FRIENDS LIFE GROUP LIMITED

(formerly Resolution Limited)

ANNUAL REPORT AND ACCOUNTS 2014

Registered Company Number 49558
Registered as a UK Establishment with company number BR016431
Friends Life Group Limited
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Chairman's statement

Accelerating value creation

On 2 December 2014, we announced that we had agreed the terms of a proposed offer by Aviva plc ("Aviva") to acquire Friends Life Group Limited (the "Proposed Acquisition"). The combination of Friends Life's existing customer base with Aviva's will create the UK's largest life insurer, and is an attractive opportunity to accelerate the delivery of the Friends Life strategy. The increased scale, brand recognition and resourcing, combined with the expected financial synergies and cost savings strongly supports our focus on generating value for our shareholders and policyholders.

Proposed terms and dividend

Under the terms of the Proposed Acquisition, our shareholders will receive 0.74 Aviva shares for each Friends Life share owned. In addition, a proposed second interim dividend of 24.1 pence per share will be paid to Friends Life shareholders after the Scheme is approved, resulting in a 2014 full year dividend of 31.15 pence per share, payable in April 2015 (the 2013 full year dividend was 21.14 pence per share). Full details are set out in the Scheme Document that was published by Friends Life on 19 January 2015, and the Aviva Prospectus which was issued by Aviva on the same day (both documents are available on the Aviva and Friends Life websites). As noted in the Scheme Document, in the event that the Proposed Acquisition does not complete, the proposed second interim dividend will not be paid, and we expect that the 2014 full year dividend would be in line with the 2013 full year dividend.

Next steps

Shareholder and regulatory approval is required for the Proposed Acquisition which, if approved, will be implemented by way of a scheme of arrangement (the "Scheme"). Shareholders will have the opportunity to attend and vote at the required shareholders meetings which will be held on 26 March 2015 to approve the proposals. The relevant documents and voting forms have been sent to shareholders in preparation for the meetings. The Friends Life Directors unanimously recommend that Friends Life shareholders vote in favour of the Scheme and the associated resolutions to be proposed at the shareholders meetings, and it is not too late to submit your vote. Deadlines for submitting your vote are set out in the Scheme document. If the Proposed Acquisition is approved by shareholders and the Court, the Scheme will become effective on 10 April 2015, new Aviva shares will be issued to Friends Life shareholders on 13 April 2015, and the proposed second interim dividend will be paid by 24 April 2015.

Performance

Aside from the Proposed Acquisition, I am pleased to confirm that the Group has performed well throughout 2014. Notwithstanding the historic changes to the pensions market brought about by the UK Chancellor's 2014 Budget, I am pleased to report that the Company continues to deliver strongly as clearly evidenced in our 2014 results. Highlights of the Group's delivery throughout the year include sustainable free surplus rising to £373 million in 2014 from £325 million in 2013, and the successful disposal of the Lombard business. The Group is also well placed to support its customers when the pension reforms come into force in April 2015, having developed a new customer platform and enhanced our customer service offering, as detailed in the Group Chief Executive's Review.

Colleagues and the Board

Finally, I would like to thank the Board and all our employees for their continued commitment, without which the Company would not have had the success it has achieved, nor delivered these returns to our shareholders.

Sir Malcolm Williamson
Chairman, Friends Life Group Limited
4 March 2015

Business model

Friends Life Group's operating model is structured around three distinct divisions: Heritage, UK and International.

The **Heritage** division has around 3.6 million customers, a large set of products which are either closed to new business or are not actively marketed, and complex legacy systems.

The **UK** division comprises open market operations in Corporate Benefits, Retirement Income and Protection:

- The **Corporate Benefits** business focuses on UK retirement saving through employer-sponsored schemes. As at 31 December 2014 the business had £22.0 billion of assets under administration, making it the number two player in this part of the market, which is one set for fast growth.
- The **Retirement Income** business provides annuities for individual retirees, both retiring Friends Life pension customers and those who saved with other providers. As a result of the changes announced in the UK Chancellor's 2014 Budget, we expect annuity sales to be lower going forward. In response, the Group is developing a new range of products and services as part of a comprehensive retirement proposition.
- The **Protection** business includes life assurance, income protection and critical illness policies for individual customers and group schemes for companies.

The **International** division offers a range of products including single premium investment products, regular premium savings plans and individual assurance policies. International's products are distributed worldwide by independent financial advisers, with a focus on affluent expatriate individuals, via distribution hubs in Hong Kong, Singapore and Dubai.

	How we make money	**Success factors**
Heritage 3.6 million customers	• Taking a share of bonuses allocated to with-profits policyholders • Taking a regular charge on assets under administration or collecting regular policy fees • Releasing capital held against risks as business runs off	• Effective management of customer service and costs as policy numbers reduce over time • Risk management expertise to manage complex portfolio of exposures • Capital management capability for business restructuring
UK 1.6 million customers	**Corporate Benefits** • Taking a regular charge on assets under administration • Administering growing assets for existing members and scheme joiners • Winning new schemes on terms acceptable to employers, customers and the business	• Ease of doing business for members and employers through automation and technology • Critical scale achieved on a low cost administration platform, competitive charging rates • Reputation with key intermediaries
Corporate Benefits: 1.3 million customers Retirement Income: 0.1 million customers	**Retirement Income** • Winning new business by offering competitive rates to customers allowing for risks taken on • Releasing capital held against carefully managed and suitably priced risks as business runs off • Investing assets to optimise long-term returns and investment risk	• Ability to engage with Friends Life existing pension customers approaching retirement • Relationships with intermediaries in the retirement market • Ability to offer better prices based on individual customers' health
Protection: 0.3 million customers	**Protection** • Winning new business by offering competitive rates to customers allowing for risks taken on • Releasing capital held against carefully managed and suitably priced risks as business runs off	• Relationships with key intermediaries in individual and group markets • Pricing flexibility, adaptability, speed to market • Reinsurance know-how to optimise retention and transfer of risk
International 0.2 million customers	• Winning new business by offering competitive rates to customers allowing for risks taken on • Releasing capital held against carefully managed and suitably priced risks as business runs off • Taking a regular charge on assets under administration, and/or regular policy fees	• Offer wide fund choice at competitive rates • Nimble operational structure to react to developments in diverse markets • Governance expertise to work with multiple regulators

Group Chief Executive's review

Our Strategy

2014 has been a year of unprecedented change for both the UK life and pensions industry and Friends Life itself. Throughout this time, the company has been consistent in the execution of its strategy that can be summarised in three main principles:

- To maximise the value of the Heritage book through efficient management of legacy products, innovative capital and revenue optimisation initiatives and a focus on deepening the relationship with our significant customer base;
- To participate in key growth areas in the UK life and pensions market, where we have scale and a demonstrable competitive advantage, focusing on our existing customers; and
- To look for opportunities to enhance or accelerate value through inorganic activities.

The sweeping reforms to the pensions market resulting from the UK Chancellor's 2014 Budget have meant that every pensions provider, including Friends Life, has needed to adapt to a new approach to retirement provision. I have been extremely pleased with how we have responded to these challenges, making great improvements by enhancing our customer engagement, taking the time to understand our customers' needs and focusing on developing the products and services our customers will require as the pension reforms come into force in April 2015.

Our new individual customer platform My Savings is on track to launch in April 2015. It will enable our existing customers to make the most of the new pension freedoms whilst providing an online system to manage their pensions and other savings in one place. Our goal is to help our customers make informed choices and decisions based on their personal circumstances. We will offer a range of products including flexi-access drawdown, NISAs and a general investment account alongside our standard and enhanced annuity offerings. This will be complemented by a range of other tools and services including an income tool to help customers understand the potential income from the different options available, investment risk appetite assessments, retirement planning, accumulation modelling, and tax information and tools to assist our customers in understanding the tax implications of taking cash from their pension.

Given the volume of legislative and regulatory change to pensions and workplace savings, customers will need more support than ever before to clarify their options. We have enhanced and strengthened our customer service teams, who are well equipped to anticipate, prompt and resolve all kinds of customer enquiries, from the simple to the complex. We know that around half a million of our current customers will be in a position to take advantage of the pension rule changes in April 2015 so we have dedicated significant resources to create a Retirement Information Centre to support customers and intermediaries.

Friends Life has successfully managed a number of major change programmes and their impact on customers in recent years. Following the changes brought about by the Budget, our UK business has already been restructured into a more customer centred model, fostering better collaboration across the business and enabling us to engage better with our customers.

In October 2014, we announced completion of the disposal of the Lombard business to the Blackstone Group. Lombard, although a good business, has always had a different profile to the rest of the Group. The disposal was in the best interests of both Friends Life and Lombard and allowed us to deliver on our commitment to secure maximum value for shareholders.

Our other international business, Friends Provident International, has faced a number of challenges this year, particularly in Asia where difficult market conditions impacted the business performance in the first half of the year. However, I have been encouraged by how the team responded to these challenges and we have started to see improved momentum in the business in the second half, particularly in the Middle East.

Our journey so far

The amount of change we have undergone this year is substantial but it is not dissimilar to the transformation the business has been undergoing over the last four years.

When we started our restructuring and transformation journey four years ago, the Group was generating less than £100 million of sustainable free surplus. In 2014, this has risen to £373 million. This turnaround in cash generation has been delivered by applying rigorous financial discipline including delivering run-rate cost savings of £140 million and contractually securing total run-rate cost savings of £160 million by the end of 2015.

Beyond the cost synergies, we have delivered substantial capital synergies. Through the capital optimisation programme, in which the seven UK life companies were re-organised into two UK life companies for closed and open business, we drove efficiencies which have delivered a benefit of nearly £300 million to total free surplus over three years.

To enhance value further, our Heritage management team has carried out revenue optimisation initiatives since 2012 that have generated increases of over £40 million per annum in future cash generation through:

- The reallocation of three tranches of annuity policies from with-profits funds to the shareholder fund;
- The strategic partnership with Schroders;
- The establishment of Friends Life Investments Limited ("FLI") for the management of fixed income assets; and
- The recapture of £1.6 billion of assets backing annuities in November 2014.

Group Chief Executive's review continued

For the last of these revenue optimisation initiatives, our Heritage division has undertaken the recapture in November 2014 of £1.6 billion of assets backing annuities where the investment risk was previously reinsured, which is expected to deliver a benefit of circa £13 million of sustainable free surplus per annum from 2015 onwards at a cost of £4 million in 2014. This clearly demonstrates the skills and capabilities that the Friends Life team has in enhancing value for shareholders.

We have rationalised our open business in the UK, reducing the number of open lines of business to three. The UK division is focused on Retirement Income, Corporate Benefits and Protection, where we have the scale and expertise to grow new business and where we have delivered a turnaround in value generation. In 2010, when we started our transformation project, the UK business was loss making, with a negative value of new business ("VNB") of £10 million. In 2014 we have delivered UK VNB of £141 million, a strong achievement considering the business has seen much lower VNB from Retirement Income this year. Retirement Income VNB has been affected by both the improved competitiveness of our offering as we entered the open market in December 2013 and the impact of pension reforms on volumes. I am particularly pleased with the progress we have made in our Corporate Benefits business. Positive net fund flows of £0.6 billion in 2014 have driven assets under administration up to £22.0 billion. The business continues to enjoy the benefits of scale and cost efficiency. Having turned cash positive a year ago, Corporate Benefits underlying free surplus generation has more than doubled in 2014 to £29 million. As the cost base is relatively fixed, further growth in assets under administration will only further enhance the operating leverage effect.

Outlook

Looking back over what we have achieved in 2014, I have absolute confidence in Friends Life's strategy and future prospects. However it would be remiss of me not to mention the Proposed Acquisition of the Group by Aviva. My belief is that the standalone future of Friends Life is attractive, but the opportunity to accelerate the Friends Life strategy through the combination with Aviva is even more attractive. The combination is expected to create the leading player in the UK life and pensions market, with even greater scale in the key markets that Friends Life already participates in.

In terms of enhancing cash generation capacity, the combined entity is expected to have the UK's largest back book[i] and the combined group could potentially release substantial capital synergies through:

- Diversification of economic capital with general insurance and international businesses;
- Optimisation of the Friends Life businesses on an economic capital basis;
- Further capital initiatives on the combined back book; and
- Leveraging Friends Life's capital strength as part of a larger group.

Furthermore, the combined group expects to have a significant scale advantage and hence, post-delivery of synergies, significant cost advantage. So, if completed, the transaction is expected to not only benefit cash today, but also support growth in the future.

The combination of Aviva and Friends Life also offers attractive growth opportunities for the UK open businesses, as the increased scale will drive better profitability and improved service to customers with easier access to a broader range of products. The deal creates the UK's leading insurance, savings and asset management business with leadership positions in Corporate Benefits and Protection and one in four retiring defined contribution pension customers. All of this is underpinned by an in-house asset manager, with a broad product set, and an established track record.

The complementary benefits of the Proposed Acquisition from both a financial and strategic perspective are compelling and with our proven track record in the successful integration of UK Life businesses, we would be well placed to ensure the successful integration of the two businesses.

All in all it has been a good year for Friends Life and I would like to give my thanks to all of our staff, whose dedication and hard work have made Friends Life the success it is.

Strategic report

The Strategic report, set out on pages 2 to 36 has been approved by the Board.

On behalf of the Board

Andy Briggs

Group Chief Executive
4 March 2015

(i) Based on analysis of 2013 PRA returns of UK gross reserves. Back book defined as per Friends Life's methodology and includes with-profits products, unit-linked bonds and other legacy products.

Chief Financial Officer's review

Introduction

I am delighted that the product of our consistent strategy to maximise cash generation is clearly evident in our 2014 results. Sustainable free surplus has grown 15% on last year, an excellent result, enabled by carefully targeted growth within the UK division alongside the ability demonstrated by our expert team in the Heritage division to optimise cash generation from the in-force book. Our focus on maximising the cash generation of the Group is unwavering; further initiatives have also been completed in 2014 which are expected to contribute to increased cash generation in future years and we have more opportunities in 2015 to explore. Notwithstanding this, and despite the higher sustainable free surplus in 2014, the adverse impact from falls in long-term interest rates during the year have resulted in lower free surplus generation.

Whilst 2014 provided many new challenges for the Group, I am proud of how we have been able to react quickly and decisively. Once again, the strict financial discipline that underpins everything that we do has also ensured that our balance sheet has stayed both strong and resilient.

Financial performance

£m (unless otherwise stated)			2014	Restated[i] 2013
Cash today	**KPI**[ii]	Sustainable free surplus	**373**	325
	KPI	Free surplus generation	**160**	377
Cash tomorrow	**KPI**	Value of new business	**132**	179
	KPI	Group Embedded Value (MCEV)	**5,529**	6,065
		Open insurance business IRR	**15.1%**	18.1%
		Group IRR	**16.7%**	15.4%
		UK Corporate Benefits net fund flows (£bn)	**0.6**	(0.2)
Returns	**KPI**	IFRS based operating profit	**556**	402
	KPI	MCEV operating profit	**498**	535
		Cash return	**25.1%**	23.8%
Expenses		Operating expenses	**549**	563
Capital strength	**KPI**	IGCA surplus coverage ratio[iii]	**240%**	238%
	KPI	Economic capital surplus coverage ratio[iii]	**196%**	193%
	KPI	Group available shareholder assets	**1,066**	917

(i) With the exception of the capital strength measures, the 2013 results have been restated to exclude the results of Lombard, which has been classified as discontinued in the year.
(ii) Key performance indicator.
(iii) Capital strength coverage ratios are estimated and unaudited.

Cash today

We are reporting strong growth in sustainable free surplus, with a 15% increase to £373 million (2013: £325 million). This is an excellent result, marginally ahead of our own expectations of "low double digit percentage growth" communicated in August 2014, and demonstrates our continuing delivery on growing the cash generation of the Group.

The targeted increase of £39 million in free surplus expected returns from the UK and Heritage divisions, as set out in our 2013 results, has also been delivered in line with previous guidance with expected returns totalling £600 million in 2014. This strong growth in expected cash generation has been driven by the profitable new business written by the UK division and the benefits of the revenue optimisation initiatives undertaken in 2013, with these more than offsetting the run-off of the in-force book.

The growth in sustainable free surplus has been achieved whilst simultaneously increasing the investment in writing profitable new business in the UK division, helping to generate the cash for tomorrow and offsetting the run-off of the Heritage book. Overall however, the investment in new business is still lower than in the previous year due to the closure to new business of the non-core OLAB business during 2013.

Chief Financial Officer's review continued

Cash tomorrow

In addition to the growth in sustainable free surplus in 2014, further revenue optimisation initiatives have been undertaken during the year to help offset the Heritage run-off and drive further cash generation growth in future years. In 2014 we have:

- Completed a £760 million reallocation of annuities from with-profits funds, which is expected to generate circa £7 million per annum of sustainable free surplus from 2015 onwards. In addition to this, in the first quarter of 2015 we have completed a transfer of a further £665 million of annuities from with-profits funds, generating circa £5 million per annum of sustainable free surplus from 2015 onwards;
- Completed the previously announced £14 billion transfer of investment management of assets (£12 billion to Schroders and £2 billion to Friends Life Investments) previously managed by F&C. This is expected to generate circa £3 million per annum of sustainable free surplus from 2015 onwards;
- Undertaken a recapture of £1.6 billion of assets backing annuities, which is expected to result in a benefit of circa £13 million per annum of sustainable free surplus from 2015 onwards; and
- Made investments into a number of different asset classes to drive increased yield within the annuity portfolio and shareholder funds across the Group.

The benefits to cash generation from these initiatives are not one-off; they provide continued free surplus generation year-on-year. This is *sustainable* free surplus generation in its truest sense.

In line with expectations, and as previously communicated, VNB has been impacted by both the increased competitiveness of our annuity offering and the impact of pension reforms on annuity volumes, in addition to the continuing challenges for the International division. However, even though the headline VNB figure is lower than in 2013, there are many aspects of our new business performance to be pleased with.

The Corporate Benefits business has developed strongly during 2014. As an asset-based business, Corporate Benefits focuses primarily on the net fund flows metric for measuring performance. Positive net fund flows of £0.6 billion in 2014 is a pleasing result, considering this incorporates the previously guided loss of one very large scheme (£0.4 billion) in the fourth quarter to pursue an unbundled proposition. The continuing growth in this business is driving increased operating leverage, illustrated by the 164% increase in underlying free surplus to £29 million (2013: £11 million).

The Protection business has also performed well during 2014. APE volumes are up 6%, due to strengthened relationships with financial advisers. In line with our guidance at the start of the year, VNB of £69 million (2013: £75 million) is lower than in 2013 due to a change in mix to lower margin life business and less favourable economics. However, the free surplus investment in new business has been reduced despite the higher volumes, driven by pricing discipline and rigorous cost control.

The Retirement Income business has achieved resilient results despite the changes announced in the UK Chancellor's 2014 Budget, with sales volumes down only 15%, outperforming our peer group and exceeding expectations. This was a result of more competitive pricing, strong customer engagement and the significant proportion of policies with Guaranteed Annuity Options ("GAO"s), where new volumes are not expected to fall as significantly from their pre-Budget levels. 51% of new annuity volumes in 2014 arose from pension policies with GAOs. The move to an increasingly competitive annuity pricing position has lowered the IRR for our open insurance businesses to 15.1% (2013: 18.1%), in line with our performance ambition of 15% set a year ago. Including the benefit of discretionary investment of shareholder assets in the with-profits annuity reallocation and the recapture of assets backing annuities, the 2014 Group IRR is 16.7%.

Challenging trading conditions within the International division have led to a disappointing new business performance in the year, with VNB of £12 million (2013: £21 million). There are however causes for optimism with sales in the second half of 2014 up 34% on the first half, reflecting the benefits of sales initiatives and regulatory changes in the UAE and Hong Kong. The International IT platform development has been progressing to plan and the business is now focused on re-platforming the in-force book in 2015. In light of recent trading performance, adverse foreign exchange movements and the current low long-term interest rates the International division will not pay a dividend for 2014. The International division continues to work with the Japanese regulator on its licence application and expects to be authorised to distribute investments business in Japan in the second quarter of 2015. Our access to the market for expatriates and affluent Japanese to purchase multi-currency savings products is an exciting opportunity for the next phase of International's growth.

Returns

IFRS based operating profit has grown by 38% to £556 million (2013: £402 million). The growth was positively impacted by a number of one-off benefits including a change to annuitant longevity assumptions (£103 million), the recapture of £1.6 billion of assets backing annuities (£90 million) and a reallocation of annuities from with-profits funds (£19 million). Notwithstanding the benefits from these one-off items, IFRS in-force surplus has increased by £31 million, which principally reflects the benefit from management actions undertaken during 2013 and improved economic conditions.

Chief Financial Officer's review continued

MCEV operating profit is lower at £498 million (2013: £535 million) and principally reflects the £47 million lower VNB as described above. However, the MCEV operating profit metric does illustrate the value created by the cash optimisation activities undertaken in the year. The recapture of £1.6 billion of assets backing annuities has generated £97 million of MCEV operating profit and the previously announced £760 million reallocation of annuities from with-profits funds generated £68 million.

The cash return ratio is up to 25.1% in 2014 (2013: 23.8%), in line with our performance ambition of 25%. The growth in sustainable free surplus has been partially offset by an increased shareholder net worth, primarily due to positive economic variances in 2013 which increased the 2014 opening position.

Operating expenses

Following the 4% reduction in operating expenses in 2013 (restated to exclude Lombard), I am pleased to confirm that our operating expenses have reduced by a further 2% in 2014 to £549 million (2013: £563 million). The reduction in 2014 represents the continued realisation of benefits from the integration programme including contractual savings arising from the outsourcing agreement with Diligenta. This more than offsets the modest cost increases to support new business growth in the UK and International divisions in addition to further improvements made to customer service and engagement in the year. This demonstrates that efficient management of the cost base is a core competence of the Group.

Consistent with previous communications, all costs associated with new retirement income product and platform development have been reported within non-recurring items.

Capital strength

Our consistent financial discipline across all areas of the business has maintained the strong balance sheet and robust capital position of the Group. Our estimated and unaudited coverage ratios on both an IGCA and economic capital basis are both higher at 240% and 196% respectively (31 December 2013: 238% and 193% respectively).

Group available shareholder assets are higher at £1,066 million (31 December 2013: £917 million). The movement over the year principally reflects the proceeds from the Lombard disposal net of the £30 million utilised for the share buyback programme prior to its suspension upon the announcement of the Proposed Acquisition by Aviva. Should the Proposed Acquisition not proceed, Friends Life would look to reinstate the buyback programme at the earliest opportunity. The receipt of the Lombard disposal proceeds are partially offset by working capital which we have decided to set aside now to meet the additional capital requirements of £138 million expected to arise in relation to the Department of Work and Pensions "charge cap", which will be introduced in April 2015. Note this capital will not be required upon transition to the Solvency II regime in 2016.

Regulatory developments

2014 has been a year which has seen some major regulatory developments in the industry. I am pleased with how we have been able to respond to these developments and I believe we are well positioned to benefit from them.

We remain fully engaged with the Financial Conduct Authority ("FCA") on their legacy review. Our Heritage division was established specifically to cater to the needs of legacy business customers so we have been in a good position to respond to the FCA's questions and we look forward to learning the outcomes of their review.

The UK Chancellor's 2014 Budget dramatically changed the UK pensions market landscape and I am pleased with the way we have been able to adapt in the 12 months since the announcement. As referred to in the Group Chief Executive's review, we have developed new products and a new platform, all designed specifically for the new world of retirement provision. Our strong customer service and engagement model is an area of focus for the Group and we expect this to be an even greater differentiator in the new world. On 27 February, we received final rules from the FCA (PS15/4: "Retirement reforms and the guidance guarantee") requiring providers to give appropriate risk warnings to customers accessing their pension savings. This Policy Statement also sets out how this interacts with the new free guidance regime and with customers who have received independent regulated advice. We are adapting our processes and procedures to meet these significant additional requirements which take effect from 6 April, with the aim of providing our customers with the support they require to navigate through the choices and flexibility available to them.

We have made good progress in the year in preparation for the move to the Solvency II regime in 2016. As previously announced, we intend to use the standard formula from the beginning of 2016 and apply for internal model approval subsequent to this. In light of the Proposed Acquisition by Aviva, we are reviewing our Solvency II programme and internal model application plans.

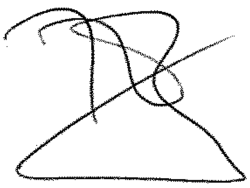
Sesame

In February 2013, we commenced a strategic review of the businesses of the Sesame Bankhall Group, including Sesame Limited. This strategic review is still ongoing with a number of potential options and outcomes being considered. There remains the risk of further adverse financial and reputational impacts to the Group, due to the ongoing trading performance of Sesame Limited, the potential future liabilities of the Sesame business and the outcomes of the strategic review.

Chief Financial Officer's review continued

Outlook

The continued growth in sustainable free surplus demonstrates our consistent focus on maximising the generation of cash for shareholders, and the continued delivery against that strategy. Our rigorous financial discipline and strong balance sheet have underpinned this delivery, and by carefully selecting the markets that we play in, we have the right strategy to build further on our success in the future.



Tim Tookey

Chief Financial Officer
4 March 2015

Business review

2014 highlights

Heritage division

- Sustainable free surplus generation up to £462 million (2013: £445 million), reflecting £19 million higher expected return from in-force business and reduced levels of free surplus invested in new business from the closed non-core OLAB business.
- Phase 2 reallocation of with-profits fund annuities completed in the third quarter of 2014, with £760 million of annuities transferred from with-profits funds to non-profit funds. This transfer is expected to provide future sustainable free surplus benefits of circa £7 million per annum for an upfront cost of £(11) million.
- Phase 3 reallocation of with-profits fund annuities to non-profit funds has been completed in the first quarter of 2015, which transferred a further £665 million of annuities. This transfer is expected to provide future sustainable free surplus benefits of circa £5 million per annum for an upfront cost of circa £(25) million.
- The transfer of investment management of assets to Schroders was completed in the fourth quarter of 2014 with £12 billion of equity and multi-asset funds transferred from F&C. As part of this transaction a further £2 billion of fixed interest assets was transferred from F&C to Friends Life Investments. These transfers are expected to provide future sustainable free surplus benefits of circa £3 million per annum.
- Recapture of £1.6 billion of assets backing annuities in November 2014 where the investment risk was previously reinsured. This is expected to deliver a benefit of circa £13 million of sustainable free surplus from 2015 onwards, when gilt assets received are invested in higher yielding assets, at a cost of £(4) million in 2014.

UK division

- Sustainable free surplus generation up £13 million to £(27) million, principally reflecting a £20 million increase in expected return, driven by strong growth in the Corporate Benefits business.
- New business APE up 5% from increased sales in the Corporate Benefits and Protection businesses and a lower than expected fall of 15% in annuity sales despite the UK Chancellor's 2014 Budget announcement.
- VNB down £43 million to £141 million due to the increased competitiveness of our annuity offering and the impact of pension reforms on annuity volumes. However, Retirement Income PVNBP margin has been maintained in excess of 9%.
- Strong Protection business IRR of 19.2% (2013: 13.8%) delivered through pricing discipline and optimisation of reinsurance arrangements. Retirement Income IRR at 14.6% (2013: 25%+) despite improvements in the competitiveness of the annuity proposition.
- Positive net fund flows in Corporate Benefits of £0.6 billion despite the previously announced loss of one very large scheme, taking assets under administration to £22.0 billion.
- IFRS based operating profit up £65 million to £105 million driven by a revision to long-term longevity assumptions.

International division

- Sustainable free surplus generation has increased to £25 million (2013: £20 million) due to favourable movements in investment in new business and operating variances, which more than offset a reduction in expected returns.
- International assets under administration continue to grow and total £7.0 billion (31 December 2013: £6.6 billion).
- Full year performance in 2014 continues to reflect the difficult market conditions throughout the business' regions. As a result, sales volumes have fallen by 13% to £110 million. However, sales volumes in the second half of the year are up 34% compared with the first half of 2014 to £63 million.
- VNB is also lower at £12 million (2013: £21 million) as a result of the difficult trading conditions.
- IFRS based operating profit of £54 million is £9 million lower than in 2013 due to reduced in-force surplus resulting from increased expenses and adverse experience.
- Following the re-platforming of new business, the International division is on track for re-platforming in-force business during 2015.

Business review continued

Cash today

Sustainable free surplus generation

			2014		
£m	**Heritage**	**UK**	**Int'l**	**Corporate**	**Total**
Expected return from in-force business	**481**	**119**	**52**	**–**	**652**
Investment in new business	**(35)**	**(105)**	**(29)**	**–**	**(169)**
Underlying free surplus generation	**446**	**14**	**23**	**–**	**483**
Development costs	**(11)**	**(19)**	**(4)**	**–**	**(34)**
Coupon on external debt	–	**–**	**–**	**(94)**	**(94)**
	435	**(5)**	**19**	**(94)**	**355**
Operating experience variances	**(3)**	**(25)**	**3**	**–**	**(25)**
Other operating variances	**30**	**2**	**3**	**–**	**35**
Other income and charges	**–**	**1**	**–**	**7**	**8**
Sustainable free surplus generation	**462**	**(27)**	**25**	**(87)**	**373**
Operating assumption changes	**79**	**52**	**(18)**	**–**	**113**
Operating free surplus generation(i)	**541**	**25**	**7**	**(87)**	**486**

			Restated(ii) 2013		
£m	Heritage	UK	Int'l	Corporate	Total
Expected return from in-force business	462	99	77	–	638
Investment in new business	(52)	(98)	(39)	–	(189)
Underlying free surplus generation	410	1	38	–	449
Development costs	(9)	(23)	(7)	–	(39)
Coupon on external debt	–	–	–	(92)	(92)
	401	(22)	31	(92)	318
Operating experience variances	45	(11)	–	–	34
Other operating variances	(1)	15	(9)	–	5
Other income and charges	–	(22)	(2)	(8)	(32)
Sustainable free surplus generation	445	(40)	20	(100)	325
Operating assumption changes	36	17	(1)	–	52
Operating free surplus generation(i)	481	(23)	19	(100)	377

(i) Operating free surplus generation excludes corporate costs relating to the Friends Life Group Limited holding company.
(ii) 2013 results have been restated to reflect the transfer of OLAB from the International to Heritage division and to exclude the results of Lombard, which has been classified as discontinued in the year.

Heritage

The Heritage sustainable free surplus generation of £462 million is £17 million higher than 2013 due to higher expected returns from in-force business and an improvement in investment in new business.

Business review continued

Expected return from in-force business at £481 million is £19 million higher than 2013 with the run-off of in-force business being more than offset by the ongoing benefits from the first phase of the with-profits annuity reallocation programme, FLI asset recaptures, the benefit of 2013 being the last year of repayment of a previous loan with a with-profits fund, together with improved economic conditions and increased recognition of tax relief on expenses.

The £17 million improvement in investment in new business reflects the cessation of new business sales within the transferred OLAB business.

Other operating variances include a positive impact from modelling changes offset by the day one cost of completing the second phase of the with-profits fund annuity reallocation programme with this resulting in a free surplus cost of £(11) million in 2014. A further £(4) million impact is also reflected as a result of a recapture of £1.6 billion of assets backing annuities in November 2014.

Operating assumption changes of £79 million principally reflect a change to annuitant longevity assumptions.

UK

Sustainable free surplus of £(27) million represents a £13 million improvement on 2013, driven by a £13 million increase in underlying free surplus generation, as set out in the table below.

Underlying free surplus generation by UK business unit

	2014				2013			
£m	**Protection**	**Retirement Income**	**Corporate Benefits**	**Total UK**	Protection	Retirement Income	Corporate Benefits	Total UK
Expected return from in-force business	**31**	**15**	**73**	**119**	30	10	59	99
Investment in new business	**(37)**	**(24)**	**(44)**	**(105)**	(44)	(6)	(48)	(98)
Underlying free surplus generation	**(6)**	**(9)**	**29**	**14**	(14)	4	11	1

UK underlying free surplus of £14 million is £13 million higher than 2013, due to a significant improvement in the contribution from Corporate Benefits resulting from growth in assets under administration and strong cost control. The investment in new business within the Protection business has improved by £7 million reflecting a disciplined approach to pricing and optimisation of reinsurance arrangements, including the use of a modest amount of financial reinsurance. These impacts more than offset the increased cost of writing new business in Retirement Income which reflects improvements made to the competitiveness of the annuity offering as we entered the open market in December 2013.

The 2014 sustainable free surplus reflects £(14) million lower operating experience variances than 2013, driven by a reduced utilisation of brought forward tax losses which resulted from a reduction in Retirement Income free surplus generated and adverse claims experience within the Protection business. This is more than offset by a £23 million improvement in other income and charges due to non-recurrence of 2013 provisioning within Sesame.

Operating assumption changes of £52 million principally reflect a change to annuitant longevity assumptions.

International

Sustainable free surplus generation has increased to £25 million (2013: £20 million), principally reflecting a favourable movement in operating variances.

Expected returns have decreased due to lower volumes of regular premium savings business written in 2013 compared with 2012. The surplus emergence on the regular premium savings business is weighted towards the early years of such contracts.

The decrease in expected returns is partially offset by a lower investment in new business of £(29) million (2013: £(39) million) which is partly due to lower sales volumes, but also the benefit of recognising indemnity commission over the initial period of each policy.

Operating assumption changes of £(18) million principally relate to a change to maintenance expense assumptions.

Corporate

The sustainable free surplus contribution from Corporate principally reflects the debt costs (net of tax) incurred by the Group. The 2014 result of £(87) million represents a £13 million improvement on 2013 primarily due to a lower level of holding company costs in sustainable free surplus in 2014 and a higher expected investment return as a result of the syndicated loan investments made in the year.

Business review continued

Cash tomorrow

New business profitability

£m (unless otherwise stated)	VNB	INB	IRR	APE	PVNBP Margin
			2014		
Protection	**69**	**(37)**	**19.2%**	**89**	**10.8%**
Retirement Income	**51**	**(24)**	**14.6%**	**56**	**9.1%**
Corporate Benefits	**21**	**(44)**	**8.3%**	**614**	**0.7%**
Total UK	**141**	**(105)**	**13.0%**	**759**	**3.5%**
Heritage	**(21)**	**(35)**	**(2.7)%**	**43**	**(8.1)%**
International	**12**	**(29)**	**9.4%**	**110**	**1.5%**
Total Group	**132**	**(169)**	**16.7%**	**912**	**2.6%**

2014 Group IRR of 16.7% includes the benefit of discretionary investment of shareholder assets in the with-profits annuity reallocation and the recapture of £1.6 billion of assets backing annuities. Excluding these, the Group IRR is 10.5%.

The open insurance business (UK Protection, UK Retirement Income and International) IRR in 2014 is 15.1% (2013: 18.1%), in line with the performance ambition of 15% set a year ago.

£m (unless otherwise stated)	VNB	INB	IRR	APE	PVNBP Margin
			Restated(i) 2013		
Protection	75	(44)	13.8%	84	12.0%
Retirement Income	83	(6)	25%+	66	12.5%
Corporate Benefits	26	(48)	8.4%	574	0.9%
Total UK	184	(98)	15.3%	724	4.5%
Heritage	(26)	(52)	(1.0)%	68	(6.0)%
International	21	(39)	11.0%	127	2.3%
Total Group	179	(189)	15.4%(ii)	919	3.3%

(i) 2013 results have been restated to reflect the transfer of OLAB from the International to Heritage division and to exclude the results of Lombard, which has been classified as discontinued in the year.
(ii) 2013 Group IRR includes the benefit of discretionary investment of shareholder assets in the with-profits annuity reallocation. Excluding this, the Group IRR was 11.0%.

UK

The UK division delivered good growth in volumes during 2014, with APE up 5% to £759 million. Growth has been delivered in the Corporate Benefits and Protection business units, up 7% and 6% respectively. Retirement Income volumes are showing a smaller fall than expected, outperforming the market.

Protection

The Protection business has delivered growth in sales volumes of 6% compared to 2013, with much of this driven through strengthened relationships with financial advisers. VNB is 8% lower than 2013 driven by an increase in the start of year long-term interest rates compared to 2013 (meaning future profits are worth less in today's terms) as well as changes in the mix of new business written in Group Protection, with lower volumes of Income Protection and higher volumes of Life business which is typically less profitable. These impacts have also led to a lower PVNBP margin. The IRR has improved significantly from 13.8% to 19.2% driven by pricing discipline and optimisation of reinsurance arrangements, including the use of a modest amount of financial reinsurance. Investment in new business has improved by £7 million compared to 2013 despite the growth in volumes, for similar reasons as for the growth in IRR.

Business review continued

Retirement Income

The Retirement Income business has delivered strong new sales, with volumes down just 15% on the previous year, despite changes announced in the UK Chancellor's 2014 Budget. This compares favourably to the market where overall annuity sales were down 38% in the first three quarters of 2014 compared to the equivalent period last year. The favourable comparison partly reflects the relatively high proportion of vesting pension policies with guarantees, which represented 51% of new business volumes in 2014. We continue to believe that annuity volumes will fall further and in the fourth quarter Retirement Income sales volumes were 14% down on the third quarter. In addition to the fall in volume, the more competitive pricing position has, as expected, led to adverse VNB and INB compared to 2013, although IRR and PVNBP margins remain satisfactory.

Corporate Benefits

VNB of £21 million is 19% lower than 2013, following some cost and pricing pressure on new scheme wins and the impact of low initial premium levels on auto-enrolment business. Nevertheless policies in force and assets under administration have shown strong growth, supported by this increase in auto-enrolment activity.

Investment in new business has improved by £4 million compared to 2013, principally due to a restructuring of commission terms for new entrants to existing schemes.

Volumes are 7% higher than 2013, driven by good growth in the size of the existing book from higher increments, new entrants to existing schemes and increased single premium business.

Corporate Benefits assets under administration

£bn	**2014**	2013
1 January	**20.1**	17.8
Inflows	**2.5**	2.0
Outflows	**(1.9)**	(2.2)
Net fund flows	**0.6**	(0.2)
Net investment return	**1.3**	2.5
31 December	**22.0**	20.1

The Corporate Benefits business has delivered positive net fund flows of £0.6 billion contributing to assets under administration reaching £22.0 billion. This is despite the previously communicated disinvestment of one very large scheme for £0.4 billion which left to pursue an investment only proposition. Even allowing for this disinvestment, outflows have reduced compared to 2013.

Inflows have benefitted from strong new business volumes, in particular regular premiums have grown from £1,760 million in 2013 to £1,946 million in 2014, in part resulting from auto-enrolment activity which has contributed to a net increase in members of 169,000 in the year taking the total member count to 1,312,000.

Corporate Benefits underlying free surplus

£m (unless otherwise stated)	**2014**	**2014**	2013	2013
Income	**122**	**61bps**	110	62bps
Outgoings	**(92)**	**(46)bps**	(94)	(53)bps
Other	**(1)**		(5)	
Underlying free surplus	**29**		11	

Corporate Benefits underlying free surplus income has increased by £12 million to £122 million as a consequence of growth in assets under administration. At the same time outgoings have fallen reflecting actions taken to contain commission spend and management of investment expenses, including the benefit from the appointment of Schroders as asset managers for a large proportion of the book and increased use of the lower cost My Money platform. "Other" has improved by £4 million which primarily reflects the reclassification of scheme-level expense on new policies in existing schemes from new business to in-force policies, which had a favourable impact on non-unit reserves.

Heritage

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. The reduction in investment in new business and APE reflects the lower sales volumes following the cessation of new business sales within the transferred OLAB business.

Business review continued

International

APE volumes have fallen by 13% to £110 million reflecting difficult market conditions across the regions, especially in the first half of 2014. However, volumes in the second half of the year are up 34% compared with the first half of 2014 to £63 million due to higher bond sales and regulatory changes in UAE and Hong Kong.

VNB has decreased 43% to £12 million, reflecting lower sales volumes and the impact of adverse operating assumption changes, particularly in respect of maintenance expenses.

Recent regulatory changes in the Middle East to prevent sales by unlicensed companies are expected to strengthen our competitive position in that region. Elsewhere, the regulators in Hong Kong and Singapore have initiated changes to their respective unit-linked markets which will see a move away from upfront commission. Whilst we see this as a positive move for the long term benefit of both customers and providers, it will cause some challenges and market disruption in the short term.

Business review continued

Returns

IFRS based operating profit

£m	Heritage	UK	Int'l	Corporate	Total
			2014		
New business strain	**(24)**	**(28)**	**(21)**	**–**	**(73)**
In-force surplus	**323**	**92**	**89**	**–**	**504**
Long-term investment return	**(61)**	**16**	**3**	**–**	**(42)**
Principal reserving changes and one-off items	**190**	**49**	**(4)**	**–**	**235**
Development costs	**(14)**	**(19)**	**(13)**	**–**	**(46)**
Other income and charges	**7**	**(5)**	**–**	**(24)**	**(22)**
IFRS based operating profit/(loss) before tax	**421**	**105**	**54**	**(24)**	**556**

£m	Heritage	UK	Int'l	Corporate	Total
			Restated(i) 2013		
New business strain	(41)	(1)	(24)	–	(66)
In-force surplus	304	69	100	–	473
Long-term investment return	(84)	13	(1)	3	(69)
Principal reserving changes and one-off items	159	8	(3)	–	164
Development costs	(10)	(30)	(7)	–	(47)
Other income and charges	2	(19)	(2)	(34)	(53)
IFRS based operating profit/(loss) before tax	330	40	63	(31)	402

(i) 2013 results have been restated to reflect the transfer of OLAB from the International to Heritage division and to exclude the results of Lombard, which has been classified as discontinued in the year.

Heritage

The 2014 Heritage IFRS based operating profit of £421 million is £91 million higher than in 2013. This improvement has been driven by lower new business strain, higher in-force surplus and improved long-term investment return as a result of higher expected rates of return.

The reduction in new business strain reflects the cessation of new business sales within the transferred OLAB business.

In-force surplus is favourable compared to 2013 with the run-off of the closed book of business being more than offset by the benefit from the first phase of the with-profits annuity reallocation programme, the benefit of partial repayment of a previous loan to a with-profits fund and higher management charges, due to improved economic conditions. In-force surplus has been further increased by a reduction in the level of provision movements in respect of operational items, arising from the review of the legacy business, noted in 2013.

Principal reserving changes and one-off items are higher than in 2013 with the key items in 2014 being a recapture of £1.6 billion of assets backing annuities generating a £90 million benefit alongside £19 million from the second phase of the with-profits annuity reallocation programme. There was a favourable impact from assumption changes, principally resulting from changes to annuitant longevity assumptions (£65 million).

UK

IFRS based operating profit of £105 million has increased by £65 million compared to 2013 driven by a revision to the long-term longevity assumptions in the Retirement Income business, higher in-force surplus due to the growth of the business and lower development costs. This is partly offset by an increase in new business strain principally driven by improvements made to the competitiveness of the Retirement Income business' annuity proposition.

Business review continued

International

IFRS based operating profit was lower in 2014 at £54 million (2013: £63 million) due to reduced in-force surplus primarily as a result of increased expenses and adverse experience. This was partially offset by a £3 million reduction in new business strain due to lower volumes.

Increased development costs relate to investment in the new International IT platform.

Corporate

The Corporate IFRS based operating result is principally driven by external finance costs and corporate costs, offset by interest on internal debt. The £7 million improvement in 2014 is primarily due to a lower level of holding company costs in 2014.

Business review continued

MCEV operating profit

	2014				
£m	**Heritage**	**UK**	**Int'l**	**Corporate**	**Total**
Value of new business	**(21)**	**141**	**12**	**–**	**132**
Expected existing business contribution	**211**	**73**	**21**	**(64)**	**241**
Operating experience variances	**(17)**	**(35)**	**(13)**	**–**	**(65)**
Operating assumption changes	**13**	**14**	**2**	**–**	**29**
Other operating variances	**228**	**(15)**	**6**	**–**	**219**
Development costs	**(12)**	**(19)**	**(4)**	**–**	**(35)**
Other income and charges	**1**	**(5)**	**–**	**(19)**	**(23)**
MCEV operating profit/(loss) before tax	**403**	**154**	**24**	**(83)**	**498**

	Restated(i) 2013				
£m	Heritage	UK	Int'l	Corporate	Total
Value of new business	(26)	184	21	–	179
Expected existing business contribution	214	60	16	(75)	215
Operating experience variances	(2)	(33)	3	–	(32)
Operating assumption changes	96	(6)	11	–	101
Other operating variances	138	36	(2)	–	172
Development costs	(10)	(30)	(7)	–	(47)
Other income and charges	–	(19)	(2)	(32)	(53)
MCEV operating profit/(loss) before tax	410	192	40	(107)	535

For details of VNB please see "new business profitability" section.

(i) 2013 results have been restated to reflect the transfer of OLAB from the International to Heritage division and to exclude the results of Lombard, which has been classified as discontinued in the year.

Heritage

The Heritage MCEV operating profit of £403 million is in line with the £410 million reported in 2013, with an increase in other operating variances offsetting a reduction in operating assumption changes.

Expected existing business contribution is in line with 2013 with the ongoing benefit from the first phase of the with-profits annuity reallocation programme and improved economic conditions offsetting the general run off of in-force business.

Other operating variances of £228 million include a £68 million benefit from the second phase of the with-profits annuity reallocation, the £97 million impact of a recapture of £1.6 billion of assets backing annuities and £63 million of benefits from modelling changes primarily as a result of revised modelling of the Time Value of Options and Guarantees.

UK

MCEV operating profit before tax of £154 million is £38 million lower than 2013 largely driven by a reduction in the value of new business, as referred to earlier, partially offset by a £13 million increase in expected existing business contribution due to growth in the business.

Adverse operating experience variances of £(35) million are driven by higher than expected claims in Protection, adverse persistency in Group Protection and re-pricing activity in Corporate Benefits in response to increasing competition in the market.

Business review continued

International

MCEV operating profit has decreased to £24 million (2013: £40 million). This reflects a £(9) million reduction in VNB, adverse experience variances of £(13) million primarily driven by adverse persistency, and the non-recurrence of favourable assumption changes from 2013. This is offset by an improvement in the expected existing business contribution from £16 million to £21 million reflecting higher assets under administration combined with higher rates of expected return on all assets.

Corporate

The Corporate MCEV operating result is principally driven by expected external finance costs and corporate costs. The 2014 operating profit of £(83) million represents a £24 million improvement on 2013 due to lower expected debt servicing costs as a result of a reduction in spreads on the debt in 2013 and a lower level of corporate costs.

Cash Return

The cash return ratio of 25.1% is calculated by dividing the Group sustainable free surplus of £373 million by the shareholder net worth (that is, total free surplus and required capital). The 15% growth in sustainable free surplus was partially offset by a higher shareholder net worth in 2014, primarily as a result of positive economic variances during 2013 which increased the 2014 opening position.

£m (unless otherwise stated)	**2014**	Restated(i) 2013
Sustainable free surplus	**373**	325
Adjusted shareholder net worth(ii)	**1,489**	1,368
Cash return (%)	**25.1%**	23.8%

(i) 2013 results have been restated to exclude the results of Lombard, which has been classified as discontinued in the year.
(ii) Adjusted shareholder net worth is calculated as the opening position (1 January 2014: £1,608 million, 1 January 2013: £1,504 million) with allowance for the timing of dividend payments, the receipt of the Lombard sale proceeds in October 2014, the share buyback programme in November 2014 and the AmLife sale in January 2013.

Business review continued

Operating expenses

£m	2014 Heritage	2014 UK	2014 Int'l	2014 Total	Restated(i) 2013 Heritage	Restated(i) 2013 UK	Restated(i) 2013 Int'l	Restated(i) 2013 Total
Acquisition	**30**	**112**	**22**	**164**	37	99	21	157
Maintenance	**225**	**63**	**25**	**313**	254	48	23	325
Development(ii)	**14**	**19**	**13**	**46**	10	30	7	47
	269	**194**	**60**	**523**	301	177	51	529
Corporate				**26**				34
Total				**549**				563

(i) 2013 results have been restated to reflect the transfer of OLAB from the International to Heritage division and to exclude the results of Lombard, which has been classified as discontinued in the year.
(ii) As reported under IFRS.

Consistent with previous communications, the costs associated with new retirement income product and platform development have been reported within non-recurring items and are therefore excluded from the table above.

Heritage

2014 acquisition costs are lower than 2013, mainly driven by the cessation of new business sales within the transferred OLAB business.

Maintenance costs of £225 million are lower than 2013 due to contractual savings in expenses achieved through the Diligenta partnership and a reduction in costs following the successful completion of the separation programme to move all IT infrastructure and business applications hosted by AXA to Friends Life in 2013.

Development spend of £14 million is higher than 2013 reflecting the cost of the transfer of investment management of assets to Schroders and FLI, together with improvements to existing products and systems to support the in-force business.

UK

Acquisition costs have increased by £13 million compared to 2013 driven by structural changes within the UK division to build capability pending the new pension related freedoms from April 2015, and an expected movement in overheads from maintenance to acquisition as the Heritage book runs off. Maintenance costs have increased by £15 million reflecting growth in each of the three business units. This increase is in line with our expectations as the business grows. The growth is enabling increased operational leverage, as can be seen by the significant improvement in underlying free surplus generation in the year.

Despite reduced overall development spend, there has been considerable investment in the Retirement Income proposition and in enhancing the Protection proposition and the auto-enrolment hub in Corporate Benefits. As mentioned above, the costs associated with new retirement income product and platform development have been reported within non-recurring items and are therefore excluded from the table above.

International

Acquisition and maintenance costs have increased marginally despite lower new business volumes, reflecting increases in regional branch costs and maintenance project spend.

Development expenses amounting to £13 million principally reflect investment in the new International IT platform. Following the re-platforming of new business, the division is on track for re-platforming in-force business during 2015.

Corporate

Corporate expenses are those incurred at holding company level. Lower costs were incurred in 2014 principally due to changes made to the corporate governance structure during 2013.

Business review continued

Non-operating results

Group IFRS results	2014 £m	Restated(i) 2013 £m
IFRS based operating profit before tax	**556**	402
Short-term fluctuations in investment return	**(207)**	184
Gain on sale of associates (AmLife)	**–**	20
Other non-recurring items	**(184)**	(151)
STICS(ii) interest adjustment to reflect IFRS accounting for STICS as equity	**31**	31
IFRS profit before acquisition accounting adjustments and shareholder tax	**196**	486
Amortisation and impairment of acquired in-force business	**(302)**	(342)
Amortisation and impairment of other intangible assets	**(52)**	(63)
IFRS (loss)/profit before shareholder tax from continuing operations	**(158)**	81
Shareholder tax	**91**	178
IFRS (loss)/profit after tax from continuing operations	**(67)**	259
Loss after tax from discontinued operations	**(71)**	(24)
IFRS (loss)/profit after tax	**(138)**	235

Group free surplus generation	2014 £m	Restated(i) 2013 £m
Operating free surplus generation	**486**	377
Economic variances	**(144)**	265
Other non-operating items	**(158)**	(249)
Friends Life Holdings free surplus generated	**184**	393
Friends Life Group Limited income and charges	**(21)**	(21)
Total free surplus generated from continuing operations	**163**	372
Free surplus generated from discontinued operations	**(3)**	5
Total free surplus generated	**160**	377

Group MCEV results	2014 £m	Restated(i) 2013 £m
MCEV operating profit before tax	**498**	535
Economic variances	**(143)**	401
Non-recurring costs	**(211)**	(181)
Other non-recurring items and non-operating variances	**(66)**	38
MCEV profit from continuing operations before tax	**78**	793
Tax	**(3)**	(186)
MCEV profit from continuing operations after tax	**75**	607
Profit from discontinued operations	**14**	(28)
MCEV profit/(loss) after tax	**89**	579

(i) 2013 results have been restated to exclude the results of Lombard, which has been classified as discontinued in the year.
(ii) Step-up Tier one Insurance Capital Securities.

Business review continued

Group IFRS: non-operating results

Short-term fluctuations in investment returns on assets backing the shareholder and non-profit funds amounted to £(207) million in 2014. This principally reflects £(104) million due to the incomplete trading of gilt assets into higher yielding assets as part of the recapture of £1.6 billion of assets backing annuities in November 2014 (this variance is expected to reverse as the assets are reinvested in 2015). There was a further negative impact due to reductions in long-term interest rates during the year.

Other non-recurring items of £(184) million include:

- outsourcing implementation costs, net of provision releases, of £(71) million;
- finance transformation costs, largely relating to Solvency II and net of provision movements, of £(36) million;
- costs relating to the Sesame strategic review, of £(25) million;
- project costs incurred in responding to significant regulatory changes in the year, of £(21) million;
- separation and integration programme costs of £(11) million; and
- other strategic project costs of £(20) million, including costs incurred in relation to the Proposed Acquisition by Aviva.

The costs reported above in respect of separation and integration complete this programme and no future costs are anticipated relating to the activities of bringing together the entities and operations that form Friends Life today.

We are pleased with the progress on the outsourcing implementation work which is being undertaken in conjunction with Diligenta and a number of successful migrations have completed in 2014. Total spend under this programme to date amounts to £261 million. As a result of the new pensions and annuity legislation, we have decided to defer parts of the programme until later in 2015. This deferral is expected to result in a modest increase in total programme spend compared to the most recent guidance given in March 2013 of circa £280 million.

As communicated in August 2014, the Group's intention is to report the costs associated with the new retirement income product and platform development within non-recurring items. Given the UK Chancellor referred to the changes announced in his 2014 Budget as "the most far-reaching reform to the taxation of pensions since the regime was introduced in 1921", the Group believes this approach is appropriate in this instance. In accordance with this intention, £21 million of costs associated with responding to significant regulatory changes in the year have been reported within other non-recurring items. In addition to this, for free surplus and MCEV reporting only, a further provision of £45 million has been established for the anticipated future costs in response to significant regulatory changes in the year.

Group free surplus generation: non-operating results

Total economic variances had a £(144) million impact on free surplus in the year, principally as a result of falls in long-term interest rates during the year which increased liabilities and subsequently, required capital. Similar to the IFRS result, there was a £(104) million impact due to the incomplete trading of gilt assets into higher yielding assets as part of the recapture of £1.6 billion of assets backing annuities in November 2014 (this variance is expected to reverse as the assets are reinvested in 2015). Offsetting positive variances arose from gains in equities and bonds over the period, which have allowed historic taxable losses to be valued, and a decrease in expense inflation assumptions.

Other non-operating items of £(158) million include £(184) million of non-recurring items, consistent with those reported within the IFRS result. In addition, there is a net impact of £26 million from items specific to free surplus, including £21 million benefit from the release of required capital due to a lower level of non-recurring expense in 2013.

Friends Life Group Limited ("FLGL") income and charges of £(21) million relate to costs incurred within the FLGL holding company.

Group MCEV: non-operating results

Total economic variances had a £(143) million impact on MCEV profit before tax. This principally reflects a £(119) million impact due to the incomplete trading of gilt assets into higher yielding assets as part of the recapture of £1.6 billion of assets backing annuities in November 2014 (this variance is expected to reverse as the assets are reinvested in 2015). A negative impact from an increase in the market value of the Group's external debt is largely offset by favourable movements in interest rates and expense inflation.

Non-recurring costs had a £(211) million impact on MCEV profit before tax, £(184) million of which is consistent with that reported within the IFRS result. In addition, there was a £(27) million impact from net costs specific to MCEV. This includes £(57) million due to the establishment of a provision to cover anticipated future costs in response to significant regulatory changes in the year (being a provision of £45 million notionally grossed up for tax).

Business review continued

Other non-recurring items and non-operating variances of £(66) million include, as announced in our interim results, a £50 million provision established to cover the anticipated impact of the imposition of a charge cap of 0.75% per annum on default funds for qualifying auto-enrolment schemes and a £10 million provision established to cover the anticipated impact on future profits from the removal of Active Member Discounts ("AMD") on existing schemes.

Group net assets and shares in issue

£m (unless otherwise stated)	**2014**	2013
Total IFRS net assets	5,115	5,549
Net Group MCEV	5,529	6,065
Shares in issue[(i)]	1,405,179,597	1,417,508,151

(i) Adjusted to exclude 3,872,431 FLGL shares held by the Employee Benefit Trust ("EBT") at 31 December 2014 (31 December 2013: 600,877). The increase reflects additional purchases made by the EBT to deliver shares to employees under various Share Based Payment schemes of the Group. 9,057,000 shares were purchased as part of the share buyback programme which commenced on 31 October 2014 and was suspended as of 21 November 2014.

At 31 December 2014, IFRS total equity was £5,115 million (31 December 2013: £5,549 million), with equity attributable to equity holders of the parent of £4,796 million (31 December 2013: £5,229 million). IFRS net assets per share attributable to equity holders of the parent were £3.41 (31 December 2013: £3.69) based on shares in issue at the balance sheet date.

Net Group MCEV was £5,529 million (31 December 2013: £6,065 million) giving MCEV per share of £3.93 (31 December 2013: £4.28).

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 2014 remains strong with Available Shareholder Assets ("ASA") of £1,066 million and an IGCA[(i)] surplus of £2.3 billion resulting in a coverage ratio, excluding WPICC[(ii)] ("With Profits Insurance Capital Component") of 240%. At 31 December 2014 the estimated and unaudited economic capital[(iii)] surplus at Group level was £3.7 billion corresponding to a coverage ratio of 196%.

Cash and capital definitions

(i) The IGCA position at 31 December 2014 of the Group and its subsidiaries is estimated and unaudited.

(ii) 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.

(iii) 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 economic capital position at 31 December 2014 of the Group and its subsidiaries is estimated and unaudited.

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 2013 full year results. These policies remain unchanged and are summarised below.

Life companies CMP

The CMP of FLL ("Friends Life Limited"), the principal UK life company, is to meet the higher of:

- 150% of Pillar 1 requirements, excluding WPICC and Friends Provident International Life ("FPIL"); and
- 125% of Pillar 2 requirements, including any ICG and excluding FPIL.

In addition to the above, capital within FLL is held to cover at least one year of the FLL debt servicing costs (currently £101 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 broadly designed to cover an additional year of the Company's current dividend and the holding companies' corporate costs and is currently £325 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 2014 the biting capital constraint is the Group IGCA position, and a monitoring buffer of 10% of the IGCA requirements, excluding WPICC, is held within working capital.

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. Shareholder resources comprise the free surplus, required capital and inadmissible assets of the business. For the Friends Life 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).

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

		Shareholder resources		
£m (net of tax)	Value-in-force	Required Capital[(i)]	Free surplus	Total MCEV
Opening MCEV at 1 January 2014	4,369	245	1,451	6,065
Surplus generated in the period	(170)	82	163	75
Dividend payment	–	–	(299)	(299)
Discontinued operations	15	2	(3)	14
Lombard disposal	(448)	(81)	246	(283)
Other reserve movements	(27)	29	(45)	(43)
Closing MCEV at 31 December 2014	**3,739**	**277**	**1,513**	**5,529**

(i) Required capital at 31 December 2014 includes £257 million in respect of non-covered business required capital and inadmissible assets which are classified as free surplus in MCEV.

Working capital and other assets and liabilities

Working capital represents assets set aside to cover known future requirements and amounts necessary to maintain sufficient flexibility to facilitate compliance with the Group capital policy and additional regulatory requirements. In addition, any assets subject to restriction in their availability to shareholders will be designated as working capital.

The working capital at 31 December 2014 of £447 million has decreased from £534 million at 31 December 2013 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;
- additional capital requirements (at the CMP of 150% of Pillar 1 requirements) expected to arise in relation to the Department of Work and Pensions "charge cap", which will be introduced in April 2015;
- an appropriate monitoring buffer to facilitate ongoing compliance with the Group's CMPs;
- restricted assets included within free surplus e.g. illiquid or intangible assets and any assets in excess of the CMP held within the life companies after declaration of dividends.

Available shareholder assets

ASA represents the cash and other assets available to cover Friends Life's corporate costs, to service debt issued by holding companies and, subject to shareholder approval, to pay dividends or return to shareholders. As such, ASA is stated after the deduction of working capital from free surplus.

The ASA of £1,066 million comprises £861 million of shareholder cash at Friends Life holding company level (including the £150 million interim dividend declared by FLL), and £205 million of investments in syndicated loans. Total dividends included from FLL relating to 2014 are £270 million, inclusive of the £120 million paid in the second half of the year.

£m	**2014**	2013
Friends Life holding companies' cash	**711**	644
Declared dividend from FLL	**150**	273
Investments in syndicated loans	**205**	–
Available shareholder assets	**1,066**	917

Business review continued

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

£m	**2014**	2013
Settlement of second interim dividend[(i)] (2013: final dividend)	**340**	200
Prudence buffer in accordance with Group policy	**325**	325
Non-specified ASA holdings	**401**	392
Available shareholder assets	**1,066**	917

(i) Assumes the Proposed Acquisition by Aviva completes. In the event that the Proposed Acquisition does not complete, Friends Life expects that its 2014 final dividend and therefore its 2014 full year dividend would be in line with Friends Life's 2013 final dividend and 2013 full year dividend, respectively.

The ASA balance as at 31 December 2014 is held to cover the costs of the second interim dividend which is payable subject to the approval of the Proposed Acquisition by regulators and shareholders; and to maintain a prudence buffer of £325 million, designed to cover approximately an additional year of the Company's current dividend cost (based on the 2013 full year dividends); and the holding companies corporate costs. The Group CMP requirement to hold cash at FLGL sufficient to meet one year of FLGL's debt servicing costs is expected to be met from capital retained in the life companies. As this requirement is not considered a restriction on the availability of FLGL cash, no reduction has been made to the ASA in respect of it.

Cash remittances to the ultimate holding company in 2014 amount to £610 million, comprising £350 million from principal subsidiaries and £260 million of proceeds from the sale of Lombard.

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 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, on an economic capital basis;
- the surplus of FPIL on an economic capital basis; and
- the fungible net assets of the other operating and holding companies.

The estimated and unaudited Group economic capital surplus above capital requirements as at 31 December 2014 is strong at £3.7 billion (a coverage ratio of 196%). The decrease in capital surplus since 31 December 2013 (surplus of £3.9 billion, coverage ratio 193%) reflects adverse operating variances during the year.

The sensitivities to market shocks show that economic capital surplus at a Group level at 31 December 2014 would change by:

- an estimated £(0.5) billion in the event of a combined 40% fall in equity markets and a 30% fall in property markets;
- an estimated £0.3 billion in the event of a 200bps rise 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).

The sensitivities reflect investment activities, the recapture of £1.6 billion of assets backing annuities, the with-profits annuity reallocation and modelling changes implemented since 31 December 2013.

Business review continued

Insurance Groups Capital Adequacy

In addition to individual company requirements, the Group is required to meet the IGCA requirements of the Insurance Groups Directive. The Group's capital policy is to maintain sufficient Group capital resources to cover 150% of the Group Capital Resource Requirement ("CRR") (excluding WPICC).

The balance sheet remains strong with an estimated and unaudited IGCA surplus of £2.3 billion at 31 December 2014 (1 January 2014: £2.2 billion), with Group capital resources being 240% of the CRR (1 January 2014: 238%) (excluding WPICC of £4.3 billion (1 January 2014: £4.2 billion)).

Movement in IGCA surplus

£m	2014
1 January 2014	**2,236**
Surplus emerging	**301**
Excess of Lombard sale proceeds over IGCA contribution at 1 January 2014	**219**
Dividend paid	**(299)**
Finance costs and other movements(i)	**(117)**
31 December 2014	**2,340**

(i) Finance costs and other movements include the £(30) million impact of the share buyback programme prior to its suspension upon the announcement of the Proposed Acquisition.

At 31 December 2014 the capital held to meet CMPs was £836 million (1 January 2014: £812 million) and the excess over the CMPs was £1,504 million (1 January 2014: £1,424 million).

The sensitivities to market shocks show that IGCA surplus at 31 December 2014 would change by:

- an estimated £(0.1) billion in the event of a combined 40% fall in equity markets and a 30% fall in property markets;
- an estimated £0.3 billion in the event of a 200bps rise in interest rates; and
- an estimated £(0.5) 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 recapture of £1.6 billion of assets backing annuities, the with-profits annuity reallocation and modelling changes implemented since 31 December 2013.

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)

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 2014 are presented below.

£m (unless otherwise stated)	Coupon	Principal	Clean market value of debt(i)	Finance costs(iii) IFRS	Finance costs(iii) MCEV
LT2 subordinated debt 2021	12.00%	162	228	(20)	(8)
LT2 subordinated debt 2022	8.25%	500	613	(41)	(22)
UT2 reset perpetual subordinated debt(ii)	7.875%	369	417	(28)	(15)
STICS 2003	6.875%	210	227	(14)	(8)
STICS 2005	6.292%	268	272	(17)	(11)
Total 31 December 2014		**1,509**	**1,757**	**(120)**	**(64)**
Total 31 December 2013		1,496	1,616	(120)	(75)

(i) Market value is based on listed ask price, at 31 December 2014, 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 2014. 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 £(94) million, being the IFRS amount of £(120) million net of tax.

Corporate gearing and liquidity

IFRS gearing (£m)	2014	2013
Equity attributable to equity holders of the parent	**4,796**	5,229
Loans and borrowings(i)	**1,051**	1,050
	18.0%	16.7%

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

MCEV gearing (£m)	2014	2013
Group MCEV, gross of debt	**7,276**	7,688
Debt	**1,747**	1,623
	24.0%	21.1%

At 31 December 2014, the ratio of debt to IFRS equity attributable to equity holders of the parent, gross of debt, was 18.0% (31 December 2013: 16.7%), with the fall in equity principally reflecting the payment of dividends in the period and the loss after tax for the year.

The MCEV gearing of 24.0% (31 December 2013: 21.1%) is up over the period reflecting an increase in the market value of the Group's debt and the decrease in gross Group MCEV, primarily as a result of the Lombard sale.

Business review continued

Discontinued operations – Lombard

On 30 October 2014 the Group completed the sale of its Luxembourg based business, Lombard. The financial impact of the sale, including the operating and non-operating results for the period, is included below:

Financial performance

	IFRS		Free surplus[i]		MCEV	
£m	**2014[ii]**	2013	**2014[ii]**	2013	**2014[ii]**	2013
Operating/Sustainable free surplus results	**23**	34	**7**	6	**13**	(46)
Non-operating results	**(88)**	(80)	**(10)**	(1)	**5**	11
Loss on remeasurement to fair value	**(14)**	n/a	**n/a**	n/a	**n/a**	n/a
Taxation	**8**	22	**n/a**	n/a	**(4)**	7
(Loss)/profit after tax from discontinued operations	**(71)**	(24)	**(3)**	5	**14**	(28)

(i) Free surplus is presented net of tax.
(ii) 2014 figures are up to and including 30 October 2014.

Lombard generated an IFRS based operating profit before tax of £23 million in the first ten months of 2014, £11 million lower than in 2013. The decrease principally reflects one-off costs incurred as a result of the expected sale of the business and lower fee income. The lower fee income results from lapses experienced in 2013 and 2014 and also that the 2014 profit only relates to ten months of the year.

The IFRS non-operating result of £(88) million principally reflects the £(46) million recycling of cumulative foreign exchange adjustments required on disposal and £(35) million amortisation of acquired value of in-force business and other intangible assets.

Sustainable free surplus of £7 million in the first ten months of 2014 is £1 million higher than 2013. Lower investment in new business is offset by reduced expected returns from in-force business.

Lombard generated a MCEV operating profit of £13 million in the first ten months of 2014 (2013: £(46) million). The operating loss in 2013 was principally due to the impact from basis changes to strengthen persistency assumptions. MCEV operating profit was higher in the second half of 2014 principally due to the adverse lapse experience seen in the first two quarters (notably in Belgium) not being repeated in the second half of the year.

Within the MCEV result and consistent with CFO Forum principles, a closing adjustment totalling £(283) million has been made for the remeasurement of the carrying value amount of Lombard. This is excluded from the above table as it does not form part of the profit and loss statement.

Business review continued

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 Committees. 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	The Group operates in a highly regulated financial services market both in the UK and internationally. In recent years, there have been significant changes in relevant legislation and regulation, a number of which have had a significant impact on the life assurance industry. It is impossible to predict fully 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. 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. Specific items of current note are:	The Group has processes in place to identify regulatory and legislative change and to monitor the timely implementation of new requirements. 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. The Group's 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.
	Solvency II Solvency II, which comes into effect on 1 January 2016, will have implications for the whole industry as to the way in which companies calculate capital resources and capital requirements. Solvency II continues to be viewed as potentially having a significant impact on the Group.	There remains further work to transition the Group across to a Solvency II basis. Our internal programme is fully mobilised and on track to transition. With greater certainty around the implementation dates, detailed planning work has been completed to ensure readiness. In the absence of final technical implementation standards and guidelines, 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 to optimise this in the manner that best serves our customers and shareholders.
	Pension reforms The UK government has introduced greater flexibility for customers to access their pension savings without the effective requirement to buy an annuity. This means that, from April 2015, people can choose how they access their defined contribution pension savings; for example they could take all their pension savings as a lump sum, draw them down over time, or buy an annuity with part, or all, of their pension.	These developments present both an opportunity and a threat to the Group. Our New World Retirement programme is targeted with developing a range of propositions in response to the increased flexibility. The programme is developing a new individual customer platform and is making enhancements to customer service teams to help customers make appropriate decisions.

Business review continued

Risk	Description and impact	How we manage
Regulatory change, including tax and Solvency II (continued)	**Pension reforms** (continued) Alongside this, the government is introducing a new requirement to make sure that everyone retiring with a defined contribution pension pot has access to free and impartial guidance on the choices they face when deciding how to use their retirement savings. The guidance on pension choices will be provided by independent organisations rather than pension schemes or providers. The Financial Conduct Authority ("FCA") has informed pension providers that they have responsibility to make customers aware of the impact of taking cash from their pension savings. On 27 February, the FCA issued final rules which take effect from 6 April 2015, placing additional requirements on pensions providers to ensure customers understand the implications of the choices they are making in accessing their savings, including tax issues that customers may not anticipate.	We are also working to develop our operational capability to ensure that features, such as request withdrawals and the provision of appropriate information, are implemented in accordance with requirements which is challenging due to the short implementation time since receiving the final regulatory requirements. Furthermore, it is difficult to predict the levels and nature of our customer interaction at the point the changes come into effect and it is possible that there may be some disruption to the provision of customer services.
	OFT / DWP workplace pensions consultation Following a review by the Office of Fair Trading and the Department of Work and Pensions, it has been confirmed that, from April 2015, a 0.75% charge cap will come into effect on auto-enrolment schemes. The cap will cover all member-borne deductions which include all charges on member savings other than transaction costs. Other measures will be implemented in successive years.	The implementation of the OFT and DWP reviews of workplace pension arrangements remains uncertain. The extent of the changes, including the impact from the charge cap (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 2015 and beyond.
	FCA Legacy Review In March 2014, the FCA announced that they would undertake a thematic review into the fair treatment of long standing customers in life insurance. Given the Group's significant book of legacy business within our Heritage business, we are proactively engaging with the FCA review. However, the expected outcome of this review is unclear and there is a risk that the FCA could use its powers of intervention to introduce new rules and/or require firms to take certain action in response to any issues and non-compliance identified pursuant to such review.	The FCA's work commenced in the summer and we await their findings in 2015.
Sesame Bankhall Group ("SBG")	The Group has, for some time had Sesame Limited ("Sesame"), a subsidiary of SBG, under strategic review. Due to potential liabilities from advice related claims, Sesame is reliant on the continued financial support of the Group to be able to continue to trade. If an appropriate strategic solution cannot be agreed, there remains the risk of further adverse financial and reputational impacts to the Group.	The Group and SBG are in discussions with the FCA in connection with elements of the strategic review and the various options under consideration as part of the strategic review of the SBG businesses.

Business review continued

Risk	Description and impact	How we manage
Economic conditions	Changes in economic conditions give rise to changes in the values of the assets and liabilities of the Group's insurance businesses. 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. In the first half of 2014, weaker than expected global activity led to decreased projections for the remainder of the year through to 2015. Forward looking projections point to: potentially politically motivated changes (including those associated with campaigning for the May 2015 UK General Election), strengthening recovery in North America, revised downward prospects in Germany, France and Italy; China to stabilise at lower growth rates versus recent historical averages. This mixed economic picture paints continued challenges but also potential opportunities for the Group's international subsidiaries. We continue to be in a sustained low interest rate environment. This risk typically reduces with economic growth, which 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.	The Group actively monitors changes in the economic environment to enable proactive management of impacts to relevant markets. We mitigate the impact of economic conditions through measures such as the matching of 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. Specifically, our exposure to sovereign debt from all but the strongest countries in the Eurozone is modest. 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. 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.
Credit Risk	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 In 2014, the independent credit rating of UK government debt was affirmed and the outlook is now stable; this follows the downgrade in 2013. Given the Group's asset strategy, this had a muted effect. The shareholder funds have also taken on additional credit risk following the movement of annuities from the with-profits funds. The additional risk is commensurate with the return and appetite within the shareholder funds.	We mitigate our exposure to credit risks by adopting a relatively conservative investment policy with investment skewed towards bonds with high credit ratings. 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.

Business review continued

Risk	Description and impact	How we manage
Variation in principal valuation assumptions	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. 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.	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. 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.
Outsourcing	As part of the Group's strategy for increasing operational efficiency it utilises various outsourcing capabilities, including a long-term strategic partnership with Diligenta who provide specialist IT and business processing. 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.	The Group has comprehensive 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. The Group continues to ensure the appropriate risk framework is in place to manage and monitor operational risk, including that which falls within our outsource suppliers. In 2014 a revised Sourcing Policy was developed and a Third Party Risk Management and Control Standards will be implemented and embedded throughout 2015. 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.
Transaction Risk	An all share offer for all of the issued share capital of the Group was made in December 2014. The Group has long maintained a strategy of encouraging consolidation in the market and views the Proposed Acquisition as a positive for shareholders and customers. Should the Proposed Acquisition not proceed to a conclusion, there is a risk that the Friends Life would be vulnerable to adverse market perception.	The risks of the Proposed Acquisition not proceeding have been identified and assessed. Mitigation plans are being developed for such an event.

As stated in note 1 to the IFRS consolidated financial statements, the Directors have considered the Group's risk 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.

Business review continued

Corporate responsibility

In 2014 we continued to align our business and Corporate Responsibility ("CR") agendas around delivering sustainable growth. At Friends Life this means creating a virtuous circle of highly engaged colleagues delighting our customers and delivering profitable and sustainable returns for shareholders.

The CR Strategy Committee, chaired by the Group Chief Executive, Andy Briggs, approved our overall CR agenda and areas of focus. Building on the progress made in 2013, priority was placed on employee engagement, wellbeing and diversity, and taking a leadership position on promoting the importance of sound mental health.

Key achievements – colleague engagement, diversity and wellbeing

In our November 2014 colleague engagement survey, we achieved our best ever 89% response rate and 73% overall engagement index score, exceeding ORC's Financial Services benchmark for the first time (ORC is our independent survey provider). With gender and disability being the two initial priorities for our diversity agenda, our index score for women rose to 75% (up 7%) and for those disclosing a disability, it rose to 73% (up 4%).

Focusing on diversity, in April 2014 we won Business in the Community's (BitC's) Transparency Award for our approach to gender pay gap publication, where we are one of only two FTSE 100 companies to publish this information by grade. We also saw considerable improvement in both our gender and ethnicity benchmark scores with BitC, achieving a 63% (Silver) rating for gender (up from 37% in 2013), and 43% (Bronze) for ethnicity (up from 31% in 2013). As at 31 December 2014, the total workforce was 3,745, of which 49% were female. Within the overall workforce, the Group has 148 senior managers of which 41 (28%) are females. This includes individuals who are statutory directors of the corporate entities whose financial information is included in the Company's 2014 consolidated accounts in this Annual Report.

Focusing on colleague wellbeing and mental health, the Group Chief Executive, Andy Briggs and Chief Risk Officer, Rosie Harris co-hosted a business leaders breakfast forum entitled: "Mental Health – Leading from the Boardroom". During the event, we shared new research and insights on the issue and held interviews with Olympic gold medallist Chris Boardman and a Friends Life employee who had shared a mental health condition with their team. A booklet, "Listen up – Let's talk mental health" was commissioned and published for widespread access via BitC's website, aimed at helping to break the silence around mental health. A further business roundtable event on the topic of mental health will be hosted by Friends Life during Responsible Business Week 2015.

Our partnership with Macmillan Cancer Support goes from strength to strength. We raised and donated £110,000 during 2014, towards our current target of £160,000 to cover the cost of the Bristol Macmillan Citizens Advice Bureau Team for a year, which is available to around 1,100 people diagnosed with cancer annually in the Bristol area. The Lister Hospital Macmillan Information Centre, funded by the £140,000 we raised in 2013 has supported significantly more people affected by cancer since it opened in June 2014.

Environmental update

Tonnes of CO_2 equivalent Year	Scope 1	Scope 2	Scope 3	**Total**
2014	3,595	13,693	6,210	**23,498**
2013[(i)]	4,700	13,262	6,372	**24,334**
2012	3,903	14,764	5,893	**24,560**
2011	4,822	15,122	6,124	**26,068**

(i) 2013 emissions have been restated to reflect a correction to the emissions factor used for some business travel elements of voluntary scope 3 reporting and some reclassifications between scopes.

The overall carbon footprint for the Group was established as 23,498 tonnes CO_2 (2013: 24,334 tonnes CO_2), which equates to an intensity of 0.19 tonnes per m^2 (2013: 0.20 tonnes per m^2).

AECOM Sustainable Development Group undertook verification of our environmental data in line with the GHG Protocol. Corporate Citizenship provide assurance of our Community Investment data in accordance with the London Benchmarking Group model.

Business review continued

Non-financial key 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.

	2014	2013
Customer satisfaction (%)	**75**	72

Performance

Positives

- Our customers overall rating of the quality of our products and services has improved 3% points over the last 12 months. Three quarters now state good or very good.
- Our protection customers remain the most positive with 89% stating good or very good.
- All business areas measured now achieve at least 70% of customers stating good or very good and no more than 7% stating poor or very poor.

Negatives

- Despite the pleasing improvement since 2013, we still have work to do to achieve the 80% score we believe is achievable across all business areas measured.
- 1 in 5 of our customers gave a "neither good nor poor" response to the overall quality of products and services question. We need to understand better and address the current barriers that prevent these customers from giving Friends Life a positive rating.

Definition

We conduct over 1,500 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 recovering the benefits of their policy.

	2014	2013
Colleague engagement (%)	**73**	67

Performance

Positives

- Group colleague engagement increased by another 6% during 2014 and is now 3% above ORC's Financial Services Index.
- 89% of colleagues surveyed took part, our best ever result.

Negatives

- The survey just preceded announcements about the Proposed Acquisition by Aviva. The Proposed Acquisition will create uncertainty for colleagues which could impact colleague engagement. However, the level of colleague engagement that preceded the announcements provides a strong cultural platform from which to take colleagues through the changes ahead.

Definition

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

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

	2014	2013
Women in senior management (%)	**28**	26

Performance

Positives

- Andy Briggs, Group Chief Executive, continues to sponsor the Group diversity agenda and related series of activities.
- Our programme includes supporting women as they progress into senior management roles. Over 100 women were enrolled onto our mentoring programme and more than 200 managers took part in diversity and inclusion training (including our Executive Committee).

Negatives

- Friends Life aspires to a greater balance and proportion of women in senior management. We have set ourselves an aspirational target (not a quota) of 33% by the end of 2017.

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 actual or perceived barriers to career progression, including into senior leadership roles.

	2014	2013
Equal opportunities (%)	**81**	73

Performance

Positives

- 81% of colleagues surveyed feel they have an equal opportunity for career progression and 89% feel Friends Life respects individual differences; pointing to an inclusive working culture and environment.

Negatives

- 11% of colleagues surveyed are neutral and 8% negative.

Definition

Percentage of colleagues who feel they have equal opportunity for development and career progression regardless of age, gender or cultural background.

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

	2014	2013
Community investment (£ million)	**1.9**	1.9

Performance

Positives

- 86% of colleagues feel that Friends Life is socially responsible (up 5 percentage points on 2013).
- Over £110,000 was raised with colleagues for Macmillan during 2014, towards our current challenge of £160,000 for Macmillan's information support services in the Bristol area, run in partnership with Citizens Advice Bureau.
- 750 days of colleague time was invested in local community projects.

Negatives

- There is still work to do to achieve greater levels of colleague engagement in our volunteering activities and this is being promoted as part of our Wellbeing Strategy.

Definition

Community investment refers to the total annual involvement from colleague volunteering, giving, fundraising, company matching and additional financial support via Community Foundation endowments, plus the manpower to manage our programmes.

Corporate governance report

Friends Life Group Limited is a Guernsey incorporated Company with a premium listing on the London Stock Exchange. The Company aims to maintain a high standard of corporate governance, and a sound structure for setting its strategy and objectives. A significant focus of the Board during the latter half of 2014 has been the Proposed Acquisition, which resulted in a number of additional meetings being held, as set out in the Board Attendance Chart. As a result, the internal Board evaluation that was scheduled to take place in the latter half of the year, consistent with the timing of the external effectiveness review that took place in 2013, was placed on hold pending the outcome of the Proposed Acquisition.

Compliance with the UK Corporate Governance Code

The Company has due to the reasons stated above, been unable to comply with principle B.6 of the 2012 UK Corporate Governance Code (the "Code"), which requires the Board to undertake a formal and rigorous annual evaluation of its performance, and the associated disclosure requirement set out in provision B.6.1. Should the Proposed Acquisition not go ahead, it is intended that an evaluation will be completed to ensure compliance with all Code requirements in 2015. During the year the Company complied with all other Principles and Provisions of the Code.

Guernsey Corporate Governance requirements

With the exception of Principle 2.7 requiring the Board to conduct regular performance evaluations of its members and the effectiveness of its actions, the Company complies fully with 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.

Board and Outlook

I am very proud of the way the Board and the Company have continued to progress during 2014 especially as the offer process relating to the Proposed Acquisition developed. Prior to this we had implemented all of the suggestions from last year's external board effectiveness review and developed a comprehensive succession plan to ensure a strong and effective Boardroom is maintained.

As referred to in my statement at the beginning of this Annual Report, I believe that the Proposed Acquisition is an excellent opportunity to accelerate the delivery of the Friends Life strategy and growth agenda and improve long term prospects for shareholders and policyholders of the enlarged group.

Sir Malcolm Williamson

Chairman, Friends Life Group Limited
4 March 2015

Corporate governance report

Partnership structure

The Company structure remains as set out in the 2013 Annual Report, a copy of which is available on the Company's website, www.friendslifegroup.com. Friends Life Holdings plc ("FLH") is held through a partnership, Resolution Holdco No. 1 LP. Resolution Holdco No. 1 LP has two partners: the Company as General Partner having invested 99.99% of the capital deployed in the partnership, and RCAP UK LP ("RCAP") as Limited Partner having invested the other 0.01% of the capital deployed.

The Company and RCAP are parties to a Limited Partnership Agreement ("LPA"), pursuant to which the Company is appointed to manage the Friends Life Group, as the assets of the partnership, 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 to, among other things, 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 their obligations under the LPA and 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 FLGL's discretion to manage the Friends Life Group.

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, setting the strategic goals for the Company and overseeing 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, and has to ensure it manages the company in line with the Limited Partnership Agreement. As above, 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.

The Board has in place a Corporate Governance Handbook which sets out clearly the operation of the Board, the responsibilities of the Chairman and the Group Chief Executive (which are separate and distinct), the role of the Senior Independent Director ("SID"), the role of the non-executive directors and the role of 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 the matters reserved for the Board 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). The Board monitors their performance and ability to execute the strategy agreed by the Board.

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's website.

Corporate governance report

Setting strategy

The Board sets the strategic direction for the Group. Each year there is an annual review of strategy held over two days ("away 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.

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 advisers. 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.

The Board also remains responsible for the Group's risk profile and for delivering growth within its risk appetite and in accordance with the Enterprise Risk Management ("ERM") framework.

Board composition

Director	Role
Sir Malcolm Williamson	Chairman of the Board and the Nomination Committee
David Allvey	Senior Independent Director and Chairman of the Risk and Compliance Committee
Andy Briggs	Group Chief Executive
Tim Tookey	Chief Financial Officer
Nick Lyons	Independent non-executive director and Chairman of the Remuneration Committee
Karl Sternberg	Independent non-executive director and Chairman of the Investment Oversight Committee
Tim Wade	Independent non-executive director and Chairman of the Audit Committee
Mel Carvill	Independent non-executive director
Peter Gibbs	Independent non-executive director
Marian Glen	Independent non-executive director
Roger Perkin	Independent non-executive director
Robin Phipps	Independent non-executive director
Belinda Richards	Independent non-executive director
Clive Cowdery	Non-executive director until 8 May 2014
John Tiner	Non-executive director until 8 May 2014

The Board composition for 2014 is set out above. Membership of Committees and each director's attendance at Board and Committee meetings is set out in the attendance chart overleaf.

The Board, having considered the matter carefully, is of the opinion that all of the non-executive directors in place at 31 December 2014 continue to remain independent and free from any relationship or circumstances that could affect, or appear to affect, their independent judgement. All non-executive directors' letters of appointment set out the expected time commitment for the role. A sample letter is available online at www.friendslifegroup.com. There have been no significant changes to the commitments of the Chairman during the year.

The Articles of Incorporation state that new directors appointed since the last AGM must seek re-election to the Board at the AGM. There were no new directors appointed to the Board during 2014.

Corporate governance report

Board attendance chart

Member	Role	Board	Audit	Remuneration	Risk and Compliance	Nomination	Investment Oversight
Sir Malcolm Williamson	Chairman	8 of 8	–	8 of 8	–	2 of 2	–
David Allvey	Senior Independent Director	8 of 8	5 of 5	8 of 8	7 of 7	2 of 2	–
Andy Briggs	Group Chief Executive	8 of 8	–	–	–	–	–
Tim Tookey	Chief Financial Officer	8 of 8	–	–	–	–	–
Mel Carvill	Independent non-executive director	7 of 8	–	–	7 of 7	2 of 2	–
Peter Gibbs	Independent non-executive director	8 of 8	–	–	–	–	4 of 4
Marian Glen	Independent non-executive director	8 of 8	–	7 of 8	–	–	–
Nick Lyons	Independent non-executive director	8 of 8	–	8 of 8	7 of 7	2 of 2	4 of 4
Roger Perkin	Independent non-executive director	8 of 8	5 of 5	–	–	–	–
Robin Phipps	Independent non-executive director	8 of 8	5 of 5	–	7 of 7	–	–
Belinda Richards	Independent non-executive director	7 of 8	–	–	6 of 7	2 of 2	–
Karl Sternberg	Independent non-executive director	8 of 8	5 of 5	–	–	–	4 of 4
Tim Wade	Independent non-executive director	8 of 8	5 of 5	–	7 of 7	–	–
Clive Cowdery[(i)]	Non-executive director	3 of 3	–	–	–	–	–
John Tiner[(i)]	Non-executive director	3 of 3	–	–	–	–	–

(i) John Tiner and Clive Cowdery resigned on 8 May 2014.

Additional Board and Committee meetings

The Board held a number of non-scheduled Board and Committee meetings during 2014. Three additional Board meetings were held to review strategy and seven related to the Proposed Acquisition. In addition, a Bid Committee was established which met five times during 2014 to review certain matters relating to the Proposed Acquisition on behalf of the Board. The majority of Board and Committee members attended all of these meetings.

The Remuneration Committee had several extra scheduled meetings during 2014 to ensure the successful design and implementation of new share schemes.

Conflicts of interests

The Company has 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.

Independent professional advice

Each Board member has access to independent advice at the Company's expense, to help them discharge their duties as directors. All expenditure during the year was made in accordance with the terms of non-executive directors' letters of appointment and was approved by the Chairman and reviewed by the Company Secretary.

Corporate governance report

Effectiveness

Nomination Committee report

Membership	Sir Malcolm Williamson(i) David Allvey Mel Carvill Nick Lyons Belinda Richards
Number of meetings	Two
Reporting	The Chairman formally reports to the Board in respect of the activities of the Nomination Committee.
Attendees by invitation	Group Chief Executive

(i) Chairman of the Committee.

Main activities during the year

During 2014, the Committee's main areas of focus are set out below.

- Development of a succession plan for the Board.
- Development of a succession plan for the Group Chief Executive.
- Review of the independence of directors.
- Review of the outputs of the Board performance evaluation that relate to the composition of the Board.

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.

Appointment process

The Committee has not recommended any new appointments to the Board during 2014. As part of the succession planning process described below, the Committee was considering new appointments to the Board and was in the process of reviewing a short list of candidates for appointment. This process was put on hold following the receipt of the initial offer from Aviva. 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. The process of appointment to the Board is rigorous, and the process followed during 2013 can be referred to as an example of the Committee's role in this process. This is set out in the Nomination Committee report in the 2013 Annual Report.

Succession planning

The Committee spent a great deal of time during 2014 developing a succession plan. This was considered a key priority because a number of current board members joined the business between 2008 and 2010 and would therefore be reaching their nine year tenure between 2017 and 2019. In order to put in place an effective succession plan, the Committee appointed Ridgeway Partners to work in partnership with the Company on an ongoing basis. The advantage of this approach would have been the ability of Ridgeway to start an early dialogue with a number of candidates that might be considered suitable for immediate or future appointment to the Company's Board.

The Committee also appointed Egon Zehnder to conduct a review of the external executive market and benchmarking of the Group Chief Executive role, to ensure a comprehensive executive succession plan was put in place. The Board considers that 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 has continued to review talent across the organisation. The Company has a preference for internal recruitment, and considers the development of people within an organisation to be important to strategy. The Committee has therefore continued to support the Management Development Programme, the second iteration of which has successfully taken place throughout the course of 2014.

The succession planning programme has been put on hold pending the outcome of the Proposed Acquisition.

Corporate governance report

Diversity

The gender diversity figure for the Board is 15.4%. The Board takes diversity very seriously and recognises that true diversity does not relate only to gender.

Consideration of diversity of background, culture and skills has been built into the succession planning process. All shortlists provided will reflect the need for and importance of diversity and the Company will continue to work only with executive search firms who have signed a voluntary code of conduct on gender diversity. The Board Diversity Policy acknowledges the importance of diversity and this will be referred to when looking to fit skills and gender with the strategic direction of the Company. Appointments to the Board will be made in accordance with identified objective criteria including diversity of skills, background, knowledge, international and industry experience, and gender amongst many other factors. Notwithstanding the foregoing, all Board appointments will always be made on merit as the Board continues to believe that the application of formal quotas is not appropriate.

The Board's commitment to diversity is reflected in the comprehensive diversity programme led by the Group Chief Executive and the Group Executive Committee, involving a cross-section of our employees.

Board effectiveness review

Each year the Board is required to carry out an evaluation of its own effectiveness as required by Principle B.6 of the Code. In 2013, the Board carried out an external effectiveness review, the results of which are reported in the 2013 Annual Report. During 2014 the Committee reviewed the outcomes of the 2013 review. Key achievements include the development of a succession planning process, the embedding of a new governance structure to support effective decision making at the life company level and the continued development of high quality information flows to the Board, supported by Board paper templates and author workshops - all of which supported strategic decision making at Board level.

During 2014, the Board reviewed the actions and outcomes from the external effectiveness review that took place during 2013, ensuring that all of the recommendations were adopted. However, it has not conducted an internal evaluation of its effectiveness this year. The process was due to take place from November 2014 but, due to the focus on the consideration of the Aviva offer and associated actions required from the Board and its Committees, is on hold pending the outcome of the Proposed Acquisition. If the Proposed Acquisition is not approved by shareholders, a formal evaluation of the Board's performance will be conducted internally in respect of performance during 2014 and the period to April 2015.

Sir Malcolm Williamson

Chairman of the Nomination Committee

Corporate governance report

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 sets out a description of the Company's strategy, business model and explanation of how it creates value for customers, shareholders, colleagues, and other stakeholders.

A statement of the directors' responsibility for preparing the Annual Report and Accounts is given after the directors' report, which contains the directors' going concern statement. Ernst & Young LLP's ("EY") audit report which contains its reporting responsibilities is contained within the financial statements.

Audit Committee and auditors

Following the Audit Committee's recommendation to the Board, EY were re-appointed as auditors at the AGM in 2014. Further detail on the activities of the Audit Committee is set out in their report which follows.

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 and risk management 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 and risk management;
- setting appropriate policies on risk management and 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 system of internal control and risk management 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 and risk management during 2014.

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 assessed the internal control environment within their respective areas of responsibility and completed written declarations on the status of those environments. 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 business owners with oversight from the Group Audit Committee.

The Board therefore believes that a sound system of internal control and risk management has been in place during 2014, 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 and adherence to the Group risk policies, including the Enterprise Risk Management Framework;
- embedding a risk conscious culture;
- setting risk strategy, with active monitoring of risk appetites;
- effective operation of Risk, Compliance and Internal Audit functions; and
- clearly defined senior management responsibilities and accountabilities.

Corporate governance report

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 4 March 2015.

Audit Committee report

Membership	Tim Wade[(i)(ii)] David Allvey[(ii)] Roger Perkin[(ii)] Karl Sternberg Robin Phipps
Number of meetings	Five
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, Actuarial Function Holder

(i) Chairman of the Committee.
(ii) Has recent and relevant financial experience.

Main activities during the year

The Committee has worked throughout the year to fulfil its objective to help 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 of 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 providing 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 the relationship with the external auditor, the auditor's effectiveness, ensuring the auditor's independence and monitoring non-audit fees.
- Ownership of the Whistleblowing Policy.

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, oversee the adequacy of the Group's financial controls and systems of risk management and monitor 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 Board is satisfied that as qualified accountants and Chairmen of external audit committees, Tim Wade, David Allvey and Roger Perkin have recent and relevant financial experience.

The Committee met five times in 2014. The Committee also 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 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.

Corporate governance report

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 advisers.

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 2014 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.

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 the 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 2014 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 the Actuarial Function Holder 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, along with market benchmarking and external review where appropriate.

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 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 quarterly reports on the financial control environment.

In 2014 the Finance function continued its programme of enhancing financial reporting controls which the Committee monitored against the Group's financial misstatement risk appetite. A broad range of improvements to existing models and processes were identified and implemented and consequently the control environment has been improved.

The Risk and Compliance Committee oversees the risk controls within the Group and provides assurance to the Committee in this regard twice a year.

Corporate governance report

Outsourcing

The Company places reliance on a number of major outsourcing relationships. The Audit Committee receives regular internal audit reports which cover outsourcing performance and arrangements and, in addition to this, during 2014 the Company's sourcing governance framework and the Company's continued compliance with its regulatory requirements were reviewed by both the Committee and the Risk and Compliance Committee. The management team has therefore been actively challenged to ensure that appropriate control environments are maintained.

Subsidiary Audit Committees

Sesame Bankhall Group and Friends Provident International each have an audit and risk committee. 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.

EY were appointed in 2008, and this is their seventh year of tenure. Following a rotation of Audit Partners after the 2012 audit, the current Audit Partner is in his second year. 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. Following the review of the auditor's effectiveness during the 2013 reporting period, the Committee has confirmed that EY have continued to perform satisfactorily.

Objectivity and independence

The Committee regularly reviews the independence of EY in accordance with the Group's External Auditor Policy. The policy follows the guidance issued by the Auditing Practices 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 of non-audit services, 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 2014 fees paid to EY for audit and audit-related assurance services, including MCEV, were £4.8 million and fees paid to EY for other services were £1.2 million, further details of which are set out in note 7 to the IFRS financial statements.

Audit Tender

Having reviewed the Order in relation to Statutory Audit Services published by the Competition and Markets Authority and the Code requirement to tender the external audit contract every 10 years, the Committee considered the subject of audit tender during 2014. Further consideration of audit tender is on hold, and will recommence should the Proposed Acquisition not complete.

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 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 2014 were the management of outsourcing arrangements, delivery of key projects, information technology and security, customer services and operations, conduct, capital management, risk management (including the Company's Enterprise Risk Management Framework) and financial reporting. Where control improvement actions are agreed, the Committee regularly monitors management's remediation performance.

Corporate governance report

The Committee has approved the internal audit plan and budget for 2015, and is satisfied that internal audit has access to appropriate resources to undertake its role. The Committee has also overseen the development of Internal Audit in line with the recent CIIA Code.

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.

Tim Wade

Chairman of the Audit Committee

Corporate governance report

Risk and Compliance Committee report

Membership	David Allvey[(i)] Mel Carvill Nick Lyons Robin Phipps Belinda Richards Tim Wade
Number of meetings	Seven
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, Group Chief Actuary.

(i) 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.

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 system of internal control 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.
- Advising the Board on proposed strategic transactions including acquisitions or disposals, ensuring that a due diligence appraisal of the proposition is undertaken, focussing in particular on risk aspects and implications for the risk appetite and tolerance of the Group.
- Providing risk-focused advice to the Remuneration Committee in respect of risk weightings to be applied to executive performance objectives.

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; advising the Board on proposed strategic transactions including acquisitions and disposals; evaluating the effectiveness of risk assessment processes and internal control systems; and reviewing the Group's risk and compliance policies. Solvency II compliance and risk-based performance measures are high on the agenda for the Committee, and the Committee has therefore placed particular focus on ensuring that the Company is in a position to comply with its obligations under the new legislation.

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 – this structure was implemented 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 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 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 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.

Setting of risk appetite and risk strategy

The Committee recommends to the Board the Group's overall risk appetite, which is assessed and challenged throughout the year. The Group's preferences for risk (i.e. 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 that the Group stays within its risk appetite.

During 2014 exposure against 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 Pillar 2 Solvency, Dividend and Returns.

Review of top risks

The Committee maintains regular oversight of the Group's top risks, with changes to them being 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 tolerance, the Committee tracks progress made in bringing them back in to risk appetite, as part of its duty to manage the Group's overall risk profile. The Committee may request that spotlight papers are brought back to meetings if it feels that it would benefit from more granular information. In 2014 the Committee received briefings on topics including the fair treatment of internally vesting pensions customers, conduct risk and details of several significant IT security risk scenarios.

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 CSA which reviews the soundness of the internal control environment. The conclusions from the full-year and half-year CSA were reviewed by the Committee in March and July respectively and recommended for onward approval by the Audit Committee.

Embedding 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 it has received quarterly updates on progress in embedding the ERM framework within day to day business practices and planning across the organisation.

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 and has reviewed assurance activity undertaken by the Compliance Monitoring team to ensure that business areas are responding appropriately to the conduct risk environment.

Oversight of internal modelling and stress and scenario testing

During 2014 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 into the Group's Medium Term Plan.

Corporate governance report

Solvency II and ORSA development

Over 2014, the Committee has received an update at every meeting on risks to the Group's progress towards compliance with the Solvency II directive, and has challenged management on the delivery of the programme.

The Solvency II directive requires the Group to have written policies and standards in place, and the Group Policy Framework and associated control standards, processes, procedures and methodologies are being reviewed to support the implementation of the required changes arising from the detailed Solvency II legislation. Updated documentation is being presented to the appropriate governance forums in tranches, and the Committee plays a key role in overseeing and reviewing changes to the Group Policy Framework and recommending them to the Board, and in approving control standards.

The Committee also continues to support 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 into business decision-making.

Review of the Company's Proposed Acquisition by Aviva plc

The Committee received reports from both the Chief Risk Officer and external counsel on risks associated with the Proposed Acquisition of the Company by Aviva plc. The Committee debated the risks highlighted and confirmed its support for the transaction to proceed to the Board.

David Allvey

Chairman of the Risk and Compliance Committee

Corporate governance report

Relations with shareholders

Institutional shareholders have regular access to the GCE and CFO, as well as the CEOs of our Heritage, UK & International divisions. The Chairman, SID and other non-executive directors are also available to meet major shareholders and did so on 19 occasions during the year in relation to regular business and as part of the Proposed Acquisition process. 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. The corporate brokers have also been key to the consideration of the Proposed Acquisition. 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 an electronic resource library to which they have access.

Proposed Acquisition – Court Meeting and General Meeting

All shareholders are invited to attend the shareholder meetings which will be held on 26 March 2015 at Glaziers Hall, 9 Montague Close, London, SE1 9DD.

The Court Meeting will be held at 2.00pm. This is a meeting of Friends Life shareholders which has been convened by the Court for shareholders to consider, and if thought fit, approve the Scheme. The General Meeting will take place at 2.15pm at the same venue. It will be the second meeting of Friends Life shareholders which has been convened for the purposes of implementing the Proposed Acquisition.

Voting will be conducted at the meetings via a poll. Forms of proxy and voting cards have been issued to all shareholders. We will publish the results of the meetings on the Company's website at www.friendslifegroup.com and announce them to the London Stock Exchange at the earliest possible opportunity.

If the Proposed Acquisition goes ahead, the Company will be wholly owned; therefore no Annual General Meeting has currently been scheduled for 2015. This position will be revisited if the Proposed Acquisition does not complete.

Directors’ remuneration report

Chairman’s introduction to the remuneration report

I am pleased to present the Remuneration Report for 2014.

As set out earlier in this report, the Boards of the Company and Aviva announced that they had reached an agreement on the terms of a recommended all-share acquisition of the Company by Aviva on 2 December 2014. If the Proposed Acquisition completes, the Company will be wholly owned by Aviva and there will not be a 2015 AGM of the Company or a shareholder vote on the 2014 Remuneration Report. However, the Committee has at all times continued to operate within the spirit of the Remuneration Policy that was approved by shareholders in 2014.

During 2014, the Company continued to execute its core strategy and the Committee operated the remuneration arrangements detailed in last year’s report. No adjustments were made to remuneration arrangements for executive directors set out in the Remuneration Policy to reflect the potential impact of regulatory developments or the Proposed Acquisition, except in relation to pay-outs under the Annual Bonus Plan being paid wholly in cash rather than one third deferred into shares. Further details are set out below. However, the sale of Lombard did require adjustments to be made to the targets. These were changed by the Committee without making them more or less difficult to achieve.

For 2015, the Committee concluded that it would not be appropriate to award either executive director a salary increase or make the normally anticipated annual award under the Company’s Performance Share Plan, due to the Proposed Acquisition. The Committee also considered and confirmed the impact of the Proposed Acquisition on outstanding incentives and the treatment of these arrangements is set out in this report.

2014 Arrangements

As reported last year, the Group Chief Executive received a salary increase from 1 April 2014 to £691,875 while the Group CFO received no increase.

Despite 2014 being a year of unprecedented change for both the UK Life and Pensions industry and Friends Life itself, the business has had a successful year and substantially achieved the targets it set with the only adjustment being to remove the target contribution of Lombard following its sale.

The balanced scorecard for the Annual Bonus Plan sets out the measures by which the achievement of key financial goals and management of expenses is assessed, together with metrics relating to Customers, Colleagues and Individual KPIs. Strong delivery of Group results, in particular of cash represented by SFS of £373 million, IRR of 16.7% and MCEV Operating profit of £498 million has driven a bonus out-turn that is around 85% of the maximum. The Committee considered the various risk gateway factors and concluded that the formulaic out-turn should prevail without adjustment. The deferred element of the annual bonus in respect of performance in 2014 will not be deferred into shares under the Deferred Share Award Plan due to the automatic vesting of these shares on the Scheme Effective date, should the Proposed Acquisition complete. Instead, pay-outs under the Annual Bonus Plan will be made in cash, with one third of the amount being deferred until 28 April 2015.

The Friends Life Group plc Long Term Incentive Plan (“FLG LTIP”) arrangement was subject to measurement in three annual tranches commencing in June 2014. The first tranche which was measured in June 2014 did not result in any payments being made.

Remuneration in 2015

Assuming that the Proposed Acquisition completes to the current timetable, no executive director will receive a salary increase from the Committee. The Committee considered how best to operate the Company’s incentive arrangements for 2015 and concluded that:

- The 2015 Annual Bonus Plan should operate on the same basis as for 2014 with the bonus year ending on completion of the Proposed Acquisition, with the current Committee determining the appropriate level of bonuses at that date. The Committee has approved full-year targets and a range of personal objectives against which performance will be assessed. Bonus pay-outs will be pro-rated to completion and payable in cash due to any deferred portion vesting on completion of the Proposed Acquisition. The pro-rated 2015 annual bonus will be paid in full on 28 April 2015.
- It is envisaged that Aviva will operate its own bonus arrangements for the remainder of 2015.
- No 2015 Friends Life Group Limited Performance Share Plan (“PSP”) award will be granted as it was felt more appropriate for Aviva to make equivalent awards under its own arrangements.

Directors' remuneration report

The effect of the Proposed Acquisition on share-based incentive plans has been summarised in the Scheme of Arrangement ("Scheme") document dated 19 January 2015 which highlights that:

- Outstanding awards under the Performance Share Plan and the Friends Life Group Limited Restricted Share Plan will vest when the Guernsey Court sanctions the Scheme. Both plans are subject to time pro-rating and performance conditions;
- Outstanding awards under the Resolution Limited Deferred Share Award Plan 2013 (the plan through which part of annual bonuses are deferred into shares) will vest in full on the sanction of the Scheme by the Guernsey Court;
- Shares held under the Friends Life Share Incentive Plans will remain within the plans. Following the Effective Date of the Scheme, the Friends Life Share Incentive Plans will close to new contributions and they will be administered by Aviva until all shares have been transferred to participants; and
- Units under the Friends Life Group plc Long Term Incentive Plan will crystallise on the Effective Date of the Scheme, subject to satisfaction of the internal rate of return threshold. Distribution amounts will be calculated in accordance with Plan rules and payments will be subject to time pro-rating. Payments will be made in cash in two instalments on or around 1 September 2015 and 1 September 2016, subject to certain conditions being met, generally relating to continued employment to the first of those dates.

Should the Proposed Acquisition complete, this will be my last Remuneration Report as Chairman of the Committee and I would like to take this opportunity to thank my colleagues on the Committee for their continued hard work throughout the year.

Nick Lyons

Chairman of the Remuneration Committee
4 March 2015

Directors' remuneration report

Remuneration Report

Introduction

We have presented this Remuneration Report to reflect the reporting requirements on remuneration matters for companies with a UK governance profile, particularly the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (the "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. Although the Company seeks to comply with all aspects of the Regulations, it is not technically required to do so due to it being a company incorporated outside the UK. The information contained in this Implementation Report (or annual report on remuneration as described in the Regulations) has, where indicated, been audited.

Directors' Remuneration Policy

The Directors' Remuneration Policy was approved by the Company's shareholders at the Company's AGM on 8 May 2014 and is available for inspection via the Corporate Governance section of the Company's website at: www.friendslifegroup.com

Executive directors

The following sections apply to executive directors only. Data relating to non-executive directors and past directors can be found towards the end of the Implementation Report.

Single Figure Remuneration

The tables below show for each person who was an executive director of the Company during 2014, a breakdown of the remuneration received in 2014 and 2013, together with details of total remuneration for the relevant year. No executive directors resigned their directorship during 2013 or 2014.

Audited							**2014**
Executive directors £000s	**Salary and Fees(i)**	**All Taxable Benefits(ii) (gross)**	**Annual Bonus(iii)**	**Pension related benefits(iv)**	**FLG LTIP(v)**	**Other**	**Total**
Andy Briggs	**688**	**39**	**965**	**138**	**–**	**–**	**1,830**
Tim Tookey	**650**	**19**	**840**	**130**	**–**	**–**	**1,639**

							2013
Executive directors £000s	Salary and Fees	All Taxable Benefits(ii) (gross)	Annual Bonus(iii)	Pension related benefits(iv)	FLG LTIP	Other	Total
Andy Briggs	656	37	803	131	–	–	1,627
Tim Tookey	650	19	725	130	–	–	1,524

(i) Andy Briggs' salary for 2014 is calculated as three months' salary at £675,000 p.a. plus nine months' salary at £691,875 p.a.
(ii) "Taxable Benefits" includes: car allowance, chauffeur expenses (for Andy Briggs only), and medical insurance.
(iii) The Annual Bonus figure is the bonus earned in respect of that financial year. For 2013, two-thirds of this amount was paid in cash, and one third paid under the Deferred Share Award Plan ("DSAP") in the form of shares the transfer of which is deferred for three years. For 2014, the bonus will be payable wholly in cash with one third deferred until 28 April 2015 when the Proposed Acquisition completes. Further details of the performance measures and weightings for the 2014 Annual Bonus Plan can be found overleaf. Further information on the DSAP can be found in the Share Schemes section of the Implementation Report.
(iv) 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).
(v) The first potential payout under the FLG LTIP was calculated as at 30 June 2014, and this resulted in no payment.

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 a cash value (£411,213) in 2012 and a total of 568,501 shares released in three tranches in 2012, 2013 and 2014. The final tranche of 331,348 shares was released on 25 March 2014 when the share price was £3.20.

Each of Andy Briggs and Tim Tookey has 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 for 2014 is £3.5 million (2013: £3.2 million). The 2013 figure includes emoluments paid in respect of both the Company and Friends Life Holdings plc. Single Figure Remuneration for the non-executive directors is set out towards the end of this report.

Directors' remuneration report

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 set out in the Remuneration Policy). They are not entitled to any pension benefits if they take early retirement.

Variable Pay

Annual Bonus 2014

At a glance

Annual Bonus Plan 2014:

Group Chief Executive

Amount paid out in respect of 2014 = £964,933

Amount paid was 84.5% of maximum opportunity

Chief Financial Officer

Amount paid out in respect of 2014 = £840,369

Amount paid was 86% of maximum opportunity

The performance criteria for the 2014 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

		Performance Criteria Target ranges for Metrics				
Metrics	**Weightings**	**Threshold**	**Target**	**Maximum**	**Achieved**	**Achieved %**
Financial						
Cash	20.00%	£290.7m	£306.0m	£336.6m	£373.3m	100.00%
IRR	15.00%	13.20%	14.30%	16.40%	16.70%	100.00%
MCEV operating profit	15.00%	£447.9m	£484.2m	£556.8m	£504.2m[(i)]	63.79%
Expense	10.00%	£472.5m	£461.0m	£438.0m	£453.5m	66.23%
Non Financial						
Customer	10.00%					50.00%
Colleague engagement GCE	10.00%	66.00%	69.00%	75.00%	73.00%	83.34%
Colleague engagement CFO	10.00%	64.00%	67.00%	73.00%	73.00%	100.00%
Individual	20.00%					100.00%
Total GCE	100.00%					84.50%
Total CFO	100.00%					86.00%

(i) The scorecards and the bonus calculations exclude Sesame from both target and actual. This results in a small difference in the Group MCEV performance outcome.
(ii) Colleague engagement targets differ by department for each of the GCE and the CFO.

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.

Based on the above, Andy Briggs received an Annual Bonus of £964,933 and Tim Tookey received an Annual Bonus of £840,369 in respect of the 2014 financial year.

Directors' remuneration report

Share Schemes

Deferred Share Award Plan

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(i)	Share price used to determine award	Value of Award at Grant	Opening balance 1 January 2014	Shares awarded during the year	Vested during 2014	Lapsed during 2014	Closing balance 31 December 2014	Vesting date
Andy Briggs	2011	3-Apr-12	£2.6384(ii)	£117,747	44,628	–	–	–	44,628	31-Dec-14(iii)
	2012	24-May-13	£2.9596(ii)	£159,338	53,837	–	–	–	53,837	4-Apr-16
	2013	7-Apr-14	£3.0475(iv)	£267,754	–	87,860	–	–	87,860	28-Mar-17
Total					**98,465**	**87,860**	**–**	**–**	**186,325**	
Tim Tookey	2012	24-May-13	£2.9596(ii)	£123,521	41,735	–	–	–	41,735	4-Apr-16
	2013	7-Apr-14	£3.0475(iv)	£241,667	–	79,300	–	–	79,300	28-Mar-17
Total					**41,735**	**79,300**	**–**	**–**	**121,035**	

(i) 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.
(ii) Being the average share price over the five business days preceding the date of the award.
(iii) The vesting conditions have been met in respect of this award, but the shares have not been released due to Model Code requirements.
(iv) Being the average share price over the five business days commencing on 21 March 2014, less the amount of the declared final dividend for 2013 of 14.09 pence.

Friends Life Group plc Long Term Incentive Plan ("FLG LTIP")

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 Resolution 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%).

The first tranche was measured as at the end of June 2014 with no vesting achieved. The remaining two tranches will be measured on completion of the Proposed Acquisition.

Directors' remuneration report

Executive directors' interests in the FLG LTIP are set out below:

Audited

Director	Total units at 1 January 2014	Units awarded during the year	Units lapsed or released during the year	Total units at 31 December 2014	Following impact of time pro-rating
Andy Briggs	1,500	–	500	1,000	750.71
Tim Tookey	1,200	–	400	800	503.29

The last column in the table above assumes that each executive remains employed and not under notice to 1 September 2015 so is the highest potential number of pro-rated units remaining.

Friends Life Group Limited Performance Share Plan ("PSP")

Interests in PSP

Audited

Director	Financial year to which award relates	Date of award	Share price used to determine award(i)	Value of Award at Grant	Opening balance 1 January 2014	Shares awarded during the year	Vested during 2014	Lapsed during 2014	Closing balance 31 December 2014	Vesting dates
Andy Briggs	2014	16-May-14	£3.0172	£1,383,748	–	458,620	–	–	458,620	16-May-17 16-May-18
Tim Tookey	2014	16-May-14	£3.0172	£1,137,499	–	377,005	–	–	377,005	16-May-17 16-May-18

(i) Being the average share price over the five business days preceding the date of award.

Generally the awards would be measured after 3 years and vest as to 50% at that time (once the Committee has determined that performance conditions have been met) and as to the other 50% one year later. The measures are summarised below. As explained in the Remuneration Committee Chairman's statement at the start of the Remuneration Report, performance will be assessed by the Committee on completion of the Proposed Acquisition with the awards vesting at that time subject to a time pro-rated vesting.

PSP 2014 measures and weightings

The PSP 2014 measures and weightings are shown below.

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	£7.5 billion which was adjusted to £6.83 billion on the sale of Lombard	£1.1 billion which was adjusted to £1.032 billion on the sale of Lombard
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	£7.15 billion which was adjusted to £6.48 billion on the sale of Lombard	£900 million which was adjusted to £832 million on the sale of Lombard

For each metric, there will be nil vesting of the relevant part of the award for performance beneath the threshold vesting level shown above. The above adjustments reflect the sale of Lombard and do not make the targets easier or harder to achieve.

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.

Directors' remuneration report

Total Shareholder Return ("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.

Embedded Value ("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).

Free Surplus Generation ("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.

Share Incentive Plan ("SIP")

The SIP is an HMRC approved SIP, under which the Company operates Partnership Shares and Dividend Shares. Partnership Shares are purchased out of pre-tax salary and participants may purchase up to the statutory limit as may be imposed by HMRC from time to time. A full explanation of how the SIP works can be found in the Remuneration Policy, available online.

The table below sets out executive directors' participation in the SIP during 2014:

Audited

Director	SIP Participation during 2014
Andy Briggs	£125 per month

For information on executive directors' interests in SIP shares, please see the Statement of Directors' Shareholdings set out in this Implementation Report.

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 2014 to satisfy share scheme obligations, and currently there are no plans to change the Company's approach during 2015.

Directors' remuneration report

Non-executive directors

Single Figure Remuneration

The table below shows for each person who was a non-executive director of the Company during 2014, a breakdown of the remuneration they received in 2014 and 2013, together with their total remuneration for the relevant year.

Audited

			2014			2013
£000s	**Fees**	**Other**	**Total**	Fees	Other	Total
Non-executive directors						
David Allvey	**179**	**–**	**179**	165	–	165
Mel Carvill	**123**	**–**	**123**	106	–	106
Peter Gibbs	**128**	**–**	**128**	111	–	111
Marian Glen(i)	**108**	**–**	**108**	22	–	22
Nick Lyons	**138**	**–**	**138**	136	–	136
Roger Perkin(ii)	**93**	**–**	**93**	58	–	58
Robin Phipps	**153**	**–**	**153**	139	–	139
Belinda Richards	**118**	**–**	**118**	99	–	99
Karl Sternberg	**123**	**–**	**123**	114	–	114
Tim Wade	**133**	**–**	**133**	129	–	129
Sir Malcolm Williamson	**360**	**–**	**360**	338	–	338
Total	**1,656**	**–**	**1,656**	1,417	–	1,417
Past non-executive directors						
Clive Cowdery(iii)	**30**	**–**	**30**	51	–	51
John Tiner(iii)	**30**	**–**	**30**	51	–	51
Total	**60**	**–**	**60**	102	–	102

(i) Marian Glen was appointed as a director of the Company on 10 October 2013.
(ii) Roger Perkin was appointed as a director of the Company on 16 May 2013.
(iii) Clive Cowdery and John Tiner stood down as directors at the AGM on 8 May 2014.

Directors' remuneration report

Non-executive directors

Current fees

Fee levels remain unchanged from the previous year. 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
Committee Membership[(i)]	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

(i) Certain directors hold non-executive positions on subsidiary boards and committees of subsidiary boards. The fees for these positions range from £25,000 to £35,000 dependant on the time commitment required.

Payments for loss of office

No payments for loss of office were made in 2014.

Payments to past directors

Following the governance simplification that took place 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. The consultancy fee was £5,000 per annum. The consultancy services provided included 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. This arrangement was not extended beyond March 2014.

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 Friends Life Group Limited shares as at 31 December 2014. 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 2014

Audited	Shares held beneficially	SIP shares held in Trust	Total shares held	Shareholding requirement as percentage of salary	Shareholding as a percentage of salary[(i)]
Andy Briggs	400,009	1,096	401,105	300%	212%
Tim Tookey	339,134	–	339,134	250%	191%

(i) Based on the share price of £3.662 at 31 December 2014

Directors' remuneration report

The table below shows the interests held in unvested and unreleased shares as at 31 December 2014. 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	Deferred share award plan – vests December 2014[(i)]	Deferred share award plan – vests April 2016[(ii)]	Deferred share award plan – vests 28 March 2017	Performance Share Plan – vests 50% on 16 May 2017 and 50% on 16 May 2018
Andy Briggs	44,628	53,837	87,860	458,620
Tim Tookey	–	41,735	79,300	377,005

(i) The DSAP share award vesting conditions have been met but have not been released due to Model Code restrictions.
(ii) For further information on the DSAP share awards, please refer to the Share Schemes section of the Implementation Report .

The table below shows the interests the non-executive directors have in Friends Life Group Limited shares:

Audited	Interest in Shares at 1 January 2014 or date of joining if later	Interest in Shares at 31 December 2014 or date of leaving if earlier
Non-executive directors		
David Allvey	–	–
Mel Carvill	62,400	62,400
Peter Gibbs	–	–
Marian Glen	–	–
Nick Lyons	30,000	30,000
Roger Perkin	–	–
Robin Phipps	2,100	2,100
Belinda Richards	–	–
Karl Sternberg	–	–
Tim Wade	40,000	40,000
Sir Malcolm Williamson	55,975	55,975
Past non-executive directors		
Clive Cowdery[(i)]	8,487,184	9,687,184
John Tiner[(i)]	2,829	2,829

(i) Clive Cowdery and John Tiner stood down as directors at the AGM on 8 May 2014.

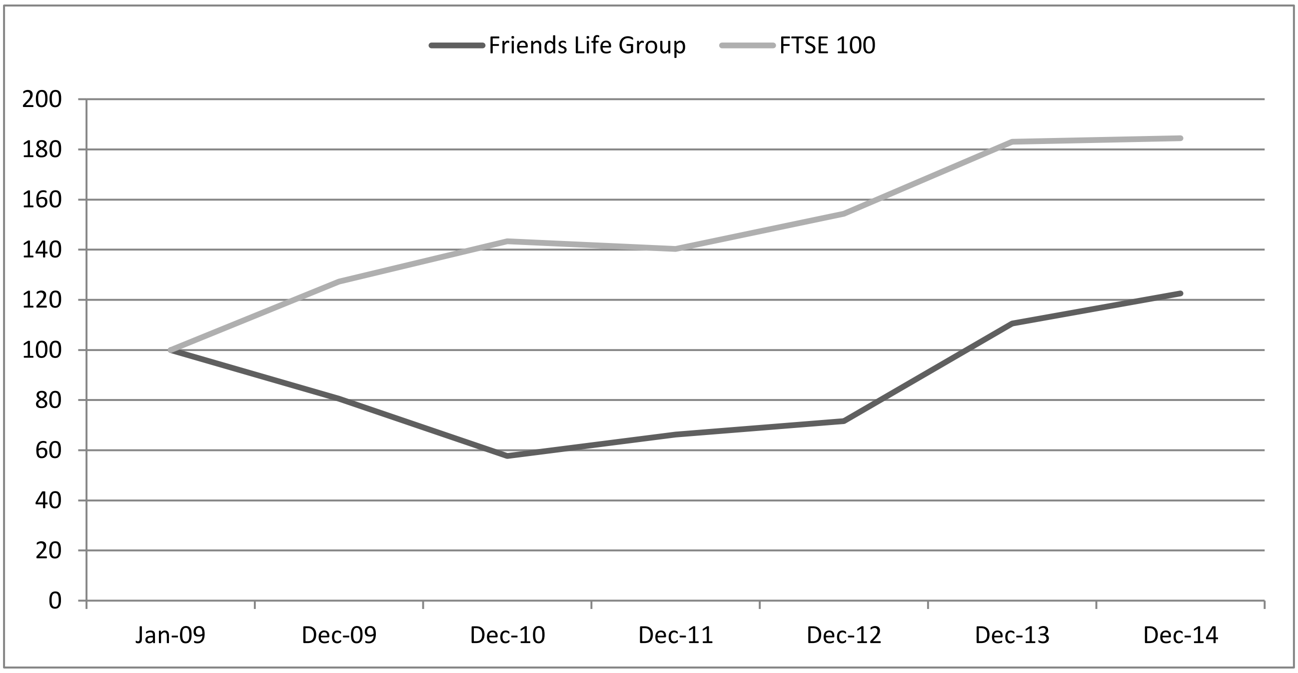
Executive directors' external appointments

During 2014, Andy Briggs (GCE) has continued to hold external positions as a member of the Board of the Association of British Insurers and the NSPCC fundraising committee. Tim Tookey (CFO) remains a member of the Development Strategy Board of the Zoological Society of London. No remuneration is receivable for any of these roles.

Directors' remuneration report

Performance graph

Throughout 2014 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 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 2014. 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.



Historic GCE remuneration outcomes

The Regulations require the Company to show a six 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 the Company before the governance changes on 28 March 2013, it is considered most appropriate to report the total remuneration for the GCE of Friends Life Holdings plc or Friends Provident Group plc as it was previously.

		2009	2010	2011	2012	2013	**2014**
GCE Single Figure Remuneration £000s	Andy Briggs	–	–	2,860	1,234	1,627	**1,830**
	Trevor Matthews	1,313	1,505	859	–	–	**–**
Annual bonus actual against maximum	Andy Briggs	–	–	57.3%	45.5%	73.1%	**84.5%**
	Trevor Matthews	50.8%	71.2%	0%	–	–	**–**
FLG LTIP vesting actual against maximum	Andy Briggs	n/a	n/a	n/a	n/a	n/a	**n/a**
	Trevor Matthews	n/a	n/a	n/a	n/a	n/a	**n/a**

Andy Briggs was appointed GCE of FLH 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.

Directors' remuneration report

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 2013 remuneration to 2014 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	4.79%	3.35%
Annual bonus(i)	20.13%	10.23%
Benefits	6.13%	(3.14)%(ii)
Total	13.06%	4.19%

(i) Including both the cash and deferred share elements.
(ii) This reduction reflects new employees being recruited on different contractual terms than former employees (e.g. lower car allowances and less expensive private medical insurance).

Relative spend on pay

The table below shows how Sustainable Free Surplus ("SFS") has been allocated between staff, shareholders and investment in new business.

The 'distributions to shareholders' figure represents dividends and shares issued in lieu of dividends, in addition to the total market value of shares purchased during the share buyback which took place during 2014.

The Committee considers it appropriate to show how spend on employee remuneration and distributions to shareholders compares with 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.

	All employees £m	Distributions to shareholders £m	Sustainable free surplus £m	Investment in new business £m
2014	**212**	**330**	**373**	**169**
2013	**200(i)**	**300**	**331**	**189(i)**
Difference	**12**	**30**	**48**	**(20)**

(i) Restated to reflect the sale of Lombard.

Directors’ remuneration report

Remuneration Committee overview

Committee membership

The Committee comprised the following non-executive directors of the Company during the year:

Membership	Nick Lyons[(i)] Sir Malcolm Williamson[(ii)] David Allvey Marian Glen
Number of meetings	Eight (plus three non-scheduled meetings)
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, Chief Operating Officer, Director of Performance and Reward,

(i) Chairman of the Committee.
(ii) Sir Malcolm was considered independent upon his appointment as Chairman of Friends Life Group 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 its terms of reference, which are reviewed annually and the Board is required formally to 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 the individual exceeds 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 FLG 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 has sought to comply with its guidance for 2014 and will continue to do so in future.

The Committee has been kept abreast of developments in regulations and market practice generally and specifically any new regulations flowing from Solvency II.

Advisers to the Committee

During 2014 the Committee received advice from the following:

Employees

Chief Operating Officer
Group Chief Executive
Director of Performance and Reward
Company Secretary
Chief Risk Officer

Directors' remuneration report

External, independent professional advisers

The Committee has received advice from the following independent professional advisers during the year:

- FIT Remuneration Consultants Limited – provision of general advice to the Committee; and
- Clifford Chance LLP – providing advice on share plan rules.

The Committee remains satisfied that FIT continued to provide good, independent and objective advice during 2014. FIT charges on its standard terms and its fee for providing advice in 2014 was £179,900 (2013: £185,300). 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.

Having made the appropriate enquiries, the Committee is satisfied that the advice received from Clifford Chance LLP was objective and independent.

Statement of voting at the Annual General Meeting

The Company's last Annual General Meeting was held in London on 8 May 2014. All resolutions put to the meeting were duly passed on a poll.

The voting at that AGM, insofar as it related to remuneration matters, was as follows:

Resolution	Number of votes for(i)	% of votes cast for	Number of votes against	% of votes cast against	Total number of votes cast	% of issued share capital	Votes withheld(ii)	% of issued share capital(iii)
Approval of Remuneration Report 2013	1,062,894,134	98.1	20,847,311	1.9	1,083,741,445	76.4	4,545,412	0.32
Approval of Remuneration Policy	1,049,780,614	96.9	33,654,159	3.1	1,083,434,773	76.4	4,853,268	0.34
Authority to establish the Resolution Limited Performance Share Plan, and to establish similar share plans outside the UK	1,016,729,589	96.2	39,753,962	3.8	1,056,483,551	74.5	31,803,674	2.24

(i) The "For" vote includes discretionary votes received.
(ii) A vote "Withheld" is not a vote in law and is not counted towards the proportion of votes "For" or "Against" a resolution.
(iii) Issued share capital at the date of the 2014 AGM was 1,418,109,028.

Directors' remuneration report

Looking ahead to 2015

Base salary

The executive directors' base salaries remain unchanged at:

Andy Briggs, GCE	£691,875 p.a.
Tim Tookey, CFO	£650,000 p.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 or 2015.

Annual bonus 2015 measures and weightings

The performance criteria for the executive directors' 2015 annual bonus will be based on a balanced scorecard approach using similar measures to the 2014 plan with the bonus year pro-rating to completion of the Proposed Acquisition.

PSP 2015

There will be no PSP awards made in 2015. The plan rules had been amended, prior to the approach from Aviva, to provide for the inclusion of a holding period on any new awards.

Share Incentive Plan

Should the Proposed Acquisition complete, the SIP will close to new contributions and will be administered by Aviva until all shares have been transferred to participants.

On behalf of the Board

Nick Lyons

Chairman of the Remuneration Committee
4 March 2015

Directors' report

The directors present their report together with the Corporate Governance Statement and financial statements of the Company and its subsidiaries for the year ended 31 December 2014. 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 is resident in the UK for tax purposes.

Proposed Acquisition by Aviva

On 2 December 2014 the Boards of the Company and Aviva plc ("Aviva") announced they had reached agreement on the terms of a recommended all share acquisition of the Company by Aviva (the "Proposed Acquisition"). The Proposed Acquisition must be approved by the Company's shareholders, Aviva's shareholders and the Guernsey Court. Subject to approval, the Proposed Acquisition will be completed by way of a Scheme of Arrangement (the "Scheme") in accordance with Guernsey company law. The Scheme will require shareholder approval at a meeting convened by order of the Guernsey Court (the "Court meeting") and at an extraordinary general meeting of the Company (the "General Meeting"). The Court Meeting will be held at 2.00 p.m. on 26 March 2015 at Glaziers Hall, 9 Montague Close, London SE1 9DD. The General Meeting will be held at the same venue at 2.15 p.m. on 26 March 2015 (or as soon thereafter as the Court Meeting has concluded or been adjourned). Notices of the Court Meeting and General Meeting, forms of proxy and voting cards were sent to shareholders on 19 January 2015 and documents relating to the Proposed Acquisition are available on the Company's website at www.friendslifegroup.com.

If the Proposed Acquisition goes ahead, the Company will be wholly owned; therefore no Annual General Meeting has currently been scheduled for 2015. This position will be revisited if the Proposed Acquisition does not complete.

Results and dividends

The financial statements show a loss for the year ended 31 December 2014 of £138 million. Further information can be found in the financial statements.

An interim dividend of 7.05p per share was paid on 6 October 2014. If the Proposed Acquisition by Aviva completes, in addition to the 0.74 new Aviva shares that shareholders will receive for each share they own, a second interim dividend of 24.1 pence will be paid, which results in a full year dividend of 31.15 pence. The second interim dividend includes a 10 pence enhancement to the 2013 final dividend. If the Proposed Acquisition does not complete, it is expected that the 2014 final dividend and therefore the 2014 full year dividend would be in line with the Company's 2013 final dividend and full year dividend respectively. For the first interim dividend, the Company operated a Dividend Reinvestment Plan ("DRIP") which allowed shareholders to purchase further shares in the Company with their dividend. Under the terms of the Scheme, the DRIP will not be applicable to the second interim dividend, should the Proposed Acquisition complete.

The Employee Benefit Trust waived its rights to any dividend during 2014.

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.

Change of name

At the Company's 2014 AGM, a special resolution was passed by shareholders authorising the change of the Company's name from Resolution Limited to Friends Life Group Limited.

Directors' report

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 4 March 2015, 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[(i)]
Schroders	10 May 13	132,570,375	9.35%
BlackRock Inc	24 Dec 13	75,737,333	5.34%
Prudential	20 Oct 14	72,461,016	5.10%

(i) The percentages reflect the proportion of share capital at the time of notification.

Share capital and authority to purchase own shares

As at 31 December 2014 the issued share capital of the Company totalled 1,409,052,028, reduced from 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 and the provisions of the Company's Articles of Incorporation. Further details can be found in the Company's Articles of Incorporation which can be found at www.friendslifegroup.com. 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.

Share Buyback

The Company had authority from shareholders, granted at the 2014 AGM to purchase up to 141,810,902 ordinary shares. On 30 October 2014 the Company announced the commencement of a £317 million buyback programme funded from the £260 million upfront consideration from the sale of Lombard together with £57 million from surplus cash resources. Between 31 October 2014 and 21 November 2014 the Company repurchased 9,057,000 shares for an aggregate consideration of £29,850,077. The repurchased shares represent 0.64% of issued shares at the commencement of the buyback programme, and all shares were subsequently cancelled. On 21 November 2014, following an announcement that the Boards of Aviva and the Company had reached agreement on the key financial terms of a possible all share combination of the companies, the Company announced a decision to suspend the buyback and no further shares were repurchased from that date.

Financial instruments

Details of the financial instruments used by the Group are set out in 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 in note 30 to the financial statements.

Post balance sheet events

Particulars of any important post balance sheet events affecting the Company are set out in note 41 to the financial statements.

International branches

Information on branches of the Company located outside the United Kingdom is set out in note 17 to the financial statements.

Employees

The number of employees of the Group as at 31 December 2014 was 3,745 (2013: 3,872). The average number of employees during the year was 3,940.

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.

Directors' report

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.

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 which is open to all employees. At the 2014 AGM a resolution was passed authorising the Company to establish the Performance Share Plan, and to establish similar share plans outside the UK.

Greenhouse gas emissions

Greenhouse Gas Emissions are disclosed within the Strategic Report.

Political donations

At the 2014 AGM a resolution was passed giving the Company authority 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 2014 by the Company or any of its subsidiaries.

Directors

The current directors together with details of Board appointments and resignations that have occurred during the year are set out in the Corporate Governance Statement.

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. 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.

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. This was followed in 2014 and such a process will recommence should the Proposed Acquisition not complete. Further provisions are set out in the Articles of Incorporation which govern the appointment and removal of directors.

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 are governed by English law.

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 to the financial statements.

Directors' report

Significant agreements and change of control

Friends Life Holdings plc, the Company's principal trading company, is held through a partnership, Resolution Holdco No. 1 LP. As set out in the Governance Report, Resolution Holdco No. 1 LP has two partners, the Company and RCAP, which are parties to a Limited Partnership Agreement ("LPA"). Further details on how this agreement will be affected in the event of a change in control of the Company are set out in notes 40 and 41 of the financial statements.

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, for the Friends Life Group on a stand alone basis, 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.

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 2014 AGM.

This directors' report, including the Corporate Governance Statement, has been approved by the Board.

By order of the Board

Victoria Hames

Company Secretary
4 March 2015

Statement of directors' 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.

On behalf of the Board

Sir Malcolm Williamson

Chairman

Andy Briggs

Group Chief Executive
4 March 2015

Registered Address:
PO Box 25, Regency Court, Glategny Esplanade, St Peter Port, Guernsey, GY1 3AP.
Registered number: 49558

FINANCIAL STATEMENTS

Independent auditor's report to the members of Friends Life Group Limited

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 2014 and of its loss 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.

What we have audited

We have audited the Group consolidated financial statements of Friends Life Group Limited for the year ended 31 December 2014 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of IFRS based operating profit, 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 41. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards ("IFRS") 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 30 July 2014 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.

Our assessment of the risks of material misstatement and our responses

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, together with our responses to those risks:

- **Selection of appropriate IFRS actuarial assumptions.** We consider the selection of appropriate IFRS actuarial assumptions including those in respect of valuation interest rates, persistency, expenses, tax, mortality, longevity and credit default to be a significant audit risk. This is an area that involves significant judgement over uncertain future outcomes, mainly the ultimate total settlement value of long term policyholder liabilities. Small changes in assumptions can result in material impacts on the valuation of long term policyholder liabilities.
- **Robustness of actuarial modelling and analysis of change**. We consider the robustness of liability modelling in reflecting the underlying product terms, as well as the granularity of explanations regarding the change in liabilities year on year, to be a significant audit risk. The Group's methodology for calculating insurance liabilities and explaining the movement in liabilities during the year are key elements in assessing whether the Group's results reflect the assumptions adopted and developments in the business.
- **Reasonableness of the assumptions used in deriving provisions**. The level of provisioning for future obligations is an area where management's judgements are important. We consider the key assumptions, available supporting information and forecasts, to test compliance with the relevant standards.

Risk	Response
Selection of appropriate IFRS actuarial assumptions	In respect of IFRS actuarial assumptions, we used our own actuarial specialists to evaluate management's processes and controls over assumption setting and validated the reserving methodologies and assumptions by testing and comparing the valuation assumptions against the Group's own experience investigations, regulatory requirements and industry benchmarks. The Board's key IFRS actuarial assumptions and the related disclosures are laid out in note 26 to the accounts.
Robustness of actuarial modelling and analysis of change	We assessed the directors calculation of liabilities by testing the underlying data processes and assumptions against recognised actuarial practices and by applying our industry knowledge and experience. We used our own actuarial specialists and: a. Tested the controls management has in place over the key actuarial models, and performed independent testing on a sample basis in particular where there are manual controls; b. Tested the robustness of actuarial models by reference to underlying policy data, and specifically considered the impact of changes to actuarial models during the year; and c. Assessed and tested the quality of analysis provided by management to explain year on year movements in liabilities.

Independent auditor's report to the members of Friends Life Group Limited

Risk	Response
Provisioning for future obligations in line with the relevant accounting standards	We considered the appropriateness of the directors' assumptions and estimates in deriving the provisions for policyholder compensation, UK business transformation and other matters. We assessed the assumptions and estimates by testing the adequacy and robustness of the supporting information and forecasts. Details of the Group's provisions are included in note 34 to the accounts.

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.

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 £23 million which is approximately 5% (2013: £20 million) of IFRS operating profit. As in the previous year, we used IFRS operating profit as the basis of determining materiality. This basis is used as it aligns with the reporting of the Group's results, it excludes both the amortisation and impairment of intangible assets and short term fluctuations in investment return (per note 3 to the accounts). 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 judgment was that, in the same way as for the previous year, overall performance materiality (i.e. our tolerance for misstatement in an individual account or balance) for the Group should be 50% of materiality, namely £11.5 million (2013: £10 million). Our objective in adopting this approach was to ensure that total uncorrected and undetected audit differences in all accounts did not exceed our materiality level.

Audit work at individual components is undertaken based on a percentage of our total performance materiality. The performance materiality set for each component is based on the relative size of the component and our view of the risk of misstatement at that component. In the current year the range of performance materiality allocated to components was £1.2 million to £9.8 million (2013: £2 million to £7.5 million).

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £2 million (2013: £2 million), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in the light of other relevant qualitative considerations.

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 three reportable segments and account for all of the Group's total assets and all of the Group's IFRS based operating profit. UK, Heritage and International were subject to a full scope audit, the Sesame and Corporate components were subject to a specific scope audit (where our work was focused on individually important account balances) and Lombard was subject to a limited scope audit, focussing on overall analytical review procedures. The extent of our 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. Those components subject to a full scope audit account for 105% of the Group's IFRS operating profit (offset by losses contributed by specific scope and limited scope components) and 98% of the Group's IFRS assets.

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. In completing this work, the Group audit team has had a particular focus on the identified significant risks.

Independent auditor's report to the members of Friends Life Group Limited

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 70, 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 Friends Life Group Limited for the year ended 31 December 2014.

Respective responsibilities of directors and auditor

As explained more fully in the statement of directors' responsibilities set out on page 71, 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.

George Reid

for and on behalf of Ernst & Young LLP
London
4 March 2015

Consolidated income statement

For the year ended 31 December 2014

For the year ended 31 December	Notes	2014 £m	Restated 2013 £m
Revenue			
Gross earned premiums	3	**1,766**	1,971
Premiums ceded to reinsurers	3	**1,000**	(595)
Net earned premiums	3	**2,766**	1,376
Fee and commission income and income from service activities		**693**	715
Investment return	4	**7,589**	7,959
Total revenue		**11,048**	10,050
Other income	3	**–**	20
Claims, benefits and expenses			
Gross claims and benefits paid	5	**(4,065)**	(4,494)
Amounts receivable from reinsurers	5	**672**	688
Net claims and benefits paid	5	**(3,393)**	(3,806)
Change in insurance contract liabilities	26	**(2,729)**	2,331
Change in investment contract liabilities	27	**(2,869)**	(6,170)
Transfer (to)/from unallocated surplus		**(65)**	29
Movement in net asset value attributable to unit-holders	33	**(60)**	(89)
Movement in policyholder liabilities		**(5,723)**	(3,899)
Acquisition expenses	6	**(554)**	(554)
Administrative and other expenses	7	**(1,183)**	(1,255)
Finance costs	10	**(131)**	(141)
Total claims, benefits and expenses		**(10,984)**	(9,655)
Profit before tax from continuing operations		**64**	415
Policyholder tax	11	**(222)**	(334)
(Loss)/profit before shareholder tax from continuing operations		**(158)**	81
Total tax charge	11	**(131)**	(156)
Policyholder tax	11	**222**	334
Shareholder tax	11	**91**	178
(Loss)/profit after tax from continuing operations		**(67)**	259
Loss after tax from discontinued operations	3	**(71)**	(24)
(Loss)/profit for the year		**(138)**	235
Attributable to:			
Equity holders of the parent			
- From continuing operations		**(98)**	228
- From discontinued operations		**(71)**	(24)
Non-controlling interests - continuing operations	38	**31**	31
(Loss)/profit for the year		**(138)**	235

Consolidated income statement
For the year ended 31 December 2014

Basic earnings per share		**2014 Pence**	Restated 2013 Pence
Basic earnings per share from continuing operations	13	**(6.93)**	16.08
Basic earnings per share from discontinued operations	13	**(5.02)**	(1.69)
Total basic earnings per share		**(11.95)**	14.39

Diluted earnings per share		**2014 Pence**	Restated 2013 Pence
Diluted earnings per share from continuing operations	13	**(6.93)**	16.07
Diluted earnings per share from discontinued operations	13	**(5.02)**	(1.69)
Total diluted earnings per share		**(11.95)**	14.38

The consolidated income statement includes the results of Lombard as a discontinued operation. A single amount is shown on the face of the income statement representing the operation's post-tax result. 2013 results have also been restated to reflect this classification.

The notes on pages 83 to 188 form an integral part of these financial statements.

Consolidated statement of comprehensive income

For the year ended 31 December 2014

For the year ended 31 December	2014 £m	Restated 2013 £m
(Loss)/profit from continuing operations(i)	**(67)**	259
Loss from discontinued operations	**(71)**	(24)
(Loss)/profit for the year	**(138)**	235
Other comprehensive income from continuing operations:		
Items that will not be reclassified to profit and loss:		
Remeasurement gains/(losses) on the defined benefit scheme	**26**	(113)
Income tax relating to items that will not be reclassified	**–**	36
Total items that will not be reclassified to profit and loss	**26**	(77)
Items that may be reclassified subsequently to profit and loss:		
Foreign exchange adjustments(ii)	**4**	(5)
Shadow accounting(iii)	**(4)**	4
Total items that may be reclassified subsequently to profit and loss	**–**	(1)
Other comprehensive income/(loss), net of tax, from continuing operations	**26**	(78)
Other comprehensive income, net of tax, from discontinued operations(iv)	**27**	10
Total other comprehensive income/(loss), net of tax	**53**	(68)
Total comprehensive (loss)/income, net of tax, from continuing operations	**(41)**	181
Total comprehensive loss, net of tax, from discontinued operations	**(44)**	(14)
Total comprehensive (loss)/income, net of tax	**(85)**	167

(i) The (loss)/profit from continuing operations includes £31 million (31 December 2013: £31 million) attributable to non-controlling interests. There are no amounts included in other comprehensive income which are attributable to non-controlling interests (2013: £nil).
(ii) Foreign exchange adjustments relate to the translation of the results and financial position of overseas subsidiaries.
(iii) Shadow accounting that may be reclassified subsequently to profit and loss is as a result of a gain of £4 million (31 December 2013: loss of £(4) million) included within foreign exchange adjustments on translation of overseas subsidiaries held by a with-profits fund of Friends Life Limited (“FLL”). Further information is provided in note 26.
(iv) Other comprehensive income from discontinued operations includes £46 million due to the recycling of cumulative foreign exchange adjustments on disposal of a foreign operation (2013: £nil) offset by a £(19) million foreign exchange loss relating to translation of the results and financial position of the foreign operation in 2014 to the date of disposal (2013: £10 million gain).

Consolidated statement of IFRS based operating profit

For the year ended 31 December 2014

For the year ended 31 December	Notes	2014 £m	Restated 2013 £m
Profit before tax from continuing operations	3	**64**	415
Policyholder tax	11	**(222)**	(334)
(Loss)/profit before shareholder tax excluding returns generated within policyholder funds		**(158)**	81
Non-recurring items	3	**184**	131
Amortisation and impairment of acquired present value of in-force business	14	**302**	342
Amortisation and impairment of other intangible assets	14	**52**	63
Interest payable on Step-up Tier one Insurance Capital Securities ("STICS")	3	**(31)**	(31)
Short-term fluctuations in investment return	3	**207**	(184)
IFRS based operating profit before tax from continuing operations	3	**556**	402
Tax on operating profit		**(17)**	4
IFRS based operating profit after tax from continuing operations attributable to equity holders of the parent[(i)]		**539**	406

Earnings per share		2014 Pence	Restated 2013 Pence
Operating earnings per share from continuing operations	13	**38.14**	28.64
Diluted operating earnings per share from continuing operations	13	**38.08**	28.62

(i) IFRS based operating profit excludes:
- (a) profit or loss from discontinued operations;
- (b) investment variances on unit-linked sterling reserves and the assets backing these reserves, which in previous periods were included within operating profit. This is a change in approach for 2014 but does not materially impact the 2013 comparative results and these have not been restated for this change;
- (c) investment variances from expected investment return for non-linked business which is calculated using a longer term rate of return;
- (d) returns attributable to non-controlling interests in policyholder funds;
- (e) significant non-recurring items;
- (f) 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 2014

As at 31 December	Notes	**2014 £m**	2013 £m
Assets			
Intangible assets	14	**3,110**	3,855
Property and equipment	15	**44**	50
Investment properties	16	**2,690**	2,561
Investment in associate		**4**	4
Financial assets	18	**92,768**	109,064
Deferred acquisition costs	20	**853**	897
Reinsurance assets	21	**1,231**	2,837
Current tax assets		**24**	33
Insurance and other receivables	23	**873**	1,100
Cash and cash equivalents	24	**7,924**	9,690
Total assets		**109,521**	130,091
Liabilities			
Insurance contracts	26	**35,750**	34,590
Unallocated surplus	28	**692**	627
Financial liabilities:			
– Investment contracts	27	**64,087**	83,502
– Loans and borrowings	31	**1,051**	1,050
– Amounts due to reinsurers	32	**–**	1,580
Net asset value attributable to unit-holders	33	**589**	621
Provisions	34	**176**	227
Pension scheme deficit	8	**7**	52
Deferred tax liabilities	22	**961**	980
Current tax liabilities		**–**	1
Insurance payables, other payables and deferred income	35	**1,093**	1,312
Total liabilities		**104,406**	124,542
Equity attributable to equity holders of the parent			
– Share capital	36	**4,181**	4,223
– Other reserves	37	**615**	1,006
		4,796	5,229
Attributable to non-controlling interests	38	**319**	320
Total equity		**5,115**	5,549
Total equity and liabilities		**109,521**	130,091

The financial statements were approved by the Board of Directors on 4 March 2015.

Tim Tookey
Director

Consolidated statement of changes in equity

For the year ended 31 December 2014

For the year ended 31 December 2014	Attributable to equity holders of the parent Share capital £m	 Other reserves £m	 Total £m	Non-controlling interests £m	Total £m
At 1 January 2014	**4,223**	**1,006**	**5,229**	**320**	**5,549**
(Loss)/profit for the year	**–**	**(169)**	**(169)**	**31**	**(138)**
Other comprehensive income	**–**	**53**	**53**	**–**	**53**
Total comprehensive (loss)/income	**–**	**(116)**	**(116)**	**31**	**(85)**
Dividends paid	**–**	**(299)**	**(299)**	**–**	**(299)**
Interest paid on STICS	**–**	**–**	**–**	**(31)**	**(31)**
Appropriations of profit	**–**	**(299)**	**(299)**	**(31)**	**(330)**
Shares repurchased and cancelled	**(30)**	**–**	**(30)**	**–**	**(30)**
Tax relief on STICS interest(i)	**–**	**20**	**20**	**–**	**20**
Increase in own shares held by the Group	**(13)**	**–**	**(13)**	**–**	**(13)**
Share-based payments, net of settlements(ii)	**1**	**4**	**5**	**(1)**	**4**
At 31 December 2014	**4,181**	**615**	**4,796**	**319**	**5,115**

For the year ended 31 December 2013	Attributable to equity holders of the parent Share capital £m	 Other reserves £m	 Total £m	Non-controlling interests £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(ii)	–	7	7	(1)	6
Other movements(iii)	–	4	4	–	4
At 31 December 2013	4,223	1,006	5,229	320	5,549

(i) Included within tax relief on STICS interest is £13 million (2013: £nil) relating to movements in deferred tax on the fair valuing of the STICS instruments on acquisition. These movements are attributable to previous years, however no prior year restatement has been recognised under IAS 8*: Accounting Policies, Changes in Accounting Estimates and Errors* on the grounds that there is no impact on previous years' profits and the immateriality of the amounts involved.

(ii) The movement in other reserves arising from share-based payment schemes is £5 million for the year (31 December 2013: £7 million) and relates to the expense, net of settlement, of the Group's share-based incentive schemes.

(iii) For the year ended 31 December 2013, other movements comprise the consolidation of the Employee Benefit Trust ("EBT") (£2 million) and release of a share entitlement provision (£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 2014

For the year ended 31 December	Note	2014 £m	2013 £m
Operating activities			
(Loss)/profit for the year		**(138)**	235
Adjusted for:			
– loss on remeasurement to fair value of discontinued operations		**14**	–
– recycling of cumulative translation differences on discontinued operations		**46**	–
– profit on disposal of investment in associate		**–**	(20)
– net realised and unrealised gains on assets at fair value		**(5,610)**	(5,507)
– finance costs		**131**	142
– amortisation and impairment of intangible assets		**390**	483
– depreciation of property and equipment		**2**	5
– movement in deferred acquisition costs		**(10)**	(59)
– total tax charge		**122**	134
– purchase of shares and other variable yield securities		**(27,477)**	(23,948)
– proceeds from sale of shares and other variable yield securities		**28,653**	25,363
– purchase of loans, debt securities and other fixed income securities		**(28,520)**	(26,911)
– proceeds from sale of loans, debt securities and other fixed income securities		**29,927**	28,257
– purchase of investment properties		**(53)**	(45)
– proceeds from sale of investment properties		**214**	265
– increase/(decrease) in insurance contract liabilities		**1,160**	(2,642)
– increase in investment contract liabilities		**957**	4,840
– increase/(decrease) in unallocated surplus		**65**	(29)
– decrease in provisions		**(46)**	(51)
– net movement in receivables and payables		**587**	216
Pre-tax cash inflow from operating activities		**414**	728
Tax paid		**(27)**	(48)
Net cash inflow from operating activities		**387**	680
Investing activities			
Disposal of held for sale assets, net of cash transferred		**(1,539)**	50
Additions to internally generated intangible assets		**(2)**	(4)
Net disposals/(additions) of property and equipment		**4**	(2)
Net cash (outflow)/inflow from investing activities		**(1,537)**	44
Financing activities			
Shares purchased and cancelled under buyback programme		**(30)**	–
Shares purchased in settlement of incentive schemes		**–**	(1)
Shares purchased by EBT		**(13)**	–
Finance costs		**(133)**	(143)
STICS interest		**(31)**	(31)
Net movement in other borrowings, net of expenses		**(19)**	(40)
Dividends paid to equity holders of the parent		**(299)**	(300)
Net cash outflow from financing activities		**(525)**	(515)
(Decrease)/increase in cash and cash equivalents		**(1,675)**	209
Balance at beginning of year	24	**9,690**	9,449
Exchange adjustments on the translation of foreign operations		**(91)**	32
Balance at end of year	24	**7,924**	9,690

Notes to the consolidated accounts

1. Accounting policies

1.1 Basis of preparation

The financial statements of the Company as at and for the year ended 31 December 2014 comprise the consolidated financial statements of the Company and its subsidiaries (together referred to as "the Group") and the Group's interests in its associates.

The consolidated financial statements as at and for the year ended 31 December 2014 have been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU").

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.

Following its classification as held for sale as at 30 June 2014 and subsequent disposal, the Lombard operating segment has been presented as a discontinued operation. A single amount is shown on the face of the consolidated income statement, comprising the post-tax result of the discontinued operation, the post-tax loss recognised on the remeasurement to fair value less costs to sell and associated corporate non-recurring costs of disposal. The consolidated income statement, consolidated statement of comprehensive income and consolidated statement of IFRS based operating profit comparatives have been restated.

The 2013 consolidated income statement includes the results of AmLife Insurance Berhad and AmFamily Berhad (collectively "AmLife") up until the date of their disposal on 4 January 2013.

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 70.

The International Accounting Standards Board ("IASB") issued the following new standards and changes to existing standards which are relevant to the Group and have been adopted in the Group financial statements with effect from 1 January 2014.

- 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*. Under IFRS 10, an investor controls an investee when it has exposure, or rights, to variable returns from involvement with the investee and has the ability to affect those returns through its power over the investee. The application of IFRS 10 has not had a material impact on the Group.
- IAS 28 (revised): *Investments in associates and joint ventures.* This standard supersedes IAS 28: *Investments in associates* and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures. The application of IAS 28 (revised) has no impact on the Group.
- IFRS 12: *Disclosure of interests in other entities.* This standard combines, enhances and replaces disclosure requirements for subsidiaries, joint arrangements, associates and structured entities. Relevant disclosures are included in notes 2, 17 and 18.
- Amendments to IAS 32: *Financial instruments*: *Presentation* relating to offsetting financial assets and financial liabilities. These amendments clarify the meaning of 'currently has a legally enforceable right to set-off' and the criteria for non-simultaneous settlement mechanisms of clearing houses to qualify for offsetting. Relevant disclosures are included in note 30.

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 2015, unless otherwise stated, but where earlier adoption is permitted. They have been endorsed by the EU unless otherwise stated. They have not been considered for early adoption by the Group. These changes are not expected to materially impact the Group unless otherwise stated.

Notes to the consolidated accounts

1. Accounting policies continued

New standards:

- IFRS 9: *Financial instruments.* This standard reflects all phases of the IASB's work on the replacement of IAS 39: *Financial instruments: recognition and measurement.* The standard introduces new requirements for classification and measurement, impairment and hedge accounting. Classification is 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 may have a material impact on the classification and measurement of the Group's financial assets. This standard is effective for accounting periods beginning on or after 1 January 2018; it is yet to be endorsed by the EU; and
- IFRS 15: *Revenue from contracts with customers.* The objective of this standard is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer. This standard is effective for accounting periods beginning on or after 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.

Amendments to existing standards:

- Amendment to IAS 16: *Property, plant and equipment* and IAS 38: *Intangible assets*: In these amendments the IASB has clarified that the use of revenue-based methods to calculate the depreciation of assets and amortisation of intangible assets is not appropriate. This amendment is effective for annual periods beginning on or after 1 January 2016 but has not yet been endorsed by the EU;
- Improvements to IFRSs 2012: These annual improvements address seven standards in the 2010-2012 reporting cycle. They include changes to IFRS 2: *Share-based payment*, IFRS 3: *Business combinations*, IFRS 8: *Operating segments*, IFRS 13: *Fair value measurement*, IAS 16: *Property, plant and equipment*, IAS 24: *Related party transactions* and IAS 38: *Intangible assets.* Consequential amendments are also made to IFRS 9: *Financial instruments*, IAS 37: *Provisions, contingent liabilities and contingent assets*, and IAS 39: *Financial instruments: recognition and measurement*. The amendments are effective for annual periods beginning on or after 1 July 2014;
- Improvements to IFRSs 2013: These annual improvements address four standards in the 2011-2013 reporting cycle. They include changes to IFRS 1: *First time adoption,* 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; and
- Improvements to IFRSs 2014: These annual improvements address four standards in the 2012-2014 reporting cycle. They include changes to IFRS 5: *Non-current assets held for sale and discontinued operations*, IFRS 7*: Financial instruments: disclosures*, IAS 19: *Employee benefits*, and IAS 34: *Interim financial reporting*. The amendments are effective for annual periods beginning on or after 1 January 2016 but have not yet been endorsed by the EU.

The impact of these amendments is currently being assessed by the Group.

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 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.

Notes to the consolidated accounts

1. Accounting policies continued

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. 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.

A discontinued operation is a component of an entity that has either been disposed of, or is classified as held for sale, and represents a separate major line of business or geographical area of operations, or is a subsidiary acquired exclusively with a view to resale.

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. 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.

Notes to the consolidated accounts

1. Accounting policies continued

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, 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 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.

Notes to the consolidated accounts

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) Consolidation principles

Subsidiaries are investees which the Group controls. An investor controls an investee when it has exposure, or has rights, to variable returns from involvement with the investee and has the ability to affect those returns through its power over the investee.

The majority of the Group's subsidiaries are wholly owned entities where determination of control does not involve significant judgement. However, the Group's insurance entities invest in various vehicles, such as limited partnerships, open-ended investment companies ("OEICs") and unit trusts where control is often determined through the exercise of judgement.

Control of limited partnerships is assessed on an individual holding basis and is determined by reference to the terms of each partnership agreement. These investments are usually established with the Group as a limited partner and the general partner being responsible for managing and operating the partnership with full discretion and authority to select and/or terminate the appointment of any investment manager. Critical factors to consider when assessing control include whether the Group has the power to remove the general partner without cause and has rights to variable returns.

The Group invests in the underlying funds of OEICs and unit trusts, but does not act as an authorised corporate director or fund manager responsible for day-to-day operations and fund performance. The Group is considered to control underlying funds where it has the ability to change the investment objectives or policies of a fund.

b) 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.

c) 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 swap 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;

Notes to the consolidated accounts

2. Use of judgements, estimates and assumptions continued

- 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.

d) 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 acquired value of in-force business ("AVIF") balances arising on acquisition by reference to a Market Consistent Embedded Value ("MCEV") methodology. Information relating to the methods used to value other intangible assets is set out in note 14.

e) 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.

An analysis of assets and liabilities by category is also disclosed in note 19.

f) Staff pension schemes assumptions

In assessing the pension benefit obligation, assumptions are made as to the life expectancy of all deferred and retired members, 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.

g) 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 provided 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.

h) 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 Royal Institution of Chartered Surveyors ("RICS") Red Book.

The valuations 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.

Notes to the consolidated accounts

2. Use of judgements, estimates and assumptions continued

i) 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.

j) 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.

Notes to the consolidated accounts

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, OLAB within the UK life and pensions subsidiaries and Friends Life Investments ("FLI"); and
- FPI comprising Friends Provident International Limited ("FPIL").

Lombard has been classified as a discontinued operation with a single amount shown on the face of the consolidated income statement comprising the post-tax loss for the period, the post-tax loss recognised on the remeasurement of its net assets to fair value less costs to sell, loss on disposal, cumulative exchange difference arising on translation to Sterling, associated corporate non-recurring costs of disposal and any profit/loss on remeasurement of contingent consideration subsequent to disposal. Lombard's result has been excluded from IFRS based operating profit in 2013 and 2014, to better reflect the expected ongoing performance of the Group.

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, OLAB was managed and reported within the FPI segment. Following the decision to stop writing new business in 2013, OLAB was transferred to the Heritage segment in January 2014 and comparatives for the full year to 31 December 2013 have been restated.

a) Operating segment information

(i) IFRS based operating profit

For the year ended 31 December 2014	UK £m	Heritage £m	FPI £m	Corporate £m	Total £m
Life and pensions operating profit	113	489	64	–	666
Longer term shareholder investment return	16	(61)	3	–	(42)
Other (expense)/income	(5)	7	–	(24)	(22)
Development costs	(19)	(14)	(13)	–	(46)
IFRS based operating profit/(loss) before tax from continuing operations	**105**	**421**	**54**	**(24)**	**556**
Tax on operating profit					(17)
IFRS based operating profit after tax from continuing operations attributable to equity holders of the parent					**539**
Operating earnings per share from continuing operations (pence)					**38.14**

Notes to the consolidated accounts

3. Segmental information continued

For the year ended 31 December 2013	UK £m	Restated Heritage £m	Restated FPI £m	Corporate £m	Restated Total £m
Life and pensions operating profit	76	422	73	–	571
Longer term shareholder investment return	13	(84)	(1)	3	(69)
Other (expense)/income	(19)	2	(2)	(34)	(53)
Development costs	(30)	(10)	(7)	–	(47)
IFRS based operating profit/(loss) before tax from continuing operations	40	330	63	(31)	402
Tax on operating profit					4
IFRS based operating profit after tax from continuing operations attributable to equity holders of the parent					406
Operating earnings per share (pence)					28.64

(ii) Reconciliation of IFRS based operating result before tax to profit or loss after tax

For the year ended 31 December 2014	**UK £m**	**Heritage £m**	**FPI £m**	**Corporate £m**	**Total £m**
IFRS based operating profit/(loss) before tax from continuing operations	**105**	**421**	**54**	**(24)**	**556**
Non-recurring items(i)(ii)(iii)(iv)	**(62)**	**(106)**	**(4)**	**(12)**	**(184)**
Amortisation and impairment of AVIF	**(48)**	**(185)**	**(69)**	**–**	**(302)**
Amortisation and impairment of other intangible assets	**(45)**	**–**	**(7)**	**–**	**(52)**
Interest payable on STICS	**–**	**31**	**–**	**–**	**31**
Short-term fluctuations in investment return(v)(vi)	**11**	**(190)**	**(16)**	**(12)**	**(207)**
Loss before policyholder and shareholder tax	**(39)**	**(29)**	**(42)**	**(48)**	**(158)**
Policyholder tax	**10**	**212**	**–**	**–**	**222**
(Loss)/profit before tax from continuing operations	**(29)**	**183**	**(42)**	**(48)**	**64**
Policyholder tax	**(10)**	**(212)**	**–**	**–**	**(222)**
Shareholder tax	**2**	**69**	**3**	**17**	**91**
(Loss)/profit after tax from continuing operations	**(37)**	**40**	**(39)**	**(31)**	**(67)**
Loss after tax from discontinued operations					**(71)**
Loss after tax for the year					**(138)**

(i) UK non-recurring items of £(62) million for the year ended 31 December 2014 include separation and integration costs of £(11) million, costs of £(19) million relating to service improvement elements of the outsourcing arrangement with Diligenta, £(3) million relating to finance transformation and Solvency II costs, £(10) million in respect of the Sesame strategic review and £(19) million relating to significant regulatory change. Non-recurring costs relating to significant regulatory change primarily relate to costs associated with the new retirement income product and platform development in response to the 2014 Budget announcement.

(ii) Heritage non-recurring items of £(106) million for the year ended 31 December 2014 include costs of £(52) million in respect of the Diligenta outsourcing agreement, costs of £(2) million relating to significant regulatory change, £(1) million of costs relating to the capital optimisation programme, £(29) million of financial transformation and Solvency II costs, and £(22) 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).

(iii) FPI non-recurring items of £(4) million for the year ended 31 December 2014 relate to finance transformation costs.

(iv) Corporate non-recurring items of £(12) million for the year ended 31 December 2014 include £22 million income from Heritage in respect of the funding relating to the Group's defined benefit pension scheme, £(11) million costs in relation to the proposed all-share acquisition of Friends Life Group Limited ("FLGL") by Aviva plc (the "Proposed Acquisition"), £(8) million relating to projects terminated as a consequence of the Proposed Acquisition, £(15) million relating to the Sesame strategic review.

(v) Includes investment variances on unit-linked sterling reserves and assets backing these reserves, which in previous periods were reported within operating profit. As this change in approach does not materially impact the 2013 comparative results, these have not been restated for this change.

(vi) 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.

Notes to the consolidated accounts

3. Segmental information continued

For the year ended 31 December 2013	UK £m	Restated Heritage £m	Restated FPI £m	Corporate £m	Restated Total £m
IFRS based operating profit/(loss) before tax from continuing operations	40	330	63	(31)	402
Non-recurring items[(i)(ii)(iii)]	(35)	(226)	18	112	(131)
Amortisation and impairment of AVIF	(47)	(221)	(74)	–	(342)
Amortisation and impairment of other intangible assets	(42)	(14)	(7)	–	(63)
Interest payable on STICS	–	31	–	–	31
Short-term fluctuations in investment return[(iv)]	19	160	3	2	184
(Loss)/profit before policyholder and shareholder tax	(65)	60	3	83	81
Policyholder tax	9	325	–	–	334
(Loss)/profit before tax from continuing operations	(56)	385	3	83	415
Policyholder tax	(9)	(325)	–	–	(334)
Shareholder tax	27	174	1	(24)	178
(Loss)/profit after tax from continuing operations	(38)	234	4	59	259
Loss after tax from discontinued operations					(24)
Profit after tax for the year					235

(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 the 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), £(10) million separation and integration costs, £(53) million of costs in respect of the Diligenta outsourcing agreement, £(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 profits 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.

Notes to the consolidated accounts

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

3. Segmental information continued

For the year ended 31 December 2014	UK £m	Heritage £m	FPI £m	Corporate £m	Elimination of inter-segment amounts[(i)] £m	Total £m
Gross earned premiums on insurance and investment contracts	3,046	1,589	954	–	–	5,589
Investment contract premiums[(ii)]	(2,426)	(473)	(924)	–	–	(3,823)
Gross earned premiums	620	1,116	30	–	–	1,766
Premiums ceded to reinsurers[(iii)]	(109)	1,114	(5)	–	–	1,000
Net earned premiums	511	2,230	25	–	–	2,766
Fee and commission income	304	261	128	–	–	693
Investment return	1,694	5,591	306	79	(81)	7,589
Total revenue	2,509	8,082	459	79	(81)	11,048
Intersegment revenue	1	–	–	80	(81)	–
Total external revenue	2,508	8,082	459	(1)	–	11,048
Other income[(iv)]	–	–	–	22	(22)	–
Net claims and benefits paid	(153)	(3,226)	(14)	–	–	(3,393)
Change in insurance and investment contract liabilities	(1,662)	(3,649)	(287)	–	–	(5,598)
Transfer to unallocated surplus	–	(65)	–	–	–	(65)
Movement in net assets attributable to unit-holders	(25)	(35)	–	–	–	(60)
Acquisition expenses	(397)	(84)	(73)	–	–	(554)
Administrative and other expenses	(301)	(719)	(123)	(62)	22	(1,183)
Finance costs	–	(121)	(4)	(87)	81	(131)
Total claims, benefits and expenses	(2,538)	(7,899)	(501)	(149)	103	(10,984)
Intersegment expenses	–	(102)	–	(1)	103	–
Total external claims, benefits and expenses	(2,538)	(7,797)	(501)	(148)	–	(10,984)
(Loss)/profit before tax from continuing operations	(29)	183	(42)	(48)	–	64
Policyholder tax	(10)	(212)	–	–	–	(222)
Shareholder tax	2	69	3	17	–	91
(Loss)/profit after tax from continuing operations	(37)	40	(39)	(31)	–	(67)
Loss after tax from discontinued operations						(71)
Loss after tax for the year						(138)

(i) Eliminations include loan interest. Intersegment transactions are undertaken on an arm's length basis.
(ii) Accounted for as deposits under IFRS.
(iii) On 24 November 2014 an existing reinsurance treaty was amended such that investment risk transferred back to the Group whilst longevity risk continued to be reinsured. The amount due to reinsurers previously recognised under the agreement of £1,622 million at the amendment date was derecognised, with a corresponding credit recognised in premiums ceded to reinsurers. See note 32 for further details.
(iv) Represents internal recharges on pension deficit reductions of £22 million.

Notes to the consolidated accounts

3. Segmental information continued

For the year ended 31 December 2013	UK £m	Restated Heritage £m	Restated FPI £m	Corporate £m	Elimination of inter-segment amounts[i] £m	Restated Total
Gross earned premiums on insurance and investment contracts	2,887	1,942	1,115	–	–	5,944
Investment contract premiums[ii]	(2,235)	(652)	(1,086)	–	–	(3,973)
Gross earned premiums	652	1,290	29	–	–	1,971
Premiums ceded to reinsurers	(96)	(496)	(3)	–	–	(595)
Net earned premiums	556	794	26	–	–	1,376
Fee and commission income	299	306	110	–	–	715
Investment return	1,800	5,917	232	94	(84)	7,959
Total revenue	2,655	7,017	368	94	(84)	10,050
Intersegment revenue	–	–	–	84	(84)	–
Total external revenue	2,655	7,017	368	10	–	10,050
Other income[iii]	–	–	20	116	(116)	20
Net claims and benefits paid	(141)	(3,652)	(13)	–	–	(3,806)
Change in insurance and investment contract liabilities	(1,851)	(1,825)	(163)	–	–	(3,839)
Transfer from unallocated surplus	–	29	–	–	–	29
Movement in net assets attributable to unit-holders	(35)	(54)	–	–	–	(89)
Acquisition expenses	(400)	(89)	(65)	–	–	(554)
Administrative and other expenses	(284)	(909)	(139)	(39)	116	(1,255)
Finance costs	–	(132)	(5)	(88)	84	(141)
Total claims, benefits and expenses	(2,711)	(6,632)	(385)	(127)	200	(9,655)
Intersegment expenses	–	(200)	–	–	200	–
Total external claims, benefits and expenses	(2,711)	(6,432)	(385)	(127)	–	(9,655)
(Loss)/profit before tax from continuing operations	(56)	385	3	83	–	415
Policyholder tax	(9)	(325)	–	–	–	(334)
Shareholder tax	27	174	1	(24)	–	178
(Loss)/profit after tax from continuing operations	(38)	234	4	59	–	259
Loss after tax from discontinued operations						(24)
Profit after tax for the year						235

(i) Eliminations include loan interest. Intersegment transactions are undertaken on an arm's length basis.
(ii) Accounted for as deposits under IFRS.
(iii) Includes internal recharges on pension deficit reduction contribution of £116 million and profit on the disposal of AmLife of £20 million.

3. Segmental information continued

(iv) Products and services

For the year ended 31 December 2014	Gross earned premiums £m	Net earned premiums £m	Fee and commission income £m	Total external revenue[(i)] £m
UK				
– Corporate benefits	–	–	113	113
– Protection	341	232	–	232
– Retirement income	279	279	–	279
– Other	–	–	191	191
Heritage				
– With-profits	291	283	–	283
– Pensions	46	44	172	216
– Investments	183	175	69	244
– Protection	295	160	–	160
– Annuities	301	1,568	–	1,568
– Other	–	–	20	20
FPI				
– Investments	12	12	128	140
– Protection	18	13	–	13
Total	1,766	2,766	693	3,459

(i) Total external revenue does not include investment return of £7,589 million.

Notes to the consolidated accounts

3. Segmental information continued

For the year ended 31 December 2013	Gross earned premiums £m	Net earned premiums £m	Restated Fee and commission income £m	Restated Total external revenue(i) £m
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 - restated	190	182	74	256
– Protection - restated	388	247	–	247
– Annuities	315	68	–	68
– Other	–	–	11	11
FPI				
– Investments - restated	14	14	110	124
– Protection - restated	15	12	–	12
Total	1,971	1,376	715	2,091

(i) Total external revenue does not include investment return of £7,959 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

3. Segmental information continued

(v) Assets and liabilities

As at 31 December 2014	UK £m	Heritage £m	FPI £m	Corporate £m	Elimination of inter-segment amounts(i) £m	Total £m
Assets						
Intangible assets	**671**	**1,937**	**502**	**–**	**–**	**3,110**
Financial assets	**24,092**	**62,014**	**6,454**	**208**	**–**	**92,768**
Other assets	**1,871**	**9,632**	**1,447**	**2,020**	**(1,327)**	**13,643**
Total assets	**26,634**	**73,583**	**8,403**	**2,228**	**(1,327)**	**109,521**
Liabilities						
Insurance contracts	**3,442**	**32,138**	**170**	**–**	**–**	**35,750**
Investment contracts	**21,194**	**35,003**	**7,890**	**–**	**–**	**64,087**
Loans and borrowings	**17**	**868**	**–**	**1,311**	**(1,145)**	**1,051**
Other liabilities	**569**	**2,857**	**125**	**149**	**(182)**	**3,518**
Total liabilities	**25,222**	**70,866**	**8,185**	**1,460**	**(1,327)**	**104,406**

As at 31 December 2013	UK £m	Restated Heritage £m	Restated FPI £m	Lombard £m	Corporate £m	Elimination of inter-segment amounts(i) £m	Total £m
Assets							
Intangible assets	763	2,123	578	391	–	–	3,855
Financial assets	21,322	63,249	6,073	18,420	–	–	109,064
Other assets	1,798	11,186	1,434	1,985	2,264	(1,495)	17,172
Total assets	23,883	76,558	8,085	20,796	2,264	(1,495)	130,091
Liabilities							
Insurance contracts	3,110	31,354	126	–	–	–	34,590
Investment contracts	19,077	36,667	7,566	20,192	–	–	83,502
Loans and borrowings	13	1,178	11	2	1,031	(1,185)	1,050
Other liabilities	593	4,539	121	254	203	(310)	5,400
Total liabilities	22,793	73,738	7,824	20,448	1,234	(1,495)	124,542

(i) Eliminations mainly comprise intercompany loans.

Notes to the consolidated accounts

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 2014	**UK £m**	**Rest of the world £m**	**Total £m**
Gross earned premiums	**1,649**	**117**	**1,766**
Fee and commission income	**547**	**146**	**693**
Revenue from external customers	**2,196**	**263**	**2,459**
Investment return			**7,589**
Premiums ceded to reinsurers			**1,000**
Total revenue			**11,048**

For the year ended 31 December 2013	Restated UK £m	Restated Rest of the world £m	Restated Total £m
Gross earned premiums	1,836	135	1,971
Fee and commission income	593	122	715
Revenue from external customers	2,429	257	2,686
Investment return			7,959
Premiums ceded to reinsurers			(595)
Total revenue			10,050

c) Disposal of discontinued operations

Following receipt of the necessary regulatory approvals, the sale of the Lombard business to the Blackstone Group LP completed on 30 October 2014.

The initial consideration received of £316 million comprised £260 million cash and deferred payment in the form of a vendor loan note with a fair value of £56 million (€70 million). The vendor loan note is denominated in Euros, has an eight year term from the completion date and bears a coupon of 7% per annum. An additional contingent element could increase or decrease the value of the vendor loan note by up to €50 million, determined with reference to Lombard's assets under administration on 30 June 2017 in the upside scenario and with reference to the assets under administration and the achievement of certain new business thresholds at 30 June 2019 in the downside scenario. The sale agreement also contains customary representations, warranties and indemnities that would be expected in a transaction of this nature.

The results of discontinued operations include all associated costs.

Notes to the consolidated accounts

3. Segmental information continued

(i) Results of discontinued operations

	2014 £m	2013 £m
Fee and commission income and income from service activities	**83**	112
Investment return	**1,300**	827
Total revenue	**1,383**	939
Movement in investment contract liabilities	**(1,215)**	(730)
Acquisition expenses	**(39)**	(49)
Administrative and other expenses	**(148)**	(205)
Finance costs	**–**	(1)
Total claims, benefits and expenses	**(1,402)**	(985)
Loss before shareholder tax	**(19)**	(46)
Shareholder tax	**8**	22
Loss after tax from discontinued operations	**(11)**	(24)
Loss on remeasurement to fair value	**(14)**	–
Recycling of cumulative translation differences	**(46)**	–
Loss from discontinued operations	**(71)**	(24)
Other comprehensive income, net of tax	**27**	10
Total comprehensive loss, net of tax	**(44)**	(14)

(ii) Cash flows of discontinued operations

	2014 £m	2013 £m
Operating cash flows	**98**	197
Investing cash flows	**(1)**	(4)
Financing cash flows	**(6)**	(23)
Total cash flows	**91**	170

Notes to the consolidated accounts

3. Segmental information continued

(iii) Major classes of assets and liabilities at disposal date

	30 October 2014 £m
Intangible assets	**338**
Financial assets	**18,254**
Other assets	**164**
Cash and cash equivalents	**1,799**
Remeasurement to fair value	**(14)**
Assets	**20,541**
Investment contracts	**19,960**
Deferred tax liabilities	**79**
Other liabilities	**191**
Liabilities	**20,230**
Equity attributable to equity holders of the parent	**311**
Total equity	**311**
Total equity and liabilities	**20,541**

d) Disposal of investment in associate undertaking

On 4 January 2013 the Group 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 £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

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.

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	2014 £m	Restated 2013 £m
Interest income on loans and receivables	**28**	20
Net interest on net defined benefit liability(i)	**(2)**	1
Dividend income	**1,301**	1,351
Rental income	**146**	156
Movement in fair value:		
– investment properties	**290**	46
– financial assets or financial liabilities at fair value through profit or loss:		
– financial derivative instruments	**222**	(305)
– financial assets designated on initial recognition, inclusive of interest income(ii)	**5,626**	6,683
Retranslation of foreign currency loans and borrowings	**(22)**	7
Total investment return	**7,589**	7,959

(i) Includes a £(2) million (2013: £(2) million) finance charge relating to penal tax recognised on the present value of pension deficit funding.
(ii) Interest income on financial assets at fair value through profit or loss is included in the movement in fair value. The 2013 comparatives have been aligned with this presentation, in addition to the restatement to reflect the disposal of the Lombard business.

Notes to the consolidated accounts

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 value 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	**2014 %**	2013 %
Equities	**6.1**	4.9
Government fixed interest	**3.1**	1.9
Other fixed interest	**4.1**	3.4
Cash (life and pensions business)	**3.1**	1.9
Cash (corporate)	**0.7**	0.7

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% (2013: 3%) and 1% (2013: 1.5%) 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.

c) Sensitivity of shareholder longer term investment return – IFRS based operating profit

For the year ended 31 December	**2014 £m**	2013 £m
Shareholder longer term investment return:	**(42)**	(69)
– After the impact of a 1% increase in the longer term rates of investment return	**(11)**	(47)
– After the impact of a 1% decrease in the longer term rates of investment return	**(71)**	(91)

d) Comparison of shareholder longer term and actual investment return – IFRS based operating profit

For the year ended 31 December	**2014 £m**	Restated 2013 £m
Actual investment return attributable to shareholders	**(47)**	(97)
Shareholder longer term investment return	**42**	69
Deficit of actual shareholder return over longer term return	**(5)**	(28)

Short-term fluctuations in investment return reported in the consolidated statement of IFRS based operating profit of £(207) million (2013: £184 million) comprises a £(5) million deficit of actual shareholder return over longer term return (2013: £(28) million), as shown above, and a £(202) million variance arising from investment variances and economic assumption changes on assets backing long-term business (2013: £212 million).

Notes to the consolidated accounts

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.

For the year ended 31 December 2014	**Gross claims and benefits paid £m**	**Amounts receivable from reinsurers £m**	**Total net claims and benefits paid £m**
UK			
– Corporate benefits	**3**	**–**	**3**
– Protection	**163**	**(83)**	**80**
– Retirement income	**70**	**–**	**70**
Heritage			
– With-profits	**1,815**	**(5)**	**1,810**
– Pensions	**228**	**(1)**	**227**
– Investments	**927**	**(2)**	**925**
– Protection	**188**	**(105)**	**83**
– Annuities	**654**	**(473)**	**181**
FPI			
– Investments	**12**	**–**	**12**
– Protection	**5**	**(3)**	**2**
Total	**4,065**	**(672)**	**3,393**

For the year ended 31 December 2013	Gross claims and benefits paid £m	Amounts receivable from reinsurers £m	Total net claims and benefits paid £m
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 - restated	951	(1)	950
– Protection - restated	220	(130)	90
– Annuities	525	(384)	141
FPI			
– Investments - restated	12	–	12
– Protection - restated	1	–	1
Total	4,494	(688)	3,806

5. Net claims and benefits paid continued

In previous reporting periods OLAB was managed and reported in the FPI segment. Following the decision to stop writing new business in 2013, OLAB has been transferred to the Heritage segment and full year 2013 comparatives have been restated.

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 incurred during the period which arise from writing the contracts.

For investment contracts without DPF, acquisition costs comprise all incremental costs incurred during the period that are directly related to the writing of the contracts.

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 Standard ("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	2014 £m	Restated 2013 £m
Commission	**187**	217
Other acquisition expenses	**378**	395
Deferral	**(126)**	(164)
Amortisation and impairment of deferred acquisition costs[(i)]	**115**	106
Net acquisition expenses	**554**	554

(i) For the year ended 31 December 2013 this includes an impairment charge of £(5) million in respect of the Heritage segment's OLAB operations.

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.

Notes to the consolidated accounts

7. Administrative and other expenses continued

a) Analysis of administrative and other expenses

For the year ended 31 December	2014 £m	Restated 2013 £m
Amortisation and impairment of intangible assets	**354**	404
Employee remuneration	**212**	200
Auditor's remuneration (note 7b)	**6**	7
Investment expenses and charges	**174**	173
Investment property expenses	**7**	6
IT costs	**39**	50
Operating lease rentals, land and buildings	**20**	19
Renewal commission	**54**	59
Non-recurring costs (note 7c)	**201**	159
Other administrative expenses	**116**	178
Total administrative and other expenses	**1,183**	1,255

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	2014 £m	2013 £m
Audit of the financial statements	**0.2**	0.2
Audit of subsidiaries	**3.0**	3.9
Total audit	**3.2**	4.1
Audit related assurance services	**1.2**	1.2
Audit of MCEV supplementary information	**0.4**	0.5
Total audit and audit related assurance services, including MCEV	**4.8**	5.8
Other services:		
Other assurance services	**0.1**	0.2
All taxation advisory services	**0.1**	0.1
Corporate finance services (excluding amounts included in other assurance services and all taxation advisory services)	**1.0**	0.4
Non-audit services not covered above	**–**	0.1
Total fees	**6.0**	6.6

In addition, £41,000 (2013: £45,850) was payable in respect of the audit of the Group pension schemes.

Included in the total fees above is £0.1 million (2013: £0.2 million) in respect of the audit of the Lombard business and £0.9 million in relation to the Proposed Acquisition of Friends Life Group Limited by Aviva plc (see note 41).

c) Non-recurring costs

Non-recurring costs for the year include charges related to separation and integration, charges for significant regulatory change, finance transformation costs including Solvency II, costs in respect of the transition and service improvement elements of the outsourcing arrangement with Diligenta, costs in relation to the Proposed Acquisition and strategic review costs.

The costs in respect of separation and integration complete this programme and no future costs are anticipated relating to the activities of bringing together the entities and operations that form Friends Life today.

Notes to the consolidated accounts

8. Staff pension schemes

Closed defined benefit scheme

The pension asset or liability recognised in the statement of financial position 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 prior years, less the value of the plan assets in the scheme. The defined benefit scheme is closed to active membership and a pension surplus is only recognised to the extent it is recoverable through a refund upon winding up. 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 are charged to the income statement and consist of past service cost or credit, net interest on net defined benefit liability or 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.

a) Introduction

The Group has one closed defined benefit scheme: the Friends Provident Pension Scheme ("FPPS"), which closed to active membership on 31 December 2012.

On 1 January 2013, the Group set up a defined contribution scheme for UK employees, details of which are provided in section (d) of this note.

FPIL and SBG also operate defined contribution arrangements.

b) Closed FPPS defined benefit scheme overview

On an IAS 19: *Employee benefits* (Revised 2011) basis, a gross surplus of £59 million has been recognised in respect of the FPPS at 31 December 2014 (2013: deficit of £4 million).

The Trustee and the Group consider the funding position of the FPPS on more than one basis. As part of the triennial review of the FPPS as at 30 September 2011, the Trustee and the Group recognised a deficit of £185 million on a Technical Provisions basis and on this funding basis agreed a deficit reduction plan as at 2 January 2013, details of which are provided in section (c)(vii) of this note. The triennial review of the FPPS as at 30 September 2014 has commenced and in normal course the review would be completed within 15 months by 31 December 2015.

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 £66 million has been recognised at 31 December 2014 (2013: £48 million), reflecting the 35% tax that would arise on any notional refund in respect of the resultant IAS 19 surplus of £190 million (£151 million of deficit reduction contributions at a present value of £131 million plus the current surplus of £59 million). A deferred tax asset of £30 million (2013: £34 million) has also been recognised to reflect tax relief at a rate of 20% (2013: 20%) 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	**2014 £m**	2013 £m
IAS 19 surplus/(deficit) (excluding deficit reduction contribution)	**59**	(4)
Authorised payments surplus charge (penal tax) at 35% of available surplus following deficit reduction contribution, discounted to present value(i)	**(66)**	(48)
Net pension deficit (excluding deficit reduction contribution)	**(7)**	(52)

(i) Included in the charge for the year ended 31 December 2014 is a finance charge of £(2) million (2013: £(2) million) relating to penal tax on the present value of the pension deficit funding, which is recognised in the consolidated income statement.

Notes to the consolidated accounts

8. Staff pension schemes continued

Movement in IAS 19 pension surplus

For the year ended 31 December	2014 £m	2013 £m
Pension (deficit)/surplus at 1 January	**(4)**	62
Net interest on net defined benefit liability/asset[(i)(ii)]	**–**	3
Employer contributions	**23**	28
Remeasurement gains/(losses)	**41**	(96)
Administration costs[(i)]	**(1)**	(1)
Pension surplus/(deficit)	**59**	(4)
Present value of deficit reduction contributions	**131**	136
Available surplus subject to authorised payments surplus charge	**190**	132

(i) Recognised in the consolidated income statement.
(ii) The actual return on plan assets for the year ended 31 December 2014 is £252 million (31 December 2013: £81 million).

The total loss relating to the pension scheme recognised in the consolidated income statement for the year ended 31 December 2014 was £(3) million (2013: £nil). In addition to the amounts shown in the table above, a finance charge of £(2) million (2013: £(2) million charge) relating to penal tax on the present value of pension deficit funding has also been recognised in the consolidated income statement.

Analysis of net pension surplus/(deficit) and related deferred tax

As at 31 December 2014	Pension surplus/ (deficit) £m	Deferred tax £m
Gross IAS 19 pension surplus and related deferred tax liability	**59**	**(12)**
Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus)	**(66)**	**–**
Restriction of asset due to authorised payments surplus charge	**–**	**12**
Tax relief available on deficit reduction contributions	**–**	**30**
Net pension deficit and related deferred tax asset	**(7)**	**30**

As at 31 December 2013	Pension deficit £m	Deferred tax £m
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)	(48)	–
Restriction of liability 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

Notes to the consolidated accounts

8. Staff pension schemes continued

Remeasurement gains/(losses) of the defined benefit scheme

For the year ended 31 December	2014 £m	2013 £m
Remeasurement gains/(losses):		
– actuarial losses of the defined benefit scheme	**(149)**	(117)
– return on pension asset (excluding amounts included in net interest on net defined benefit liability/asset)	**190**	21
– irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus)[(i)]	**(15)**	(17)
Remeasurement gains/(losses) of the defined benefit scheme	**26**	(113)
Taxation	**–**	36
Remeasurement gains/(losses) of the defined benefit scheme after tax	**26**	(77)

(i) An additional finance charge of £(2) million (2013: £(2) million) is also recognised in the consolidated income statement relating to penal tax on the present value of pension deficit funding.

A tax credit of £30 million (2013: credit of £34 million) in respect of deficit reduction contributions and a further debit of £30 million (2013: credit of £2 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	2014 %	2013 %
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	**3.79**	4.48
Discount rate for pensioners	**3.50**	4.31
Single equivalent discount rate	**3.67**	4.41

The inflation rate assumptions for revaluation of deferred pensions in excess of Guaranteed Minimum Pensions ("GMPs") have been based on the consumer price index ("CPI") as the statutory inflation index. The scheme applies the statutory CPI 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 pensions 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 Investigation ("CMI"), with proportions varying by sex and by status determined from an analysis of the members' postcodes and the annual pension amounts:

Proportion of "SAPS-All" likelihood of death in any year:	2014 %	2013 %
Male pensioner	**83**	83
Female pensioner	**98**	98
Male non-pensioner	**90**	90
Female non-pensioner	**100**	100

Notes to the consolidated accounts

8. Staff pension schemes continued

In addition, allowance was made for future improvements in mortality according to each individual's year of birth through the use of the CMI's 2014 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 47 retiring at the age of 60, and current pensioners aged 71.

For the year ended 31 December	2014 years	2013 years
Expected age at death of future male pensioner	**90**	90
Expected age at death of future female pensioner	**91**	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 and the assumptions below, is as follows:

Cost of annuities	2014 £	2013 £
Male annuity	**30.21**	28.32
Female annuity	**28.88**	27.25

These rates assume a monthly payments model with a discount rate of 3.79% (2013: 4.48%). The rates also assume two-thirds of the member's 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.

Cost of annuities	2014 % of total membership	2013 % of total membership
Deferred members	**70**	71
Pensioners	**30**	29
	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 ("Aviva Annuity") (see section (vii) below).

The sensitivities regarding the principal assumptions used to measure the scheme assets/liabilities are set out below.

	31 December 2014			31 December 2013		
Assumption	Increase/ (decrease) in assumption %	Increase in scheme liabilities £m(i)	Decrease in balance sheet surplus £m(ii)	Increase/ (decrease) in assumption %	Increase in scheme liabilities £m(i)	Increase in balance sheet deficit £m(ii)
Inflation(iii)	**0.5**	**145**	**20**	0.5	135	20
CPI(iv)	**0.5**	**70**	**70**	0.5	65	60
Pension increases in payment	**0.5**	**115**	**n/a(v)**	0.5	100	n/a(v)
Discount rate(vi)	**(0.5)**	**180**	**40**	(0.5)	165	40
Rate of mortality	**1 year**	**40**	**25**	1 year	35	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 assets other than the insured asset, the scheme has a liability driven investment strategy in place, which aims to reduce volatility in the statement of financial position and profit and loss account. Broadly the scheme has hedges that cover 70% of the nominal swap interest rate movements and 85% of the RPI inflation movements when calculated on the assumptions used in this statement. The sensitivities assume no change to asset values other than the swap portfolio and are different if calculated on the scheme's funding basis.

(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.

Notes to the consolidated accounts

8. Staff pension schemes continued

(v) Sensitivity to changes in pension increases are 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 IAS 19 liabilities and the swap portfolio).

The sensitivity information has been derived for the FPPS using projected cash flows for the scheme valued using the relevant assumptions as at 31 December 2014. 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 hedges that cover 70% of the interest rate movements and 85% of the inflation movements. As such a 0.5% increase in interest rates would reduce liabilities by £180 million and a 0.5% increase in inflation would increase liabilities by £145 million.

iii) Changes in the present value of defined benefit obligations

For the year ended 31 December	2014 £m	2013 £m
Present value of obligations at 1 January	**1,414**	1,282
Interest cost	**61**	57
Actuarial losses of the defined benefit scheme:		
– Losses from change in financial assumptions	**156**	117
– Gains from change in demographic assumptions	**(21)**	–
– Experience losses	**14**	–
Benefits paid	**(45)**	(42)
Present value of obligations at 31 December	**1,579**	1,414

iv) Analysis of defined benefit obligations

The profile of the obligations is analysed as follows:

As at 31 December	2014 £m	2013 £m
Deferred members	**948**	829
Pensioners	**631**	585
Wholly or partly funded plans	**1,579**	1,414

The weighted average duration of obligations is analysed as follows:

	2014 Years	2013 Years
Deferred members	**27**	28
Pensioners	**14**	14

The maturity profile of the obligations is analysed as follows:

Expected benefit payments for the years ending:	£m
31 December 2015	**36**
31 December 2016	**36**
31 December 2017	**37**
31 December 2018	**40**
31 December 2019	**43**
Expected benefit payments for the years ending 2020 to 31 December 2024	**255**

Notes to the consolidated accounts

8. Staff pension schemes continued

v) Changes in fair value of defined benefit plan assets

For the year ended 31 December	2014 £m	2013 £m
Fair value of plan assets at 1 January	**1,410**	1,344
Interest income on plan assets	**61**	60
Return on plan assets (excluding amounts included in net interest on the defined benefit liability/asset)	**190**	21
Employer contributions	**23**	28
Benefits paid	**(45)**	(42)
Administrative expenses	**(1)**	(1)
Fair value of plan assets at 31 December	**1,638**	1,410

At 31 December 2014, there are no investments in internal linked funds (2013: £nil).

vi) Assets in the defined benefit scheme

As at 31 December	Fair value 2014 £m	Fair value 2013 £m
Equities	**224**	206
Liability-driven investment ("LDI") pools	**575**	400
Fixed interest (LDI in specie)	**152**	196
Other fixed interest	**40**	–
Insured assets	**611**	586
Cash	**36**	22
Total fair value of plan assets	**1,638**	1,410
Present value of defined benefit obligations	**(1,579)**	(1,414)
Surplus/(deficit) in the scheme	**59**	(4)

All equities and fixed interest (LDI in specie) investments are quoted in an active market.

Notes to the consolidated accounts

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, commencing with payments of £3 million in 2013, in addition to the £20 million agreed under the previous deficit reduction plan. A further payment of £21.5 million was made in July 2014, the first of a series of eight annual payments totalling £172 million.

The next triennial valuation is being carried out and the valuation, once agreed, will assist in developing an updated funding plan and funding documents.

The scheme was closed to new members on 1 July 2007 and was closed to active membership effective from 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 will exactly match the discounted liabilities for pensioners insured under the contract. The pensions in payment up to 30 June 2013 have been reassured by the Trustees to Aviva Annuity under a buy-in annuity contract where assets backing the premium progressively transfer from the Trustee to Aviva Annuity 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 return-seeking assets.

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 (defined benefit) contributions paid	
2012	27
2013	23
2014(i)	23
FPPS contributions expected to be paid	
2015(i)	23
2016(i)	23

(i) Includes contributions of £1 million per annum towards non investment costs incurred within the scheme.

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 investment managers and insurers appointed by the Trustee, are held under the control of the Trustee and are 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 member-nominated trustee directors.

The Trustee operates an Investment and Funding Committee ("IFC") and an Operations Committee responsible for assisting the Trustee in investment policy and monitoring the scheme's investments. 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.

Notes to the consolidated accounts

8. Staff pension schemes continued

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.

Interest rate and inflation risk

The Trustee has invested in an insured bulk annuity buy-in contract that covers pensions in payment up to 30 June 2013. The buy-in contract covers market and longevity risk in addition to interest rate and inflation risk.

For non-insured liabilities, the Trustee adopts an LDI strategy to reduce exposure to interest rate and inflation risk. The LDI strategy is implemented through bespoke pooled and segregated arrangements managed by F&C Management Limited ("F&C"), in which the Trustee is the sole investor. Under the bespoke arrangements, F&C manage fixed interest securities together with interest rate and inflation swaps that can, currently, have a duration of up to 50 years.

The allocation to matched assets, including the bespoke LDI arrangements, cash and fixed interest, is 75% of the non-insured assets.

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 Annuity 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 reassured benefits for pensions in payment up to 30 June 2013.

Currency risk

The Trustee has some exposure to currency risk where assets are invested by the appointed managers in global equities or non UK securities. The managers appointed by the Trustee take account of currency risks within their pooled fund vehicles or segregated mandates.

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.

d) Other pension arrangements

Contributions to the defined contribution schemes were as follows:

For the year ended 31 December	**2014 £m**	2013 £m
Group Personal Pension Plan	**18.5**	17.1
FPIL	**1.5**	1.2
SBG	**0.9**	0.7

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 of 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.

Notes to the consolidated accounts

9. Share-based payments

The Group offers share-based payment plans to certain key employees. The expense charged to the income statement is based on 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 for the achievement of non-market related performance conditions: the impact of any revisions are recognised 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 remeasured at each reporting date, with any changes in fair value recognised in the income statement for the period.

Friends Life Group

Description of the schemes

i) Friends Life Group plc Long Term Incentive Plan ("FLG LTIP")

The scheme was introduced in 2010 as a cash-settled share-based payment scheme, and 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 FLG LTIP terms were amended so that the implicit need for an exit event was replaced with a market value based calculation to measure performance, without altering the required internal rate of return of 12%.

As part of the modification, the obligation to settle the scheme passed from Friends Life Holdings plc ("FLH") to the Company. The change to the scheme was 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 the Company over 2014 to 2016. 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 terms of the FLG LTIP provide share awards if a certain market price is achieved at 30 June 2014, 30 June 2015 and 30 June 2016. The target market price was not achieved and no shares were awarded in 2014. The number of awards issued in the period was nil, 3,031 lapsed and 900 were forfeited before pro-rating (2013: 2,600 issued, nil lapsed and 450 forfeited). At 31 December 2014 there were 6,144 awards in issue before pro-rating (2013: 10,075). Awards are pro-rated according to service period. The pro-rated number of awards in issue at 31 December 2014 was 4,033 (2013: 6,354). An expense charge of £(1) million (2013: £(1) million) has been recognised in the consolidated income statement with a corresponding increase in equity included in the consolidated statement of financial position.

ii) Deferred Share Award Plan ("DSAP")

Certain key members of management have one-third of any annual bonus deferred into shares in the Company 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 grant date based on the unadjusted share price at the grant date multiplied by the number of shares awarded and the expense charge is recognised over the course of the vesting period.

New awards were granted on 7 April 2014; 776,339 shares were granted with a fair value of £2 million.

A charge of £(1) million (2013: £(1) million) has been recognised in the consolidated income statement in respect of these schemes with a corresponding increase in equity included in the consolidated statement of financial position.

iii) Contractual share awards

Certain directors are entitled to cash and shares in the Company to compensate them for awards they forfeited from their previous employer as a result of joining. 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.

Notes to the consolidated accounts

9. Share-based payments continued

A charge of £(1) million (2013: £(1) million) has been recognised in the consolidated income statement in respect of these schemes with a corresponding increase in equity included in the consolidated statement of financial position.

iv) Friends Life Group Limited Performance Share Plan ("PSP")

The PSP was approved at the AGM on 8 May 2014 and awards were granted by the Company on 16 May 2014. The aim of the plan is to incentivise the executives to increase the market value of the Company over the longer term. It is accounted for as an equity-settled scheme.

Awards were granted subject to performance conditions which must be met for awards to vest: Total Shareholder Return ("TSR"), Embedded Value ("EV") and Total Group Free Surplus Generated ("FSG"), with 50%, 25% and 25% respectively of shares vesting if the performance targets are achieved. It is not necessary for all targets to be met for the shares to vest as each performance condition applies separately to the portion of the award to which it relates. All performance conditions will be measured over a three year period. The TSR performance period commenced on the grant date and the EV and FSG performance periods commenced on 1 January 2014.

For each of the three elements of the award to vest, the Remuneration Committee must be satisfied that:

- the Group's general financial performance over the vesting period is reflective of the above three conditions; and
- there have been no material risk failings within the Group during the vesting period.

50% of any shares awarded will vest on the third anniversary of the grant date; the remaining 50% of shares awarded will vest on the fourth anniversary of the grant date.

The fair value of the TSR is calculated at grant date with the expense charge recognised over the course of the vesting period. The fair values of the non-market elements (EV and FSG) are reassessed at each reporting date with any revisions to the expense charge recognised over the course of the remaining vesting period.

The number of shares over which awards were granted at grant date was 1,877,718 with a fair value of £3 million. A further award of over 35,560 shares was made during the year, nil have lapsed and 45,862 have been forfeited.

A charge of £(1) million has been recognised in the consolidated income statement in respect of the plan with a corresponding increase in equity 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. During the course of 2013 the scheme was settled via the purchase of management's shares in FLDL by Friends Provident Distribution Holdings Limited for approximate aggregate consideration of £4 million, with the potential for further contingent consideration being payable to certain ex-management shareholders in the future depending on the value generated by the SBG companies. As at 31 December 2014 it was determined that no provision was required in relation to the contingent future consideration payable.

Lombard International Assurance SA

Description of the scheme

Lombard senior management were incentivised through a Group equity-settled scheme that entitled them to share in the growth in value of Lombard. The scheme was closed prior to the disposal of the Lombard business. No shares were awarded to Lombard management during 2014.

A charge of £(1) million (2013: £(2) million) has been recognised in the consolidated income statement in respect of the scheme prior to its closure, with a corresponding increase in equity included in the consolidated statement of financial position.

Notes to the consolidated accounts

10. Finance costs

Interest expense is calculated using the effective interest rate method.

For the year ended 31 December	2014 £m	Restated 2013 £m
Subordinated loan interest	**86**	87
Interest payable to reinsurers	**36**	47
Interest payable to credit institutions	**9**	7
Total finance costs	**131**	141

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.

Notes to the consolidated accounts

11. Taxation continued

a) Tax recognised in the consolidated income statement

For the year ended 31 December	2014 £m	Restated 2013 £m
Current tax		
UK corporation tax at 21.5% (2013: 23.25%)	**56**	1
Adjustments in respect of prior periods	**(37)**	(6)
Overseas tax	**26**	15
Total current tax charge	**45**	10
Deferred tax		
Origination and reversal of temporary differences	**100**	266
Change in tax rates	**–**	(70)
Recognition of deferred tax assets previously unrecognised	**(5)**	(50)
Adjustments in respect of prior periods	**(9)**	–
Total deferred tax charge	**86**	146
Total tax charge	**131**	156
Analysis:		
Policyholder tax	**222**	334
Shareholder tax	**(91)**	(178)
Total tax charge	**131**	156

Legislation was enacted in 2013 to reduce the rate of corporation tax 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. In 2014, the average rate of corporation tax for the full calendar year is 21.5%.

b) Factors affecting tax charge for year

For the year ended 31 December	2014 £m	Restated 2013 £m
Profit before tax from continuing operations	**64**	415
Profit before tax from continuing operations determined with reference to the average rate of corporation tax in the UK of 21.5% (2013: 23.25%)	**14**	96
Effects of:		
– non-taxable income	**(85)**	(93)
– deductions not allowable for tax purposes	**11**	(9)
– overseas tax	**4**	(6)
– valuation of tax assets and liabilities	**(18)**	(49)
– adjustments in respect of prior periods	**(29)**	(21)
– impact of reduction in corporation tax rate to 20% on deferred tax asset/liability	**–**	(70)
– policyholder tax	**222**	334
– other	**12**	(26)
Total tax charge	**131**	156

Notes to the consolidated accounts

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 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.

	2014 £m	2013 £m
Ordinary dividends declared and charged to equity in the period		
Interim 2014 – 7.05 pence per share, paid on 6 October 2014	**100**	n/a
Final 2013 – 14.09 pence per share, paid on 16 May 2014	**199**	n/a
Interim 2013 – 7.05 pence per share, paid on 4 October 2013	**n/a**	100
Final 2012 – 14.09 pence per share, paid on 20 May 2013	**n/a**	200
Total dividends	**299**	300
Interest on 2003 STICS (coupon rate 6.875%)	**14**	14
Interest on 2005 STICS (coupon rate 6.292%)	**17**	17
Total appropriations of profit	**330**	331

a) Dividends paid on ordinary shares

An interim dividend of 7.05 pence per share was paid on 6 October 2014. If the Proposed Acquisition by Aviva completes, in addition to the 0.74 new Aviva shares that shareholders will receive for each share they own, a second interim dividend of 24.1 pence per share will be paid, which results in a full year dividend of 31.15 pence per share. The second interim dividend includes a 10.01 pence per share enhancement to the 2013 final dividend. If the Proposed Acquisition does not complete, it is expected that the 2014 final dividend and therefore the 2014 full year dividend would be in line with the Company's 2013 final dividend and full year dividend respectively, subject to shareholders' approval.

b) STICS interest

Interest on the 2003 STICS is paid in equal instalments in May and November each year at a rate of 6.875%. Interest on the 2005 STICS is paid annually in either June or July at a rate of 6.292%.

Notes to the consolidated accounts

13. Earnings per share

a) Basic and operating earnings per share

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	2014 Earnings £m	2014 Pence per share	Restated 2013 Earnings £m	Restated 2013 Pence per share
(Loss)/profit after tax from continuing operations attributable to equity holders of the parent	**(98)**	**(6.93)**	228	16.08
Add back:				
– short-term fluctuations in investment return	**207**	**14.64**	(184)	(12.98)
– non-recurring items	**184**	**13.02**	131	9.24
– amortisation and impairment of acquired intangible assets	**354**	**25.05**	405	28.57
– tax credit on items excluded from operating profit	**(108)**	**(7.64)**	(174)	(12.27)
Operating profit after tax from continuing operations attributable to equity holders of the parent	**539**	**38.14**	406	28.64

(Loss)/profit after tax from continuing operations attributable to equity holders of the parent	**(98)**	**(6.93)**	228	16.08
Loss after tax from discontinued operations attributable to equity holders of the parent	**(71)**	**(5.02)**	(24)	(1.69)
(Loss)/profit after tax attributable to equity holders of the parent	**(169)**	**(11.95)**	204	14.39

b) Diluted earnings per share from continuing operations

i) Based on (loss)/profit after tax attributable to equity holders of the parent

For the year ended 31 December 2014	Earnings £m	Weighted average number of shares	Pence per share
Loss after tax from continuing operations attributable to equity holders of the parent	**(98)**	**1,413,304,704**	**(6.93)**
Dilutive effect of share awards	**–**	**2,093,441**	**–**
Diluted earnings per share on loss after tax from continuing operations attributable to equity holders of the parent	**(98)**	**1,415,398,145**	**(6.93)**

For the year ended 31 December 2013	Restated Earnings £m	Weighted average number of shares	Restated Pence per share
Profit after tax from continuing operations attributable to equity holders of the parent	228	1,417,808,590	16.08
Dilutive effect of share awards	–	904,272	(0.01)
Diluted earnings per share on profit after tax from continuing operations attributable to equity holders of the parent	228	1,418,712,862	16.07

Notes to the consolidated accounts

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 2014	**Earnings £m**	**Weighted average number of shares**	**Pence per share**
Operating profit after tax from continuing operations attributable to equity holders of the parent	**539**	**1,413,304,704**	**38.14**
Dilutive effect of share awards	**–**	**2,093,441**	**(0.06)**
Diluted earnings per share on operating profit after tax from continuing operations attributable to equity holders of the parent	**539**	**1,415,398,145**	**38.08**

For the year ended 31 December 2013	Restated Earnings £m	Weighted average number of shares	Restated Pence per share
Operating profit after tax from continuing operations attributable to equity holders of the parent	406	1,417,808,590	28.64
Dilutive effect of share awards	–	904,272	(0.02)
Diluted earnings per share on operating profit after tax from continuing operations attributable to equity holders of the parent	406	1,418,712,862	28.62

c) Diluted earnings per share from discontinued operations

i) Based on loss after tax attributable to equity holders of the parent

For the year ended 31 December 2014	**Earnings £m**	**Weighted average number of shares**	**Pence per share**
Loss after tax from discontinued operations attributable to equity holders of the parent	**(71)**	**1,413,304,704**	**(5.02)**
Dilutive effect of share awards	**–**	**2,093,441**	**–**
Diluted earnings per share on loss after tax from discontinued operations attributable to equity holders of the parent	**(71)**	**1,415,398,145**	**(5.02)**

For the year ended 31 December 2013	Restated Earnings £m	Weighted average number of shares	Restated Pence per share
Loss after tax from discontinued operations attributable to equity holders of the parent	(24)	1,417,808,590	(1.69)
Dilutive effect of share awards	–	904,272	–
Diluted earnings per share on loss after tax from discontinued operations attributable to equity holders of the parent	(24)	1,418,712,862	(1.69)

Notes to the consolidated accounts

13. Earnings per share continued

d) Weighted average number of ordinary shares

For the year ended 31 December 2014	**Actual**	**Weighted**
Issued ordinary shares at beginning of period	**1,417,508,151**	**1,417,508,151**
Effect of:		
– purchase of own shares held	**(3,271,554)**	**(2,978,592)**
– shares repurchased and cancelled	**(9,057,000)**	**(1,224,855)**
Number of ordinary shares at end of period	**1,405,179,597**	**1,413,304,704**

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

Notes to the consolidated accounts

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.

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 MCEV 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 represents 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.

Notes to the consolidated accounts

14. Intangible assets continued

Movements in intangible assets are as follows:

For the year ended 31 December 2014	**AVIF £m**	**Other £m**	**Total £m**
Cost			
At 1 January 2014	**5,520**	**560**	**6,080**
Additions	**–**	**1**	**1**
Foreign exchange adjustments	**(23)**	**(6)**	**(29)**
Transferred to operations classified as held for sale	**(576)**	**(153)**	**(729)**
At 31 December 2014	**4,921**	**402**	**5,323**
Amortisation and impairment			
At 1 January 2014	**1,893**	**332**	**2,225**
Amortisation charge for the year(i)	**324**	**60**	**384**
Impairment charge for the year(i)(ii)	**–**	**6**	**6**
Foreign exchange adjustments	**(11)**	**(5)**	**(16)**
Transferred to operations classified as held for sale	**(271)**	**(115)**	**(386)**
At 31 December 2014	**1,935**	**278**	**2,213**
Carrying amounts at 31 December 2014	**2,986**	**124**	**3,110**

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(iii)	–	(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

(i) Amortisation and impairment charges on continuing operations are included within administrative and other expenses in the consolidated income statement. Amortisation for the year of £(36) million relating to Lombard is included within loss after tax from discontinued operations in the consolidated income statement.

(ii) Impairment in 2014 of £(6) million related to intangible assets in SBG and reflects the ongoing strategic review of that business unit. AVIF impairment in 2013 of £(11) million has been recognised within OLAB as a result of worsening persistency.

(iii) Disposals in 2013 related to the sale of fully amortised software of £(8) million.

AVIF is shown gross of policyholder and shareholder tax of £544 million (2013: £693 million), with the offsetting balance included in deferred taxation.

Notes to the consolidated accounts

14. Intangible assets continued

i) AVIF

An analysis of AVIF by operating segment used for segmental reporting is set out below. The 2013 comparatives have been restated following the transfer of OLAB to Heritage in January 2014, as explained in note 3.

As at 31 December 2014	**Cost £m**	**Amortisation and impairment £m**	**Net book value £m**
UK	**896**	**(339)**	**557**
Heritage	**3,113**	**(1,176)**	**1,937**
FPI	**912**	**(420)**	**492**
Total	**4,921**	**(1,935)**	**2,986**

As at 31 December 2013	Cost £m	Amortisation and impairment £m	Net book value £m
UK	896	(291)	605
Heritage - restated	3,113	(991)	2,122
FPI - restated	912	(351)	561
Lombard	599	(260)	339
Total	5,520	(1,893)	3,627

ii) Other intangibles

Other intangibles are made up of the following:

As at 31 December 2014	**Cost £m**	**Amortisation and impairment £m**	**Net book value £m**
Customer and distribution relationships	**314**	**(191)**	**123**
Brand	**37**	**(36)**	**1**
Software	**39**	**(39)**	**–**
Goodwill	**12**	**(12)**	**–**
Total	**402**	**(278)**	**124**

As at 31 December 2013	Cost £m	Amortisation and impairment £m	Net book value £m
Customer and distribution relationships	444	(237)	207
Brand	49	(37)	12
Software	55	(46)	9
Goodwill	12	(12)	–
Total	560	(332)	228

As at 31 December 2013 other intangibles of £54 million (£41 million customer and distribution relationships; £4 million brand; £9 million software) related to Lombard.

Notes to the consolidated accounts

14. Intangible assets continued

iii) Impairment

During 2014 an impairment charge of £6 million was recognised (£5 million in respect of customer and distribution relationships and £1 million in respect of brand) relating to SBG. This impairment charge (which has reduced the value of the Sesame intangibles to £nil) reflects the outcomes identified to date from the ongoing strategic review of that business unit. Apart from this impairment charge, as at 31 December 2014, based on an impairment review of each of the CGUs, the directors are satisfied that none of the Group's intangible assets are impaired.

Following an impairment review at 31 December 2013, an impairment charge of £11 million was recognised in respect of the OLAB operation which was transferred from FPI to Heritage in January 2014. The impairment charge of £11 million was based on a recoverable amount of £25 million for OLAB AVIF. The calculation of the recoverable amount is based on value in use, determined from the current MCEV VIF balance for pre-acquisition business only, adjusted for differences between the IFRS and MCEV measurement basis for other net assets.

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, 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
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.

Notes to the consolidated accounts

15. Property and equipment continued

For the year ended 31 December 2014	Owner-occupied properties £m	Computer equipment £m	Fixtures, fittings and office equipment £m	Total £m
Fair value/cost				
At 1 January 2014	**40**	**9**	**19**	**68**
Additions	**–**	**–**	**1**	**1**
Disposals	**(5)**	**–**	**–**	**(5)**
Transferred to operations classified as held for sale	**–**	**–**	**(4)**	**(4)**
At 31 December 2014	**35**	**9**	**16**	**60**
Depreciation				
At 1 January 2014	**–**	**8**	**10**	**18**
Depreciation charge	**–**	**–**	**2**	**2**
Transferred to operations classified as held for sale	**–**	**–**	**(4)**	**(4)**
At 31 December 2014	**–**	**8**	**8**	**16**
Carrying amounts at 31 December 2014	**35**	**1**	**8**	**44**

For the year ended 31 December 2013	Owner-occupied properties £m	Computer equipment £m	Fixtures, fittings and office equipment £m	Total £m
Fair value/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

If owner-occupied properties were measured on a cost basis, the carrying amount would be £41 million (2013: £49 million).

Notes to the consolidated accounts

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	2014 £m	2013 £m
At 1 January	**2,561**	2,735
Purchases	**53**	45
Disposals	**(214)**	(265)
Fair value adjustments	**290**	46
At 31 December	**2,690**	2,561

Of the total, £1,316 million (2013: £1,259 million) is held in with-profits funds and £1,374 million (2013: £1,302 million) in unit-linked funds. The majority of the investment properties held in the with-profits and unit-linked funds are leased out under operating leases in order to generate a rental income to match policyholder liabilities.

Future minimum lease payments receivable under non-cancellable operating leases are as follows:

For the year ended 31 December	2014 £m	2013 £m
Due in the period:		
Not later than one year	**126**	140
Later than one year and not later than five years	**393**	458
Later than five years	**569**	633
Total	**1,088**	1,231

17. Principal Group undertakings

Subsidiaries are investees which the Group controls. An investor controls an investee when it has exposure, or has rights, to variable returns from involvement with the investee and has the ability to affect those returns through its power over the investee. 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.

The Group controls some structured entities. These are entities that have been designed so that the voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights generally relate to administrative tasks only and the relevant activities are directed by means of contractual relationships. Structured entities often have restricted activities and narrow, well-defined objectives. Examples can include investment funds, such as OEICs and some private equity investments, and asset-backed securities ("ABS").

Principal subsidiary undertakings of the Group as at 31 December 2014 are shown below.

As explained in the Corporate Governance section, Friends Life Group 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.

Notes to the consolidated accounts

17. Principal Group undertakings continued

Unless otherwise stated, they are undertakings incorporated and registered 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. FLH is the principal UK holding company of the Group and a full list of FLH's subsidiaries will be annexed to FLH's annual return filed at Companies House.

On 30 October 2014 the Group disposed of its interest in Lombard International Assurance SA, a subsidiary undertaking incorporated in Luxembourg. Refer to note 3(c) for further details.

Subsidiary undertaking	Activity	% held
Corporate		
Resolution Holdco No.1 LP(i)(ii)	Holding company	99.99
FLG Holdings Limited(iii) (formerly Resolution Holdings (Guernsey) Limited)	Holding company	100
Friends Life Holdings plc (formerly Friends Life Group plc)	Holding company	100
Friends Life FPG Limited ("FPG")	Holding company	100
Friends Life FPL Limited(iv)	Holding company	100
Life and pensions		
Friends Annuities Limited ("FAL")	Insurance	100
Friends Life Limited(v)	Insurance	100
Friends Life and Pensions Limited ("FLPL")	Insurance	100
Friends Provident International Limited(vi)	Insurance	100
Friends Life Management Services Limited ("FLMS")	Management services	100
Friends Life Services Limited ("FLSL")	Management services	100
Other		
Friends Life Investments Limited	Investment management	100
Sesame Bankhall Group Limited	Financial distribution business	100

(i) Held directly by Friends Life Group Limited whose name changed on 8 May 2014 (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) Has a branch in Guernsey.
(vi) Incorporated in the Isle of Man. Company has both Ordinary A and Ordinary B shares in issue. Has branches in Hong Kong, Singapore and United Arab Emirates.

Certain Group subsidiaries are subject to restrictions on the amount of funds they may transfer in the form of cash dividends or otherwise to the parent company.

Under UK company law, dividends can only be paid if a UK company has sufficient distributable reserves to cover the dividend and UK insurance companies are required to maintain solvency margins in accordance with Prudential Regulation Authority ("PRA") rules.

FPIL may remit dividends to the Group, provided it has sufficient distributable reserves and capital resources exceed the capital requirements required under local regulatory regulations of the countries in which the company operates.

Note 29 includes details of the principal regulatory and intra-group arrangements restricting availability of capital.

Funds invested in private equity vehicles are generally returned through distributions of income and capital. Immediate access to these funds can be restricted and may require the disposal of illiquid assets at a discount. Total net assets of consolidated private equity vehicles at 31 December 2014 are £795 million (31 December 2013: £1,012 million).

All OEICs consolidated by the Group are structured entities. There are no other contractual arrangements that could require a Group entity to provide financial support to these structured entities. The Group has not provided any support in the period and there are no current intentions to provide support.

Notes to the consolidated accounts

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 a financial asset is accounted for as a derecognition if substantially all of the assets' 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	**2014 £m**	2013 £m
Fair value through profit or loss (note 18(a)):		
Designated on initial recognition	**92,179**	108,791
Held for trading	**588**	265
Loans at amortised cost (note 18(b))	**1**	8
Total financial assets	**92,768**	109,064

a) Analysis of financial assets at fair value through profit or loss

As at 31 December 2014	**With-profits £m**	**Unit-linked £m**	**Non-linked annuities £m**	**Non-linked other £m**	**Shareholder £m**	**Total £m**
Shares and other variable yield securities	**6,081**	**48,951**	**–**	**109**	**2**	**55,143**
Debt securities and other fixed income securities:						
– Government securities	**6,837**	**7,240**	**3,010**	**697**	**28**	**17,812**
– Corporate bonds and loans at fair value	**6,693**	**2,513**	**8,082**	**1,278**	**649**	**19,215**
Derivative financial instruments	**479**	**13**	**80**	**5**	**11**	**588**
Deposits with credit institutions	**–**	**9**	**–**	**–**	**–**	**9**
Total financial assets held at fair value	**20,090**	**58,726**	**11,172**	**2,089**	**690**	**92,767**

Notes to the consolidated accounts

18. Financial assets continued

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

Included within the unit-linked and with-profits assets are a total of £582 million (2013: £614 million) of financial assets relating to the non-controlling interests in the OEICs that have been consolidated as the Group is deemed to have control. These comprise £504 million of shares and other variable yield securities, £54 million of government securities and £24 million of corporate bonds (2013: £523 million of shares and other variable yield securities, £69 million of government securities and £22 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 £82,496 million (2013: £98,798 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.

ABS (excluding those held by the unit-linked funds) amount to £4,353 million (2013: £4,124 million) and 99% (2013: 98%) of these are at investment grade as set out in note 30.

b) Loans at amortised cost

As at 31 December	**2014 £m**	2013 £m
Mortgage loans	**–**	4
Other loans	**1**	4
Total loans	**1**	8

The fair value of loans is considered to be the same as their carrying value.

Notes to the consolidated accounts

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 Group's consolidated statement of financial position and are analysed as follows:

As at 31 December	2014 £m	2013 £m
Shares and other variable yield securities	**48,951**	63,145
Debt securities and other fixed income securities	**9,753**	12,647
Derivative financial instruments	**13**	66
Deposits with credit institutions	**9**	217
Total financial assets held at fair value	**58,726**	76,075
Investment properties	**1,374**	1,302
Insurance and other receivables	**191**	639
Cash and cash equivalents	**2,743**	4,783
Total assets	**63,034**	82,799
Net asset value attributable to unit-holders[i] and other payables	**(1,317)**	(1,655)
Total unit-linked net assets	**61,717**	81,144

(i) Represents non-controlling interests in respect of consolidated OEICs, which the Group is deemed to control.

d) Interests in unconsolidated structured entities

The following is a summary of the Group's interest in unconsolidated structured entities as included in the Group's consolidated statement of financial position at 31 December 2014 and classified as financial assets held at fair value through profit or loss.

As at 31 December	2014 £m
Shares and other variable yield securities:	
Unit trusts and other investment vehicles	**20,221**
Private equity	**258**
Debt securities and other fixed income securities:	
Loans	**248**
Asset-backed securities	**2,988**
Total	**23,715**

IFRS 12: *Disclosure of interests in other entities* is effective for the first time in 2014 and no comparative disclosure is required for interests in unconsolidated structured entities in the first year of application.

Outstanding commitments to private equity vehicles are £65 million.

There are no other contractual arrangements that could require a Group entity to provide financial support to these structured entities, the Group has not provided any support in the period and there is no current intention to provide support. The carrying amounts represent the Group's maximum exposure to loss from its interests in unconsolidated structured entities other than commitments to private equity vehicles.

The Group does not sponsor any unconsolidated structured entities.

Notes to the consolidated accounts

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 investment contract liabilities, 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 6% (12% excluding unit-linked assets) of the Group's assets are based on valuation techniques where significant observable market data is not available (2013: 7% (11% excluding unit-linked assets)) 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. 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. Corporate bonds with single price feeds or limited trading activity are included in the level 3 category.

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 reporting 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. 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.

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 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.

Notes to the consolidated accounts

19. Fair values of assets and liabilities continued

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.

The Group has financial liabilities which contain DPF of £9,335 million (2013: £8,991 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

	Including unit-linked				Excluding unit-linked			
As at 31 December 2014	**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	–	–	2,690	2,690	–	–	1,316	1,316
Owner-occupied property	–	–	35	35	–	–	35	35
Financial assets held at fair value								
Shares and other variable yield securities	47,355	6,471	1,317	55,143	5,275	43	874	6,192
Debt securities and other fixed income securities:								
– Government securities	17,802	10	–	17,812	10,568	4	–	10,572
– Corporate bonds and loans at fair value (including asset-backed securities)	13,931	3,312	1,972	19,215	11,938	2,813	1,951	16,702
Derivative financial instruments	42	546	–	588	32	543	–	575
Deposits with credit institutions	9	–	–	9	–	–	–	–
Total assets held at fair value	79,139	10,339	6,014	95,492	27,813	3,403	4,176	35,392
Financial liabilities held at fair value								
Unit-linked investment contracts	–	53,233	–	53,233	–	–	–	–
Net asset value attributable to unit-holders	589	–	–	589	4	–	–	4
Derivative financial instruments	55	323	–	378	27	319	–	346
Total liabilities held at fair value	644	53,556	–	54,200	31	319	–	350

There are no non-recurring fair value measurements at 31 December 2014.

Notes to the consolidated accounts

19. Fair values of assets and liabilities continued

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 asset-backed securities)	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.

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.

For the Friends Life Holdings plc £162 million subordinated debt due 2021, Friends Life Holdings plc £500 million subordinated debt due 2022 and the Friends Life Holdings 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

As at 31 December 2014, £9,637 million (2013: £2,175 million) of corporate bonds, shares and other variable yield securities were transferred from level 1 to level 2 and £765 million (2013: £6,102 million) of corporate bonds, shares and other variable yield securities were transferred from level 2 to level 1. The transfers from level 1 to level 2 as at 31 December 2013 and 31 December 2014 include movements arising from refinements to the methodology under which shares and other variable yield securities are classified. Other movements between level 1 and level 2 reflect changes in market activity and in the availability of current quoted prices.

Notes to the consolidated accounts

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 properties £m**	**Shares and other variable yield securities £m**	**Corporate bonds and loans at fair value (including ABS) £m**	**Total assets held at fair value £m**
At 1 January 2014	**2,561**	**40**	**3,463**	**1,855**	**7,919**
Total gains/(losses) in consolidated income statement[(i)]	**290**	**–**	**(338)**	**121**	**73**
Purchases	**53**	**–**	**325**	**609**	**987**
Sales	**(214)**	**(5)**	**(428)**	**(397)**	**(1,044)**
Issues	**–**	**–**	**–**	**191**	**191**
Settlements	**–**	**–**	**–**	**(15)**	**(15)**
Net transfer (to)/from level 1 and level 2[(ii)]	**–**	**–**	**(202)**	**97**	**(105)**
Foreign exchange adjustments	**–**	**–**	**(57)**	**(18)**	**(75)**
Transferred to operations classified as held for sale[(iii)]	**–**	**–**	**(1,446)**	**(471)**	**(1,917)**
At 31 December 2014	**2,690**	**35**	**1,317**	**1,972**	**6,014**
Total unrealised gains/(losses) for the year included in profit or loss for assets held at 31 December 2014	**304**	**–**	**(89)**	**125**	**340**

	Investment property £m	Owner-occupied properties £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

(i) Gains and their reversal on owner-occupied properties 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.

(iii) Lombard assets were transferred to operations classified as held for sale as at 30 June 2014.

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 and loans at fair value include £346 million (2013: £331 million) of private loans; credit rating assumptions, ranging between AA and CC, have been used to derive discounted cash flow values.
- Shares and other variable yield securities include private equity investments, £194 million (2013: £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

	2014		2013	
As at 31 December	**Carrying amount £m**	**Effect of reasonably possible alternative assumptions £m**	Carrying amount £m	Effect of reasonably possible alternative assumptions £m
Unit-linked investments	**464**	**–**	2,847	–
Shares and other variable yield securities	**874**	**175**	1,134	227
Corporate bonds and loans at fair value (including ABS)	**1,951**	**195**	1,337	134
Total level 3 financial assets	**3,289**	**370**	5,318	361

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 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.

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.

For the year ended 31 December 2014	**Insurance contracts £m**	**Investment contracts £m**	**Total £m**
At 1 January	**117**	**780**	**897**
Incurred and deferred in the period	**19**	**108**	**127**
Amortisation and impairment	**(36)**	**(83)**	**(119)**
Transferred to operations classified as held for sale	**–**	**(52)**	**(52)**
At 31 December	**100**	**753**	**853**

Notes to the consolidated accounts

20. Deferred acquisition costs continued

For the year ended 31 December 2013	Insurance contracts £m	Investment contracts £m	Total £m
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

(i) Includes an impairment charge of £(5) million in respect of the Heritage segment's OLAB operations.

Included in the carrying values above, £740 million (2013: £742 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	**2014 £m**	2013 £m
At 1 January	**2,837**	3,153
Premiums(i)	**(1,000)**	595
Claims	**(672)**	(688)
Other movements(ii)	**66**	(223)
At 31 December	**1,231**	2,837

(i) On 24 November 2014 an existing reinsurance treaty was amended such that the investment risk was transferred back to the Group whilst the longevity risk continued to be reinsured. A reinsurance asset of £1.6 billion was derecognised at the amendment date. See note 32 for further details.
(ii) Other movements include changes in economic and non-economic assumptions.

No significant gain or loss arose on reinsurance contracts incepted in the year.

Included in the carrying values above, £971 million (2013: £2,565 million) is expected to be recovered more than 12 months after the reporting date.

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.

Notes to the consolidated accounts

22. Deferred tax assets and liabilities continued

a) Recognised deferred tax assets and liabilities

Deferred tax assets and liabilities are attributable to the following:

	2014			2013		
As at 31 December	**Assets £m**	**Liabilities £m**	**Net £m**	Assets £m	Liabilities £m	Net £m
Property and equipment	**23**	**–**	**23**	12	–	12
AVIF	**–**	**(544)**	**(544)**	–	(693)	(693)
Other intangible assets	**–**	**(17)**	**(17)**	–	(35)	(35)
Unrealised gains on investments	**–**	**(520)**	**(520)**	–	(581)	(581)
Employee benefits	**30**	**–**	**30**	38	–	38
Deferred acquisition costs	**–**	**(11)**	**(11)**	–	(14)	(14)
Tax value of recognised tax losses	**151**	**–**	**151**	389	–	389
Short-term temporary differences	**–**	**(73)**	**(73)**	–	(96)	(96)
Deferred tax assets/(liabilities)	**204**	**(1,165)**	**(961)**	439	(1,419)	(980)
Offset of deferred tax assets	**(204)**	**204**	**–**	(439)	439	–
Net deferred tax liabilities	**–**	**(961)**	**(961)**	–	(980)	(980)

At 31 December 2014, all of the deferred tax assets above (2013: £439 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 2014	At 1 January 2014 £m	Recognised in income[(i)] £m	Recognised in other comprehensive income £m	Foreign exchange £m	Transferred to operations classified as held for sale £m	At 31 December 2014 £m
Property and equipment	**12**	**11**	**–**	**–**	**–**	**23**
AVIF	**(693)**	**57**	**–**	**3**	**89**	**(544)**
Other intangible assets	**(35)**	**9**	**–**	**–**	**9**	**(17)**
Unrealised gains on investments	**(581)**	**61**	**–**	**–**	**–**	**(520)**
Employee benefits	**38**	**(8)**	**–**	**–**	**–**	**30**
Deferred acquisition costs	**(14)**	**4**	**–**	**–**	**(1)**	**(11)**
Tax value of recognised tax losses	**389**	**(225)**	**–**	**–**	**(13)**	**151**
Short-term temporary differences	**(96)**	**17**	**10**	**–**	**(4)**	**(73)**
Net deferred tax (liabilities)/assets	**(980)**	**(74)**	**10**	**3**	**80**	**(961)**

(i) This amount includes £12 million relating to Lombard that is included within loss after tax on discontinued operations.

Notes to the consolidated accounts

22. Deferred tax assets and liabilities continued

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	(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)

c) Unrecognised deferred tax assets and liabilities

As at 31 December 2014 the Group has £40 million (2013: £34 million) of unrecognised deferred tax assets in respect of tax losses to carry forward against future taxable profits or capital gains. Of the £40 million unrecognised deferred tax assets, £19 million (2013: £26 million) relate to trading losses, £12 million (2013: £nil) relate to non-trade loan relationship losses and the remaining £9 million (2013: £8 million) relate to capital losses. None of these losses have expiry dates.

No deferred tax assets have been recognised on these losses as there is currently no convincing evidence that future profits or capital gains will be available against which these 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	**2014 £m**	2013 £m
Receivables arising out of direct insurance operations:		
– policyholders	**92**	91
– agents, brokers and intermediaries	**24**	36
Investment income receivables	**109**	132
Investments sold for subsequent settlement	**53**	103
Prepayments and accrued income	**468**	527
Other receivables	**127**	211
Total insurance and other receivables	**873**	1,100

Of the carrying value above, £20 million (2013: £39 million) is expected to be recovered more than 12 months after the reporting date. The carrying value of each item approximates to fair value.

Notes to the consolidated accounts

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 fewer. 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	2014 £m	2013 £m
Bank and cash balances	**3,915**	5,008
Short-term deposits	**4,009**	4,682
Total cash and cash equivalents	**7,924**	9,690

The Group holds the following balances of cash and cash equivalents that are not available for use by shareholders:

As at 31 December	2014 £m	2013 £m
OEICs	**52**	85
Long-term funds	**5,850**	7,426
Total cash and cash equivalents not available for use by shareholders	**5,902**	7,511

Notes to the consolidated accounts

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 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.

c) 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 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

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 operations conducted in the UK, insurance contract liabilities are calculated based on the relevant 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 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.

Notes to the consolidated accounts

26. Insurance contracts continued

a) Changes in insurance contracts liabilities

The following table shows the movements in insurance contracts liabilities in the year:

For the year ended 31 December	**2014 £m**	2013 £m
At 1 January	**34,590**	37,232
Increase in liability from premiums	**1,517**	1,607
Release of liability due to recorded claims	**(3,710)**	(4,191)
Unwinding of discount	**409**	488
Change in assumptions:		
– Economic	**1,653**	(398)
– Non-economic	**(147)**	(66)
Other movements including net investment return	**1,438**	(82)
At 31 December	**35,750**	34,590

Included in the carrying amount above is £30,603 million (2013: £29,931 million) which is expected to be settled more than 12 months after the reporting date.

A liability adequacy test was carried out at portfolio level and resulted in no additional provision in 2014 (2013: £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 for Insurers.

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. This note 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

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 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 2014 £m	31 December 2013 £m
Maturity guarantees	FP WPF	**239**	192
	FLC New WPF	**160**	250
	FLC Old WPF	**38**	62
	FLAS WPF	**187**	209
	WL WPF	**97**	81
Guaranteed annuity options	FP WPF	**645**	495
	FLC New WPF	**197**	127
	FLC Old WPF	**73**	46
	FLAS WPF	**107**	84
	WL WPF	**7**	5
Return of premium guarantee	OLAB	**110**	60

Notes to the consolidated accounts

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 swap risk-free curve assuming interest rates of between 0.6% and 2.2% per annum (2013: 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 1.6% per annum (2013: 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

	31 December 2014 swap term			
Option term	**10 years**	**15 years**	**20 years**	**25 years**
UK Sterling				
10 years	**27%**	**26%**	**25%**	**24%**
15 years	**27%**	**27%**	**26%**	**25%**
20 years	**26%**	**25%**	**24%**	**23%**
25 years	**27%**	**26%**	**24%**	**22%**

	31 December 2013 swap term			
Option 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%

Notes to the consolidated accounts

26. Insurance contracts continued

Swaption implied volatilities – OLAB

	31 December 2014 swap term			
Option term	**10 years**	**15 years**	**20 years**	**25 years**
Euro				
10 years	**35%**	**34%**	**32%**	**31%**
15 years	**35%**	**34%**	**32%**	**30%**
20 years	**32%**	**30%**	**28%**	**26%**
25 years	**28%**	**26%**	**24%**	**23%**

	31 December 2013 swap term			
Option 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%

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

	31 December 2014		31 December 2013	
Option term	**Equities**	**Property**	Equities	Property
5 years	**21%**	**13%**	19%	15%
10 years	**22%**	**13%**	22%	15%
15 years	**23%**	**13%**	24%	15%

OLAB

	31 December 2014	31 December 2013
Option term	**Equities**	Equities
5 years	**21%**	20%
10 years	**21%**	21%
15 years	**21%**	21%

The cost of with-profits guarantees also depends on management actions that would be taken under various scenarios. Regular bonus rates are set each year such that, guaranteed maturity 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 and FLPL. Within FLL and FLPL, there are provisions for future expenses to cover the expected level of maintenance cost recharges payable to FLSL and FLMS under the management services agreements in place, 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.

For some classes of protection business, the benefit from a prudent view of expected future mortality improvements is taken on 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

	2014 % pa	2013 % pa
Pensions – lapses	**0.5 to 7**	1 to 9
Life – lapses	**4.5 to 14**	4.5 to 18
Mortgage endowments – lapses	**2.5 to 3**	3 to 4
With-profits bonds – lapses	**6.5**	9
Pensions – paid-up	**4 to 17**	4 to 17
Life – paid-up	**0.5 to 2**	0.5 to 2

FLC New WPF

	2014 % pa	2013 % pa
Pensions – lapses	**4 to 10**	4 to 10
Life – lapses	**4 to 8**	4 to 8
Mortgage endowments – lapses	**1 to 6.5**	1 to 6.5
With-profits bonds – lapses	**5.5 to 8.5**	6.25 to 8.5
Pensions – paid-up	**4 to 12**	4 to 12
Life – paid-up	**0.5 to 2**	0.5 to 2

Notes to the consolidated accounts

26. Insurance contracts continued

FLC Old WPF

	2014 % pa	2013 % pa
Pensions – lapses	**4 to 10**	4 to 10
Life – lapses	**4 to 8**	4 to 8
Mortgage endowments – lapses	**1 to 6.5**	1 to 6.5
With-profits bonds – lapses	**5.5 to 8.5**	6.25 to 8.5
Pensions – paid-up	**4 to 12**	4 to 12
Life – paid-up	**0.5 to 2**	0.5 to 2

FLAS WPF

	2014 % pa	2013 % pa
Pensions – lapses	**5.5 to 11**	6.5 to 11
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	**5.5 to 8.5**	6.25 to 8.25
Pensions – paid-up	**4.5 to 12**	4.5 to 12.5
Life – paid-up	**1 to 2**	1 to 2

WL WPF

	2014 % pa	2013 % pa
Pensions – lapses	**3 to 8**	3 to 8
Life – lapses	**4 to 9**	3 to 8
Mortgage endowments – lapses	**2 to 8**	2 to 8
With-profits bonds – lapses	**5**	5 to 9

FPLAL WPF

	2014 % pa	2013 % pa
Whole of Life – lapses	**2.5 to 3.5**	2.5 to 3.5
Whole of Life – paid-up	**5**	5

OLAB

	2014 % pa	2013 % pa
Pensions – lapses	**7.5**	2 to 12
Pensions – paid-up	**2.5**	2.5 to 12

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% (2013: 5% to 27%) 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.

Notes to the consolidated accounts

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	2014 %	2013 %
Life	FLL	Endowment and Whole Life in non-profit funds	**1.70**	2.50
		Protection	**1.70**	2.50
		Endowment and Whole Life in with-profits funds	**1.80**	2.60
	ex-FLC	Over 50 Plan in non-profit funds	**1.35**	1.95
		Over 50 Plan in with-profits funds	**1.65**	2.35
		Additional life reserves	**1.35**	1.95
		Other conventional life in non-profit funds	**1.35**	1.95
		Other conventional life in with-profits funds	**1.95**	1.95
		Life annuities from FLAS	**1.90**	2.85
		Unit-linked life	**1.35**	1.95
	ex-FLAS	Conventional life	**2.25**	3.00
		Unit-linked life	**2.25**	3.00
	ex-FLWL	With-profits fund immediate annuities	**1.45**	2.15
		Life (other)	**2.20**	2.45
		Non-profit fund life	**1.65**	2.00
	FPIL	International Protector	**2.15**	3.20
Income Protection	FLL	Income Protection	**1.60**	2.60
	ex-FLC	Permanent Health Insurance	**1.70**	2.40
Pensions	FLL	Annuities in payment	**2.08 to 2.72**	3.76
		Protection	**2.10**	3.10
		Individual and Group pensions in non-profit funds	**2.10**	3.20
		Individual and Group pensions in with-profits funds	**2.30**	3.30
	ex-FLC	Unit-linked pensions	**1.70**	2.40
		Conventional pensions in non-profit funds	**1.70**	2.40
		Conventional pensions in with-profits funds	**2.60**	3.40
		WPAD stage 1 ring-fenced NP Fund	**2.75**	3.65
		WPAD stage 2 ring-fenced NP Fund	**2.70**	n/a
		Additional pensions reserves	**1.70**	2.40
	ex-FLAS	Conventional pensions	**2.65**	3.80
		Unit-linked pensions	**2.80**	3.80
	FAL	Ex-FLC annuities reinsured December 2007	**2.45**	3.45
		Ex-FLAS annuities reinsured July 2009	**2.45**	3.55
		Ex-FLC index-linked annuities reinsured December 2007	**(0.55)**	0.15
		Ex-FLAS index-linked annuities reinsured July 2009	**(0.55)**	0.10
	ex-FLWL	With-profits fund pensions (immediate annuities)	**1.80**	2.70
		Non-profit fund pensions (immediate annuities)	**2.60**	3.65
		Non-profit fund pensions (other)	**2.10**	2.50
		With-profits fund with-profits business deferred	**1.30**	2.60
		With-profits fund with-profits business other	**2.75**	3.10

Notes to the consolidated accounts

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 2014		31 December 2013	
	Positive reserves %	**Negative reserves %**	Positive reserves %	Negative reserves %
FLL	**1.20**	**3.20**	2.00	4.40
ex-FLC non-critical illness	**0.85**	**1.85**	1.45	2.45
ex-FLC critical illness	**1.20**	**2.20**	1.90	2.90

Notes to the consolidated accounts

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 2014	31 December 2013
Term assurances – FLL	Smoker male	**82.5% TMS00(5)**	82.5% TMS00(5)
	Smoker female	**71.5% TFS00(5)**	71.5% TFS00(5)
	Non-smoker male	**82.5% TMN00(5)**	82.5% TMN00(5)
	Non-smoker female	**71.5% TFN00(5)**	71.5% TFN00(5)
Term assurances – ex-FLC/ex-FLAS	Smoker male	**82.5% TMS00(5)**	82.5% TMS00(5)
	Smoker female	**71.5% TFS00(5)**	71.5% TFS00(5)
	Non-smoker male	**82.5% TMN00(5)**	82.5% TMN00(5)
	Non-smoker female	**71.5% TFN00(5)**	71.5% TFN00(5)
Term assurance – ex-FLWL	Smoker male	**114% TM92ult(i)**	114% TM92ult(i)
	Smoker female	**114% TF92ult(i)**	114% TF92ult(i)
	Non-smoker male	**66% TM92ult(i)**	66% TM92ult(i)
	Non-smoker female	**60% TF92ult(i)**	60% 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	**105% AMC00ult**	102.5% AMC00ult
	Life/Other – ex-FLC/ex-FLAS female	**110% 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	**94.3% PCMA00(vi)**	96.6% PCMA00(vi)
	ex-FLC/FAL pension annuities female	**98.9% PCFA00(vi)**	98.9% PCFA00(vi)
	ex-FLAS pension annuities male	**94.3% PCMA00(vi)**	89.7% PCMA00(vi)
	ex-FLAS pension annuities female	**89.7% PCFA00(vi)**	92% PCFA00(vi)
Immediate annuities – ex-FLWL	Male	**101.2% PCMA00(vi)**	98.9% PCMA00(vi)
	Female	**101.2% PCFA00(vi)**	98.9% PCFA00(vi)

Notes to the consolidated accounts

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 0.50% (2013: 1.25%) per annum and 0.75% (2013: 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) 0.50% (2013: 0.75%) per annum and 0.75% (2013: 1.50%) per annum for males and females respectively for standalone critical illness

b) 0.50% (2013: 0.50%) per annum and 0.75% (2013: 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-2013 with long-term rates of 2.0% male and 1.75% female (2013: CMI-2011 with a long-term rate of 2% for both males and females).

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.

Notes to the consolidated accounts

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.

An investment contract is a financial liability 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, the fair value of the investment contract liability includes provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to the policyholders and provision for renewal commissions where intermediaries are not required to perform any service once the policy is incepted. 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 contracts liabilities are shown in the table below.

For the year ended 31 December	2014 £m	2013 £m
At 1 January	**83,502**	78,184
Premiums	**4,550**	5,956
Claims	**(6,513)**	(8,472)
Investment return, annual management charges and other expenses	**2,920**	7,356
Foreign exchange adjustments	**(756)**	478
Transferred to operations classified as held for sale	**(19,616)**	–
At 31 December	**64,087**	83,502
Analysed as follows:		
Unit-linked contracts	**53,233**	72,682
Policies with DPF	**9,335**	8,991
Other non-unit reserves	**1,519**	1,829
Total investment contract liabilities	**64,087**	83,502

None of the movement in liabilities is attributable to changes in the credit risk of the liabilities. Investment return of £3,102 million (2013: £6,900 million) is included within the income statement arising from movements in investment contract liabilities.

Included in the carrying amount above, £53,311 million (2013: £72,814 million) is expected to be settled more than 12 months after the reporting date.

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 PPFM 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.

	2014 £m	2013 £m
At 31 December	**692**	627

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 Friends Life Group that meet a minimum of 150% (2013: 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 and as such monitors the insurance groups capital adequacy ("IGCA") requirements at FLGL level.

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 estimated local regulatory positions 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 Group's estimated and unaudited 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

29. Capital continued

As at 31 December 2014	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	–	438	36	474	2,650	3,124
Inside long-term fund	–	1,656	16	1,672	–	1,672
	–	2,094	52	2,146	2,650	4,796
Other qualifying capital						
Innovative tier one capital (STICS)	–	511	–	511	(23)	488
Subordinated debt	–	869	–	869	162	1,031
Unallocated surplus	692	–	–	692	–	692
	692	3,474	52	4,218	2,789	7,007
Regulatory adjustments						
Assets	(23)	(1,292)	(2)	(1,317)	(2,523)	(3,840)
Liabilities	4,879	(26)	1	4,854	594	5,448
Available capital resources	5,548	2,156	51	7,755	860	8,615
Capital requirement						
UK realistic basis	5,054	–	–	5,054	–	5,054
Other regulatory bases	–	904	18	922	24	946
	5,054	904	18	5,976	24	6,000
Local basis capital resources over capital requirement						2,615
IGCA valuation adjustments						
Restricted assets[(i)] and shareholders' capital support of the with-profits funds						(498)
Assets in excess of market risk and counterparty limits						230
Other						(7)
Estimated IGCA surplus						2,340
Analysis of policyholder liabilities						
With-profits	17,552	–	–	17,552	–	17,552
Unit-linked	246	54,510	6,961	61,717	–	61,717
Non-participating and other non-unit reserves	4,458	15,010	1,100	20,568	–	20,568
Total policyholder liabilities	22,256	69,520	8,061	99,837	–	99,837

(i) Long-term fund surplus capital over and above capital requirements is excluded from capital resources on an IGCA basis.

Notes to the consolidated accounts

29. Capital continued

UK with-profits funds

As at 31 December 2014	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	**224**	**3**	**187**	**63**	**206**	**9**	**692**
Regulatory adjustments							
Assets	**(24)**	**–**	**–**	**–**	**–**	**1**	**(23)**
Liabilities	**1,313**	**34**	**1,557**	**467**	**1,421**	**87**	**4,879**
Available capital resources	**1,513**	**37**	**1,744**	**530**	**1,627**	**97**	**5,548**
Capital requirement							
UK realistic basis	**1,305**	**37**	**1,640**	**489**	**1,482**	**101**	**5,054**
Local basis capital resources over capital resources requirement							**494**
Analysis of policyholder liabilities							
With-profits	**7,227**	**177**	**4,669**	**1,289**	**3,607**	**583**	**17,552**
Unit-linked	**50**	**–**	**21**	**3**	**172**	**–**	**246**
Non-participating and other non-unit reserves	**2,283**	**73**	**843**	**146**	**1,000**	**113**	**4,458**
Total	**9,560**	**250**	**5,533**	**1,438**	**4,779**	**696**	**22,256**

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

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)
Assets in excess of market risk and counterparty limits						(2)
Estimated IGCA surplus						2,236
Analysis of policyholder 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.

Notes to the consolidated accounts

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 requirement							587
Analysis of policyholder 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 resources of WL WPF is covered by available capital resources of UK shareholder and non-profit funds.

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 WPF 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

29. Capital continued

c) Movement in available capital

At 31 December 2014, total available capital resources in the life operations have decreased during the year by £79 million to £7,755 million (2013: £740 million increase to £7,834 million), as shown below.

For the year ended 31 December 2014	UK Total with-profits funds £m	UK shareholders' and non-profit funds £m	Overseas life operations £m	Total life operations £m
At 1 January 2014	**5,546**	**2,123**	**165**	**7,834**
New business strain	**–**	**(65)**	**(28)**	**(93)**
Expected existing business contribution	**115**	**504**	**52**	**671**
Experience variances and development costs	**68**	**(52)**	**–**	**16**
Operating assumption changes	**118**	**121**	**(18)**	**221**
Other operating items	**14**	**166**	**4**	**184**
Economic variance and other non-operating items	**(313)**	**(179)**	**(28)**	**(520)**
Total earnings from continuing operations	**2**	**495**	**(18)**	**479**
Total earnings from discontinued operations	**–**	**–**	**–**	**–**
Other capital and dividend flows	**–**	**(462)**	**(94)**	**(556)**
Foreign exchange variances	**–**	**–**	**(2)**	**(2)**
At 31 December 2014	**5,548**	**2,156**	**51**	**7,755**

Analysis of with-profits funds

For the year ended 31 December 2014	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 2014	**1,648**	**44**	**1,706**	**508**	**1,546**	**94**	**5,546**
Expected existing business contribution	**12**	**–**	**47**	**14**	**41**	**1**	**115**
Experience variances and development costs	**3**	**–**	**8**	**2**	**39**	**16**	**68**
Operating assumption changes	**56**	**3**	**7**	**1**	**48**	**3**	**118**
Other operating items	**1**	**–**	**1**	**2**	**10**	**–**	**14**
Economic variance and other non-operating items	**(207)**	**(10)**	**(25)**	**3**	**(57)**	**(17)**	**(313)**
At 31 December 2014	**1,513**	**37**	**1,744**	**530**	**1,627**	**97**	**5,548**

Notes to the consolidated accounts

29. Capital continued

For the year ended 31 December 2013	UK Total with-profits funds £m	Restated UK shareholders' and non-profit funds £m	Restated Overseas life operations £m	Restated 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)	(70)	(34)	(121)
Expected existing business contribution	224	462	70	756
Experience variances and development costs	(266)	(37)	(1)	(304)
Operating assumption changes	59	57	5	121
Other operating items	3	107	(8)	102
Economic variance and other non-operating items	713	(6)	(3)	704
Total earnings from continuing operations	716	513	29	1,258
Total earnings from discontinued operations	–	–	10	10
Other capital and dividend flows	7	(469)	(18)	(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

Notes to the consolidated accounts

29. Capital continued

d) Intra-group capital arrangements

FLL has guaranteed the £210 million (2013: £210 million) STICS issued in 2003 and the £268 million (2013: £268 million) STICS issued in 2005. The FLH £162 million subordinated debt is also guaranteed by FLL.

On 21 April 2011, FLH 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, FLH 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 in 2013, all with-profits support arrangements were incorporated into one FLL scheme. The FLL shareholder and non-profit fund are required to retain £1.1 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 2014 £30 million (2013: £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 2014, the transfer to the FLC WPFs was £nil (2013: £nil). In the case of the WL WPF, should any transfer of the £13 million (2013: £15 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.

Notes to the consolidated accounts

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 and liquidity risks. Although under IFRS 4 insurance risk is risk other than financial risk, for risk management purposes, insurance risk is considered together with financial risk;
- 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. These results are also used 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 following tables show the sensitivity of the embedded value for covered business and the contribution from new business to changes in assumptions at 31 December 2014 and 2013, split by UK, Heritage (including the Corporate business where relevant) and International.

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 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

30. Risk management objectives and policies for mitigating risks continued

2014 Sensitivities	Change in MCEV (net of tax) UK £m	Heritage £m	Int'l £m	Total £m	Change in VNB (gross of tax) UK £m	Heritage £m	Int'l £m	Total £m
Base MCEV and VNB (per note 11 of the supplementary information)	1,780	2,172	516	4,468	141	(21)	12	132
Market and credit risk								
100bps increase in reference rates	(45)	3	3	(39)	(12)	–	(1)	(13)
100bps decrease in reference rates	51	(21)	(5)	25	13	–	1	14
Removal of illiquidity premium for immediate annuities	(174)	(563)	–	(737)	(42)	–	–	(42)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	(52)	(156)	(26)	(234)	n/a	n/a	n/a	n/a
25% increase in equity and property volatility at the valuation date	–	(31)	–	(31)	n/a	n/a	n/a	n/a
25% increase in swaption implied volatility at the valuation date	–	(1)	–	(1)	n/a	n/a	n/a	n/a
100bps increase in corporate bond spreads[(i)]	(90)	(209)	–	(299)	(19)	–	–	(19)
100bps decrease in corporate bond spreads[(i)]	116	270	–	386	24	–	–	24
10% adverse movement in Sterling/overseas exchange rate[(ii)]	(7)	(31)	(20)	(58)	n/a	n/a	n/a	n/a
10% fall in value in unit-linked funds	(67)	(233)	(31)	(331)	n/a	n/a	n/a	n/a
100bps increase in expense inflation	(33)	(91)	(10)	(134)	(8)	–	–	(8)
100bps decrease in expense inflation	30	76	9	115	7	–	–	7
Insurance and other risk								
Reduction to EU minimum capital or equivalent[(iii)]	8	43	–	51	2	–	–	2
10% decrease in maintenance expenses	38	71	23	132	5	–	2	7
10% proportionate decrease in lapse rates	44	55	8	107	15	–	1	16
10% proportionate decrease in paid-up rates	10	1	2	13	5	–	–	5
5% decrease in mortality/morbidity – life assurance								
– Before reinsurance	38	52	6	96	10	–	–	10
– After reinsurance	17	24	2	43	1	–	–	1
5% decrease in mortality/morbidity – annuity business								
– Before reinsurance	(20)	(172)	–	(192)	(3)	–	–	(3)
– After reinsurance	(20)	(59)	–	(79)	(5)	–	–	(5)
Effect of end of period assumptions on VNB	n/a	n/a	n/a	n/a	7	–	–	7

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

2013 Sensitivities	Change in MCEV (net of tax) UK £m	Restated Heritage[iv] £m	Restated Int'l[iv] £m	Total £m	Change in VNB (gross of tax) UK £m	Restated Heritage[iv] £m	Restated Int'l[iv] £m	Total £m
Base MCEV and VNB (per note 11 of the supplementary information)	1,418	2,530	1,106	5,054	184	(26)	46	204
Market and credit risk								
100bps increase in reference rates	(21)	45	(1)	23	(3)	–	–	(3)
100bps decrease in reference rates	20	(35)	(3)	(18)	1	–	2	3
Removal of illiquidity premium for immediate annuities	(118)	(399)	–	(517)	(44)	–	–	(44)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	(48)	(149)	(62)	(259)	n/a	n/a	n/a	n/a
25% increase in equity and property volatility at the valuation date	–	(30)	–	(30)	n/a	n/a	n/a	n/a
25% increase in swaption implied volatility at the valuation date	–	(4)	–	(4)	n/a	n/a	n/a	n/a
100bps increase in corporate bond spreads[i]	(72)	(177)	(9)	(258)	(18)	–	–	(18)
100bps decrease in corporate bond spreads[i]	77	150	9	236	19	–	–	19
10% adverse movement in Sterling/overseas exchange rate[ii]	(7)	(32)	(71)	(110)	n/a	n/a	n/a	n/a
10% fall in value in unit-linked funds	(62)	(212)	(94)	(368)	n/a	n/a	n/a	n/a
100bps increase in expense inflation	(30)	(94)	(18)	(142)	(7)	–	–	(7)
100bps decrease in expense inflation	26	81	14	121	5	–	–	5
Insurance and other risk								
Reduction to EU minimum capital or equivalent[iii]	9	42	–	51	2	–	–	2
10% decrease in maintenance expenses	30	69	35	134	8	–	4	12
10% proportionate decrease in lapse rates	36	57	46	139	14	–	5	19
10% proportionate decrease in paid-up rates	9	2	3	14	5	–	1	6
5% decrease in mortality/morbidity – life assurance								
– Before reinsurance	27	50	9	86	8	–	–	8
– After reinsurance	12	19	5	36	3	–	–	3
5% decrease in mortality/morbidity – annuity business								
– Before reinsurance	(17)	(129)	–	(146)	(3)	–	–	(3)
– After reinsurance	(17)	(51)	–	(68)	(5)	–	–	(5)
Effect of end of period assumptions on VNB	n/a	n/a	n/a	n/a	(11)	–	(3)	(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 (2013: 40bps) for in-force business and 40bps (2013: 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 £835 million (2013: £812 million). This sensitivity shows the impact on EV and value of new business of using the lower regulatory capital requirement.
(iv) The 2013 comparatives for International include the Lombard business. OLAB was transferred to the Heritage segment in 2014 and comparatives have been restated.

Notes to the consolidated accounts

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 economic capital model. These are equity and property risk, interest rate risk, volatility risk and foreign exchange risk.

The 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 attached 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 notes 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 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 documentation.

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:

- Schroders Investment Management Limited ("Schroders") in respect of some with-profits funds within FLL, non-profit portfolios within FLPL as well as a proportion of the unit-linked business sold by FLL and FLPL;
- AXA Investment Managers ("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 with-profits funds 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;
- restrictions on the maximum exposure to any one issuer; and
- defined sector, country or regional limits.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

Use of derivatives to manage market risk

FLI, Schroders 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 ("EBRs"). 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 (the WL WPF target corresponds to the equity participation portion of the fund only). These target levels are unchanged from 31 December 2013. 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, FP and FPLAL WPFs are managed on a basis which targets a stable proportion over time. This is also true in WL WPF 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, 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 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, Schroders 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 Schroders 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 2014 there has been no material exposure to equity risk within any of the shareholders' funds.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

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.

The Group is also exposed to foreign exchange risk through its issuance of US$575 million reset perpetual subordinated notes, guaranteed by its principal subsidiary, FLL. The USD cash flows for the coupons and principal up until the first reset date in 2018 have been hedged.

The disposal of the Lombard business has reduced the Group's exposure to translation risk. Prior to the disposal, Lombard was the only significant subsidiary undertaking with a reporting currency other than Sterling. The Lombard disposal proceeds included a deferred payment in the form of a vendor loan note, denominated in Euros, with a fair value of £56 million (€70 million). The vendor loan has an eight year term.

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 WPFs 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 most of the Group's insurance businesses.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

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.

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 ABS. Creditworthiness assessment for new and existing investments is largely undertaken on behalf of the Group by Schroders, AXA IM and FLI. In their decision-making, Schroders, 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 continued to diversify and expand its assets backing the growing annuity portfolios. During 2014, following the appointment of Metlife and Pramerica, the Group invested an additional circa £60 million in infrastructure loans and circa £70 million in commercial real estate loans.

During 2014, the exposure of the Group's shareholder funds to credit risk has been increased through a £206 million investment in a syndicated loans fund.

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 in three different ways:

- 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.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

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.

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 Advisers ("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;
- rental income due; and
- vendor loan note which formed part of the Lombard sale proceeds (refer to note 3(c)).

In general, these quantitative credit exposures are relatively low but, in some cases, they can bear relatively high likelihoods of default.

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 and corporates in non-domestic currency. The mandates that govern all Schroders, AXA IM and FLI managed funds restrict the purchase of foreign government bonds and corporate 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 Schroders, 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.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

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.

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 below 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.

As at 31 December 2014	**AAA £m**	**AA £m**	**A £m**	**BBB £m**	**BB £m**	**B £m**	**Not rated £m**	**Total £m**
Corporate bonds and loans at fair value	**204**	**2,158**	**5,598**	**3,776**	**307**	**159**	**147**	**12,349**
Asset-backed securities	**1,350**	**828**	**1,568**	**564**	**29**	**10**	**4**	**4,353**
Derivative financial instruments	**–**	**–**	**419**	**114**	**–**	**–**	**42**	**575**
Reinsurance assets	**–**	**1,149**	**82**	**–**	**–**	**–**	**–**	**1,231**
Cash and cash equivalents	**3,932**	**397**	**567**	**268**	**–**	**–**	**17**	**5,181**
Insurance and other receivables	**32**	**129**	**120**	**66**	**5**	**–**	**330**	**682**
Total	**5,518**	**4,661**	**8,354**	**4,788**	**341**	**169**	**540**	**24,371**
%	**23%**	**19%**	**34%**	**20%**	**1%**	**1%**	**2%**	**100%**

As at 31 December 2013	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Not rated £m	Total £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
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
%	20%	31%	30%	16%	1%	1%	1%	100%

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

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.

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. The carrying value of collateral is fair value. No collateral has been sold or repledged (2013: £nil).

The reinsurance assets of £1,580 million shown as at 31 December 2013 related to a reinsurance agreement that was amended in 2014 as set out in note 32. In 2013 the asset was secured by a collateral arrangement with HSBC offering protection should any counterparty supporting the reinsurance agreement default. An investment management agreement was in place to govern the suitability of collateral assets.

The following table provides information on derivative financial instruments and reinsurance assets that are subject to master netting agreements and illustrates the potential effect of netting offset arrangements after taking into account these agreements.

		Related amounts not set off in the consolidated statement of financial position(i)			
As at 31 December 2014	**Gross amounts recognised £m**	**Financial instruments £m**	**Collateral received £m**	**Collateral pledged £m**	**Net exposure £m**
Financial assets(ii)	**471**	**(176)**	**(245)**	**n/a**	**50**
Financial liabilities(ii)	**(144)**	**18**	**n/a**	**91**	**(35)**

		Related amounts not set off in the consolidated statement of financial position(i)			
As at 31 December 2013	Gross amounts recognised £m	Financial instruments £m	Collateral received £m	Collateral pledged £m	Net exposure £m
Financial assets(ii)	61	(18)	(32)	n/a	11
Reinsurance assets	1,580	–	(1,580)	n/a	–
Total	1,641	(18)	(1,612)	n/a	11
Financial liabilities(ii)	(355)	131	n/a	213	(11)

(i) Financial assets and financial liabilities that do not meet the offsetting criteria under IAS 32: *Financial instruments* and are reported gross in the consolidated statement of financial position.

(ii) Total derivative financial instruments disclosed in note 18 of £588 million (2013: £265 million) consist of the gross amounts of recognised financial assets of £471 million (2013: £61 million) and the total financial instruments offsetting financial liabilities of £18 million (2013: £131 million) in the tables above, plus other derivative financial instruments that are not subject to master netting agreements of £99 million (2013: £73 million). Total derivative financial instruments of £378 million disclosed in note 35 (2013: £430 million) consist of the gross amounts of recognised financial liabilities of £144 million (2013: £355 million) and the total financial instruments offsetting financial assets of £176 million (2013: £18 million) in the tables above, plus other derivative financial instruments that are not subject to master netting agreements of £58 million (2013: £57 million).

Notes to the consolidated accounts

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.

	2014		2013	
As at 31 December	**Insurance receivables**	**Loans**	Insurance receivables	Loans
Financial assets that are neither past due nor impaired	**92.23%**	**40.71%**	87.02%	100%
Financial assets that are past due:				
0–3 months past due	**3.61%**	**–**	5.38%	–
3–6 months past due	**0.79%**	**–**	1.98%	–
6–12 months past due	**0.52%**	**–**	1.11%	–
Impaired financial assets for which provision is made	**2.85%**	**59.29%**	4.51%	–
Total before provision for impairment (£m)	**701**	**2**	483	8

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;
- 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;

30. Risk management objectives and policies for mitigating risks continued

- assets of a suitable maturity and marketability are held to meet policyholder liabilities as they fall due;
- the implementation of temporary restrictions on the withdrawal of funds such as extension of the notice periods for switches and restrictions on withdrawals from property funds; and
- a £250 million credit facility with a syndicate of banks (Barclays Bank plc, Royal Bank of Canada, HSBC Bank plc and The Royal Bank of Scotland plc, with Barclays Bank plc as agent) exists to enable cash to be raised in a relatively short time-span. If a third party who does not presently have control of the Group acquires such control, 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 31 December 2014 the facility remains undrawn.

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			
For the year ended 31 December 2014	**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	**35,750**	**19,193**	**3,535**	**15,922**
Investment contracts	**64,087**	**64,087**	**–**	**–**
Loans and borrowings:[i]				
– Principal	**1,051**	**13**	**4**	**1,031**
– Interest	**–**	**89**	**351**	**132**
Net asset value attributable to unit-holders	**589**	**589**	**–**	**–**
Insurance payables and other payables	**629**	**589**	**40**	**–**
Derivative financial liabilities				
Interest rate swaps	**234**	**2**	**9**	**223**
Inflation rate swaps	**54**	**1**	**4**	**49**
Futures backing equities	**29**	**29**	**–**	**–**
Credit default swaps	**6**	**–**	**6**	**–**
Cross-currency swaps	**20**	**3**	**16**	**1**
Futures – fixed interest	**26**	**26**	**–**	**–**
Forward currency contracts	**9**	**9**	**–**	**–**

30. Risk management objectives and policies for mitigating risks continued

For the year ended 31 December 2013	Carrying value £m	Contractual undiscounted cash flows: Within 1 year or payable on demand £m	1–5 years £m	More than 5 years £m
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
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	–	–

(i) There is an option for the Friends Life Holdings plc US$575 million 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, £634 million (2013: £584 million) is expected to be settled more than 12 months after the reporting date.

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

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

- 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.

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.

Longevity and investment risk in respect of annuities was reduced through a reinsurance agreement put in place in April 2007. The agreement covered 100% of FLPL's in-force post-demutualisation annuity books as at 31 December 2006. On 24 November 2014 the reinsurance agreement was amended such that investment risk transferred back to the Group whilst the longevity risk continued to be reinsured. The agreement covers annuity contracts valued at £1,679 million at 31 December 2014 (2013: £1,580 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 £2,905 million of annuity liabilities in FAL and a further £1,779 million of annuity liabilities in the FLL NPF.

In September 2014 the Group's longevity exposure was increased by a further reallocation of £760 million of annuities from the with-profits funds to the shareholder funds within the Heritage Division (initial reallocation of £2 billion was performed in 2013). This transfer mitigated some of the longevity risk within the with-profits funds, transferring it to the shareholder funds which are actively seeking these risks. A third transfer of £665 million of annuity liabilities has taken place during January 2015.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

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 advisers 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 next for review in 2018 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

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:

		2014		2013	
	Coupon %	**Carrying Amount £m**	**Fair Value £m**	Carrying Amount £m	Fair Value £m
Subordinated liabilities:					
Friends Life Holdings plc £162 million LT2 subordinated debt due 2021	12.00	**176**	**228**	178	210
Friends Life Holdings plc £500 million LT2 subordinated debt due 2022	8.25	**497**	**613**	497	550
Friends Life Holdings plc US$575 million UT2 reset perpetual subordinated debt	7.875	**361**	**417**	339	378
Financial reinsurance:					
UK financial reinsurance treaties	Various	**5**	**5**	–	–
Heritage financial reinsurance treaties	Various	**9**	**9**	17	17
FPI financial reinsurance treaties	Various	**–**	**–**	11	11
Lombard financial reinsurance treaties	Various	**–**	**–**	3	3
Other:					
Amounts owed to credit institutions (overdrafts)		**3**	**3**	5	5
Total loans and borrowings		**1,051**	**1,275**	1,050	1,174

Subordinated liabilities

The FLH 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 FLH.

The FLH LT2 subordinated debt 2022 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 (2013: £3 million).

The FLH UT2 reset perpetual subordinated debt instrument 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 has an initial call date in November 2018 and is callable 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%. FLH holds a derivative instrument to manage the risks associated with fluctuations in exchange rates on the issue of this debt.

Financial reinsurance

On 30 June 2014, FLPL entered into a financial reinsurance treaty with Munich Reinsurance Company UK Limited ("Munich Re") to finance new protection business written in the first half of 2014 in the UK division. The total amount owed to Munich Re under this financial reinsurance agreement as at 31 December 2014 was £5 million (31 December 2013: £nil).

FLL has three financial reinsurance contracts with Munich Re to finance German unit-linked pensions business (now reported within the Heritage division) written in the years ended 31 December 2010, 2011 and 2012. The total amount owed to Munich Re under these financial reinsurance arrangements as at 31 December 2014 was £9 million (31 December 2013: £17 million).

31. Loans and borrowings continued

During 2013, FPI 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 2014 was £nil (31 December 2013: £11 million).

Other

Amounts owed to credit institutions (overdrafts) include £3 million (31 December 2013: £5 million) relating to credit balances held within OEICs that have been consolidated as the Group is deemed to have control. 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. If a third party who does not presently have control of the Group acquires such control, 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 31 December 2014, the facility remains undrawn.

Total interest-bearing loans and borrowings are repayable as follows:

As at 31 December	**2014 £m**	2013 £m
Within one year or on demand	**15**	31
Between one and two years	**3**	9
Between two and three years	**3**	2
Between three and four years	**4**	2
Between four and five years	**3**	2
In more than five years	**1,023**	1,004
Total loans and borrowings	**1,051**	1,050

Annual repayments include £2 million per annum amortisation of fair value adjustments and issue costs.

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 (2013: £94 million).

32. Amounts due to reinsurers

The amounts due to reinsurers represent future reassurance 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 2007 FLPL entered into a reinsurance agreement which took effect from 1 January 2007 and reinsured the longevity 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 was not reinsured under the treaty. Reassurance premium payments were 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.

On 24 November 2014 the reinsurance agreement was amended such that investment risk transferred back to the Group whilst longevity risk continued to be reinsured. This amendment resulted in the derecognition of the HSBC amortising loan note previously held and the receipt of a £1,650 million portfolio of directly held assets (UK government securities and cash) generating a realised investment gain of £28 million. The amount due to reinsurers under the agreement of £1,622 million was also derecognised with a corresponding credit recognised in premiums ceded to reinsurers. This credit was offset by a reduction in insurance contract liabilities net of reinsurance assets previously recognised in respect of this agreement of £1,659 million. During 2015, it is the Group's intention to trade the assets received into higher yielding assets thereby reducing the IFRS valuation of annuity liabilities backed by the assets.

Notes to the consolidated accounts

33. Net asset value attributable to unit-holders

OEICs and unit trusts where the Group has a controlling interest and the units are not owned by the Group are treated as a liability, as there is a contractual obligation to deliver cash, and are presented as "net asset value attributable to unit-holders".

The movements in the value of third-party interests in OEICS and unit trusts that are consolidated by the Group are as follows:

For the year ended 31 December	2014 £m	2013 £m
At 1 January	**621**	754
Share of total return in the year	**60**	89
Share of distributions in the year	**(14)**	(7)
Amount paid on issue of shares	**273**	194
Disposals	**(92)**	(156)
Amount received on cancellation of shares	**(259)**	(253)
At 31 December	**589**	621

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.

For the year ended 31 December 2014	At 1 January £m	Charged in the period £m	Released in the period £m	Utilised in the period £m	Transferred to operations classified as held for sale £m	At 31 December £m
Customer redress	**117**	**35**	**(5)**	**(30)**	**–**	**117**
Separation and integration	**2**	**–**	**–**	**(1)**	**–**	**1**
Outsourcing	**19**	**–**	**–**	**(17)**	**–**	**2**
ROL separation costs	**3**	**–**	**(1)**	**(1)**	**–**	**1**
Sesame lapses	**16**	**15**	**–**	**(18)**	**–**	**13**
Vacant property	**13**	**4**	**–**	**(9)**	**–**	**8**
Other	**57**	**23**	**(21)**	**(17)**	**(8)**	**34**
Total provisions	**227**	**77**	**(27)**	**(93)**	**(8)**	**176**

For the year ended 31 December 2013	At 1 January £m	Charged in the period £m	Released in the period £m	Utilised in the period £m	At 31 December £m
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

34. Provisions continued

Included in the carrying amount above, £28 million (2013: £43 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 (2013: £nil) is included within the charge for the year in respect of the unwind of discount and £nil (2013: £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 £47 million (2013: £49 million);
- provision for expected costs of customer redress in relation to the SBG business, totalling £23 million (2013: £35 million). This includes a provision in relation to a review of past pension transfer business of £12 million (2013: £16 million), and a provision of £11 million (2013: £19 million) in relation to complaints and other past business reviews. Whilst SBG is liable for redress costs, it is estimated that £10 million (2013: £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 £47 million (2013: £33 million).

In addition to accounting provisions, an actuarial reserve of £2 million (2013: £2 million) is held in insurance contract liabilities in respect of estimated further customer redress payments.

Timing and amounts are uncertain, but the provisions are expected to be largely utilised within two years.

b) Separation and integration

As part of the respective purchase agreements, costs were incurred 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. The remaining provision is expected to be utilised during 2015.

c) Outsourcing

The outsourcing provision relates to committed costs of the Diligenta outsourcing agreement. The provision is expected to be utilised during 2015.

d) Resolution Operations LLP ("ROL") separation costs

Provision was made in 2012 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, including associated restructuring costs. The remaining provision is expected to be utilised during 2015.

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 largely to be utilised within six years.

g) Other

Other includes £13 million relating to the Sesame strategic review, which is expected to be utilised during 2015, together with 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	2014 £m	2013 £m
Creditors arising out of direct insurance operations	**50**	104
Creditors arising out of reinsurance operations	**76**	72
Accruals and deferred income	**220**	204
Investments purchased for subsequent settlement	**82**	149
Deferred front-end fees	**61**	64
Derivative contracts	**378**	430
Other payables	**226**	289
Total insurance payables, other payables and deferred income	**1,093**	1,312

Included in the carrying amount above, £304 million (2013: £309 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 EBT to purchase and hold shares of the Company 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.

	2014		2013	
Issued and fully paid	Number of shares (million)	£m	Number of shares (million)	£m
Shares of no par value fully paid	**1,405.2**	**4,181**	1,417.5	4,223
Total at 31 December	**1,405.2**	**4,181**	1,417.5	4,223

Notes to the consolidated accounts

36. Share capital continued

Changes to share capital during the year

Issued and fully paid	31 December 2014 Number of shares (million)	Share capital £m
Opening share capital at 1 January	**1,417.5**	**4,223**
Net increase in own shares held by the Group	**(3.2)**	**(12)**
Shares repurchased and cancelled	**(9.1)**	**(30)**
Closing share capital	**1,405.2**	**4,181**

Issued and fully paid	31 December 2013 Number of shares (million)	Share capital £m
Opening share capital at 1 January	1,418.1	4,225
Net increase in own shares held by the Group	(0.6)	(2)
Closing share capital	1,417.5	4,223

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.

The increase in own shares held by the Group relates to shares held in the EBT.

On 11 July 2014, the Company announced an intention to return cash to shareholders via a share buyback programme. The Company entered into an arrangement with its corporate brokers to repurchase £317 million worth of ordinary shares of nil par value of the Company, representing 6.7% of the Company's issued share capital at that time. The share buyback commenced on 31 October 2014 following the completion of the Lombard sale.

On 21 November 2014, following the announcement that the boards of Aviva and the Group had reached agreement on the key financial terms of a possible all share combination of Aviva and Friends Life, the buyback programme was suspended and no further shares were repurchased from that date. In the period between 31 October and 21 November 2014, 9,057,000 ordinary shares were purchased for an aggregate consideration of £30 million.

37. Other reserves

Other reserves included in equity attributable to equity holders of the parent are as follows:

For the year ended 31 December 2014	Retained earnings £m	Foreign currency translation reserve £m	Total £m
1 January 2014	**1,033**	**(27)**	**1,006**
Loss for the period	**(169)**	**–**	**(169)**
Remeasurements of the defined benefit scheme (net of tax)	**26**	**–**	**26**
Tax relief on STICS interest	**20**	**–**	**20**
Foreign exchange adjustments (net of tax) and other items	**–**	**(19)**	**(19)**
Recycling of cumulative foreign exchange adjustments on disposal of foreign operations	**–**	**46**	**46**
Share-based payments	**4**	**–**	**4**
Dividends paid	**(299)**	**–**	**(299)**
At 31 December 2014	**615**	**–**	**615**

Notes to the consolidated accounts

37. Other reserves continued

For the year ended 31 December 2013	Retained earnings £m	Foreign currency translation reserve £m	Total £m
1 January 2013	1,188	(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 paid	(300)	–	(300)
At 31 December 2013	1,033	(27)	1,006

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.

FLH has issued the STICS described below which are classified as non-controlling interests. The STICS have no voting rights attached. The profit allocated to the STICS holders for the financial year, as shown in the consolidated income statement, is £31 million (2013: £31 million). The STICS holders have no interest in the accumulated profits of FLH.

As at 31 December	**2014 £m**	2013 £m
2003 STICS	**135**	135
2005 STICS	**183**	183
Other	**1**	2
Total non-controlling interests	**319**	320

The STICS are carried at their fair value at the date of acquisition of Friends Provident.

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 interest 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.

Notes to the consolidated accounts

38. Non-controlling interests continued

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 in whole or part at the option of FLH on 21 November 2019, 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 FLH, but they are irrevocably guaranteed on a subordinated basis by 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. If they pay out, they bear interest 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 (except in 2015 when the interest payment date is 1 July). The remaining STICS have no maturity date but will be redeemable in whole or part at the option of FLH 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 FLH, 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.

The profit allocated to STICS holders and interest paid is disclosed in the consolidated statement of changes in equity.

The financial results of FLH can be found in its 2014 Report and Accounts, which are publicly available.

b) Other

As at 31 December 2014 other non-controlling interests relate to minority interest holdings in foreign subsidiaries.

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. In addition, the sale agreement for the disposal of the Lombard business includes representations, warranties and indemnifications that would be expected in a transaction of this nature. Whilst 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.

In February 2013 the Group commenced a strategic review of the businesses of SBG, including Sesame Limited. This strategic review is still ongoing with a number of potential options and outcomes for the Sesame business being considered. Due to potential liabilities from future advice related claims, Sesame is reliant on the continued financial support of the Group to be able to continue to trade. Existing provisions for customer redress are disclosed in note 34. Any costs associated with future complaints are not expected to have a material adverse impact for the Group.

Notes to the consolidated accounts

39. Contingent liabilities and commitments continued

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:

	2014			2013		
	Land and buildings £m	**Other £m**	**Total £m**	Land and buildings £m	Other £m	Total £m
Within one year	**12**	**–**	**12**	15	1	16
Between one and five years	**43**	**–**	**43**	55	1	56
In more than five years	**71**	**–**	**71**	81	1	82
Total operating lease payables	**126**	**–**	**126**	151	3	154

At 31 December 2013, £17 million of lease commitments related to the Lombard business that was sold in 2014 (£14 million land and buildings; £3 million other).

Other commitments

The Group has investment property commitments of £24 million (2013: £16 million) relating to ongoing construction, renovation costs and costs of acquiring existing properties.

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

The key management personnel of Friends Life Group Limited are 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 of the key management personnel in respect of the year ending 31 December 2014 is as set out below:

	2014 Number	**2014 £m**	2013 Number	2013 £m
Salary and short-term employee benefits[(i)]	**21**	**10**	30	10
Post-employment benefits (excluding defined benefit scheme)	**1**	**–**	1	–
Share-based payments	**1**	**1**	7	2
Total key management personnel compensation charged to the income statement		**11**		12
Post-employment benefits: defined benefit schemes	**–**	**–**	–	–
Total key management personnel compensation		**11**		12

(i) Including Messrs Cowdery and Tiner who stepped down from the board on 8 May 2014.

There were no balances outstanding at the year end with key management (2013: £nil).

Salary and short term employment benefits include £nil payments for loss of office (2013: £0.9 million).

Notes to the consolidated accounts

40. Related parties continued

b) Other related parties

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 which owns FLG Holdings Limited, the holding company for the Friends Life Group. The limited partner in RHN1 is RCAP UK LP ("RCAP"). RCAP is an entity established by current and former partners and employees of ROL including Messrs Cowdery and Tiner who served as directors of the Company during the year as set out in the Governance report. RCAP is entitled to share in the value created by RHN1.

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 in March 2013.

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 £1,676 million of capital returned to the Company to date) is approximately £3,065 million as shown below.

	Gross equity deployed		
Transaction	**The Company £m**	**RCAP £m**	**Total £m**
Friends Provident[i]	**1,916.0**	**0.2**	**1,916.2**
AXA UK Life Business[ii]	**2,139.8**	**0.2**	**2,140.0**
Total	**4,055.8**	**0.4**	**4,056.2**

(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.

Accumulated value of net equity deployed	**2014 £m**	2013 £m
At 1 January	**3,543**	3,752
Distributions from RHN1	**(610)**	(350)
Accumulations in the year	**132**	141
At 31 December	**3,065**	3,543

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 (refer to note 41).

If the Company 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.

c) Related party transactions

There were no related party transactions entered into by Friends Life Group Limited or any member of the Friends Life Group during the year ended 31 December 2014, save for transactions with Clive Cowdery, or entities with which he is associated, which are related party transactions under Listing Rule 11 by virtue of him being a director of Friends Life Group Limited until 8 May 2014.

Notes to the consolidated accounts

40. Related parties continued

Property lease

On 12 March 2014, Friends Life entered into a deed of variation and settlement with ROL and Resolution Capital Limited (entities controlled by Clive Cowdery) under which the Company paid £875,000 to discharge certain obligations which arose from the business sale agreement entered into between the Company and ROL in December 2012. The value of the transactions amounted to £875,000 and did not require shareholder or any other approval.

Resolution (Brands) Limited

The Company was party to an amended and restated trademark licensing agreement (the "Trademark Licence Agreement") with Resolution (Brands) Limited, (a company wholly owned by Clive Cowdery), under which the Company had been granted a licence to use the "Resolution" trademark. There were no fees payable under the agreement in 2014 (2013: £nil). The Trademark Licence Agreement was terminated following the change of name to Friends Life Group Limited, approved by shareholders at the Company's Annual General Meeting held on 8 May 2014.

41. Post balance sheet events

On 19 January 2015, the Group published a Scheme of Arrangement ("the Scheme") document in relation to the Proposed Acquisition by Aviva plc of Friends Life Group Limited. An Aviva Prospectus was issued by Aviva plc on the same day.

Under the terms of the Proposed Acquisition, Friends Life shareholders will receive 0.74 Aviva shares for each Friends Life share owned. In addition, a second interim dividend of 24.1 pence per share will be paid to Friends Life shareholders after the Scheme is approved. In the event that the transaction does not complete, the second interim dividend will not be paid, and it would be expected that the 2014 full year dividend would be in line with the 2013 full year dividend. At completion of the Proposed Acquisition the Group is required to settle the RCAP value share arrangement (see note 40) in cash. The cash consideration payable to RCAP is expected to be approximately £220 million. However, under the terms of the Limited Partnership Agreement, RCAP can elect to receive the consideration in shares.

The Proposed Acquisition must be approved by the Company's shareholders, Aviva's shareholders and the Guernsey Court. Subject to approval, the Proposed Acquisition will be completed by way of a Scheme of Arrangement in accordance with Guernsey company law. The Scheme will require shareholder approval at a meeting convened by order of the Guernsey Court ("the Court Meeting") and at an extraordinary general meeting of the Company ("the General Meeting"). The Court Meeting and General Meeting will be held on 26 March 2015. If the Proposed Acquisition is approved by shareholders and the Court, the Scheme will become effective on 10 April 2015, Aviva shares will be issued to Friends Life shareholders, and the second interim dividend will be paid by 24 April 2015.

Statement of directors' responsibilities in respect of the Market Consistent Embedded Value ("MCEV") basis

The directors of Friends Life Group 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.

On behalf of the Board

Tim Tookey
Chief Financial Officer

4 March 2015

Independent auditor's report to the directors of Friends Life Group Limited on the consolidated Market Consistent Embedded Value ("MCEV") financial statements

We have audited the consolidated MCEV financial statements of Friends Life Group Limited for the year ended 31 December 2014, 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 Friends Life Group 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 196 to 199.

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 196 to 199 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 judgment, 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 2014 are prepared, in all material respects, in accordance with the CFO Forum Principles and the basis of preparation set out on pages 196 to 199.

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 Friends Life Group 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 30 July 2014 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 Friends Life Group Limited for the year ended 31 December 2014. 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.

Ernst & Young LLP
London
4 March 2015

Consolidated income statement – MCEV basis

For the year ended 31 December 2014

For the year ended 31 December	Notes	2014 £m	Restated 2013 £m
Covered business			
Value of new business	6	**132**	179
Expected existing business contribution		**241**	215
Operating experience variances		**(65)**	(32)
Operating assumption changes		**29**	101
Other operating variances		**219**	172
Development costs	10	**(35)**	(47)
Covered business operating profit before tax	3	**521**	588
Other income and charges		**(23)**	(53)
Operating profit before tax		**498**	535
Economic variances	3	**(143)**	401
Non-recurring items and non-operating variances	3	**(277)**	(143)
Profit from continuing operations before tax		**78**	793
Tax on operating profit		**(91)**	(127)
Tax on other activities		**88**	(59)
Profit from continuing operations after tax		**75**	607
Profit/(loss) from discontinued operations after tax		**14**	(28)
Profit for the year[(i)]		**89**	579

(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 2014 includes the results of Lombard International Assurance S.A. and Insurance Development Holdings AG (collectively "Lombard") as a discontinued operation. The Lombard result after tax up until the date of disposal on 30 October 2014 is shown as a single amount in the consolidated income statement. The 2013 comparative results have been restated to reflect Lombard as a discontinued operation.

Earnings per share – MCEV basis

For the year ended 31 December 2014

Basic earnings per share	Note	2014 Pence	Restated 2013 Pence
Basic earnings per share on MCEV basis after tax from continuing operations, attributable to equity holders of the parent	4	**5.31**	42.81
Basic earnings per share on MCEV basis after tax from discontinued operations, attributable to equity holders of the parent	4	**0.99**	(1.97)
Total basic earnings per share		**6.30**	40.84

Diluted earnings per share	Note	2014 Pence	Restated 2013 Pence
Diluted earnings per share on MCEV basis after tax from continuing operations, attributable to equity holders of the parent	4	**5.30**	42.79
Diluted earnings per share on MCEV basis after tax from discontinued operations, attributable to equity holders of the parent	4	**0.99**	(1.97)
Total diluted earnings per share		**6.29**	40.82

Consolidated statement of comprehensive income – MCEV basis

For the year ended 31 December 2014

	2014 £m	Restated 2013 £m
Profit from continuing operations after tax	**75**	607
Profit/(loss) from discontinued operations after tax	**14**	(28)
Profit for the year	**89**	579
Remeasurement gains/(losses) on defined benefit pension schemes, net of tax	**26**	(77)
Other comprehensive income/(loss) for the year from continuing operations	**26**	(77)
Foreign exchange adjustments	**(31)**	16
Other comprehensive (loss)/income for the year from discontinued operations	**(31)**	16
Total other comprehensive loss for the year, net of tax	**(5)**	(61)
Total comprehensive income for the year from continuing operations	**101**	530
Total comprehensive loss for the year from discontinued operations	**(17)**	(12)
Total comprehensive income for the year[(i)]	**84**	518

(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 2014

	2014 £m	2013 £m
Opening ordinary shareholders' equity	**6,065**	5,831
Disposal of AmLife on 4 January 2013	**–**	7
Total comprehensive income for the year	**84**	518
Increase in own shares held by the Group	**(13)**	(2)
Dividends paid	**(299)**	(300)
Share-based payments, net of settlements	**5**	7
Disposal of Lombard on 30 October 2014[(i)]	**(283)**	–
Shares repurchased and cancelled	**(30)**	–
Other movements[(ii)]	**–**	4
(Decrease)/increase in MCEV reserves for the year	**(536)**	234
Closing ordinary shareholders' equity	**5,529**	6,065

(i) Lombard was sold on 30 October 2014 for a consideration of £316 million. The disposal value of Lombard of £(283) million reflects the £316 million sale value less the £594 million MCEV value of Lombard as at the date of sale, less the impact of liabilities assumed as a result of the transaction.

(ii) For 31 December 2013, other movements comprise the consolidation of the Group's Employee Benefit Trust (£2 million) and release of a share entitlement provision (£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 financial position – MCEV basis

For the year ended 31 December 2014

	2014 £m	2013 £m
Assets		
VIF of covered business	**3,739**	4,369
Intangible assets	**–**	7
Property and equipment	**44**	50
Investment properties	**2,690**	2,561
Financial assets	**92,709**	109,064
Deferred acquisition costs	**–**	76
Reinsurance assets	**1,231**	2,837
Current tax assets	**24**	33
Insurance and other receivables	**900**	1,134
Cash and cash equivalents	**7,924**	9,690
Total assets	**109,261**	129,821
Liabilities		
Insurance contracts	**35,822**	34,647
Unallocated surplus	**692**	627
Financial liabilities		
– Investment contracts	**63,229**	82,574
– Loans and borrowings	**1,770**	1,633
– Amounts due to reinsurers	**–**	1,580
Net asset value attributable to unit-holders	**589**	621
Provisions	**176**	230
Pension scheme deficit	**7**	52
Deferred tax liabilities	**419**	544
Current tax liabilities	**–**	1
Insurance payables, other payables and deferred income	**1,027**	1,245
Total liabilities	**103,731**	123,754
Equity attributable to:		
– Equity holders of the parent	**5,529**	6,065
– Non-controlling interests	**1**	2
Total equity	**5,530**	6,067
Total equity and liabilities	**109,261**	129,821

Group MCEV analysis of earnings

For the year ended 31 December 2014

	2014			Restated 2013
	Covered business £m	**Non-covered business £m**	**Total business £m**	Total business £m
Opening Group MCEV	**5,054**	**1,011**	**6,065**	5,831
Opening adjustments:				
– disposal of AmLife	**–**	**–**	**–**	7
Adjusted opening Group MCEV	**5,054**	**1,011**	**6,065**	5,838
Operating MCEV earnings	**415**	**(8)**	**407**	408
Non-operating MCEV earnings	**(306)**	**(26)**	**(332)**	199
Total MCEV earnings from continuing operations	**109**	**(34)**	**75**	607
Earnings from discontinued operations	**21**	**(7)**	**14**	(28)
Other movements in IFRS net equity	**–**	**26**	**26**	(77)
Closing adjustments:				
– capital and dividend flows	**(416)**	**79**	**(337)**	(291)
– foreign exchange variances	**(31)**	**–**	**(31)**	16
– disposal of Lombard	**(269)**	**(14)**	**(283)**	–
Closing Group MCEV	**4,468**	**1,061**	**5,529**	6,065

Notes to the MCEV results

1. Basis of preparation

Introduction

Friends Life Group 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 4 March 2015.

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 the 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 Group holding company level and certain holding company costs 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; and
- FPI.

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.

In previous reporting periods, OLAB was managed and reported within the FPI segment. Following the decision to stop writing new business in 2013, OLAB was transferred to the Heritage segment in January 2014 and the segmental comparatives for 31 December 2013 have been restated.

On 30 October 2014, the Company disposed of its entire holding of Lombard for a total consideration of £316 million, comprising £260 million upfront cash consideration and £56 million deferred consideration in the form of a vendor loan note. The results of Lombard for the period to disposal have been shown under discontinued operations, and comparatives for the year ended 31 December 2013 have been restated as appropriate.

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, corporate costs and the cost of holding any required capital in excess of the operating segment capital policy.

Notes to the MCEV results

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 includes certain corporate benefit schemes that have been transferred within Friends Life on to the new 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.

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.

Notes to the MCEV results

1. Basis of preparation continued

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 the 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 by fitting statistical distributions to each material risk that the with-profits funds are exposed to, randomly sampling from these distributions over the lifespan of the funds. Monte Carlo simulation has been used, and any simulation where adverse risk events exceed the total fund assets represents a cost to the shareholder. TVOG is the average of these costs over all simulations. Allowance has been made under the different scenarios for management actions, such as reductions in the enhancements made to asset shares. 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.

Notes to the MCEV results

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 mitigate the risk fully. 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. 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

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 2014

	Covered business					
Net of tax	Free surplus £m	Required capital £m	VIF £m	Total £m	Non-covered business £m	Total MCEV £m
Opening Group MCEV	**664**	**21**	**4,369**	**5,054**	**1,011**	**6,065**
Value of new business	**(169)**	**76**	**199**	**106**	**–**	**106**
Expected existing business contribution:						
– reference rate	**16**	**(9)**	**29**	**36**	**–**	**36**
– in excess of reference rate	**7**	**(41)**	**191**	**157**	**–**	**157**
Transfers from VIF and required capital to free surplus	**535**	**(2)**	**(533)**	**–**	**–**	**–**
Operating experience variances and development costs	**(59)**	**8**	**(30)**	**(81)**	**–**	**(81)**
Operating assumption changes	**113**	**(9)**	**(80)**	**24**	**–**	**24**
Other operating items	**35**	**133**	**5**	**173**	**(8)**	**165**
Operating Group MCEV earnings	**478**	**156**	**(219)**	**415**	**(8)**	**407**
Economic variances	**(142)**	**(45)**	**77**	**(110)**	**(3)**	**(113)**
Other non-operating items	**(139)**	**(29)**	**(28)**	**(196)**	**(23)**	**(219)**
Total Group MCEV earnings from continuing operations	**197**	**82**	**(170)**	**109**	**(34)**	**75**
Earnings from discontinued operations	**4**	**2**	**15**	**21**	**(7)**	**14**
Total Group MCEV earnings	**201**	**84**	**(155)**	**130**	**(41)**	**89**
Other movements in IFRS net equity	**–**	**–**	**–**	**–**	**26**	**26**
Closing adjustments:						
– capital and dividend flows	**(416)**	**–**	**–**	**(416)**	**79**	**(337)**
– foreign exchange variances	**–**	**(4)**	**(27)**	**(31)**	**–**	**(31)**
– acquired/divested businesses	**260**	**(81)**	**(448)**	**(269)**	**(14)**	**(283)**
Closing Group MCEV	**709**	**20**	**3,739**	**4,468**	**1,061**	**5,529**

Notes to the MCEV results

2. Analysis of MCEV earnings continued

For the year ended 31 December 2013

Net of tax	Restated Covered business Free surplus £m	Restated Covered business Required capital £m	Restated Covered business VIF £m	Restated Covered business Total £m	Restated Non-covered business £m	Restated Total MCEV £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	(189)	82	249	142	–	142
Expected existing business contribution:						
– reference rate	13	(8)	28	33	–	33
– in excess of reference rate	7	(49)	179	137	–	137
Transfers from VIF and required capital to free surplus	526	(13)	(513)	–	–	–
Operating experience variances and development costs	(5)	(34)	(30)	(69)	–	(69)
Operating assumption changes	52	5	26	83	–	83
Other operating items	5	93	34	132	(50)	82
Operating Group MCEV earnings	409	76	(27)	458	(50)	408
Economic variances	265	(81)	127	311	–	311
Other non-operating items	(231)	(21)	63	(189)	77	(112)
Total Group MCEV earnings from continuing operations	443	(26)	163	580	27	607
Earnings from discontinued operations	5	3	(36)	(28)	–	(28)
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

Notes to the MCEV results

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 2014

	Covered business					Non-covered business	
Gross of tax	**UK £m**	**Heritage £m**	**FPI £m**	**Lombard £m**	**Corporate £m**	**£m**	**Total £m**
Value of new business	**141**	**(21)**	**12**	**–**	**–**	**–**	**132**
Expected existing business contribution	**73**	**211**	**21**	**–**	**(64)**	**–**	**241**
Operating experience variances	**(35)**	**(17)**	**(13)**	**–**	**–**	**–**	**(65)**
Operating assumption changes	**14**	**13**	**2**	**–**	**–**	**–**	**29**
Other operating variances	**(15)**	**228**	**6**	**–**	**–**	**–**	**219**
Development costs	**(19)**	**(12)**	**(4)**	**–**	**–**	**–**	**(35)**
Covered business operating profit/(loss) before tax	**159**	**402**	**24**	**–**	**(64)**	**–**	**521**
Other income and charges	**–**	**–**	**–**	**–**	**–**	**(23)**	**(23)**
Operating profit/(loss) before tax	**159**	**402**	**24**	**–**	**(64)**	**(23)**	**498**
Economic variances	**64**	**(24)**	**2**	**–**	**(180)**	**(5)**	**(143)**
Other non-operating items	**(127)**	**(117)**	**(4)**	**–**	**–**	**(29)**	**(277)**
Profit/(loss) from continuing operations before tax	**96**	**261**	**22**	**–**	**(244)**	**(57)**	**78**
Attributed tax on operating result	**(34)**	**(86)**	**–**	**–**	**14**	**15**	**(91)**
Attributed tax on other activities	**14**	**35**	**–**	**–**	**31**	**8**	**88**
Profit/(loss) from continuing operations after tax	**76**	**210**	**22**	**–**	**(199)**	**(34)**	**75**
Profit/(loss) from discontinued operations after tax	**–**	**–**	**–**	**21**	**–**	**(7)**	**14**
Profit/(loss) after tax	**76**	**210**	**22**	**21**	**(199)**	**(41)**	**89**

Notes to the MCEV results

3. Segmental analysis of MCEV earnings continued

For the year ended 31 December 2013

Gross of tax	Covered business UK £m	Restated Heritage(i) £m	Restated FPI(i) £m	Restated Lombard(ii) £m	Corporate £m	Restated Non-covered business(ii) £m	Restated Total(ii) £m
Value of new business	184	(26)	21	–	–	–	179
Expected existing business contribution	60	214	16	–	(75)	–	215
Operating experience variances	(33)	(2)	3	–	–	–	(32)
Operating assumption changes	(6)	96	11	–	–	–	101
Other operating variances	36	138	(2)	–	–	–	172
Development costs	(30)	(10)	(7)	–	–	–	(47)
Covered business operating profit/(loss) before tax	211	410	42	–	(75)	–	588
Other income and charges	–	–	–	–	–	(53)	(53)
Operating profit/(loss) before tax	211	410	42	–	(75)	(53)	535
Economic variances	60	417	(5)	–	(71)	–	401
Other non-operating items	(5)	(240)	(2)	–	–	104	(143)
Profit/(loss) from continuing operations before tax	266	587	35	–	(146)	51	793
Attributed tax on operating result	(49)	(99)	–	–	18	3	(127)
Attributed tax on other activities	(18)	(30)	–	–	16	(27)	(59)
Profit/(loss) from continuing operations after tax	199	458	35	–	(112)	27	607
Loss from discontinued operations after tax	–	–	–	(28)	–	–	(28)
Profit/(loss) after tax	199	458	35	(28)	(112)	27	579

(i) Heritage and FPI 31 December 2013 segmental analysis have been restated following the transfer of OLAB business from FPI to Heritage in January 2014.
(ii) Lombard has been treated as discontinued operations as at 31 December 2014 and consequently the 31 December 2013 comparatives have been restated.

Notes to the MCEV results

3. Segmental analysis of MCEV earnings continued

Continuing operations

UK covered business

The life and pensions covered business operating profit before tax for the UK segment was £159 million (2013: £211 million).

VNB

Further details of the calculation and analysis of the VNB are discussed in note 6.

Expected existing business contribution

The total expected contribution of £73 million (2013: £60 million) comprises £67 million from applying expected rates of return to the value of in-force of £1,033 million at the start of the period, and £6 million of expected return on shareholders' net assets. The UK expected contribution on shareholders' net assets of £6 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 £(35) million (2013: £(33) million) and comprise the following elements:

- £(19) million charge from worse than expected persistency experience, in particular on the Corporate Benefits and Group Protection businesses. As at 31 December 2013 a provision of £50 million was held to cover adverse persistency on existing corporate pensions schemes. £13 million of this provision has been used to meet the adverse experience during 2014;
- £(8) million charge from worse than assumed mortality experience, in particular in the Group Protection business;
- £(6) million charge from expenses, primarily due to a short-term expense overrun on the Corporate Benefits platform as the volume of business gets up to scale; and
- £(2) million net charge from other sources.

Operating assumption changes

Operating assumption changes of £14 million in the year (2013: £(6) million) comprise:

- £27 million benefit from updating the long-term expense assumptions including a reduction in Corporate Benefits investment expenses, of which the strategic investment partnership with Schroders had a significant contribution;
- £17 million benefit from adopting longevity assumptions for annuities that assume a shorter expectation of life in line with the updated mortality projections released by the Continuous Mortality Investigation ("CMI");
- £(23) million charge from strengthening the morbidity assumptions primarily on critical illness and income protection business; and
- £(7) million net charge for persistency which includes a £(13) million charge from the increase in the provision to cover renegotiation of terms on existing schemes and the impact of updating the lapse assumptions on Corporate Benefits business following experience, partially offset by the benefit from updating persistency assumptions on Protection business.

Other operating variances

Other operating variances of £(15) million in the year (2013: £36 million) is primarily driven by modelling improvements within the Protection business.

Development costs

Development costs of £(19) million (2013: £(30) 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 Benefits platform; and
- the development of the Protection proposition.

Notes to the MCEV results

3. Segmental analysis of MCEV earnings continued

Heritage covered business

The life and pensions covered business operating profit before tax for the Heritage segment was £402 million (2013: £410 million).

VNB

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 (2013: £214 million) comprises £194 million from applying expected rates of return to the value of in-force of £2,397 million at the start of the period, and £17 million of expected return on shareholders' net assets. The Heritage expected contribution on shareholders' net assets of £17 million primarily reflects the return based on the reference rate.

Operating experience variances

Operating experience variances totalled £(17) million (2013: £(2) million) and comprise the following elements:

- £(21) million charge from changes in provisions in respect of legacy business;
- £(14) 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;
- £20 million benefit from persistency experience being better than anticipated primarily on unit-linked bonds;
- £6 million benefit from better than assumed mortality experience, in particular on the life protection business; and
- £(8) million net charges from other sources.

Operating assumption changes

Operating assumption changes of £13 million in the year (2013: £96 million) comprise:

- £34 million benefit from updating persistency assumptions primarily from investment bond business;
- £27 million benefit from adopting longevity assumptions for annuities that assume a shorter expectation of life in line with the updated mortality projections released by the CMI;
- £18 million benefit from an increase in deferred tax assets following the removal of restrictions on the valuation of deferred acquisition expenses;
- £6 million net benefit from a revision on inception and recovery rates on income protection and critical illness business, partially offset by an update to mortality rates for investment bonds;
- £(50) million charge from establishing a provision to cover anticipated adverse persistency on pensions business following the UK Chancellor's Budget announcement in March 2014; and
- £(22) million net charge from updating the long-term expense assumptions and partially offset by the benefit of savings on future investment expenses, of which the strategic investment partnership with Schroders had a significant contribution.

Other operating variances

Other operating variances of £228 million (2013: £138 million) comprise:

- £97 million as a result of a project to recapture £1.6 billion of assets backing annuities;
- £68 million benefit reflecting the impact of the with-profits annuity reallocation activity;
- £94 million from a change to the modelling used in the Time Value of Options and Guarantees, to align with the Group's Economic Capital model; and
- £(31) million net charge from various other modelling changes.

Development costs

Development costs of £(12) million (2013: £(10) 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.

Notes to the MCEV results

3. Segmental analysis of MCEV earnings continued

FPI covered business

The life and pensions covered business operating profit before tax for the FPI segment was £24 million (2013: £42 million).

VNB

Further details of the calculation and analysis of the VNB are discussed in note 6.

Expected existing business contribution

The expected contribution of £21 million (2013: £16 million) comprises £20 million which reflects the expected return on the opening value of in-force of £424 million at 1 January 2014, and £1 million from the expected return on shareholders' net assets.

Operating experience variances

Operating experience variances of £(13) million (2013: £3 million) comprise:

- £(8) million charge from worse than expected persistency experience, primarily on regular savings plans;
- £(2) 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; and
- £(3) million net charge from other operational elements and other minor variances.

Operating assumption changes

Operating assumption changes of £2 million in the year (2013: £11 million) comprise:

- £14 million benefit from updating mortality assumptions;
- £(21) million charge from increasing the long-term expense assumptions;
- £(5) million charge from updating persistency assumptions principally from an increase in partial withdrawal assumptions; and
- £14 million net benefit from other assumption changes, primarily relating to deferral of maturity dates on regular savings plans.

Other operating variances

Other operating variances, amounting to £6 million in the year (2013: £(2) million) principally reflect enhancements to models following internal review and movements in the cost of non-hedgeable risk.

Development costs

Development costs of £(4) million (2013: £(7) million) primarily relate to a small number of product and systems driven projects.

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 £(64) million (2013: £(75) million) represents the expected interest costs arising on the debt held within the life and pensions covered business with the decrease being driven principally by a reduction in spread on the Group's external debt.

Non-covered business

The non-covered business generated an operating loss of £(23) million (2013: £(53) million) which comprises:

- £(19) million of corporate costs;
- £(5) million operating result of Sesame Bankhall; and
- £1 million operating result of fpb AG, the Group's distributor of German business.

Notes to the MCEV results

3. Segmental analysis of MCEV earnings continued

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 £(143) million (2013: £401 million) and these comprise:

- £(185) million from an increase in the market value of debt;
- £(119) million principally reflects the incomplete trading of gilt assets into higher yielding assets as part of the recapture of £1.6 billion of assets backing annuities. This variance is expected to reverse as the assets are reinvested in 2015;
- £(70) million as a result of worse than expected investment returns on equities which reduced the value of future charges, and hence PVFP, on unit-linked business;
- £(64) million due to the widening of credit spreads on corporate bonds;
- £(17) million reflecting adverse currency movements;
- £98 million benefit due to an increase in the illiquidity premium assumption;
- £82 million reflecting falling reference rates;
- £73 million from a decrease in inflation assumptions;
- £56 million tax benefit primarily due to losses brought into value by equity realisations and gilt bond gains during the year; and
- £3 million of other economic variances.

Other non-operating items

Total other non-operating items of £(277) million (2013: £(143) million) comprise:

- £(65) 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);
- £(50) million from establishing a provision to cover the anticipated impact of the imposition of a charge cap of 0.75% on default funds for qualifying auto-enrolment schemes;
- £(45) million from establishing a provision to cover the anticipated costs associated with new Retirement Income product and platform development;
- £(25) million of costs relating to the Sesame strategic review;
- £(21) million from costs relating to significant regulatory change;
- £(19) million from project costs primarily in relation to the Aviva transaction;
- £(15) million from non-recurring costs in respect of Solvency II, partially offset by utilisation of the provision established against these costs;
- £(13) million from Finance Transformation project costs;
- £(10) million due to the establishment of provisions to cover the anticipated impact on future profits from the removal of Active Member Discounts on existing schemes;
- £(5) million net charge from tax related non-operating items; and
- £(9) million of other non-recurring items.

Discontinued operations

Lombard business

The profit from discontinued operations after tax of £14 million (2013: £(28) million loss) is the net of tax earnings from the Lombard business. This result reflects the non-recurrence of negative assumption changes, positive economic variances and offset by a lower contribution from new business, materially adverse operational experience variances and adverse other non-operating items primarily from the costs related to the sale of Lombard.

Notes to the MCEV results

4. Earnings per share

a) Basic and operating earnings per share

For the year ended 31 December	2014 Earnings £m	2014 Pence per share	Restated 2013 Earnings £m	Restated 2013 Pence per share
Profit after tax from continuing operations attributable to ordinary equity holders of the parent	**75**	**5.31**	607	42.81
Add back:				
– Economic variances	**143**	**10.12**	(401)	(28.28)
– Non-recurring items and non-operating variances	**277**	**19.60**	143	10.09
– Tax credit on items excluded from operating profit	**(88)**	**(6.23)**	59	4.16
Operating profit after tax from continuing operations attributable to ordinary equity holders of the parent	**407**	**28.80**	408	28.78

Profit after tax from continuing operations attributable to ordinary equity holders of the parent	**75**	**5.31**	607	42.81
Profit/(loss) after tax from discontinued operations attributable to ordinary equity holders of the parent	**14**	**0.99**	(28)	(1.97)
Profit after tax attributable to ordinary equity holders of the parent	**89**	**6.30**	579	40.84

b) Diluted earnings per share from continuing operations

(i) Based on profit after tax attributable to ordinary equity holders of the parent

For the year ended 31 December 2014	Earnings £m	Weighted average number of shares	Pence per share
Profit after tax from continuing operations attributable to ordinary equity holders of the parent	**75**	**1,413,304,704**	**5.31**
Dilutive effect of share awards	**–**	**2,093,441**	**(0.01)**
Diluted earnings per share on profit after tax from continuing operations attributable to ordinary equity holders of the parent	**75**	**1,415,398,145**	**5.30**

For the year ended 31 December 2013	Restated Earnings £m	Weighted average number of shares	Restated Pence per share
Profit after tax from continuing operations attributable to ordinary equity holders of the parent	607	1,417,808,590	42.81
Dilutive effect of share awards	–	904,272	(0.02)
Diluted earnings per share on profit after tax from continuing operations attributable to ordinary equity holders of the parent	607	1,418,712,862	42.79

Notes to the MCEV results

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 2014	Earnings £m	Weighted average number of shares	Pence per share
Operating profit after tax from continuing operations attributable to ordinary equity holders of the parent	**407**	**1,413,304,704**	**28.80**
Dilutive effect of share awards	**–**	**2,093,441**	**(0.04)**
Diluted earnings per share on operating profit after tax from continuing operations attributable to ordinary equity holders of the parent	**407**	**1,415,398,145**	**28.76**

For the year ended 31 December 2013	Restated Earnings £m	Weighted average number of shares	Restated Pence per share
Operating profit after tax from continuing operations attributable to ordinary equity holders of the parent	408	1,417,808,590	28.78
Dilutive effect of share awards	–	904,272	(0.02)
Diluted earnings per share on operating profit after tax from continuing operations attributable to ordinary equity holders of the parent	408	1,418,712,862	28.76

c) Diluted earnings per share from discontinued operations

(i) Based on profit after tax attributable to ordinary equity holders of the parent

For the year ended 31 December 2014	Earnings £m	Weighted average number of shares	Pence per share
Profit after tax from discontinued operations attributable to ordinary equity holders of the parent	**14**	**1,413,304,704**	**0.99**
Dilutive effect of share awards	**–**	**2,093,441**	**–**
Diluted earnings per share on profit after tax from discontinued operations attributable to ordinary equity holders of the parent	**14**	**1,415,398,145**	**0.99**

For the year ended 31 December 2013	Restated Earnings £m	Weighted average number of shares	Restated Pence per share
Loss after tax from discontinued operations attributable to ordinary equity holders of the parent	(28)	1,417,808,590	(1.97)
Dilutive effect of share awards	–	904,272	–
Diluted earnings per share on loss after tax from discontinued operations attributable to ordinary equity holders of the parent	(28)	1,418,712,862	(1.97)

Notes to the MCEV results

4. Earnings per share continued

d) Weighted average number of ordinary shares

For the year ended 31 December 2014	**Actual**	**Weighted**
Issued ordinary shares at beginning of period	**1,417,508,151**	**1,417,508,151**
Effect of:		
– shares repurchased and cancelled	**(9,057,000)**	**(1,224,855)**
– purchase of own shares held	**(3,271,554)**	**(2,978,592)**
Number of ordinary shares at end of period	**1,405,179,597**	**1,413,304,704**

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

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:

	2014 £m	2013 £m
Equity attributable to ordinary shareholders on an IFRS basis	**4,796**	5,229
Less items only included on an IFRS basis (net of tax):		
– IFRS reserving and other IFRS adjustments	**632**	540
– Deferred front end fees	**59**	58
– Deferred acquisition costs	**(824)**	(795)
– Acquired present value of in-force	**(2,442)**	(2,933)
– Other intangible assets	**(107)**	(186)
Add items only included on a MCEV basis (net of tax):		
– Adjustment for long-term debt to market value	**(324)**	(217)
Net worth on a MCEV basis	**1,790**	1,696
Value of in-force covered business	**3,739**	4,369
Equity attributable to ordinary shareholders on a MCEV basis	**5,529**	6,065

Notes to the MCEV results

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 86bps to 106bps.

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 the expenses within the value of new business reflect:

- the level of acquisition 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 2014, this short-term overrun was £8 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.

New business value

	New business premiums							
For the year ended 31 December 2014	**Single £m**	**Regular £m**	**APE £m**	**Average annual premium multiplier(i)**	**PVNBP £m**	**Post-tax VNB £m**	**Pre-tax VNB £m**	**New business margin %**
UK Corporate Benefits	**578**	**556**	**614**	**4.0**	**2,817**	**16**	**21**	**0.7**
UK Protection	**–**	**89**	**89**	**7.2**	**638**	**54**	**69**	**10.8**
UK Retirement Income(ii)	**559**	**–**	**56**	**–**	**559**	**40**	**51**	**9.1**
UK total	**1,137**	**645**	**759**	**4.5**	**4,014**	**110**	**141**	**3.5**
Heritage	**167**	**26**	**43**	**3.5**	**258**	**(16)**	**(21)**	**(8.1)**
FPI	**507**	**60**	**110**	**4.9**	**801**	**12**	**12**	**1.5**
Total	**1,811**	**731**	**912**	**4.5**	**5,073**	**106**	**132**	**2.6**

Notes to the MCEV results

6. New business continued

For the year ended 31 December 2013	New business premiums Single £m	Regular £m	APE £m	Average annual premium multiplier[(i)]	PVNBP £m	Post-tax VNB £m	Pre-tax VNB £m	New business margin %
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[(ii)]	664	–	66	–	664	63	83	12.5
UK total	1,206	604	724	4.8	4,086	140	184	4.5
Heritage[(iii)]	201	48	68	4.8	431	(19)	(26)	(6.0)
FPI[(iii)]	595	67	127	5.0	927	21	21	2.3
Total	2,002	719	919	4.8	5,444	142	179	3.3

(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 as this business only has single premium business therefore PVNBP is the same as the premiums received in the year.
(ii) The value of new business for annuities shown in the table above has been valued assuming an illiquidity premium ranging from 86bps to 106bps during 2014 and from 65bps to 85bps during 2013.
(iii) OLAB was transferred from the FPI segment to the Heritage segment in January 2014 and the segmental comparatives for 31 December 2013 have been restated.

UK

The VNB from the UK segment was £141 million (2013: £184 million), comprising:

- UK Corporate Benefits VNB of £21 million (2013: £26 million), with the reduction reflecting an increase in acquisition costs and reduced margins;
- UK Protection VNB of £69 million (2013: £75 million), with the decrease being driven by an adverse movement in the opening interest rate and mix of new business written, partially offset by an increase in Individual Protection volumes; and
- UK Retirement Income VNB of £51 million (2013: £83 million), with the lower VNB reflecting reduced margins as a result of improvements in the competitive pricing of annuities and reduced volumes following the Budget announcement in March 2014.

Heritage

Heritage VNB of £(21) million (2013: £(26) million), with the increase primarily reflecting reduced expenses following the closure of business in OLAB in 2013. The negative VNB reflects the fact that Heritage now only writes increments to products no longer actively marketed.

FPI

FPI VNB was £12 million (2013: £21 million), with the reduction reflecting lower volumes for regular premium unit-linked insurance business throughout the regions.

New business performance metrics

New business written requires an initial capital investment to meet the set-up costs and capital requirements.

The 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 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.

Notes to the MCEV results

6. New business continued

New business key performance metrics

	2014			Restated 2013[i]		
	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
UK Corporate Benefits	**21**	**8.3**	**11**	26	8.4	11
UK Protection	**69**	**19.2**	**5**	75	13.8	7
UK Retirement Income	**51**	**14.6**	**7**	83	>25.0	2
UK total	**141**	**13.0**	**8**	184	15.3	7
Heritage	**(21)**	**(2.7)**	**n/a**	(26)	(1.0)	n/a
FPI	**12**	**9.4**	**8**	21	11.0	7
Total	**132**	**10.5**	**9**	179	11.0	9

(i) Heritage and FPI year ended 31 December 2013 new business metrics have been restated following the transfer of OLAB business from FPI to Heritage in January 2014. Total year ended 31 December 2013 new business metrics have been restated following the sale of Lombard in October 2014.

The Group new business IRR was 10.5% (2013: 11.0%) and the payback period on new business was 9 years (2013: 9 years). The new business IRR on open insurance businesses (UK Protection, UK Retirement Income and FPI) was 15.1% (2013: 18.1%).

The decrease in UK IRR is impacted by reduced margins from Retirement Income, partially offset by changes to reinsurance terms on Protection business.

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.

The FPI IRR has reduced reflecting the impact of reduced volumes pushing up unit acquisition costs.

The Group new business IRR does not include the impact of the with-profits annuity reallocation activity or the recapture of assets backing annuities. If these activities, which represent a discretionary use of capital for the purposes of generating returns, were to be included within the IRR, then the Group IRR would increase to 16.7%.

Notes to the MCEV results

7. Segmental analysis of Group MCEV

	2014									Restated 2013[iv]
	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	**228**	**431**	**659**	**1,208**	**–**	**(24)**	**(63)**	**1,121**	**1,780**	1,418
Heritage	**457**	**1,298**	**1,755**	**2,374**	**(36)**	**(82)**	**(102)**	**2,154**	**3,909**	4,161
FPI	**24**	**28**	**52**	**492**	**–**	**(1)**	**(27)**	**464**	**516**	508
Lombard	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	598
Corporate[i]										
– IFA and distribution	**59**	**–**	**59**	**–**	**–**	**–**	**–**	**–**	**59**	41
– Pension deficit of FPPS	**23**	**–**	**23**	**–**	**–**	**–**	**–**	**–**	**23**	(18)
– Other	**979**	**10**	**989**	**–**	**–**	**–**	**–**	**–**	**989**	980
Gross Group MCEV[ii]	**1,770**	**1,767**	**3,537**	**4,074**	**(36)**	**(107)**	**(192)**	**3,739**	**7,276**	7,688
Corporate – external STICS	**–**	**(499)**	**(499)**	**–**	**–**	**–**	**–**	**–**	**(499)**	(478)
Corporate – external debt[iii]	**–**	**(1,248)**	**(1,248)**	**–**	**–**	**–**	**–**	**–**	**(1,248)**	(1,145)
Net Group MCEV	**1,770**	**20**	**1,790**	**4,074**	**(36)**	**(107)**	**(192)**	**3,739**	**5,529**	6,065

(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. Corporate includes non-covered business of £(8) million relating to UK (2013: £2 million), £67 million relating to Heritage (2013: £40 million) and £nil relating to discontinued operations (2013: £5 million)

(ii) 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.

(iii) 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.

(iv) OLAB was transferred from the FPI segment to the Heritage segment in January 2014 and the comparatives for 31 December 2013 have been restated.

7.1 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 minimum 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.

7.2 PVFP

The PVFP at 31 December 2014 includes a £140 million net of tax (2013: £46 million) deduction in respect of anticipated adverse experience on pensions business comprising of £70 million within the UK segment (2013: £27 million) and £70 million within the Heritage segment (2013: £19 million). Further details on these provisions are provided in note 10.

7.3 TVOG

The TVOG at 31 December 2014 of £36 million (2013: £114 million), is split between £19 million (2013: £79 million) market risk and £17 million (2013: £35 million) non-market risk. The significant fall in the level of TVOG for market risk is primarily due to a change in the modelling used in the TVOG, to align with the Group's Economic Capital model. 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.

Notes to the MCEV results

7. Segmental analysis of Group MCEV continued

7.4 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 ("ICG").

Additionally, the Group capital management policy in respect of FLGL is to hold 150% of Group CRR excluding WPICC (2013: 150%). The cost of holding any additional capital is shown in the FLGL covered business segment. At 31 December 2014, no additional capital was required to meet the Group capital management policy and hence no additional cost was required.

7.5 CNHR

The cost of residual non-hedgeable risk of £192 million (2013: £203 million) is presented as an equivalent annual cost of capital charge of 1.0% (2013: 1.2%) on projected risk-based Group required capital for all non-hedgeable risks. 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.

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.

	Covered business					Non-covered business	
For the year ended 31 December 2014	**UK £m**	**Heritage £m**	**FPI £m**	**Lombard £m**	**Corporate £m**	**£m**	**Total £m**
Opening Group MCEV	**1,418**	**4,161**	**508**	**598**	**(1,631)**	**1,011**	**6,065**
Operating MCEV earnings	**125**	**316**	**24**	**–**	**(50)**	**(8)**	**407**
Non-operating MCEV earnings	**(49)**	**(106)**	**(2)**	**–**	**(149)**	**(26)**	**(332)**
Group MCEV earnings from continuing operations	**76**	**210**	**22**	**–**	**(199)**	**(34)**	**75**
Earnings from discontinued operations	**–**	**–**	**–**	**21**	**–**	**(7)**	**14**
Total Group MCEV earnings	**76**	**210**	**22**	**21**	**(199)**	**(41)**	**89**
Other movements in IFRS net equity	**–**	**–**	**–**	**–**	**–**	**26**	**26**
Closing adjustments:							
– capital and dividend flows	**(25)**	**(462)**	**(14)**	**(8)**	**93**	**79**	**(337)**
– foreign exchange variances	**–**	**–**	**–**	**(31)**	**–**	**–**	**(31)**
– disposal of Lombard	**311**	**–**	**–**	**(580)**	**–**	**(14)**	**(283)**
Closing Group MCEV	**1,780**	**3,909**	**516**	**–**	**(1,737)**	**1,061**	**5,529**

Notes to the MCEV results

8. Segmental analysis of Group MCEV earnings continued

For the year ended 31 December 2013	Covered business UK £m	Restated Heritage £m	Restated FPI £m	Restated Lombard £m	Corporate £m	Restated Non-covered business £m	Restated Total £m
Opening Group MCEV	1,227	4,181	511	615	(1,611)	908	5,831
Opening adjustments:							
– disposal of AmLife	–	–	(43)	–	–	50	7
Adjusted opening Group MCEV	1,227	4,181	468	615	(1,611)	958	5,838
Operating MCEV earnings	162	311	42	–	(57)	(50)	408
Non-operating MCEV earnings	37	147	(7)	–	(55)	77	199
Group MCEV earnings from continuing operations	199	458	35	–	(112)	27	607
Earnings from discontinued operations	–	–	–	(28)	–	–	(28)
Total Group MCEV earnings	199	458	35	(28)	(112)	27	579
Other movements in IFRS net equity	–	–	–	–	–	(77)	(77)
Closing adjustments:							
– capital and dividend flows	(8)	(478)	5	(5)	92	103	(291)
– foreign exchange variances	–	–	–	16	–	–	16
Closing Group MCEV	1,418	4,161	508	598	(1,631)	1,011	6,065

9. Maturity profile of value of in-force business by proposition

At 31 December 2014	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
UK Corporate Benefits	**692**	**276**	**190**	**120**	**63**	**29**	**11**	**3**	**–**	**–**
UK Protection	**278**	**108**	**61**	**44**	**31**	**18**	**9**	**5**	**2**	**–**
UK Retirement Income	**95**	**9**	**10**	**13**	**17**	**17**	**14**	**9**	**4**	**2**
Vendor Loan Note	**56**	**16**	**40**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
UK Total	**1,121**	**409**	**301**	**177**	**111**	**64**	**34**	**17**	**6**	**2**
Heritage	**2,154**	**1,087**	**446**	**304**	**157**	**80**	**46**	**19**	**9**	**6**
FPI	**464**	**215**	**128**	**69**	**32**	**12**	**5**	**2**	**1**	**–**
Total VIF	**3,739**	**1,711**	**875**	**550**	**300**	**156**	**85**	**38**	**16**	**8**

Notes to the MCEV results

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	
	2014 %	2013 %
UK and Heritage		
Long-term rate	**1.90**	3.10
Swap yield curve		
– Term 1 year	**0.74**	0.71
– Term 5 years	**1.46**	2.18
– Term 10 years	**1.88**	3.11
– Term 15 years	**2.12**	3.48
– Term 20 years	**2.26**	3.58
FPI long-term rate	**1.90**	3.10

Reference rate – Illiquidity premium adjustment

The 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 premiums 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.

Notes to the MCEV results

10. MCEV assumptions continued

The reference rate has been adjusted for immediate and some deferred annuities as set out in the table below.

	Embedded value		New business	
	2014	2013	**2014**	2013
UK and Heritage immediate annuities	**70bps**	60bps	**86-106bps**	65-85bps

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 UK immediate annuity business only, an illiquidity premium equivalent to 60bps (2013: 75bps) at the beginning of the period. The reference rate at 31 December 2014 will form the basis for the expected existing business contribution during 2015.

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.

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 IRR and 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 (2013: 3%) and 2% for property (2013: 2%).

For cash and government bonds no excess over the one-year risk free reference rate has been assumed. 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 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% (2013: 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.

	Expense inflation	
	2014 %	2013 %
UK	**3.80**	4.30
Heritage	**3.80**	4.30
FPI	**3.80**	4.30

Notes to the MCEV results

10. MCEV assumptions continued

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	
	2014	2013
Closing exchange rate	**0.789**	0.832
Average exchange rate	**0.808**	0.847

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 WPF, the shareholder receives the management charges in the non-profit fund for these.

The requirement to retain the FLC reattributed inherited estate ("RIE") to support FLC Old WPF and FLC New WPF, together with the other with-profit fund support arrangements are governed by the 2013 FLL Scheme.

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 from 31 December 2014 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 Moody's economic scenario generator and are calculated using 2,000 simulations. The with-profits model is consistent with the model used for the Economic Capital Balance Sheet and is calibrated to market conditions at the valuation date using the EIOPA swap 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

10. MCEV assumptions continued

Swaption implied volatilities – with-profits time value of financial options and guarantees

	2014 Swap term				2013 Swap term			
Option term	**10 yrs %**	**15 yrs %**	**20 yrs %**	**25 yrs %**	10 yrs %	15 yrs %	20 yrs %	25 yrs %
UK Sterling								
10 years	**27**	**26**	**25**	**24**	18	17	16	15
15 years	**27**	**27**	**26**	**25**	19	18	17	16
20 years	**26**	**25**	**24**	**23**	17	16	15	14
25 years	**27**	**26**	**24**	**22**	16	15	14	13

Swaption implied volatilities – OLAB return of premium guarantee

	2014 Swap term				2013 Swap term			
Option term	**10 yrs %**	**15 yrs %**	**20 yrs %**	**25 yrs %**	10 yrs %	15 yrs %	20 yrs %	25 yrs %
Euro								
10 years	**35**	**34**	**32**	**31**	23	22	21	20
15 years	**35**	**34**	**32**	**30**	25	23	22	20
20 years	**32**	**30**	**28**	**26**	22	20	19	18
25 years	**28**	**26**	**24**	**23**	21	19	18	16

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 13.1% (2013: 15%) and a running yield of 4.3% (2013: 4.3%). Sample implied volatilities are shown in the table below.

	2014		2013	
Option term	**Equity %**	**Property %**	Equity %	Property %
5 years	**21**	**13**	19	15
10 years	**22**	**13**	22	15
15 years	**23**	**13**	24	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.

	2014	2013
Option term	**Equity %**	Equity %
5 years	**21**	20
10 years	**21**	21
15 years	**21**	21

Notes to the MCEV results

10. MCEV assumptions continued

10.3 Other assumptions

Required capital

Required capital under MCEV amounted to £20 million (2013: £21 million). The required capital is shown net of £1,737 million (2013: £1,631 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 2013.

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 and Isle of Man. 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 and Heritage 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 2014 reflects the reduction in corporation tax that took effect from April 2014.

For non-covered business, attributed tax is consistent with the IFRS financial statements.

	Tax rates	
	2014 %	2013 %
UK	**21.50**	23.25
Heritage	**21.50**	23.25
FPI	**0.00**	0.00

The PVFP for UK and Heritage 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 21% to 20% over the period to 2015 (2013: 23% to 21% over the period to 2014) and for an ultimate rate of 20% from April 2015 (2013: 20% from April 2015).

VAT in the UK of 20.0% (2013: 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.

In 2014, a provision of £50 million gross of tax has been established to cover the anticipated impact of the imposition of a charge cap of 0.75% p.a. on default funds for qualifying auto-enrolment schemes and a provision of £10 million gross of tax has been established to cover the anticipated impact on future profits from the removal of Active Member Discounts on existing schemes. Note that the establishment of these provisions has been included as non-operating within the analysis of MCEV earnings as they relate to regulatory changes.

Provisions are also held to cover adverse persistency experience on corporate pensions business in the UK covering the impact of renegotiation of terms on existing schemes, anticipated short-term persistency following the implementation of auto-enrolment and the impact of the new pension freedoms announced in the 2014 Budget. At 31 December 2014 these totalled £123 million, gross of tax (2013: £60 million).

Notes to the MCEV results

10. MCEV assumptions continued

Future improvements in annuitant mortality have been assumed to be in accordance with the projections published by the CMI in 2013, with a long-term rate of 1.5% per annum for males, 1.25% females (2013: CMI 2011 mortality projections, with a long-term rate 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 reflects the anticipated acquisition 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.

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. A provision of £7 million was held at 31 December 2014 (31 December 2013: £39 million). During 2014 development expenditure of £(97) million has been incurred in relation to the Diligenta arrangement which have been partially offset by a £32 million utilisation of the remaining provision. The net cost of £(65) million is shown in the consolidated income statement within other non-operating items.

In March 2014, the UK Chancellor announced major changes to the pension system in his Budget and the costs associated with responding to these significant regulatory changes have been reported within other non-recurring items. At 31 December 2014, £21 million costs associated with the new retirement income product and platform development together with a £45 million impact from establishing a provision for future costs in response to significant regulatory changes have been reported within non-recurring items for the year.

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;
- Significant regulatory change; 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.

Development costs

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 £35 million (2013: £47 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 year's financial results until the value is realised.

Notes to the MCEV results

10. MCEV assumptions continued

	Development costs	
	2014 £m	Restated 2013 £m
UK	**19**	30
Heritage	**12**	10
FPI	**4**	7
Total	**35**	47

Non-hedgeable risks

A charge equivalent to 1.0% (2013: 1.2%) 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 2014	**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**	**227**	**2**	**(5)**	**224**
STICS 2005	**268**	**272**	**8**	**(3)**	**277**
LT2 subordinated debt 2021	**162**	**228**	**12**	**(12)**	**228**
LT2 subordinated debt 2022	**500**	**613**	**29**	**(32)**	**610**
UT2 subordinated debt(ii)	**356**	**417**	**4**	**(15)**	**406**
Currency swap	**–**	**(10)**	**–**	**2**	**(8)**
Total	**1,496**	**1,747**	**55**	**(65)**	**1,737**

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

(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.

Notes to the MCEV results

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 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.

	FLGL covered business				
Change in MCEV (net of tax) in 2014	**UK £m**	**Heritage £m**	**FPI £m**	**Corporate £m**	**Total £m**
Base MCEV	**1,780**	**3,909**	**516**	**(1,737)**	**4,468**
Market risk					
100bps increase in reference rates	**(45)**	**(67)**	**3**	**70**	**(39)**
100bps decrease in reference rates	**51**	**53**	**(5)**	**(74)**	**25**
Removal of illiquidity premium for immediate annuities	**(174)**	**(563)**	**–**	**–**	**(737)**
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	**(52)**	**(156)**	**(26)**	**–**	**(234)**
25% increase in equity/property volatility at the valuation date	**–**	**(31)**	**–**	**–**	**(31)**
25% increase in swaption implied volatility at the valuation date	**–**	**(1)**	**–**	**–**	**(1)**
100bp increase in corporate bond spreads(i)	**(90)**	**(279)**	**–**	**70**	**(299)**
100bp decrease in corporate bond spreads(i)	**116**	**344**	**–**	**(74)**	**386**
10% adverse movement in Sterling/overseas exchange rate(ii)	**(7)**	**(31)**	**(20)**	**–**	**(58)**
10% fall in value of unit-linked funds	**(67)**	**(233)**	**(31)**	**–**	**(331)**
100bp increase in expense inflation	**(33)**	**(91)**	**(10)**	**–**	**(134)**
100bp decrease in expense inflation	**30**	**76**	**9**	**–**	**115**
Insurance and other risk					
Reduction to EU minimum capital or equivalent(iii)	**8**	**43**	**–**	**–**	**51**
10% decrease in maintenance expenses	**38**	**71**	**23**	**–**	**132**
10% proportionate decrease in lapse rates	**44**	**55**	**8**	**–**	**107**
10% proportionate decrease in PUP rates	**10**	**1**	**2**	**–**	**13**
5% decrease in mortality/morbidity – life assurance					
– Before reinsurance	**38**	**52**	**6**	**–**	**96**
– After reinsurance	**17**	**24**	**2**	**–**	**43**
5% decrease in mortality/morbidity – annuity business					
– Before reinsurance	**(20)**	**(172)**	**–**	**–**	**(192)**
– After reinsurance	**(20)**	**(59)**	**–**	**–**	**(79)**

(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 (2013: 40bps) for in-force business and 40bps (2013: 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 £835 million (2013: £812 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.

Notes to the MCEV results

11. Sensitivity analysis continued

	FLGL covered business					
Change in MCEV (net of tax) in 2013	UK £m	Restated Heritage(i) £m	Restated FPI(i) £m	Lombard £m	Corporate £m	Total £m
Base MCEV	1,418	4,161	508	598	(1,631)	5,054
Market risk						
100bps increase in reference rates	(21)	(64)	1	(2)	109	23
100bps decrease in reference rates	20	89	(3)	–	(124)	(18)
Removal of illiquidity premium for immediate annuities	(118)	(399)	–	–	–	(517)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	(48)	(149)	(26)	(36)	–	(259)
25% increase in equity/property volatility at the valuation date	–	(30)	–	–	–	(30)
25% increase in swaption implied volatility at the valuation date	–	(4)	–	–	–	(4)
100bp increase in corporate bond spreads(ii)	(72)	(286)	–	(9)	109	(258)
100bp decrease in corporate bond spreads(ii)	77	274	–	9	(124)	236
10% adverse movement in Sterling/overseas exchange rate(iii)	(7)	(32)	(19)	(52)	–	(110)
10% fall in value of unit-linked funds	(62)	(212)	(31)	(63)	–	(368)
100bp increase in expense inflation	(30)	(94)	(9)	(9)	–	(142)
100bp decrease in expense inflation	26	81	7	7	–	121
Insurance and other risk						
Reduction to EU minimum capital or equivalent(iv)	9	42	–	–	–	51
10% decrease in maintenance expenses	30	69	19	16	–	134
10% proportionate decrease in lapse rates	36	57	9	37	–	139
10% proportionate decrease in PUP rates	9	2	3	–	–	14
5% decrease in mortality/morbidity – life assurance						–
– Before reinsurance	27	50	6	3	–	86
– After reinsurance	12	19	3	2	–	36
5% decrease in mortality/morbidity – annuity business						–
– Before reinsurance	(17)	(129)	–	–	–	(146)
– After reinsurance	(17)	(51)	–	–	–	(68)

(i) Heritage and FPI 31 December 2013 sensitivities have been restated following the transfer of OLAB business from FPI to Heritage in January 2014.
(ii) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40bps (2013: 40bps) for in-force business and 40bps (2013: 40bps) for the value of new business.
(iii) 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.
(iv) 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 £835 million (2013: £812 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.

Notes to the MCEV results

11. Sensitivity analysis continued

	FLGL covered business			
Change in value of new business (gross of tax) in 2014	**UK £m**	**Heritage £m**	**FPI £m**	**Total £m**
Base value of new business	**141**	**(21)**	**12**	**132**
Market risk				
100bps increase in reference rates	**(12)**	**–**	**(1)**	**(13)**
100bps decrease in reference rates	**13**	**–**	**1**	**14**
Removal of illiquidity premium for immediate annuities	**(42)**	**–**	**–**	**(42)**
100bps increase in corporate bond spreads(i)	**(19)**	**–**	**–**	**(19)**
100bps decrease in corporate bond spreads(i)	**24**	**–**	**–**	**24**
100bps increase in expense inflation	**(8)**	**–**	**–**	**(8)**
100bps decrease in expense inflation	**7**	**–**	**–**	**7**
Insurance and other risk				
Reduction to EU minimum capital or equivalent	**2**	**–**	**–**	**2**
10% decrease in maintenance expenses	**5**	**–**	**2**	**7**
10% proportionate decrease in lapse rates	**15**	**–**	**1**	**16**
10% proportionate decrease in PUP rates	**5**	**–**	**–**	**5**
5% decrease in mortality/morbidity – life assurance				
– Before reinsurance	**10**	**–**	**–**	**10**
– After reinsurance	**1**	**–**	**–**	**1**
5% decrease in mortality/morbidity – annuity business				
– Before reinsurance	**(3)**	**–**	**–**	**(3)**
– After reinsurance	**(5)**	**–**	**–**	**(5)**
Impact of end of period assumptions on VNB	**7**	**–**	**–**	**7**

(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 (2013: 40bps) for in-force business and 40bps (2013: 40bps) for the value of new business.

Notes to the MCEV results

11. Sensitivity analysis continued

Change in value of new business (gross of tax) in 2013	FLGL covered business				
	UK £m	Restated Heritage(i) £m	Restated FPI(i) £m	Lombard £m	Total £m
Base value of new business	184	(26)	21	25	204
Market risk					
100bps increase in reference rates	(3)	–	–	–	(3)
100bps decrease in reference rates	1	–	2	–	3
Removal of illiquidity premium for immediate annuities	(44)	–	–	–	(44)
100bps increase in corporate bond spreads(ii)	(18)	–	–	–	(18)
100bps decrease in corporate bond spreads(ii)	19	–	–	–	19
100bps increase in expense inflation	(7)	–	–	–	(7)
100bps decrease in expense inflation	5	–	–	–	5
Insurance and other risk					
Reduction to EU minimum capital or equivalent	2	–	–	–	2
10% decrease in maintenance expenses	8	–	2	2	12
10% proportionate decrease in lapse rates	14	–	1	4	19
10% proportionate decrease in PUP rates	5	–	1	–	6
5% decrease in mortality/morbidity – life assurance					
– Before reinsurance	8	–	–	–	8
– After reinsurance	3	–	–	–	3
5% decrease in mortality/morbidity – annuity business					
– Before reinsurance	(3)	–	–	–	(3)
– After reinsurance	(5)	–	–	–	(5)
Impact of end of period assumptions on VNB	(11)	–	(2)	(1)	(14)

(i) Heritage and FPI 31 December 2013 sensitivities have been restated following the transfer of OLAB business from FPI to Heritage in January 2014.
(ii) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40bps (2013: 40bps) for in-force business and 40bps (2013: 40bps) for the value of new business.

Notes to the MCEV results

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						
At 31 December 2014	**UK £m**	**Heritage £m**	**FPI £m**	**Lombard £m**	**Corporate £m**	**Non-covered business[(i)] £m**	**Total MCEV by IFRS segments £m**
IFRS segment							
UK	**1,780**	**–**	**–**	**–**	**–**	**(8)**	**1,772**
Heritage	**–**	**3,909**	**–**	**–**	**–**	**67**	**3,976**
FPI	**–**	**–**	**516**	**–**	**–**	**–**	**516**
Corporate	**–**	**–**	**–**	**–**	**(1,737)**	**1,002**	**(735)**
Total MCEV (by MCEV segments)	**1,780**	**3,909**	**516**	**–**	**(1,737)**	**1,061**	**5,529**

(i) The non-covered business includes £422 million within Corporate representing the MCEV of the Friends Life Group holding companies above FLH.

	MCEV classification						
At 31 December 2013	UK £m	Restated Heritage £m	Restated FPI £m	Lombard £m	Corporate £m	Restated Non-covered business[(i)] £m	Total MCEV by IFRS segments £m
IFRS segment							
UK	1,418	–	–	–	–	2	1,420
Heritage – restated	–	4,161	–	–	–	40	4,201
FPI – restated	–	–	508	–	–	(1)	507
Lombard	–	–	–	598	–	5	603
Corporate	–	–	–	–	(1,631)	965	(666)
Total MCEV (by MCEV segments)	1,418	4,161	508	598	(1,631)	1,011	6,065

(i) The non-covered business includes £164 million within Corporate representing the MCEV of the Friends Life Group holding companies above FLH.

Notes to the MCEV results

13. FLH return on embedded value

	2014		Restated 2013	
	£m	% p.a.	£m	% p.a.
Value of new business	**132**	**2.0**	179	2.8
Expected existing business contribution(i)	**305**	**4.5**	290	4.4
Operating experience variances	**(65)**	**(1.0)**	(32)	(0.6)
Operating assumption changes	**29**	**0.4**	101	1.6
Other operating variance	**219**	**3.3**	172	2.7
Development costs	**(35)**	**(0.5)**	(47)	(0.7)
Other income and charges	**1**	**–**	(26)	(0.4)
FLH MCEV operating profit before tax and financing	**586**	**8.7**	637	9.8
Impact of financing(i)	**(64)**	**1.5**	(75)	1.7
Attributed tax charge on MCEV operating profit	**(96)**	**(1.8)**	(132)	(2.7)
FLH MCEV operating profit after tax	**426**	**8.4**	430	8.8
Economic variances	**(143)**	**(2.8)**	401	8.2
Other non-operating items	**(277)**	**(5.5)**	(143)	(2.9)
Attributed tax on other activities	**88**	**1.7**	(59)	(1.2)
FLH MCEV profit from continuing operations after tax	**94**	**1.8**	629	12.9
Profit/(loss) from discontinued operations(ii)	**14**	**0.1**	(28)	(2.0)
FLH MCEV profit	**108**	**1.9**	601	10.9
Remeasurement losses on defined benefit pension schemes	**26**	**0.5**	(77)	(1.4)
Foreign exchange adjustments	**(31)**	**(0.6)**	16	0.3
Total return on FLH MCEV over the year	**103**	**1.8**	540	9.8

(i) Impact of financing comprises the expected impact of financing of covered debt of £64 million for 2014 (2013: £75 million). These amounts have been deducted from the expected existing business contribution.
(ii) The profit/(loss) from discontinued operations allows for inclusion of embedded value from discontinued operations.

The table above provides an analysis of the return on FLH embedded value, excluding the Friends Life Group Limited holding companies above FLH, consistent with previous years. The starting FLH embedded value for continuing operations for 2014 is £5,298 million, net of the market-consistent value of debt instruments of £1,623 million and having excluded £603 million in respect of discontinued operations and £164 million in respect of the Friends Life Group holding companies above FLH. The 2014 embedded value has been adjusted to allow for the timing of dividend payments.

The starting embedded value for 2013 is £5,078 million, net of the market-consistent value of debt instruments of £1,596 million and having excluded £620 million in respect of discontinued operations and £133 million in respect of the Friends Life Group holding companies above FLH. The 2013 embedded value has been adjusted to allow for the timing of dividend payments.

The FLH MCEV operating return before tax and financing is based on the gross FLH 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 FLH 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 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") represent assets and other financial instruments available to cover corporate costs, to service debt issued by Friends Life holding companies and, subject to shareholder approval, to pay dividends or return to shareholders. ASA reflects the deduction of working capital from free surplus.

Aviva – Aviva plc, a company incorporated under the laws of England and Wales with registered number 2468686, whose registered office is St Helen's, 1 Undershaft, London, EC3P 3DQ.

Aviva General Meeting – The meeting of the Aviva shareholders convened for the purpose of approving the Proposed Acquisition.

Aviva Prospectus – The document that Aviva will produce and make available that tells shareholders about the new Aviva shares that will be issued if the Proposed Acquisition completes.

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 Friends Life Group 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 Friends Life Group Limited.

Computershare – Computershare Investor Services PLC, which acts as the Registrar for Aviva **or** Computershare Investor Services (Jersey) Ltd which acts as Registrar for Friends Life (as applicable).

Court – The Royal Court of Guernsey.

Court Hearing – This is the hearing by the Guernsey Court to approve the Scheme under Part VIII of the Companies (Guernsey) Law, 2008.

CREST – CREST is the system for the paperless settlement of trades in securities and the holding of uncertificated securities.

DRIP – The Friends Life Dividend Reinvestment Plan allows shareholders to purchase additional shares on the dividend payment date from the proceeds of their cash dividend. It will not be applicable for the second interim dividend.

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 ("FLGL") means Friends Life Group Limited (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 Court Meeting – The meeting of the Friends Life shareholders convened by the Court to consider, and if thought fit, approve the Scheme.

Friends Life General Meeting – The meeting of the Friends Life shareholders convened for the purposes of implementing the Proposed Acquisition.

Definitions

Friends Life holding companies means RHN1, FLG Holdings Limited, Friends Life Group Limited, Friends Life Holdings plc, Friends Life FPG Limited, Friends Life FPL Limited and London and Manchester Group Limited.

Friends Life Share Account – The corporate sponsored nominee account service of Friends Life operated by Computershare Investor Services PLC. If you hold your shares in the Friends Life Share Account, you will not be in possession of a share certificate, because the shares are held by Computershare Company Nominees Limited on your behalf. A similar service is operated by Computershare on behalf of Aviva, known as the Aviva Share Account.

Friends Life Share Incentive Plans - The Friends Provident Holdings (UK) plc Share Incentive Plan 2010 and the Friends Provident Group plc Share Incentive Plan 2009.

Group means Friends Life Group 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. In previous reporting periods, OLAB was managed and reported within the FPI segment. Following the decision to stop writing new business in 2013, OLAB was transferred to the Heritage segment in January 2014 and the segmental comparatives for 31 December 2013 have been restated.

IFRS based operating profit/(loss) is the profit (or loss) based on longer-term investment return excluding: (i) profit (or loss) from discontinued operations, (ii) investment variances on unit-linked sterling reserves and the assets backing these reserves, which in previous periods were included within operating profit, (iii) investment return variances from expected investment return for non-linked business which is calculated on a long-term rate of return, (iv) returns attributable to non-controlling interests in policyholder funds, (v) policyholder tax, (vi) significant non-recurring items, (vii) 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 internal 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.

Proposed Acquisition – The Proposed Acquisition of Friends Life by Aviva to be implemented by way of the Scheme.

Required capital of the Group is based on the most onerous capital management policy for the Group, currently IGCA.

Resolution Operations LLP ("ROL") is a privately owned advisory and operating firm which provided services to the Company 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.

Definitions

Scheme of Arrangement ("the Scheme") – The Scheme is the method by which Friends Life shares will be exchanged for new Aviva shares.

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 FLGL 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 policy holders 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 FLH 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 – refer to note 40 of the IFRS financial statements

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
ABS	Asset-Backed Securities
AC	Audit Committee
AGM	Annual General Meeting
ALM	Asset and Liability Management
AMC	Annual Management Charge
AMD	Active Member Discount
APE	Annual Premium Equivalent
ASA	Available Shareholder Assets
AUA	Assets Under Administration
AVIF	Acquired Value of In-Force
AXA IM	AXA Investment Management
BHA	Friends Life BHA Limited
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CGU	Cash Generating Unit
CIIA	Chartered Institute of Internal Auditors
CMI	Continuous Mortality Investigation
CMIR	Continuous Mortality Investigation Report
CMPs	Capital Management Policies
CNHR	Cost of Non-Hedgeable Risk
COP	Capital Optimisation Programme
CRO	Chief Risk Officer
CRR	Capital Resource Requirements
CSA	Control Self-Assessment
DAC	Deferred Acquisition Costs
DFF	Deferred Front End Fees
DPF	Discretionary Participation Features
DSAP	Deferred Share Award Plan
EBC	Employee Benefit Consultant
EBT	Employee Benefit Trust
EBR	Equity Backing Ratio
ECJ	European Court of Justice
EEA	European Economic Area
ERC	Executive Risk Committee
EU	European Union
EV	Embedded Value
FAL	Friends Annuities Limited
FCA	Financial Conduct Authority
FLAS	Friends Life Assurance Society Limited
FLC	Friends Life Company Limited
FLDL	Friends Life Distribution Limited
FLGL	Friends Life Group Limited (formerly known as Resolution Limited)
FLG LTIP	Friends Life Group plc Long Term Incentive Plan

Abbreviations

FLH	Friends Life Holdings plc (formerly known as Friends Life Group plc)
FLI	Friends Life Investments
FLL	Friends Life Limited
FLMS	Friends Life Management Services Limited
FLPL	Friends Life and Pensions Limited
FLSL	Friends Life Services Limited
FLWL	Friends Life WL Limited
fpb AG	Financial Business Partners AG
FPI	A segment within the International division comprising FPIL (Friends Provident International Limited)
FPPS	Friends Provident Pension Scheme
FRA	Flexible Retirement Account
FRS	Financial Reporting Standards
FSG	Free Surplus Generation
FSMA	Financial Services and Markets Act 2000
FTE	Full Time Equivalent
GAO	Guaranteed Annuity Options
GCE	Group Chief Executive
GEC	Group Executive Committee
GMP	Guaranteed Minimum Pension
HMRC	Her Majesty's Revenue & Customs
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICA	Individual Capital Assessment
ICG	Individual Capital Guidance
IFA	Independent Financial Adviser
IFRIC	IFRS Interpretation Committee
IFRS	International Financial Reporting Standards
IGCA	Insurance Groups Capital Adequacy
IMAP	Internal Model Approval Process
INB	Investment in New Business
IPEV	International Private Equity and Venture Capital
IRR	Internal Rate of Return
KPI	Key Performance Indicator
LDI	Liability Driven Investment
LPA	Limited Partnership Agreement
LT2	Lower Tier 2
MCEV	Market Consistent Embedded Value
MVR	Market Value Reduction
NBS	New Business Strain
NGP	New Generation Pension
NIC	National Insurance Contribution
NLTR	New Life Tax Regime
NPF	Non-Profit Fund
OCI	Other Comprehensive Income
OEIC	Open Ended Investment Company

Abbreviations

OLAB	Overseas Life Assurance Business
OMO	Open Market Option
ORSA	Own Risk and Solvency Assessment
PBSE	Post-Balance Sheet Event
PPFM	Principles and Practices of Financial Management
PRA	Prudential Regulation Authority
PSP	Performance Share Plan
PUP	Paid Up Policies
PVFP	Present Value of Future Profits
PVNBP	Present Value of New Business Premiums
RCAP	RCAP UK LP. The limited partner in Resolution Holdco No.1 LP.
RCC	Risk and Compliance Committee
RCM	Risk Capital Margin
RDR	Retail Distribution Review
RHN1	Resolution Holdco No.1 LP.
RICS	Royal Institution of Chartered Surveyors
RIE	Re-attributed Inherited Estate
ROEV	Return on Embedded Value
ROL	Resolution Operations LLP
RPI	Retail Prices Index
SBG	Sesame Bankhall Group
SFS	Sustainable Free Surplus
SID	Senior Independent Director
SIP	Share Incentive Plan
SSF	Segregated Sub Fund
STICS	Step-up Tier one Insurance Capital Securities
TSR	Total Shareholder Return
TVOG	Time Value of financial Options and Guarantees
UKLA	UK Listing Authority
UT2	Upper Tier 2
VIF	Value of In-Force
VLN	Vendor Loan Note
VNB	Value of New Business
WPF	With-Profits Fund
WPICC	With-Profits Insurance Capital Component

Shareholder Information

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)

Friends Life Share Account holders

If your Shareholder Reference Number starts with an "I", your shares are held in the Share Account.

Computershare Investor Services PLC
The Pavilions
Bridgwater Road
Bristol
BS99 6ZY

Email: web.queries@computershare.co.uk

Ordinary shareholders

If your Shareholder Reference Number commences with a "C" or a "G", your shares are held in certificated form or in CREST. Please write to the following address:

Computershare Investor Services (Jersey) Ltd
Queensway House
Hilgrove Street
St Helier
Jersey
JE1 1ES

Email: info@computershare.co.je

Share information

ISIN code: GG00B62W2327
Stock Exchange Daily Official List ("SEDOL"): B62W232

Share price information can be found on our website
www.friendslifegroup.com

Company registration

Friends Life Group Limited is incorporated in Guernsey, company registration: 49558.

Friends Life Group Limited has a UK branch of the same name, branch registration: BR016431.

Registered office	Branch address and Corporate head office
PO Box 25 Regency Court Glategny Esplanade St Peter Port Guernsey GY1 3AP	One New Change Cheapside London EC4M 9EF