SCOTTISH WIDOWS LIMITED

ANNUAL REPORT

AND

FINANCIAL STATEMENTS

31 DECEMBER 2018

Member of Lloyds Banking Group plc

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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
J E M Curtis
J F Hylands
A Lorenzo*
K Cheetham
J Pfaudler

* 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

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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 2018. 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.

As we look to the future, we see the external environment evolving rapidly. The rapid pace of technological change, new regulation and increased competition are driving significant changes in customer needs and expectations. As a customer-driven business, we see these as opportunities. Our strategic plan responds to all of these challenges and transforms the Group for success in a digital world.

We have identified four strategic priorities focused on the financial needs and behaviours of the customer of the future and our progress against those priorities are:

- **Delivering a leading customer experience** - Scottish Widows won 5 star service awards at the Financial Adviser Service Awards 2018 for the third consecutive year.

- **Digitising the Group** - Launched Single Customer View; a unique capability already enabling over 3 million customers to view their Scottish Widows pension alongside their banking and insurance products on their mobile.

- **Maximising the Group's capabilities** - Strong progress towards one million new pension customers by end 2020 with 630,000 new customers in 2018.

- **Transforming ways of working** - Involved customers and colleagues in developing a simple to understand protection product, with advisers now having fuller conversations with more customers around their protection needs.

Our strategy will enable us to transform ourselves into a **digitised, simple, low risk, customer focused**, UK financial services provider.

Our strong foundations, differentiated business model and our great, highly engaged team will enable sustainable success in a digital world and ensure we continue to help Britain prosper.

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 through branches, 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 and LBG.

Result for the Year

The result for the year ended 31 December 2018 is a Group profit after tax £389m (2017: £899m). The result is reflective of market conditions during the year but includes assumption changes, primarily those relating to the mortality assumption basis along with the impact of a reduction in business commission rates payable to other LBG entities.

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

The United Kingdom leaving the European Union

The continued lack of clarity over the UK's eventual relationship with the EU has heightened risks in the Eurozone and raises uncertainty for the UK economic outlook. Leadership changes in the EU have contributed to further uncertainty. There is a risk of a no deal EU exit outcome, which could have a significant impact given our UK-centric footprint. The Group's response to these risks, as described in note 38, includes internal contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts. Also a no deal EU exit outcome has been analysed to identify impacts and assess robustness of contingency plans along with the formation of a new EU entity, as described in Review of business section below.

GROUP STRATEGIC REPORT (CONTINUED)

Climate Change

As part of LBG, the Group is committed to supporting the UK to successfully engage with the opportunities and challenges created by climate change and the need to transition to a low carbon economy. LBG has set ambitions anchored to the goals laid out in the UK Government's Clean Growth Strategy, which align closely to LBG's business priorities. Those that are relevant to the Group are:

- Pensions & Investments: be a leading UK pension provider that offers our customers sustainable investment choices, and challenges companies we invest in to behave more sustainably and responsibly.
- Our Own Footprint: be part of a leading UK bank in reducing our own carbon footprint and challenging our suppliers to ensure our own consumption of resources, goods and services is sustainable.

Further details of the LBG approach of transitioning to a low carbon economy can be found in the Lloyds Banking Group Annual Report and Accounts, which does not form part of our report can be downloaded via www.lloydsbankinggroup.com

Key performance indicators

Funds under management

Funds under management relating to policyholder liabilities were £116.5bn (2017: £124.4bn). The movement reflects net flows from policyholders offset by lower investment returns 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"), the wider insurance division submitted a single Own Risk and Solvency Assessment ("ORSA") for 2017 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 2018 was submitted to the PRA in March 2019.

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 £2.4bn (2017: £2.3bn).

The Solvency II ratio for the insurance division of 167 per cent (2017: pre dividend position: 160 per cent) represents the shareholder view of Solvency II surplus. During 2018, benefits arose from market movements, capital initiatives and the impact of changes to comply with Ring-fencing requirements, offset by the repayment subordinated debt and the acquisition of Zurich business. In addition, the Company paid dividends of £540m in February 2018 (2017: £600m), £225m in July 2018 (2017: £50m) and £1,000m in December 2018 (2017: nil). Further information on the capital position of the Company is given in note 38.

During the year, the Group has delivered Solvency II reporting in respect of full annual quantitative reporting for 31 December 2017, as well as the narrative reporting required by Solvency II. 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 2018.

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 2018, the Company (excluding the matched annuity portfolio, which is fully matched for liquidity purposes) had liquidity coverage of 193% (2017: 168%). Liquidity methodology and reporting is compliant with Solvency II.

Present value of new business premiums ("PVNBP")

Life and pensions sales (PVNBP) for the year were £14,384m (2017: £9,951m). PVNBP increased 45 per cent driven by increases in new members in new and existing workplace schemes, increases in auto enrolment workplace contributions and bulk annuities.

GROUP STRATEGIC REPORT (CONTINUED)

Key performance indicators (continued)

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.

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 Insurance Group. The acquisition will enable the Group to accelerate the development of its financial planning and retirement business and will bring around £17bn of assets under administration once finalised.

The savings business was acquired by Scottish Widows Administration Services Limited ("SWAS"), a subsidiary undertaking, on 3 April 2018. The Company will also acquire the pensions business, with the transfer expected to complete on 1st July 2019. 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. Consideration will be payable at completion. The agreement allows for further contingent consideration to be paid at a date up to 12 months later than completion.

Outsourcing of long-standing customer administration platform

The outsourcing contract with Diligenta was signed on 19 September 2017. The service improvement activity under the contract has delivery of the first five life and pension system data migrations scheduled in quarter 2 and quarter 3 2019. Further life and pension system data migrations are planned through to mid 2021.

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.

Bulk Annuities

We have continued to support corporate customers in de-risking their balance sheets, with the successful completion of a further nine (2017: eight) bulk annuity transactions, bringing in £1.9bn (2017: £0.65bn) of liabilities from third party pension schemes.

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 transferred ownership of a subsidiary undertaking, Scottish Widows Services Limited ("SWSL"), to Lloyds Bank plc, a subsidiary of LBG on 1 May 2018 for the net asset value at that date. The Group committed to the disposal on 20 February 2018 and, as such, the Group has accounted for the operations of SWSL as discontinued operations in both 2017 and 2018. The assets and liabilities of SWSL have been reclassified in the 2017 balance sheet as assets and related liabilities held for sale and the result for SWSL for 2018 and 2017 has been reclassified in the statement of comprehensive income as discontinued operations. Costs recharged to the Group from SWSL are incurred on an arm's length basis from the date of the disposal.

In addition to the disposal of SWSL, the Group transferred its obligations relating to the Scottish Widows Retirement Benefit Scheme ("SWRBS") to Lloyds Bank plc for consideration of £284m reflecting the value of the scheme liabilities.

UK's exit from the European Union and the Part VII Transfer Scheme

The management of the Company has chosen to form a new Luxembourg based company – Scottish Widows Europe S.A. ("SWE") as its primary contingency plan for mitigating the risks which have arisen from the UK's intended exit from the EU. SWE is a subsidiary of the Company and the existing European business transferred to SWE via an insurance business transfer scheme, under Part VII of the Financial Services and Markets Act 2000. On the 14 March 2019, the High Court approved the Part VII transfer of the European business to SWE. The transfer was effective 29 March 2019 and the business was transferred on this date and, as such, the Company has accounted for the operations of the European business as discontinued operations. The assets and liabilities of the European business have been reclassified in the Company balance sheet as assets and related liabilities held for sale. SWE will remain a wholly owned subsidiary of the Company and so there is minimal impact on the Group as a result of the transfer of the European business from the Company to SWE.

Outlook

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

The Directors consider that the Company's principal activities in relation to its UK business will continue to be unchanged for the foreseeable future, however in relation the Company's European business this will be transferred to a new Luxembourg subsidiary as discussed in the strategic report above.

Principal risks and uncertainties

Details of key risks are set out in note 38.

In addition, as described in note 28, 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
29 April 2019

DIRECTORS' REPORT

The Directors present the audited consolidated financial statements of the Company and the Group. The Company is a limited Company, domiciled and incorporated in the United Kingdom. The Company also has freedom of services overseas through branches, 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 2018 is a Group profit after tax £389m (2017: £899m). The result is reflective of market conditions during the year which includes assumption changes, primarily those relating to the mortality assumption basis along with the impact of a reduction in business commission rates payable to other LBG entities. 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, £1,765m interim dividends (2017: £2,563m) were paid. The Directors recommend no payment of a final dividend in respect of the year ended 31 December 2018 (2017: £nil). Details of dividends paid during the year are given in note 36.

Post balance sheet events

An interim dividend of £300m in respect of the year ending 31 December 2019 was declared on 07 February 2019 and paid to Scottish Widows Group Limited on 11 February 2019.

On the 14 March 2019, the High Court approved the Part VII transfer of the European business to SWE, and was effective on the 29 March 2019. The Part VII transfer allowed for all the European in-force policyholder related liabilities to transfer to SWE, along with the relevant assets to back those liabilities, ahead of the UK's expected exit from the European Union. As part of the transfer process SWE has issued share capital to the Company sufficient for it to cover its relevant capital requirement and risk margin. The total capital issued by SWE was £73m (€81m) and was subscribed for in cash.

Further information on post balance sheet events is set out in note 28.

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:

K Cook	(resigned 22 June 2018)
K Cheetham	(appointed 27 September 2018)
R Wohanka	(resigned 18 October 2018)
J Pfaudler	(appointed 5 November 2018)

Particulars of the Directors' emoluments are set out in note 39.

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.

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 42.

DIRECTORS' REPORT (continued)

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 (2017: £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 38 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 note number under principal risks and uncertainties: funding and liquidity on pages 97 to 100 and capital position on page 96 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 20 to the accounts; disclosures relating to financial risk management are included in note 38 to the accounts and are therefore incorporated into this report by reference.

Independent auditors

PricewaterhouseCoopers LLP are deemed to be reappointed under section 487(2) of the Companies Act 2006.

Statement of Directors' responsibilities

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

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union 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 for the Group financial statements and IFRSs as adopted by the European Union have been followed for the Company financial statements, subject to any material departures disclosed and explained in the financial statements;
- make judgments 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 Company will continue in business.

DIRECTORS' REPORT (continued)

Statement of Directors' responsibilities (continued)

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.

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

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 Group strategic report on pages 4 to 7, and the Directors' Report on pages 8 to 10 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
29 April 2019

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 2018 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 International Financial Reporting Standards (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 2018; the consolidated statement of comprehensive income, the Group and Company statements of cash flows, and 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

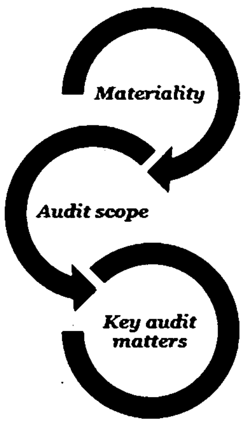
We remained independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities 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 2018 to 31 December 2018.

Our audit approach

Overview



- Overall Group materiality: £48.3 million (2017: £58.6 million), based on 1.4% of net assets (2017: 1% of average net assets over the last 3 years).
- Overall Company materiality: £45.9 million (2017: £55.7 million), based on 1.4% of net assets (2017: 1% of average net assets over the last 3 years), capped 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 one component we considered financially significant in the context of the group (full scope audit) and over six 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.

- Determination of significant actuarial assumptions for life insurance 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 judgments, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

Capability of the audit in detecting irregularities, including fraud

Based on our understanding of the Group and Company and its industry, we identified that the principal risks of non-compliance with laws and regulations related to breaches of UK and European regulatory principles, such as those governed by the Prudential Regulation Authority and the Financial Conduct Authority, and we considered the extent to which non-compliance might have a material effect on the financial statements of the Group and Company. We also considered those laws and regulations that have a direct impact on the preparation of the financial statements of the Group and Company such as the Companies Act 2006, the Financial Conduct Authority's regulations, the Prudential Regulation Authority's regulations and UK tax legislation. We evaluated management's incentives and opportunities for fraudulent manipulation of the financial statements (including the risk of override of controls), and determined that the principal risks were related to posting inappropriate journal entries to increase revenue or increase the capital position of the Group and Company, and management bias in accounting estimates and judgmental areas of the financial statements such as the valuation of insurance contract liabilities, conduct provisions and the valuation of illiquid financial instruments. Audit procedures performed by the Group engagement team included:

- Discussions with the Insurance Board, management, internal audit, senior management involved in the Risk and Compliance functions and the Group's and Company's legal function, including consideration of known or suspected instances of non-compliance with laws and regulation and fraud;

- Evaluation and testing the operating effectiveness of management's entity level controls designed to prevent and detect irregularities, in particular their whistleblowing hotline and code of conduct;

- Reading key correspondence with, reports to and meetings with the Prudential Regulation Authority and the Financial Conduct Authority in relation to compliance with laws and regulations;

- Reviewing relevant meeting minutes including those of the Insurance Board and its key sub-committees (including the Risk Oversight Committee and the Insurance Audit Committee);

- Reviewing data regarding policyholder complaints, the Group's and Company's register of litigation and claims, internal audit reports;

- Identifying and testing journal entries, in particular any journal entries posted with unusual account combinations, posted on unusual days, posted by infrequent users, posted by senior management or posted with descriptions indicating a higher level of risk;

- Challenging assumptions and judgments made by management in their accounting estimates, in particular in relation to the valuation of life insurance liabilities; conduct risk and provisions and the valuation of illiquid financial instruments (see related key audit matters below); and

- Designing audit procedures to incorporate unpredictability around the nature, timing or extent of our testing in relation to a sample of fraud related procedures performed by management in tendering for new bulk annuity transactions.

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. Also, 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.

Key audit matters

Key audit matters are those matters that, in the auditors' professional judgment, 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.

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

Key audit matter	How our audit addressed the key audit matter
Determination of significant actuarial assumptions for life insurance liabilities - Group and Company *Refer to pages 34 and 35 (Accounting Policies) and pages 38, 56 and 67 to 77 (Critical accounting estimates and judgments in applying accounting policies and Notes 25 and 37).* The valuations of the Group's insurance and participating investment contracts ("insurance contract liabilities") are dependent on a number of subjective and complex assumptions about future experience and events, both internal and external to the business. Small changes in each of these assumptions can result in a material impact on the financial statements. The key assumptions we have focussed on are: • **Longevity:** these assumptions reflect how long policyholders receiving annuity payments are expected to live and how that might change over time. There are two main components to the longevity assumptions: o Base mortality assumption: this component is derived using past mortality experience. Judgment is required when determining the level of prudence used. o Mortality improvement assumption: this component is determined using an external model issued by the Institute and Faculty of Actuaries. The Group has adopted the most recent available model and dataset (CMI 2017); however, significant judgment is required to make adjustments to the model to reflect the profile of the Group's annuitants. • **Maintenance expenses:** these assumptions reflect the expected future expenses that will be required to maintain policies existing at the balance sheet date to maturity. Judgment is required to identify all expenses which are attributable to the Group's insurance business, identify the subset of total expenses that are required to maintain the in-force insurance policies, to allocate these expenses between product types and to make adjustments where the best estimate is that these expenses will change in the future. • **Credit default:** is an assumption used to determine the valuation interest rate (VIR) which is used in the calculation of the annuity liabilities. There is a significant level of judgment applied in order to set this assumption, including the reference period from which to use observed market default rates.	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, and over the calculation of the base mortality assumptions were designed and implemented effectively. Therefore we were able to place reliance on these controls for the purposes of our financial statement audit. Our actuarial specialists assessed the reasonableness of the actuarial assumptions, including considering and challenging management's rationale for judgments applied and any reliance placed on industry information. Where appropriate, assumptions are benchmarked by comparing to the Group's peers in the insurance market whilst overlaying an understanding of the specific policy features of the Group's business. For longevity, we assessed the appropriateness of how the Group's own experience and industry data were used in setting future assumptions and compared resulting life expectancies to benchmarking data. We performed the following procedure over maintenance expenses: • we assessed the appropriateness of the judgments in respect of costs deemed to be non-attributable to insurance business, such as recharges to the Group from Lloyds Banking Group which were not considered to be required to maintain the insurance policies in force at the balance sheet date; • we assessed the resulting per-policy cost assumptions; • we evaluated the sufficiency of future project-related costs attributable to the Group's in-force business, such as estimates of costs of implementation of future accounting standards; and • we reviewed the adjustments to expenses to reflect the impact of the Group's outsourcing agreements, increased costs due to the mandatory ring-fencing of the Group's insurance business from the wider Lloyds Banking Group, and changes to the cost base that are expected to be incurred after the UK leaves the European Union. We performed the following procedures over credit default assumptions: • we assessed the appropriateness of the methodology, including consideration of the allowance of prudence, the market default data and current economic conditions. • we performed industry benchmarking to validate the accuracy of the market default data used in the Group's calculations, as well as the overall level of prudence within the calculation. Based on the evidence obtained, we found that the methodologies, modelled assumptions, data used within the models and overlays to modelled outputs are appropriate.

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

Provisions relating to conduct of business practices - Group and Company

Refer to page 36 (Accounting Policies) and pages 39 and 57 to 58 (Critical accounting estimates and judgments in applying accounting policies and Note 28).

Matters relating to conduct of business practices, 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 judgmental inputs into the measurement of provisions.

We understood and tested the key controls and processes for identifying emerging conduct risk exposures and assessing whether provisions or disclosures were necessary. We also tested the calculation and review of material conduct provisions including understanding the 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 analysed 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 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; and
- we read the minutes of key governance meetings including those of the Insurance Board and its key sub-committees, and attended meetings of the Insurance Audit Committee and Risk Oversight Committee.

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:

- we challenged the assumptions set by management and used within the provision and agreed to supporting evidence;
- we assessed the assumptions used, including against a range of possible factors identified by management, discussed these with internal legal counsel and, where appropriate, obtained independent confirmations from external legal counsel;
- we compared future expectations with past experience; and
- we 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.

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

Valuation of illiquid financial instruments - Group and Company

Refer to pages 26 and 31 to 32 (Accounting Policies) and pages 39, 54 to 55, 79 to 85 and 87 to 90 (Critical accounting estimates and judgments in applying accounting policies and Notes 22, 38(c)(1) and 38(c)(3)).

The Group and Company continue to expand their significant portfolio of illiquid investment securities, which require specific judgments 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 valuation of illiquid assets remains a highly judgmental area which is a significant risk area due to the magnitude and the complexity of the valuation models used and that the use of judgment by the Directors and/or the involvement of valuation experts are required. Valuations also require the use of judgment 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.

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 consists of one main life insurance Company, Scottish Widows Limited, and a number of subsidiaries, as set out on page 47, within note 15 to the consolidated financial statements. Scottish Widows Limited is comprised of three reporting units (being UK, Isle of Man and Europe), each of which represents a separate component. The subsidiaries of Scottish Widows Limited are aggregated into a number of reporting units. Each of these reporting units is also deemed to represent a separate component.

In establishing the overall approach to the Group audit, we determined the type of work that was required to be performed over each component. All audit work was undertaken by the Group engagement team.

One component (being the UK reporting unit of Scottish Widows Limited) was considered individually financially significant in the context of the Group's consolidated financial statements. It contributed greater than 90 per cent of Group net assets and greater than 95 per cent of Group premiums net of reinsurance, and was deemed to be a full scope component.

We considered the individual financial significance of other components in relation to primary statement account balances. 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 contributes a significant proportion of one or more primary statement account balances was subject to specific audit procedures over those account balances (including components which contributed a significant portion of total impact). We performed such procedures over certain account balances and transactions within six components, in addition to the UK reporting unit of Scottish Widows Limited.

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. All remaining components which were neither inconsequential nor individually financially significant were subject to procedures which mitigated the risk of material misstatement including testing of entity level controls, information technology general controls and Group and component level analytical review procedures.

Components within the scope of our audit contributed 99 per cent of Group net assets and 100 per cent of Group premiums net of reinsurance.

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

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 judgment, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Company financial statements
Overall materiality	£48.3 million (2017: £58.6 million).	£45.9 million (2017: £55.7 million).
How we determined it	1.4% of net assets (2017: 1% of average net assets over the last 3 years).	1.4% of net assets (2017: 1% of average net assets over the last 3 years) capped as described below.
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 focussed on managing capital held under Solvency II reporting; capital management to release internal dividends up to Lloyds Banking Group Limited; 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. Company materiality has been capped at £45.9 million to reflect its allocation of materiality for the purpose of the Group audit.	

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 £4.6 million and £45.9 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 £2.4 million (Group audit) (2017: £3.2 million) and £2.4 million (Company audit) (2017: £3.2 million) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern

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.

We have nothing to report in respect of the above matters.

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. For example, the terms on which the United Kingdom may withdraw from the European Union, are not clear, and it is difficult to evaluate all of the potential implications on the Group's and Company's trade, customers, suppliers and the wider economy.

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

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

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.

Group Strategic Report and Directors' Report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Group Strategic Report and Directors' Report for the year ended 31 December 2018 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 Group 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 9 and 10, 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.

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.

<u>Other required reporting</u>

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.

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

Appointment

Following the recommendation of the Audit Committee, we were appointed by the Directors on 30 April 2009 to audit the financial statements for the year ended 31 December 2009 and subsequent financial periods. The period of total uninterrupted engagement is 10 years, covering the years ended 31 December 2009 to 31 December 2018.

Sue Morling (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Bristol
30 April 2019

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2018

	Note	2018 £m	2017 £m
		Group	Group
Revenue			
Gross earned premiums	3	8,794	7,358
Premiums ceded to reinsurers		(271)	(167)
Premiums net of reinsurance		8,523	7,191
Fee and commission income	4	242	291
Investment income	5	4,022	3,842
Net (loss)/gain on assets and liabilities at fair value through profit or loss	6	(8,200)	6,771
Other operating income	7	122	97
Total revenue		4,709	18,192
Expenses			
Gross claims and benefits paid		(8,503)	(8,871)
Claims recoveries from reinsurers		260	153
		(8,243)	(8,718)
Change in liabilities arising from insurance contracts and participating investment contracts	25	4,658	(9,135)
Change in liabilities arising from non-participating investment contracts		625	2,830
Change in assets arising from reinsurance contracts held	18	(425)	939
Change in unallocated surplus	26	(10)	(152)
		4,848	(5,518)
Net loss/(profit) attributable to external interests in collective investment vehicles		842	(1,433)
Operating expenses	8	(1,426)	(1,066)
Expenses for asset management services received		(220)	(203)
Finance costs	10	(89)	(80)
		(893)	(2,782)
Total expenses		(4,288)	(17,018)
Profit before tax – continuing operations		421	1,174
Taxation charge	11	(6)	(222)
Profit after tax – continuing operations		415	952
Loss after tax – discontinued operations	44	(26)	(53)
Profit for the year		389	899
Other comprehensive income			
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)	26	53
		26	53
Items that may subsequently be reclassified to profit or loss			
Currency translation differences		(10)	6
		(10)	6
Other comprehensive income, net of tax		16	59
Total comprehensive income for the year		405	958
Total comprehensive income arising from continuing operations		405	958
Total comprehensive income arising from discontinued operations		-	-
Total comprehensive income for the year		405	958

The notes set out on pages 23 to 110 are an integral part of these financial statements.

BALANCE SHEETS AS AT 31 DECEMBER 2018

		31 December 2018		31 December 2017	
	Note	£m	£m	£m	£m
		Group	*Company*	*Group*	*Company*
ASSETS					
Intangible assets including insurance intangible assets	12	98	62	69	69
Deferred costs	13	1,652	1,637	1,656	1,637
Investment in subsidiaries	15	-	467	-	392
Tangible fixed assets	16	-	-	13	-
Investment properties	17	3,729	184	3,640	189
Assets arising from reinsurance contracts held	18	7,860	7,860	8,377	8,377
Other assets	19	91	87	39	27
Derivative financial instruments	20	3,157	3,129	3,465	3,424
Loans and receivables at amortised cost	21	2,674	2,196	4,037	2,868
Assets classified as held for sale	44	-	2,165	702	14
Investments at fair value through profit or loss	22	116,781	104,943	123,377	113,441
Cash and cash equivalents	23	174	41	1,932	1,063
Total assets		136,216	122,771	147,307	131,501
EQUITY AND LIABILITIES					
Capital and reserves attributable to the Group's equity shareholder					
Share capital	24	70	70	70	70
Share premium		1	1	1	1
Retained profits		3,317	3,628	4,682	4,837
Total equity		3,388	3,699	4,753	4,908
Liabilities					
Insurance contracts and participating investment contract liabilities	25	98,252	96,117	102,916	102,916
Unallocated surplus	26	390	390	380	380
		98,642	96,507	103,296	103,296
Future profits on non-participating business in the With Profits Funds	27	(28)	(28)	(43)	(43)
Current tax liabilities	14	86	74	174	154
Deferred tax liabilities	14	210	209	355	355
Provisions for other liabilities and charges	28	259	211	227	225
Accruals and deferred income	30	37	21	49	30
Subordinated debt	31	1,769	1,799	1,795	1,836
Non-participating investment contract liabilities	32	13,855	13,825	15,447	15,447
Derivative financial instruments	20	2,719	2,681	3,147	3,058
Other financial liabilities	33	2,331	1,608	3,005	2,233
External interests in collective investment vehicles		12,944	-	14,485	-
Borrowings	34	4	-	10	2
Liabilities directly associated with assets classified as held for sale	44	-	2,165	607	-
Total liabilities		132,828	119,072	142,554	126,593
Total equity and liabilities		136,216	122,771	147,307	131,501

The notes set out on pages 23 to 110 are an integral part of these financial statements.

The financial statements on pages 18 to 19 were approved by the Board on 29 April 2019.

M Harris
Director

STATEMENTS OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2018

	Note	2018 £m	2018 £m	2017 £m	2017 £m
		Group	*Company*	*Group*	*Company*
Cash flows from operating activities					
Profit before tax[1]		391	498	1,110	1,127
Adjusted for:					
Depreciation of tangible fixed assets	16	-	-	1	-
Amortisation of intangible assets	12	9	7	48	12
Finance costs	10	89	88	80	79
Impairment in investment in subsidiary	15	-	-	-	22
Dividends received		-	(74)	-	(113)
Gain on disposal of subsidiary		-	(81)	-	-
Net (increase)/decrease in operating assets and liabilities	35	(220)	469	1,334	1,235
Impact of IFRS 9		(5)	(2)	-	-
Remeasurements of retirement benefit obligations	29	31	-	67	-
Impact of the Insurance Business Transfer Scheme		-	-	22	13
Currency translation differences		(10)	(10)	6	-
Taxation paid		(240)	(156)	(153)	(72)
Net cash flows generated from operating activities		45	739	2,515	2,303
Cash flows from investing activities					
Addition of intangible assets	12	(38)	-	(46)	-
Cash held in disposed subsidiary at year end 2017	44	(99)	-	-	-
Proceeds from disposal of subsidiary	44	95	95	-	-
Investment in subsidiary	15	-	(75)	-	-
Dividends received		-	74	-	113
Net cash flows (used in) / generated from investing activities		(42)	94	(46)	113
Cash flows from financing activities					
Dividends paid	36	(1,765)	(1,765)	(2,563)	(2,563)
Finance costs paid	10	(89)	(88)	(80)	(79)
Net cash flows used in financing activities		(1,854)	(1,853)	(2,643)	(2,642)
Net decrease in cash and cash equivalents		(1,851)	(1,020)	(174)	(226)
Cash and cash equivalents at the beginning of the year		2,021	1,061	2,195	1,287
Net cash and cash equivalents at the end of the year[2]	23	170	41	2,021	1,061

[1] Group profit before tax comprises £455m in respect of continuing operations and a Group loss before tax of £30m in respect of discontinued operations (2017: Group profit before tax of £1,174m in respect of continuing operations and a loss before tax of £64m in respect of discontinued operations).
[2] Group net cash and cash equivalents at the end of the year is £170m in respect of continuing operations (2017: Group cash and cash equivalents of £1,922m in respect of continuing operations and £99m in respect of discontinued operations).

The notes set out on pages 23 to 108 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:

	2018 £m	2017 £m
	Group	*Group*
Net cash flows used in operating activities	-	(134)
Net cash flows used in investing activities	(99)	(46)
Net decrease in cash and cash equivalents	(99)	(180)

The net cash flows used in investing activities at the end of the current year represents cash held in the disposed subsidiary at 2017 year end.

STATEMENTS OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2018

Group

	Note	Share capital £m	Share premium £m	Retained profits £m	Total equity £m
Balance as at 1 January 2017		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
Adjustment on adoption of IFRS 9, net of tax	45(b)	-	-	(5)	(5)
Balance as at 1 January 2018		70	1	4,677	4,748
Profit for the year		-	-	389	389
Other comprehensive income					
Remeasurement of retirement benefit obligations/assets, net of tax due to discontinued operations		-	-	26	26
Currency translation		-	-	(10)	(10)
Total comprehensive income for the year		-	-	405	405
Dividend		-	-	(1,765)	(1,765)
Balance as at 31 December 2018		70	1	3,317	3,388

Company

		Share capital £m	Share premium £m	Retained profits £m	Total equity £m
Balance as at 1 January 2017		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
Adjustment on adoption of IFRS 9, net of tax	45(b)	-	-	(2)	(2)
Balance as at 1 January 2018		70	1	4,835	4,906
Total comprehensive income for the year		-	-	569	569
Currency translation differences		-	-	(11)	(11)
Dividend		-	-	(1,765)	(1,765)
Balance as at 31 December 2018		70	1	3,628	3,699

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 38.

The notes set out on pages 23 to 110 are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

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" (formerly FRS 27 "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 2018

The Group has adopted IFRS 9 "Financial Instruments" as at 1 January 2018. In accordance with the transitional provisions in IFRS 9.7.2.15, comparative figures have not been restated. The resulting changes to accounting policies are summarised in note 45(a). The adoption of IFRS 9 has not had a significant impact on the overall financial position of the Group and Company, although £2,926m of financial assets for Group and £1,435m for Company have been reclassified from amortised cost to fair value through profit or loss at 1 January 2018. Further details are set out in note 45.

The Group has adopted IFRS 15 "Revenue from Contracts with Customers" as at 1 January 2018. Since insurance contracts are out of scope of IFRS 15 and existing accounting policies are consistent with the requirements of IFRS 15, the application of this standard has not had a material impact on the Group.

Details of standards and interpretations in issue but which have not been adopted early are set out at note 42.

(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 2018

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 2018.

(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 significant insurance risk as 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, 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 2018

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.

On initial recognition, financial assets are classified as measured at amortised cost or fair value through profit or loss, depending on the Group's business model for managing the financial assets and whether the cash flows represent solely payments of principal and interest. The Group assesses its business models at a portfolio level based on its objectives for the relevant portfolio, how the performance of the portfolio is managed and reported, and the frequency of asset sales. Financial assets with embedded derivatives are considered in their entirety when considering their cash flow characteristics. The Group reclassifies financial assets when and only when its business model for managing those assets changes. A reclassification will only take place when the change is significant to the Group's operations and will occur at a portfolio level and not for individual instruments; reclassifications are expected to be rare.

The Group initially recognises loans, debt securities and subordinated liabilities when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either: substantially all of the risks and rewards of ownership have been transferred; or the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when the obligation is discharged, cancelled or expires.

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); and
- 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 2018

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 38. 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 2018

1. Accounting policies (continued)

(f) Revenue recognition (continued)

Other operating income

Until the disposal of SWSL, other income recognised in the statement of comprehensive income comprised of 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. Rebates are recognised when they are earned.

(g) Accruals and deferred income

For non-participating investment contracts, the recognition of income is governed by IFRS 15. 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. 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 30.

(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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

(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.

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).

(iii) Goodwill

Goodwill arises on business combinations and represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the statement of comprehensive income.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the statement of comprehensive income and is not subsequently reversed. Further information on the Group's impairment policy is set out at policy (t). At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal.

(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 on a straight line basis or 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. Deferred acquisition costs are reviewed by category of business at the end of each reporting period and are written-off where they are no longer considered to be recoverable.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

(k) Deferred costs (continued)

(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 which are considered to be part of a business model that is managed and whose performance is evaluated on a fair value basis. Accordingly, such subsidiaries are carried at fair value and presented within investments at fair value through profit or loss in the Company (see policy r). 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

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 investment income and operating expense notes.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

(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).

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 measured as fair value through profit or loss as they are within a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis. 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

Fair values are obtained from quoted market prices or, if these are not available, by using valuation techniques such as discounted cash flow models or other pricing models. Derivatives are carried as assets when the fair values are positive and as liabilities when the fair values are negative.

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

(p) Derivative financial instruments (continued)

Hedge accounting

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

Derivatives may only be designated as hedging instruments provided certain strict criteria are met. At the inception of a hedge, its terms must be clearly documented and there must be an expectation that the derivative will be highly effective in offsetting changes in the fair value of the hedged risk. The hedge documentation must also specify the methodology that will be used to measure effectiveness. Changes in the fair value of derivatives that are designated 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 20.

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 at amortised cost

Loans and receivables at amortised cost are financial assets, other than cash and cash equivalents that are held to collect contractual cash flows where those cash flows represent solely payments of principal and interest, a basic lending arrangement results in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Where the contractual cash flows introduce exposure to risks or volatility unrelated to a basic lending arrangement such as changes in equity prices or commodity prices, the payments do not comprise solely principal and interest.

Loans and receivables at amortised cost are initially recognised at fair value less directly attributable transaction costs and subsequently measured at amortised cost, subject to impairment. 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 and certain cash and cash equivalents

Classification

Financial assets are classified at fair value through profit or loss where they are within a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis or they do not meet the criteria to be measured at amortised cost. All derivatives and equity instruments are carried at fair value through profit or loss.

Financial liabilities are measured at fair value through profit or loss where they are designated at fair value through profit or loss in order to reduce accounting mismatch or the liabilities are part of a group of liabilities (or assets and liabilities) which is managed, and its performance evaluated, on a fair value basis; or where the liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

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

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. Refer to note 1(e) Fair value methodology and note 38(c) Financial risk management for details of valuation techniques and significant inputs to valuation models.

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.

Cash and cash equivalents that are held to collect contractual cash flows where those cash flows represent solely payments of principal and interest are measured at amortised cost. A basic lending arrangement results in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Cash and cash equivalents that are within a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis or do not meet the criteria to be measured at amortised cost are classified and measured as investments at fair value through profit or loss, as set out in policy (r).

(t) Impairment

Financial assets

The impairment charge in the statement of comprehensive income includes the change in expected credit losses for financial assets held at amortised cost and certain lease receivables. Expected credit losses are calculated by using an appropriate probability of default and applying this to the estimated exposure of the Group at the point of default after taking into account the value of any collateral held or other mitigants of loss.

At initial recognition, allowance is made for expected credit losses resulting from default events that are possible within the next 12 months (12-month expected credit losses). In the event of a significant increase in credit risk, allowance is made for expected credit losses resulting from all possible default events over the expected life of the financial instrument (lifetime expected credit losses). Financial assets where 12-month expected credit losses are recognised are considered to be Stage 1; financial assets which are considered to have experienced a significant increase in credit risk are in Stage 2; and financial assets which have defaulted or are otherwise considered to be credit impaired are allocated to Stage 3.

An assessment of whether credit risk has increased significantly since initial recognition considers the change in the risk of default occurring over the remaining expected life of the financial instrument. The assessment is unbiased, probability-weighted and uses forward-looking information consistent with that used in the measurement of expected credit losses. In determining whether there has been a significant increase in credit risk, the Group uses quantitative tests based on relative and absolute probability of default (PD) movements linked to internal credit ratings and other indicators of historic delinquency. However, unless identified at an earlier stage, the credit risk of financial assets is deemed to have increased significantly when more than 30 days past due. Where the credit risk subsequently improves such that it no longer represents a significant increase in credit risk since initial recognition, the asset is transferred back to Stage 1.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

(t) Impairment (continued)

Financial assets (continued)

For financial instruments that are considered to have low credit risk, the credit risk is assumed to not have increased significantly since initial recognition. Financial instruments are considered to have low credit risk when the borrower is considered to have a low risk of default from a market perspective. Typically financial instruments with an external credit rating of investment grade are considered to have low credit risk.

Assets are transferred to Stage 3 when they have defaulted or are otherwise considered to be credit impaired. IFRS 9 contains a rebuttable presumption that default occurs no later than when a payment is 90 days past due. The Group uses this 90 day backstop.

The loss allowance for lease receivables and trade receivables without a significant financing component is measured at an amount equal to lifetime expected credit losses, in accordance with the simplified approach in IFRS 9.

A loan or receivable is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the statement of comprehensive income.

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.

(u) Taxes

Tax expense comprises current and deferred tax. Current and deferred tax are charged or credited in the income statement except to the extent that the tax arises from a transaction or event which is recognised, in the same or a different period, outside the income statement (either in other comprehensive income, directly in equity, or through a business combination), in which case the tax appears in the same statement as the transaction that gave rise to it.

Current tax

Current tax is the amount of corporate income taxes expected to be payable or recoverable based on the profit for the period as adjusted for items that are not taxable or not deductible, and is calculated using tax rates and laws that were enacted or substantively enacted at the balance sheet date.

Current tax includes amounts provided in respect of uncertain tax positions when management expects that, upon examination of the uncertainty by Her Majesty's Revenue and Customs (HMRC) or other relevant tax authority, it is more likely than not that an economic outflow will occur. Provisions reflect management's best estimate of the ultimate liability based on their interpretation of tax law, precedent and guidance, informed by external tax advice as necessary. Changes in facts and circumstances underlying these provisions are reassessed at each balance sheet date, and the provisions are re-measured as required to reflect current information.

Deferred tax

Deferred tax is recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the balance sheet. Deferred tax is calculated using tax rates and laws that have been enacted or substantively enacted at the balance sheet date, and which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

(u) Taxes (continued)

Deferred tax (continued)

Deferred tax liabilities are generally recognised for all taxable temporary differences but not recognised for taxable temporary differences arising on investments in subsidiaries where the reversal of the temporary difference can be controlled and it is probable that the difference will not reverse in the foreseeable future. Deferred tax liabilities are not recognised on temporary differences that arise from goodwill which is not deductible for tax purposes.

Deferred tax assets are recognised to the extent it is probable that taxable profits will be available against which the deductible temporary differences can be utilised, and are reviewed at each balance sheet 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 asset to be recovered.

Deferred tax assets and liabilities are not recognised in respect of temporary differences that arise on initial recognition of assets and liabilities acquired other than in a business combination. Deferred tax is not discounted.

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.

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

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

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; and
- Terminal and interim bonuses paid out to policyholders on maturity and included within gross claims and benefits paid.

Equity Release Mortgages

The equity release mortgages held within a special purpose vehicle provide a no-negative equity guarantee which meets the definition of an insurance contract. The guarantee is embedded in the mortgage and included within the mortgage valuation; it is not unbundled or disclosed separately.

(x) Retirement benefit obligations

SWSL assumes the role of principal employer for the SWRBS pension scheme within LBG. SWSL was disposed of on 1 May 2018, resulting in the SWRBS being presented as part of discontinued operations in 2017. Until the disposal, individuals employed by the Group may have been 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.

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

(x) Retirement benefit obligations (continued)

Insurance contracts which are unit-linked

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.

(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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

(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 measured at amortised cost. Due to the nature of these balances, the carrying value equates to the 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 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.

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, certain loans made to related parties and bulk annuity contracts. 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. Accounting policies (continued)

(ah) Discontinued operations

Non-current assets are classified as held for sale if the Group and Company 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. See note 44 for further detail.

In order to fairly reflect the results and financial position of the Group and Company 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 and Company 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 and Company 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.

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

(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.

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 37.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

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

(b) 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 IFRS 15 "Revenue from Contracts with Customers". 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.

(c) Retirement benefit obligations

Until the disposal of SWSL, the majority of the Group's employees were 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 (SWSL), which was consolidated into the Group up until the prior year (see note 44), holds a defined benefit obligation which represents 100% of the SWRBS pension scheme due to SWSL being principal employer and scheme guarantor. Further information on these liabilities including associated estimates and sensitivities is given in note 29.

(d) 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 38.

(e) 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 2018 as 2017. The total provision made to 31 December 2018 is £639m (2017: £639m); Settlement experience has improved and therefore only £26m was utilised in the year ended 31 December 2018 (2017: £30m), the remaining unutilised provision as at 31 December 2018 is £112m (2017: £138m).

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 28.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

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

(f) Taxation

Estimation of income taxes includes the assessment of recoverability of deferred tax assets. Deferred tax assets are only recognised to the extent they are considered more likely than not to be recoverable based on existing tax laws and forecasts of future taxable profits against which the underlying tax deductions can be utilised

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 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	2018 £m	2017 £m
Regular premiums	3,369	2,935
Single premiums	5,425	4,423
Total	8,794	7,358

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

Group	2018 £m	2017 £m
Bulk Annuities	1,753	644
Corporate pensions	4,165	3,497
Individual pensions	410	426
Retirement income	455	508
Protection	400	429
Investments	205	246
Retirement account	1,406	1,608
Total	8,794	7,358

Of the above gross written premiums, £102m (2017: £126m) relates to the European business with the remaining written in the UK.

4. Fee and commission income

Group	2018 £m	2017 £m
Fund management and policy administration fees	235	283
Change in deferred income	7	8
Total	242	291

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

5. Investment income

Group	2018 £m	2017 £m
Net income on investments at fair value through profit or loss	3,757	3,579
Financial instruments at amortised cost		
Interest income on LBG Group loans	36	33
Rental income on investment properties	197	204
Service charge income	14	14
Foreign currency translation differences	-	(5)
Other	18	17
Total	4,022	3,842

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

Group	2018 £m	2017 £m
Derivative financial instruments at fair value through profit or loss	88	25
Investments at fair value through profit or loss	(8,480)	6,350
Investment properties at fair value through profit or loss	123	232
Fair value hedge adjustment in respect of swap	33	17
Foreign exchange	36	147
Total	(8,200)	6,771

7. Other operating income

Group	2018 £m	2017 £m
External rebates	97	77
Other	25	20
Total	122	97

8. Operating expenses

Group	2018 £m	2017 £m
Acquisition and origination costs in respect of insurance and investment contracts	141	148
Expenses for administration	784	737
	925	885
Fees and commissions payable	32	48
Change in deferred costs	4	33
Service charge expense	14	15
Pension risk premium	284	-
Amortisation of acquired VIF	7	12
Other	160	73
Total	1,426	1,066

The Pension risk premium of £284m was incurred to transfer the Group's obligations in respect of the SWRBS to Lloyds Bank plc, a related party. This transaction is related to the disposal of subsidiary entities, see note 29.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

8. Operating expenses (continued)

All staff costs are reported within SWSL that is now shown within assets classified as held for sale as a discontinued operation. See note 44 for further details.

The following staff and other employee related costs were reported within SWSL as operating expenses prior to its disposal.

	2018 £m	2017 £m
Wages and salaries	37	114
Share based payments	9	23
Social security costs	6	17
Other pension costs – defined contribution plan	5	14
Service costs – defined benefit plan	4	22
Total	61	190

During the year ended 31 December 2018 and 2017 the Group received charges from SWSL relating to share-based payment schemes, all of which are equity settled. SWSL was disposed on the 1 May 2018 (see note 44).

The monthly average number of employees directly employed by the Group until the disposal on the 1 May 2018 of SWSL was as follows:

	2018	2017
UK	2,411	2,506
Total	2,411	2,506

9. Auditors' remuneration

Group	2018 £000	2017 £000
Fees payable to the Group's auditors for the audit of the Company's annual financial statements and the consolidation	2,813	2,745
Fees payable to the Group's auditor and its associates for other services:		
Audit of subsidiaries	911	1,011
Audit-related assurance services	1,002	818
Non Audit Services	78	-
Total fees payable	4,804	4,574

During the year, the audit fee in respect of pension schemes of £Nil (2017: £34,500) is borne by the Company.

10. Finance costs

Group	2018 £m	2017 £m
Interest on swaps	(14)	(23)
Interest on subordinated debt	96	96
Other	7	7
Total	89	80

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

11. Taxation charge

(a) Current year tax charge

Group	2018 £m	2017 £m
Current tax:		
UK corporation tax	155	263
Overseas Tax	1	-
Adjustment in respect of prior years	(4)	-
Total current tax	152	263
Deferred tax:		
Reversal of temporary differences	(142)	(31)
Change in tax rate	(1)	(2)
Adjustment in respect of prior years	(3)	(8)
Total deferred tax	(146)	(41)
Total income tax charge	6	222

The policyholder tax benefit or expense is included in the income tax charge. Policyholder tax is a credit of £(22)m (2017: charge of £73m), including a prior year tax charge of £nil (2017: charge of £nil)

(b) Reconciliation of tax charge

Group	2018 £m	2017 £m
Profit before tax	421	1,174
Tax at 19% (2017: 19.25%)	80	226
Effects of:		
Non-taxable income	(61)	(53)
Policyholder tax	(17)	59
Adjustment in respect of prior years	(7)	(8)
Disallowable expenses	12	1
Change in tax rate	(1)	(2)
Other	-	(1)
Total	6	222

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	2018			2017		
	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	31	(5)	26	67	(14)	53
Total	31	(5)	26	67	(14)	53

Further analysis of the remeasurements of retirement benefit obligations / assets in the above table is set out in note 29.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

12. Intangible assets including insurance intangible assets

	2018 £m Group	2018 £m Company	2017 £m Group	2017 £m Company
Acquired VIF	68	62	69	69
Goodwill	5	-	-	-
Software development costs	25	-	-	-
Total	98	62	69	69

Group

	2018 Acquired VIF £m	2018 Goodwill £m	2018 Software development costs £m	2018 Total £m	2017 Acquired VIF £m	2017 Software development costs £m	2017 Total £m
Cost							
At 1 January	651	-	-	651	651	282	933
Additions	6	5	27	38	-	46	46
Disposals/Write-downs of impaired assets	-	-	-	-	-	(53)	(53)
Transferred to assets held for sale	-	-	-	-	-	(275)	(275)
At 31 December	657	5	27	689	651	-	651
Accumulated amortisation and impairment							
At 1 January	(582)	-	-	(582)	(570)	(122)	(692)
Amortisation during the year	(7)	-	(2)	(9)	(12)	(36)	(48)
Amortisation on disposals/write-downs of impaired assets	-	-	-	-	-	51	51
Transferred to assets held for sale	-	-	-	-	-	107	107
At 31 December	(589)	-	(2)	(591)	(582)	-	(582)
Carrying amount							
At 31 December	68	5	25	98	69	-	69

The additions to intangible assets in 2018 arose from the acquisition of the savings business of Zurich Insurance Group by SWAS during the year.

Company

	2018 Acquired VIF £m	2018 Total £m	2017 Acquired VIF £m	2017 Total £m
Cost				
At 1 January	651	651	651	651
At 31 December	651	651	651	651
Accumulated amortisation and impairment				
At 1 January	(582)	(582)	(570)	(570)
Amortisation during the year	(7)	(7)	(12)	(12)
At 31 December	(589)	(589)	(582)	(582)
Carrying amount				
At 31 December	62	62	69	69

Of the above total for acquired VIF, £50m (2017: £62m) is expected to be recovered more than one year after the reporting date. The remaining amortisation period is 9 years (2017: 10 years).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

13. Deferred costs

		2018		2017	
		£m	£m	£m	£m
		Group	*Company*	*Group*	*Company*
Deferred acquisition costs	(a)	1,515	1,515	1,485	1,485
Deferred origination costs	(b)	137	122	171	152
Total		1,652	1,637	1,656	1,637

(a) Deferred acquisition costs

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	1,485	1,485	1,495	1,495
Amounts incurred during the year	170	170	124	124
Write down of deferred costs	(56)	(56)	-	-
Amortisation during the year	(84)	(84)	(134)	(134)
At 31 December	1,515	1,515	1,485	1,485

Of the above total, £1,367m for Group and Company (2017: £1,349m for Group and Company) is expected to be recovered more than one year after the reporting date.

(b) Deferred origination costs

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	171	152	194	177
Amounts incurred during the year	2	-	2	1
Amortisation during the year	(36)	(30)	(25)	(26)
At 31 December	137	122	171	152

Of the above total, £97m for Group and £85m for Company (2017: £123m for Group and £111m for Company) is expected to be recovered more than one year after the reporting date.

14. Tax assets and liabilities

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Current tax liabilities	86	74	174	154
Deferred tax liabilities	210	209	355	355
Total tax liabilities	296	283	529	509

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

14. Tax assets and liabilities (continued)

(a) Recognised deferred tax

Deferred tax assets and liabilities have been offset in the balance sheet where there is a legally enforceable right of offset. The tables below split the individual deferred tax assets and liabilities by type, before such netting.

The amounts are as follows:

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Deferred tax assets comprise:				
Trading losses	-	-	22	22
Expenses deductible in future periods	107	107	116	116
Accelerated capital allowances	2	2	1	1
Total deferred tax assets	109	109	139	139
Deferred tax liabilities comprise:				
Unrealised gains on investment assets	9	9	116	116
Deferred acquisition costs	147	147	173	173
Transitional adjustments on introduction of new life tax regime	151	151	193	193
Deferred tax on acquired VIF	12	11	12	12
Other	-	-	-	-
Total deferred tax liabilities	319	318	494	494
Net deferred tax liabilities	210	209	355	355

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 (2017: £ nil for Group and for Company) is expected to be realised within one year of the reporting date.

Of the deferred tax liabilities included in the above table, £68m for Group and Company (2017: £38m for Group and Company) is expected to be settled within one year of the reporting date.

Of the deferred tax assets and liabilities balances shown in the above table, £110m for Group and Company (2017: £155m 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 credit in the statement of comprehensive income relating to each item is as follows:

	2018	2017
	£m	£m
	Group	*Group*
Trading losses	22	21
Expenses deductible in future periods	9	-
Accelerated capital allowances	(1)	-
Unrealised gains/losses on investment assets	(107)	-
Deferred acquisition costs	(26)	(21)
Transitional adjustments on introduction of new life tax regime	(42)	(37)
Deferred tax on acquired VIF	(1)	(3)
Other	-	-
Total deferred tax credit	(146)	(40)

(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 £241m (2017: £208m) as there is insufficient certainty as to the availability of future profits.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

15. Investment in subsidiaries

Company	2018 £m	2017 £m
At 1 January	392	428
Impairment of investment in subsidiaries	-	(22)
Disposal of subsidiary	(1)	-
Acquisition of subsidiary	1	-
Investment in subsidiary	75	-
Transferred to assets held for sale	-	(14)
At 31 December	467	392

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

During the year, the Company disposed of the subsidiaries, SWSL (presented as an asset held for sale in the prior year until disposal) and Scottish Widows Pensions Trustees Limited ("SWPTL") (see note 44).

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

On 3 April 2018, the Company acquired 100% of the share capital of Zurich Group Pensions Services Limited ("ZGPS"). ZGPS was later renamed to Scottish Widows Auto Enrolment Services Limited on the 13 April 2018.

On 24 October 2018, the Company acquired 100% of the share capital of Scottish Widows Europe SA ("SWE").

All entities detailed below 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:

Celsius European Lux 2 SARL	(2)
Clerical Medical (Dartford Number 3) Limited*	(1)
Clerical Medical (Dartford Number 2) Limited*	(1)
Clerical Medical Forestry Limited*	(1)
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*	(1)
CM Venture Investments Limited	(8)
Dalkeith Corporation	(9)
Delancey Arnold UK Limited (50%)*	(10)
Delancey Rolls UK Limited (50%)*	(10)
Fontview Limited*	(1)
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*	(22)
Industrial Real Estate Nominee Limited *	(22)
Newfont Limited*	(1)
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 Administration Services Limited	(16)
Scottish Widows Auto Enrolment Services Limited	(16)
Scottish Widows Europe SA	(23)
Scottish Widows Fund and Life Assurance Society	(17)
Scottish Widows Industrial Properties Europe BV	(18)
Scottish Widows (Port Hamilton) Limited*	(14)
Scottish Widows Property Management Limited	(17)
Scottish Widows Trustees Limited	(17)
Scottish Widows Unit Trust Managers Limited	(20)
St Andrew's Life Assurance plc	(3)
Starfort Limited*	(1)
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 2018

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) Ernst & Young 1 More London Place, London, SE1 2AF
(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, 50Izquierda, 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) Atria One, 144 Morrison Street, Edinburgh, EH3 8EX
(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
(22) Unit 2 Spinnaker Court 1c Becketts Place, Hampton Wick, Kingston Upon Thames, Surrey, KT1 4EQ
(23) 20 Rue De La Poste, L-2346, Luxembourg

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 2018

15. Investment in subsidiaries (continued)

Name Of Umbrella And Undertaking	% Held
HBOS International Investment Funds ICVC (i)	
North American Fund	95.54%
Far Eastern Fund	81.38%
European Fund	93.81%
International Growth Fund	52.71%
Japanese Fund	95.42%
HBOS Specialised Investment Funds ICVC (i)	
Cautious Managed Fund	52.07%
Ethical Fund	83.31%
Fund Of Investment Trusts	39.58%
Smaller Companies Fund	66.00%
Special Situations Fund	51.22%
HBOS UK Investment Funds ICVC (i)	
UK Equity Income Fund	61.54%
UK Growth Fund	62.02%
U.K. FTSE All-Share Index Tracking Fund	57.90%
HBOS Actively Managed Portfolio Funds ICVC (i)	
Diversified Return Fund	94.27%
Absolute Return Fund	92.45%
Dynamic Return Fund	96.62%
HBOS Property Investment Funds ICVC (i)	
UK Property Fund	43.38%
Scottish Widows Tracker And Specialist Investment Funds ICVC (ii)	
UK All Share Tracker Fund	92.03%
International Bond Fund	31.12%
UK Tracker Fund	46.76%
UK Fixed Interest Tracker Fund	97.40%
Emerging Markets Fund	88.39%
UK Index-Linked Tracker Fund	48.60%
UK Smaller Companies Fund	28.26%
Scottish Widows UK And Income Investment Funds ICVC (ii)	
UK Corporate Bond Fund	62.99%
UK Growth Fund	61.64%
Gilt Fund	96.41%
High Income Bond Fund	26.71%
Strategic Income Fund	64.74%
Environmental Investor Fund	70.17%
Ethical Fund	75.23%
Scottish Widows Overseas Growth Investment Funds ICVC (ii)	
Global Growth Fund	54.49%
European Growth Fund	89.53%
American Growth Fund	85.34%
Pacific Growth Fund	76.50%
Japan Growth Fund	95.54%
Scottish Widows Managed Investment Funds ICVC (ii)	
International Equity Tracker Fund	7554%
Balanced Portfolio Fund	82.08%
Progressive Portfolio Fund	72.12%
Cautious Portfolio Fund	59.60%
Cash Fund	99.11%
Opportunities Portfolio Fund	91.99%
Multi-Manager ICVC (ii)	
Multi Manager UK Equity Growth Fund	81.19%
Multi Manager UK Equity Income Fund	29.64%
Multi Manager UK Equity Focus Fund	20.34%
Scottish Widows Investment Solutions Funds ICVC (ii)	
Balanced Solution	43.06%
Cautious Solution	33.65%
Discovery Solution	42.24%
Strategic Solution	54.38%
Dynamic Solution	55.88%
Defensive Solution	66.27%
Adventurous Solution	76.03%
European (Ex UK) Equity Fund	96.43%
Asia Pacific (Ex Japan) Equity Fund	95.59%
Japan Equities Fund	85.21%
US Equities Fund	100.00%
Fundamental Index UK Equity Fund	88.02%
Fundamental Index Global Equity Fund	96.24%
Fundamental Index Emerging Markets Equity Fund	95.16%
Fundamental Low Volatility Index Global Equity	98.24%
Fundamental Low Volatility Index Emerging Markets Equity	95.82%
Fundamental Low Volatility Index UK Equity	93.10%
Scottish Widows Income And Growth Funds ICVC (ii)	
Balanced Growth Fund	27.18%
UK Index Linked Gilt Fund	100.00%
Corporate Bond PPF Fund	100.00%
SW Corporate Bond Tracker	100.00%
Scottish Widows GTAA 1	83.69%
Corporate Bond 1 Fund	100.00%
Adventurous Growth Fund	70.93%
Investment Portfolio ICVC (ii)	
IPS Income	20.87%
IPS Growth	23.54%
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	74.74%
US Enhanced Equity	87.92%
Japan Enhanced Equity	93.24%
Pacific Enhanced Basin	78.79%
Euro Bond	69.13%
US Bond	93.72%
US Currency Reserve	74.05%

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

15. Investment in subsidiaries (continued)

Name Of Umbrella And Undertaking	% Held
Universe, The CMI Global.Network (iii)	
Euro Currency Reserve	98.57%
Euro Cautious	90.35%
US Tracker	27.67%
Euro Tracker	22.00%
Aberdeen Liquidity Fund (Lux) (iv)	
Aberdeen Liquidity Fund (Lux) - Sterling Fund	21.14%
Aberdeen Liquidity Fund (Lux) - Ultra Short Duration Sterling Fund	29.02%
Aberdeen Investment ICVC (v)	
Aberdeen Global High Yield Bond Fund	23.39%
Aberdeen European Property Share Fund	48.26%
Aberdeen Sterling Opportunistic Corporate Bond Fund	35.18%
Aberdeen Sterling Bond Fund	77.98%
Aberdeen Investment ICVC II (v)	
Aberdeen Global Corporate Bond Tracker Fund	99.86%
Aberdeen Investment ICVC III (v)	
Aberdeen Global Emerging Markets Quantitative Equity Fund	61.15%
BNY Mellon Investments Funds ICVC (vi)	
Insight Global Multi-Strategy Fund	43.72%
Insight Global Absolute Return Fund	73.84%
Newton Multi-Asset Growth Fund	28.57%
Newton UK Opportunities Fund	47.74%
Newton UK Income Fund	31.53%
BNY Mellon Manages Funds II	
Absolute Insight Fund	73.62%

Name Of Umbrella And Undertaking	% Held
Invesco Perpetual Far Eastern Investment Series (viii)	
Invesco Perpetual Asian Equity Income Fund	20.92%
Russell Investment Company Plc (ix)	
Russell Euro Fixed Income Fund	33.29%
Russell Sterling Bond Fund	35.10%
Russell U.S Bond Fund	76.04%
UBS Investment Funds ICVC (x)	
UBS Global Optimal Fund	23.14%
UBS UK Opportunities Fund	36.80%
BNP Paribas InstiCash	
BNP Paribas InstiCash GBP	57.84%
The TM Levitas Funds (xii)	
TM Levitas A Fund	33.81%
TM Levitas B Fund	28.23%
Aberdeen Private Equity Fund Of Funds (2007) Plc (xiii)	96.33%
PAN European Urban Retail Fund	22.00%
SSGA UK Equity Tracker Fund (xv)	93.64%
SSGA Europe (Ex UK) (xv)	96.11%
SSGA Asia Pacific Tracker Fund (xv)	90.53%
SSGA North American Equity Fund (xv)	100.00%
Blackrock Balanced Growth Portfolio Fund (xvi)	32.10%
Blackrock UK Smaller Companies Fund (xvi)	20.70%
Schroder Gilt And Fixed Interest Fund (xvii)	22.71%
HLE Active Managed Portfolio Konservativ (xviii)	41.73%
HLE Active Managed Portfolio Dynamisch (xviii)	51.14%
HLE Active Managed Portfolio Ausgewogen (xviii)	57.17%
AgFe UK Real Estate Senior Debt Fund LP	77.91%

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) 10, rue Edward Steichen, L-2540 Luxembourg, Grand-Duche de Luxembourg
(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) Jackson House, 18 Saville Row, London, W1S 3PW
(xii) Exchange Building, St. John's Street, Chichester, West Sussex PO19 1UP
(xiii) 39/40 Upper Mount Street, Dublin 2, Ireland
(xiv) 3rd Floor South, 55 Baker Street, London, W1U 8EW
(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 2018

16. Tangible fixed assets

Land and buildings	2018 £m Group	2017 £m Group
Cost		
At 1 January	23	25
Disposals	(23)	(2)
At 31 December	-	23
Accumulated depreciation		
At 1 January	(10)	(10)
Depreciation charge for the year	-	(1)
Disposals/Write-offs	10	1
At 31 December	-	(10)
Carrying amount		
At 1 January	13	15
At 31 December	-	13

During the year, the Group transferred £13m of owner occupied property out of tangible fixed assets as part of LBG's implementation of ring-fencing requirements.

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.

17. Investment properties

	2018		2017	
	£m Group	£m Company	£m Group	£m Company
At 1 January	3,640	189	3,643	178
Additions – new properties	64	1	60	1
Additions – subsequent expenditure on existing properties	62	-	125	-
Transfers (to)/from fellow Group company	20	-	-	-
Disposals	(179)	(12)	(420)	-
Net gain from change in fair values	122	6	232	10
At 31 December	3,729	184	3,640	189

Rental income arising from investment properties during the year, included in investment income, amounted to: Group £197m (2017: £204m) and Company £12m (2017: £11m). Direct operating expenses (included within operating expenses) arising in respect of such investment properties during the year amounted to: Group £23m (2017: £26m) and Company £nil (2017: £nil).

Expenditure on investment properties which did not generate rental income was: Group £1m (2017: £nil) and Company £nil (2017: £nil). The carrying value of land held for development in Group is £35m (2017: £28m) and Company is £nil (2017: £nil). The carrying value of investment property under development in Group is £163m (2017: £54m) and Company is £nil (2017: £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, or 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

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 at fair value through profit or loss as follows:

Group and Company	2018			2017		
		Classified as			Classified as	
	Re-insurance contracts	Fair value through profit or loss	Total	Re-insurance contracts	Fair value through profit or loss	Total
	£m	£m	£m	£m	£m	£m
At 1 January	565	7,812	8,377	704	6,683	7,387
Movement recognised through the statement of comprehensive income	163	(588)	(425)	(139)	1,078	939
Other movements recognised directly through the balance sheet	-	(92)	(92)	-	51	51
At 31 December	728	7,132	7,860	565	7,812	8,377
Amounts in respect of liabilities arising from insurance and participating investment contracts	728	6,728	7,456	565	7,416	7,981
Amounts in respect of liabilities arising from non-participating investment contracts	-	404	404	-	396	396
Total	728	7,132	7,860	565	7,812	8,377

Assets arising from reinsurance contracts held include £7,231m for Group and Company (2017: £7,734m for Group and Company) that is expected to be settled more than one year after the reporting date.

19. Other assets

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Prepayments	44	40	39	27
Other receivables	47	47	-	-
Total	91	87	39	27

The adoption of IFRS 9 on 1 January 2018 resulted in changes to the classification and measurement of certain financial instruments, as set out in note 45. The above table presents classification and measurement under IFRS 9.

20. 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 31.

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

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

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

20. Derivative financial instruments (continued)

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

Group	2018 Contract Amount £m	2018 Fair value assets £m	2018 Fair value liabilities £m	2017 Contract Amount £m	2017 Fair value assets £m	2017 Fair value liabilities £m
Derivative financial instruments held for trading:						
Swap contracts	36,753	2,367	(2,345)	33,445	2,454	(2,289)
Option contracts	6,983	434	(287)	16,245	650	(761)
Index futures contracts	6,829	81	(69)	6,758	62	(60)
Forward foreign exchange contracts	5,394	32	(18)	5,981	23	(37)
Derivative financial instruments designated as fair value hedges	1,500	243	-	1,500	276	-
Total	57,459	3,157	(2,719)	63,929	3,465	(3,147)

Company	2018 Contract Amount £m	2018 Fair value assets £m	2018 Fair value liabilities £m	2017 Contract Amount £m	2017 Fair value assets £m	2017 Fair value liabilities £m
Derivative financial instruments held for trading:						
Swap contracts	36,556	2,367	(2,344)	33,141	2,454	(2,282)
Option contracts	6,288	433	(285)	14,439	644	(728)
Index futures contracts	4,117	69	(42)	3,748	37	(37)
Forward foreign exchange contracts	2,690	17	(10)	2,662	13	(11)
Derivative financial instruments designated as fair value hedges	1,500	243	-	1,500	276	-
Total	51,151	3,129	(2,681)	55,490	3,424	(3,058)

Derivative financial instrument fair value assets include £2,991m for Group and £2,991m for Company (2017: £3,150m for Group and £3,149m for Company) that is expected to be recovered more than one year after the reporting date.

Derivative financial instrument fair value liabilities include £2,545m for Group and £2,544m for Company (2017: £2,498m for Group and £2,490m 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 38.

21. Loans and receivables at amortised cost

	2018 £m *Group*	2018 £m *Company*	2017 £m *Group*	2017 £m *Company*
Accrued income, dividend and rent	248	8	524	162
Loans to related parties	1,765	1,765	1,753	1,752
Other amounts due from related parties	57	65	140	167
Amounts receivable from direct insurance business	156	156	182	182
Reverse repurchase asset and collateral asset	-	-	988	345
Other	448	202	450	260
Total	2,674	2,196	4,037	2,868

The adoption of IFRS 9 on 1 January 2018 resulted in changes to the classification and measurement of certain financial instruments, as set out in note 45. The above table presents classification and measurement under IFRS 9.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

21. Loans and receivables at amortised cost (continued)

Of the above total, £348m for Group and Company (2017: £348m for Group and 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.

Reverse repurchase assets relate to cash collateral received and reinvested under derivatives and stock lending programmes and are now reported in note 22 - as loans and advances to banks in accordance with IFRS9.

Within loans and receivables at amortised cost, the largest credit concentration is with Lloyds Bank Plc of £1,400m (2017: Lloyds Bank Plc of £1,400m). Further information in respect of credit risk, including credit concentration risk and collateral held against loans to related parties, is given in note 38.

22. Investments at fair value through profit or loss

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Shares and other variable yield securities	75,384	85,641	84,533	93,873
Debt and other fixed/variable income securities	31,033	12,738	38,844	19,568
Loans and Advances to Customers	7,845	7,259	-	-
Loans and Advances to Banks	2,519	1,470	-	-
Transferred to assets held for sale	-	(2,165)	-	-
Total investments at fair value	116,781	104,943	123,377	113,441

The adoption of IFRS 9 on 1 January 2018 resulted in changes to the classification and measurement of certain financial instruments, as set out in note 45. The above table presents classification and measurement under IFRS 9.

Debt securities of £29,018m for Group and £12,094m for Company (2017: £37,224m for Group and £19,306m 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 £62,858m (2017: £68,479m), which are held at fair value through profit or loss.

During 2018, the Group acquired illiquid credit assets from, or issued by, parties within LBG totalling £nil (2017: £450m). The Group also originated loans during the year totalling £695m (2017: £352m) and committed to lend a further £231m (2017: £245m). 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 38.

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 38.

As a result of the reclassification of the European business of the Company to assets and liabilities held for sale there has been a reduction in investments at fair value through profit or loss for the Company in 2018. See note 44 for further detail.

Structured entities are consolidated when the Group has control in accordance with the consolidation policy set out in note 1(b).

Of the total Loans and advances to customers above £4,173m for Group (2017: £4,775m) and £4,256m for Company (2017: £4,774m) is secured on real estate. Of the Loans and advances to customers above, £6,503m (2017: £6,759m) for Group and £6,584 (2017: £6,834m) 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 £259m for Group and £259m for Company (2017: £271m for Group and £270m for Company) representing collateral received and reinvested in relation to derivatives contracts and stocklending programmes, further details is given in note 38.

Interests in unconsolidated structured entities

Included within investments at fair value through profit or loss are investments in unconsolidated structured entities for Group of £24,208m (2017: £27,393m) 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

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

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 2018, the total net assets of unconsolidated collective investment vehicles and limited partnerships in which the Group held a beneficial interest were £2,435bn (2017: £2,338bn). During the year the Group has not provided any non-contractual financial or other support to these unconsolidated collective investment vehicles and limited partnerships (2017: none).

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 2018 was £99m (2017: £103m).

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. 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 (2017: 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 (2017: none).

23. Cash and cash equivalents

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

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Cash at bank	166	34	1,651	795
Short term deposits	8	7	281	268
Cash at bank	174	41	1,932	1,063
Less: bank overdrafts (note 34)	(4)	-	(10)	(2)
Total	170	41	1,922	1,061

The adoption of IFRS 9 on 1 January 2018 resulted in changes to the classification and measurement of certain financial instruments, as set out in note 45. This included £1,561m of cash balances with Loans and Advances to Banks for Group and £915m of cash balances with Loans and Advances to Banks for Company, which is now held at fair value through profit or loss and has therefore been represented for 2018 in note 22.

24. Share capital

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Issued and fully paid share capital:				
70,000,000 (2017: 70,000,000) ordinary shares of £1 each	70	70	70	70
Total	70	70	70	70

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

25. 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		2018			2017	
	£m	£m	£m	£m	£m	£m
	Gross	*Reinsurance*	*Net*	*Gross*	*Reinsurance*	*Net*
At 1 January	102,916	(7,981)	94,935	93,799	(7,071)	86,728
New business	5,508	(42)	5,466	4,197	(21)	4,176
Changes in existing business	(9,617)	580	(9,037)	773	(941)	(168)
Assumption changes	(555)	(13)	(568)	(316)	52	(264)
Change in classification	-	-	-	4,463	-	4,463
At 31 December	98,252	(7,456)	90,796	102,916	(7,981)	94,935

Company		2018			2017	
	£m	£m	£m	£m	£m	£m
	Gross	*Reinsurance*	*Net*	*Gross*	*Reinsurance*	*Net*
At 1 January	102,916	(7,981)	94,935	93,799	(7,071)	86,728
New business	5,508	(42)	5,466	4,197	(21)	4,176
Changes in existing business	(9,617)	580	(9,037)	773	(941)	(168)
Assumption changes	(555)	(13)	(568)	(316)	52	(264)
Change in classification	-	-	-	4,463	-	4,463
Transferred to liabilities held for sale	(2,135)	-	(2,135)	-	-	-
At 31 December	96,117	(7,456)	88,661	102,916	(7,981)	94,935

An analysis of the expected maturities of liabilities arising from insurance contracts and participating investment contracts is given in note 38. The portfolio is subject to a number of risks as set out in note 38.

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 was recognised through insurance contract liability reserves in that year. This resulted in a net increase to reserves of £89m in 2017.

As detailed in note 44, insurance contracts and participating investment contracts have been reclassified to liabilities held for sale as part of the transfer of the European business of the Company to SWE.

26. Unallocated surplus

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

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	380	380	228	228
Change recognised through the statement of comprehensive income	10	10	152	152
At 31 December	390	390	380	380

Of the above total, £341m for Group and Company (2017: £324m 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 2018

27. 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:

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	43	43	47	47
Change recognised through the statement of comprehensive income	(15)	(15)	(4)	(4)
At 31 December	28	28	43	43

£28m for Group and Company (2017: £42m for Group and Company) is expected to be recovered more than one year after the reporting date.

28. Provisions for other liabilities and charges

Group	2018 German insurance business litigation £m	2018 Other £m	2018 Total £m	2017 German insurance business litigation £m	2017 Other £m	2017 Total £m
At 1 January	138	89	227	168	99	267
Increase in the year	-	126	126	-	52	52
Amount utilised in the period	(26)	(68)	(94)	(30)	(62)	(92)
At 31 December	112	147	259	138	89	227

Company	2018 German insurance business litigation £m	2018 Other £m	2018 Total £m	2017 German insurance business litigation £m	2017 Other £m	2017 Total £m
At 1 January	138	87	225	168	90	258
Increase in the year	-	79	79	-	52	52
Amount utilised in the period	(26)	(67)	(93)	(30)	(55)	(85)
At 31 December	112	99	211	138	87	225

Of the above total, provisions for other liabilities and charges include £175m for Group and £128m for Company (2017: £102m for Group and Company) 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 total provision made to 31 December 2018 is £639m (2017: £639m). Claim volumes and settlement experience have improved and therefore only £26m was utilised in the year ended 31 December 2018 (2017: £30m); the remaining unutilised provision as at 31 December 2018 is £112m (2017: £138m).

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 10% of the relevant total policy population. Key metrics and sensitivities are highlighted in the table below:

Sensitivities	Actuals to date	Anticipated Future	Sensitivity
Number of claims	14,700	6,700	1,000 = £7m
Average uphold rate per claim	65%	50%	10% = £11m
Average redress per upheld claim	£45,000	£11,000	£1,000 = £5m
Administrative expenses	£153m	£20m	1 case = £1,500

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

28. Provisions for other liabilities and charges (continued)

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.

Other provisions

Other provisions include amounts for customer remediation costs, restructuring and third party contractual compensation. This includes provisions arising from the termination of the asset management agreements with Aberdeen Standard Investments, which reflect management's current view of the appropriate level of provision. The amount of compensation ultimately payable is yet to be determined and may vary from current estimates. There are no further disclosures in relation to this matter as, to do so, can be expected to seriously prejudice the Group's position.

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.

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. At 31 December 2018, no conditions exist for such payments to be made, and as such these payments are continued to be regarded as contingent in nature in continuation of the approach from 2017. A proportion of these costs (£14m) 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. 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.

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 Zurich Group. The acquisition of corporate pension business agreed with Zurich includes future payments in relation to certain performance targets prior to the Company acquiring the remaining business.

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

The FCA 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 investigated the behaviour around disclosing exit and paid-up charges to customers after December 2008. The FCA confirmed in June 2018 that the investigation announced in March 2016 has been discontinued with no formal action against the Company. Consequently, Company no longer has a contingent liability in respect of this investigation.

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 2018

29. 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. During the year, SWSL was disposed of in a sale to Lloyds Bank plc and the Group paid £284m to a related party to transfer the obligations in respect of SWRBS. Consequently, the parent Company of SWSL is now outside the Group and the Group was released from the obligations of the SWRBS from 1 May 2018. The information in this note reflects this change.

(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 parent Company of SWSL and the Trustee and sent to the Pensions Regulator for review. The Group has not provided for these deficit contributions as SWSL is no longer part of 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 SWSL 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 was required to pay contributions to fund its obligations to the SWRBS until the disposal of SWSL on 1 May 2018. The Group has paid contributions of £36m (2017: £13m) to the SWRBS in 2018. Employee contributions made during the year were £nil (2017: £nil). The Group does not expect to pay any contributions in 2019.

As a result of the reclassification of the subsidiary SWSL to assets and liabilities held for sale in 2017 there was a reduction in pension benefit obligations for the Group in that year. See note 44 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 44 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 LBG 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:

	2018 £m	2017 £m
Fair value of scheme assets	-	1,171
Present value of defined benefit obligations	-	(1,248)
Transferred to liabilities held for sale	-	77
Liability recognised in the balance sheet	-	-

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

29. Retirement benefit obligations (continued)

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

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

	2018 £m	2017 £m
Net amount recognised in the balance sheet		
At 1 January	-	(130)
Service cost	-	(22)
Net interest on net defined benefit asset	-	(4)
Remeasurement effects recognised in other comprehensive income	-	67
Employer contributions	-	13
Administration costs incurred during the period	-	(1)
Transferred to liabilities held for sale	-	77
At 31 December	-	-

	2018 £m	2017 £m
Movements in the defined benefit obligation		
At 1 January	1,248	1,389
Current service cost	4	15
Interest expense	11	37
Remeasurements:		
Actuarial losses – experience	-	(11)
Actuarial losses – demographic assumptions	-	(53)
Actuarial gains – financial assumptions	(60)	42
Benefits paid	(43)	(177)
Past service cost – curtailments	-	6
Defined benefit obligation derecognised on disposal of SWSL (note 44)	(1,160)	-
At 31 December	-	1,248

The following tables provide an analysis of the SWRBS assets:

	2018 £m	2017 £m
Changes in the fair value of scheme assets		
At 1 January	1,171	1,259
Return on plan assets excluding amounts included in interest income	(29)	44
Interest income	11	34
Employer contributions	36	12
Benefits paid	(43)	(177)
Administrative costs paid	(1)	(1)
Scheme assets derecognised on disposal of SWSL (note 44)	(1,145)	-
At 31 December	-	1,171

The following tables provide an analysis of the SWRBS assets for the comparative period only, since the SWRBS assets were derecognised in 2018 as part of the sale of SWSL:

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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

29. Retirement benefit obligations (continued)

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

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	-	-	-	-

The SWRBS' collective investment vehicles comprise

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

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

	2018 £m	2017 £m
Current service cost	4	15
Past service cost - curtailments	0	6
Net interest amount	0	4
Plan administration costs incurred in the year	1	1
Net expense recognised	5	26

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

	2018 %	2017 %
Discount rate	2.74	2.59
Rate of inflation		
Retail Prices Index	3.13	3.20
Consumer Price Index	2.08	2.15
Rate of salary increases	0.00	0.00

	2018 Years	2017 Years
Life expectancy for member aged 60, on the valuation date:		
Men	27.2	27.3
Women	29.4	29.5
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	28.3	28.4
Women	30.6	30.7

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

29. Retirement benefit obligations (continued)

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

Risk exposure of SWRBS

The Group was exposed to the following risks in relation to the SWRBS scheme before the sale of SWSL and transfer of SWRBS obligations:

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.

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

A sensitivity analysis has been provided for the comparative period only, since the Group is no longer exposed to the risks of changes in assumptions. 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 2017 £m	Increase / (decrease) in the net defined benefit pension scheme liability 2017 £m
Central basis	(14)	(77)
Inflation:		
Increase of 0.1%	(15)	(101)
Decrease of 0.1%	(13)	(54)
Discount rate:		
Increase of 0.1%	(13)	(50)
Decrease of 0.1%	(15)	(106)
Expected life expectancy of members:		
Increase of one year	(16)	(138)
Decrease of one year	(12)	(20)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

29. Retirement benefit obligations (continued)

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

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.

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 comprised approximately 60% of the SWRBS assets in 2017 (nil in 2018 since all assets were derecognised as part of the sale of SWSL). The remaining assets were 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 was 25 years in 2017.

(a) Guarantee to the trustees of SWRBS

Prior to 1 May 2018, the Company provided 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 was 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. As part of the transaction to dispose of SWSL on 1 May 2018 (see note 44), the Company transferred this guarantee to a related party outside the Group.

(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 2018, the charge to the Group's statement of comprehensive income in respect of the SWRBS was £15m (2017: £14m), representing the contributions payable by SWSL in accordance with the scheme's rules. There were no outstanding or prepaid contributions at 31 December 2018 (2017: 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:

<u>Group</u>	2018			2017		
	Before tax £m	Tax expense £m	After tax £m	Before tax £m	Tax expense £m	After tax £m
SWRBS	31	(5)	26	67	(14)	53
Total	31	(5)	26	67	(14)	53

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

30. Accruals and deferred income

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Accrued expenses	6	3	11	10
Deferred income	31	18	38	20
Total	37	21	49	30

Of the above total, £25m for Group and £15m for Company (2017: £30m for Group and £18m for Company) is expected to be settled more than one year after the reporting date.

31. Subordinated debt

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

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Subordinated debt	1,523	1,554	1,518	1,559
Issue costs	(14)	(14)	(15)	(15)
	1,509	1,540	1,503	1,544
Accrued interest on subordinated debt	50	50	50	50
Fair value hedge adjustment	210	209	242	242
Total	1,769	1,799	1,795	1,836

Movements in the carrying value are as follows:

	£m	£m
	Group	*Company*
At 1 January 2018	1,795	1,836
Changes in fair value	(27)	(38)
Other non-cash movements	1	1
At 31 December 2018	1,769	1,799

£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	2018		2017	
	£m	£m	£m	£m
	Carrying value	*Fair value*	*Carrying value*	*Fair value*
Undated subordinated debt	53	54	59	56
Dated subordinated debt	1,716	1,656	1,736	1,655
Total	1,769	1,710	1,795	1,711

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

31. Subordinated debt (continued)

Company	2018 £m *Carrying value*	2018 £m *Fair value*	2017 £m *Carrying value*	2017 £m *Fair value*
Undated subordinated debt	53	53	59	56
Dated subordinated debt	1,746	1,657	1,777	1,696
Total	1,799	1,710	1,836	1,752

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.

32. Non-participating investment contract liabilities

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

Group	2018 Gross £m	2018 Reinsurance £m	2018 Net £m	2017 Gross £m	2017 Reinsurance £m	2017 Net £m
At 1 January	15,447	(396)	15,051	20,112	(317)	19,795
New business	668	-	668	608	-	608
Changes in existing business	(2,260)	(8)	(2,268)	(813)	(79)	(892)
Change in classification	-	-	-	(4,460)	-	(4,460)
At 31 December	13,855	(404)	13,451	15,447	(396)	15,051

Company	2018 Gross £m	2018 Reinsurance £m	2018 Net £m	2017 Gross £m	2017 Reinsurance £m	2017 Net £m
At 1 January	15,447	(396)	15,051	20,112	(317)	19,795
New business	668	-	668	608	-	608
Changes in existing business	(2,260)	(8)	(2,268)	(813)	(79)	(892)
Change in classification	-	-	-	(4,460)	-	(4,460)
Transferred to liabilities held for sale	(30)	-	(30)	-	-	-
At 31 December	13,825	(404)	13,421	15,447	(396)	15,051

An analysis of the contractual and expected maturities of liabilities arising from non-participating investment contracts is given in note 38.

As detailed in note 44, non-participating investment contracts have been reclassified to liabilities held for sale as part of the transfer of the European business of the Company to SWE.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

33. Other financial liabilities

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Amounts payable in respect of direct insurance business	516	516	565	565
Amounts payable on reinsurance contracts	11	11	5	5
Due to related parties	366	372	933	981
Due to brokers	54	23	108	83
Collateral liability	885	372	925	283
Other	499	314	469	316
Total	2,331	1,608	3,005	2,233

Of the above total, £nil for Group and £nil for Company (2017: £nil for Group and £nil for Company) is expected to be settled more than one year after the reporting date.

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 at Amortised Cost and liquidity funds within Investments at fair value through profit or loss.

34. Borrowings

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Bank overdrafts	4	-	10	2
Total	4	-	10	2

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.

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

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Net decrease/(increase) in operating assets:				
Deferred costs	4	-	33	35
Investment properties	(89)	5	3	(11)
Assets arising from reinsurance contracts held	517	517	(990)	(990)
Tangible fixed assets	13	-	2	-
Other Assets	(52)	(60)	24	(1)
Financial assets:				
Derivative financial instruments	308	295	335	295
Loans and receivables at amortised cost	1,363	672	1,801	2,294
Investments at fair value through profit or loss	6,596	8,498	(5,074)	(5,111)
Net decrease/(increase) in operating assets	8,660	9,927	(3,866)	(3,489)
Net (decrease)/increase in operating liabilities:				
Insurance contracts and participating investment contract liabilities	(4,664)	(6,799)	9,117	9,117
Future profits on non-participating business in the With Profits Funds	15	15	4	4
Unallocated surplus	10	10	152	152
Retirement benefit obligations	-	-	(53)	-
Provisions for other liabilities and charges	32	(14)	(40)	(33)
Accruals and deferred income	(12)	(9)	3	4
Financial liabilities:				
Subordinated debt	(26)	(37)	(24)	(12)
Non-participating investment contract liabilities	(1,592)	(1,622)	(4,665)	(4,665)
Derivative financial instruments	(428)	(377)	139	128
Other financial liabilities	(674)	(625)	289	29
External interest in collective investment vehicles	(1,541)	-	278	-
Net (decrease)/increase in operating liabilities	(8,880)	(9,458)	5,200	4,724
Net (increase)/decrease in operating assets and liabilities	(220)	469	1,334	1,235

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

36. Dividends paid

	2018 £m	2017 £m
Total dividends paid on equity shares	1,765	2,563

The Company paid dividends of £540m in February 2018 (2017: £600m), £225m in July 2018 (2017: £50m) and £1,000m in December 2018 (2017: £nil). 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 £25.21 per share (2017: £36.61 per share).

37. 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; and 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

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

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

(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.

Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality, costs and credit default. 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

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.

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_2017 mortality projection model for females from the Actuarial profession's Continuous Mortality Investigation with a long term rate of improvement of 2.8% per annum and a higher smoothing parameter. Similarly improvements in male annuitant mortality are assumed to follow the CMI_2017 mortality projection model for males from the Actuarial Profession's Continuous Mortality Investigation with a long term rate of improvement of 3.0% 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. There is no allowance for prudence on contractual costs.

From 1 May 2018, to comply with Ring-Fenced Bank regulations, a mark-up of 4.5% on certain cost recharges from Lloyds Banking Group has been included.

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

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

(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 Scottish Widows 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 Scottish Widows With Profits Fund:

	Interest rate (net)	
	2018	**2017**
Class of business	**%**	**%**
Annuities in Payment	1.70	1.50
Deferred Annuities	1.30	1.30

(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 2018, the 10 year-equity-implied-at-the-money assumption was 18.0% (20.9% as at 31 December 2017). The assumption for property volatility at 31 December 2018 was 12.7% (31 December 2017: 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 2018 (0.63% at 31 December 2017), 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:

Scottish Widows With Profits Fund

		2018	**2017**
Assurances (excluding term assurances)			
Conventional With Profits	Males		
	Smoker	68% AMS00 Ultimate	68% AMS00 Ultimate
	Non-smoker	62% AMN00 Ultimate	68% AMN00 Ultimate
	Unknown	62% AMC00 Ultimate	60% AMC00 Ultimate
	Females		
	Smoker	68% AFS00 Ultimate	68% AFS00 Ultimate
	Non-smoker	79% AFN00 Ultimate	80% AFN00 Ultimate
	Unknown	67% AFC00 Ultimate	65% AFC00 Ultimate
Unitised Assurances	Males	36% AMC00 Ultimate	36% AMC00 Ultimate
	Females	60% AFC00 Ultimate	59% AFC00 Ultimate

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

37. 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)

Annuities

Purchased (whole life)	Males	Bespoke mortality tables CMI_2017_M [2.00%] T80-110	Bespoke mortality tables CMI_2016_M [2.00%] T80-110
	Females	Bespoke mortality tables CMI_2017_F [1.80%] T80-110	Bespoke mortality tables CMI_2016_F [1.80%] T80-110
Self-employed / Personal Pensions	Males	Bespoke mortality tables CMI_2017_M [2.00%] T80-110	Bespoke mortality tables CMI_2016_M [2.00%] T80-110
	Females	Bespoke mortality tables CMI_2017_F [1.80%] T80-110	Bespoke mortality tables CMI_2016_F [1.80%] T80-110
Other Annuities in payment	Males	Bespoke mortality tables CMI_2017_M [2.00%] T80-110	Bespoke mortality tables CMI_2016_M [2.00%] T80-110
	Females	Bespoke mortality tables CMI_2017_F [1.80%] T80-110	Bespoke mortality tables CMI_2016_F [1.80%] T80-110
Deferred Annuities	Males	64% AMC00 Ultimate CMI_2017_M [2.00%] T80-110	65% AMC00 Ultimate CMI_2016_M [2.00%] T80-110
	Females	68% AFC00 Ultimate CMI_2017_F [1.80%] T80-110	68% AFC00 Ultimate CMI_2016_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 and CMI_2017.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

37. 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)

CMIG With Profits Fund

		2018	2017
Assurances (excluding term assurances)			
Conventional With Profits	Males	35% AMC00 Ultimate	35% AMC00 Ultimate
	Females	50% AFC00 Ultimate	50% AFC00 Ultimate
Unitised Assurances	Males	80% AMC00 Ultimate	80% AMC00 Ultimate
	Females	85% AFC00 Ultimate	80% AFC00 Ultimate
Annuities			
Self-employed / Personal Pensions	Males	Bespoke mortality tables CMI_2017_M [2.00%] T80-110	Bespoke mortality tables CMI_2016_M [2.00%] T80-110
	Females	Bespoke mortality tables CMI_2017_F [1.80%] T80-110	Bespoke mortality tables CMI_2016_F [1.80%] T80-110
Deferred Annuities	Males	Bespoke mortality tables CMI_2017_M [2.00%] T80-110	Bespoke mortality tables CMI_2016_M [2.00%] T80-110
	Females	Bespoke mortality tables CMI_2017_F [1.80%] T80-110	Bespoke mortality tables CMI_2016_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 and CMI_2017.

(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 75% for business which is formerly Scottish Widows plc and 85% for business which is formerly Clerical Medical Investment Group Ltd, for the realistic assessment (85% assumed for both heritages at 31 December 2017).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

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

(2) Key assumptions (continued)

(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)** **2018** %	 **2017** %
Conventional Life business and non-unit reserves on linked life business (pre-2013)	0.64	0.50
Conventional Life business and non-unit reserves on linked life business (post-2013)	0.80	0.62
Non-unit reserves on linked pension business (Retirement account, solutions and stakeholder)	0.80	0.62
Conventional pensions business and non-unit reserves on other linked pensions business	0.80	0.62
Annuities in payment	2.48	2.23

Formerly Clerical Medical Investment Group Ltd **Class of business**	**Interest rate (net)** **2018** %	 **2017** %
Conventional Life business and non-unit reserves on linked life business	0.64	0.50
Formerly SW Protection business	0.64	0.50
Conventional pensions business and non-unit reserves on other linked pensions business	0.80	0.62
Annuities in payment	2.48	2.23

Formerly Halifax Life Limited **Class of business**	**Interest rate (net)** **2018** %	 **2017** %
Non-unit reserves on linked pension business	0.80	0.62
ELAS reassured annuities in payment	2.48	2.23
Annuities in payment	2.48	2.23

(ii) Investment returns and discount rates

Formerly St Andrew's Life Assurance plc **Class of business**	**Interest rate (net)** **2018** %	 **2017** %
Conventional Life business	0.64	0.50
Non-unit reserves on linked life business	0.64	0.50

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

37. 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

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

Formerly Scottish Widows plc

			2018	2017
Protection for Life (Term)				
	Males			
		Smoker	90% TMS00 Select	91% TMS00 Select
		Non smoker	79% TMN00 Select	81% TMN00 Select
	Females			
		Smoker	86% TFS00 Select	89% TFS00 Select
		Non smoker	75% TFN00 Select	73% TFN00 Select
Protection for Life (Whole of Life)				
	Males			
		Smoker	89% ADJTMS00 Ultimate	89% ADJTMS00 Select
		Non smoker	84% ADJTMN00 Ultimate	84% ADJTMN00 Select
	Females			
		Smoker	88% ADJTFS00 Ultimate	88% ADJTFS00 Select
		Non smoker	87% ADJTFN00 Ultimate	87% ADJTFN00 Select
Term Assurances				
	Males			
		Smoker	77% TMS00 Ultimate	77% TMS00 Select
		Non smoker	64% TMN00 Ultimate	67% TMN00 Select
		Unknown	64% TMN00 Ultimate	67% TMN00 Select
	Females			
		Smoker	79% TFS00 Ultimate	79% TFS00 Select
		Non smoker	79% TFN00 Ultimate	84% TFN00 Select
		Unknown	79% TFN00 Ultimate	84% TFN00 Select
Unitised Pensions (Solutions, Stakeholder)	Males		53% AMC00 Ultimate	53% AMC00 Ultimate
	Females		50% AFC00 Ultimate	51% AFC00 Ultimate
Retirement Account	Males		54% AM92 Ultimate	66% AM92 Ultimate
	Females		45% AF92 Ultimate	55% AF92 Ultimate
Transferred from Lloyds Bank	Males			
		Smoker	54% AMS00 Ultimate	56% AMS00 Ultimate
		Non smoker	72% AMN00 Ultimate	72% AMN00 Ultimate
		Unknown	72% AMN00 Ultimate	72% AMN00 Ultimate
	Females			
		Smoker	61% AFS00 Ultimate	62% AFS00 Ultimate
		Non smoker	69% AFN00 Ultimate	70% AFN00 Ultimate
		Unknown	69% AFN00 Ultimate	70% AFN00 Ultimate

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

37. 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)

		2018	2017
Annuities			
Purchased (whole life)	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]
Self-employed/ personal pensions	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]
Other Annuities in payment	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]
Executive Pensions	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]
Group scheme annuities	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]
Transferred from Lloyds TSB	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]

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

		2018	2017
Deferred Annuities			
	Males	60% AMC00 Ultimate CMI _2017_M [3.0%]	59% AMC00 Ultimate CMI _2016_M [2.25%]
	Females	64% AFC00 Ultimate CMI _2017_F [2.8%]	61% AFC00 Ultimate CMI _2016_F [2.05%]

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

37. 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)

A smoothing parameter higher than the default parameter was used in CMI_2016 and CMI_2017.

Formerly Clerical Medical Investment Group Ltd

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

		2018	2017
Term Assurances	Males	29% TMC00 Ultimate	29% TMC00 Ultimate
	Females	40% TFC00 Ultimate	40% TFC00 Ultimate
Annuities			
Purchased (whole life)	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]
Self-employed/ personal pensions	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]
Other Annuities in payment	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]
Deferred annuities	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]

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 2018

37. 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:

		2018	2017
UL Individual Pensions Regular Premium	Males	50% AMC00 Ultimate	54% AMC00 Ultimate
	Females	50% AFC00 Ultimate	54% AFC00 Ultimate
UL Individual Pensions Single Premium	Males	50% AMC00 Ultimate	54% AMC00 Ultimate
	Females	50% AFC00 Ultimate	54% AFC00 Ultimate
UL Group Pension	Males	77% AMC00 Ultimate	72% AMC00 Ultimate
	Females	63% AFC00 Ultimate	68% AFC00 Ultimate
Pension Annuities	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]
Deferred Annuities	Males	Bespoke mortality tables CMI_2017_M [3.0%]	Bespoke mortality tables CMI_2016_M [2.25%]
	Females	Bespoke mortality tables CMI_2017_F [2.8%]	Bespoke mortality tables CMI_2016_F [2.05%]

Formerly St Andrew's Life Assurance plc

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

		2018	2017
Term Assurances	Males		
	Smoker	98% TMS00 Ultimate	98% TMS00 Select
	Non-Smoker	98% TMN00 Ultimate	98% TMN00 Select
	Females		
	Smoker	86% TFS00 Ultimate	104% TFS00 Select
	Non-Smoker	104% TFN00 Ultimate	104% TFN00 Select
Investment Bonds	Males	54% AMC00 Ultimate	72% AMC00 Ultimate
	Females	81% AFC00 Ultimate	94% AFC00 Ultimate

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

37. 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:

	Impact on profit after tax			
	2018		2017	
Variable	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Mortality	164	164	213	213
Expenses	(46)	(46)	10	10
Lapses	(28)	(28)	(15)	(15)
Valuation interest rate	43	43	34	34
Inflation	(1)	(1)	33	33

The 2017 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.

		Impact on profit after tax			
	Change in	2018		2017	
Variable	variable	£m	£m	£m	£m
		Group	*Company*	*Group*	*Company*
Annuitant Mortality	5% reduction	(210)	(210)	(193)	(193)
Non-annuitant Mortality	5% reduction	9	9	8	8
Lapses	10% reduction	(33)	(33)	(50)	(50)
Future maintenance expenses and investment expenses	10% reduction	125	125	136	136
Interest rate – change in redemption yield (1)	0.25% reduction	(24)	(24)	(16)	(16)
Interest rate – change in valuation margin(2)	0.25% reduction	(378)	(378)	(356)	(356)

(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 2018

38. 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 appropriate Insurance executive committees and onto the Board if required.

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 underwriting, model risk, 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 ("ROC") with operational implementation assigned to the Insurance and Wealth Risk Committee ("IWRC").

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 Insurance 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 prefers, accepts or wishes to avoid and is 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 (capital, insurance underwriting, credit, market and liquidity), operational risks, people, conduct risks, regulatory & legal risks, financial reporting, model risk 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) to each meeting of IWRC and ROC. 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 ROC 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 underwriting, credit, capital and liquidity risk.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. 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 moves (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 2018

38. 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 2018

	Fair value hierarchy			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	-	-	3,729	3,729
Assets arising from reinsurance contracts held at fair value through profit or loss	-	7,132	-	7,132
Shares and other variable yield securities	74,718	-	666	75,384
Debt and other fixed/variable income securities	10,819	19,962	252	31,033
Loans and advances to customers	-	-	7,845	7,845
Loans and advances to banks	-	2,518	1	2,519
Derivative financial assets	90	3,028	39	3,157
Total assets	85,627	32,640	12,532	130,799
Derivative financial liabilities	132	2,587	-	2,719
Liabilities arising from non-participating investment contracts	-	13,855	-	13,855
Subordinated debt	-	1,769	-	1,769
Total liabilities	132	18,211	-	18,343

For all financial instruments held at amortised cost by the Group and Company, carrying value is a reasonable approximation of fair value.

Company As at 31 December 2018

	Fair value hierarchy			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	-	-	184	184
Assets arising from reinsurance contracts held at fair value through profit or loss	-	7,132	-	7,132
Shares and other variable yield securities	84,876	84	681	85,641
Debt and other fixed/variable income securities	5,345	6,511	882	12,738
Loans and advances to customers	-	-	7,259	7,259
Loans and advances to banks	-	1,470	-	1,470
Derivative financial assets	76	3,013	40	3,129
Transfer of Assets held for sale	(2,051)	-	(114)	(2,165)
Total assets	88,246	18,210	8,932	115,388
Derivative financial liabilities	103	2,578	-	2,681
Liabilities arising from non-participating investment contracts	-	13,825	-	13,825
Subordinated debt	-	1,799	-	1,799
Total liabilities	103	18,202	-	18,305

For all financial instruments held at amortised cost by the Group and Company, carrying value is a reasonable approximation of fair value.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

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
Shares and other variable yield securities	83,661	-	872	84,533
Debt and other fixed/variable income 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
Shares and other variable yield securities	92,908	142	823	93,873
Debt and other fixed/variable income 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

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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

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 (2018 loan to bond spreads: 18.5bps to 51.5bps) and Inferred spreads (2018 credit spreads: 129.97bps to 53.98bps). The effect of applying reasonably possible alternative assumptions to the value of these loans would be to decrease the fair value by £304m (2017: £235m) or increase it by £326m (2017: £276m). There are no material interdependencies between the above assumptions.

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 (£16.7m) (2017: £18.2m)

Unobservable inputs in the valuation model include gross interest rate on mortgages 4.26% to 5.58% (Dec 2017: 5.75% to 7.25%), spread over risk-free (over swap) 2.43% to 2.95% (Dec 2017: 3.44% to 3.78%), residential property volatility and value 4.7% to 21.3% (Dec 2017: 3.6% to 16.4%), voluntary early repayment rate 5.29% to 11.14% (Dec 2017: 6.26% to 9.08%), delay in settlement of loan 3 months to 26 months (Dec2017: 3 months to 26 months), property valuation haircut -5% to -10% (Dec 2017: -5% to -10%), and expected equity return 8% to 12% (Dec 2017: 8% to 12%). For December 2018 Valuation Uncertainty calculations, the Pricing Adjustment was excluded which resulted in more conservative figures and skewed valuation uncertainty figures with the favourable more aligned towards the base and a greater downside. The effect of applying the aforementioned reasonably possible alternative assumptions in line with the ranges disclosed above would decrease the fair value by £16.5m (Dec. 2017: £4.9m) or increase it by £0.6m (Dec. 2017: £14.2m). 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 a Monte Carlo simulation is applied to value the derivative. Calculation of the downside valuation uncertainty is taken as the difference between the 99th percentile value of the Monte Carlo simulation and the mean valuation. The effect of applying a reasonably possible alternative assumption to the value of this asset would be to decrease the fair value by £30m (2017: £14m) or increase it by £0m (2017: £16m).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

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% (Dec. 2017 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 £6.0m (Dec. 2017: £8.2m) or increase it by £2.3m (Dec. 2017: £0.8m).

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, a spread to represent the risks associated with the Agricultural sector (Via CMBS bonds as a proxy) and an incremental illiquidity premium as well as a prepayment cost of capital premium. 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.

Unobservable inputs in the Agriculture valuation model include: Generic spreads based of Merrill Lynch pool of bonds (change of +12,8bps and 0bps to base), Illiquidity premium (2018 loan to bond spreads: 18.5bps to 51.5bps), and Commercial Mortgage Backed Securities (CMBS) inferred spreads (2018 spreads: -10bps to 67bps) and prepayment rates (2018 rates: 0.11% to 0.22% for 1-5yrs and 0.13% to 0.38% for 5+ yrs.).

The effect of applying reasonably possible alternative assumptions to the valuation of the loans and senior note would be to decrease the fair value of the SPV by £15.4m or increase it by £17.6m. 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).

Group

	2018		2017	
	£m	£m	£m	£m
	Assets	*Liabilities*	*Assets*	*Liabilities*
Balance at 1 January	12,235	-	11,535	-
Transfers in	703	-	103	19
Transfers out	(664)	-	(195)	(19)
Purchases	1,125	-	1,268	-
Disposals	(950)	-	(1,013)	-
Net gains recognised within net gains on assets and liabilities at fair value through profit or loss in the statement of comprehensive income	83	-	537	-
Balance at 31 December	12,532	-	12,235	-
Total unrealised gains for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	32	-	209	-

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

Company

	2018		2017	
	£m	£m	£m	£m
	Assets	*Liabilities*	*Assets*	*Liabilities*
Balance at 1 January	8,756	-	8,059	-
Transfers in	21	-	4	-
Transfers out	(85)	-	(52)	-
Purchases	953	-	1,026	-
Disposals	(521)	-	(512)	-
Assets held for sale	(114)	-	-	-
Net gains recognised within net gains on assets and liabilities at fair value through profit or loss in the statement of comprehensive income	(78)	-	231	-
Balance at 31 December	8,932	-	8,756	-
Total unrealised gains for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	20	-	192	-

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.

During 2018, exposure to market risk was managed by the implementation of unit matching and equity hedging to reduce the sensitivity of future dividend payments to market movements. Unit matching involves more effectively matching unit linked liabilities on a best-estimate view (as defined by Solvency regulations). This best-estimate view incorporates an allowance for expected future income and expenses, which are not fully allowed for under IFRS. As a result, this leads to a mismatch between IFRS statutory assets and liabilities in respect of market movements. For example, in the event of rising markets, a loss would now be recognised in the accounts as a result of this mismatch, which would be offset in the future due to higher income as fees are received.

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. The equity sensitivity includes the impact of unit matching and equity hedging which leads to a statutory profit, mainly due to the hedge payoff under falling markets.

	Impact on profit after tax and equity for the year	
	2018	2017
	£m	£m
10% (2017: 10%) decrease in equity prices	140	(100)
10% (2017: 10%) decrease in property prices	(5)	(6)

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.

(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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

(ii) Interest rate risk (continued)

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 may result in losses, 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 37. 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	
	2018	**2017**
	£m	**£m**
25 basis points (2017: 25 basis points) increase in yield curves	18	11
25 basis points (2017: 25 basis points) decrease in yield curves	(24)	(16)

(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 2018 on profit after tax and equity (2017: £nil).

(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. When transacting new business, the Group underwrites policies to ensure an appropriate premium is charged for the risk or that the risk is declined.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(2) Insurance underwriting risk (continued)

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.

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 37.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk

The risk that parties 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.

The tables below analyse financial assets and reinsurance assets subject to credit risk exposure 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

Group As at 31 December 2018

	Total £m	AAA £m	AA £m	A £m	BBB or lower £m	Not rated £m
Stage 1 assets						
Cash and cash equivalents	174	1	24	122	18	9
Loans and receivables at amortised cost	2,312	-	-	1,789	-	523
Loss allowance	-	-	-	-	-	-
Exposure to credit risk	2,486	1	24	1,911	18	532
Simplified approach assets						
Loans and receivables at amortised cost	362	-	-	72	-	290
Loss allowance	(6)	-	-	(3)	-	(3)
Exposure to credit risk	356	-	-	69	-	287
Assets at FVTPL						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	7,132	-	-	7,111	21	-
Debt and other fixed/variable income securities	31,033	2,423	13,261	7,034	8,156	159
Derivative financial instruments	3,157	-	322	2,413	333	89
Loans and advances to customers	7,845	72	945	4,774	1,418	636
Loans and advances to banks	2,519	-	540	448	110	1,421
Other						
Reinsurance contracts	728	-	555	172	1	-
Total	55,256	2,496	15,647	23,932	10,057	3,124

Cash at bank, included with Stage 1 assets, is considered to have low credit 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

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

Company As at 31 December 2018

	Total £m	AAA £m	AA £m	A £m	BBB or lower £m	Not rated £m
Stage 1 assets						
Cash and cash equivalents	41	-	7	21	13	-
Loans and receivables at amortised cost	1,838	-	-	1,797	-	41
Loss allowance	-	-	-	-	-	-
Exposure to credit risk	1,879	-	7	1,818	13	41
Simplified approach assets						
Loans and receivables at amortised cost	358	-	-	72	-	286
Loss allowance	(2)	-	-	(2)	-	-
Exposure to credit risk	356	-	-	70	-	286
Assets at FVTPL						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	7,132	-	-	7,111	21	-
Debt and other fixed/variable income securities	12,738	652	7,059	2,552	2,237	238
Derivative financial instruments	3,129	-	311	2,409	333	76
Loans and advances to customers	7,259	72	945	4,774	1,417	51
Loans and advances to banks	1,470	-	13	38	17	1,402
Transferred to Assets held for sale	(234)	-	-	-	-	(234)
Other						
Reinsurance contracts	728	-	555	172	1	-
Total	34,457	724	8,890	18,944	4,039	1,860

Cash at bank, included with Stage 1 assets, is considered to have low credit risk.

As a result of the reclassification of the European business of the Company to assets and liabilities held for sale there has been a reduction in investments at fair value through profit or loss for the Company in 2018. See note 44 for further detail.

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

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.

Expected credit losses are calculated using three key input parameters: the probability of default ("PD") (except for lifetime expected credit losses), the expected loss given default ("LGD") and the exposure at default ("EAD"). The probability of default and expected loss given default are determined using internally generated credit ratings. For lease receivables, the past due information is used to determine the expected loss given default.

Expected credit losses are measured on a collective basis for certain Groups of financial assets, such as control accounts, trade receivables and intercompany receivables, which are considered to be homogenous in terms of their risk of default.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

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	2018 Maximum exposure £m	2018 Offset £m	2018 Net exposure £m	2017 Maximum exposure £m	2017 Offset £m	2017 Net exposure £m
Loans and receivables at amortised cost	2,674	-	2,674	4,037	-	4,037
Investments at fair value through profit or loss:						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	7,132	-	7,132	8,377	-	8,377
Debt securities	31,033	-	31,033	38,844	-	38,844
Derivative Financial Instruments	3,157	-	3,157	3,465	-	3,465
Loans and advances to customers	7,845	-	7,845	-	-	-
Loans and advances to banks	2,519	-	2,519	-	-	-
Reinsurance contracts	728	-	728	-	-	-
Cash and cash equivalents	174	-	174	1,932	-	1,932
At 31 December	55,262	-	55,262	56,655	-	56,655

Company	2018 Maximum exposure £m	2018 Offset £m	2018 Net exposure £m	2017 Maximum exposure £m	2017 Offset £m	2017 Net exposure £m
Loans and receivables at amortised cost	2,196	-	2,196	2,868	-	2,868
Investments at fair value through profit or loss:						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	7,132	-	7,132	8,377	-	8,377
Debt securities	12,738	-	12,738	19,568	-	19,568
Derivative Financial Instruments	3,129	-	3,129	3,424	-	3,424
Loans and advances to customers	7,259	-	7,259	-	-	-
Loans and advances to banks	1,470	-	1,470	-	-	-
Reinsurance contracts	728	-	728	-	-	-
Cash and cash equivalents	41	-	41	1,063	-	1,063
At 31 December	34,693	-	34,693	35,300	-	35,300

(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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(i) Concentration risk (continued)

At 31 December 2018 and 31 December 2017, 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% (2017: 1.0% of the Group's total assets).

	Total £m
Trade and other receivables:	
Amounts due from brokers	76
Amounts due from group undertakings	1,822
Other receivables	776
Cash and cash equivalents with financial institutions	174
Total	2,848

For other receivables, the largest single counterparty balance is with policyholders, which totals £265m.

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:

	2018		2017	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Financial assets:				
Investments at fair value through profit or loss	547	547	353	353
Cash and cash equivalents	378	378	314	307
Total	925	925	667	660

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(ii) Collateral management (continued)

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 £811m (2017: £932m) by the Group and £811m (2017: £932m) 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.

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 £259m (2017: £271m) and £259m (2017: £270m) 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 £3,962m (2017: £5,080m) and by the Company is £831m (2017: £951m).

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 £4,232m (2017: £4,750m) by the Group and £873m (2017: £962m) 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 £622m (2017: £677m) and £109m (2017: £34m) respectively.

There were no defaults in respect of stock lending during the year ended 31 December 2018 (2017: 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 £622m (2017: £677m) for the Group and £109m (2017: £34m) 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 £651m (2017: £720m) for the Group and £116m (2017: £36m) for Company.

Collateral in respect of Repurchase Agreement

Collateral pledged in respect of a repurchase agreement with Lloyds Bank Corporate Markets PLC continues to be recognised on the Company's balance sheet, the amount pledged was £137m (2017: £594m) for Group and Company.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(ii) Collateral management (continued)

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 2018 collateral with a fair value of £1,860m (2017: £1,835m) was held by the Group and £1,860m (2017: £1,835m) available to the Group to sell or repledge in the absence of default by the counterparty. Of this, £1,860m (2017: £1,835m) was held by the Company and £1,860m (2017: £1,835m) available to the Company to sell or repledge in the absence of default by the counterparty. No other collateral (2017: £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.

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 2018, 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 £1,504m (2017: £1,644m) 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 (2017: nil). Total derivatives presented in the balance sheet are shown in note 20.

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 respect 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 2018

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(iii) Offsetting (continued)

Group as at 31 December 2018

	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]		Potential net amounts if offset of related amounts permitted
				Financial instruments	Collateral	
	£m	£m	£m	£m	£m	£m
Financial assets						
OTC Derivatives	3,067	-	3,067	(2,681)	(355)	31
ET Derivatives	89	-	89	(28)	(61)	-
Repo	135	-	135	-	(135)	-
Reverse Repo	622	-	622	-	(622)	-
Financial liabilities						
OTC Derivatives	(2,586)	-	(2,586)	2,681	(113)	(18)
ET Derivatives	(132)	-	(132)	28	104	-

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]		Potential net amounts if offset of related amounts permitted
				Financial instruments	Collateral	
	£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	-

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(iii) Offsetting (continued)

Company as at 31 December 2018

	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	3,052	-	3,052	(2,681)	(355)	16
ET Derivatives	76	-	76	(19)	(57)	-
Repo	135	-	135	-	(135)	-
Reverse Repo	109	-	109	-	(109)	-
Financial liabilities						
OTC Derivatives	(2,578)	-	(2,578)	2,682	(114)	(10)
ET Derivatives	(103)	-	(103)	19	84	-

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	-

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 20.

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 2018

38. Risk management (continued)

(c) Financial risks (continued)

(4) Capital Risk

Capital risk is defined as the risk that the Group has a sub-optimal quantity 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.

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 31).

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

	2018 £m	2017 £m
Regulatory Capital held	7,944	8,387

All minimum regulatory requirements were met during the year.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(5) 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 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 2018, there are no funds under management subject to deferral (2017: 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 2018

38. Risk management (continued)

(c) Financial risks (continued)

(5) 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 2018			**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	13,855	-	13,855	-	-	-	-
External interests in collective investment vehicles	12,944	12,886	-	-	-	-	-
Derivatives held for trading	2,719	-	10	98	128	340	2,823
Subordinated debt	1,769	48	-	-	113	1,173	1,505
Borrowings	4	-	4	-	-	-	-
Other financial liabilities	2,331	260	1,884	28	159	-	-
Total	33,622	13,194	15,753	126	400	1,513	4,328

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

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

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

Group As at 31 December 2018 **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	98,252	1,147	1,496	5,039	23,678	66,892
Non-participating investment contracts	13,855	308	258	1,056	4,534	7,699

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(5) Liquidity risks (continued)

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

Company As at 31 December 2018			**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	-	-	-	-	-	-	-
Liabilities arising from non-participating investment contracts	13,825	-	13,825	-	-	-	-
Derivative financial instruments	2,681	-	9	64	127	338	2,143
Subordinated debt	1,799	48	-	-	92	1,194	1,536
Other financial liabilities	1,608	257	1,215	-	136	-	-
Total	19,913	305	15,049	64	355	1,532	3,679

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

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

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

Company As at 31 December 2018 **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	96,117	1,125	1,464	4,922	23,166	65,440
Non-participating investment contracts	13,825	308	257	1,052	4,519	7,689

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(c) Financial risks (continued)

(5) Liquidity risk (continued)

Company 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

(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.

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.

People risk

People risk is defined as the risk that the Group fails to provide an appropriate colleague and customer centric culture, supported by robust regard and wellbeing policies and processes; effective leadership to manage colleague resources; effective talent and succession management; and robust control to ensure all colleague-related requirements are met.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

38. Risk management (continued)

(d) Operational risk (continued)

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; or to civil or criminal proceedings in the courts (or equivalent) and/or the Group is unable to enforce its rights due to failing to comply with applicable laws (including Codes of Practice which could have legal implications), regulations, codes of conduct or legal obligations.

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.

Conduct risk

Conduct risk is defined as the risk of customer detriment due to poor design, distribution and execution of products and services or other activities which could undermine the integrity of the market or distort competition, leading to unfair customer outcomes, regulatory censure and financial and reputational loss.

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

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 business or finance processes impacting financial, prudential regulatory, and tax reporting, failure to manage the associated risks of changes in taxation rates, law, corporate ownership or structure and the failure to disclose timely and appropriate information in accordance with regulatory requirements.

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.

(f) UK political uncertainties including EU exit

The continued lack of clarity over the UK's eventual relationship with the EU has heightened risks in the Eurozone and raises uncertainty for the UK economic outlook. Leadership changes in the EU have contributed to further uncertainty. There is a risk of a no deal EU exit outcome, which could have a significant impact given our UK-centric footprint. The Group's response to these risks and uncertainty is as follows:

- Internal contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts.
- As part of the LBG, engagement with politicians, officials, media, trade and other bodies to reassure our commitment to helping Britain prosper.
- Committed investments to establish a new entity in the EU to ensure continuity of certain business activities, and contingency planning in relation to wider areas of impact
- No deal EU exit outcome analysed to identify impacts and assess robustness of contingency plans.

(g) Economic Risk

UK economic growth remains muted and there are signs of pressure in business investment and consumer related sectors. High levels of credit market liquidity have reduced spreads and weakened terms in some sectors, creating a potential under-pricing of risk and heightened risk of a market correction. The Group's response to these risks is as follows:

- Internal contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts, with a plan specifically for working through the potential impacts of the EU exit on the Group.
- Wide array of risks considered in setting strategic plans.
- Capital and liquidity is reviewed regularly through committees, ensuring compliance with risk appetite and regulatory requirements.
- The Group has a robust through the cycle credit risk appetite, including individual limit guidelines, specific sector appetite statements and policies, and affordability and indebtedness controls at origination. In addition to ongoing focused monitoring, we conduct portfolio deep dives and larger exposure reviews. We have enhanced our use of early warning indicators including sector specific indicators.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

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

(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.

	2018			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	15	(1,765)	-	348
Other related parties	600	(894)	(1,419)	3,213

	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

The Company has entered into transactions with related parties in the normal course of business during the year. Holdings by the Group, including consolidated OEIC investments, give rise to £476m (2017: £584m) of shares in the ultimate parent undertaking on the balance sheet, with associated transactions of £14m (2017: £92m) during the year.

	2018			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	15	(1,765)	-	348
Subsidiary	112	(193)	(6)	671
Other related parties	522	(1,037)	(2,376)	4,064

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

39. 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

Further, amounts relating to other related parties of £2,153m due from OEICs investments were outstanding at 31 December 2018 (2017: £2,328m). 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 (expense)/income amounts related to other parties of (£139m) (2017: £217m) 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 includes 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:

	2018 £m	2018 £m	2017 £m	2017 £m
	Group	*Company*	*Group*	*Company*
Short-term employee benefits	7.5	7.5	7.3	7.3
Post-employment benefits	0.0	0.0	0.1	0.1
Share-based payments	2.0	2.0	2.2	2.2
Total	9.5	9.5	9.6	9.6

Included in short term employee benefits is the aggregate amount of emoluments paid to or receivable by Directors in respect of qualifying services of £3.2m (2017: £3.0m).

There were no retirement benefits accruing to Directors (2017: none) under defined benefit pension schemes. Six Directors (2017: four Directors) are paying into a defined contribution scheme. There were no contributions paid to a pension scheme for qualifying services (2017: £nil) for Group and Company.

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 £0.9m (2017: £1.2m). During the year, one Director exercised share options (2017: two Directors) and two Directors received qualifying service shares under long term incentive schemes (2017: six Directors). Movements in share options are as follows:

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

39. Related party transactions (continued)

	2018 £m Options	2017 £m Options
Outstanding at 1 January	13	12
Granted	6	9
Exercised	(3)	(4)
Forfeited	(1)	(4)
Outstanding at 31 December	15	13

Detail regarding the highest paid Director is as follows:

	2018 £m	2018 £m	2017 £m	2017 £m
	Group	*Company*	*Group*	*Company*
Apportioned aggregate emoluments	1.7	1.7	1.6	1.6
Apportioned post-employment benefits	0.0	0.0	0.0	0.0
Apportioned share-based payments	0.7	0.7	1.0	1.0

The highest paid Director did not exercise share options during the year. (2017: The highest paid Director did exercise share options during the year).

40. Operating leases

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

	2018 £m	2018 £m	2017 £m	2017 £m
	Group	*Company*	*Group*	*Company*
Within one year	173	10	179	11
Between two and five years	531	37	553	41
Beyond five years	960	118	1,077	127
Total	1,664	165	1,809	179

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

	2018 £m	2018 £m	2017 £m	2017 £m
	Group	*Company*	*Group*	*Company*
Within one year	1	-	2	-
Between two and five years	4	-	7	-
Beyond five years	182	-	370	-
Total	187	-	379	-

The total of contingent rents recognised as income during the year was £1m (2017: £nil). The total of contingent rents recognised as operating expenses during the year was £nil (2017: £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.

41. Capital commitments

The Group and company has given an undertaking to provide up to £1,574m (2017: £1,366m) of capital to private equity investments and at 31 December 2018, £1,428m had been drawn down (2017: £1,218m). The remainder of the funds committed can no longer be drawn down as the draw down period has closed. The Group has also agreed £231m of undrawn loan commitments in 2018 (2017: £245m). £156m of this undrawn balance is to be drawn within one year (2017: £83m) and the remaining £75m will be drawn within three years (2017: £162m). The commitments are irrevocable if the borrowers meet the terms of the agreements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

42. 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 2018 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 16 "Leases"	IFRS 16 Replaces IAS 17 'Leases'. The Group's accounting as a lessor will remain aligned to the current approach under IAS 17; however for lessee accounting there will no longer be a distinction between finance and operating leases. The transition approach adopted by the Group will result in the recognition of right-of-use assets and lease liabilities in respect of properties previously accounted for as operating leases; there will be no impact on shareholders' equity. As permitted by the transition options under IFRS 16, comparative figures for the prior year will not be restated. Going forward, the Group will recognise a finance charge on the lease liability. The right-of-use assets meet the definition of investment property which are held at fair value and not depreciated. Previously the Group included lease rentals within operating expenses. The Group intends to take advantage of a number of exemptions within IFRS 16, including the election not to recognise a lease liability and a right-of-use asset for leases for which the underlying asset is of low value. The impact on the financial statements of the Group as a result of adopting IFRS 16 is not expected to be material. There will be no impact on the financial statements of the Company as a result of adopting IFRS 16.	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. These requirements will result in changes to the timing of profit recognition for insurance and participating investment contracts issued by the Group and Company. The Group has developed a detailed project plan for designing and implementing the operational and systems changes required by IFRS 17. Following the IASB's tentative decision to delay the effective date of IFRS 17 one year to 1 January 2022, the Group is finalising the plan for the revised implementation date. Work on the plan has progressed significantly, particularly on methodology, data platforms and actuarial systems and processes. The Group will continue to monitor updates and future changes to the standard issued by the IASB to ensure compliance and operational capability. The standard will have a significant impact on the accounting for the insurance and participating investment contracts issued by the Group and Company. Presentation and disclosure for these contracts will be considerably different and more extensive than under IFRS 4.	Annual periods beginning on or after 1 January 2022

[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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

43. Post balance sheet events

An interim dividend of £300m in respect of the year ending 31 December 2018 was declared on 07 February 2019 and paid to Scottish Widows Group on 11 February 2019.

On the 14 March 2019, the High Court approved the Part VII transfer of the European business to SWE, and on the 29 March 2019, the Part VII transfer was effective. The Part VII transfer essentially allowed for all the European in-force policyholder related liabilities to transfer to SWE, along with the relevant assets to back those liabilities ahead of the UK's expected exit from the European Union. As part of the transfer process SWE has issued share capital to the Company sufficient for it to cover its relevant capital requirement and risk margin. The total capital issued by SWE is £73m (€81m) and was subscribed for in cash.

Further information on post balance sheet events is set out in note 28.

44. Discontinued operations

Part VII Transfer Scheme

The Company has completed the transfer of the European business from the Company to SWE on 29 March 2019. The assets and liabilities of the European business are therefore classified as held for sale at 31 December 2018 and shown separately on the face of the balance sheet.

The business transferred includes insurance and participating investment contract liabilities. The policies relating to participating investment contracts participate in the CM With Profits Fund, and the transferring liability in relation to these policies has been reinsured back to that fund at the point of transfer. The value of assets transferred disclosed does not include any potential future estate distribution or unallocated surplus. Policyholders will retain their rights to participate in the CM With Profits Fund, including any share in estate distribution, through the reinsurance agreement.

The valuation of assets classified as held for sale and the liabilities directly associated with assets classified as held for sale is an estimate as at the 31 December 2018, and the actual value of assets and liabilities transferred on the effective date is different to that disclosed.

The Company has not recognised any impairment relating to assets held for sale during 2018.

The transfer of the European business has no net impact on profit before tax or equity on the Company and the Group.

(a) Balance sheet (Company)

The assets and liabilities of the discontinued operations of the European business are as follows:

	2018 £m	2017 £m
ASSETS		
Derivative financial instruments	-	14
Investments at fair value through profit or loss	2,165	2,211
Total Assets	2,165	2,225
LIABILITIES		
Insurance contracts and participating investment contract liabilities	2,135	2,189
Non-participating investment contract liabilities	30	36
Total liabilities	2,165	2,225

Ring-fenced bank

During 2017, the Group committed to the sale of SWSL to Lloyds Bank plc. The assets and liabilities of this subsidiary were therefore classified as held for sale at 31 December 2017 and shown separately on the face of the balance sheet. On 1 May 2018, the Group completed the sale of SWSL. The assets and liabilities of this subsidiary are therefore reported in the current period as a discontinued operation.

The Group did not recognise any impairment relating to assets held for sale during 2017 or 2018. 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.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

44. Discontinued operations (continued)

(b) Statement of comprehensive income (Group)

The results of the discontinued operations for SWSL are as follows:

	2018 £m	2017 £m
Other operating income	268	806
Staff costs and other employee related costs	(61)	(190)
Operating expenses	(237)	(677)
Finance costs	-	(3)
Total expenses	(298)	(870)
Loss before tax	(30)	(64)
Taxation	4	11
Loss for the year from discontinued operations	(26)	(53)

(c) Balance sheet (Group)

The assets and liabilities of the discontinued operations for SWSL are as follows:

	2018 £m	2017 £m
ASSETS		
Intangible assets	-	168
Current tax assets	-	14
Deferred tax assets	-	31
Loans and receivables	-	390
Cash and cash equivalents	-	99
Total Assets	-	702
EQUITY AND LIABILITIES		
Capital and reserves attributable to Company's shareholder		
Share Capital	-	81
Retained earnings	-	14
Total equity	-	95
LIABILITIES		
Accruals	-	93
Financial liabilities: trade and other payables	-	437
Retirement benefit obligation	-	77
Total liabilities	-	607
Total liabilities and equity	-	702

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

(c) **Balance sheet (Group) (continued)**

44. Discontinued operations (continued)

(i) Disposal of SWSL

On 1 May 2018, the subsidiary, SWSL, was disposed to Lloyds Bank plc, a related party, at net asset value of £97m. Consideration was paid in cash and is considered to be representative of an arm's length transaction.

The carrying amounts of assets and liabilities as at the date of sale (1 May 2018) were:

	2018 £m
ASSETS	
Intangible assets	157
Current tax assets	23
Deferred tax assets	21
Loans and receivables	312
Cash and cash equivalents	423
Total Assets	936
EQUITY AND LIABILITIES	
Capital and reserves attributable to Company's shareholder	
Share Capital	81
Retained earnings	15
Total equity	96
LIABILITIES	
Accruals	127
Financial liabilities: trade and other payables	699
Retirement benefit obligation	14
Total liabilities	840
Total liabilities and equity	936

(ii) Disposal of SWPTL

On 1 May 2018, the subsidiary, SWPTL, was also disposed to Lloyds Bank plc, a related party, at net asset value of £1.

45. Adoption of IFRS 9

On 1 January 2018, the Group adopted IFRS 9 "Financial Instruments", which replaced IAS 39 "Financial Instruments: Recognition and Measurement". Adoption of this standard has had the following impacts on the financial statements:

(a) **Changes to accounting policies**

The new accounting policies, as amended for IFRS 9, are set out in note 1 (d), (l), (o) (q), (r), (s) and (t). A summary of the changes is as follows:

(i) Financial assets and financial liabilities

The classification of financial assets has changed such that the assessment is based on the Group's business model for managing the financial assets, and whether cash flows represent solely payments of principal and interest, with the exception of derivative financial instruments, which continue to be mandatorily at fair value through profit or loss, unless designated as effective hedging instruments. All other financial assets held in a business model that is managed and whose performance is evaluated on a fair value basis are held at fair value through profit or loss and those that are held in a business model that is held to collect contractual cash flows are classified as amortised cost. See note 1(d) for more detail.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

45. Adoption of IFRS 9 (continued)

(ii) Loans and receivables at amortised cost

Under IAS 39, loans and receivables were held at amortised cost. Under IFRS 9, certain loans and receivables continue to be held at amortised cost, but some are now held at fair value through profit or loss. The classification is dependent on whether those loans and receivables are held in a business model whose purpose is to hold assets to collect the contractual cash flows and where the cash flows represent solely payments of principal and interest (resulting in amortised cost classification) or where the assets are held in a business model that is managed and whose performance is evaluated on a fair value basis (resulting in a mandatory fair value through profit or loss classification).

Loans and receivables at amortised cost continue to be subject to impairment. However, the "incurred loss" approach under IAS 39 has been replaced with an "expected credit losses" approach under IFRS 9, as described in note 1(t).

(iii) Investments at fair value through profit or loss

The accounting policy for classification has changed from financial assets being held at fair value through profit or loss if designated as such under IAS 39, to financial assets being in this category if they are part of a business model that is managed and whose performance is evaluated on a fair value basis or where the cash do not represent solely payments of principal and interest. For more detail see note 1(r).

(iv) Impairment

IFRS 9 results in changes to the impairment approach for financial assets at amortised cost. Under IAS 39, an "incurred loss" approach was used, which required a charge for impairment when events or circumstances indicated that amounts were not recoverable. The approach under IFRS 9 is an "expected credit loss" approach, which requires an assessment of expected future losses on initial recognition. For more detail see note 1(t).

(v) Hedge Accounting

The Group has chosen as its accounting policy to continue to apply the hedge accounting requirements of IAS 39 in accordance with the transitional provisions in IFRS 9.7.2.21. Accordingly, there was no change to hedge accounting on adoption of IFRS 9. For more detail see note 1(p).

(b) Opening reserves on transition

Opening reserves at 31 December 2017 were Group: £4,753m and Company: £4,908m. At 1 January 2018, this has decrease by £5m for Group and £2m for Company due to the loss allowance (net of tax) transitional adjustment on loans and receivables at amortised cost.

(c) Classification of financial assets and liabilities on initial application of IFRS 9

Group

Financial Assets	IAS 39 Measurement Category £m	IAS 39 Carrying Amount £m	IFRS 9 Measurement Category £m	IFRS 9 Carrying Amount £m
Assets arising from reinsurance contracts held	FVTPL (Designated)	7,812	FVTPL (Mandatory)	7,812
Derivative financial instruments	FVTPL (Mandatory)	3,465	FVTPL (Mandatory)	3,465
Loans and receivables	Amortised cost	1,330	FVTPL (Mandatory)	1,330
Loans and receivables	Amortised cost	2,634	Amortised cost	2,629
Loans and receivables	Amortised cost	73	Other assets	73
Investments at fair value through profit or loss	FVTPL (Designated)	123,377	FVTPL (Mandatory)	123,377
Cash and cash equivalents	Amortised cost	1,561	FVTPL (Mandatory)	1,561
Cash and cash equivalents	Amortised cost	371	Amortised cost	371
Total		140,623		140,618

There have been no changes to the classification or carrying amounts of financial liabilities as a result of adopting IFRS 9.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

45. Adoption of IFRS 9 (continued)

(c) Classification of financial assets and liabilities on initial application of IFRS 9 (continued)

Company

Financial Assets	IAS 39 Measurement Category £m	IAS 39 Carrying Amount £m	IFRS 9 Measurement Category £m	IFRS 9 Carrying Amount £m
Assets arising from reinsurance contracts held	FVTPL (Designated)	7,812	FVTPL (Mandatory)	7,812
Derivative financial instruments	FVTPL (Mandatory)	3,424	FVTPL (Mandatory)	3,424
Loans and receivables	Amortised cost	488	FVTPL (Mandatory)	488
Loans and receivables	Amortised cost	2,307	Amortised cost	2,305
Loans and receivables	Amortised cost	73	Other assets	73
Investments at fair value through profit or loss	FVTPL (Designated)	113,441	FVTPL (Mandatory)	113,441
Cash and cash equivalents	Amortised cost	915	FVTPL (Mandatory)	915
Cash and cash equivalents	Amortised cost	148	Amortised cost	148
Total		128,608		128,606

There have been no changes to the classification or carrying amounts of financial liabilities as a result of adopting IFRS 9.

As set out in the table above, certain loans and receivables (reverse repurchase assets, collateral assets and accrued interest) and cash and cash equivalents that were previously held at amortised cost are now held at fair value through profit or loss. This is the result of identifying these assets as being part of a business model that is managed and whose performance is evaluated on a fair value basis. Similarly, investments that were previously designated at fair value through profit or loss under IAS 39 are now mandatorily at fair value through profit or loss due to them being part of a business model that is managed and whose performance is evaluated on a fair value basis or where the cash do not represent solely payments of principal and interest. £73m for Group and £73m for Company included within loans and receivables under IAS 39, have been reclassified to other assets to reflect the nature of these balances.

At 1 January 2018, the amortised cost of these assets was equal to their fair value, resulting in no impact on opening retained earnings. There are no differences between the IAS 39 carrying amounts for financial assets at 31 December 2018 and the IFRS 9 carrying amounts at 1 January 2018, with the exception of Loans and Receivables, for which the change in carrying amount is the result of recognition of the loss allowance (see note 45(d)).

(d) Loss allowance on transition

At 31 December 2017, the IAS 39 allowance for impairment losses for loans and receivables was nil for Group and nil for Company. At 1 January 2018, the IFRS 9 loss allowance was £5m for Group and £2m for Company. The movement is due to a transitional adjustment in loss allowance.