



Resolution Limited

Securing your tomorrow, today

Annual report and accounts 2013

Resolution Limited is a Guernsey incorporated Company with a premium listing on the London Stock Exchange.

The Company holds its investment in the Friends Life group, a provider of pensions, investment and insurance with a heritage of over 200 years, through Resolution Holdco No. 1 LP, a Guernsey registered Limited Partnership. Further details on our group structure can be found on pages 72 to 74.

In March 2013 we sought shareholders' approval for changes to the Company's constitution that enabled the Group to adopt a simplified governance structure. In practice this meant unifying the board membership of both Resolution Limited and its key operating subsidiary, Friends Life Group plc. We also stated that the Company would no longer target a specific exit event, but would seek to secure maximum value from each part of the Group and retain its focus on rigorous financial discipline and generating returns. This annual report includes an update to the Company's strategy.

In May 2014 we will seek permission from our shareholders at the Annual General Meeting (AGM) to change the Company name to Friends Life Group Limited to align this with our trading brand. We have described our restructuring and transformation journey on the following pages.

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Financial highlights

£331m +10%

Sustainable free surplus
(2012: £300m)

£436m +59%

IFRS based operating profit
(2012: £274m)

£489m +28%

MCEV operating profit
(2012: £382m)

£917m +8%

Available shareholder assets
(2012: £850m)

£2.2bn unchanged

IGCA surplus
(2012: £2.2bn)

21.14p unchanged

Full year dividend per share
(2012: 21.14p)

£204m +5%

Value of new business
(2012: £194m)

£117.6bn +3%

Assets under administration
(2012: £114.0bn)

£129m +50%

Run-rate savings achieved
(2012: £86m)

Operational highlights

- Restructuring of the three businesses is complete, cost savings secured
- Successful delivery of key 2013 financial targets
- Completion of circa £2bn with-profits annuity reallocation
- Investment mandates placed for £1bn commercial real estate and infrastructure loans
- Delivery of simplified corporate governance structure
- Major new strategic partnership with Schroders announced
- Proposed change of name to Friends Life Group Limited to align the Company with its trading brand



Strategic report
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Strategic report



Securing your tomorrow, today

Our strategy is focused on meeting the needs of our customers, colleagues and shareholders by providing high quality propositions delivered by the best people, to ensure returns for our investors.

Chairman's statement

Successfully navigating change



A year of change

This is my first report as Chairman of the Company in what has been a significant year of change for the organisation. The Company completed the final phase of the three-year restructuring programme, made a number of changes to its governance arrangements and achieved strong operating profits for the year.

This performance has been led by a motivated and committed executive management team, which has navigated the Company through a period of exceptional change, and turned its financial performance around. Under their guidance, Sustainable Free Surplus ("SFS") has risen from less than £100 million in 2010 to £331 million in 2013, and the value of UK new business has increased from a loss of £10 million to a profit of £184 million. Their disciplined focus has created shareholder value by delivering 'cash today' and 'cash tomorrow'. Maintaining a strong balance sheet has enabled the Board to propose a final dividend of 14.09 pence per share (unchanged from 2012) making a total dividend for the year of 21.14 pence per share.

2013 was also significant in that we have achieved most of the key financial targets, and the Company has revisited its financial framework to ensure the way we measure the business performance supports the strategic direction of the Group. Further information on this is contained on page 29.

The executive management team has presided over a very ambitious restructuring programme. The three-year programme has had its challenges; separating IT infrastructures and undertaking customer migrations of legacy platforms is a complex process and not without risk to the control environment; however the executive management team has delivered against these operational challenges and secured the synergies six months earlier than anticipated. Where issues have arisen during the year which impacted the control environment, the team responded quickly providing remediating actions and procedures to minimise risks to customers and shareholders.

Sir Malcolm Williamson
Chairman

Change of name

Now that the restructuring programme has come to a close, the Board believes it is time to change the name of the Company to Friends Life Group Limited. Becoming Friends Life, a name known to over five million customers, is a logical step in our strategy to consolidate our position as a sustainable provider of pensions, investments and insurance. As such we will ask shareholders for approval to change the name of the Company at the forthcoming AGM, details of which are set out in the directors' report within the Governance section of this report. The Board and I recommend that shareholders vote in favour of these changes.

Board changes

The Company and Friends Life Group plc ("FLG") boards unified their membership in March 2013. We explain the changes in detail on page 81 and I encourage you to read about the structure of the Group, on page 72. I took over as Chairman from Mike Biggs following the AGM in 2013 and I want to thank Mike for steering the Board through a period of change. I would also like to thank all of the non-executive directors who stepped down in 2013. We took the opportunity to refresh the Board in May to provide further independent balance. I am therefore delighted to welcome both Roger Perkin and Marian Glen as independent non-executive directors. Roger brings considerable financial acumen to the boardroom and Marian contributes corporate finance and merger and acquisitions expertise.

An effective board develops and promotes its collective vision of a company's purpose, its culture and its values, as well as engaging in and promoting constructive challenge. As the Board settled into its new structure, I thought it would be beneficial to undertake an externally-facilitated board evaluation, to ensure we are functioning effectively as a team. You can read more about this in the Governance section.

Diversity

Diversity is very important in the boardroom and throughout the Company, and it is clear that it is not just a gender issue. The Group Chief Executive has established a number of Group-wide diversity forums in the organisation to help develop the pipeline of future leaders, and I am very proud of the Company's efforts in this area. You can read more about the actions we are taking and initiatives being led by the Group Chief Executive in the Corporate Responsibility report.

Managing regulatory change

The regulatory background has been as challenging as the economic background. There have been significant changes in the industry approach to customers as a result of the Retail Distribution Review, the commencement of Auto-Enrolment Pensions and the reviews into the operation of the annuity market. We are fully supportive of the efforts being made by the government and the FCA to help people achieve adequate retirement provision and to give consumers confidence that the advice they are given and products and services we sell are appropriate for their needs. We work across our teams to respond to these developments and deliver our ambition of providing high quality products and services for our customers.


The Company is also embracing the changes required in preparing for Solvency II. It has invested significantly in its enterprise wide risk management approach, covered in the strategic report on pages 4 to 69. As part of the transformation process the Group undertook a review of the governance structures in the organisation, in particular the delegated authority framework and matters reserved for the boards across the Group, underscoring our commitment to the control framework and effective risk management.

Shareholder consultation

Since my appointment I have met a significant proportion of our top institutional shareholders and I hope to meet some of our retail shareholders at the AGM this year. The Chairman of the Remuneration Committee also met a number of investors this year as part of the consultation process we undertook to seek institutional views on the new Performance Share Plan and our proposed Remuneration Policy.

Our employees

Delivering strong results and a turnaround can be a challenging task. While the executive management team has overseen delivery of an excellent set of results and driven considerable change throughout the organisation, this cannot be achieved without the skill and commitment of our employees. It remains for me to thank all of our employees for their immense contribution and dedication to the business to deliver the results we are reporting to you. And finally, I am very positive about the future growth prospects for the business, and the continued delivery of returns to our shareholders.



Sir Malcolm Williamson
Chairman

17 March 2014

Evolving customer needs

We understand how customers' changing retirement needs will drive development of the life and pensions market.

20yrs

30yrs

40yrs

50yrs



1 in 3 to 1 in 10 – fall in private sector defined benefit pension participation over 15 years¹

91% – initial take-up rate for new savers as auto-enrolment to workplace schemes begins²

>1m – highly skilled UK expatriates living abroad³

Customers building their careers and starting families might need:

- Support from their employer and tax-efficient contributions to get under way with retirement saving
- Investment for long-term returns and low charges to allow savings to grow
- Flexibility to fit with changing responsibilities and locations
- Protection for family in case of illness or death



11.5m – people aged 50-64 in the UK¹

£195,000 – typical household savings in 50-64 age group¹

Customers with established lifestyles might need:

- Help and information to understand their retirement savings choices and opportunities
- Their money to work hard for them through using the right tax-efficient structures, asset classes and fund choices
- Protection for family in case of illness or death

Retirement savings ↑

Sources:

- 1 Office for National Statistics;
- 2 Department for Work and Pensions;
- 3 Organisation for Economic Co-operation and Development;
- 4 Dilnot Commission

Statistics relate to UK.

60yrs

70yrs

80yrs

90yrs



700,000 – baby boomers reaching 65 each year¹

7 years – increase in expected male lifespan at age 65 over 30 years, from 14 years to 21 years¹

50% – increase in working past state retirement age over last 20 years¹

Customers around retirement age might need:

- Flexibility to balance changes in income from work and savings
- Suitable investment strategies to manage exposure to market volatility
- Awareness and confidence to make the right decisions to secure their income through retirement



Double – population of over-80s projected to increase to 6 million over the next 25 years¹

55% – demand growth for care in next 20 years⁴

Customers in retirement might need:

- Certainty of knowing their income is guaranteed for as long as they live
- Income growth to meet future increases in the cost of living
- Ongoing income for their partner in the event of their death
- Provision for increased care needs in later life

Organised around our market

Our business is focused on retirement provision and the legacy products segment of the UK life and pensions market.

The UK life and pensions market:

Market segment and related Friends Life business unit	Description	Estimated market scale, 2013*	Estimated market growth, 2013–23*
Legacy products Heritage	Closed businesses and products no longer actively marketed, including <i>with-profits</i> .	£410bn AUA	0.7x
Individual wealth	Individual pensions and fund investments via retail products.	£810bn AUA	2.0x
Workplace savings Heritage Corporate benefits	Employer-sponsored defined contribution pensions.	£350bn AUA	3.5x
Retirement income Heritage Retirement income	Annuities provide income guaranteed for customer's lifetime, purchased by individuals at retirement, or by companies to de-risk pension scheme liabilities. Other products include income drawdown.	£2,300m New business APE	3.3x
Protection Heritage Protection	Lump sum or income payments made on death or serious illness of customer.	£1,100m New business APE	1.7x



£1.8 trillion

Amount of investments the UK insurance industry is responsible for**



£196.2 billion

Benefits paid by UK life and long-term savings companies in 2012**



47%

of the working population contribute to a pension policy**



£37.1 million

Average annuity payments customers received every day in 2012**

* Oliver Wyman, 2014

** Association of British Insurers, 2013

Our organisation:

FriendsLife

Heritage division	UK division				International division	
Heritage Our specialist business managing legacy products and other older-style business. Includes Friends Life Investments, providing asset management services for Group businesses.	Corporate benefits Workplace savings business focused on retirement saving through employer sponsored schemes.	Retirement income Annuities for individual retirees, both retiring Friends Life pension customers and those who saved with other providers.	Protection Life assurance, income protection and critical illness policies for individual customers and group schemes for companies.	Friends Provident International Savings, investment and protection products for expatriates and affluent local nationals in selected high-growth markets.	Lombard Unit-linked life assurance structures for high net worth individuals across Europe and selected markets in Latin America and Asia.	
3.8m Customers	1.1m Customers	0.1m Customers	0.2m Customers*	0.3m Customers	< 0.1m Customers	
£68bn AUA	£20bn AUA	£66m New business APE	£84m New business APE	£7bn AUA	€24bn AUA	
Leading specialist in closed funds with track record of success.	Number 2 by assets under administration in market set for fast growth.	34% of Friends Life vesting pensions are used to take a Friends Life annuity.	In the top 5 for protection new business.	17% share of Hong Kong linked offshore life market.	Leading pan-European specialist in estate and succession planning solutions.	



£118 billion
Assets under administration



4,000
Colleagues



£1.1 billion
Total new business APE



> 5 million
Customers in the UK

* Individual protection customers on main administration platform

How we create value and generate returns

Our aim is to grow cash generation by developing a sustainable business meeting the needs of customers.

		Heritage division	
		Heritage	Corporate Benefits
What we do	Compete for new business	✗	✓
	Administer policies	✓	✓
	Take risk for customers <ul style="list-style-type: none"> Life events Investment 	✓*	✗
		✓*	✗
	Investment governance and oversight	✓	✓
	Fixed interest asset management	✓*	✗
How we make money	All business types: Keep maintenance expenses within expected levels	Mechanisms vary by business type: <ul style="list-style-type: none"> Take a share of bonuses allocated to policyholders (with-profits) Take a small regular charge on assets under administration or regular policy fees Release capital held against risks as business runs off 	<ul style="list-style-type: none"> Take a small regular charge on assets under administration Administer growing assets for existing customers and scheme joiners Win new schemes on terms acceptable to employers, customers and the business
		<ul style="list-style-type: none"> Effective management of customer service and costs as policy numbers reduce over time Risk management expertise to manage complex portfolio of exposures Capital management ability for business restructuring 	<ul style="list-style-type: none"> Ease of doing business for customers and employers – automation and technology Critical scale on low cost administration platform Competitive charging rates and reputation with key intermediaries
Our performance	Cash today	£431 million Sustainable Free Surplus ("SFS")	£(40) million SFS
	Cash tomorrow	c. £10 million added to SFS from 2014	£20 billion AUA, up 13% over the year

* Applies to certain business types

→ Group Chief Executive's Review see page 14
Financial review see page 32

→ Group Chief Executive's Review see page 14
Financial review see page 32

Enablers:

**People**

We have around 4,000 colleagues based in the UK, Isle of Man, Hong Kong, Singapore, Dubai and Luxembourg. Our people uphold our values of Ease, Empathy and Expertise.

**Capital**

We hold capital against risk. Shareholder capital is invested in high quality, low risk assets. Friends Life Group has issued a number of subordinated debt instruments which strengthen the capital position of the business and ensure suitable capital is available to deliver our business plan.

**Service partnerships**

Delivery of some customer service procedures and most IT platform management and support is carried out under service agreements with major providers. Management of assets in certain Friends Life funds, including with-profits funds, is carried out in partnership with asset managers, under discretionary agreements.

**Governance & oversight**

We have a streamlined Board and committee structure to ensure effective oversight at group and operating company level. Particular attention is paid to risk identification and management.

UK division

Retirement Income	Protection
✓	✓
✓	✓
✓	✓
✓	✗
✓	✓
✓	✓
<ul style="list-style-type: none"> Win new business by offering competitive rates to customers allowing for risks taken on Release capital held against risks as business runs off Invest assets to optimise long-term returns and investment risk 	<ul style="list-style-type: none"> Win new business by offering competitive rates to customers allowing for risks taken on Release capital held against risks as business runs off
<ul style="list-style-type: none"> Ability to offer better prices based on individual customers' health Engaging with Friends Life customers approaching retirement Links to intermediaries in developing retirement market 	<ul style="list-style-type: none"> Relationships with key intermediaries in individual and group markets Pricing flexibility, adaptability and speed Reinsurance know-how to optimise retention and transfer of risk
£83 million VNB	£75 million VNB

International division

Friends Provident International	Lombard
✓	✓
✓	✓
✓*	✓*
✗	✗
✓	✓
✗	✗
<ul style="list-style-type: none"> Win new business by offering competitive rates to customers allowing for risks taken on Release capital held against risks as business runs off Take a small regular charge on assets under administration, and/or regular policy fees 	<ul style="list-style-type: none"> Take a small regular charge on assets under administration, and/or regular policy fees
<ul style="list-style-type: none"> Offer wide fund choice at competitive rates Nimble operational structure to react to developments in diverse markets Governance expertise to work with multiple regulators 	<ul style="list-style-type: none"> Expertise in compliant product structures across multiple territories Deep market knowledge and relationships with advisers to high net-worth customers Ability to adapt to changes in regulatory and fiscal environments
£40 million SFS	
£14 million VNB	€24 billion AUA, up 3% over the year

Business environment changes

The key developments over the last year affecting our industry include improvement in the economic outlook and a variety of initiatives addressing how the industry should meet customer needs.

Economic developments

Investment markets continue to reflect historically low interest rates as policy-setters attempt to nurture sustainable economic growth. Equity markets traded higher through most of the year, although global uncertainty impacted investment markets through the summer, linked to budget disagreements and uncertainty around scaling down of central bank activity in the US, the world's largest economy. The year ended with improved sentiment and increased economic growth expectations in the UK.

Equity markets

FTSE 100:

5,898 → 6,749

Improving equity markets increase the value of customer assets under administration, in turn increasing the value of regular charges on assets.

Corporate bond spreads

Reduction of:

c.50bps

Credit spreads indicate the level of risk of investing in corporate bonds compared to government bonds, a lower spread reflecting increased confidence that companies will pay in full and on time.

Interest rates

UK base rate:

0.5% through year

The base rate drives returns on cash, important for returns for customers and shareholder assets held in cash.

UK 10-year swap yield:

1.9% → 3.1%

Long-term interest rates are a key indicator of future expected performance of the UK economy, rising when growth expectations increase. An increase in rate means that government bond prices fall, but allow us to offer better rates to new annuity customers.

Social and technological developments

The demographic fact of an aging population is combining with reducing ability and willingness of state and employers to meet customer retirement needs. At the same time, the industry is not immune to wider social developments affecting how we all communicate with companies and each other.

Workplace savings auto-enrolment

Increased life expectancy and economic factors have driven the decline of private sector defined benefit pension schemes in the UK, and increases in the state pension age. In response to the growing gap in retirement provision, auto-enrolment into workplace savings schemes is becoming mandatory for employers. Implementation is being staggered over a number of years, starting with the biggest employers in 2013. New customers will have a significant impact on the workplace savings market, and providers have invested in systems to successfully bring on board new savers.

Online communication channels

Use of aggregator sites provides an alternative route to market for providers. Social media provides a new channel for customer feedback and market insight.

Regulatory developments

There has been significant change in the UK regulatory landscape over the course of the last year, with the roles of the previous regulator, the Financial Services Authority ("FSA"), split between two new bodies from April. The Financial Conduct Authority ("FCA") now oversees conduct regulation, with the objective of ensuring insurance markets function well. The Prudential Regulation Authority ("PRA") has the objective of promoting insurers' safety and soundness while contributing to policyholder protection. Meanwhile, significant progress was made between European bodies allowing increased certainty over future regulatory changes.

Retail Distribution Review

The FSA brought in new conduct regulation affecting the relationship between customers, advisers and product providers in December 2012. 2013 was the first full year in which these rules, which affect savings products, were in force. The most significant change for providers is that product structures including adviser remuneration through commission payments are now banned.

Solvency II

Solvency II is a new, Europe-wide solvency framework which has been under discussion between European regulators for many years. It was confirmed in November 2013 that the implementation date for insurers to meet new capital rules will be January 2016 from which point firms will assess their solvency position using either a standard formula approach or an approved internal model. This will require investment by providers to ensure readiness.

Annuity market review

Despite a number of industry initiatives led by the ABI, less than half of pensions customers switch providers when they buy an annuity at retirement. The FCA launched a thematic review of the market in 2013, and will now undertake a market study during 2014 to assess whether competition in this market is working well and in the interests of consumers.

Political developments

The political cycle of approaching European Parliament elections in 2014 and a UK general election in 2015 means we expect political uncertainty to persist through 2014. Looking further out, the possibility of a referendum over UK membership of the EU and implications of the Scottish referendum on independence from the rest of the UK could significantly affect the industry.

Pensions market reviews

During 2013, a number of investigations were made into the workplace savings market, in the light of auto-enrolment bringing new customers into the market for the first time. At the time of writing, the Department for Work & Pensions is considering the timing and level for a charge cap on workplace savings business.

Later life support

There remains a lack of clarity over the long-term level of provision of government support for care in later life, despite the report of a commission in 2011. This is holding back the development of mainstream care cost insurance products that might be in the interests of our customers.

Group Chief Executive's review

Restructuring of the
business complete.
Strategic outlook
attractive.



Andy Briggs
Group Chief Executive

Introduction

We reached a significant turning point for the Group in 2013, and are entering a new and exciting chapter for Resolution. Our customers are at the heart of everything we do. As we help them prepare for the future, we will continue to deliver returns to our investors and focus on growing the business to support sustainable cash generation.

Our four-fold strategic objectives:

- focus on managing legacy life and pension products, and capturing value in the fast growing retirement provision market;
- make customers' money work harder to help them realise their financial goals;
- attract and retain best-in-class people, building distinctive capability and competitive advantage; and
- generate growth in both cash today and cash tomorrow while maintaining our strong capital base.

As our strong, financially disciplined team focus on these objectives we are confident in our ability to deliver returns to our investors. Over time we will continue to grow cash generation, underpinned by a strong capital base and rigorous capital allocation; this creates a platform to grow our dividend in due course.

During the second half of 2013, we saw signs of economic improvement and a more stable financial environment in the UK. Against this backdrop we are well positioned for key market trends. An ageing population and reduced state support, together with a shift from defined benefit to defined contribution schemes provide the foundation for growth in the pensions market. The UK Government's drive to help people achieve adequate retirement provision has resulted in the introduction of new regulations including the Retail Distribution Review ("RDR") and auto-enrolment which provide further impetus for growth. Auto-enrolment in particular will see many UK workers making private contributions towards a pension for the first time.

Our success is driven by a focus on profitable business lines where our scale and expertise can deliver high quality outcomes for customers and attractive returns for investors. We continuously strive to improve customer service and offer high quality propositions, ensuring that we demonstrate our brand values of ease, empathy and expertise in our customer interactions. A focus on the needs and objectives of our customers is central to our culture and ultimately we expect this will result in strong growth in profitable new business, driving cash generation in the future.

For over 200 years Friends Life has built up the expertise to help its customers prepare for the future with confidence, standing with them through life's ebbs and flows, protecting them against adversity and supporting them during and after full time employment. Our commitment to financial discipline and the careful management of our customers' money means they can trust us to commit to a life-long relationship.

This customer focus has never been compromised despite the restructuring and integration programme undertaken over the last three years. We have simplified management structures, upgraded systems, focused current and new business onto target platforms, removed duplication and outsourced non-core functions. We have simplified the structure of our senior executive team. Both our open market business and Heritage division have their own, dedicated Chief Executives. The senior management team has continued to deliver the strategy and this gives me real confidence for the prospects of the business.

Aligning strategic aims with social ones is part of our proud heritage. It runs through everything we do. It can be seen in the design of our insurance products which provide customers with comfort in the face of an uncertain future; in the partnerships we make in our long-term investments that support socially responsible infrastructure projects; most of all it can be seen in our people, who make a difference to both our customers and to the wider community.

Over the last few decades there has been a gradual shift in the corporate benefits market towards defined contribution schemes, shifting the investment risk from the corporate sector to individuals. This has been happening at the same time as state support has been reducing. We believe that we have an important role to play in plugging the savings gap: to help people as they accumulate wealth over their productive working years, as a partner as they make the transition to retirement, and by providing them with a secure income through their retirement. In addition to helping families through the accumulation and decumulation cycle we also provide protection products that provide a safety net for when our customers fall ill.

There are other ways in which we have a role to play in society. The long-term investment horizon for infrastructure projects is an obvious match with the long-term liabilities of insurance companies. In November, we awarded a £500 million mandate to MetLife Investment Management for infrastructure loans. The Group has also agreed a £75 million amortising loan facility with Drax Group plc. This loan will part-finance a £700 million project to convert three of the six plants at Britain's biggest coal-fired power station into the country's largest green energy generator. This is only the beginning. It makes good business sense to contribute to the UK recovery by investing in socially responsible long-term infrastructure projects of this kind.

As a company, we have a clear role to play in the community. This is strongly supported by our employees who engage in a variety of social and charitable initiatives. It is good for the community and good for our people, and is one of the reasons why Resolution is a great place to work. Every year we measure the level of staff engagement and we have seen a strong improvement this year. The Group's strong performance in 2013 was thanks to disciplined execution against a consistent strategy, a stable management, supportive customers and shareholders, and, above all, our great people.

Group Chief Executive's review continued

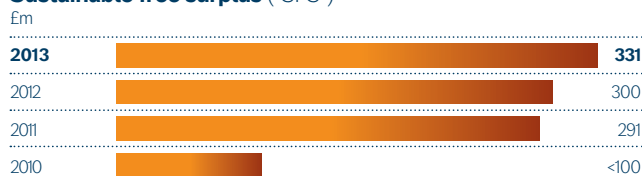
Our journey so far...

Our actions over the last three years have transformed the Group. The completion of the capital optimisation programme, in which the business was re-organised into two UK life companies for closed and open business, drove efficiencies which have delivered a benefit of nearly £300 million to total free surplus over the last three years.

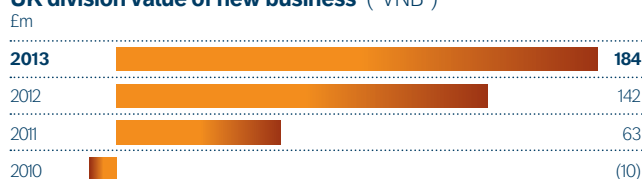
Our approach to managing the in-force book is unique in that we believe that a separate, dedicated management team ensures accountability, rigorous financial discipline and helps drive the focus on cash generation. In 2011 we formed Heritage, our closed book division. Heritage continues to generate cash and drive value through outsourcing of the cost base, capital and risk management initiatives, and the development of in-house investment management capabilities.

As part of our restructuring journey, we have rationalised our open business in the UK, reducing the number of open lines of business to three. The UK division today is focused on Retirement Income, Corporate Benefits and Protection, where we have scale and expertise to grow new business and where we have delivered a turnaround in value generation.

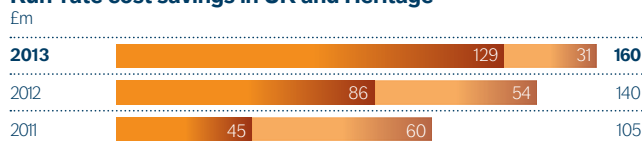
Sustainable free surplus ("SFS")



UK division value of new business ("VNB")



Run-rate cost savings in UK and Heritage



Secured
Delivered

When we started the restructuring and transformation journey, the Group was generating less than £100 million of sustainable free surplus. In 2013, this has risen to £331 million. The value of UK new business was negative three years ago whereas in 2013 our businesses generated £184 million of VNB. This turnaround in profitability has been delivered by applying rigorous financial discipline and we have now reduced our UK and Heritage operating cost base by one-third since 2010.

2009

2010

Acquisition phase

Friends Provident acquired in November

AXA UK Life Business acquired in September

In our International division, we are focused on cash generation and upstreaming dividend payments to the Group. We target low risk, high value new business and have exited those markets that do not fit these criteria. Following the closure or disposal of a number of non-core International businesses over the last 18 months, our core Friends Provident International ("FPI") business offers savings, investment and protection products for expatriates and affluent local nationals in Asia and the Middle East.

In 2014 we will transfer Overseas Life Assurance Business ("OLAB") to our Heritage division following the decision in early 2013 to stop writing new business in Germany. This will allow us to further leverage our expertise in managing closed books in our Heritage division.

The Group is now more efficient, more customer-focused and more profitable. Our cash position has strengthened, capital adequacy is robust and we have delivered strongly against our 2013 new business and cost saving targets.

In 2014 we intend to create a unified brand for the Group, subject to shareholder approval, renaming our parent company Friends Life Group Limited, reflecting the unified structure and governance of the business. This change demonstrates the transformation of the Group and is not only the right decision for shareholders, but will also provide significant benefits from a customer, distributor and colleague perspective.

→ **Evolving customer needs** see page 6
Organised around our market see page 8
How we create value see page 10
Generating value safely see page 64

2011	2012	2013
Restructuring and transformation phase		
Separation and integration project		
Capital Optimisation Programme: simplified legal structure to two operating companies		
BHA acquired in January	Outsourcing of c. 1,900 roles to Diligenta; cost savings of c. £60 million from 2015	Simplified governance structure in March
Launched selective participation strategy in the UK in February	Repaid DCN loan notes and issued re-set perpetual securities in November	Cancelled scrip dividend; launched drip dividend option in March
Heritage business split out as a separate entity with dedicated management in November	Friends Life Investments launched in July	Ceased writing non-core international new business in September
£250 million share buyback completed in October	International Strategic Review in November	Launched lifestyle annuities offering in the open market in December
		£2 billion annuities transferred from with-profits fund to non-profit fund in September
		Friends Life Investments assets reached £17.1 billion
		Key 2013 financial targets achieved

Group Chief Executive's review continued

Operational highlights

Heritage

In June, the Group completed the single largest remaining element of the separation programme, the Application Hosting Migration ("AHM") which moved legacy AXA business applications and IT infrastructure from AXA-Tech to Friends Life.

In the fourth quarter of 2013, the Group executed the first major migration from two legacy administration systems to the BaNCS IT platform operated by one of the Group's strategic partners, Diligenta. This represented a major operational milestone. In addition, as part of a multi-year programme to implement a uniform capital management framework for the with-profits business, circa £2 billion of annuity business has been re-allocated from the with-profits fund to the non-profit fund of Friends Life Limited ("FLL") and is expected to deliver circa £10 million per annum of sustainable free surplus from 2014. This is a significant achievement and a further tranche of with-profits fund reallocations with a value of circa £700 million is being considered in 2014.

This is underpinned by progress in our fixed income in-house asset management operation, Friends Life Investments ("FLI"), which was launched in July 2012. FLI now manages a total of £17.1 billion of Group assets, including £7.0 billion of assets recaptured in 2013. Setting up FLI, and restructuring approximately 20% of the Heritage assets, has saved the Group £5 million per annum, utilising its in-house investment capability and asset liability management skills to support the management of fixed income assets within the annuity, shareholder and with-profit portfolios. In 2014 we anticipate FLI will take responsibility for a further £2.3 billion of Resolution's sterling fixed income assets.

The Group has also announced a new, scalable partnership with Schroders to manage £12.2 billion of equity and multi-asset funds from the fourth quarter of 2014.

→ **Heritage division** see page 35

UK division

We have also made great progress in the UK division. Our Retirement Income strategy is built on the strong foundations of the Heritage and Corporate Benefits pension books encompassing around 50,000 vesting pensioners per year and we made great progress in 2013 with an increase in the number of existing customers choosing to buy an annuity from Friends Life. The proportion of vestings increased to 34% from 25% in 2011. This proportion increases significantly where customers have engaged with our Lifestyle annuity proposition which is designed to deliver better value to customers by taking account of their lifestyle factors to offer a more tailored solution. Having seen this encouraging response from existing customers, we extended our Lifestyle annuity to the open market at the end of 2013 and we anticipate further growth in this area. We have also strengthened the support we offer our customers nearing retirement by launching a "shopping around" service in partnership with Key Retirement Solutions.

In Corporate Benefits we have continued to build scale with assets now at £20.1 billion, an increase of £2.3 billion over the year, whilst maintaining strict financial discipline on attracting new schemes. Over the course of the year 180,000 employees within 274 schemes of 203 employers have "staged" with the Group. We now have sufficient scale to be cash generative on an underlying free surplus basis and remain focused on writing profitable business.

Our values in action

Ease

BMI Healthcare is a long-standing Corporate Benefits client with around 10,000 pension scheme members.

Resolution's team presented our technology and communications solutions to show how we could **make it easy** to transition to auto-enrolment by managing all the communications and employee queries on the client's behalf. BMI Healthcare's pension scheme members were successfully auto-enrolled in November 2013.

In addition, we worked with the pension scheme trustees to move the pensions of deferred members (former employees of BMI Healthcare) to plans operated by Friends Life, enabling the trustees to focus on governing the scheme for the active members currently employed.

Resolution's team also reviewed the scheme's default investment strategy to ensure their existing members could benefit from a modern, well-governed investment strategy. This resulted in the multi-million pound move of around 85% of the scheme's assets to the Friends Life My Future investment programme.

Our values in action

Empathy

When Amanda's 11-month-old daughter Willow was diagnosed with a cancerous tumour in her eye, we **understood the family's needs** and were able to provide the financial peace of mind to enable them to concentrate on caring for their daughter.

Amanda was still on maternity leave, the family's monthly outgoings had increased and they had additional travel costs associated with Willow's medical treatment. They therefore contacted their financial adviser to ask about their critical illness insurance with Resolution.

Amanda and her partner received a payment under the child cover part of their critical illness policy and this payment from Resolution enabled Amanda to leave her job so that she was able to care for Willow full-time.

We have positioned ourselves strongly to take advantage of the opportunities presented by auto-enrolment, with our My Money platform providing a strong proposition in the market. In addition, we launched My Future, a new range of default funds that has had an encouraging early take up.

All Protection new business is now written on our specialist platforms, and this has transformed the profitability of this business which provides highly regarded customer propositions in both individual and group protection. In 2013 we have introduced new solutions that meet our customers' changing needs such as our Cancer Work Support service to help members through treatment, recovery and returning to work.

→ **UK division** see page 39

We also recognise the need for investment in this business to improve IT infrastructure and operational efficiency so that it maintains its competitive advantage in the fast moving markets of Asia and the Middle East. In 2013 we have commenced work on moving our core FPI business onto a standalone platform that works in Asian timezones, currencies and languages. This is both right to drive growth in the business and to give FPI much-needed operational independence from the UK mainframe platform.

We have achieved an enormous amount in 2013 as we completed the restructuring of our business and we are now strongly positioned to build on the growth opportunities.

→ **International division** see page 44

International

Following the strategic review in 2012, we have applied a consistently rigorous approach in the International division, ceasing new business which was unprofitable, sub-scale or out of line with our risk and value criteria.

We completed the sale of our minority stake in AmLife at the beginning of 2013. In line with the 2012 strategic review, non-core operations in Germany and Japan have been closed to new business. FPI continues to make a positive contribution to the Group with a £6 million dividend paid in 2013 and a final dividend in respect of 2013 of £14 million paid in March 2014. Together with the dividends paid by Lombard, the 2013 dividend target for the International division of £33 million was met.

Our values in action

Expertise

Resolution's expertise in retirement income has enabled us to develop our new lifestyle annuity.

There are a number of annuities available catering for people with serious medical conditions. However, by using our knowledge of the annuities market, we developed a new proposition for customers who could qualify for an increased retirement income as a result of lifestyle factors.

Our specialist approach focuses on providing a tailored annuity for customers by complementing the existing underwriting questions with additional lifestyle questions to fully understand the customer's needs. Lifestyle factors such as smoking history, alcohol consumption, occupation and family medical history are all considered as we **share our expertise** with our customers.

In launching this innovative new product, we are seeking to bring the benefits of an enhanced annuity to more people than ever before.

Group Chief Executive's review continued

Our strategy

Our stakeholders

Our strategy is based on meeting the needs of our three key stakeholder groups – our customers, our people and our shareholders. Our competitive advantage is driven by the areas in which we play, and the strength of our people who help us win in these markets. This drives the cash and returns we deliver to investors.

We aim to provide high quality propositions and services that protect our customers during their working lives should they fall ill or die, help them to prepare for a secure retirement and help them optimise returns on the money they save.

We do this by managing the business effectively, creating a working environment where our people are energised to deliver the best service by understanding our customers' needs. We have built a strong, financially disciplined team with distinctive capabilities that will enable us to deliver sustainable cash flows, new business growth and appropriate returns for our investors.

We also remain focused on generating value for our shareholders. We treat different parts of the Group very differently, based on what will secure maximum returns. We are unique in managing a separate Heritage division, and we invest in new business in a very disciplined manner.



Our markets

We only compete in attractive growth markets where we have scale and competitive advantage so that we are able to deliver good propositions for customers whilst generating sustainable cash and returns.

We expect to see growth in each of our chosen open markets. The UK life and pensions market, in particular, will benefit from two key drivers over the next decade:

- legacy life and pensions products, which are largely closed, and need skilled management; and
- a fast growing retirement market.

We are extremely well placed to participate profitably in both of these areas. In Heritage, Corporate Benefits and Retirement Income, where most of our new business comes from existing customers, management have control over many of the levers of value. There are significant revenue synergies across the different parts of the Group. These include the natural flow of business from Heritage and Corporate Benefits into Retirement Income, asset management synergies across Heritage and Corporate Benefits, and between Protection and Corporate Benefits in dealing with the needs of employers. In addition, there are significant cost and capital synergies.

As we deliver profitable new business, we strive to treat our customers fairly, and work together with the government and regulators to achieve this aim. Corporate Benefits and Retirement Income, in particular, are large and fast growing markets and it is right that they are being closely monitored by regulators. The impacts of RDR and recent scrutiny of annuity and pensions charges are still being addressed by the industry, but the overarching ambition of regulators and insurers alike is to give consumers confidence that the advice they are given, and products they buy, are appropriate to their needs.

Legacy life and pension products

Transition to retirement is one of the biggest movements of money UK financial services has ever experienced. The Group has a huge structural advantage in the market, with approximately one in nine of those retiring in the UK being customers of our Heritage or Corporate Benefits business. Historically not enough has been done to support our customers as they transition to retirement and there is a significant opportunity to enhance our capability and leverage the structural advantage and expertise we have.

Over £400 billion of assets across the UK life market are held in funds or product lines that are closed to new business. By their very nature these assets are expected to decline over time. A number of players in the UK today manage sizeable in-force books and have largely fixed cost bases to support these businesses. As their in-force assets decline, the cost of running these books will increasingly become a driver for consolidation in the market.

The skill set required to manage a closed business is distinct from that required for actively marketed businesses with growth strategies. Our Heritage division is a leading specialist in the UK closed book market and we expect to benefit, in due course, from our expertise in this area.

Retirement provision market

The retirement income market is projected to experience strong growth driven by demographic trends in the UK as well as asset accumulation in defined contribution pensions which will fuel annuity markets in the future. We are the second biggest participant in the corporate benefits market which currently has circa £350 billion of assets under administration and this is expected to more than triple by the end of the decade. We believe that most of the growth will be captured within the existing schemes. Given our scale we stand to benefit from substantial growth in assets under administration and hence revenue.

Our Corporate Benefits book, combined with the pensions in our Heritage division gives us access to approximately 50,000 vesting pensioners each year. This feeds our Retirement Income business where VNB increased by 84% between 2011 and 2012 and then grew again by 41% in 2013. This growth is consistent with our customer focus; we are committed to providing products that are appropriate to our customers' needs.

The process of accumulating pension funds and then decumulating them in retirement is complemented by our Protection propositions which offer support to our customers and their families during the key stages of their lives. In a stable marketplace we continue to successfully write profitable new business with innovative new life, critical illness and income protection solutions and services.

All of this is supported by our growing capability in investment management and strategic asset allocation.

International

The markets in which our International division operates are each expected to see future growth, although they are highly competitive and becoming increasingly regulated. Economic and regulatory uncertainty has led to challenging environments for the business, although we expect to grow our share of income among the upper middle and mass affluent markets.

The Group is currently in discussions regarding the potential sale of the Luxembourg based business, Lombard International Assurance. Notwithstanding this, Lombard's strategy remains unchanged with this business continuing to be a leading pan-European specialist in estate and succession planning solutions for high and ultra-high net worth individuals. FPI is well placed to enhance value creation through its portfolio of international licences in Singapore, Hong Kong, UAE and Isle of Man, focusing on profitable growth and cash generation.

→ **Organised around our market** see page 8

Generation of cash and returns

Going forward the strategic focus of the Group will remain on cash and returns generation to investors and shareholders, underpinned by the strict financial discipline that we apply to every business in our portfolio.

We have already made great progress in our existing businesses on the path to this objective:

- our UK businesses have been turned around and are well placed for future growth;
- our Heritage division remains the key source of cash generation today as we continue to drive incremental opportunities for growth from the operation; and
- our International division has met its dividend target for 2013 of £33 million.

Focus on cash generation and financial discipline also sets a framework to consider the Group's participation in closed book acquisitions. We start with confidence that we have a strategy that is delivering growing cash on our current business, and hence are not compelled to do deals. We would only consider acquisitions if this would improve the Group's cash and dividend profile. If we do deploy more capital, we would expect to meet a returns threshold, designed to ensure we achieve appropriate risk-adjusted returns.

We continue to maintain a robust, low risk balance sheet and, while markets have improved over the last few years, we still believe this to be appropriate. As global investment markets improve it is possible to both maintain this low risk approach and invest a proportion of available shareholder assets in order to generate strong, risk-adjusted returns.

We remain committed to our ambitions for ordinary dividend growth. In the past we have based the move to a progressive dividend on the achievement of an absolute amount of distributable cash generation. Going forward there will be a more explicit link between ordinary dividend costs and SFS generation. Our dividend policy is to pay 21.14 pence per share per annum, with the expectation that a progressive dividend will be considered once the coverage ratio of SFS : Dividend costs exceeds 1.3 times. This is broadly consistent with our previous £400 million target but this target is now formally replaced by the coverage ratio. We are confident that we can achieve the 1.3 times coverage in due course through continued focus on capital efficiency, business growth and financial discipline.

To conclude, the last three years have been transformational in the history of the Group. We have combined three disparate businesses and generated capital synergies through that consolidation. We have focused our new business operations on areas where we have scale and competitive advantage, and have closed to new business areas in both the UK and overseas that do not meet this strategic rationale. As a result, we are now a leaner and more focused business, excellently placed to benefit from strong macro drivers in the retirement market, and from further consolidation of closed books. While we have achieved a lot, my real excitement is the prospects for this business over the coming years as we reap the benefits of the changes we have made.

Strategic report

The Strategic report, set out on pages 4 to 69 has been approved by the Board.

On behalf of the Board



Andy Briggs
Group Chief Executive
17 March 2014

Key performance indicators

Set out below are the Group's financial key performance indicators ("KPIs"). These have been updated to reflect the Group's revised financial framework and have been set to align with the Group's ongoing strategy. Further details on the updated financial framework can be found in the Chief Financial Officer's review.

Cash today: Providing insight into the Group's ability to support dividends

Sustainable free surplus ("SFS")

£331m



Performance

Positives

- Continued financial discipline reducing cost of investment in new business by 25%
- Expected return growth reflecting spike in with-profit maturities
- Managing non-core closure to new business reducing drag on surplus generation

Negatives

- Poor performance from Sesame Bankhall Group
- Higher finance costs following debt issue in 2012

Definition

SFS is the free surplus generated within FLG based on expected investment return less investment in new business and excludes operating assumption changes, amortisation and impairment of non-covered business intangible assets, economic variances, non-recurring items and non-operating items. It is presented net of tax.

Free surplus generation ("FSG")

£377m



Performance

Positives

- Positive economic impacts as economy recovers

Negatives

- Increased non-recurring costs reflecting increase in Solvency II spend

Definition

FSG reflects the after tax free surplus generated in the period including both operating and non-operating items.

Cash tomorrow: Looking at the value of tomorrow's cash flows, today

Value of new business ("VNB")

£204m



Performance

Positives

- Strong VNB growth in UK, up 30%, reflecting growth across all business units
- Exits from non-core International business significantly reducing loss on new business

Negatives

- Challenging market conditions for Lombard resulting in a 44% reduction in VNB

Definition

VNB is the present value of future post-tax cash flows on new business written, net of the frictional cost of required capital and the cost of non-hedgeable risk.

Group embedded value MCEV basis

£6,065m



Performance

- Embedded value up 4% in 2013 reflecting the strong operating performance and non-operating economic variances as markets improve. These benefits are partially offset by non-operating expenses and dividend payments

Definition

Group embedded value comprises shareholder net assets on an MCEV basis and the net present value of future cash flows expected to be derived from the in-force business.

Capital strength: Demonstrating the Group's financial strength

IGCA surplus coverage

238%



Performance

- IGCA coverage ratio improved over 2013 with surplus emerging and proceeds from AmLife sale more than offsetting financing and dividend costs

Definition

The IGCA is the calculation of the capital resources and capital requirement as defined by the PRA in the Insurance Groups Directive. The coverage ratio represents the proportion of capital resources to capital resource requirements (excluding WPICC). The position at 31 December 2013 of the Group and its subsidiaries is estimated.

Economic capital surplus coverage

193%



Performance

- Economic capital surplus coverage ratio improved by 8% reflecting economic and experience variance benefits, offset by dividend payments

Definition

Economic capital represents management's internal risk-based estimate of the amount of capital needed to be held to mitigate the risk of insolvency to a minimum of a 99.5% confidence level over a one year period. The coverage ratio represents the proportion of capital resources to capital resource requirements. The position at 31 December 2013 of the Group and its subsidiaries is estimated and unaudited.

Available shareholder assets ("ASA")

£917m



Performance

- ASA increased in 2013 principally reflecting the receipt of dividends from life companies which exceeded dividends paid to the Company's shareholders

Definition

Group ASA consists of cash and financial assets held by the Friends Life and Resolution holding companies, together with any dividends declared and approved from life companies that are yet to be remitted.

Returns: Illustrating the returns achieved from operating activities

IFRS based operating profit

£436m



Performance

- Positives**
- New business strain reduced by 32% reflecting strong financial discipline
 - Improved economic conditions result in lower guarantee reserves in International division
 - Benefits of with-profits annuity reallocation total £76 million
- Negatives**
- Surplus from Heritage in-force book reduced as business runs off
 - Shareholder asset returns lower reflecting reduced long-term investment returns

Definition

IFRS is the primary accounting basis for all EU listed companies. IFRS based operating profit is a component of the IFRS result. It is based on longer term investment return, and excludes non-recurring items, and impairment of acquired intangible assets. It is stated after policyholder tax and deducting interest payable on the Step-up Tier one Insurance Capital Securities.

MCEV operating profit

£489m



Performance

- Positives**
- VNB growth underpinned by strong UK growth and exit from non-core International markets
 - With-profits annuity reallocation benefits total £96 million
 - Favourable impact from recognising value of tax losses
- Negatives**
- Lombard results significantly impacted by challenging market environment
 - Lower expected returns from the in-force book reflecting significantly lower opening rates of return

Definition

MCEV operating profit is based on expected investment return and excludes economic variances, non-recurring items, amortisation and impairment of non-covered intangible assets and other non-operating variances.

Key performance indicators continued

Other performance indicators

Set out below are the Group's other, non-financial, key performance indicators. These reflect our growth strategy in meeting the needs of our colleagues, customers and shareholders.

Customer satisfaction¹

72%



¹ Between May 2012 and October 2013.

Performance

Positives

- Consistent performance; over 70% of our customers consistently rate the overall quality of our products and services as good or very good
- For our Protection customers, this score is 86%
- Our scores have remained stable at a time of economic difficulty and financial uncertainty in the UK

Negatives

- We have an immediate ambition to increase the level of customer satisfaction with our products and services to nearer 80%
- Whilst only 6% of our customers rated us as poor or very poor, over one in five customers did not express an opinion and we are working to reduce this number

Definition

We conduct over 1,600 interviews each year with customers who have recently bought, continue to hold or have recently received the benefits from their Friends Life policy.

This provides us with an overall view of all aspects of our customers' experience with Friends Life from purchase to receiving the benefits of their policy.

Colleague engagement

67%



Performance

Positives

- Colleague engagement levels have significantly improved over the last 12 months, increasing by 11 percentage points to 67% at Group level

Negatives

- Engagement levels are beneath the Financial Services industry benchmark of 73%
- We aspire to be at least as good as the wider Financial Services industry and will continue to work towards achieving this

Definition

Colleague engagement is measured across an index of 6 questions relating to advocacy, retention, and effort in relation to working at Friends Life. Colleagues are surveyed twice a year.

Achieving the high level of commitment that comes from an engaged workforce is an enabler of our growth strategy.

Women in senior management

26%



Performance

Positives

- Andy Briggs, Group Chief Executive personally sponsors the Group Diversity agenda and related programme of initiatives
- 26% of women in senior management can be considered a reasonable foundation
- We have plans in place to support women as they progress into senior leadership roles including networking sessions, mentoring programmes and enhanced diversity training for line managers

Negatives

- Friends Life aspires to a greater gender balance and proportion of women in senior leadership roles

Definition

This measure refers to women in Senior Management grades (roughly equating to our top 150 leadership positions).

We want to help female colleagues to realise their potential and remove any potential barriers to career progression, including into senior leadership roles.

Equal opportunities

73%



Performance

Positives

- 73% of colleagues surveyed feel they have equal opportunities, which can be considered a strong position to improve on
- Our current diversity initiatives have initiated a cultural shift in the organisation and, in the longer term, will lead to a higher number of colleagues feeling positive about developing and progressing their careers in Friends Life

Negatives

- Of colleagues surveyed 16% are neutral and 11% are negative in their response

Definition

Percentage of surveyed employees who feel they have equal opportunity for development and career progression.

We want all our colleagues to feel they have the opportunity to develop, progress their careers within Friends Life and contribute fully to our business success.

Community investment

£1.9m



Performance

Positives

- 81% of colleagues feel that Friends Life is socially responsible
- Annual community investment has increased by 58%
- £140,000 was raised by colleagues for Macmillan in 2013
- Over 700 days of colleague time was invested in local community volunteering projects

Negatives

- There is still work to do to achieve greater levels of colleague engagement in our volunteering activities and this is being embraced as part of our Community Investment Strategy (see pages 60 to 63)

Definition

Community investment refers to the annual investment in community involvement and fundraising activities and is measured through colleague feedback, annual spend and number of colleague days invested.

Community investment reflects our core business purpose and leads to higher levels of colleague engagement.

Chief Financial Officer's review

Disciplined investment, generating cash and returns

Introduction

Three years ago we set out on the journey to build the Friends Life group. Throughout this journey, 2013 has been a key milestone for us and I'm pleased to report that the restructuring phase is now complete. We have integrated the three acquired businesses, delivered targeted cost savings and are working with our outsourcers to finish the migration of legacy platforms to deliver the remaining secured cost savings. Financial targets were put in place at the outset, and whilst economic conditions have not made progress smooth, I am pleased to be reflecting on the delivery of some material achievements.

Over the years, the Group's transformation has been extraordinary. The activities to separate, integrate and transform the acquired businesses have been especially pleasing with our success demonstrated through improved profitability, greater capital efficiency and enhanced competitiveness of the business. The life operating businesses are now tangibly different from those acquired.

Delivering cash today and securing cash tomorrow, whilst maintaining a strong balance sheet, is reinforced by the Group's strong 2013 operating performance across all measures. Cash generation today remains strong, underpinned by a culture of innovation, whilst cash generation tomorrow is now well embedded in the Group's new business capabilities.

Tim Tookey
Chief Financial Officer



Chief Financial Officer's review continued

Financial performance

£m (unless otherwise stated)	2013	2012
Sustainable free surplus	331	300
Free surplus generation	377	215
Value of new business	204	194
Group embedded value on an MCEV basis	6,065	5,831
IGCA surplus coverage ratio ⁽ⁱ⁾	238%	221%
Economic capital surplus coverage ratio ⁽ⁱ⁾	193%	185%
Group available shareholder assets	917	850
IFRS based operating profit	436	274
MCEV operating profit	489	382

(i) 2012 IGCA and economic capital surplus has been revised to include Resolution entities. These measures were previously presented at the FLG level.

The results in the table above show an improving picture of cash generation, profitability and capital discipline and underpin our confidence that we have the right strategy.

The Group generated sustainable free surplus of £331 million in the year, up 10% on 2012. This is a strong performance and continues to highlight our focus on delivering cash to support our dividend. In 2013 we have maintained our financial discipline and reduced the cost of investing in new business by a further 25%. Importantly, this includes actions taken in the UK division where improvements in efficiency have reduced the free surplus cost of writing new business by 8%.

Benefits have also been realised in the Heritage division and non-core International business, where lower sales increments through either natural run-off or active market-exit decisions have resulted in reduced new business costs.

Development spend has been maintained at a relatively stable level in 2013. Notwithstanding this we do expect to invest additional funds in 2014, circa £15 million, focused on the development of the Retirement Income business.

The Group has delivered an increase in expected returns, outside those achieved on shareholder funds, across all divisions. As reported in our 2013 half year results, this improvement reflects the benefit of surplus emergence from new business written in 2012 as well as higher with-profits fund product maturities.

The generation of free surplus from our in-force books and subsequent investment in new business are core drivers of the sustainable free surplus result, and are key to our ongoing dividend policy. In line with this policy, a 2013 final dividend of 14.09 pence per share has been proposed subject to shareholder approval. This equates to a cash cost of £200 million, giving total expected dividend payments of £300 million in respect of 2013, and is covered 1.1 times by sustainable free surplus earnings.

Free surplus generation as a whole is up 75% to £377 million and largely reflects the benefit of positive economic variances in 2013 with narrowing credit spreads following increased confidence in the economy. It is widely acknowledged that, whilst confidence in the economy is not at the level it was before the financial crisis, it has improved markedly in 2013.

Group IFRS based operating profit of £436 million is up 59% on that delivered in 2012. Excluding the £(82) million impact of the International strategic review in 2012, the Group result is up 22% in 2013. One of the key drivers of this is the reduction in new business strain, similar to that seen within sustainable free surplus.

In-force surplus returns are up across the majority of divisions with economic improvements benefiting both the increase in annual charges as well as reducing the cost of guarantees, particularly in our non-core International business. Surplus generation has also benefited from continued maintenance cost control in the UK and Heritage divisions with the International division also benefiting from the absence of costs relating to the strategic review in 2012.

Heritage division initiatives have contributed favourably to the Group results with the reallocation of circa £2 billion of with-profits fund annuities to the non-profit funds contributing £76 million to the IFRS based operating result. This continues the Group's approach to strong and effective with-profits risk management.

The Group's MCEV operating result of £489 million is up on the £382 million reported in 2012 albeit the 2012 result included a £(94) million impact from the International strategic review. Excluding this impact, the 2013 result is up 3% and reflects a number of key factors.

New business VNB has increased 5% on 2012 with a strong UK division performance, up 30%, partially offset by reductions elsewhere. The operating performance also includes a £96 million benefit in the Heritage division from the annuity reallocation programme, with this slightly higher than the IFRS impact due to the recognition of additional VIF benefits.

As reported in the 2013 half year results, the impact of lower expected rates of return has materially reduced the returns generated from the in-force book. Expected existing business contribution in 2013 is therefore £77 million lower than in 2012. The rates applied to the opening balance sheet are shown below including the cash and gilt rate which halved to 0.67%. The table also shows the rates expected to be used in our 2014 results which, whilst higher in many cases, remain low for cash and government bonds.

%	Rates used for expected return contribution		
	2014	2013	2012
Reference rate:			
non-annuity business	0.71	0.67	1.35
annuity business	1.31	1.42	2.25
Best estimate returns:			
corporate bonds ⁽ⁱ⁾	1.85	2.25	3.30
cash/Government bonds	0.71	0.67	1.35
equity	6.10	4.90	5.40
property	5.10	3.90	4.40

(i) Returns on corporate bonds vary by portfolio with the rates shown being a weighted average.

Group embedded value, on an MCEV basis, is a key measure of the Group's future cash generation ability and has increased to £6,065 million in 2013. The operating performance has been an important element of this growth, together with the benefit of narrowing credit spreads, as seen in free surplus generation, which have combined with equity market improvements to make a material contribution in 2013.

In November we notified the market that we were in discussions regarding the potential sale of Lombard and as at the time of writing these discussions are continuing. Disappointingly, 2013 has been a challenging year for Lombard with market conditions in Luxembourg and some core markets, notably Belgium, undergoing regulatory and legislative changes. These factors combined with the uncertainty about Lombard's ownership have to varying degrees impacted new business volumes, whilst the change to arrangements under which Belgian nationals could repatriate funds has materially impacted persistency levels in this market. As a result Lombard has contributed an operating loss of £(46) million to the 2013 Group MCEV results.

The capital position of the Group remains strong with the Group's estimated IGCA surplus at £2.2 billion representing a coverage ratio of 238% (31 December 2012: £2.2 billion, coverage ratio 221%). The Group's estimated economic capital surplus also remains strong at £3.9 billion with a coverage ratio of 193%.

Available shareholder assets ("ASA") of £917 million (31 December 2012: £850 million) reflect the continued strong cash generation within the life businesses. The life companies have paid £383 million of dividends in respect of 2013 to the Group holding companies. These dividends include £33 million from the International division.

Free surplus emergence

The estimated emergence of surplus from the UK and Heritage divisions' in-force book over the next 10 years is shown in the chart below. The estimates provided last year in respect of the five years through to 2017 are also shown, adjusted to include returns on shareholder assets. In comparison with the high-level estimates provided in 2012, free surplus generation in 2013 has been stronger at £541 million reflecting a spike in with-profits fund maturities.

The continued growth of free surplus generation from the in-force book is fundamental to the Group's ability to grow sustainable free surplus and as a result move on to a progressive dividend policy. The updated expectations for surplus generation shown below highlight a step up in ongoing surplus generation, with this growth expected to be split evenly between the UK and Heritage divisions and more than offsetting the run-off of the in-force book.

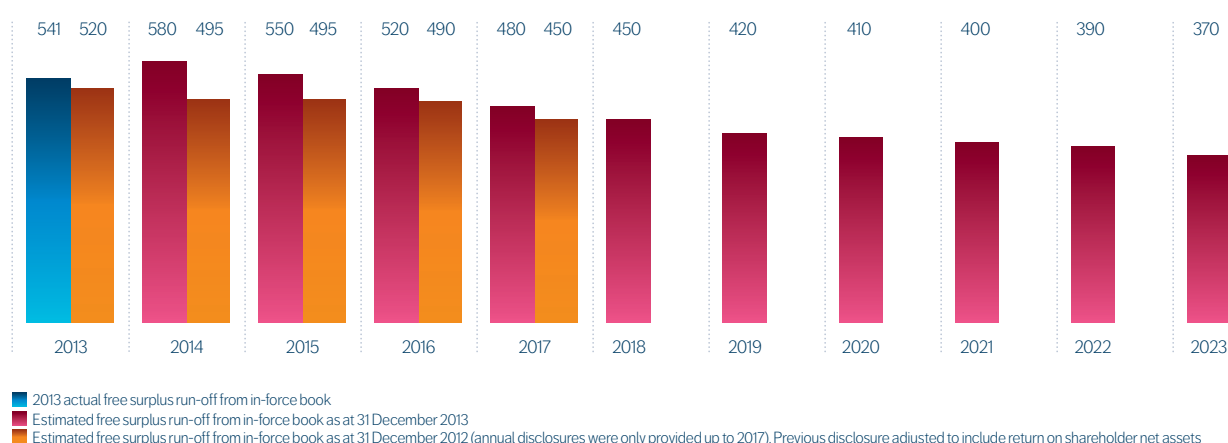
In the UK division the investment in profitable new business will be a key part of this growth, with the updated cash profile now including the benefit of new business written in 2013.

In the Heritage division, and as reported in our 2013 half year results, we have undertaken a number of initiatives, principally aimed at reducing the impact from the run-off of the Heritage book. These include the first tranche of with-profits annuity reallocations, which was completed at a free surplus cost of £(16) million in the second half of 2013, and the transfer of fixed income asset management in-house to the FLI team.

Supporting this performance, the cash run-off profile reflects year end economic benefits, with future returns now including the benefit of higher equity market levels at the end of 2013.

Going forwards, we expect to continue growing the contribution from new business and delivering on Heritage initiatives which gives us increased confidence in our ability to offset the future run-off.

UK and Heritage – Estimated expected return from in-force business (including returns on shareholder net assets)
£m



Chief Financial Officer's review continued

Target deliveries

Em (unless otherwise stated)		2013 Targets	2013 Actual	2010 Full year (baseline)
Corporate Benefits	VNB	25	26	(23)
	NBS	(75)	(51)	(80)
	IRR	10%+	8.4%	4.2%
Protection	VNB	80	75	(20)
	NBS	(30)	(5)	(193)
	IRR	20%	13.8%	3.3%
Retirement Income	VNB	50	83	33
	IRR	15%+	25%+	16.5%
FPI core business and Lombard IRR		20%	12.0%	n/a
Group IRR		15%+	15.3%⁽ⁱ⁾	8.6%
UK and Heritage new business cash strain reduction		£200m reduction	£251m reduction	n/a
UK and Heritage cost reductions		126	129⁽ⁱⁱ⁾	–
International division dividends		33	33	–

(i) 2013 Group IRR includes the benefit of discretionary investment of shareholder assets in the with-profits annuity reallocation. Excluding this, the Group IRR is 11.2%.

(ii) With 2015 target of £160 million also secured.

We have made good progress in 2013 and I am pleased to be reporting on the successful delivery of our key 2013 financial targets. These have been achieved despite the relatively turbulent macroeconomic environment.

New business targets

New business profitability, a key growth measure for the Group, has been of particular importance. Historically, the legacy business did not deliver adequate returns. The UK businesses have undergone radical change, closing unprofitable lines and moving to more efficient platforms. New products have been designed to better meet our customers' changing needs and we have ensured that we are well placed to support customers by only competing in areas where we have scale and competitive advantage in attractive growth markets.

Financial discipline has been consistently applied, demonstrated in 2012 when the Group, a year earlier than targeted, achieved its goal of a £200 million reduction in UK and Heritage new business cash strain whilst at the same time delivering significant increases in VNB. I am delighted that progress on this front has continued in 2013 with new business cash strain now reduced by £251 million, which, along with the annuity reallocation programme, supported the delivery of a Group IRR of 15.3%, above the 15% target.

As previously reported, much of the improvement in new business profitability has been driven by the 'migration' of new business to more efficient platforms and the delivery of targeted cost reductions. This is particularly evident in the Protection business which contributed £75 million VNB at an IRR of 13.8% in 2013 compared to a loss in 2010. Whilst the performance of this business is marginally below the targeted levels, I am delighted with the level of profitability this business has achieved.

The Corporate Benefits business is a key business for the Group and one which continues to be subject to numerous regulatory changes. The business has been well prepared for these trends, principally RDR and auto-enrolment, and whilst the IRR target has not been achieved, this business has successfully delivered £26 million of VNB in 2013, up 24% from 2012 and exceeding the target level of £25 million. Going forwards we expect to monitor the performance of the Corporate Benefits business unit through its ability to generate underlying free surplus. This is covered in more detail in the financial framework section that follows.

The Retirement Income business has had another strong year building on the 2013 targets achieved 12 months ahead of schedule. The business is a key growth area for the Group with a contribution from new business of £83 million in 2013 up 41% on 2012. We aim to develop the product propositions with the enhanced annuity product now well established and the business's recent entry into the open market has already seen a good flow of enquiries and quotations established. These channels will provide greater product coverage for our customers which we expect will support the higher proportion of customers choosing to stay with the Group in retirement.

Cost savings

The Group has made great progress over the last few years to deliver the targeted UK and Heritage divisions' cost savings and as at the 31 December 2013 has achieved run-rate savings of £129 million, marginally ahead of the £126 million target. In addition to the savings already achieved, the Group has secured the delivery of the remaining £31 million run-rate savings due to be delivered by the end of 2015. The Group's outsourcing arrangements are the main driver of these contractualised savings and will take total run-rate savings to £160 million. We will of course continue our

focus on efficiency and effectiveness but we will not be setting new cost saving targets.

In line with our focus on financial discipline, we have continued to reduce the Group's operating expense base. Group operating expenses totalled £584 million in 2013, a 5% reduction on 2012. The UK and Heritage divisions have been principal drivers of this reduction.

As reported in our interim results, we completed the single largest remaining element of the Group's separation and integration programme in June. This completed the move from the Group's historic IT infrastructure with AXA-Tech to Friends Life. Alongside this, the continuing work with our outsource providers has resulted in a number of IT services moving to Diligenta in March 2013.

International targets

In November 2012, the Group set out a revised strategy for the International division. This included the exit from a number of markets and the sale of the Group's Malaysian joint venture, AmLife (AmLife Insurance Berhad and AmFamily Takaful Berhad). I'm delighted with the progress made on this front and the swift action taken to exit unprofitable areas of this division. However, notwithstanding the good operational performance, the International division has continued to experience challenging competitive conditions particularly in Lombard. As a result, new business profitability has fallen in 2013 and the International division core new business IRR, including Lombard, of 12.0% remains below the targeted level of 20%.

The Group also set dividend expectations for the FPI and Lombard business units, with these commitments in respect of 2013 amounting to £33 million (FPI £20 million; Lombard £13 million). Both businesses have met these commitments with FPI and Lombard paying £14 million in 2013 with a further total of £19 million paid in January and March 2014.

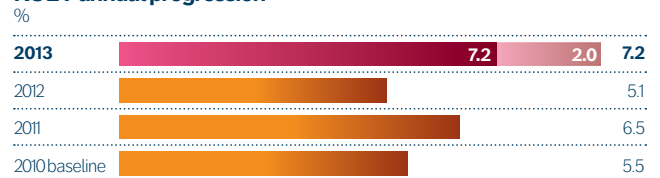
Medium-term targets

As previously reported, the macroeconomic environment is vastly different from that prevailing at the time the Group's targets were set. Although market conditions are currently improving, the returns achievable at present are significantly lower than in 2010. This has materially impacted the Group's ability to deliver the returns required to achieve both the £400 million cash generation from sustainable sources and 10% return on embedded value although neither of these targets were set for 2013.

Cash generation has been hindered by the reduced ability to generate surplus from shareholder net assets with cash and gilt

returns significantly lower than in 2010. Similarly, reflecting the principles of MCEV reporting, the impact of a lower risk free rate has reduced the expected returns generated from the in-force book. At the end of 2012 we reported that opening 2013 returns would be lower than in 2012, including a 50bps reduction in equity returns. Whilst this is a material reduction in its own right, it also continues the trend seen since 2010. In 2013, expected returns, which are set using risk-free interest rates, are significantly lower than those applied in 2010 (equity returns down 240bps, corporate bond returns down 110bps and cash returns down 34bps). This is estimated to have had a circa 2% impact on 2013 MCEV operating returns. Adjusting for this reduction we estimate that, with all other things being equal, we would have expected to achieve an ROEV in the region of 9.2% in 2013.

ROEV annual progression



■ Impact of lower expected rates of return in 2013 compared to 2010.

Financial framework

The transformation of the Group over recent years has been completed under the spotlight of a large number of financial targets, KPIs and additional metrics. The majority of these emerged over the acquisition phase of the UK Life Project with a number of the targets due for delivery at the end of 2013. As 2013 and associated targets are now behind us, the Group has revisited its financial framework. The revised framework ensures that the way we measure the performance of the business is aligned with our aim to generate suitable returns through the delivery of cash today and tomorrow whilst maintaining a strong capital base and allowing sufficient flexibility for financially disciplined investment.

We are transitioning to the Solvency II regime, building on our current, well-established economic capital models and processes. We are currently discussing our approach to implementation of Solvency II with the PRA (ie standard formula or internal model) and expect to enter the process for PRA approval of our internal model ("IMAP") such that approval is granted before the end of 2016. Although the final guidelines for calibration of the standard formula approach have not yet been released, our current expectation is that this would not give the most appropriate assessment of our solvency position. We do not currently expect to gain any capital

“Significant progress made in delivery of cost savings and closure of unprofitable business lines.”

Chief Financial Officer's review continued

benefit from IMAP, but continue to monitor this closely as further guidance emerges and our discussions with the PRA continue.

Strong capital base

As a long-term savings and insurance business, we maintain a strong balance sheet to assist us in meeting the needs of policyholders and generating returns for shareholders. This means that we not only hold assets to cover expected payments to customers but also include additional solvency requirements to allow for future uncertainty. We currently maintain and monitor our solvency capital position on two bases, being IGCA and economic capital. We will continue to report both these measures, with economic capital surplus now also included as a Group KPI.

We will also continue to report on our stock of available shareholder assets ("ASA"), previously known as available shareholder cash ("ASC"). In prior years, ASA has been invested entirely in cash or cash equivalent assets, with this mirroring the low risk appetite applied to shareholder funds. In line with previous communications and reflecting increased confidence in the macroeconomic environment, it is now appropriate to invest a proportion of these lower returning cash assets in higher risk-adjusted yielding asset classes. Following the streamlining of the Group's governance structure, we have also recalibrated the prudence buffer held within ASA. This has been changed to reflect one year's dividend and corporate holding company costs, equivalent to £325 million at the end of 2013 based on current ordinary dividend and expense levels.

Finally, we have removed shareholder asset quality from our KPIs. This measure was introduced at the height of the financial crisis and highlighted the strength of our balance sheet. We have consistently maintained a high level of asset quality since the inclusion of this measure as a KPI and now consider that the prominence of this measure can be reduced. Whilst this measure is no longer a KPI, we will continue to report shareholder asset quality within the financial performance section of the strategic report.

Delivery of cash today

The delivery of cash today and the continued focus on growing cash tomorrow are fundamental to the Group's ability to move to a progressive dividend policy. We continue to consider SFS the most appropriate metric for demonstrating the Group's cash generation abilities. However, there are areas where additional information will be provided to make it clearer how our business units contribute to this measure.

The Group currently writes both insurance and asset-based savings business. For insurance products such as those sold by our Protection and Retirement Income businesses, the current free surplus presentation, showing the investment in new business and expected return on in-force, works well. This is because the terms of customers' policies are largely established at the point of sale, allowing the related costs and benefits to be allocated between new business impact and in-force surplus benefit. This also applies to the VNB measure, where future expectations of cash generation are recognised when the product is sold.

For asset-based businesses, such as Corporate Benefits and Lombard, the growth in assets over the life of the policies is a key driver of cash generation but is not recognised in VNB or SFS investment in new business. For this reason we will no longer focus on the VNB of asset-based business, even though this business will continue to contribute to the Group metric. Instead we will extend the analysis of surplus generation for this business as follows:

£m	Corporate Benefits	Lombard	Total 2013
Income	110	139	249
Outgoings	(94)	(110)	(204)
Other	(5)	(9)	(14)
Asset-based underlying free surplus generation	11	20	31

Income represents the expected charges earned in the period across both new business and the in-force book. Similarly, outgoings include both costs incurred in writing new business (acquisition costs) and servicing the in-force book (maintenance costs, investment management fees and renewal commission). We believe that for asset-based businesses this presentation establishes a more holistic view of their cash generation ability and will help inform the choices available and decisions taken when writing new business.

In 2013, Corporate Benefits delivered a positive underlying free surplus with income (62bps) in relation to opening assets under administration exceeding outgoings (53bps) on this business for the first time. This is an inflection point for this business and highlights the benefit of scale and tight cost control with assets under administration now exceeding £20 billion.

So, in summary, 'cash today' metrics will be split between insurance and asset-based business and into primary and secondary metrics as set out below:

	Insurance	Asset-based
VNB	✓	✓
IRR	✓	✓
INB	✓	✓
Payback	✓	n/a
Net fund flows	n/a	✓
Income bps	n/a	✓
Outgoings bps	n/a	✓
Regular premiums	n/a	✓

✓ Primary reporting metric

✓ Secondary reporting metric

Cash tomorrow

Notwithstanding the focus on cash, other measures, such as VNB, continue to be relevant in understanding the Group's cash generation potential. VNB as a measure of new business profitability is not new to the Group and has been a key target for elements of the business.

In recent years, we have delivered exceptional VNB growth rates, particularly in the UK division, with much of this improvement delivered through the integration of the acquired businesses, focus on target platforms and continuous financial discipline. Going forwards, whilst we do not expect this rate of growth to continue, it is our ambition to grow Group VNB at around 10% per annum. Although we expect the primary driver of Group VNB growth to be our Retirement Income business, it is not our intention to set specific business unit level ambitions and VNB will be a Group KPI managed at Group level. In addition, we will continue to focus on the intrinsic profitability of new business. To demonstrate this, we remain committed to the delivery of a new business IRR of 15% across our open insurance businesses.

Alongside new business growth we expect to deliver growing sustainable free surplus through ongoing scale efficiencies in the asset-based businesses and the completion of further Heritage initiatives. Reflecting our increased confidence in the macroeconomic environment and our desire to diversify our investment approach, thereby optimising returns for customers and shareholders, we intend to increase risk-adjusted returns in our shareholder-backed annuity portfolios.

Returns

The changes to our KPIs reflect the Group's focus on cash generation. This means that we are more focused on reporting earnings emerging from existing business with consideration for the key constraints such as the need to hold solvency capital.

Free surplus generation has therefore replaced IFRS and MCEV results after tax as a KPI, strengthening the link between the ongoing performance of the Group, described by SFS, and the total returns generated including economic movements and non-operating expenses. Similarly, we will no longer report FLG operating ROEV as a KPI. Whilst we continue to believe a 10% ROEV is achievable in a better economic climate, we are focused on the Group's cash generation performance and do not believe that ROEV is the best measure of this. Consequently, we will increase our focus on a returns measure that compares sustainable free surplus to shareholder net worth (that is, total free surplus and required capital). In normal circumstances we would expect our ambition for this 'cash return' to be above 25%.

We will continue to report IFRS and MCEV profit after tax as well as ROEV within the detail of the strategic report.

Dividend progression

Aligning the KPIs with the measures through which we intend to manage the Group is an important step in delivering our dividend growth ambitions. We are also updating our ordinary dividend policy. The previous commitment of considering a move to a progressive dividend when distributable cash generation reached £400 million is being replaced by a policy that relates ordinary dividend cost coverage to SFS generation. Our ordinary dividend policy is to pay 21.14 pence per share per annum, with the expectation that a progressive dividend would be considered once the coverage ratio of SFS:Dividend cost exceeds 1.3 times. This is broadly consistent with our previous £400 million commitment based on a current dividend cost of £300 million. Our SFS of £331 million currently remains outside this range at 1.1 times, however, we are confident that we can achieve the 1.3 times coverage in due course (and thus trigger a review of the move to a progressive dividend) through continued focus on capital efficiency, business growth and financial discipline.

Capital

Strong capital base

Cash today

Dividend cover of >1.3x

Cash tomorrow

Group VNB growth of 10% p.a. & IRR of 15% across open insurance businesses

Returns

Maintain 'cash return' measure above 25%

Dividend

Consider move to a progressive dividend on achieving >1.3x coverage

Outlook

I am delighted with the progress the Group has made over the last few years and am confident that the Group will continue to progress against its key strategic objectives. We have now established a new financial framework and as we transition over the next few years to an economic capital based Solvency II regime, this will ensure that the Group's performance is appropriately measured and supports decision-making in line with the Group's strategy and focus.

Looking forward, we will continue to develop the Group's key strengths particularly in the management of closed books and in the retirement income market, supporting the delivery of positive outcomes for both customers and investors alike.



Tim Tookey
Chief Financial Officer

17 March 2014

Financial review

Group results

Group operating results

Shown below are the Group operating IFRS, free surplus and MCEV results. Further detail on business unit performances can be found in the sections that follow.

£m						
Group IFRS operating results	UK	Heritage	Int'l	Corporate	2013	2012
New business strain	(1)	(25)	(71)	–	(97)	(142)
In-force surplus	69	264	208	–	541	550
Long-term investment return	13	(84)	(1)	3	(69)	(23)
Principal reserving changes and one-off items	8	141	15	–	164	(23)
Development costs	(30)	(7)	(13)	–	(50)	(50)
Other income and charges	(19)	2	(2)	(34)	(53)	(38)
IFRS based operating profit/(loss) before tax	40	291	136	(31)	436	274
Group operating free surplus generation						
Expected return from in-force business	99	442	141	–	682	668
Investment in new business	(98)	(30)	(85)	–	(213)	(285)
Underlying free surplus generation	1	412	56	–	469	383
Development costs	(23)	(7)	(11)	–	(41)	(38)
Coupon on external debt	–	–	–	(92)	(92)	(73)
Coupon on internal debt	–	–	–	–	–	(12)
	(22)	405	45	(92)	336	260
Operating experience variances	(11)	27	9	–	25	(31)
Other operating variances	15	(1)	(12)	–	2	86
Other income and charges	(22)	–	(2)	(8)	(32)	(15)
Sustainable free surplus generation	(40)	431	40	(100)	331	300
Operating assumption changes	17	48	(13)	–	52	(68)
Operating FLG free surplus generation	(23)	479	27	(100)	383	232
Group MCEV operating results						
Value of new business	184	(19)	39	–	204	194
Expected existing business contribution	60	211	52	(75)	248	325
Operating experience variances	(33)	(12)	(12)	–	(57)	(56)
Operating assumption changes	(6)	93	(68)	–	19	(9)
Other operating variances	36	127	15	–	178	27
Development costs	(30)	(7)	(13)	–	(50)	(50)
Other income and charges	(19)	–	(2)	(32)	(53)	(49)
MCEV operating profit/(loss) before tax	192	393	11	(107)	489	382

Non-operating results

£m		
Group IFRS results	2013	2012
IFRS based operating profit before tax	436	274
Short-term fluctuations in investment return	182	275
Gain on sale of associates (AmLife)	20	–
Other non-recurring items	(151)	(258)
STICS ⁽ⁱ⁾ interest adjustment to reflect IFRS accounting for STICS as equity	31	31
IFRS profit before acquisition accounting adjustments and shareholder tax	518	322
Amortisation and impairment of acquired in-force business	(392)	(417)
Amortisation and impairment of other intangible assets	(91)	(97)
IFRS profit/(loss) before shareholder tax	35	(192)
Shareholder tax	200	151
IFRS profit/(loss) after tax	235	(41)
Group free surplus generation		
Operating FLG free surplus generation	383	232
Economic variances	264	120
Capital optimisation programme	–	101
Other non-operating items	(249)	(208)
FLG free surplus generated	398	245
RSL income and charges	(21)	(30)
Total free surplus generated	377	215
Group MCEV results		
MCEV operating profit before tax	489	382
Economic variances	412	154
Amortisation and impairment of non-covered business intangible assets	–	(15)
Non-recurring costs	(181)	(255)
Other non-recurring items and non-operating variances	38	128
MCEV profit before tax	758	394
Tax	(179)	(126)
MCEV profit after tax	579	268

(i) Step-up Tier one Insurance Capital Securities.

Financial review continued

Group IFRS: non-operating results

Short-term fluctuations in investment returns on assets backing the shareholder and non-profit funds amounted to a favourable £182 million. This principally reflects the release of credit default reserves and annuity portfolio mismatch variances, where the liabilities are matched on a realistic basis as opposed to the reported regulatory basis.

Gain on sale of associates of £20 million reflects the profit on the sale of the Group's 30% stake in AmLife (AmLife Insurance Berhad and AmFamily Takaful Berhad), which was completed on 4 January 2013.

Other non-recurring items of £(151) million include:

- separation and integration programme costs, net of provision releases, of £(24) million;
- outsourcing implementation costs of £(65) million;
- finance transformation costs of £(49) million largely relating to Solvency II; and
- other non-recurring costs of £(13) million include costs of the 2013 capital optimisation programme amounting to £(9) million and strategic review fees of £(4) million.

A shareholder tax credit of £200 million is recognised for the year. This tax credit is different from the expected shareholder tax on a profit before shareholder tax of £35 million. The difference includes £70 million in respect of the reduction in the rate of UK corporation tax, and a further £70 million in relation to tax reliefs, charges and expenses predominantly in relation to the life insurance companies in the Group, which are taxed on the "I minus E" basis. The difference also includes £25 million in respect of the use of previously unvalued shareholder tax losses, £21 million from adjustments relating to prior periods and a net £22 million from various adjustments such as the impact of lower tax rates on overseas business and the non-taxable gain on the disposal of the Group's holding in AmLife.

The tax credit in relation to the amortisation and impairment of AVIF and other intangibles in the year, including the associated impact of the reduction in the corporation tax rate, is £185 million.

Group free surplus generation: non-operating results

Economic variances combine the impact of changes to economic assumptions with the investment return variances over the year. Total economic variances in 2013 had a £264 million positive impact on free surplus. A £156 million positive impact resulted from annuity business, primarily as a result of the unwind of credit default allowances, in addition to an assumption change to reduce future credit default allowances due to the narrowing of corporate bond spreads in 2013. A further £108 million positive impact resulted on other lines of business, primarily due to movements in interest rates and equity markets during the year.

Other non-operating items of £(249) million include £(151) million of non-recurring items, consistent with those reported within the IFRS result. In addition, there is a net impact of £(98) million from items specific to free surplus, including £(89) million in respect of a provision made to contribute towards the deficit reduction plan for the Group's defined benefit pension scheme.

RSL income and charges of £(21) million relate to corporate costs incurred within the Resolution Limited holding company.

Group MCEV: non-operating results

Economic variances combine the impact of changes to economic assumptions with the investment return variances over the year. Total economic variances in 2013 had a £412 million positive impact on MCEV profit before tax. Corporate bond spreads narrowed by around 50bps over the period which resulted in an increase in MCEV profit of £318 million, primarily in respect of annuity business in the UK and Heritage divisions. The equity market movements increased the value of future annual management charges on unit-linked business, resulting in an increase of £354 million. These positive movements were partially offset by a £(210) million charge from an increase in long-term interest rates from low opening levels, and a further £(50) million charge principally from an increase in assumed expense inflation.

Non-recurring costs in 2013 total £181 million and include costs of £151 million, consistent with those reported within the IFRS result, in addition to net costs of £30 million specific to MCEV. The £30 million specific to MCEV includes a £7 million difference between the actual tax relief expected and the notional tax gross up applied to all non-recurring costs under MCEV. The application of these different tax rates results in a higher cost, gross of notional tax, under MCEV than under IFRS. In addition, a further provision of £20 million for Solvency II costs is partially offset by the release of £(6) million of provisions for the Diligenta outsourcing under MCEV. The balance of non-recurring and non-operating variances represent the impact of the additional 1% reduction in the rate of Corporation Tax from 1 April 2015 announced on 20 March 2013.

Group net assets and shares in issue

£m	2013	2012
Total IFRS net assets	5,549	5,698
Net Group MCEV	6,065	5,831
Shares in issue⁽ⁱ⁾	1,417,508,151	1,418,109,028

(i) Adjusted to exclude 600,877 Resolution Limited shares held by subsidiaries at 31 December 2013 (31 December 2012: nil)

At 31 December 2013, IFRS total equity was £5,549 million (31 December 2012: £5,698 million), with equity attributable to equity holders of the parent of £5,229 million (31 December 2012: £5,377 million). IFRS net assets per share attributable to shareholders were £3.69 (31 December 2012: £3.79) based on shares in issue at the balance sheet date.

Net Group MCEV was £6,065 million (31 December 2012: £5,831 million) giving MCEV per share of £4.28 (31 December 2012: £4.11).

Heritage division

2013 highlights

- Reallocation of with-profits annuities (phase 1) completed, circa £2 billion of annuities transferred from with-profits fund to FLL non-profit fund as part of the with-profits annuity reallocation programme. This transfer is expected to provide future free surplus benefits of circa £10 million per annum.
- Service improvement programme achieved a key milestone, with the transfer of policies from two legacy administration systems to the Diligenta BaNCS IT platform in December.
- Internal company restructuring completed, delivering material operational simplification and leaving only two UK based life companies, broadly aligned with the UK and Heritage divisions.
- Heritage IFRS based operating result of £291 million (2012: £332 million) with a reduction from the run-off of the business and lower interest rates, partially offset by increased one-off benefits driven by the with-profits annuity reallocation activity.
- SFS generation of £431 million (2012: £489 million) reflecting strong in-force surplus emergence but with the material prior year one-off benefits not fully repeated in 2013.
- MCEV operating profit of £393 million (2012: £359 million) reflecting the impact of the with-profits annuity reallocation activity with the benefits of the transaction more than offsetting the material reduction in expected return on all asset classes, as anticipated at the end of 2012.
- Deal announced to transfer £12.2 billion of equity and multi-asset funds of Friends Life from F&C to Schroders and £2.3 billion of fixed income assets from F&C to FLI.

Strategy

The Heritage division has £68 billion of assets under administration and serves circa 4 million customers across a range of products. These products are no longer actively marketed and are largely administered on legacy systems.

A dedicated management team is in place with a focus on looking after customers' needs and enabling the Heritage division to become the UK's leading legacy business manager.

The value drivers for the Heritage division, in the context of the overall Group's strategy are:

- operational excellence: dedicated customer service within an efficient cost base in line with business scale;
- capital efficiency: optimisation of capital required for the business;
- cash generation: safe generation with focused opportunities for enhancing future cash generation;
- strong risk focus: robust financial risk and balance sheet volatility management; and
- focus on asset management: utilising the recently created internal asset management capability to maximise returns and lower costs.

The Heritage division is making good progress towards achieving its strategic outcomes.

Infrastructure investment

Following extensive analysis of our annuity fund portfolios, we identified infrastructure loans as an attractive alternative credit asset that would effectively meet the ongoing needs of our funds. Infrastructure loans fulfil our desire for increased diversification of assets within the annuity book, while facilitating further investment into current UK development opportunities. These projects offer long-term, senior secured, regular returns which fit well with long-term liabilities on annuities sold to pensioners.

In the fourth quarter of 2013, we announced a new £500 million infrastructure mandate, recognising our desire for increased diversification of assets within the annuity book, while facilitating further investment into current UK development opportunities. Depending on market opportunities, there is appetite to extend the current mandate further.

And last April we made an investment with Drax and HM Treasury. £75 million will be spent converting part of the power station to greener biomass fuel. This deal demonstrates Friends Life's ability to explore infrastructure and other alternative investment opportunities to ensure we stay competitive and nimble in a changing market.



Financial review continued

The Group continues to provide good customer service supported by its outsourced suppliers. The first major migration from two legacy administration systems onto the Diligenta BaNCS IT platform was completed in December, with the resulting cost synergies being part of the contractualised savings already reported. The migration of data and processes was successful, however, it has led to a temporary increase in waiting times for some customers. These issues are being addressed, with actions in place to ensure there are no similar impacts for the migrations planned in 2014.

The Group has completed the planned Part VII transfers of all life company business and as a result there are now only two active life companies: Friends Life Limited ("FLL") which mainly contains the Heritage division's business (including all six with-profits funds) and Friends Life and Pensions Limited ("FLPL") which mainly contains the UK division's business. As part of this programme, Friends Life Company Limited ("FLC") and Friends Life WL Limited ("FLWL") have ceased to underwrite long-term insurance business and are in the process of being de-authorised. The capital efficiency gains delivered broadly cover the programme's costs, with the principal benefits achieved through material operational simplification of the Group.

A multi-year programme to implement a uniform capital management framework for the six with-profits funds is ongoing. As part of that initiative and the ongoing objective to ensure that with-profits funds remain appropriately invested for customers and shareholders, the with-profits annuity reallocation programme involved a reallocation of circa £2 billion of annuities from a with-profits fund to FLL non-profit fund. A free surplus investment of £(16) million in 2013 is expected to generate circa £10 million per annum of SFS, whilst also significantly de-risking future returns for policyholders. Other tranches of with-profits fund annuities are being investigated with a further reallocation of circa £700 million being considered in 2014. If suitable financial terms can be agreed for this and further reallocations, then future tranches would be expected to require at least the same level of investment, but with significantly smaller benefits.

Friends Life Investments Limited ("FLI") now manages £17.1 billion of fixed interest assets, including £7.0 billion from recaptures in 2013. This has delivered more internal control over the investment performance, together with a material reduction in investment costs, benefitting MCEV operating profit in 2013 by £31 million. The recaptures to date have enabled £5 million per annum ongoing benefits. Work continues to assess further potential recaptures.

Investments have also been made in a number of different asset classes in order to support increased yield for the assets within the annuity portfolios in both UK and Heritage divisions. This includes investments in the first government guaranteed infrastructure loan of £75 million in April 2013 and the Group's first export credit agency arrangement of £74 million in September 2013. In addition, a commercial real estate loan mandate and an infrastructure loan mandate, each of £500 million, have been put in place.

Financial performance

IFRS based operating profit

£m	2013	2012
New business strain	(25)	(23)
In-force surplus	264	334
Long-term investment return ⁽ⁱ⁾	(84)	(41)
Principal reserving changes and one-off items	141	68
Development costs	(7)	(6)
Other income	2	–
IFRS based operating profit before tax	291	332

(i) Long-term investment returns are now reported separately for the UK and Heritage divisions, with them previously having been consolidated at UK territory level and reported in Heritage division only in 2012.

The 2013 Heritage IFRS based operating profit of £291 million is £(41) million lower than in 2012, with reduced in-force surplus and lower long-term investment return being partially offset by increased benefit from principal reserving changes and one-off items.

In-force surplus has reduced due to the run-off of the closed book of business and as a result of £(36) million of provision movements in respect of a number of operational items, arising from the review of the legacy business. This review is designed to reduce the risk of future negative variances and safeguard future cash emergence. In-force surplus has been further reduced by the non-recurrence of some positive experience variances noted in 2012.

The reduction in long-term investment return is due to lower interest rates and increased internal debt costs paid to the Corporate segment following the US\$575 million UT2 debt issued in November 2012. The Heritage division meets all of these internal debt costs. In addition, there has been a transfer of assets to the UK division reducing the Heritage division return and increasing the UK division return by £12 million.

Principal reserving changes and one-off items are significantly higher than in 2012 largely due to the with-profits reallocation programme generating a £76 million benefit. Other favourable operating assumption changes have been included principally resulting from improved mortality and morbidity experience on term assurance (£17 million) and income protection business (£31 million).

Operating expenses

£m	2013	2012
Acquisition	30	40
Maintenance	246	244
	276	284
Development	7	6
Total	283	290

2013 acquisition costs are lower than 2012, mainly driven by the strategic decision to stop actively selling new business. Contractual savings in customer service and IT achieved through the Diligenta partnership along with the successful completion of the AHM programme to move all IT infrastructure and business applications hosted by AXA to Friends Life have further reduced the acquisition costs of the division.

Maintenance costs of £246 million include a £9 million impact of expense provision movements following a review of the legacy business. While temporarily increasing the division's costs, the review was designed to provide future stability in the ongoing management of the business and safeguard future cash emergence. Excluding the provision increases, the Diligenta and IT contractual savings also reduced the underlying maintenance cost base for Heritage.

Development spend of £7 million is broadly in line with 2012 full year costs and reflects the ongoing cost of implementing regulatory change, such as auto-enrolment, as well as improvements to existing products and systems to support the in-force business.

Sustainable free surplus generation

£m	2013	2012
Expected return from in-force business:		
Free surplus emergence	428	420
Return on shareholder assets	14	33
Investment in new business	(30)	(55)
Underlying free surplus generation	412	398
Development costs	(7)	(5)
Operating experience variances	27	8
Other operating variances	(1)	88
Sustainable free surplus generation	431	489

The Heritage SFS generation of £431 million is down £(58) million on 2012, with the strongly favourable other operating variances in 2012 not repeating in 2013.

Expected return from in-force business at £442 million is broadly consistent with that in 2012, with the general run-off of in-force being offset by a spike in with-profits surplus emergence as policies mature. This is not expected to recur in 2014.

Operating experience variances include £31 million from the release of tax provisions.

Other operating variances include the impact of the with-profits annuity reallocation which has resulted in a strain of £(16) million in 2013. The impact of this has been offset by £16 million revised transfers on guaranteed annuity options triggered by the vesting of previous pensions business within the with-profits funds.

MCEV operating profit

£m	2013	2012
Value of new business	(19)	2
Expected existing business contribution	211	281
Operating experience variances	(12)	9
Operating assumption changes	93	65
Other operating variances	127	8
Development costs	(7)	(6)
MCEV operating profit before tax	393	359

The Heritage MCEV operating profit of £393 million is £34 million higher than the £359 million reported in 2012, with an increase in other operating variances from the benefit of the with-profits annuity reallocation offsetting a reduction in the expected existing business contribution, due to lower rates of return.

MCEV operating profit includes an expected existing business contribution which is calculated with reference to risk-free interest rates. As communicated previously, expected existing business contribution has reduced significantly compared to 2012, due to material reductions in the level of expected rates of return on all asset classes in line with rates reported at the end of 2012.

The £93 million operating assumption changes include a £31 million benefit reflecting revised assumptions in respect of future investment expenses. This has been enabled by the recapture of certain asset portfolios by FLI. Operating assumption changes also includes an increased recognition of deferred tax assets of £46 million.

Other operating variances of £127 million include a £96 million benefit from the with-profits annuity reallocation and benefits from modelling changes.

Value of in-force business

The Heritage business represents a significant proportion of the Group's in-force value. The breakdown by product is shown below.

£bn	31 December 2013	31 December 2012
Pensions	0.6	0.5
Investments	0.7	0.6
Annuities	0.2	0.2
Protection	0.4	0.5
With-profits	0.4	0.5
Total	2.3	2.3

Financial review continued

Total Heritage value of in-force business remains unchanged from 2012. This reflects the positive economic conditions in 2013 which have offset the run-off of the closed book.

Heritage assets under administration

£bn	31 December 2013	31 December 2012
Unit-linked pensions	19.3	18.3
Unit-linked investment	15.5	15.4
Annuities and protection	9.5	7.7
With-profits	23.7	27.3
Total	68.0	68.7

The increase in annuities and protection assets under administration and corresponding decrease in with-profits funds principally reflects the transfer of circa £2 billion annuities from the with-profits funds under the with-profits annuity reallocation. For unit-linked business the favourable investment returns over 2013 have offset the run-off of the business.

New business

£m (unless otherwise stated)	2013	2012
VNB	(19)	2
Investment in new business	(30)	(55)
IRR	(1.9)%	4.6%
APE	54	102

The Heritage division specifically focuses on those products no longer actively marketed. Despite not actively seeking new business, the Heritage book delivers ongoing incremental business written across all product types. This incremental new business is largely accepted as part of the contracts on existing business.

The contribution from Heritage new business in 2013 was a loss of £(19) million compared to a profit of £2 million in 2012. This reduction reflects 2012 being the final year of Department of Work and Pensions ("DWP") rebate new business, following regulatory changes alongside a general run-off of volumes in Heritage with new business now focused in other divisions. The 2012 full year VNB for DWP business was £13 million.

The improvement in investment in new business reflects the lower sales volumes and corresponding reduction in capital requirements.

Outlook

During 2014, further migrations are planned from legacy administration systems to the Diligenta BaNCS IT platform. A migration programme has also been agreed with the existing outsource supplier (Capita) to transfer the business that they administer from the legacy systems. Although these projects are not expected to deliver further synergies beyond those already contractualised, they will support the drive for operational efficiency and simplification, and improve customer service.

A robust Enterprise Risk Management framework for financial risk and balance sheet management is being embedded, which will include further progress in delivering a controlled framework for taking investment and risk decisions within all Friends Life with-profits funds. As part of this the reallocation of additional with-profits fund annuity books is being considered. Future tranches are expected to require similar investment, but with smaller benefits, with a further reallocation of circa £700 million being considered in 2014.

Following the cessation of sales of new business in September 2013, the Overseas Life Assurance Business ("OLAB"), previously reported in the International division, will be transferred to Heritage in 2014. This will take advantage of Heritage's expertise in managing closed books of business.

We will continue to review options for ensuring that asset management is both cost efficient and generating good returns for policyholders and shareholders. The deal entered into with Schroders, with the transfer of assets expected to be complete in the fourth quarter of 2014, is an example of this activity.

UK division

2013 highlights

- VNB up 30% on 2012 to £184 million on an 8% increase in sales, with £8 million lower investment in new business.
- IRR has increased from 13.3% to 15.3% reflecting the financial discipline behind the growth in new business.
- IFRS-based operating profit of £40 million significantly improved from a loss of £(32) million in 2012 as a result of reduced new business strain and increased in-force surplus.
- SFS improved from £(66) million to £(40) million demonstrating increased returns from in-force business and lower development costs.
- These results have been achieved despite a disappointing loss from Sesame Bankhall Group amounting to £(22) million SFS and £(19) million in IFRS and MCEV.
- MCEV operating profit of £192 million is up from £143 million in 2012 reflecting a £42 million increase in VNB.
- The division has demonstrated strong operational progress in 2013 through investment in target platforms, rigorous cost control and propositional developments.

Strategy

Friends Life presented the UK division's strategic agenda in November 2011 and excellent progress has been made in the past two years. Business integration and transformation activities have largely been completed and the focus of the UK division is on driving profitable growth in its chosen markets whilst maintaining financial discipline. Good progress has been made on developing key proposition initiatives across the division's markets.

The Retirement Income business has delivered a number of key customer propositions that will support sustainable growth in the 'at retirement' market. It has upgraded the proposition for existing customers approaching retirement, including the promotion of a comprehensive enhanced annuity option and launched the Friends Lifestyle Annuity into the open market in the final quarter of 2013. It has also piloted a 'shopping around' service in partnership with Key Retirement Solutions which supports customers at, or close to, retirement with options around provider and product type.

In the Corporate Benefits market, the Group has developed auto-enrolment technology which provides simple solutions to the regulatory and technical burden on employers. In addition, a new range of default funds, My Future, launched in the first quarter, has had encouraging early take up.

Further enhancements were made to the already highly regarded Protection proposition in 2013. These were very well received and retained the focus on continued innovation and ensuring products meet customer needs and expectations

More than just insurance

In our UK business, when a customer takes out protection cover with Friends Life they get more than just insurance, while others are benefiting from our proposition enhancements:

Group Income Protection – Cancer Work Support

In 2013 Friends Life introduced a new service to support Group Income Protection members who have suffered a cancer-related condition and are ready to return to work or need support to return to work in the future. The Cancer Work Support package has been designed by leading rehabilitation experts Working Towards Wellbeing.

With cancer-related illness now the second most common reason for an income protection claim, according to figures from reinsurer Swiss Re, the need for additional support for cancer survivors remaining in or returning to the workplace has never been so great.

The comprehensive service offers specialised work support, allowing employers to engage early with members to help them plan for a return to work. The scheme also ensures that employers fully understand how their employee's condition can impact them when returning to the workplace.

The scheme produces tailored plans specific to the individual, helping all parties to address any potential challenges to returning to work. In this way, the service helps ensure that any employee returning to work following a cancer diagnosis will have the right level of support for their particular needs.

The Friends Lifetime Annuity

An enhanced annuity offers our customers a potentially higher income in retirement. This is because, unlike standard lifetime annuities, it takes into account lifestyle and health to help work out their retirement income. As customers get a more personalised quote, because they told us about their health and lifestyle, their income could be higher than our standard quote.

8 out of 10 customers who complete our questionnaire are offered a higher income in retirement than previously quoted. Typically the increase can be between 5% and 15% and in some cases as much as 30% higher than our standard quote.

Friends Life Group Critical Illness Scheme – Best Doctors

The Best Doctors® service is available to all eligible Friends Life Group Critical Illness scheme members and all eligible Friends Life Individual Protection policy holders. If a member, their spouse or partner or any of their children are diagnosed with a serious medical condition they can contact Best Doctors at anytime to get a second opinion and medical support from a world leading expert on their condition. The member will get a full and confidential report back and their case manager will review the report in detail with them over the phone.

Financial review continued

Financial performance

New business profitability

UK division 2013 VNB up 30% on prior year, from £142 million to £184 million

£m (unless otherwise stated)	2013	2012
VNB		
Corporate Benefits	26	21
Protection	75	62
Retirement Income	83	59
Total VNB	184	142
Investment in new business		
Corporate Benefits	(48)	n/a
Protection	(44)	n/a
Retirement Income	(6)	n/a
Total investment in new business	(98)	(106)
IRR		
Corporate Benefits	8.4%	7.2%
Protection	13.8%	13.8%
Retirement Income	25%+	25%+
Total IRR	15.3%	13.3%
APE		
Corporate Benefits	574	535
Protection	84	90
Retirement Income	66	44
Total APE	724	669

UK division VNB is up 30% on 2012 at £184 million with growth in each business, particularly in Retirement Income which grew by 41% on 2012. The growth was achieved whilst reducing the level of investment in new business for the division from £(106) million in 2012 to £(98) million in 2013. The focus on operational efficiency as well as an improved mix, higher investment returns and a change to the reinsurance programme for Protection were the main drivers of the additional value and lower strain.

Corporate Benefits: £26 million VNB, 24% increase on prior year

Corporate Benefits VNB was up 24% with a growth in APE of 7%. This growth is increasingly supported by the success of the My Money platform where there is continued focus on proposition development to enhance the customer experience and innovative new product design.

The Workplace Solutions team continues to drive new business opportunities from the existing book and has seen material growth as a result of auto-enrolment. Auto-enrolment has significantly increased the number of members in existing schemes on target platforms. This has driven up the value of new business through the recognition of increased economies of scale including the benefit to the Group of focusing on auto-enrolment mandates from existing customers where set up and other initial costs have largely been incurred already. There has been good progress on the Embassy Transition programme, such that new members joining certain schemes on the Embassy platform are assumed to transition on to target platforms by 2015.

Sales of new schemes have shown steady growth and the pipeline of confirmed scheme wins is comparable with that taken into the start of 2013. There is an expectation that the flow of new scheme volumes will increase following the enhancements to the division's proposition and distribution reach. Furthermore, increments and new entrants to existing schemes are also showing strong growth with sales in the second half of the year up 16% on the first half.

Over the course of the year 274 schemes of 203 employers have staged with the Group. The trend of employers enrolling on minimum contributions and with qualifying earnings has continued into the last quarter of the year, exerting pressure on new business margins. This trend is expected to continue for new business resulting from auto-enrolment and has also impacted the IRR of 8.4% (2012: 7.2%).

Whilst it has been disappointing to see employees' retirement savings limited by the significant numbers of schemes paying only minimum contributions, the division expects to see these contributions, and the value to the Group from these schemes, increase as statutory minimum levels move from 2% to 8% in aggregate by 2018. The Group expects an increased number of smaller schemes to auto-enrol during 2014 and is introducing a fee paying arrangement for the employer services offered to ensure these remain commercially attractive.

Corporate Benefits assets under administration

£bn	
1 January 2013	17.8
Inflows	2.0
Outflows	(1.1)
Net funds flow before exceptional losses	0.9
Exceptional losses	(1.1)
Net investment return	2.5
31 December 2013	20.1

Total assets under administration are £20.1 billion, an increase of £2.3 billion over the period driven by positive market movements.

Retention of the in-force book remains a key priority and increasing focus on this has driven improved net fund flows in the final quarter of the year with notifications of schemes expected to disinvest in the coming year well down on the level 12 months ago.

Outflows for the period are heavily impacted by the run-off of two, now closed, non-strategic products. Additionally, there have been heavy outflows from schemes secured by commission paying competitors in the run up to RDR. After adjusting for these exceptional items, there were net inflows. Whilst this has created short term pressure through reduced incremental business on existing schemes, the Group has applied financial discipline and avoided a significant cash strain that would have been payable as a result of employees auto-enrolling into schemes paying initial commission.

Protection: £75 million VNB, 21% increase on prior year

The Protection business has delivered VNB of £75 million up 21% on prior year on 7% lower volumes. The increase in value has been driven by the use of more cost efficient target platforms, and the successful restructuring of reinsurance contracts.

Sales of individual protection are down 15% on prior year, largely driven by an acceleration of business into the fourth quarter of 2012 ahead of the implementation of gender neutral pricing on 21 December 2012. This acceleration had a knock-on impact on the first quarter of 2013, however the subsequent quarter on quarter trajectory shows strong growth with fourth quarter volumes being some 191% of the first quarter volumes.

Group protection sales have delivered a 70% increase in value on a 9% increase in APE. As well as volume growth, margins have improved from the restructure of reinsurance arrangements and a shift in mix towards the more profitable critical illness and income protection products.

Retirement Income: VNB of £83 million up 41% on prior year

Retirement Income VNB of £83 million is 41% ahead of 2012. This growth is driven by increased volumes from better customer engagement and product innovation, improved investment returns and the benefit of lower investment costs from FLI. Results for the fourth quarter of the year have been impacted by competitive pressure and the business expects this to continue into 2014.

The new annuity platform has been delivered to facilitate more sophisticated pricing and the underwriting necessary to support

enhanced annuity products. Through the course of 2013, the business migrated increasing numbers of its retiring customers onto this new platform to ensure they benefit from this new proposition and the improved support the business is now able to offer for their retirement decision making. These migrations will continue through 2014 and it is expected that it will support the Group's retention rate through a period of market uncertainty. The number of existing customers choosing to buy an annuity from Friends Life rose in the period with the proportion of vestings increasing to 34% up from 25% in 2011.

The new Flexible Lifestyle Annuity ("FLA") was launched in December following a period of pilot activity. A successful launch has been executed via the main intermediary portals and a small initial pipeline of business established providing a foundation for growing volumes through the first quarter of 2014.

IFRS based operating profit

£m	2013	2012
New business strain	(1)	(36)
In-force surplus	69	61
Long-term investment return ⁽ⁱ⁾	13	1
Principal reserving changes and one-off items	8	(21)
Development costs	(30)	(36)
Other income and charges	(19)	(1)
IFRS based operating profit before tax	40	(32)

(i) Long-term investment returns are now reported separately for the UK and Heritage divisions, with them previously having been consolidated at UK territory level.

The UK division IFRS-based operating profit before tax of £40 million increased by £72 million in the year to 31 December 2013.

New business strain improved by £35 million, a fall of 97% despite a 8% increase in new business volumes. Protection delivered £22 million of this saving, predominantly driven by synergies achieved from writing Protection business on more efficient target platforms and restructuring reinsurance arrangements in the year.

In-force surplus has increased by £8 million compared to prior year, in line with higher Corporate Benefits AMC income from a growing in-force book.

Principal reserving changes and one-off items of £8 million reflect a number of small model refinements in each of the businesses.

Whilst development costs have reduced by £6 million compared with 2012, there has been considerable investment in enhancing the Protection proposition and the launch of the open market annuity product within Retirement Income.

The movement in other income and charges of £(18) million reflects the results of the Sesame Bankhall Group (full year loss of £(19) million) where a provision has been set up following a review of past business including pensions transfers. The strategic review of Sesame Bankhall Group is ongoing.

Financial review continued

Operating expenses

£m	2013	2012
Acquisition	99	110
Maintenance	48	49
	147	159
Development	30	36
Total	177	195

Tight expense management and the efficiency savings from moving onto target platforms in Protection resulted in a reduction in operating expenses which are 9% lower than 2012.

Development costs have reduced by £6 million compared to the prior year despite the high level of regulatory change impacting the division, considerable investment in enhancing the Protection proposition and the launch of the open market annuity product within Retirement Income.

Sustainable free surplus generation

£m	2013	2012
Expected return from in-force business:		
Free surplus emergence	93	85
Return on shareholder assets	6	1
Investment in new business	(98)	(106)
Underlying free surplus generation	1	(20)
Development costs	(23)	(27)
Operating experience variances	(11)	(14)
Other operating variances	15	–
Sustainable free surplus before Sesame	(18)	(61)
Sesame	(22)	(5)
Sustainable free surplus generation	(40)	(66)

Expected return on in-force business has increased in the year reflecting the additional contribution from new business written in 2012 as well as the growth in assets under administration in

Corporate Benefits. This has been partially offset by the lower returns on reserves, as a result of lower expected short-term interest rates in 2013. Investment in new business has reduced by £8 million compared with 2012, despite new business volumes increasing by 8%. This is as a result of significantly improved new business strain for Protection due to operating efficiencies from being on the target platforms for the whole year and successfully restructuring reinsurance contracts, offset by an increase in capital requirements from higher volumes of more competitively priced annuities.

Operating experience variances of £(11) million are £3 million favourable compared to 2012. In 2013, the variance is driven by adverse claims experience of individual protection products, and temporary maintenance expenses associated with My Money, the newly established Corporate Benefits platform.

Other operating variances of £15 million are largely driven by a release of reserves following completion of the Part VII transfers.

MCEV operating profit

£m	2013	2012
VNB	184	142
Expected existing business contribution	60	61
Operating experience variances	(33)	(30)
Operating assumption changes	(6)	(3)
Other operating variances	36	11
Development costs	(30)	(36)
Life and pensions covered business operating profit before tax	211	145
Other income and charges	(19)	(2)
MCEV operating profit before tax	192	143

MCEV operating profit before tax of £192 million is up £49 million on prior year.

VNB has improved significantly across the division with all businesses demonstrating good growth on 2012, particularly from Retirement Income.

Expected existing business contribution is in-line with that of 2012 with growth on the existing book being offset by a lower expectation of yields on assets, in particular on fixed income assets.

Operating experience variances are £(33) million for the year, heavily impacted by short-term adverse persistency from Corporate Benefits as a result of exercising financial discipline and allowing certain commission paying schemes to transfer away. A provision of £33 million in respect of these RDR related losses has been released.

Operating assumption changes include £46 million in respect of increased recognition of deferred tax assets and favourable expense basis adjustments of £7 million. Offsetting this is a £(50) million impact from a provision for re-writing some group pensions business on more competitive terms combined with a revised view of expected lapse rates, and a £(9) million impact in respect of a change in mortality assumptions within the Protection business.

Other operating variances of £36 million include £15 million in respect of the migration to target platform of a book of group protection business and £8 million from restructuring reinsurance contracts.

Outlook

Despite the continued regulatory and political scrutiny surrounding the charges associated with corporate pension schemes and the annuity market generally, the UK division is well placed to benefit from the expected economic recovery. Higher employment levels and salary inflation will drive the new business contribution for workplace schemes in Corporate Benefits and the expected growth in markets will drive increased revenue flows. Economic improvement is also expected to drive recovery in the housing market.

The Corporate Benefits business will continue to drive assets under administration through its focus on auto-enrolling clients (the Group expects to stage several hundred schemes in 2014), through the right level of attention from relationship managers, further enhancement of auto-enrolment services, and appropriate focus on those clients transitioning from the Embassy platform to ensure high levels of retention. Growth opportunities are expected from the development of the Master Trust proposition, recently launched on NGP, and the development of a proposition suitable for small to medium sized employers, which will be particularly important as the business expands distribution into the corporate IFA sector.

Increased assets under administration in turn drive larger retirement savings which will increase the number and size of annuities being written. The Retirement Income business is expected to grow, though at a more modest rate than in 2013, driven by continued improvement in customer retention as a result of engagement initiatives and steady growth of open market opportunities. The Group believes that the margin pressure seen in the latter part of 2013 will continue and anticipates addressing this through further evolution of the investment strategy.

Continued recovery of the housing market is expected to present an opportunity for increased levels of Protection business, in particular through estate agencies. The Protection proposition suite remains highly regarded and the Group is well placed to benefit from strong relationships from the division's partnerships with estate agencies and intermediaries operating through panels. The Protection business continues to develop new channels through existing partners and through the growth of new partners.

In addition, greater focus is being placed on strengthening and expanding relationships with key partners, customers and extending distribution reach through corporate IFAs.

“The value of new business improved significantly across the division with all businesses demonstrating good growth on 2012”.

Financial review continued

International division

2013 highlights

- The International division has met its dividend target for 2013 of £33 million with the final dividend payment of £23 million (£14 million from FPI and £9 million from Lombard). An interim dividend of £10 million was paid in July 2013.
- The exit from FPI non-core markets has been completed. The sale of the Group's 30% stake in AmLife in January 2013 has been followed by the cessation of new business in Germany in September 2013.
- International VNB is £39 million (31 December 2012: £50 million). FPI VNB has improved by 180% reflecting good performance in challenging market conditions. However, Lombard VNB has disappointed and is down 44% having been adversely impacted by challenging conditions in its markets, especially Belgium.
- The International businesses generated sustainable free surplus of £40 million in 2013 (31 December 2012: £(28) million) supporting dividend commitments.
- International IFRS based operating profit of £136 million (31 December 2012: £(9) million) reflects increased income from the larger in-force book, favourable economic experience on the return of premium guarantee on German business and the non-recurrence of adverse assumption changes and one-off costs which impacted 2012.
- International MCEV operating profit of £11 million (31 December 2012: £1 million) reflects the improvement in the profitability of the FPI business driven by the strategic changes implemented in 2013, which is mostly offset by the impact of macroeconomic uncertainty in Europe and more particularly legal and tax changes in Belgium, on Lombard's persistency.
- International assets under administration continue to grow supported by market returns. Assets under administration now total £20.2 billion (31 December 2012: £18.9 billion) for Lombard and £7.2 billion (31 December 2012: £6.7 billion) for FPI.
- In FPI, the combination of decreasing operating expenses and growing assets under administration is expected to support cash generation in future years.

25 years in Asia and 10 years in the Middle East

In 2013 we celebrated our 25 year anniversary in Hong Kong and Singapore. This was a key milestone, demonstrating our heritage and experience in Asia and an opportunity to confirm our commitment to an ongoing presence in the region. Our theme for the year was 'your vision, our passion' which encapsulated our commitment to developing quality financial solutions to help customers achieve their financial goals.

In February 2014, we celebrated our 10 year presence in the Middle East. We are one of only a handful of international life offices, operating in the expatriate market, to hold a full federal UAE insurance licence.

By using this detailed experience that we have gained over the last 25 years we have created a range of innovative wealth management and protection products. We understand that our customers are looking to build their financial future security; whether it's building a dream home, their children's education, milestones with family and friends, or planning for retirement. This expert support gives our customers freedom to enjoy today, knowing that tomorrow is taken care of, and the peace of mind that their financial future is in the hands of a company committed to their needs.



Strategy

The Group is committed to realising value for shareholders and, as confirmed in November 2013, has held discussions regarding the potential sale of the Luxembourg based business, Lombard International Assurance. Notwithstanding this, Lombard's strategy remains unchanged with this business continuing to be a leading pan-European specialist in estate and succession planning solutions for high and ultra-high net worth individuals.

The strategy for FPI also remains unchanged. FPI will enhance value creation through its sustainable portfolio of international licenses in Singapore, Hong Kong, UAE and Isle of Man, focusing on profitable growth and cash generation.

The priorities of the division are to:

- selectively grow the business and generate sales of profitable products;
- improve the efficiency of the back-office and deploy more resources to Asia;
- increase the dividends to Group to £50 million per annum for 2015 onwards (target of £33 million for 2013 has been met); and
- target growth in assets under administration to support future cash generation.

Financial performance

The consolidated results of the International division are set out below. The results of the Lombard and FPI businesses are set out in the following sections, including a split of the core and non-core elements in FPI.

£m	2013	2012
IFRS		
Lombard	34	28
FPI – core	63	58
FPI – non-core	39	(95)
Total International IFRS based operating result before tax	136	(9)
SFS		
Lombard	6	(4)
FPI – core	20	30
FPI – non-core	14	(54)
Total International sustainable free surplus generation	40	(28)
MCEV		
Lombard	(46)	104
FPI – core	40	(2)
FPI – non-core	17	(101)
Total International MCEV operating result before tax	11	1

The International division results include good progress on IFRS based operating profit and cash generation, although MCEV operating profit was impacted by the loss in Lombard due to lower new business levels and adverse persistency, particularly in Belgium.

The International division's IFRS based operating profit was £136 million, up £145 million on 2012. This largely reflects the non-recurrence of adverse assumption changes and one-off costs that impacted 2012, favourable economic experience on the return of premium guarantee on German business and income from the larger in-force book in FPI.

Sustainable free surplus of £40 million for the International division increased by £68 million above 2012 and largely reflects lower investment in new business partially offset by higher development spend as the Group continues to invest in its open businesses.

International MCEV operating profit of £11 million is £10 million higher than 2012. This result reflects good progress in FPI which is £160 million higher than 2012 at £57 million. However this has been mostly offset by the adverse tax and regulatory changes in Lombard's markets.

Outlook

The Group remains confident that the International division will make an increasing contribution towards generating shareholder cash, as evidenced by the £33 million of dividends paid in respect of 2013 and the core business will continue to generate value for the future.

However, £33 million of dividends paid to the Group for 2013 exceeds total free surplus generated in the year. As a result 2014 dividends are increasingly dependent on in year performance and surplus generation.

Notwithstanding the current challenging conditions in Lombard's markets, the longer term drivers of the demand for individually structured wealth solutions using life assurance remain compelling.

Following the cessation of sales of new business in September 2013, the non-core business ("OLAB") will be transferred to the Heritage division in 2014 to take advantage of Heritage's expertise in managing closed books of business.

Increased focus on retention of the in-force book will drive improved assets under management for FPI which will in turn drive future cash generation.

Financial review continued

Lombard operating review

£m (unless otherwise stated)	2013	2012
IFRS based operating profit	34	28
MCEV operating result	(46)	104
Sustainable free surplus	6	(4)
Assets under administration (£bn)	20.2	18.9
Dividends paid to Group relating to each year	13	4

The Lombard MCEV result is very disappointing compared to 2012 and reflects the persisting significant macroeconomic uncertainty, combined with important changes in the tax and legal framework of several of Lombard's key markets during 2013, especially Belgium. In addition, the uncertainty from the potential sale of the business has adversely impacted the sales volumes and lapse experience and hence MCEV operating results. Notwithstanding this, assets under administration continue to grow supported by market returns and total £20.2 billion (€24.3 billion) at 31 December 2013. This increase, coupled with the non-recurrence of significant one-offs incurred in 2012 in respect of the strategic development plan launched in 2012 resulted in a significantly higher IFRS based operating profit and sustainable free surplus. Lombard paid a £13 million (€16 million) dividend meeting its 2013 dividend commitments.

New business profitability

£m (unless otherwise stated)	2013	2012
VNB	25	45
Investment in new business	(24)	(23)
IRR ⁽ⁱ⁾	13.3%	22.5%
APE	198	238
APE in constant currency	190	n/a

(i) Lombard IRR takes into account the Luxembourg regulatory regime in which DAC is an allowable asset.

Lombard's value of new business amounted to £25 million, 44% below 2012. The impact of lower volumes (20% down on the same period last year in constant currency) and the negative impact of persistency basis changes are partly offset by lower acquisition expenses. IRR is similarly impacted.

APE performance by region is as follows:

APE (actual exchange rates, £m)	2013	2012
UK and Nordic	68	54
Northern Europe	12	35
Southern Europe	110	123
Rest of world	8	26
Total including large cases	198	238
Of which: large cases (greater than €10 million)	87	102
Total excluding large cases	111	136

Some regions have performed well compared to 2012, notably France, Germany, UK and the Nordic region. However, Northern Europe saw a significant reduction in sales driven by Belgium underperformance. Rest of world decreased significantly on 2012 due to a reduced level of large cases written in 2013.

IFRS based operating profit

£m	2013	2012
New business strain	(31)	(30)
In-force surplus	68	60
Development costs	(3)	(2)
IFRS based operating profit before tax	34	28

Lombard generated an IFRS based operating profit before tax of £34 million in 2013, £6 million up on 2012. The year on year increase principally reflects the non-recurrence of one-off expenses incurred in 2012 in respect of the strategic review.

IFRS new business strain is 3% higher than 2012 (1% in constant currency) due to lower AMC's on new business, resulting from lower sales volumes.

Assets under administration

Despite difficult trading conditions assets under administration continued to increase in 2013. Positive net trading volumes combined with positive investment return and the strengthening of the Euro against Sterling drove assets under administration from £18.9 billion (€23.3 billion) at the end of 2012 to £20.2 billion (€24.3 billion) at 31 December 2013. Over the 12-month period from 31 December 2012, assets under administration have grown 4% in Euro terms.

	£bn	£bn
1 January 2013	23.3	18.9
Inflows	2.3	2.0
Outflows	(2.3)	(2.0)
Net investment return	1.0	0.8
Foreign exchange	–	0.5
31 December 2013	24.3	20.2

Operating expenses

£m	2013	2012
Acquisition	39	41
Maintenance	29	34
	68	75
Development	3	2
Total	71	77

Operating expenses, which exclude commission payments, were 8% below 2012 reflecting the lower amount of one-off expenses in respect of the strategic review that were mainly recognised in 2012. As projected in the original strategic review plan, maintenance costs are expected to reduce in 2014.

Sustainable free surplus generation

£m	2013	2012
Expected return from in-force business	44	36
Investment in new business	(24)	(23)
Underlying free surplus generation	20	13
Development costs	(2)	(1)
Operating experience variance	(9)	(16)
Other operating variances	(3)	–
Sustainable free surplus generation	6	(4)

Sustainable free surplus of £6 million is up £10 million on 2012 and supports the 2013 dividend payment. The result is driven by both the higher opening assets under administration as well as the non-recurrence of one-off expenses incurred in 2012.

MCEV operating result

£m	2013	2012
VNB	25	45
Expected existing business contribution	33	35
Operating experience variances	(25)	(23)
Operating assumption changes	(82)	36
Other operating variances	6	13
Development costs	(3)	(2)
Life and pensions covered business operating result before tax	(46)	104

As a result of the unprecedented difficult trading environment in Lombard's core markets, due largely to the regulatory and legal framework changes, the MCEV operating result for 2013 is materially down on 2012, resulting in a loss of £(46) million. The result reflects a lower contribution from new business and materially adverse lapse experience particularly in Belgium as a result of tax and legal changes. Furthermore, the lapse assumptions for

the future have been revised upwards as a result of the adverse experience. The combined effects of both 2013 lapse experience and revised future lapse assumptions for the Belgian book account for two thirds of the operating loss. The 2012 results benefited from one-off positive changes resulting from the Lombard restructuring project totalling £46 million not repeated in 2013.

Expected existing business contribution has decreased from £35 million in 2012 to £33 million as a result of the impact of lower economic assumptions partly offset by the higher opening value of the in-force book.

%	Rates used for expected return contribution	
	2013	2012
Reference rate	2.13	1.61
Best estimate returns:		
Corporate bonds	3.13	3.55
Equity	5.13	5.55

Adverse operating experience variances of £(25) million primarily consist of persistency experience relating to surrenders, particularly in Belgium, where new tax reforms including the launch of new rules around asset repatriation have been implemented in 2013. This new landscape has materially affected the wider Luxembourg life assurance market and is not specific to Lombard.

Operating assumption changes of £(82) million mainly consist of the adverse impact of lapse assumptions. Lapse expectations in the Belgian market have been revised upwards reflecting ongoing outflows and represent circa 90% of the lapse assumption impact. Although overall expenses remain well controlled and within prior projections, lower new business volumes coupled with higher lapses result in an increased per policy modelled expenses.

FPI operating review

£m (unless otherwise stated)	2013	2012
IFRS based operating result	102	(37)
Sustainable free surplus	34	(24)
MCEV operating result	57	(103)
Dividends paid to Group	20	–
Assets under administration (£bn)	7.2	6.7

The results of the FPI business in 2013 are encouraging with strong IFRS and MCEV operating profits as well as robust sustainable free surplus, supporting the dividend payment. The return to profitability reflects the strategic actions taken and the results are significantly better than the results for 2012, which were dominated by the impact of one-off charges relating to market exits and assumption changes principally in the non-core businesses.

The FPI results are shown in the sections below analysed between the core and non-core business. Additional detail is shown at the end of this section including the Lombard business. The core business excludes AmLife, OLAB (mainly Germany) and new business to Japanese nationals, which ceased in 2012.

Financial review continued

New business profitability

£m (unless otherwise stated)	2013	2012
VNB		
Core	21	17
Non-core	(7)	(12)
Total VNB	14	5
Investment in new business		
Core	(39)	(39)
Non-core	(22)	(62)
Total Investment in new business	(61)	(101)
IRR		
Core	11.0%	11.0%
Non-core	0.0%	2.0%
Total IRR	6.4%	5.4%
APE		
Core	127	146
Non-core	14	56
Total APE	141	202

Total FPI sales volumes were 30% lower than in 2012, reflecting the exit from all non-core markets, in particular new business with

Japanese nationals, the sale of AmLife and a controlled exit from writing new business in Germany.

VNB of the core business has increased 24% to £21 million, despite a 13% fall in core APE, reflecting the strategic focus towards value over volume and the benefit from the impact of favourable expense and mortality assumption changes. Moreover, the Group is leveraging its longstanding IFA relationships and continuing to diversify its distribution mix, including bancassurance opportunities with potential new partners and remains well positioned to take advantage when markets improve.

In North Asia, APE was in line with 2012 at £30 million despite regulatory and media pressures on the overall region's unit-linked market which experienced a fall of 18% for the first three quarters of 2013 compared to the same period in 2012. Market fundamentals continue to be strong, led by the trend of Chinese mainlanders looking to invest and diversify offshore.

Volumes in South East Asia and the Middle East have both decreased by circa 20% due to increasing competition from existing and new competitors which are all aggressively investing in new business. Despite these factors, volumes of bancassurance in South East Asia continue to improve with a 4% increase compared to the same period in 2012.

Non-core sales volumes of £14 million are significantly lower than 31 December 2012 reflecting the planned reduction in volumes following the closure to new business with Japanese nationals in 2012, the sale of the Group's 30% stake in AmLife on 4 January 2013, and the closure to new pensions business from Germany on 30 September 2013.

IFRS based operating result

£m	Core	Non-core	2013	2012
New business strain	(24)	(16)	(40)	(53)
In-force surplus	100	40	140	95
Long-term investment return	(1)	–	(1)	–
Principal reserving changes and one-off items	(3)	18	15	(70)
Development costs	(7)	(3)	(10)	(6)
Other income and charges	(2)	–	(2)	(3)
IFRS based operating profit/(loss) before tax	63	39	102	(37)

FPI IFRS based operating result increased to £102 million from £(37) million in the same period of 2012. This reflects an increase in IFRS in-force surplus of £45 million due to a larger book together with improved economics largely relating to the return of premium guarantee business in Germany. Additionally, the results have benefited from a £13 million reduction in IFRS new business strain, driven by lower acquisition expenses combined with lower German volumes and the non-recurrence of the large adverse 2012 principal reserving changes and one-offs.

Principal reserving changes of £15 million in 2013 mainly relate to favourable operating assumption changes on the non-core business.

Assets under administration

£bn	FPI	OLAB	AmLife	FPI Total
1 January 2013	6.1	0.5	0.1	6.7
Inflows	1.1	0.1	–	1.2
Outflows	(0.7)	–	–	(0.7)
Market and other movements	0.1	–	–	0.1
Sale of AmLife	–	–	(0.1)	(0.1)
31 December 2013	6.6	0.6	–	7.2

Assets under administration as at 31 December 2013 increased to £7.2 billion. Despite challenging market conditions the business generated net inflows of £0.5 billion supported by stable regular premiums year-on-year, market growth accounted for a £0.1 billion increase.

Operating expenses

£m	2013	2012
Acquisition	28	33
Maintenance	31	34
	59	67
Development	10	6
Total	69	73

Operating expenses, which exclude commission payments and non-recurring costs, decreased to £69 million from £73 million in 2012. Acquisition costs decreased largely as a result of the lower new business volumes following the strategic market exits. Maintenance expenses have decreased as a result of tight cost management. Development expenses amounting to £10 million principally reflect the International Transformation programme focusing on system and process improvements. Work on core Personal Portfolio Bond systems and the development of the Digital Portal strategy will drive future efficiencies including the online submission of new business and dealing. In addition, a service improvement programme will deliver staffing efficiencies in the back office by June 2014.

Sustainable free surplus generation

£m	Core	Non-core	2013	2012
Expected return from in-force business	77	20	97	93
Investment in new business	(39)	(22)	(61)	(101)
Underlying free surplus generation	38	(2)	36	(8)
Development costs	(7)	(2)	(9)	(5)
Operating experience variances	–	18	18	(9)
Other operating variances	(9)	–	(9)	(2)
Other income and charges	(2)	–	(2)	–
Sustainable free surplus generation	20	14	34	(24)

FPI sustainable free surplus increased by £58 million to £34 million arising from lower investment in new business and better experience variances.

The core business sustainable free surplus of £20 million (31 December 2012: £30 million) has decreased driven by lower in-force surplus from lower volumes of regular premium savings business written in 2012 compared with 2011. The surplus emergence on the regular premium savings business is weighted towards the early years of the contract, hence the recent volumes of new business and the phasing over the year will impact expected returns in subsequent reporting periods.

The non-core sustainable free surplus of £14 million (31 December 2012: £(54) million) has improved as the volume of regular premium German pensions business, and hence the investment in new business, is reduced. Apart from receiving regular premiums and increments in line with standard policy terms, there will be no further investment in non-core new business and the Group will be focused on generating surplus from the existing book. Overall we do not expect to see a material change in non-core sustainable free surplus in 2014.

Financial review continued

MCEV operating result

£m	Core	Non-core	2013	2012
VNB	21	(7)	14	5
Expected existing business contribution	16	3	19	23
Operating experience variances	3	10	13	(12)
Operating assumption changes	11	3	14	(107)
Other operating variances	(2)	11	9	(5)
Development costs	(7)	(3)	(10)	(6)
Life and pensions covered business operating profit/(loss) before tax	42	17	59	(102)
Other income and charges	(2)	–	(2)	(1)
MCEV operating profit/(loss) before tax	40	17	57	(103)

FPI MCEV operating profit of £57 million has improved £160 million and reflects a £9 million improvement in VNB as well as the non-recurrence of the 2012 adverse assumption changes and other operating variances. MCEV operating profits on core business at £40 million have improved by £42 million (31 December 2012: £(2) million). Non-core MCEV operating profit of £17 million has improved £118 million (31 December 2012: £(101) million) primarily due to £(86) million assumption changes impacting 2012 principally arising from the strategic review.

The expected existing business contribution has reduced from £23 million to £19 million, reflecting the lower opening in-force book resulting from the assumption changes arising from the strategic review, combined with lower rates of expected return on all assets.

%	Rates used for expected return contribution	
	2013	2012
Reference rate	0.67	1.35
Best estimate returns:		
Corporate bonds	2.40	2.98
Equity	4.90	5.40
Property	3.90	4.40

Operating experience variances totalling £13 million are driven by improved persistency and a reduction in reserves held to back the German return of premium guarantee due to high surrender rates.

Operating assumption changes of £14 million relate to improved unit-linked mortality assumptions, improved maintenance expenses on Personal Portfolio Bonds and improved fund management rebate assumptions. These are partially offset by adverse changes to the persistency assumptions.

Other operating variances of £9 million include a favourable improvement to the modelling of the German return of premium guarantee liability.

International division additional information

IFRS based operating profit

£m	2013				2012			
	Lombard	FPI Core	FPI Non-core	Total International	Lombard	FPI Core	FPI Non-core	Total International
New business strain	(31)	(24)	(16)	(71)	(30)	(23)	(30)	(83)
In-force surplus	68	100	40	208	60	82	13	155
Long-term investment return	–	(1)	–	(1)	–	–	–	–
Principal reserving changes and one-off items	–	(3)	18	15	–	4	(74)	(70)
Development costs	(3)	(7)	(3)	(13)	(2)	(5)	(1)	(8)
Other income and charges	–	(2)	–	(2)	–	–	(3)	(3)
IFRS based operating result before tax	34	63	39	136	28	58	(95)	(9)

Sustainable free surplus

£m	2013				2012			
	Lombard	FPI Core	FPI Non-core	Total International	Lombard	FPI Core	FPI Non-core	Total International
Expected return from in-force business	44	77	20	141	36	78	15	129
Investment in new business	(24)	(39)	(22)	(85)	(23)	(39)	(62)	(124)
Development costs	(2)	(7)	(2)	(11)	(1)	(4)	(1)	(6)
Operating experience	(9)	–	18	9	(16)	(5)	(4)	(25)
Other operating variances	(3)	(9)	–	(12)	–	–	(2)	(2)
Other income and charges	–	(2)	–	(2)	–	–	–	–
Sustainable free surplus	6	20	14	40	(4)	30	(54)	(28)

MCEV operating result

£m	2013				2012			
	Lombard	FPI Core	FPI Non-core	Total International	Lombard	FPI Core	FPI Non-core	Total International
VNB	25	21	(7)	39	45	17	(12)	50
Expected existing business contribution	33	16	3	52	35	18	5	58
Operating experience variance	(25)	3	10	(12)	(23)	(5)	(7)	(35)
Other assumption changes	(82)	11	3	(68)	36	(21)	(86)	(71)
Other operating variances	6	(2)	11	15	13	(5)	–	8
Development costs	(3)	(7)	(3)	(13)	(2)	(5)	(1)	(8)
Other income and charges	–	(2)	–	(2)	–	(1)	–	(1)
MCEV operating result before tax	(46)	40	17	11	104	(2)	(101)	1

Financial review continued

Corporate

The Corporate segment includes the corporate holding and service companies of the Group, and holds all the external debt of the Group.

IFRS-based operating result

£m	2013	2012
Investment return and other items	123	118
External finance costs	(120)	(108)
Other corporate net costs	(34)	(27)
IFRS based operating loss before tax	(31)	(17)

The Corporate IFRS-based operating result is principally driven by external finance costs and corporate costs, offset by interest on internal debt. The increase in 2013 external finance costs reflects the issue of UT2 perpetual subordinated debt and repayment of the remaining deferred consideration notes from AXA Group in November 2012, together with a refinement to the finance cost methodology.

Other corporate net costs of £(34) million relate to overhead costs associated with management of the Resolution holding companies principally in respect of investor related activities. The change since 2012 reflects the increased focus of Friends Life staff on investor related activities and changes to the costs allocated from the life businesses.

Sustainable free surplus generation

£m	2013	2012
Coupon on external debt	(92)	(73)
Coupon on internal debt	–	(12)
Other income and charges	(8)	(10)
Sustainable free surplus generation	(100)	(95)

The sustainable free surplus contribution from Corporate principally reflects the debt costs (net of tax) incurred by the Group. Following the Corporate debt restructuring in November 2012, all of the Group's finance costs are now reflected within sustainable free surplus.

Sustainable free surplus continues to exclude corporate costs relating to the Resolution holding companies.

MCEV operating results

The Corporate segment consists of both non-covered and covered business. The non-covered element relates to the net assets of the corporate holding and service companies whilst the covered element principally represents the net debt liabilities held at the Group level.

£m	2013	2012
Expected existing business contribution on debt	(75)	(75)
Life and pensions covered business operating loss before tax	(75)	(75)
Other income and charges	(32)	(46)
Operating loss before tax	(107)	(121)

The expected existing business contribution on debt has remained unchanged from the previous year. The benefit of the reduction in the year in the expected rates of return applied in the calculation of the debt contribution, was offset by the higher market value of debt and the impact of debt restructuring in November 2012.

Other income and charges in 2012 included £(23) million coupon on the Resolution Limited deferred consideration notes.

Financing and interest costs

The Group has a number of debt instruments and the operating costs of financing these for the year ended 31 December 2013 are presented below.

£m (unless otherwise stated)	Coupon	Principal	Clean market value of debt ⁽ⁱ⁾	Finance costs ⁽ⁱⁱⁱ⁾	
				IFRS	MCEV
LT2 subordinated debt 2021	12.00%	162	210	(20)	(10)
LT2 subordinated debt 2022	8.25%	500	550	(41)	(26)
UT2 reset perpetual subordinated debt ⁽ⁱⁱ⁾	7.875%	356	378	(28)	(18)
STICS 2003	6.875%	210	210	(14)	(9)
STICS 2005	6.292%	268	268	(17)	(12)
Total 31 December 2013		1,496	1,616	(120)	(75)
Total 31 December 2012		1,494	1,590	(108)	(75)

(i) Market value is based on listed ask price, at 31 December 2013, excluding accrued interest.

(ii) The UT2 reset perpetual subordinated debt is a \$575 million US Dollar denominated instrument. The principal and clean market values represent Sterling equivalent values as at 31 December 2013. The finance cost of £28 million is based on the Sterling equivalent principal on the day of issue of £356 million.

(iii) Finance costs within sustainable free surplus amount to £(92) million, being the IFRS amount of £(120) million net of tax.

The finance cost included within IFRS based operating profit reflects the actual coupon paid. This represents a refinement in estimation to reflect a more accurate view of the longer term cost of the Group's external debt. In previous years, operating finance costs were based on the market value of the debt instruments. The change has not had a material impact on the results of the Group. Finance costs within the MCEV result continue to reflect the expected rate of return.

Gearing and liquidity

IFRS gearing (£m)	2013	2012
Equity attributable to equity holders of the parent	5,229	5,377
Loans and borrowings ⁽ⁱ⁾	1,050	1,099
	16.7%	17.0%

(i) IFRS debt gearing excludes the 2003 and 2005 STICS, as these securities are classified as equity in IFRS.

MCEV gearing (£m)	2013	2012
Group MCEV, gross of debt	7,688	7,427
Debt	1,623	1,596
	21.1%	21.5%

At 31 December 2013, the ratio of debt to IFRS equity attributable to equity holders of the parent, gross of debt, was 16.7% (31 December 2012: 17.0%), with the change in equity principally reflecting the payment of dividends in the period.

The MCEV gearing of 21.1% (31 December 2012: 21.5%) is marginally down over the period reflecting the increase in gross Group MCEV.

The liquidity of the Group remains strong and is complemented with an undrawn £250 million funding facility with a consortium of banks. This facility was renegotiated in May 2013 with a five year term and replaces the previous £500 million facility which had never been drawn.

Financial review continued

Cash and capital

Introduction

The Group remains committed to the optimisation of capital within the business. The Group has established cash and capital frameworks which are used to evaluate and monitor excess cash and capital, driven by strong governance and subject to regulatory approval. The cash and capital position of the Group at 31 December 2013 remains strong with ASA of £917 million and an estimated IGCA surplus of £2.2 billion resulting in a coverage ratio, excluding WPICC of 238%. At 31 December 2013 the estimated economic capital surplus at Group level was £3.9 billion corresponding to a coverage ratio of 193%.

Capital management policies and monitoring buffers

The Group's capital management policies ("CMPs") that apply at a life company level and at the Group level were set out in the 2012 full year results. These policies remain unchanged and are summarised below.

Life companies CMP

The CMP of FLL, the principal UK life company, is to meet the higher of:

- 150% of Pillar 1 requirements, excluding WPICC, FPIL and Lombard; and
- 125% of Pillar 2 requirements, including any ICG and specifically excluding FPIL and Lombard.

In addition to the above, capital within FLL is held to cover at least one year of the FLL debt servicing costs (currently £115 million per annum) and any debt repayment requirements in the following year.

Group CMP

The CMP at Group level is to meet 150% of IGCA requirements, excluding WPICC. In order to protect the CMP in the highly remote event that payment of debt costs would lead to a breach of the policy, the Group has an additional requirement in respect of debt servicing costs. This requirement is to hold excess capital, over 150%, in the form of cash or cash equivalents at holding company level sufficient to pay at least the next year's gross annual interest cost (currently £120 million per annum) and any mandatory repayments of principal that fall due on debt in the next year.

Capital monitoring buffers

The Group has a robust monitoring system and in addition to the amounts held to meet its CMPs, it holds a prudence buffer together with a monitoring buffer held within working capital.

The prudence buffer is designed to cover an additional year of the Company's current dividend and the holding companies' corporate costs. In prior years this prudence buffer also included an allowance for the interest costs associated with the DCNs, which were repaid in November 2012. At 31 December 2013 the prudence buffer was therefore reduced to £325 million (2012: £400 million), reflecting the current level of dividends and corporate costs.

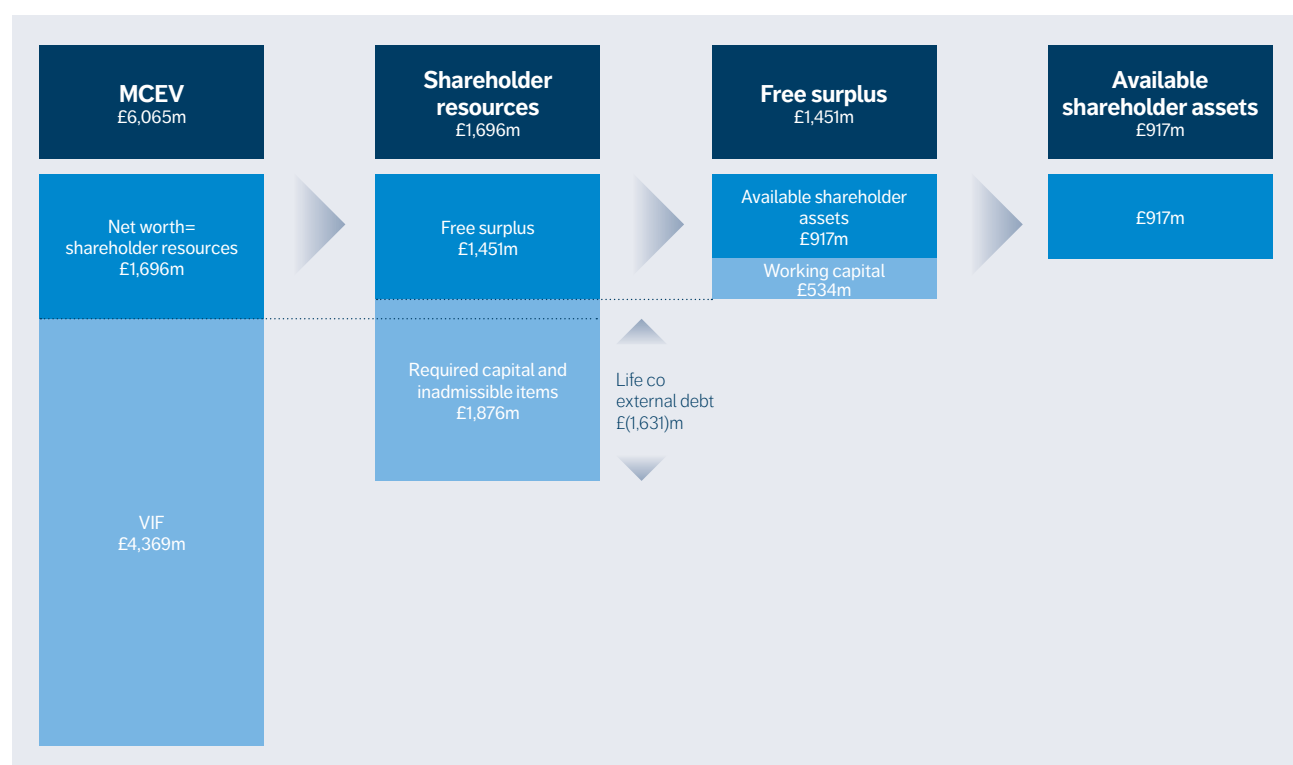
The monitoring buffers for the Group and life companies are reviewed regularly alongside the Group and life company solvency risk appetites. At 31 December 2013 the biting constraint is the Group IGCA position, and a monitoring buffer of 10% of the IGCA requirements, excluding WPICC, is held within the working capital.

Cash and capital definitions

- WPICC** represents the difference between the surplus capital calculated on a regulatory basis and that on a realistic basis, in accordance with regulations, and is excluded from both IGCA capital resources and capital resources requirements under the CMP.
- Economic capital** represents management's internal risk-based estimate of the amount of capital needed to be held to mitigate the risk of insolvency to a minimum of a 99.5% confidence level over a one year period. The coverage ratio represents the proportion of capital resources to capital resource requirements.
- The IGCA and economic capital position at 31 December 2013 of the Group and its subsidiaries are **estimated**.

Cash and capital management framework

The Group's cash and capital management framework is based on MCEV as this comprises the discounted value of expected future cash flows on a market consistent basis. The chart below shows how the core components of MCEV reconcile to ASA as at 31 December 2013.



The total MCEV is split between the net worth, or shareholder resources, and the VIF. Shareholder resources comprise the free surplus, required capital and inadmissible assets of the business. Required capital is based on the most onerous CMP for the Group, currently the IGCA. For the holding companies and other non-regulated businesses, free surplus is defined as IFRS net assets less required capital and inadmissible assets on an IGCA basis (for MCEV, where these assets relate to non-covered business, they are all included within free surplus). VIF comprises the value of the future cash flows arising from the policies currently in-force.

External debt issued by FLG is offset against required capital in the life businesses as this debt has been guaranteed by life operating companies and has been used to support their activities.

Working capital represents assets set aside to cover known future requirements and amounts necessary to maintain sufficient

flexibility to facilitate compliance with the Group CMP and additional regulatory requirements. In addition, any assets subject to restriction in their availability to shareholders will be designated as working capital and this includes any free surplus held in the life companies in excess of the life companies CMP.

ASA consists of cash and other liquid assets held by the Friends Life and Resolution holding companies, together with any dividends declared and approved by the operating companies that are yet to be remitted. As such, ASA is stated after the deduction of working capital from free surplus. ASA represents cash available to cover Resolution's corporate costs, to service debt issued by holding companies and, subject to shareholder approval, to pay dividends or return to shareholders. The generation of ASA therefore represents a key performance metric of the Group.

Financial review continued

The following table outlines the key movements in each of the components of total MCEV during the period:

£m (net of tax)	Shareholder resources			Total MCEV
	Value in-force	Required capital ⁽ⁱ⁾	Free surplus	
Opening MCEV at 1 January 2013	4,242	269	1,320	5,831
Sale of AmLife	(15)	(25)	47	7
Free surplus generated in the year	127	75	377	579
Dividend payment	–	–	(300)	(300)
Other reserve movements	15	(74)	7	(52)
Closing MCEV at 31 December 2013⁽ⁱ⁾	4,369	245	1,451	6,065

(i) Required capital is calculated based on the requirements under the Group CMP, and includes required capital of £224 million (2012: £229 million) in respect of non-covered business and £21 million (2012: £40 million) in respect of covered business.

The free surplus generated in the year of £377 million is explained in the financial performance section of the Chief Financial Officer's review.

Other reserve movements include the impact of foreign exchange movements and actuarial losses on the Group's defined benefit pension scheme.

Working capital and other assets and liabilities

The working capital at 31 December 2013 of £534 million has increased from £470 million at 31 December 2012 and is held in both the life companies and the holding companies.

The working capital comprises:

- amounts required to meet current estimates of future non-recurring costs and discretionary working capital allowances, offset by related benefits that are expected in the short term;
- an appropriate monitoring buffer to facilitate ongoing compliance with the Group's CMPs;
- amounts to cover the necessary funding to protect against any temporary shortfall in delivery of cash generation relative to Group targets; and
- restricted assets included within free surplus eg illiquid or intangible assets and any assets in excess of the CMP held within the life companies after declaration of dividends.

The largest components of working capital are the monitoring buffer (£162 million), the amounts retained within the life companies in excess of the CMP (£133 million), and amounts set aside to meet non-recurring costs (£92 million).

Available shareholder assets

The ASA of £917 million comprises £758 million of shareholder cash at Friends Life holding company level (including the £273 million interim dividend proposed by FLL), together with £159 million held by Resolution holding companies.

£m	2013	2012
Friends Life holding companies cash	485	464
Proposed dividend from FLL	273	250
Friends Life available shareholder cash	758	714
Resolution holding companies cash	159	136
Available shareholder assets	917	850

The following table outlines the key components of ASA by reference to the expected utilisation of the cash balances:

£m	2013	2012
Settlement of final dividend	200	200
Prudence buffer in accordance with Group policy	325	400
Non-specified ASA holdings	392	250
Available shareholder assets	917	850

The ASA balance as at 31 December 2013 is held to cover the costs of the proposed final dividend and to maintain a prudence buffer of £325 million which is designed to cover an additional year of the Company's current dividend cost, and the holding companies corporate costs. The Group CMP requirement to hold cash at FLG sufficient to meet one year of FLG's debt servicing costs is expected to be met from capital retained in the life companies. This is not considered to be a restriction on the availability of FLG cash, however is covered by the additional ASA holdings at Group level.

Economic capital position

The UK life operations perform a risk-based assessment of economic capital, incorporating management's estimate of the capital required to mitigate the risk of insolvency to a minimum of a 99.5% confidence level over a one year period ("the ICA"). At an individual life company level this is referred to as the Pillar 2 basis of capital management.

The Group's CMP is to maintain capital resources at the life company level to cover 125% of the capital requirements on an economic capital basis.

The Group also monitors a pro forma economic capital position at a Group level, which comprises:

- the surplus of FLL, excluding FPIL and Lombard, on an economic capital basis;
- the surpluses of the International life companies on an economic capital basis; and
- the fungible net assets of the other operating and holding companies.

The estimated Group economic capital surplus above capital requirements as at 31 December 2013 is strong at £3.9 billion (a coverage ratio of 193%). The increase since 31 December 2012 (surplus of £3.5 billion) primarily reflects market movements.

The sensitivities to market shocks show that economic capital surplus at a Group level would have reduced by:

- an estimated £0.8 billion in the event of a combined 40% fall in equity markets and a 30% fall in property markets;
- an estimated £0.1 billion in the event of a 200bps fall in interest rates; and
- an estimated £0.8 billion in the event of a widening of corporate bond spreads of 200bps (of which one-third is assumed to relate to defaults).

The sensitivities reflect investment activities, the with-profits annuity reallocation and model changes implemented since 31 December 2012.

Insurance Groups Capital Adequacy

In addition to individual company requirements, the Group is required to meet the IGCA requirements of the Insurance Groups Directive. Following the governance changes made in the first half of 2013 Resolution Limited is now deemed to be the ultimate EEA parent undertaking of the Group and as such the IGCA requirements are now reported at the Resolution Limited level. The Group's capital policy is to maintain sufficient Group capital resources to cover 150% of Group CRR (excluding WPICC).

The balance sheet remains strong with an estimated IGCA surplus of £2.2 billion at 31 December 2013, with Group capital resources being 238% of Group CRR (excluding WPICC of £4.2 billion).

The movement in IGCA surplus over the period largely reflects the generation of surplus and the proceeds from the sale of the 30% stake in AmLife, offset by external dividend paid.

Movement in IGCA surplus	£m
1 January 2013	2,154
Surplus emerging	420
Proceeds from sale of AmLife	50
Dividend paid	(300)
Finance costs and other movements	(88)
31 December 2013	2,236

At 31 December 2013 the capital held to meet CMPs was £812 million (1 January 2013: £889 million) and the excess over the CMPs was £1,424 million (1 January 2013: £1,265 million).

The sensitivities to market shocks show that IGCA surplus would have reduced by:

- an estimated £0.2 billion in the event of a combined 40% fall in equity markets and a 30% fall in property markets;
- an estimated £0.2 billion in the event of a 200bps fall in interest rates; and
- an estimated £0.6 billion in the event of a widening of corporate bond spreads of 200bps (of which one-third is assumed to relate to defaults).

Financial review continued

Management of the with-profits funds

Friends Life manages six with-profits funds, with the five significant funds shown below. Asset allocation within these with-profits funds is actively managed with the proportion of equities and property backing assets shares (equity backing ratio or "EBR") managed to the target levels shown below:

%	Target fund hedging ratio	Target EBR level	2013 Full year	2012 Full year
Friends Life FP With Profits Fund (pre-demutualisation business)	100%	45	47	47
Friends Life FP With Profits Fund (post-demutualisation business)	100%	55	57	57
Friends Life FLC Old With Profits Fund	100%	60	61	60
Friends Life FLC New With Profits Fund	100%	60	61	60
Friends Life FLAS With Profits Fund	95%	50	52	51
Friends Life WL With Profits Fund	90%	50	51	51

The target fund hedging ratio shown is the proportion of the guarantees in the fund which are hedged against falls in listed equity values.

The EBRs apply to the funds backing the majority of asset shares, although sub-funds within these may have different allocations.

For example, for Friends Life WL With Profits Fund, the benchmark applies to products with equity participation; there are some products invested wholly or partly in a purely fixed interest asset mix and these are not allowed for in the figures quoted above.

The allocation for assets backing guarantees and options within the with-profits funds comprises a range of assets including gilts, bonds and hedging derivatives (equity put and call options, equity futures, interest rate swaps and swaptions).

Non-profit business in the with-profits funds, the majority of which is annuities, is backed by a mix of gilts and corporate bonds (some with credit default swap protection to hedge the default risk). During 2013, around £2 billion of immediate annuity liabilities were moved out of the FLAS With Profits Fund to the FLL non-profit fund. However, around £0.9 billion of immediate annuity liabilities still remain in the FLAS With Profits Fund, as well as some immediate annuity liabilities in other with-profits funds.

Asset quality and exposure

The Group's financial assets as at 31 December 2013, excluding cash, are summarised as follows:

Ebn	Unit-linked	With-profits	Non-profit	Shareholder	2013 Total	2012 Total
Shares, unit trusts and OEICs	63.1	6.8	0.1	–	70.0	63.9
Government securities	7.2	7.1	1.8	0.1	16.2	18.7
Corporate bonds and asset-backed securities	5.5	7.4	9.4	0.1	22.4	22.4
Derivatives	0.1	0.2	–	–	0.3	0.8
Deposits	0.2	–	–	–	0.2	0.2
Total 31 December 2013	76.1	21.5	11.3	0.2	109.1	–
Total 31 December 2012	70.7	24.9	10.2	0.2	–	106.0

Shareholder exposure to corporate bonds and asset-backed securities is analysed by fund and credit rating as follows:

£bn	Unit-linked funds	With-profits funds	Non-profit funds	Shareholder funds	2013 Total	2012 Total
Corporate bonds and asset-backed securities	5.5	7.4	9.4	0.1	22.4	22.4
less: policyholder exposure	5.5	6.4	–	–	11.9	13.2
Shareholder exposure	–	1.0	9.4	0.1	10.5	9.2
AAA		0.1	1.0	–	1.1	1.3
AA		0.1	3.3	–	3.4	3.0
A		0.4	3.3	0.1	3.8	3.4
BBB		0.3	1.7	–	2.0	1.2
Sub-BBB or rating not available		0.1	0.1	–	0.2	0.3
% Investment grade					98.1%	96.7%

98.1% of the corporate bond and asset-backed securities to which the shareholder funds are exposed are investment grade. The Group controls its exposures to corporate issuers by rating, type of instrument and type of issuer. The sub-investment grade bonds held in investment portfolios are monitored closely in order to maximise exit values. Where asset-backed securities and other complex securities are held, the Group monitors closely its exposures to ensure that the relevant structure, liquidity and tail credit risks are well understood and controlled.

No defaults have been experienced in the period to 31 December 2013. The Group holds default reserves to cover the risk of defaults and credit rating downgrades on corporate bonds that back all annuity business within the Friends Life group. The reserves reflect assumed defaults over the outstanding terms to maturity of the bonds. The shareholder share of default reserves at 31 December 2013 was £0.45 billion (31 December 2012: £0.5 billion). This represents a haircut of 48% of the overall corporate bond spreads over gilts of equivalent term (31 December 2012: 43%).

The vast majority of the Group's exposure to sovereign debt holdings is to UK gilts. The Group has £13 million direct shareholder exposure (including shareholder fund exposure to non-profit and with-profits funds) to the higher risk government debts of Spain, Portugal, Italy, Ireland and Greece (31 December 2012: £7 million).

Financial strength ratings

The Group targets financial strength ratings in the single "A" range for its principal life business and expects them to remain there for the foreseeable future. Current financial strength ratings are set out below.

	Friends Life Limited
Fitch	A+ (strong)
Moody's	A3 (strong)
Standard & Poor's	A – (strong)

Corporate responsibility

Overview

Following the simplification of the governance structure, the composition of the Corporate Responsibility Strategy Committee ("CRSC") changed. Until May 2013 it was chaired by Phil Hodgkinson and on his resignation Andy Briggs, Group Chief Executive, took responsibility for chairing these meetings. The CRSC comprises all members of the Group Executive Committee and Marian Glen, an independent non-executive director. The CRSC's terms of reference are reviewed annually to ensure they clearly set out the purpose of the Committee and guidance on the parameters of the Group's activities. Each year the CRSC produce a report which summarises the Group's activities throughout the year. This will be published in May 2014; see <http://www.friendslife.com/crreport/>

A particular area of focus across the business this year has been employee engagement, which contributes to one of its key strategic objectives: to attract and retain best-in-class people, enabling the Group to deliver returns to our investors and focus on growing the business. Setting the tone from the top is essential to embed Corporate Responsibility ("CR") activity across the Group, and the CR Policy forms part of the Company's risk management and internal control processes.

Achievements during 2013

The CRSC meets on a quarterly basis and the Committee is supported by the CR Leadership Team, which comprises functional leaders representing each of our four strategic pillars: workplace, environment, community and marketplace. During 2013 there were some significant achievements:

- The GCE established a Diversity Forum initiative, leading to the formation of several diversity work streams throughout the business;
- The Group joined as a Champion member of Business in the Community's ("BitC") Opportunity Now and Race for Opportunity campaigns;

- The Company continued to meet the inclusion criteria to maintain its membership of FTSE4Good Index Series;
- An 11% uplift in our employee engagement score to 67%, with the CR agenda contributing to this success; and
- Accreditations during the year included certification as a Living Wage Employer and receipt of the Carbon Trust Standard, demonstrating success in our emissions reduction efforts since 2009. We also achieved the Silver level for the BitC CR Index, hoping to reach Gold by 2015.

Corporate responsibility strategy

During 2013 the CRSC identified four overarching areas: Workplace, Environment, Community and Marketplace, and within each of these four core areas identified 16 areas of activity. These were prioritised according to business need. Key initiatives prioritised during the year were actions within Workplace and Community that focused on driving up employee engagement, strengthening our partnership with Macmillan Cancer Support and generating momentum for Diversity and Wellbeing.

Workplace

People

Due to the governance simplification and the change programme, employee engagement and well being was a key area of focus for the CRSC. The annual employee engagement survey "Have Your Say", was reviewed to ensure the responses would be informative to the management team and assist in identifying what additional actions could be implemented to make the organisation a great place to work.

Two major colleague attitude surveys were conducted during 2013 to assess employee engagement. In 2013, engagement increased significantly from 56% in November 2012 to 67% in November 2013, with an 85% response rate. Whilst still short of the average within

Friends Life Corporate Responsibility strategy

Workplace	Environment	Community	Marketplace
			
Colleague engagement Wellbeing Diversity Skills development Health & Safety	Carbon management Travel – business and commuting Water usage Waste and recycling	Community volunteering Charity partnerships – fundraising and strategic collaboration Friends Provident Foundation	Socially responsible investment Supply chain management Treating customers fairly ("TCF") Code of conduct

the financial services sector, this is a clear indication we are making substantial progress towards making Friends Life a great place to work.

After the publication of engagement survey results each team leader in the organisation reports the results to their team and engagement action plans are developed at a local level. Site specific employee engagement initiatives have also taken place throughout the year. Feedback from the engagement surveys in 2012 was focused on training and development, and as the organisation was no longer focused on an exit strategy for 2014, the group was able, during 2013 to launch the following new training and development programmes for employees:

1. A Management Development Programme ("MDP") for 120 high potential managers, delivered in partnership with the Group Executive Committee ("GEC");
2. A Transition to Leadership Programme for senior leaders (GEC direct reports); and
3. Skills training sessions for other colleagues – both face-to-face and online through a Learning, Performance and Talent System.

More investment will be made during 2014, when we plan to enrol another 250 managers into our new management development programme and deliver more face-to-face training.

A series of Wellbeing Fairs, attended by approximately 25% of colleagues, were held across all our offices in the UK and overseas, to showcase and raise awareness of the breadth of benefits, facilities and opportunities available to support colleague wellbeing.

In March 2013 we were accredited as a Living Wage Employer by the Living Wage Foundation, meeting the commitment we had given in 2011.

Diversity

Encouraging a diverse and inclusive culture in the workplace is a key initiative for the Committee. The GEC regularly monitors diversity and our gender pay gap. Additional gender analysis is made for development, recruitment and performance management.

As at 31 December 2013, 2029 of our workforce of 3872 were male and 1843 female (48%). Of these, there are 146 male and 50 female senior managers – 26%. This includes individuals who are statutory directors of the corporate entities whose financial information is included in the Company's 2013 consolidated accounts in this Annual Report.

The CRSC has established a Group Wide Diversity Forum, led by the GEC, for 12 senior managers from across the business, including our International division, to facilitate appropriate action. A BitC diversity adviser supported the Forum as they established how well we meet our ambitions. The Diversity Forum held 20 Diversity Focus Groups involving 310 colleagues, and through this process identified three areas on which to focus work streams: gender, disability and improving the management information available on all areas of inclusivity data reporting.

Following the Focus Groups, a report was prepared for the Board and GEC, setting out the Forum's findings and recommendations around two main areas:

1. Supporting female colleagues as they progress in to senior roles.
2. Developing suitable training/awareness on unconscious bias, particularly in relation to disability.

An 81% score, (up 6% points) for "respecting individual differences" in our November 2013 employee survey reflects the inclusive approach adopted by the Diversity Forum in carrying out their study and the GCE's commitment to share the report with all colleagues.

The Company also completed the BitC Gender and Race benchmarking for the first time, achieving Bronze status in each. The momentum created by the work of the Forum and the GCE's very public support met with public recognition from BitC as they referenced our inclusive approach in an Opportunity Now blog, and the Company is a BitC "Big Tick" winner for the Opportunity Now Transparency Award.

Environment

This year the Group participated in the Carbon Disclosure Project, both as a signatory and as a reporting company, and were re-accredited with the Carbon Trust Standard, an award we have held since 2009. This demonstrates continued success in managing our emissions. The decision has been taken to apply for the new Carbon Trust Waste Standard in the year 2014. Due to our re-invigorated CR agenda, there was a 15% point increase in the engagement survey question "I believe that this organisation is environmentally responsible".

Following changes in Defra's emissions reporting guidelines, our emissions figures were re-calculated back to our baseline year of 2011. For 2013 we further expanded the boundary of our Scope 3 reporting, to include water waste and refrigerant leaks from air conditioning and chillers.

The overall carbon footprint for the Group was established as 23,353 tonnes CO₂ (2012: 24,560 tonnes CO₂), which equates to an intensity of 0.19 tonnes per m² or 6.03 tonnes per employee (2012: 0.21 tonnes per m² or 6.36 tonnes per employee). The 2013 emissions figure includes 1,405 tonnes CO₂ from FGas and waste water treatment, not previously measured. Like for like emissions reduction were therefore 10.6%.

Besides energy consumption, the Company seeks to manage waste and water. In 2013, 2,851 tonnes or 65% of generated waste was recycled (2012: 63%), with the remaining 1,510 tonnes going to landfill (2012: 1,313 tonnes). Total water consumption was 104,491 m³ (2012: 78,428 m³), which equates to an intensity measure of 26,986 litres of water per employee (2012: 20,840 litres). The reasons behind this increase are being investigated through in depth year on year comparisons.

CO₂ equivalent emissions all scopes

Tonnes of CO₂ equivalent

	2013	2012	2011
Scope 1: Direct energy used in operations, for example, gas and oil	5,512	5,893	6,124
Scope 2: Electricity purchased for owned/occupied buildings	13,262	14,764	15,122
Scope 3: Electricity purchased for leased and occupied buildings, business travel, waste, water and refrigerant gas leakage	4,579	3,903	4,822

Scope 1: Direct energy used in operations, for example, gas and oil
Scope 2: Electricity purchased for owned/occupied buildings
Scope 3: Electricity purchased for leased and occupied buildings, business travel, waste, water and refrigerant gas leakage

Corporate responsibility continued

Community

The CRSC approved a number of developments to our Community Investment Strategy during 2013. The aim was to create a balance between Group promoted activity for our charity partner, Macmillan Cancer Support, and supporting the charities chosen by colleagues and the local communities in which we operate. Matched funding was approved for individual colleague charity fundraising. The Company is also setting up new Community Foundation Endowments for UK offices from 2014. There was a 24% point increase in the community responsibility score in November to 81% which reflects well on these activities.

The total community investment in 2013 was £1.9 million compared to £1.2 million in 2012, measured against London Benchmarking Group guidelines. The increase is due in part to the expanded elements of our community strategy, but mainly better data capture throughout the Group. Employees volunteered 7,835 hours in company time. Fundraising and company donations for our charity partner, Macmillan Cancer Support amounted to £140,000, bringing our total since the partnership began in 2011, to £262,000.

We set ourselves a target of raising £140,000 to pay for the Information and Support Centre in a £3 million refurbishment project for cancer services at Lister Hospital in Stevenage. We met that target in one year; six months ahead of the opening of the new Macmillan Cancer Centre.

A "Challenge Fortnight" is held annually, where teams engage in a variety of team building projects benefiting the local community, including ground clearance for a local hospice and creating a relaxation area for a disability charity. 2013 saw a 20% uplift in the number of team challenges undertaken, involving 700 colleagues, equating to approximately £100,000 community investment in employee time. The Company introduced new internal CR Awards to recognise the contribution colleagues make to their local communities, support charity or environmental activity. There were winners for each office site with the overall winner chosen by the GCE. The winner of the 2013 has been a volunteer fireman for the past 17 years, and received £500 towards a charity of his choosing.

2013 was the second year of a three-year commitment of support of BitC's "Seeing is Believing" programme. The programme seeks to help business leaders see first-hand what a difference a responsible business can make. The programme highlights success stories of community investment projects to future business leaders, in order to grow the network of engaged companies in the UK. The development of the Seeing is Believing alumni network and the impact of the programme as a whole will support BitC's campaign to develop more responsible business leadership and provide opportunities to engage the next generation of responsible leaders.

Assurance

AECOM Sustainable Development Group has undertaken verification of our environmental data, based on the process outlined in the Greenhouse Gas Protocol which includes a rigorous examination of the methods used to record, collate, calculate and audit greenhouse gas emissions reporting. Corporate Citizenship has provided assurance to the Company's community investment data in accordance with the London Benchmarking Group model. More information is available on the Company's website: www.resolution.gg.

Marketplace Customers

Delivering a positive outcome for customers remains a core focus across the Group – from the development and distribution of new propositions in our UK and International businesses to customer retention in our Heritage business.

The GCE and executive management team are committed to ensuring that a focus on customer outcomes remains embedded in the Group's values, which is why it is one of a number of mandatory online training modules that must be completed annually. Employees have at least one performance objective linked to their personal delivery of positive customer outcomes and our corporate values include a specific customer focus. To monitor our ongoing TCF delivery and to mitigate emerging customer risks, performance against a consistent set of measures is reported by each business unit (including our suppliers). These reports enable our executive management teams to take timely actions and decisions to protect customer outcomes.

There were a number of developments to support current Friends Life customers. Under the Group Income Protection proposition, the Cancer Work Support service has been introduced to support members who have a cancer-related condition and are ready to return to work or need support to return to work in the future. Our claims team have received training from Macmillan Cancer Support, and the mental health charity Mind was conducted during the year. The objective of this training was to enable greater empathy and knowledge of additional information and services for members who have a mental health-related condition.

Responsible investment

The Group has in excess of £100 billion of funds under management and is aware of its duty to invest responsibly and ensure that the management of ethical, social and governance ("ESG") factors are incorporated into the investment decision-making process. Friends Life continues to offer socially responsible investment solutions for customers who wish to invest in line with their ethical principles.

Such factors are now embraced by the UK Stewardship Code, which encourages asset managers to research and analyse ESG factors, engage in dialogue with companies to encourage responsible business practice and vote in respect of their shareholdings. Both of the Group's major asset management houses are signatories to the Code whilst ESG processes and controls of all other fund managers form part of Resolution's ongoing oversight and governance.

Participation in industry initiatives, public policy and regulation

2013 has been an important year for industry developments, with the introduction from 1st January of Gender-Neutral Pricing, and of the Retail Distribution Review. Although auto-enrolment started in late 2012, it has taken considerable strides during 2013, with many of the largest employers in the country "staging", and their employees being auto-enrolled into new or existing pension schemes.

The Friends Life business strongly supports Auto Enrolment initiatives and during 2013 supported 274 employers through their auto-enrolment staging process, with over 100,000 employees being enrolled.

The regulatory environment continues to develop, and the Company has been increasingly active in discussions through the year, both via the Association of British Insurers ("ABI") and directly with our regulators, seeking to ensure good outcomes for consumers and intermediaries, as well as supporting the commercial interests of life insurance providers.

We have worked alongside the ABI and the Office of Fair Trading ("OFT") to help design the industry agreements on Independent Governance Committees and legacy pension scheme audits. We have also contributed to the Department for Work and Pensions' ("DWP") consultation on charges in workplace pensions, and to the debates around provision for long-term care.

We expect that these issues will continue to be active during 2014, and that others – for example annuity market reform – will come to the fore. The Company will continue to make an active contribution, providing its own unique perspectives as well as working alongside like-minded organisations both within and outside our industry sector.

Governance of with-profit funds

Various safeguards exist to maintain an appropriate balance between the interests of with-profits policyholders and shareholders.

As required by the industry regulator, Friends Life Limited ("FLL") publishes Principles and Practices of Financial Management ("PPFM") in respect of each with-profits fund which set out how it will ensure fairness between these with-profits policyholders and shareholders.

The With-Profits Committee of FLL and FLP, chaired by Robin Phipps, a non-executive director of the Company, provides an independent opinion on whether each PPFM is being adhered to and more generally on whether the Boards of FLL and FLP have exercised their discretion on with-profits policies fairly.

In accordance with statutory requirements, whenever policies and backing assets are transferred between life companies, an independent report must be obtained to assess the impact of the transfer, in order to obtain court approval. This requirement was adhered to in relation to the 2013 and previous Part VII transfers.

The With-Profits Committee reports annually to the FLL Board, and publishes its report on the Friends Life website.

“We will continue to drive forward our diversity agenda and make further progress with colleague engagement.”

Risk management

Generating value safely through a strong risk culture

Our strategic aim is to develop a sustainable business that meets the needs of customers and delivers cash and appropriate returns to shareholders. As with all businesses, the Group is exposed to risk in pursuit of its objectives.

Enterprise risk management (“ERM”) is the discipline by which we safeguard the interests of customers and shareholders. This is achieved through the identification, assessment, management, monitoring and control of current and emerging risks, against a set of agreed risk appetites and limits, in order to develop a sustainable business that meets the needs of customers and delivers cash and appropriate returns to shareholders within appropriate risk boundaries.

Specifically, this means ensuring a strong risk culture supported by:

- strong leadership and tone from the top, which focuses on generating value safely through clear articulation of the risks, and the quantum of those risks, that the Group is willing to accept in the pursuit of managing customer and shareholder expectations;
- investment in the development and capability of our people, systems and processes that are fundamental to effective risk management;
- appropriate incentives to drive desired behaviours that are consistent with our risk strategy;
- organisational and governance structures, led by the Board, to ensure appropriate control and oversight of risks in an effective and efficient manner;
- effective controls to ensure that adequate capital is being held in relation to the risk profile and this is deployed effectively; and
- management information and reporting that evidences and supports risk based decision-making.

Day-to-day, this means making better business decisions.

Key activities over 2013

- Fundamental shift in how we run our business through the successful de-layering of management structures, including a complete update of the Risk and Governance structure to reflect the organisational design;
- risk strategy and appetite firmly integrated into strategic and business planning;
- proactive management decisions to improve our ability to generate value safely and to de-risk the embedded value;
- continued investment in our risk framework;
- improvements to our credit and longevity modelling capability;
- development of the Group policy framework and revision of our risk policies to ensure that they remain relevant to our risk profile and set the right tone; and
- development of the Own Risk and Solvency assessment (“ORSA”) and the Business Use framework that demonstrates how risk is embedded in the business.

2014 outlook

Having completed the transformation of the business, we are now strategically positioned to build on the growth opportunities within the clear risk parameters that have been established through the risk framework. We continuously improve and develop our risk framework through:

- continued development towards Solvency II compliance;
- initiatives, such as reallocation of with-profits annuities to non-profit funds to further de-risk the with-profit funds within our balance sheet;
- risk based performance measures; and
- delivering our strategic objectives, safely.

Generating value safely through a strong risk culture



Risk management framework

The Board's philosophy underpinning the Group's risk management approach is that it should be designed, implemented and maintained in a manner that supports management's decision making and helps management to deal effectively with uncertainty.

Our ERM framework sets out the key activities that we undertake in order to operate in a risk-conscious manner.

The diagram below illustrates the key components of the ERM framework.



Risk strategy, appetite and limits

The setting of risk strategy, appetite and limits sits at the heart of the ERM framework. As part of the business planning cycle, we consider the principal risks to which the Group is exposed and determine the types and level of risk that we are willing to take in order to achieve strategic objectives and meet obligations to stakeholders.

Risk strategy

The Group's risk strategy provides an informed, risk adjusted lens through which all business decisions are made. The risk strategy is regularly reviewed by our Risk and Compliance Committee who take a disciplined view of the risks that the Group takes in order to deliver the business strategy. The risk strategy articulates the Group's preference for risks in terms of: risk that we seek, risks that we accept and risks to which we are adverse. For example, the 2013 review confirmed that the Group will seek to take additional longevity, mortality and morbidity risk, reflecting the expected rewards in taking these risks, their diversification benefits and the expertise the Group has in their management. By contrast, we aim to minimise risks, where there is little or no reward for taking these, such as persistency and expense risks.

Risk appetite and limits

The Group's risk appetite articulates the magnitude of different risk types that the Group is prepared to take. During 2013 work has been undertaken to review the Group's high level risk appetite statements for:

- solvency
- dividend
- return
- reputation
- liquidity

The risk appetite provides a reference point against which the Group's risk profile and business opportunities can be assessed and monitored.

The risk appetite and limits influence our strategic direction and material business decisions. As an integral part of business planning, each of the Group's businesses are required to explicitly consider the extent to which business plans remain within risk strategy and appetite. This ensures that plans are considered in light of the impacts to risk strategy and appetite.

Furthermore, business plans are stressed against extreme events to give confidence as to the strength of the capital position and our ability to deliver on our strategic objectives, now and over the planning horizon.



ERM life cycle

Once the risk strategy and limits have been agreed, they are given practical effect through the operation of the ERM lifecycle.

The ERM lifecycle provides a consistent approach to identifying, assessing, monitoring and managing enterprise risks across the Group and enables meaningful reporting of current and emerging risks.

The ERM lifecycle safeguards the interests of our customers, shareholders and staff through:

- the identification and categorisation of current and emerging principal risks
- assessment and measurement of the identified risks in order to understand the nature and scale of the risk profile
- monitoring of the risk profile to ensure adequate capital is held and deployed effectively
- appropriate and prudent risk management approaches to mitigate and control these risks
- effective management information and reporting to allow decisions to be taken (including those relating to strategic objectives) in a risk-conscious manner.

Risk management continued



Risk fundamentals

There are a number of components that support and drive the effectiveness of the ERM lifecycle, which the Group articulates as:

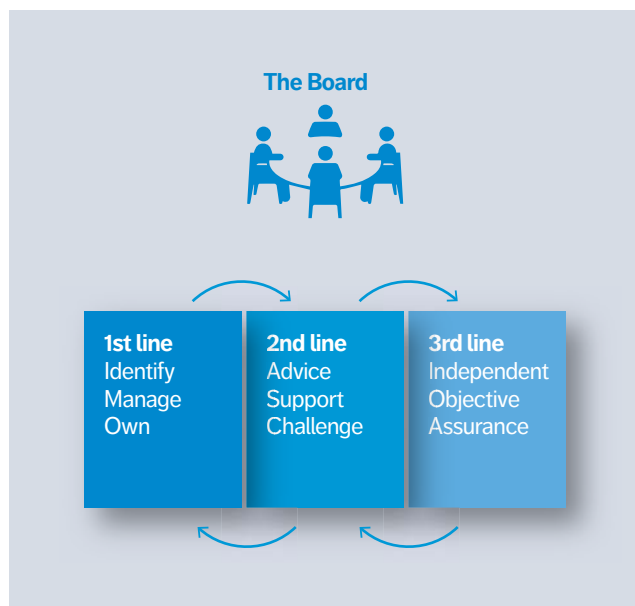
- insight and use
- systems and data
- culture and communications
- external environment

These fundamental components combine to create an effective Enterprise Risk Framework and we invest heavily in supporting these tools.



Risk governance and oversight

Supporting our risk framework activity is a robust **governance and oversight structure** that ensures that enterprise risk management is overseen and controlled in an effective and efficient manner.



The Board is ultimately responsible for ensuring that good corporate governance is in place and establishing the systems of internal control and risk management across the Group. Throughout the organisation, the “three lines of defence” model is used to structure roles, responsibilities and accountabilities for risk and control activity, including risk governance and risk based decision making within the business. The Group has established risk committees at various levels throughout the organisation to assist the Board in discharging its responsibility for ensuring effective systems of internal control and risk management. The Board delegates responsibility to ensure robust risk management practices are in place to the Risk and Compliance Committee, membership of which is made up of non-executive directors and is regularly attended by the executive directors of the company.

Following the organisational restructure during the year, a full review of the governance structure and Risk Committees terms of references were completed to ensure consistency and alignment of duties. The revised Governance structure:

- promotes the separation of the Audit Committee and Risk and Compliance Committee;
- continues to place decision-making and accountability at the right level within our organisation;
- creates an effective risk culture so that we make decisions conscious of any risks and mitigate appropriately;
- provides clarity in relation to the roles and responsibilities of the three lines of defence and delegated authorities; and
- maintains that all staff within the Group have some responsibility for risk and control activities as part of their performance objectives.

The Board has actively encouraged the Executive and management to contribute to the development of the Group’s Enterprise Risk Management framework and optimisation of the overall risk profile, consistent with the overall risk appetite set by the Board.

Essentially, the model aims to ensure that everyone in the Group is clear about their responsibility in relation to risk activities in order to promote efficient systems of governance.

Risk policies

The Group has a set of policies that outlines the core principles to which the Group must adhere. The policies are reviewed on an annual basis to ensure they remain fit for purpose and aligned to the risk profile of the business, its strategic direction and the external environment in which it operates.

Through the annual review process, the Board continued to refine the set of Group policies. The Group policies cover the key risk areas that the Board has identified as most important to its business and set minimum standards by which the Board expects each part of the Group to operate, thereby creating a consistent framework for management and governance. The Group has processes in place to ensure that as changes in the Group policies are cascaded down to its businesses, gap analyses are performed against any new requirements and plans developed to address any gaps identified. The ERM framework includes our Governance and Oversight arrangements, which set out how risk management is directed and controlled. It aims to support risk management through a defined and documented framework of policies, processes and procedures, and specified responsibilities and authorities. Delegated Authorities have been collated and documented to ensure the right people carry out certain roles and activities that require specific skills, knowledge and expertise when making business decisions. Delegated authorities and the terms of reference of the Board committees are subject to review at least annually, to ensure they continue to reflect the needs of the Group.

The Group is assessed on its adherence to the Group policies through the bi-annual Control Self Assessment process as required by Turnbull, which incorporates all key policy requirements. Further detail on the review of the system of internal controls is set out in the governance report on page 91.

Principal risks and uncertainties

The Group actively identifies, assesses and monitors current and emerging principal risks. These are regularly reviewed by the Executive and Risk and Compliance Committee. The following risks present the principal risks deemed to be facing the Group at the current time:

Risk	Description and impact	How we manage
Regulatory change, including tax and Solvency II	<p>The Group operates in a highly regulated financial services market both in the UK and internationally. This has a significant impact and influence on both strategic decisions and day-to-day management of the Group.</p> <p>It is impossible to fully predict the nature of the regulatory changes which may occur in the future or the impact that such changes may have on the Group and its strategic objectives.</p> <p>Some changes in legal requirements (including taxation) and regulatory regimes, or the differing interpretation and application of regulation over time, may have detrimental effects on the Group. The risk of the regulatory environment having a detrimental impact on the Group is believed to be increasing.</p> <p>Specific items of current note are:</p>	<p>The Group has processes in place to identify emerging risks from regulatory and legislative change and to monitor the timely implementation of new requirements.</p> <p>There is often only limited opportunity to influence regulatory change outcomes and therefore the Group's response is to base its business strategy on prevailing regulation as well as both known and planned change.</p> <p>The business plans are stressed against extreme events, including regulatory change, to give confidence as to the strength of the capital position and our ability to deliver on our strategic objective, now and over the planning horizon.</p>
	<p>Solvency II</p> <p>Solvency II will have implications for the whole industry as to the way in which companies calculate capital. Solvency II continues to be viewed as potentially having a significant impact on the Group.</p> <p>A trilogue meeting in November 2013 finally resulted in an agreement on Omnibus II (Solvency II). The outcome confirmed the goal of the long awaited start date for Solvency II as being 1 January 2016 and produced a position on long standing areas of debate. We are awaiting the final text of outcomes but these details already provide greater certainty over the content and timeframe of Solvency II.</p>	<p>There remains considerable further work to transition the Group across to a Solvency II basis.</p> <p>With greater certainty around the implementation dates, detailed planning work has been completed to ensure readiness. In the absence of final regulation, we will continue to adapt our plans as specific requirements are confirmed. Nonetheless, as we transition, there will be an impact in terms of the way in which the Group needs to hold capital against a Solvency II balance sheet and we will consider how best to do this in the manner that best serves our customers and shareholders.</p>
	<p>Annuity market developments</p> <p>There is a risk that politically motivated changes will impact on the annuity market in the run up to the next General Election which will be called on or before 7 May 2015. The direction has been made clear by the Financial Services Consumer Panel ("FSCP") recommending regulatory and government-led structural reform of the annuities market. Views have been expressed by Government on the desirability of a "portable" annuity. Coupled with the FSCP views, the Financial Conduct Authority has suggested that some parts of the annuity market are not working well for consumers and identified a number of concerns; a competition market study has also been launched as a continuation of this work.</p>	<p>These developments potentially pose a challenge to the current structure of the annuity market. We will consider how the Group can develop our annuity proposition in the market in line with a changing environment.</p>

Principal risks and uncertainties continued

Risk	Description and impact	How we manage
Regulatory change, including tax and Solvency II (continued)	Retail Distribution Review <p>The Retail Distribution Review ("RDR") came into effect in January 2014 and will have a wide reaching impact on the way in which financial advice is provided across the industry and the way in which consumers pay for that advice. Now that the measures are in effect, the real implications of RDR on the financial services advisory market and consumer purchasing patterns are expected to emerge. This will be an area that all those providers offering advice will inevitably watch closely for emerging trends over the coming year.</p>	<p>In the lead up to RDR becoming effective, the Group has taken a rigorous approach to ensuring compliance with RDR measures and the potential effect of RDR on our products and services. We will continue to track emerging trends to ensure that our business model continues to be relevant and appropriate for customers. This is particularly relevant within Sesame, where, given the distribution via Authorised Representatives, it is expected that trends towards restricted advice may emerge quicker than in other advisory areas.</p>
	OFT/DWP workplace pensions consultation <p>Following a review by the Office of Fair Trading, the Department of Work and Pensions have stated that they are considering proposing a pension scheme charge cap.</p>	<p>The outcome and implementation of the OFT and DWP reviews of workplace pension arrangements remains uncertain. The extent of any changes, including the potential impact from charge caps (and any consequent increased requirement to hold capital) on providers of workplace pensions together with any requirement to remove commission payments and the industry response to these measures could have a range of possible impacts on the Group's trading and financial performance in 2014 and beyond.</p>
Economic conditions	<p>Changes in economic conditions give rise to changes in the values of the assets and liabilities of the Group's insurance businesses.</p> <p>The Group is impacted by conditions in the UK and other European countries as a result of its operations and investment assets being predominantly focused in these countries.</p> <p>Global economic output strengthened in the second half of 2013 and it is anticipated that this trend will continue in the short-medium term. Forward-looking projections point to: a turning point from recession to recovery within the Euro area; continued growth in emerging market and developing economies; revised downward growth in the Middle East. This mixed economic picture paints continued challenges but also potential opportunities for the Group's international subsidiaries.</p> <p>Sustained low interest rate was noted as a principal risk in 2012. This risk typically reduces with economic growth, however, should it materialise sustained low interest rates could have a material impact on the business. This is due to insurance businesses and shareholder funds being invested in corporate bonds, cash instruments and government debt which typically see yields reduce in a low interest environment.</p>	<p>The Group actively monitors changes in the economic environment to enable proactive management of impacts to relevant markets.</p> <p>We mitigate the impact of economic conditions through measures such as the matching of long-term assets and liabilities, the use of financial instruments to reduce the volatility of returns on assets, diversification in the product portfolio, and by ensuring that the Group is robustly capitalised.</p> <p>Specifically, our exposure to sovereign debt from all but the strongest countries in the Eurozone is modest.</p> <p>Stress and scenario testing is used to form a view on the implications of extreme events, such as long-term low interest rates so as to understand how best to manage that scenario.</p> <p>Approaches, such as further diversification into additional asset classes in which the Group invests, are being considered as part of investigating the opportunities to increase the rate of return achieved without significantly increasing the investment risks taken.</p>

Risk	Description and impact	How we manage
Credit	<p>The Group faces significant credit risk exposure (both from credit default and credit spread widening) as a result of its use of corporate bonds to back non-profit business and for the investment of shareholder funds.</p> <p>In 2013, UK Government debt was downgraded. Given the nature of the Group's liabilities, this did not have a material effect on the asset strategy.</p> <p>The shareholder funds have also taken on additional credit risk following the transfer of annuities from the with-profits funds. The additional risk is commensurate with the return and appetite within the shareholder funds.</p>	<p>We mitigate our exposure to credit risks by adopting a conservative investment policy with investment skewed towards bonds with high credit ratings.</p> <p>Credit risk is regularly monitored within the Group and the Group has improved its credit modelling with the implementation of a market leading credit risk model.</p>
Variation in principal valuation assumptions	<p>Writing life assurance and pension business requires the setting of assumptions about future experience. The factors considered in these assumptions include mortality and longevity, lapse and persistency rates, valuation interest rates, credit defaults and expense levels.</p> <p>Events causing a substantial change to these assumptions could require them to be recalibrated and impact the profitability, earnings and capital position of the Group.</p>	<p>Assumptions that are made are subject to rigorous and ongoing review and we take a prudent approach to evaluating the appropriate level of provisions and capital for each of the Group's risks.</p> <p>Stress and scenario testing is used to validate the appropriateness of key assumptions against single events and combinations of extreme events including economic conditions, investment performance, lapse and mortality/morbidity events.</p>
Outsourcing	<p>As part of the Group's strategy for increasing operational efficiency it utilises various outsourcing capabilities, including long-term strategic partnerships with Diligenta and Capita who provide specialist IT and business processing.</p> <p>The Group also has key relationships with HSBC and State Street who, between them, provide Investment middle office, fund accounting and unit pricing operations.</p> <p>Fund management services are provided by AXA Investment Managers and F&C Asset Management plc.</p> <p>There are risks associated with outsourcing, for example, if the outsourcer is or becomes unable to provide the expected services or does not provide them to the standards and quality expected.</p>	<p>The Group's outsource suppliers continue to provide good service. During 2013, the Group executed the first major migration from two legacy systems to a system operated by Diligenta. This was a significant operational milestone. Further migrations are planned for 2014 and 2015.</p> <p>The Group has service level agreements in place with its outsource partners and actively monitors the standards of delivery against these agreements in order to mitigate the risks associated with outsourcing.</p> <p>The Group is part way through a programme which will improve the risk framework in place to manage and monitor operational risk, including that which falls within our outsource suppliers. The improvements will ensure that the framework is appropriate to the Group's evolving needs and operations.</p> <p>The financial strength and strategic position of the Group's major outsource partners are actively monitored in order to manage potential counterparty credit and continuity of service risks.</p>

As stated in note 1 to the IFRS consolidated financial statements, the Directors have considered the Group's risks and uncertainties and are satisfied that the Group has sufficient resources to continue in operation for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the consolidated financial statements.



Governance

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Governance



Securing your tomorrow, today

By managing our business effectively, we create a working environment that enables us to understand our customers' needs and generate value safely, by managing risk and operating with integrity, responsibility and respect.

Company structure and the partnership model

Corporate structure

The Company is a limited company incorporated in Guernsey, with a premium listing on the London Stock Exchange. It was originally established as an investment vehicle to buy and sell assets in the financial services sector, which it would hold through a Guernsey incorporated limited partnership, Resolution Holdco No. 1 LP. The Company is the General Partner of Resolution Holdco No. 1 LP and operates and manages its assets for the benefit of itself and RCAP UK LP ("RCAP"), the Limited Partner. For UK purposes, Resolution Holdco No. 1 LP is regulated as a Collective Investment Scheme. See below for further detail.

When the Company was formed in 2008, it had an independent Board of nine non-executive directors and no executive directors. The executive management function was undertaken by Resolution Operations LLP ("ROL") under an outsourcing arrangement documented in an Operating Agreement. For the purposes of the Listing Rules this structure was described as an externally managed structure.

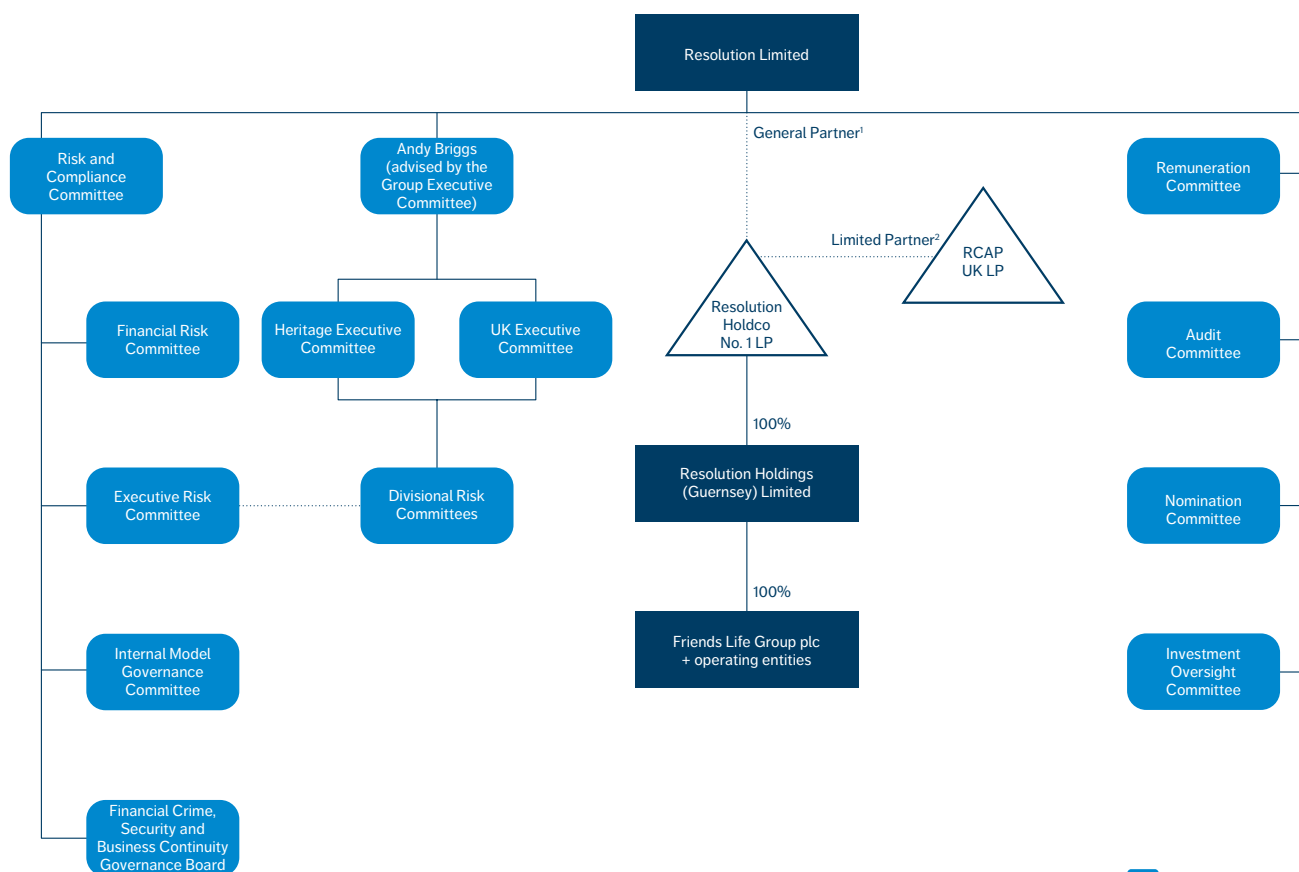
Between November 2009 and 31 January 2011, the Company acquired three assets, namely Friends Provident Group in 2009, the AXA UK Life businesses in 2010 and Bupa Health Assurance in 2011. The collective name for these assets is the Friends Life Group but they are also referred to as the UK Life Project.

The Company holds its investment in the Friends Life Group through Resolution Holdco No. 1 LP.

From the time of the acquisition of Friends Provident Group in 2009 until 27 March 2013, the Board of FLG was different to that of the Company. It comprised a Group Chief Executive (GCE), Chief Financial Officer (CFO), seven independent non-executive directors and two non-executive directors who were not classed as independent. Both the Company and FLG had their own independent governance and committee structures with clearly defined decisions reserved for each board and a delegated authority framework between the two companies.

During 2011 and 2012, various amendments were made to the constitution and governance of the Company as a result of developments in its strategy. In 2011, the Company indicated that it would not undertake any additional restructuring projects until it had successfully completed the UK Life Project. The Operating Agreement between the Company and ROL was amended to reflect that the new focus of the Company would be the successful completion of the UK Life Project.

Governance structure



1 99.99% capital interest and exclusive responsibility for the management and control of the business of the RHN1 Partnership.

2 0.01% capital interest.

Following feedback from shareholders in 2012, and in part as a result of changes to the Listing Rules regarding externally managed companies (CP2/12), the Company announced on 15 August 2012 that it would no longer seek acquisitions or target a specific exit event in respect of the UK Life Project. In connection with that development, the Company collapsed the twin governance structures in place. In practice, this meant unifying the membership of the boards of the Company and FLG such that the directors of each company were the same, including appointing the GCE and CFO to the Board of the Company, novating the Operating Agreement from ROL to a subsidiary of FLG and transferring to FLG the capability to provide the business services which to that point had been provided by ROL. This also reduced the overhead costs attributable to managing a two-tier governance structure. Furthermore, the changes ensured that there was no risk to the Company's premium listing from the implementation of CP2/12.

In order to achieve the unified board membership, changes to the Articles of Incorporation of the Company were required to enable UK-resident executive directors to join the Board, to

remove residency restrictions on non-executive directors and the company secretary, and to enable board meetings to take place in the UK. Shareholders endorsed these changes, including the changes to the composition of the Board, at a General Meeting held on 20 March 2013 and the new structure was implemented on 28 March 2013. From that date, the Board has managed the business and all key strategic operational decisions have been reserved to it.

The changes to the corporate governance structure implemented in March 2013 also meant that the Company became UK tax resident. As General Partner of Resolution Holdco No. 1 LP moved onshore, the Company was required to be approved by the FCA as the operator of a Collective Investment Scheme. This approval was obtained in 2013. In addition, the FLG Board Committees were dissolved and the Board of FLG now meets solely to approve the statutory matters detailed on page 80. Details of further changes to the composition of the Board during the year can also be found on page 81.

Partnership structure

FLG is held through a partnership, Resolution Holdco No. 1 LP. Resolution Holdco No. 1 LP has two partners: The Company as General Partner invested 99.99% of the capital deployed in the partnership, and RCAP as Limited Partner invested the other 0.01% of the capital deployed.

The partnership structure was created in order to reward the founders of the Company (the partners in ROL, including Clive Cowdery and John Tiner¹) and other former partners and employees of ROL for the added value created in Resolution Holdco No. 1 LP. The founders hold interests in RCAP and it is through these interests that they are rewarded. This arrangement through which the founders are rewarded is known as the "Value Share".

The Company and RCAP are parties to a Limited Partnership Agreement ("LPA"), pursuant to which the Company is appointed to manage the assets of the partnership, ie the Friends Life

Group, for a specified purpose, namely to generate returns for the partners; both the Company as General Partner and RCAP as Limited Partner.

The Company as General Partner also owes statutory duties under Guernsey law to RCAP, among other things, to act with the utmost good faith towards RCAP as Limited Partner.

In managing and developing the Company's strategy for the Friends Life Group, the Company and the Board must bear in mind its obligations under the LPA and its duties under the relevant Guernsey laws. As the interests of the Company as the General Partner and RCAP as the Limited Partner are generally aligned (both benefit from the generation of returns), and are expected to continue to be aligned, these obligations and duties are unlikely to constrain RSL's discretion to manage the Friends Life Group.

¹ Clive Cowdery and John Tiner's respective interests in the Value Share are set out in the Directors' Remuneration Report in the footnotes on page 115. Interests in the Value Share are also held by former partners and employees of ROL.

How the Value Share works¹

As and when capital is required by Resolution Holdco No. 1 LP, eg returns in order to make acquisitions, the Company as General Partner contributes 99.99% of the required capital (usually by raising funds from shareholders) and RCAP as Limited Partner would contribute the other 0.01% of the required capital (which it would obtain from the owners of RCAP).

As and when returns are generated at Resolution Holdco No.1 LP these returns may be distributed to its partners. Returns distributed from Resolution Holdco No. 1 LP are distributed according to the following rules:

- Firstly returns are distributed to the Company until it has received back all of the gross capital it invested plus an agreed annual return (currently 4% p.a.).
- Secondly returns are distributed to RCAP until it has received back all of the gross capital it originally invested.
- All returns distributed from Resolution Holdco No. 1 LP after the satisfaction of these two thresholds will be distributed 90% to the Company and 10% to RCAP.

RCAP's 10% economic interest in such distributions is what we describe as the "Value Share".

The gross capital contributed to Resolution Holdco No. 1 LP by the Company to date is £4,056 million. As at 31 December 2013, the Company had received aggregate distributions of returns from the partnership of £1,066 million and the aggregate "agreed return" to 31 December 2013 was £553 million. Therefore the cumulative returns which still needed to be distributed to the Company from Resolution Holdco No. 1 LP before RCAP would become entitled to share in future distributions was £3,543 million at 31 December 2013.

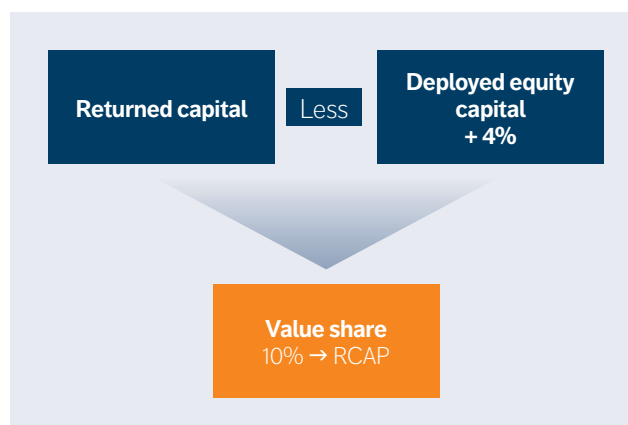
If the returns distributed from Resolution Holdco No. 1 LP remain at the current level of £350 million per annum; and assuming that no additional capital is deployed in Resolution Holdco No. 1 LP; that the agreed return figure does not change from 4.0% p.a., and that there are no one-off special returns distributions from Resolution Holdco No. 1 LP; RCAP's entitlement to 10% of future returns distributed from Resolution Holdco No. 1 LP would commence in 2026.

It should be noted that the use of any returns distributed to the Company from Resolution Holdco No. 1 LP has no impact on the date on which RCAP becomes entitled to share in future distributions of returns from Resolution Holdco No. 1 LP. That is, it is irrelevant for this purpose whether the returns received by the Company are retained in the Company itself, used to pay an ordinary or special dividend to the Company shareholders, or are used to fund a share buyback.

If the Company were to undertake further acquisitions and additional capital needed to be injected into Resolution Holdco No. 1 LP in order to fund these, RCAP would be required to contribute 0.01% of any such capital required by the partnership. Such a capital raising would increase the amount of deployed equity capital at work in Resolution Holdco No. 1 LP from which RCAP would eventually be entitled to receive 10% of distributed profits.

Such further acquisitions made in Resolution Holdco No. 1 LP might, or might not, extend the time period until RCAP started to receive such distributions. The impact on timing would depend on whether the FLG business was proportionately more or less cash generative relative to total capital deployed after the acquisition compared to the position before the acquisition.

Operation of the Value Share



Resolution Operations LLP ("ROL")

ROL is a UK registered limited liability partnership and is a member of The Resolution Group the original sponsor and founder of the Company, which is not controlled by the Company or linked to the Company in any way other than through the named individuals below and the Value Share as explained above.

The original partners of ROL included Board members Clive Cowdery and John Tiner, as well as Jim Newman, a member of the Group Executive Committee. Clive's and John's interests in the Value Share are explained on page 115.

In the event of a change of control of the Company, the LPA requires the Company to purchase RCAP's interests in Resolution Holdco No. 1 LP for cash unless RCAP agrees to accept the Company ordinary shares instead. The purchase price for RCAP's interest would be 10% of the added value deemed to have been generated as at the date of the change of control based on the total consideration paid for the Company less any net assets of the Company itself (ie net assets held outside of the partnership).

If a change of control of the Company had taken place at 31 December 2013, at the Company share price of £3.54 on that date, the added value would have been £1,333 million, and the Company would have been required to acquire RCAP's interest in Resolution Holdco No. 1 LP for approximately £133 million in cash.

1. The information on the Value Share set out in this section is a summary of the arrangements in place as between the Company and RCAP. For further details please refer to the Prospectus issued in respect of the Company's proposed acquisition of Friends Provident Group.

Chairman's governance letter

Dear shareholders

In my first report as Chairman, I would like to reflect on the changes that have taken place this year, and we do this in some detail on the ensuing pages.

As Chairman, I am responsible for the governance of the organisation and one of my key objectives is to ensure the Board is led effectively, and sets the right tone and culture as the business executes its strategy. As part of the governance changes in March, I worked with Mike Biggs, Phil Hodgkinson, the former Senior Independent Director, and the Nomination Committee, to ensure we selected a Board from the two pools of directors available who would further the above objective. Having worked through a significant amount of change, I am delighted with the way the Board has risen to the challenge and quickly become an effective, open and challenging team. In addition, we appointed two further independent non-executive directors during the year who provide increased balance to the composition of the Board.

We have focused on the balance of the Board during the year, addressing gender diversity and diversity of experience. As detailed in this report, I led a self-assessment exercise of skills on the Board which will help the Nomination Committee create a succession plan and focus on Board development and future capabilities, particularly important given the number of Board directors who will rotate off the Board in 2017 if they complete their 9 year tenure. At Board level, our gender diversity is now 15.7%. Due to the composition of our Board and each director's respective appointment period, it is unlikely we will achieve the Davies targets in 2015, although I am very proud of the Group-wide diversity initiative to address this, described on page 61.

One of the key decisions I made as Chairman was to undertake an external effectiveness review of the Board, to ensure the Board and its Committees were performing effectively. This is explained in more detail on pages 88 and 89, and I will report further on our progress next year. The effectiveness review underlined the valuable work undertaken on behalf of the Board by the Committees and the support provided by the wider governance structure in general, and more detail on this is provided in the following pages.

During 2013 the Board spent a great deal of time focussed on the strategic direction of the Group. Key to these discussions is the Board having a deep understanding of the business, so the quality of information presented to Board members has been particularly important. This year the Board has revised the structure of its Board papers and provided training for all authors across the business. The finance team has also worked extremely hard to ensure the management information the Board receives is insightful.

I have now established a comprehensive Board training programme and a professional learning and development programme for all non-executive directors. During the year the Board examined each of the business units closely, and received a series of training sessions on UK corporate governance, understanding the customer more, and how we distribute our products to market.

I continue to believe there are three core areas in which the Board serves our customers and shareholders:

- It holds the management team to account as they execute the chosen strategy within an appropriate risk framework.
- It ensures we have the right people in the organisation to achieve the strategy.
- It plans appropriately for succession, to ensure the long-term success of the Company.

I am very proud of the way the Board and Company have developed during 2013 and over the past nine months in particular since the structure of the organisation has changed. We have much further to go in achieving the organisation's objectives, but we have made a good start.



Sir Malcolm Williamson
Chairman

Board of directors

Sir Malcolm Williamson

Chairman

Appointed Chairman Designate in March 2013 and as Chairman of the Board in May 2013



Skills, competencies and experience

Sir Malcolm has over 50 years' experience in the insurance and banking sectors, having held Board positions in an executive and non-executive capacity in a variety of financial services companies. Sir Malcolm brings considerable strategic and leadership experience to the Board together with substantial knowledge of the regulated financial services environment.

Career

Sir Malcolm has previously served as Chairman of Clydesdale Bank plc, National Australia Group Europe Limited, CDC Group plc, and Britannic Group plc. Sir Malcolm was Deputy Chairman of Resolution plc until 2008 and has held a number of other non-executive roles. Prior to this, he held executive positions as President and CEO of Visa International and Group Chief Executive of Standard Chartered plc.

External appointments

Sir Malcolm is Chairman of Cass Business School's Strategy and Development Board and Chairman of Invicta Card Services Limited. He is also Chairman of the Board of Trustees of The Prince of Wales Youth Business International Limited and of the Governing Council of the Centre for the Study of Financial Innovation.

Committee membership

Nomination Committee (Chairman)
Remuneration Committee

Andy Briggs

Group Chief Executive

Appointed March 2013



Skills, competencies and experience

Andy has significant experience in a number of sectors within the insurance industry. He has extensive knowledge of the UK regulated environment, and brings his skills in strategic and business planning to the Board along with the benefit of his experience in capital and risk management and organisational change. Andy is a Fellow of the Institute of Actuaries.

Career

Andy has held positions as CEO of Scottish Widows and of the General Insurance businesses of Lloyds Banking Group. Prior to joining Lloyds Banking Group, Andy was at the Prudential Group for 19 years, working in the intermediated, face-to-face and online businesses, both in the UK and overseas. Andy's final role at the Prudential Group was as CEO of their Retirement Income business.

External appointments

Andy is a member of the Board of the Association of British Insurers ("ABI"), was appointed Chairman of the ABI Audit Committee in July 2012 and represents the ABI at the Prudential Regulation Authority ("PRA") Practitioner Panel. Andy is also a member of the NSPCC's fundraising committee, and chairs one of their larger fundraising sub-committees.

Committee membership

None

Tim Tookey

Chief Financial Officer

Appointed March 2013



Skills, competencies and experience

Tim is an experienced CFO having held a number of senior positions in the financial services and insurance sector. Tim has considerable knowledge of working in highly regulated environments and applies this experience to the Board. Tim is a Fellow of The Institute of Chartered Accountants in England and Wales.

Career

Tim has held positions at Lloyds Banking Group including Interim Group Chief Executive Officer between November 2011 and January 2012, Group Finance Director from 2008 to 2012, and Deputy Group Finance Director from 2006. Prior to his time at Lloyds, Tim was Finance Director at Prudential UK. Tim was instrumental in the development of Heath Lambert, the insurance broker where he was Finance Director. Before his corporate roles, Tim qualified as a chartered accountant at KPMG.

Tim was Chairman of the Audit and Remuneration Committees of the British Bankers' Association from 2008 to 2012.

External appointments

Tim is a member of the Development Strategy Board of the Zoological Society of London.

Committee membership

None

David Allvey

Senior Independent Director

Appointed March 2013, and appointed as Senior Independent Director in May 2013



Skills, competencies and experience

David has significant executive leadership experience gained in positions held in UK listed and international financial services companies. He also brings extensive recent and relevant financial experience to the Board with a focus on corporate governance and risk management.

Career

David has held senior executive positions in major international businesses including appointments as Group Finance Director of BAT Industries plc and Barclays plc, and as Chief Operating Officer for Zurich Financial Services AG. David was a member of the UK Accounting Standards Board and has also held non-executive directorships at Thomas Cook Group plc and as Senior Independent Director at Intertek Group plc and William Hill plc. He was the Chairman of Arena Coventry Limited until May 2012.

External appointments

David is the Chairman of Costain Group plc and holds non-executive directorships with Clydesdale Bank plc and National Australia Group Europe Limited.

Committee membership

Risk and Compliance Committee (Chairman)
Audit Committee
Nomination Committee
Remuneration Committee

Tim Wade

Independent non-executive director

Appointed in May 2010



Skills, competencies and experience

Tim has many years' experience in the UK and international financial services sector and is a qualified lawyer and accountant, with current and relevant financial expertise. Tim was closely involved in the rationalisation of the life insurance industry in Australia and is well placed to provide guidance to the Board on all facets of the life insurance sector.

Career

Up until 2002 Tim was a Managing Director of the financial services company, AMP Limited. Before that Tim was CFO of Colonial Limited, during its demutualisation and listed phase. From 1984 until 1994, Tim worked at Arthur Andersen in Melbourne and Singapore where he became a Partner in 1992.

External appointments

Tim is currently non-executive director and Chairman of the Audit Committee of Macquarie Bank International Limited and Monitise Plc, non-executive director and Chairman of the Credit and Remuneration Committees of Access Bank UK Limited, non-executive director of ACE European Group Limited and Chairman of the Coeliac Society.

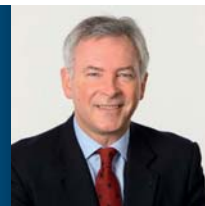
Committee membership

Audit Committee (Chairman)
Risk and Compliance Committee

Nick Lyons

Independent non-executive director

Appointed March 2013



Skills, competencies and experience

Nick brings the benefit of a broad range of financial and insurance sector experience gained in large and complex international businesses to the Board. In addition, his experience within the recruitment and reward sector is invaluable to the Board and its Remuneration Committee.

Career

Nick was formerly a Managing Director of Lehman Brothers in London, where he headed the European Financial Institutions Group until 2001, moving to the role of Global Co-Head of Recruitment, Training and Career Development until his retirement in 2003. Nick has also held executive positions at JP Morgan & Co and Salomon Brothers, and was previously the Chairman of Miller Insurance Investment Limited and a non-executive director of Quayle Munro plc.

External appointments

Nick is Chairman of Longbow Capital LLP and Miller Insurance Services LLP and holds a non-executive directorship at Catlin Group Limited.

Committee membership

Remuneration Committee (Chairman)
Investment Oversight Committee
Nomination Committee
Risk and Compliance Committee

Karl Sternberg

Independent non-executive director
Appointed March 2013



Skills, competencies and experience

Karl brings the benefit of his considerable investment and financial sector experience to the Board. He also provides extensive executive knowledge of investment strategy and global markets.

Career

Karl spent his early career at Mercury Asset Management and Barclays de Zoete Wedd, followed by 12 years at Morgan Grenfell which became part of Deutsche Asset Management, where he held a number of Chief Investment Officer roles in different regions. Karl was a founding partner of Oxford Investment Partners Limited, which he continues to advise.

External appointments

Karl is Chairman of JP Morgan Income & Growth Trust plc, a director of Lowland Investment Company plc and a director of The Monks Investment Trust plc. Karl is also a member of the Governing Body of Christ Church Oxford.

Committee membership

Investment Oversight Committee (Chairman)
Audit Committee

Mel Carvill

Independent non-executive director
Appointed February 2010



Skills, competencies and experience

Mel has extensive practical experience in risk and capital management having worked in a number of senior positions across a range of sectors in the European financial services industry. As a Fellow of both the ICAEW and the Chartered Institute for Securities and Investment, an Associate of the Chartered Insurance Institute and a Chartered Insurer, he is well placed to bring his recent and relevant financial experience to the Board and its committees. Mel is Chairman of the Board of Friends Life Limited.

Career

Mel is the founder and President of PPF Partners (a private equity firm). In addition, he was previously a Commissioner of the Guernsey Financial Services Commission. Prior to this Mel worked at Generali for over 25 years where he held a number of senior positions, including, Head of Western Europe, Americas and Middle East, Head of Risk Management and Head of Corporate Finance.

External appointments

Mel holds a number of directorships within financial services companies operating in Europe, the Americas and Asia.

Committee membership

Nomination Committee
Risk and Compliance Committee

Clive Cowdery

Non-executive director
Appointed March 2013



Skills, competencies and experience

Clive brings the benefit of his significant experience in the life insurance industry to the Board. His in-depth knowledge of the market in which the Company operates in addition to his recent direct experience of mergers and acquisitions, is invaluable.

Career

Clive is Founder of Resolution Operations LLP, a financial services adviser which specialises primarily in sponsoring insurance vehicles and advised the Company until March 2013. Clive was previously the Chairman of Resolution plc, which was acquired by Pearl Group in 2008, before which he was Chief Executive of Resolution Life Group which was founded in 2003. From 1998–2003, Clive was Chairman and Chief Executive of General Electric Insurance Holdings.

External appointments

Clive is Chairman of Resolution Life, a US insurance vehicle. Clive is also Founder and Chairman of the Resolution Foundation, an independent research and policy organisation. Clive is majority owner and a non-executive director of Prospect Publishing Limited.

Committee membership

None

Marian Glen

Independent non-executive director
Appointed October 2013



Skills, competencies and experience

Marian brings the benefit of over 25 years of experience as a solicitor to the Board, having worked both in private practice and in senior executive positions at AEGON. Marian has extensive recent and relevant merger and acquisitions and corporate finance expertise, gained across a wide range of sectors including financial services.

Career

Marian was formerly General Counsel of AEGON UK and a member of its Executive Committee and AEGON's Global Leadership Team. Prior to joining AEGON, she gained extensive experience as a solicitor in corporate finance at both Linklaters and Shepherd and Wedderburn, where she became Head of Funds and Financial Services.

External appointments

Marian is currently a non-executive director at the Financial Services Compensation Scheme and of Shires Income PLC, a listed investment trust managed by Aberdeen Asset Managers. In addition, Marian is an external member of the Audit Committee of the Water Industry Commission for Scotland, the economic regulator of the Scottish water industry.

Committee membership

Remuneration Committee

Peter Gibbs

Independent non-executive director
Appointed March 2013



Skills, competencies and experience

Peter brings the benefit of significant knowledge of the financial services and asset management sectors to the Board, its Committees, and the Board of Friends Life Investments Limited. Peter has extensive recent leadership experience of companies subject to the UK financial services regulatory regime. Peter is Chairman of the Board of Friends Life Investments Limited.

Career

Peter was the Senior Independent Non-Executive Director of The Evolution Group plc until its takeover by Investec in December 2011, and a member of its Audit, Remuneration and Nomination Committees. Peter was also the non-executive Chairman of Turquoise, the pan-European trading platform, until 2009. Peter was Chief Investment Officer and Head of Region for the non-US Investment Management activities of Merrill Lynch, having spent his early Career at Brown Shipley and Bankers Trust.

External appointments

Peter holds non-executive directorships at Aspect Capital Limited, UK Financial Investments Limited and Intermediate Capital Group plc. Peter is also a director of Bank of America Merrill Lynch (UK) Pension Plan Trustees Limited.

Committee membership

Investment Oversight Committee

Roger Perkin

Independent non-executive director
Appointed May 2013



Skills, competencies and experience

Roger has a strong audit and regulatory background having been a partner at Ernst & Young LLP until 2009. With 40 years of experience in the accounting profession his current direct experience of the financial services and regulatory environment is invaluable.

Experience

Roger advised boards across the spectrum of financial services during his time at Ernst & Young, including banking, insurance, fund management and private equity companies. He was a non-executive director at The Evolution Group plc until its acquisition in December 2011. Roger is a Fellow of the Institute of Chartered Accountants of England and Wales.

External appointments

Roger is currently a non-executive director of the Nationwide Building Society where he is the Senior Independent Director. He also holds non-executive directorships at Electra Private Equity plc and Tullett Prebon plc. Roger is also a trustee of two charities, Chiddingstone Castle and Crime Reduction Initiatives.

Committee membership

Audit Committee

Board of directors continued

Robin Phipps

Independent non-executive director
Appointed March 2013



Skills, competencies and experience

Robin has extensive knowledge of the life insurance and pensions industry and brings significant knowledge of the heritage Friends business to the Board, having been a non-executive director of Friends Provident plc. Robin is Chairman of the With Profits Committee of Friends Life Limited.

Career

Robin was a member of the board of Legal & General Group plc from 1996 to 2007, holding the position of Group Director UK. Prior to his appointment as a director, he held various senior roles within Legal & General Group plc. Robin has also been a Non-Executive Director of GE Money Credit Cards and a Senior Advisor (Financial Services) of Ernst & Young.

External appointments

Robin holds non-executive directorships at the IFG Group plc and Arrow Global Group plc.

Committee membership

Audit Committee
Risk and Compliance Committee

Belinda Richards

Independent non-executive director
Appointed March 2013



Skills, competencies and experience

Belinda has a wealth of insight and experience in the financial and insurance sectors with a particular emphasis on strategic and operational transformation. Belinda also brings her recent direct experience of the UK regulated environment and life company insurance industry to the Board of the Company and Friends Life Limited.

Career

Belinda was previously a senior Corporate Finance partner for 10 years at Deloitte LLP, where she was the Global Head of Merger Integration and Separation Advisory Services. Clients at Deloitte included a number of leading UK and global banks and insurance companies. Prior to Deloitte, Belinda was Vice President at Cap Gemini Ernst & Young.

External appointments

Belinda holds non-executive directorships at Grainger plc, where she is Chairman of the Audit Committee and a member of the Risk and Compliance and Nomination Committees and also at Balfour Beatty plc where she is a member of the Audit, Risk and Assurance Committee, the Nomination Committee and the Business Practices Committee. Belinda is also a member of the Governing Council of the Centre for the study of financial innovation.

Committee membership and subsidiary directorships

Nomination Committee
Risk and Compliance Committee

John Tiner

Non-executive director
Appointed March 2013



Skills, competencies and experience

John has considerable regulatory experience, having held a number of senior positions at the FSA. Whilst at the FSA, John led the review which substantially overhauled regulation of the UK insurance industry and promoted financial capability to become a public policy priority.

Career

John was CEO and Founding Partner of Resolution Operations LLP, a financial services adviser which specialises primarily in sponsoring insurance vehicles and advised the Company until March 2013. John's previous roles at the FSA included Chief Executive and Managing Director of Consumer, Insurance and Investment Business. Before joining the FSA, John was a Managing Partner at Arthur Andersen, responsible for its worldwide financial services practice. John was also a member of the Committee of European Insurance and Occupational Pensions Regulators which steered the development of the Solvency II proposals.

External appointments

John is a non-executive director with Credit Suisse Group AG and is Deputy Chairman of the Urology Foundation.

Committee membership

None

Group Executive Committee



Jonathan Moss
CEO Heritage division

Jonathan has a strong Heritage background having joined Friends Life from Phoenix Group Limited where he was Group Chief Executive.

While at Phoenix Jonathan led a significant, complex and successful restructure of the group's financing arrangements.



Rosie Harris
Chief Risk Officer

Rosie has extensive experience and has held roles as Chief Risk Officer for the Insurance Division at Lloyds Banking Group and Group Risk Director at Old Mutual plc.

Prior to Friends Life Rosie also held positions as Managing Director of General Insurance at Lloyds Banking Group and Chief Operating Officer of Prudential UK and Europe.



Rob Barnett
Group HR and Business Services Director

Rob has a strong track record of delivery of significant organisational change. He also has general management experience at executive level.

Before joining Friends Life, Rob was HR Director for RBS Insurance and latterly, HR Chief Operating Officer at Royal Bank of Scotland.



Jim Newman
Group Transformation Director

Jim was appointed to Friends Life Group plc, as an alternate director, in November 2009.

Jim retired from the Board in March 2013 when the Boards of Friends Life Group plc and Resolution Limited were streamlined. On this date, Jim became Group Transformation Director and joined the Resolution Limited Group Executive Committee.



John Van Der Wielen
CEO UK and International

John has over 20 years' experience in life and general insurance as well as wealth management and banking. He has undertaken a variety of executive positions including international secondments across Europe and Australia.

John was previously the Managing Director of Wealth at ANZ Australia.

Compliance with UK Corporate Governance Code

The Company aims to maintain a high standard of corporate governance, and a sound structure for setting its strategy and objectives.

At 31 December 2013, the Company was fully compliant with the provisions of the 2012 UK Corporate Governance Code (the "Code"). Prior to 28 March 2013 the Company, due to the historical governance structure, was unable to comply with certain aspects of the Code. Copies of the Code are publicly available at www.frc.org.uk.

The table below illustrates the Company's compliance with the Code both before and after the governance simplification which took place on 28 March 2013. We achieved compliance with Principles A.2 and D.1.1 and Supporting Principle to B.1 following the creation of a more normalised unitary board structure. The 2014 Notice of AGM complies with the provisions of the Code in respect of Principle E.2.1.

Principle	Position prior to 28 March 2013	Position as at 31 December 2013
A.2 There should be a clear division of responsibilities at the head of the Company between the running of the Board and the executive responsibility for the running of the Company's business. No one individual should have unfettered powers of decision.	The Board was wholly non-executive. Executive functions were outsourced to ROL under an operating agreement. A clear division of responsibilities existed between the Chairman, SID and NEDs, as did a clear division of responsibilities in respect of ROL's executive function.	The appointment of the Group Chief Executive and Chief Financial Officer on 28 March 2013 brought the Company into compliance with this principle.
Supporting principle to B.1 The Board should include an appropriate balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the Board's decision-making.	The Board was wholly comprised of independent non-executive directors with the exception of the Chairman, who, by definition, was not regarded as independent. No individual on the Board, the Board of FLG or at ROL had unfettered decision making authority.	The appointment of the Group Chief Executive and Chief Financial Officer on 28 March 2013 brought the Company into compliance with this principle.
D.1.1 In designing schemes of performance-related remuneration for executive directors, the Remuneration Committee should follow the provisions in Schedule A to the Code.	The Company did not have any executive directors for whom the Board would design such schemes.	Following the appointment of the Group Chief Executive and Chief Financial Officer to the Board, the Company now complies with this principle. The Board has regard to the provisions in Schedule A in reviewing and approving the executive directors' remuneration.
E.2.1 At any general meeting, the Company should propose a separate resolution on each substantially separate issue.	At the 2013 EGM one resolution was proposed for the adoption of a new set of Articles of Incorporation and a change to the period of notice required for general meetings. This constituted bundling of resolutions. In future, changes of this nature will be the subject of a separate resolution and vote, rather than being proposed as one resolution.	At the Company's forthcoming AGM, a separate resolution is proposed for each different issue.

Guernsey Corporate Governance requirements

Guernsey companies which comply with the UK Corporate Governance code are deemed to meet the requirements of the Guernsey Financial Services Commissions Finance Sector Code of Corporate Governance which came into effect on 1 January 2012.

The Guernsey Financial Services Commission's Finance Sector Code of Corporate Governance is available at www.gfsc.gg.

Leadership

Role and operation of the Board

The Company's governance structure is based on the principles of the UK Corporate Governance Code. The Board is collectively responsible to shareholders for the long-term success of the Company. It does this by providing entrepreneurial leadership, sets the strategic goals for the Company and oversees the execution of this strategy by management within an approved risk appetite. It ensures the Company has adequate resources to deliver the strategy and reviews the operating and financial performance of the Group. The Board ensures the Group generates value safely by having effective internal controls and good governance structures in place. It sets the values and ethical standards of the organisation and as part of this ensures that the Group has due regard for its customers.

The Company's Articles of Incorporation, Guernsey law, UK legal best practice and UKLA listing rules also provide an external structure for the way the Company operates. The Company is the general partner of Resolution Holdco No 1 (see page 72), and has to ensure it manages the company in line with the Limited Partnership Agreement. The interests of shareholders and those of RCAP are aligned, and there should be no conflict of interest between the General Partner and the Limited Partner.

In April, following the governance simplification, the Board adopted a new Corporate Governance Handbook which sets out clearly the operation of the Board, the responsibilities of the Chairman and the GCE, which are separate and distinct, the role of the Senior Independent Director, the role of the non-executive directors and the Company Secretary. It details those matters that are reserved for the Board's approval and not delegated to senior management, as well as the policies and controls that sit within the Board's remit. We have highlighted some of these Board approvals in the box below.

The Board delegates some of its responsibilities to each of its board committees. We have described how the committees discharge these responsibilities on the following pages. Both the Board and the committees have a rolling annual schedule of decisions and items for discussion. The agendas for board meetings are put together by the Chairman and the Group Chief Executive assisted by the Company Secretary. They reflect the annual calendar and corporate activity. The same process is followed with each of the Committee Chairmen.

Whilst the Chairman provides leadership of the board, the day-to-day management of the Company is delegated to the Group Chief Executive and his senior management team. The Group Executive Committee is discussed on page 82. The Board monitors their performance and ability to execute the strategy agreed by the Board.

Setting strategy

The Board sets the strategic direction for the Group. Each year there is an annual review of strategy held over two days, where the Group Chief Executive and the management team present their plans to the Board, to be challenged and tested by the non-executives.

Developing strategy in a changing regulatory environment whilst completing the final phase of a complex separation and integration plan tests the effective performance of a Board. The Board works collectively to provide constructive challenge to executive management and fully understand the market conditions. This may mean seeking guidance from senior management and external advisors.

Strategic discussions are therefore not confined to the away days, but evolve throughout the year. As such the Board agendas contain incremental strategy updates to provide regular opportunities to review, question and challenge key initiatives as they progress.

This year due to the completion of the restructuring phase, the future strategic direction of the Group has occupied a great deal of the Board's time. Building an organic and sustainable plan was a key priority as they debated the role the Group will play in the fast growing retirement market. Key decisions have been to extend the lifestyle annuity proposition to the open market and the new financial framework. The Board also remains responsible for the Group's risk profile delivering growth within a risk appetite, as such, it spent time reviewing the ERM framework. Further reviews were held on progress made in each of the business divisions. The format of these was half day sessions followed by dinner.

Decisions reserved for the Boards of the Company and FLG

Key matters reserved for the Board:

- Capital expenditure above £25 million
- Group Strategy, objectives and business plan
- Operational performance
- Financial statements
- Financial reporting to the market
- Capital solvency
- Acquisitions, disposals and material contracts
- Board membership
- Entry into new products or new geographies
- Internal controls and risk management
- Remuneration
- New executive share plans
- Dividend policy
- Governance matters

A copy of reserved matters is available to view on the Company website.

What does the FLG Board do now?

The Board of FLG has the same membership as the Board and meets after the Company's Board meetings to approve statutory matters:

Examples of FLG Board approvals

- Financial statements
- Changes to share capital
- Director changes
- Dividend payments
- Debt issues

Board composition

You can see the composition of the Board before and after March 2013 below. Since 28 March 2013 the Board has consisted of ten independent non-executive directors ("INED"), two non-independent non-executive directors, two executive directors, and a Chairman who was independent on appointment to RSL.

The chairmanship formally transferred on the 16 May 2013 following the AGM, when Mike Biggs stepped down and Sir Malcolm Williamson took over. Sir Malcolm was Chairman Designate from January until May 2013 and had previously been Chairman of FLG. We have described the selection process in the Nomination Committee Report.

The non-independent non-executive directors are Clive Cowdery and John Tiner. They are not classified as independent because they have both previously had a material business relationship with the Company. John was CEO of ROL and Clive was the founder of Resolution Limited. On 18 March 2014 the Company announced that, following the completion of the transformation phase, both John and Clive will not seek re-election at the AGM. The INEDs are all independent minded and the recent Board effectiveness review noted that there was very healthy challenge at meetings.

Due to the governance simplification, there have been numerous changes to the Board, as detailed below. Phil Hodgkinson and

Mike Biggs agreed to stay on the Board until after the AGM to ensure there was continuity through the simplification process. Following the resignation of Phil Hodgkinson, in May 2013 the Board appointed Roger Perkin, and a further independent NED, Marian Glen, was appointed in October 2013.

Directors have been selected for their record in the financial and insurance sectors, as well as their general business acumen. Some Board members were selected for their specialism in change management or their investment management experience, but this is not to the detriment of their rounded contribution to the Board. In the Nomination Committee section, we have described the Committees work in undertaking a skills assessment and the succession planning, which is the output of the review, especially important as the business moves towards fulfilling its growth targets.

The Articles of Incorporation state that new directors appointed since the last AGM must seek re-election to the Board at the AGM. Also the Board has agreed that all directors with the exception of Clive and John will seek annual re-election in accordance with the Code. The Notice of Meeting sets out the reasons for supporting the re-election of directors at the forthcoming AGM. Biographies of the individual directors are on pages 76 to 78. Details of their skills and contributions are provided in the Notice of Meeting and this will help shareholders form a view as to their re-election. The Chairman is satisfied, following the external effectiveness review, that each of the Board members continue to contribute effectively.

Board attendance chart

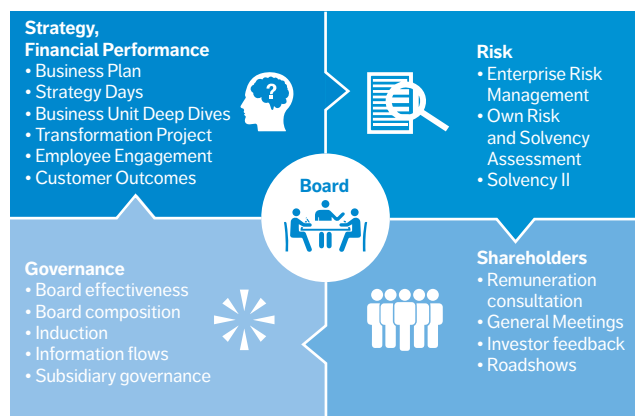
Member	Role/Former role	Scheduled Board meetings attended	Non-scheduled Board meetings attended	Audit	Remuneration	Risk and Compliance	Nomination	Investment Oversight
RSL Board members from 28 March 2013								
Sir Malcolm Williamson ⁽ⁱ⁾	Chairman	6 of 6	2 of 2	–	7 of 7	–	5 of 5	–
David Allvey ⁽ⁱⁱ⁾	Senior Independent Director	5 of 6	2 of 2	3 of 3	7 of 7	5 of 5	4 of 5	–
Andy Briggs ⁽ⁱⁱⁱ⁾	Group Chief Executive	6 of 6	2 of 2	–	–	–	4 of 4	–
Tim Tookey ⁽ⁱⁱⁱ⁾	Chief Financial Officer	6 of 6	2 of 2	–	–	–	–	–
Mel Carvill ^(iv)	Independent non-executive director	7 of 8	4 of 4	2 of 2	–	4 of 5	7 of 8	–
Peter Gibbs ⁽ⁱⁱⁱ⁾	Independent non-executive director	5 of 6	2 of 2	–	–	–	–	3 of 3
Marian Glen ^(v)	Independent non-executive director	2 of 2	–	–	2 of 2	–	–	–
Nick Lyons ⁽ⁱⁱⁱ⁾	Independent non-executive director	5 of 6	2 of 2	–	7 of 7	5 of 5	2 of 2	3 of 3
Roger Perkin ^(v)	Independent non-executive director	5 of 5	1 of 1	2 of 3	–	–	–	–
Robin Phipps ⁽ⁱⁱⁱ⁾	Independent non-executive director	6 of 6	2 of 2	2 of 2	–	5 of 5	–	–
Belinda Richards ⁽ⁱⁱⁱ⁾	Independent non-executive director	6 of 6	2 of 2	–	–	4 of 5	5 of 5	–
Karl Sternberg ⁽ⁱⁱⁱ⁾	Independent non-executive director	6 of 6	2 of 2	3 of 3	–	–	–	3 of 3
Tim Wade ^(iv)	Independent non-executive director	8 of 8	4 of 4	5 of 5	–	5 of 5	–	–
Clive Cowdery ⁽ⁱⁱⁱ⁾	Non-executive director	5 of 6	0 of 2	–	–	–	–	–
John Tiner ⁽ⁱⁱⁱ⁾	Non-executive director	5 of 6	2 of 2	–	–	–	–	–
Mike Biggs ^(vi)	Chairman	3 of 3	3 of 3	–	3 of 5	–	5 of 5	–
Phil Hodgkinson ^(vii)	Senior Independent Director	3 of 3	3 of 3	2 of 2	2 of 2	–	5 of 5	–
RSL Board members to 28 March 2013								
Jacques Aigrain	Independent non-executive director	2 of 2	2 of 2	–	2 of 3	–	3 of 3	–
Gerardo Arostegui	Independent non-executive director	2 of 2	2 of 2	–	3 of 3	–	3 of 3	–
Fergus Dunlop	Independent non-executive director	2 of 2	2 of 2	2 of 2	–	–	–	–
Denise Mileham	Independent non-executive director	2 of 2	2 of 2	2 of 2	–	–	3 of 3	–
Peter Niven	Independent non-executive director	2 of 2	1 of 2	–	3 of 3	–	3 of 3	–
Gerhard Roggemann	Independent non-executive director	2 of 2	2 of 2	–	3 of 3	–	–	–

- (i) Appointed Chairman Designate on 28 March, Chairman on 16 May 2013.
(ii) Appointed 28 March 2013, became Senior Independent Director on 2 May 2013.
(iii) Appointed 28 March 2013.
(iv) Current Board members who were appointed prior to March 2013

- (v) Roger Perkin was appointed on 16 May 2013 and Marian Glen was appointed on 10 October 2013.
(vi) Resigned 16 May 2013.
(vii) Resigned as Senior Independent Director on 2 May 2013 and from the Company on 16 May 2013.

Leadership continued

Board – areas of focus during 2013



Board meetings

The Board held eight scheduled meetings, details of directors attendance is on page 81. Prior to 28 March, Board meetings were held in Guernsey. Following the governance changes all Board meetings are now held in the UK. Due to the governance changes, the dates of scheduled meetings were changed, and all NEDs were exceptionally accommodating; the maximum number of missed meetings was one. There were four non-scheduled meetings to discuss the structural changes and two sub-committees to approve financial results. Due to the governance changes a key focus for the Company has been developing a strategic plan and building an organic business plan. The Board has also overseen the work undertaken by the Risk and Compliance Committee in developing and approving an Enterprise Risk Management Framework for the organisation.

Both the GCE and CFO present reports to each board meeting, the GCE updates the board on the execution of the strategy, corporate transactions, the progress of the transformation programme, employee engagement, customer developments and investor relations matters. The CFO reports on the financial performance of the business, the financial results, the rating agencies views, debt structures and the financial aspects of transactions. The CRO attends meetings and has kept the Board apprised of the development of Enterprise Risk Management Framework developed and any regulatory matters. The Board held three Board dinners in 2013 as an informal way to discuss strategy and provide an informal setting for Board members to get to know one another. Where appropriate, GEC and senior management make presentations to the Board.

As a result of the governance changes, the Board also reviewed its processes and procedures and developed a new corporate governance manual and induction manuals for the key committees. The Board held five scheduled training sessions from March to December, covering regulatory updates, customer insight, and product distribution. There has also been training on specific topics for directors, for example on Solvency II and outsourcing environment. In 2013 these sessions took place after Board meetings but following feedback from the effectiveness review and Board members, the 2014 sessions will take place outside the Board meeting schedule. The Board also held three half-day sessions focused on each of the divisional businesses areas to help them monitor their performance against strategy.

Committees

It is the Board's responsibility to ensure there is an effective governance structure in place throughout the Group.

The governance manuals set out the clear reporting lines that exist between the Board and its principal subsidiaries. The Board has the following committees in place to assist with this responsibility: Audit, Remuneration, Risk and Compliance and Nomination committees, the terms of reference are available on our website. Further details on these committees can be found below.

In addition, and as part of the broader governance structure, the Group has the following committees to provide robust review and challenge.

Group Executive Committee (GEC)

The Group Chief Executive, Andy Briggs, is assisted in his responsibilities by the GEC, whose composition is shown on page 78. There are seven members, the GCE, CFO, CRO, the CEO Heritage, the CEO UK & International, the Transformation Director and the Group Human Resources and Business Services Director. The Group Internal Audit Director attends the meetings but is not a member of the Committee in order to maintain his independence. The Committee has a delegated authority from the Board for the performance of the Group, execution and development of strategy, the development of the business plan, and the risk management framework and ensuring the Group is adequately capitalised. It also oversees any outsourced relationships, and ensures customer service is of the highest quality.

Investment Oversight Committee

The Investment Oversight Committee is chaired by Karl Sternberg, and is responsible for monitoring investment policy throughout the Group, in accordance with risk appetite. There are three non-executive directors on the committee. Peter Gibbs and Nick Lyons are members and all three have significant investment management experience. The role includes overseeing the relationship between the Company and its investment managers. During 2013, the Investment Oversight Committee has looked closely at the annuity strategy and optimisation of investment performance for the benefit of policyholders and shareholders. The Committee has a delegated authority in place from FLL to manage all investment oversight on FLL's behalf. The Committee also worked closely with the With Profits Committee on the With Profit Annuity De-Risking project ("WPAD") and on the transfer of funds between asset managers.

Friends Life Limited

Friends Life Limited is one of the main operating entities in the Group. During 2013, plans were put in place to implement a series of governance changes to the management of this entity. Further information on these changes can be found on page 83.

With Profits Committee

To assist the Board of Friends Life Limited in ensuring that all groups of policyholders are treated fairly in managing the with-profits business, it is advised by a wholly independent With Profits Committee ("WPC"), chaired by Robin Phipps. The purpose of the WPC is to independently consider issues that will affect with-profits policyholders, especially where the FLL Board is required to exercise discretion.

During 2013, main focus of the WPC was on WPAD, a project to transfer the non-profit annuity business out of FLL's with-profits fund and into the FLL non-profit fund, effectively reducing the volatility of the with-profits fund and reducing the amount of capital that needs to be held. This will help ensure a better outcome for policyholders.

Friends Life Investments

Friends Life Investments Limited, chaired by Peter Gibbs, a non-executive director, is the dedicated in-house asset management firm for the Group. The other members of the Board are the CIO and CEO, Heritage. FLI's focus during 2013 has been recapturing and managing the group's fixed income assets. The number of assets being managed by FLI has steadily increased since 2012, with £17.1 billion now being under management.

FPIL and Lombard

We also have two international governance structures with independent non-executives not connected to the Company's Board sitting on them. The minutes of these boards and their committees are reviewed by the Board. Each of FPIL and Lombard has an independent Audit and Risk committee, attended annually by Tim Wade and David Allvey respectively to ensure continued oversight.

Subsidiary governance

During 2013, as the Board continued to develop plans for the Company's sustainable organic future, it reviewed oversight and controls in its principal subsidiaries and regulated entities. The Group has five regulated subsidiaries through which it operates and conducts the majority of its business activities and therefore a strong oversight role must be maintained by the Board. There is a balance to be struck between ensuring the subsidiaries are managed independently but in line with Group reporting

requirements. In 2013 the secretariat put together a subsidiary governance manual and guidelines which implemented appropriate structures around the reporting and oversight requirements of the Board and its subsidiaries.

The Board believes that it is important to set the correct tone across the Group and therefore retains ownership of the guidelines.

Compliance with the guidelines enables the Board to have effective oversight and stewardship of activities within its subsidiaries. It also ensures the promotion of improved standards and behaviours by the directors and staff of each subsidiary, improved information flows to and from the Board, both generally and specifically in regard to risk, and improved alignment with the Company's strategy and policies.

On appointment to a subsidiary entity within the Group, directors receive a tailored induction pack which accompanies the subsidiary governance guidelines and includes key statutory and regulatory information about the Company, tailored advice on managing any potential conflicts of interest and a note setting out the entity and the directors' statutory and regulatory duties. Subsidiary directors are also offered tailored induction and training programmes where relevant, through the scheduling of training sessions, one to ones with executive management and external service providers.

The Board and the Boards of the operational and regulated subsidiaries are required to review the subsidiary governance guidelines annually to ensure that they remain fit for purpose.

Further consideration is underway to leverage the sharing of information the Group and subsidiary needs such as hosting a joint risk training event for all NEDS within the organisation.

Friends Life Limited

The Company reviewed the governance arrangements for its main subsidiaries during 2013, with the review focusing on the following key areas:

- the size and membership of the FLL Board;
- the apportionment of responsibilities between the Board, Board Committees and the FLL Board; and
- oversight of the risk and controls within FLL at FLL Board level.

We are pleased to report that there were no adverse findings, but in aiming to reflect best practice and industry guidance, this case study illustrates some of the actions taken as an outcome of the review.

Structure and membership of the Board

The FLL Board appointed three independent non-executive directors in November 2013. The new directors hold these appointments in addition to their directorships of the Company. These appointments introduce a wider balance of skills, experience and independence to the formerly wholly executive FLL Board, which now comprises:

Non-executive Chairman	Mel Carvill
Executive director	Jonathan Moss (CEO, Heritage)
Independent non-executive director	Marian Glen
Independent non-executive director	Belinda Richards

Reporting lines and governance structure

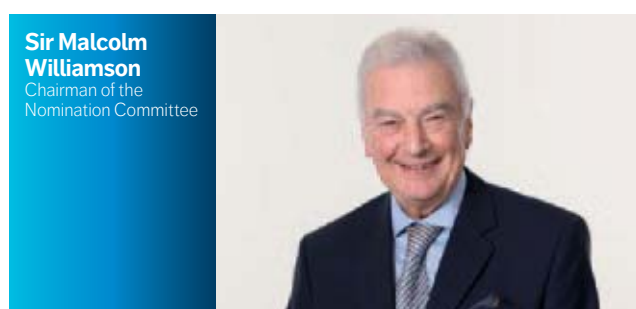
The reporting lines to and from the FLL Board were reviewed and formalised, especially in respect of FLL's advisory committees which include the With Profits Committee and, from June 2014, the Independent Governance Committee, which following the implementation of auto enrolment, will advise the FLL Board on the ongoing interests of defined contribution workplace scheme policyholders, and ensure that these are appropriately considered by the relevant parties.

The formal reporting lines that existed between the Company's Audit, Risk and Compliance and Investment Oversight Committees have been documented to ensure that the responsibilities delegated to them in respect of FLL business and the oversight that those Committees provide is appropriate and effectively monitored by the FLL Board. The Chairman of the FLL Board will formally report to the Board on its activities, similar to the reporting lines between the Board and its Committees.

The structures adopted and improvements made to the FLL Board aim to provide further strategic direction for FLL management, and enable the FLL Board to make well informed, high quality decisions within a suitable framework which enables the FLL directors to meet their statutory and regulatory duties. The FLL Board will undertake annual reviews of its own effectiveness and its work will form part of the scope of any external effectiveness review conducted by the Company.

Effectiveness

Nomination Committee report



“The Committee has elected the Chairman, strengthened the balance and independence of the Board, and established succession planning for the Board and senior management team to ensure the correct skills are in place for the Company to achieve its strategic objectives”.

	Pre-March 2013	Post-March 2013
Membership	Mike Biggs* Phil Hodgkinson** Jacques Aigran Gerardo Arostegui Mel Carvill Denise Mileham Peter Niven	Sir Malcolm Williamson* David Allvey*** Mel Carvill Nick Lyons Belinda Richards Andy Briggs
Number of meetings	Three	Five
Reporting	The Chairman formally reports to the Board in respect of the activities of the Nomination Committee.	
Attendees by invitation	n/a	

* Chairman

** Senior Independent Director (“SID”) until May 2013

*** SID from May 2013. Chairs meetings where the Chairman’s succession or performance is discussed

Main activities during the year

The Committee had a busy 2013 as it oversaw the unification of the membership of the Boards of the Company and FLG. This process began in 2012, led by the SID at the time, Phil Hodgkinson. I have asked his successor David Allvey to report on the process of my own appointment as Chairman which took effect in May 2013.

During 2013, the Committee’s main areas of focus have been:

- Appointment of the Company’s Chairman and two independent non-executive directors;
- Adoption of a diversity policy;
- Development of a succession plan for the Board;
- Review of the independence of directors; and
- Review the outputs of the Board performance evaluation that relate to the composition of the Board.

Key responsibilities

As Chairman of the Board I have responsibility for the Nomination Committee, which, with the focus on diversity in the boardroom, plays an increasingly important role. Although its key purpose is to nominate candidates for the Board and ensure integrity is maintained in this process, it also has to balance the Board diversity policy with the skills required to execute the Group’s strategy; a challenging responsibility. Ensuring the Board is set up to rise to this challenge is the key focus for this committee under my leadership.

The Committee now comprises myself as Chairman, in addition to four independent directors. The Group Chief Executive has a standing invitation to attend.

Purpose

To ensure that the Board is functioning effectively and in supporting this objective, to regularly review and compare the current and required structure, size and composition of the Board, giving full consideration to succession planning for directors and other senior executives within the organisation, remaining mindful of the need to develop a suitable “talent pipeline” to meet the future needs of the Group as it continues to develop its strategy.

Objective for 2013

The objective for this year, now that the Board is no longer seeking an exit strategy for FLG, has been to extend the remit of the Committee to include succession planning for the Board and senior management team beyond the previously anticipated 2014 exit date. Prior to March 2013, succession planning had been focused on recruiting a strong management team in FLG to prepare it for exit.

Appointments during the year

During the year the Committee appointed me to the role of Chairman in addition to appointing two independent non-executive directors. The process for my appointment is described overleaf by David Allvey, the current SID.

Appointment process

The Committee has a responsibility to ensure there is integrity in the appointment process, balancing the requirements of the business and expertise required with a fully transparent recruitment process. The Committee must also consider the skills required for membership to the Committees.

Following the resignation of Phil Hodgkinson, the Committee identified the need to strengthen both the Audit and Remuneration Committees. We listed the key attributes required for new non-executive directors to sit on these Committees and included experience of integration projects and the financial services sector. For each of these appointments we used Spencer Stewart to search for suitable non-executive directors. Spencer Stewart does not have any other connection with the Company. Given the importance of gender diversity on boards, the Committee requested an additional shortlist of female candidates. The Committee recognises that diversity is also about breadth of professional background and culture, and that consideration of such matters is essential in building an effective and independent minded Board.

The Committee then met with a number of suitable candidates, some of whom met with several of the Company's independent non-executive directors as part of the interview process. In May 2013 the Committee formally recommended that the Board appoint Roger Perkin. Roger joined the Audit Committee, and with his background as an Audit Partner and his role on other Audit Committees has recent and relevant financial experience. Roger was a Partner at Ernst & Young LLP, the Company's external auditors, until 2009. This fact was not considered a conflict in respect of his appointment as an independent director because four years had passed since he held that position. The Committee conducted a similar process for the appointment of Marian Glen in October 2013.

Following their appointment the new directors undertook bespoke induction programmes, described on page 90.

Diversity

Gender diversity on the Board increases to 13.1% following Marian's appointment. The Board takes diversity very seriously and as mentioned above, recognises that true diversity does not relate only to gender.

The target of 25% set by Lord Davies may be difficult for our Board to achieve by 2015 unless there is natural attrition. A period of stability is essential following the unification of the two Boards. However, consideration of this will be built into the succession planning process which is currently underway. We will continue to ensure that all shortlists adequately represent the world we live in and work only with executive search firms who have signed a voluntary code of conduct on gender diversity. The Nomination Committee has this year adopted a Board Diversity Policy which acknowledges the importance of diversity; and will refer to it when looking to fit skills and gender with the strategic direction of the Company. All appointments will however, be made on merit rather than solely on the basis of gender.

The Board's commitment to diversity is reflected in the comprehensive diversity programme led by the GCE and the Group Executive Committee, involving a cross-section of our employees. Further detail on this initiative is contained within the Corporate Responsibility report.

Succession planning

In November 2013, we commenced a succession planning programme because between 2017 and 2019 a significant number of directors will have completed nine year's tenure. The need for a comprehensive succession plan was also identified during the Board Effectiveness Review having not existed previously due to the nature of the restructuring project. All Board members were therefore invited to complete a skills self-assessment survey, the results of which are a first step in reviewing Board composition. This will also support and influence the individual training and development plans for current non-executive directors. In 2014, the Committee will continue to develop the plan and report on progress next year.

The importance of succession planning extends to the senior management team and their direct reports, and with the assistance of the Human Resources function, the Committee also reviewed the talent across the organisation. The Company has a preference for internal recruitment, and in considering the development of people within an organisation to be important to strategy, supported the introduction of a Management Development Programme. The Programme began in 2013 to spot and develop future leaders and will continue into 2014. Further detail concerning this initiative is set out in the Corporate Responsibility report.

The following pages include further detail of how the Committee has supported the Board in establishing an effective decision making culture to support the strategy of the business.

Committee evaluation

The Committee's activities formed part of the external review of Board effectiveness performed in the year. Details of this process can be found on the following pages.



Sir Malcolm Williamson
Chairman of the Nomination Committee

Effectiveness continued

Independence

Since March 2013 the Board has had two non-independent non-executive directors, Clive Cowdery and John Tiner. They are not deemed independent due to their previous business relationship with ROL (see page 74 for description of ROL) and their economic interest in the Value Share as described on page 74. While it was considered appropriate for them to join the board in March 2013 to provide continuity as the Board was unified; following the completion of the transformation programme they have decided not to seek re-election to the board at the 2014 AGM. The Committee will consider through the succession planning process whether to fill the vacancies on the Board. The Committee also gave careful consideration to the re-appointment of Robin Phipps as he reaches his six-year term during 2014. In considering his independence and the contribution he makes to the Board the Committee reviewed his previous experience as an executive director of a life and pensions company, his external commitments and his chairmanship of the With Profits Committee. The Committee concluded that he remains sufficiently independent, citing his constructive challenge at the Board and his championing of the customer agenda outside the boardroom with the TCF team. The Committee recommends Robin's re-appointment for a further three year term subject to continuing support from shareholders.

Time commitments and terms of appointment

The letters of appointment set out the expected time commitment: approximately 26-30 days a year. However, in a recent analysis undertaken by the Company Secretary as part of the Nomination Committee's annual review, time devoted by the Committee Chairs and other members of the Board exceeded this figure and was in excess of 40 days. The Chairman devotes 2.5 days a week to the company. The NEDs inform the Company Secretary and Chairman of any changes to their external commitments so that the Chairman can ensure NEDs have sufficient time to carry out their duties. The Board reviews the changes to individuals' external responsibilities as and when they arise. This year the Nomination Committee confirmed that in their opinion, each of the NEDs seeking election or re-election at the AGM will have sufficient time to discharge their duties to the Company in 2014.

In principle, the Board supports executive directors accepting non-executive directorships at listed companies and charities, believing that it provides valuable experience. The GCE and CFO hold charitable non-executive positions; the GCE with the NSPCC and the CFO at the Zoological Society of London. All other external commitments will be assessed by the Chairman and Nomination Committee on a case by case basis.

Appointment of Chairman

The role of Chairman is pivotal to a successful Board. Following the announcement that Mike Biggs would not seek re-election at the AGM in May 2013, Phil Hodgkinson commenced a search for the role of Chairman of the unified Board. He created a Special Nomination Committee to advise on the process which comprised the non-executive directors that had been proposed as members of the future RSL Board, excluding Sir Malcolm Williamson as he was an internal candidate for the role of Chairman.

The SID appointed Spencer Stewart to identify suitable internal and external candidates. They assessed candidates against a list of characteristics required for the role with due regard to the Company's strategy. In particular, we considered financial services experience, the ability to build good relationships with the regulators and a consensus building style key for a Board that had undergone a period of significant change. The Special Nomination Committee agreed a shortlist and a number of candidates, including Sir Malcolm Williamson, were considered for the role and various members of the future RSL Board interviewed these candidates.

Having considered the view of the Special Nomination Committee, the RSL Nomination Committee approved the appointment of Sir Malcolm Williamson as Chairman Designate in January and he succeeded to the role of Chairman following the AGM in May 2013. The appointment was made on the basis that Sir Malcolm

had originally been selected by RSL to lead FLG through to the planned exit and was the outstanding candidate against the defined recruitment criteria. As part of the process we sought the views of major shareholders and they supported the election of Sir Malcolm. For the purposes of the UK Corporate Governance Code and judging the tenure of a director, Sir Malcolm's appointment date is considered to be 5 November 2009, the date he was appointed as Chairman of FLG.

As the candidate was an internal appointment the RSL Nomination Committee suggested there would be benefit in recruiting externally for a further independent non-executive director who would not be drawn from either legacy FLG or RSL Boards. They gave the responsibility for this process to Sir Malcolm Williamson as Chairman Designate, which resulted in the appointment of Roger Perkin in May 2013 and Marian Glen in October 2013.



David Allvey
Senior Independent non-executive director

Professional development for non-executive directors

It is the Chairman's responsibility, supported by the Company Secretary, to ensure that each director refreshes their skills and knowledge to enable them to carry out their duties effectively. During 2013 we held five scheduled training sessions and three sessions with the business units to monitor their progress against strategy. Each year we send the NEDs a questionnaire to seek their feedback on professional development for the year. The suggestions from the Company generally anticipate regulatory and strategic change. This year we have proposed a programme that is divided into three areas – committee-specific training on technical developments, a "getting to know the business" section, and broader topics which will be the core training programme for the Board dealing with key strategic issues. While the core board training will be mandatory, the other pools of sessions will be open to all directors to enable them to select topics according to interest or in line with strengthening their skills in specific areas. The "getting to know the business" sessions will offer NEDs the opportunity to participate in the senior management leadership days and therefore build towards the board effectiveness actions regarding interacting with senior management. The Chairman and the Nomination Committee have reviewed the suggested training agenda and the Chairman will discuss each of the options with the NEDs through his year end review, and assist in putting together their professional development programmes. In addition, targeted training is often provided by management prior to key decisions being made – for example decisions relating to Solvency II planning, the With Profits Annuities De-Risking Project and changes to investment management supplier are some examples of sessions held in 2013.

Skills self-assessment

Board skills and experience

	%
Regulated industry	100
Listed company leadership	100
Corporate governance	86
Financial services	55
Life company insurance	55
Strategy/business plan	86
Capital management	43
Risk management	36
Culture change	50

Nomination Committee

- Board training
- Succession planning
- Learning and development
- Induction

Conflicts of interests

We have established procedures in place through the Articles of Incorporation to manage conflicts to comply with Guernsey law. The articles allow for interested directors to vote provided they have made sufficient disclosure to the Board. Directors are permitted to recuse themselves from decisions when they are concerned about a conflict or potential conflict, even though the legal framework allows them to vote on a topic.

As we have two non-independent NEDs on the Board, the Board in March put in place a process for managing any conflicts that might arise as a result of their holdings of the Value Share. There are very few circumstances envisaged where a conflict may arise, as under the principles of the Limited Partnership Agreement the interests of shareholders and holders of the Value Share are generally aligned. Other conflicts for directors are managed through the normal process, where directors are concerned about a conflict they would recuse themselves from the discussion.

Independent professional advice

Each Board member has access to independent advice at the Company's expense, to help them discharge their duties as directors. Limited consultancy expenses were incurred during the year on behalf of the Board as a result of the various business restructurings. All expenditure was in accordance with the terms of non-executive directors' letters of appointment and was approved by the Chairman and continually reviewed by the Company Secretary.

Effectiveness continued

Board effectiveness review

Each year the Board, as required by the Code, carries out an evaluation of its own effectiveness. In 2013 the Boards of both FLG and the Company were scheduled to have their three-yearly external effectiveness review. Following unification of the Boards, the Chairman believed that it would be beneficial to proceed with the external review at the end of 2013.

The Committee reviewed the outcomes of the 2012 review, implemented during 2013. Key achievements were improvements to the quality of board papers, the introduction of board dinners, review of the annual Board agenda and reduction in attendees of Board Committee meetings.

Process for the review

Following a tender process, the Chairman selected Advanced Boardroom Excellence ("ABE") to conduct the external review. ABE have no other connection to the Company. The review consisted of interviews, documentation reviews, feedback to the chairman, SID and Company Secretary. The results were presented to the board in January 2014 and action plans drawn up and approved for the Board and Committees in March 2014. Progress against these will be reviewed in November of this year. The process is described in detail below:

- Interviews conducted with all directors, the Company Secretary, members of the Group Executive Committee, senior managers who regularly meet the Board, and external parties such as auditors, lawyers, company brokers.
- Observation at two board meetings, all board committees and a number of the Company's subsidiary boards. This included the weekly Group Executive Committee and the Friends Life Limited Board.

- Governance documents were reviewed, including terms of reference, Matters Reserved for the Board, induction and corporate governance manuals and the Board resource library.

Conclusions of the review

The review focused on strategic development, credible challenge, talent and succession planning, risk governance, customers and culture. It also looked at the Company's strengths and weaknesses, its balance of skills, and diversity. Strengths of the Board were found to be cohesiveness and openness, which will be preserved as more challenging decisions come to the fore. The effectiveness of challenge and debate were recognised but cautioned against group think creeping in. Other strengths were indicated as the way the committees report to and are accountable to the board at each meeting.

The review included feedback on the performance of each of the NEDs which the Chairman has discussed with them privately. The SID received feedback from the review regarding the Chairman's performance and this has been communicated to the Chairman.

The size of the Board was also highlighted during the review as to whether its composition of 15 members could inhibit debate. Following discussion at the Nomination Committee in January 2014 it was agreed that such size did not prevent adequate challenge. More importantly the review noted there was substantial evidence of constructive challenge in the Committees. The Committee also noted that size of the Board was necessary to not only balance the independent non-executive directors with the non-independent directors but also to enable the additional responsibilities to be shared appropriately according to skill set across the Committees and subsidiary boards.

Information flows for the Board

The Board's decision-making process depends on the quality of information it receives. This information needs to be timely and also to clearly identify both the decisions required and how they relate to, and affect, the overall Group strategy, employees, investors and customers.

The 2012 Board Effectiveness Review identified a need to streamline information provided to the Board. The Company Secretary was tasked to resolve this issue. After consulting Board members the outcome of the review was that reports needed to highlight and summarise the decisions being requested without compromising the detailed information being provided.

The challenge of satisfying these differing requirements was dealt with by:

Developing new board paper templates

The Company Secretariat team worked with the Transformation Director to develop new board paper templates. Templates now differ, depending on the nature of the topic and decision required. The Company Secretary arranged workshops for authors, helping to signpost key areas of focus, and to streamline the information provided. Following a trial run, follow-up sessions helped to further improve the quality of information presented to the Board.

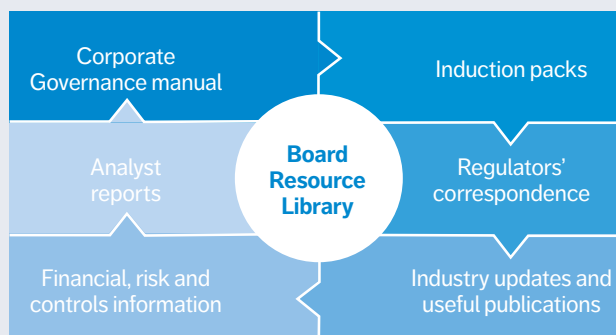
Introducing supporting reference packs

These packs are an appendix to the main board papers which set out additional information and detail; and items for noting such as subsidiary company minutes.

In parallel, the CFO has created a management information pack which now provides insight rather than information.

To further improve the information available to directors, the Company Secretary regularly circulates a short survey to directors asking whether specified papers provided an adequate basis for debate and decision-making, and whether the presentation on the topic was satisfactory.

The Board also has access to their Board and Committee papers and a Resource Library on their iPads, illustrated below.



Topic	Recommendation	Action
Composition: Composition of the Board and succession planning	Succession planning should be given more prominence on the Board agenda. In particular the size of the Board should be kept under review.	Given that the Board was formed in March, it left little room for potential changes other than through natural attrition. A period of stability is also recommended following the governance changes. However, in December the Board members took a skills self-assessment exercise to help assess future vacancies. The Nomination Committee will review this and put together a matrix of future skills required on the Board as the Company moves into a growth phase.
Resources: Increased visibility of talented executives for the Board	Senior managers to present to the Board or find an informal way of engaging the two groups.	Under the previous governance structure this was not a priority. Since April this has been an increasingly active part of the agenda. For 2014, Board members will be invited as part of their learning and development to join the leadership days. In addition, GEC members will present to the Board rather than just the committees. We are exploring further opportunities for interaction between senior executives and NEDs.
Resources: Review succession planning in the wider organisation	As the Company restructured, succession planning was not necessarily a priority. Over the last year this has become more of a focus and development is underway.	The October talent review covered all managers in the organisation. As reported in the Corporate Responsibility report, we have created two management development courses, the first completed successfully in September. More will follow in 2014.
Information: Board papers	Quantity of Board papers needs considering with more appropriate executive summaries.	Huge improvements made in 2013, embed changes in 2014.
Governance: Better reporting into the governance structure for life companies	This was underway, see note in Governance Report.	The activities of the FLL Board and WPC are now reported to the RSL Board, with an accompanying written report.
Conduct: Customer agenda	As the Board moves out of the transformation phase there needs to be a more formal acknowledgement of the customer agenda in the Board room.	A good start has been made with increasing visibility of the customer agenda due to the acceleration of this programme and focus in 2014. Specific customer and conduct training is to take place in 2014.
Effectiveness: Encourage non-executive directors to develop as a team		We introduced Board dinners in March 2013 and holding half-day training sessions outside of the formal schedule. This allows for more informal interaction between NEDs.
Effectiveness: Review Board schedule and length of meetings	The Board agendas have been extremely focused on operational matters. As the Company completes its transformation phase and moves into a growth phase, a review of the rolling agenda will take place.	The training sessions have been taken out of the scheduled Board meeting agendas and will be held in a separate week. This will also encourage more interaction between Board members and with senior managers and executives.
Risk management	Recognition that although development of a risk management culture has made good progress, it requires embedding fully throughout the organisation.	Continued improvements and training are planned for 2014 from the Enterprise Risk team on Turnbull disclosures and policy adherence.

Effectiveness continued

Induction programmes

The Company Secretary has created a standard induction programme (outlined below) for each new non-executive director joining the Board which includes access to all parts of the business and senior management. The plan is discussed with the individual and tailored to their own needs.

Three induction programmes have been completed in 2013. Firstly, as the Board was unified in March 2013, bespoke sessions focusing on the Friends Life Group were held for Phil Hodgkinson, Tim Wade and Mel Carvill to enable them to meet key members of senior management and strengthen their knowledge of the three business units.

The second tailored programme was put together for Roger Perkin. Having spent a significant part of his career as a financial services audit partner, Roger did not require in depth sector specific financial training. His induction focused on meeting the external and internal auditors to get a sense of the key risks facing the organisation and key members of the group financial reporting and capital teams due to his role on the Audit Committee. The rest of his induction was spent understanding the Company's strategy, risk framework, people issues and talent management as well as the outsourcing model.

The third induction programme this year was developed for Marian Glen. As an experienced solicitor, Marian's expertise is in the areas of mergers, acquisitions and corporate finance. Marian's induction commenced with sessions with a number of the Company's external advisors which set the wider industry context and the Company's role in this. Given her role on the Board of Friends Life Limited her tailored programme is focused on financial reporting and group capital matters. In parallel Marian also had a separate induction in respect of her role on the Remuneration Committee.

In addition to the Board induction and corporate governance manuals, the Company Secretary has produced separate induction packs for each Committee. In preparation for the new appointments a due diligence manual for directors considering a position with the Company was produced which was an amalgamation of publicly available information as an easy reference manual for prospective directors.

Succession and tenure

Between 2017 and 2019, ten directors will complete nine years service on the Board, and it is therefore essential that there are identifiable plans in place for both natural and unexpected attrition, which align with a skills-based succession plan. These plans should effectively mitigate the risk of disruption and reduced performance which may occur in the event of uncoordinated Board turnover. In November 2013 the Nomination Committee instigated a process which will map out boardroom capabilities and enable the Chairman and the Committee to correlate the succession plan with the strategic direction of the Company.

Each director has completed a self-assessed skills analysis, the results of which were compiled into a skills matrix. This will enable the Committee to identify ongoing learning and development requirements and will form part of an annual review of Board composition and tenure, which when required, will be the first step in forming a job specification for the appointment of new directors. In addition, the Board Diversity Policy will be factored into this process, recognising that a breadth of skills and professional background is fundamental to a high performing board. During 2014 the Committee will use this work to identify a strategy for managing directors' appointment duration. The skills matrix and gap analysis will have input from the SID, GCE and Group Human Resources and HR and Business Services Director. We will report on progress in the next Annual Report.

Induction: key areas

Market Environment and Competitors: The Company's external advisers provide an overview of the market, competitors and the Company's position.

Strategy: An overview is provided by Group Strategy, followed by tailored sessions with each of the three divisions.

Customer: The Customer Insight team profiles our customers and sets out our responsibilities regarding Treating Customers Fairly.

Human resources: The Group HR and Business Services director provides an overview of Remuneration and Reward arrangements and the Talent Development programme.

Financial Reporting Metrics: This is a two-day programme with the external auditors covering actuarial and tax matters as well as financial reporting. It is followed by sessions with the Group's finance team.

Capital and Solvency: The Group Chief Actuary provides an overview of the key capital requirements and the processes and policies in place to manage adherence with the requirements.

With Profits: A specific tailored programme is provided with the With Profits Actuary.

Conduct Risk: The compliance function provides a review of the regulatory environment from a customer perspective.

Risk: The CRO and Enterprise Risk Director explain the Enterprise Risk Management framework and how it helps the Group generate value safely.

Corporate Responsibility: This focuses on the CR strategy and Diversity programme.

Accountability

Financial and business reporting

The Board has procedures in place to satisfy itself that the Annual Report and Accounts, when taken as a whole, is a fair, balanced and understandable assessment of the Company's position and prospects, and that the Company continues to be a going concern. The Audit Committee plays a key role in supporting the Board in making this assessment and the way in which it satisfies itself that all relevant requirements have been met, is set out in its report overleaf.

The Strategic report on pages 4 to 69 sets out a clear and understandable description of the Company's strategy, business model and explanation of how it creates value for customers, shareholders, colleagues, and other stakeholders. Following the completion of the restructuring activity, for the year ended 31 December 2013 the Company is reporting its UK, Heritage, Lombard and FPI results separately for the first time.

A statement of the directors' responsibility for preparing the Annual Report and Accounts is given on page 125 and Ernst & Young LLP's audit report which contains its reporting responsibilities is set out on page 128.

Audit Committee and auditors

The membership of the Audit Committee and a summary of their terms of reference is set out in their report overleaf. The Board is satisfied that as qualified accountants and Chairman of external audit committees, Tim Wade, David Allvey and Roger Perkin have recent and relevant financial experience. The Board will recommend to shareholders at the Company's Annual General Meeting that Ernst & Young LLP be reappointed. Further detail on the reason for this recommendation and the role and activities of the Audit Committee is set out overleaf.

Risk management and internal control

The Group operates Internal Audit, Risk and Compliance functions with specific responsibilities to provide oversight and assurance of risk management and internal control processes and structures across the Group. Reviews and audits are undertaken based on assessments of the risk profile of the Company and its principal subsidiaries, and the results are reported formally to executive management and the Board and its Committees as appropriate.

The Board is responsible for ensuring the maintenance of a sound system of internal control for the Group including:

- ensuring the legal and regulated entities within the Group meet all regulatory capital and solvency requirements;
- accountability for annual (at a minimum) delivery of internal control assessment and declaration regarding the soundness of the Internal Control environment known as the Control Self Assessment ("CSA") and Turnbull Declaration.
- collectively having the necessary knowledge, skills, information and authority to establish, operate and monitor the system of internal control;
- setting appropriate policies on internal control and seeking regular assurance to ensure that the system is functioning effectively; and
- ensuring the system of internal control is effective in managing the risks which it is there to manage or mitigate.

The Board reviews the internal control framework on an ongoing basis, including internal audit reports, reports from the Group's external Auditor and regular reporting to the Board, Audit, and Risk and Compliance Committees. As part of the half year and year end reporting processes, and consistent with the UK Corporate Governance Code, the Audit Committee and the Risk and Compliance Committee, on behalf of the Board, conducted reviews of the effectiveness of the Group's system of internal control during 2013.

These reviews covered all material controls, including financial, operational and compliance controls and risk management systems. As part of the process, members of the senior management teams reviewed the internal control frameworks within their respective areas of responsibility and completed written declarations on the status of those frameworks. Any exceptions identified were reported through the structure of risk committees at a local and business unit level with any potentially material exceptions being reported through to the Audit Committee. Actions to address the exceptions identified will be monitored by the relevant local audit committee with oversight from the Group Audit Committee.

The Board therefore believes that a sound internal control framework has been in place during 2013, and up to the date of this document consisting of:

- articulation of Group-wide delegated authorities;
- Terms of Reference of committees;
- effective execution of the bi-annual CSA;
- revision of the Group risk policies, including implementation of a specific Group Internal Controls policy;
- effective operation of Risk, Compliance and Internal Audit functions, including appointment of a Group Internal Audit Director; and
- clearly defined senior management responsibilities.

During the year, the framework has been successful in identifying areas of potential weakness in systems and controls. Where further improvement could be made, timely action has been taken to address these points. In line with the requirements of the UK Corporate Governance Code, the Board confirms that there is an ongoing process for identifying, evaluating and managing significant risks faced by the Group, which has been in place throughout the period covered by this report and up to 17 March 2014.

Accountability continued

Audit Committee report

Tim Wade
Chairman of the
Audit Committee



“The focus of our activities during the year has been to support the Group to continue to safely execute its growth ambitions. This will remain a key objective throughout 2014 whilst the Committee remains mindful of its role in the light of ongoing regulatory developments.”

	Pre-March 2013	Post-March 2013
	RSL Audit and Risk Committee	RSL Audit Committee
Membership	Tim Wade** Mel Carvill* Phil Hodgkinson* Fergus Dunlop Denise Mileham	Tim Wade** David Allvey* Roger Perkin (from May 2013)* Karl Sternberg Robin Phipps (from Aug 2013)
Number of meetings	Two	Three
Reporting	Audit Committee meetings are scheduled to take place shortly before Board meetings. The Audit Committee Chair formally reports to the Board after each meeting.	
Attendees by invitation	External auditors, CFO and GCE and Group Internal Audit Director, Chief Risk Officer, Finance Director – Group Finance, Group Chief Actuary	

* Has recent and relevant financial experience

** Chairman of the Committee

Main activities during the year

The Committee has worked throughout the year to fulfil its objective to ensure that the Board can be satisfied that financial reporting requirements are met and internal controls are appropriate.

Key responsibilities

- Review of the integrity of the financial statements and monitoring compliance with statutory and listing requirements.
- Review of the effectiveness of the Group's financial reporting and internal controls, including reviewing the actions of subsidiary company Audit Committees.
- Consideration of significant accounting policies and actuarial methodologies.
- Advising the Board whether the Committee believes the Report and Accounts, taken as a whole, are fair, balanced and understandable and provide the information necessary for shareholders to assess the Company's performance, business model and strategy.

- Review of the scope, resources, results and effectiveness of the internal audit function and the annual internal audit programme.
- Overseeing of the relationship with the external auditor, their effectiveness, ensuring their independence and monitoring non-audit fees.
- Ownership of the Whistleblowing Policy.

This is my first report as Chairman of the stand-alone Audit Committee, having previously chaired the Company's joint Audit, Risk and Compliance Committee. In a year of significant change for the organisation, the Committee has operated effectively and achieved appropriate separation from the Risk and Compliance Committee, but with continued alignment on areas of overlap, such as the Turnbull requirements. A full account of the role of the Committee and how it discharged its duties during the year is set out below.

Purpose

The terms of reference set out the Committee's duties in assisting the Board in undertaking its responsibility to monitor the integrity of the financial statements of the Company; overseeing the adequacy of the Group's financial controls and systems of risk management; and monitoring the effectiveness and independence of both the internal and external auditors. The Board delegates responsibility to the Audit Committee to help ensure that financial reporting processes are robust and overseen with appropriate independent financial expertise and challenge.

Committee membership and attendance

The Committee is comprised entirely of independent non-executive directors. The Chairman of the Audit Committee is a member of the Risk and Compliance Committee to ensure that there is sufficient overlap on key issues.

The Committee holds private sessions with both the external and internal auditors at least twice a year without management present.

The agendas for the meetings follow a rolling annual calendar. The CFO, members of the finance team and the Group Company Secretary assist the Chairman in putting together the agendas for the year and in making sure that the Committee receives information and papers on a timely basis.

The Committee met five times in 2013. The Chairman and two further Committee members have recent and relevant financial

experience. Roger Perkin joined the Committee in May 2013 and brings over 40 years' experience in the accounting profession and the financial services industry to the Board and Audit Committee. Roger is a former partner of EY who are the Company's auditors. The Board and Nomination Committee considered Roger's appointment and were, and remain, satisfied that he is independent given it is four years since he retired as an audit partner.

Financial reporting

The Committee reviews the Company's financial statements, including the Annual Report and Accounts, half-year results and solvency statements. There are a number of areas of judgement (set out below), and the Committee spends time discussing and debating these with the requisite support from management and external advisors.

In line with the UK Corporate Governance Code, the Board has asked the Committee to advise whether it believes that the Annual Report as a whole is fair, balanced and understandable. The Committee confirmed this position.

In order to make this assessment, the Audit Committee has retained continued oversight of the 2013 Report and Accounts process, has been provided with regular updates, and received assurance of continuing verification to ensure consistency, impartiality and balance throughout the document. This includes, for example, the use of non-financial KPIs, information about our valuation assumptions and increased segmental reporting.

Key areas of focus in relation to financial reporting during the year were:

- review of actuarial methodology and setting of assumptions;
- review of accounting policies/practices;
- review of the financial control systems environment to ensure robustness in reporting;
- review of quality of narrative reporting, clarity of disclosures and compliance with relevant compliance and governance best practice;
- review of any relevant correspondence from the regulators and consideration of follow-up actions where required; and
- review of best practice developments and changes in the external environment.

The primary areas of judgement considered by the Committee in relation to the 2013 Report and Accounts were as follows:

1. Principal valuation assumptions

Writing life assurance and pension business requires the setting of assumptions for future experience. The factors considered in these assumptions include mortality and longevity, lapse and persistency rates, valuation interest rates, credit defaults and expense levels. The value of insurance and investment contract liabilities in IFRS and MCEV reporting is sensitive to the principal assumptions used, as is the value of the in-force business asset recognised in MCEV reporting.

The Committee addresses these matters by regularly receiving reports from management on the setting of valuation assumptions. The reports include a comparison of the proposed assumptions against past experience, the justification for the assumptions and a summary of the impact of assumption changes on the financial results. Actuarial experts from within the Group attend meetings of the Committee to facilitate a detailed consideration of the principal valuation assumptions.

2. Actuarial modelling

Actuarial models are used in calculating the value of insurance and investment contract liabilities. Actuarial models are simulations of the future and, due to the level of complexity involved, different models applied with the same input assumptions can produce different outcomes. The models used within the Group follow recognised actuarial principles and best practice. However, the selection of modelling methods involves professional judgement. The models used within the Group are going through a period of change as described in the internal controls section below.

The Committee receives reports from management which explain the reasons for and the financial impacts arising from proposed changes to actuarial models. The Committee also receives progress updates on work being done to validate and enhance existing models and on development work in respect of new models.

3. Provisions

The level of provisioning for future obligations is an issue where management judgements are important. Provisions are held in respect of policyholder compensation in the ordinary course of business, for future costs arising from the transformation of the UK business and for other matters. The Committee discusses with management the key judgements made and challenges these where required, as well as considering the extent to which they are supported by professional advice.

Internal controls

The Committee keeps internal financial controls under continuous detailed review and receives a report twice a year on the internal controls in the organisation in addition to quarterly reports on the financial controls environment.

During 2013 the Committee reviewed the financial reporting control environment thoroughly. The finance function has embarked on a transformation programme over the last two years and has reviewed or replaced a significant number of its internal financial models. During 2013 the embedding of these models by the finance team was critical and the interim and year end process was monitored closely by the Audit Committee. As is to be expected during complex finance transformations, management had to address a range of emerging controls issues. The Committee monitored the rectification of the controls issues and were pleased to note an improving control environment as the year end process completed.

The Risk and Compliance Committee oversees the risk controls within the Group and provides assurance to the Committee in this regard.

Accountability continued

Outsourcing

The Company also places reliance on a number of major outsourcing relationships which are key to delivering improvements to customers in large part through migration off legacy platforms. The Audit Committee received Internal Audit reports on outsourcing and together with the Risk and Compliance Committee, actively challenged the management team to ensure that appropriate control environments are maintained.

Subsidiary Audit Committees

The Group's principal subsidiaries each have an audit and risk committee with the exception of Friends Life Limited and Friends Life Investments Limited. The Chairmen of the Audit Committee and the Risk and Compliance Committee each attend a subsidiary audit and risk committee annually. FLL and FLI report separately through the Group's internal risk management structure.

External audit

The Committee ensures that the key risks and issues are identified by the external auditors at the start of the audit cycle, and keeps the progress and scope of the audit plan under review throughout the year.

Key risks and issues identified by the external auditor relate to the reasonableness of actuarial assumptions, robustness of actuarial modelling and the reasonableness of provisions.

The Committee regularly reviews the effectiveness of the external auditor, taking into account the views of management, the quality and depth of reporting, and the nature of the relationship, which needs to be challenging yet constructive.

In assessing the effectiveness of the external auditors, the Committee takes into account the findings of relevant external inspections.

Objectivity and independence

The Committee regularly reviews the independence of EY and there is an External Auditor Policy in place to ensure that EY can remain independent. The policy follows the guidance issued by the Auditing Practice Board of the Financial Reporting Council.

Key principles of this policy include provisions that there must not be mutual or conflicting interests; and EY cannot audit their own work or act as an employee or advocate of the Company. In the limited circumstances, where EY are considered to be the most suitable supplier, a robust approvals process is in place, with management able to engage EY subject to fee limits and quarterly caps, with all non-audit work above £100,000 requiring approval from the Committee. During 2013 fees paid to EY for audit and audit-related assurance services, including MCEV, were £5.8 million and fees paid to EY for other services were £0.8 million which related to consultancy spend on projects and aligning these to the audit process.

Audit engagement partner

This year, following a five year tenure, the lead audit partner was changed in accordance with the Auditing Practice Board guidance. Although the Company, incorporated in 2008, did not commence trading until 2009, the rotation of the audit partner was considered best practice. In order to ensure a smooth transition the new audit partner shadowed the previous audit partner during the latter half of 2013 and took full ownership of the 2013 audit plan.

Appointment of auditors

Having reviewed the Competition Commission guidance and the Code requirement to tender the external audit contract every 10 years, the Committee will, during 2014, consider the subject of audit tender. It is likely that any tender process will align with the audit engagement partner rotation in accordance with FRC guidance.

Following the review of the auditor's effectiveness during the 2012 reporting period, the Committee has recommended to the Board the re-appointment of EY. EY were appointed in 2008, and this is their sixth year of tenure. A resolution proposing their re-appointment will be put to the shareholders at the 2014 AGM.

Internal audit

The internal audit function reports to the Audit Committee and provides independent, objective assurance on the internal control environment across the Group and the operation of risk management, control and governance processes. An Internal Audit Charter sets out the remit of the internal audit function.

The Committee considered the July 2013 CIIA Guidance for Financial Services and has embarked on a programme to further develop its capability. The Group Internal Audit Director has a direct reporting line to the Chairman of the Audit Committee who also sets his objectives and reviews his performance and a secondary reporting line to the Group Chief Executive. His annual performance bonus is unconnected to the Group's financial performance and is approved by the Remuneration Committee. The Group Internal Audit Director attends the Group Executive Committee and in order to preserve his independence is a non-voting member.

Planned audits are risk-based. Areas of focus during 2013 were the management of outsourcing arrangements, delivery of key projects, information technology and security, customer services and operations, capital management, risk management and financial reporting. Where control improvement actions are agreed, the Committee regularly monitors management's remediation performance.

The Committee has approved the internal audit plan and budget for 2014, and is satisfied that internal audit has access to appropriate resources to undertake its role.

The Group also has in place a Whistleblowing Policy which enables employees to air their concerns freely without fear of detrimental treatment. Monitoring of this falls within the remit of the Committee. Concerns can be reported to an independent third-party or specified personnel within the Group and the Policy is reviewed annually by the Committee.

Committee evaluation

The Committee's activities formed part of the external review of Board effectiveness performed in the year. The findings of this report were discussed by the Board in March 2014 and generally relate to improvements in the quality, volume and signposting of information presented to the Committee. Details of this process can be found on page 88 in the Governance report.



Tim Wade
Chairman of the Audit Committee

Risk and Compliance Committee report

David Allvey
Chairman of the Risk
and Compliance
Committee



“The focus of our activities during the year has been to support the Group in developing its Enterprise Risk Management Framework, and to ensure that risk strategy and appetite is suitably integrated into strategic planning.”

	Pre-March 2013 (RSL Audit and Risk Committee)	Post-March 2013 (RSL Risk and Compliance Committee)
Membership	Tim Wade* Mel Carvill Phil Hodgkinson Fergus Dunlop Denise Mileham	David Allvey* Mel Carvill Nick Lyons Robin Phipps Belinda Richards Tim Wade
Number of meetings	Two	Five
Reporting	Risk and Compliance Committee meetings are scheduled to take place shortly before Board meetings. The Risk and Compliance Committee Chairman formally reports to the Board after each meeting, and the Board receives the minutes of Risk and Compliance Committee meetings.	
Attendees by invitation	Executive directors, External Audit Partner, Chief Risk Officer, CEO, Heritage division, Group Internal Audit Director, Group Compliance and UK Risk Director, Group Enterprise Risk Director.	

* Chairman of the Committee

Main activities during the year

The Committee has worked throughout the year to fulfil its objective to ensure that the Board can be satisfied that the risk management and compliance framework across the Group is adequate and will enable the Company to generate value safely. During 2013, the Committee's main areas of focus have been:

Key responsibilities

- Recommending to the Board the Group's overall risk appetite and risk strategy and reviewing the adequacy of actions taken to control key risk exposures.
- Overseeing the development, implementation and effectiveness of the risk management framework and recommending it for adoption by the Board.
- Review of Group policies and recommendation to the Board for approval.

- Overseeing of internal modelling and stress and scenario testing methods and assumptions.
- Reviewing the methodology and assumptions used in determining the Group's economic and regulatory capital requirements for onward approval by the Board.
- Reviewing and monitoring activities of Group Compliance and the effectiveness of the compliance management programme.
- Providing risk-focused advice to the Remuneration Committee in respect of risk weightings to be applied to executive performance objectives

This is my first report as Chairman of the Risk and Compliance Committee. I am pleased with the progress we have made during the year, further details of which are set out below. Looking forward, Solvency II compliance and risk-based performance measures remain high on the agenda for the Committee, and to this end, the Committee has placed particular focus on matters relating to the development of our Own Risk and Solvency Assessment.

Purpose

The terms of reference set out the Committee's duties in assisting the Board in its oversight of the risk and compliance framework and associated activities of the Group. This includes advising the Board on the Company's overall risk appetite, tolerance, strategy and limits; overseeing and advising the Board on risk exposures and future risk strategy; evaluating the effectiveness of risk assessment processes and internal control systems; and reviewing the Group's risk and compliance policies.

Committee membership and attendance

The Committee is comprised entirely of independent non-executive directors. To ensure that risk issues are appropriately considered by other committees, the Chairman of the Risk and Compliance Committee is a member of the Audit Committee. The Chairman of the Remuneration Committee is also a member of the Risk and Compliance Committee – we implemented this structure to create a specific link between risk and remuneration. The audit and risk committees of the key operating subsidiaries have each been attended by a member of the Committee at least once during the year, and any material findings are reported to the Committee. The chairs of these subsidiary committees are also invited to attend the Risk and Compliance Committee once during the year.

Accountability continued

The agendas for the meetings follow a rolling annual calendar, and are also flexed to reflect developments in the external macro-economic and regulatory environment and developments in the Company's strategy. The Chief Risk Officer, members of the risk senior management team and the Group Company Secretary assist the Chairman in putting together the agendas for the year and in making sure that the Committee receives information and papers on a timely basis. The Group Internal Audit Director has a standing item on Committee agendas to report to the Committee on any risk related internal audit matters.

In performing their duties the Committee has access to the Chief Risk Officer and Group Company Secretary and, where relevant, other senior managers within the business. The Committee holds private sessions with the Chief Risk Officer without management present to discuss issues to be raised with management in the main meeting. It is able to seek external professional advice at the Company's expense.

The Committee met five times in 2013. Details of Committee members' attendance is set out on page 81.

Setting of risk appetite and risk strategy

The Committee sets the Group's overall risk appetite, which is assessed and challenged throughout the year. The Group's preferences for risk (ie risks that we seek, risks that we accept, and risks to which we are averse) feed in to the risk appetite and are regularly reviewed by the Committee. The Committee considers all categories of risk – financial, strategic and operational – and the Board approved risk metrics are articulated as risk appetite statements. These have become a core component of business planning. The Group's Medium Term Plan, business objectives and strategy are closely aligned with the preferences for these risks to ensure the Group stays within risk appetite.

During 2013 risk appetite statements were reviewed by the Committee on a regular basis and the Committee recommended to the Board updates to the Group's risk appetite in respect of Solvency, Dividend, Return, Reputation and Liquidity.

Review of top risks

Following the governance changes in the Group, a full review of the Group's top risks was undertaken during June 2013, and the output was reviewed and challenged by the Committee. The Committee maintains regular oversight of these risks, and in particular changes to them are highlighted at each meeting. Consideration of emerging risks is a key part of the process and the Committee plays a role in challenging management as to whether due consideration is being given to these matters. Where top risks are outside of risk appetite, the Committee tracks progress made in bringing them back in to risk appetite, thereby fulfilling its duty to manage the Group's overall risk profile.

Development of the Enterprise Risk Management framework

This year the Committee has spent a considerable amount of time reviewing the risk and governance structure, in particular ensuring that Enterprise Risk Management (ERM) is embedded in the organisation. This is described further on page 65. The Committee's engagement in the ongoing development of the ERM framework has supported its embedding within day to day business practices and planning.

Customer and conduct risks

The Committee regularly reviews reports from the Compliance Monitoring team, including their work with our outsourced partners. The Committee has played an active role in shaping a conduct risk appetite for the Group.

Oversight of internal modelling and stress and scenario testing

During 2013 the Committee reviewed the design, key assumptions and outcome of the Group's stress testing programme which tested the robustness of the Group's balance sheet to respond to changes in the economic environment. Management used the outcome to gain greater insight in to the Group's Medium-Term Plan. The Committee also reviewed the output of the Group's participation in an industry-wide stress testing exercise.

This year the Committee also reviewed a new credit risk model which allows for deeper understanding of the capital implications and diversification benefits of asset purchases.

Internal controls

Working with the Audit Committee, the Committee has assessed the effectiveness of the Group's internal control and risk management systems. In November, the Committee reviewed the approach to be taken to the year-end Control Self Assessment ("CSA") which reviews the soundness of the internal control environment in November. The conclusions from the CSA were reviewed by the Committee in March and recommended for onward approval by the Audit Committee.

Solvency II and ORSA development

The Committee has supported the development of the Own Risk and Solvency Assessment (ORSA), which is required under the Solvency II directive. The ORSA sets out the Board's formal view of the Group's capital requirements, given the risks currently faced and how these might evolve over the medium-term horizon, in order to prudently deliver the business strategy. Beyond the regulatory requirement to develop ORSA, the Committee firmly believes that it will benefit the Group and its shareholders as a business tool by which capital and risk considerations can be factored in to business decision-making.

Committee evaluation

The Committee's activities formed part of the external review of Board effectiveness performed in the year. The Board discussed the findings of this report in March 2014. The findings generally relate to improvements in the quality, volume and signposting of information presented to the Committee. Details of this process can be found on page 88.



David Allvey

Chairman of the Risk and Compliance Committee

Relations with shareholders

Institutional shareholders have regular access to the GCE and CFO, as well as the CEOs of our Heritage and UK & International divisions. This is evidenced by 210 meetings the GCE and CFO carried out with equity investors since March 2013. Management also attended a number of investor conferences, including four in London, two in New York and one in Hong Kong.

In his first year as Chairman, Sir Malcolm Williamson met the majority of the Company's top fifteen shareholders to ensure he could communicate their views concerning governance and strategy to the newly formed Board. The SID and other non-executive directors are also available to meet major shareholders. The Board believes that allowing shareholders direct access to non-executive directors is essential to help the Board develop a balanced understanding of any issues or concerns that may exist in the investment community.

Institutional shareholders

The Board also receives regular feedback on investor meetings and other Investor Relations activities. Twice a year the corporate brokers are invited to meet with the Board to offer their interpretation of shareholder sentiment following results announcements. Following the publication of the 2012 preliminary results, the Company's public relations advisors conducted a survey of the market participants to gauge investment sentiment following the implementation of the governance changes in March 2013, and the Board was pleased with the positive feedback received. The Board is also kept up to date with the sell-side research and all analyst notes on the Company are provided to the Board via the Resource Library outlined on page 88.

We have sought investor views in the following key areas this year:

Financial performance and strategy

Following the release of 2012 full year results and 2013 half year results, the Company hosted presentation and Q&A sessions for investors and analysts, allowing market participants to share their feedback with management directly and to ask any pertinent questions.

A similar format will be followed on 18 March when the 2013 full year results are released, albeit on this occasion the financial results announcement will be followed by an Investor Update. A series of presentations by senior management will outline the strategic direction of the Company going forward and will introduce the newly adopted financial framework.

Governance

In forming the proposals for the governance simplification and the unification of the Boards of the Company and FLG which took effect in March 2013, the Company undertook a consultation with its major shareholders to seek their views in advance of finalising these important changes. In addition, major shareholders were consulted in relation to the appointment of the Chairman, Sir Malcolm Williamson.

Articles of Incorporation

We also sought shareholder views on the changes to the Articles of Incorporation put forward for approval at the General Meeting held on 20 March 2013. Following issuance of the notice of the General Meeting, we received further constructive feedback, in relation to the proposed change to the notice period for General Meetings. As a result of this, shareholders endorsed further amendments to the Articles of Incorporation at the Annual General Meeting held in May 2013.

Remuneration

This year we consulted three times with the top ten shareholders over remuneration proposals: on the GCE salary, the amendments to the Long Term Incentive Plan due to the decision not to seek an exit, and the introduction of the new Performance Share Plan.

Retail shareholders

We have over 90,000 retail shareholders. We value their opinions and aim to respond to all letters we receive. In the last 12 months we have responded to approximately 480 letters. We ensure all our retail shareholders have access to the investor presentations on our website and for those whose email address we have, we communicate by email. We also invite shareholders to write to us ahead of the AGM.

Private retail shareholders have access to a wealth of information on the corporate website, from investor presentations and financial reports to information about the Board and its Committees and governance arrangements. Every shareholder has the opportunity to attend the AGM and can also write to the Company Secretary to communicate their views to directors.

AGM

All shareholders are invited to our 2014 AGM which will be held on 8 May 2014 at the Queen Elizabeth II Conference Centre in London. All Board members including the Chairmen of Board Committees will be available to answer shareholders' questions relating to the business of the meeting. We encourage advance registration of questions and question registration points will be open prior to the meeting to facilitate this. At the AGM the Chairman will give an overview of the 2013 results prior to dealing with the formal business of the meeting and shareholders' questions.

Voting will be conducted at the AGM via a poll. A separate resolution has been put forward in respect of each substantially separate issue and forms of proxy and voting cards have been issued to all shareholders. We will publish the results of the AGM on the Company's website at www.resolution.gg and announce them to the London Stock Exchange at the earliest possible opportunity.

Chairman's introduction to the remuneration report

Nick Lyons

Chairman of the
Remuneration
Committee



"Rewarding and incentivising performance which is aligned with the interests of Shareholders, Customers and Colleagues".

I am delighted to present my first Remuneration Report as Chairman of the Committee having taken over from Gerhard Roggemann on 28 March 2013.

I would like to thank Gerhard and my former colleagues, Mike Biggs, Jacques Aigrain, Gerardo Arostegui and Peter Niven, who sat on the Remuneration Committee prior to the 28 March 2013 and to Phil Hodgkinson who resigned on 16 May 2013.

As reported in last year's Remuneration Report the Company's governance arrangements were simplified in 2013 to reflect a more conventional Board structure. 2013 also saw the final phase of the transformation of the three separate businesses into one group that could sustainably meet customer needs whilst delivering returns for shareholders.

Bonus out-turn for 2013

The business has had a successful year. We have built on the foundations supporting our development as a sustainable and profitable business. This has seen the share price increase by over 40% from 12 months ago while our total shareholder return has increased by over 50%. This significant level of total shareholder return represented an upper quartile performance over the year compared with other FTSE 100 companies.

The delivery of operating results across the majority of the Group has been strong although there have been some performance issues within our subsidiaries which have impacted overall performance. The balanced scorecard sets out the measures by which we assess the achievement of key financial goals and management of expenses, together with metrics relating to Customers, Colleagues and Risk outcomes. Strong delivery in particular of cash represented by SFS of £331 million, IRR of 15.3% and MCEV Operating profit of £489 million has driven a bonus out-turn that is around 75% of the maximum. Target bonus opportunities are 50% of the maximum award.

All employees share in the success of the Company through an annual bonus scheme. For 2013 the average bonus award for all employees was 17.8% of qualifying earnings.

We believe that our remuneration policy is appropriate for creating value for all our stakeholders, including our customers, in a sustainable way which will ensure the long-term success of the organisation. We believe the remuneration policy, which aims to keep rewards at or around the median of FTSE 31-100 companies, to be fair and balanced.

Key decisions on remuneration during 2013

The structural changes that took place in 2013, set out on pages 72 and 73, meant that the Committee had to review the remuneration policy to ensure it not only reflected the Group's strategic goals but also complied with best practice given that the two executive directors became members of the listed company board. The Committee reviewed the basic salaries and variable remuneration of the executives, recommended the adoption of share ownership guidelines and, in the latter half of the year, reviewed the balanced scorecards for the wider organisation to ensure they reflected the new financial framework to be adopted.

In addition, given the Group was no longer pursuing an exit event, shareholders were asked to approve amendments to the FLG LTIP at the AGM in 2013. While the performance conditions for the LTIP remained the same (a 12% internal rate of return threshold) both the calculation of the threshold and the vesting periods were amended (see page 111). These amendments were required to ensure that the plan continued to operate as intended and provided a meaningful incentive for participants. There will be no further grants made under this scheme.

As reported last year, our largest shareholders were consulted on the proposed increase to the Group Chief Executive's base salary to £675,000 to reflect the additional responsibilities of that role. His salary will be increased to £691,875 (up 2.5%) as part of the annual pay review in April 2014 and in line with the pay pot for all colleagues. The CFO's salary is considered to be market competitive, and remains unchanged from his appointment.

The variable elements of executive remuneration have been reviewed to ensure that they appropriately incentivise executives to deliver superior shareholder returns and reflect the strategic aims of the Group, cash today (SFS) cash tomorrow (VNB and MCEV) and maintaining a strong balance sheet within a balanced scorecard. The variable elements of pay are the annual bonus and the long-term incentive scheme or performance share plan.

The annual bonus is driven off a balanced scorecard and this was reviewed by the Committee to ensure it aligned appropriately with the introduction of the new financial framework (pages 29 to 31). The Committee concluded that the risk measure and weighting within the scorecard should be replaced by a risk gateway approach for 2014, where the Committee will consider risk across the whole scorecard and have discretion to adjust scorecard outcomes. This seeks to ensure that the Group generates value safely by linking bonus outcomes to the Board's risk appetite. The Customer and Colleague weightings were increased following the removal of the risk measure.

Looking to the future given the existing LTIP will end in 2016, we reviewed the incentivisation and retention of the executive team going forward and the Committee has, following consultation over a six month period with our largest shareholders (representing approximately 46.8% of the Group's issued capital), proposed the introduction of a new Performance Share Plan ("PSP"); approval for this will be sought at the AGM. The performance conditions for the new PSP were of particular importance to the Committee and these have received careful deliberation. For awards made in 2014, the performance conditions will be TSR for 50% of the award, and the remaining 50% will be split equally between Absolute Embedded Value ("EV") and Absolute Total Group Free Surplus Generated ("FSG"). TSR was selected as a direct means of aligning the PSP to the shareholder experience. EV was deemed a suitable metric as it comprises shareholder net assets and the net present value of future cash flows expected to arise from the in-force business (cash tomorrow) and FSG is deemed appropriate as it represents the after tax free surplus generated in the relevant period and is a lead indicator of the Group's dividend capabilities (cash today).

Equally important in aligning the interests of the executives with shareholders has been the introduction of share ownership guidelines which require the GCE to hold shares with a value of 300% of salary and the CFO to hold 250% of salary. The Committee also adopted a leading approach to malus and clawback in its share plan rules.

New structure for Directors' Remuneration Report ("DRR")

This report has been prepared on behalf of the Board by the Remuneration Committee in accordance with the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (the "Regulations").

Annual General Meeting – 8 May 2014

At the AGM we will be requesting shareholders' approval of the Company's Remuneration Policy (see pages 100 to 107) and Implementation Report (see pages 108 to 121).

In addition, as explained above, we will be seeking shareholders' approval for a "PSP", in which the Executive Directors and other senior executives will be eligible to participate. Further details of this PSP can be found on page 104 and in the Notice of AGM.

At the AGM in 2013 the Remuneration Report was supported by 89.53% of shareholders, with votes against of 10.47%. This represented 73.45% of the capital voted and the Committee believed this outcome represented support for the remuneration policy, although it hopes that, following the adoption of the new governance arrangements, it will receive a higher level of support at the 2014 AGM.

In this report, we have sought to make a complex area as transparent and simple as possible. I hope that you find the new reporting format helpful in understanding our approach to pay. I am open to discussing remuneration matters with our shareholders and look forward to your support at the AGM for the remuneration related resolutions.



Nick Lyons

Chairman of the Remuneration Committee

17 March 2014

Remuneration policy

Introduction

We have presented this Remuneration Report to reflect the recent changes in reporting requirements on remuneration matters for companies with a UK governance profile, particularly the new Regulations. The report also describes how the Board has complied with the provisions set out in the UK Corporate Governance Code relating to remuneration matters.

The Remuneration Report sets out which of its sections have been audited.

In defining the Company's remuneration policy, the Committee has been mindful of the public interest in executive remuneration as well as emerging best practice in this area. As Resolution Limited is a company incorporated outside the UK, it is not technically subject to these Regulations. However the Board advocates that it should seek to comply with all aspects of the Regulations.

The key change introduced by the Regulations is that the Company's Remuneration Policy (the 'Policy'), will be subject to a vote by shareholders at the Company's AGM on 8 May 2014 (the "AGM"). It is intended that the Policy will become effective immediately upon approval by shareholders and will remain in force for three years. Even though compliance with the Regulations is technically voluntary for the Company, as a non-UK incorporated entity, if the Company wishes to amend any aspect of its Policy it will seek shareholder approval. This vote on the Policy is separate from the vote which shareholders will be asked to participate in at the AGM relating to the Implementation Report (the "Report"), set out on pages 108 to 121. In addition to the new voting requirements, the Regulations also require companies to make enhanced and

additional disclosures relating to executive remuneration and the Company has sought to fully comply with these aspects.

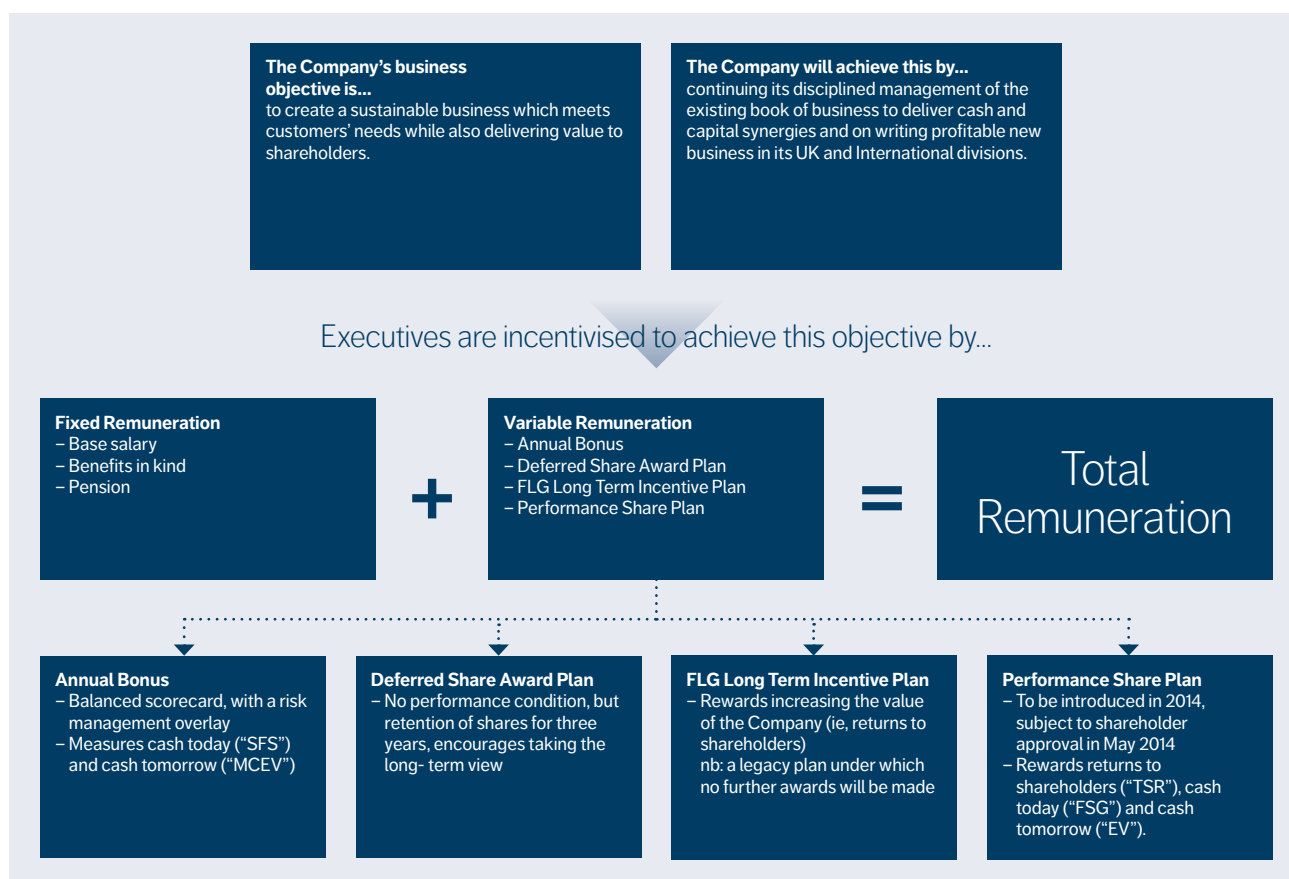
The Committee recognises the importance of being able to attract, retain and incentivise high calibre executives, in a manner which aligns their interests with those of the Group and its shareholders, and which supports the Company's commercial objectives while balancing this against the clear objective of avoiding paying more than it considers to be necessary. However, it is also important that the Policy is sufficiently flexible to allow the business to be managed efficiently.

Total remuneration opportunities

Executive directors' remuneration comprises both fixed and variable elements. The "fixed" elements are those that an executive can be certain of receiving in any given year under the terms of his service agreement, assuming his role does not change significantly during that period. The "variable" elements of remuneration are those that have contingencies measured over one or more years, and where the extent to which those contingencies are met indicates the level of remuneration received.

Future remuneration policy table

The Policy table starting on page 102 sets out the Remuneration Policy as it relates to directors. The information contained in the Policy (ie, pages 100 to 107) is not audited by the Company's external auditors.



At a glance**Philosophy on remuneration packages:**

- regard is given to all employees' remuneration generally when setting executive remuneration packages;
- policy +/- median of FTSE 31-100 for the role; and
- a hard cap is applied of the median level of salaries for that role in the FTSE 100.

Overall approach

Executive remuneration packages are structured so that they:

- Are aligned to the Group's strategy by encouraging and rewarding the delivery of a sustainable business that meets the needs of customers and delivers value to shareholders;
- Are aligned with the interests of shareholders, with a significant proportion being performance-related to areas which impact value;
- Are competitive but not, in the view of the Committee, excessive, in relation to the UK life insurance market;
- Do not promote unacceptable behaviours or encourage unacceptable risk taking. In particular, the 2014 Annual Bonus Plan has a risk gateway that allows judgement to be applied across the whole scorecard outcome; and
- Take into account Group-wide pay and employment conditions. The Committee reviews the average Group-wide base salary increase and bonus costs and is responsible for all discretionary and all-employee share arrangements.

While cautious of over-reliance on benchmark data, the Committee has due regard to median data for both the FTSE 31-100 companies and the UK insurance sector both in setting base salaries and in structuring the overall packages.

Fixed

- Consists of base salary, benefits and pension.
- Base salary is the salary to be paid in 2014.
- Benefits measured as benefits paid in 2013 as set out in the single figure table.
- Pension measured as the 20% of base salary receivable either as a contribution or in cash.

£'000	Base salary*	Benefits	Pension	Total fixed
Andy Briggs	£688	£37	£137	£862
Tim Tookey	£650	£19	£130	£799

* Andy Briggs' base salary is calculated as three months' salary at £675,000 p.a. plus nine months' salary at £691,875 p.a., which includes a 2.5% annual salary increase.

Target

Based on what the director would receive if performance was on target (excluding share price appreciation and dividends):

- Annual bonus: consists of the on-target bonus (82.5% and 75% of base salary for the GCE and CFO respectively).
- PSP: consists of the threshold level of vesting under the proposed new PSP (40% and 35% of base salary for the GCE and CFO respectively). The benefit of participation in the SIP has been ignored as the Company does not offer any match.

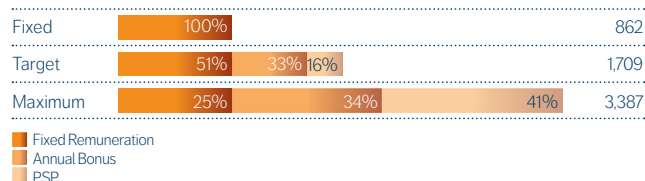
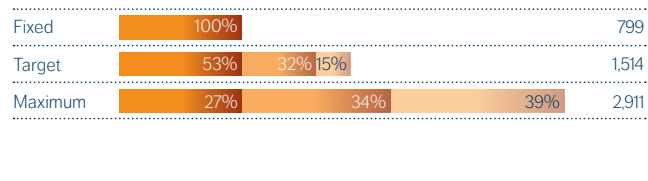
Maximum

Based on the maximum remuneration receivable (excluding share price appreciation and dividends):

- Annual bonus: consists of the maximum bonus (165% and 150% of base salary for the GCE and CFO respectively).
- PSP: assumes maximum vesting of awards and valued as on the date of grant (200% and 175% of base salary for the GCE and CFO respectively).

Indicative earnings in 2014 for executive directors under the terms of this Policy**Split between fixed and variable pay**

£000

Group Chief Executive**Chief Financial Officer**

The charts above illustrate the fixed, target and maximum potential remuneration opportunities for executive directors in 2014 using the assumptions set out below. For the purpose of this disclosure we have assumed that the introduction of the PSP receives shareholder approval at the AGM on 8 May 2014.

Remuneration policy continued

Fixed elements: Base salary

Purpose and link to Strategy	<ul style="list-style-type: none"> To recruit, retain and incentivise high calibre executives to deliver the Group's strategic objectives. To reflect an individual's experience, role and responsibilities within the Group.
How it works	<ul style="list-style-type: none"> Salaries are normally reviewed annually, with any increases generally effective from 1 April. In advance of that review, the Committee Chairman discusses the performance of each executive director with the Group Chairman, and also considers the views of the GCE on the contribution of other executive directors. The concepts of malus and clawback do not apply to base salary. Company and individual performance, and any change in role and/or accountabilities, are also taken into account.
Opportunity/Cap	<ul style="list-style-type: none"> The Committee will apply the factors set out in the previous section in considering salary adjustments. No increase will be awarded to an executive director which exceeds the average increase in base salary awarded for that year to staff generally unless, having regard to the median for FTSE 31-100 companies as explained above, the Committee concludes that it is appropriate to make a higher increase. In which case, the Committee may increase the salary within an overall cap of the median level of salaries for that role in the FTSE 100 as advised to the Committee at or shortly prior to when any increase is considered.
Measures	<ul style="list-style-type: none"> The Committee believes it is appropriate to consider all relevant factors when setting executive directors' salaries rather than simply following market data. However, it has due regard to median data for FTSE 31-100 companies and other FTSE 350 insurers. Where an executive has, in the view of the Committee, achieved the appropriate performance level and there are no other compelling factors, the Committee would seek to limit his or her increase to that awarded to staff generally.

Fixed elements: Benefits

Purpose and link to Strategy	<ul style="list-style-type: none"> To provide other, generally non-cash, benefits valued by the recipient, which help to recruit and retain employees, and assist them to perform their roles effectively.
How it works	<ul style="list-style-type: none"> Provision of paid annual leave, a car allowance and/or chauffeur expenses and private medical insurance. Executive directors may select from a menu of Flexible Benefits which are funded by salary sacrifice, including: critical illness cover for the employee and their partner, dental insurance, health assessments, childcare vouchers, giving up an entitlement to annual bonus in lieu of a Company contribution to the pension scheme, Give As You Earn (under which the Company will match donations up to £20 per month). In certain circumstances, it may be appropriate for an executive to relocate for the ongoing performance of his role. In this situation additional benefits may be provided, such as relocation allowance, housing allowance, schooling for children, legal advice, tax advice and for international relocations, language training for the family. The Committee may review the benefits available to executive directors periodically and change the benefits available, within the overall caps and after considering changes in market practice. Generally the concepts of malus and clawback do not apply to benefits. However, should an executive leave the Group's employment within one year of relocating, they would generally be required to repay the allowances received.
Opportunity/Cap	<ul style="list-style-type: none"> The new legislation requires that a maximum value is prescribed for each element of remuneration. It is not possible to prescribe the likely change in the cost of insured benefits or the cost of some of the other reported benefits so a monetary limit of £100,000 p.a. (excluding life cover) per executive director has been set although, clearly, the Committee will monitor the costs in practice and ensure that the overall costs do not increase by more than the Committee considers to be appropriate in all the circumstances. The executive directors' nominated beneficiaries will receive four times the executive's base salary, should the executive die whilst in employment. This amount is outside the £100,000 cap referred to earlier. The total allowances paid in the event of an executive relocating will be capped at 100% of base salary (see 'How it Works' section above for circumstances in which relocation expenses may be repaid by the executive).
Measures	<ul style="list-style-type: none"> Not applicable.

Fixed elements: Retirement benefits

Purpose and link to Strategy	<ul style="list-style-type: none"> To recruit, retain and motivate key executives by providing a framework within which they can save for their retirement.
How it works	<ul style="list-style-type: none"> Provision of market competitive post-retirement benefits within a defined contribution scheme or via an annual pension allowance. The Company will honour pensions obligations entered into under all previous policies in accordance with their terms.
Opportunity/Cap	<ul style="list-style-type: none"> Andy Briggs (GCE) and Tim Tookey (CFO) do not participate in the FLG pension plan and instead each receive a pension allowance of 20% of base salary (which is not taken into account for bonus, incentive plan or insured benefits purposes). Any newly appointed executive director would have the choice of whether to join the Company's defined contribution pension scheme or receive 20% of salary in lieu of Company pension contributions. The Company's defined contribution pension scheme offers a sliding scale of Company contributions. The concepts of malus and clawback do not apply to retirement benefits.
Measures	<ul style="list-style-type: none"> Not applicable.

Variable elements: Annual bonus

Purpose and link to Strategy	<ul style="list-style-type: none"> Based on a balanced scorecard approach, the annual bonus aims to incentivise executives to achieve, on an annual basis, the key financial and non-financial metrics of the business and delivery of a set of individual objectives linked to the Group's overall strategy.
How it works	<ul style="list-style-type: none"> The performance measures applied may be financial or non-financial and corporate, divisional or individual and in such proportions as the Committee considers appropriate. At the threshold level of performance no bonus is earned in respect of the financial and non financial targets. On target performance outcomes against these measures represent 50% of the maximum opportunity and this is calculated on a straight line basis between threshold and target. The Committee reserves the right to adjust these threshold and target levels for future financial years in light of competitive practice. Each metric is weighted to provide a percentage payout of the annual bonus as a whole. For each metric, threshold, target and maximum ranges are set. Performance for each metric against those ranges, and allocated according to the weightings assigned to each metric, results in a provisional annual bonus payout figure. Two-thirds of the annual bonus is paid in cash in the March following the financial year end to which the award relates. One-third of any annual bonus earned is compulsorily deferred, in the form of shares, for three years under the Deferred Share Award Plan (see below).
Opportunity/Cap	<ul style="list-style-type: none"> Maximum awards are capped at 165% of base salary.
Measures	<ul style="list-style-type: none"> The Committee has discretion to determine the appropriate measures and weightings applicable to the annual bonus, according to the measures and weightings it believes are most appropriate to incentivise the executives to achieve the short term goals of the business. The deferred element of the annual bonus, see DSAP below, provides a longer term alignment for executives.
Discretion	<ul style="list-style-type: none"> The Committee may adjust the provisional payout figure (subject to any over-riding cap) to take account of its broad assessment of performance both against pre-set targets and more generally, and of the wider shareholder experience. With respect to financial performance measures, this assessment will look at the quality of how particular outcomes were achieved. The annual bonus remains a discretionary arrangement and the Committee reserves the right to adjust the out-turn (from zero to any cap) should it consider that to be appropriate. In particular, the Committee will operate this discretion in respect of any risk concerns. The Committee has discretion to adjust the deferred proportion, in which case it will not be reduced below one-third. Malus and clawback will be assessed by reference to (1) performance of the individual, the business in which the individual works or the Company as a whole, (2) failures of risk management, and/or (3) circumstances adjudged by the Committee to have a significant reputational impact. Paid amounts may be clawed back for up to three years from the determination of the performance outcomes in respect of the award.

Variable elements: Deferred Share Award Plan ("DSAP")

Purpose and link to Strategy	<ul style="list-style-type: none"> To incentivise key executives over the longer term in a way which is aligned with delivery of the Group's strategy and the delivery of value to shareholders.
How it works	<ul style="list-style-type: none"> Of the annual bonus amount, two-thirds is paid in cash (see Annual bonus above), and one-third is paid in the form of shares, the release of which is deferred for three years under the DSAP. Shares are granted as conditional awards. While the shares are held in trust for the deferral period, they will attract dividend equivalents that will be paid out at the point of vesting, in either shares or cash, as determined by the Committee.
Opportunity/Cap	<ul style="list-style-type: none"> Release of the deferred shares is not subject to any performance conditions over the deferral period, however subject to certain specified 'good leaver' conditions contained in the DSAP rules, the executive must still be in the Group's employment at the point the shares vest. Good leaver conditions include situations such as redundancy, retirement with the Company's consent and/or due to ill health, injury or disability, or otherwise as determined by the Committee.
Measures	<ul style="list-style-type: none"> None.
Discretion	<ul style="list-style-type: none"> The deferral proportion may be increased but will not be reduced. The deferral period may be extended but will not be less than three years. Malus/clawback will be assessed by reference to (1) performance of the individual, the business in which the individual works and/or the Company as a whole, (2) failures of risk management, and (3) circumstances adjudged by the Committee to have a significant reputational impact. Vested amounts may be clawed back for up to three years from the point of release.

Remuneration policy continued

Variable elements: Performance Share Plan (“PSP”)

Purpose and link to Strategy	<ul style="list-style-type: none"> The introduction of the PSP is subject to receiving shareholder approval at the AGM on 8 May 2014. The aim of the PSP, which will succeed the FLG LTIP (see page 111) is to incentivise executives to increase the market value of the Company over the longer term, in accordance with our strategy of creating a successful and sustainable life insurance group that meets the needs of our customers and delivers value to our shareholders. By awarding shares to executives they, together with other shareholders, will benefit from delivering actions designed to promote the long-term success of the Company.
How it works	<ul style="list-style-type: none"> Conditional awards of shares or nil or nominal cost options over shares, at the discretion of the Committee, may be granted to executives. At the end of three years, and following determination of performance condition outcomes: <ul style="list-style-type: none"> - 50% of the calculated shares will vest following the third anniversary of the award date; and - 50% of the calculated shares will vest on the fourth anniversary of the award date. There is no opportunity to re-test the performance outcomes. Awards will attract dividend equivalents in respect of the period up to the point of vesting, in either shares or cash at the discretion of the Committee. Not more than 20% of maximum will vest for achieving threshold performance. Consistent with many such plans there is no formal ‘on-target’ level.
Opportunity/Cap	<ul style="list-style-type: none"> Individual awards are limited to shares worth 200% of base salary in any award year. The rules include a higher limit for grant of awards in “exceptional circumstances” of 300% of base salary. To manage problems arising from extended prohibited share dealing periods, the annual limit will be carried forward if no grant at all is made to an individual in a plan year due to Model Code constraints.
Measures	<ul style="list-style-type: none"> The Committee may set such performance conditions on PSP awards as it considers appropriate to incentivise and reward achievement of the Company’s stated strategy (whether financial or non-financial) from time to time. The Committee will consider the appropriate conditions for each award shortly prior to its grant (for information, the conditions planned to be used in 2014 and, subject to ongoing review by the Committee, thereafter are set out on page 121).
Discretion	<ul style="list-style-type: none"> Vesting periods may be increased but will not be decreased (eg, currently 50% vests after three years and 50% vests after four years). Malus/clawback will be assessed by reference to (1) performance of the individual, the business in which the individual works and/or the Company as a whole, (2) failures of risk management, and (3) circumstances adjudged by the Committee to have a significant reputational impact. Vested amounts can be clawed back for up to three years from the determination of performance in respect of the award. Consistent with market practice, the formal rules reserve discretion for the Committee to adjust or replace the performance conditions applying to subsisting awards in certain exceptional circumstances. The time period over which performance conditions are measured is at the discretion of the Committee, as long as it shall be not less than three years. The Committee similarly may lengthen any subsequent vesting period(s). The Committee may introduce a period of time for which vested shares must be retained.

- 1 The Company will honour all subsisting awards including those under the FLG LTIP summarised on page 111 and the Value Share summarised on page 115. No additional awards will be made under either arrangement.
- 2 The performance measures applicable to the Annual bonus and the PSP are considered appropriate as they provide a blend of relative and absolute measures.
- 3 While the Company does not consider it to form part of Benefits in the normal usage of that term, it has been advised that corporate hospitality and attendance at certain events by a director (whether executive or non-executive) and/or their family members (whether paid for by the Company or another) may technically come within the applicable definition for Benefits and so the Company expressly reserves the right for the Company to authorise attendance at such activities within its agreed policies from time to time.

Share Incentive Plan (“SIP”)

This is an HMRC approved SIP, under which the Company operates Partnership Shares and Dividend Shares. The SIP facilitates the long-term investment in the Company’s shares by UK based employees, in a tax efficient manner. Ownership of the Company’s shares by employees aligns their interests with those of shareholders and encourages them to take a long-term view of the business.

Partnership shares are purchased out of pre-tax salary. To achieve maximum benefits Partnership Shares need to be held in trust for five years.

Participants may purchase up to the statutory limit as may be imposed by HMRC from time to time (currently £1,500 worth) of Partnership shares in a tax year.

Dividends due on the Partnership Shares can be reinvested in further Company shares, which must be held in trust for three years. Alternatively dividends can be paid out in cash.

The Plan rules do allow the Company to operate Free and Matching shares in line with HMRC limits, should the Committee determine that it is appropriate to do so and the Company reserves the right to operate such elements within the statutory limits.

Save As You Earn (“Sharesave”)

This plan encourages employees to take an interest in the Company’s long-term success by offering them a chance to save money and then buy shares in the Company. This plan has received shareholder approval, however no invitations to participate in Sharesave have yet been issued.

Employees may be invited to save up to the statutory limit (currently £250 per month) from their salary. Savings contracts are for a three or five year period.

At the end of that savings contract, participants will be able to purchase the Company’s shares at an option price specified at the start of the savings contract. The option price can be up to 20% lower than the market price at or about the time invitations are issued.

At the end of the savings contract, if participants decide not to buy shares, their savings are returned to them.

The limits within the plan rules, are in line with HMRC limits as they may be from time to time, however the Company may set a lower cap.

Fees paid for external appointments

Executive directors can augment their skills, knowledge and experience by taking on appropriate external directorships. As a result, their contribution to the future long-term success of the Company may be enhanced.

The taking up of any external directorship, and the retention of any fees paid in that respect, is at the discretion of the RSL Nomination and Remuneration Committees. However, executive directors would generally be permitted to retain the fees they received in respect of an external directorship.

Shareholding guidelines

Shareholding guidelines were introduced to further strengthen the alignment between the interests of senior executives and those of shareholders, by incentivising senior executives to promote the long-term success and value of the Company.

Executive directors are required to acquire and maintain an interest in the Company’s shares over time. All shares that vest (after deductions for the settlement of tax liabilities) from participation in the Company’s share plans must be retained until the thresholds have been achieved, and subsequently maintained.

There is no formal penalty for non-compliance with the guidelines but the Committee monitors the position.

The GCE is required to hold shares to a value of 300% of base salary. The CFO is required to hold shares to a value of 250% of base salary.

These limits will be kept under periodic review by the Committee and, while the limits may be amended should the Committee consider it appropriate, they will not be reduced.

Non-executive directors’ fees

Fees are designed to help the Company to recruit, retain and incentivise high calibre non-executive directors.

These fees are designed to be competitive when assessed against companies of a similar size in terms of market capitalisation and complexity. They are reviewed annually, with any increases generally effective in January.

The fees are set having regard to the Board/Committee’s assessment of what is appropriate for non-executive directors of the right calibre and does not have a fixed approach to setting those fees against a set percentile relative to benchmark data although fees are benchmarked against comparator groups, primarily the FTSE 31-100 companies and other insurance companies.

In addition to their base fee, non-executive directors receive fees in connection with subsidiary boards and committees that they may chair or be members of (see page 114 for more information).

The members of the Nomination Committee waived their fee entitlement in respect of their membership of that Committee from 1 January 2014 onwards.

The Company Chairman’s fee is determined by the Committee.

The fees of non-executive directors are determined by the Company Chairman and the executive directors.

Non-executive directors are not currently entitled to receive any benefits over and above their fees. However the Committee reserves the right to offer benefits (eg, office costs) if it considers it appropriate to do so, provided that any such benefits are included within the cap for non-executive directors’ fees contained in the Articles of Incorporation.

This cap may be changed from time to time by shareholders’ resolution. At the date of this report, the annual limit is £2 million.

The Company reserves the right to vary the structure of fees within this limit including, for example, introducing time-based fees or reflecting the establishment of new committees.

Remuneration policy continued

Policy on recruitment remuneration

The Company strives to appoint high calibre individuals to senior executive positions, whether through internal promotion or external recruitment.

Under the Regulations, when determining a recruitment package the caps on fixed pay outlined in this Policy section do not strictly apply. However, the Committee would expect any recruitment packages to fit within the overall Policy, and envisages operating within the caps in practice.

The components of any recruitment package for an executive director would include those elements set out in the executive director's Remuneration Policy table on pages 102 to 104. (including the caps on variable pay) except for amounts to compensate for forfeited amounts from a previous employer (see below).

For internal promotions, any variable pay element awarded in respect of the prior role may either continue on its original terms or be adjusted to reflect the new appointment as appropriate. Any legacy awards or payments would be honoured.

All awards for external appointments will take account of the nature, time-horizons and performance requirements of any remuneration relinquished by the individual when leaving a previous employer, and will be appropriately discounted to ensure that the Company does not, in the opinion of the Committee, overpay.

The Committee is conscious that best practice as regards such "buy-outs" continues to evolve and will take advice on such developments in considering any arrangements. Its starting point will be to make sure that any awards that are bought out and still have outstanding performance and/or service requirements, are replaced with awards granted on similar terms unless the Committee thinks that, overall, it would be in the interests of shareholders to reflect those terms in some other way (eg through a significant discount to the face value of the awards being forfeited). When negotiating the recruitment of the current executive directors, to protect shareholders, it imposed an obligation to repay such amounts if the executive resigned within a longer period than that to which the forfeited awards were subject.

Executive directors' service agreements

The service contract for the executive directors of RSL provides for 12 months' notice by either party. It includes express permission for the employer to terminate without notice and compensation in defined misconduct situations and, in other cases, provides for compensation in respect of fixed remuneration elements only. The Committee endorses the principles of mitigation and does not provide for an enhancement in the event of a change of control.

Tim Tookey's service agreement contains details of his recruitment award, see page 108.

Service agreements for any future executive directors would be on the same basis as those for the current executive directors. However, it is to be expected that different recruitment arrangements may apply taking into account developments in best practice but also balancing the need to secure the appointment. In addition, to secure the appointment of a high calibre external candidate it may be necessary to provide an initial notice period greater than one year. If that was the case, the notice period would be reduced on a sliding scale to one year as soon as possible.

A summary of the executive directors' service agreements is below:

Executive director	Title	Date of contract	RSL notice period	Director notice period
Andy Briggs	GCE	27 Sep 2011	12 months	12 months
Tim Tookey	CFO	27 April 2012	12 months	12 months

The executive directors' service agreements and non-executive directors' letters of appointment can be inspected at the Company's London office, One New Change, London EC4M 9EF.

At a glance

Notice Periods:

Executive directors – 12 months

Non-executive directors – 1 month

Non-executive directors' letters of appointment

All non-executive directors (including the Chairman) have a letter of appointment setting out the terms of their appointment, which is for an initial period of three years, subject to election and then annual re-election by shareholders. Non-executive directors may generally serve up to an additional two three-year terms, again subject to annual re-election.

Letters of appointment contain a one month notice period, from both the Company and the non-executive director.

All non-executive directors, with the exception of Mel Carvill, Tim Wade, Roger Perkin and Marian Glen were appointed with effect from 28 March 2013, and they were last elected by shareholders on 16 May 2013.

Mel Carvill and Tim Wade have been directors of the Company since 2010. Roger Perkin was appointed with effect from 16 May 2013 and Marian Glen was appointed with effect from 10 October 2013. Both Roger and Marian will seek election as directors for the first time at the Company's AGM to be held on 8 May 2014, and Mel and Tim will seek re-election.

Policy on payments for loss of office

In determining termination payments, the Company will have regard to the individual circumstances, pre-existing contractual entitlements including those governing incentive scheme awards and the principles of phased mitigation. The Company's policy is not to reward poor performance. Service agreements do not provide for any enhancement of terms in the event of a change of control.

In practice, the facts surrounding any termination do not always fit neatly into defined categories for good or bad leavers. Therefore, it is appropriate for the Committee to consider the suitable treatment on a termination having regard to all of the relevant facts and circumstances available at that time. Good leavers are typically those leaving through redundancy, serious ill health or death or otherwise at the discretion of the Committee. Bad leavers are typically those leaving through voluntary resignation or leaving for disciplinary reasons. Exceptional circumstances would include, eg, a change in control. This policy applies both to any negotiations linked to notice periods on a termination and any treatment which the Committee may choose to apply under the discretions available to it under the terms of the Annual bonus plan, DSAP, FLG LTIP and PSP. The potential treatments on termination under these plans are summarised below.

Incentives	Good leaver	Bad leaver	Exceptional events
Annual bonus plan	Pro-rated bonus to be paid soon after results for the year under review are agreed. Committee has discretion to pay early if appropriate	No awards made	Default is for bonus year to continue unaffected but the Committee may choose to agree early release of pro-rated bonus
DSAP	Deferred awards normally vest	Deferred awards normally lapse	Deferred awards vest
PSP	Will receive a time pro-rated award subject to the application of the performance conditions at the normal measurement date. Committee may pay out early if it considers it to be fair and reasonable to do so	All awards will normally lapse	Will receive a time pro-rated award subject to the application of the performance conditions at the date of the event. Committee has discretion to disapply pro-rating

In addition, and consistent with market practice, in the event of termination of an executive director's employment, the Company may pay a contribution towards the individual's legal fees and fees for outplacement services as part of a negotiated settlement. Any such fees would be disclosed as part of the detail of termination arrangements.

Under the Regulations, no formal cap is imposed on termination payments. The Committee will, however, seek to apply the contract terms and have regard to evolving best practice when considering the specific circumstances and will seek to avoid paying more than it considers to be fair and reasonable in all the circumstances.

In addition, the Company may pay additional sums in settlement of legal claims as considered necessary following the obtaining of appropriate legal advice.

Consideration of Friends Life employment conditions

The Board and Committee are cognisant of the importance of considering the remuneration levels of employees in the Group as a whole when setting remuneration for executive directors. While the Committee does not consult with employees or their representative bodies when setting directors' remuneration, the Committee does take into account the average pay increases awarded to Group employees and strives to ensure consistency of approach. The components of the executive directors' remuneration package are set out on pages 102 to 104.

Group employees benefit from a market-competitive salary which is reviewed annually; the opportunity (subject to at least three month's employment and not receiving a bonus under any other arrangements) to receive an annual bonus cash payment dependent upon both corporate and individual performance; and the ability to contribute towards a pension scheme (by way of example, the minimum employee contribution is 3% of pensionable pay at which level the Company contributes 6.3%; for employee contributions of between 6% and 10%, the Company contributes 13% and for each additional percentage point that the employee contributes, the Company contribution increases by 0.1 percentage point). Group employees, depending upon their grade, may also benefit from a season ticket loan and, for UK resident employees, the opportunity to select from a menu of flexible benefits should they so wish (eg, purchasing up to one week's additional holiday, private dental care, income protection, childcare vouchers, etc., via salary sacrifice).

Consistent with best practice, employees within the control functions participate in different bonus plans which exclude linkage to the financial results.

Substantially all UK employees may participate in the SIP arrangements and certain employees may receive other share based incentives.

Different arrangements apply within the overseas divisions, designed to reflect their local markets and brands but within the same general framework.

Engagement with shareholders on remuneration matters

The Committee actively consulted and considered feedback from major shareholders prior to finalising the remuneration proposals being presented to shareholders for approval at the 2014 AGM, to ensure that the proposals are aligned with the delivery of shareholder value.

In particular, shareholder views were sought on executive directors' remuneration packages following the changes to the Company's governance structure effective from 28 March 2013, and views were also sought on the development of the proposed new PSP.

Implementation report

The information contained in this Implementation Report (or annual report on remuneration as described in the Regulations) has, where indicated, been audited.

Executive directors

The following sections apply to executive directors only. Data relating to non-executive directors and past directors can be found on pages 113 to 115.

Single Figure Remuneration

The table below shows for each person who was an executive director of the Company during 2013, a breakdown of the remuneration they received in 2013 and 2012, together with their total remuneration for the relevant year. No executive directors resigned their directorship during 2013.

Audited		2013					
Executive directors £000s	Salary and Fees ⁽¹⁾	All Taxable Benefits ⁽²⁾ (gross)	Annual Bonus ⁽³⁾	Pension related benefits ⁽⁴⁾	FLG LTIP ⁽⁵⁾	Other	Total
Andy Briggs	656	37	803	131	–	–	1,627
Tim Tookey	650	19	725	130	–	–	1,524
		2012					
Executive directors £000s	Salary and Fees	All Taxable Benefits ⁽²⁾ (gross)	Annual Bonus ⁽³⁾	Pension related benefits ⁽⁴⁾	FLG LTIP ⁽⁵⁾	Other	Total
Andy Briggs	600	36	478	120	–	–	1,234
Tim Tookey	537	15	371	107	–	1,814 ⁽⁶⁾	2,844

1 Andy Briggs' salary for 2013 is calculated as three months' salary at £600,000 p.a. plus nine months' salary at £675,000 p.a.

2 "Taxable Benefits" includes: car allowance, chauffeur expenses (for Andy Briggs only), and medical insurance.

3 The Annual Bonus figure is the bonus earned in respect of that financial year. Two-thirds of this amount was paid in cash, and one-third paid under the DSAP in the form of shares the transfer of which is deferred for three years. Further details of the performance measures and weightings for the 2013 Annual Bonus Plan can be found on page 109. Further information on the DSAP can be found on page 110.

4 Andy Briggs and Tim Tookey each received a pension allowance of 20% of base salary (which is not taken into account for Annual bonus, PSP or insured benefits purposes).

5 This column is included for completeness only; the first potential payout under the FLG LTIP will be calculated as at 30 June 2014, with any payment made during September 2014.

6 As reported in the 2011 Annual Report and Accounts, upon joining Friends Life in March 2012, Tim Tookey was compensated for the loss of awards from his previous employer which he forfeited as a result of joining Friends Life. Mr Tookey received £411,213 in cash and a total of 568,501 Resolution shares were to be released in three tranches, in 2012, 2013 and 2014. In accordance with the Regulations the total value of the award is shown above in 2012. At the date of this report the third and final tranche of 331,348 shares is still to be released to Mr Tookey. These awards are subject to clawback if he voluntarily resigns or is subject to summary dismissal before March 2015, the third anniversary of his appointment. The first tranche of 141,116 shares was valued at £2,6320 per share being the closing price on 28 March 2012. The second tranche of 96,037 shares was valued at £2,7250 per share being the closing price on 28 March 2013. The final tranche of 331,348 shares was valued at £2,3230, being the average closing mid-market price of Resolution shares for the period 1 October to 31 December 2012, the year of grant, this valuation method being used as the shares have not yet been transferred to Mr Tookey.

Andy Briggs received comparable awards upon joining the Group in 2011, and these awards are fully disclosed on page 116.

Each of Andy Briggs and Tim Tookey have confirmed to the Company that they have not received any further remuneration type payments or benefits other than those detailed above.

The total emoluments of all executive directors under the definition for 2013 is £3.2 million (2012: £2.8 million). This figure includes emoluments paid in respect of both Resolution Limited and FLG.

Pensions

Neither Andy Briggs nor Tim Tookey are members of the Company's pension scheme. Instead they each receive a supplement equivalent to 20% of base salary in lieu of pension (as shown in the table on page 101). They are not entitled to any pension benefits if they take early retirement.

Variable Pay

Annual Bonus 2013

At a glance

Annual bonus plan 2013:

Group Chief Executive

Amount paid out in respect of 2013 = £803,261
Amount paid was 73% of maximum opportunity

Chief Financial Officer

Amount paid out in respect of 2013 = £725,004
Amount paid was 74% of maximum opportunity

An explanation of how the annual bonus works can be found on page 103.

The performance criteria for the 2013 Annual bonus were based on a balanced scorecard approach. This is set out in the tables below, together with the percentage payout achieved under each metric:

Audited									
Andy Briggs		Target ranges for Metrics				Opportunity	Opportunity	Actual achieved	Actual achieved
Metrics	Weightings	Threshold	Target	Maximum	Achieved	%	£	%	£
Financial									
Cash	20.00%	£273.6m	£288.0m	£316.8m	£330.8m	33.45%	£219,620	33.45%	£219,620
IRR	15.00%	12.50%	13.50%	15.50%	15.30%	25.09%	£164,723	23.69%	£155,550
MCEV	15.00%	£447.1m	£483.3m	£555.8m	£489.3m	25.09%	£164,723	13.58%	£89,186
Expense	10.00%	n/a	£539.9m	£512.9m	£538.4m	16.72%	£109,811	8.83%	£57,971
Non Financials									
Customer	8.00%					13.38%	£87,848	5.57%	£36,592
Colleague engagement	6.00%	56.00%	62.00%	74.00%	67.00%	10.03%	£65,887	7.11%	£46,691
Risk	6.00%					10.03%	£65,887	5.01%	£32,920
Individual	20.00%					33.45%	£219,620	25.09%	£164,731
Total	100.00%					167.24%	£1,098,119	122.33%	£803,261

Bonus opportunity for Andy Briggs was decreased when his salary was increased in April 2013.

The above table reflects the pro-rated position based on:

64/261ths Salary £600,00 and Bonus Opportunity 175%. On target bonus 87.5%.

197/261ths Salary £675,000 and Bonus Opportunity 165%. On target bonus 82.5%.

The table includes the actual targets and out-turn for the various financial (and colleague) elements. The non financial measures other than colleague engagement, were internal measures which are commercially sensitive and are likely to remain so.

Implementation report continued

Audited									
Tim Tookey		Target ranges for metrics				Opportunity	Opportunity	Actual achieved	Actual achieved
Metrics	Weightings	Threshold	Target	Maximum	Achieved	%	£	%	£
Financial									
Cash	20.00%	£273.6m	£288.0m	£316.8m	£330.8m	30.00%	£195,000	30.00%	£195,000
IRR	15.00%	12.50%	13.50%	15.50%	15.30%	22.50%	£146,250	21.25%	£138,125
MCEV	15.00%	£4471m	£483.3m	£555.8m	£489.3m	22.50%	£146,250	12.18%	£79,170
Expense	10.00%	n/a	£539.9m	£512.9m	£538.4m	15.00%	£97,500	7.92%	£51,461
Non Financials									
Customer	4.00%					6.00%	£39,000	2.50%	£16,250
Colleague engagement	8.00%	49.00%	55.00%	67.00%	62.00%	12.00%	£78,000	9.50%	£61,750
Risk	8.00%					12.00%	£78,000	5.69%	£36,998
Individual	20.00%					30.00%	£195,000	22.50%	£146,250
Totals	100.00%					150.00%	£975,000	111.54%	£725,004

The table includes the actual targets and out-turn for the various financial (and colleague) elements. The non financial measures other than colleague engagement, were internal measures which are commercially sensitive and are likely to remain so.

While the Committee applied judgement under the Annual bonus rules in 2012 to reduce the awards, given the strong performance achieved throughout 2013, the Committee determined that the indicative out-turn suggested by the balanced scorecard should apply without further moderation.

Based on the above, Andy Briggs received an Annual bonus of £803,261 and Tim Tookey received an Annual bonus of £725,004 in respect of the 2013 financial year. Two-thirds of these bonus amounts will be paid in cash. One-third will be converted into RSL shares under the DSAP (see further details on page 111).

At a glance

Annual bonus plan opportunity:

Vesting at target and maximum levels:

GCE's opportunity

Target = from 1 January to 31 March 2013, 87.5% of base salary
and from 1 April to 31 December 2013, 82.5% of base salary
Maximum = from 1 January to 31 March 2013, 175% of base salary
and from 1 April to 31 December 2013, 165% of base salary

CFO's opportunity

Target = 75% of base salary
Maximum = 150% of base salary

Two-thirds payout in cash;
One-third paid out in shares deferred for 3 years
Divided equivalents earned on deferred shares

Share Schemes

Deferred Share Award Plan ("DSAP")

An explanation of how the DSAP works can be found on page 103.

Following Shareholders' approval of the new DSAP rules at the May 2013 Annual General Meeting, in respect of DSAP awards granted in 2013 and future years:

- awards are subject to malus and clawback provisions for a period of up to three years from the point of release; and
- participants will accrue dividend equivalents on their deferred shares, which will be paid to the participant at the point of vesting, and which are expected to be paid in shares, although the Committee may decide to pay them in cash.

The table below sets out DSAP awards made to the executive directors. The deferred shares are not subject to any further performance conditions.

Interests in Deferred Share Award Plan

Audited										
Director	Financial year to which award relates	Date of award ⁽¹⁾	Share price used to determine award ⁽²⁾	Value of Award at Grant	Opening balance 1 January 2013	Shares awarded during the year	Vested during 2013	Lapsed during 2013	Closing balance 31 December 2013	Vesting date
Andy Briggs	2011	03-Apr-12	£2.6384	£117,747	44,628	–	–	–	44,628	31-Dec-14
	2012	24-May-13	£2.9596	£159,338	–	53,837	–	–	53,837	04-Apr-16
	Total				44,628	53,837	–	–	98,465	
Tim Tookey	2011	n/a	n/a	n/a	–	–	–	–	–	n/a
	2012	24-May-13	£2.9596	£123,521	–	41,735	–	–	41,735	04-Apr-16
	Total				–	41,735	–	–	41,735	

1. The Deferred Share Award Plan is the arrangement pursuant to which one-third of the Annual bonus for any year is deferred into shares of the Company and subject to Committee discretion made contingent on continuing employment for three years.
2. Being the average share price over the five business days preceding the date of the award.

FLG Long Term Incentive Plan ("FLG LTIP")

No awards were made during 2013 to executive directors under the FLG LTIP, and no further awards will be made under the plan.

The FLG LTIP created a profit pool which was divided into a maximum of 10,000 units, of which approximately 75% has been issued to participants.

The FLG LTIP was initially designed to reward a successful exit of FLG from the original private equity type structure. The FLG LTIP was amended in May 2013 following a shareholder resolution as the Group's strategy no longer targeted a specific exit event. Instead, the focus was to ensure that the Company is a successful and sustainable life insurance group with a clear and strong cash profile focused on maximising shareholder value. Accordingly, a market value based calculation was introduced to enable measurement of performance in the absence of an exit event.

The total value of the pool available for distribution to participants was capped at 2% of the increase in realised value since the Company's first acquisition in November 2009. In the end, the Company only awarded 75% of the available pool, so the total value is limited to 1.5% of the increase in realised value (the Company will also bear employers' NICs in addition to the 1.5%).

One-third of participants' units (before the application of time pro-rating) will be measured against the internal rate of return performance threshold on each of 30 June 2014, 2015 and 2016. Time pro-rating reflects an individual's period of employment since November 2009. For certain individuals, the impact of pro-rating is reduced to ensure that the level of vesting will not be below 50%.

The average closing share prices of the Company over the 40 dealing days following 30 June will be used to determine the value realised from FLG, with an adjustment for any net assets of the Company which do not form part of FLG (such as cash held by the Company itself). Accordingly, the relevant units will vest if the aggregate of actual distributions from FLG to the Company plus the deemed value exceeds the aggregate amount of the contributions made to FLG plus the 12% cumulative return. While the outcome is measured in cash, it will be paid out in shares in the Company.

If there is a change of control of the Company prior to 30 June 2016, the offer price will be used to determine the value realised from FLG and any unvested tranches of the units awarded to each individual will be subject to measurement and pro-rating on the date of the change of control, with payment deferred to September 2015 or September 2016 depending upon when the change of control occurs.

Under the rules of the FLG LTIP, there is no formal cap on the number of shares that may be earned under the FLG LTIP.

As this is not a conventional share plan and, instead, rewards the growth in value of the Company but only if the threshold is achieved, potential payouts are more geared than under a conventional "PLC" style LTIP (such as the proposed new PSP). Instead, the plan has a greater prospect of no payout but the potential to earn more significant amounts if the threshold is achieved. The threshold is a dynamic formula impacted by share price, a required return on capital and distributions from FLG. Had all three tranches of the plan matured on 31 December 2013, no payments would have been due as the then threshold share price of £3.58 would not have been met. If the £3.58 threshold had been achieved but adjusted to assume pro-rating to the anticipated vesting dates, the GCE and CFO would have received £4,595,362 and £2,969,832 respectively in aggregate in respect of all three tranches.

There is no opportunity to re-test performance outcomes.

Malus and clawback provisions do not apply to this plan.

Implementation report continued

Executive directors' interests in FLG LTIP:

Audited					
Director	Total units at 1 January 2013	Units awarded during the year	Units lapsed or released during the year	Total units at 31 December 2013	Following impact of time pro-rating
Andy Briggs	1,500	0	0	1,500	1,075
Tim Tookey	1,200	0	0	1,200	695

Share Incentive Plan ("SIP")

An explanation of how the SIP works can be found on page 104.

The table below sets out executive directors' participation in the SIP during 2013:

Audited	
Director	SIP Participation during 2013
Andy Briggs	£125 per month
Tim Tookey	n/a

For information on executive directors' interests in SIP shares, please see page 114.

Save As You Earn ("Sharesave")

At its Annual General Meeting in May 2013, the Company received shareholder approval to operate an HMRC approved Sharesave scheme for all UK tax resident employees, including executive directors. The Company also received shareholder approval to offer similar arrangements to employees based overseas, in accordance with local laws and regulations.

No invitations to participate in the Sharesave have yet been issued.

Dilution and Headroom

The rules of each of the Company's share schemes limit the number of new shares that can be issued to satisfy share awards. Those limits are in line with the Association of British Insurers' Principles of Remuneration guidelines published in November 2013.

Currently the Company satisfies all share scheme awards using shares that have been purchased in the market. No new shares were issued during 2013 to satisfy share scheme obligations, and currently there are no plans to change the Company's approach during 2014.

Non-executive directors

Single Figure Remuneration

The table below shows for each person who was a non-executive director of the Company during 2013, a breakdown of the remuneration they received in 2013 and 2012, together with their total remuneration for the relevant year.

Audited						
£000s	2013			2012		
	Fees	Other	Total	Fees	Other	Total
Non-executive directors						
David Allvey	165	–	165	120	–	120
Mel Carvill	106	–	106	103	–	103
Clive Cowdery	51	–	51	68	–	68
Peter Gibbs	111	–	111	95	–	95
Marian Glen ⁽¹⁾	22	–	22	–	–	–
Nick Lyons	136	–	136	115	–	115
Roger Perkin ⁽²⁾	58	–	58	–	–	–
Robin Phipps	139	–	139	130	–	130
Belinda Richards	99	–	99	75	–	75
Karl Sternberg	114	–	114	90	–	90
John Tiner	51	–	51	68	–	68
Tim Wade	129	–	129	118	–	118
Sir Malcolm Williamson	338	–	338	300	–	300
Total	1,519	–	1,519	1,282	–	1,282
Past directors						
Jacques Aigrain ⁽³⁾	23	46	69	93	–	93
Gerardo Arostegui ⁽³⁾	23	46	69	93	–	93
Michael Biggs ⁽⁴⁾	165	–	165	360	–	360
Fergus Dunlop ⁽³⁾	23	46	69	93	–	93
Phil Hodgkinson ⁽⁵⁾	58	–	58	128	–	128
Denise Mileham ⁽³⁾	26	51	77	103	–	103
Peter Niven ⁽³⁾	23	46	69	93	–	93
Gerhard Roggemann ⁽³⁾	39	54	93	98	–	98
Total	380	289	669	1,061	–	1,061

1 Marian Glen was appointed as a director of the Company on 10 October 2013.

2 Roger Perkin was appointed as a director of the Company on 16 May 2013.

3 Non-executive directors who retired from the Company's Board on 28 March 2013 were paid fees in lieu of their contractual entitlement to six month's notice.

4 Mike Biggs did not receive any fees in lieu of notice when he stepped down from the Board at the conclusion of the Company's AGM on 16 May 2013.

5 Phil Hodgkinson stood down as a director at the AGM on 16 May 2013.

Implementation report continued

Non-executive directors

Current fees

The Chairman received a fee of £360,000 and did not receive any other fees for membership of committees. The other non-executive directors received a base fee of £67,500. The following annual amounts were paid to reflect additional responsibilities:

Senior independent director	£25,000	
	Chairman	Member/ director
Audit Committee	£40,000	£25,000
Investment Oversight Committee	£30,000	£15,000
Nomination Committee	£ nil	£ nil
Remuneration Committee	£30,000	£15,000
Risk and Compliance Committee	£40,000	£25,000
Friends Life Limited board	£30,000	£25,000
Friends Life Investments Limited board	£30,000	n/a
With Profits Committee	£35,000	n/a

At a glance

Nomination Committee:

Members have waived their Committee fees from 1 January 2014 onwards.

Payments to past directors

Following the RSL and Friends Life Group plc governance simplification changes in March 2013, each of Fergus Dunlop, Denise Mileham and Peter Niven were retained on a consultancy basis for an initial 12 month period, with the potential for that to be extended for further periods of 12 months. Termination of this appointment is upon either side giving the other 30 day's notice. The consultancy fee is £5,000 per annum. The consultancy services to be provided include membership of the Company's Guernsey Community Committee, acting as an ambassador for the Company and representing it at events and in respect of charitable commitments.

Payments for loss of office

When the Company's governance structure was simplified in March 2013, a number of directors of RSL prior to the governance changes were not retained as directors of RSL. They each received six month's fee in lieu of notice in accordance with their letters of appointment. These payments are disclosed in the table on page 113.

Statements of directors' shareholdings and share guidelines

Share ownership guidelines

Share ownership guidelines are in place for executive directors, aimed at strengthening the alignment of directors' interests with those of the Company's shareholders as a whole.

Interests in Shares

The tables below shows the interests the executive directors have in Resolution Limited shares as at 31 December 2013. Some of the shares are held directly, some are held in Trust, and some shares have been awarded to the executive but are not yet due to be transferred to him.

Executive directors' interests in shares as at 31 December 2013

Audited	Shares held beneficially	SIP shares held in Trust	Total shares held	Shareholding requirement as percent of salary	Shareholding as a percent of salary
Andy Briggs	353,009	582	353,591	300%	197%
Tim Tookey	143,832	–	143,832	250%	83%

The table below shows the interests held in unvested and unreleased shares as at 31 December 2013. These shares are not included in the calculations to assess compliance with shareholding guidelines as the shares have not been released to the executives and require conditions (whether performance or continued employment) to be met before they are released:

Audited	Contractual share award – vests March 2014 ¹	Deferred share award plan – vests December 2014 ²	Deferred share award plan – vests April 2016 ²
Andy Briggs	–	44,628	53,837
Tim Tookey	331,348	–	41,735

1. For further information on Tim Tookey's contractual share award, see page 108.
2. For further information on the DSAP share awards, see page 110.

The above table excludes the FLG LTIP as it is not a conventional share plan (see page 111). However, if the plan does vest in June 2014, 2015 and for 2016 any shares released would count towards the executive directors' compliance with the shareholding guidelines.

The table below shows the interests the non-executive directors have in Resolution Limited shares:

Audited	Interest in Shares at 1 January 2013 or date of joining if later	Interest in Shares at 31 December 2013 or date of leaving if earlier
Non-executive directors		
David Allvey	–	–
Mel Carvill	62,400	62,400
Clive Cowdery ^{(1) (6)}	8,487,184	8,487,184
Peter Gibbs	–	–
Marian Glen ⁽²⁾	–	–
Nick Lyons	–	30,000
Roger Perkin ⁽³⁾	–	–
Robin Phipps	2,100	2,100
Karl Sternberg	–	–
John Tiner ⁽⁷⁾	2,829	2,829
Tim Wade	40,000	40,000
Sir Malcolm Williamson	55,975	55,975
Past non-executive directors		
Jacques Aigrain ⁽⁴⁾	84,880	84,880
Gerardo Arostegui ⁽⁴⁾	90,000	90,000
Michael Biggs ⁽⁵⁾	113,513	113,513
Fergus Dunlop ⁽⁴⁾	–	–
Phil Hodgkinson ⁽⁵⁾	–	–
Denise Mileham ⁽⁴⁾	18,595	18,595
Peter Niven ⁽⁴⁾	–	–
Gerhard Roggemann ⁽⁴⁾	18,000	18,000

1. Clive Cowdery's shareholding represents 0.6% of the Company's issued share capital as at 17 March 2014. No other non-executive director holds more than 0.01% of the Company's issued share capital at that date.
2. Marian Glen was appointed as a Director of the Company on 10 October 2013.
3. Roger Perkin was appointed as a Director of the Company on 16 May 2013.
4. These Directors resigned as directors of the Company on 28 March 2013.
5. Messrs Biggs and Hodgkinson resigned as Directors of the Company on 16 May 2013.
6. While not an interest in shares, Clive Cowdery holds an economic right to a 60% share of 10% of the value of future distributions from Resolution Holdco No. 1 LLP to Resolution Limited. This arrangement is commonly referred to as the Value Share, and is explained further on page 74.
7. While not an interest in shares, John Tiner holds an economic right to a 4% share of 10% of the value of future distributions from Resolution Holdco No. 1 LLP to Resolution Limited. This arrangement is commonly referred to as the Value Share, and is explained further on page 74.

Implementation report continued

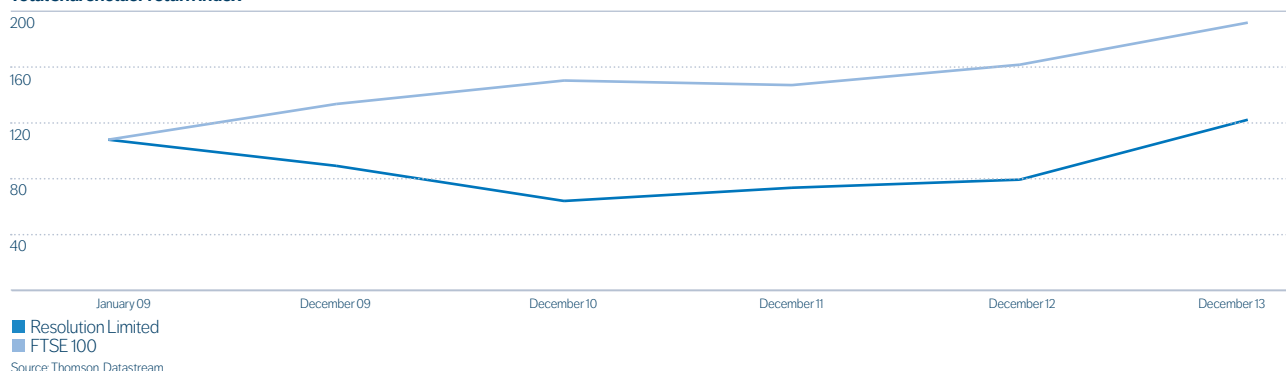
Executive directors' external appointments

Neither Andy Briggs (GCE) nor Tim Tookey (CFO) undertook any paid external directorships or committee memberships during 2013.

Performance graph

Throughout 2013 the Company was a member of the FTSE 100. As such, the Directors consider that to be the most suitable comparator group against which to compare the Company's Total Shareholder Return ("TSR"). For the Company, the graph below shows the TSR for a hypothetical holding of £100 worth of shares from 1 January 2009 to 31 December 2013. For that holding it is assumed that all cash dividends are used at the relevant ex-dividend date to buy additional shares in the Company at market price, which are added to the total holding.

Total shareholder return index



The Regulations require the Company to show a five year history of payments to the Company's Chief Executive. Given the changes in corporate structure of the Company over the last five years, and the primary purpose of Resolution Limited before the governance changes on 28 March 2013, it is considered most appropriate to report the total remuneration for the GCE of Friends Life Group plc or Friends Provident Group plc as it was previously.

		2009	2010	2011	2012	2013
GCE Single Figure Remuneration £000s	Andy Briggs	–	–	2,860	1,234	1,627
	Trevor Matthews	1,313	1,505	859	–	–
Annual bonus actual against maximum	Andy Briggs	–	–	57.3%	45.5%	73.1%
	Trevor Matthews	50.8%	71.2%	0%	–	–
LTIP vesting actual against maximum	Andy Briggs	n/a	n/a	n/a	n/a	n/a
	Trevor Matthews	n/a	n/a	n/a	n/a	n/a

Notes

1. Andy Briggs was appointed GCE of FLG on 1 June 2011 on an annual base salary of £600,000 per annum. On appointment Andy Briggs received an award of £249,000 payable in cash and 236,920 Resolution Limited shares. He received a further £124,500 on each of the first and second anniversaries of his joining and a further 236,920 shares vesting on each of the two anniversaries. All of these sums were to compensate him for awards lost from his previous employer as a result of his joining FLG. The Remuneration Committee at the time was satisfied that these payments were appropriate and not excessive and had protected the Company's position by providing for full clawback if Andy Briggs resigned or was summarily dismissed before the third anniversary of his joining. These amounts are included in the 2011 figure above.
2. Trevor Matthews was CEO of FLG from 30 July 2008 until 2 June 2011. The 2011 figure excluded £441,475 as the fixed remuneration for his six month notice period. In addition he received £49,655 as a payment in lieu of holidays and FLG settled £38,405 in legal fees incurred for his exit arrangements.

Percentage change in remuneration of GCE and others

The Committee, and indeed the Board as a whole, is committed to balancing the need for the Company to attract, retain and incentivise high calibre executives with the interests of other stakeholders in ensuring that remuneration packages are not excessive.

The charts below show the percentage changes from 2012 remuneration to 2013 remuneration for Andy Briggs, the GCE, and also for Group UK based employees as a whole. The data is shown separately for base salary, taxable benefits and annual bonus.

	GCE % Change	Average UK Employees % Change
Base salary	9%	2%
Annual bonus*	68%	8%
Benefits	0%	-2%
Total	34%	2%

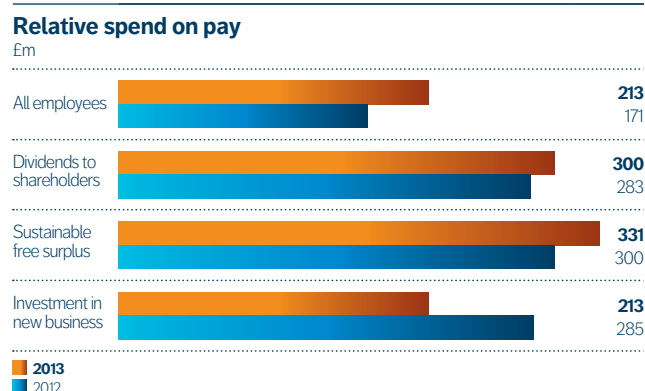
*including both the cash and deferred share elements

The numbers reported in the table above reflect the following:

1. Andy Briggs' salary was increased on 1 April 2013 from £600,000 per annum to £675,000 per annum. This increase was not a "cost of living" increase but reflected the change in his role and the added responsibilities he assumed when he became GCE of Resolution Limited, a FTSE 100 company rather than CEO of Friends Life Group plc, a subsidiary of Resolution Limited.
2. At the same time as Andy Briggs' salary increased, his maximum Annual bonus opportunity reduced from 175% to 165% of base salary.
3. This reduction reflects (i) a negotiated reduction in the cost of providing private medical insurance; and (ii) new employees being recruited on different contractual terms than former employees (eg. lower car allowances and less expensive private medical insurance).

Relative spend on pay

The graph below shows how sustainable free surplus has been allocated between staff, shareholders and investment in new business.



The 'dividends to shareholders' figure represents dividends and shares issued in lieu of dividends, as no share buy-backs were made during 2013 and 2012.

The Committee considers it appropriate to show how spend on employee remuneration and distributions to shareholders compare with Sustainable Free Surplus ("SFS") and Investment in New Business.

SFS is the surplus money generated within the business. It is an important measure as, in part, it demonstrates the Company's ability to meet future dividend payments to shareholders.

Investment in new business is the amount of free surplus that has been deployed to generate new business.

Implementation report continued

Remuneration Committee overview

Committee membership

The Committee comprised the following non-executive directors of the Company during the year:

	Pre- March 2013	Post-March 2013
Membership	Gerhard Roggemann Mike Biggs Jacques Aigrain Gerardo Arostegui Peter Niven	Nick Lyons Sir Malcolm Williamson* David Allvey Marian Glen
Number of meetings	Three	Seven
Reporting	The Committee meetings are scheduled to take place shortly before Board meetings. The Committee Chair formally reports to the Board after each meeting.	
Attendees by invitation	External remuneration consultant, GCE, Chief Risk Officer, Company Secretary, Human Resources and Business Services Director, Director of Performance and Reward,	

*Sir Malcolm was considered independent upon his appointment as Chairman of Resolution Limited.

Terms of reference

The Board has delegated authority to the Committee to provide governance and strategic oversight of remuneration matters within the Group, and to determine the actual remuneration of certain individuals. The Committee must act within the scope of the Policy for which the Company is seeking shareholder approval at its AGM on 8 May 2014. It is expected that the Policy, if approved, will be in place for three years. The Committee's terms of reference are reviewed annually and the Board is required to formally approve any changes made to the terms of reference. The principal responsibilities of the Committee are to:

- set, review and approve remuneration policy;
- determine the individual remuneration packages for the Company's Chairman, executive directors and other executives whose base salary exceeds £200,000 per annum or whose total target remuneration or the value of awards made on recruitment to secure the appointment of an individual exceed pre-set thresholds ("relevant individuals");
- design and determine targets for any performance measures applied to variable elements of the remuneration package operated by the Group, principally the Annual bonus scheme and the LTIP/PSP;
- measure actual performance against performance measures and determine any consequent award to relevant individuals;
- set the policy for and scope of pension arrangements for relevant individuals;
- set the policy for terms and conditions to be included in service agreements or letters of appointment for relevant individuals;
- determine termination payments and compensation commitments for relevant individuals;
- monitor and reflect, where appropriate, changing market practice and governance requirements; and
- prepare and recommend to the Board the Remuneration report of the Company.

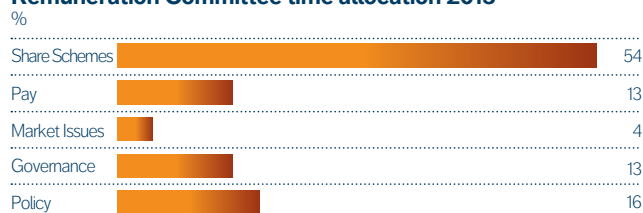
The Company is not formally subject to the PRA's Remuneration Code (the "PRA Code"), with the exception of one small subsidiary. The Committee acknowledges that the PRA Code is reflective of best practice and the Company sought to comply with its guidance for 2013 and will continue to do so in future.

The Committee will be kept abreast of developments in regulations and market practice generally and specifically any new regulations flowing from Solvency II.

Committee business during 2013

The chart below shows how the Committee allocated its time during meetings in 2013. There was a large amount of time spent on share schemes, as this covered not just the setting of performance metrics, and assessments of payouts against performance targets, but also changes to the rules of the DSAP and FLG LTIP and the introduction of a Sharesave scheme that were approved by shareholders in May 2013. In addition, the Committee has considered introducing a new Performance Share Plan, designed so that the first payout would be after the final payout under the FLG LTIP, and appropriate arrangements for other employees. Shareholder approval for the PSP will be sought at the AGM in May 2014.

Remuneration Committee time allocation 2013



Shareholder engagement

During 2013 the Company consulted with key shareholders and their representative bodies on a number of remuneration-related matters, namely:

1. salaries for the GCE and CFO following the governance restructuring in March 2013;
2. a reduction in the maximum potential entitlement under the Annual bonus plan payable to the GCE applicable following the governance restructuring in March 2013;
3. changes to the structure of the FLG LTIP to reflect the change in the Group's strategy, as outlined above;
4. the introduction of Shareholding Guidelines applicable to the executive directors and members of the Group Executive Committee;
5. the introduction of malus and clawback provisions into the Annual bonus plan and Deferred Share Award Plan; and
6. the introduction of the new Performance Share Plan, subject to shareholder approval.

Feedback received from those consultations, was carefully considered by the Committee and a number of adjustments to its initial proposals were made following constructive engagement from our largest shareholders. The final proposals received the support of 89.5% of the shareholders at the AGM in 2013, votes against 10.5% and abstentions 0.2%. The Committee believes this represents broad support for the remuneration principles particularly as it transitioned from the previous governance structure although the Committee aspires to achieving higher levels of support in future years under the new, more conventional, governance arrangements.

Advisors to the Committee

During 2013 the Committee received advice from the following:

Employees

Human Resources and Business Services Director
Group Chief Executive
Director of Performance and Reward
Company Secretary
Chief Risk Officer

External, independent professional advisors

FIT Remuneration Consultants Limited – provision of general advice to the Committee

Deloitte LLP – provision of advice relating to Lombard LTIP matters

Clifford Chance LLP – providing advice on share plan rules

During 2013, the Committee undertook a re-tendering exercise of its advisers. Following that review, FIT Remuneration Consultants LLP was re-appointed as the Committee was satisfied that it continued to provide good, independent and objective advice.

FIT's charges on its standard terms. Its fee for providing advice in 2013 was £185,300 (2012 £60,000 plus £109,000 for advice to the Friends Life Group plc's Remuneration Advisory Group. The RAG was disbanded upon the governance changes effective from 28 March 2013). FIT were initially appointed in August 2011. FIT did not provide any other advice or services to the Company. FIT is a member of the Remuneration Consultants Group (the professional association for executive remuneration consultants) and adheres to its code of conduct.

Deloitte LLP was appointed by the Committee to act as an Independent Valuer in accordance with the terms of the Lombard Long Term Incentive Plan. The fee for this work was £60,068 (2012 £60,411). Deloitte was selected for this work as they had performed the same role the prior year and as such had significant relevant knowledge of the scheme. Deloitte LLP also provided a number of other consultancy services for the Group in 2013, primarily relating to governance matters.

Having made appropriate enquiries, the Committee is satisfied that the advice received from Deloitte was objective and independent.

Implementation report continued

Statement of voting at the Annual General Meeting

The Company's last Annual General Meeting was held in London on 16 May 2013. All resolutions put to the meeting were duly passed on a poll. Given Phil Hodgkinson's decision to resign from the Board, the resolution proposing his re-election was withdrawn with the consent of the meeting.

The voting at that AGM insofar as it related to remuneration matters, was as follows:

Resolution	Number of votes for ⁽¹⁾	% of votes cast	Number of votes against	% of votes cast	Total number of votes cast	% of issued share capital	Votes withheld ⁽²⁾	% of issued share capital
Approval of Remuneration Report 2012	932,618,710	89.53	109,016,919	10.47	1,041,635,629	73.45	3,125,882	0.22%
Amendment of rules of the Friends Life Group plc Deferred Share Award Plan 2010	1,025,400,236	99.75	2,539,044	0.25	1,027,939,280	72.49	16,823,805	1.19%
Authority to establish future share plans outside the UK based on the above Deferred Share Award Plan	1,025,472,398	99.74	2,683,814	0.26	1,028,156,212	72.50	16,607,045	1.17%
Amendment of rules of the Friends Life Group plc Long Term Incentive Plan	911,614,212	89.74	104,197,865	10.26	1,015,812,077	71.63	28,950,893	2.04%
Approval of the Resolution Limited Sharesave Plan 2013	1,041,284,495	99.68	3,302,744	0.32	1,044,587,239	73.66	175,998	0.01%
Authority to establish future share plans outside the UK based on the Resolution Limited Sharesave Plan	1,043,639,742	99.91	926,418	0.09	1,044,566,160	73.66	193,349	0.01%

1. The "For" vote includes discretionary votes received.

2. A vote "Withheld" is not a vote in law and is not counted towards the proportion of votes "For" or "Against" a resolution.

Looking ahead to 2014

Base salary

The executive directors' base salaries with effect from 1 April 2014 will be:

Andy Briggs, GCE £691,875p.a.

Tim Tookey, CFO £650,000p.a.

Non-executive directors' fees were reviewed at the end of 2013. It was agreed that no increases would be made to Non-executive director fees for 2014. The members of the Nomination Committee have waived their entitlement to those fees from 1 January 2014 onwards.

Annual bonus 2014 measures and weightings

The performance criteria for the executive directors' 2014 annual bonus will be based on a balanced scorecard approach, as set out in the table below:

Type	Measure	2014 Weighting
Financial	Cash (sustainable free surplus)	20%
	IRR	15%
	MCEV operating profit before tax	15%
	Expense management	10%
Customer	Customer index	10%
Colleague	Colleague engagement	10%
Individual	Individual Key Performance Indicators	20%

In addition, scorecard outcomes will be subject to a Risk Gateway and the Committee, upon recommendation by the Chief Risk Officer, may apply discretion to decrease bonuses in circumstances where appropriate having regard to performance against agreed risk parameters.

PSP 2014 measures and weightings

The PSP 2014 measures and weightings are shown below. The maximum award that may be granted to Andy Briggs will be based on 200% of base salary and for Tim Tookey will be based on 175% of base salary.

Performance Condition	TSR	EV	FSG
% of Total Award Shares subject to this Performance Condition	50% of Award Shares	25% of Award Shares	25% of Award Shares
Full vesting performance level (100% vesting of this part)	Upper quintile	Maximum target	Maximum target
Between full vesting performance and threshold vesting performance	Vesting on a straight-line basis by interpolation between rankings	Vesting on a straight-line basis	Vesting on a straight-line basis
Threshold vesting performance level (20% vesting of this part)	Median	Threshold target	Threshold target

For each metric, there will be nil vesting of the relevant part of the award for performance beneath the threshold vesting level shown above.

Each performance condition applies separately to the portion of the award to which it relates.

The core parameters of each performance condition are as set out below.

TSR – the TSR Performance Condition will compare the Company's TSR performance relative to that of a comparator group being the constituents of the FTSE 350 Index (excluding Investment Trusts and excluding the Company itself) at the commencement of the performance period. The performance period for the TSR Performance Condition will be a period of three years beginning with the date of grant. For the purposes of measuring the TSR Performance Condition, the Company's TSR and that of the comparator group constituents will be averaged over a period of one month prior to the beginning and the end of the performance period. For performance between median and upper quintile levels, vesting will be by straight-line interpolation by ranking.

EV – the EV Performance Condition will measure the Company's reported MCEV for the final year of the performance period using the figure directly taken from the published accounts as adjusted for any subsequent change in methodology. Any dividends paid will be added back and the impact of any share buybacks adjusted for (but without crediting any return on such expenditure).

FSG – the FSG Performance Condition will measure the Company's aggregate Total Group Free Surplus generated over the performance period with the figure again directly taken from the published accounts and using the current definition with discretion to adjust for any changes in approach; this measure is before dividends and buybacks.

In addition, awards will be subject to an underpin that the Committee is satisfied that the relevant performance condition is reflective of the underlying financial performance of the Company.

SIP

The Company will adopt the increased purchase limits introduced by HMRC of £1,800 p.a., up from £1,500 p.a., effective 6 April 2014.

On behalf of the Board



Nick Lyons
Chairman of the Remuneration Committee

17 March 2014

Directors' report

The directors present their report together with the financial statements of the Company and its subsidiaries for the year ended 31 December 2013. Although the Company is Guernsey incorporated and is therefore subject primarily to the Companies (Guernsey) Law 2008 (as amended), the Articles of Incorporation import the Companies Act 2006 (the "Act") and the Company aims to comply where possible with UK legislation. The Company has a branch in the UK.

Results and dividends

The consolidated income statement shows a profit for the year ended 31 December 2013 of £235 million. Further information can be found in the Financial Statements from page 126 and in the Strategic report from page 4.

An interim dividend of 7.05p per share was paid on 4 October 2013. The directors propose a final dividend for the year ended 31 December 2013 of 14.09p per share. Subject to shareholder approval at the AGM, the final dividend will be paid on 16 May 2014 to shareholders whose names are on the Register of Members at the close of business on 4 April 2014.

The Company also operates a Dividend Reinvestment Plan ("DRIP") which allows shareholders to purchase further shares in the Company with their dividend. Further information on how to elect for this can be found on page 280.

The Employee Benefit Trust waived its rights to any dividend during 2013.

Future developments

The Strategic report covers information relating to the Company's strategy, the future of the markets that the Company operates in, along with economic, social, political and regulatory developments and how they will affect the future of the Company.

Major shareholdings

Information provided to the Company under the Disclosure and Transparency Rules of the UK Listing Authority (DTR 5) is published via a Regulatory Information Service and on the Company's website.

As at 17 March 2014, the Company had been notified of the following substantial interests in the issued ordinary shares of the Company:

Company subject to notification obligation	Date of RNS announcement	Voting rights held	% of voting rights announced
Schroders	10-May-13	132,570,375	9.35%
BlackRock Inc	24-Dec-13	75,737,333	5.34%
Invesco Limited	04-Mar-14	71,035,903	5.00%

The percentages reflect the proportion of share capital at the time of notification.

Share capital

The issued share capital of the Company totalled 1,418,109,028 as at 31 December 2013. Each share entitles the holder to one vote at general meetings of the Company.

Without prejudice to any rights attached to existing shares, any shares may be issued with such rights or restrictions as the Company may by ordinary resolution determine, remaining mindful of the obligations placed on UK companies by the Companies Act 2006. Further details can be found in the Company's Articles of Incorporation which can be found at www.resolution.gg. Unless in the circumstances specified in the Articles of Incorporation, the Articles can only be amended by way of special resolution of the Company's shareholders in general meeting.

All shareholders entitled to attend, speak and vote at general meetings of the Company may also appoint a proxy or proxies to attend and vote on their behalf. A member may appoint more than one proxy provided that each proxy is appointed to exercise the rights attached to a different share or shares by the shareholder. On a poll, every member present in person or proxy and entitled to vote shall have one vote for every ordinary share held.

There are no restrictions on the transfer of securities in the Company's Articles of Incorporation or prevailing legislation.

Authority to purchase own shares

At the Company's 2013 AGM, a special resolution was passed giving the Company authority to purchase up to 141,810,902 ordinary shares. These authorities were neither used during the year, nor up until the date of this Report. At the 2014 AGM, shareholders will once again be asked to renew this authority, allowing the Company to purchase no more than 10% of the issued shares. The details of this authority will be contained in the Notice of AGM.

Financial instruments

Details of the financial instruments used by the Group are set out in note 31 of the consolidated financial statements, which are incorporated into this Directors report by reference. More information on the Group's exposure to financial risks can be found on pages 67 to 69 in the Principal Risks & Uncertainties contained within the Strategic report.

Employees

The number of employees of the Group as at 31 December 2013 was 3,872 (2012: 3,861). The average number of employees during the year was 3,867.

The Group has amongst its employees a number who are disabled. It gives full and fair consideration to applications for employment from disabled persons. In the event of employees becoming disabled, every effort is made to ensure that their employment with the Group continues and to provide specialised training where this is appropriate.

Further information on diversity can be found in the Corporate Responsibility report on pages 60 to 63.

The Group continued its culture of informing and involving employees in matters which concern them through various channels including the use of regular meetings between management and employees, workshops on understanding the financial results of the Company, the products that it manufactures and the strategy of the Company, the employee intranet and a Learning Performance and Talent System ("LPTS").

The employee intranet also includes a number of pages outlining the Company's values:

Customer Understanding

Accountability

Respect

Enterprise

These pages set out how employees can contribute through their role to ensure that they are providing the best services that they can to the Company's customers, colleagues and shareholders.

Employee share schemes

The Company has in place a Share Incentive Plan ("SIP") which is open to all employees. The Company's Save As You Earn ("SAYE") schemes received shareholder approval at the 2013 AGM however no invitations to participate in the schemes have yet been issued. Further information can be found in the Directors' Remuneration report on pages 104 to 105.

Greenhouse gas emissions

Information on the Company's greenhouse gas emissions can be found in the Corporate Responsibility report on pages 60 to 63.

Political donations

The Company will seek shareholder approval at the 2014 AGM for authorisation to make political donations and/or incur political expenditure as defined in Sections 362 to 379 of the Companies Act 2006. It is not the policy of the Company or its subsidiaries to make political donations or incur political expenditure.

No political donations were made in 2013 by the Company or any of its subsidiaries.

Directors

The current directors are shown together with their biographical details on pages 76 to 78. Details of Board appointments and resignations that have occurred during the year are set out on page 81.

The business of the Company is managed by the Board who may exercise all of the powers of the Company, as set out in the Articles of Incorporation.

Although the Company is not required by its Articles of Incorporation to re-elect directors annually at the AGM, the Company's policy is for all directors to stand for re-election at the AGM to ensure compliance with the UK Corporate Governance Code.

The directors may from time to time appoint one or more directors. Any such director shall hold office until the next AGM and shall be eligible for reappointment. In accordance with the Corporate Governance Code, all directors will retire annually and, with the exception of Clive Cowdery and John Tiner who are not seeking re-election, will offer themselves for reappointment at the 2014 AGM.

Further provisions are set out in the Articles of Incorporation which govern the appointment and removal of directors. Details of continuing professional programmes of all directors can be found on page 87.

Qualifying third party indemnities

The Group maintains insurance cover for all approved persons including directors, officers and other senior employees against liabilities which may be incurred by them whilst performing their duties. The indemnities of the directors of the Company who served until 28 March 2013 while governed by Guernsey law, are consistent with the scope of the directors' indemnities that would be permitted under the Companies Act 2006. Following the governance changes on 28 March 2013, the indemnities of the directors are governed by English law.

Conflict of interests

Under section 175 of the Companies Act 2006, a director of a company must avoid a situation in which he has, or can have, a direct or indirect interest which conflicts with the interests of the Company. Under the Act, the Board of directors have the power to authorise potential conflict situations.

The Company has a policy in place to manage any potential conflicts of interest. Directors are required to inform the Board of any interests that they may have in a proposed transaction of the Company, in addition to any external directorships that they are undertaking.

Corporate Structure and Governance

A structure chart illustrating changes to the Company's corporate and partnership structure can be found on page 72. Notable changes to the governance structure include the termination of the agreement between the Company and ROL, and amendments effected by the Articles of Incorporation adopted by the Company on 16 May 2013.

Directors' report continued

Related party transactions

Transactions with Clive Cowdery, John Tiner or the entities with which they are associated are related party transactions under Listing Rule 11 by virtue of them being directors of the Company. Further details on this are set out in note 40.

Subsequent to 31 December 2013, the Company entered into a deed of Variation and Settlement with Resolution (Capital) Limited and ROL (entities controlled by Clive Cowdery) which released the Company from certain contractual obligations which arose from the business sale agreement entered into between the parties in December 2012. The value of transaction amounted to £875,000 and did not require shareholder or any other approval.

Going concern

The directors have undertaken a going concern assessment in accordance with "Going Concern and Liquidity Risk: Guidance for UK directors of UK Companies 2009", published by the Financial Reporting Council in October 2009.

As a result of this assessment, the directors have a reasonable expectation that the Group and the Company have adequate resources to continue to operate as a going concern for the foreseeable future and have prepared the financial statements on that basis. In assessing whether the going concern basis is appropriate, the directors have considered the information contained in the financial statements, the latest business plan, profit forecasts, the latest working capital forecasts and estimated forecast solvency of the regulated subsidiaries of the Group.

These forecasts have been subject to sensitivity tests and the directors have a reasonable expectation that the Group and the Company have adequate resources to continue in operational existence for the foreseeable future.

Key information in respect of the Group's risk management framework, objectives and processes for mitigating risks including liquidity risk are set out in detail in the risk management section of the Strategic report on pages 64 to 69.

Auditors

Each of the directors of the Company as at the date of approval of this report confirms that:

- so far as each director is aware, there is no relevant audit information (as defined in the Companies (Guernsey) Law, 2008 (as amended)) of which the Company's auditor is unaware; and
- each of the directors has taken all the steps that he/she ought to have taken as a director to make him/her aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of the Companies (Guernsey) Law, 2008 (as amended).

Resolutions to appoint Ernst & Young LLP as auditors of the Company and for the Board to determine their remuneration were passed at the 2013 AGM and will be proposed again at the 2014 AGM following Audit Committee recommendation. Further detail surrounding this recommendation is set out in the Audit Committee Report on pages 92 to 94.

Annual General Meeting

The Notice convening the 2014 AGM to be held on Thursday 8 May 2014 in the Mountbatten Room at The Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE, United Kingdom, has been distributed to shareholders and is also available on the website <http://www.resolution.gg>.

The directors consider that all resolutions to be proposed at the AGM are in the best interests of the Company and its shareholders as a whole and they recommend that all shareholders vote in favour of the resolutions.

By order of the Board



Victoria Hames
Company Secretary

17 March 2014

Directors' statement of responsibilities

The directors are responsible for preparing the Annual Report and the consolidated financial statements in accordance with applicable Guernsey law and International Financial Reporting Standards ("IFRS") adopted for use in the European Union.

The directors are required to prepare consolidated financial statements for each financial year that present fairly the financial position of the Group and the financial performance and cash flows of the Group for that period. In preparing those financial statements, the directors are required to:

- select suitable accounting policies and apply them consistently;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- state that the Group has complied with IFRS, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on a going concern basis unless it is inappropriate to presume that the Group will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy the financial position of the Group at any time and to enable them to ensure that the financial statements comply with the Companies (Guernsey) Law 2008 (as amended). They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Responsibility statement

Pursuant to Disclosure and Transparency Rule 4, each of the directors previously listed in this Report confirm that, to the best of their knowledge:

- The financial statements of the Company, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit/loss of the Company and the undertakings included in the consolidation taken as a whole; and
- The Strategic report includes a fair review of the development and performance of the business, and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

The Board considers that the annual report and accounts taken as a whole are fair, balanced and understandable and provide the information necessary for shareholders to accurately assess the financial position and strategy of the Company. Further information on the fair, balanced and understandable process can be found in the Governance Report on page 93.

On behalf of the Board



Sir Malcolm Williamson
Chairman



Andy Briggs
Group Chief Executive

17 March 2014

Registered Address:
Trafalgar Court, Les Banques, St Peter Port, GY1 3QL, Guernsey

Registered number: 49558



IFRS financial statements

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MCEV financial statements

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Additional information

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280 Shareholder information



Financial statements



Securing your tomorrow, today

Our success is driven by a focus on profitable business lines where our scale and expertise deliver high quality outcomes for customers and attractive returns for investors through applying rigorous financial discipline and delivering cash today and tomorrow.

Independent auditor's report to the members of Resolution Limited

We have audited the Group consolidated financial statements of Resolution Limited for the year ended 31 December 2013 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of financial position, the consolidated statement of changes in equity, the consolidated statement of cash flows and the related notes 1 to 40. 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 the provisions of our engagement letter dated 7 August 2013 and Section 262 of the Companies (Guernsey) Law, 2008. 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' statement of responsibilities set out on page 125, the directors are responsible for the preparation of the Group 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 Group 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.

Notwithstanding the Company's incorporation in Guernsey, the Company has also instructed us to:

- review the directors' statement on going concern which, for a listed UK-incorporated company, is specified for review by the Listing Rules of the Financial Conduct Authority; and
- audit the section of the Directors' remuneration report that has been described as audited and state whether it has been properly prepared in accordance with the basis of preparation described therein.

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

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Group's affairs as at 31 December 2013 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 (Guernsey) Law, 2008.

Our assessment of the risks of material misstatement

We identified the following risks that have had the greatest effect on the overall audit strategy, the allocation of resources in the audit, and directing the efforts of the engagement team:

- reasonableness of IFRS actuarial assumptions including persistency, expenses, longevity and credit default assumptions;
- robustness of actuarial modelling and analysis of change; and
- reasonableness of the assumptions used in deriving provisions.

Our application of materiality

We apply the concept of materiality in both planning and performing the audit, and in evaluating the effect of identified misstatements on our audit and of uncorrected misstatements, if any, on the financial statements and in forming our opinion in the Audit Report.

When establishing our overall audit strategy, we determined the magnitude of uncorrected misstatements that we judged would be material for the financial statements as a whole. We determined materiality for the Group to be £20 million which is approximately 5% of IFRS based operating profit. We used operating profit as a basis of determining materiality. This provided a basis for determining the nature, timing and extent of risk assessment procedures, identifying and assessing the risk of material misstatement and determining the nature, timings and extent of further audit procedures.

On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgement was that overall performance materiality (i.e. our tolerance for misstatement in an individual account or balance) for the Group should be 50% of materiality, namely £10 million. Our objective in adopting this approach was to ensure that total detected and undetected audit differences in all accounts did not exceed our materiality level.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £2 million, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

An overview of the scope of our audit

Following our assessment of the risk of material misstatement to the Group financial statements, we selected six components which represent the principal business units within the Group's four reportable segments and account for all of the Group's total assets and all of the Group's IFRS based operating profit. UK, Heritage, International and Lombard were subject to a full scope audit, whilst the Sesame and Corporate components were subject to a specific scope audit where the extent of audit work was based on our assessment of the risks of material misstatement and of the materiality of the Group's business operations at those locations. They were also selected to provide an appropriate basis for undertaking audit work to address the risks of material misstatement identified above.

The Group audit team continued to follow a programme of planned visits that has been designed to ensure that the Group audit team visits each of the locations where the Group audit scope was focused at least once every year. In addition to the location visits the Group audit team reviewed key working papers and participated in key meetings involving the component teams.

Our response to the risks identified above was as follows:

- in respect of the actuarial assumptions, we evaluated management's processes and controls over assumption setting and validated the reserving methodologies and assumptions by comparing the valuation assumptions against the Group's own experience investigations, regulatory requirements and industry benchmarks;
- we tested the controls management have in place over the key actuarial models, and performed independent testing on a sample basis in particular where there are manual controls; and
- we considered the appropriateness of management's assumptions and estimates in deriving the provisions, and challenged those assumptions and estimates by considering the supporting information and forecasts.

Opinion on other matters

In our opinion the part of the Directors' remuneration report that has been described as having been audited has been properly prepared in accordance with the basis of preparation as described therein.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the ISAs (UK and Ireland), we are required to report to you if, in our opinion, information in the annual report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit; or
- is otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the annual report is fair, balanced and understandable and whether the annual report appropriately discloses those matters that we communicated to the Audit Committee which we consider should have been disclosed.

Under the Companies (Guernsey) Law, 2008 we are required to report to you if, in our opinion:

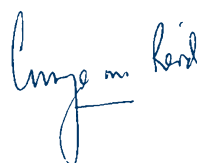
- proper accounting records have not been kept; or
- the financial statements are not in agreement with the accounting records; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review the part of the corporate governance statement relating to the Company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review; and

The directors' statement, set out on page 124 in relation to going concern, which the Company has requested that we review.

Other matter

We have reported separately on the parent company financial statements of Resolution Limited for the year ended 31 December 2013.



George Reid
for and on behalf of Ernst & Young LLP
London

17 March 2014

1. The maintenance and integrity of the Resolution Limited website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

2. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Consolidated income statement

For the year ended 31 December 2013

	Notes	2013 £m	Restated 2012 £m
Revenue			
Gross earned premiums	3	1,971	1,906
Premiums ceded to reinsurers	3	(595)	(602)
Net earned premiums	3	1,376	1,304
Fee and commission income and income from service activities		827	749
Investment return ⁽ⁱ⁾	4	8,786	9,045
Total revenue		10,989	11,098
Other income	3	20	–
Claims, benefits and expenses			
Gross claims and benefits paid	5	(4,494)	(4,175)
Amounts receivable from reinsurers	5	688	680
Net claims and benefits paid	5	(3,806)	(3,495)
Change in insurance contract liabilities	26	2,331	8
Change in investment contract liabilities	27	(6,900)	(5,052)
Transfer from/(to) unallocated surplus		29	(4)
Movement in net asset value attributable to unit-holders	33	(89)	(118)
Movement in policyholder liabilities		(4,629)	(5,166)
Acquisition expenses	6	(603)	(614)
Administrative and other expenses ⁽ⁱⁱ⁾	7	(1,460)	(1,597)
Finance costs	10	(142)	(157)
Total claims, benefits and expenses		(10,640)	(11,029)
Share of loss of associates		–	(3)
Profit before tax from continuing operations		369	66
Policyholder tax	11	(334)	(258)
Profit/(loss) before shareholder tax from continuing operations		35	(192)
Total tax charge	11	(134)	(107)
Policyholder tax	11	334	258
Shareholder tax	11	200	151
Profit/(loss) for the year		235	(41)
Attributable to:			
Equity holders of the parent ⁽ⁱⁱ⁾		204	(72)
Non-controlling interests		31	31
Profit/(loss) for the year		235	(41)
Earnings per share from continuing operations		2013 pence	2012 pence
Basic earnings per share	13	14.39	(5.17)
Diluted earnings per share	13	14.38	(5.17)

(i) As a result of the revision to IAS 19: *Employee benefits*, curtailment gains of £32 million for the year ended 31 December 2012 have been presented within administrative expenses, rather than within investment return. Refer to note 8 for further details.

(ii) All profit attributable to equity holders of the parent is from continuing operations.

The notes on pages 136 to 236 form an integral part of these financial statements.

Consolidated statement of comprehensive income

For the year ended 31 December 2013

For the year ended 31 December 2013	Equity holders of the parent £m	Non-controlling interests £m	Total £m
Profit for the year	204	31	235
Other comprehensive income:			
Items that will not be reclassified to profit and loss:			
Remeasurement losses on the defined benefit scheme	(113)	–	(113)
Income tax relating to items that will not be reclassified	36	–	36
Total items that will not be reclassified to profit and loss	(77)	–	(77)
Items that may be reclassified subsequently to profit and loss:			
Foreign exchange adjustments ⁽ⁱ⁾	5	–	5
Shadow accounting ⁽ⁱⁱ⁾	4	–	4
Total items that may be reclassified subsequently to profit and loss	9	–	9
Other comprehensive loss, net of tax	(68)	–	(68)
Total comprehensive income, net of tax	136	31	167

For the year ended 31 December 2012	Equity holders of the parent £m	Non-controlling interests £m	Total £m
(Loss)/profit for the year	(72)	31	(41)
Other comprehensive income:			
Items that will not be reclassified to profit and loss:			
Remeasurement losses on the defined benefit scheme	(42)	–	(42)
Revaluation of owner-occupied properties	(2)	–	(2)
Shadow accounting ⁽ⁱⁱⁱ⁾	2	–	2
Income tax relating to items that will not be reclassified	7	–	7
Total items that will not be reclassified to profit and loss	(35)	–	(35)
Items that may be reclassified subsequently to profit and loss:			
Foreign exchange adjustments ⁽ⁱ⁾	(17)	–	(17)
Shadow accounting ⁽ⁱⁱ⁾	5	–	5
Total items that may be reclassified subsequently to profit and loss	(12)	–	(12)
Other comprehensive loss, net of tax	(47)	–	(47)
Total comprehensive (loss)/income, net of tax	(119)	31	(88)

(i) Foreign exchange adjustments relate to the translation of overseas subsidiaries.

(ii) Shadow accounting that may be reclassified subsequently to profit and loss is as a result of a loss of £(4) million (31 December 2012: loss of £(5) million) included within foreign exchange adjustments on translation of overseas subsidiaries held by a with-profits fund of Friends Life Limited ("FLL").

(iii) Shadow accounting that will not be reclassified to profit and loss is in respect of a loss of £(2) million relating to the revaluation of owner-occupied properties, held by a with-profits fund of FLL.

Consolidated statement of IFRS based operating profit

For the year ended 31 December 2013

	Notes	2013 £m	2012 £m
Profit before tax from continuing operations	3	369	66
Policyholder tax	11	(334)	(258)
Profit/(loss) before shareholder tax excluding returns generated within policyholder funds		35	(192)
Non-recurring items	3	131	258
Amortisation and impairment of acquired present value of in-force business	14	392	417
Amortisation and impairment of other intangible assets	14	91	97
Interest payable on STICS	3	(31)	(31)
Short-term fluctuations in investment return	3	(182)	(275)
IFRS based operating profit before tax	3	436	274
Tax on operating profit		4	2
IFRS based operating profit after tax attributable to equity holders of the parent⁽ⁱ⁾		440	276

		2013 Pence	2012 Pence
Earnings per share			
Operating earnings per share	13	31.03	19.84
Diluted operating earnings per share	13	31.01	19.84

(i) IFRS based operating profit excludes:

- (a) investment variances from expected investment return for non-linked business which is calculated using a longer-term rate of return;
- (b) returns attributable to non-controlling interests in policyholder funds;
- (c) significant non-recurring items;
- (d) amortisation and impairment of present value of acquired in-force business and other intangible assets and is stated after policyholder tax and the deduction of interest payable on STICS. Given the long-term nature of the Group's operations, IFRS based operating profit is considered to be a better measure of the performance of the Group and this measure of profit is used internally to monitor the Group's IFRS results.

Consolidated statement of financial position

At 31 December 2013

As at 31 December	Notes	2013 £m	2012 £m
Assets			
Pension scheme surplus	8	–	33
Intangible assets	14	3,855	4,321
Property and equipment	15	50	53
Investment properties	16	2,561	2,735
Investment in associate		4	4
Financial assets	18	109,064	105,990
Deferred acquisition costs	20	897	838
Reinsurance assets	21	2,837	3,153
Current tax assets		33	8
Insurance and other receivables	23	1,100	1,125
Cash and cash equivalents	24	9,690	9,449
Net assets of operations classified as held for sale		–	30
Total assets		130,091	127,739
Liabilities			
Insurance contracts	26	34,590	37,232
Unallocated surplus	28	627	656
Financial liabilities:			
– investment contracts	27	83,502	78,184
– loans and borrowings	31	1,050	1,099
– amounts due to reinsurers	32	1,580	1,767
Net asset value attributable to unit-holders	33	621	754
Provisions	34	227	278
Pension scheme deficit	8	52	–
Deferred tax liabilities	22	980	893
Current tax liabilities		1	21
Insurance payables, other payables and deferred income	35	1,312	1,157
Total liabilities		124,542	122,041
Equity attributable to equity holders of the parent			
– Share capital	36	4,223	4,225
– Other reserves	37	1,006	1,152
		5,229	5,377
Attributable to non-controlling interests	38	320	321
Total equity		5,549	5,698
Total equity and liabilities		130,091	127,739

The financial statements were approved by the Board of Directors on 17 March 2014.



Tim Tookey
Director

Consolidated statement of changes in equity

For the year ended 31 December 2013

For the year ended 31 December 2013	Attributable to equity holders of the parent			Non-controlling interests £m	Total £m
	Share capital £m	Other reserves £m	Total £m		
At 1 January 2013	4,225	1,152	5,377	321	5,698
Profit for the year	–	204	204	31	235
Other comprehensive loss	–	(68)	(68)	–	(68)
Total comprehensive income	–	136	136	31	167
Dividends paid	–	(300)	(300)	–	(300)
Interest paid on STICS	–	–	–	(31)	(31)
Appropriations of profit	–	(300)	(300)	(31)	(331)
Tax relief on STICS interest	–	7	7	–	7
Increase in own shares held by the Group	(2)	–	(2)	–	(2)
Share-based payments, net of settlements ⁽ⁱ⁾	–	7	7	(1)	6
Other movements ⁽ⁱⁱ⁾	–	4	4	–	4
At 31 December 2013	4,223	1,006	5,229	320	5,549

For the year ended 31 December 2012	Attributable to equity holders of the parent			Non-controlling interests £m	Total £m
	Share capital £m	Other reserves £m	Total £m		
At 1 January 2012	4,128	1,544	5,672	323	5,995
(Loss)/profit for the year	–	(72)	(72)	31	(41)
Other comprehensive loss	–	(47)	(47)	–	(47)
Total comprehensive (loss)/income	–	(119)	(119)	31	(88)
Dividends paid	–	(283)	(283)	–	(283)
Interest paid on STICS	–	–	–	(31)	(31)
Appropriations of profit	–	(283)	(283)	(31)	(314)
Tax relief on STICS interest	–	7	7	–	7
Shares issued in lieu of dividend	90	–	90	–	90
Reduction in own shares held by the Group	7	–	7	–	7
Share-based payments, net of settlements ⁽ⁱ⁾	–	3	3	(2)	1
At 31 December 2012	4,225	1,152	5,377	321	5,698

(i) The other reserves movement for equity-settled schemes is £7 million for the year (31 December 2012: £3 million) and relates to the expense, net of partial settlement, of the Lombard long-term incentive plan ("LTIP") along with the expense for the deferred share award plans ("DSAP") and the Friends Life group LTIP.

(ii) Other movements comprise the release of a share entitlement provision (£2 million) and consolidation of the Group's Employee Benefit Trust (£2 million). Following demutualisation of Friends Provident in 2001, share and cash entitlements that were not claimed were placed into two trusts. The trusts were wound up in 2004 and the liability for any future claims in respect of demutualisation was transferred to the Group. This provision was released following expiry of the Group's obligation on 9 July 2013.

Consolidated statement of cash flows

For the year ended 31 December 2013

For the year ended 31 December	Note	2013 £m	2012 £m
Operating activities			
Profit/(loss) for the year		235	(41)
Adjusted for:			
– profit on disposal of investment in associate		(20)	–
– net realised and unrealised gains on assets at fair value		(5,507)	(5,630)
– finance costs		142	157
– amortisation and impairment of intangible assets		483	514
– depreciation of property and equipment		5	5
– movement in deferred acquisition costs		(59)	(195)
– total tax charge		134	107
– purchase of shares and other variable yield securities		(23,948)	(22,536)
– proceeds from sale of shares and other variable yield securities		25,363	23,045
– purchase of loans, debt securities and other fixed income securities		(26,911)	(23,841)
– proceeds from sale of loans, debt securities and other fixed income securities		28,257	26,166
– purchase of investment properties		(45)	(51)
– proceeds from sale of investment properties		265	228
– decrease in insurance contract liabilities		(2,642)	(32)
– increase in investment contract liabilities		4,840	3,532
– (decrease)/increase in unallocated surplus		(29)	4
– (decrease)/increase in provisions		(51)	50
– net movement in receivables and payables		216	(214)
Pre-tax cash inflow from operating activities		728	1,268
Tax paid		(48)	(70)
Net cash inflow from operating activities		680	1,198
Investing activities			
Disposal of held for sale assets, net of cash transferred		50	–
Additions to internally generated intangible assets		(4)	(4)
Net additions of property and equipment		(2)	(2)
Net cash inflow/(outflow) from investing activities		44	(6)
Financing activities			
Shares purchased in settlement of incentive schemes		(1)	(4)
Proceeds from increase in long-term debt		–	349
Repayment of long-term debt		–	(423)
Finance costs		(143)	(170)
STICS interest		(31)	(31)
Net movement in other borrowings, net of expenses		(40)	(20)
Dividends paid to equity holders of the parent		(300)	(193)
Net cash outflow from financing activities		(515)	(492)
Increase in cash and cash equivalents		209	700
Balance at beginning of year	24	9,449	8,791
Exchange adjustments on the translation of foreign operations		32	(42)
Balance at end of year		9,690	9,449

Notes to the consolidated accounts

For the year ended 31 December 2013

1. Accounting policies

1.1 Basis of preparation

The financial statements of the Company as at and for the year ended 31 December 2013 comprise the consolidated financial statements of the Company and its subsidiaries (together referred to as "the Group") and the Group's interests in its associate.

For the year ended 31 December 2013 the consolidated income statement includes the results of AmLife Insurance Berhad and AmFamily Takaful Berhad (collectively "AmLife") up until the date of their disposal on 4 January 2013. The consolidated income statement for the year ended 31 December 2012 includes the results of AmLife for the full year.

The consolidated financial statements as at and for the year ended 31 December 2013 have been prepared in accordance with IFRS as adopted by the European Union ("IFRS").

The presentation currency of the Group is Sterling. Unless otherwise stated the amounts shown in the consolidated financial statements are in millions of pounds Sterling (£ million).

The preparation of the financial statements under IFRS requires management to make judgements, estimates and assumptions that affect the application of policies and the reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both current and future periods. Further information on the use of judgements, estimates, and assumptions is set out in note 2.

The directors have, at the time of approving the financial statements, a reasonable expectation that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the financial statements. Further detail is contained in the Directors' report on page 124.

The International Accounting Standards Board ("IASB") issued the following new standards and changes to existing standards which are relevant to the Group and effective for the Group financial statements from 1 January 2013.

- IFRS 13: *Fair value measurement* establishes a single source of guidance under IFRS for all fair value measurements. IFRS 13 does not change when an entity is required to use fair value, but rather provides guidance on how to measure fair value under IFRS when fair value is required or permitted. The standard is applied prospectively. The application of IFRS 13 has not materially impacted the fair value measurements carried out by the Group.

IFRS 13 also requires specific disclosures on fair values; the Group provides these disclosures in note 19.

- IAS 19: *Employee benefits* (Revised 2011): IAS 19R includes a number of amendments to the accounting for defined benefit plans, including elimination of the corridor approach and recognition of all actuarial gains and losses in other comprehensive income ("OCI") under the heading of "Remeasurements on the defined benefit scheme" as they occur; to immediately recognise all past service costs; and to replace interest cost and expected returns on plan assets with a net interest amount, calculated by applying the discount rate used to measure

the defined benefit obligation to the net defined benefit liability or asset. These are applied retrospectively. The amendments also include enhancements to disclosure requirements; the Group is already largely compliant and no material updates have been required.

Elimination of the corridor approach has no impact on the results of the Group, as the existing policy is to recognise all actuarial losses in OCI as they occur. The change in accounting for net interest income/expense, which represents a change in accounting policy, has not impacted profit before tax or the statement of comprehensive income in prior years or the year ended 31 December 2013.

The income statement has been restated for the requirement to present curtailment gains within administrative and other expenses; previously, curtailment gains of £32 million at 31 December 2012 were included within investment return.

- Amendments to IAS 1: *Presentation of financial statements*: The amendments introduce a grouping of items presented in OCI. The items that could be reclassified to profit and loss at a future point in time, e.g. foreign exchange adjustments, are required to be presented separately from items that will never be reclassified.

Below is a list of new standards and changes to existing standards, relevant to the Group, that have been issued by the IASB with effective dates for annual accounting periods beginning on or after 1 January 2014, unless otherwise stated, but where earlier adoption is permitted. They have been endorsed by the European Union ("EU") unless otherwise stated. They have not been considered for early adoption by the Group. These changes will not materially impact the Group unless otherwise stated.

New standards:

- IFRS 9: *Financial instruments*. This standard reflects the first phase of the IASB's work on the replacement of IAS 39: *Financial instruments: recognition and measurement*, and relates to the classification and measurement of financial assets and liabilities as defined in IAS 39, with classification dependent upon the entity's business model for managing its financial instruments and the contractual cash flow characteristics of the instruments. The adoption of IFRS 9 will have a material impact on the classification and measurement of the Group's financial assets and liabilities. It is not anticipated that this standard will become effective before 1 January 2017; it is yet to be endorsed by the EU. The impact of these new requirements is currently being assessed by the Group;
- IFRS 10: *Consolidated financial statements*. This standard provides a single consolidation model that identifies control as the basis for consolidation for all types of entities. It replaces the requirements in IAS 27: *Consolidated and separate financial statements* and SIC 12: *Consolidation – special purpose entities*;
- IFRS 11: *Joint arrangements*. This IFRS establishes principles for the financial reporting by parties to a joint arrangement. It supersedes the requirements in IAS 31: *Interests in Joint Ventures* and SIC 13: *Jointly controlled entities-non-monetary contributions by venturers*; and
- IFRS 12: *Disclosure of interests in other entities*. This IFRS combines, enhances and replaces disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities.

1. Accounting policies continued

Amendments to existing standards:

- improvements to IFRSs 2010 to 2012: These annual improvements address eight standards in the 2010-2012 reporting cycle. They include changes to IFRS 2: *Share-based payments*, IFRS 3: *Business combinations*, IFRS 8: *Operating segments*, IFRS 13: *Fair value measurement*, IAS 7: *Cash flow statements*, IAS 16: *Property, plant and equipment*, IAS 24: *Related party disclosures* and IAS 38: *Intangible assets*. The amendments are effective for annual periods beginning on or after 1 July 2014 but have not yet been endorsed by the EU; and
- improvements to IFRSs 2011 to 2013: These annual improvements address four issues to four standards in the 2011-2013 reporting cycle. They include changes to IFRS 1: *First time adoption of IFRS*, IFRS 3: *Business combinations*, IFRS 13: *Fair value measurement*, and IAS 40: *Investment property*. The amendments are effective for annual periods beginning on or after 1 July 2014 but have not yet been endorsed by the EU.

The Group has not early adopted any other standard, interpretation or amendment that has been issued but is not yet effective.

The financial statements comply with the Statement of Recommended Practice issued by the Association of British Insurers in December 2005 (as amended in December 2006) insofar as these requirements do not contradict the requirements of IFRS.

The Group presents its consolidated statement of financial position in order of liquidity. Where applicable, for each asset and liability line item that combines amounts expected to be recovered or settled both within and beyond 12 months after the reporting date, disclosure of the amount due beyond 12 months is made in the respective note.

Financial assets and financial liabilities are not offset, unless there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liability simultaneously. Income and expenses are not offset in the income statement unless required or permitted by an accounting standard or interpretation, as specifically disclosed in the accounting policies of the Group.

1.2 Accounting policies

The principal accounting policies have been consistently applied in these consolidated financial statements. Where an accounting policy can be directly attributed to a specific line item in the accounts, the policy is now presented within the relevant note, with a view to enabling greater understanding of the results and financial position of the Group. All other significant accounting policies are disclosed below.

1.2.1 Business combinations

The consolidated financial statements incorporate the assets, liabilities, results and cash flows of the Company and its subsidiaries. The results of subsidiaries acquired or sold during the period are included in the consolidated results from the date of acquisition or up to the date of disposal. Intra-group balances and income and expenses arising from intra-group transactions are eliminated in preparing the consolidated financial statements.

Profits or losses arising from changes in holdings in subsidiaries that do not impact the Group's control over that subsidiary are recognised as changes in equity.

Business combinations are accounted for under IFRS 3: *Business combinations*, using the purchase method. The cost of a business combination is measured as the fair value of the consideration transferred. Identifiable assets acquired, including intangible assets arising on acquisition, and liabilities assumed in a business combination are measured initially at their fair value at the business combination date. Any excess of the cost of the business combination over the fair value of the net assets acquired is recognised in the statement of financial position as goodwill. To the extent that the fair value of the acquired entity's net assets is greater than the cost of the acquisition, a gain is recognised immediately in the income statement. Acquisition related costs are expensed as incurred except insofar as they relate to the raising of debt or equity when such expenses are capitalised.

For further details on accounting policies for subsidiaries, see note 17.

a) Associates

Associates are all entities over whose operating policies the Group has significant influence but not control, generally arising from holding between 20% and 50% of the voting rights. Investments in associates are accounted for by the equity method of accounting and are initially recognised at cost. The Group's investment in associates includes goodwill (net of any impairment loss) identified on acquisition.

Under the equity method, an investment is included as a single line item in the consolidated statement of financial position as the Group's share of the fair value of the investee undertaking's net assets plus goodwill. The Group's share of post-tax profits or losses is presented as a single line item in the consolidated income statement, adjusted for the effect of measuring assets and liabilities to fair value on acquisition.

b) Classification of a non-current asset or disposal group as held for sale and discontinued operations

Where the Group holds a non-current asset or disposal group which is held exclusively with a view to its disposal in the near future, then it is classified as an asset held for sale.

An asset or disposal group is classified as held for sale when:

- management is committed to a plan to sell;
- the asset is available for immediate sale;
- an active programme to locate a buyer is initiated;
- the sale is highly probable, within 12 months of classification as held for sale (subject to limited exceptions);
- the asset is being actively marketed for sale at a sales price reasonable in relation to its fair value; and
- actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

Non-current assets or disposal groups that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.

Notes to the consolidated accounts continued

1. Accounting policies continued

1.2.2 Impairment

The Group assesses at each reporting date whether there is an indication that an asset (other than those assets recognised at fair value) may be impaired.

If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash generating unit's ("CGU") fair value less costs to sell and its value in use, and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Impairment losses on continuing operations are recognised in the income statement in those expense categories consistent with the function of the impaired asset.

An assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the recoverable amount of the asset is estimated. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case, the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years. Such a reversal is recognised in the income statement unless the asset is carried at a revalued amount, in which case the reversal is treated as a revaluation increase. After such a reversal the depreciation charge is adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

Further detail on the impairment testing of intangible assets is provided in note 14.

1.2.3 Financial liabilities

The Group classifies financial liabilities as either financial liabilities at fair value through profit or loss or financial liabilities at amortised cost. The Group's principal financial liabilities at fair value through profit or loss are classified in notes 27 and 32 and at amortised cost in note 31.

A financial liability is recognised when, and only when, the Group becomes a party to the contractual provisions of a financial instrument.

A financial liability is derecognised when, and only when, the obligation specified in the contract is discharged, or cancelled or expires.

1.2.4 Foreign currency translation

a) Foreign currency transactions

Transactions in foreign currencies are translated to the functional currency of each company in the Group at the foreign exchange rates ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated to the functional currency at the exchange rate ruling at the reporting date, and any exchange differences arising are taken to the income statement. Non-monetary assets and liabilities measured at historical cost in a foreign currency are translated using the exchange rate at the date of the transaction and are not subsequently restated. Non-monetary assets and liabilities stated at fair value in a foreign currency are translated at the rate on the date the fair value was determined.

When a gain or loss on a non-monetary item is recognised directly in equity, any exchange component of that gain or loss is recognised directly in equity. Conversely, when a gain or loss on a non-monetary item is recognised in the income statement, any exchange component of that gain or loss is recognised in the income statement. Foreign exchange adjustments recognised in equity are reported in the Group's foreign currency translation reserve within retained earnings and reported in the consolidated statement of comprehensive income.

b) Overseas subsidiaries and associates

The assets and liabilities of overseas subsidiaries and associates, including goodwill and intangible assets attributable to the acquisition of the overseas subsidiary or associate, and fair value adjustments arising on consolidation, are translated to Sterling (the presentational currency of the Group) at foreign exchange rates ruling at the reporting date. The revenues and expenses of overseas subsidiaries and associates are translated to Sterling at average foreign exchange rates for the period.

Foreign exchange differences arising on the translation to Sterling are classified as equity movements and recognised in the Group's foreign currency translation reserve, and reported in the statement of comprehensive income. These exchange differences are recognised in the income statement in the period in which the overseas subsidiary or associate is sold.

1.2.5 Own shares

The cost of own shares held in the Employee Benefit Trust ("EBT") is deducted from shareholders' equity until the shares are vested, cancelled or disposed.

1.2.6 Financial instruments treated as equity

A financial instrument is treated as equity if:

- 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
- the instrument is not a derivative and contains no contractual obligations to deliver a variable number of shares or is a derivative that will be settled only by the Group exchanging a fixed amount of cash or other assets for a fixed number of the Group's own equity instruments.

2. Use of judgements, estimates and assumptions

The Group makes judgements in the application of critical accounting policies that affect the reported amounts of assets and liabilities. The Group also makes key assumptions about the future and other sources of uncertainty. These are continually evaluated and based on historical experience and other factors, including expectations of future events that are considered to be reasonable under the circumstances.

a) Product classification

IFRS 4: *Insurance contracts* requires judgement in classifying contracts as either "insurance contracts" or "investment contracts" based on the significance of insurance risk present in the contract with consequential impacts on the accounting policies applied to the valuation of policyholder liabilities, deferral of acquisition costs and pattern of revenue recognition.

b) Liabilities arising from insurance contracts and investment contracts with DPF

A contract with Discretionary Participation Features ("DPF") is a contractual right held by a policyholder to receive, as a supplement to guaranteed minimum payments, additional payments:

- that are likely to be a significant portion of the total contractual payments; and
- whose amount or timing is contractually at the discretion of the issuer and that are contractually based on:
- the performance of a specified pool of contracts, or a specified type of contract; or
- realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
- the profit or loss of the company that issues the contracts.

Determination of the ultimate liabilities of insurance contracts or investment contracts with DPF arising is a critical accounting estimate. There are several sources of uncertainty that need to be considered in determining the key assumptions made in estimating the liabilities that the Group will ultimately pay on claims made and on maturity of the policies.

The most significant assumptions are:

- mortality, morbidity, persistency and expense assumptions;
- for with-profits policies, the stochastic models used to value liabilities are sensitive to risk-free rates, assumed asset volatilities and the assumed correlation between asset volatilities. Risk-free rates are set in accordance with current market gilt rates;
- for Overseas Life Assurance Business ("OLAB") policies with return of premium guarantees, the stochastic models used to value the cost of the guarantee are sensitive to risk-free rates, assumed asset volatilities and the assumed correlation between asset volatilities. Risk-free rates are set in accordance with current market swap rates. The cost also depends on assumptions such as the level of policy discontinuance;

- valuation interest rate for annuities in payment – fixed-interest assets, predominantly corporate bonds, are held to match the expected annuity portfolio benefits payable. The excess yields on corporate bonds over that on gilts are called bond spreads and these reflect compensation for the higher risk of default (credit risk premium) and lower liquidity (illiquidity premium) compared to gilts. One of the key judgements is the assessment of how much of the spread is attributable to credit default, as benefit cannot be taken for this element when determining the valuation interest rate. The valuation interest rate is derived by deducting the allowance for defaults, based on an analysis of historical defaults, from the total bond yield. This approach is consistent with current industry practice;
- other valuation interest rates have been calculated by reference to changes in consistent economic indices. The impact of all interest rate changes on liabilities is included within the impact of economic basis changes in note 26(a). The impact of these liability changes on surplus is generally to offset some or all of the corresponding impact on the value of fixed-interest assets backing the liabilities;
- for guaranteed annuity options (one of the principal guarantees written by the Group) the cost depends on assumptions such as the level of policy discontinuance and the tax-free cash take-up rate; and
- changes in assumptions behind the valuation techniques for assets that are not quoted in active markets could have a significant impact on the value of assets that are backing insurance and investment contract liabilities, and therefore could have a subsequent impact on the valuation of the liability itself.

Details of insurance and investment contract liabilities are given in notes 25, 26 and 27.

c) AVIF and other intangible assets

The determination of the present value of future profits on a portfolio of long-term insurance and investment contracts, acquired through the purchase of a subsidiary, and recognised as an intangible asset, is subject to judgement and estimation. The Group's policy is to calculate AVIF balances arising on acquisition by reference to a market consistent embedded value methodology. Information relating to the methods used to value other intangible assets is set out in note 14.

d) Fair value determination of financial instruments at fair value through profit or loss

Financial assets are designated at fair value where they are managed on a fair value basis or at amortised cost. Financial liabilities such as investment contracts are designated at fair value to eliminate mismatch with corresponding assets which are managed on a fair value basis.

Fair values of financial instruments that are quoted in active markets are based on bid prices for the assets held. When independent prices are not available, fair values are determined by using valuation techniques which refer to market observable data. These include comparison with similar instruments when market observable prices are available.

Valuation methodologies are detailed in note 19.

Notes to the consolidated accounts continued**2. Use of judgements, estimates and assumptions** continued

An analysis of assets and liabilities by category is also disclosed in note 19.

e) Staff pension schemes assumptions

In assessing the pension benefit obligation, assumptions are made as to the life expectancy of all current, deferred and retired members, rates of increases of salaries and pensions, interest and inflation rates. Material assumptions used and sensitivities are explained in detail in note 8. Estimates are made for the recoverability of any surplus through a potential refund should the scheme be wound up when in surplus.

f) Deferred tax assets and liabilities and unit-linked tax loss provisions

In assessing deferred tax assets, an estimate of probable future taxable profits is made, against which the temporary differences, being the carry forward of excess tax expenses, and tax losses are utilised. These involve management's best estimate based on past profit experience, adjusted for possible future deviations that management considers might occur. Details of deferred tax assets and liabilities are analysed in note 22.

The principal deferred tax liabilities relate to deferred tax on purchased value of in-force business which are subsequently being amortised in line with the run-off of the underlying assets. The deferred tax assets and liabilities were calculated using detailed actuarial forecast cash flows.

In assessing investment and insurance contract liabilities in respect of unit-linked tax loss provisions, the most significant assumptions are in relation to estimates of future fund growth rates; these are aligned with the Group's MCEV reporting assumptions, as provided in the MCEV supplementary information within the Report and Accounts. Provision is required where future investment return assumptions suggest linked funds will use their carried forward tax losses. Where growth rate assumptions for equities and property are less than RPI assumptions no provision is made in respect of capital gains tax losses because no future taxable growth is anticipated against which losses can be used.

g) Fair value determination of investment properties and owner-occupied properties

Investment properties and properties occupied by the Group are measured at fair value at the reporting date by external independent valuers using methods set out in the RICS Red Book.

The valuations used are based on valuation techniques using multiples of future rental incomes. The rental multiples are based on multiples observed in recent similar transactions in the market. Key assumptions include occupancy and rental income.

h) Longer term shareholder investment return – IFRS based operating profit

In assessing the longer term investment return used in arriving at IFRS based operating profit before tax, assumptions are made as to the appropriate gilt and cash returns to apply, adjusted where appropriate to reflect the additional risks associated with other types of investment class.

Material assumptions used and sensitivities are detailed in note 4.

i) Provisions

The amounts recognised as provision liabilities are the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. All estimates are based on management's knowledge of current circumstances and predictions of future events. Actual experience may differ from these estimates.

Provisions are detailed in note 34.

3. Segmental information

Segmental information is presented on the same basis as internal financial information used by the Group to evaluate operating performance. An operating segment is a component of the Group that engages in business activities from which it earns revenues and incurs expenses. The Group's reportable segments under IFRS 8: *Operating segments* are as follows:

- UK comprising Corporate Benefits, Protection and Retirement Income market-facing businesses and Sesame Bankhall Group ("SBG");
- Heritage, comprising the bulk of the UK business that is no longer actively marketed and Friends Life Investments ("FLI");
- FPI comprising Friends Provident International Limited ("FPIL"), the Overseas Life Assurance Business ("OLAB") within the UK life and pensions subsidiaries and the Group's share of AmLife (prior to its disposal on 4 January 2013); and
- Lombard.

Corporate functions are not strictly an operating segment, but are reported to management and are provided in the analysis below to reconcile the Group's reportable segments to total profit.

In previous reporting periods, UK and Heritage were reported as a single segment. The comparatives have been restated to provide separate disclosure of UK and Heritage for the full year to 31 December 2012.

a) Operating segment information

(i) IFRS based operating profit

Year ended 31 December 2013	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m	Total £m
Life and pensions operating profit	76	380	115	37	–	608
Longer term shareholder investment return	13	(84)	(1)	–	3	(69)
Other (expense)/income	(19)	2	(2)	–	(34)	(53)
Development costs	(30)	(7)	(10)	(3)	–	(50)
IFRS based operating profit/(loss) before tax	40	291	102	34	(31)	436
Tax on operating profit						4
IFRS based operating profit after tax attributable to equity holders of the parent						440
Operating earnings per share (pence)						31.03

Year ended 31 December 2012	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m	Total £m
Life and pensions operating profit/(loss)	4	379	(28)	30	–	385
Longer term shareholder investment return	1	(41)	–	–	17	(23)
Other expense	(1)	–	(3)	–	(34)	(38)
Development costs	(36)	(6)	(6)	(2)	–	(50)
IFRS based operating (loss)/profit before tax	(32)	332	(37)	28	(17)	274
Tax on operating profit						2
IFRS based operating profit after tax attributable to equity holders of the parent						276
Operating earnings per share (pence)						19.84

Notes to the consolidated accounts continued

3. Segmental information continued

(ii) Reconciliation of IFRS based operating result before tax to profit before tax from continuing operations

Year ended 31 December 2013	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m	Total £m
IFRS based operating profit/(loss) before tax	40	291	102	34	(31)	436
Non-recurring items ⁽ⁱ⁾⁽ⁱⁱ⁾⁽ⁱⁱⁱ⁾	(35)	(226)	18	–	112	(131)
Amortisation and impairment of acquired value of in-force business	(47)	(203)	(92)	(50)	–	(392)
Amortisation and impairment of other intangible assets	(42)	(14)	(7)	(28)	–	(91)
Interest payable on STICS	–	31	–	–	–	31
Short-term fluctuations in investment return ^(iv)	19	158	5	(2)	2	182
(Loss)/profit before policyholder and shareholder tax	(65)	37	26	(46)	83	35
Policyholder tax	9	325	–	–	–	334
(Loss)/profit before tax from continuing operations	(56)	362	26	(46)	83	369

Year ended 31 December 2012	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m	Total £m
IFRS based operating (loss)/profit before tax	(32)	332	(37)	28	(17)	274
Non-recurring items ^{(v)(vi)(vii)(viii)}	(9)	(264)	–	(1)	16	(258)
Amortisation and impairment of acquired value of in-force business	(52)	(216)	(94)	(55)	–	(417)
Amortisation and impairment of other intangible assets	(42)	(4)	(22)	(28)	(1)	(97)
Interest payable on STICS	–	31	–	–	–	31
Short-term fluctuations in investment return ^(iv)	52	246	(4)	(1)	(18)	275
(Loss)/profit before policyholder and shareholder tax	(83)	125	(157)	(57)	(20)	(192)
Policyholder tax	2	256	–	–	–	258
(Loss)/profit before tax from continuing operations	(81)	381	(157)	(57)	(20)	66

- (i) UK non-recurring items of £(35) million for the year ended 31 December 2013 include separation and integration costs of £(14) million, costs of £(12) million relating to service improvement elements of the outsourcing arrangement with Diligenta, £(5) million in respect of Solvency II costs of which £(3) million relates to a provision for future costs, costs in respect of capital optimisation programme of £(3) million and finance transformation costs of £(1) million.
- (ii) Heritage non-recurring items of £(226) million for the year ended 31 December 2013 include costs of £(116) million in respect of a charge for deficit funding relating to the Group's defined benefit pension scheme (the income for which is reported within the Corporate segment results), £(63) million separation and integration costs offset by a £53 million provision release in respect of AHM, £(75) million of costs in respect of the Diligenta outsourcing agreement offset by a £22 million provision release, £(34) million of Solvency II costs which include a provision of £(26) million for future costs, finance transformation costs of £(7) million and £(6) million of costs relating to the 2013 capital optimisation programme. Corporate non-recurring items also include costs of £(4) million relating to strategic review fees.
- (iii) FPI non-recurring items of £18 million for the year ended 31 December 2013 include profit on disposal of the Group's entire 30% holding in AmLife of £20 million and finance transformation costs of £(2) million.
- (iv) Includes shareholder investment return short-term fluctuations and investment variances arising from the mismatch of fixed-interest assets and the liabilities they are backing as well as the impact of credit default assumptions. This latter variance reflects profits or losses in excess of the expected investment return on the assets and the impact of the corresponding economic assumption changes on the liabilities. In the year ended 31 December 2012, this includes a £99 million benefit within Heritage that relates to the release of unit-linked tax loss provisions as a result of updated fund growth estimates.
- (v) UK non-recurring items of £(9) million for the year ended 31 December 2012 relate to costs in respect of the transition and service improvement elements of the outsourcing arrangement with Diligenta.
- (vi) Heritage non-recurring items of £(264) million for the year ended 31 December 2012 include £(124) million of costs in respect of the separation and integration programme, £(75) million in respect of Solvency II and finance system developments, £(73) million of costs in respect of the transition and service improvement elements of the outsourcing arrangement with Diligenta offset partially by £31 million release of reserves, non-recurring costs of £(17) million related to the 2012 capital optimisation programme and other non-recurring costs of £(6) million.
- (vii) Corporate non-recurring items of £16 million for the year ended 31 December 2012 include a curtailment gain of £32 million arising on the defined benefit pension scheme, of which £22 million relates to the closure of the scheme to future service accrual and £10 million to reduced future anticipated costs due to the Diligenta outsourcing arrangement. This is partially offset by £(16) million of costs in relation to the transition of Resolution Operations LLP ("ROL"). The transition costs include £(10) million mainly in relation to the costs of transferring an operating agreement, under which the Company outsourced most of its operations, from ROL to the Group, and the recognition of an onerous lease provision in respect of the ROL offices to be taken on by the Group; a further £(6) million relates to restructuring activities.
- (viii) Lombard non-recurring items of £(1) million for the year ended 31 December 2012 relate to Solvency II costs.

3. Segmental information continued

(iii) Revenue and expenses

Premiums

Premium income in respect of single premium insurance policies and business not subject to contractual regular premiums is accounted for when the premiums are received.

For all other insurance contracts, premium income is accounted for in the year in which it falls due.

Under IFRS, investment contract premiums are not recognised as revenue but are accounted for as deposits, included within movements in investment contract liabilities.

Fee and commission income

Investment contract policyholders are charged for policy administration services, investment management services and for surrenders. Investment management services comprise primarily fees and charges from unit-linked investment contracts issued by the life and pensions business. Fees earned on investment management contracts relate to the sale and management of retail investment products and from managing investments in the institutional market. These fees and charges are recognised as revenue in the accounting period in which the services are rendered.

Front-end fees charged at the inception of certain investment contracts are recognised as income over the expected term of the contract on a straight-line basis with the unrecognised amount at the end of the year presented as a liability.

Regular fees charged to the policyholder periodically (monthly, quarterly or annually), are recognised on a straight-line basis over the period that the service is rendered.

Expenses

Details on the Group's accounting policies in respect of expense recognition are explained in notes 6, 7 and 10.

Notes to the consolidated accounts continued

3. Segmental information continued

For the year ended 31 December 2013	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m	Elimination of inter- segment amounts ⁽ⁱ⁾ £m	Total £m
Gross earned premiums on insurance and investment contracts	2,887	1,818	1,239	1,983	–	–	7,927
Investment contract premiums ⁽ⁱ⁾	(2,235)	(629)	(1,109)	(1,983)	–	–	(5,956)
Gross earned premiums	652	1,189	130	–	–	–	1,971
Premiums ceded to reinsurers	(96)	(495)	(4)	–	–	–	(595)
Net earned premiums	556	694	126	–	–	–	1,376
Fee and commission income	299	299	117	112	–	–	827
Investment return	1,800	5,857	292	827	94	(84)	8,786
Total revenue	2,655	6,850	535	939	94	(84)	10,989
Intersegment revenue	–	–	–	–	84	(84)	–
Total external revenue	2,655	6,850	535	939	10	–	10,989
Other income⁽ⁱⁱⁱ⁾	–	–	20	–	116	(116)	20
Net claims and benefits paid	(141)	(3,643)	(22)	–	–	–	(3,806)
Change in insurance and investment contract liabilities	(1,851)	(1,758)	(230)	(730)	–	–	(4,569)
Transfer from unallocated surplus	–	26	3	–	–	–	29
Movement in net assets attributable to unit-holders	(35)	(54)	–	–	–	–	(89)
Acquisition expenses	(400)	(56)	(98)	(49)	–	–	(603)
Administrative and other expenses	(284)	(873)	(175)	(205)	(39)	116	(1,460)
Finance costs	–	(130)	(7)	(1)	(88)	84	(142)
Total claims, benefits and expenses	(2,711)	(6,488)	(529)	(985)	(127)	200	(10,640)
Intersegment expenses	–	(200)	–	–	–	200	–
Total external claims, benefits and expenses	(2,711)	(6,288)	(529)	(985)	(127)	–	(10,640)
(Loss)/profit before tax from continuing operations	(56)	362	26	(46)	83	–	369
Policyholder tax	(9)	(325)	–	–	–	–	(334)
Shareholder tax	27	164	11	22	(24)	–	200
Segmental result after tax	(38)	201	37	(24)	59	–	235

(i) Accounted for as deposits under IFRS.

(ii) Eliminations include intersegment premiums and loan interest. Intersegment transactions are undertaken on an arm's length basis.

(iii) Includes internal recharges on pension deficit reduction contributions of £116 million and profit from the disposal of AmLife of £20 million, refer to note 3 section c) for further details.

3. Segmental information continued

For the year ended 31 December 2012	Restated UK £m	Restated Heritage £m	FPI £m	Lombard £m	Restated Corporate £m	Elimination of inter- segment amounts ⁽ⁱ⁾ £m	Restated total £m
Gross earned premiums on insurance and investment contracts	3,389	2,596	1,268	2,377	–	–	9,630
Investment contract premiums ⁽ⁱⁱ⁾	(2,814)	(1,383)	(1,150)	(2,377)	–	–	(7,724)
Gross earned premiums	575	1,213	118	–	–	–	1,906
Premiums ceded to reinsurers	(85)	(512)	(5)	–	–	–	(602)
Net earned premiums	490	701	113	–	–	–	1,304
Fee and commission income	310	259	75	105	–	–	749
Investment return ⁽ⁱⁱⁱ⁾	1,476	6,108	305	1,154	96	(94)	9,045
Total revenue	2,276	7,068	493	1,259	96	(94)	11,098
Intersegment revenue	–	1	–	–	93	(94)	–
Total external revenue	2,276	7,067	493	1,259	3	–	11,098
Other income	–	–	–	–	–	–	–
Net claims and benefits paid ^(iv)	(101)	(3,376)	(18)	–	–	–	(3,495)
Change in insurance and investment contract liabilities ^(iv)	(1,481)	(2,150)	(347)	(1,066)	–	–	(5,044)
Transfer to unallocated surplus	–	(1)	(3)	–	–	–	(4)
Movement in net assets attributable to unit-holders	(50)	(68)	–	–	–	–	(118)
Acquisition expenses	(372)	(111)	(89)	(42)	–	–	(614)
Administrative and other expenses ⁽ⁱⁱⁱ⁾	(353)	(842)	(183)	(207)	(12)	–	(1,597)
Finance costs	–	(138)	(8)	(1)	(104)	94	(157)
Total claims, benefits and expenses	(2,357)	(6,686)	(648)	(1,316)	(116)	94	(11,029)
Intersegment expenses	–	(77)	(1)	–	(16)	94	–
Total external claims, benefits and expenses	(2,357)	(6,609)	(647)	(1,316)	(100)	–	(11,029)
Share of loss of associates	–	(1)	(2)	–	–	–	(3)
(Loss)/profit before tax from continuing operations	(81)	381	(157)	(57)	(20)	–	66
Policyholder tax	(1)	(257)	–	–	–	–	(258)
Shareholder tax	21	100	26	22	(18)	–	151
Segmental result after tax	(61)	224	(131)	(35)	(38)	–	(41)

(i) Accounted for as deposits under IFRS.

(ii) Eliminations include intersegment premiums and loan interest. Intersegment transactions are undertaken on an arm's length basis.

(iii) As a result of the revision to IAS 19: *Employee benefits*, curtailment gains of £32 million have been presented within administrative expenses, rather than within investment return. Refer to note 8 for further details.

(iv) As a result of a review of investment contract disclosure during the year a restatement has been made between UK and Heritage for the allocation of claims offset by a change in investment contract liabilities. Refer to note 5 for further details.

Notes to the consolidated accounts continued

3. Segmental information continued

(iv) Products and services

	Gross earned premiums £m	Net earned premiums £m	Fee and commission income £m	Total external revenue ⁽ⁱ⁾ £m
For the year ended 31 December 2013				
UK				
– Corporate benefits	28	28	88	116
– Protection	271	175	–	175
– Retirement income	353	353	–	353
– Other	–	–	211	211
Heritage				
– With-profits	369	271	–	271
– Pensions	28	26	221	247
– Investments	104	96	67	163
– Protection	373	233	–	233
– Annuities	315	68	–	68
– Other	–	–	11	11
FPI				
– Investments	100	100	117	217
– Protection	30	26	–	26
Lombard				
– Investments	–	–	112	112
Total	1,971	1,376	827	2,203

(i) Total external revenue does not include investment return of £8,786 million.

3. Segmental information continued

For the year ended 31 December 2012	Gross earned premiums £m	Net earned premiums £m	Fee and commission income £m	Total external revenue ⁽ⁱ⁾ £m
UK				
– Corporate benefits	30	24	98	122
– Protection	224	144	–	144
– Retirement income	321	321	–	321
– Other	–	–	210	210
Heritage				
– With-profits	397	344	3	347
– Pensions	71	(15)	178	163
– Investments	139	132	79	211
– Protection	426	278	(5)	273
– Annuities	180	(37)	6	(31)
FPI				
– Investments	92	90	68	158
– Protection	26	23	–	23
– Other	–	–	7	7
Lombard				
– Investments	–	–	105	105
Total	1,906	1,304	749	2,053

(i) Total external revenue does not include investment return of £9,045 million.

Products and services are presented consistently with the disclosure of business segments, with each segment being broken down into the business units and products of which they comprise.

Notes to the consolidated accounts continued

3. Segmental information continued

(v) Assets and liabilities

As at 31 December 2013	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m	Elimination of inter- segment amounts ⁽ⁱ⁾ £m	Total £m
Segment assets	23,883	75,809	8,830	20,796	2,264	(1,495)	130,087
Investment in associate	–	4	–	–	–	–	4
Total assets	23,883	75,813	8,830	20,796	2,264	(1,495)	130,091
Total liabilities	22,793	73,000	8,562	20,448	1,234	(1,495)	124,542
Other segment information:							
– Capital expenditure	–	–	1	4	1	–	6
– Depreciation	1	1	–	1	2	–	5
– Amortisation of intangibles	89	217	88	78	–	–	472
– Impairment	–	–	11	–	–	–	11

As at 31 December 2012	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m	Elimination of inter- segment amounts ⁽ⁱ⁾ £m	Total £m
Segment assets	21,725	77,530	8,306	19,485	2,102	(1,443)	127,705
Investments in associates (including held for sale)	–	4	30	–	–	–	34
Total assets	21,725	77,534	8,336	19,485	2,102	(1,443)	127,739
Total liabilities	20,609	74,560	8,014	19,116	1,185	(1,443)	122,041
Other segment information:							
– Capital expenditure	1	–	–	4	2	–	7
– Depreciation	–	1	–	2	2	–	5
– Amortisation of intangibles	94	220	97	83	1	–	495
– Impairment	–	–	19	–	–	–	19

(i) Eliminations mainly comprise intercompany loans.

3. Segmental information continued

b) Geographical segmental information

In presenting geographical segment information, revenue is based on the geographical location of customers. The Group has defined two geographical areas: UK and the rest of the world.

For the year ended 31 December 2013	UK £m	Rest of the world £m	Total £m
Gross earned premiums	1,836	135	1,971
Fee and commission income	615	212	827
Revenue from external customers	2,451	347	2,798
Investment return			8,786
Premiums ceded to reinsurers			(595)
Total revenue			10,989

For the year ended 31 December 2012	UK £m	Rest of the world £m	Restated Total £m ⁽ⁱ⁾
Gross earned premiums	1,785	121	1,906
Fee and commission income	587	162	749
Revenue from external customers	2,372	283	2,655
Investment return ⁽ⁱ⁾			9,045
Premiums ceded to reinsurers			(602)
Total revenue			11,098

(i) As a result of the revision to IAS 19: *Employee benefits*, curtailment gains of £32 million have been presented within administrative expenses rather than within investment return. Refer to note 8 for further details.

c) Disposal of investment in associate undertakings

On 4 January 2013 the Group disposed of its entire holding of 30% of the ordinary share capital of both AmLife Insurance Berhad and AmFamily Takaful Berhad (collectively "AmLife") to AmBank Group of Malaysia for RM 245 million (£50 million) resulting in a profit on disposal of £20 million.

The Group's share of the carrying value of AmLife at the date of sale on 4 January 2013 is shown below:

	2013 £m
Carrying value	30
Proceeds from disposal	50
Profit on disposal recognised through other income	20

Notes to the consolidated accounts continued

4. Investment return

All investment income is recognised in the income statement and includes dividends, interest, rental income, the movement in financial assets and investment properties, at fair value through profit or loss, and realised losses and gains on assets classified as available-for-sale.

Interest income is recognised in the income statement as it accrues, taking into account the relevant coupon rate, and applicable floating rate or, for loan assets at amortised cost, the effective interest rate method. Interest income includes the amortisation of any discount or premium.

Dividend income from listed and unlisted securities is recognised as revenue when the right to receive payment is established. For listed securities this is the date the security is listed as ex-dividend.

Rental income from investment properties under operating leases is recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives received are recognised in the income statement as an integral part of the total lease income.

Determination of gains and losses and the movement in investment properties and financial assets at fair value through profit or loss are explained in notes 16 and 18.

a) Analysis of investment return

For the year ended 31 December	2013 £m	Restated ⁽ⁱ⁾ 2012 £m
Interest income:		
– assets at fair value through profit or loss	1,547	1,565
– loans and receivables	20	24
Net interest on net defined benefit liability ⁽ⁱⁱ⁾	1	3
Dividend income	1,548	1,636
Rental income	156	185
Movement in fair value:		
– investment properties	46	(103)
– financial assets or financial liabilities at fair value through profit or loss:		
– financial derivative instruments	(305)	57
– financial assets designated on initial recognition	5,766	5,676
Retranslation of foreign currency loans and borrowings	7	2
Total investment return	8,786	9,045

(i) As a result of the revision to IAS 19: *Employee benefits*, curtailment gains of £32 million have been presented within administrative expenses rather than within investment return. Refer to note 8 for further details.

(ii) Includes a £(2) million (2012: £nil) finance charge relating to penal tax recognised on the present value of pension deficit funding.

4. Investment return continued

b) Longer term investment return – IFRS based operating profit

The longer term investment return used in arriving at IFRS based operating profit before tax is calculated in respect of equity and fixed interest investments of shareholder funds and surplus assets held within long-term funds, by applying the longer term rate of return for each investment category to the quarterly weighted average of the corresponding assets, after adjusting for the effect of any short-term market movements. The longer term rates of return are based on assumed gilt and cash returns, adjusted where appropriate to reflect the additional risks associated with the type of investment. The directors have determined the assumptions to be applied as follows:

For the year ended 31 December	2013 %	2012 %
Equities	4.90	5.40
Government fixed interest	1.90	2.40
Other fixed interest	3.40	4.22
Cash (life and pensions business)	1.90	2.40
Cash (corporate)	0.70	1.35

The rate applied to cash held in the life and pensions businesses and government fixed interest investments reflects the annualised swap curve spot rate, based on the term of the gilt portfolio (typically around 10 years). The expected rate of return applied to equities and other fixed interest investments incorporates an additional risk premium of 3% (2012: 3%) and 1.5% (2012: 1.82%) respectively. The rate applied to the cash held at corporate level is the one year spot rate reflecting the typically short-term nature of those cash balances.

The longer term investment return also includes the return on the Group's external debt, including the STICS. The finance cost included within IFRS based operating profit reflects the actual coupon paid. This represents a refinement in estimation to reflect a more accurate view of the longer term cost of the Group's external debt. In previous periods operating finance costs were based on the market value of the debt instruments. The change has not had a material impact on the results of the Group.

c) Sensitivity of shareholder longer term investment return – IFRS based operating profit

For the year ended 31 December	2013 £m	2012 £m
Shareholder longer term investment return:	(69)	(23)
– After the impact of a 1% increase in the longer term rates of investment return	(47)	(4)
– After the impact of a 1% decrease in the longer term rates of investment return	(91)	(41)

d) Comparison of shareholder longer term and actual investment return – IFRS based operating profit

	2013 £m	2012 £m
Actual investment return attributable to shareholders	(98)	(44)
Longer term shareholder investment return	69	23
Deficit of actual shareholder return over longer term return	(29)	(21)

Short-term fluctuations in investment return reported in the consolidated statement of IFRS based operating profit of £182 million (2012: £275 million) comprises £(29) million deficit of actual shareholder return over longer term return (2012: £(21) million), as shown above, together with £211 million variance arising from investment variances and economic assumption changes on assets backing long-term business (2012: £197 million), and £nil benefit from the release of unit-linked tax loss provisions (2012: £99 million).

Notes to the consolidated accounts continued

5. Net claims and benefits paid

Insurance claims reflect the cost of all claims incurred during the year on insurance contracts, including claims handling costs. Death claims and surrenders are recognised on the basis of notifications received. Maturities and annuity payments are recorded when due. Claims and benefits recorded are accrued to the policyholder and included within insurance and investment contract liabilities, as appropriate.

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 general administrative costs directly attributable to the claims function.

Reinsurance recoveries are accounted for in the same period as the related claim.

	Gross claims and benefits paid £m	Amounts receivable from reinsurers £m	Total net claims and benefits paid £m
For the year ended 31 December 2013			
UK			
– Corporate benefits	9	–	9
– Protection	138	(67)	71
– Retirement income	61	–	61
Heritage			
– With-profits	2,329	(106)	2,223
– Pensions	248	–	248
– Investments	945	(1)	944
– Protection	217	(130)	87
– Annuities	525	(384)	141
FPI			
– Investments	18	–	18
– Protection	4	–	4
Total	4,494	(688)	3,806

	Restated gross claims and benefits paid £m	Restated amounts receivable from reinsurers £m	Restated total net claims and benefits paid £m
For the year ended 31 December 2012			
UK			
– Corporate benefits	5	–	5
– Protection	116	(68)	48
– Retirement income	48	–	48
Heritage			
– With-profits	1,979	(141)	1,838
– Pensions	206	(1)	205
– Investments	1,038	(22)	1,016
– Protection	172	(89)	83
– Annuities	591	(357)	234
FPI			
– Investments	16	(1)	15
– Protection	4	(1)	3
Total	4,175	(680)	3,495

5. Net claims and benefits paid continued

Net claims and benefits paid have been restated in the prior year following a review of investment contract disclosures. This has resulted in £146 million of gross claims and benefits paid and £13 million of reinsurance receivables being moved from Corporate benefits to Heritage With-profits (gross claims and benefits paid of £135 million and £13 million reinsurance receivables) and Heritage Pensions (gross claims and benefits paid of £11 million). Additionally, £123 million of amounts receivable from reinsurers have been moved from Heritage Pensions to Heritage With-profits.

Net claims and benefits are presented consistently with the disclosure of business segments, with each segment being broken down into the business units and products of which they are comprised.

6. Acquisition expenses

For both insurance contracts and investment contracts with DPF acquisition costs comprise all direct and indirect costs arising from writing the contracts, incurred during the financial period.

For investment contracts without DPF, acquisition costs comprise all incremental costs that are directly related to the writing of the contract, incurred during the financial period.

Where policyholder liabilities take into account all future cash flows, acquisition costs are expensed, rather than deferred. This treatment is applied to UK protection business, annuity business and all classes of business in the with-profits funds, which are accounted for on a realistic basis in accordance with UK Financial Reporting Standards ("FRS") 27: *Life assurance*. For other policyholder liabilities that do not take into account all future cash flows to recover the acquisition costs, such as investments, pensions and overseas business, acquisition costs are deferred, to the extent they are recoverable, and amortised over the life of the contracts.

For the year ended 31 December	2013 £m	2012 £m
Commission	225	323
Other acquisition expenses	437	486
Deferral	(171)	(274)
Amortisation and impairment of deferred acquisition costs ⁽ⁱ⁾	112	79
Net acquisition expenses	603	614

(i) For the year ended 31 December 2013 this includes an impairment charge of £(5) million (2012: £(8) million) in respect of the FPI segment's OLAB operations.

Notes to the consolidated accounts continued

7. Administrative and other expenses

Ongoing administrative and other expenses are recognised as incurred.

Payments made under operating leases, including any incentive payments, are recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives paid are recognised in the income statement over the term of the lease.

Recognition of provision related expenses is discussed in note 34.

a) Analysis of administrative and other expenses

For the year ended 31 December	2013 £m	Restated 2012 £m
Amortisation and impairment of intangible assets	483	514
Employee remuneration	213	171
Auditor's remuneration (note 7b)	7	6
Investment expenses and charges	271	248
Investment property expenses	6	8
Past service credit on defined benefit pension scheme ⁽ⁱ⁾	–	(32)
IT costs	50	36
Operating lease rentals, land and buildings	22	21
Renewal commission	59	62
Non-recurring costs (note 7c)	159	333
Other administrative expenses	190	230
Total administrative and other expenses	1,460	1,597

(i) As a result of the revision to IAS 19: *Employee benefits*, administrative expenses have been restated to include past service credit of £32 million for the year ended 31 December 2012. These were previously included within investment return.

7. Administrative and other expenses continued

b) Auditor's remuneration

During the year the Group obtained the following services from the Group's auditor, Ernst & Young LLP, at costs as detailed in the table below.

For the year ended 31 December	2013 £m	2012 £m
Audit of the financial statements	0.2	0.2
Audit of subsidiaries	3.9	4.0
Total audit	4.1	4.2
Audit related assurance services	1.2	1.1
Audit of Market Consistent Embedded Value ("MCEV") supplementary information	0.5	0.5
Total audit and audit related assurance services, including MCEV	5.8	5.8
Other services:		
Other assurance services	0.2	0.6
All taxation advisory services	0.1	0.1
Corporate finance services (excluding amounts included in other assurance services and all taxation advisory services)	0.4	–
Non-audit services not covered above	0.1	–
Total fees	6.6	6.5

In addition, £45,850 (2012: £45,850) was payable in respect of the audit of the Group pension schemes.

c) Non-recurring costs

Non-recurring costs for the year include charges related to separation and integration activities in respect of the acquired businesses, expenditure on enhancing systems and reporting processes including Solvency II, costs in respect of the transition and service improvement elements of the outsourcing arrangement with Diligenta and costs related to the capital optimisation programme.

8. Staff pension schemes

Closed defined benefit scheme

The pension asset or liability recognised in the balance sheet is the present obligation of the employer, which is the estimated present value of future benefits that employees have earned in return for their services in the current and prior years, less the value of the plan assets in the schemes. A pension surplus is recognised to the extent it is recoverable through refunds or expected reductions in future contributions. The rate used to discount pension obligations is determined by reference to market yields at the end of the reporting period on high quality corporate bonds. A qualified actuary performs the calculation of the present value of the defined benefit obligation annually using the projected unit credit method.

The pension costs for the scheme is charged to the income statement and consist of current service cost (prior to scheme closure), past service cost/(credit), net interest on net defined benefit liability (asset) and administrative costs incurred by the scheme.

The actuarial gains and losses, included within remeasurements of the defined benefit scheme, which arise from any new actuarial valuation or from updating the latest actuarial valuation to reflect conditions at the balance sheet date and any restrictions to recognised surpluses, are taken to the consolidated statement of comprehensive income.

Defined contribution arrangements

Contributions made to these arrangements are charged to the income statement as they become payable in accordance with the rules of the arrangements.

Notes to the consolidated accounts continued

8. Staff pension schemes continued

a) Introduction

On 1 January 2013, the Group set up a defined contribution scheme for UK employees as part of the "My Money" savings and investments platform, called the Flexible Retirement Account ("FRA"). Employer contributions are typically in the range 6.3% to 13% depending on contribution levels selected by members and the platform has a minimum employer plus member contribution level of 9.3% of pensionable salary (basic annual salary up to a defined earnings cap). The FRA has been used for auto-enrolment from the Group's UK staging date of July 2013.

The Group has one closed defined benefit scheme: the Friends Provident Pension Scheme ("FPPS"), which closed to active membership at 31 December 2012.

FPIL and SBG operate defined contribution arrangements. Lombard does not operate a pension scheme.

b) Closed FPPS defined benefit scheme overview

On an IAS 19: *Employee benefits* (Revised 2011) basis, a gross deficit of £(4) million has been recognised in respect of the FPPS at 31 December 2013 (2012: surplus of £62 million). A deficit reduction plan was entered into during January 2013 based on the triennial valuation as at 30 September 2011, which showed a deficit on a funding basis of £185 million. That plan set out a new schedule of deficit reduction contributions of £175 million, in addition to a £20 million payment which was made in July 2012 and £20 million in July 2013 under the previous deficit reduction plan. The new recovery plan commenced in January 2013 with a payment of £1.5 million, and a further £1.5 million has been paid in July 2013 in addition to the £20 million previously agreed. Further deficit reduction contributions totalling £172 million will be paid into the scheme, with payments of £21.5 million to be made by 31 July each year for the next eight years from 2014 to 2021.

Under IFRIC 14, deficit reduction contributions are considered to be a minimum funding requirement and, to the extent that the contributions payable will not be available after they are paid into the scheme, a liability is recognised when the obligation arises. In accordance with s207(4) Finance Act 2004, an additional liability of £48 million has been recognised at 31 December 2013 (2012: £29 million), reflecting the 35% tax that would arise on any notional refund in respect of the resultant IAS 19 surplus of £132 million (£172 million of deficit reduction contributions at a present value of £136 million, partially offset by the current deficit of £(4) million). A deferred tax asset of £34 million (2012: £5 million) has also been recognised to reflect tax relief at a rate of 20% (2012: 23%) that is expected to be available on the deficit reduction contributions, in future periods.

An analysis of the amounts recognised in the financial statements in respect of the FPPS is set out below.

Amounts recognised in the consolidated statement of financial position

As at 31 December	2013 £m	2012 £m
IAS 19 (deficit)/surplus (excluding deficit reduction contribution)	(4)	62
Authorised payments surplus charge (penal tax) at 35% of available surplus following deficit reduction contribution, discounted to present value ⁽ⁱ⁾	(48)	(29)
Net pension (deficit)/surplus (excluding deficit reduction contribution)	(52)	33

(i) Included in the charge for the year ended 31 December 2013 is a finance charge of £(2) million (2012: £nil) relating to penal tax on the present value of pension deficit funding, which is recognised in the consolidated income statement.

8. Staff pension schemes continued

Movement in IAS 19 pension surplus

	2013 £m	Restated ^(iv) 2012 £m
For the year ended 31 December		
Pension surplus at 1 January	62	52
Current service cost ⁽ⁱ⁾	–	(7)
Past service credit ⁽ⁱⁱ⁾	–	32
Net interest on net defined benefit liability (asset) ⁽ⁱⁱⁱ⁾	3	3
Employer contributions	28	27
Remeasurement losses	(96)	(45)
Administration costs ⁽ⁱ⁾	(1)	–
Pension (deficit)/surplus	(4)	62
Present value of deficit reduction contributions	136	20
Available surplus subject to authorised payments surplus charge	132	82

(i) Recognised in the consolidated income statement.

(ii) The restated past service credit for 2012 includes two credits resulting from curtailment gains arising within the FPPS, £10 million on the Diligenta outsourcing agreement entered into by the Group in January 2012 and £22 million as a result of the closure of the FPPS to future accrual in the second half of 2012.

(iii) The actual return on plan assets for the year ended 31 December 2013 is £81 million (31 December 2012: £64 million).

(iv) As a result of the revision to IAS 19: *Employee benefits*, comparatives have been restated as follows:

- Service cost is now split into current service cost and past service credit.
- Curtailment gains of £32 million for the year ended 31 December 2012 are now presented as a past service credit. These were previously included within investment return.
- Remeasurement gains and losses are now presented as remeasurements of the net defined benefit liability (asset).
- Interest cost and expected return on plan assets have been replaced with net interest on net defined benefit liability (asset) calculated by applying the discount rate used to measure the defined benefit obligation to the net defined benefit liability (asset).

The total gain recognised in the income statement for the year ended 31 December 2013 was £nil (2012: gain of £28 million). In addition to the amounts shown in the table above, a finance charge of £(2) million (2012: £nil) relating to penal tax on the present value of pension deficit funding has also been recognised in the income statement.

Analysis of net pension surplus and related deferred tax asset

	Pension deficit £m	Deferred tax £m
As at 31 December 2013		
Gross IAS 19 pension deficit and related deferred tax asset	(4)	1
Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus) ⁽ⁱ⁾	(48)	–
Restriction of asset due to authorised payments surplus charge	–	(1)
Tax relief available on deficit reduction contributions	–	34
Net pension deficit and related deferred tax asset	(52)	34

(i) Includes a finance charge of £(2) million (2012: £nil) relating to penal tax on the present value of pension deficit funding.

	Pension surplus £m	Deferred tax £m
As at 31 December 2012		
Gross IAS 19 pension surplus and related deferred tax liability	62	(14)
Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus)	(29)	–
Restriction of liability due to authorised payments surplus charge	–	14
Tax relief available on deficit reduction contributions	–	5
Net pension surplus and related deferred tax asset	33	5

Notes to the consolidated accounts continued

8. Staff pension schemes continued

Remeasurement losses recognised in the consolidated statement of comprehensive income

	2013 £m	Restated 2012 £m
For the year ended 31 December		
Remeasurement losses:		
– actuarial losses of the defined benefit scheme	(117)	(46)
– return on pension asset (excluding amounts included in net interest on net defined benefit liability)	21	1
– irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus) ⁽ⁱ⁾	(17)	3
Remeasurement losses of the defined benefit scheme	(113)	(42)
Taxation	36	7
Remeasurement losses of the net defined benefit scheme after tax	(77)	(35)

(i) An additional finance charge of £(2) million (2012: £nil) is also recognised in the consolidated income statement relating to penal tax on the present value of pension deficit funding.

A tax credit of £34 million (2012: charge of £(5) million) in respect of deficit reduction contributions and a further credit of £2 million (2012: credit of £12 million) in respect of other movements in the pension scheme are included in the aggregate tax line for items that will not be reclassified to profit and loss in the consolidated statement of comprehensive income.

c) FPPS additional disclosures

i) Principal assumptions used by the Scheme Actuary in calculating the scheme liabilities

For the year ended 31 December	2013 %	2012 %
Rate of increase in salaries ⁽ⁱ⁾	n/a	3.00
Rate of increase for pensions in payment	Relevant RPI inflation swap curve	Relevant RPI inflation swap curve
Rate of increase for deferred benefits	Relevant RPI inflation swap curve less 75 bps	Relevant RPI inflation swap curve less 75 bps
Discount rate for deferred members (and active members in 2012)	4.48	4.75
Discount rate for pensioners	4.31	4.20
Single equivalent discount rate	4.41	4.51

(i) For 2012, a fixed rate of salary increases assumed for two years of 3% then salary increases at National Average Earnings (assumed retail price index ("RPI") + 1%) plus an allowance for salary scale increases. With the closure of the scheme as at 31 December 2012, all active members became deferred members and the impact of the 2012 salary assumptions are reflected in the past service costs noted.

The inflation rate assumptions for revaluation of deferred pensions in excess of Guaranteed Minimum Pensions ("GMPs") have been based on the consumer price index as the statutory inflation index. The scheme applies the revaluation factors published by the Government with the factors based on the higher compound cap of 5% per annum applied in respect of benefits accrued up to 31 December 2010 and on the lower compound cap of 2.5% per annum applied for benefits between 1 January 2011 and 31 December 2012 (when the scheme closed to active membership).

Pensions in payment in excess of the GMPs accrued up to 31 December 2010 will increase each year in line with the RPI with a minimum of zero and a maximum of 5% and pension accrued from 1 January 2011 to 31 December 2012 (when the scheme closed to active membership) will increase each year in line with the RPI with a minimum of zero and a maximum of 2.5%.

ii) Mortality assumptions

Mortality assumptions are a proportion of the "SAPS-All" series mortality tables published by the Continuous Mortality Investigations ("CMI"), with proportions varying by sex and by status determined from an analysis of the members' postcodes and annual pension amounts:

Proportion of "SAPS-All" likelihood of death in any year:	2013 %	2012 %
Male pensioner	83	83
Female pensioner	98	98
Male non-pensioner	90	90
Female non-pensioner	100	100

8. Staff pension schemes continued

In addition, allowance is made for future improvements in mortality according to each individual's year of birth through the use of the CMI's 2011 projection method, with a long-term trend parameter of 1.5% p.a. The mortality assumptions provide the following average life expectancies of future pensioners currently aged 46 retiring at the age of 60, and current pensioners aged 70.

For the year ended 31 December	2013 years	2012 years
Expected age at death of future male pensioner	90	90
Expected age at death of future female pensioner	92	92
Expected age at death of current male pensioner	89	89
Expected age at death of current female pensioner	90	90

The present value of providing an annuity of £1 per annum for members aged 60, based on the above assumptions, is as follows:

Cost of annuities	2013 £	2012 £
Male annuity	28.32	25.69
Female annuity	27.25	24.75

These rates assume a monthly payments model with a discount rate of 4.48% (2012: 4.75%). The rates also assume two-thirds of the members' benefit will be paid to the spouse or civil partner on the death of the member. A guarantee is provided for pensioners who die within five years of retiring. Pensions in payment in excess of the GMPs accrued up to 31 December 2010 will increase in line with the RPI with a minimum of zero and a maximum of 5% and accrued from 1 January 2011 to 31 December 2012 (when the scheme closed to active membership) will increase in line with the RPI with a minimum of zero and a maximum of 2.5%.

Cost of annuities	2013 % of total membership	2012 % of total membership
Deferred members	71	72
Pensioners	29	28
	100	100

The cost of providing pensioner benefits for members who retired before 30 June 2013 is met by the insurance contract with Aviva Annuity UK Limited (see section (vii) below).

The sensitivities regarding the principal assumptions used to measure the scheme assets/liabilities are set out below:

Assumption	Increase/ (decrease) in assumption %	Increase/ (decrease) in scheme liabilities % ⁽ⁱ⁾	Increase/ (decrease) in balance sheet deficit £m ⁽ⁱⁱ⁾
Inflation ⁽ⁱⁱⁱ⁾	0.5	10.0	20
CPI ^(iv)	0.5	5.0	60
Salaries	0.5	0.0	0
Pension increases in payment	0.5	7.0	n/a ^(v)
Discount rate ^(vi)	0.5	(12.0)	(40)
Rate of mortality	1 year	2.5	20

- (i) The value of the insured asset is set equal to the defined benefit obligation of the corresponding insured members. Changes to the value of the defined benefit obligation relating to these members as a result of changes to expected future inflation or interest rates (or of mortality experience differing from that expected) are completely offset by corresponding changes to the insured asset value.
- (ii) In respect of the assets not held on annuities, the scheme has a hedging strategy in place, based on swap contracts overlaying the bond portfolio, which aims to reduce volatility in the statement of financial position and profit and loss account. Broadly the scheme has hedging that covers 65% of the nominal swap interest rate movements and 90% of the RPI inflation movements on the scheme's funding valuation basis. We have assumed no change to asset values other than the swap portfolio.
- (iii) Assuming that expectations of future RPI and CPI increase by 0.5%, and that expectations of future annual pension increases (LPI) in payment increase by a proportionate amount.
- (iv) Assuming that expectations of future CPI increase by 0.5%, and that RPI inflation and associated RPI based increases are unchanged.
- (v) Sensitivity to changes in pension increases included in balance sheet inflation sensitivity.
- (vi) Assuming a change to interest rates but no change to the implied spread between corporate bond yields and nominal swap yields (i.e. nominal swap yields also change leading to the change in swap value partially offsetting the change in liabilities. If corporate bond yields change differently to nominal swap yields this may lead to a mismatch in the change to the IAS19 liabilities and the swap portfolio).

Notes to the consolidated accounts continued

8. Staff pension schemes continued

The sensitivity information has been derived for the FPPS using projected cash flows for the scheme valued using the relevant assumptions and membership profile as at 31 December 2013. Extrapolation of these results beyond the sensitivity figures shown may not be appropriate.

The methods and types of assumptions used in preparing the sensitivity analysis did not change compared to the previous period.

In addition to the annuities held by the scheme, the scheme partially hedges its exposure to inflation risk and nominal risk for the deferred liability by investing in liability driven investments including RPI and nominal swaps. This hedging strategy serves to reduce volatility in the statement of financial position and income statement. Broadly the scheme has hedging that covers 65% of the interest rate movements and 90% of the inflation movements. As such a 0.25% increase in interest rates would reduce liabilities by £80 million and a 0.25% increase in inflation would increase liabilities by £71 million.

iii) Changes in the present value of defined benefit obligations

	2013 £m	Restated 2012 £m
For the year ended 31 December		
Present value of obligations at 1 January	1,282	1,242
Interest cost	57	60
Current service cost	–	7
Past service credit	–	(32)
Actuarial losses of the defined benefit scheme:		
- Losses from change in financial assumptions	117	42
- Experience losses	–	4
Benefits paid	(42)	(41)
Present value of obligations at 31 December	1,414	1,282

iv) Analysis of defined benefit obligations

The profile of the obligations is analysed as follows:

As at 31 December	2013 £m	2012 £m
Deferred members	829	716
Pensioners	585	566
Wholly or partly funded plans	1,414	1,282

The weighted average duration of obligations is analysed as follows:

	2013 Years	2012 Years
Deferred members	28	26
Pensioners	14	14

The maturity profile of the obligations is analysed as follows:

Expected benefit payments for the years ending:	£m
31 December 2014	33
31 December 2015	34
31 December 2016	36
31 December 2017	37
Expected benefit payments for the years ending 2018 to 31 December 2023	277

8. Staff pension schemes continued

v) Changes in fair value of defined benefit plan assets

	2013 £m	Restated 2012 £m
For the year ended 31 December		
Fair value of plan assets at 1 January	1,344	1,294
Interest income on plan assets	60	63
Return on plan assets, excluding amounts included in net interest on the defined benefit liability (asset)	21	1
Employer contributions	28	27
Benefits paid	(42)	(41)
Administrative expenses	(1)	–
Fair value of plan assets at 31 December	1,410	1,344

At 31 December 2013, there are no investments in internal linked funds (2012: £nil).

vi) Assets in the defined benefit scheme

	Fair value 2013 £m	Fair value 2012 £m
Equities by geographical location:		
– UK	33	28
– Rest of Europe	37	38
– North America	80	69
– Latin America	10	12
– Asia Pacific	46	54
Total equities	206	201
Liability-driven investment (“LDI”) pools	400	385
Fixed interest (LDI in specie)	196	170
Insured assets	586	559
Cash	22	29
Total fair value of plan assets	1,410	1,344
Present value of defined benefit obligations	(1,414)	(1,282)
(Deficit)/surplus in the scheme	(4)	62

All equities and fixed interest (LDI in specie) investments are quoted in an active market.

Notes to the consolidated accounts continued

8. Staff pension schemes continued

vii) Future funding

As stated in section (b), a deficit reduction plan was entered into during January 2013 based on the triennial valuation as at 30 September 2011, which showed a deficit on a funding basis of £185 million. That plan set out a new schedule of deficit reduction contributions of £175 million, in addition to a £20 million payment which was made in July 2012 and £20 million in July 2013 under the previous deficit reduction plan. The new recovery plan commenced in January 2013 with a payment of £1.5 million, and a further £1.5 million has been paid in July 2013 in addition to the £20 million previously agreed. Further deficit reduction contributions totalling £172 million will be paid into the scheme, with payments of £21.5 million to be made by 31 July each year for the next eight years from 2014 to 2021.

From 1 July 2007 the scheme has been closed to new members and was closed to active membership effective from 31 December 2012.

Existing member contributions were 7% in 2012 for benefits with a pension age of 60, and 2% for benefits with a pension age of 65. The Group paid contributions of 15% in 2012 plus a shortfall contribution paid in January 2013, agreed with the Trustee, of £4 million for the cost of accrual between 1 October 2011 and 31 December 2012.

A Statement of Funding Principles was agreed by the Group and the Trustee in January 2013. That statement provides the principles around assumption setting, in particular, choosing the discount rate, future price inflation, future pension increases, rates of mortality, pension commencement age, and typical partner or dependant information and assumes:

- the discounted value of the annuity contract with Aviva Annuity UK Limited ("Aviva") will exactly match the discounted liabilities for pensioners insured under the contract. The pensions in payment up to 30 June 2013 have now been reassured by the Trustees to Aviva under a buy-in annuity contract where the premium progressively transfers from the Trustee to Aviva over the duration of the contract; and
- the discounted value of non-insured liabilities will be measured using an interest rate swap curve plus a margin of 0.75%, reflecting an expected return on the scheme's other investments equivalent to swap yields, and the strategic allocation of 25% of the scheme's non-annuity investments in equities.

In addition the Trustee has the following objectives for investments, as set out in the Statement of Investment Principles:

- to achieve and maintain a minimum funding level of 100% on a long-term ongoing basis; and
- to agree the cost of providing the benefits and consult the Employer on any material changes that may be required to the agreed funding arrangements in light of experience.

Amounts paid to FPPS in the past three years and expected future payments over the next two years are as follows:

	£m
FPPS (DB) contributions paid	
2011	33
2012	27
2013	23
FPPS contributions expected to be paid	
2014 ⁽ⁱ⁾	23
2015 ⁽ⁱ⁾	23

(i) Includes contributions to cover administration expenses incurred within the scheme of £1 million per annum.

viii) Risk management

The present value of the scheme's obligations and the market value of assets are volatile with the values at any given date being dependent on financial market conditions at that date. A number of steps have been taken to minimise the relative volatility of the scheme's obligations and the market value of assets when determining the investment strategy. The scheme's assets, which are administered by five external investment managers, are held under the control of the Trustee and used to secure benefits for the members of the scheme and their dependants in accordance with the Trust Deed and Rules. The Trustee Board consists of a chairman who is appointed by the employer and six additional directors of which three are employer-appointed directors and three are members nominated trustee directors.

The Trustee operated a Risk and Investment Subcommittee ("RISC") which was responsible for assisting the Trustee in investment policy and monitoring the scheme's investments. The Trustee has updated the committee structure in 2014. RISC has become the Investment and Funding Committee ("IFC") with an updated scope. The Trustee has introduced an Operations Committee ("OC"). The Trustee and its committees seek advice from the investment adviser, the funding adviser, the covenant adviser and the legal adviser and believe they have sufficient skills and expertise to make decisions taking into account this advice.

The Trustee sets general investment policy but delegates day-to-day responsibility for the selection of specific investments (other than investments in respect of members' voluntary contributions) to the Investment Manager.

The Trustee has set performance and risk targets for the Investment Manager on non-insured assets. The performance objectives are long term (five years), however, the Trustee monitors the Investment Manager on a regular basis in order to ensure that it is on track to meet its long-term objectives.

8. Staff pension schemes continued

Interest rate and inflation risk

The Trustee originally adopted a LDI strategy in 2003 to reduce exposure to interest rate and inflation risk. This strategy was extended in 2008 to reduce exposure to a wider range of risks in respect of pensions in payment through investing in an insured bulk annuity buy-in contract that covers pensions in payment up to 30 June 2013. The trustee also invests in a pooled LDI product managed by F&C Asset Management ("F&C") to reduce exposure to interest rate and inflation risk for some non insured liabilities. Within F&C's pooled product, the Trustee now has a bespoke pool in which the Trustee is the sole investor. Under the bespoke LDI pool, F&C manage fixed interest securities together with interest rate and inflation swaps that can have durations of up to 50 years or potentially longer if appropriate market instruments become available. The LDI product is collateralised daily and is managed within a controlled leverage range by F&C; the LDI pools have a weekly investment valuation. European Market Infrastructure Regulation ("EMIR") imposes requirements on derivatives including swaps contracts. F&C are managing the progressive implementation and implications of EMIR for pension scheme investors in its LDI pools and LDI investments are subject to monitoring and review.

The allocation to matched assets including the bespoke LDI pool, cash and fixed interest is currently 75% of the non insured assets.

It is acknowledged that when considering the present value of obligations under IAS 19 there is an inconsistency between the discount rate used to value the obligations (which is derived with reference to corporate bonds) and the 'swap' interest rates underlying the LDI pool and there is therefore a risk that these two interest rates will not move in line with each other.

The buy-in annuity contract mitigates a wider range of risks than the original LDI strategy and for the pensions in payment that have been progressively insured up to 30 June 2013, covers market and longevity risk in addition to interest rate and inflation risk.

Market risk

The Trustee, with the full support of the Group, has agreed and implemented a strategic asset allocation to return-seeking assets of 25% of the non-insured fund.

Longevity risk

The Trustee, with the full support and involvement of the Group, first invested in a bulk annuity contract with Aviva as a buy-in investment in 2008 with further tranches of investment in each of the years from 2009 to 2013. No more tranches will be placed under the 2008 contract. The contract reassures benefits for pensioners in payment up to 30 June 2013. The contract is an investment of the Trustee and includes additional security to that of a standard bulk annuity contract with an insurance company. The ownership of the scheme's assets are being drip fed to Aviva over the duration of the contract. This additional protection has been negotiated by the Trustee to mitigate the risk of any decline in the financial strength of Aviva as the counterparty under the contract. This was a general requirement of the tender process for any counterparty to be selected. These assets have been set up under a ring-fenced Trustee Investment Plan that is managed by Aviva and with the title to those assets secured in the Trustee's name through a safekeeping custody account set up with Citibank. These ring-fenced assets would only be accessed by the Trustee in the event of Aviva failing to meet its obligations under this long-term contract.

Currency risk

The Trustee has some exposure to currency risk by investing the scheme's return seeking assets in global equities. The two managers appointed by the Trustee, Aberdeen Asset Management Life & Pensions Limited and Walter Scott & Partners Limited, take account of currency risks within their pooled fund vehicles.

Operational risk

The investment managers do not directly hold the scheme's securities for non-insured assets. These non-insured assets are held in separate accounts with custodians, as appointed by the Investment Manager for pooled vehicles or by the Trustee for non-pooled investments. Special arrangements noted above apply to insured assets under the Aviva contract.

Notes to the consolidated accounts continued

8. Staff pension schemes continued

d) Other pension arrangements

Contributions to the defined contribution schemes were as follows:

For the year ended 31 December	2013 £m	2012 £m
Group Personal Pension Plan	17.1	12.2
FPI	1.2	1.0
SBG	0.7	0.8

On 1 January 2013, the Group set up a defined contribution arrangement for UK employees as part of the "My Money" savings and investments platform, called the Flexible Retirement Account ("FRA"). Employer contributions are typically in the range 6.3% to 13% depending on contribution levels selected by members and the arrangement has a minimum employer plus member contribution level of 9.3% of pensionable salary (basic annual salary up to a defined earnings cap). The FRA has been used for auto-enrolment from the Group's UK staging date of July 2013 and each member has their own personal pension.

The FRA replaced the previous Group Personal Pension arrangements that were provided for UK employees during 2012, which closed to future contributions from 31 December 2012.

9. Share-based payments

The Group offers share-based payment plans to certain key employees. The expense charged to the income statement is based upon the fair value of the options granted, the vesting period and the vesting conditions. Fair values are determined using stochastic and scenario-based modelling techniques where appropriate.

For equity-settled schemes, the fair value is determined at grant date and expensed on a straight-line basis over the vesting period in the income statement. A corresponding amount is credited to equity. At each reporting date the Group revises its estimates of the number of shares that are expected to be issued and recognises the impact of the revision of original estimates, if any, in the income statement, with a corresponding adjustment to equity over the remaining vesting period. Where a leaver is entitled to their scheme benefits, this is treated as an acceleration of vesting and hence a shortening of the period over which the expense is charged.

For cash-settled schemes, the fair value is expensed on a straight-line basis over the vesting period in the income statement and the cumulative provision for obligations under cash-settled schemes is recognised as a liability in the statement of financial position. The fair value is re-measured at each reporting date, with any changes in fair value recognised in the income statement for the period.

Lombard International Assurance SA

Description of the schemes

i) Equity based scheme

Lombard senior management have been incentivised through a scheme that entitles them to share in the growth in value in Lombard. The scheme is an equity-settled share-based payment scheme. Subject to achievement of performance conditions, the scheme entitles participants to shares in Resolution Limited. The scheme lasts for six years, with 25% of the value accruing on the third, fourth, fifth and sixth anniversary of the scheme, with an effective start date of 1 January 2009. Scheme participants purchase shares in Lombard when they join the scheme. As at 31 December 2013 participants owned 0.4 million shares in Lombard (2012: 0.8 million). A total of 0.3 million Lombard shares (2012: 0.5 million) were repurchased by the Group in June 2013 as part of the 2013 scheme payout and 0.1 million Lombard shares (2012: 0.3 million) were returned by scheme leavers.

The scheme's fair value on the commencement date was the best estimate of the cost of the scheme, based on probability weighted performance scenarios to estimate the number of awards expected to vest. This initially resulted in a fair value of £10 million to be expensed over the six-year term of the scheme.

During 2010, the terms of the scheme were modified resulting in the fair value of the scheme increasing from £10 million to £22 million. This increased the total expense by £12 million spread over the years 2010 to 2015.

In 2013 and 2012, being the fourth and third anniversaries respectively following the commencement of the scheme, independent assessments were carried out to determine whether performance conditions had been met to require payouts under the terms of the scheme. The assessments concluded that performance conditions had been met and accordingly Lombard senior management received shares in Resolution Limited equating to a total market value of £4 million (2012: £5 million). No new Resolution Limited shares were issued in connection with these payouts under the scheme.

A charge of £(2) million has been recognised in the consolidated income statement in respect of this scheme in 2013 (2012: £(4) million) with a corresponding increase to equity.

9. Share-based payments continued

ii) Cash based schemes

Lombard middle management are incentivised through a scheme that entitles them to cash payments, based on a valuation of the Lombard business as at 31 December each maturity year. The first allocations were granted to participants in April 2010 and the first pay-outs occurred in 2013.

In order to estimate the required liability, as each tranche of the scheme has a duration of three years, stochastic modelling techniques (based on option pricing methodology) are used to calculate both the intrinsic value and the time value of the liability under the scheme.

A charge of £nil has been recognised in the consolidated income statement (2012: £(1) million) and a corresponding liability is included in the consolidated statement of financial position. The total liability as at 31 December 2013 is £2 million (2012: £2 million).

A cash-settled retention bonus plan was put in place alongside, but separate to, the equity based scheme, enabling participants to receive a return of their initial investment if certain performance conditions are met.

A charge of £nil has been recognised in the consolidated income statement (2012: £(4) million) and a corresponding liability is included in the consolidated statement of financial position. A total of £1 million (2012: £2 million) was paid out to the scheme participants in the year with a resultant total liability as at 31 December 2013 of £1 million (2012: £2 million).

Friends Life group

Description of the schemes

i) Long Term Incentive Plan ("LTIP")

The Company introduced a LTIP in 2010 to incentivise key individuals in the business by entitling them to a percentage share in the difference between the value realised from the Friends Life group (for example through payment of dividends to the Resolution holding companies) and the aggregate cost of the acquired Friends Life companies.

The scheme was originally set up as a cash-settled share-based payment scheme. The fair value of the awards in issue, being the relevant percentage of the value expected to emerge from the Friends Life group, was measured at each reporting date, with any changes in fair value being recognised in the consolidated income statement for the period.

The scheme was modified in May 2013 in order to continue to properly incentivise the Group's senior executives following the change in the Group's strategy, as announced in August 2012. The LTIP was primarily designed to mature on an exit by the Company from the Friends Life business, provided that a 12% internal rate of return had been achieved. As the Company strategy is no longer focused on an exit event, the LTIP terms have been amended so that the implicit need for an exit event is replaced with a market value based calculation to measure performance, without altering the required internal rate of return.

As part of the modification, the obligation to settle the scheme passed from Friends Life Group plc ("FLG") to the Company. The change to the scheme has been accounted for as a modification under IFRS 2: *Share based payment*. The modified scheme is an equity-settled scheme, settled in three tranches of shares in Resolution Limited over 2015 to 2017. The scheme has been valued using economic scenario generators ("ESGs"), with key inputs as follows:

Volatility: 28%

Risk free rate: 0.61% – 0.81%

Dividend yield: 7%

The cumulative charge calculated for the original scheme to modification date at 16 May 2013 was £3 million lower than the cash-settled provision of £5 million reported at 31 December 2012. This reduction has been credited to the income statement and the remaining provision of £2 million transferred to equity. The total scheme value, calculated at modification date, is £6 million. The remaining charge of £(4) million for the modified equity scheme will be expensed over the vesting period to 2017.

Units are pro-rated according to service period. The total number of pro-rated units capable of being awarded is 10,000 and awards are allocated in single units of 1/10,000 of this number. The number of awards issued in the period was 2,600 and 450 were forfeited before pro-rating (2012: 3,700 and 1,100 respectively). At 31 December 2013 there were 10,075 in issue before pro-rating (2012: 7,925). The pro-rated number of awards in issue at 31 December 2013 was 6,354 (2012: 7,925). Since modification, an expense charge of £(1) million has been recognised in the consolidated income statement with a corresponding increase in equity (2012: a credit of £2 million was recognised in the consolidated income statement with a corresponding decrease in the provision in the consolidated statement of financial position).

ii) Deferred Share Award Plan ("DSAP")

Certain key management have one-third of any annual bonus deferred into shares in Resolution Limited for a period of three years. The awards are accounted for as equity-settled schemes. The fair value of these schemes is calculated at each award date based upon the number of shares awarded and the expense charge is recognised over the course of the vesting period.

A charge of £(1) million (2012: £(1) million) has been recognised in the consolidated income statement in respect of these schemes with a corresponding increase in equity is included in the consolidated statement of financial position.

Notes to the consolidated accounts continued

9. Share-based payments continued

iii) Share awards

Certain directors are entitled to cash and shares in Resolution Limited to compensate them for awards they forfeited from their previous employer as a result of joining FLG. The share elements of these awards are treated as equity-settled schemes. The fair value of these schemes is estimated at the grant date and is recognised over the course of the vesting periods.

A charge of £(1) million (2012: £(1)million) has been recognised in the consolidated income statement in respect of these schemes and a corresponding increase in equity of £1 million (2012: £1 million) is included in the consolidated statement of financial position.

Sesame Bankhall Group

Description of the scheme

Key management of SBG were incentivised through a cash-settled scheme that entitled them to a share in the growth of SBG via ownership of shares in Friends Life Distribution Limited ("FLDL"); the immediate parent of the SBG companies. As at 31 December 2012 a liability of £9 million had been recognised in the consolidated statement of financial position in respect of this scheme. During 2013 the scheme was settled via the purchase of management's shares in FLDL by Friends Provident Distribution Holdings Limited for an initial consideration of £4 million with the potential for further contingent consideration being payable in the future depending on the value generated by the SBG companies. As at 31 December 2013 it was determined that no provision was required in relation to the contingent future consideration payable.

10. Finance costs

Interest expense is calculated using the effective interest rate method.

For the year ended 31 December	2013 £m	2012 £m
Subordinated loan interest	87	62
Deferred consideration notes interest	–	23
Interest payable to reinsurers	47	58
Interest payable to credit institutions	8	14
Total finance costs	142	157

Interest payable to reinsurers represents payments in relation to a reinsurance treaty as detailed in note 32.

11. Taxation

Current tax is based on profits and income for the period as determined in accordance with the relevant tax legislation, together with adjustments to provisions for prior periods.

Tax payable is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

The tax charge is analysed between tax in respect of income and investment return on the policyholders' interest in the with-profits and linked fund assets, representing policyholders' tax, with the balance being tax on equity holders' investment return and profits, representing shareholders' tax.

Deferred tax is recognised in the income statement for the period, except to the extent that it is attributable to items that are recognised in the same or a different period outside the income statement, in which case the deferred tax will be recognised in other comprehensive income or equity, as applicable.

11. Taxation continued

a) Tax recognised in the consolidated income statement

For the year ended 31 December	2013 £m	2012 £m
Current tax		
UK corporation tax at 23.25% (2012: 24.5%)	1	68
Adjustments in respect of prior periods	(6)	(4)
Overseas tax	19	11
Total current tax charge	14	75
Deferred tax		
Origination and reversal of temporary differences	240	92
Change in tax rates	(70)	(61)
Recognition of deferred tax assets previously unrecognised	(50)	–
Adjustments in respect of prior periods	–	1
Total deferred tax charge	120	32
Total tax charge	134	107
Analysis:		
– policyholder tax	334	258
– shareholder tax	(200)	(151)
Total tax charge	134	107

Legislation was enacted in 2012 to bring a decrease in the rate of corporation tax from 24% on 1 April 2012 to 23% on 1 April 2013. During the year legislation was enacted to reduce the rate to 21% from 1 April 2014 and 20% from 1 April 2015. Under IFRS, deferred tax is calculated using rates substantively enacted by the reporting date and as such the reduction to a 20% rate has been taken into account in deferred tax balances. The average rate of corporation tax for the full calendar year is 23.25%.

b) Factors affecting tax charge for year

For the year ended 31 December	2013 £m	2012 £m
Profit before tax from continuing operations	369	66
Profit before tax from continuing operations determined with reference to the average rate of corporation tax in the UK of 23.25% (2012: 24.5%)	86	16
Effects of:		
– non-taxable income	(106)	(120)
– deductions not allowable for tax purposes	(9)	26
– tax on reserving adjustments and other IFRS adjustments	–	24
– overseas tax	(5)	(10)
– valuation of tax assets and liabilities	(49)	(75)
– valuation of unrealised capital losses	–	43
– adjustments in respect of prior periods	(21)	(2)
– impact of reduction in corporation tax rate to 20% (2012: 23%) on deferred tax asset/liability	(70)	(61)
– non-taxable result of Resolution holding companies	–	8
– policyholder tax	334	258
– other	(26)	–
Total tax charge	134	107

Notes to the consolidated accounts continued

12. Appropriations of profit

Dividends approved by ordinary shareholders are recognised as a liability on the date of approval and dividends declared by directors are recognised on the date of payment. Dividends are charged directly to equity. Dividends declared after the balance sheet date are not accrued in these accounts.

The Step-up tier one Insurance Capital Securities ("STICS") are accounted for as equity instruments under IFRS, as there is no requirement to settle the obligation in cash or another financial asset. Consistent with this equity classification, interest on these instruments is not treated as an expense but as an appropriation of profit, charged directly to equity, together with the related tax relief.

a) Dividends paid on ordinary shares

A final dividend in respect of 2012 of 14.09 pence per share was paid on 20 May 2013 totalling £200 million. An interim dividend of 7.05 pence per ordinary share was paid on 4 October 2013 amounting to £100 million.

Subject to the approval of shareholders at the annual general meeting on 8 May 2014, a final dividend of 14.09 pence per share will be paid on 16 May 2014 amounting to £200 million. This amount is not reflected in these financial statements. Shareholders have been offered a dividend reinvestment plan ("DRIP"), which allows them to purchase additional shares on the dividend payment date from the proceeds of their cash dividend.

b) Step-up tier one Insurance Capital Securities interest

Interest on the 2003 STICS is paid in equal instalments in May and November each year at a rate of 6.875%. During the year ended 31 December 2013, interest of £14 million (2012: £14 million) was paid to the 2003 STICS holders.

Interest on the 2005 STICS is paid annually in June at a rate of 6.292%. During the year ended 31 December 2013, interest of £17 million (2012: £17 million) was paid to the 2005 STICS holders.

13. Earnings per share

a) Basic and operating earnings per share from continuing operations

Earnings per share have been calculated based on the profit or loss after tax and on the operating profit after tax attributable to equity holders of the parent and the weighted number of shares in issue adjusted for own shares held. The directors consider that operating earnings per share provides a better indication of the performance of the Group.

For the year ended 31 December	2013 Earnings £m	2013 Pence per share	2012 Earnings £m	2012 Pence per share
Profit/(loss) after tax attributable to equity holders of the parent	204	14.39	(72)	(5.17)
Add back:				
– short-term fluctuations in investment return	(182)	(12.85)	(275)	(19.76)
– non-recurring items	131	9.24	258	18.54
– amortisation and impairment of acquired intangible assets	483	34.07	514	36.94
– tax credit on items excluded from operating profit	(196)	(13.82)	(149)	(10.71)
Operating profit after tax attributable to equity holders of the parent	440	31.03	276	19.84

b) Diluted basic earnings per share from continuing operations

i) Based on profit after tax attributable to equity holders of the parent

For the year ended 31 December	2013 Earnings £m	2013 Weighted average number of shares	2013 Pence per share
Profit after tax attributable to equity holders of the parent	204	1,417,808,590	14.39
Dilutive effect of share awards	–	904,272	(0.01)
Diluted basic earnings per share on profit after tax attributable to equity holders of the parent	204	1,418,712,862	14.38

13. Earnings per share continued

ii) Based on operating profit after tax attributable to equity holders of the parent

For the year ended 31 December	2013 Earnings £m	2013 Weighted average number of shares	2013 Pence per share
Operating profit after tax attributable to equity holders of the parent	440	1,417,808,590	31.03
Dilutive effect of share awards	–	904,272	(0.02)
Diluted basic earnings per share on operating profit after tax attributable to equity holders of the parent	440	1,418,712,862	31.01

There were no dilutive factors for the year ended 31 December 2012.

c) Weighted average number of ordinary shares

For the year ended 31 December 2013	Actual	Weighted
Issued ordinary shares at beginning of period	1,418,109,028	1,418,109,028
Effect of:		
– purchase of own shares held	(600,877)	(300,438)
Number of ordinary shares at end of period	1,417,508,151	1,417,808,590

For the year ended 31 December 2012	Actual	Weighted
Issued ordinary shares at beginning of period	1,376,188,989	1,376,188,989
Own shares held by the Group	(2,661,384)	(2,661,384)
	1,373,527,605	1,373,527,605
Effect of:		
– scrip dividend (final 2011)	15,484,945	9,477,125
– scrip dividend (interim 2012)	26,435,094	6,283,752
– reduction in own shares held	2,661,384	1,999,674
Number of ordinary shares at end of period	1,418,109,028	1,391,288,156

Notes to the consolidated accounts continued

14. Intangible assets

Goodwill

Goodwill arising on business combinations is the future economic benefit arising from assets that are not capable of being individually identified and separately recognised. After initial recognition, goodwill is stated at cost less any accumulated impairment losses, with the carrying value being reviewed for impairment at least annually and whenever events or changes in circumstances indicate that the carrying value may be impaired.

For the purpose of impairment testing, goodwill is allocated to the related CGUs. Where the recoverable amount of the CGU is less than its carrying amount, including the related goodwill, an impairment loss is recognised in the income statement.

In a business combination, where the purchase consideration is lower than the fair value of the net assets acquired, a gain on acquisition arises, sometimes referred to as negative goodwill. Such a gain on acquisition is recognised in the income statement in the period in which it arises.

Acquired value of in-force business ("AVIF")

On acquisition of a portfolio of insurance contracts and/or investment contracts, either directly or through the acquisition of a subsidiary undertaking, the net present value of the Group's interest in the expected pre-tax cash flows of the in-force business is capitalised in the statement of financial position, using a market consistent embedded value methodology. AVIF is amortised over the anticipated lives of the related contracts which typically vary between five years and 35 years, with the amortisation profile being in accordance with expected profit emergence from the contracts. Any changes in estimated useful lives are accounted for prospectively with the effect of the change being recognised in the current and future periods, if relevant.

Other intangible assets

Customer relationships, distribution relationships and brands acquired are capitalised at cost, being the fair value of the consideration paid. Software is capitalised on the basis of the costs incurred to acquire and bring it into use.

These intangible assets have finite useful lives and are consequently carried at cost less accumulated amortisation and impairment. Any changes in estimated useful lives are accounted for prospectively with the effect of the change being recognised in the current and future periods, if relevant. Amortisation is calculated using the straight-line method to allocate the cost over the estimated useful lives of the intangible assets with ranges as shown below:

	Years
Customer relationships	8–12
Distribution relationships	5–10
Brands	10–15
Computer software	3–4

Intangible assets relating to customer relationships and distribution channels have been valued using an income approach method, specifically the Multi-period Excess Earnings Method ("MEEM"). The principle behind the MEEM is that the value of an intangible asset is equal to the present value of the after tax cash flows attributable only to that intangible asset. Other intangibles include in-house developed IT systems and databases which have been valued using a replacement cost approach which assesses the cost of reproducing the equivalent technology in its current form.

Subsequent expenditure on other intangible assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Impairment testing

All identifiable intangible assets are reviewed at each reporting date, or where impairment indicators are present, to assess whether there are any circumstances that might indicate that they are impaired. If such circumstances exist, impairment testing is performed and any resulting impairment losses are charged to the consolidated income statement.

For the purpose of impairment testing, goodwill and AVIF are allocated to the related CGU, which represent the lowest level within the Group at which the intangible assets are monitored for internal management purposes.

AVIF is tested for impairment by comparing the carrying amount with its recoverable amount. The calculation of the recoverable amount is consistent with the measurement methodology for AVIF at initial recognition and is based on the current MCEV VIF balance for pre-acquisition business only, adjusted for differences between the IFRS and MCEV measurement basis for other net assets. The assumptions underpinning the Group's MCEV basis of reporting are provided in the MCEV supplementary information.

14. Intangible assets continued

Movements in intangible assets are as follows:

For the year ended 31 December 2013	AVIF £m	Other £m	Total £m
Cost			
At 1 January 2013	5,505	560	6,065
Additions	–	4	4
Disposals ⁽ⁱ⁾	–	(8)	(8)
Foreign exchange adjustments	15	4	19
At 31 December 2013	5,520	560	6,080
Amortisation and impairment			
At 1 January 2013	1,497	247	1,744
Amortisation charge for the year ⁽ⁱ⁾	381	91	472
Impairment charge for the year ^{(i) (ii)}	11	–	11
Disposals ⁽ⁱⁱⁱ⁾	–	(8)	(8)
Foreign exchange adjustments	4	2	6
At 31 December 2013	1,893	332	2,225
Carrying amounts at 31 December 2013	3,627	228	3,855

For the year ended 31 December 2012	AVIF £m	Other £m	Total £m
Cost			
At 1 January 2012	5,521	560	6,081
Additions	–	4	4
Foreign exchange adjustments	(16)	(4)	(20)
At 31 December 2012	5,505	560	6,065
Amortisation and impairment			
At 1 January 2012	1,084	150	1,234
Amortisation charge for the year ⁽ⁱ⁾	412	83	495
Impairment charge for the year ^{(i) (ii)}	5	14	19
Foreign exchange adjustments	(4)	–	(4)
At 31 December 2012	1,497	247	1,744
Carrying amounts at 31 December 2012	4,008	313	4,321

(i) Amortisation and impairment charges are included within administrative and other expenses in the consolidated income statement.

(ii) AVIF impairment of £(11) million (2012: £(5) million) has been recognised within OLAB in the FPI segment, as a result of worsening persistency. 2012 also includes a £(12) million impairment of goodwill and £(2) million impairment of distributor relationships in respect of Financial Business Partners AG ("fbb AG") part of the FPI segment.

(iii) Disposals relate to the sale of fully amortised software of £(8) million.

AVIF is shown gross of policyholder and shareholder tax of £693 million (2012: £849 million), with the offsetting balance included in deferred taxation.

Notes to the consolidated accounts continued

14. Intangible assets continued

i) AVIF

An analysis of AVIF by operating segments used for segmental reporting (see note 3) is set out below:

As at 31 December 2013	Cost £m	Amortisation and impairment £m	Net book value £m
UK	896	(291)	605
Heritage	3,011	(906)	2,105
FPI	1,014	(436)	578
Lombard	599	(260)	339
Total	5,520	(1,893)	3,627

As at 31 December 2012	Cost £m	Amortisation and impairment £m	Net book value £m
UK	896	(245)	651
Heritage	3,011	(702)	2,309
FPI	1,014	(344)	670
Lombard	584	(206)	378
Total	5,505	(1,497)	4,008

ii) Other intangibles

Other intangibles are made up of the following:

As at 31 December 2013	Cost £m	Amortisation and impairment £m	Net book value £m
Distribution channels and customer relationships	444	(237)	207
Brand	49	(37)	12
Software	55	(46)	9
Goodwill	12	(12)	–
Total	560	(332)	228

As at 31 December 2012	Cost £m	Amortisation and impairment £m	Net book value £m
Distribution channels and customer relationships	441	(174)	267
Brand	49	(28)	21
Software	58	(33)	25
Goodwill	12	(12)	–
Total	560	(247)	313

iii) Impairment

As at 31 December 2013, based on an impairment review of each of the CGUs, an impairment charge of £(11) million has been recognised in FPI AVIF in respect of its OLAB operation. Following an impairment review at 31 December 2012, FPI AVIF in respect of its OLAB operation and other intangible assets in respect of fpb AG, the Group's distributor of German business, were impaired by £(5) million and £(14) million respectively.

15. Property and equipment

Owned assets

Land and buildings are initially recognised at cost and subsequently measured at fair value. Revaluations are performed annually by independent valuers, who hold a recognised and relevant professional qualification and have recent experience in the location and category of properties being valued. Valuations are performed with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair values at the balance sheet date. The fair value is the amount for which a property could be exchanged between knowledgeable and willing parties in an arm's length transaction.

Properties occupied by the Group are held at fair value, based on highest and best use, at the date of revaluation, measured at the date of revaluation. Revaluation surpluses, and their reversal, are recognised in the statement of other comprehensive income. Revaluation losses, and their reversal, are recognised in the income statement.

Equipment is recognised at cost less accumulated depreciation and impairment losses.

Depreciation

Depreciation is charged so as to write off the cost of certain assets net of the estimated residual value, using the straight-line method, over the estimated useful life of the asset, as follows:

	Years
Motor vehicles	3–4
Computer hardware and related software	1–4
Fixtures, fittings and office equipment	3–10

Residual values and useful lives are reviewed at each financial year end and adjusted if appropriate. Any changes in estimated useful lives are accounted for prospectively with the effect of the change being recognised in the current and future periods, if relevant.

Disposal and derecognition

An item of property and equipment is derecognised upon disposal or when no further future economic benefits are expected from its use. Any gain or loss arising on derecognition of the asset is included in the income statement in the year the asset is derecognised.

Any revaluation reserve relating to the particular asset being disposed of or no longer in use is transferred to retained earnings.

	Owner-occupied properties £m	Computer equipment £m	Fixtures, fittings and office equipment £m	Total £m
For the year ended 31 December 2013				
Cost				
At 1 January 2013	40	9	17	66
Additions	–	–	2	2
At 31 December 2013	40	9	19	68
Depreciation				
At 1 January 2013	–	6	7	13
Depreciation charge	–	2	3	5
At 31 December 2013	–	8	10	18
Carrying amounts at 31 December 2013	40	1	9	50

Notes to the consolidated accounts continued

15. Property and equipment continued

	Owner occupied properties £m	Computer equipment £m	Fixtures, fittings and office equipment £m	Total £m
For the year ended 31 December 2012				
Cost				
At 1 January 2012	43	8	15	66
Additions	–	1	2	3
Disposals	(1)	–	–	(1)
Revaluation	(2)	–	–	(2)
At 31 December 2012	40	9	17	66
Depreciation				
At 1 January 2012	–	4	4	8
Depreciation charge	–	2	3	5
At 31 December 2012	–	6	7	13
Carrying amounts at 31 December 2012	40	3	10	53

If owner-occupied properties were measured on a cost basis, the carrying amount would be £49 million (2012: £49 million).

16. Investment properties

Investment properties comprise land and/or buildings that are not occupied by the Group and are held either to earn rental income or for capital appreciation, or for both.

Investment properties are initially included in the balance sheet at cost and subsequently measured at fair value, at least annually at the reporting date. Fair values, based on highest and best use, are measured by external independent valuers, who hold a recognised and relevant professional qualification and have recent experience in the location and category of the investment property being valued.

Movements in the fair value of investment properties are taken to the income statement in the period in which they arise.

In accordance with IAS 17: *Leases*, properties held by the Group under operating leases are classified as investment properties when the properties otherwise meet the definition of investment properties.

For the year ended 31 December	2013 £m	2012 £m
At 1 January	2,735	3,015
Purchases	45	51
Disposals	(265)	(228)
Fair value adjustments	46	(103)
At 31 December	2,561	2,735

Of the total, £1,259 million (2012: £1,284 million) is held in with-profits funds and £1,302 million (2012: £1,451 million) in unit-linked funds. The majority of the investment properties held within the with-profits and unit-linked funds are leased out under operating leases in order to generate a rental income to match policyholders' liabilities.

Future minimum lease payments receivable under non-cancellable operating leases are as follows:

For the year ended 31 December	2013 £m	2012 £m
Due in the period:		
Not later than one year	140	151
Later than one year and not later than five years	458	503
Later than five years	633	716
Total	1,231	1,370

17. Principal Group undertakings

Subsidiaries are all entities (including special purpose entities) over which the Group has control, defined as the power, directly or indirectly, to govern the financial and operating policies so as to obtain economic benefits, generally accompanying a shareholding of more than one half of the voting rights. Potential voting rights that are presently exercisable or convertible are also taken into account. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date on which control ceases. Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

Principal subsidiary undertakings of the Group as at 31 December 2013 are shown below.

As explained in the Corporate Governance section, Resolution Limited is the general partner of Resolution Holdco No.1 LP ("RHN1"), a Guernsey Limited partnership, and owns 99.99% of RHN1's capital. The remaining 0.01% of RHN1's capital is owned by RCAP UK LP ("RCAP") which is not part of the Group.

All other subsidiaries are owned directly or indirectly by RHN1, and the table below reflects RHN1's ownership in these entities.

Unless otherwise stated, they are undertakings incorporated in England and Wales and have only one class of issued ordinary shares. The voting rights are equal to the percentage holdings unless otherwise stated.

In addition to the companies shown below, the Company also holds investments in a number of other subsidiary undertakings, which in the directors' opinion do not significantly affect the consolidated financial statements. A full list of FLG subsidiaries will be annexed to FLG's annual return filed at Companies House.

On 28 December 2013 business transfers under the provisions of Part VII of the Financial Services and Markets Act 2000 were made to transfer:

- all of the long-term business in FLC to FLPL; and
- all of the long-term business in FLWL to FLL apart from a portfolio of non profit unit-linked pensions business, which was transferred to FLPL.

The purpose of this internal reorganisation was to realise capital and operating synergies in the Friends Life group. As the Part VII transfers are between companies which are 100% owned by the Group there is no material impact on the consolidated financial statements.

Subsidiary undertaking	Activity	% held
Corporate		
Resolution Holdco No.1 LP ⁽ⁱ⁾	Holding company	99.99
Resolution Holdings (Guernsey) Limited ⁽ⁱⁱ⁾	Holding company	100
Friends Life Group plc	Holding company	100
Friends Life FPG Limited	Holding company	100
Friends Life FPL Limited ^(iv)	Holding company	100
Life and pensions		
Friends Annuities Limited	Insurance	100
Friends Life Limited ^(v)	Insurance	100
Friends Life and Pensions Limited	Insurance	100
Friends Provident International Limited ^(vi)	Insurance	100
Lombard International Assurance SA ^(vii)	Insurance	99.78
Friends Life Management Services Limited	Management services	100
Friends Life Services Limited	Management services	100
Other		
Friends Life Investments Limited	Investment management	100
Sesame Bankhall Group Limited	Financial Distribution Business	100

(i) Held directly by Resolution Limited (all other companies are held indirectly).

(ii) Guernsey Limited partnership.

(iii) Incorporated in Guernsey.

(iv) Company has both Ordinary and Deferred shares in issue.

(v) Company has both Ordinary and Preference shares in issue.

(vi) Incorporated in the Isle of Man. Company has both Ordinary A and Ordinary B shares in issue.

(vii) Incorporated in Luxembourg. The Group's holding in 2013 was 99.78% (2012: 99.62%). Ordinary shares in issue to FLPL and BC, CC and DC shares in issue to LTIP participants.

Notes to the consolidated accounts continued

18. Financial assets

The Group classifies its financial assets at fair value through profit or loss or as loans at amortised cost.

Financial assets at fair value through profit or loss comprise assets which are designated as such on initial recognition, as they are managed individually or together on a fair value basis, and derivatives, which are classified as held for trading in accordance with IAS 39: *Financial instruments recognition and measurement*.

The fair value on initial recognition is generally the consideration given, excluding any transaction costs directly attributable to their acquisition which are expensed. Movements in fair value are taken to the income statement as investment return in the period in which they arise. Financial assets carried at fair value are initially recognised at fair value and subsequently remeasured at fair value based on quoted bid prices, where such prices are available from a third party in a liquid market. If quoted bid prices are unavailable, the fair value of the financial asset is derived from cash flow or other models designed to reflect the specific circumstances of the issuer. Securities for which fair value cannot be measured reliably are recognised at cost less impairment.

Purchases and sales of financial assets are recognised on the date the Group commits to purchase or sell the asset, generally the trade date. A transfer of financial asset is accounted for as a derecognition if substantially all of the asset's risks and rewards of ownership are transferred, or, control of the asset is transferred to a party external to the Group. Control is deemed to have been transferred if the transferee has a practical ability to sell the asset unilaterally without needing to impose additional restrictions on any subsequent transfer.

Loans are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans are measured on initial recognition at the fair value of the consideration given plus incremental costs that are incurred on the acquisition of the investment. Subsequent to initial recognition, loans are either measured at amortised cost less impairment losses or, if they meet the criteria for designation at fair value through profit or loss (such as the elimination of, or significant reduction in, accounting mismatches), and are so designated on initial recognition, they are measured at fair value.

The amortised cost is the present value of estimated future cash flows discounted at the effective interest rate at the date of acquisition or origination of the loan. Subsequent to initial recognition, any difference between cost and redemption value is amortised through the income statement over the life of the instrument. The carrying values of loans at amortised cost are reviewed for impairment in accordance with IAS 39 at each reporting date. If there is objective evidence of impairment, for example there is a default or delinquency in payment, the impairment loss is calculated and recognised.

The Group's financial assets are summarised by measurement category as follows:

As at 31 December	2013 £m	2012 £m
Fair value through profit or loss (note 18(a))		
Designated on initial recognition	108,791	105,172
Held for trading	265	812
Loans at amortised cost (note 18(b))	8	6
Total financial assets	109,064	105,990

a) Analysis of financial assets at fair value through profit or loss

As at 31 December 2013	With-profits £m	Unit-linked £m	Non-linked annuities £m	Non-linked other £m	Shareholder £m	Total £m
Shares and other variable yield securities	6,803	63,145	–	122	15	70,085
Debt securities and other fixed income securities:						
– Government securities	7,084	7,181	1,044	724	78	16,111
– Corporate bonds and loans at fair value	7,388	5,466	8,115	1,297	112	22,378
Derivative financial instruments	170	66	22	5	2	265
Deposits with credit institutions	–	217	–	–	–	217
Total financial assets held at fair value	21,445	76,075	9,181	2,148	207	109,056

18. Financial assets continued

As at 31 December 2012	With-profits £m	Unit-linked £m	Non-linked annuities £m	Non-linked other £m	Shareholder £m	Total £m
Shares and other variable yield securities	6,801	56,940	–	125	13	63,879
Debt securities and other fixed income securities:						
– Government securities	8,903	7,617	1,018	1,074	79	18,691
– Corporate bonds and loans at fair value	8,533	5,891	6,546	1,302	124	22,396
Derivative financial instruments	675	22	107	8	–	812
Deposits with credit institutions	–	206	–	–	–	206
Total financial assets held at fair value	24,912	70,676	7,671	2,509	216	105,984

The unit-linked column and with-profits column in the tables above include £614 million (2012: £744 million) of financial assets relating to the non-controlling interests in the OEICs that have been consolidated as the Group holding is 50% or more. These comprise £523 million of shares and other variable yield securities, £69 million of government securities and £22 million of corporate bonds (2012: £535 million of shares and other variable yield securities, £87 million of government securities and £122 million of corporate bonds).

For unit-linked funds, the policyholders bear the investment risk and any change in asset values is matched by a broadly equivalent change in the liability.

The majority of financial assets held are readily realisable, however amounts of £98,798 million (2012: £96,900 million) are not expected to be realised for more than 12 months after the reporting date in line with the expected maturity of insurance and investment contract liabilities.

Asset-backed securities (excluding those held by the linked funds) amount to £4,124 million (2012: £3,940 million) and 98% (2012: 96%) of these are at investment grade as set out in note 30.

b) Loans at amortised cost

As at 31 December	2013 £m	2012 £m
Mortgage loans	4	2
Other loans	4	4
Total loans	8	6

The fair value of loans is considered to be the same as their carrying value.

Notes to the consolidated accounts continued

18. Financial assets continued

c) Assets backing unit-linked liabilities

The carrying value of policyholder liabilities relating to unit-linked business is shown in note 29(b). These liabilities are classified as either insurance or investment contracts. The net assets backing these liabilities are included within the relevant balances in the consolidated statement of financial position and are analysed as follows:

As at 31 December	2013 £m	2012 £m
Shares and other variable yield securities	63,145	56,940
Debt securities and other fixed income securities	12,647	13,508
Derivative financial instruments	66	22
Deposits with credit institutions	217	206
Total financial assets held at fair value	76,075	70,676
Investment properties	1,302	1,451
Insurance and other receivables	639	723
Cash and cash equivalents	4,783	4,835
Total assets	82,799	77,685
Net asset value attributable to unit-holders ⁽ⁱ⁾ and other payables	(1,655)	(1,743)
Total unit-linked net assets	81,144	75,942

(i) Represents non-controlling interests in respect of consolidated OEICs, which the Group are deemed to control.

19. Fair values of assets and liabilities

In accordance with the requirements of IFRS 13: *Fair value measurement* assets and liabilities which are measured at fair value have been classified into three categories as set out below. Financial assets at fair value include shares and other variable yield securities, government securities, corporate bonds (including ABS and loans at fair value), derivative financial instruments and deposits with credit institutions. Financial liabilities at fair value include unit-linked contracts, amounts due to reinsurers, net asset value attributable to unit-holders (non-controlling interest in the OEICs that are consolidated) and derivative financial instruments.

Level 1 – quoted prices (unadjusted) in active markets for identical assets. An active market is one in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. Examples include listed equities and bonds in active markets and quoted unit trusts/OEICs.

Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset, either directly (i.e. as prices) or indirectly (i.e. derived from prices). This category generally includes assets that are priced based on models using market observable inputs. Examples include certain corporate bonds, certificates of deposit and derivatives.

Level 3 – inputs for the assets that are not based on observable market data. Assets with single price feeds and/or limited trading activity are included in this category. Examples include unlisted equities, private equity investments and property.

The majority of the Group's assets held at fair value are valued based on quoted market information or market observable data. Approximately 5% (8% excluding unit-linked assets) of the Group's financial assets are based on valuation techniques where significant observable market data is not available or the price is not observable from current market transactions. However, the fair value measurement objective of these assets remains the same, that is, an exit price from the perspective of the Group.

The fair values of financial and non-financial assets are generally provided by external parties. During the year, the Group has performed independent reviews of pricing models to ensure that appropriate methodologies have been applied. The approach taken for each class of specific unlisted investment is as follows:

Corporate bond valuations are generally obtained from brokers and pricing services. Where the number of transactions has declined under the current market conditions, valuations have become more subjective. Bond prices provided by pricing services are based on the best estimate of market price determined by market makers based on a variety of factors and are considered to be observable prices. In determining fair value, market makers will take into account transactions they have observed in identical or similar assets as well as movements in market indices and any other factors that they regard as relevant. In some cases, consensus prices have been based on fewer, and potentially more historic, transactions.

Exchange-traded derivatives are valued using active market prices. The values of over-the-counter derivative financial instruments are estimated by applying valuation techniques, using pricing models or discounted cash flow methods. Where pricing models are used, inputs – including future dividends, swap rates and volatilities – based on market data at the statement of financial position date are used to estimate derivative values. Where discounted cash flow techniques are used, estimated future cash flows and discount rates are based on current market swap rates at the valuation date.

Investment properties and properties occupied by the Group are measured at fair value at the reporting date. Fair values are measured by external independent valuers, using methods set out in the Royal Institute of Chartered Surveyors' guidelines ("RICS Red Book"). The valuations used are based on valuation techniques using multiples of future rental incomes. The rental multiples are based on multiples observed in recent similar transactions in the market. Key assumptions include occupancy and rental income.

Methods considered when determining fair values of unlisted shares and other variable yield securities include discounted cash flow techniques and net asset valuation. Regular checks are performed of tolerance levels for changes such as percentage movements in prices, excess movements and inter vendor price comparisons, where tolerance levels are pre-defined for security types.

The valuation of the holdings in private equity limited partnerships and companies is based on the most recent underlying valuations available at the reporting date as adjusted for contributions, distributions and known diminutions in value of individual underlying investments in the period since valuations were performed. The valuation technique is not supported by observable market values. Valuations of private equity holdings are prepared in accordance with International Private Equity and Venture Capital Board ("IPEV") guidelines.

The fair value of the investments in property limited partnerships is taken as the Group's appropriate share of the net asset value of the partnerships. The net asset value is based on the latest external market valuation of the underlying property investments, which is updated at least every six months. The valuation would be adjusted in the event of a significant market movement in the period between the last market valuation and the reporting date.

Loans are valued using a general discounted cash flow methodology, with the discount rates derived from the relevant risk-free curve and a credit spread curve. The valuation process is carried out by the investment manager and reviewed by management. All spreads are reviewed at least twice a year and will be recalibrated accordingly if they appear to be outliers relative to factors such as available market proxies and spreads of underlying securities.

Participation in investment pools mainly relates to property investments. Property is independently valued in accordance with the methods set out in the RICS Red Book at each year end.

The classifications of financial liabilities take into account the types of inputs used to determine the fair value measurements. For unit-linked funds this has been undertaken on a fund-by-fund basis. For the net asset value attributable to unit-holders, this has been analysed in the same proportion as the underlying consolidated investments categorisation.

Notes to the consolidated accounts continued

19. Fair values of assets and liabilities continued

The Group has financial liabilities which contain discretionary participation features of £8,991 million (2012: £9,543 million) that form part of its with-profits funds. Products giving rise to these liabilities are mainly investment or pension contracts with a unitised with-profits element. The Group is unable to measure the fair value of these financial liabilities reliably due to the lack of a robust basis to measure the supplemental discretionary returns arising on with-profits contracts and because there is not an active market for such instruments. These liabilities have therefore been excluded from the fair value hierarchy analysis below. Investment contract non-unit reserves, relating primarily to deferral of front-end fees in the form of unfunded units, have also been excluded from the fair value hierarchy analysis.

An analysis of recurring non-financial assets, financial assets and liabilities held at fair value in accordance with the fair value hierarchy is set out below. The table shows both the total recurring non financial assets, financial assets and liabilities and the total excluding unit-linked assets and liabilities, as shareholders have no direct exposure to profits or losses on unit-linked assets (other than through investment management and annual management fees).

a) Recurring fair value measurements

As at 31 December 2013	Including unit-linked				Excluding unit-linked			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Non-financial assets held at fair value								
Investment properties	–	–	2,561	2,561	–	–	1,259	1,259
Owner-occupied property	–	–	40	40	–	–	40	40
Financial assets held at fair value								
Shares and other variable yield securities	64,679	1,943	3,463	70,085	5,725	81	1,134	6,940
Debt securities and other fixed income securities:								
– Government securities	15,716	395	–	16,111	8,885	45	–	8,930
– Corporate bonds and loans at fair value (including ABS)	15,549	4,974	1,855	22,378	12,375	3,200	1,337	16,912
Derivative financial instruments	34	231	–	265	10	189	–	199
Deposits with credit institutions	217	–	–	217	–	–	–	–
Total assets held at fair value	96,195	7,543	7,919	111,657	26,995	3,515	3,770	34,280
Financial liabilities held at fair value								
Unit-linked investment contracts	–	72,682	–	72,682	–	–	–	–
Amounts due to reinsurers	–	1,580	–	1,580	–	1,580	–	1,580
Net asset value attributable to unit holders	621	–	–	621	28	–	–	28
Derivative financial instruments	37	393	–	430	30	375	–	405
Total liabilities held at fair value	658	74,655	–	75,313	58	1,955	–	2,013

There are no non-recurring fair value measurements at 31 December 2013.

19. Fair values of assets and liabilities continued

	Including unit-linked				Excluding unit-linked			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
As at 31 December 2012								
Non-financial assets held at fair value								
Investment properties	–	–	2,735	2,735	–	–	1,284	1,284
Owner-occupied property	–	–	40	40	–	–	40	40
Financial assets held at fair value								
Shares and other variable yield securities	53,459	7,608	2,812	63,879	5,156	555	1,228	6,939
Debt securities and other fixed income securities:								
– Government securities	18,209	474	8	18,691	10,917	152	5	11,074
– Corporate bonds and loans at fair value (including ABS)	15,595	5,653	1,148	22,396	12,121	3,788	596	16,505
Derivative financial instruments	52	760	–	812	32	758	–	790
Deposits with credit institutions	206	–	–	206	–	–	–	–
Total assets held at fair value	87,521	14,495	6,743	108,759	28,226	5,253	3,153	36,632
Financial liabilities held at fair value								
Unit-linked investment contracts	–	67,428	–	67,428	–	–	–	–
Amounts due to reinsurers	–	1,767	–	1,767	–	1,767	–	1,767
Net asset value attributable to unit holders	754	–	–	754	17	–	–	17
Derivative financial instruments	8	222	–	230	4	220	–	224
Total liabilities held at fair value	762	69,417	–	70,179	21	1,987	–	2,008

There are no non-recurring fair value measurements at 31 December 2012.

The Group's policy is to recognise transfers into and transfers out of levels 1, 2 and 3 as of the date the statement of financial position is prepared.

Derivative financial instruments and amounts due to reinsurers are managed on the basis of net exposure, after taking into account related collateral, with fair value determined on the basis of the price of the net position.

For the Friends Life Group plc £162 million subordinated debt due 2021, Friends Life Group plc £500 million subordinated debt due 2022 and the Friends Life Group plc US\$575 million reset perpetual subordinated debt, the fair value measurements (as disclosed in note 31) are categorised as level 1.

b) Transfers between level 1 and level 2

During the year, £2,175 million (2012: £3,732 million) of corporate bonds, shares and other variable yield securities were transferred from level 1 to level 2 and £6,102 million (2012: £10,496 million) of corporate bonds, shares and other variable yield securities were transferred from level 2 to level 1. These movements arose from changes in the availability of current quoted prices, market activity and refinements to the methodology under which shares and other variable yield securities are classified. There were no significant transfers between level 1 and level 2 for other assets.

Notes to the consolidated accounts continued

19. Fair values of assets and liabilities continued

c) Level 3 assets

The following table shows a reconciliation of Level 3 assets which are recorded at fair value.

	Investment property £m	Owner-occupied property £m	Shares and other variable yield securities £m	Government securities £m	Corporate bonds and loans at fair value (including ABS) £m	Total assets held at fair value £m
At 1 January 2013	2,735	40	2,812	8	1,148	6,743
Total gains/(losses) in consolidated income statement ⁽ⁱ⁾	46	–	(33)	–	(153)	(140)
Purchases	45	–	226	–	103	374
Sales	(265)	–	(221)	–	(93)	(579)
Issues	–	–	12	–	174	186
Settlements	–	–	–	–	(19)	(19)
Net transfer from/(to) level 1 and level 2 ⁽ⁱⁱ⁾	–	–	632	(8)	681	1,305
Foreign exchange adjustments	–	–	35	–	14	49
At 31 December 2013	2,561	40	3,463	–	1,855	7,919
Total unrealised gains/(losses) for the year included in profit or loss for assets held at 31 December 2013	47	–	26	–	(7)	66

	Shares and other variable yield securities £m	Government securities £m	Corporate bonds and loans at fair value (including ABS) £m	Total financial assets held at fair value £m
At 1 January 2012	3,210	5	1,259	4,474
Total gains/(losses) in consolidated income statement ⁽ⁱ⁾	66	(1)	46	111
Purchases	1,262	–	247	1,509
Sales	(1,340)	–	(502)	(1,842)
Issues	–	–	58	58
Settlements	–	–	(24)	(24)
Net transfer (to)/from level 1 and level 2 ⁽ⁱⁱ⁾	(349)	4	84	(261)
Foreign exchange adjustments	(37)	–	(20)	(57)
At 31 December 2012	2,812	8	1,148	3,968
Total unrealised gains/(losses) for the year included in profit or loss for assets held at 31 December 2012	57	(1)	37	93

(i) Gains and their reversal on owner-occupied property are recognised in the consolidated statement of comprehensive income, losses and their reversal are recognised in the income statement within investment return. All other gains and losses on assets held at fair value are recognised in the income statement within investment return.

(ii) Amounts were transferred from level 1 and level 2 because of a lack of observable market data, resulting from a decrease in market activities for the securities. Amounts were transferred to level 1 and level 2 because observable market data became available for the securities.

Comparative figures for investment property and owner-occupied property for the year ended 31 December 2012 are not available and the costs to develop them would be excessive.

The Group's Securities Pricing Committee provides oversight of the valuation of securities, including the review of valuation methodologies, appropriateness of prices provided by external valuers, and fair value hierarchy disclosures made by the Group.

19. Fair values of assets and liabilities continued

IFRS 13 requires the disclosure, where available, of quantitative information relating to significant unobservable inputs used to derive the valuation of investments classified within the fair value hierarchy as level 3. The majority of the Group's investments are valued by third parties, resulting in limited availability of unobservable inputs used. Available unobservable inputs are as follows:

- Corporate bonds include £331 million of private loans; credit rating assumptions, ranging between AA- and BB-, have been used to derive discounted cash flow fair values.
- Shares and other variable yield securities include private equity investments, £268 million of which are valued using multiples of earnings before interest, tax, depreciation and amortisation ranging between 5 and 11.5.
- Investment properties have typically been valued based on equivalent rental multiples, ranging between 4 and 30.

d) Level 3 financial assets sensitivity analysis

	2013		2012	
	Carrying amount £m	Effect of reasonably possible alternative assumptions £m	Carrying amount £m	Effect of reasonably possible alternative assumptions £m
As at 31 December				
Unit-linked investments	2,847	–	2,139	–
Shares and other variable yield securities	1,134	227	1,228	246
Government securities	–	–	5	1
Corporate bonds and loans at fair value (including ABS)	1,337	134	596	60
Total Level 3 financial assets	5,318	361	3,968	307

For unit-linked investments, the policyholders bear the investment risk and any change in asset values is matched by a broadly equivalent change in the liability. Shareholder profits from annual management charges levied on such funds will, however, vary according to the change in asset values leading to some limited investment risk.

For shares and other variable yield securities, where there is no active market the price at year end could reasonably be expected to be higher or lower by approximately 20%.

For government bonds and corporate bonds, it could reasonably be expected that the fair values could be higher or lower by approximately 10% to reflect changes in the credit ratings of the underlying bonds.

Notes to the consolidated accounts continued

20. Deferred acquisition costs

Insurance and Investment contracts with DPF

Acquisition costs comprise all direct and indirect costs arising from writing the contracts, which are incurred during a financial period. Acquisition costs are deferred and amortised over the life of the contracts where their recovery has not been reflected in the valuation of policyholder liabilities but only to the extent that they are recoverable from future margins.

The rate of amortisation of acquisition costs on such contracts is proportional to the future margins expected to emerge in respect of the related policies, over the life of those policies.

Investment contracts without DPF

Acquisition costs comprise all incremental costs that are directly related to the writing of the contract, which are incurred during a financial period, and are amortised on a straight-line basis over the lifetime of the contract if they are recoverable out of future margins.

	Insurance contracts £m	Investment contracts £m	Total £m
For the year ended 31 December 2013			
At 1 January	121	717	838
Incurred and deferred in the period	28	143	171
Amortisation and impairment ⁽ⁱ⁾	(32)	(80)	(112)
At 31 December	117	780	897

	Insurance contracts £m	Investment contracts £m	Total £m
For the year ended 31 December 2012			
At 1 January	90	553	643
Incurred and deferred in the period	47	227	274
Amortisation and impairment ⁽ⁱ⁾	(16)	(63)	(79)
At 31 December	121	717	838

(i) Includes an impairment charge of £(5) million (2012: £(8) million) in respect of the FPI segment's OLAB operations.

Included in the carrying values above, £742 million (2012: £733 million) is expected to be recovered more than 12 months after the reporting date. Acquisition expenses that do not meet the criteria for deferral are expensed directly as incurred.

21. Reinsurance assets

The benefits to which the Group is entitled under its reinsurance contracts are recognised as reinsurance assets. Amounts recoverable from reinsurers are measured consistently with the amounts associated with the underlying insurance contracts that are being reinsured and in accordance with the terms of each reinsurance contract.

Contracts that do not give rise to a significant transfer of insurance risk to the reinsurer are considered financial reinsurance and are accounted for and disclosed in a manner consistent with financial instruments (see note 31 for further details).

For the year ended 31 December	2013 £m	2012 £m
At 1 January	3,153	3,213
Premiums	595	602
Claims	(688)	(680)
Other movements ⁽ⁱ⁾	(223)	18
At 31 December	2,837	3,153

(i) Other movements include changes in economic and non-economic assumptions.

No significant gain or loss arose on reinsurance contracts inception in the year.

Included in the carrying values above, £2,565 million (2012: £2,849 million) is expected to be recovered more than 12 months after the reporting date.

Notes to the consolidated accounts continued

22. Deferred tax assets and liabilities

Deferred tax is the tax expected to be payable or recoverable on temporary differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax basis used in the computation of taxable profit. This is accounted for using the balance sheet liability method and the amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities. The tax rates used are the rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax liabilities are recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable future profits will be available against which deductible temporary differences, being the carry forward of excess tax expenses and tax losses, can be utilised.

Deferred taxation is not recognised on the initial recognition of goodwill or an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss.

a) Recognised deferred tax assets and liabilities

Deferred tax assets and liabilities are attributable to the following:

As at 31 December	2013			2012		
	Assets £m	Liabilities £m	Net £m	Assets £m	Liabilities £m	Net £m
Property and equipment	12	–	12	31	–	31
AVIF	–	(693)	(693)	–	(849)	(849)
Other intangible assets	–	(35)	(35)	–	(60)	(60)
Unrealised gains on investments	–	(581)	(581)	–	(279)	(279)
Employee benefits	38	–	38	5	–	5
Deferred acquisition costs	–	(14)	(14)	–	(42)	(42)
Tax value of recognised tax losses	389	–	389	339	–	339
Short-term temporary differences	–	(96)	(96)	–	(38)	(38)
Deferred tax assets/(liabilities)	439	(1,419)	(980)	375	(1,268)	(893)
Offset of deferred tax (liabilities)/assets	(439)	439	–	(375)	375	–
Net deferred tax liabilities	–	(980)	(980)	–	(893)	(893)

At 31 December 2013, all of the deferred tax assets above (2012: £375 million) can be offset against deferred tax liabilities and are presented net in the consolidated statement of financial position.

b) Movement in deferred tax assets and liabilities

For the year ended 31 December 2013	At 1 January 2013 £m	Recognised in income £m	Recognised in other comprehensive income £m	Foreign exchange £m	At 31 December 2013 £m
Property and equipment	31	(20)	–	1	12
AVIF ⁽ⁱ⁾	(849)	159	–	(3)	(693)
Other intangible assets	(60)	26	–	(1)	(35)
Unrealised gains on investments	(279)	(302)	–	–	(581)
Employee benefits	5	(3)	36	–	38
Deferred acquisition costs	(42)	28	–	–	(14)
Tax value of recognised tax losses	339	50	–	–	389
Short-term temporary differences	(38)	(58)	–	–	(96)
Net deferred tax (liabilities)/assets	(893)	(120)	36	(3)	(980)

22. Deferred tax assets and liabilities continued

	At 1 January 2012 £m	Recognised in income £m	Recognised in other comprehensive income £m	Foreign exchange £m	At 31 December 2012 £m
For the year ended 31 December 2012					
Property and equipment	32	(1)	–	–	31
AVIF ⁽ⁱ⁾	(995)	142	–	4	(849)
Other intangible assets	(82)	22	–	–	(60)
Unrealised gains on investments	(215)	(64)	–	–	(279)
Employee benefits	10	(12)	7	–	5
Deferred acquisition costs	(25)	(17)	–	–	(42)
Tax value of recognised tax losses	467	(128)	–	–	339
Short-term temporary differences	(64)	26	–	–	(38)
Net deferred tax (liabilities)/assets	(872)	(32)	7	4	(893)

(i) Deferred tax liabilities on AVIF are being amortised in line with the run-off of the underlying assets.

c) Unrecognised deferred tax assets and liabilities

As at 31 December 2013, the Group has unrecognised tax losses of £34 million (2012: £87 million) to carry forward against future taxable profits or capital gains. Of the £34 million losses, £26 million (2012: £50 million) are trading losses and the remaining £8 million are capital losses (2012: £37 million). Neither of these losses have expiry dates.

No deferred tax assets have been recognised on these losses as there is currently no convincing evidence that the future profits or capital gains will be available against which the losses can be utilised.

23. Insurance and other receivables

Insurance and other receivables are recognised when due and measured on initial recognition at the fair value of the amount receivable plus incremental costs. Subsequent to initial recognition, these receivables are measured at amortised cost using the effective interest rate method.

As at 31 December	2013 £m	2012 £m
Receivables arising out of direct insurance operations:		
– policyholders	91	81
– agents, brokers and intermediaries	36	33
Investment income receivables	132	108
Investments sold for subsequent settlement	103	195
Prepayments and accrued income	527	528
Other receivables	211	180
Total insurance and other receivables	1,100	1,125

Of the carrying value above, £39 million (2012: £78 million) is expected to be recovered more than 12 months after the reporting date. The carrying value of each item approximates fair value.

Notes to the consolidated accounts continued

24. Cash and cash equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks and other short-term highly liquid investments with original maturities of three months or less. Where bank overdrafts with a right of set off are repayable on demand and form an integral part of cash management, such overdrafts are also included as a component of cash and cash equivalents.

As at 31 December	2013 £m	2012 £m
Bank and cash balances	5,008	4,944
Short-term deposits	4,682	4,505
Total cash and cash equivalents	9,690	9,449

The Group holds the following balances of cash and cash equivalents that are not available for use by shareholders:

As at 31 December	2013 £m	2012 £m
OEICs	85	153
Long-term funds	7,426	7,047
Total cash and cash equivalents not available for use by shareholders	7,511	7,200

25. Terms and conditions of insurance and investment contracts

The main types of insurance and investment contracts that the Group currently has in-force are life assurance and pensions. These contracts may include guarantees and options.

a) Life assurance

Protection business (other than whole life products): these insurance contracts consist mainly of regular premium term assurance, critical illness and income protection products, which pay out a fixed amount (the sum assured) on ill health or death. The premium rate is usually guaranteed for the lifetime of the contract. For most policies this payout will be a single amount, whereas income protection products provide a regular income upon incapacity either for the length of illness or to the end of the contract if earlier, depending on the specific policyholder terms. Most contracts have no surrender value.

Endowments and whole life products: these insurance contracts both provide benefits upon death or, in the case of endowments, at a preset maturity date if earlier. These policies usually have a surrender value. The amount payable on death is subject to a guaranteed minimum amount. The maturity value usually depends on the investment performance of the underlying assets. For with-profits business, it is underpinned by a minimum guarantee, which may be increased by the addition of bonuses.

Single premium bonds: these are unit-linked or unitised with-profits investment contracts that have no maturity date. On death, the amount paid is 100%–105% of the value of the units. On surrender the value of units is paid, sometimes in the first few years less a surrender penalty. For some contracts sold by Lombard a fixed exit penalty is applied to all surrenders, regardless of the length of time the policy has been in-force. For with-profits contracts a final bonus may be payable on death or surrender, or if markets are depressed a market value reduction may be applied to surrender values.

b) Pensions

Individual and group pensions: these contracts generally provide a cash sum at retirement. If death occurs before retirement, they generally return the value of the fund accumulated or in some cases premiums paid are returned. Contracts with guaranteed cash and annuity options (see below) are defined as insurance contracts but in the absence of these guarantees products are normally defined as investment contracts.

Annuities in payment: these insurance contracts are typically single premium products which provide for a regular payment to the policyholder whilst they and/or their spouse are still alive. Payments are generally either fixed or increased each year at a specified rate or in line with the rate of inflation. Most contracts guarantee an income for a minimum period usually of five years, irrespective of death.

Guarantees and options

The main guarantees and options included within the Group's insurance contracts are set out below. The majority of these arise within Friends Life FP With Profits Fund ("FP WPF"), Friends Life FPLAL With Profits Fund ("FPLAL WPF"), Friends Life FLC New With Profits Fund ("FLC New WPF"), Friends Life FLC Old With Profits Fund ("FLC Old WPF"), Friends Life FLAS With Profits Fund ("FLAS WPF"), Friends Life WL With Profits Fund ("WL WPF") and OLAB:

- **guaranteed cash and annuity options:** most conventional deferred annuity contracts have benefit options expressed in terms of cash and annuity payments with a guaranteed conversion rate, allowing the policyholder the option of taking the more valuable of the two at retirement;
- **guarantees in respect of bonus additions:** bonuses added to with-profits policies increase the guaranteed minimum benefit that policyholders are entitled to at maturity. These are set at a level that takes account of expected market fluctuations, such that the cost of the guarantee is generally met by the investment performance of the assets backing the policyholder liability. However in circumstances where there has been a significant fall in investment markets, the guaranteed maturity benefits may exceed asset shares and these guarantees become valuable to the policyholder. Also, for unitised with-profits policies, it is guaranteed that the value of units will not fall provided the policy is held until maturity or another guaranteed date, and for some older product classes, the value of units rises at a minimum guaranteed rate;
- **guaranteed surrender bases:** certain older products have a guaranteed basis for calculating surrender values. In all these cases the basis includes an element of final bonus which can be reduced or taken away. The effect of the guaranteed surrender basis is to extend the guarantee in respect of bonus additions so that they apply over an extended period and not just at the maturity date;
- **guaranteed minimum pensions:** certain policies secured by transfer values from pension schemes provide a guarantee that the pension at retirement will not be less than the Guaranteed Minimum Pension ("GMP") accrued as a result of contracting out of the State Earnings Related Pension Scheme or State Second Pension; and
- **guaranteed return of premiums:** certain pension contracts including OLAB contracts provide a guarantee for the return of premiums at maturity date. For some contracts the guarantee continues to apply when policies are paid up.

Notes to the consolidated accounts continued

26. Insurance contracts

Contracts under which the Group accepts significant insurance risk from another party (the policyholder), by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder, are classified as insurance contracts. Under IFRS 4: *Insurance contracts*, insurance risk is risk other than financial risk. Financial risk is the risk of a possible future change in one or more of: a specified interest rate, security price, commodity price, foreign exchange rate, index of price or rates, a credit rating or credit index or other variable. Insurance contracts may also transfer some financial risk.

Once a policyholder contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly during this period. As a general guideline, the Group defines as significant insurance risk the possibility of having to pay benefits on the occurrence of an insured event that are more than 5% greater than the benefits payable if the insured event did not occur.

For UK operations, insurance contract liabilities are calculated based on the relevant Prudential Regulation Authority ("PRA") rules contained in the Prudential Sourcebook for Insurers. For overseas operations, insurance contract liabilities are calculated on recognised actuarial principles, based on local regulatory requirements.

For the conventional with-profits policies, the liabilities to policyholders include both declared and constructive obligations for future bonuses not yet declared (excluding the shareholders' share of future bonuses) and include the cost of options and guarantees measured on a market consistent basis. The basis of calculation does not recognise deferred acquisition costs, but allows for future profits of non-profit and unit-linked business written in the with-profits fund to be recognised.

The calculation of liabilities to policyholders for non-profit contracts includes explicit allowance for future expenses and allows for lapses where appropriate.

The value of unit-linked insurance contract liabilities includes provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to policyholders.

The Group applies shadow accounting in relation to certain insurance contract liabilities, which are supported by owner-occupied properties and overseas subsidiaries, on which unrealised gains and losses are recognised in the statement of other comprehensive income. Adjustments are made to the insurance contract provisions to reflect the movements that would have arisen if the unrealised gains and losses had been recognised in the income statement. The corresponding change in the value of these insurance contract liabilities is recognised in the consolidated statement of comprehensive income.

The Group carries out an annual liability adequacy test on its insurance contract liabilities less related deferred acquisition costs and other related intangible assets to ensure that the carrying amount of its liabilities is sufficient in light of estimated future cash flows. Where a shortfall is identified, an additional provision is made.

26. Insurance contracts continued

a) Changes in insurance contract liabilities

The following table shows the movements in insurance contract liabilities in the year:

For the year ended 31 December	2013 £m	2012 £m
At 1 January	37,232	37,264
Increase in liability from premiums	1,607	1,556
Release of liability due to recorded claims	(4,191)	(3,829)
Unwinding of discount	488	343
Change in assumptions:		
– Economic	(398)	558
– Non-economic	(66)	(25)
Other movements including net investment return	(82)	1,365
At 31 December	34,590	37,232

Included in the carrying amount above is £29,931 million (2012: £32,266 million) which is expected to be settled more than 12 months after the reporting date.

During 2012, the long-term business of FLAS, the majority of the long-term business of FLC and the ownership of FAL were transferred to FLL under the provisions of Part VII of the Financial Services and Markets Act 2000. During 2013, the majority of the long-term business of FLWL was transferred to FLL, with the remaining long-term business in FLC and FLWL being transferred to FLPL.

A liability adequacy test was carried out at portfolio level and resulted in no additional provision in 2013 (2012: £nil).

It should be noted that changes in the financial assets backing the liabilities are typically largely offset by corresponding changes in the economic assumptions. In addition, assumption changes on with-profits contracts will result in changes in the unallocated surplus, and not in retained earnings.

b) Method used for reserving for both insurance contracts and investment contracts with DPF

The liability for insurance contracts and investment contracts with DPF is calculated on the basis of recognised actuarial methods, having due regard to actuarial principles and best practice, including compliance with the PRA's rules contained in the Prudential Sourcebook.

The principal method of actuarial valuation of liabilities arising under long-term insurance contracts is the gross premium method which involves the discounting of projected income (e.g. premiums and annual management charges) and charges (e.g. claims and expenses). It includes explicit assumptions for valuation interest rates, mortality and morbidity, persistency and future expenses. The assumptions used can vary by contract type and reflect current and expected future experience. Note 26 includes details of mortality tables, valuation interest rates and lapse rate assumptions by class of business.

For unit-linked insurance contracts and some unitised with-profits business, the liabilities are valued by adding a non-unit reserve to the bid value of units. The non-unit reserve is based on non-unit cash flows, assuming future premiums cease, unless it is more onerous to assume that they continue. In circumstances where the resultant future income is greater than charges (i.e. negative liabilities), credit can only be taken in circumstances where penalties exist to recover this income on surrender of the policy.

For the UK non-linked business, where the discounted value of future income is greater than the discounted value of future charges at a policy level (i.e. negative liabilities), credit can be taken to the extent that it offsets policies with positive liabilities within the same broad product group. For overseas business, negative liabilities are limited to zero at a policy level.

The valuation of with-profits business uses the realistic basis in accordance with FRS 27: *Life assurance*. The realistic valuation includes an assessment of the cost of any future options and guarantees, anticipated future and regular bonuses and future profits on non-participating business written in the with-profits fund. The valuation excludes amounts attributable to shareholders in respect of future bonuses. In calculating the realistic liability, account is taken of the future management actions consistent with those set out in the Principles and Practices of Financial Management ("PPFM").

Calculations are generally made on an individual policy basis; however in addition there are some global provisions which are calculated using statistical or mathematical methods. The results are expected to be approximately the same as if the individual insurance/investment contract liability was calculated for each contract.

Notes to the consolidated accounts continued

26. Insurance contracts continued

c) Options and guarantees

Options and guarantees are features of life assurance and pensions contracts that confer potentially valuable benefits to policyholders. They are not unique to with-profits funds and can arise in non-participating funds. They can expose an insurance company to two types of risk: insurance (such as mortality/morbidity) and financial (such as market prices/interest rates). The value of an option or guarantee comprises two elements: the intrinsic value and the time value. The intrinsic value is the amount that would be payable if the option or guarantee was exercised immediately. The time value is the additional value that reflects the possibility of the intrinsic value increasing in the future, before the expiry of the option or guarantee. Under PRA rules all options and guarantees must be valued and included in policyholder liabilities.

For funds within the PRA's realistic capital methodology, options and guarantees are valued on a market consistent basis that takes into account both the time value and the intrinsic value of the options and guarantees.

All material options and guarantees are valued stochastically and included in the liabilities. There are two main types of guarantees and options within the with-profits funds: maturity guarantees and guaranteed annuity options, and in addition, a return of premium guarantee for OLAB. Maturity guarantees are in respect of conventional with-profits business and unitised with-profits business and represent the sum assured and reversionary bonuses declared to date. For certain with-profits pension policies there are options guaranteeing the rates at which annuities can be purchased. OLAB return of premium guarantees relate to a guarantee to repay all premiums paid to maturity.

The cost of the maturity guarantees, guaranteed annuity options and return of premium guarantees have been calculated as:

		31 December 2013 £m	31 December 2012 £m
Maturity guarantees	FP WPF	192	362
	FLC New WPF	250	332
	FLC Old WPF	62	84
	FLAS WPF	209	264
	WL WPF	81	103
Guaranteed annuity options	FP WPF	495	583
	FLC New WPF	127	210
	FLC Old WPF	46	71
	FLAS WPF	84	116
	WL WPF	5	8
Return of premium guarantee	OLAB	60	72

26. Insurance contracts continued

d) Year end assumptions

i) Economic assumptions

Details regarding the economic assumptions used in the stochastic model for the valuation of with-profits policyholder liabilities are set out below.

The cost of with-profits guarantees is most sensitive to the assumed volatility of future returns on asset shares, the level of future interest rates and the rates of discontinuance on these policies. The guarantee cost in respect of guaranteed annuity options is most sensitive to the level of future interest rates, future mortality rates, assumed rates of discontinuance and early retirements, and the assumptions relating to the exercise of the tax free cash option on these policies. The cost of OLAB return of premium guarantees is most sensitive to the assumed volatility of future investment returns on unit funds, the level of future interest rates and the rates of discontinuance on these policies. Further details on these assumptions are provided below.

The cost of the with-profits guarantees and OLAB return of premium guarantee is assessed using a market consistent stochastic model as the economic scenario generator (produced by Moody's Analytics) and is calculated using 2,000 simulations.

The with-profits guarantees model is calibrated using the gilt risk-free curve assuming interest rates of between 0.4% and 3.8% per annum and implied volatilities in the market as shown in the following disclosures. The OLAB return of premium guarantee model is calibrated using the Euro swap curve assuming interest rates of between 0.2% and 3.5% per annum and implied volatilities as shown in the following disclosures.

Swaption implied volatilities – FP WPF, FPLAL WPF, FLC New WPF, FLC Old WPF, FLAS WPF and WL WPF

Option term	31 December 2013 swap term			
	10 years	15 years	20 years	25 years
UK Sterling				
10 years	18%	17%	16%	15%
15 years	19%	18%	17%	16%
20 years	17%	16%	15%	14%
25 years	16%	15%	14%	13%

Option term	31 December 2012 swap term			
	10 years	15 years	20 years	25 years
UK Sterling				
10 years	18%	17%	16%	15%
15 years	18%	17%	16%	16%
20 years	16%	16%	15%	15%
25 years	16%	16%	16%	15%

Notes to the consolidated accounts continued

26. Insurance contracts continued

Swaption implied volatilities – OLAB

Option term	31 December 2013 swap term			
	10 years	15 years	20 years	25 years
Euro				
10 years	23%	22%	21%	20%
15 years	25%	23%	22%	20%
20 years	22%	20%	19%	18%
25 years	21%	19%	18%	16%

Option term	31 December 2012 swap term			
	10 years	15 years	20 years	25 years
Euro				
10 years	24%	24%	23%	20%
15 years	27%	26%	24%	20%
20 years	26%	24%	21%	17%
25 years	23%	20%	18%	15%

For equity capital return and property total return, implied volatilities are shown in the table below:

FP WPF, FPLAL WPF, FLC New WPF, FLC Old WPF, FLAS WPF and WL WPF

Option term	31 December 2013		31 December 2012	
	Equities	Property	Equities	Property
5 years	19%	15%	24%	15%
10 years	22%	15%	26%	15%
15 years	24%	15%	27%	15%

OLAB

Option term	31 December 2013		31 December 2012	
	Equities	Property	Equities	Property
5 years	20%	n/a	25%	n/a
10 years	21%	n/a	25%	n/a
15 years	21%	n/a	25%	n/a

The cost of with-profits guarantees also depends on management actions that would be taken under various scenarios. For WL WPF and FP WPF, the regular bonus rate is set each year such that, by maturity, guaranteed benefits are targeted as a predefined proportion of asset share, leaving the remaining portion of the asset share to be paid as a final bonus. This management action is in line with the Company's PPFM.

For FLAS WPF, FLC Old WPF and FLC New WPF, the regular bonus rates are derived from the gross redemption yields on gilts with deductions for guaranteed interest rates, tax, expenses, shareholder transfers and a contingency margin. The remaining portion of the asset share is paid as a final bonus. This management action is in line with the Company's PPFM.

The guarantee cost in respect of guaranteed annuity options is assessed using a market consistent stochastic model and values both the current level of the guaranteed annuity rate benefit (allowing for future improvements in annuitant mortality) and the time value due to uncertainty in future interest rates. The guarantee cost in each scenario is the value of the excess annuity benefit provided by the options, relative to an annuity purchased in the open market. In estimating the future open market annuity rate, the model allows for stochastic variation in interest rates and for future mortality improvements. The stochastic interest rate assumption reflects that implied by current market interest rate derivative prices. Future annuitant mortality within the FLL with-profits balance sheet has been derived from the premium basis at which annuities can be purchased from FLPL, which allows for future mortality improvements.

26. Insurance contracts continued

The guarantee cost in respect of premium guarantees is assessed using a market consistent stochastic model and values both the current level of the guarantee and the time value due to uncertainty in future unit growth. The guarantee cost in each scenario is the value of the excess benefit provided by the guarantee relative to the projected unit fund at maturity, including future contractual premiums. In estimating the projected fund at maturity, the model allows for stochastic variation in equity and cash values.

ii) Non-economic assumptions

The provision for insurance contracts and investment contracts with DPF liabilities is sensitive to the principal assumptions in respect of mortality, morbidity and maintenance expenses, persistency and guaranteed annuity option take-up rates, although the relative sensitivity will vary depending on the insurance or investment contract.

Long-term estimates of future mortality and morbidity assumptions are based on standard tables wherever possible but adjusted to reflect the Group's own experience. Expense assumptions are based on recent experience for FLL. Within FLL and FLPL, there are provisions for future expenses to cover the expected level of servicing fees payable to Friends Life Services Limited ("FLSL") under the management services agreement, fees payable to investment managers and further amounts in respect of other expenses.

Experience investigations for mortality, morbidity, persistency, guaranteed annuity option take-up rates and maintenance expenses are performed at least annually for major product classes. Where industry analysis indicates that changes in expected future mortality, morbidity or other assumptions mean that claim costs are likely to rise in the future, then this is taken into account in the liability calculation.

Generally, no benefit is taken in regulatory reserves where industry analysis indicates that future trends are likely to reduce claim costs in the future. However, for FLC New WPF, FLC Old WPF and FLAS WPF, the benefit from a prudent view of expected future mortality improvements is taken on non-profit protection business in the realistic balance sheet. Improving mortality has been assumed when valuing annuities. Also, deteriorating morbidity has been assumed when valuing some critical illness business. Assumptions, for policies other than with-profits, are generally intended to be a prudent estimate of future experience.

The guaranteed annuity options and OLAB return of premium cost also depend upon other factors such as policy discontinuance and for guaranteed annuity options, the take up rate for the options. The factors are based on recent experience adjusted to reflect industry benchmarks and to anticipate trends in policyholder behaviour. A summary of the key assumptions is as follows:

Policy discontinuances: lapse, early retirement and paid-up rates vary by policy type and period and have been based on recent experience.

Policy lapses and paid up rates are generally in the ranges shown below:

FP WPF

	2013 % pa	2012 % pa
Pensions – lapses	1 to 9	1 to 9
Life – lapses	4.5 to 18	3 to 15
Mortgage endowments – lapses	3 to 4	3 to 4
With-profits bonds – lapses	9	9
Pensions – paid-up	4 to 17	4 to 17
Life – paid-up	0.5 to 2	0.5 to 2

FLC New WPF

	2013 % pa	2012 % pa
Pensions – lapses	4 to 10	4 to 11.5
Life – lapses	4 to 8	3 to 8
Mortgage endowments – lapses	1 to 6.5	1 to 6.5
With-profits bonds – lapses	6.25 to 8.5	7.5 to 8.5
Pensions – paid-up	4 to 12	4.5 to 12
Life – paid-up	0.5 to 2	0.5 to 2

Notes to the consolidated accounts continued

26. Insurance contracts continued

FLC Old WPF

	2013 % pa	2012 % pa
Pensions – lapses	4 to 10	4 to 11.5
Life – lapses	4 to 8	3 to 8
Mortgage endowments – lapses	1 to 6.5	1 to 6.5
With-profits bonds – lapses	6.25 to 8.5	7.5 to 8.5
Pensions – paid-up	4 to 12	4.5 to 12
Life – paid-up	0.5 to 2	0.5 to 2

FLAS WPF

	2013 % pa	2012 % pa
Pensions – lapses	6.5 to 11	6 to 10
Life – lapses	4.5 to 12	4.5 to 12
Mortgage endowments – lapses	1 to 6.5	1 to 6.5
With-profits bonds – lapses	6.25 to 8.25	7.5 to 8.5
Pensions – paid-up	4.5 to 12.5	5 to 12
Life – paid-up	1 to 2	1 to 2

WL WPF

	2013 % pa	2012 % pa
Pensions – lapses	3 to 8	3 to 8
Life – lapses	3 to 8	3 to 8
Mortgage endowments – lapses	2 to 8	2 to 8
With-profits bonds – lapses	5 to 9	5 to 9

FPLAL WPF

	2013 % pa	2012 % pa
Whole of Life – lapses	2.5 to 3.5	3.5
Whole of Life – paid up	5	5

OLAB

	2013 % pa	2012 % pa
Pensions – lapses	2 to 12	2.5 to 10
Pensions – paid up	2.5 to 12	0 to 9

Early retirement rates vary by age band and policy type and are set based on recent experience.

Tax free cash option: where a guaranteed annuity option is more valuable than the cash equivalent it is assumed that 5% to 27% (2012: 5% to 30%) of the benefit of the option is taken tax-free depending on the type of business. This is based on recent experience.

There are also guarantees and options in respect of some of the other life assurance business within the Group, but these are not considered to be material to the Group's future cash flows. In addition, they have largely been matched with suitable assets and there is no material exposure to market or interest rate changes. Provisions have been established using deterministic scenarios based on prudent assumptions.

26. Insurance contracts continued

e) Valuation interest rates

As explained above, with-profits business within FLL is valued in accordance with the PRA's realistic reporting regime.

Valuation interest rates for other than conventional with-profits business are shown in the table below.

	Company	Class of Business	2013 %	2012 %
Life	FLL	Endowment and Whole Life in non-profit funds	2.50	1.80
		Protection	2.50	1.80
		Endowment and Whole Life in with-profits funds	2.60	2.30
	ex-FLC	Over 50 Plan in non-profit funds	1.95	1.45
		Over 50 Plan in with-profits funds	2.35	1.40
		Additional life reserves	1.95	1.45
		Other conventional life in non-profit funds	1.95	1.45
		Other conventional life in with-profits funds	1.95	1.40
		Life annuities from FLAS	2.85	1.80
		Unit-linked life	1.95	1.45
	ex-FLAS	Conventional life	3.00	1.95
		Unit-linked life	3.00	1.95
	ex-FLWL	With-profits fund immediate annuities	2.15	1.60
		Life (other)	2.45	2.15
		Non-profit fund life	2.00	1.35
	FPIL	International Protector	3.20	2.20
Income Protection	FLL	Income Protection	2.60	1.70
	ex-FLC	Permanent Health Insurance	2.40	1.80
Pensions	FLL	Annuities in payment	3.76	3.25 to 3.27
		Protection	3.10	2.20
		Individual and Group pensions in non-profit funds	3.20	2.20
		Individual and Group pensions in with-profits funds	3.30	2.80
	ex-FLC	Unit-linked pensions	2.40	1.80
		Conventional pensions in non-profit funds	2.40	1.80
		Conventional pensions in with-profits funds	3.40	1.80
		WPAD ring-fenced funds	3.65	n/a
		Additional pensions reserves	2.40	1.80
	ex-FLAS	Conventional pensions	3.80	2.70
		Unit-linked pensions	3.80	2.45
	FAL	Ex-FLC annuities reinsured December 2007	3.45	2.90
		Ex-FLAS annuities reinsured July 2009	3.55	2.95
		Ex-FLC index-linked annuities reinsured December 2007	0.15	(0.60)
		Ex-FLAS index-linked annuities reinsured July 2009	0.10	(0.85)
	ex-FLWL	With-profits fund pensions (immediate annuities)	2.70	2.00
		Non-profit fund pensions (immediate annuities)	3.65	3.05
		Non-profit fund pensions (other)	2.50	1.70
		With-profits fund with-profits business deferred	2.60	1.80
		With-profits fund with-profits business other	3.10	2.65

Notes to the consolidated accounts continued

26. Insurance contracts continued

Within FLL certain products can have positive or negative reserves. The interest rate used for these products depends on which is more onerous.

	31 December 2013		31 December 2012	
	Positive reserves %	Negative reserves %	Positive reserves %	Negative reserves %
FLL	2.00	4.40	1.30	3.30
ex-FLC non-CIC	1.45	2.45	0.95	1.95
ex-FLC CIC	1.90	2.90	1.30	2.30

26. Insurance contracts continued

f) Mortality, morbidity and lapse rates

Insurance contract liabilities allow for mortality and morbidity risk by making assumptions about the proportion of policyholders who die or become sick. Allowance for future mortality has been made using the following percentages of the standard published tables below:

		31 December 2013	31 December 2012
Term assurances – FLL	Smoker male	82.5% TMS00(5)	83% TMS00(5)
	Smoker female	71.5% TFS00(5)	77% TFS00(5)
	Non-smoker male	82.5% TMN00(5)	88% TMN00(5)
	Non-smoker female	71.5% TFN00(5)	72% TFN00(5)
Term assurances – ex-FLC/ex-FLAS	Smoker male	82.5% TMS00(5)	90% TMS00(5)
	Smoker female	71.5% TFS00(5)	84% TFS00(5)
	Non-smoker male	82.5% TMN00(5)	96% TMN00(5)
	Non-smoker female	71.5% TFN00(5)	78% TFN00(5)
Term assurance – ex-FLWL	Smoker male	114% TM92ult⁽ⁱ⁾	126% TM92ult ⁽ⁱ⁾
	Smoker female	114% TF92ult⁽ⁱ⁾	108% TF92ult ⁽ⁱ⁾
	Non-smoker male	66% TM92ult⁽ⁱ⁾	66% TM92ult ⁽ⁱ⁾
	Non-smoker female	60% TF92ult⁽ⁱ⁾	66% TF92ult ⁽ⁱ⁾
Term assurance – FPIL	Smoker male	180% HKA01	180% HKA01
	Smoker female	210% HKA01	210% HKA01
	Non-smoker male	97.5% HKA01	97.5% HKA01
	Non-smoker female	97.5% HKA01	97.5% HKA01
Critical illness	FLL	CIBT02⁽ⁱⁱ⁾	CIBT02 ⁽ⁱⁱ⁾
Critical illness	ex-FLC/ex-FLAS	CIBT02⁽ⁱⁱⁱ⁾	CIBT02 ⁽ⁱⁱⁱ⁾
Other life assurances	FLL	120% AM/FC00ult	120% AM/FC00ult
Other life assurances	ex-FLC/ex-FLAS male	140% AMC00	140% AMC00
	ex-FLC/ex-FLAS female	125% AFC00	125% AFC00
Unitised policies	Life – FLL	130% AM/FC00ult	130% AM/FC00ult
	Other – FLL	110% AM/FC00ult	110% AM/FC00ult
Unitised policies	Life/Other – ex-FLC/ex-FLAS male	102.5% AMC00ult	102.5% AMC00ult
	Life/Other – ex-FLC/ex-FLAS female	100% AFC00ult	100% AFC00ult
Pensions	FLL/FLPL male	65% AMC00ult	65% AMC00ult
	FLL/FLPL female	55% AMFC00ult	55% AMFC00ult
	ex-FLC/ex-FLAS male	90.91% A67/70ult–1	90.91% A67/70ult–1
	ex-FLC/ex-FLAS female	90.91% AF80ult–1	90.91% AF80ult–1
Individual income protection	FLL	60% AM/F80ult^(iv)	60% AM/F80ult ^(iv)
	ex-FLC/ex-FLAS	100% AM/AF92^(iv)	100% AM/AF92 ^(iv)
Annuities in payment	FLL/FLPL individual annuities	PCMA/PCFA00^(v)	PCMA/PCFA00 ^(v)
	FLL/FLPL group annuities	PCMA/PCFA00^(v)	PCMA/PCFA00 ^(v)
	ex-FLC/FAL pension annuities male	96.6% PCMA00^(vi)	92% PCMA00 ^(vi)
	ex-FLC/FAL pension annuities female	98.9% PCFA00^(vi)	87.4% PCFA00 ^(vi)
	ex-FLAS pension annuities male	89.7% PCMA00^(vi)	89.7% PCMA00 ^(vi)
	ex-FLAS pension annuities female	92% PCFA00^(vi)	92% PCFA00 ^(vi)
Immediate annuities – ex-FLWL	Male	98.9% PCMA00^(vi)	98.9% PCMA00 ^(vi)
	Female	98.9% PCFA00^(vi)	98.9% PCFA00 ^(vi)

Notes to the consolidated accounts continued**26. Insurance contracts** continued

- (i) Aids loading at 1/3 of the R6A standard requirement applied to reserving basis.
- (ii) The percentages of the table used differ by sex and smoker status. CIBT02 has been adjusted to allow for a select period as follows: Year 1: 80% of CIBT02; Year 2: 95% of CIBT02; Year 3+: 100% of CIBT02. Future deterioration in morbidity is allowed for by assuming claim rates increase by 1.25% per annum and 1.5% per annum for males and females respectively.
- (iii) The percentages of the table used differ by sex, smoker status and sales group. Future deterioration in morbidity is allowed for by assuming claim rates increase by:
 - a) 0.75% per annum and 1.50% per annum for males and females respectively for standalone critical illness
 - b) 0.50% per annum and 1.00% per annum for males and females respectively for accelerated critical illness
- (iv) Individual income protection sickness and recovery rates are based on percentages of CMIR 12 (male and female) published tables. Rates differentiate by smoker status, deferred period and occupational class.
- (v) Age related percentages of the mortality tables are used.
- (vi) Future improvements in mortality are based on the CMI's core model CMI-2011 with a long-term rate of 2%.

For protection business, lapse rates are based on recent experience with a prudent margin.

In determining liabilities for with-profits business, it is assumed that a proportion of policies is discontinued (surrendered, lapsed or converted paid-up) in each future year. The relevant rates vary by product and duration.

g) Apportionment of surplus between shareholders and with-profits policyholders

Shareholders are entitled to 100% of surplus emerging from companies within the Group, with the exception of surplus emerging in the with-profits funds.

The Group has six with-profits funds of which only FP WPF is open to new business and five (FLC New WPF, FLC Old WPF, WL WPF, FPLAL WPF and FLAS WPF) are closed to new business.

Shareholders are entitled to one-ninth of the cost of bonuses added to policies, except for:

- within the FP WPF, surplus arising on pre-demutualisation non-profit and unitised business (excluding the investment element) arises within the with-profits fund but assets of the with-profits fund equal to 60% of the surplus arising are transferred to shareholders;
- within the FP WPF, post demutualisation policyholders are only entitled to surplus from the return on their investments; other sources of surplus are wholly-owned by shareholders including policies written by FPLAL and FLPL, where the investment element is reinsured to the FP WPF;
- within the FPLAL WPF, policyholders are entitled to all the surplus of that fund. In addition, FLL has a closed unitised with-profits fund. Shareholders are entitled to all profits from the unitised with-profits fund other than investment profits, which are wholly-owned by with-profits policyholders. The investment element of the contract is wholly reinsured to the FP WPF;
- certain unitised with-profits policies in FLL which are written in the non-profit fund and reassured to the WL WPF; and
- certain policies in FLC New WPF and FLC Old WPF with guaranteed bonus rates, where the shareholders do not receive one-ninth of guaranteed bonuses.

The effect of the fund structure is that investment risk, in respect of assets backing with-profits policies is largely borne by policyholders; shareholders bear 10% of the investment risk from conventional with-profits policies, other than within the FPLAL WPF.

Expense risk is borne by shareholders, other than within the FPLAL WPF. Increases to expenses that can be charged to the WL WPF are capped in line with RPI.

27. Investment contracts

Policyholder contracts not considered insurance contracts under IFRS 4 are classified as investment contracts. Contracts classified as investment contracts are either unit-linked or contracts with DPF with no significant insurance risk. The latter are mainly unitised with-profits contracts.

Investment contracts are financial liabilities designated on initial recognition at fair value through profit or loss, when one of the following criteria is satisfied:

- it eliminates or significantly reduces an accounting mismatch with corresponding assets which are managed on a fair value basis.
- it contains or may contain an embedded derivative.

A unit-linked contract is recognised at fair value through profit or loss and is calculated as the number of units allocated to policyholders in each of the unit-linked funds multiplied by the bid price of the units which reflects the fair value of the assets in the fund at the balance sheet date. In addition to this the fair value of the investment contract liability includes a provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to the policyholders. Provision is made for renewal commissions at the inception of an investment contract as intermediaries are not required to perform any service once the policy is inception. Non-unit reserves, relating primarily to deferral of front end fees in the form of unfunded units, are also included as an investment contract liability and recognised as income on a straight-line basis over the period in which services are rendered.

Investment contracts with DPF held within the with-profits funds (which are mainly unitised with-profits contracts) are measured on a basis that is consistent with a measurement basis for insurance contracts held within these funds.

Movement in investment contract liabilities are shown in the table below.

For the year ended 31 December	2013 £m	2012 £m
At 1 January	78,184	75,191
Premiums	5,956	7,724
Claims	(8,472)	(8,224)
Investment return, annual management charges and other expenses	7,356	4,032
Foreign exchange adjustments	478	(539)
At 31 December	83,502	78,184
Analysed as follows:		
Unit-linked contracts	72,682	67,428
Policies with DPF	8,991	9,543
Other non-unit reserves	1,829	1,213
Total investments contract liabilities	83,502	78,184

None of the movement in liabilities is attributable to changes in credit risk of the liabilities. Investment return of £6,900 million (2012: £5,052 million) is included within the income statement arising from movements in investment contract liabilities.

Included in the carrying amount above, £72,814 million (2012: £68,587 million) is expected to be settled more than 12 months after the reporting date.

Notes to the consolidated accounts continued

28. Unallocated surplus

The unallocated surplus in the with-profits funds is presented as a liability and comprises all amounts available for allocation, either to policyholders or to shareholders, the allocation of which has not been determined at the balance sheet date.

Insurance and investment contract liabilities within with-profits funds are measured on a realistic basis and therefore include amounts attributable in respect of future bonuses. Such amounts are estimated in accordance with the published Principles and Practices of Financial Management and represent a constructive obligation. The realistic liabilities include an estimate of the fair value of policyholder options and guarantees. The unallocated surplus within the with-profits funds represents the excess of assets of the fund relative to the realistic liabilities and other current liabilities not included within the realistic liability measurement. The unallocated surplus can be considered to represent the working capital of the funds and includes a part which represents the value of future transfers to shareholders from the with-profits funds.

	2013 £m	2012 £m
At 31 December	627	656

29. Capital

a) Overview

The Group manages its capital resources on both regulatory and economic capital bases, focusing primarily on capital efficiency and the ease with which cash and capital resources can be transferred between entities.

The capital management objectives are:

- to maintain capital resources for life operations at the greater of the capital resources requirement ("CRR") as required by local solvency rules and CRR as required by the local capital management policy;
- to hold capital resources for RSL that meet a minimum of 150% (2012: 150%) of the Group CRR (excluding the with-profits insurance capital component ("WPICC");
- to maintain financial strength within the Group and regulated entities sufficient to support new business growth targets, and to satisfy the requirements of the policyholders, regulators and stakeholders including rating agencies;
- to retain financial flexibility by maintaining strong liquidity to cover expected and unexpected events, which includes access to an undrawn facility with a consortium of banks;
- to manage the with-profits business of the Group in accordance with agreed risk appetites and all statutory requirements; and
- to ensure that transfers from long-term business funds and dividends from entities that support the cash generation requirements of the Group are balanced with the need to maintain appropriate capital within the Group and regulated entities.

The operations of the Group are subject to regulatory requirements within the countries where it operates. Such regulations specify that a minimum amount of required capital must be maintained at all times throughout the financial year.

Under PRA rules, the UK life operations are also required to perform a private individual capital assessment ("ICA") of the economic capital required to mitigate the risk of insolvency to a minimum of a 99.5% confidence level over a one year period. The PRA review the ICA and may impose additional capital requirements by way of individual capital guidance ("ICG").

In addition to the regulatory requirements for individual life operations, the Group must comply with the requirements of the Insurance Groups Directive. Following the governance changes made in April 2013 Resolution Limited is now deemed to be the ultimate EEA parent undertaking of the Group and as such the insurance groups capital adequacy ("IGCA") requirements are now monitored at the RSL level.

An internal reorganisation has taken place during the year with the objective of realising capital and operating synergies in the Friends Life group. In this regard, the following business transfers have taken place in the period under the provisions of Part VII of the Financial Services and Markets Act 2000 (the "2013 Scheme"):

- all of the long-term business in FLC was transferred to FLPL; and
- the majority of the long-term business of FLWL was transferred to FLL and its with-profits funds renamed as "Friends Life WL With Profits Fund" ("WL WPF"), the remaining long-term business of FLWL, being a small amount of non profit unit-linked pensions business, was transferred to FLPL.

The Part VII transfers took place on 28 December 2013 and FLC and FLWL remained authorised life companies at 31 December 2013.

The formal procedures for identifying and assessing risks that could affect the capital position of the Group are described in the risk management policies set out in note 30.

b) Capital statement

The Group capital statement is set out below. It is based on local regulatory returns and incorporates the following:

- a statement showing local basis capital resources and the related capital requirement. For UK life operations, the capital statement shows capital resources and regulatory capital resource requirements as specified by PRA rules. For overseas life operations, capital resources and requirements are calculated according to local regulatory requirements; and
- a reconciliation from the local basis regulatory surpluses to the Resolution Limited group's estimated IGCA surplus, calculated in accordance with the valuation rules of the Insurance Groups Directive; and an analysis of policyholder liabilities on an IFRS basis.

Notes to the consolidated accounts continued

29. Capital continued

As at 31 December 2013	Total UK with-profits funds £m	UK shareholder and non-profit funds £m	Overseas life operations £m	Total life operations £m	Other operations and consolidation adjustments £m	Total £m
Shareholders' equity						
Outside long-term fund	–	74	133	207	3,361	3,568
Inside long-term fund	–	1,627	34	1,661	–	1,661
	–	1,701	167	1,868	3,361	5,229
Other qualifying capital						
Preference shares	–	300	–	300	(300)	–
Innovative tier one capital (STICS)	–	511	–	511	(23)	488
Subordinated debt	–	847	–	847	162	1,009
Unallocated surplus	627	–	–	627	–	627
	627	3,359	167	4,153	3,200	7,353
Regulatory adjustments						
Assets	6	(1,295)	(49)	(1,338)	(3,016)	(4,354)
Liabilities	4,913	59	47	5,019	657	5,676
Available capital resources	5,546	2,123	165	7,834	841	8,675
Capital requirement						
UK realistic basis	4,959	–	–	4,959	–	4,959
Other regulatory bases	–	765	73	838	24	862
	4,959	765	73	5,797	24	5,821
Local basis capital resources over capital requirement						2,854
IGCA valuation adjustments						
Restricted assets ⁽ⁱ⁾ and shareholders capital support of the with-profits funds						(616)
Other						(2)
Estimated IGCA surplus						2,236
Analysis of policyholders' liabilities						
With-profits	17,614	–	131	17,745	–	17,745
Unit-linked	251	53,621	27,272	81,144	–	81,144
Non-participating and other non-unit reserves	5,198	12,809	1,196	19,203	–	19,203
Total policyholder liabilities	23,063	66,430	28,599	118,092	–	118,092

(i) Long-term fund surplus capital over and above capital requirements is excluded from capital resources on an IGCA basis.

29. Capital continued

UK with-profits funds

As at 31 December 2013	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
Other qualifying capital							
Unallocated surplus	155	3	200	62	193	14	627
Regulatory adjustments							
Assets	6	–	–	–	–	–	6
Liabilities	1,487	41	1,506	446	1,353	80	4,913
Available capital resources	1,648	44	1,706	508	1,546	94	5,546
Capital requirement							
UK realistic basis	1,366	44	1,584	467	1,398	100	4,959
Local basis capital resources over capital resources requirement							587
Analysis of policyholders' liabilities							
With-profits	7,277	137	4,797	1,282	3,591	530	17,614
Unit-linked	29	–	–	–	45	177	251
Non-participating and other non-unit reserves	2,235	104	806	139	1,831	83	5,198
Total	9,541	241	5,603	1,421	5,467	790	23,063

The excess of capital requirements over available capital resources of WL WPF is covered by available capital resources of UK shareholder and non-profit funds.

Notes to the consolidated accounts continued

29. Capital continued

As at 31 December 2012	Total UK with-profits funds £m	UK shareholder and non-profit funds £m	Overseas life operations £m	Total life operations £m	Restated other operations and consolidation adjustments ⁽ⁱ⁾ £m	Restated Total £m
Shareholders' equity						
Outside long-term fund	–	46	110	156	3,451	3,607
Inside long-term fund	–	1,717	53	1,770	–	1,770
	–	1,763	163	1,926	3,451	5,377
Other qualifying capital						
Preference shares	–	300	–	300	(300)	–
Innovative tier one capital (STICS)	–	511	–	511	(23)	488
Subordinated debt	–	854	1	855	162	1,017
Unallocated surplus	656	–	–	656	–	656
	656	3,428	164	4,248	3,290	7,538
Regulatory adjustments						
Assets	(33)	(1,468)	(15)	(1,516)	(3,413)	(4,929)
Liabilities	4,200	119	43	4,362	862	5,224
Available capital resources	4,823	2,079	192	7,094	739	7,833
Capital requirement						
UK realistic basis	4,386	–	–	4,386	–	4,386
Other regulatory bases	–	687	88	775	24	799
	4,386	687	88	5,161	24	5,185
Local basis capital resources over capital requirement						2,648
IGCA valuation adjustments						
Restricted assets ⁽ⁱⁱ⁾ and shareholders capital support of the with-profits funds						(495)
Assets in excess of market risk and counterparty limits						1
IGCA surplus						2,154
Analysis of policyholders' liabilities						
With-profits	18,703	–	146	18,849	–	18,849
Unit-linked	242	50,373	25,327	75,942	–	75,942
Non-participating and other non-unit reserves	7,984	11,427	1,214	20,625	–	20,625
Total policyholder liabilities	26,929	61,800	26,687	115,416	–	115,416

(i) Following the governance changes made in April 2013 Resolution Limited is now deemed to be the ultimate EEA parent undertaking of the Group and as such the IGCA requirements are now monitored at the RSL level. Other operations and consolidation adjustments have been restated to show the 31 December 2012 IGCA surplus at the RSL level.

(ii) Long-term fund surplus capital over and above capital requirements is excluded from capital resources on an IGCA basis.

29. Capital continued

UK with-profits funds

As at 31 December 2012	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
Other qualifying capital							
Unallocated surplus	243	3	162	52	186	10	656
Regulatory adjustments							
Assets	(14)	–	–	–	(1)	(18)	(33)
Liabilities	1,484	29	1,217	400	973	97	4,200
Available capital resources	1,713	32	1,379	452	1,158	89	4,823
Capital requirement							
UK realistic basis	1,507	32	1,309	411	1,033	94	4,386
Local basis capital resources over capital requirement							437
Analysis of policyholders' liabilities							
With-profits	8,202	155	4,840	1,344	3,641	521	18,703
Unit-linked	33	–	–	–	42	167	242
Non-participating and other non unit reserves	2,399	96	973	134	4,291	91	7,984
Total	10,634	251	5,813	1,478	7,974	779	26,929

Restrictions on availability of capital

The available capital in a regulated entity is generally subject to restrictions as to its availability to meet capital requirements elsewhere in the Group. The principal restrictions are:

UK with-profits funds

- **FP WPF:** shareholders are entitled to one-ninth of the amount distributed to conventional with-profits policyholders in the form of bonuses. In addition, shareholders are entitled to 60% of the surplus arising in respect of the pre-demutualisation non-profit and unitised business written in the fund (excluding the investment element); the remaining 40% belongs to with-profits policyholders. Also, post-demutualisation policyholders are only entitled to surplus from the return on their investments; other sources of surplus are wholly owned by shareholders.
- **FPLAL WPF:** the surplus in the closed with-profits fund may only be distributed to policyholders.
- **FLC New WPF, FLC Old WPF and FLAS WPF:** shareholders are entitled to one ninth of the amount distributed to policyholders in the form of bonuses, with the following exception: certain policies in FLC WPFs with guaranteed bonus rates, where the shareholders do not receive one ninth of guaranteed bonuses.
- **WL WPF:** shareholders are entitled to one ninth of the amount distributed to policyholders in the form of bonuses, with the following exception: where elements of the non-profit fund policies are invested in the WL WPF the shareholder receives the management charges in the non-profit fund.

Non-participating business

For non-participating business, surplus can generally be distributed to shareholders subject to meeting regulatory requirements and those of the 2013 scheme in relation to support arrangements for the with-profits funds in FLL as set out in the disclosures on intra-group capital arrangements in section d.

Notes to the consolidated accounts continued

29. Capital continued

c) Movement in available capital

At 31 December 2013, total available capital resources in the life operations have increased during the year by £740 million to £7,834 million (2012: £255 million increase to £7,094 million), as shown below.

For the year ended 31 December 2013	UK Total with-profits funds £m	UK shareholders' and non-profit funds £m	Overseas life operations £m	Total life operations £m
At 1 January 2013	4,823	2,079	192	7,094
Opening adjustment: divested business	–	–	(50)	(50)
New business strain	(17)	(48)	(76)	(141)
Expected existing business contribution	224	443	138	805
Experience variances and development costs	(266)	(54)	(1)	(321)
Operating assumption changes	59	69	(7)	121
Other operating items	3	107	(11)	99
Economic variance and other non-operating items	713	(17)	9	705
Other capital and dividend flows	7	(456)	(31)	(480)
Foreign exchange variances	–	–	2	2
At 31 December 2013	5,546	2,123	165	7,834

Analysis of with-profits funds

For the year ended 31 December 2013	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
At 1 January 2013	1,710	33	1,382	451	1,157	90	4,823
New business strain	–	–	(2)	–	(15)	–	(17)
Expected existing business contribution	(2)	–	(18)	30	148	66	224
Experience variances and development costs	7	–	(217)	(118)	43	19	(266)
Operating assumption changes	(2)	1	53	7	1	(1)	59
Other operating items	(23)	–	(52)	(7)	85	–	3
Economic variance and other non-operating items	(42)	10	560	145	120	(80)	713
Other capital and dividend flows	–	–	–	–	7	–	7
At 31 December 2013	1,648	44	1,706	508	1,546	94	5,546

29. Capital continued

For the year ended 31 December 2012	UK Total with-profits funds £m	UK shareholders' and non-profit funds £m	Overseas life operations £m	Total life operations £m
At 1 January 2012	4,230	2,432	177	6,839
New business strain	–	(75)	(113)	(188)
Expected existing business contribution	54	444	126	624
Experience variances and development costs	34	(55)	(33)	(54)
Operating assumption changes	7	7	(74)	(60)
Other operating items	(8)	50	(1)	41
Economic variance and other non-operating items	506	(79)	(15)	412
Other capital and dividend flows	–	(645)	128	(517)
Foreign exchange variances	–	–	(3)	(3)
At 31 December 2012	4,823	2,079	192	7,094

Analysis of with-profits funds

For the year ended 31 December 2012	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
At 1 January 2012	1,526	27	1,123	322	1,149	83	4,230
Expected existing business contribution	(71)	1	131	61	(68)	–	54
Experience variances and development costs	33	–	2	1	–	(2)	34
Operating assumption changes	1	–	6	1	(1)	–	7
Other capital and dividend flows	(8)	–	–	–	–	–	(8)
Economic variance and other non-operating items	229	5	120	66	77	9	506
At 31 December 2012	1,710	33	1,382	451	1,157	90	4,823

Notes to the consolidated accounts continued**29. Capital** continued**d) Intra-group capital arrangements**

There is a financing arrangement in the form of reinsurance of certain business written by FLAS which was transferred into FLC from Sun Life Pensions Management Limited ("SLPM") through a Part VII Scheme in 2007. Following the COP 2012 Part VII transfer this financing arrangement exists between the FLAS WPF and the FLL non-profit fund both of which are separate funds in FLL. During the year the total balance of the financing outstanding was repaid and as such the net amount of financing outstanding at 31 December 2013 was £nil (2012: £26 million).

FLL has guaranteed the £210 million (2012: £210 million) STICS issued in 2003 and the £268 million (2012: £268 million) STICS issued in 2005 by FPG, but now transferred to FLG. The FLG £162 million subordinated debt is also guaranteed by FLL.

On 21 April 2011, FLG issued a £500 million external Lower Tier 2 ("LT2") debt instrument with a coupon of 8.25% and a maturity of 2022. The £500 million external LT2 debt is guaranteed on a subordinated basis by FLL.

On 8 November 2012, the Group issued a US\$575 million Upper Tier 2 ("UT2") reset perpetual subordinated debt instrument with a coupon of 7.875%, which is irrevocably guaranteed on a subordinated basis by FLL. A derivative instrument was entered into on 8 November 2012 to manage the risks associated with fluctuations in exchange rates on the issue of this debt.

Following the Part VII transfer of business from FLC and FLWL to FLL and FLPL, the requirement to retain the FLWL Segregated Sub-Fund to support the WL WPF and the other previously existing with-profits fund support arrangements have been incorporated into one FLL scheme such that, as at 31 December 2013, the FLL shareholder fund and non-profit fund are required to retain £1.2 billion of capital support assets. Of this, £0.7 billion needs to be held in the form of tangible assets which could be transferred to the various FLL with-profits funds on a temporary basis if necessary. As at 31 December 2013 £59 million (2012: £59 million) of these support assets have been temporarily transferred to the FP WPF in the form of a contingent loan.

In the case of a temporary transfer to the with-profits funds, assets and related investment income would remain attributable to the shareholders as they would be returned when they are no longer required to support the capital requirements of the with-profits funds, under the tests set out in the 2013 scheme. In the case of the FLC WPFs if all or part of the assets transferred were unlikely to be returned in the foreseeable future (taking into consideration the duration of the in-force with-profits policies), then the relevant part of the transfer would be designated permanent resulting in an income statement charge to the shareholders. Under the rules of the 2013 scheme a test must be performed once in every 12 month period and may result in a transfer being made to the with-profits funds. As at 31 December 2013 the transfer to the FLC WPFs was £nil (2012: £nil). In the case of the WL WPF should any transfer of the £15 million (2012: £18 million) support arrangement be made, it would be on a permanent basis and would result in an income statement charge to the shareholders.

e) Policyholder liabilities

The assumptions which have the greatest effect on policyholder liabilities (including options and guarantees) and the process used to determine those assumptions are summarised in note 26. The terms and conditions of options and guarantees relating to life assurance contracts are disclosed in note 25.

The sensitivity of policyholder liabilities to changes in market conditions and to key assumptions and other variables are disclosed in note 30.

30. Risk management objectives and policies for mitigating risks

Overview

Risks to which the Group is exposed

The Group, in the course of doing business, is exposed to the following categories of risk:

- financial risks: these are risks relating to the financial management of the business, the economy and other external events which result in the Group being unable to meet its financial obligations, and include market, credit, liquidity and insurance risks;
- strategic risks: these are risks related to the Group's business strategy and decision making, and include risks associated with mergers and acquisitions activity and the composition of the Group's capital structure;
- operational risks: these are risks of losses arising from inadequate or failed internal processes, personnel or systems, or from external events. Operational risks include regulatory, financial crime, people, legal, outsourcing, information technology and business protection risks; and
- Group risks: these are risks of losses or reputational damage due to the activities of a Group member, including any business unit or subsidiary.

This note presents information about the Group's exposure to financial risks and the Group's preferences, policies and processes for measuring and managing these risks. The Group's risk preferences are approved by the Board and form part of the Group's Enterprise Risk Management framework. The Group policies outline the core principles to which the Group must adhere. The Group policy framework consists of nine Group policies, with a number of supporting control standards and detailed processes and procedures. The risks noted above form part of the Group Enterprise Risk Management Policy. Further quantitative disclosures are included throughout these consolidated financial statements.

a) Quantitative risk exposure

The Group applies sensitivity and scenario tests to economic and experience assumptions to understand the volatility of earnings, the volatility of its capital requirements, and to manage its capital more efficiently. The sensitivity and scenario results are produced to inform the Group's decision making and planning processes, and as part of the framework for identifying and quantifying the risks to which each of its business units, and the Group as a whole, are exposed.

The Group's quantitative exposure to a range of financial risks can be illustrated in the MCEV sensitivity analysis, where the impacts of reasonably possible changes in risk variables are disclosed. The basis of preparation and limitations of the MCEV methodology are provided in the MCEV supplementary information.

Limitations of sensitivity analysis

The sensitivities assume that only the key assumption is changed while the other assumptions remain unchanged. The sensitivities do not take account of any correlation between the assumptions and other factors that may occur in reality. The sensitivities shown are non-linear, and larger or smaller impacts should not be interpolated or extrapolated from these results. Other limitations in the sensitivities shown include the use of hypothetical market movements to demonstrate potential risks that only represent the Group's view of possible near-term market changes that cannot be predicted with any certainty, and the assumption that all interest rates move in an identical fashion.

Life and pensions

The tables on the following page show the sensitivity of the embedded value for covered business and the contribution from new business to changes in assumptions at year end 2013 and 2012, split by UK and Heritage (including the Corporate business where relevant) and International (comprising of FPI and Lombard).

The sensitivities shown reflect movement in MCEV covered business only.

In calculating each sensitivity it is assumed that other future experience assumptions remain unchanged, except where changes in economic conditions directly affect them. Any changes in the assumptions underlying the statutory reserving calculations have no material impact on the MCEV sensitivities shown. For Heritage, Lombard and UK businesses statutory assumptions have not been changed in applying the MCEV sensitivities, but for FPI the statutory assumptions have been changed to fit with regulatory requirements.

Notes to the consolidated accounts continued

30. Risk management objectives and policies for mitigating risks continued

	Change in MCEV (net of tax)					Change in VNB (gross of tax)				
	UK £m	Heritage £m	UK and Heritage £m	Int'l £m	Total £m	UK £m	Heritage £m	UK and Heritage £m	Int'l £m	Total £m
2013 sensitivities										
Base MCEV and VNB (per note 11 of the supplementary information)	1,418	2,435	3,853	1,201	5,054	184	(19)	165	39	204
Market and credit risk										
100bps increase in reference rates	(21)	19	(2)	25	23	(3)	–	(3)	–	(3)
100bps reduction in reference rates	20	(6)	14	(32)	(18)	1	–	1	2	3
Removal of illiquidity premium for immediate annuities	(118)	(399)	(517)	–	(517)	(44)	–	(44)	–	(44)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	(48)	(149)	(197)	(62)	(259)	n/a	n/a	n/a	n/a	n/a
25% increase in equity and property volatility at the valuation date	–	(12)	(12)	(18)	(30)	n/a	n/a	n/a	n/a	n/a
25% increase in swaption implied volatility at the valuation date	–	(4)	(4)	–	(4)	n/a	n/a	n/a	n/a	n/a
100bps increase in corporate bond spreads ⁽ⁱ⁾	(72)	(177)	(249)	(9)	(258)	(18)	–	(18)	–	(18)
100bps decrease in corporate bond spreads ⁽ⁱ⁾	77	150	227	9	236	19	–	19	–	19
10% adverse movement in Sterling/overseas exchange rate ⁽ⁱ⁾	(7)	(25)	(32)	(78)	(110)	n/a	n/a	n/a	n/a	n/a
10% fall in value in unit-linked funds	(62)	(212)	(274)	(94)	(368)	n/a	n/a	n/a	n/a	n/a
100bps increase in expense inflation	(30)	(81)	(111)	(31)	(142)	(7)	–	(7)	–	(7)
100bps decrease in expense inflation	26	70	96	25	121	5	–	5	–	5
Insurance and other risk										
Reduction to EU minimum capital or equivalent ⁽ⁱⁱ⁾	9	42	51	–	51	2	–	2	–	2
10% proportionate reduction in maintenance expenses	30	59	89	45	134	8	–	8	4	12
10% proportionate reduction in lapse rates	36	58	94	45	139	14	–	14	5	19
10% reduction in paid-up rates	9	1	10	4	14	5	–	5	1	6
5% reduction in mortality and morbidity (excluding annuities):										
Before reinsurance	27	47	74	12	86	8	–	8	–	8
After reinsurance	12	16	28	8	36	3	–	3	–	3
5% reduction in annuitant mortality/morbidity:										
Before reinsurance	(17)	(129)	(146)	–	(146)	(3)	–	(3)	–	(3)
After reinsurance	(17)	(51)	(68)	–	(68)	(5)	–	(5)	–	(5)
Effect of end of period assumptions on VNB	n/a	n/a	n/a	n/a	n/a	(11)	–	(11)	(3)	(14)

30. Risk management objectives and policies for mitigating risks continued

	Change in MCEV (net of tax)			Change in VNB (gross of tax)		
	UK and Heritage £m	Int'l ^(iv) £m	Total £m	UK and Heritage £m	Int'l ^(iv) £m	Total £m
2012 sensitivities						
Base MCEV and VNB (per note 11 of the supplementary information)	3,696	1,227	4,923	144	50	194
Market and credit risk						
100bps increase in reference rates	(53)	(3)	(56)	(6)	(2)	(8)
100bps reduction in reference rates	37	15	52	5	2	7
Removal of illiquidity premium for immediate annuities	(544)	–	(544)	(31)	–	(31)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	(181)	(60)	(241)	n/a	n/a	n/a
25% increase in equity and property volatility at the valuation date	(32)	–	(32)	n/a	n/a	n/a
25% increase in swaption implied volatility at the valuation date	(4)	–	(4)	n/a	n/a	n/a
100bps increase in corporate bond spreads ⁽ⁱ⁾	(203)	(11)	(214)	(14)	–	(14)
100bps decrease in corporate bond spreads ⁽ⁱ⁾	261	11	272	13	–	13
10% adverse movement in Sterling/overseas exchange rate ⁽ⁱⁱ⁾	(30)	(92)	(122)	n/a	n/a	n/a
10% fall in value in unit-linked funds	(207)	(96)	(303)	n/a	n/a	n/a
100bps increase in expense inflation	(65)	(39)	(104)	(7)	(5)	(12)
100bps decrease in expense inflation	57	32	89	6	4	10
Insurance and other risk						
Reduction to EU minimum capital or equivalent ⁽ⁱⁱⁱ⁾	40	–	40	2	–	2
10% proportionate reduction in maintenance expenses	109	50	159	8	8	16
10% proportionate reduction in lapse rates	83	49	132	13	5	18
10% reduction in paid-up rates	13	12	25	5	1	6
5% reduction in mortality and morbidity (excluding annuities):						
Before reinsurance	79	12	91	10	4	14
After reinsurance	38	8	46	5	1	6
5% reduction in annuitant mortality/morbidity:						
Before reinsurance	(132)	–	(132)	(4)	–	(4)
After reinsurance	(67)	–	(67)	(4)	–	(4)
Effect of end of period assumptions on VNB	n/a	n/a	n/a	4	(1)	3

Comparative figures for splits to the UK and Heritage operating segments for the year ended 31 December 2012 are not available and the costs to develop them would be excessive.

- (i) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40bps (2012: 40bps) for in-force business and 40bps (2012: 40bps) for the value of new business.
- (ii) Currency risk is expressed in terms of total overseas exposure; the Group's principal currency exposures other than Sterling are the Euro and US Dollar.
- (iii) Required capital is set at the greater of regulatory capital and requirements arising from internal capital management policies. In aggregate, the required capital is higher than the regulatory requirement by £812 million (2012: £886 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.
- (iv) The 2012 FPI embedded value included £43 million in respect of AmLife. This was sold on 4 January 2013 and consequently there is no sensitivity included in respect of AmLife in 2013.

Notes to the consolidated accounts continued

30. Risk management objectives and policies for mitigating risks continued

b) Market risk

Overview

Market risk is defined within the Group as: "The risk that movement in market factors impacts adversely on the value of, or income from, shareholder or policyholder funds".

Market risk can be categorised into the following risk drivers which correspond to the sub-modules through which they are modelled within Friends Life's internal model. These are equity and property risk, interest rate risk, volatility risk and foreign exchange risk.

The RSL Board sets preferences for market risk for each of the different asset classes taking account of the risk appetite set by the Board. Consideration is given to the objectives of the asset pools to which they relate and the nature of the liabilities backed by those assets.

Shareholders' earnings are directly affected by market movements. For shareholder funds, the exposure will impact both the assets and associated liabilities. The Group manages market risk attaching to assets backing specific policyholder liabilities and to assets held to deliver income and gains for the shareholder. The principal objective for shareholder assets is to manage them so that they meet the capital requirements of the Group, and support its future strategic objectives.

Shareholders' earnings are further exposed to market risk to the extent that the income from policyholder funds is based on the value of financial assets held within those unit-linked or with-profits funds. Within the unit-linked funds and with-profits funds, the Group manages market risk so as to provide a return in line with the expectations of policyholders.

Market risk arises on guarantees and options offered on some of the Group's products. As described within the section on policyholder liabilities (see note 25 and 26), the Group is exposed to guarantees on bonus additions that become more valuable as investment values fall and where the cost of hedging increases. In addition, the Group is exposed to guaranteed cash and annuity options on certain pension policies that become more valuable as interest rates fall and where the cost of hedging increases.

Management of market risk

The following summarises the key actions undertaken by the Group to manage market risk:

The RSL Board has adopted a Group Enterprise Risk Management Policy, underpinned by the Market Risk Control Standard. The Market Risk Control Standard sets out how market risk should be managed within the Group. The Market Risk Control Standard is reviewed as part of the Group's annual review of policies.

The Market Risk Control Standard is further embedded in the business through the operation of investment limits. These specify the permitted asset classes for investment, the limits for exposures to asset classes including gilts and corporate bond exposures, cash exposures, derivative exposures, equity and other exposures, and also limits in relation to interest rate risk, inflation risk, foreign exchange risk, implied equity and interest rate volatility. The relevant limits are also reflected in investment guideline documents which are maintained for each fund.

To support the setting of investment limits, the Asset and Liability Management ("ALM") function is responsible for carrying out strategic asset allocation studies on each block of business within a three year life cycle. This review considers risk appetite, capital requirements and other metrics.

The Investment Oversight Committee, which is a Committee of the Board, oversees investment policy and strategy, which the Group controls primarily through the use of investment fund mandates. Day-to-day implementation of investment policy and strategy is managed predominantly by:

- F&C in respect of some WPFs within FLL, non-profit and shareholder portfolios within FLL and FLPL as well as a proportion of the unit-linked business sold by FLL and FLPL.
- AXA IM in respect of the FLC WPFs, FLAS WPF and WL WPF, non-profit, and shareholder portfolios within FLL and FLPL, as well as a proportion of the unit-linked business sold by FLL and FLPL, and the management of the Group's cash fund; and
- FLI in respect of some WPFs within FLL, non-profit, and shareholder portfolios within FLL and FLPL, as well as the Group's collateral management.

Mandates are set for each fund within each of the insurance legal entities within the Group taking account of the relevant factors outlined above. Unit-linked funds are managed in line with their underlying objectives as set out in fund guidelines. The mandates seek to limit exposure to market risk by using some or all of the following mechanisms:

- restrictions on the asset classes held; and
- restrictions on the maximum exposure to any one issuer; and defined sector, country or regional limits.

30. Risk management objectives and policies for mitigating risks continued

Use of derivatives to manage market risk

FLI, F&C and AXA IM managed funds may hold derivatives to facilitate efficient portfolio management where their use is provided for in the relevant fund mandates. The types of derivatives held vary between investment mandates but may include both interest rate and equity derivatives. Currency forwards and other derivatives may also be held to manage currency risk, but only if permitted by individual fund mandates. The Group may seek to reduce investment risk by holding derivatives (without disproportionately increasing other types of risk).

Unit-linked funds may use derivatives for the purposes of efficient portfolio management and risk reduction in accordance with fund guidelines and marketing literature relevant to the funds.

In addition to the mandates, the Group undertakes a programme of asset/liability management. For example, in order to manage the impact of interest rate changes on profit, corporate bonds and gilts are held to match the duration, profile and cash flows of annuity and income protection policies.

In order to manage the exposure arising from guarantees and options, the Group has purchased a number of derivatives, including interest rate swaps, equity put options, currency forwards, inflation swaps, interest rate swaptions and equity futures to manage exposures to movements in equity prices or interest rates. Hedge accounting has not been applied to these derivatives, as movements in the fair value of these instruments will be offset by the movement in the valuation of the liability. As noted, the majority of these guarantees arise within the Group's with-profits funds and so any net fair value movement will be reflected in the unallocated surplus rather than within shareholders' funds. In addition, derivatives are used to manage guarantees in respect of non-profit business.

Additional information

The following provides additional information on the exposure to equity and property risk, foreign exchange risk, interest rate risk and volatility risk:

i) Equity and property risk

Equity and property risk are accepted in accordance with agreed risk preferences in order to achieve the desired level of return from policyholder assets.

Asset allocation within the with-profits funds is actively managed with the proportion of property and equity backing asset shares monitored against target equity backing ratios ("EBR"). The target EBRs are 45% for the FP WPF pre-demutualisation business, 55% for the FP WPF post-demutualisation business, 60% for the FLC WPFs and 50% for the FLAS and WL WPFs. These target levels are unchanged from 31 December 2012. These ratios reflect the perceived risk preferences of the with-profits funds and are in line with the Group's commitment to fair treatment of all its customers and the published PPFM.

The proportion of equity and property backing asset shares in the FLAS WPF is managed on a basis which targets a stable proportion over time. This is also true in ex-FLWL for policies with equity participation, although as policies get close to maturity their allocation is moved towards short-term fixed interest investments, and thus the overall equity and property proportion is likely to fall over time. For the FLC WPFs, asset allocation varies for different policies depending on how close they are to maturity, and thus the overall equity and property proportion within the fund is expected to gradually reduce over time.

For with-profits and unit-linked policies, the policyholders bear the majority of the investment risk and any change in asset values is matched by a broadly equivalent change in the realistic liability. For with-profits business, in very adverse circumstances shareholders may be obliged to provide additional support to these funds. In addition, for unit-linked business charges that are expressed as a percentage of fund values are impacted by movements in asset values and therefore falling values still have an adverse effect on shareholder earnings.

In some cases, the Group has issued policies containing return of premium guarantees and in severe adverse investment conditions these guarantees may become in the money, leading to shareholders bearing the investment risk associated with the policy.

In their decision-making on equity investments, F&C and AXA IM assess the extent of equity risk required or allowed by the fund as set out in the fund objectives and relative to defined performance benchmarks. The management of equity investments by non F&C and AXA IM fund managers is performed in accordance with the objectives of the fund as set out in policy contracts and marketing literature.

Throughout 2013 there has been no material exposure to equity risk within any of the shareholders' funds.

ii) Foreign exchange risk

The Group is exposed to foreign exchange risk through its investment in foreign operations, fee income derived from financial instruments denominated in currencies other than its measurement currency (pounds Sterling), revenues receivable and payables due in foreign currency. Consequently, the Group is exposed to the risk that the exchange rate of its measurement currency relative to other currencies may change in a manner that has an adverse effect on the value of the Group's financial assets and liabilities. Derivative instruments are used to manage potential foreign exchange volatility in relation to foreign currency loans and borrowings; all other exchange rate risk is accepted as being within the Group's agreed risk preferences given the relative materiality of the exposure.

The net exposure to foreign exchange risk through investment in overseas equities is currently small, and exposure through debt securities is limited due to the restrictions through limits placed by investment mandates. For unit-linked contracts and with-profits policies (to the extent that currency risk on overseas equities held by the with-profits funds are only partially hedged), currency risk is borne by the policyholder. As noted above, the shareholder is subject to currency risk only to the extent that income from policyholder funds is based on the value of the financial assets held in those funds. The liability for non-linked insurance contracts in currencies other than Sterling is immaterial.

Notes to the consolidated accounts continued**30. Risk management objectives and policies for mitigating risks** continued

The Group announced on 8 November 2012 that FLG had completed an issuance of US\$ 575 million reset perpetual subordinated notes, guaranteed by its principal subsidiary, FLL. The RSL Board agreed that the foreign exchange risk associated with the issuance was an unrewarded risk and as such the USD/GBP cash flows for the coupons and principal up until the first reset date in 2018 have been hedged.

iii) Interest rate risk

The Group is exposed to fair value interest rate risk where changes to interest rates result in changes to fair values rather than cash flows, for example fixed interest rate loans and assets. Conversely, floating rate loans expose the Group to cash flow interest rate risk. The Group makes use of derivatives to manage interest rate risk. In the case of swaps the Group holds both:

- receiver interest rate swaps (where fixed payments are received in return for floating payments being paid) – increases to interest rates increase cash flows payable and reduce fair value; and
- payer interest rate swaps (where floating payments are received in return for fixed payments being paid) – reductions to interest rates reduce cash flows receivable and reduce fair value.

However both types of swaps are held in order to reduce the net asset/liability rate risk which would otherwise arise.

Bond-related performance benchmarks within fund mandates are generally set so that asset profiles broadly match liability profiles and hence the interest rate risk is minimised. However in FAL and in FLL, the FP, FPLAL, FLC, FLAS and WL with-profits funds assets have been invested intentionally in bonds with a shorter duration than the companies' liabilities. Interest rate swaps have then been put in place to reduce the reinvestment risk which would otherwise arise.

Day-to-day investment decisions around the management of interest rate risk and its impact on the value of the Group's investments are largely undertaken on behalf of the Group by the relevant investment manager, within the boundaries set by fund mandates. In its decision-making on gilt and corporate bond investments, the investment manager will assess the extent of interest rate risk allowed by the fund as set out in the fund objectives and relative to the defined performance benchmarks.

The ALM function is responsible for monitoring and managing net asset/liability interest rate risk across all of the businesses. From time to time the ALM function may propose changes to the fund mandates to reflect changes in interest rate risk preferences.

The Group may also be exposed to interest rate risk on its strategic investments, and on any debt issuance. As part of any proposal for strategic investment or debt capital raising, the interest rate risk to which the Group is exposed will be given careful consideration as one of the factors impacting on the final recommendation. Ultimate approval for any strategic investments or debt raising rests with the Board.

iv) Volatility risk

The Group is exposed to the risk of loss or of adverse change in its financial position arising from changes in the market implied volatility used to value its realistic liabilities.

Swaptions and equity put options are held to mitigate interest rate volatility and implied equity volatility risk impacting the value of guarantees offered by the Group's insurance businesses.

c) Credit risk

Credit risk includes the following seven elements:

- investment credit risk – financial loss arising from a change in the value of an investment due to a rating downgrade, default, or widening of credit spread. Changes in credit spreads are also affected by the liquidity of the stock and market expectations in respect of whether any option embedded within it will be exercised, but since the liquidity and effects related to embedded options are usually closely related to credit risk, these risks are managed as credit risk;
- derivative counterparty risk – financial loss arising from a derivative counterparty's default, or the deterioration of the derivative counterparty's financial position;
- reinsurance counterparty risk – financial loss arising from a reinsurer's default, or the deterioration of the reinsurer's financial position;
- deposit risk – financial loss arising from a deposit institution's default, or the deterioration of the deposit institution's financial position;
- loan risk – financial loss arising from a debtor's inability to repay all, or part, of its loan obligations or the deterioration of the debtor's financial position;
- country risk – financial loss arising from economic agents in a sovereign foreign country, including its government, being unable or unwilling to fulfil their international obligations due to a shortage of foreign exchange or another common reason such as currency inconvertibility; and
- settlement risk – financial loss arising from the failure or substantial delay of an expected settlement in a transfer system to take place, due to a party other than the Group defaulting/not delivering on its settlement obligations.

30. Risk management objectives and policies for mitigating risks continued

i) Investment Credit risk

The Group's Life and Pensions business will take on investment credit risk when it is commensurate to do so in support of its financial objectives.

The Group is exposed to investment credit risk on its investment portfolio (in line with the Group's risk preferences), primarily from investments in corporate bonds and asset backed securities. Creditworthiness assessment for new and existing investments is largely undertaken on behalf of the Group by F&C, AXA IM and FLI. In their decision making, F&C, AXA IM or FLI (as appropriate), will assess the extent of investment credit risk allowed by each fund as set out in the fund mandates and relative to defined performance benchmarks.

The majority of the Group's corporate bond portfolio has a high credit rating (see subsequent tables in this note).

The Group has also looked to diversify and expand its assets backing the growing annuity portfolio. During 2013, the Group made a £75 million infrastructure investment in the Drax power station in North Yorkshire, illustrating where the Group has sourced investments with an explicit Treasury underpin and reduced the credit risk accompanying such infrastructure projects. The Group has also made subsequent infrastructure investments and investments in other illiquid asset classes, such as commercial real estate loans; awarding mandates to Metlife and Pramerica, respectively.

ii) Derivative counterparty risk

Derivatives purchased over the counter have the potential to expose the Group to substantial credit risk but this risk is significantly reduced through collateral arrangements with counterparties. When transacting over the counter the Group endeavours only to transact derivatives with highly rated counterparties.

iii) Reinsurance counterparty risk

The Group is exposed to reinsurance counterparty risk of three different types:

- as a result of debts arising from claims made but not yet paid by the reinsurer;
- from reinsurance premium payments made to the reinsurer in advance; and
- as a result of reserves held by the reinsurer which would have to be met by the Group in the event of default.

In addition, there is potential for the Group's credit risk exposure to increase significantly under adverse insurance risk events, e.g. if one of the insurance companies within the Group received a large number of claims for which it needed to recover amounts from its reinsurers. In order to mitigate reinsurance counterparty risk, the Group gives consideration to the credit quality of a reinsurer before incepting a reinsurance treaty. To facilitate this process, a list of acceptable reinsurers is maintained.

iv) Deposit risk

The Group is exposed to credit risk on the balances deposited with banks in the form of cash, certificates of deposit and money market instruments. Money market instruments issued by parties other than banks such as commercial paper are also covered under this heading. The primary risk is borrower quality; this is mitigated by limiting holdings in any one issuer.

In certain limited circumstances, Lombard is exposed to deposit risk:

- of custodian banks relating to unit-linked policyholder cash positions; and
- for cash amounts held on behalf of unit-linked policyholders for premium proceeds with respect to policies not yet issued, and withdrawal/surrenders/death claim proceeds not yet paid to beneficiaries.

v) Loan risk

Companies in the Group are exposed to loan risk in several different areas, the most material of which are:

- loans to Independent Financial Advisors ("IFAs") as part of strategic investments;
- other strategic loans;
- loans to appointed representatives;
- loans to brokers;
- agency debt (including debt arising as a result of clawback of commission);
- policyholder debt; and
- rental income due.

In general, these quantitative credit exposures are relatively low but they can bear relatively high likelihoods of default.

Notes to the consolidated accounts continued**30. Risk management objectives and policies for mitigating risks** continued**vi) Country risk**

The Group is exposed to country risk in a number of key areas, the most significant of which is bonds issued by foreign governments in non-domestic currency. The mandates that govern all F&C, AXA IM and FLI managed funds restrict the purchase of foreign government bonds to only those that exceed a minimum level of creditworthiness.

The management of country risk on the creditworthiness of the investments is largely undertaken on behalf of the Group by F&C, AXA IM and FLI. Counterparties are assessed on an individual basis, including the counterparty's sensitivity to a sovereign debt crisis in its country of domicile.

vii) Settlement risk

Settlement risk is a form of credit risk that arises at the settlement of a transaction, as a result of a counterparty failing to perform its obligations. The Group is exposed to settlement risk in the following key areas:

- bank transfers, including foreign exchange transactions;
- the purchase or sale of investments;
- the purchase or sale of property;
- the purchase, sale or expiry of exchange-traded derivatives or the transfer of periodic payments under these contracts; and
- the settlement of derivative contracts.

Objectives in managing credit risk

To mitigate credit risk:

- investment mandates for many funds will have a prescribed minimum credit rating of bonds that may be held and will generally prohibit investment in bonds of below specified minimum ratings, subject to some discretion where assets are downgraded. Investing in a diverse portfolio reduces the impact from individual companies defaulting;
- counterparty limits are set for investments, cash deposits, foreign exchange trade exposure and stock lending;
- all over-the-counter derivative transactions are covered by collateral, with minor exceptions;
- the Group regularly reviews the financial security of its reinsurers; and
- in some cases, derivatives are held to protect against the risk of credit default or internal hedge solutions have been implemented.

The exposure to individual counterparties is limited to specific percentages of total non-linked assets in the long-term fund, based on regulatory categorisation of counterparties.

Concentrations of credit risk might exist where the Group has significant exposure to a group of counterparties with similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic and other conditions.

Lombard deposits cash amounts with custodian banks. The deposit risk is managed by diversification across a number of custodian banks, holdings via diversified monetary collective funds, longer-term balances being held in highly rated and/or state-backed custodian banks and via, in some cases, clients' acceptance of the risk in general policy conditions.

An indication of the Group's exposure to credit risk is the quality of the investments and counterparties with which it transacts. The Group is most exposed to credit risk on debt and other fixed income securities, derivative financial instruments, deposits with credit institutions, reinsurance arrangements and cash equivalents. Debt and other fixed income securities mainly comprise government bonds and corporate bonds. The Group monitors the quality of its corporate bonds and sovereign debt.

The following table gives an indication of the level of creditworthiness of those categories of assets which are neither past due nor impaired and are most exposed to credit risk using principally ratings prescribed by Standard & Poor's and Moody's. Assets held within unit-linked funds have been excluded from the table overleaf as the credit risk on these assets is borne by the policyholders rather than the shareholders. The carrying amount of assets included in the consolidated statement of financial position represents the maximum credit exposure.

30. Risk management objectives and policies for mitigating risks continued

As at 31 December 2013	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Not rated £m	Total £m	Collateral held £m
Corporate bonds and loans at fair value	210	3,626	5,139	3,404	297	53	59	12,788	–
Asset-backed securities	1,395	825	1,326	498	47	29	4	4,124	–
Derivative financial instruments	–	30	149	–	–	–	20	199	46
Reinsurance assets	–	2,736	101	–	–	–	–	2,837	–
Cash and cash equivalents	3,460	555	754	21	–	–	117	4,907	–
Insurance and other receivables	30	118	120	106	6	1	80	461	–
Total	5,095	7,890	7,589	4,029	350	83	280	25,316	46
%	20%	31%	30%	16%	1%	1%	1%	100%	

As at 31 December 2012	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Not rated £m	Total £m	Collateral held £m
Corporate bonds and loans at fair value	1,037	3,043	5,035	2,945	417	44	44	12,565	–
Asset-backed securities	1,493	1,007	873	423	67	58	19	3,940	–
Derivative financial instruments	–	6	760	–	–	–	24	790	564
Reinsurance assets	–	3,021	131	–	–	–	1	3,153	–
Cash and cash equivalents	2,579	270	1,644	–	25	–	86	4,604	–
Insurance and other receivables	68	61	107	71	8	1	86	402	–
Total	5,177	7,408	8,550	3,439	517	103	260	25,454	564
%	20%	29%	34%	13%	2%	1%	1%	100%	

The Group holds collateral in respect of over-the-counter derivatives. Such collateral held by the Group consists of gilts, non-Sterling government bonds and cash. Collateral is valued at bid price.

The direct exposure of the Group to government and corporate debt of Ireland, Portugal, Italy and Spain (being countries where the risk of credit default is perceived as higher) in shareholder and annuity funds at 31 December 2013 and 2012 is set out in the table below. There is no exposure to Greece. Where the Group holds securities issued by financial companies, it has considered the company's financial strength and the ability of the domicile government to provide financial support in the event of stress.

As at 31 December	2013			2012		
	Govt. debt £m	Corporate debt £m	Total £m	Govt. debt £m	Corporate debt £m	Total £m
Ireland	–	26	26	–	38	38
Portugal	–	6	6	–	5	5
Italy	10	100	110	7	145	152
Spain	3	80	83	–	146	146
Total	13	212	225	7	334	341

Notes to the consolidated accounts continued

30. Risk management objectives and policies for mitigating risks continued

The following table shows the amounts of insurance receivables and loans that were impaired and the amounts of insurance receivables and loans that were not impaired but either past due or not past due at the end of the year. No other financial assets were either past due or impaired at the end of the year. However, some issuers of subordinated bonds in which the Group has holdings have suspended or announced that they intend to suspend the payment of coupons. Assets held in unit-linked funds have been excluded from the table.

As at 31 December	2013		2012	
	Insurance receivables	Loans	Insurance receivables	Loans
Financial assets that are neither past due nor impaired	87.02%	100%	94.78%	100%
Financial assets that are past due:				
0–3 months past due	5.38%		0.78%	
3–6 months past due	1.98%		1.55%	
6–12 months past due	1.11%		0.67%	
Impaired financial assets for which provision is made	4.51%		2.22%	
Total before provision for impairment (£m)	483	8	902	6

For the majority of over the counter derivative transactions undertaken by the Group, collateral is received from the counterparty if the sum of all contracts held with the counterparty is in-the-money (i.e. it is being valued as an asset). The Group has a legal right to this collateral if the counterparty does not meet its obligations but has no economic benefit from holding the assets and the counterparty may substitute at any time the collateral delivered for another asset of the same value and quality. It is repayable if the contract terminates or the contract's fair value falls. Contractual agreements between the Group and each counterparty exist to protect the interests of each party, taking into consideration minimum threshold, asset class of collateral pledged and the frequency of valuation. At 31 December 2013, the fair value of such collateral held was £46 million (2012: £564 million). No collateral has been sold or repledged (2012: £nil).

Reinsurance assets include an amount of £1,580 million (2012: £1,767 million) which relates to a reinsurance agreement with Swiss Reinsurance Company Ltd ("Swiss Re"), as set out in note 32. The asset is secured by a collateral arrangement with HSBC offering protection should any counterparty supporting the reinsurance agreement default. An Investment Management Agreement is in place between FLL and Swiss Re to govern the suitability of collateral assets. As at 31 December 2013, the value of such collateral was £1,609 million (2012: £1,783 million). During the year, novation activity was executed by the Heritage Division – as a result there is now greater financial security to both policyholders and shareholders.

The value of the reinsurance and underlying collateral are reviewed annually to ensure that the future payments received from the loan note continue to match the best estimate liability cash flows.

30. Risk management objectives and policies for mitigating risks continued

d) Liquidity risk

Liquidity risk is the risk that, any of the Group's undertakings are unable to realise investments and other assets in order to settle their financial obligations when they fall due or can secure them only at excessive cost.

The Group faces two key stakeholders of liquidity risk:

- shareholder liquidity risk (liquidity within funds managed for the benefit of shareholders, including shareholders' interests in long-term funds); and
- policyholder liquidity risk (liquidity within funds managed for the benefit of policyholders).

The Group will meet shareholder liquidity needs arising in a number of key areas. For example:

- the ability to support the liquidity requirements arising from new business;
- the capacity to maintain dividend payments/loan repayments and interest;
- the ability to deal with the liquidity implications of strategic initiatives, such as merger and acquisition activity;
- the capacity to provide financial support across the Group; and
- the ability to fund its day-to-day cash flow requirements.

The overall objective of shareholder liquidity risk management is to ensure that there is sufficient liquidity over short (up to one year) and medium time horizons to meet the cash flow needs of the business.

For policyholder funds, liquidity needs arise from a number of potential areas, including:

- a short-term mismatch between cash flows arising from assets, premium receipts and cash flow requirements of liabilities;
- having to realise assets to meet liabilities during stressed market conditions;
- investments in illiquid assets such as property and private placement debt;
- higher than expected levels of lapses/surrenders caused by economic shock, adverse reputational issues or other events; and
- higher than expected payments of claims on insurance contracts.

The overall objective of policyholder liquidity risk management is to ensure that sufficient liquid funds are available to meet cash flow requirements under all but the most extreme scenarios.

Liquidity risk is managed in the following way:

- forecasts are prepared regularly to predict required liquidity levels over both the short and medium term;
- a credit facility with a syndicate of banks exists to enable cash to be raised in a relatively short time-span;
- credit risk of cash deposits is managed by applying counterparty limits and imposing restrictions over the credit ratings of third parties with whom cash is deposited;
- assets of a suitable maturity and marketability are held to meet policyholder liabilities as they fall due; and
- the implementation of temporary restrictions on the withdrawal of funds such as extension of the notice periods of switches and restrictions of withdrawals from property funds.

The Group benefits from a £250 million (2012: £500 million) multi-currency revolving credit facility with Barclays Bank plc, Royal Bank of Canada, HSBC Bank plc and The Royal Bank of Scotland plc, with Barclays Bank plc as agent, entered into on 24 June 2010 and amended on 10 May 2013. During 2013, the Group's risk appetite was reviewed against the liquidity profile of the business and the facility was reduced on the basis that the Group would continue to hold sufficient liquidity to protect both policyholders and debt holders; shareholders would also benefit from a fee reduction on the facility. The borrower is now FLL (previously guarantor for FLG).

In addition, there has been no change to the terms of the agreement in the event of a change in control of the Group. The Group must notify the agent immediately and in this circumstance, the lenders are not obliged to fund utilisation and may notify the agent to cancel their commitments under the facility. This would have the effect of rendering all of their loans repayable within ten business days from the date of notice. As at the date of this report, the facility remains undrawn.

Notes to the consolidated accounts continued

30. Risk management objectives and policies for mitigating risks continued

The following table details the undiscounted contractual net cash flows in respect of financial and insurance liabilities. Where contracts have a surrender value (i.e. the policy is theoretically payable on demand), the current surrender value is disclosed within the "within one year or payable on demand" column.

	Contractual undiscounted cash flows			
	Carrying value £m	Within 1 year or payable on demand £m	1–5 years £m	More than 5 years £m
Year ended 31 December 2013				
Non-derivative financial liabilities				
Insurance contracts	34,590	20,321	3,252	15,880
Investment contracts	83,502	83,502	–	–
Loans and borrowings: ⁽ⁱ⁾				
– Principal	1,050	28	7	1,009
– Interest	–	89	379	192
Due to reinsurers	1,580	115	444	1,653
Net asset value attributable to unit-holders	621	621	–	–
Insurance payables and other payables	818	718	100	–
Derivative financial liabilities				
Interest rate swaps	337	1	28	308
Inflation rate swaps	–	–	–	–
Futures backing equities	56	56	–	–
Credit default swaps	7	–	7	–
Cross-currency swaps	28	7	21	–
Futures – fixed-interest	1	1	–	–
Forward currency contracts	1	1	–	–

30. Risk management objectives and policies for mitigating risks continued

Year ended 31 December 2012	Contractual undiscounted cash flows			
	Carrying value £m	Within 1 year or payable on demand £m	1–5 years £m	More than 5 years £m
Non-derivative financial liabilities				
Insurance contracts	37,232	20,564	3,535	15,895
Investment contracts	78,184	78,184	–	–
Loans and borrowings: ⁽ⁱ⁾				
– Principal	1,099	59	17	1,015
– Interest	–	50	200	145
Due to reinsurers	1,767	116	451	1,752
Net asset value attributable to unit-holders	754	754	–	–
Insurance payables and other payables	871	865	–	6
Derivative financial liabilities				
Interest rate swaps	158	4	103	51
Inflation rate swaps	1	–	1	–
Futures backing equities	6	6	–	–
Credit default swaps	4	–	2	1
Cross-currency swaps	56	7	4	45
Futures – fixed-interest	1	1	–	–
Forward currency contracts	4	4	–	–

(i) There is an option for the Friends Life Group plc US\$575 UT2 reset perpetual subordinated debt to be repaid in November 2018 but there is no obligation to repay.

Amounts expected to be settled from the unallocated surplus are excluded from the analysis above as there is no contractual obligation to settle the liability. Of the carrying amount in the consolidated statement of financial position in respect of the unallocated surplus, £584 million (2012: £577 million) is expected to be settled more than 12 months after the reporting date.

Notes to the consolidated accounts continued

30. Risk management objectives and policies for mitigating risks continued**e) Insurance risk**

Insurance risk includes the following areas:

- mortality risk – risk of loss arising due to policyholder death experience being different from expectations; or for annuities, risk of annuitants living longer than expected (called annuity longevity risk);
- morbidity risk – risk of loss arising due to policyholder health experience being different from expectations;
- persistency risk – risk of loss arising from lapse experience being different from expectations;
- expense risk – risk of loss due to expense experience being different from expectations; and
- option risk – risk of loss arising from experience of take up of options and guarantees being different from expectations.

The Group's Life and Pensions business actively pursues mortality risk, longevity risk and morbidity risk in those areas where it believes it has a competitive advantage in managing these risks to generate shareholder value (without compromising the interests of policyholders, and the need to treat customers fairly). Persistency risk and expense risk are taken on when it is deemed financially beneficial for the organisation to do so, or where the taking of these risks is in support of the Group's strategic objectives.

Underpinning the Group's management of insurance risk is:

- adherence to an approved underwriting policy that takes into account the level of risk that the Group is prepared to accept;
- controls around the development of products and their pricing;
- regular analysis of actual mortality, morbidity and lapse experience which feeds into the development of products and policies. If the analysis changes expectations of future liability cash flows, periodic adjustments are made to asset cash flows to maintain the asset/liability match; and
- monitoring concentration of risk using a variety of risk monitoring tools, involving scenario testing and sensitivity analysis of the Group's capital and profitability metrics, including MCEV, IGCA and Group economic capital. MCEV sensitivity analysis is provided in section (a) of this note.

Risks in excess of agreed underwriting limits may be reinsured. The Group's Reinsurance Strategy outlines the instances when reinsurance arrangements should be entered into or amended. With any reinsurance arrangement, the Group's objective is to undertake this in the most cost-effective manner and work with reinsurers whose creditworthiness is deemed appropriate.

Substantially all insurance contracts, and the majority of the combined insurance and investment contract portfolio, are written in the UK and so results are sensitive to changes in the UK insurance market and tax regime. Otherwise the Group sells a diverse range of products to a diverse group of people.

i) Mortality and morbidity risk*Life assurance*

Most insurance policies other than annuities and deferred annuity policies include life assurance. When pricing policies, an assumption is made as to the likelihood of death during the policy term and this assumption is reviewed as part of the annual valuation of policies. To the extent that actual mortality experience is worse than that anticipated in pricing (and subsequently in the insurance liability valuation) a loss will be made. The risk is greater for those policies such as term assurance where the maturity or surrender benefit is small in relation to the death benefit. Other policies which have a savings element, such as endowment assurance, have significant liabilities relating to the maturity benefit, particularly as the policy approaches maturity. Contractual terms for unit-linked and unitised with-profits products include provision for increases in mortality charges.

Critical illness

The Group writes a number of critical illness policies that pay out in the event of a policyholder's ill-health. As for life assurance, the amount payable on ill-health can be significantly higher than the amount payable if the policy is surrendered.

Income protection

The two main risks related to income protection are an increase in the frequency of claims (the inception rate) and an increase in the average length of the claim (a reduction in recovery rate). Most income protection policies are regular premium with the premium and cover fixed at inception. Some group policies allow premiums to be reviewed but the premium rates are usually guaranteed for two years.

30. Risk management objectives and policies for mitigating risks continued

Annuities

If annuitants live longer than expected on average, then profits will reduce. In most cases there is an initial guarantee period in which, in the event of death, annuity payments continue to be made to dependants or the policyholder's estate and many policies are written so that when the first life dies the benefit continues, often at a reduced level. These features tend to reduce the volatility of results to random fluctuations in experience but not the impact of a general increase in longevity.

Deferred annuities are subject to a similar risk from the impact of longevity, the only difference being that the risk of adverse impact is greater given that the annuity is payable further into the future.

Annuity risk was reduced through a reinsurance agreement with Swiss Re put in place in April 2007. The agreement covers annuity contracts written between July 2001 and December 2006 within FLPL. The Swiss Re agreement covers annuity contracts valued at £1,580 million at 31 December 2013 (2012: £1,767 million).

Longevity risk within FAL and the FLL NPF has been reduced by reinsurance of the annuity business with external parties. The agreement reinsures 95% of the longevity risk in respect of £3 billion of annuity liabilities in FAL and a further £2 billion of annuity liabilities in the FLL NPF.

In 2013, there have been a number of initiatives, which have increased and will increase the Group's longevity exposure. The Heritage Division implemented the first reallocation of c. £2 billion of annuities from the with-profits funds to the shareholder funds. This mitigated some of the longevity risk within the with-profits funds, whilst transferring to the shareholder funds which are actively seeking these risks. The UK Division – Retirement Income saw success with the launch of the enhanced annuity proposition, and in the fourth quarter of 2013, Retirement Income also launched into the open market with the Friends lifestyle annuity.

ii) Persistency and option risk

Persistency experience varies over time as well as from one type of contract to another. Factors that will cause lapse rates to vary over time include changes in investment performance of the assets underlying the contract where appropriate, regulatory changes that make alternative products more attractive (or incentivise advisors to be more or less active in recommending policyholders to switch provider), customer perceptions of the insurance industry in general and the Group in particular, and the general economic environment.

The valuation of the Group's guarantees and options is described in note 26. As stated in that note, the cost of guaranteed annuity options is dependent on decisions made by policyholders such as policy discontinuance and tax-free cash take-up. These assumptions are set by reference to recent experience.

iii) Expense risk

Although under IFRS 4 expense risk is not a component of insurance risk, it is an important policy cash flow risk in the context of insurance and investment contracts.

The whole of the impact of changes in expense levels is borne by shareholders with the following exceptions:

- the charges made to the FP WPFs for managing policies are due to be reviewed in 2014 to reflect market rates at that time. Pre demutualisation with-profits policyholders will bear the impact of any resulting changes to charges;
- FPLAL WPF closed fund with-profits policyholders bear the full expense risk for the fund; and
- FLC WPFs, FLAS WPF and WL WPF have a fee agreement with FLSL, under which increased expenses may be passed on to the funds provided independent review of the proposed expenses shows they are in line with market rates.

Contractual terms for unit-linked and unitised with-profits products include provision for increases in charges. Certain expenses such as fees and commissions are fixed at the time a contract is written.

The Group follows a heavily outsourced operating model which assists in the management of expense risk by ensuring the cost base allows for variable costs built into contractual assumptions. While such deals seek to deliver cost savings and greater certainty in relation to expenses, risks nevertheless remain that expense savings will not emerge as expected.

Notes to the consolidated accounts continued

31. Loans and borrowings

The Group classifies its loans and borrowings as financial liabilities carried at amortised cost. Borrowings are recognised initially at fair value, which is generally the cash consideration received, net of transaction costs incurred, and subsequently stated at amortised cost. The amortised cost of a financial liability is the amount at which the financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest rate method of any difference between that initial amount and the maturity amount.

Any difference between the proceeds, net of transaction costs, and the redemption value is recognised in the income statement over the period of the borrowings, using the effective interest rate method. Interest accrued on loans and borrowings is recognised under insurance payables, other payables and deferred income and not included in the carrying value of interest-bearing loans and borrowings.

The Group's loans and borrowings are as follows:

	Coupon %	2013 £m	2012 £m
Subordinated liabilities:			
Lombard undated subordinated loans	Various	–	1
Friends Life Group plc £162 million LT2 subordinated debt due 2021	12.00	178	181
Friends Life Group plc £500 million LT2 subordinated debt due 2022	8.25	497	496
Friends Life Group plc US\$575 million UT2 reset perpetual subordinated debt	7.875	339	346
Financial reinsurance:			
Lombard financial reinsurance treaties	Various	3	4
International financial reinsurance treaties	Various	28	57
Other:			
Amounts owed to credit institutions (overdrafts)		5	14
Total loans and borrowings		1,050	1,099

Unless otherwise stated below, the carrying values of interest bearing loans and borrowings closely approximate fair value.

Subordinated liabilities

The FLG LT2 subordinated debt 2021 is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost based on the fair value at the date of acquisition of Friends Provident by FLG. The fair value of this subordinated debt at 31 December 2013 is £210 million (2012: £215 million).

On 21 April 2011, FLG issued a £500 million LT2 subordinated debt instrument with a coupon of 8.25% and a maturity of 2022, which is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost being £500 million principal less capitalised issue costs of £3 million (2012: £4 million). The fair value of this subordinated debt at 31 December 2013 is £550 million (2012: £554 million).

On 8 November 2012, FLG issued a US\$575 million UT2 reset perpetual subordinated debt instrument with a coupon of 7.875%, which is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost being the US\$575 million principal translated at the effective exchange rate less capitalised issue costs of £8 million. The debt does not have a fixed repayment date but is callable in five years' time (initial call in November 2018) and on every subsequent interest payment date from the initial call date. With effect from the initial call date, and for so long as the debt is outstanding, the interest coupon will be reset every six years at a rate equal to the six year US dollar mid swap rate plus a margin of 6.828%. The fair value of this subordinated debt at 31 December 2013 is £378 million (2012: £378 million). A derivative instrument was entered into on 8 November 2012 to manage the risks associated with fluctuations in exchange rates on the issue of this debt.

31. Loans and borrowings continued

Financial reinsurance

FLL has three financial reinsurance contracts with Munich Reinsurance Company UK Limited ("Munich Re") to finance new German unit-linked pensions business written in the years ended 31 December 2010, 2011 and 2012 respectively. The total amount owed to Munich Re under these financial reinsurance arrangements as at 31 December 2013 was £17 million (31 December 2012: £37 million).

During 2013, FPIL entered into a financial reinsurance agreement with Munich Re to finance new Rest of World Premier regular premium savings business written between 1 January 2013 and 31 December 2013 in certain territories. The total amount owed to Munich Re under this financial reinsurance agreement as at 31 December 2013 was £11 million (31 December 2012: £nil).

In 2012, FPIL entered into a financial reinsurance agreement with Munich Re to finance new Rest of World Premier regular premium savings business written between 1 January 2012 and 31 December 2012. The total amount owed to Munich Re under this financial reinsurance agreement as at 31 December 2013 was £nil (31 December 2012: £20 million).

Other

Amounts owed to credit institutions (overdrafts) include £5 million (31 December 2012: £4 million) relating to credit balances held within OEICs that have been consolidated as the Group's holding is 50% or more. Such overdrafts are fully repayable out of the assets of the OEICs.

The Group benefits from a £250 million multi-currency revolving credit facility with Barclays Bank plc, Royal Bank of Canada, HSBC Bank plc and The Royal Bank of Scotland plc, with Barclays Bank plc as agent. The £250 million facility was entered into by FLL on 10 May 2013 and replaces the previous £500 million facility entered into by FLG. If a third party, who does not presently have control of FLG or FLL, acquires such control, FLL must notify the agent immediately. In this circumstance, the lenders are not obliged to fund utilisation and may notify the agent to cancel their commitments under the facility. This would have the effect of rendering all of their loans repayable within ten business days from the date of notice. As at the date of this report, the facility remains undrawn.

Total interest-bearing loans and borrowings are repayable as follows:

As at 31 December	2013 £m	2012 £m
Within one year or on demand	31	61
Between one and two years	9	14
Between two and three years	2	8
Between three and four years	2	2
Between four and five years	2	2
In more than five years	1,004	1,012
Total loans and borrowings	1,050	1,099

Included in the carrying amount above, £1,019 million (2012: £1,038 million) is expected to be settled more than 12 months after the reporting date.

Total interest expense for financial liabilities not measured at fair value through profit or loss, which arises solely from interest-bearing loans and borrowings, is £95 million (2012: £92 million).

Notes to the consolidated accounts continued

32. Amounts due to reinsurers

The amounts due to reinsurers represent future reinsurance premiums payable and are accounted for as a financial liability at fair value through profit or loss, thereby avoiding a mismatch with the assets backing the liability.

During April 2007, FLPL entered into a reinsurance treaty with Windsor Life Assurance Company Limited, a subsidiary of Swiss Re. The agreement, which took effect from 1 January 2007, reinsures the mortality and investment risk, but not expense risk, of 100% of FLPL's in-force post-demutualisation annuity books as at 31 December 2006. Business written after 31 December 2006 is not reinsured under the treaty. Reassurance premium payments are funded from the fixed return on an investment in a collateralised HSBC amortising note, purchased with a transfer of the assets previously backing the annuity policies.

Included in the carrying amount of £1,580 million (2012: £1,767 million) is £1,464 million (2012: £1,648 million) that is expected to be settled more than 12 months after the reporting date.

33. Net asset value attributable to unit-holders

Open-ended investment companies ("OEICs") and unit trusts where the Group has a percentage holding in excess of 50% are consolidated under IAS 27: *Consolidated and separate financial statements*. Where the OEIC or unit trust qualifies as a special purpose vehicle, it is consolidated under SIC 12: *Consolidation – special purpose entities* as the Group obtains the majority of the benefits. In addition other investment vehicles such as limited partnerships where the Group obtains the majority of the benefits and is exposed to the majority of risks are consolidated under SIC 12. The units not owned by the Group are treated as a liability, as there is a contractual obligation to deliver cash, and presented as "net asset value attributable to unit-holders".

The movements in the value of third-party interests in open-ended investment companies and unit trusts that are consolidated by the Group are as follows:

	2013 £m	2012 £m
For the year ended 31 December		
At 1 January	754	1,173
Share of total return in the year	89	118
Share of distributions in the year	(7)	(22)
Amount paid on issue of shares	194	409
Disposals	(156)	(515)
Amount received on cancellation of shares	(253)	(409)
At 31 December	621	754

The carrying value of the net asset value attributable to unit-holders approximates fair value.

34. Provisions

A provision is recognised when the Group has a present legal or constructive obligation, as a result of a past event, which is likely to result in an outflow of resources and where a reliable estimate of the amount of the obligation can be made. If the effect is material, the provision is determined by discounting the expected future cash flows.

The Group recognises a provision for onerous contracts when the expected benefits to be derived from the contracts are less than the related unavoidable costs.

The format of the provisions note, including comparative information, has been revised to enhance the clarity of the disclosures.

	At 1 January £m	Charged in the period £m	Released in the period £m	Utilised in the period £m	At 31 December £m
For the year ended 31 December 2013					
Customer redress	114	63	(50)	(10)	117
Separation and integration	35	–	–	(33)	2
Outsourcing	32	–	–	(13)	19
ROL separation costs	14	1	–	(12)	3
Sesame lapses	19	25	–	(28)	16
Vacant property	11	4	–	(2)	13
Other	53	41	(21)	(16)	57
Total provisions	278	134	(71)	(114)	227

	At 1 January £m	Charged in the period £m	Released in the period £m	Utilised in the period £m	At 31 December £m
For the year ended 31 December 2012					
Customer redress	112	17	–	(15)	114
Separation and integration	18	28	–	(11)	35
Outsourcing	–	32	–	–	32
ROL separation costs	–	14	–	–	14
Sesame lapses	22	14	–	(17)	19
Vacant property	20	–	(4)	(5)	11
Other	56	33	(28)	(8)	53
Total provisions	228	138	(32)	(56)	278

Included in the carrying amount above, £43 million (2012: £147 million) is expected to be settled more than 12 months after the reporting date. Where provisions are held for the longer term, discounting is applied at a rate of 3% per annum, a net £nil (2012: £nil) is included within the charge for the year in respect of the unwind of discount and £nil (2012: £nil) relating to a change in the discount rate applied.

a) Customer redress

Provision for customer redress and associated costs includes:

- provisions relating to aspects of the administration of defined benefit pension schemes, totalling £49 million (2012: £97million);
- provision for expected costs of customer redress in relation to the SBG business, totalling £35 million (2012: £13 million). This includes the establishment of new provisions in the year of £16 million, largely in relation to a review of past pension transfer business, and a provision of £19 million (2012: £13 million) in relation to complaints and other past business reviews. Whilst SBG is liable for redress costs, it is estimated that £17 million will be recoverable from third parties. The provisions are best estimates, based on available information. The Group's review of the SBG business is continuing and there is considerable uncertainty with regards to potential additional adverse impacts; and
- other redress provisions, totalling £33 million (2012: £4 million)

In addition to accounting provisions, an actuarial reserve of £2 million (2012: £3 million) is held in insurance contract liabilities in respect of estimated further payments.

Timing and amounts are uncertain, but the provisions are expected to be largely utilised within two years.

Notes to the consolidated accounts continued

34. Provisions continued

b) Separation and integration costs

As part of the respective purchase agreements, the Group continues to incur various costs to separate the businesses purchased from AXA UK plc, Bupa Investments Limited and its parent, Bupa Finance plc, and to integrate the businesses within the Group. In addition to accounting provisions, an actuarial reserve of £nil (2012: £28 million) is held in insurance contract liabilities in respect of estimated further payments. The provisions are expected to be largely utilised within one year.

c) Outsourcing

The outsourcing provision relates to committed costs of the Diligenta outsourcing agreement. The provision is expected to be utilised within two years.

d) ROL separation costs

Provision of £14 million was made in 2012 for ROL transition costs. £10 million was in relation to the costs of transferring an operating agreement, under which the Company outsourced most of its operating functions, from ROL to the Group and the recognition of an onerous lease provision in respect of the ROL offices to be taken over by the Group. A further £4 million was provided for restructuring activities. The majority of this expenditure has been incurred in 2013 and the provision was increased by £1 million in the year to provide for additional onerous lease costs.

e) Sesame lapses

This provision has been incurred in the ordinary course of business and is short term in nature, with full utilisation and reassessment on an annual basis.

f) Vacant property

This provision has been incurred in the ordinary course of business and is expected to be largely utilised within four years.

g) Other

Other relates to a number of minor provisions incurred in the ordinary course of business.

35. Insurance payables, other payables and deferred income

Insurance and other payables are recognised when due and are measured on initial recognition at the fair value of the consideration payable. Subsequent to initial recognition, derivative contract liabilities are carried at fair value and other payables are measured at amortised cost using the effective interest rate method.

Front-end fees charged at the inception of certain investment contracts are recognised as income over the expected term of the contract on a straight-line basis with the unrecognised amount at the end of the year presented as a liability.

As at 31 December	2013 £m	2012 £m
Creditors arising out of direct insurance operations	104	73
Creditors arising out of reinsurance operations	72	84
Accruals and deferred income	204	186
Investments purchased for subsequent settlement	149	210
Deferred front-end fees	64	53
Derivative contracts	430	230
Other payables	289	321
Total insurance payables, other payables and deferred income	1,312	1,157

Included in the carrying amount above, £309 million (2012: £278 million) is expected to be settled more than 12 months after the reporting date.

All insurance payables, other payables and deferred income balances are carried at cost, which approximates to fair value, with the exception of derivative contract liabilities which are carried at fair value.

36. Share capital

The authorised share capital of the Company is represented by an unlimited number of ordinary shares of no par value.

The Group uses the Employee Benefit Trust ("EBT") to purchase and hold shares of the Group for delivery to employees under various employee share schemes. Shares owned by the EBT are included at cost in the consolidated balance sheet and are shown as a deduction from shareholders' equity, until they vest to employees.

Incremental external costs which are directly attributable to the issue of new shares are shown in equity as a deduction, net of tax, from the proceeds of the issue.

	2013		2012	
	Number of shares (million)	£m	Number of shares (million)	£m
Issued and fully paid				
Shares of no par value fully paid	1,417.5	4,223	1,418.1	4,225
Total at 31 December	1,417.5	4,223	1,418.1	4,225

Changes to share capital during the year

	31 December 2013	
	Number of shares (million)	Share capital £m
Issued and fully paid		
Opening share capital	1,418.1	4,225
Increase in own shares held by the Group	(0.6)	(2)
Closing share capital	1,417.5	4,223

	31 December 2012	
	Number of shares (million)	Share capital £m
Issued and fully paid		
Opening share capital	1,376.2	4,135
Own shares held by the Group	(2.7)	(7)
Adjusted opening share capital	1,373.5	4,128
Shares issued in respect of scrip dividend (final 2011)	15.5	35
Shares issued in respect of scrip dividend (interim 2012)	26.4	55
Reduction in own shares held by the Group	2.7	7
Closing share capital	1,418.1	4,225

All ordinary shares in issue in the Company rank pari passu and carry the same voting rights and rights to receive dividends and other distributions declared or paid by the Company.

Notes to the consolidated accounts continued

37. Other reserves

Other reserves included in equity attributable to equity holders of the parent are as follows:

	Capital reserve £m	Retained earnings £m	Foreign currency translation reserve £m	Total £m
For the year ended 31 December 2013				
1 January 2013	1	1,187	(36)	1,152
Profit for the period	–	204	–	204
Remeasurements of the defined benefit scheme (net of tax)	–	(77)	–	(77)
Tax relief on STICS interest	–	7	–	7
Foreign exchange adjustments (net of tax) and other items	–	–	9	9
Share-based payments	–	7	–	7
Release of share entitlement provision	–	2	–	2
Increase in own shares held by the Group	–	2	–	2
Dividends	–	(300)	–	(300)
At 31 December 2013	1	1,032	(27)	1,006

	Capital reserve £m	Retained earnings £m	Foreign currency translation reserve £m	Total £m
For the year ended 31 December 2012				
1 January 2012	1	1,567	(24)	1,544
Loss for the period	–	(72)	–	(72)
Remeasurements of the defined benefit scheme (net of tax)	–	(35)	–	(35)
Tax relief on STICS interest	–	7	–	7
Foreign exchange adjustments (net of tax) and other items	–	–	(12)	(12)
Share-based payments	–	3	–	3
Dividends	–	(283)	–	(283)
At 31 December 2012	1	1,187	(36)	1,152

38. Non-controlling interests

Non-controlling interests are equity that is not attributable, directly or indirectly, to the parent undertaking.

A financial instrument is treated as equity if:

- 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
- the instrument is not a derivative and contains no contractual obligations to deliver a variable number of shares or is a derivative that will be settled only by the Group exchanging a fixed amount of cash or other assets for a fixed number of the Group's own equity instruments.

As at 31 December	2013 £m	2012 £m
2003 STICS	135	135
2005 STICS	183	183
Other	2	3
Total non-controlling interests	320	321

The STICS are carried at their fair value at the date of acquisition.

a) Step-up tier one insurance capital securities

The Group's external STICS have been recognised at fair value at the acquisition date of Friends Provident. These securities are described as the 2003 STICS and the 2005 STICS, respectively, reflecting the year in which they were originally issued by Friends Provident.

Under IFRS, the STICS are accounted for as equity as there is no requirement to settle the obligation in cash or another financial asset. Consistent with this equity classification, interest on these instruments is not treated as an expense but as an appropriation of profit. However, given the operating nature of the interest payments on these securities, the Group has deducted the interest on the securities in computing the IFRS based operating profit for the Group. No ordinary dividend can be paid if the STICS dividend is not paid. The STICS are presented in the financial statements as a non-controlling interest.

A summary of the principal terms of the STICS is set out in the following paragraphs.

2003 STICS

£210 million remain in issue. If they pay out, they bear interest from 21 November 2003 to 21 November 2019 at a rate of 6.875% with interest payable in equal instalments in arrears on 21 May and 21 November of each year. The remaining STICS have no maturity date but will be redeemable at the option of FLG on 21 November 2019, thereafter on the coupon payment date falling on or nearest successive fifth anniversaries of this date. The STICS are perpetual securities and are not redeemable at the option of the holders at any time. The principal obligor of the STICS is FLG, but they are irrevocably guaranteed on a subordinated basis by FLL. The guarantee is intended to provide holders with rights against FLL in respect of the guaranteed payments which are as near as possible equivalent to those they would have had if the STICS had been directly issued preference shares of FLL. For each coupon period beginning after 20 November 2019, the STICS will bear interest that is reset every five years.

2005 STICS

£268 million remain in issue. They bear interest, if they pay out, from 30 June 2005 to 30 June 2015 at a rate of 6.292% with interest payable in arrears on 30 June of each year. The remaining STICS have no maturity date but will be redeemable in whole or part at the option of FLG on 1 July 2015, thereafter on every fifth anniversary of this date. The STICS are perpetual securities and are not redeemable at the option of the holders at any time. The principal obligor of the STICS is FLG, but they are irrevocably guaranteed on a subordinated basis by FLL. For each coupon period after 1 July 2015, the STICS will bear interest that is reset every five years.

b) Other

Other non-controlling interests mainly relate to investments made by the senior managers of Lombard in that company. The investments comprise holdings in Class B, C and D ordinary shares which generally do not have rights to receive a share of the annual profits of Lombard. The carrying value at 31 December 2013 is £2 million (31 December 2012: £3 million), and the decrease in the year reflects leavers from the scheme. In addition, RCAP (a UK Limited partnership) holds a 0.01% capital interest in Resolution Holdco No.1 LP.

Notes to the consolidated accounts continued

39. Contingent liabilities and commitments**a) Contingent liabilities**

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 reliably estimated.

In the normal course of its business, the Group is subject to matters of litigation or dispute and interpretation of tax law. While there can be no assurances, at this time the directors believe, based on the information currently available to them, that it is not probable that the ultimate outcome of any of these matters will have a material adverse effect on the financial condition of the Group.

Friends Life Group plc has given a letter of support to SBG to assist them in meeting their liabilities as they fall due. A number of business reviews are currently being undertaken in these companies and provisions of £35 million have been included in respect of customer redress (see note 34: Provisions). There is considerable uncertainty surrounding the outcome of these reviews, the number of future complaints and the associated costs for dealing with redress and complaint administration activities. Any costs arising from this are not expected to have a material adverse impact for the Group.

b) Commitments**Operating leases where the Group is lessee**

The Group leases a number of properties under operating leases with the most material running to 2026. Lease terms include annual escalation clauses to reflect current market conditions.

The future minimum rentals payable under all non-cancellable leases are as follows:

	2013			2012		
	Land and buildings £m	Other £m	Total £m	Land and buildings £m	Other £m	Total £m
Within one year	15	1	16	14	1	15
Between one and five years	55	1	56	54	1	55
In more than five years	81	1	82	101	–	101
Total operating lease payables	151	3	154	169	2	171

Other commitments

The Group has investment property commitments of £16 million (2012: £6 million) relating to ongoing construction, renovation costs and costs of acquiring existing properties.

The Group has potential commitments of £213 million (2012: £218 million) to venture capital vehicles (partnerships and similar vehicles) that allow exposure to private equity investments in UK, US and European markets. All investments are held under agreements between the private equity managers and the Group, which have committed the Group to providing an agreed maximum level of funding to the managers to invest. As at 31 December 2013 there are still funds that have yet to be utilised that, under the agreements, are still available to the private equity managers and hence are classified as potential commitments.

The Group has entered into a number of outsourcing arrangements which have resulted in financial commitments amounting to £1,501 million as at 31 December 2013 (2012: £1,641 million). The average weighted years remaining on these outsourcing contracts is 13 years as at 31 December 2013 (31 December 2012: 14 years). Included within these amounts is £1,157 million (2012: £1,274 million) relating to the outsourcing arrangement with Diligenta announced in November 2011.

40. Related parties

In the ordinary course of business, the Group and its subsidiary undertakings carry out transactions with related parties, as defined by IAS 24: *Related party disclosures*. Material transactions for the year are set out below.

The principal subsidiary undertakings of the Group are shown in note 17.

a) Key management personnel compensation

From 1 January to 27 March 2013 the key management personnel were considered to be the directors of Resolution Limited, executive directors of FLG and Resolution Operations LLP ("ROL") as a body corporate. On implementation of the governance simplification, from 28 March 2013 the key management personnel of Resolution Limited became the directors of the Company and the members of its Group Executive Committee. The directors and the Group Executive Committee have responsibility for planning, directing and controlling the activities of the Group.

In aggregate the compensation paid to key management personnel, excluding the fees paid to ROL, in respect of the year ending 31 December 2013 is as set out below:

	2013 Number	2013 £m	2012 Number	2012 £m
Salary and short-term employee benefits	30	10	16	6
Post-employment benefits (excluding defined benefit scheme)	1	–	–	–
Share-based payments	7	2	–	–
Total key management personnel compensation charged to the income statement		12		6
Post-employment benefits: defined benefit schemes	–	–	–	–
Total key management personnel compensation		12		6

There were £nil balances outstanding at the year end with key management (2012: £nil).

Salary and short-term employment benefits include £0.9 million of payments for loss of office (2012: £0.3 million). As at 31 December 2013, there were £nil balances outstanding in respect of these payments (31 December 2012: £0.3 million outstanding).

b) Other related parties

Operating agreement – ROL

Until 27 March 2013, the Company outsourced most of its operating functions to ROL under the terms of an Operating Agreement. On 28 March 2013 the Operating Agreement was novated to Friends Life Management Services Limited ("FLMS") as a result of the business sale agreement between the Company and FLMS signed on 10 December 2012. This Operating Agreement was subsequently terminated on 10 December 2013.

Under the terms of the agreement:

- the Company paid ROL an annual operating fee; under which the total amount charged in the period between 1 January and 28 March 2013 amounted to £5 million (amount charged for the full year to 31 December 2012: £18 million). Between 28 March and 10 December 2013 the Company paid FLMS operating fees amounting to £15 million in accordance with the terms of the same agreement. Following termination of the agreement, FLMS continues to provide management services to the Company and recharges the Company for the services provided. £3 million was recharged from FLMS to the Company for other corporate costs during the year; this amount was outstanding as at 31 December 2013;
- the Company could, subject to certain conditions, advance funds to ROL for development work on new projects outside the UK Life Project. No funding remained in place at 31 December 2013 (31 December 2012: £1 million); and
- subject to certain exceptions, members of The Resolution Group, including Clive Cowdery (referred to on page 74), were restricted from selling or pledging as security for a loan any of their shares in the Company held as at 13 January 2012, with a total number of locked-up shares of 8,247,184. As a result of the termination of the Operating Agreement these shares were transferred to RCAP UK LP and the lock-up agreement was terminated. The Resolution Group is not controlled by the Company or linked in any way other than through Clive Cowdery, John Tiner and Jim Newman (a member of the GEC).

Notes to the consolidated accounts continued

40. Related parties continued

Resolution Holdco No.1 LP and RCAP UK LP

The Company has a 99.99% interest in, and is the General Partner in, Resolution Holdco No.1 LP ("RHN1"), a Guernsey limited partnership. The Limited Partner in RHN1 is RCAP UK LP ("RCAP"). RCAP is an entity established by current and former partners and employees of ROL and is entitled to share in the value created in RHN1, which owns the Friends Life group.

The value share arrangement was established at the time the Company was formed and, in broad terms, entitles RCAP to 10% of all distributions made from RHN1 where the accumulated value of the deployed equity capital contributed into RHN1 (as set out below), plus an agreed return, has been returned to the Company or its shareholders, or there has been a change of control of the Group. There is no time limit applying to the value share arrangements and the arrangements are not affected by the termination of the operating agreement between ROL and the Company.

Deployed equity capital has been contributed to RHN1, by the Company and RCAP, to fund the acquisitions of both Friends Provident Group plc in 2009 and the majority of AXA S.A.'s UK life business in 2010. The agreed return is the greater of 4% and a three year risk free rate. The risk free rate is recalculated at three yearly intervals following the initial contribution in November 2009. The agreed return is currently 4% per annum.

Total gross equity deployed in RHN1 is approximately £4,056 million and the accumulated value of net equity deployed (at 4% per annum and after the return of £1,066 million of capital returned to the Company to date) is approximately £3,543 million as shown below.

Transaction	Gross equity deployed		
	The Company £m	RCAP £m	Total £m
Friends Provident ⁽ⁱ⁾	1,915.8	0.2	1,916.0
AXA UK Life Business ⁽ⁱⁱ⁾	2,139.8	0.2	2,140.0
BHA ⁽ⁱⁱⁱ⁾	–	–	–
Total	4,055.6	0.4	4,056.0

(i) See page 102 of Friends Provident Group plc acquisition prospectus for more details of equity deployed.

(ii) See page 89 of AXA UK Life Business acquisition prospectus for more details of equity deployed.

(iii) The acquisition of BHA was funded using existing FLG resources.

Accumulated value of net equity deployed	2013 £m	2012 £m
At 1 January	3,752	3,844
Distributions from RHN1	(350)	(240)
Accumulations in the year	141	148
At 31 December	3,543	3,752

The Company's share price does not itself influence whether payments are made under the terms of the Value Share. The payment under the Value Share depends on the aggregate amount of distributions made to the Company by RHN1, including to fund payments to shareholders (dividends or returns of capital), or there being a relevant change of control event.

If Resolution Limited were to undertake further acquisitions, the agreement with RCAP means that RCAP would be required to contribute 0.01% of any capital involved; this would increase the amount of deployed equity capital and increase the potential added value to which RCAP would be entitled in excess of the accumulated value of net equity deployed.

Resolution (Brands) Limited

The Company is party to an amended and restated trademark licensing agreement with Resolution (Brands) Limited, a company wholly owned by Clive Cowdery, under which the Company has been granted a licence to use the "Resolution" trademark. There were no fees payable under the agreement in 2013 (2012: £0.1 million). The agreement was amended in 2014 to enable both parties 30 days' written notice.

Statement of directors' responsibilities in respect of the Market Consistent Embedded Value ("MCEV") basis

The directors of Resolution Limited have chosen to prepare supplementary information in accordance with European Insurance CFO Forum ("MCEV Principles"), issued in October 2009. When compliance with the MCEV Principles is stated, those principles require the directors to prepare supplementary information in accordance with the methodology contained in the MCEV Principles and to disclose and explain any non-compliance with the guidance included in the MCEV Principles.

In preparing the MCEV supplementary information, the directors have:

- done so in accordance with the MCEV Principles and fully complied with the guidance included therein;
- determined assumptions on a realistic basis, having regard to past, current and expected future experience and to any relevant external data, and then applied them consistently;
- made estimates that are reasonable and consistent; and
- described the basis on which business that is non-covered has been included in the supplementary information, including any material departures from the accounting framework applicable to the Group consolidated IFRS financial statements.

By order of the Board



Tim Tookey
Director

17 March 2014

Independent auditor's report to the directors of Resolution Limited on the consolidated Market Consistent Embedded Value ("MCEV") financial statements

We have audited the consolidated MCEV financial statements of Resolution Limited for the year ended 31 December 2013, which comprise the consolidated income statement – MCEV basis, the earnings per share – MCEV basis, the consolidated statement of comprehensive income – MCEV basis, the consolidated statement of changes in equity – MCEV basis, the consolidated statement of financial position – MCEV basis, the Group MCEV analysis of earnings and the related notes 1 to 13. The consolidated MCEV financial statements have been prepared by the directors of Resolution Limited in accordance with the Market Consistent Embedded Value Principles issued in October 2009 by the CFO Forum ("the CFO Forum Principles") and the basis of preparation set out on pages 244 to 247.

Directors' responsibilities for the consolidated MCEV financial statements

The directors are responsible for the preparation of these consolidated MCEV financial statements in accordance with the basis of preparation set out on pages 244 to 247 and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on the consolidated MCEV financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require us to comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated MCEV financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated MCEV financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated MCEV financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation of the consolidated MCEV financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the consolidated MCEV financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

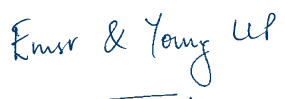
In our opinion the consolidated MCEV financial statements for the year ended 31 December 2013 are prepared, in all material respects, in accordance with the CFO Forum Principles and the basis of preparation set out on pages 244 to 247.

Basis of accounting and restriction on use

Without modifying our opinion, we draw attention to note 1 to the consolidated MCEV financial statements, which describes the basis of preparation. The consolidated MCEV financial statements are prepared by Resolution Limited in accordance with the CFO Forum Principles. As a result, the consolidated MCEV financial statements may not be suitable for another purpose. This report, including the opinion, has been prepared for and only for the Company's directors as a body in accordance with our letter of engagement dated 7 August 2013 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Other matter

We have reported separately on the statutory Group IFRS financial statements of Resolution Limited for the year ended 31 December 2013. The information contained in the consolidated MCEV financial statements should be read in conjunction with the financial statements prepared on an IFRS basis.



Ernst & Young LLP
London

17 March 2014

1. The maintenance and integrity of the Resolution Limited website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
2. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Consolidated income statement – MCEV basis

For the year ended 31 December 2013

	Notes	2013 £m	2012 £m
Covered business			
Value of new business	6	204	194
Expected existing business contribution		248	325
Operating experience variances		(57)	(56)
Operating assumption changes		19	(9)
Other operating variances		178	27
Development costs	10	(50)	(50)
Covered business operating profit before tax	3	542	431
Other income and charges		(53)	(49)
Operating profit before tax		489	382
Economic variances	3	412	154
Amortisation and impairment of non-covered business intangible assets		–	(15)
Non-recurring items and non-operating variances	3	(143)	(127)
Profit from continuing operations before tax		758	394
Tax on operating profit		(117)	(120)
Tax on other activities		(62)	(6)
Profit for the year⁽ⁱ⁾		579	268

(i) Profit for the year is attributable to equity holders of the parent.

The notes 1 to 13 form an integral part of these financial statements.

The consolidated income statement for the year ended 31 December 2012 includes the results of AmLife Insurance Berhad and AmFamily Takaful Berhad (collectively "AmLife"). The consolidated income statement for the year ended 31 December 2013 includes the results of AmLife up until the date of disposal on 4 January 2013.

Earnings per share – MCEV basis

For the year ended 31 December 2013

	Note	2013 pence	2012 pence
Earnings per share			
Operating earnings per share on MCEV basis after tax, attributable to equity holders of the parent			
– Basic	4	26.24	18.83
– Diluted	4	26.22	18.83
Earnings per share on MCEV basis after tax, attributable to equity holders of the parent			
– Basic	4	40.84	19.26
– Diluted	4	40.81	19.26

MCEV operating profit arises from continuing operations, incorporates an expected investment return and excludes:

- amortisation and impairment of non-covered business intangible assets;
- the effect of economic variances (including the impact of economic assumption changes); and
- significant non-recurring items and non-operating items.

Given the long-term nature of the Group's operations, operating profit is considered to be a better measure of the performance of the Group and this measure of profit is used internally to monitor the Group's MCEV results.

Consolidated statement of comprehensive income – MCEV basis

For the year ended 31 December 2013

	2013 £m	2012 £m
Profit for the year	579	268
Remeasurement losses on defined benefit pension schemes, net of tax	(77)	(35)
Foreign exchange adjustments	16	(16)
Other comprehensive loss for the year, net of tax	(61)	(51)
Total comprehensive income for the year⁽ⁱ⁾	518	217

(i) Total comprehensive income for the year is attributable to equity holders of the parent.

Consolidated statement of changes in equity – MCEV basis

For the year ended 31 December 2013

	2013 £m	2012 £m
Opening ordinary shareholders' equity	5,831	5,796
Disposal of AmLife as at 4 January 2013	7	–
Total comprehensive income for the year	518	217
Issue of share capital (net of capitalised expenses)	–	90
Movement in own shares held by the Group	(2)	7
Dividends on equity shares	(300)	(283)
Share-based payments	7	4
Other movements ⁽ⁱ⁾	4	–
Increase in MCEV reserves for the year	234	35
Closing ordinary shareholders' equity	6,065	5,831

(i) Other movements comprise the release of a share entitlement provision (£2 million) and consolidation of the Group's Employee Benefit Trust (£2 million). Following demutualisation of Friends Provident in 2001, share and cash entitlements that were not claimed were placed into two trusts. The trusts were wound up in 2004 and the liability for any future claims in respect of demutualisation was transferred to the Group. This provision was released following expiry of the Group's obligation on 9 July.

Consolidated statement of financial position – MCEV basis

As at 31 December 2013

	2013 £m	2012 £m
Assets		
Pension scheme surplus	–	33
VIF of covered business excluding assets of operations classified as held for sale	4,369	4,230
Intangible assets	7	9
Property and equipment	50	53
Investment properties	2,561	2,735
Financial assets	109,064	105,990
Deferred acquisition costs	76	88
Reinsurance assets	2,837	3,153
Current tax assets	33	8
Insurance and other receivables	1,134	1,133
Cash and cash equivalents	9,690	9,449
Net assets of operations classified as held for sale	–	43
Total assets	129,821	126,924
Liabilities		
Insurance contracts	34,647	37,294
Unallocated surplus	627	656
Financial liabilities		
– investment contracts	82,574	77,276
– loans and borrowings	1,633	1,641
– amounts due to reinsurers	1,580	1,767
Net asset value attributable to unit holders	621	754
Provisions	230	223
Pension scheme deficit	52	–
Deferred tax liabilities	544	362
Current tax liabilities	1	21
Insurance payables, other payables and deferred income	1,245	1,096
Total liabilities	123,754	121,090
Equity attributable to:		
– Equity holders of the parent	6,065	5,831
– Non-controlling interests	2	3
Total equity	6,067	5,834
Total equity and liabilities	129,821	126,924

Group MCEV analysis of earnings

For the year ended 31 December 2013

	2013			2012
	Covered business £m	Non-covered business £m	Total business £m	Total business £m
Opening Group MCEV	4,923	908	5,831	5,796
Opening adjustments:				
– disposal of AmLife	(43)	50	7	–
Adjusted opening Group MCEV	4,880	958	5,838	5,796
Operating MCEV earnings	422	(50)	372	262
Non-operating MCEV earnings	130	77	207	6
Total MCEV earnings	552	27	579	268
Other movements in IFRS net equity	–	(77)	(77)	(28)
Closing adjustments:				
– capital and dividend flows	(394)	103	(291)	(189)
– foreign exchange variances	16	–	16	(16)
Closing Group MCEV	5,054	1,011	6,065	5,831

Notes to the MCEV results

For the year ended 31 December 2013

1. Basis of preparation

Introduction

Resolution Limited is presenting the results and financial position for its life and pensions business on the MCEV basis and for its other businesses on the IFRS basis. The MCEV basis is in compliance with the European Insurance CFO Forum MCEV Principles⁽ⁱ⁾ ("the MCEV Principles"), issued in June 2008, and re-issued in amended form in October 2009. In accordance with guidance issued by the CFO Forum in September 2012, no allowance has been made for the impacts of the developing Solvency II regulatory regime.

The MCEV results were approved by the Board of Directors on 17 March 2014.

Segmental analysis and definitions

The results for 31 December 2013 have been shown for UK and Heritage divisions separately, reflecting the internal financial information used by the Group to evaluate operating performance. The 2012 comparatives, with the exception of the sensitivity analysis in note 11, have been updated accordingly to show UK and Heritage divisions separately.

Following the simplification of the Group's governance arrangements, the results and comparatives for the non-covered business of Resolution Limited and Friends Life group have been combined.

MCEV methodology

Overview

The MCEV basis of reporting is designed to recognise profit as it is earned over the term of a life insurance policy. The total profit recognised over the lifetime of the policy is the same as that recognised under the IFRS basis of reporting, but the timing of recognition is different.

Covered business

Covered business comprises all life and pensions business written by Friends Life group in the UK and through overseas life insurance subsidiaries and associates (collectively referred to as "life and pensions covered business").

The external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 are formally allocated to covered business on the basis that all obligations to make payments in respect of this debt are guaranteed by FLL. These instruments are included within the MCEV at market value, based on listed ask prices.

Non-covered business

The Group's non-covered business includes the IFA distribution businesses, the management services businesses, Friends Life Investments ("FLI") and the net pension deficit of FPPS on an IAS 19 basis. Corporate net assets held at Friends Life and Resolution holding company level, certain holding company costs, the deferred consideration notes issued by Resolution Limited (until the date of their repayment on 20 November 2012) are all non-covered business.

Whilst the management services businesses and FLI are classified as non-covered, the expenses and cash flows of those businesses are linked to the life and pensions businesses via service and investment management agreements. The cash flows of the companies are calculated on the "look-through" principle and are allowed for when setting appropriate expense and tax assumptions.

Segmental reporting under MCEV

The covered business within the Group has been split into the following segments in line with IFRS reporting:

- UK;
- Heritage;
- FPI; and
- Lombard.

On 4 January 2013 the Company disposed of its entire holding of 30% of the ordinary share capital of AmLife to AmBank Group of Malaysia for RM 245 million (£50 million) resulting in a profit on disposal of £7 million on an MCEV basis.

Corporate functions are not strictly an operating segment, but are reported to management, and are provided to reconcile the Group's reportable segments to the total result. Corporate includes the external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021, the external LT2 subordinated debt 2022, internal LT2 subordinated debt 2020, corporate costs and the cost of holding any required capital in excess of the operating segment capital policy.

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1. Basis of preparation continued

New business

New business within the life and pensions covered business includes:

- premiums from the sale of new policies;
- payments on recurring single premium policies, except existing stakeholder-style pensions business where, if a regular pattern in the receipt of premiums for individuals has been established, the regular payment is treated as a renewal of an existing policy and not new business;
- non-contractual increments on existing policies;
- new entrants to existing schemes in the corporate benefits business; and
- immediate pension annuity contracts arising from internal vestings.

New business in 2012 also included Department for Work and Pensions rebate premiums, which are no longer received.

New business includes certain corporate benefit schemes that have been transferred within Friends Life on to the auto-enrolment platform. These are only included in new business where the transfer was instigated by the client and where significant new business activities have been undertaken by Friends Life.

The MCEV new business definition is consistent with the quarterly new business disclosures.

Calculation of embedded value

The reported Group MCEV provides an estimate of the total consolidated MCEV of the Group and comprises the MCEV in respect of the life and pensions covered business, together with the IFRS net assets in respect of the non-covered business.

The MCEV provides an estimate of the value of shareholders' interest in the covered business, excluding any value that may be generated from future new business. The MCEV comprises the sum of the shareholders' net worth of the life and pensions covered business and the value of in-force covered business. The shareholders' net worth of the life and pensions covered business includes the listed debt of the external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 at market value, based on listed ask prices.

The MCEV is calculated on a post-tax basis. Where gross results are presented, these have been calculated by grossing up the post-tax results for covered business at the appropriate rate of corporation tax for each segment. For non-covered business the gross results are presented gross of any IFRS tax attributed.

(a) Shareholders' net worth

The shareholders' net worth of the life and pensions covered business consists of free surplus and required capital.

Free surplus is the market value of any assets allocated, but not required, to support the in-force covered business at the valuation date. Required capital is the market value of assets, attributed to the covered business over and above that required to back liabilities for covered business, whose distribution to shareholders is restricted. The Group's required capital is set at the greater of local regulatory capital requirements and those requirements arising from internal capital management policies, which include economic risk capital objectives. The economic risk capital is determined from internal models, based on the Group's risk appetite. The level of required capital is shown in note 10.

(b) Value of in-force covered business

The value of in-force covered business consists of:

- present value of future profits; less
- time value of financial options and guarantees;
- frictional costs of required capital; and
- cost of residual non-hedgeable risks.

Notes to the MCEV results continued

1. Basis of preparation continued*Present value of future profits ("PVFP")*

The value of existing business is the present value of the future distributable profits available to shareholders from the in-force covered business. Future profits are projected using best estimate non-economic assumptions and market consistent economic assumptions.

The non-economic assumptions include: the behaviour of customers (e.g. persistency), mortality, morbidity, the level of expenses required to maintain the book of business, tax and the regulatory environment. The assumptions are a reflection of best estimates of the likely behaviours, outcomes, or circumstances in the future. The estimates are made, typically, on an annual basis following experience investigations based on the data available at the time both from the book of business and externally sourced information. The aim is to set assumptions at a level that reflects recent or current experience.

The PVFP includes the capitalised value of profits and losses arising in subsidiary companies providing investment management, administration and other services to the extent that they relate to covered business. This is referred to as the "look-through" into investment management and service company expenses. In addition expenses arising in holding companies that relate directly to acquiring or maintaining covered business have been allowed for.

In valuing shareholders' cash flows, allowance is made in the cash flow projections for taxes in the relevant jurisdiction affecting the covered business. Tax assumptions are based on best estimate assumptions, applying local corporate tax legislation and practice together with known future changes and taking credit for any deferred tax assets.

The economic assumptions are market consistent whereby, in principle, each cash flow is valued in line with the price of similar cash flows that are traded in the capital markets. For example, an equity cash flow is valued using an equity risk discount rate, and a bond cash flow is valued using a bond risk discount rate. If a higher return is assumed for equities, the equity cash flow is discounted at this higher rate.

In practice, for liabilities where the payouts are either independent or move linearly with market movements, a method known as the "certainty equivalent approach" has been applied whereby all assumed assets earn the reference rate and all cash flows are discounted using the reference rate. This gives the same result as applying the method in the previous paragraph.

Time value of financial options and guarantees ("TVOG")

The PVFP is based on a single deterministic projection of future economic assumptions. However, a single projection does not fully reflect the potential for extreme events and the resulting impact of options and guarantees on the shareholder cash flows. While the PVFP allows for the intrinsic value of an option or guarantee under a single set of economic assumptions, it does not reflect the potential range of future economic scenarios on the shareholder cash flows. Stochastic modelling techniques are used to assess the impact of potential future economic scenarios on an option or guarantee and to determine the average value of shareholder cash flows under a number of market consistent scenarios.

The TVOG is calculated as the difference between the average value of shareholder cash flows under a number of market consistent scenarios, and the intrinsic value under a single projection within the PVFP.

The material financial options and guarantees are those in the with-profits funds of the subsidiary life companies of Friends Life group, in the form of the benefits guaranteed to policyholders and the guaranteed annuity rates associated with certain policies. The risk to shareholders is that the assets of the with-profits funds are insufficient to meet these guarantees. While shareholders are entitled to only a small share of profits in the with-profits funds (e.g. via one-ninth of the cost of bonus), they can potentially be exposed to the full cost of fund assets being insufficient to meet policyholder guarantees. The TVOG has been assessed using a stochastic model derived from the current Realistic Balance Sheet ("RBS") model. This model has been calibrated to market conditions at the valuation date. Allowance has been made under the different scenarios for management actions, such as altered investment strategy, consistent with the RBS model. The TVOG would be markedly higher without the hedging activities and management actions currently undertaken. No allowance has been made for the impact of dynamic policyholder behaviour under the different scenarios, however the impact is not considered to be material.

Only modest amounts of new with-profits business are written and the guarantee levels offered are lower, hence there is no material impact in respect of the TVOG on the value of new business.

Frictional costs of required capital

The value of in-force covered business includes a deduction for the additional costs to an investor of holding the assets backing required capital through investment in a life company, rather than investing in the asset directly. These additional frictional costs comprise taxation and investment expenses on the assets backing the required capital.

The frictional costs of required capital are calculated as the difference between the market value of assets backing required capital and the present value of future releases of that capital allowing for future investment return (net of frictional costs) on that capital. The calculation allows for the run-off of the required capital over time using projections of the run-off of the underlying risks and regulatory requirements.

Details of the level of required capital are set out in note 10.

1. Basis of preparation continued

Cost of residual non-hedgeable risks ("CNHR")

The main area of non-hedgeable risk relates to non-financial risks, such as insurance and operational risks, where no deep, liquid market exists to fully mitigate the risk. Allowance for non-financial risk is made directly within:

- the PVFP via an appropriate choice of best estimate assumptions and with the impact of variability of the risk on the level, and hence cost, of required capital; and
- the TVOG for the impact of variations of non-financial risks on the possibility of shareholders needing to meet the guarantees within the with-profits funds of the subsidiary life companies of Friends Life group.

The CNHR covers those non-hedgeable risks that are not already allowed for fully in the PVFP or in the TVOG. The most significant of these risks are those for which the impact of fluctuations in experience is asymmetric; where adverse experience has a higher impact on shareholder value than favourable experience and the best estimate assumptions do not reflect this asymmetry. The areas identified as having the potential for material asymmetry are operational risk, persistency risk and reinsurance counterparty default risk.

The CNHR has been calculated by considering the financial cost to shareholders of the impact of asymmetric risks and with regard to the results of risk-based capital modelling. The risk-based capital is calculated using internal models, consistent with those used in the Group's Individual Capital Assessment, with:

- a 99.5% confidence level over one year;
- allowance for diversification between non-hedgeable risks;
- no allowance for diversification between non-hedgeable and hedgeable risks; and
- no allowance for diversification between covered and non-covered business.

The CNHR impacts both the value of existing business and new business.

Participating business

Future regular bonuses on participating business are projected in a manner consistent with current bonus rates and expected future market consistent returns on assets deemed to back the policies.

Future terminal bonuses are assumed to be set at a level to exhaust all the assets deemed to back the policies over the future lifetime of the in-force with-profit policies.

The PVFP includes the shareholders' share of future profits from the with-profits funds, based on the assumed bonus rates.

There may be some extreme future economic scenarios in which total assets in each of the with-profits funds are not sufficient to pay all policyholder claims and the resulting shortfall would be met by shareholders. Stochastic modelling techniques are used to assess the impact of future economic scenarios on the with-profits funds' ability to pay all policyholder claims and to determine the average additional cost to shareholders arising from future projected shortfalls. This cost to shareholders has been included in the TVOG.

Consolidation adjustments

The effect of transactions and reinsurance arrangements between life insurance subsidiary companies has been included in the results split by segment in a consistent manner. No elimination is required on consolidation.

Goodwill and intangible assets

Goodwill and intangible assets relating to the non-covered business are included on an IFRS basis.

Exchange rates

The results and cash flows of overseas subsidiaries and joint ventures have been translated at the average exchange rates for the period and the assets and liabilities have been translated at the period end rates. Translation differences are shown as foreign exchange adjustments in the consolidated statement of comprehensive income. Exchange rate driven movements in MCEV earnings are reported within economic variances.

Details of the exchange rates used are shown in note 10.

Notes to the MCEV results continued

2. Analysis of MCEV earnings

The following tables show the movement in the MCEV of the Group. The analysis is shown separately for free surplus, required capital and the value of the in-force covered business. All figures are shown net of tax.

For the year ended 31 December 2013

Net of tax	Covered business				Non-covered business £m	Total MCEV £m
	Free surplus £m	Required capital £m	VIF £m	Total £m		
Opening Group MCEV	641	40	4,242	4,923	908	5,831
Opening adjustments:						
– acquired/divested businesses	(3)	(25)	(15)	(43)	50	7
Adjusted opening Group MCEV	638	15	4,227	4,880	958	5,838
Value of new business	(213)	89	285	161	–	161
Expected existing business contribution:						
– reference rate	13	(8)	30	35	–	35
– in excess of reference rate	7	(49)	202	160	–	160
Transfers from VIF and required capital to free surplus	570	(16)	(554)	–	–	–
Operating experience variances and development costs	(16)	(36)	(37)	(89)	–	(89)
Operating assumption changes	52	5	(38)	19	–	19
Other operating items	2	93	41	136	(50)	86
Operating Group MCEV earnings	415	78	(71)	422	(50)	372
Economic variances	264	(80)	135	319	–	319
Other non-operating items	(231)	(21)	63	(189)	77	(112)
Total Group MCEV earnings	448	(23)	127	552	27	579
Other movements in IFRS net equity	–	–	–	–	(77)	(77)
Closing adjustments:						
– capital and dividend flows	(422)	27	1	(394)	103	(291)
– foreign exchange variances	–	2	14	16	–	16
Closing Group MCEV	664	21	4,369	5,054	1,011	6,065

2. Analysis of MCEV earnings continued

For the year ended 31 December 2012

Net of tax	Covered business				Non-covered business £m	Total MCEV £m
	Free surplus £m	Required capital £m	VIF £m	Total £m		
Opening Group MCEV	821	747	3,844	5,412	384	5,796
Value of new business	(285)	97	340	152	–	152
Expected existing business contribution:						
– reference rate	26	(10)	57	73	–	73
– in excess of reference rate	9	(47)	215	177	–	177
Transfers from VIF and required capital to free surplus	560	(18)	(542)	–	–	–
Operating experience variances and development costs	(69)	(12)	(3)	(84)	–	(84)
Operating assumption changes	(67)	–	54	(13)	–	(13)
Other operating items	86	(37)	(29)	20	(63)	(43)
Operating Group MCEV earnings	260	(27)	92	325	(63)	262
Economic variances	119	(200)	197	116	1	117
Other non-operating items	(107)	(120)	120	(107)	(4)	(111)
Total Group MCEV earnings	272	(347)	409	334	(66)	268
Other movements in IFRS net equity	–	–	–	–	(28)	(28)
Closing adjustments:						
– capital and dividend flows	(452)	(356)	1	(807)	618	(189)
– foreign exchange variances	–	(4)	(12)	(16)	–	(16)
Closing Group MCEV	641	40	4,242	4,923	908	5,831

Notes to the MCEV results continued

3. Segmental analysis of MCEV earnings

The table below shows a further breakdown of the MCEV earnings. All earnings are shown on a gross of tax basis with attributed tax shown separately.

For the year ended 31 December 2013

Gross of tax	Covered business					Non-covered business £m	Total £m
	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m		
Value of new business	184	(19)	14	25	–	–	204
Expected existing business contribution	60	211	19	33	(75)	–	248
Operating experience variances	(33)	(12)	13	(25)	–	–	(57)
Operating assumption changes	(6)	93	14	(82)	–	–	19
Other operating variances	36	127	9	6	–	–	178
Development costs	(30)	(7)	(10)	(3)	–	–	(50)
Covered business operating profit/(loss) before tax	211	393	59	(46)	(75)	–	542
Other income and charges	–	–	–	–	–	(53)	(53)
Operating profit/(loss) before tax	211	393	59	(46)	(75)	(53)	489
Economic variances	60	405	7	11	(71)	–	412
Other non-operating items	(5)	(241)	(1)	–	–	104	(143)
Profit/(loss) before tax	266	557	65	(35)	(146)	51	758
Attributed tax on operating result	(49)	(98)	(1)	10	18	3	(117)
Attributed tax on other activities	(18)	(27)	(3)	(3)	16	(27)	(62)
Profit/(loss) after tax	199	432	61	(28)	(112)	27	579

For the year ended 31 December 2012

Gross of tax	Covered business					Non-covered business £m	Total £m
	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m		
Value of new business	142	2	5	45	–	–	194
Expected existing business contribution	61	281	23	35	(75)	–	325
Operating experience variances	(30)	9	(12)	(23)	–	–	(56)
Operating assumption changes	(3)	65	(107)	36	–	–	(9)
Other operating variances	11	8	(5)	13	–	–	27
Development costs	(36)	(6)	(6)	(2)	–	–	(50)
Covered business operating profit/(loss) before tax	145	359	(102)	104	(75)	–	431
Other income and charges ⁽ⁱ⁾	–	–	–	–	–	(49)	(49)
Operating profit/(loss) before tax	145	359	(102)	104	(75)	(49)	382
Economic variances	117	342	(19)	17	(304)	1	154
Other non-operating items	23	(162)	1	(4)	–	–	(142)
Profit/(loss) before tax	285	539	(120)	117	(379)	(48)	394
Attributed tax on operating result	(35)	(88)	23	(24)	18	(14)	(120)
Attributed tax on other activities	(34)	(43)	2	(3)	76	(4)	(6)
Profit/(loss) after tax	216	408	(95)	90	(285)	(66)	268

(i) Other income and charges were previously disclosed separately for those arising within FLG (£21 million) and those arising within the RSL holding companies (£28 million). Following the simplification of the governance structure these are now shown as a single item. The 31 December 2012 comparative has been updated accordingly.

3. Segmental analysis of MCEV earnings continued

UK covered business

The life and pensions covered business operating profit before tax for the UK segment was £211 million (2012: £145 million).

Value of new business

Further details of the calculation and analysis of the value of new business ("VNB") are discussed in note 6.

Expected existing business contribution

The expected existing business contribution is the sum of two components:

- the expected earnings over the period assuming the opening assets earn the beginning of period reference rate; and
- the additional expected earnings (in excess of the beginning of period reference rate) consistent with management's expectation for the business.

The reference rate is based on the one-year swap return plus, for immediate annuity business only, an illiquidity premium equivalent to 75bps (2012: 90bps) at the beginning of the period.

The additional earnings are the excess over the reference rate and reflect management's long-term expectation of asset returns, based on assumed asset mix.

The total expected contribution of £60 million (2012: £61 million) comprises £53 million from applying expected rates of return to the value of in-force of £925 million at the start of the period, and £7 million of expected return on shareholders' net assets. The UK expected contribution on shareholders' net assets of £7 million primarily reflects the return based on the reference rate.

Operating experience variances

Operating experience variances relate to variances between actual experience and that anticipated in the projection assumptions.

Operating experience variances totalled £(33) million (2012: £(30) million) and comprise the following elements:

- £(17) million charge from worse than expected persistency experience primarily as a result of the Retail Distribution Review ("RDR"). At 31 December 2012 a provision of £33 million was held to cover adverse persistency experience as a result of the RDR and this has been fully released to partially offset the adverse experience during 2013;
- £(10) million charge from short term expense overrun on the corporate benefits platform as the volume of business gets up to scale;
- £(5) million charge from worse than assumed mortality experience, in particular in the individual protection business; and
- £(1) million net charge from other sources.

Operating assumption changes

Operating assumption changes of £(6) million in the year (2012: £(3) million) comprise:

- £(50) million charge from updating the long-term persistency assumptions for corporate pensions business to reflect recent experience which cannot be attributed to the RDR, including establishing a £35 million provision to cover renegotiation of terms on existing schemes;
- £(9) million charge from strengthening the morbidity assumptions primarily on critical illness business;
- £46 million benefit from an increase in deferred tax assets following a review of assumptions driving the valuation of deferred acquisition expenses; and
- £7 million benefit from reducing the long-term maintenance and investment expense assumptions.

Other operating variances

Other operating variances of £36 million in the year (2012: £11 million) comprise:

- £15 million benefit from lower maintenance expenses from migrating group income protection business to the target platform;
- £8 million benefit from restructuring reinsurance contracts on group protection business;
- £8 million benefit from modelling changes; and
- £5 million benefit from other sources.

Notes to the MCEV results continued**3. Segmental analysis of MCEV earnings** continued**Development costs**

Development costs of £(30) million (2012: £(36) million) relate to costs that are expected to enhance current propositions and generate future profits which are not captured in the MCEV. These costs relate principally to:

- the development and delivery of the retirement income annuity business strategy;
- the development of the corporate investment platform;
- the development of business systems for the introduction of auto-enrolment; and
- the development of the protection proposition.

Heritage covered business

The life and pensions covered business operating profit before tax for the Heritage segment was £393 million (2012: £359 million).

Value of new business

Further details of the calculation and analysis of the VNB are discussed in note 6.

Expected existing business contribution

The total expected contribution of £211 million (2012: £281 million) comprises £196 million from applying expected rates of return to the value of in-force of £2,267 million at the start of the period, and £15 million of expected return on shareholders' net assets. The Heritage expected contribution on shareholders' net assets of £15 million primarily reflects the return based on the reference rate.

Operating experience variances

Operating experience variances totalled a charge of £(12) million (2012: benefit of £9 million) and comprise the following elements:

- £(16) million charge from actual expenses being higher than long-term expense assumptions, the majority of which relates to costs incurred during the period that will not form part of the ongoing cost base;
- £(6) million charge from persistency experience being worse than anticipated on pensions business partially offset by persistency experience being better than anticipated on unit linked bonds;
- £9 million benefit from better than assumed mortality experience, in particular on the life protection business and long-term care business; and
- £1 million net benefit in respect of changes in statutory and tax provisions in respect of legacy business.

Operating assumption changes

Operating assumption changes of £93 million in the year (2012: £65 million) comprise:

- £46 million benefit from an increase in deferred tax assets following a review of assumptions driving the valuation of deferred acquisition expenses;
- £37 million benefit from an increase in fees payable by certain with-profits funds following a review of fees;
- £35 million benefit reflecting savings on future investment expenses following the recapture of certain asset portfolios by FLI;
- £30 million benefit from a revision of inception and recovery rates on income protection business;
- £13 million benefit from adopting longevity assumptions that assume a shorter expectation of life on annuity business;
- £12 million benefit from updating of mortality assumptions on a small block of legacy protection business to reflect recent experience;
- £(66) million charge from the strengthening of maintenance expense assumptions; and
- £(14) million net charge from updating persistency assumptions reflecting a benefit of £22 million from investment bond business, a charge of £8 million from unitised whole of life business, and the establishment of a £25 million short-term provision to cover anticipated adverse persistency on group pensions business following the introduction of auto-enrolment.

Other operating variances

Other operating variances of £127 million (2012: £8 million) comprise:

- £96 million benefit reflecting the impact of the with-profit annuity reallocation activity;
- £16 million benefit from an increase in deferred tax assets on pensions business following a review of methodology; and
- £15 million other benefits, primarily from various modelling changes.

3. Segmental analysis of MCEV earnings continued

Development costs

Development costs of £(7) million (2012: £(6) million) relate to costs that are expected to generate future profits which are not captured in the MCEV. These costs relate to a number of small development projects.

FPI covered business

The life and pensions covered business operating profit before tax for the FPI segment was £59 million (2012: £(102) million).

Value of new business

Further details of the calculation and analysis of the VNB are discussed in note 6.

Expected existing business contribution

The expected contribution of £19 million (2012: £23 million) comprises £18 million (2012: £21 million) which reflects the expected return on the opening value of in-force of £515 million at 1 January 2013 (2012: £502 million), and £1 million (2012: £2 million) from the expected return on shareholders' net assets.

Operating experience variances

Operating experience variances of £13 million (2012: £(12) million) comprise:

- £12 million benefit from better than expected persistency experience, primarily on regular savings plans;
- £3 million benefit from mortality experience being better than anticipated; and
- £(2) million charge from other operational elements and other minor variances.

Operating assumption changes

Operating assumption changes of £14 million in the year (2012: £(107) million) comprise:

- £14 million benefit from updating mortality assumptions;
- £4 million net benefit from updating the long-term expense assumptions partially offset by a short-term provision to cover the future costs of the development of the International platform;
- £(7) million charge from updating persistency assumptions principally from an increase in partial withdrawal assumptions; and
- £3 million net change from other assumption changes.

The operating assumption changes of £(107) million in 2012 included the impacts of the FPI strategic review which are not repeated in 2013.

Other operating variances

Other net positive operating variances amounting to £9 million in the year (2012: £(5) million) principally reflect enhancements to models following internal review, including enhancements to the modelling of return of premium guarantees and movements in the cost of non-hedgeable risk.

Development costs

Development costs of £(10) million (2012: £(6) million) primarily relate to the development of the International platform.

Lombard covered business

The life and pensions covered business operating result before tax for the Lombard segment was £(46) million loss (2012: £104 million profit).

Value of new business

Further details of the calculation and analysis of the VNB are discussed in note 6.

Expected existing business contribution

The expected contribution of £33 million (2012: £35 million) reflects the expected return on the opening value of in-force of £535 million at 1 January 2013 (2012: £457 million). The impact of the higher opening value of in-force has been offset by the lower expected rates of return.

Notes to the MCEV results continued**3. Segmental analysis of MCEV earnings** continued**Operating experience variances**

Operating experience variances of £(25) million (2012: £(23) million) comprise:

- £(18) million charge resulting from persistency experience being worse than anticipated in a number of territories, predominantly Belgium. At 31 December 2012, an £8 million provision was established for short-term adverse persistency experience in the Belgian market and this has been released to partially offset the adverse experience during 2013; and
- £(7) million charge from share-based payments representing the fair value charge of the Lombard long-term incentive plans and other project costs.

Operating assumption changes

Operating assumption changes of £(82) million in the year (2012: £36 million) comprise:

- £(61) million charge from strengthening of the long-term persistency assumptions, primarily in the Belgian market, reflecting recent experience;
- £(22) million charge from updating the long-term per policy expense assumptions following the adverse persistency and new business experience which resulted in a lower number of policies; and
- £1 million benefit from updates to mortality assumptions to reflect experience.

Other operating variances

Other operating variances of £6 million (2012: £13 million) primarily relate to the reduction in cost of non-hedgeable risk resulting from an updated economic capital model.

Development costs

Development costs of £(3) million (2012: £(2) million) relate to the development of new products throughout the year.

Corporate covered business

Corporate includes the external STICS, the external UT2 subordinated debt with associated currency swap, the external LT2 subordinated debt 2021, the external LT2 subordinated debt 2022 and the cost of holding any required capital in excess of the operating segment capital policy.

The expected existing business contribution of £(75) million (2012: £(75) million) represents the expected interest costs arising on the debt held within the life and pensions covered business. The increase driven by the issuance of the new UT2 subordinated debt in November 2012 has been offset by the change in expected return due to market movements.

Non-covered business

The non-covered business generated an operating loss of £(53) million (2012: £(49) million) which comprises £(32) million of corporate costs, the £(19) million operating result of Sesame Bankhall and the £(2) million operating result of fpb AG, the Group's distributor of German business. The £(19) million operating loss from Sesame Bankhall includes a regulatory fine and a provision that has been set up following a review of past business including pensions transfers.

Economic variances

Economic variances combine the impact of changes to economic assumptions with the investment return variances to expected investment returns over the year. The total economic variances were £412 million (2012: £154 million) and these comprise:

- £354 million as a result of better than expected investment returns on equities which increased the value of future charges, and hence the PVFP, on unit-linked business;
- £318 million due to the narrowing of credit spreads on corporate bonds;
- £94 million tax benefit due to losses brought into value by equity realisations and gilt and bond gains during the year;
- £(210) million from a reduction in value of fixed interest assets which for unit-linked business also reduces the value of future charges;
- £(71) million from an increase in the market value of debt;
- £(56) million from an increase in inflation assumptions; and
- £(17) million of other minor economic variances.

3. Segmental analysis of MCEV earnings continued

Other non-operating items

Total other non-operating items of £(143) million (2012: £(142) million) comprise:

- £(59) million of non-recurring project costs within the covered business in respect of Solvency II costs, £10 million incurred during 2013 and an increase of £49 million in the provision for future costs;
- £(59) million from the initial costs associated with the outsourcing agreement with Diligenta; partially offset by the utilisation of the provision established against these costs (discussed in note 10);
- £(34) million of non-recurring project costs, net of provision releases, within the covered business in respect of separation and integration of UK and Heritage businesses and financial reporting improvements;
- £(9) million of cost related to the capital optimisation programme;
- £(4) million of costs related to the potential sale of Lombard;
- £31 million benefit from tax related non-operating items including a £38 million benefit on the UK value of in-force business of changing the ultimate corporation tax rate effective from April 2015 from 21% to 20%, following the Chancellor's Budget in March 2013; and
- £(9) million of other non-recurring items.

4. Earnings per share

Basic and operating earnings per share

	2013 Earnings £m	2013 Pence per share	2012 Earnings £m	2012 Pence per share
For the year ended 31 December 2013				
Profit after tax attributable to ordinary equity holders of the parent	579	40.84	268	19.26
Add back:				
– Economic variances	(412)	(29.06)	(154)	(11.07)
– Amortisation of non-covered business intangible assets	–	–	15	1.08
– Non-recurring items and non-operating variances	143	10.09	127	9.13
– Tax credit on items excluded from operating profit	62	4.37	6	0.43
Operating profit after tax attributable to ordinary equity holders of the parent	372	26.24	262	18.83

Diluted earnings per share from continuing operations

(i) Based on profit after tax attributable to ordinary equity holders of the parent

	2013 Earnings £m	2013 Weighted average number of shares	2013 Pence per share
For the year ended 31 December			
Profit after tax attributable to ordinary equity holders of the parent	579	1,417,808,590	40.84
Dilutive effect of share awards	–	904,272	(0.03)
Diluted basic earnings per share on profit after tax attributable to ordinary equity holders of the parent	579	1,418,712,862	40.81

Notes to the MCEV results continued

4. Earnings per share continued

(ii) Based on operating profit after tax attributable to ordinary equity holders of the parent

For the year ended 31 December	2013 Earnings £m	2013 Weighted average number of shares	2013 Pence per share
Operating profit after tax attributable to equity ordinary holders of the parent	372	1,417,808,590	26.24
Dilutive effect of share awards	–	904,272	(0.02)
Diluted basic earnings per share on operating profit after tax attributable to ordinary equity holders of the parent	372	1,418,712,862	26.22

There were no dilutive factors for the year ended 31 December 2012.

Weighted average number of ordinary shares

For the year ended 31 December 2013	Actual	Weighted
Issued ordinary shares at beginning of period	1,418,109,028	1,418,109,028
Effect of:		
– purchase of own shares held	(600,877)	(300,438)
Number of ordinary shares at end of period	1,417,508,151	1,417,808,590

For the year ended 31 December 2012	Actual	Weighted
Issued ordinary shares at beginning of period	1,376,188,989	1,376,188,989
Own shares held by the Group at beginning of period	(2,661,384)	(2,661,384)
Effect of:		
– scrip dividend (final 2011)	15,484,945	9,477,125
– scrip dividend (interim 2012)	26,435,094	6,283,752
– reduction in own shares held by the Group	2,661,384	1,999,674
Number of ordinary shares at end of period	1,418,109,028	1,391,288,156

5. Reconciliation of equity attributable to ordinary shareholders

Ordinary shareholders' equity on the MCEV basis reconciles to equity attributable to ordinary shareholders on the IFRS basis as follows:

	2013 £m	2012 £m
Equity attributable to ordinary shareholders on an IFRS basis	5,229	5,377
Less items only included on an IFRS basis (net of tax):		
– IFRS reserving and other IFRS adjustments	540	(32)
– Deferred front end fees	58	47
– Deferred acquisition costs	(795)	(708)
– Acquired present value of in-force	(2,933)	(3,159)
– Other intangible assets	(186)	(246)
Add items only included on a MCEV basis (net of tax):		
– Adjustment for long-term debt to market value	(217)	310
Net worth on a MCEV basis	1,696	1,589
Value of in-force covered business	4,369	4,242
Equity attributable to ordinary shareholders on a MCEV basis	6,065	5,831

6. New business

The following tables set out the analysis of new business in terms of volumes and profitability.

New business volumes have been shown using two measures:

- Present Value of New Business Premiums ("PVNBP") is equal to the total single premium sales received in the period plus the discounted value of regular premiums expected to be received over the lifetime of new contracts, and is expressed at point of sale; and
- Annual Premium Equivalent ("APE") is calculated as the new regular premium per annum plus 10% of single premiums.

The MCEV new business definition is consistent with the quarterly new business disclosures.

The premium volumes and projection assumptions used to calculate the present value of regular premiums within PVNBP are the same as those used to calculate the value of new business.

The value of new business is calculated using economic assumptions at the beginning of the period for all products except immediate annuities.

For annuity business, as the contribution is sensitive to the interest rate at outset, the appropriate rate for each month's new business is used. In addition for Retirement Income the investment strategy for new annuity business targets assets with higher illiquidity premiums. The illiquidity premium assumption within the value of new business is also recalculated monthly and over the year has ranged from 65 bps to 85 bps.

The value of new business is calculated using operating assumptions at the end of the period for all products. The operating assumptions are consistent with those used to determine the embedded value.

For Corporate Benefits new business the maintenance expenses within the value of new business reflect:

- the level of maintenance expense expected to be incurred once the Corporate Benefits platform has reached anticipated scale in 2016. Any short term expense overruns are shown in operating experience variance. In 2013 this short term overrun was £10 million; and
- the marginal maintenance expense for new members to existing growing schemes, given scheme costs were included in the value of new business when the scheme was originally set up.

For corporate benefit schemes, the value of new business assumes no salary inflation and does not anticipate any benefit from future increments as a result of increases in the statutory minimum contribution levels on auto-enrolment business, which rise from 2% to 8% by 2018.

The value of new business is shown after the effects of the frictional costs of holding required capital and share-based payments, and after the effect of the costs of residual non-hedgeable risks on the same basis as for the in-force covered business.

Notes to the MCEV results continued

6. New business continued

New business value

Year ended 31 December 2013	New business premiums		APE £m	Average annual premium multiplier ⁽ⁱ⁾	PVNBP £m	Post-tax VNB £m	Pre-tax VNB £m	New business margin %
	Single £m	Regular £m						
UK Corporate Benefits	542	520	574	4.3	2,799	20	26	0.9
UK Protection	–	84	84	7.4	623	57	75	12.0
UK Retirement Income	664	–	66	–	664	63	83	12.5
UK total	1,206	604	724	4.8	4,086	140	184	4.5
Heritage	189	35	54	4.6	351	(14)	(19)	(5.4)
FPI	607	80	141	5.0	1,007	16	14	1.4
Lombard	1,983	–	198	–	1,983	19	25	1.3
Total	3,985	719	1,117	4.8	7,427	161	204	2.7

Year ended 31 December 2012	New business premiums		APE £m	Average annual premium multiplier ⁽ⁱ⁾	PVNBP £m	Post-tax VNB £m	Pre-tax VNB £m	New business margin %
	Single £m	Regular £m						
UK Corporate Benefits	844	451	535	4.1	2,714	16	21	0.8
UK Protection	–	90	90	6.6	590	47	62	10.5
UK Retirement Income ⁽ⁱⁱ⁾	436	–	44	–	436	44	59	13.5
UK total	1,280	541	669	4.5	3,740	107	142	3.8
Heritage	550	47	102	4.9	780	2	2	0.3
FPI	633	139	202	4.9	1,315	8	5	0.4
Lombard	2,376	–	238	–	2,376	35	45	1.9
Total	4,839	727	1,211	4.6	8,211	152	194	2.4

(i) Defined as (PVNBP less total amount of single premiums)/(total annualised amount of regular premiums) this is shown as zero for UK Retirement Income and Lombard as these businesses have only single premium business therefore PVNBP is the same as the premiums received in the period.

(ii) The value of new business for annuities shown in the table above has been valued assuming an illiquidity premium of 90bps from 1 January 2012 to 30 June 2012 and 80bps from 1 July 2012 to 31 December 2012, and over 2013 has ranged from 65bps to 85bps.

6. New business continued

UK

The VNB from the UK segment was £184 million (2012: £142 million), comprising:

- UK Corporate Benefits VNB of £26 million (2012: £21 million), reflecting higher volumes of business and the benefits of the migration to target platforms with the associated longer term lower maintenance costs once the platform has reached anticipated scale;
- UK Protection VNB of £75 million (2012: £62 million), driven by improved margins on lower volumes in 2013. The margins have improved following migration to the lower cost strategic platforms and the benefit from restructuring reinsurance contracts; and
- UK Retirement Income VNB of £83 million (2012: £59 million), driven by a significant increase in the volume of business written.

Heritage

Heritage VNB of £(19) million (2012: £2 million), reflects the fact that Heritage now only writes increments to products no longer actively marketed, where VNB is negative. The 2012 VNB included £13 million in respect of Department of Work and Pensions rebate premiums, which are no longer received.

FPI

FPI VNB was £14 million (2012: £5 million), comprising:

- Core VNB of £21 million (2012: £17 million), reflecting improved margins on lower volumes, particularly following favourable expense and mortality assumption changes; and
- Non-core VNB of £(7) million (2012: £(12) million), reflecting the closure of business in non-core markets and lower volumes following the sale of the Group's 30% stake in AmLife.

Lombard

Lombard VNB was £25 million (2012: £45 million); reflecting a reduction in volumes and the strengthening of the basis assumptions following a review of recent experience.

New business performance metrics

New business written requires an initial capital investment to meet the set-up costs and capital requirements.

The internal rate of return ("IRR") provides a measure of the return to shareholders on this initial capital investment. It is equivalent to the discount rate at which the present value of the after-tax cash flows expected to be earned over the lifetime of the business written is equal to the initial capital invested, including setting aside the required capital, to support the writing of the business. The Lombard IRR (and therefore the blended Group IRR) takes account of the Luxembourg regulatory regime in which DAC is an allowable asset.

The cash payback on new business is the time elapsed until the total of expected (undiscounted) cash flows is sufficient to recoup the initial capital invested, including the release of the required capital, to support the writing of new business.

New business key performance metrics

	2013			2012		
	Pre-tax value of new business £m	Internal rate of return on new business %	Cash payback on new business Years	Pre-tax value of new business £m	Internal rate of return on new business %	Cash payback on new business Years
Corporate Benefits	26	8.4	11	21	7.2	12
Protection	75	13.8	7	62	13.8	6
Retirement Income	83	>25.0	2	59	n/a ⁽ⁱ⁾	n/a ⁽ⁱ⁾
UK total	184	15.3	7	142	13.3	8
Heritage	(19)	(1.9)	n/a	2	4.6	14
FPI	14	6.4	10	5	5.4	12
Lombard	25	13.3	8	45	22.5	5
Total	204	11.2	9	194	10.4	9

(i) Strong new business margin in 2012 meant the initial capital invested in writing Retirement Income new business was fully recouped by the single premium paid. This also means that an IRR for this business was not relevant.

Notes to the MCEV results continued

6. New business continued

The Group new business IRR was 11.2% (2012: 10.4%) and the payback period on new business was 9 years (2012: 9 years). These metrics include positive movements for UK and FPI, offset by adverse movements for Heritage and Lombard.

The increase in UK reflects an increase in volumes of business from Retirement Income, and also higher Corporate Benefits IRR where lower acquisition and maintenance costs more than offset the reduced margins and lower assumed investment returns. The stable Protection IRR reflects the offsetting effects of lower volumes and lower acquisition costs, which also slightly increased the payback period. The Retirement Income IRR remains high but has reduced from 2012 reflecting the competitive pricing undertaken in 2013.

The Heritage IRR and payback period reflect the fact that the new business written in Heritage focuses on increments to products no longer actively marketed. The associated investment in new business is not expected to be recouped and hence results in a negative IRR. In 2012 the metrics included the benefits of Department of Work and Pensions rebate premiums.

The FPI IRR has increased reflecting the actions taken following the strategic review in 2012, which reduced the proportion of new business received from the less profitable non-core business.

The Lombard IRR has reduced significantly reflecting the combination of reduced volumes and relatively fixed acquisition costs.

The Group new business IRR does not include the impact of the with-profit annuity reallocation activity. If this activity, which represents a discretionary use of capital for the purposes of generating returns, was to be included within the IRR, then the Group IRR would increase to 15.3%.

7. Segmental analysis of Group MCEV

	2013									2012
	Free surplus £m	Required capital £m	Total net worth £m	PVFP £m	TVOG £m	Frictional costs £m	CNHR £m	Total VIF £m	Total £m	Total £m
UK	16	369	385	1,121	–	(29)	(59)	1,033	1,418	1,227
Heritage	590	1,174	1,764	2,615	(114)	(80)	(119)	2,302	4,066	4,080
FPI	58	26	84	547	–	(3)	(25)	519	603	612
Lombard	–	83	83	544	–	(4)	(25)	515	598	615
Corporate ⁽ⁱ⁾										
– IFA and distribution	41	–	41	–	–	–	–	–	41	39
– Pension deficit of FPPS	(18)	–	(18)	–	–	–	–	–	(18)	38
– Other ⁽ⁱⁱ⁾	988	(8)	980	–	–	–	–	–	980	816
Gross Group MCEV⁽ⁱⁱⁱ⁾	1,675	1,644	3,319	4,827	(114)	(116)	(228)	4,369	7,688	7,427
Corporate– external STICS	–	(478)	(478)	–	–	–	–	–	(478)	(443)
Corporate– external debt ^(iv)	–	(1,145)	(1,145)	–	–	–	–	–	(1,145)	(1,153)
Net Group MCEV	1,675	21	1,696	4,827	(114)	(116)	(228)	4,369	6,065	5,831

(i) Corporate excludes external STICS, the external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022.

(ii) Other includes £164 million (2012: £133 million) in respect of the Resolution holding companies.

(iii) For the purposes of this table "Gross" refers to the MCEV gross of the clean market value of the external STICS, the external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022. The accrued interest and tax adjustment on market valuation is included in the gross MCEV of Corporate.

(iv) The Corporate external debt comprises: the external LT2 subordinated debt 2021; the external LT2 subordinated debt 2022; and the external UT2 subordinated debt with associated currency swap.

7. Segmental analysis of Group MCEV continued

i) Required capital

Each life company within the Group has an individual capital management policy which, whilst aligned to Group policies, will take account of local regulatory requirements. All the life companies in the Group meet their individual capital management policies.

Required capital within MCEV is calculated and allocated to business units based on the Group's capital management policy of holding 150% of the Group CRR (excluding WPICC) even where this allocation is in excess of local capital management policies. In practice the extra required capital held to meet the Group's capital management policy can be covered by any of the companies within the Group.

The external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 are included within the MCEV at market value, as detailed in note 10.

ii) PVFP

The PVFP at 31 December 2013 includes a £27 million net of tax (2012: nil) deduction in respect of anticipated adverse persistency on corporate pensions business in the UK segment to cover renegotiation of terms on existing schemes, and a £19 million net of tax (2012: nil) deduction in respect of anticipated short term adverse persistency on group pensions business in the Heritage segment following the introduction of auto-enrolment.

At 31 December 2012 provisions of £25 million net of tax and £9 million net of tax were held in UK and Lombard respectively against short term adverse persistency experience. Both these provisions have been released against the actual experience in 2013 and no additional provisions are held at 31 December 2013.

iii) TVOG

The TVOG at 31 December 2013 of £114 million (2012: £126 million), is split between £79 million (2012: £90 million) market risk and £35 million (2012: £36 million) non-market risk. The non-market risks include lapses, annuitant longevity, and operational risk within the with-profits fund. The allowance for non-market risks is made by consideration of the impact of extreme scenarios from the Group's economic capital model.

iv) Frictional costs of holding required capital

The projected required capital for life company subsidiaries is derived from the Group's capital management policy which is to hold the greater of 150% of Pillar 1 CRR excluding WPICC and 125% Pillar 2 CRR including any Individual Capital Guidance.

Additionally, the Group capital management policy in respect of FLG is to hold 150% of Group CRR excluding WPICC (2012: 150%). The cost of holding any additional capital is shown in the FLG covered business segment. At 31 December 2013 no additional capital was required to meet the Group capital management policy and hence no additional cost was required.

v) CNHR

The cost of residual non-hedgeable risk of £228 million (2012: £222 million) is presented as an equivalent annual cost of capital charge of 1.2% (2012: 1.5%) on projected risk-based Group required capital for all non-hedgeable risk. In line with management's view of the business, allowance has been made for diversification benefits within the non-hedgeable risks of the covered business.

Notes to the MCEV results continued

8. Segmental analysis of Group MCEV earnings

The tables below show a further breakdown of the Group MCEV earnings comprising the MCEV earnings for the life and pensions covered business and the IFRS earnings for the non-covered businesses.

All figures are shown net of attributed tax.

Year ended 31 December 2013	Covered business					Non-covered business £m	Total £m
	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m		
Opening Group MCEV	1,227	4,080	612	615	(1,611)	908	5,831
Opening adjustments:							
– disposal of AmLife	–	–	(43)	–	–	50	7
Adjusted opening Group MCEV	1,227	4,080	569	615	(1,611)	958	5,838
Operating MCEV earnings	162	295	58	(36)	(57)	(50)	372
Non-operating MCEV earnings	37	137	3	8	(55)	77	207
Total Group MCEV earnings	199	432	61	(28)	(112)	27	579
Other movements in IFRS net equity	–	–	–	–	–	(77)	(77)
Closing adjustments:							
– capital and dividend flows	(8)	(446)	(27)	(5)	92	103	(291)
– foreign exchange variances	–	–	–	16	–	–	16
Closing Group MCEV	1,418	4,066	603	598	(1,631)	1,011	6,065

Year ended 31 December 2012	Covered business					Non-covered business £m	Total £m
	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m		
Opening Group MCEV	1,011	4,330	571	541	(1,041)	384	5,796
Operating MCEV earnings	110	271	(79)	80	(57)	(63)	262
Non-operating MCEV earnings	106	137	(16)	10	(228)	(3)	6
Total Group MCEV earnings	216	408	(95)	90	(285)	(66)	268
Other movements in IFRS net equity	–	–	–	–	–	(28)	(28)
Closing adjustments:							
– capital and dividend flows	–	(658)	136	–	(285)	618	(189)
– foreign exchange variances	–	–	–	(16)	–	–	(16)
Closing Group MCEV	1,227	4,080	612	615	(1,611)	908	5,831

9. Maturity profile of value of in-force business by proposition

At 31 December 2013	Total £m	Years								
		1–5 £m	6–10 £m	11–15 £m	16–20 £m	21–25 £m	26–30 £m	31–35 £m	36–40 £m	41+ £m
Corporate Benefits	708	277	192	126	66	31	12	3	1	–
Protection	238	92	49	39	29	17	8	3	1	–
Retirement Income	87	8	9	12	15	16	13	8	4	2
UK	1,033	377	250	177	110	64	33	14	6	2
Heritage	2,302	1,107	505	313	186	96	51	25	11	8
FPI	519	261	131	70	34	12	5	3	3	–
Lombard	515	203	123	77	46	28	17	10	6	5
Total VIF	4,369	1,948	1,009	637	376	200	106	52	26	15

10. MCEV assumptions

10.1 Economic assumptions – deterministic calculations

Economic assumptions are derived actively, based on market yields on risk-free fixed interest assets at the end of each reporting period.

Reference rates – risk free

The risk free reference rate is determined with reference to the swap yield curve appropriate to the currency of the cash flows. For some business types, where the impact on the VIF is small, a long-term risk free reference rate has been used.

For annuity business the swap yield curve is extrapolated where necessary, assuming the last observable forward rate is constant thereafter, to provide rates appropriate to the duration of the liabilities.

No adjustment has been made to the reference rate for current sovereign debt market conditions because the exposure of the Group to such debt is minimal.

	Reference rate – risk free	
	2013 %	2012 %
UK and Heritage		
Long-term rate	3.10	1.90
Swap yield curve		
– Term 1 year	0.71	0.67
– Term 5 years	2.18	1.03
– Term 10 years	3.11	1.93
– Term 15 years	3.48	2.58
– Term 20 years	3.58	2.94
FPI long-term rate	3.10	1.90
Lombard long-term rate	2.62	2.13

Notes to the MCEV results continued

10. MCEV assumptions continued

Reference rate – Illiquidity premium adjustment

The updated MCEV Principles recognise that the inclusion of an illiquidity premium within the reference rate is appropriate where the liabilities are not liquid.

In this regard, the methodology adopted for the valuation of immediate annuities in the UK and Heritage uses a reference rate that has been increased above the swap yield curve to allow for an illiquidity premium. This reflects the fact that, for these products, the backing asset portfolio can be held to maturity and earns risk-free returns in excess of swaps. Any illiquidity premia in respect of assets backing other product types are recognised within the MCEV as and when they are earned.

The illiquidity premium has been evaluated by considering a number of different sources of information and methodologies. Two of the main approaches being commonly used to determine the illiquidity premium within the life insurance industry are:

- a “negative basis trade”, which attributes a component of the difference between the spread on a corporate bond and a credit default swap (for the same issuing entity, maturity, seniority and currency) as being the illiquidity premium; and
- structural models – such as that used by the Bank of England in their analysis of corporate bond spreads – that use option pricing techniques to decompose the spread into its constituent parts including default risk, credit risk premium and a residual illiquidity premium.

Both of these methods have been used to help inform the extent of the illiquidity premium within the asset portfolios backing immediate annuity business and some deferred annuity business.

No illiquidity premium has been applied for any other covered business.

Investment strategy for annuity new business targets assets with higher illiquidity premiums than the back book portfolio. Given the contribution to new business is sensitive to the interest rate and illiquidity premium at outset, an appropriate rate for each month's new business is used.

The reference rate has been adjusted for immediate and some deferred annuities as set out in the table below.

	Embedded value		New business	
	2013	2012	2013	2012
UK and Heritage immediate annuities	60bps	75bps	65-85bps	80-90bps

Expected asset returns in excess of reference rates

Margins are added to the reference rates to obtain investment return assumptions for equity, property and corporate bonds. These risk premia reflect management's expectations of asset returns in excess of the reference rate from investing in different asset classes. As a market consistent approach has been followed, these investment return assumptions affect the expected existing business contribution and the economic variances within the analysis of MCEV earnings, but do not affect the opening or closing embedded values. In addition, they will affect the additional disclosures of the payback periods.

For equities and property, the excess is calculated as the difference between the long-term rate of return and the one-year risk free reference rate. The long-term rate of return is derived using a 10 year swap rate plus a risk premium of 3% for equities (2012: 3%) and 2% for property (2012: 2%).

For cash and government bonds no excess over the one-year risk free reference rate has been assumed for UK, Heritage or FPI. Lombard assumes the long-term rate is achieved. For corporate bonds, the return is based on the excess of actual corporate bond spreads on the reporting date, less an allowance for defaults, over the one-year risk free reference rate for UK, Heritage and FPI. For Lombard the corporate bond return is derived using the long-term rate plus a risk premium of 1% (2012: 1%).

For annuity business the excess return reflects the excess of the bond portfolio over the reference rate including the illiquidity premium adjustment.

Expense inflation

Maintenance expenses for UK, Heritage and FPI business are assumed to increase in the future at a rate of 1% (2012: 1%) per annum in excess of the assumed long-term rate of inflation. Long-term inflation assumptions are set relative to gilt curves at appropriate durations.

Maintenance expenses for Lombard are assumed to increase in the future at a rate of 0.75% (2012: 0.75%) per annum in excess of the assumed long-term rate of inflation. This is derived from an inflation swap curve based on a Eurozone price index taking into account the run-off profile of the business.

10. MCEV assumptions continued

	Expense inflation	
	2013 %	2012 %
UK	4.30	3.70
Heritage	4.30	3.70
FPI	4.30	3.70
Lombard	2.75	3.00

Exchange rates

The results and cash flows of all businesses, except Lombard, are calculated in Sterling. The results and cash flows for Lombard are calculated in Euros and converted to Sterling at the following rates:

	Exchange rates	
	2013	2012
Closing exchange rate	0.832	0.811
Average exchange rate	0.847	0.813

Other economic assumptions

Bonus rates on participating business have been set at levels consistent with the economic assumptions.

The MCEV allows for distribution of profit between the policyholders and shareholders within the following with-profits funds:

- Friends Life FP With-Profits Fund ("FP WPF")
- Friends Life FLAS With-Profits Fund ("FLAS WPF")
- Friends Life FLC Old With-Profits Fund ("FLC Old WPF")
- Friends Life FLC New With-Profits Fund ("FLC New WPF")
- Friends Life WL With-Profits Fund ("WL WPF")

The distribution is at the current rate of one-ninth of the cost of bonus with the following exceptions:

- Within the FP WPF it is assumed that the shareholder interest in the pre-demutualisation non-profit and unitised business (excluding the investment element) continues at the current rate of 60% of future profits;
- For certain policies in FLC with-profits funds with guaranteed bonus rates shareholders do not receive one ninth of guaranteed bonuses; and
- Where elements of the non-profit fund policies are invested in the WL with-profits fund, the shareholder receives the management charges in the non-profit fund for these.

Following the Part VII transfer of business from FLC to FLL, the requirement to retain the FLC reattributed inherited estate ("RIE") to support FLC Old WPF and FLC New WPF along with other previously existing with-profit fund support arrangements have been incorporated into one FLL Scheme effective from 28 December 2012.

The FLL Scheme rules require that a test be undertaken every five years to determine the level of shareholder capital support required for FLC Old WPF and FLC New WPF. The test also determines whether it is possible to distribute any of the inherited estate retained in the FLC Old WPF in the form of Special Bonuses (and associated transfer to the shareholders' fund). The latest five yearly test was undertaken as at 31 December 2010.

The remaining RIE in the FLL NPF is predominantly in the form of the VIF of non-profit business written within the fund. To the extent that this VIF emerges into cash during the period 31 December 2013 to the next five year test date at 31 December 2015, the cash may be available to be transferred to the FLL shareholders' fund subject to passing the relevant financial strength tests. The MCEV allows for best estimate projections of the amounts to be transferred in future.

10.2 Economic assumptions – stochastic calculations

Model

The time value of financial options and guarantees and the OLAB return of premium guarantee are determined using a Barrie & Hibbert economic scenario generator and are calculated using 2,000 simulations. The with-profits model is consistent with the model used for the Realistic Balance Sheet and is calibrated to market conditions at the valuation date using the gilt risk-free curve and implied volatilities in the market. The OLAB return of premium guarantee model is calibrated to market conditions at the valuation date using a Euro swap curve and implied volatilities in the market. Correlations between the asset classes are derived from historic data.

Notes to the MCEV results continued

10. MCEV assumptions continued

Swaption implied volatilities – with-profits time value of financial options and guarantees

Option term	2013 Swap term				2012 Swap term			
	10 yrs %	15 yrs %	20 yrs %	25 yrs %	10 yrs %	15 yrs %	20 yrs %	25 yrs %
UK Sterling								
10 years	18	17	16	15	18	17	16	15
15 years	19	18	17	16	18	17	16	16
20 years	17	16	15	14	16	16	15	15
25 years	16	15	14	13	16	16	16	15

Swaption implied volatilities – OLAB return of premium guarantee

Option term	2013 Swap term				2012 Swap term			
	10 yrs %	15 yrs %	20 yrs %	30 yrs %	10 yrs %	15 yrs %	20 yrs %	30 yrs %
Euro								
10 years	23	22	21	20	24	24	23	20
15 years	25	23	22	20	27	26	24	20
20 years	22	20	19	18	26	24	21	17
25 years	21	19	18	16	23	20	18	15

Equity and property implied volatilities – with-profits time value of financial options and guarantees

Equity volatility is calibrated to market implied volatility and is a reasonable fit to the implied volatility of the FTSE 100 put options held by the with-profits funds. Property holdings are modelled assuming an initial volatility of 15% (2012: 15%) and a running yield of 4.3% (2012: 4.3%). Sample implied volatilities are shown in the table below.

Option term	2013		2012	
	Equity %	Property %	Equity %	Property %
5 years	19	15	24	15
10 years	22	15	26	15
15 years	24	15	27	15

Equity implied volatilities – OLAB return of premium guarantee

Equity volatility is calibrated to put options on the EUROSTOXX50 index as an objective measure of market implied volatility. Sample implied "at-the-money" volatilities are shown in the table below.

Option term	2013	2012
	Equity %	Equity %
5 years	20	25
10 years	21	25
15 years	21	25

10. MCEV assumptions continued

10.3 Other assumptions

Required capital

Required capital under MCEV amounted to £21 million (2012: £40 million). The required capital is shown net of £1,631 million (2012 £1,611 million) representing the market value of the external debt.

The projected required capital is derived from the Group's capital management policy which is to hold, within life company subsidiaries, the greater of 150% Pillar 1 CRR excluding WPICC and 125% of ICA plus ICG. In addition the Group's capital management policy is to hold 150% of Group CRR excluding WPICC, and any cost of holding this additional capital is shown within the Corporate covered business segment. These policies are unchanged from 2012. At 31 December 2013 no additional capital, and hence no cost of additional capital was included within the Corporate covered business segment (2012: nil).

Taxation

The opening and closing embedded values in respect of covered business are determined on an after tax basis. The tax assumptions used are based upon the best estimate of the actual tax expected to arise. The attributable tax charge and profit before tax are derived by grossing up the profit after tax at the appropriate tax rates for each of the UK, Isle of Man and Luxembourg. Deferred tax is provided on the mark-to-market revaluation of the external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 allocated to the life and pensions covered business within Corporate. For UK, Heritage and OLAB business the appropriate tax rate has been calculated as the average rate of corporation tax applicable over the period, and hence the rate applicable for 2013 reflects the reduction in corporation tax that took effect from April 2013.

For non-covered business, attributed tax is consistent with the IFRS financial statements.

	Tax rates	
	2013 %	2012 %
UK	23.25	24.5
Heritage	23.25	24.5
FPI		
– OLAB (UK)	23.25	24.5
– FPIL (Isle of Man)	0.0	0.0
Lombard	22.5	22.5

The PVFP for UK, Heritage and OLAB business includes allowance for the annual reductions in corporation tax announced in the Emergency Budget in June 2010 and the further reductions of 1% announced in subsequent Budgets. The MCEV allows for anticipated future annual reductions in corporation tax from 23% to 20% over the period to 2015 (2012: 24% to 21% over the period to 2014) and for an ultimate rate of 20% from April 2015 (2012: 21% from April 2014).

Legislation in respect of the new life tax regime was included in Finance Act 2012, which received Royal Assent on 17 July 2012. The new life tax regime took effect from 1 January 2013 and a best estimate of its effect is therefore included in MCEV, being a forward-looking measure. There remains an element of risk and uncertainty in estimating its effects given that the legislation is newly introduced therefore the outcomes may be subject to change as a result of either legislative update or by development in interpretation.

VAT in the UK of 20.0% (2012: 20.0%) less expected recoveries has been included on relevant investment management expenses and, where applicable, on outsourced administration contracts.

Demographic assumptions

Other assumptions (for example mortality, morbidity and persistency) are a reflection of the best estimate of the likely behaviours, outcomes or circumstances in the future. Typically the estimates are made on an annual basis following experience investigations based on the data available at the time both from the book of business and externally sourced information. The aim is to set assumptions at a level that reflects recent experience, unless there are reliable indicators that suggest their adoption would result in a significant variance compared to these assumptions in the future. In some instances, there may be little or no direct experience to use in setting assumptions and the future outcome is therefore uncertain.

The RDR came into effect from 1 January 2013 and a £33 million provision (gross of tax) was held at 31 December 2012, to cover negative variances expected on initial commission business written pre-RDR in 2012 where long-term assumptions were expected to be temporarily inadequate. Following the release of £33 million against adverse experience in the UK segment in 2013, no provision for this business is held at 31 December 2013.

Notes to the MCEV results continued

10. MCEV assumptions continued

A provision of £35 million (gross of tax) is held at 31 December 2013 in respect of anticipated adverse persistency on corporate pensions business in the UK segment to cover renegotiation of terms on existing schemes, and a provision of £25 million (gross of tax) is held to cover anticipated short term adverse persistency on group pensions business in the Heritage segment following the implementation of auto-enrolment.

Future improvements in annuitant mortality have been assumed to be in accordance with the projections published by the Continuous Mortality Investigation ("CMI") in 2011, with a long-term rate of 1.25% per annum (2012: 1.25%).

Expense assumptions

The management expenses (including those relating to holding companies) attributable to the covered businesses have been analysed between expenses relating to the acquisition of new business, maintenance of in-force business (including investment management expenses) and development expenses.

Future maintenance expense assumptions reflect the expected ongoing expense levels required to manage the in-force business.

Productivity gains have generally only been included to the extent they have been achieved by the end of the reporting period. For new corporate benefit schemes, the value of new business and value of in force reflect the anticipated maintenance expenses once the level of business on the corporate benefit platform has reached anticipated scale in 2016. Whilst the business reaches scale any temporary expense overrun will be reflected in operating experience variance.

At 31 December 2012 a £2 million deduction to PVFP was made to reflect a short-term expense overrun in 2013 for Lombard. There is no deduction at 31 December 2013, and the maintenance expense assumptions reflect the ongoing expense levels required to manage the Lombard in-force business.

In June 2009 Friends Life Services Limited ("FLSL") entered into a 15 year agreement with Capita Life & Pensions Regulated Services Limited ("Capita") to outsource the administration of mature traditional life and pensions policies. The maintenance expense assumptions for the relevant business allow for the agreed service fees with Capita. In addition allowance is made for the initial significant development expenditure and anticipated longer term savings as a result of a reduction in costs, which result in an overall expense overrun in FLSL.

In November 2011 Friends Life announced a 15 year agreement with Diligenta to outsource IT and Programmes and in-house Customer Service functions (along with HR, Finance and Business Risk services that support these functions). This agreement resulted in significant longer term cost reductions and an overall increase to MCEV. Allowance was made in 2011 for the initial significant development expenditure, with the establishment of a specific provision. In 2013, initial development costs of £(87) million have been incurred in relation to the Diligenta arrangement which have been partially offset by a £28 million utilisation of the remaining £92 million provision. The net cost of £(59) million is shown in the consolidated income statement within other non-operating items.

Other one-off costs shown within non-recurring items can be categorised as:

- Solvency II and Finance Transformation project costs;
- Separation and integration costs;
- Capital restructuring costs; or
- Corporate acquisitions/disposal costs.

Any other one-off costs that do not fall into these categories are treated as operating exceptional costs within operating experience variances.

The MCEV makes provision for certain development costs to the extent that these are known with sufficient certainty and in line with current plans.

Development costs of £50 million (2012: £50 million) have been excluded from the calculation of unit costs and have been recognised in operating profits. Development costs relate to investment in activities expected to create value in the future, but where that expected value cannot be anticipated within the current period's financial results until the value is realised.

Development costs

	2013 £m	2012 £m
UK	30	36
Heritage	7	6
FPI	10	6
Lombard	3	2
Total	50	50

10. MCEV assumptions continued

Non-hedgeable risks

A charge equivalent to 1.2% (2012: 1.5%) has been applied to the projected risk-based group required capital for all non-hedgeable risks over the remaining lifetime of in-force business.

In line with management's view of the business, allowance has been made for diversification benefits within the non-hedgeable risks of the covered business.

Other assumptions

The external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 are included within the MCEV at market value, based on listed ask price.

At 31 December 2013	Principal £m	Clean market value of debt £m	Accrued interest £m	Tax adjustment on market valuation £m	Value of debt included in Corporate ⁽ⁱ⁾ £m
STICS 2003	210	210	2	(1)	211
STICS 2005	268	268	8	(3)	273
LT2 subordinated debt 2021	162	210	12	(14)	208
LT2 subordinated debt 2022	500	550	29	(19)	560
UT2 subordinated debt⁽ⁱⁱ⁾	356	378	4	(8)	374
Currency swap	–	7	–	(2)	5
Total	1,496	1,623	55	(47)	1,631

At 31 December 2012	Principal £m	Clean market value of debt £m	Accrued interest £m	Tax adjustment on market valuation £m	Value of debt included in Corporate ⁽ⁱ⁾ £m
STICS 2003	210	193	2	4	199
STICS 2005	268	250	8	1	259
LT2 subordinated debt 2021	162	215	12	(16)	211
LT2 subordinated debt 2022	500	554	29	(21)	562
UT2 subordinated debt ⁽ⁱⁱ⁾	356	378	4	(8)	374
Currency swap	–	6	–	–	6
Total	1,496	1,596	55	(40)	1,611

(i) The value of debt included in the corporate category is the market value of debt, including accrued interest, and the tax asset/liability on the market value adjustment.

(ii) The UT2 subordinated debt was issued in US Dollars with principal of \$575 million, equivalent to £356 million at issue in November 2012.

The deferred consideration notes, issued in September 2010 in connection with the acquisition of the AXA UK Life Business, were repaid on 20 November 2012.

Notes to the MCEV results continued

11. Sensitivity analysis

The following tables show the sensitivity of the embedded value and the value of new business to changes in assumptions. The sensitivities below apply to covered business only and include the impact on both shareholder net worth and VIF.

For each sensitivity, the other future experience assumptions remain unchanged, except where changes in economic assumptions directly affect them. Any changes in the assumptions underlying the statutory reserving calculations have no material impact on the MCEV sensitivities shown. For Heritage, Lombard and UK businesses statutory assumptions have not been changed in applying the MCEV sensitivities, but for FPI the statutory assumptions have been changed to fit with regulatory requirements. There are no additional management actions or changes in policyholder behaviour assumed within any of the sensitivities.

Sensitivities shown in a single direction have broadly symmetrical impacts.

At 31 December 2013	Covered business						
	UK £m	Heritage £m	UK & Heritage £m	FPI £m	Lombard £m	Corporate £m	Total £m
Change in MCEV (net of tax)							
Base MCEV	1,418	4,066	5,484	603	598	(1,631)	5,054
Market risk							
100bps increase in reference rates	(21)	(90)	(111)	27	(2)	109	23
100bps decrease in reference rates	20	118	138	(32)	–	(124)	(18)
Removal of illiquidity premium for immediate annuities	(118)	(399)	(517)	–	–	–	(517)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	(48)	(149)	(197)	(26)	(36)	–	(259)
25% increase in equity/property volatility at the valuation date	–	(12)	(12)	(18)	–	–	(30)
25% increase in swaption implied volatility at the valuation date	–	(4)	(4)	–	–	–	(4)
100bps increase in corporate bond spreads ⁽ⁱ⁾	(72)	(286)	(358)	–	(9)	109	(258)
100bps decrease in corporate bond spreads ⁽ⁱ⁾	77	274	351	–	9	(124)	236
10% adverse movement in Sterling/overseas exchange rate ⁽ⁱ⁾	(7)	(25)	(32)	(26)	(52)	–	(110)
10% fall in value of unit linked funds	(62)	(212)	(274)	(31)	(63)	–	(368)
100bps increase in expense inflation	(30)	(81)	(111)	(22)	(9)	–	(142)
100bps decrease in expense inflation	26	70	96	18	7	–	121
Insurance and other risk							
Reduction to EU minimum capital or equivalent ⁽ⁱⁱ⁾	9	42	51	–	–	–	51
10% decrease in maintenance expenses	30	59	89	29	16	–	134
10% proportionate decrease in lapse rates	36	58	94	8	37	–	139
10% proportionate decrease in PUP rates	9	1	10	4	–	–	14
5% decrease in mortality/morbidity – life assurance							
– Before reinsurance	27	47	74	9	3	–	86
– After reinsurance	12	16	28	6	2	–	36
5% decrease in mortality/morbidity – annuity business							
– Before reinsurance	(17)	(129)	(146)	–	–	–	(146)
– After reinsurance	(17)	(51)	(68)	–	–	–	(68)

11. Sensitivity analysis continued

At 31 December 2012	Covered business				
	UK & Heritage ^(vi) £m	FPI ^(v) £m	Lombard £m	Corporate £m	Total £m
Change in MCEV (net of tax)					
Base MCEV	5,307	612	615	(1,611)	4,923
Market risk					
100bps increase in reference rates	(160)	(3)	–	107	(56)
100bps decrease in reference rates	156	19	(4)	(119)	52
Removal of illiquidity premium for immediate annuities	(544)	–	–	–	(544)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	(181)	(23)	(37)	–	(241)
25% increase in equity/property volatility at the valuation date	(32)	–	–	–	(32)
25% increase in swaption implied volatility at the valuation date	(4)	–	–	–	(4)
100bps increase in corporate bond spreads ⁽ⁱ⁾	(310)	–	(11)	107	(214)
100bps decrease in corporate bond spreads ⁽ⁱ⁾	380	–	11	(119)	272
10% adverse movement in Sterling/overseas exchange rate ⁽ⁱⁱ⁾	(30)	(39)	(53)	–	(122)
10% fall in value of unit linked funds	(207)	(27)	(69)	–	(303)
100bps increase in expense inflation	(65)	(24)	(15)	–	(104)
100bps decrease in expense inflation	57	20	12	–	89
Insurance and other risk					
Reduction to EU minimum capital or equivalent ⁽ⁱⁱⁱ⁾	40	–	–	–	40
10% decrease in maintenance expenses	109	31	19	–	159
10% proportionate decrease in lapse rates	83	12	37	–	132
10% proportionate decrease in PUP rates	13	12	–	–	25
5% decrease in mortality/morbidity – life assurance					
– Before reinsurance	79	9	3	–	91
– After reinsurance	38	6	2	–	46
5% decrease in mortality/morbidity – annuity business					
– Before reinsurance	(132)	–	–	–	(132)
– After reinsurance	(67)	–	–	–	(67)

(i) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40bps (2012: 40bps) for in-force business and 40bps (2012: 40bps) for the value of new business.

(ii) Currency risk is expressed in terms of total overseas exposure; the Group's principal currency exposures other than sterling are the Euro and US Dollar.

(iii) Required capital is set at the greater of regulatory capital and requirements arising from internal capital management policies. In aggregate, the required capital is higher than the regulatory requirement by £812 million (2012: £886 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.

(iv) Comparative figures for splits to the UK and Heritage operating segments for the year ended 31 December 2012 are not available and the costs to develop them would be excessive.

(v) The 2012 FPI embedded value included £43 million in respect of AmLife. This was sold on 4 January 2013 and consequently there is no sensitivity included in respect of AmLife in 2012.

Notes to the MCEV results continued

11. Sensitivity analysis continued

At 31 December 2013	Covered business					
	UK £m	Heritage £m	UK & Heritage £m	FPI £m	Lombard £m	Total £m
Change in value of new business (gross of tax)						
Base value of new business	184	(19)	165	14	25	204
Market risk						
100bps increase in reference rates	(3)	–	(3)	–	–	(3)
100bps decrease in reference rates	1	–	1	2	–	3
Removal of illiquidity premium for immediate annuities	(44)	–	(44)	–	–	(44)
100bps increase in corporate bond spreads ⁽ⁱ⁾	(18)	–	(18)	–	–	(18)
100bps decrease in corporate bond spreads ⁽ⁱ⁾	19	–	19	–	–	19
100bps increase in expense inflation	(7)	–	(7)	–	–	(7)
100bps decrease in expense inflation	5	–	5	–	–	5
Insurance and other risk						
Reduction to EU minimum capital or equivalent	2	–	2	–	–	2
10% decrease in maintenance expenses	8	–	8	2	2	12
10% proportionate decrease in lapse rates	14	–	14	1	4	19
10% proportionate decrease in PUP rates	5	–	5	1	–	6
5% decrease in mortality/morbidity – life assurance						
– Before reinsurance	8	–	8	–	–	8
– After reinsurance	3	–	3	–	–	3
5% decrease in mortality/morbidity – annuity business						
– Before reinsurance	(3)	–	(3)	–	–	(3)
– After reinsurance	(5)	–	(5)	–	–	(5)
Impact of end of period assumptions on VNB	(11)	–	(11)	(2)	(1)	(14)

(i) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40bps (2012: 40bps) for in-force business and 40bps (2012: 40bps) for the value of new business.

11. Sensitivity analysis continued

At 31 December 2012	Covered business			Total £m
	UK & Heritage ⁽ⁱ⁾ £m	FPI £m	Lombard £m	
Change in value of new business (gross of tax)				
Base value of new business	144	5	45	194
Market risk				
100bps increase in reference rates	(6)	(2)	–	(8)
100bps decrease in reference rates	5	2	–	7
Removal of illiquidity premium for immediate annuities	(31)	–	–	(31)
100bps increase in corporate bond spreads ⁽ⁱ⁾	(14)	–	–	(14)
100bps decrease in corporate bond spreads ⁽ⁱ⁾	13	–	–	13
100bps increase in expense inflation	(7)	(5)	–	(12)
100bps decrease in expense inflation	6	4	–	10
Insurance and other risk				
Reduction to EU minimum capital or equivalent	2	–	–	2
10% decrease in maintenance expenses	8	6	2	16
10% proportionate decrease in lapse rates	13	–	5	18
10% proportionate decrease in PUP rates	5	1	–	6
5% decrease in mortality/morbidity – life assurance				
– Before reinsurance	10	3	1	14
– After reinsurance	5	1	–	6
5% decrease in mortality/morbidity – annuity business				
– Before reinsurance	(4)	–	–	(4)
– After reinsurance	(4)	–	–	(4)
Impact of end of period assumptions on VNB	4	(1)	–	3

(i) See previous page.

(ii) Comparative figures for splits to the UK and Heritage operating segments for the year ended 31 December 2012 are not available and the costs to develop them would be excessive.

Notes to the MCEV results continued

12. Comparison of MCEV and IFRS classification and segments

The covered business segments within MCEV are consistent with the IFRS business segments.

The split of the MCEV by IFRS business segment is shown in the tables below:

	MCEV classification						Total MCEV by IFRS segments £m
	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m	Non-covered business ⁽ⁱ⁾ £m	
At 31 December 2013							
IFRS segment							
UK	1,418	–	–	–	–	2	1,420
Heritage	–	4,066	–	–	–	40	4,106
FPI	–	–	603	–	–	(1)	602
Lombard	–	–	–	598	–	5	603
Corporate	–	–	–	–	(1,631)	965	(666)
Total MCEV (by MCEV segments)	1,418	4,066	603	598	(1,631)	1,011	6,065

	MCEV classification						Total MCEV by IFRS segments £m
At 31 December 2012	UK £m	Heritage £m	FPI £m	Lombard £m	Corporate £m	Non-covered business® £m	
IFRS segment							
UK	1,227	–	–	–	–	26	1,253
Heritage	–	4,080	–	–	–	12	4,092
FPI	–	–	612	–	–	1	613
Lombard	–	–	–	615	–	5	620
Corporate	–	–	–	–	(1,611)	864	(747)
Total MCEV (by MCEV segments)	1,227	4,080	612	615	(1,611)	908	5,831

(i) The non-covered business includes £164 million (2012: £133 million) within Corporate representing the MCEV of the Resolution holding companies.

13. FLG return on embedded value

	2013		2012	
	£m	% p.a.	£m	% p.a.
Value of new business	204	2.9	194	2.8
Expected existing business contribution ⁽ⁱ⁾	323	4.5	400	5.7
Operating experience variances	(57)	(0.8)	(56)	(0.8)
Operating assumption changes	19	0.3	(9)	(0.1)
Other operating variance	178	2.5	27	0.4
Development costs	(50)	(0.7)	(50)	(0.7)
Other income and charges ⁽ⁱ⁾	(26)	(0.4)	(5)	(0.1)
FLG MCEV operating profit before tax and financing	591	8.3	501	7.2
Impact of financing ⁽ⁱ⁾	(75)	1.1	(91)	–
Attributed tax charge on MCEV operating profit	(122)	(2.2)	(120)	(2.1)
FLG MCEV operating profit after tax	394	7.2	290	5.1
Economic variances	412	7.5	154	2.7
Other non-operating items	(143)	(2.7)	(140)	(2.5)
Attributed tax on other activities	(62)	(1.1)	(6)	(0.1)
FLG MCEV profit after tax	601	10.9	298	5.2
Remeasurement losses on defined benefit pension schemes	(77)	(1.4)	(35)	(0.5)
Foreign exchange adjustments	16	0.3	(16)	(0.3)
Total return on FLG MCEV over the year	540	9.8	247	4.4

(i) Impact of financing comprises the expected impact of financing of covered debt of £75 million for 2013 (2012: £75 million). In 2012 it also contained the impact of financing the non-covered debt of £200 million which was repaid in November 2012 (with an impact of financing of £16 million for 2012). These amounts have been deducted from the expected existing business contribution and other income and charges respectively.

The table above provides an analysis of the return on FLG embedded value, excluding the Resolution holding companies. The starting FLG embedded value for 2013 is £5,698 million, net of the market-consistent value of debt instruments of £1,596 million and having excluded £133 million in respect of the Resolution holding companies. The 2013 embedded value has been adjusted to allow for the timing of dividend payments and the proceeds from the disposal of AmLife on 4 January 2013.

The starting embedded value for 2012 is £5,949 million, net of the market-consistent value of debt instruments of £1,159 million and having excluded £(153) million in respect of the Resolution holding companies. The 2012 embedded value has been adjusted to allow for the timing of dividend payments, the repayment of the internal LT2 subordinated debt 2020 issued to Resolution holding companies by FLG and the new external UT2 subordinated debt and associated currency swap issued during the period.

The MCEV operating return before tax and financing is based on the gross MCEV (i.e. before the market-consistent value of debt). The return includes both covered and non-covered business. The impact of the financing item reflects the leverage on the return on embedded value created within FLG through the use of debt instruments, net of the cost of financing these instruments.

Definitions

AmFamily	means AmFamily Takaful Berhad
AmLife	means, collectively, AmFamily and AmLife Insurance Berhad
Annual Premium Equivalent ("APE")	represents annualised new regular premiums plus 10% of single premiums.
Annualised operating return on embedded value	is calculated as the MCEV operating profit after tax over the period divided by the net Group MCEV at the start of the period adjusted to allow for the timing of dividend payments and any acquisitions or disposals through the period. Where the period is not a full year, the calculated rate is then annualised.
Asset quality	is the percentage of corporate bonds and asset-backed securities in the shareholder and non-profit funds at investment grade compared to the total of such assets in these funds.
Asset share	is a measure of the share of assets attributable to a with-profits policy, calculated by accumulating premiums paid at the rates of return earned on the assets assumed to be backing the policy, after allowing for deductions for partial payments of benefits and charges such as expenses, mortality, distributions to shareholders and tax.
Available shareholder assets ("ASA")	represents assets and other financial instruments available to cover corporate costs, to service debt issued by Resolution holding companies and, subject to shareholder approval, to pay dividends or return to shareholders. ASA reflects the deduction of working capital from free surplus.
AXA UK Life Businesses	means the traditional and protection businesses, a majority of the corporate benefits business and a minority of the wealth management business carried on by AXA UK which were acquired by the Group in September 2010 and which includes FLWL from November 2011.
Board	means the Resolution Limited Board.
Cash payback on new business	is the time at which the value of the expected cash flows, after tax, is sufficient to have recouped the capital invested to support the writing of the business. The cash flows are calculated on the same assumptions and expense basis as those used for the contribution from new business.
Company	means Resolution Limited.
Core International	consists of Friends Provident International Limited and excludes all non-core FPI business (OLAB, AmLife and new business to Japanese nationals).
Economic capital surplus	is the surplus of the Group's realistic capital resources over management's internal risk-based estimate of the amount of capital needed to be held to mitigate the risk of insolvency to a minimum of a 99.5% confidence level over a one year period.
Equity Backing Ratio ("EBR")	is the proportion of equities and property backing asset shares.
Free surplus	at the end of the period represents the excess of net worth (equivalent to shareholder resources) over required capital and inadmissible items on an MCEV basis for covered businesses plus IFRS net assets, less required capital and inadmissible assets on an IGCA basis for non-covered businesses and holding companies. Free surplus comprises ASA plus working capital.
Free surplus generated	comprises the movement in free surplus over the period adjusted for capital, foreign exchange and other reserve movements.
Friends Life or Friends Life group	means Friends Life Group plc (and its subsidiaries and subsidiary undertakings from time to time including Friends Provident from November 2009, the AXA UK Life business from September 2010, BHA from January 2011 and FLWL from November 2011).
Friends Life holding companies	means Friends Life Group plc, Friends Life FPG Limited and Friends Life FPL Limited.
Group	means Resolution Limited and its subsidiaries and subsidiary undertakings from time to time.
Group embedded value	on an MCEV basis ("Group MCEV") is the equity attributable to equity holders of the parent as shown in the consolidated statement of financial position—MCEV basis.
Heritage division	means Friends Life's UK based business comprising products that are no longer actively marketed to new customers and legacy products that have previously been closed to new business.
IFRS based operating profit/(loss)	is the profit (or loss) based on longer-term investment return excluding: (i) all investment return variances from expected investment return which is calculated on a long-term rate of return, (ii) policyholder tax, (iii) returns attributable to minority interests in policyholder funds (iv), significant non-recurring items, (v) amortisation and impairment of acquired intangible assets and present value of acquired in-force business; and is stated after deducting interest payable on STICS.
IFRS profit/(loss) after tax	is the profit (or loss) after tax as shown in the consolidated income statement.
IGCA surplus	is the Insurance Groups Capital Adequacy surplus capital as defined by the PRA in the Insurance Groups Directive. It is calculated as the surplus of the available capital resources over the capital resources requirement. It excludes the surplus capital held within the long-term funds.

Internal Model Approval Process (“IMAP”)	is the process whereby the PRA reviews and approves the appropriateness of a firm’s model for use within the Solvency II framework.
Internal rate of return (“IRR”) on new business	is equivalent to the discount rate at which the present value of the after tax cash flows expected to be earned over the lifetime of the business written is equal to the capital invested to support the writing of the business. With the exception of investment return, all assumptions and expenses are consistent with those used for calculating VNB. IRR assumes best estimate investment returns after an allowance for default risk, whereas VNB assumes (market consistent) risk-free rates. IRR also takes into account the funding and release of regulatory capital requirements.
MCEV operating profit/(loss)	is the MCEV profit (or loss) based on expected investment return and excludes: (i) amortisation and impairment of non-covered business acquired intangible assets, (ii) effect of economic variances (including the impact of economic assumption changes) and (iii) significant non-recurring items.
MCEV profit/(loss) after tax	is the MCEV profit (or loss) after tax as shown in the consolidated income statement–MCEV basis.
New business margins	are defined as the pre-tax VNB divided by the PVNBP.
New Life Tax Regime (“NLTR”)	refers to legislation enacted in the Finance Act 2012 and supporting regulations. NLTR applies to life insurance companies with effect from 1 January 2013 and has not altered the “I minus E” basis of taxation.
Pillar 1 surplus	is the excess of capital resources over capital resource requirements calculated in accordance with regulatory requirements.
Pillar 2 surplus	is the excess of capital resources over the capital calculated on an economic basis required to ensure that the regulated entities can meet their liabilities, with a high likelihood, as they fall due. The result is reviewed and may be modified by the PRA. Pillar 2 requirements are not generally disclosed.
Present value of new business premiums (“PVNBP”)	represents new single premiums plus the expected present value of new business regular premiums expressed at the point of sale.
Required capital	of the Group is based on the most onerous capital management policy for the Group, currently IGCA.
Resolution Holding companies	means the Company, Resolution Holdco No. 1 LP and Resolution Holdings (Guernsey) Limited.
Resolution Operations LLP (“ROL”)	is a privately owned advisory and operating firm which, as part of the Resolution Group, has provided services to Resolution Limited within the framework of an operating agreement. On 27 March 2013, under a Business Sale Agreement, ROL transferred to the Company business activities that related to the services provided to the Company and the ROL employees who provided the services. At the same time, ROL ceased to provide services to the Company.
Shareholder resources	are a measure of the tangible assets available to the life and pensions business and attributable to shareholders. The movement in shareholder resources provides a view of the sustainability of the business model. Shareholder resources are based on shareholders’ invested net assets included within the embedded value.
Shareholders and Investors	in this Report, these terms are used variously to describe investors who hold shares in Resolution Limited and who also invest in the Company through RCAP’s limited partnership interest in the economic value and returns being generated through the Group’s activities. Generally speaking, the terms used throughout this Report should be interpreted as interchangeable.
Solvency II	establishes a revised set of EU-wide capital requirements and risk management standards with the aim of increasing protection for policyholders and reducing the possibility of market disruption in insurance. The new regime will now formally come into force on 1 January 2016.
Sustainable Free Surplus (“SFS”)	is the surplus generated within FLG based on expected investment return and excludes operating assumption changes, amortisation and impairment of non-covered business, acquired intangible assets, effect of economic variances (including the impact of economic assumption changes) and significant non-recurring items.
Value of new business (“VNB”)	relates to new business written in the reporting period and reflects the present value of future cash flows on that block of business. It is calculated using economic assumptions at the beginning of the period except for immediate annuities for which the assumptions used are appropriate for each month’s new business on account of their interest rate sensitivity. It is also calculated using year end operating assumptions consistent with those used to determine the year end MCEV embedded value. VNB is shown after the effects of the frictional costs of holding required capital and share-based payments, and after the effect of the costs of residual non-hedgeable risks.
Value share	please refer to page 74 for a full definition
Working capital	as a component of the Group’s cash and capital management framework, represents free surplus assets set aside to cover known future requirements and amounts necessary to maintain sufficient flexibility to facilitate compliance with the Group capital policy, additional regulatory requirements and any other assets restricted in their availability to shareholders.

Abbreviations

ABI	Association of British Insurers	FLPL	Friends Life and Pensions Limited
ABS	Asset-Backed Securities	FLSL	Friends Life Services Limited
AC	Audit Committee	FLWL	Friends Life WL Limited
AGM	Annual General Meeting	fpb	Financial Business Partners AG
ALM	Asset and Liability Management	FPI	A segment within the International division comprising FPIL, OLAB and AmLife
AMC	Annual Management Charge	FPIL	Friends Provident International Limited
APE	Annual Premium Equivalent	FPL	Friends Life FPL Limited
ASA	Available Shareholder Assets	FPPS	Friends Provident Pension Scheme
AUA	Assets under Administration	FRA	Flexible Retirement Account
AVIF	Acquired Value of In-Force	FRC	Financial Risk Committee
AXA IM	AXA Investment Management	FRS	Financial Reporting Standards
BHA	Friends Life BHA Limited	FSG	Free Surplus Generation
CEO	Chief Executive Officer (Divisional)	FSMA	Financial Services and Markets Act 2000
CFO	Chief Financial Officer	FTE	Full Time Equivalent
CGU	Cash Generating Unit	FUM	Funds Under Management
CMI	Continuous Mortality Investigations	GCE	Group Chief Executive
CMIR	Continuous Mortality Investigations Report	GEC	Group Executive Committee
CMPs	Capital Management Policies	GMP	Guaranteed Minimum Pension
CNHR	Cost of Non-Hedgeable Risk	HNWI	Higher Net Worth Individuals
COP	Capital Optimisation Programme	IAS	International Accounting Standards
CRO	Chief Risk Officer	IASB	International Accounting Standards Board
CRR	Capital Resource Requirements	ICA	Individual Capital Assessment
DAC	Deferred Acquisition Costs	ICG	Individual Capital Guidance
DCN	Deferred Consideration Notes	IFA	Independent Financial Adviser
DFF	Deferred Front End Fees	IFRIC	IFRS Interpretation Committee
DPF	Discretionary Participation Features	IFRS	International Financial Reporting Standards
EBC	Employee Benefit Consultant	IGCA	Insurance Groups Capital Adequacy
EBR	Equity Backing Ratio	IMAP	Internal Model Approval Process
ECJ	European Court of Justice	INB	Investment in New Business
EEA	European Economic Area	IPEV	International Private Equity and Venture Capital
ERC	Executive Risk Committee	IRR	Internal Rate of Return
EU	European Union	KPI	Key Performance Indicator
FAL	Friends Annuities Limited	LDI	Liability Driven Investment
FASLH	Friends ASLH Limited	LTIP	Long-Term Incentive Plan
FCA	Financial Conduct Authority	LT2	Lower Tier 2
FLAS	Friends Life Assurance Society Limited	MCEV	Market Consistent Embedded Value
FLC	Friends Life Company Limited	MVR	Market Value Reduction
FLDL	Friends Life Distribution Limited	NBS	New Business Strain
FLG	Friends Life Group plc	NGP	New Generation Pension
FLI	Friends Life Investments	NLTR	New Life Tax Regime
FLL	Friends Life Limited	NPF	Non-Profit Fund
FLMS	Friends Life Management Services Limited		

OCI	Other Comprehensive Income
OEIC	Open Ended Investment Company
OLAB	Overseas Life Assurance Business
OMO	Open Market Option
PBSE	Post-Balance Sheet Event
PPFM	Principles and Practices of Financial Management
PRA	Prudential Regulation Authority
PUP	Paid Up Policies
PVFP	Present Value of Future Profits
PVNB	Present Value of New Business Premiums
RCAP	RCAP UK LP. The limited partner in Resolution Holdco No.1 LP. Please refer to page 72 for further information
RCC	Risk and Compliance Committee
RCM	Risk Capital Margin
RDR	Retail Distribution Review
RHG	Resolution Holdings (Guernsey) Limited
RHN1	Resolution Holdco No.1 LP. Please refer to page 72 for further information
RICS	Royal Institution of Chartered Surveyors
RIE	Re-attributed Inherited Estate
ROEV	Return on Embedded Value
ROL	Resolution Operations LLP
RPI	Retail Prices Index
RSL	Resolution Limited
SBG	Sesame Bankhall Group
SFS	Sustainable Free Surplus
SID	Senior Independent Director
SSF	Segregated Sub Fund
STICS	Step-up Tier one Insurance Capital Securities
TIP	Trustee Investment Plan
TVOG	Time Value of financial Options and Guarantees
UT2	Upper Tier 2
VIF	Value of In-Force
VNB	Value of New Business
WPF	With-Profits Fund
WPICC	With Profits Insurance Capital Component

Shareholder information

AGM

The Resolution AGM will be held on Thursday 8 May 2014 at the Queen Elizabeth II Conference Centre, Mountbatten Room, starting at 11.00 am.

Financial calendar

Annual General Meeting	8 May 2014
First quarter interim management statement	9 May 2014
Half year 2014 results	6 August 2014
Third quarter interim management statement	11 November 2014

2013 final dividend

Ex-dividend date	2 April 2014
Record date	4 April 2014
Final date for DRIP elections	24 April 2014
Dividend payment date	16 May 2014

Contacts

All enquires relating to shareholdings in the Company, including notification of change of address and the reissue of dividend cheques, should be addressed to Computershare, the Company's registrar as set out below:

Tel: 0870 707 1444 (Calls are charged at the national rate. Lines are open 8.30 am – 5.30 pm Monday - Friday)

Resolution Share Account holders

If you hold your shares in the Resolution Share Account, and your Shareholder Reference Number commences with an "I".

Computershare Investor Services PLC
The Pavilions
Bridgwater Road
Bristol
BS99 6ZY

Email: web.queries@computershare.co.uk

Ordinary shareholders

If you hold your shares in certificated form or in CREST, and your Shareholder Reference Number commences with a "C" or a "G".

Computershare Investor Services (Jersey) Ltd
Queensway House
Hilgrove Street
St Helier
Jersey
JE1 1ES

Email: info@computershare.co.je

Managing your shareholding

Dividends

Shareholders are encouraged to have their dividends paid directly into their bank or building society account as a more secure, faster alternative to receiving a cheque in the post.

To register, please request a dividend mandate form from Computershare.

Electronic communications

An increasing number of our shareholders have opted to receive communications from us via email.

Advantages to electronic communications include:

- rapid and secure notification of documents available;
- reduced printing and postage costs for the Company; and
- environmentally friendly.

If you would like to sign up for this service you can do this by providing Computershare with an email address using the contact numbers provided.

Dividend reinvestment plan

The Company operates a dividend reinvestment plan ("DRIP") which provides shareholders with a cost-efficient way of increasing their shareholding in the Company by reinvesting their dividends. To sign up to the DRIP, please contact Computershare.

Investor Centre

Resolution shareholders can register free for Investor Centre, a secure online service provided by Computershare that allows access to information regarding your Resolution shareholding including:

- share balances and movements;
- indicative share prices;
- dividend payment history, mandate changes and tax information;
- address changes; and
- you can also use Investor Centre to manage your personal shareholdings in other companies.

To register for Investor Centre, please visit www-uk.computershare.com/investor and follow the simple steps (you will need your Shareholder Reference Number to register). If you have any queries, please call 0870 707 1444.

Shareholder information continued

Boiler Room Fraud

During the year, a number of shareholders informed us that they had received unsolicited telephone calls and/or correspondence from individuals offering to purchase shares at significantly inflated prices.

In order to protect yourself you should consider the following:

- make sure your share certificates are kept in a safe place or hold your shares electronically in CREST via a nominee company such as the Corporate Sponsored Nominee;
- sign up for electronic communications and keep all remaining correspondence from the registrar in a safe place. Destroy any unwanted material;
- inform Computershare promptly if you move house;
- be on guard – if somebody is offering to buy shares at a hugely inflated price, it's not likely to be genuine;
- check the Financial Services Register to ensure that anyone who is offering to sell your shares is properly authorised. For more information, please view the FCA's advice on how to avoid investment scams;
- report suspected boiler room fraud to the FCA by calling 0800 111 6768 or by completing their online boiler room reporting form which can be found on their website; and
- remember that details of share dealing facilities endorsed by the Company will be included in Company mailings.

Join the Corporate Sponsored Nominee

Our Corporate Sponsored Nominee allows you to hold shares in the Company without the need for a paper share certificate. Shares are held electronically in a nominee registered in Computershare's name.

Benefits to holding your shares electronically via a nominee include:

- simpler to trade than certificated holdings;
- typically shorter trading periods;
- your name and address are not shown on the share register and are therefore not publicly available; and
- no need to worry about losing a paper certificate.

For further information, or to arrange the transfer of your Resolution shares into the Resolution Share Account, please contact Computershare.

Share information

ISIN code: GG00B62W2327

Stock Exchange Daily Official List ("SEDOL"): B62W232

Share price information can be found on our website www.resolution.gg

Company registration

Resolution Limited is incorporated in Guernsey, company registration: 49558.

Resolution Limited has a UK branch in the name Friends Life Group Holdings Limited, branch registration: BR016432.

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