.15% for 1-5yrs and 57.37% to 157.72% for 5+ yrs).

The effect of applying reasonably possible alternative assumptions to the value of these loans would be to decrease the fair value by £21m (2016: £79m) or increase it by £26m (2016: £68m). There are no material interdependencies between the above assumptions.

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).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

Group

	2017		2016	
	£m	£m	£m	£m
	Assets	*Liabilities*	*Assets*	*Liabilities*
Balance at 1 January	11,535	-	12,276	-
Transfers in	103	19	143	-
Transfers out	(195)	(19)	(308)	-
Purchases	1,268	-	1,980	-
Disposals	(1,013)	-	(2,977)	-
Net gains recognised within net gains on assets and liabilities at fair value through profit or loss in the statement of comprehensive income	537	-	421	-
Balance at 31 December	12,235	-	11,535	-
Total unrealised gains for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	209	-	64	-

Company

	2017		2016	
	£m	£m	£m	£m
	Assets	*Liabilities*	*Assets*	*Liabilities*
Balance at 1 January	8,059	-	8,110	-
Transfers in	4	-	2	-
Transfers out	(52)	-	(94)	-
Purchases	1,026	-	1,681	-
Disposals	(512)	-	(2,085)	-
Net gains recognised within net gains on assets and liabilities at fair value through profit or loss in the statement of comprehensive income	231	-	445	-
Balance at 31 December	8,756	-	8,059	-
Total unrealised gains for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	192	-	196	-

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

(i) Equity and property risk

The exposure of the Group's insurance and investment contract business to equity risk relates to financial assets and financial liabilities whose values will fluctuate as a result of changes in market prices other than from interest and foreign exchange fluctuations. This is due to factors specific to individual instruments, their issuers or factors affecting all instruments traded in the market. Accordingly, the Group 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 for the year	
	2017	2016
	£m	£m
10% (2016: 10%) decrease in equity prices	(100)	(3)
10% (2016: 10%) decrease in property prices	(6)	(2)

Following an update to the methodology the sensitivities now allow for the impact on charges to funds for policyholder tax. This has significantly changed the size of the impacts.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

(ii) Interest rate risk

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

The Group'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 result in losses may 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 36. The effect on the Group 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 for the year	
	2017 £m	2016 £m
25 basis points (2016: 25 basis points) increase in yield curves	11	72
25 basis points (2016: 25 basis points) decrease in yield curves	(16)	(80)

(iii) Foreign exchange risk

Foreign exchange risk relates to the effects of movements in exchange markets including changes in exchange rates.

US corporate bonds are held within the annuity portfolio, the cash flows of which are hedged to ensure close matching of the annuity liabilities is maintained. Foreign exchange risk arises on these investments as there may be a mismatch in fair values of the bonds and derivatives resulting from movements in US dollar - sterling exchange rates.

With the exception of these holdings, the overall risk to the Group is minimal due to the following:

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

The fair value of US dollar assets and liabilities, net of offsetting movements in insurance and investment contract liabilities, will fluctuate because of changes in exchange rates at the reporting date. Sensitivity analysis for the impact of a 10% depreciation of sterling against the US dollar shows a £nil impact for 2017 on profit after tax and equity (2016: £(1)m).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(2) Insurance underwriting risk

Insurance underwriting risk is defined as the risk of adverse developments in longevity, mortality, persistency, General Insurance underwriting and policyholder behaviour, leading to reductions in earnings and/or value.

The principal risk the Group 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 Group's business involves the accepting of insurance underwriting risks which primarily relate to mortality, longevity, morbidity, persistency and expenses. Each company within the Group which transacts new business underwrites policies to ensure an appropriate premium is charged for the risk or that the risk is declined.

The Group 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; and
- Morbidity products – where the policyholder is insured against the risk of contracting a defined illness.

For contracts where death is the insured risk, the most significant factors that could increase the overall level of claims are epidemics or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected. The possibility of a pandemic, for example one arising from influenza, 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 underwriting risk accepted. For participating investment contracts, the participating nature of these contracts results in a significant portion of the insurance underwriting risk being shared with the policyholder.

Insurance underwriting risk is also affected by the policyholders' right to pay reduced or no future premiums, to terminate the contract completely, to exercise a guaranteed annuity option or, for bulk annuity business, for pensioners to exercise options following retirement. As a result, the amount of insurance underwriting risk is also subject to policyholder behaviour. On the assumption that policyholders will make decisions that are in their best interests, overall insurance underwriting 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 Group has taken account of the expected impact of policyholder behaviour in setting the assumptions used to measure insurance and investment contract liabilities.

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

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

Rates of mortality and morbidity are investigated annually based on the Group's recent experience. Future mortality improvement assumptions are set using the latest population data available. In addition, bulk annuity business pricing and valuation assumptions also consider underlying experience of the scheme where available. Where they exist, the reinsurance arrangements of each company in the Group are reviewed at least annually.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(2) Insurance underwriting risk (continued)

Persistency risk is the risk associated with the ability to retain long-term business and the ability to renew short-term business. The Group 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 36.

(3) Credit risk

The risk that counterparties with whom we have contracted, fail to meet their financial obligations, resulting in loss to the Group.

The Group accepts credit risk with a variety of counterparties through invested assets which are primarily used to back annuity business, cash in liquidity funds and bank accounts, derivatives and reinsurance. These are managed through a credit control framework which uses a tiered approach to set credit limits:

- Tier 1: Credit limits are set by the Insurance Board as part of the overall Insurance Risk Appetite.
- Tier 2: Insurance and Wealth Investment Strategy Committee ('IWISC') assists the IWISC Chair to set additional controls, sub limits and guidelines. These operate within the boundaries of the Board's Tier 1 Risk Appetite statements and are designed to assist the business with more efficient utilisation of higher level Board Risk Appetite statements in delivery of Insurance's investment strategy.
- Tier 3: Insurance Credit approvers have individual personal delegated authorities from the Insurance Board to approve exposures to individual counterparties. Amounts above these delegated authorities require approval by the Insurance Board.

Group exposure limits are set for the maximum single name concentration, industry sector, country of risk and portfolio quality. In addition, each individual counterparty exposure requires a counterparty limit or is within the criteria of an approved sanction matrix.

Group exposures are reported on a monthly basis to the Insurance Shareholder Investment Management Committee ('ISIM') and semi-annually to IWISC, and other senior committees. Any exceptions to limits must be approved in advance by the relevant authority that owns that limit, and any unapproved excesses notified to that authority as a breach.

A core part of the invested asset portfolio which backs the annuity business is invested in loan assets. These have predominately been purchased from LBG although the Group has also started originating new business. All loan assets are assessed and monitored using established robust processes and controls.

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 policyholders access to third party funds via Investment Fund Links which we are unable to provide through other means. The Group'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 Group has reinsurance on all significant lines of business where mortality, morbidity or property risks exceed set retention limits. This does not, however, discharge the Group's liability as primary insurer. If a reinsurer fails to pay a claim for any reason, the Group 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. Reinsurance for Investment Fund Links is not assessed as a counterparty exposure for the Group since with invested assets matching liabilities, any loss to the Group would only be the result of operational failures of internal controls and as such it is outside of the credit control framework described above.

Shareholder funds are managed in line with the Insurance Credit Risk Policy and the wider LBG Credit Risk Policy which set out the principles of the credit control framework outlined above.

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

The tables below analyse financial assets subject to credit risk using Standard & Poor's rating or equivalent. For certain classes of assets, internally generated ratings have been used where external ratings are not available. This includes credit assets held in both shareholder and policyholder funds. No account is taken of any collateral held to mitigate the risk.

Group As at 31 December 2017

	Total £m	AAA £m	AA £m	A £m	BBB or lower £m	Not rated £m
Assets arising from reinsurance contracts held	8,377	-	202	363	7,812	-
Debt securities	38,844	2,632	13,305	12,903	9,639	365
Derivative financial instruments	3,465	-	79	2,823	319	244
Loans and receivables	4,037	-	24	2,585	(25)	1,453
Cash at bank	1,932	14	286	1,594	8	30
Total	56,655	2,646	13,896	20,268	17,753	2,092

Group As at 31 December 2016

	Total £m	AAA £m	AA £m	A £m	BBB or lower £m	Not rated £m
Assets arising from reinsurance contracts held	7,387	-	736	6,642	9	-
Debt securities	41,084	3,433	14,870	12,996	8,823	962
Derivative financial instruments	3,800	-	412	2,738	383	267
Loans and receivables	6,227	8	67	817	4,415	920
Cash at bank	2,207	140	1,017	1,002	37	11
Total	60,705	3,581	17,102	24,195	13,667	2,160

Company As at 31 December 2017

	Total £m	AAA £m	AA £m	A £m	BBB or lower £m	Not rated £m
Assets arising from reinsurance contracts held	8,377	-	202	363	7,812	-
Debt securities	19,568	727	6,996	7,657	3,348	840
Derivative financial instruments	3,424	-	73	2,820	318	213
Loans and receivables	2,868	-	-	2,008	-	860
Cash at bank	1,063	-	25	1,037	1	-
Total	35,300	727	7,296	13,885	11,479	1,913

Company As at 31 December 2016

	Total £m	AAA £m	AA £m	A £m	BBB or lower £m	Not rated £m
Assets arising from reinsurance contracts held	7,387	-	736	6,642	9	-
Debt securities	18,884	810	7,466	6,642	3,183	783
Derivative financial instruments	3,719	-	390	2,722	383	224
Loans and receivables	5,162	8	40	455	4,420	239
Cash at bank	1,291	-	688	597	6	-
Total	36,443	818	9,320	17,058	8,001	1,246

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

Amounts classified as "not rated" within assets arising from reinsurance contracts held principally relate to amounts due from other Group companies which are not rated by Standard & Poor's or an equivalent rating agency.

Maximum credit exposure

The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss, which includes amounts held to cover unit-linked and With Profits Funds liabilities, is considered to be the balance sheet carrying amount.

Group	2017 Maximum exposure £m	2017 Offset £m	2017 Net exposure £m	2016 Maximum exposure £m	2016 Offset £m	2016 Net exposure £m
Loans and receivables	4,037	-	4,037	6,227	-	6,227
Investments at fair value through profit or loss:						
Debt Securities	38,844	-	38,844	41,084	-	41,084
Assets arising from reinsurance contracts held	8,377	-	8,377	7,387	-	7,387
Derivative financial instruments	3,465	-	3,465	3,800	-	3,800
Cash and cash equivalents	1,932	-	1,932	2,207	-	2,207
At 31 December	56,655	-	56,655	60,705	-	60,705

Company	2017 Maximum exposure £m	2017 Offset £m	2017 Net exposure £m	2016 Maximum exposure £m	2016 Offset £m	2016 Net exposure £m
Loans and receivables	2,868	-	2,868	5,162	-	5,162
Investments at fair value through profit or loss:						
Debt Securities	19,568	-	19,568	18,884	-	18,884
Assets arising from reinsurance contracts held	8,377	-	8,377	7,387	-	7,387
Derivative financial instruments	3,424	-	3,424	3,719	-	3,719
Cash and cash equivalents	1,063	-	1,063	1,291	-	1,291
At 31 December	35,300	-	35,300	36,443	-	36,443

(i) Concentration risk

Credit concentration risk

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

Credit risk is managed through the setting and regular review of counterparty credit and concentration limits on asset types which are considered more likely to lead to a concentration of credit risk. For other asset types, such as UK government securities or investments in funds falling under the Undertakings for Collective Investment in Transferable Securities "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 PRA for regulatory reporting.

At 31 December 2017 and 31 December 2016, the Group 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 1.0% (2016: 1.6% of the Group's total assets).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(i) Concentration risk (continued)

Liquidity concentration risk

Liquidity concentration risk arises where the Group 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 Group'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 Group, to ensure that even under stress conditions the Group has sufficient liquidity as required to meet its obligations. This is delegated by the Board to and monitored through the Insurance and Wealth Asset and Liability Committee ("IWALCO"), IWRC, ISIM and Banking and Liquidity Operating Committee ("BLOC").

(ii) Collateral management

Collateral in respect of derivatives

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"), which forms part of the International Swaps and Derivatives Association ("ISDA") agreement between the Company and the counterparty.

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 Derivatives Risk Policy ("DRP"). The aggregate uncollateralised exposure to any one counterparty must not exceed limits specified in the DRP. Where derivative counterparties are related, the aggregate net exposure is considered for the purposes of applying these limits.

Acceptable collateral is defined in each instance and must take into account the quality and appropriateness of the proposed collateral as well as being acceptable to the entity receiving the collateral. Collateral may include cash, corporate bonds, supranational debt and government debt.

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 and other derivative contracts:

	2017		2016	
	£m	£m	£m	£m
	Group	Company	Group	Company
Financial assets:				
Investments at fair value through profit or loss	353	353	202	202
Cash and cash equivalents	314	307	413	410
Total	667	660	615	612

Collateral pledged in form of financial assets, is continued to be recognised in the balance sheet as the Group and Company retains all risks and rewards of the transferred assets. The Group and the Company has the right to recall any collateral pledged provided that this is replaced with alternative acceptable assets. The counterparty has right to repledge or sell the collateral in the absence of default by the Group and Company.

Cash collateral pledged where the counterparty retains the risks and rewards is derecognised from the balance sheet and a corresponding receivable is recognised for its return.

Where the Group and Company receives collateral in form of financial instruments for which counterparty retains all risks and rewards, it is not recognised in the balance sheet. The fair value of financial assets accepted as collateral for OTC derivatives but not recognised in the balance sheet amounts to £932m (2016: £1,255m) by the Group and £932m (2016: £1,255m) by the Company, all of which is permitted to be sold or repledged in the absence of default. However the policy of the Group and Company is not to repledge assets, and hence no collateral was sold or repledged by the Group or Company during the year or in the prior year.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(ii) Collateral management (continued)

Where the Group and Company receives collateral in form of cash, it is recognised in the balance sheet along with a corresponding liability to repay the amount of collateral received within other financial liabilities. The amount of cash collateral received by the Group and Company amounts to £271m (2016: £230m) and £270m (2016: £221m) respectively.

Collateral in respect of Stock Lending

The Group and Company lend financial assets held in its portfolio to other institutions. The IWISC and its sub-committee Investment Management Operational Review Committee (IMOR) are responsible for setting the parameters of stock lending. Stock lending is permitted in accordance with the Insurance Stock Lending Policy. All stock lending takes place on an open/call basis, enabling the loan to be recalled at any time within the standard settlement terms of the market concerned

The financial assets lent do not qualify for derecognition as the Group and Company retains all risks and rewards of the transferred assets except for the voting rights. The aggregate carrying value of securities on loan by the Group is £5,080m (2016: £5,048m) and by the Company is £951m (2016: £748m).

It is the Group's and Company's practice to obtain collateral in stock lending transactions. 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.

Where the Group and Company receives collateral in form of financial instruments for which counterparty retains all risks and rewards, it is not recognised in the balance sheet. The fair value of financial assets accepted as collateral but not recognised in the balance sheet amounts to £4,750m (2016: £4,969m) by the Group and £962m (2016: £762m) by the Company. The Group and the Company is not permitted to sell or repledge the collateral in the absence of default.

Where the Group and Company receives collateral in form of cash, it is recognised in the balance sheet along with a corresponding liability to repay the amount of collateral received within other financial liabilities. The amount of cash collateral received by the Group and Company amounts to £677m (2016: £465m) and £34m (2016: £41m) respectively.

There were no defaults in respect of stock lending during the year ended 31 December 2017 (2016: none) which required a call to be made on collateral.

Collateral in respect of Reverse Repurchase Agreement

The Group and Company entered into Reverse Repurchase Agreements whereby it purchased financial instruments with an agreement to resell them back to the counterparty at an agreed price. These transactions are in effect collateralised loans and are reported accordingly. The cash on loan is recognised as Loans and Receivables. The amount of cash on loan in this regard is £677m (2016: £465m) for the Group and £34m (2016: £41m) for Company.

The financial assets received as collateral are not recognised on the balance sheet as the counterparty retains all risks and rewards. The fair value of financial assets accepted as collateral amounted to is £720m (2016: £493m) for the Group and £36m (2016: £43m) for Company.

Collateral in respect of Repurchase Agreement

Collateral pledged in respect of a repurchase agreement with Lloyds Bank Plc continues to be recognised on the Company's balance sheet, the amount pledged was £594m (2016: £595m) for Group and Company.

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. The minimum 130% collateral to loan ratio reflects the illiquid nature of some of the asset backed securities used in the collateral arrangement. If any of the collateral was not readily realisable the Company would hold it for investment purposes.

Collateral amounts held are not recognised as assets. At 31 December 2017 collateral with a fair value of £1,835m (2016: £1,840m) was held by the group and £1,835m (2016: £1,840m) available to the Group to sell or repledge in the absence of default by the counterparty. Of this, £1,835m (2016: £1,840m) was held by the Company and £1,835m (2016: £1,840m) available to the Company to sell or repledge in the absence of default by the counterparty. No other collateral (2016: £nil) was repledged during the year by the Group or Company. The Group and Company have an obligation to return these assets to the pledgor.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(ii) Collateral management (continued)

Collateral in respect of Bulk Annuity Business

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 cash, corporate bonds, supranational debt and government debt.

During 2017, the Company purchased Bulk Annuity contracts which provide buy in and buy out solutions to defined benefit pension schemes. To enter into the transaction some trustees may seek collateral to cover the counterparty default scenario. Collateral pledged in respect of Bulk Annuity business was £1,644m (2016: £1,333m) for Group and Company.

(iii) Offsetting

The following tables show financial assets and liabilities which have been set off in the balance sheet and those which have not been set off but for which the Group and the Company has enforceable master netting agreements in place with counterparties. They include Derivatives, Repurchase and Reverse Repurchase arrangements.

a) *Derivatives*

The derivative assets and liabilities in the tables below consist of OTC and exchange traded (ET) derivatives. The value of gross/net amounts for derivatives in the table below comprises those that are subject to master netting arrangements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32. As a result no amount has been set off in the balance sheet (2016: nil). Total derivatives presented in the balance sheet are shown in note 19.

The "financial instruments" amounts in the tables below show the values that can be set off against the relevant derivatives asset and liabilities in the event of default under master netting agreements. In addition, the Group and the Company holds and provides cash and securities collateral in respective of derivative transactions to mitigate credit risks.

In the tables below, the amounts of derivative assets or liabilities presented are offset first by financial instruments that have the right of offset under master netting with any remaining amount reduced by the amount collateral.

b) Repurchase and Reverse Repurchase Arrangements

The Group and the Company participates in repurchase (repo) and reverse repurchase arrangements (reverse repo). The gross/net amount in the table shows the relevant assets that the Group and the Company has transferred to counterparties under these arrangements. Cash and non cash collateral is received by the Group and the Company for securities transferred. Cash collateral may be reinvested by the Group and Company through reverse repo against non cash collateral.

In the tables below, the amounts that are subject to repo and reverse repo are set off against the amount of collateral received according to the relevant legal agreements, showing the potential net amounts.

The actual fair value of collateral may be greater than amounts presented in the tables below in the case of over collateralisation.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(iii) Offsetting (continued)

Group as at 31 December 2017

	Gross amounts of assets / liabilities	Amounts set off in the balance sheet	Net amounts presented in the balance sheet[1]	Related amounts where set off not permitted in the balance sheet[2] Financial instruments	Collateral	Potential net amounts if offset of related amounts permitted
	£m	£m	£m	£m	£m	£m
Financial assets						
OTC Derivatives	3,220	-	3,220	(1,906)	(1,202)	112
ET Derivatives	245	-	245	(231)	(14)	-
Repo	592	-	592	-	(592)	-
Reverse Repo	677	-	677	-	(677)	-
Financial liabilities						
OTC Derivatives	(2,561)	-	(2,561)	1,906	618	(37)
ET Derivatives	(586)	-	(586)	231	355	-

Group as at 31 December 2016

	Gross amounts of assets / liabilities	Amounts set off in the balance sheet	Net amounts presented in the balance sheet[1]	Related amounts where set off not permitted in the balance sheet[2] Financial instruments	Collateral	Potential net amounts if offset of related amounts permitted
	£m	£m	£m	£m	£m	£m
Financial assets						
OTC Derivatives	3,474	-	3,474	(1,957)	(1,485)	32
ET Derivatives	267	-	267	(240)	(27)	-
Repo	595	-	595	-	(587)	8
Reverse Repo	465	-	465	-	(465)	-
Financial liabilities						
OTC Derivatives	(2,563)	-	(2,563)	1,957	602	(4)
ET Derivatives	(355)	-	(355)	240	56	(59)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(iii) Offsetting (continued)

Company as at 31 December 2017

	Gross amounts of assets / liabilities £m	Amounts set off in the balance sheet £m	Net amounts presented in the balance sheet[1] £m	Related amounts where set off not permitted in the balance sheet[2] Financial instruments £m	Collateral £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
OTC Derivatives	3,211	-	3,211	(1,906)	(1,203)	102
ET Derivatives	213	-	213	(210)	(3)	-
Repo	592	-	592	-	(592)	-
Reverse Repo	34	-	34	-	(34)	-
Financial liabilities						
OTC Derivatives	(2,528)	-	(2,528)	1,906	611	(11)
ET Derivatives	(530)	-	(530)	210	320	-

Company as at 31 December 2016

	Gross amounts of assets / liabilities £m	Amounts set off in the balance sheet £m	Net amounts presented in the balance sheet[1] £m	Related amounts where set off not permitted in the balance sheet[2] Financial instruments £m	Collateral £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
OTC Derivatives	3,465	-	3,465	(1,957)	(1,476)	32
ET Derivatives	224	-	224	(223)	(1)	-
Repo	595	-	595	-	(587)	8
Reverse Repo	41	-	41	-	(41)	-
Financial liabilities						
OTC Derivatives	(2,560)	-	(2,560)	1,956	600	(4)
ET Derivatives	(333)	-	(333)	223	51	(59)

The following notes are relevant to the tables on this and the preceding page:

1. The value of net amounts presented in the balance sheet for derivatives comprises those derivatives held by the Group and the Company that are subject to master netting arrangements. Total derivatives presented in the balance sheet are shown in note 19.

2. The Group and the Company enters into derivative transactions with various counterparties which are governed by industry standard master netting agreements. The Group and the Company holds and provides cash and securities collateral in respective of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(iv) Liquidity risk

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at 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 Group's liquidity is assessed in a stress scenario. Liquidity risk is actively managed and monitored to ensure that, even under stress conditions, the Company and Group 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. The stressed outflows also make allowance for the increased collateral that needs to be posted under derivative contracts in stressed conditions. Liquidity risk is actively managed and monitored to ensure that, even under stress conditions, the Group has sufficient liquidity to meet its obligations and remains within approved risk appetite.

Liquidity methodology and reporting was updated to ensure compliance with Solvency II.

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, loans 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 policyholders' reasonable expectations.

Liquidity is maintained within the portfolio via the holding of cash balances and a substantial number of highly liquid assets, principally gilts, bonds and listed equities. Management also have the ability to sell less liquid assets at a reduced price if necessary, with any loss being borne within the With Profits Fund. Losses are managed and mitigated by anticipating policyholder claim payments to plan 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 2017, there are no funds under management subject to deferral (2016: none).

For non-linked products other than annuity contracts, backing 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 is maintained within the portfolio via the holding of cash balances and a substantial number of highly liquid assets, principally gilts and bonds.

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(iv) Liquidity risk (continued)

Liquidity risk in respect of liabilities arising from insurance contracts and participating investment contracts has been analysed based on the expected pattern of maturities as permitted by IFRS 4 rather than by contractual maturity. A maturity analysis of liabilities arising from 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 Group and Company.

Group As at 31 December 2017			Contractual cash flows				
Liabilities	**Carrying amount**	**No stated maturity**	**Less than 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**More than 5 years**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Liabilities arising from non-participating investment contracts	15,447	-	15,447	-	-	-	-
External interests in collective investment vehicles	14,485	14,395	-	-	-	-	90
Derivatives held for trading	3,147	-	13	123	641	524	2,305
Subordinated debt	1,795	51	-	-	113	416	2,345
Borrowings	10	-	10	-	-	-	-
Other financial liabilities	3,005	226	2,141	8	630	-	-
Total	37,889	14,672	17,611	131	1,384	940	4,740

Group As at 31 December 2016			Contractual cash flows				
Liabilities	***Carrying amount***	***No stated maturity***	***Less than 1 month***	***1-3 months***	***3-12 months***	***1-5 years***	***More than 5 years***
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Liabilities arising from non-participating investment contracts	20,112	-	20,112	-	-	-	-
External interests in collective investment vehicles	14,207	14,207	-	-	-	-	-
Derivatives held for trading	3,008	-	56	114	469	707	2,071
Subordinated debt	1,819	51	-	-	92	462	2,424
Borrowings	12	-	12	-	-	-	-
Other financial liabilities	3,153	355	2,204	24	570	-	-
Total	42,311	14,613	22,384	138	1,131	1,169	4,495

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(iv) Liquidity risk (continued)

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

Group As at 31 December 2017 Maturity Analysis for liabilities arising from 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 and participating investment contracts	102,916	1,121	1,496	5,076	23,944	71,279
Non-participating investment contracts	15,447	324	297	1,181	4,923	8,722

Group As at 31 December 2016 Maturity Analysis for liabilities arising from 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 and participating investment contracts	93,799	989	1,418	4,616	21,461	65,315
Non-participating investment contracts	20,112	123	232	1,025	4,929	13,803

Company As at 31 December 2017			Contractual cash flows				
Liabilities	Carrying amount £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
Borrowings	2	-	2	-	-	-	-
Liabilities arising from non-participating investment contracts	15,447	-	15,447	-	-	-	-
Derivative financial instruments	3,058	-	3	79	609	517	2,305
Subordinated debt	1,836	51	-	-	92	436	2,386
Other financial liabilities	2,233	196	1,445	-	592	-	-
Total	22,576	247	16,897	79	1,293	953	4,691

Company As at 31 December 2016			Contractual cash flows				
Liabilities	Carrying amount £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
Borrowings	4	-	4	-	-	-	-
Liabilities arising from non-participating investment contracts	20,112	-	20,112	-	-	-	-
Derivative financial instruments	2,930	-	9	89	465	702	2,071
Subordinated debt	1,848	51	-	-	92	461	2,453
Other financial liabilities	2,204	340	1,347	-	517	-	-
Total	27,098	391	21,472	89	1,074	1,163	4,524

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(iv) Liquidity risk (continued)

An analysis of liabilities arising from insurance and investment contracts by expected contract maturity, on a discounted basis, is shown below:

Company As at 31 December 2017 Maturity Analysis for liabilities arising from insurance contracts 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 and participating investment contracts	102,916	1,121	1,496	5,076	23,944	71,279
Non-participating investment contracts	15,447	324	297	1,181	4,923	8,722

Company As at 31 December 2016 Maturity Analysis for liabilities arising from 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 and participating investment contracts	93,799	989	1,418	4,616	21,461	65,315
Non-participating investment contracts	20,112	123	232	1,025	4,929	13,803

(v) Capital risk

Capital risk is defined as the risk that the Group has a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group. The risk that:

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

The business of several of the companies within the Group is regulated by the PRA and the FCA. The PRA rules, which incorporate all Solvency II requirements, specify the minimum amount of capital that must be held by the regulated companies within the Group in addition to their insurance liabilities. Under the Solvency II rules, each insurance company within the Group must hold assets in excess of this minimum amount, which is derived from an economic capital assessment undertaken by each regulated company and the quality of capital held must also satisfy Solvency II tiering rules. This is reviewed on a quarterly basis by the PRA.

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

The Group's objectives when managing capital are:

- to have sufficient capital to safeguard the Group'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 Schemes of Transfer.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(v) Capital risk (continued)

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

The Company's capital comprises all components of equity, movements in which are set out in the statement of changes in equity and includes subordinated debt (note 30).

The table below sets out the regulatory capital held at 31 December in each year for the Company on a Solvency II basis. The current year information is an estimate of the final result:

Company

	2017 £m	2016 £m
Regulatory Capital held	8,387	7,882

All minimum regulatory requirements were met during the year.

(d) Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. There are a number of secondary categories of operational risk including the undernoted:

Financial crime and fraud risk

Financial crime concerns activity related to money laundering, sanctions, terrorist financing and bribery. Fraud covers acts intended to defraud, misappropriate property or circumvent the law. These activities could give rise to risk of reduction in earnings and/or value, through financial or reputational loss. Losses may include censure, fines or the cost of litigation.

Information security and physical security risk

Information security risk relates to the risk of reductions in earnings and/or value, through financial or reputational loss, resulting from theft of or damage to the security of the Group's information and data. Physical security risk relates to the risk to the security of people and property.

Operational resilience risk

Operational resilience risk covers the risk or instances of interruptions to business operations (including critical buildings, critical and core infrastructure and IT systems, suppliers and colleagues), as a consequence of external or internal events due to insufficient resilience, inadequate recovery strategies and/or continuity systems and controls.

Change risk

Change risk is related to the management of change - designing and implementing key projects or programme. Potential loss could arise from failure requirements, budget or timescale; failure to implement change effectively; or failure to realise desired benefits.

Sourcing and service provision risk

Sourcing risk covers the risk of reductions in earnings and/or value through financial or reputational loss from risks associated with activity related to the agreement and management of services provided by third parties including outsourcing.

Service provision risk covers the risks associated with provision of services to a third party and with the management of internal intra-group service arrangements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

37. Risk management (continued)

(d) Operational risk (continued)

IT systems and cyber risk

The risk of reductions in earnings and/or value through financial or reputational loss resulting from the failure to develop, deliver or maintain a resilient IT solution or protect against cyber attack and other system disruption. The Directors have embedded a risk framework and monitor the effective operation of this across the Group.

(e) People risk

People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver to customers, shareholders and regulators leading to an inability to deliver the Group's strategy.

(f) Regulatory and Legal risk

Regulatory and legal risk is defined as the risk that the Group is exposed to fines, censure, legal or enforcement action, civil or criminal proceedings in the courts (or equivalent) and risk that the Group is unable to enforce its rights as anticipated.

Regulators aim to protect the rights of customers, ensuring firms satisfactorily manage their affairs for the benefit of customers and that they retain sufficient capital and liquidity. The Group has embedded a risk framework to closely monitor and manage its legal and regulatory risks, and maintains regular interaction with its regulators.

(g) Conduct risk

Conduct risk is defined as the risk of customer detriment or regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment or business conduct.

The Group is focused on delivering fair customer outcomes, and has embedded a risk framework to effectively monitor and manage its conduct risks.

(h) Financial reporting risk

Financial reporting risk is defined as the risk that the Group suffers reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial and regulatory reporting, failure to manage the associated risks of changes in taxation rates, law, ownership or corporate structure and the failure to disclose accurate and timely information.

(i) Governance risk

Governance risk is defined as the risk that the Group's organisational infrastructure fails to provide robust oversight of decision making and the control mechanisms to ensure strategies and management instructions are implemented effectively.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

38. Related party transactions

(a) Ultimate parent and shareholding

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

The Company's ultimate parent company and ultimate controlling party is Lloyds Banking Group plc, which is also the parent undertaking of the largest group of undertakings for which group accounts are drawn up and of which the Company is a member. Lloyds Bank plc is the parent undertaking of the smallest such group of undertakings for which group accounts are drawn up and of which the Company is a member. Copies of the Lloyds Banking Group plc financial statements in which the Company is consolidated can be obtained from the Group Secretary's Department, Lloyds Banking Group plc, 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com.

(b) Transactions and balances with related parties

Transactions with other LBG companies

In accordance with IAS 24 "Related Party Disclosures", transactions and balances between Group companies have been eliminated on consolidation and have not been reported as part of the consolidated financial statements.

The Group has entered into transactions with related parties in the normal course of business during the year.

	2017			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	20	(2,563)	-	348
Other related parties	508	(826)	(2,296)	2,875

	2016			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	32	(250)	(7)	2,271
Other related parties	849	(587)	(1,923)	3,206

The Company has entered into transactions with related parties in the normal course of business during the year.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

38. Related party transactions (continued)

(b) Transactions and balances with related parties (continued)

	2017			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	20	(2,563)	-	348
Subsidiary	177	(545)	(270)	702
Other related parties	244	(266)	(1,864)	2,714

	2016			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	32	(250)	(7)	2,271
Subsidiary	37	(629)	(409)	674
Other related parties	614	(119)	(1,617)	3,158

Further, amounts relating to other related parties of £2,328m due from OEICs investments were outstanding at 31 December 2017 (2016: £11,586m). The above balances are unsecured in nature and are expected to be settled in cash.

Included within the consolidated statement of comprehensive income were net income amounts relating to related other parties of £217m (2016: £336m) from OEIC investments.

Parent undertaking transactions relate to all reported transactions and balances with Scottish Widows Group Limited, the group's immediate parent. Such transactions with the parent company are primarily financing (through capital and sub-ordinated debt), provision of loans and payment of dividends.

Transactions with other related parties (which including Subsidiary and Other categories above) are primarily in relation to operating and employee expenses.

Transactions between the Group and entity employing key management

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 all directors and Insurance and Wealth Executive Committee ("IWEC") members. Key management personnel, as defined by IAS 24, are employed by a management entity, transactions with this entity are as follows:

Key management compensation:

	2017 £m	2017 £m	2016 £m	2016 £m
	Group	*Company*	*Group*	*Company*
Short-term employee benefits	7.3	7.3	5.5	5.5
Post-employment benefits	0.1	0.1	0.2	0.2
Share-based payments	2.2	2.2	1.6	1.6
Total	9.6	9.6	7.3	7.3

Included in short term employee benefits is the aggregate amount of emoluments paid to or receivable by directors in respect of qualifying services of £3.0m (2016: £2.8m).

There were no retirement benefits accruing to directors (2016: none) under defined benefit pension schemes. Four directors (2016: six directors) are paying into a defined contribution scheme. There were no contributions paid to a pension scheme for qualifying services (2016: £15.7k) for Group and Company.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

38. Related party transactions (continued)

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

The aggregate amount of money receivable and the net value of assets received/receivable under share based incentive schemes in respect of directors qualifying services was £1.2m (2016: £1.1m). During the year, two directors exercised share options (2016: three directors) and five directors' received qualifying service shares under long term incentive schemes (2016: eight directors). Movements in share options are as follows:

	2017 Millions Options	2016 Millions Options
Outstanding at 1 January	12	12
Granted	9	5
Exercised	(4)	(5)
Forfeited	(4)	-
Outstanding at 31 December	13	12

Detail regarding the highest paid Director is as follows:

	2017 £m	2017 £m	2016 £m	2016 £m
	Group	*Company*	*Group*	*Company*
Apportioned aggregate emoluments	1.6	1.6	2.2	2.2
Apportioned post-employment benefits	0.0	0.0	0.0	0.0
Apportioned share-based payments	1.0	1.0	0.8	0.8

The highest paid Director did exercise share options during the year. (2016: The highest paid director did exercise share options during the year).

39. Operating leases

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

	2017 £m	2017 £m	2016 £m	2016 £m
	Group	*Company*	*Group*	*Company*
Within one year	179	11	189	11
Between two and five years	553	41	633	41
Beyond five years	1,077	127	1,265	133
Total	1,809	179	2,087	185

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

	2017 £m	2017 £m	2016 £m	2016 £m
	Group	*Company*	*Group*	*Company*
Within one year	2	-	3	-
Between two and five years	7	-	12	-
Beyond five years	370	-	429	-
Total	379	-	444	-

The total of contingent rents recognised as income during the year was £nil (2016: £nil). The total of contingent rents recognised as operating expenses during the year was £1m (2016: £1m). Operating lease receipts and payments represent rental receivable and payable by the Group for certain of its properties. Generally the Group's operating leases are for terms of 15 years or more.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

40. Capital commitments

The Group has given an undertaking to provide up to £1,366m (2016: £1,518m) of capital to private equity investments and at 31 December 2017, £1,218m had been drawn down (2016: £1,372m). The remainder of the funds committed can no longer be drawn down as the draw down period has closed. The Group has contracted for, but not paid for, £21m (2016: £65m) of development expenses for investment property. Of this amount, the Company has contracted for, but not paid for, £nil (2016: £nil). The Company invests in a number of private equity entities to which capital of £1,366m was committed at 31 December 2017 (2016: £1,518m). The total amount drawn down at 31 December 2017 was £1,218m (2016: £1,372m). The remainder of the funds committed can no longer be drawn down as the draw down period has closed. The Group has also agreed £245m of undrawn loan commitments in 2017 (2016: £nil). £5m was drawn by the balance sheet date with £83m to be drawn within one year and the remaining £162m to be drawn within three years. The commitments are irrevocable if the borrowers meet the terms of the agreements.

41. Future accounting developments

The following pronouncements may have a significant effect on the Group's financial statements but are not applicable for the year ending 31 December 2017 and have not been applied in preparing these financial statements. Except as disclosed below, the full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	IASB effective date
IFRS 9 "Financial Instruments"	Replaces IAS 39 "Financial Instruments: Recognition and Measurement." *Classification and Measurement* IFRS 9 requires financial assets to be classified into one of three measurement categories, fair value through profit or loss, fair value through other comprehensive income or amortised cost. Financial assets will be measured at amortised cost if they are held within a business model the objective of which is to hold financial assets in order to collect contractual cash flows, and their contractual cash flows represent solely payments of principal and interest. Financial assets will be measured at fair value through other comprehensive income if they are held within a business model the objective of which is achieved by both collecting contractual cash flows and selling financial assets and their contractual cash flows represent solely payments of principal and interest. Financial assets not meeting either of these two business models; and all equity instruments (unless designated at inception to fair value through other comprehensive income); and all derivatives are measured at fair value through profit and loss. An entity may, at initial recognition, designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch. The Group has undertaken an assessment of the classification and measurement of financial assets. The majority of assets retain the existing measurement category as under IAS 39. However, approximately £2,927m of financial assets will be reclassified from amortised cost to fair value through profit or loss at 1 January 2018. The reclassification will not result in a significant change to their valuation. IFRS 9 retains most of the existing requirements for financial liabilities. However, for financial liabilities designated at fair value through profit or loss, gains or losses attributable to changes in own credit risk may be presented in other comprehensive income. *Impairment* The IFRS 9 impairment model will be applicable to all financial assets at amortised cost, debt instruments measured at fair value through other comprehensive income, lease receivables, loan commitments and financial guarantees not measured at fair value through profit or loss.	Annual periods beginning on or after 1 January 2018

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

41. Future accounting developments (continued)

Pronouncement	Nature of change	IASB effective date
IFRS 9 "Financial Instruments" (continued)	IFRS 9 replaces the existing 'incurred loss' impairment approach with an Expected Credit Loss ('ECL') model, resulting in earlier recognition of credit losses compared with IAS 39. Expected credit losses are the unbiased probability weighted average credit losses determined by evaluating a range of possible outcomes and future economic conditions. The ECL model has three stages. Entities are required to recognise a 12 month expected loss allowance on initial recognition (stage 1) and a lifetime expected loss allowance when there has been a significant increase in credit risk since initial recognition (stage 2). Stage 3 requires objective evidence that an asset is credit-impaired, which is similar to the guidance on incurred losses in IAS 39. The requirement to recognise lifetime ECL for loans which have experienced a significant increase in credit risk since origination, but which are not credit impaired, does not exist under IAS 39. The assessment of whether an asset is in stage 1 or 2 considers the relative change in the probability of default occurring over the expected life of the instrument, not the change in the amount of expected credit losses. This will involve setting quantitative tests combined with supplementary indicators such as credit risk classification. Reasonable and supportable forward looking information will also be used in determining the stage allocation. Any asset more than 30 days past due, but not credit impaired, will be classed as stage 2. The new impairment requirements will result in an increase in the Group's balance sheet provisions for credit losses and may have a negative impact on the Group's regulatory capital position. The initial impact at 1 January 2018 is expected to be a reduction to retained profits of approximately £6.0m. The ongoing impact on the financial results will only become clearer after running the IFRS 9 impairment models over a period of time and under different economic environments, however, it could result in impairment charges being more volatile when compared to the current IAS 39 impairment model, due to the forward looking nature of expected credit losses. *Hedge Accounting* The hedge accounting requirements of IFRS 9 are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39. The standard does not address macro hedge accounting, which is being considered in a separate project. There is an option to maintain the existing IAS 39 hedge accounting rules until the IASB completes its project on macro hedging. The Group and Company currently expects to continue applying IAS 39 hedge accounting in accordance with this accounting policy choice.	Annual periods beginning on or after 1 January 2018
IFRS 15 "Revenue from Contracts with Customers"	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. Insurance contracts are out of scope and the current accounting policies for other sources of revenue are materially consistent with the requirements of IFRS 15 and, accordingly, no transition adjustments are required for the Company or Group.	Annual periods beginning on or after 1 January 2018

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

41. Future accounting developments (continued)

Pronouncement	Nature of change	IASB effective date
IFRS 16 "Leases"	IFRS 16 Replaces IAS 17 'Leases'. IFRS 16 requires lessees to recognise a right of use asset and a liability for future payments arising from a lease contract. Lessees will recognise a finance charge on the liability and a depreciation charge on the asset which could affect the timing of the recognition of expenses on leased assets. This change will mainly impact the properties that the Group and Company currently accounts for as operating leases. Finance systems will need to be changed to reflect the new accounting rules and disclosures. Lessor accounting requirements remain aligned to the current approach under IAS 17.	Annual periods beginning on or after 1 January 2019
IFRS 17 "Insurance Contracts"[1]	IFRS 17 replaces IFRS 4 'Insurance Contracts'. IFRS 17 requires insurance contracts and participating investment contracts to be measured on the balance sheet as the total of the fulfilment cash flows and the contractual service margin. Changes to estimates of future cash flows from one reporting date to another are recognised either as an amount in profit or loss or as an adjustment to the expected profit for providing insurance coverage, depending on the type of change and the reason for it. The effects of some changes in discount rates can either be recognised in profit or loss or in other comprehensive income as an accounting policy choice. The risk adjustment is released to profit and loss as an insurer's risk reduces. Profits which are currently recognised through a Value in Force asset will no longer be recognised at inception of an insurance contract. Instead, the expected profit for providing insurance coverage is recognised in profit or loss over time as the insurance coverage is provided. The standard will have a significant impact on the accounting for the insurance and participating investment contracts issued by the Group and Company.	Annual periods beginning on or after 1 January 2021
Minor amendments to other accounting standards [1]	The IASB has issued a number of minor amendments to IFRSs effective 1 January 2018 (including IFRS 2 Share-based Payment and IAS 40 Investment Property) and effective 1 January 2019 (including IAS 12 Income Taxes, IAS19 Employee Benefits and IFRIC 23 Uncertainty over Income Tax Treatments). These revised requirements are not expected to have a significant impact on the Group or Company.	Annual periods beginning on or after 1 January 2018 or 2019

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

There are no other standards or interpretations that are not yet effective and that would be expected to have a material impact on the Group or Company.

42. Post balance sheet events

An interim dividend of £540m in respect of the year ending 31 December 2018 was declared on 08 February 2018 and paid to Scottish Widows Group on 14 February 2018.

On 15 February 2018, the Group gave notice to Standard Life Aberdeen to terminate its partnership agreements with Aberdeen Asset Management and to review their long-term asset management arrangements to ensure they remain up-to-date and that customers continue to receive good service and investment performance. There are no immediate changes for customers. Following completion of the review, the Group anticipates implementing the new arrangements by the end of June 2019. The Group will work with Standard Life Aberdeen to ensure no disruption to performance or service in the interim.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

42. Post balance sheet events (continued)

On 20 February 2018, the LBG Board approved proposals on restructuring its legal entity framework, business and operating model in line with its Ring-fencing programme to ensure compliance in advance of the 1 January 2019 implementation date. This includes the sale of SWSL, during 2018, for a value equivalent to its net asset value at the time of sale to Lloyds Bank plc along with obligations relating to the Scottish Widows Retirement Benefit Scheme ("SWRBS"). This is in line with the Group's Shared Services model under which the Insurance sub-group will transfer its employees into the Ring-Fenced Bank. The Company is expected to pay SWSL a risk premium as part of a tri-partite agreement under which Lloyds Bank plc will take on the role of principal employer and guarantor of SWRBS.

On 26 February 2018, Scottish Widows Administration Services Limited ("SWAS") issued £75m of ordinary share capital to the Company.

43. Discontinued operations

The Group expects to complete the sale of Scottish Widows Services Limited to Lloyds Bank plc during 2018. The assets and liabilities of this subsidiary are therefore classified as held for sale at 31 December 2017 and shown separately on the face of the balance sheet.

The Group has not recognised any impairment relating to assets held for sale during 2017. The subsidiary has been classified as discontinued operations and the profit after tax from these activities reported as a single line on the Group's statement of comprehensive income for both the current and prior years.

In order to fairly reflect the results and financial position of the Group's continuing operations and its discontinued operations, transactions that the continuing operations have with the discontinued operations are reported on the relevant line in the Group's statement of comprehensive income or balance sheet, with the matching transaction similarly reported in the discontinued operations statement of comprehensive income or balance sheet within the disposal entity. All such transactions fully eliminate within the Group's statutory consolidation and there is no net impact on profit before tax or equity.

(a) Statement of comprehensive income

The results of the discontinued operations are as follows:

	2017 £m	2016 £m
Revenue	806	909
Staff costs and other employee related costs	(190)	(190)
Operating expenses	(677)	(637)
Finance costs	(3)	(2)
Total expenses	(870)	(829)
Investment income	-	1
(Loss) / Profit before tax	(64)	81
Taxation	11	(17)
(Loss) / Profit for the year from discontinued operations	(53)	64

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

43. Discontinued operations (continued)

(b) Balance sheet

The assets and liabilities of the discontinued operations are as follows:

	2017 £m	2016 £m
ASSETS		
Intangible assets	168	160
Current tax assets	14	-
Deferred tax assets	31	49
Tangible fixed assets	-	1
Loans and receivables	390	385
Cash and cash equivalents	99	279
Total Assets	702	874
EQUITY AND LIABILITIES		
Capital and reserves attributable to Company's shareholder		
Share Capital	81	81
Retained earnings	14	15
Total equity	95	96
LIABILITIES		
Current tax payable	-	10
Accruals	93	89
Financial liabilities: trade and other payables	437	549
Retirement benefit obligation	77	130
Total liabilities	607	778
Total liabilities and equity	702	874