# Royal Scottish Assurance plc

## Directors and Officers

### Directors

J R Lister
T E Strauss (Chief Executive)
D B Barral
G S Boffey
R I Houghton

### Company Secretary

J J Wilman
Wellington Row
York
YO90 1WR

### Auditor

Deloitte LLP
Hill House
1 Little New Street
London
EC4A 3TR

### Registered Office

24/25 St Andrew Square
Edinburgh
EH2 1AF

### Company Number

Registered in Scotland: No SC119820

### Other Information

Royal Scottish Assurance plc ("the Company") is a member of the Association of British Insurers and is authorised and regulated by the Financial Services Authority.

The Company is a member of the Aviva plc group of companies ("the Group").

# Royal Scottish Assurance plc
## Contents

# Royal Scottish Assurance plc
## Directors' report

The directors present their annual report and audited financial statements for Royal Scottish Assurance plc ("the Company") for the year ended 31 December 2010.

### Directors and secretary

The names of the present directors and secretary who have served throughout the year, except where noted below, are listed on page 1. From 1 January 2010, changes are as follows:

| Directors | Appointed | Resigned |
|---|---|---|
| Toby Emil Strauss | - | 1 January 2010 |
| Robert James Mackenzie Bulloch | - | 31 December 2010 |
| Sarah Jane Deaves | - | 31 December 2010 |
| Stuart Arthur Haire | - | 31 December 2010 |
| Graham Storrie | - | 31 December 2010 |
| Angela Seymour-Jackson | 16 April 2010 | 31 December 2010 |
| David John Grant | - | 7 February 2011 |
| Toby Emil Strauss | 31 December 2010 | - |
| David Barclay Barral | 31 December 2010 | - |
| Graham Stirling Boffey | 31 December 2010 | - |
| Robert Ian Houghton | 7 February 2011 | - |

| Company Secretary | Appointed | Resigned |
|---|---|---|
| Alan Ewing Mills | - | 31 December 2010 |
| Jennifer Jane Wilman | 31 December 2010 | - |

### Business review, principal activities and future outlook

The principal activity of the Company is the provision of life assurance, investment and pension products in the United Kingdom. The directors consider that this will continue unchanged into the foreseeable future.

As a result of its acquisition by Aviva Life UK Limited (formerly Aviva Life RBS JV UK Limited), shown in the major events section on page 4, the Company's parent, Aviva Life Investments UK Limited (formerly RBS Life Investments Limited), became a 100% owned subsidiary of Aviva plc.

The Company's financial performance is presented in the Income statement on page 15. Income fell by £70.6m (*2009: grew by £251.0m*) and expenses fell by £68.4m (*2009: rose by £262.1m*). The profit for the year was £21.0m (*2009: £22.1m*), a decrease of 5% over 2009. Net insurance premiums fell by £4.1m (*2009: fell £88.3m*) and insurance claims rose by £1.7m (*2009: fell by £13.2m*).

2010 saw continued growth in the investment markets, although growth was less strong than in 2009, which has resulted in a decrease in profit before tax. Measured as annualised new regular premiums sold in the period plus a tenth of all single premiums sold in the period, new business fell from £12.5m in 2009 to £8.8m, reflecting the withdrawal from sale of the Guaranteed Capital Bond in early 2009, as well as a general decrease against all life products. At the end of the year, the financial position showed total assets of £1,350m (*2009: £1,410m*) and equity of £244m (*2009: £232m*).

### Financial Position and Performance

The financial position of the Company at 31 December 2010 is shown in the Statement of financial position on page 16, with the results shown in the Income statement on page 15 and the Statement of cash flows on page 18.

### Principal risks and uncertainties

A description of the principal risks and uncertainties facing the Company and the Company's risk management policies are set out in note 27 to the financial statements.

**Key performance indicators (KPIs)**

Net premiums for the year decreased by 10% to £37.3m (*2009: £41.5m*).

The profit after tax for the year is £21.0m (*2009: £22.1m*).

**Dividend**

An interim dividend amounting to £9.0m was paid on 25 October 2010 (*2009: £14.5m*). The directors do not recommend the payment of a final dividend for the year (*2009: £nil*).

**Going concern**

The Company's business activities, together with the factors likely to affect its future development and position, are set out in the business review section above.

The Company is expected to continue to generate positive cash flows on its own account for the foreseeable future.

After making enquiries into the solvency and liquidity of the Company at the year end and of forecasts for the next 12 months, the directors have a reasonable expectation that the company has adequate resources to continue in operational existence for at least the next 12 months. Thus they continue to adopt the going concern basis of accounting preparation for annual financial statements.

**Major events**

On 14 December 2010 the parent of the Company approved the following, which took effect from 31 December 2010:

- the termination of the joint venture ("JV") agreements with The Royal Bank of Scotland Group plc ("RBSG") and associated services, resources, administration and other ancillary documents;

- the acquisition by Aviva Life UK Limited (formerly Aviva Life RBS JV UK Limited) of RBS Life Holdings Limited's shares in Aviva Life Investments UK Limited (the "Life JV") and the acquisition by RBSG Collective Investments Holdings Limited of Aviva Life UK Limited's shares in RBSG Collective Investments Limited (the "Collectives JV");

- a transition period intended to last from 1 January 2011 until 31 December 2012 during which, in accordance with an agreed transition plan, products and services will continue to be distributed to the same extent as they are currently, with the aim of moving to the Aviva standard operating model by 31 December 2012. Aviva will supply transitional services (based on existing service levels) for which RBSG shall pay charges for the duration of the transition period. Services will also be provided to the business of the Collectives JV by Aviva (at agreed charges and service levels) following the termination of the Collectives JV; and

- the introduction of a new 7 year distribution arrangement based on the Aviva standard operating model for the exclusive promotion, marketing and offering of certain Aviva protection and pension products by RBSG to defined customer segments in the United Kingdom in return for the payment by Aviva to the distributors of a commission.

On the same date, the share capital of the Company was reduced from £148,200,000 to £58,200,000 by cancelling and extinguishing in full 90,000,000 ordinary shares of £1 each.

**Events after the Statement of financial position**

In 2010, a test case was taken to the European Court of Justice (ECJ) to rule on the current law and practice whereby insurers may take into account a person's gender in calculating the costs and benefits of their insurance. On 1 March 2011, the ECJ ruled that, with effect from 21 December 2012, insurers will no longer be able to use a person's gender in this way. Whilst the ruling does not apply retrospectively, we are unable at the current time to assess the risk of the judgement having implications for our existing insurance liabilities.

**Use of financial instruments**

The business of the Company includes use of financial instruments. Details of the Company's risk management objectives and policies and exposures to risk relating to financial instruments are set out in note 27 to the financial statements.

**Creditor payment policy and practice**

Under a management agreement, The Royal Bank of Scotland plc, a fellow group undertaking up to 31 December 2010, provided services in relation to creditor payments and a charge was made to the Company for this service. Accordingly, the relevant disclosures in relation to creditor payment policy and practice are included in the directors' report of The Royal Bank of Scotland plc.

**Employees**

During the year, sales force employees were employed by The Royal Bank of Scotland Group plc ("RBSG") and other staff, including administrative staff, were employed by RBSG and Aviva Employment Services Ltd ("AESL"). As of 31 December 2010 all employees, excluding sale force staff, are employed by AESL. Disclosures relating to employees may be found in the Annual Report and Accounts of Aviva plc.

**Disclosure of information to the auditor**

Each person who was a director of the Company on the date that this report was approved, confirms that so far as the director is aware, there is no relevant audit information, being information needed by the auditor in connection with preparing their report, of which the auditor is unaware. 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 auditor is aware of that information.

**Directors' Indemnities**

In terms of Section 236 of The Companies Act 2006, Robert James Mackenzie Bulloch, Sarah Jane Deaves, Stuart Arthur Haire and Graham Storrie have been granted Qualifying Third Party Indemnity Provisions by The Royal Bank of Scotland Group plc.

In terms of Section 236 of The Companies Act 2006, John Robert Lister, Angela Seymour-Jackson, David John Grant, Toby Strauss, David Barclay Barral, Graham Stirling Boffey and Robert Ian Houghton have been granted Qualifying Third Party Indemnity Provisions by Aviva plc.

**Statement of Directors' Responsibilities**

The directors are required to prepare financial statements for each accounting period that comply with the relevant provisions of the Companies Act 2006 and International Financial Reporting Standards (IFRS) as adopted by the European Union, and which present fairly the financial position, financial performance and cash flows of the Company at the end of the accounting period. Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. A fair presentation of the financial statements in accordance with IFRS requires the directors to:

- select suitable accounting policies and verify they are applied consistently in preparing the financial statements on a going concern basis unless it is inappropriate to presume that the Company will continue in business;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Company's financial position and financial performance; and
- state that the Company has complied with applicable IFRS, subject to any material departures disclosed and explained in the financial statements.

The directors are responsible for maintaining adequate accounting records which are intended to disclose with reasonable accuracy, the financial position of the Company at that time. They are also ultimately responsible for the systems of internal control maintained for safeguarding the assets of the Company and for the prevention and detection of fraud and other irregularities.

By order of the Board 29 March 2011

JJ Wilman

**J J Wilman**
*Company Secretary*

**Independent auditor's report to the members of Royal Scottish Assurance plc**

We have audited the financial statements of Royal Scottish Assurance plc for the year ended 31 December 2010 which comprise the Income statement, the Statement of comprehensive income, the Statement of financial position, the Statement of changes in equity, the Statement of cash flows, the Accounting policies and the related notes 1 to 29. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

**Respective responsibilities of directors and auditor**

As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

**Scope of the audit of the financial statements**

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

**Opinion on financial statements**

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 December 2010 and of its profit for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

**Opinion on other matter prescribed by the Companies Act 2006**

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

**Matters on which we are required to report by exception**

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

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

Paul R. Stephenson

Paul Stephenson BA ACA (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London, United Kingdom
29 March 2011

The Company, a limited company incorporated and domiciled in the United Kingdom (UK), transacts long-term insurance business.

The principal accounting policies adopted in the preparation of these financial statements are set out below.

**Basis of presentation**

The financial statements have been prepared on a going concern basis and in accordance with IFRS applicable at 31 December 2010. The financial statements are prepared on the historical cost basis, except for investment properties, mortgage loans and those financial instruments and financial liabilities that have been measured at fair value.

In 2008, the IASB issued revised versions of IFRS 3, *Business Combinations*, and IAS 27, *Consolidated and Separate Financial Statements*. The former introduced a number of changes in accounting for such transactions that impact the amount of goodwill recognised, the reported results in the period an acquisition occurs, and future reported results. The latter now requires a change in the ownership interest of a subsidiary (without loss of control) to be accounted for as an equity transaction, rather than giving rise to goodwill or a gain or loss. Consequential amendments were made to IAS 7, *Statement of Cash Flows*, IAS 12, *Income Taxes*, IAS 21, *The Effects of Changes in Foreign Exchange Rates*, IAS 28, *Investments in Associates*, and IAS 31, *Interests in Joint Ventures*. These have no impact on the Company's financial reporting.

During 2008 and 2009, the IASB also issued amendments to IFRS 1, *First Time Adoption of IFRS*, IFRS 2, *Share-Based Payment*, IAS 39, *Financial Instruments: Recognition and Measurement* and the results of its annual improvements project. IFRIC interpretation 17, *Distributions of Non-cash Assets to Owners*, issued in 2008, has also been endorsed by the EU. These are all applicable for the first time in the current accounting period and they have no impact on the Company's financial reporting.

Further amendments to IFRS 1, IAS 24, *Related Party Disclosures*, and IAS 32, *Financial Instruments – Presentation*, and the results of its next annual improvements project have been issued and endorsed by the EU, while other amendments to IFRS 1, IFRS 7, *Financial Instruments – Disclosures*, and IAS 12 have been issued but have not yet been so endorsed. These are applicable prospectively for accounting periods commencing 1 February 2010 or later, and are therefore not applicable for the current accounting period. On adoption, they will not have any material impact on the Company's financial reporting.

In 2009, the IASB issued IFRS 9, *Financial Instruments – Classification and Measurement*, followed by additional requirements on accounting for financial liabilities in 2010. These are the first two parts of a replacement standard for IAS 39. They are applicable prospectively for accounting periods commencing 1 January 2013 or later, and are therefore not applicable for the current accounting period. IFRS 9 has not yet been endorsed by the EU but, on adoption, will require us to review the classification of certain financial instruments while allowing us to retain fair value measurement as we deem necessary. We have not yet completed our assessment of its impact.

IFRIC interpretation 19, *Extinguishing Financial Liabilities with Equity Instruments*, and an amendment to interpretation 14, *IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*, were issued during 2008 and 2009 and have been endorsed by the EU. These are applicable prospectively for accounting periods commencing 1 July 2010 or later, and are therefore not applicable for the current accounting period. On adoption, they will not have any impact on the Company's financial reporting.

In accordance with IFRS 4, *Insurance Contracts*, the Company has applied existing accounting practices for insurance and participating investment contracts, modified as appropriate to comply with the IFRS framework and applicable standards. Further details are given in insurance contract liabilities below.

Unless otherwise noted, the amounts shown in these financial statements are in thousands of pounds sterling ("£'000").

As permitted under IAS 27, the Company has elected not to present consolidated financial statements. These financial statements present information about the Company as an individual undertaking and not about its group. Information on the ultimate controlling parent and immediate parent can be found in note 29.

**Use of estimates**

The preparation of financial statements requires the Company to make estimates and assumptions that affect items reported in the Income statement, Statement of financial position, other primary statements and notes to the financial statements. Although these estimates are based on management's knowledge of current facts, circumstances and, to some extent, future events and actions, actual results ultimately may differ from those estimates, possibly significantly.

**Foreign currency translation**

Foreign currency transactions are accounted for at the exchange rates prevailing at the date of the transactions. Gains and losses resulting from the settlement of such transactions, and from the translation of monetary assets and liabilities denominated in foreign currencies, are recognised in the income statement.

Translation differences on debt securities and other monetary financial assets measured at fair value and designated as held at fair value through profit or loss ("FV") are included in foreign exchange gains and losses in the income statement. Translation differences on non-monetary items, such as equities which are designated as FV, are reported as part of the fair value gain or loss.

**Product classification**

Insurance contracts are defined as those containing significant insurance risk if, and only if, an insured event could cause an insurer to pay significant additional payments in any scenario, excluding scenarios that lack commercial substance, at the inception of the contract. Such contracts remain insurance contracts until all rights and obligations are extinguished or expire. Contracts can be reclassified as insurance contracts after inception if insurance risk becomes significant. Any contracts not considered to be insurance contracts under IFRS are classified as investment contracts.

Insurance contracts and participating investment contracts in general continue to be measured and accounted for under existing accounting practices at the later of the date of transition to IFRS or the date of the acquisition of the entity, in accordance with IFRS 4. Accounting for insurance contracts in UK companies is determined in accordance with the Statement of Recommended Practice issued by the Association of British Insurers, the most recent version of which was issued in December 2005 and amended in December 2006.

**Premiums earned**

Premiums on long-term insurance contracts are recognised as income when receivable, except for investment-linked premiums that are accounted for when the corresponding liabilities are recognised. For single premium business, this is the date from which the policy is effective. For regular premium contracts, receivables are recognised at the date when payments are due. Premiums are shown before deduction of commission and before any sales-based taxes or duties. Where policies lapse due to non-receipt of premiums, then all the related premium income accrued but not received from the date they are deemed to have lapsed is offset against premiums.

Non-participating investment contracts have no associated premium income.

**Fee and commission income**

Non-participating investment contract policyholders are charged fees for mortality, policy administration, investment management, surrenders or other contract services. These fees are recognised as revenue in the period in which they are collected unless they relate to services to be provided in future periods. Amounts are considered to be assessed when the policyholder's balance has been adjusted for those fees. If the fees are for services to be provided in future periods, then they are deferred and recognised as the service is provided.

Initiation and other "front-end" fees (fees that are assessed against the policyholder balance as consideration for origination of the contract) are charged on some non-participating investment contracts. The front-end fees that relate to the provision of investment management services are deferred and recognised as the services are provided.

**Net investment income**

Investment income consists of dividends, interest and rents receivable for the year, movements in fair value on debt securities, realised gains and losses, and unrealised gains and losses on FV investments at fair value through profit or loss (as defined in the Financial Investments policy). Dividends on equity securities are recorded as revenue on the ex-dividend date. Interest income is recognised as it accrues, taking into account the effective yield on the investment. It includes the interest rate differential on forward foreign exchange contracts and is net of interest paid on margin loans.

A gain or loss on a financial investment is only realised on disposal or transfer, and is the difference between the proceeds received, net of transaction costs, and its original cost or amortised cost as appropriate. Unrealised gains and losses, arising on investments which have not been derecognised as a result of disposal or transfer, represent the difference between the carrying value at the year end and the carrying value at the previous year end or purchase value during the year, less the reversal of previously recognised unrealised gains and losses in respect of disposals made during the year.

**Insurance contract liabilities**

*Claims*

Claims reflect the cost of all claims arising during the year, including claims handling costs.

Claims handling costs include internal and external costs incurred in connection with the negotiation and settlement of claims. Internal costs include all direct expenses of the claims department and any part of the general administrative costs directly attributable to the claims function.

*Long-term business provisions*

Under current IFRS requirements, insurance contract liabilities are measured using accounting policies consistent with those adopted previously under existing accounting practices.

Calculations of the long-term business provisions are based on regulatory requirements and represent a determination within a range of possible outcomes, where the assumptions used in the calculations depend on the prevailing circumstances. The principal assumptions are disclosed in note 15 (b) (iv).

*Liability adequacy*

At each reporting date an assessment is made of whether the recognised long-term business provisions are adequate, using current estimates of future cash flows. If that assessment shows that the carrying amount of the liabilities (less related assets) is insufficient in the light of the estimated future cash flows, the deficiency is recognised in the income statement by setting up an additional provision in the statement of financial position.

**Non-participating investment contract liabilities**

*Claims*

For non-participating investment contracts with an account balance, claims reflect the excess of amounts paid over the account balance released.

*Investment contract liabilities*

Deposits collected under non-participating investment contracts are not accounted for through the income statement, except for the investment income attributable to those contracts, but are accounted for directly through the statement of financial position as an adjustment to the investment contract liability.

Nearly all of the Company's contracts classified as non-participating investment contracts are unit-linked contracts and are measured at fair value.

The fair value liability is determined in accordance with IAS 39, using a valuation technique to provide a reliable estimate of the amount for which the liability could be settled between knowledgeable willing parties in an arm's length transaction. For non-linked contracts, the fair value liability is based on a discounted cash flow analysis, with allowance for risk calibrated to match the market price for risk.

**Reinsurance**

The Company cedes reinsurance in the normal course of business, with retention limits varying by line of business. The cost of reinsurance related to long-duration contracts is accounted for over the life of the underlying reinsured policies, using assumptions consistent with those used to account for these policies.

Reinsurance assets primarily include balances due from both insurance and reinsurance companies for ceded insurance liabilities. Amounts recoverable from reinsurers are estimated in a manner consistent with the outstanding claims provisions or settled claims associated with the reinsured policies and in accordance with the relevant reinsurance contract.

If a reinsurance asset is impaired, the Company reduces the carrying amount accordingly and recognises that impairment loss in the income statement. A reinsurance asset is impaired if there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the Company may not receive all amounts due to it under the terms of the contract, and the event has a reliably measurable impact on the amounts that the Company will receive from the reinsurer.

**Investment in subsidiaries**

Shares in subsidiaries are included at cost less any impairment in value. Impairments in value are charged to the income statement.

**Impairment of non-financial assets**

Non-financial assets held at cost are reviewed for impairment losses 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 carrying amount of the asset exceeds its recoverable amount, which is the higher of an asset's net selling price and value in use. For the purposes of assessing impairment, assets are grouped at the lowest level for which there are separately identifiable cash flows.

**Derecognition and offset of financial assets and financial liabilities**

A financial asset (or, where applicable, a part of a financial asset or part of a group of similar financial assets) is derecognised where:

- the rights to receive cash flows from the asset have expired;
- the Company retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a "pass-through" arrangement; or
- the Company has transferred its rights to receive cash flows from the asset and has either transferred substantially all the risks and rewards of the asset, or has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

A financial liability is derecognised when the obligation under the liability is discharged, cancelled or expires.

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

**Financial investments**

The Company classifies its investments as financial assets at fair value through profit or loss ("FV"). The FV category has two sub-categories – those that meet the definition as being held for trading and those the Company chooses to designate as FV (referred to in this accounting policy as 'other than trading').

In general, the FV category is used as, in most cases, the Company's investment or risk management strategy is to manage its financial investments on a fair value basis. In certain circumstances, the FV category is used where this eliminates an accounting mismatch. Only derivatives are classified as trading. All securities in the FV category are classified as other than trading.

Purchases and sales of investments are recognised on the trade date, which is the date that the Company commits to purchase or sell the assets, at their fair values less transaction costs. Debt securities are recorded at their fair value, which is initially taken to be amortised cost, with amortisation credited or charged to the income statement. Investments classified as trading and other than trading are subsequently carried at fair value. Changes in the fair value of trading and other than trading investments are included in the income statement in the period in which they arise.

Investments carried at fair value are measured using a fair value hierarchy, described in note 7, with values based on quoted bid prices or amounts derived from cash flow models Fair values for unlisted equity securities are estimated using applicable price/earnings or price/cash flow ratios refined to reflect the specific circumstances of the issuer. Equity securities for which fair values cannot be measured reliably are recognised at cost less impairment.

*Impairment*

The Company reviews the carrying value of its investments on a regular basis. If the carrying value of an investment is greater than the recoverable amount, the carrying value is reduced through a charge to the income statement in the period of impairment.

Reversals of impairments on any of these assets are only recognised where the decrease in the impairment can be objectively related to an event occurring after the write down (such as an improvement in the debtor's credit rating), and are not recognised in respect of equity instruments.

**Derivative financial instruments**

Derivative financial instruments include foreign exchange contracts, interest rate futures, currency and interest rate swaps, currency and interest rate options and other financial instruments that derive their value mainly from underlying interest rates, foreign exchange rates, commodity values or equity instruments. All derivatives are initially recognised in the statement of financial position at their fair value, which usually represents their cost. They are subsequently re-measured at their fair value. 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 option pricing models. All derivatives are carried as assets when the fair values are positive and as liabilities when the fair values are negative. Premiums paid for derivatives are recorded as an asset on the statement of financial position at the date of purchase, representing their fair value at that date.

Derivative contracts may be traded on an exchange or over-the-counter ("OTC"). Exchange-traded derivatives are standardised and include certain futures and option contracts. OTC derivative contracts are individually negotiated between contracting parties and include forwards, swaps, caps and floors. Derivatives are subject to various risks including market, liquidity and credit risk, similar to those related to the underlying financial instruments.

The notional or contractual amounts associated with derivative financial instruments are not recorded as assets or liabilities on the statement of financial position as they do not represent the potential gain or loss associated with such transactions. These amounts are disclosed in note 28.

**Deferred acquisition costs**

The costs directly attributable to the acquisition of new business for non-participating insurance contracts are deferred to the extent that they are expected to be recoverable out of future margins in revenues on these contracts. For non-participating investment contracts, incremental acquisition costs and sales enhancements that are directly attributable to securing an investment management service are also deferred.

Where such business is reinsured, an appropriate proportion of the deferred acquisition costs is attributed to the reinsurer, and is treated as a separate liability.

Deferred acquisition costs are amortised systematically over a period no longer than that in which they are expected to be recoverable out of future margins. Deferrable acquisition costs for non-participating investment contracts are amortised over the period in which the service is provided.

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.

**Statement of cash flows**

*Cash and cash equivalents*

Cash and cash equivalents consist of cash at banks and in hand, deposits held on call with banks, treasury bills and other short-term highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are those with less than three months' maturity from the date of acquisition, or which are redeemable on demand with only an insignificant change in their fair values.

For the purposes of the statement of cash flows, cash and cash equivalents also include bank overdrafts, which are included within payables and other financial liabilities on the statement of financial position.

*Operating cash flows*

Financial investments are included within operating cash flows as the purchases are funded from cash flows associated with the origination of insurance and investment contracts, net of payments of related benefits and claims.

**Provisions and contingent liabilities**

Provisions are recognised when the Company has a present legal or constructive obligation as a result of past events, it is more probable than not that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made. Where the Company expects a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

The Company recognises a provision for onerous contracts when the expected benefits to be derived from a contract are less than the unavoidable costs of meeting the obligations under the contract. Contingent liabilities are disclosed if there is a possible future obligation as a result of a past event, or if there is a present obligation as a result of a past event but either a payment is not probable or the amount cannot be reasonably estimated.

**Income taxes**

The current tax expense is based on the taxable profits for the year, after any adjustments in respect of prior years. Tax, including tax relief for losses if applicable, is allocated over profits before taxation and amounts charged or credited to reserves as appropriate.

Provision is made for deferred tax liabilities, or credit taken for deferred tax assets, using the liability method, on all material temporary differences between the tax bases of assets and liabilities and their carrying amounts in the financial statements.

The principal temporary differences arise from unrealised gains and losses on capital assets, deferred acquisition costs, tax acquisition expenses and tax losses carried forward. The rates enacted or substantively enacted at the statement of financial position date are used to determine the deferred tax.

Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

In addition to paying tax on shareholders' profits, the Company pays tax on policyholders' investment returns ("policyholder tax") on certain products at policyholder tax rates. Policyholder tax is accounted for as an income tax and is included within the total tax expense.

**Share capital**

*Equity instruments*

An equity instrument is a contract that evidences a residual interest in the assets of an entity after deducting all its liabilities. Accordingly, a financial instrument is treated as equity if:

(i) there is no contractual obligation to deliver cash or other financial assets or to exchange financial assets or liabilities on terms that may be unfavourable; and

(ii) the instrument will not be settled by delivery of a variable number of shares or is a derivative that can be settled other than for a fixed amount of cash, shares or other financial assets.

*Dividends*

Interim dividends on ordinary shares are recognised in equity in the period in which they are paid. Final dividends on these shares are recognised when they have been approved by shareholders.

# Royal Scottish Assurance plc
## Income statement
## For the year ended 31 December 2010

| | Note | 2010 £'000 | 2009 £'000 |
|---|---|---|---|
| **Income** | | | |
| Gross written premiums | 1 | **61,668** | 65,485 |
| Premiums ceded to reinsurers | 1 | **(24,325)** | (24,012) |
| Net premiums earned | | **37,343** | 41,473 |
| Fee and commission income | 1 | **8,013** | 7,580 |
| Net investment income | 1 | **100,650** | 167,565 |
| | | **146,006** | 216,618 |
| **Expenses** | | | |
| Claims and benefits paid, net of recoveries from reinsurers | 2 | **(109,614)** | (107,939) |
| Change in insurance liabilities, net of reinsurance | 2 | **78,141** | 61,797 |
| Change in non-participating investment contract provision | 2 | **(65,596)** | (111,473) |
| Fee and commission expense | 2 | **(15,075)** | (19,638) |
| Other expenses | 2 | **(8,872)** | (12,205) |
| **Profit before tax** | | **24,990** | 27,160 |
| Tax expense | 5 | **(3,981)** | (5,079) |
| **Profit for the year** | | **21,009** | 22,081 |

All results relate to continuing operations.

## Statement of comprehensive income
## For the year ended 31 December 2010

The Company has no other comprehensive income in the current or prior period. As such no Statement of comprehensive income is disclosed.

The accounting policies on pages 8 to 14 and notes on pages 19 to 49 are an integral part of these financial statements.

# Royal Scottish Assurance plc
## Statement of financial position
## At 31 December 2010

| | Note | **2010** £'000 | 2009 £'000 |
|---|---|---|---|
| **Assets** | | | |
| Financial investments | 8 | **981,452** | 1,135,268 |
| Reinsurance assets | 16 | **127,070** | 113,671 |
| Current tax assets | 20 | **-** | 1,593 |
| Receivables | 9 | **15,674** | 28,362 |
| Deferred acquisition costs | 10 | **17,099** | 17,808 |
| Prepayments and accrued income | 11 | **5,237** | 5,511 |
| Cash and cash equivalents | 25 | **203,298** | 107,992 |
| **Total assets** | | **1,349,830** | 1,410,205 |
| **Equity** | | | |
| Ordinary share capital | 13 | **58,200** | 148,200 |
| Retained earnings | 14 | **185,641** | 83,632 |
| **Total equity** | | **243,841** | 231,832 |
| **Liabilities** | | | |
| Gross insurance liabilities | 15 | **499,559** | 564,071 |
| Gross liability for non-participating investment contracts | 17 | **552,193** | 531,199 |
| Current tax liability | 20 | **743** | - |
| Deferred tax liabilities | 20 | **18,295** | 21,747 |
| Payables and other financial liabilities | 21 | **28,804** | 47,139 |
| Other liabilities | 22 | **6,395** | 14,217 |
| **Total liabilities** | | **1,105,989** | 1,178,373 |
| **Total equity and liabilities** | | **1,349,830** | 1,410,205 |

Approved by the Board on 29 March 2011

**J R Lister**
Royal Scottish Assurance plc
Registered number: SC119820

The accounting policies on pages 8 to 14 and notes on pages 19 to 49 are an integral part of these financial statements.

# Royal Scottish Assurance plc
## Statement of changes in equity
## For the year ended 31 December 2010

| | Note | Ordinary share capital £'000 | Retained earnings £'000 | Total equity £'000 |
|---|---|---|---|---|
| **Balance at 1 January 2009** | | 148,200 | 76,051 | 224,251 |
| Total recognised income and expense for the year | 14 | - | 22,081 | 22,081 |
| Dividends | 24 | - | (14,500) | (14,500) |
| Total movements in the year | | - | 7,581 | 7,581 |
| **Balance at 31 December 2009** | | 148,200 | 83,632 | 231,832 |
| Total recognised income and expense for the year | 14 | - | **21,009** | **21,009** |
| Dividends | 24 | - | **(9,000)** | **(9,000)** |
| Share capital reduction | 13 | **(90,000)** | **90,000** | - |
| Total movements in the year | | **(90,000)** | **102,009** | **12,009** |
| **Balance at 31 December 2010** | | **58,200** | **185,641** | **243,841** |

The accounting policies on pages 8 to 14 and notes on pages 19 to 49 are an integral part of these financial statements.

# Royal Scottish Assurance plc
## Statement of cash flows
## For the year ended 31 December 2010

The cash flows presented in this statement cover all the Company's activities and include flows from both policyholder and shareholder activities.

| | Note | 2010 £'000 | 2009 £'000 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Cash generated by operations | 25 | **80,907** | 10,390 |
| Interest received on investments | | **10,857** | 14,080 |
| Dividends received on investments | | **12,778** | 15,403 |
| Tax paid | | **(236)** | (6,166) |
| **Net cash generated by operating activities** | | **104,306** | 33,707 |
| **Cash flows from financing activities** | | | |
| Ordinary dividends paid | | **(9,000)** | (14,500) |
| **Net cash used in financing activities** | | **(9,000)** | (14,500) |
| **Net increase in cash and cash equivalents** | | **95,306** | 19,207 |
| Cash and cash equivalents at 1 January | | **107,992** | 88,785 |
| **Cash and cash equivalents at 31 December** | 25 | **203,298** | 107,992 |

The accounting policies on pages 8 to 14 and notes on pages 19 to 49 are an integral part of these financial statements.

## 1. Details of income

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| **Gross written premiums** | | |
| Insurance contracts | **61,668** | 65,485 |
| Less: Premiums ceded to reinsurers | **(24,325)** | (24,012) |
| **Net premiums earned** | **37,343** | 41,473 |
| **Fee and commission income** | | |
| Policy administration and asset management services | **6,381** | 6,276 |
| Change in deferred income reserve | **640** | 944 |
| Surrender charges | **(20)** | (37) |
| Death benefit credit | **221** | 397 |
| Other fee and commission income | **791** | - |
| **Fee and commission income** | **8,013** | 7,580 |
| **Net investment income** | | |
| Interest and similar income | **10,723** | 11,819 |
| Dividend income | **12,638** | 12,975 |
| Other income from investments designated as trading | | |
| Realised losses | **(9,690)** | (9,767) |
| Unrealised gains | **10,648** | 9,222 |
| Other income from investments designated as other than trading | | |
| Realised gains / (losses) | **28,055** | (7,903) |
| Unrealised gains | **47,632** | 149,871 |
| Foreign exchange losses | **(10)** | (30) |
| Other investment income | **654** | 1,378 |
| **Net investment income** | **100,650** | 167,565 |
| **Total income** | **146,006** | 216,618 |

## 2. Details of expenses

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| **Claims and benefits paid to policyholders on long term business** | | |
| Insurance contracts | **120,558** | 119,977 |
| Less: Claim recoveries from reinsurers | | |
| Insurance contracts | **(10,944)** | (12,038) |
| **Claims and benefits paid, net of recoveries from reinsurers** | **109,614** | 107,939 |
| **Change in insurance liabilities** | **(64,512)** | (56,008) |
| Less: Change in reinsurance asset for insurance provisions | **(13,629)** | (5,789) |
| **Change in insurance liabilities, net of reinsurance** | **(78,141)** | (61,797) |
| **Change in non-participating investment contract provision** | | |
| Investment income allocated to non-participating investment contracts | **65,596** | 111,473 |
| **Change in non-participating investment contract provision** | **65,596** | 111,473 |
| **Fee and commission expense** | | |
| Acquisition costs | | |
| Commission expenses and other acquisition costs for insurance contracts | **14,366** | 17,122 |
| Change in deferred acquisition costs for insurance contracts | **420** | 2,027 |
| Change in deferred acquisition costs for non-participating investment contracts | **289** | 315 |
| Other fee and commission expense | **-** | 174 |
| **Fee and commission expense** | **15,075** | 19,638 |
| **Other expenses** | | |
| Administrative expenses | **8,872** | 12,205 |
| **Other expenses** | **8,872** | 12,205 |
| **Total expenses** | **121,016** | 189,458 |

Total commission paid to external agents in respect of direct business included above is £2,137,000 (*2009: £2,185,000*).

## 3. Directors' emoluments

The members of the Board of Directors are listed on pages 1 and 3 of these financial statements. During the year, the directors were remunerated by The Royal Bank of Scotland Group plc ("RBSG") or Aviva Employment Services Ltd ("AESL"), a subsidiary of Aviva plc, the ultimate holding company. Details of their emoluments are given in the financial statements of the relevant group.

## 4. Auditor's remuneration

The total remuneration payable by the Company, excluding VAT and any overseas equivalent thereof, to its principal auditor, Deloitte LLP, in respect of the audit of these accounts is shown below, together with fees payable in respect of other work.

| | **2010** **£'000** | 2009 £'000 |
|---|---|---|
| Audit services | | |
| Fees payable to the Company's auditor for the audit of the Company's annual accounts | **83** | 75 |
| Other services | | |
| Other services pursuant to legislation | **104** | 101 |
| | **187** | 176 |

## 5. Tax

### (a) Tax charged to the income statement

***(i) The total tax charge comprises:***

| | **2010** **£'000** | 2009 £'000 |
|---|---|---|
| **Current tax** | | |
| For the year | **7,437** | 9,688 |
| Prior year adjustments | **(4)** | 866 |
| Total current tax | **7,433** | 10,554 |
| **Deferred tax** | | |
| Origination and reversal of temporary differences | **(3,452)** | (5,475) |
| Total deferred tax | **(3,452)** | (5,475) |
| Total tax charged to the income statement (note 5(b)) | **3,981** | 5,079 |

***(ii) The current tax charge can be analysed as follows:***

| | **2010** **£'000** | 2009 £'000 |
|---|---|---|
| United Kingdom tax | **7,083** | 10,612 |
| Overseas tax | **350** | (58) |
| | **7,433** | 10,554 |

### (b) Tax reconciliation

The tax on the Company's profit before tax differs from the theoretical amount that would arise using the United Kingdom tax rate as follows:

| | **2010 £'000** | 2009 £'000 |
|---|---|---|
| Profit before tax | **24,990** | 27,160 |
| Tax calculated at standard UK corporation tax rate of 28% *(2009: 28%)* | **6,997** | 7,605 |
| Adjustments arising from tax attributable for UK life insurance | | |
| Different basis of tax for UK life insurance | **(3,912)** | 15,202 |
| Adjustment to tax charge in respect of prior years | **(4)** | 866 |
| Reduction in future UK tax rate | **(678)** | - |
| Deferred tax assets not recognised | **1,578** | (18,594) |
| Total tax charged to the income statement (note 5(a)) | **3,981** | 5,079 |

A gradual reduction in the UK corporation tax rate from 28% to 24% over four years was announced in the Emergency Budget of 22 June 2010. The Finance (No 2) Act published on 28 July 2010 enacted the first of the 1% rate reductions with effect from April 2011, the effect of which is shown in the table above. Subsequent reductions will be dealt with by future legislation. The benefit to the Company's net assets from the further 3% reduction in the rate is estimated as approximately £2,033,000 in total and will be recognised as the legislation is substantively enacted.

## 6. Investment in subsidiaries

### (a) Carrying amount

The carrying value of investments in subsidiaries at the beginning and end of the year is £100.

### (b) The investment of shares in subsidiaries is shown below.

| Company | Type of business | Class of share | Proportion held | Country of incorporation and operation |
|---|---|---|---|---|
| RSA (Services) Limited | Not trading | Ordinary | 100% | Scotland |

## 7. Fair value methodology

### (a) Basis for determining fair value hierarchy of financial instruments

For financial assets and liabilities carried at fair value, the measurement basis has been categorised into a 'fair value hierarchy' as follows:

***Quoted market prices in active markets – ("Level 1")***

Inputs to Level 1 fair values are quoted prices (unadjusted) in active markets for identical assets and liabilities. An active market is one in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. Examples are listed equities in active markets, listed debt securities in active markets and quoted unit trusts in active markets.

***Modelled with significant observable market inputs – ("Level 2")***

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

- Quoted prices for similar (i.e. not identical) assets and liabilities in active markets;
- Quoted prices for identical or similar assets and liabilities in markets that are not active, the prices are not current, or price quotations vary substantially either over time or among market makers, or in which little information is released publicly;
- Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates); and
- Inputs that are derived principally from, or corroborated by, observable market data by correlation or other means (market-corroborated inputs).

***Modelled with significant unobservable market inputs – ("Level 3")***

Inputs to Level 3 fair values are unobservable inputs for the asset. Unobservable inputs may have been used to measure fair value to the extent that observable inputs are not available, thereby allowing 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). As such, unobservable inputs reflect the assumptions the business unit considers that market participants would use in pricing the asset. Examples are certain private equity investments and private placements.

**(b) Fair value hierarchy analysis**

An analysis of financial assets and liabilities according to fair value hierarchy is given below:

| | Fair Value Hierarchy | | | | | 2010 |
|---|---|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Sub-total Fair Value** | **Amortised cost** | **Statement of financial position Total** |
| | **£'000** | **£'000** | **£'000** | **£'000** | **£'000** | **£'000** |
| Financial investments | | | | | | |
| Debt securities | **417,870** | - | - | **417,870** | - | **417,870** |
| Equity securities | **426,680** | - | **54** | **426,734** | - | **426,734** |
| Other investments (including derivatives) | **136,848** | - | - | **136,848** | - | **136,848** |
| Total | **981,398** | - | **54** | **981,452** | - | **981,452** |
| Financial liabilities | | | | | | |
| Non-participating investment contracts (note 17) | **528,237** | **23,956** | - | **552,193** | - | **552,193** |
| Derivative liabilities (note 21) | **1,613** | - | - | **1,613** | - | **1,613** |
| Total | **529,850** | **23,956** | - | **553,806** | - | **553,806** |

**2009**

| | Fair Value Hierarchy | | | | | |
|---|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Sub-total Fair Value | Amortised cost | Statement of financial position Total |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Financial investments | | | | | | |
| Debt securities | 578,724 | - | - | 578,724 | - | 578,724 |
| Equity securities | 406,502 | 119 | 30 | 406,651 | - | 406,651 |
| Other investments (including derivatives) | 149,855 | 38 | - | 149,893 | - | 149,893 |
| Total | 1,135,081 | 157 | 30 | 1,135,268 | - | 1,135,268 |
| Financial liabilities | | | | | | |
| Non-participating investment contracts (note 17) | 510,473 | 20,726 | - | 531,199 | - | 531,199 |
| Derivative liabilities (note 21) | 4,748 | - | - | 4,748 | - | 4,748 |
| Total | 515,221 | 20,726 | - | 535,947 | - | 535,947 |

There were no significant transfers between Level 1 and Level 2 of the fair value hierarchy during 2010 or 2009.

**(c) Further information on Level 3 financial instruments**

(i) The tables below show movements in the Level 3 financial assets and liabilities measured at fair value.

**2010**

| | Equity securities | Financial investments Total | Financial liabilities Total |
|---|---|---|---|
| | £'000 | £'000 | £'000 |
| **Total funds** | | | |
| Balance at 1 January | 30 | 30 | - |
| Total net gains or losses recognised in the income statement | (4) | (4) | - |
| Purchases | 58 | 58 | - |
| Disposals | (30) | (30) | - |
| **Balance at 31 December** | 54 | 54 | - |

**2009**

| | Equity securities | Financial investments Total | Financial liabilities Total |
|---|---|---|---|
| | £'000 | £'000 | £'000 |
| **Total funds** | | | |
| Balance at 1 January | 4 | 4 | - |
| Total net gains or losses recognised in the income statement | - | - | - |
| Purchases | 26 | 26 | - |
| **Balance at 31 December** | 30 | 30 | - |

The Company assesses the fair value hierarchy of its financial investments biannually at 30 June and 31 December.

Of the £4,000 (*2009: £356*) net losses recognised in the income statement during the year, £4,000 (*2009: £1,847 gain*) relates to investments still held at 31 December 2010. Of the net losses recognised in the income statement, £4,000 (*2009: £356*) is included in net investment income.

Level 3 investments amount to £54,000 (*2009: £30,000*) and relate to investments with non-market observable inputs.

## 8. Financial investments

### (a) Financial investments at 31 December comprise:

| | **2010** |
|---|---|
| | **Other than trading** |
| At fair value through profit or loss: | **£'000** |
| Debt securities | **417,870** |
| Equity securities | **426,734** |
| Other investments | |
| Collective investment schemes | **136,456** |
| Derivative financial instruments | **392** |
| Total financial investments | **981,452** |

| | **2009** |
|---|---|
| | **Other than trading** |
| At fair value through profit or loss: | **£'000** |
| Debt securities | 578,724 |
| Equity securities | 406,651 |
| Other investments | |
| Collective investment schemes | 149,504 |
| Derivative financial instruments | 389 |
| Total financial investments | 1,135,268 |

Of the above total, £239,362,000 *(2009: £365,487,000)* is expected to be recovered more than one year after the statement of financial position date.

### (b) Stock lending

The Company has entered into stock lending arrangements during the year in accordance with established market conventions. The majority of the Company's stock lending transactions occur in the UK, where investments are lent to EEA-regulated, locally domiciled counterparties and governed by agreements written under English law.

The Company receives collateral in order to reduce the credit risk of these arrangements. Collateral must be in a readily realisable form, such as listed securities, and is held in segregated accounts. Transfer of title always occurs for collateral received, although no market risk or economic benefit is taken. The level of collateral held is monitored regularly, with further collateral obtained where this is considered necessary to manage the Company's risk exposure.

In certain markets, the Company or the Company's appointed stock lending managers obtain legal ownership of the collateral received and can repledge it as collateral elsewhere or sell outright in the absence of default. The carrying amounts of financial assets received and pledged in this manner at 31 December 2010 were £16,089,000 and £nil respectively *(2009: £15,032,000 and £nil respectively)*. The value of collateral that was actually sold or repledged in the absence of default was £nil *(2009: £nil)*.

In addition to the above the Company has received and pledged cash collateral under stock lending arrangements of £9,283,000 and £nil respectively *(2009: £12,206,000 and £nil respectively).*

## 9. Receivables

| | **2010** | 2009 |
|---|---|---|
| | **£'000** | £'000 |
| Amounts due from fellow group undertakings | **6,473** | 2,498 |
| Amounts due from entities with significant influence | **-** | 4,535 |
| Amounts owed by contract holders | **4,399** | 9,281 |
| Other financial assets | **4,802** | 12,048 |
| | **15,674** | 28,362 |

Concentrations of credit risk with respect to receivables are limited due to the size and spread of the Company's trading base. No further credit risk provision is therefore required in excess of the normal provision for doubtful receivables.

On 31 December 2010, Royal Scottish Assurance plc's parent company Aviva Life Investments UK Limited (formerly RBS Life Investments Ltd) became a 100% owned subsidiary of Aviva plc. As a result in 2010, amounts due from fellow group undertakings are balances with Aviva plc (*2009: included within amounts due from entities with significant influence*) and balances with RBSG are within other financial assets (*2009: included within amounts due from fellow group undertakings*).

Of the above total, £1,967,000 (*2009: £218,000*) is expected to be recovered more than one year after the statement of financial position date.

## 10. Deferred acquisition costs

### (a) The carrying amount comprises:

| | **2010** | 2009 |
|---|---|---|
| | **£'000** | £'000 |
| Deferred acquisition costs in respect of: | | |
| Insurance contracts | **15,040** | 15,460 |
| Non-participating investment contracts | **2,059** | 2,348 |
| | **17,099** | 17,808 |

Of the above total, £12,855,000 *(2009: £13,208,000)* is expected to be recovered more than one year after the statement of financial position date.

**(b) The movements in deferred acquisition costs in respect of insurance contracts during the year were:**

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| **Carrying amount** | | |
| At 1 January | **15,460** | 17,487 |
| Acquisition costs deferred during the year | **3,883** | 4,160 |
| Amortisation | **(4,303)** | (5,058) |
| Impairment losses | **-** | (1,129) |
| At 31 December | **15,040** | 15,460 |

**(c) The movements in deferred acquisition costs in respect of non-participating investment contracts during the year were:**

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| **Carrying amount** | | |
| At 1 January | **2,348** | 2,663 |
| Acquisition costs deferred during the year | **-** | 95 |
| Amortisation | **(289)** | (410) |
| At 31 December | **2,059** | 2,348 |

## 11. Prepayments and accrued income

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| Accrued interest | **1,758** | 1,892 |
| Other accrued income | **3,479** | 3,619 |
| | **5,237** | 5,511 |

Prepayments and accrued income of include £nil (*2009: £nil*) that is expected to be recovered more than one year after the statement of financial position date.

## 12. Assets held to cover linked liabilities

Certain unit-linked and investment-linked products have been classified as non-participating investment contracts, while some are included within the definition of an insurance contract. The assets backing these linked liabilities are included within the relevant balances in the statement of financial position. The carrying values of assets backing these linked liabilities are as follows:

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| Debt securities | **152,194** | 151,569 |
| Equity securities | **478,715** | 458,403 |
| Derivative financial instruments (*) | **251,370** | 321,173 |
| Cash and cash equivalents | **15,601** | 5,607 |
| Other assets | **2,184** | 5,404 |
| | **900,064** | 942,156 |
| The associated liabilities are: | | |
| Linked contracts classified as insurance contracts | **373,936** | 438,049 |
| Linked contracts classified as non-participating investment contracts | **526,128** | 504,107 |
| | **900,064** | 942,156 |

* Derivative financial instruments includes the derivative assets backing the guaranteed capital bond products. These assets are offset against loans provided as collateral and are shown in note 21.

## 13. Ordinary share capital

**Details of the Company's ordinary share capital are as follows:**

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| The authorised share capital of the Company at 31 December was: 172,000,000 (*2009: 172,000,000*) ordinary shares of £1 each | **172,000** | 172,000 |
| The allotted, called up and fully paid share capital of the Company at 31 December was: 58,200,000 (*2009: 148,200,000*) ordinary shares of £1 each | **58,200** | 148,200 |

On 30 December 2010, the share capital of the Company was reduced from £148,200,000 to £58,200,000 by cancelling and extinguishing in full 90,000,000 ordinary shares of £1 each.

Ordinary shares in issue in the Company rank *pari passu*. All the ordinary shares in issue carry the same right to receive all dividends and other distributions declared, made or paid by the Company.

## 14. Retained earnings

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| Balance at 1 January | **83,632** | 76,051 |
| Profit for the year | **21,009** | 22,081 |
| Dividends (note 24) | **(9,000)** | (14,500) |
| Share capital reduction (note 13) | **90,000** | - |
| Balance at 31 December | **185,641** | 83,632 |

The Company is required to hold sufficient capital to meet acceptable solvency levels based on rules applicable to insurance companies imposed by the FSA. Its ability to transfer retained earnings to its parent company is therefore restricted to the extent that these earnings form part of regulatory capital.

## 15. Gross insurance liabilities

### (a) The carrying amount comprises:

| | **2010** | 2009 |
|---|---|---|
| | **£'000** | £'000 |
| Long-term business provisions | | |
| Unit-linked non-participating | **122,861** | 117,013 |
| Other non-participating | **362,170** | 424,800 |
| Outstanding claims provisions | **14,528** | 22,258 |
| | **499,559** | 564,071 |

Of the above total, £367,779,000 *(2009: £433,866,000)* is expected to be paid more than one year after the statement of financial position date.

### (b) Long-term business liabilities

*(i) **Business description***

The Company underwrites long-term business on 'non-profit' funds where shareholders are entitled to 100% of the distributed profits. Shareholder profits on unitised business are derived from management fees and policy charges, and emerge in the non-profit funds.

The directors have been advised by the Company's Reporting Actuary that the assets of the long-term operation were at least sufficient to meet their respective liabilities at 31 December 2010.

*(ii) **Methodology***

A prospective gross premium valuation method has been used for all non-linked business with the exception of some minor classes of business. For unit-linked contracts, the provisions are based on the market value of the related assets. The gross premium method uses the amount of contractual premiums payable and includes explicit assumptions for interest and discount rates, mortality, morbidity, persistency and future expenses. Provisions are sensitive to these assumptions. The assumptions can vary by contract type and reflect current and expected future experience. The assumptions contain an allowance for prudence and are reviewed annually against actual experience and industry and economic trends.

*(iii) **Company practice***

Material judgement is required in calculating the provisions and is exercised particularly through the choice of assumptions where there is discretion over these. Provisions are most sensitive to assumptions regarding discount rates, mortality/morbidity rates and persistency.

*(iv) **Assumptions***

The principal assumptions are:

The gross premium method is used for the majority of non-linked contracts.

For unit-linked business, the provisions are valued initially by adding a prospective non-unit reserve to the bid value of units. The prospective non-unit reserve is calculated by projecting the future non-unit cashflows on the assumption that future premiums continue.

Valuation discount rate assumptions are set with regard to yields on the supporting assets and the general level of long-term interest rates as measured by gilt yields. An explicit allowance for risk is included by making an explicit deduction from the yields on floating rate notes and deposits, based on historical default experience of each asset class. A further margin for risk is then deducted for all asset classes.

The changes in the valuation discount rates since 2009 reflect the changes in the yields on the supporting assets.

**Valuation discount rates**

| | **2010** | 2009 |
|---|---|---|
| Term assurances | **3.3% gross** | 3.6% gross |
| Sterling interest | **3.3% gross** | 3.6% gross |
| Unit growth | **4.6% gross** | 4.8% gross |
| Expense inflation | **4.3% gross** | 4.4% gross |

Mortality assumptions are set with regard to recent company experience.

**Mortality tables used**

| | **2010** | 2009 |
|---|---|---|
| Term assurance mortality | **TMC00/TFC00 adjusted for smoker status and sex** | TMC00/TFC00 adjusted for smoker status and sex |
| Term assurance critical illness | **Reinsurer rates adjusted for smoker status and sex** | Reinsurer rates adjusted for smoker status and sex |
| Over 50's whole of life | **AMC00/AFC00 adjusted for smoker status and sex** | AMC00/AFC00 adjusted for smoker status and sex |
| Unit linked/GCB mortality | **AMC00/AFC00 adjusted for smoker status and sex** | AMC00/AFC00 adjusted for smoker status and sex |

Lapse assumptions are set with regard to recent company experience. The table below shows the average over each 5-year duration period. The most prudent of the high and low lapse rates is chosen at each point in the projection.

**Lapse rates used**

| | **2010** | 2009 |
|---|---|---|
| | **High / Low** | High / Low |
| Level term assurance (duration 1-5 yrs) | **22% / 11%** | 21% / 11% |
| Level term assurance (duration 6+ yrs) | **11% / 5%** | 11% / 5% |
| Decreasing term assurance (duration 1-5 years) | **19% / 9%** | 19% / 10% |
| Decreasing term assurance (duration 6+ yrs) | **15% / 7%** | 15% / 8% |
| Over 50's whole of life (duration 1-5 yrs) | **9% / 4%** | 9% / 4% |
| Over 50's whole of life (duration 6+ yrs) | **2% / 1%** | 3% / 1% |

Expense assumptions are set with regard to company experience.

**Expense assumption used**

| | 2010 | 2009 |
|---|---|---|
| **Written prior to October 1997** | | |
| Term assurances | **£26.91 p.a.** | £26.68 p.a. |
| Mortgage Protection Plan | **£26.91 p.a.** | £26.68 p.a. |
| Lifetime Security Plan | **£89.70 p.a.** | £88.55 p.a. |
| Flexible Mortgage Plan | **£69.58 p.a.** | £69.00 p.a. |
| Endowment Savings Plan | **£65.55 p.a.** | £65.09 p.a. |
| Income Security Plan | **£89.70 p.a.** | £88.55 p.a. |
| **Written after October 1997** | | |
| Lifestyle Protection Plan (without/with CI) | **£26.91 / £29.44 p.a.** | £26.68 / £29.21 p.a. |
| Mortgage Protection Plan (without/with CI) | **£26.91 / £29.44 p.a.** | £26.68 / £29.21 p.a. |
| Pensions Term Assurance (standalone/in conjunction) | **£25.88 / £13.00 p.a.** | £25.65 / £12.82 p.a. |
| Mortgage Savings Plan | **£60.26 p.a.** | £59.80 p.a. |
| Over 50's Plan | **£28.41 p.a.** | £27.98 p.a. |
| **Joint Venture** | | |
| Term assurance | **£17.60 p.a.** | £20.70 p.a. |
| Mortgage protection | **£17.60 p.a.** | £20.70 p.a. |
| Standalone critical illness | **£17.60 p.a.** | £20.70 p.a. |
| Family Income Benefit Plan | **£17.60 p.a.** | £20.70 p.a. |
| Flexible Investment Bond | **£17.60 p.a.** | £20.70 p.a. |
| Guaranteed Capital Bond | **£19.78 p.a.** | £23.23 p.a. |
| Guaranteed Income Bond | **£19.55 p.a.** | £23.00 p.a. |

*(v) Movements*

The following movements have occurred in the long-term business provisions during the year:

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| **Carrying amount** | | |
| At 1 January | **564,071** | 620,079 |
| Provisions in respect of new business | **(12,556)** | (6,083) |
| Expected change in existing business provisions | **(61,120)** | (66,470) |
| Variance between actual and expected experience | **12,918** | 30,711 |
| Impact of operating assumption changes | **1,152** | (20,700) |
| Impact of economic assumption changes | **2,825** | 4,200 |
| Change in outstanding claims | **(7,730)** | 2,332 |
| Other movements | **(1)** | 2 |
| **Change in liability** | **(64,512)** | (56,008) |
| At 31 December | **499,559** | 564,071 |

The effect of changes in the main assumptions is given in note 19.

## 16. Reinsurance assets

### (a) The carrying amount comprises:

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| Long-term insurance contracts | **118,950** | 106,405 |
| Non-participating investment contracts | **2,454** | 2,483 |
| Other reinsurance receivables | **2,395** | 2,596 |
| Outstanding claims | **3,271** | 2,187 |
| | **127,070** | 113,671 |

Of the above total, £87,765,000 *(2009: £85,137,000)* is expected to be recovered more than one year after the statement of financial position date.

### (b) Assumptions

The assumptions used for reinsurance contracts follow those used for insurance contracts. Reinsurance assets are valued net of an allowance for their recoverability.

### (c) Movements

The following movements have occurred in the reinsurance asset during the year:

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| **Carrying amount** | | |
| At 1 January | **113,671** | 106,738 |
| Asset in respect of new business | **2,995** | 3,096 |
| Expected change in existing business asset | **6,205** | 17,622 |
| Variance between actual and expected experience | **2,102** | (8,234) |
| Impact of operating assumption changes | **1,345** | (6,858) |
| Impact of economic assumption changes | **(101)** | 64 |
| Increase in reinsurers' share of claims outstanding | **1,084** | 102 |
| (Decrease) / increase in other reinsurance debtors | **(201)** | 1,537 |
| Decrease in asset recoverable on non-participating investment contracts | **(28)** | (393) |
| Other movements | **(2)** | (3) |
| **Change in asset** | **13,399** | 6,933 |
| At 31 December | **127,070** | 113,671 |

The effects of changes in the main assumptions are given in note 19.

## 17. Liability for non-participating investment contracts

### (a) The carrying amount comprises:

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| Non-participating investment contracts | **552,193** | 531,199 |

### (b) Long-term business investment liabilities

Non-participating investment contracts included under long-term business are those that do not transfer significant insurance risk from the contract holder to the issuer, and are therefore treated as financial instruments under IFRS.

Investment contracts that do not contain a discretionary participation feature are referred to as non-participating contracts and the liability is measured at fair value.

Most non-participating investment contracts measured at fair value are unit-linked in structure and the fair value liability is equal to the unit reserve plus additional non-unit reserves if required on a fair value basis. For this business, a deferred acquisition cost asset and deferred income reserve liability are recognised in respect of transaction costs and front-end fees respectively, that relate to the provision of investment management services, and which are amortised on a systematic basis over the contract term. The amount of the related deferred acquisition cost asset is shown in note 10 and the deferred income reserve is shown in note 22.

### (c) Movements in the year

The following movements have occurred in the year:

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| **Carrying amount** | | |
| At 1 January | **531,199** | 481,948 |
| Premiums received | **7,527** | 17,973 |
| Fees deducted from account balances | **(5,228)** | (4,635) |
| Account balances paid on surrender and other terminations in the year | **(47,027)** | (75,510) |
| Investment income allocated to non-participating investment contracts | **65,722** | 111,423 |
| At 31 December | **552,193** | 531,199 |

The effect of changes in main assumptions is given in note 19.

## 18. Financial guarantees and options

The products with significant financial guarantees to policyholders are the Guaranteed Capital Bonds and the Guaranteed Income Bonds. The Guaranteed Capital Bonds provide a return linked to FTSE growth with a guaranteed minimum return on maturity of a percentage of the premium paid by the policyholder. This contract is matched by derivative assets and so there is no significant financial risk remaining with the Company. Collateral is paid to the Company by the holders of the derivative assets so as to minimise any credit risk. The

Guaranteed Income Bond provides a guaranteed fixed income and maturity value and these guarantees are matched by backing assets.

## 19. Effect of changes in assumptions and estimates during the year

The following estimates and assumptions used in determining assets and liabilities for insurance and non-participating investment contract business were changed, and had the following effect on the profit recognised for the year:

| Assumptions | **Effect on profit 2010 £'000** | Effect on profit 2009 £'000 |
|---|---|---|
| **Long-term insurance business** | | |
| Interest rates | **(2,926)** | (4,136) |
| Expenses | **2,974** | 3,033 |
| Mortality | **(1,006)** | 8,609 |
| Persistency rates | **(1,775)** | 2,200 |
| | **(2,733)** | 9,706 |
| **Investment contracts – Non-participating** | | |
| Interest rates | **8** | (54) |
| Expenses | **6** | (5) |
| Other | **7** | (16) |
| | **21** | (75) |
| **Total** | **(2,712)** | 9,631 |

## 20. Tax assets and liabilities

### (a) Tax assets and liabilities

| | **2010 £'000** | 2009 £'000 |
|---|---|---|
| Current tax assets | **5,305** | 8,086 |
| Deferred tax assets | **1,433** | 1,665 |
| Total tax assets | **6,738** | 9,751 |
| Current tax liabilities | **(6,048)** | (6,493) |
| Deferred tax liabilities | **(19,728)** | (23,412) |
| Total tax liabilities | **(25,776)** | (29,905) |
| Net current tax (liabilities) / assets | **(743)** | 1,593 |
| Net deferred tax liabilities | **(18,295)** | (21,747) |
| Net total tax liabilities | **(19,038)** | (20,154) |

Current tax liabilities payable in more than one year are £nil *(2009: £nil)*.

**(b) Deferred taxes**

***(i) The balance at 31 December comprises:***

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| Long-term business technical provisions and other insurance items | **(15,111)** | (18,426) |
| Deferred acquisition costs | **(4,617)** | (4,986) |
| Other temporary differences | **1,433** | 1,665 |
| Net deferred tax liability | **(18,295)** | (21,747) |

| ***(ii) The movement in the net deferred tax liability was as follows:*** | 2010 £'000 | 2009 £'000 |
|---|---|---|
| Net liability at 1 January | **(21,747)** | (27,222) |
| Amounts credited to profit (note 5(a)) | **3,452** | 5,475 |
| Net liability at 31 December | **(18,295)** | (21,747) |

***(iii) Unrecognised deferred tax assets:***

Deferred tax assets are recognised for tax losses carried forward to the extent that realisation of the related tax benefit through future taxable profits is probable. The Company has unrecognised deferred tax assets of £40,282,000 *(2009: £38,704,000)* to carry forward against future taxable income.

***(iv) Changes to life assurance taxation:***

Considerable changes to the regime for taxing UK life insurance companies were announced with the budget of 23 March 2011. The timing of the announcement and the complexity of the changes means that it has not been possible to estimate their impact on the deferred tax assets and liabilities shown in the balance sheet.

## 21. Payables and other financial liabilities

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| Payables arising out of direct insurance | **6,887** | 7,019 |
| Payables arising out of reinsurance operations | **1,242** | 1,153 |
| Amounts due to fellow group undertakings | **8,889** | 7,012 |
| Other financial liabilities | **10,008** | 26,439 |
| Derivative financial instruments | **1,613** | 4,748 |
| Bank overdraft | **165** | 768 |
| | **28,804** | 47,139 |

Of the above total, £2,355,000 *(2009: £1,583,000)* is payable more than one year after the statement of financial position date.

All payables and other financial liabilities are carried at cost, which approximates to fair value, except for derivative liabilities, which are carried at their fair values.

On 31 December 2010, Royal Scottish Assurance plc's parent company Aviva Life Investments UK Limited (formerly RBS Life Investments Ltd) became a 100% owned subsidiary of Aviva plc. As a result in 2010, amounts due to group undertakings are balances with Aviva plc (*2009: £nil*) and balances with RBSG are within other financial liabilities (*2009: included within amounts due to group undertakings*).

## 22. Other liabilities

| | **2010** | 2009 |
|---|---|---|
| | **£'000** | £'000 |
| Deferred income | **5,306** | 5,946 |
| Accruals | **1,089** | 8,271 |
| | **6,395** | 14,217 |

Of the above total, £4,779,000 *(2009: £5,161,000)* is expected to be released more than one year after the statement of financial position date.

## 23. Contingent liabilities and other risk factors

In 2010, a test case was taken to the European Court of Justice (ECJ) to rule on the current law and practice whereby insurers may take into account a person's gender in calculating the costs and benefits of their insurance. On 1 March 2011, the ECJ ruled that, with effect from 21 December 2012, insurers will no longer be able to use a person's gender in this way. Whilst the ruling does not apply retrospectively, we are unable at the current time to assess the risk of the judgement having implications for our existing insurance liabilities.

## 24. Dividends

| | **2010** | 2009 |
|---|---|---|
| | **£'000** | £'000 |
| Dividends paid: £0.0607 per share (*2009: £0.0978 per share*) | **9,000** | 14,500 |

## 25. Statement of cash flows

### (a) The reconciliation of profit before tax to the net cash inflow from operating activities is:

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| **Profit before tax** | **24,990** | 27,160 |
| Adjustments for: | | |
| (Profit) / loss on sale of other financial investments | **(18,365)** | 17,670 |
| Fair value gains on investments | **(58,270)** | (159,063) |
| Interest received on investments | **(10,723)** | (11,819) |
| Dividends received on investments | **(12,638)** | (12,975) |
| Changes in working capital: | | |
| Increase in reinsurance assets | **(13,399)** | (6,933) |
| Decrease in deferred acquisition costs | **709** | 2,342 |
| Decrease / (increase) in receivables | **12,688** | (18,536) |
| Decrease in insurance liabilities | **(64,512)** | (56,008) |
| Increase in liability for non-participating investment contracts | **20,994** | 49,251 |
| (Decrease) / increase in payables and other financial liabilities | **(18,335)** | 24,093 |
| Consortium relief reallocated from tax liability to other financial liability | **(4,861)** | (2,872) |
| Decrease in other liabilities | **(7,822)** | (514) |
| Net sale of operating assets | | |
| Financial investments | **230,451** | 158,594 |
| Cash generated by operations | **80,907** | 10,390 |

Purchases and sales of financial investments are included within operating cash flows as the purchases are funded from cash flows associated with the origination of insurance and non-participating investment contracts, net of payments of related benefits and claims.

### (b) Cash and cash equivalents in the statement of cash flows at 31 December comprised:

| | 2010 £'000 | 2009 £'000 |
|---|---|---|
| Cash at bank and in hand | **53,611** | 48,483 |
| Cash equivalents | **149,687** | 59,509 |
| | **203,298** | 107,992 |

## 26. Capital

In managing its capital, the Company seeks to:

- Match the profile of its assets and liabilities, taking account of the risks inherent in the business;
- Maintain sufficient, but not excessive, financial strength to support new business growth and satisfy the requirements of its policyholders and its regulator, the Financial Services Authority ("FSA");
- Retain financial flexibility by maintaining strong liquidity; and
- Allocate capital efficiently to support growth and repatriate excess capital where appropriate.

The Company is subject to the capital requirements applicable to insurance firms imposed by the FSA. The Company fully complied with these regulatory requirements during the year, and to the date of those financial statements.

The Company considers not only the traditional sources of capital funding, but alternative sources of capital as appropriate when assessing its available capital. This includes reinsurance that can be recognised as capital on a regulatory basis. The analysis below sets out the Company's capital resources available to meet its capital requirements on an FSA pillar 1 basis.

**Available capital resources**

| | **2010** | 2009 |
|---|---|---|
| | **£'000** | £'000 |
| Shareholders' funds outside long term funds | **151,395** | 123,344 |
| Shareholders' funds held in long term funds | **92,446** | 108,488 |
| **Total shareholders' funds** | **243,841** | 231,832 |
| Adjustments onto a regulatory basis: | | |
| Regulatory valuation and admissibility restrictions | **(58,693)** | (64,284) |
| **Total available capital resources** | **185,148** | 167,548 |

## 27. Risk management policies

During the year, the Company formed part of RBSG and therefore continued to operate under its existing governance framework. From 2011 onwards, the Company was solely owned by Aviva plc and has adopted its governance framework. The following policies describe the 2010 governance framework.

### (a) The Company's approach to risk management

#### *(i) Objectives*

The primary objective of the Company's risk and financial management framework is to protect it from events that hinder the sustainable achievement of the Company's performance objectives, including failing to exploit opportunities. The risk management policies include the setting of risk appetite and establishment of processes to ensure that the Company operates within the acceptable range of risk.

#### *(ii) Governance framework*

The management of risk is a fundamental management activity performed throughout all RBSG's operations. As such it underpins RBSG's reputation, performance and future success. It is, therefore critically important that the adequacy and effectiveness of RBSG's risk management processes are of the highest standard and subject to continuous review and enhancement. RBSG has put in place a comprehensive risk management framework comprising: leadership, strategy and culture set by the Board and put into effect through Executive Management; policies, procedures, processes and systems to execute effective risk management throughout RBSG; a comprehensive committee structure operating at a RBSG level to direct, approve and review actions taken to manage risk, where appropriate this is replicated at a Divisional level; and risk management functions that are independent of the business management to enforce agreed policy. A number of high-level committees support the Board in the effective measurement and management of risk.

RBSG has developed, and adopted globally, one comprehensive RBS Group Policy Framework. The aim of the RBS Group Policy Framework is to provide a simplified and effective framework to standardise presentation and control of RBS Group policy including new policies and amendments. All employees have easy access to current RBS Group policies and policy standards through a single RBSG intranet site. RBS Group Policies address the major areas of risk to the RBSG and the standards that must be met to enable those risks to be managed in line with RBSG risk appetite. All RBS Group Policies must be approved by the Executive Committee (ExCo).

The Company's governance structure has been designed to ensure that it complies with the Financial Services Authority's requirements in the Prudential Sourcebook for Insurers. It operates at a number of levels. For each of the FSA's six generic risk categories (Operational Risk, Market Risk, Credit Risk, Liquidity Risk, Insurance Risk and Group Risk) there is an Executive Owner with responsibility for monitoring compliance with the relevant risk policies. Identification of risk, setting risk appetite and monitoring of compliance with risk policies are all embedded within the Board Committee structure of the Company.

***(iii) Integration of risk and capital management***

The Company has developed a framework using Individual Capital Assessment ("ICA") principles for identifying the risks to which the Company is exposed, quantifying their impact on economic capital. The ICA estimates how much capital is needed to mitigate the risk of insolvency to a selected remote level of risk applied to a number of tests (both financial and non-financial) on the capital position of the business. The ICA works to a 99.5% confidence level over one year, in line with UK FSA regulatory requirements. Although the ICA is an internal process, the FSA can use ICA information in discussing target capital levels it believes the Company should have available.

***(iv) Impact of regulatory context on nature of the risks***

A significant proportion of the Company's long-term savings business involves insurance products where the majority of investment risks are borne by the Company's policyholders. Risks attributable to policyholders are actively and prudently managed. In addition, the insurance operations are subject to numerous regulatory requirements, which prescribe the prudent values which can be placed on assets and liabilities depending on their type, quality and the level of concentration of investments, and the level of assets to be maintained in order to meet liabilities. These requirements help to maintain the risk levels at an acceptable level.

**(b) Management of financial and non-financial risks**

As explained above, the Company has established a number of policies focusing on the management of financial and non-financial risks. In addition, the Company operates a risk committee at which the aggregation of these risks is monitored and risk management decisions are taken, for example to require further risk mitigating actions. Further details as to the operation of policies and the risk committee are provided by risk area below.

***(i) Life insurance risk***

*(1) Types of life insurance risk*

Life insurance risk within the Company arises through its exposure to claims on mortality and morbidity insurance and exposure to worse than anticipated operating experience on factors such as persistency levels and administration expenses.

The impact of life insurance risks is monitored by the Company as part of the control cycle of business management. Exposure is monitored through the assessment of liabilities, profit reporting, Actuary's Report, and the ICA process

*(2) Risk mitigation techniques employed*

The Company has developed a policy for the management of life insurance risk and guidelines for the practical application of key areas of life insurance practice.

Through its various committees, the Company considers all areas of life insurance risk, but in particular has a remit to monitor mortality, morbidity, longevity, persistency, pricing and expenses. The Company also considers the reinsurance coverage across the life businesses. The key points of this framework are as follows:

**Mortality and morbidity risks** are mitigated by the implementation of formal underwriting procedures, regular monitoring of experience and the use of reinsurance. The Company assesses the risk exposures and monitors the aggregation of risk ceded to individual reinsurers.

**Longevity risk** is controlled by transfer of the risk through reinsurance.

**Persistency risk** is managed through active monitoring and management of experience and customer research.

**Expense risk** is primarily managed through the assessment of profitability, and frequent monitoring of expense levels.

Apart from the ICA and Actuary's Report, sensitivity testing is widely used to measure the capital required from various life insurance risks. This enables the Company to determine whether action is required to reduce risk, or whether that risk is within the overall risk appetite.

*(3) Concentrations of life insurance risk*

The Company underwrites a diverse mix of business, which are all subject to a variety of risks. The Company assesses the relative costs and concentrations of each type of risk through the ICA requirements. This analysis enables the Company to assess whether accumulations of risk exceed risk appetite.

***(ii) Asset/liability management ("ALM")***

The Company has a policy on ALM of matching closely assets to technical provisions to manage the key ALM risks to which the Company is exposed. The Company monitors adherence to this policy through the Investment Control Committee.

The Company has established criteria for matching assets and liabilities for all classes of business, in order to minimise the financial risk from the mismatching of assets and liabilities as investment markets change.

***(iii) Liquidity risk***

The Company has a Liquidity Policy, which has been formulated to ensure that it meets all its obligations as they fall due and to ensure compliance with evolving liquidity requirements; in particular, Chapter 4 "Liquidity Risk Systems and Controls" of the Prudential Sourcebook for Insurers.

*Analysis of expected maturity of liabilities*

For insurance and investment business, the following shows the gross liability analysed by duration. The total liability is split by duration in proportion to the policy cash flows estimated to arise during that period.

| | Total | Within 1 year | 1-5 years | 5-15 years | 2010 Over 15 years |
|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'000 |
| Non-linked insurance | **362,170** | **101,526** | **171,639** | **9,096** | **79,909** |
| Non-linked investment | **23,956** | **1,671** | **22,285** | **-** | **-** |
| Unit linked | **651,098** | **83,341** | **256,582** | **271,724** | **39,451** |
| Outstanding claims | **14,528** | **14,528** | **-** | **-** | **-** |
| Total | **1,051,752** | **201,066** | **450,506** | **280,820** | **119,360** |

| | Total | Within 1 year | 1-5 years | 5-15 years | 2009 Over 15 years |
|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'000 |
| Non-linked insurance | 424,800 | 93,665 | 268,205 | 2,644 | 60,286 |
| Non-linked investment | 22,871 | 1,846 | 21,025 | - | - |
| Unit linked | 625,341 | 76,324 | 248,977 | 261,782 | 38,258 |
| Outstanding claims | 22,258 | 22,258 | - | - | - |
| Total | 1,095,270 | 194,093 | 538,207 | 264,426 | 98,544 |

***(iv) Market risk***

Market risk is the risk of adverse financial impact due to changes in fair values of financial instruments from fluctuations in interest rates, property prices and equity prices. Market risk arises within the Company due to fluctuations in the relationship between the values of the liabilities and the value of investments held as a result of movements in market prices.

The Company manages market risks through the Investment Control Committee and within regulatory constraints. The Company is also constrained by the requirements of Treating Customers Fairly and to minimise or avoid market risk in a number of areas.

For each of the major components of market risk, described in more detail below, the Company has put in place policies and procedures to set out how each risk is to be managed and monitored, and the approach to setting an appropriate risk appetite.

*(1) Interest rate risk*

Interest rate risk arises primarily from the Company's nominal and real yield curve exposure within both assets and liabilities.

The Company manages this risk by adopting close asset liability matching criteria in order to minimise the impact of mismatches between the value of assets and liabilities from interest rate movements.

*(2) Mark to market risk*

The Company is indirectly subject to mark to market risk due to daily changes in the market values of the securities within the unit linked portfolio. The Company's shareholders are exposed to the indirect impact from changes in the value of the securities held in policyholders' funds from which management charges or a share of performance are taken.

The Company is directly subject to mark to market risk due to changes in the value of shareholder assets and collateral relating to derivative investments.

Investment performance is monitored by the Investment Management Committee and the Board Investment Committee.

*(3) Derivative risk*

Derivatives are used to a limited extent, within policy guidelines set out in the Investment Management Agreement and the Derivatives Policy. Derivatives are used for efficient investment management, risk hedging purposes, or to structure specific retail savings products. Speculative activity is prohibited. OTC derivative contracts are entered into only with approved counterparties, in accordance with the Company's policies, thereby reducing the risk of credit loss. The Company applies strict requirements to the administration and valuation processes used in order to set a control framework that is consistent with market and industry practice. The Investment Controls Committee monitors the use of derivatives and approves large or complex transactions on behalf of the Company.

*(4) Correlations between market risk and other risks*

Lapse behaviour and potential increases in consumer expectations are sensitive to, and interdependent with, market movements. These interdependencies are taken into consideration in the ICA during the compilation of the financial stress tests.

***(v) Credit risk***

Credit risk is the risk of loss in the value of financial assets due to counterparties failing to meet all or part of their obligations, or changes to the market value of assets caused by changed perceptions of the credit worthiness of such counterparties.

The Company's management of credit risk, through the Investment Control Committee, includes measurement of large individual counterparty exposures using credit ratings produced by companies such as Standard & Poor's.

Financial assets are graded according to credit ratings issued. AAA is the highest possible rating. Investment grade financial assets are classified within the range of AAA to BBB ratings. For the purposes of the table below financial assets which fall outside this range are classified as speculative grade.

The following table provides information regarding the credit risk exposure of the Company at 31 December.

| | Credit rating | | | | | | 2010 |
|---|---|---|---|---|---|---|---|
| | AAA | AA | A | BBB | Speculative grade | Not rated | Total |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Debt securities | **114,891** | **203,520** | **62,188** | **30,347** | **1,631** | **5,293** | **417,870** |
| Reinsurance assets | - | **41,904** | **85,116** | - | - | **50** | **127,070** |
| | **114,891** | **245,424** | **147,304** | **30,347** | **1,631** | **5,343** | **544,940** |

| | Credit rating | | | | | | 2009 |
|---|---|---|---|---|---|---|---|
| | AAA | AA | A | BBB | Speculative grade | Not rated | Total |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Debt securities | 174,182 | 288,903 | 82,521 | 27,065 | 652 | 5,401 | 578,724 |
| Reinsurance assets | - | 34,466 | 75,630 | - | - | 3,575 | 113,671 |
| | 174,182 | 323,369 | 158,151 | 27,065 | 652 | 8,976 | 692,395 |

The carrying amount of assets included above represents the maximum credit exposure.

With the exception of AAA rated Governments securities the largest aggregated counterparty exposure does not exceed 3% (*2009: 3%*) of the Company's total financial assets.

The following table provides information regarding the carrying value of financial assets that have been impaired and the ageing of financial assets that are past due but not impaired.

**Arrears and impairment**

| | | Financial assets that are past due but not impaired | | | | | 2010 |
|---|---|---|---|---|---|---|---|
| | Neither past due nor impaired | 0-3 months | 3-6 months | 6 months to 1 year | Greater than 1 year | Carrying value of impaired financial assets | Total |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Debt securities | **417,870** | - | - | - | - | - | **417,870** |
| Reinsurance assets | **123,733** | **2,437** | **247** | **286** | **367** | - | **127,070** |
| Other investments | **136,848** | - | - | - | - | - | **136,848** |
| Receivables | **15,674** | - | - | - | - | - | **15,674** |

| | | Financial assets that are past due but not impaired | | | | | 2009 |
|---|---|---|---|---|---|---|---|
| | Neither past due nor impaired | 0-3 months | 3-6 months | 6 months to 1 year | Greater than 1 year | Carrying value of impaired financial assets | Total |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Debt securities | 578,724 | - | - | - | - | - | 578,724 |
| Reinsurance assets | 110,807 | 1,450 | 742 | 330 | 342 | - | 113,671 |
| Other investments | 149,893 | - | - | - | - | - | 149,893 |
| Receivables | 28,362 | - | - | - | - | - | 28,362 |

The fair value of collateral held against loans that are past due or impaired at 31 December 2010 was £nil *(2009: £nil).*

*(1) Concentrations of credit risk*

The long-term business is generally not individually exposed to significant concentrations of credit risk due to regulations limiting investments in individual assets and asset classes.

*(2) Reinsurance credit exposures*

The Company is exposed to concentrations of risk with individual reinsurers due to the nature of the reinsurance market and the restricted range of reinsurers that the Company deals with who have acceptable credit ratings. The Company operates a policy to manage its reinsurance counterparty exposures. The impact from reinsurer default is measured, among other things, through ICA tests and is managed accordingly.

***(vi) Operational risk***

Operational risk arises as a result of inadequate or failed internal processes, people or systems; or from external events.

As with other risk categories, line management of business areas have primary responsibility for the effective identification, management, monitoring and reporting of risks to the Board, in accordance with Company policies. A Risk Committee is responsible for implementing the Company's risk management methodologies and frameworks to assist line management in this work. They also provide support and independent challenge on the completeness, accuracy and consistency of risk assessments, and the adequacy of mitigating action plans. In this way, the Board satisfies itself that material risks are being mitigated and reported to an acceptable level.

The business' operational risks are recorded on a risk and control assessment which is subject to regular review.

**(c) Sensitivity analysis and capital management**

***(i) Life insurance and non-participating investment contracts***

The nature of long-term business is such that a number of assumptions have been made in compiling these financial statements. Assumptions are made about future investment returns, expenses, mortality rates, morbidity rates and persistency in connection with the in force policies. These assumptions are intended to be best estimates based on historic and expected experience of the business. A number of the key assumptions are disclosed in note 15.

Some results of sensitivity testing for long-term business are set out below. For each sensitivity test the impact of a change in a single factor is shown, with other assumptions left unchanged.

| Sensitivity factor | Description of sensitivity factor applied |
|---|---|
| Interest rate and investment return | The impact of a change in market interest rates by ± 1% (e.g. if a current interest rate is 5%, the impact of an immediate change to 4% and 6%). The test allows consistently for similar changes to investment returns and movements in the market value of backing fixed interest securities. |
| Expenses | The impact of an increase in maintenance expenses by 10%. |
| Assurance mortality/morbidity | The impact of an increase in mortality/morbidity rates for assurance contracts by 5%. |
| Equity prices | The impact of a change in equity prices by ± 10% |

The above sensitivity factors are applied via actuarial and statistical models, with the following pre-tax impacts on profit and shareholders' equity:

**Long-term business – impact on profit before tax and shareholders' equity before tax (£'000)**

| 2010 | Interest rates | Interest rates | Expenses | Assurance Mortality/ morbidity | Equity prices | Equity prices |
|---|---|---|---|---|---|---|
| | +1% | -1% | +10% | +5% | +10% | -10% |
| Insurance | (1,960) | 686 | (3,919) | (4,988) | 2,052 | (2,052) |
| Investment non-participating | (779) | 786 | (3) | - | 2,962 | (2,962) |
| **Total** | (2,739) | 1,472 | (3,922) | (4,988) | 5,014 | (5,014) |

**Long-term business – impact on profit before tax and shareholders' equity before tax (£'000)**

| 2009 | Interest rates | Interest rates | Expenses | Assurance Mortality/ morbidity | Equity prices | Equity prices |
|---|---|---|---|---|---|---|
| | +1% | -1% | +10% | +5% | +10% | -10% |
| Insurance | (3,154) | 2,063 | (3,774) | (4,837) | 1,724 | (1,511) |
| Investment non-participating | (233) | 242 | (5) | - | 2,255 | (2,255) |
| **Total** | (3,387) | 2,305 | (3,779) | (4,837) | 3,979 | (3,766) |

The tables above indicate the impact of the stated changes after the effect of reinsurance. The impact of changes in assurance mortality and interest rates would be significantly higher if existing reinsurance arrangements were not in place.

***(ii) Limitations of sensitivity analysis***

The above tables demonstrate the effect of a change in a key assumption whilst other assumptions remain unaffected. In reality, such an occurrence is unlikely due to correlation between the assumptions and other factors. It should also be noted that these sensitivities are non-linear, and larger or smaller impacts should not be interpolated or extrapolated from these results.

The sensitivity analyses do not take into consideration that the Company's assets and liabilities are actively managed and may vary at the time that any actual market movement occurs.

Other limitations in the above sensitivity analyses include the use of hypothetical market movements to demonstrate potential risk that only represent the Company's view of possible near-term market changes that cannot be predicted with any certainty as well as the assumption that all interest rates move in an identical fashion.

## 28. Derivative financial instruments

The Company uses non-hedge derivatives to mitigate risk, as detailed below:

| | | | **2010** | | | 2009 |
|---|---|---|---|---|---|---|
| | **Contract/ notional amount £'000** | **Fair value asset £'000** | **Fair value liability £'000** | Contract/ notional amount £'000 | Fair value asset £'000 | Fair value liability £'000 |
| **Equity/index contracts** | | | | | | |
| OTC | | | | | | |
| Options | **224,471** | **-** | **1,568** | 302,748 | - | 4,513 |
| Interest rate swaps | **17,017** | **6** | **-** | 15,035 | 23 | 14 |
| Forward and future contracts | **1,178** | **10** | **16** | 3,663 | 7 | - |
| Exchange traded | | | | | | |
| Forward and future contracts | **18,135** | **376** | **29** | 17,759 | 359 | 221 |
| **Total** | **260,801** | **392** | **1,613** | 339,205 | 389 | 4,748 |

The notional amounts above reflect the aggregate of individual derivative positions on a gross basis and so give an indication of the overall scale of the derivative transaction. They do not reflect the current market values of the open positions.

Fair value assets are recognised as 'derivative financial instruments' in note 8. Fair value liabilities are recognised as 'derivative financial instruments' in note 21. There are no contractual undiscounted cash flows in relation to derivative liabilities (*2009: none*).

## 29. Related party transactions

On 31 December 2010, Royal Scottish Assurance plc's parent company Aviva Life Investments UK Limited (formerly RBS Life Investments Ltd) became a 100% owned subsidiary of Aviva plc.

As a result of this change in ownership, related party relationships with other companies have changed. The table below shows the relationship in the 2009 and 2010 accounts along with the relationship post 31 December 2010.

| Company | Relationship at prior year-end and during the year | Relationship at end of year |
|---|---|---|
| The Royal Bank of Scotland Group plc (RBSG) | Fellow group undertakings | No longer related |
| Aviva plc | Entities with significant influence | Ultimate controlling entity |
| RBSG Subsidiaries | Fellow group undertakings | No longer related |
| Aviva Group Subsidiaries | Entities with significant influence | Fellow group undertakings |
| National Westminster Life Assurance Ltd | Fellow group undertakings | Fellow group undertakings |

During the year, there was a change in ownership of the Company. For further details see the Directors' report on page 3.

The following transactions were carried out with related parties.

(a) The members of the Board of Directors are listed on pages 1 and 3 of these financial statements. There are no accounts receivable from or payments due to members of the Board of Directors.

Management services have been provided throughout the financial year to the Company by Aviva Life Services UK Limited. Fees in relation to these services are paid by The Royal Bank of Scotland Group plc and the relevant proportion recharged to the Company.

Aviva Investors Global Services Limited's (an Aviva Group Subsidiary) provides investment management services to the Company.

During the year, the Company received dividends of £nil (*2009: £nil*) from its subsidiaries, and paid dividends of £9.0m (*2009: £14.5m*) to its parent, Aviva Life Investments UK Limited.

**(b) Other income receivable from related parties**

| | **2010 Income earned in year £'000** | 2009 Income earned in year £'000 |
|---|---|---|
| Fellow group undertakings | | |
| RBSG Subsidiaries - Retail structured deposit commission | **791** | - |
| | **791** | - |

**(c) Other expenses payable to related parties**

| | **2010 Expense incurred in year £'000** | 2009 Expense incurred in year £'000 |
|---|---|---|
| Fellow group undertakings | | |
| Interest payable on margin loan (RBSG Subsidiaries) | **1,828** | 5,846 |
| Expense recharge (RBSG) | **20,440** | 28,322 |
| Profit share and commissions due to RBSG Subsidiaries | **485** | 738 |
| RBSG Subsidiaries - Retail structured deposit | **-** | 174 |
| Expenses payable (Aviva Group Subsidiaries) | **1,266** | 914 |
| | **24,019** | 35,994 |

### (d) Receivable at year end

| | 2010 Receivable at year end £'000 | 2009 Receivable at year end £'000 |
|---|---|---|
| Fellow group undertakings | | |
| RBSG Subsidiaries | - | 593 |
| The Royal Bank of Scotland Plc | - | 1,905 |
| Aviva Group Subsidiaries | **6,473** | - |
| Entities with significant influence | | |
| Aviva Group Subsidiaries | - | 4,535 |
| | **6,473** | 7,033 |

The related parties' receivables are not secured and no guarantees were received in respect thereof. The receivables will be settled in accordance with normal credit terms.

### (e) Payable at year end

| | 2010 Payable at year end £'000 | 2009 Payable at year end £'000 |
|---|---|---|
| Fellow group undertakings | | |
| National Westminster Life Assurance Ltd | **4,028** | 314 |
| RBSG Subsidiaries | - | 173 |
| Aviva Group Subsidiaries | **272** | - |
| Profit share and commissions due to RBSG Subsidiaries | - | 2,943 |
| The Royal Bank of Scotland Plc | - | 14,440 |
| Aviva Group Subsidiaries | **4,861** | - |
| Entities with significant influence | | |
| Aviva Group Subsidiaries | - | 6,843 |
| | **9,161** | 24,713 |

The related parties' payables are not secured and no guarantees were received in respect thereof. The payables will be settled in accordance with normal credit terms.

### (f) Balances with UK Government

Prior to the acquisition of Royal Scottish Assurance plc's parent company Aviva Life Investments UK Limited (formerly RBS Life Investments Ltd) by Aviva plc, UK Government bodies were deemed to be related parties of the Company. During the year, the Company had transactions with UK Government bodies on an arms' length basis. Due to the change of ownership at the year-end, referred to in the Directors' report, there is no relationship requiring disclosure at 31 December 2010.

As at 31 December 2009, balances with the UK Government and affiliated bodies were:

| Debt securities | 2009<br>£'000 |
|---|---|
| Central Government (including the Bank of England) | 21,463 |
| Banks, Financial Corporations and Public Corporations | 8,606 |
| | 30,069 |

**(g) Key management compensation**

There are no accounts *(2009: none)* receivable from or payments due to key management personnel.

**(h) Employees**

The sales force is employed by RBSG. Other staff, including administrative staff, are employed by RBSG and AESL. The cost of the RBSG employees, an element in respect of directors' emoluments and other costs incurred by RBSG in relation to the provision of other services, are recharged to the Company. The cost of the AESL employees is charged to the Company via a management services agreement with Aviva Life Services Limited, another company within the Aviva plc group. The proportion of the charge relating to staff costs and directors' emoluments is not separately identifiable.

**(i) Parent entity**

The immediate holding company is Aviva Life Investments UK Limited (formerly RBS Life Investments Limited), a company registered in Scotland.

**(j) Ultimate controlling entity**

The ultimate controlling entity is Aviva plc, a company registered in England. Its Group financial statements are available on www.aviva.com or by application to the Group Company Secretary, Aviva plc, St. Helen's, 1 Undershaft, London EC3P 3DQ.