Resolution Limited

26 March 2013

Preliminary results for the year ended 31 December 2012

Improved cash generation, strong capital base, dividend up 6.3%

- Sustainable free surplus £300 million (2011: £291 million)
- Available shareholder cash £850 million (2011: £853 million)
- FLG IGCA surplus £2.0 billion, coverage ratio 214% (2011: £2.1 billion, 219%)
- FLG economic capital surplus(i) £3.4 billion, coverage ratio 182%
- Full year dividend per share 21.14 pence (2011: 19.89 pence); scrip dividend discontinued
- Full year dividend covered 117% by cash up-streamed to Resolution holding companies

Continuing growth in new business

- Value of new business up 28% to £194 million, including 125% increase in UK division
- Group new business APE £1,211 million; UK division sales up 19% to £669 million (2011: £564 million)

Good financial performance

- IFRS based operating profit before tax of £274 million, £309 million excluding one-offs (2011: £681 million; £277 million, excluding one-offs)
- MCEV operating profit before tax of £382 million, £420 million excluding one-offs (2011: £517 million; £377 million, excluding one-offs)

Operating highlights

- Friends Life Investments successfully launched and now managing £11 billion of fixed interest assets
- Outsourcing deal with Diligenta completed and progressing well
- Run-rate savings of £86 million (2011: £45 million); 88% of the 2015 £160 million target secured

Simplified governance

- Streamlined governance including unified membership of Resolution Limited and FLG boards announced
- Operating agreement with Resolution Operations LLP ends 27 March 2013

Commenting on the results, Andy Briggs, CEO designate of Resolution Limited, said:

The Group has made good operational and financial progress in 2012 and, importantly, sustainable free surplus has improved. Our dividend is 117% covered by cash up-streamed to Resolution holding companies. The UK division performance has been especially strong with a 125% increase in the value of new business from sales up 19% and this has been achieved whilst reducing new business strain by 56%. Our UK and Heritage divisions are progressing strongly through their transformations. The strategic review of our International division was communicated to shareholders last November and has required some difficult, but right, decisions to be made, and the impact of this is reflected in that division's 2012 performance, in line with previous guidance.

Our strategic outlook is attractive, we have scale businesses and our delivery in 2012 has given us competitive advantage so we are well placed for the key market trends. I am confident that we are creating a sustainable business that will improve returns for shareholders.

Mike Biggs, Chairman of Resolution Limited, said:

These results evidence the financial benefits of strategic decisions taken in 2011, particularly in the UK. Following the International strategic review in 2012 the Board believes the Group is well positioned for future success.

(i) Estimated, unaudited

Enquiries:

Investors/analysts

Neil Wesley, Resolution Operations LLP	+44 (0)7584 219213

Media

Alex Child-Villiers, Temple Bar Advisory	+44 (0)7795 425580

Forward-looking statements

This announcement includes statements that are, or may be deemed to be, "forward-looking statements" with respect to Resolution, its subsidiary undertakings and their outlook, plans and current goals. In some cases, these forward-looking statements can be identified by the use of forward-looking terminology, including the terms "targets", "believes", "estimates", "anticipates", "expects", "intends", "may", "will" or "should" or, in each case, their negative or other variations or comparable terminology. By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend upon circumstances that may or may not occur in the future. Forward-looking statements are not guarantees of future performance. Resolution's actual performance, results of operations, internal rate of return, financial condition, liquidity, distributions to shareholders and the development of its acquisition, financing and restructuring and consolidation strategies may differ materially from the impression created by the forward-looking statements contained in this announcement. Forward-looking statements in this announcement are current only as of the date of this announcement. Resolution undertakes no obligation to update the forward-looking statement it may make. Nothing in this announcement should be construed as a profit forecast.

Media

There will be a conference call today for wire services at 07.30 (GMT). Dial in telephone number: UK FreeCall 0800 6940257, UK Standard International +44 (0) 1452 555566 Passcode: 20851136.

Analysts/Investors

A presentation to analysts will take place at 09.00 (GMT) at the Andaz Hotel, Liverpool Street, London, EC2M 7QN. Dial in telephone number: 0800 634 5205, UK standard International +44 (0) 208 817 9301, confirmation number: 10300845. A webcast of the presentation and the presentation slides will be available on Resolution's website, www.resolution.gg.

In accordance with the obligations for issuers of listed debt contained in the Disclosure and Transparency Rules, Friends Life Group plc will issue a separate preliminary results announcement later today.

Financial calendar

First quarter interim management statement	8 May 2013
Annual General Meeting	16 May 2013
Interim results 2013	13 August 2013
Third quarter interim management statement	12 November 2013

2012 final dividend

Ex-dividend date	17 April 2013
Record date	19 April 2013
Final date for DRIP elections	26 April 2013
Dividend payment date	20 May 2013

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Chairman’s statement

Overview

The year was marked by good operational progress against a clear strategy and solid progress towards the simplification of the Company’s governance structure.

The results in the second half of 2012 demonstrate that the UK division has continued to make strong progress with its cost reduction programme and in improving the value of new business. The Heritage division, which contains the UK book of business of products no longer marketed, has delivered further capital releases and was successful in reducing its expense risk through an outsourcing of a large part of its cost base. The success of the Group’s separation and integration programme has allowed the target for cost reductions to be raised, albeit at higher costs to complete. The International division reported the outcome of a significant strategic review that refocused the business on its core segments of domestic affluent and global expatriate in the Friends Provident International business and high net worth individuals in the Lombard business. The overall returns on new business written have improved on the prior year.

The Company remains focused on extracting synergies from the acquisitions made and improving the underlying cash generation from the Group. I am pleased to report that the sustainable free surplus generated by the Group, which is a key driver of cash generated by the Group’s life companies, improved steadily over the full year.

The net Market Consistent Embedded Value (“MCEV”) of the Group as at 31 December 2012 was £5,831 million, an increase of 0.6%, after cash dividends paid to shareholders of £193 million.

The Operating Report and Business Review that follow this statement contain a comprehensive account of the full year results in 2012.

Cash and capital

Dividend

The Company’s dividend policy can be summarised as being an absolute amount determined by the Board, currently 21.14 pence per share from 2012 onward, with the expectation that a progressive dividend would be considered once sustainable cash generation reached the £400 million per annum distributable cash target. The Company expects to pay one-third of the total annual dividend as an interim dividend and two-thirds of the total annual dividend as the final dividend. The existing scrip dividend alternative is being discontinued and, in its place, shareholders will be offered a dividend reinvestment plan (“DRIP”). The Board has proposed a final dividend for 2012 of 14.09 pence per share, subject to shareholder approval.

Capital

The capital position of the Company remains strong. The Board is confident that the Group remains well capitalised on both regulatory and economic bases. The Company remains focused on maintaining a robust, low risk balance sheet and on improving the underlying cash generation of the Group.

Simplifying the governance structure

The Company’s UK Life Project, which was focused on the consolidation and restructuring of assets in the UK financial services sector, has resulted in the creation of a financially disciplined, value focused Group. On 15 August 2012, following a review undertaken by the Company and Resolution Operations LLP (“ROL”) of the UK Life Project, the Company and ROL concluded and announced that shareholder value going forward would be best delivered by moving from the externally advised project based structure to a more conventional, simplified governance structure. As part of those changes, the Company confirmed, among other things, that it would no longer actively seek acquisitions or target a specific exit event, but would rather continue to focus on maximising the value of the Group.

Progress on simplifying the governance structure

On 15 August 2012 the Company announced a proposal to adopt a more conventional governance structure by unifying membership of the boards of the Company and the main UK holding company for its regulated life insurance group, Friends Life Group plc (“FLG”), transferring many of the skills from ROL to the Company and ceasing to receive services from ROL under the Operating Agreement.

The Company believes that adopting a more conventional, simplified structure is appropriate for a company no longer seeking acquisitions or a specific exit event. It will also ensure that there is no risk to the Company’s premium listing from the amendments made to the Listing Rules regarding “externally managed companies” which come into effect from 1 January 2014.

Details of the proposed composition of the board of directors of both the Company and FLG were announced on 19 October 2012. On 10 December 2012 the Company confirmed that, subject to implementation of the proposed amendments to the articles, changes to the Board membership would take effect by the end of March 2013. These amendments were approved by shareholders on 20 March 2013. The Company expects to appoint an additional independent non-executive director, not drawn from either of the existing boards, in due course and a search process is under way.

On 19 October 2012 the Company also announced that I had informed the Board that, whilst I remain committed to chairing the new Board to oversee this period of change, I had decided that it would be appropriate to hand over to a new chairman once the transition has been completed. The Company commenced an appointment process for the new chairman and the additional independent non-executive director. On 21 January 2013 the Company announced that Sir Malcolm Williamson would be appointed as chairman when I step down later this year. I intend to step down, and Sir Malcolm’s appointment is expected to become effective, immediately after the close of the annual general meeting of the Company on 16 May 2013.

On 10 December 2012 the Company announced that it had finalised arrangements regarding the final phase of the simplification of the governance of the Company and entered into a Business Sale Agreement with ROL under which ROL will, on 27 March 2013, transfer to the Company business activities that relate to the services it currently provides to the Company and the ROL employees who provide these services. ROL will cease to provide services to the Company, and the Company's payments to ROL under the Operating Agreement will terminate, at the same time.

Outlook

The Company expects that its clear value philosophy will deliver shareholder value going forward. The simplified governance structure should allow investors to focus on and value the considerable operational progress being made in the Group.

While I am looking forward to continuing to chair the Board until the annual general meeting of the Company on 16 May 2013, I would like to take this opportunity to thank my fellow members of the Board, the staff at ROL and at Friends Life for their support and hard work over the course of my chairmanship.

Operating report

1. Executive summary

2012 was another important year for the Company and the Group as a whole. Overall, the Group is pleased to report significant progress with measurable improvements towards its financial and operational targets. The Group has significantly reduced its UK new business strain (2013 target achieved one year early), delivered considerable progress in the value of new business written, improved the rates of return on new business, increased its expected cost savings target, achieved a cash remittance from its International business, materially de-risked the Group's dividend-supporting cash flows and increased its sustainable free surplus generation – a key driver of cash generation of the Group.

This was against a backdrop of macroeconomic uncertainty over the course of the year and a sizeable regulatory agenda impacting the UK life sector. The progress in 2012 has been possible because of the tough strategic and financial decisions taken over the last eighteen months that have prioritised value over volume and focused the Group on profits, returns and cash generation.

2. Strategy

The Company's overall strategic aim remains unchanged: to create a sustainable business that meets customers' needs while also delivering cash and returns to shareholders. When the Company was formed this strategic aim was expected to be fulfilled within a project based structure. On 15 August 2012, the Company announced that while the project based structure was appropriate at the time the Company was launched, shareholder value going forward will be best delivered by moving from an externally advised project based structure to a more conventional, simplified governance structure. As part of that announcement, the Company confirmed, among other things, that it would no longer seek acquisitions or a specific exit event. The Company retains its focus on cash emergence and maximising value for shareholders.

The Group is focused on continuing its disciplined management of the existing book of business to deliver cash and capital synergies and on writing profitable new business in its UK and International divisions. Its approach to managing the business is unchanged, with its three financial priorities remaining: maintaining a robust, low risk balance sheet; improving sustainable cash flow generation; and writing profitable new business to ensure future cash flow generation.

In the UK, the Group has a selective new business focus on three core product areas (Corporate Benefits, Protection and Retirement Income), where the Group believes it has, and can sustain, competitive advantage and scale and thereby achieve appropriate returns. In addition, through the Heritage division, the Group is focused on a disciplined approach to management of closed books of business.

The Group also completed a major strategic review of the International division which was set out in a detailed investor update in November 2012. As a result, Friends Provident International ("FPI") will refocus on two core areas of serving expatriates globally and affluent customers in selected markets, principally Hong Kong, Singapore and Dubai. Lombard will continue its existing strategy with increasing focus on private bank distribution in Europe and explore opportunities for targeted expansion in Asia.

3. Economic and regulatory environment

The economic environment in 2012 was characterised by continued uncertainty globally and the UK economy undergoing a further period of recession. This resulted in volatility across asset classes, especially equities and corporate bonds, and to a lesser degree top-tier government bonds. Growth was weaker than expectations particularly in the euro zone, UK and Japan but exceeded initial expectations in emerging markets. European economies and sentiment, were impacted by ongoing sovereign debt concerns, which together with the impact of the UK Government's austerity programme, negatively affected UK consumer demand and sentiment. Asia continued to benefit from its favourable demographics and relatively healthy fiscal position. The Group's businesses were impacted primarily by the events in Europe and the UK and its selective participation in Asia with the International division impacted by economic uncertainty that dented consumer confidence, resulting in clients postponing many investment decisions. The UK division was also subject to the impacts of the upcoming regulatory changes.

The Group has made good progress preparing for regulatory changes – the Retail Distribution Review ("RDR"), gender neutral pricing and the auto-enrolment of pensions – by making the product and systems changes necessary to meet the new regulatory requirements. In the UK division, Corporate Benefits expects that it will be a beneficiary from the structural shift from defined benefit to defined contribution schemes, the introduction of auto-enrolment of pensions and RDR with selective participation in profitable schemes and leveraging its position of scale in this market. In Protection, the market has seen pricing adjustments to reflect the implementation of gender neutral pricing. The International division will navigate the economic uncertainty in its markets by continuing to focus on its niche offerings and selective market participation although customer sentiment improvements are important.

4. Business performance

£m (unless otherwise stated)	2013 Target	**2012 Full year**	2012 Half year	2011 Full year	2010 Full year baseline(i)
APE		**1,211**	613	1,210	1,217
VNB		**194**	97	151	137
IRR, blended group new business (%)	15+	**10.4**	10.0	10.0	8.6
IFRS based operating profit		**274**	163	681	
– excluding one-off items		**309**		277	
MCEV operating profit		**382**	235	517	
– excluding one-off items		**420**		377	
Sustainable free surplus		**300**	120	291	<100
UK run-rate savings(ii)	126	**86**	65	45	
Funds under management (£bn)		**114.0**	110.4	111.3	
FLG IGCA surplus coverage (%)		**214**	204	219	

(i) 2010 baseline includes an estimate of 12 months BHA and AXA UK Life Business results.
(ii) UK run-rate savings targeted to be £160 million by end 2015.

4.1 Operating results

Financial performance in the year shows continued strong new business performance, progress in sustainable free surplus generation – a key driver of cash generation, and higher returns on new business written, but was impacted by the negative financial impacts of the International strategic review.

The overall improvement in new business performance has been driven by the UK division, with new business written achieving higher returns at a lower cost. Good progress has been made towards UK new business targets with value of new business (“VNB”) more than double that achieved in 2011. This improvement in financial performance validates the actions taken to date, with Retirement Income VNB already above its 2013 target and the Corporate Benefits VNB target within sight. The Protection business has also performed well in 2012 and has delivered strong VNB growth. The IFRS based operating profit of the UK and Heritage divisions reflects the benefits of reduced operating costs but lower investment returns given the weaker economic environment. As a result, the UK and Heritage divisions’ IFRS based operating profit of £300 million (£253 million excluding one-off items) reflects a robust performance against that achieved in 2011 (31 December 2011: £672 million; £256 million excluding one-off items). Similarly, the UK and Heritage divisions’ MCEV operating profit of £502 million (£440 million excluding one-off items) reflects the significant improvement in new business contribution with further benefits accruing as expense reductions are recognised (31 December 2011: £507 million; £360 million excluding one-off items).

The International division’s performance in 2012 has been dominated by the impact of the strategic review conducted in 2012. Overall, Lombard has performed well despite a challenging economic environment in its core markets in Europe. Lombard’s sales volumes have grown by 7% and funds under management are now £19 billion (€23 billion) an 11% increase in euro balances year on year. Selective changes to distribution channels introduced by management during 2012 means more business is sold through the lower margin but more stable private bank channels and less through IFAs. Lombard’s restructuring programme is expected to remove over 20% of head office costs and has resulted in some restructuring charges in 2012.

Within International’s other business, Friends Provident International (“FPI”), the German business unit was the primary driver of the poor financial performance in 2012. The performance relates mainly to low interest rates increasing the costs of guarantees on German products, together with lapse and expense assumption changes as the Group moves towards a distribution model in Germany rather than a model combining distribution and product manufacture.

In November 2012, the Group set out its expectations for a £50-£100 million reduction in MCEV as a result of the International strategic review. This reflected the expected impact of the annual review of assumptions across the International division including a positive £46 million benefit in the Lombard business unit arising from the head office restructuring. The Group also highlighted the ongoing review of the German and Japanese businesses but had not concluded on the financial implications at that point. These reviews have since been completed and, when combined with the annual basis review, the overall impact on the result is an MCEV reduction of £(94) million. Whilst this impact is clearly disappointing, it is pleasing that the overall impact is within expectations despite now including adjustments relating to the German and Japanese businesses.

4.2 Cash and capital

The Group continues to maintain a robust low risk balance sheet and deliver improvements in sustainable free surplus generation. The Group remains committed to increasing sustainable free surplus, which is a key driver of cash generation of the Group, to meet its target of £400 million per annum. However, in August 2012, the Group set out that achieving this target had become circa £50 million per annum more challenging than when the target was set due to the lower interest rate environment. In addition to the sustainable free surplus generated of £300 million in 2012, the Group completed its 2012 capital optimisation programme in December 2012. As a result, the number of active life companies in the Group was reduced from five to four and this generated additional free surplus of £101 million.

The Group took a significant step to de-risk the cash flow available to shareholders with the issue in November 2012 of US$575 million Reset Perpetual Subordinated Notes. The proceeds were used to make early repayment of the remaining £363 million deferred consideration notes ("DCNs") issued to AXA UK in connection with the acquisition of the AXA UK life business. Following the repayment of the DCNs, the Group's external cash commitments reduced by approximately £60 million per annum as a result of the removal of the requirement to amortise the DCNs, providing increased dividend security. The Group's gearing level at 31 December 2012 was 21.5% calculated as debt as a percentage of gross Group MCEV.

The scrip dividend alternative is being discontinued in respect of the 2012 final dividend. Shareholders will be offered a dividend reinvestment plan ("DRIP") in its place.

4.3 Separation, integration and outsourcing

The separation, integration and outsourcing programmes have seen significant delivery in 2012 including the commencement in March of the Diligenta outsourcing contract. As this work has continued, further cost efficiency opportunities have been identified. As a result, in November 2012 the Group increased its target for UK run-rate cost reductions by £14 million to £126 million by the end of 2013, and by £17 million to £160 million by the end of 2015. The Group remains confident of reaching these targets with run-rate savings of £86 million per annum achieved and a further £54 million secured at December 2012.

In November 2012, the Group announced that the costs of completing certain of the more complex elements, including the migration from the AXA systems hosting environment and the overall outsourcing project, would be higher than originally expected. The Group continues to believe these programmes can be completed within the revised cost guidance given in November 2012.

5. Outlook

A low interest rate environment is expected to persist as central banks around the world retain an accommodative stance with respect to monetary policy to combat weak global economic growth. This presents a significant challenge as persistent lower rates of return impact the ability of the business to generate cash and free surplus. Notwithstanding this, the Group's full year results demonstrate good operational progress and the benefits of disciplined execution of a clear strategy. The progress reflects the Group's focus and capital deployment on attractive growth markets where the Group has a sustainable competitive advantage.

The Group is confident that focusing on applying rigorous financial discipline and maintaining an appropriate balance between risk and return will allow it to continue to make good progress in the coming year. As a result, the Board is confident that the Group is on track to meet its financial targets, whilst creating a sustainable business that meets customers' needs and delivering cash and returns to shareholders.

Business review

1 Key performance indicators

The Group uses the following key performance indicators:

KPI: IFRS based operating profit

2012: £274 million	£m
UK and Heritage	300
International	(9)
Corporate	(17)
Group IFRS based operating profit	274

2011: £681 million	£m
UK and Heritage	672
International	78
Corporate	(69)
Group IFRS based operating profit	681

IFRS based operating profit before tax of £274 million is lower than the £681 million reported in 2011 principally reflecting the one-off benefits of £404 million included in the prior year. Excluding one-off items (comprising the impact of the International strategic review and principal reserving changes), the 2012 underlying result of £309 million is up 12% on 2011 (31 December 2011, excluding principal assumption changes: £277 million), reflecting the reduction in new business strain due to cost savings achieved.

KPI: IFRS loss after tax

2012: £(41) million	£m
IFRS based operating profit	274
Investment fluctuations	275
Amortisation & impairment	(514)
Non-recurring costs & other items	(227)
Tax	151
Group IFRS loss after tax	(41)

2011: £(31) million	£m
IFRS based operating profit	681
Investment fluctuations	(261)
Acquisition gain	116
Amortisation & impairment	(759)
Non-recurring costs & other items	(265)
Tax	457
Group IFRS loss after tax	(31)

IFRS loss after tax of £(41) million (31 December 2011: £(31) million) principally reflects one-off project costs as the Group integrates the businesses, as well as the amortisation of the acquired intangible assets. These are partially offset by favourable investment return variances as corporate bond spreads narrowed in the year.

KPI: MCEV operating profit before tax

2012: £382 million	£m
UK and Heritage	502
International	1
Corporate	(121)
Group MCEV operating profit	382

2011: £517 million	£m
UK and Heritage	507
International	111
Corporate	(101)
Group MCEV operating profit	517

Segment results comprise covered and non-covered businesses.

MCEV[(i)] operating profit before tax of £382 million (31 December 2011: £517 million) is lower than the 2011 result, reflecting the significant one-off benefits totalling £140 million in the prior year, principally due to the benefit of the outsourcing agreement with Diligenta. Excluding one-off items (comprising the impact of the International strategic review and other assumption changes), the 2012 underlying result of £420 million is 11% higher than 2011 (31 December 2011, excluding assumption changes: £377 million). The improvement principally reflects the significant growth in the UK division's value of new business.

(i) The MCEV basis is in compliance with the European Insurance CFO Forum MCEV Principles ("MCEV Principles") (Copyright© Stichting CFO Forum Foundation 2008), issued in June 2008, and reissued in amended form in October 2009.

KPI: MCEV profit/(loss) after tax

2012: £268 million	£m
MCEV operating profit	382
Economic variances	154
Amortisation of intangibles	(15)
Non-recurring costs and other items	(127)
Tax	(126)
Group MCEV profit after tax	268

2011: £(295) million	£m
MCEV operating profit	517
Economic variances	(600)
Amortisation of intangibles	(3)
Non-recurring costs and other items	(282)
Tax	73
Group MCEV loss after tax	(295)

MCEV profit after tax of £268 million is significantly higher than the £(295) million loss reported in 2011 principally reflecting the recovery of equity markets and narrowing of corporate bond spreads in 2012.

KPI: Group embedded value on an MCEV basis

2012: £5,831 million	£m
UK and Heritage	5,307
International	1,227
FLG corporate and other (gross)	760
FLG debt	(1,596)
RSL holding companies	133
Group MCEV	5,831

2011: £5,796 million	£m
UK and Heritage	5,341
International	1,112
FLG corporate and other (gross)	655
FLG debt	(1,159)
RSL holding companies	(153)
Group MCEV	5,796

Group embedded value on an MCEV basis of £5,831 million (31 December 2011: £5,796 million) is up by £35 million with the operating performance partially offset by dividend payments.

KPI: FLG return on embedded value

2012: 5.1%	%
Expected existing business contribution	5.7
Value of new business	2.8
Assumption changes	(0.1)
Operating variances	(0.4)
Development and net other costs	(0.8)
Financing impact	0.0
Tax on operating profit	(2.1)
FLG return on embedded value	5.1

2011: 6.5%	%
Expected existing business contribution	5.3
Value of new business	2.0
Assumption changes	1.8
Operating variances	(0.3)
Development and net other costs	(0.4)
Financing impact	0.5
Tax on operating profit	(2.4)
FLG return on embedded value	6.5

FLG[(i)] operating ROEV of 5.1% has been negatively impacted by the International division strategic review.

(i) FLG operating ROEV is calculated as the MCEV operating return, after tax and financing, divided by the start of period net embedded value, and is adjusted to allow for the timing of significant capital movements such as dividends and acquisitions.

KPI: Asset quality (corporate debt and asset-backed securities)

2012: £9.2 billion	%
AAA	14
AA	33
A	37
BBB	13
<BBB/not rated	3

2011: £8.6 billion	%
AAA	13
AA	35
A	34
BBB	15
<BBB/not rated	3

The Group has maintained high asset quality, with 97% of shareholder-related corporate debt and asset backed securities at investment grade or above (31 December 2011: 97%). The Group has no significant shareholder exposure to sovereign debt or corporate bonds of higher risk European economies. No defaults were recorded in the year and the shareholder share of default provisions amounted to £0.5 billion.

KPI: Available shareholder cash

	£m
1 January 2012	853
Dividends	(193)
Debt movement	(75)
Corporate costs & other	(89)
Contribution from Life Companies to ASC	354
31 December 2012	850

Group available shareholder cash of £850 million (31 December 2011: £853 million) is in line with 2011 with dividends paid to shareholders and the impact of refinancing largely offset by the contribution from the life companies.

KPI: IGCA

	£m
1 January 2012	2,139
Surplus emerging	300
Dividend to RSL	(500)
External UT2 debt	348
Repay RSL debt	(200)
Finance costs and other	(67)
31 December 2012	2,020

FLG IGCA surplus capital of £2.0 billion (31 December 2011: £2.1 billion) represents a coverage ratio of 214% (31 December 2011: 219%). Surplus capital has remained strong over 2012 with the cost of debt financing and dividends paid to the Resolution holding companies largely offset by the operating performance of the Group.

2 Group results

2.1 Group IFRS results

The Group's IFRS results are set out below, including a reconciliation from IFRS based operating profit to the IFRS result after tax. The Group uses the operating profit measure as its key IFRS metric as the Board considers that this better represents the underlying performance of the business and the way in which it is managed.

£m	UK & Heritage	International	Corporate	Full year 2012	Full year[(i)] 2011
New business strain	**(59)**	**(83)**	**–**	**(142)**	(181)
In-force surplus	**395**	**155**	**–**	**550**	572
Long-term investment return	**(40)**	**–**	**17**	**(23)**	(26)
Principal reserving changes and one-off items	**47**	**(70)**	**–**	**(23)**	404
Development costs	**(42)**	**(8)**	**–**	**(50)**	(36)
Other income and charges	**(1)**	**(3)**	**(34)**	**(38)**	(52)
IFRS based operating profit/(loss) before tax	**300**	**(9)**	**(17)**	**274**	681
Short-term fluctuations in investment return				**275**	(261)
Non-recurring items				**(258)**	(293)
STICS interest adjustment to reflect IFRS accounting for STICS as equity				**31**	31
IFRS profit before acquisition accounting adjustments and shareholder tax				**322**	158
Amortisation and impairment of acquired in-force business				**(417)**	(675)
Amortisation and impairment of other intangible assets				**(97)**	(84)
Gain on acquisition of businesses				**–**	116
Costs associated with business acquisitions				**–**	(3)
IFRS loss before shareholder tax				**(192)**	(488)
Shareholder tax				**151**	457
IFRS loss after tax				**(41)**	(31)

(i) Full year 2011 results comprise 12 months results for Friends Provident and the AXA UK Life Business, 11 months for BHA, ten months for GOF and TIP and two months for the acquired WLUK business.

Operating profit

The Group IFRS based operating profit in the year to 31 December 2012 totalled £274 million, £407 million lower than the full year 2011 result. The principal driver of the year on year reduction is the £404 million one-off benefit reported in the 2011 result. On an underlying basis, excluding the impact of the International strategic review and increased cost of guarantees of £(82) million and favourable assumption changes of £47 million within the UK and Heritage divisions, the 2012 IFRS based operating profit of £309 million compares to £277 million for 2011. The International strategic review has impacted both new business strain (£(12) million) and principal reserving changes and one-off items £(70) million).

The improvement largely reflects the good progress made in delivering operating cost savings within the UK and Heritage divisions, notwithstanding the need to increase development spend as the Group prepared for the significant regulatory driven change (RDR, auto-enrolment and gender neutral pricing) implemented towards the end of 2012.

Further details of the operating performance of the Group are included in the relevant operating reviews below.

Non-operating items

Short-term fluctuations in investment returns, on assets backing the shareholder and non-profit funds, were a favourable £275 million in the year to 31 December 2012. This benefit mainly reflects a reversal of the negative variances experienced in 2011, and principally includes:

- £118 million benefit as confidence returned to bond markets, resulting in lower credit default assumptions and the application of a higher valuation interest rate;
- £99 million benefit from the release of unit-linked tax loss provisions as a result of updated fund growth estimates; and
- £45 million release of credit default allowances, as credit defaults have been lower than assumed in the long-term investment return.

Non-recurring items of £(258) million include:

- separation and integration programme costs of £(124) million;
  - costs, net of provision releases, of the separation and integration programmes totalled £(124) million in the year and take cumulative spend on these projects to £(257) million (31 December 2011: £(133) million). In November 2012, the Group provided an update on the costs of completing these programmes with extensive re-planning undertaken to assess the impacts of addressing the complexities and necessary remediation work arising from the proposed migration from AXA systems hosting environment. Including these incremental elements the total lifetime costs for the separation and integration programme are now expected to be approximately £(280) million.
- finance transformation costs of £(76) million largely relating to Solvency II;
- outsourcing implementation costs of £(41) million;
  - costs of £(84) million relating to the Diligenta outsourcing implementation were provided for as at 31 December 2011. In 2012, a further £(82) million of costs have been incurred, offset by a £31 million provision release and £10 million pension scheme curtailment gain following the transfer of outsourced employees. Costs incurred to date total £(125) million with total implementation costs expected to be in the region of £(280) million, incurred in the period to the end of 2014.
- costs of £(16) million relating to the separation from ROL, principally comprising £(7) million for the transfer of the ROL operating agreement, £(3) million in connection with property costs and £(6) million of legal, restructuring and other costs; and
- other net non-recurring costs of £(1) million including costs of the capital optimisation programme (£(17) million), curtailment gain of £22 million following the closure to further accrual of a Friends Life pension scheme and other non-recurring costs of £(6) million.

Interest payable on the FLG STICS of £(31) million is included as a £(22) million deduction to corporate long-term investment return in the operating profit analysis, and a £(9) million adverse short-term fluctuation in investment return. As the STICS are accounted for as equity in IFRS (with interest being recorded as a reserve movement), £31 million is added back to the non operating result to reflect the requirements of IFRS.

Acquisition accounting adjustments, totalling £(514) million, represent the amortisation and impairment of the intangible assets recognised on acquisitions. These charges comprise £(417) million of amortisation and impairment of acquired in-force business, and £(97) million of amortisation and impairment of other intangible assets (including £(14) million in respect of impairment of International assets, mainly goodwill). The amortisation of acquired in-force business in 2011 included a one-off charge of £(201) million (£(130) million for the AXA UK Life Business, £(71) million for BHA) which reflected the accelerated run-off of in-force surplus following the recognition of negative reserves in these businesses. The Group continues to monitor the expected run-off profile of the acquired in-force business with this adjusted in 2012 to reflect changes to the expected run-off profile of the International division's acquired in-force book.

A shareholder tax credit of £151 million is recognised for the year. This is higher than the loss before tax of £(192) million would imply. The actual tax credit includes £61 million in respect of the reduction in the rate of UK corporation tax, and net tax credits of £78 million in relation to tax reliefs, charges and expenses predominantly in relation to the life insurance companies in the Group which are taxed on the "I minus E" basis.

The tax credit in relation to the amortisation and impairment of AVIF and other intangibles in the year, including the associated impact of the reduction in the corporation tax rate, is £164 million.

Summary IFRS balance sheet

£m	**31 December 2012**	31 December 2011
Acquired value of in-force business	**4,008**	4,437
Other intangible assets	**313**	410
Financial assets	**105,990**	103,636
Cash and cash equivalents	**9,449**	8,791
Other assets	**7,979**	8,132
Total assets	**127,739**	125,406
Insurance and investment contracts	**115,416**	112,455
Loans and borrowings		
– deferred consideration notes	**–**	423
– subordinated debt	**1,024**	681
– other	**75**	91
Other liabilities	**5,526**	5,761
Total liabilities	**122,041**	119,411
IFRS net assets	**5,698**	5,995
Equity attributable to equity holders of the parent	**5,377**	5,672
Attributable to non-controlling interests	**321**	323
Total equity	**5,698**	5,995
Shares in issue(i)	**1,418,109,028**	1,373,527,605

(i) Shares in issue at 31 December 2011 were adjusted to exclude Resolution Limited shares held by subsidiaries of 2,661,384 (31 December 2012: nil).

At 31 December 2012, IFRS total equity was £5,698 million (31 December 2011: £5,995 million), with equity attributable to equity holders of the parent of £5,377 million (31 December 2011: £5,672 million). IFRS net assets per share attributable to shareholders were £3.79 (31 December 2011: £4.13) based on shares in issue at the balance sheet date, excluding, at 31 December 2011, the Company's shares held by subsidiaries. The change in shares in issue in 2012 reflects the impact of scrip dividends taken up and the disposal of the Company’s shares held by subsidiaries.

Financial assets are predominantly invested in listed shares, other variable yield securities, corporate bonds, asset-backed securities and government securities. Asset quality has been maintained with 97% of shareholder-related corporate bonds and asset-backed securities held at investment grade or above and there is limited exposure to European sovereign debt.

At 31 December 2012, the ratio of debt to IFRS equity attributable to equity holders of the parent, gross of debt, was 17.0% (31 December 2011: 17.4%), with the impact of the repayment of the DCNs in the year offsetting the reduction in equity.

2.2 Group MCEV results

MCEV is an alternative accounting basis to IFRS for life assurance companies. MCEV reporting is designed to recognise profit as it is earned over the lifetime of each policy and reflects the future cash flows that are expected to arise from sales in the period, together with the effect of updating the previous period's assumptions on existing business for the actual experience. The total profit recognised under both MCEV and IFRS will be the same over the life of each policy, it is the timing of the recognition of that profit which differs.

The results and financial position of the Group's life and pensions business ("covered business") are presented on the MCEV basis with all other businesses included on an IFRS basis.

£m	UK & Heritage	International	Corporate	Full year 2012	Full year[i] 2011
Value of new business	**144**	**50**	**–**	**194**	151
Expected existing business contribution	**342**	**58**	**(75)**	**325**	360
Operating experience variances	**(21)**	**(35)**	**–**	**(56)**	(28)
Operating assumption changes	**62**	**(71)**	**–**	**(9)**	140
Other operating variances	**19**	**8**	**–**	**27**	6
Development costs	**(42)**	**(8)**	**–**	**(50)**	(36)
Other income and charges	**(2)**	**(1)**	**(46)**	**(49)**	(76)
Operating profit/(loss) before tax	**502**	**1**	**(121)**	**382**	517
Economic variances				**154**	(600)
Amortisation and impairment of non-covered business intangible assets				**(15)**	(3)
Non-recurring costs				**(255)**	(345)
Other non-recurring items and non-operating variances				**128**	66
Costs associated with business acquisitions				**–**	(3)
Profit/(loss) from continuing operations before tax				**394**	(368)
Tax				**(126)**	73
Profit/(loss) from continuing operations after tax				**268**	(295)

(i) Full year 2011 results comprise 12 months results for Friends Provident and the AXA UK Life Business, 11 months for BHA, ten months for GOF and TIP and two months for the acquired WLUK business.

Operating profit

The Group MCEV operating profit in the year to 31 December 2012 was £382 million, down £135 million on the prior year reflecting the inclusion of significant one-off benefits in 2011 relating to the Diligenta outsourcing. Excluding one-off items in both years (comprising, for 2012, the impacts of the International division strategic review and other operating assumption changes), the 2012 result of £420 million (31 December: £377 million) represents a good performance. This improvement is underpinned by the UK and Heritage divisions where actions to reduce costs and migrate new business to the target platforms has significantly increased the value of new business.

The Group set out at the November 2012 investor day an expected £50-100 million adverse impact on the MCEV result of the International strategic review, which principally related to expense overruns and embedded value costs in FPI's OLAB business. At that time, the Group also highlighted that it was undertaking a review into the viability of the OLAB business (principally in Germany) as well as assessing assumptions for the Japanese book, with any costs of these reviews expected to be additive to the November range. These reviews have since been concluded and whilst the outcomes (which include the exit of product manufacturing in Germany) have been incrementally negative, it is notable that total International strategic review impacts, including related basis changes, of £(94) million remain within the original range. The impact of the International division strategic review is reflected in the value of new business (£(27) million), operating assumption changes (£(65) million) and other operating variances (£(2) million).

Notwithstanding the outcomes of the International division strategic review, the UK and Heritage divisions' operating result highlights the significant improvements in the value of new business, offset by the market driven lower expected returns.

Further details on the operating performance of the Group are included in the relevant divisional operating reviews below.

Non-operating items

Economic variances combine the impact of changes to economic assumptions with the investment return variances over the year. Total economic variances in 2012 had a £154 million positive impact on MCEV profit before tax (2011: £600 million adverse). The key positive variances arose from the narrowing of corporate bond spreads and the higher than expected movement in the equity markets. Corporate bond spreads narrowed by circa 70bps over 2012 which resulted in an increase in MCEV of £306 million, primarily in respect of annuity business written in the UK. The equity market movements increased the value of future annual management charges on unit-linked business, resulting in an increase of £157 million. These positives were offset by the change in the market value of Group debt of £(303) million. Other minor variances including those from foreign exchange movements and interest rates totalled £(6) million.

Non-recurring costs in 2012 total £(255) million and include costs of £(258) million, consistent with those reported within the IFRS result, offset by net items of £3 million specific to MCEV. The £3 million MCEV-specific element includes the release of a £34 million provision, originally set aside for the costs of implementing Solvency II, principally offset by the difference between the actual tax relief expected and the notional tax gross up applied to all non-recurring costs under MCEV. The application of these different tax rates results in a higher cost, gross of notional tax, under MCEV than under IFRS.

Other non-recurring items and non-operating variances of £128 million include a benefit of £62 million from the amalgamation of certain profits and losses under the New Life Tax Regime and a £70 million benefit principally from the impact on the UK and Heritage VIF of changing the ultimate corporation tax rate effective from April 2014 from 23% to 21%, following the Chancellor's Autumn Statement in December 2012.

MCEV balance sheet

Gross life and pensions MCEV £m	31 December 2012 Net worth	31 December 2012 VIF	31 December 2012 Total	31 December 2011 Total
UK and Heritage	**2,115**	**3,192**	**5,307**	5,341
International	**177**	**1,050**	**1,227**	1,112
FLG corporate	**683**	**–**	**683**	564
FLG other[(i)]	**77**	**–**	**77**	91
Gross FLG MCEV	**3,052**	**4,242**	**7,294**	7,108
FLG corporate – external STICS	**(443)**	**–**	**(443)**	(327)
FLG corporate – external LT2 and UT2 subordinated debt	**(1,153)**	**–**	**(1,153)**	(632)
FLG corporate – internal LT2 subordinated debt	**–**	**–**	**–**	(200)
Net FLG MCEV	**1,456**	**4,242**	**5,698**	5,949
RSL net assets[(ii)]	**133**	**–**	**133**	270
RSL deferred consideration notes	**–**	**–**	**–**	(423)
Net Group MCEV	**1,589**	**4,242**	**5,831**	5,796
Shares in issue[(iii)]			**1,418,109,028**	1,373,527,605

(i) Includes IFA distribution and management services businesses including the pension asset of FPPS.
(ii) RSL 2011 net assets include the internal LT2 subordinated debt which was redeemed in November 2012.
(iii) Shares in issue at 31 December 2011 have been adjusted to exclude Resolution Limited shares held by subsidiaries of 2,661,384 (31 December 2012: nil).

At 31 December 2012, net Group MCEV was £5,831 million (31 December 2011: £5,796 million) giving MCEV per share of £4.11 (31 December 2011: £4.22). The fall in year on year MCEV per share, despite an increase in net Group MCEV, reflects the increased shares in issue following the fulfilment of the 2012 scrip dividend.

At the end of the year the ratio of debt to gross Group MCEV was 21.5% (31 December 2011: 19.3%), with the change primarily reflecting the increase in Group MCEV combined with the repayment of the DCNs. The ratio of debt to gross FLG MCEV has increased to 21.9% (31 December 2011: 16.3%), principally reflecting the increased market value of debt held at the FLG level and the successful raising of US $575 million (£356 million) of UT2 reset perpetual subordinated debt partially offset by the repayment of £200 million debt to Resolution holding companies in November 2012.

The Resolution holding companies' net worth increased by £285 million reflecting the payment of cash dividends of £(193) million and corporate costs incurred in the year of £(29) million, offset by the receipt of £500 million dividends from FLG and the disposal of £7 million of Company shares previously held by subsidiaries.

Resolution Limited shares held by Group subsidiaries are excluded from Resolution holding companies' net worth (in accordance with IFRS) therefore the disposal of these shares increases the Resolution holding companies' net worth.

The FLG operating ROEV, after tax, for the year to 31 December 2012 was 5.1% (31 December 2011: 6.5%). The year on year reduction highlights the inclusion of significant one-off benefits in the 2011 result, principally driven by revised expense assumptions following the completion of the Diligenta outsourcing. In 2012, whilst improvements have been made to the contribution from new business, particularly in the UK division, returns have been adversely affected by low expected returns on the in-force book and the strategic review of the International division.

2.3 Group free surplus generation

The generation of free surplus, net of movements in required capital, underpins the declaration of future dividends. The table below analyses the free surplus result after tax for the year.

£m	UK & Heritage	International	Corporate	Full year 2012	Full year 2011
Expected return from in-force business[(i)]	**539**	**129**	**–**	**668**	679
Investment in new business	**(161)**	**(124)**	**–**	**(285)**	(325)
Underlying free surplus generation	**378**	**5**	**–**	**383**	354
Development costs	**(32)**	**(6)**	**–**	**(38)**	(28)
Coupon on external debt	**–**	**–**	**(73)**	**(73)**	(58)
Coupon on internal debt	**–**	**–**	**(12)**	**(12)**	(24)
Operating experience variances	**(6)**	**(25)**	**–**	**(31)**	(23)
Other operating items[(ii)]	**88**	**(2)**	**–**	**86**	81
Other income and charges[(iii)]	**(5)**	**–**	**(10)**	**(15)**	(11)
Sustainable free surplus generation	**423**	**(28)**	**(95)**	**300**	291
Operating assumption changes	**5**	**(73)**	**–**	**(68)**	204
Impact of PS06/14	**–**	**–**	**–**	**–**	161
GOF/TIP result	**–**	**–**	**–**	**–**	41
Operating free surplus generation	**428**	**(101)**	**(95)**	**232**	697
Economic variances				**120**	(352)
Capital optimisation programme				**101**	181
Change in Group capital policy				**–**	172
Other non-operating items				**(208)**	(244)
FLG free surplus generated				**245**	454
RSL income and charges				**(30)**	(41)
Total free surplus generated				**215**	413

(i) 2011 result excludes the GOF/TIP profit of £41 million, following the sale of this business in November 2011.
(ii) 2011 result excludes PS06/14 impact.
(iii) Other income and charges excludes the coupon on internal debt.

Sustainable free surplus

Sustainable free surplus generated in the year of £300 million (31 December 2011: £291 million) is up 3% on the 2011 result. This reflects the benefit from migrating new business onto the target platforms and reducing operating costs which has more than offset the lower return generated from the in-force book reflecting the current economic environment.

In addition, the higher than normal volume of regulatory change towards the end of 2012, including the implementation of RDR, auto-enrolment and gender neutral pricing, has resulted in additional development spend as the Group prepared for these changes.

Debt costs within sustainable free surplus are broadly flat year on year at £85 million (31 December 2011: £82 million). Going forward, debt costs within sustainable free surplus will increase by circa £7 million and reflect the refinancing of the deferred consideration notes and successful de-risking of the Group's dividend servicing capability.

Favourable other operating items in the year comprise £35 million release of unit-linked tax loss provisions as a result of updated fund growth estimates, £27 million benefit related to the refinement of capital allocation between with-profits and non-profits funds and £24 million of benefits principally resulting from refinements to models across the UK and Heritage divisions.

Non-sustainable items

Operating assumption changes, primarily in respect of expenses and persistency, reduced free surplus by £68 million, this includes £(73) million in the International division following the implementation of the strategic review. In 2011 the free surplus was increased significantly by the combined impacts of completing the implementation of PS06/14 and the benefits from the Diligenta outsourcing deal.

In the year to 31 December 2012, positive economic variances of £120 million increased free surplus, primarily driven by the impact of the narrowing of corporate bond spreads on assets backing the annuity business. In addition, the implementation of the Part VII transfers within the UK life companies in December 2012 reduced capital requirements and increased free surplus by £101 million. Other non-operating items reduced free surplus by £(208) million, broadly consistent with MCEV non-recurring costs, net of tax and excluding required capital.

Available shareholder cash

£m	**2012 Full year**	2011 Full year
Opening available shareholder cash	**853**	1,067
Dividends from life companies declared in the year (contribution to DCT)	**354**	350
Issue of UT2 reset perpetual debt (net of costs)	**348**	–
DCN capital payments	**(423)**	(77)
Dividends to shareholders and share buy-back settlements	**(193)**	(476)
Corporate costs and other	**(89)**	(11)
Closing available shareholder cash	**850**	853

Available shareholder cash represents cash available to cover corporate costs, to service debt issued by holding companies and, subject to shareholder approval, to pay dividends.

The good delivery of free surplus in the UK and Heritage divisions, and Lombard, supported the declaration of £350 million of dividends from FLL together with the payment of £4 million from Lombard in 2012. Dividends actually paid by life companies in 2012 totalled £454 million, however £350 million of this was included in opening ASC as it had been declared at that point. The remaining £104 million, along with £250 million of FLL dividends declared at 31 December 2012, gives the contribution to the distributable cash target ("DCT") of £354 million. The issue of £348 million of UT2 reset perpetual debt (net of costs) and dividends from FLG enabled the repayment of the DCNs and the payment of the external dividend to shareholders. Other movements in ASC comprise corporate cash flows, including external interest payments net of interest received from life companies, and an increase in the amount of cash set aside at FLG holding company level to fund working capital requirements, relating to the funding for the pension scheme deficit.

Dividends

The Company's dividend policy can be summarised as being an absolute amount determined by the Board, currently 21.14 pence per share from 2012 onward, with the expectation that a progressive dividend would be considered once sustainable cash generation reaches the £400 million per annum distributable cash target. The Company expects to pay one-third of the total annual dividend as an interim dividend and two-thirds of the total annual dividend as the final dividend. In addition, the Board has decided that, the current scrip alternative will be discontinued and, subject to shareholder approval, will be replaced with a dividend reinvestment plan ("DRIP") thereby allowing shareholders to retain optionality regarding the method of receipt of dividends. Elimination of the scrip will remove shareholder dilution and further improves the clarity of cash flows and dividends.

Dividends from life companies to be up-streamed to Resolution holding companies in respect of 2012 are £350 million. The total cost of the dividend to shareholders is expected to be £298 million, comprising £98 million in respect of the interim 2012 dividend and £200 million in respect of the proposed final dividend, subject to shareholder approval. This gives a coverage ratio of 117%.

3 UK and Heritage divisions

Structure

The transformation of the UK business has continued throughout 2012 with the management structures now in place for the UK and Heritage divisions.

The Heritage division forms the bulk of the UK business by assets and in-force value and as a result is the principal driver of the Group's surplus generation. The division is focused on the management of products that are no longer actively marketed and is therefore distinct from the activities undertaken by the UK division.

The UK division combines the Corporate Benefits, Protection and Retirement Income business units which were formerly identified as 'Go to Market' businesses. These business units are focused on scale markets where good margins are generally available and where the Group has strong market positions enabling access to those margins.

The operational reviews of these stand alone divisions are set out in the sections that follow. However, whilst the transformation of these businesses is progressing well, until this is complete the financial results of the UK and Heritage divisions will continue to be presented as a combined unit although certain financial information is split between the divisions. The financial metrics for the combined UK and Heritage divisions are shown below.

2012 operational highlights

- **UK and Heritage IFRS based operating result of £300 million; £253 million excluding one-off items (2011: £672 million; £256 million excluding one-off items)** principally reflects a focused operating performance with IFRS new business strain reduced by 47%.
- **UK and Heritage MCEV operating profit of £502 million is in line with the £507 million result in 2011**, despite the reduced impact of one-off positive items (2012: £62 million, 2011: £147 million). The 2012 result reflects a material increase in the value of new business as the business focuses new business onto the target platforms and reduces operating costs.
- **UK sustainable free surplus generation up to £423 million from £374 million in 2011** reflecting reduced levels of free surplus invested in new business.
- **Run-rate cost savings achieved up to £86 million. Together with the £54 million now contractualised, savings totalling £140 million have been secured, equivalent to 88% of the 2015 cost saving target.**
- **Targeted £200 million reduction in new business cash strain achieved a year early;** total UK and Heritage new business cash strain now at £(91) million.

£m (unless otherwise stated)	**2012 Full year**	2012 Half year	2011 Full year
IFRS based operating profit before tax	**300**	137	672
MCEV operating profit before tax	**502**	249	507
Sustainable free surplus	**423**	160	374
Regular dividends paid /proposed to Group[(i)]	**350**	350	350
Value of new business	**144**	67	59
New business cash strain	**(91)**	(60)	(169)
IRR (%)	**11.1**	9.4	7.7
APE	**771**	414	721
Funds under management			
– Heritage division (£bn)	**68.7**	68.9	70.8
– UK division (£bn)	**19.7**	17.5	16.9

(i) Dividends of £450 million were paid by FLL in 2012, comprising £350 million regular dividends and £100 million additional dividends.

3.1 UK and Heritage divisions, financial performance

UK and Heritage divisions IFRS based operating profit

£m	**2012 Full year**	2012 Half year	2011 Full year[i]
New business strain	**(59)**	(41)	(112)
In-force surplus	**395**	196	402
Long-term investment return	**(40)**	(26)	(5)
Principal reserving changes and one-off items	**47**	27	416
Development costs	**(42)**	(18)	(28)
Other income and charges	**(1)**	(1)	(1)
IFRS based operating profit before tax	**300**	137	672

(i) Full year 2011 results comprise 12 months results for Friends Provident and the AXA UK Life Business, 11 months for BHA, ten months for GOF and TIP and two months for the acquired WLUK business.

The 2012 UK IFRS based operating profit of £300 million is £372 million lower than in 2011 mainly reflecting the £416 million one-off benefits reported in the prior year. The 2012 UK result reflects the significant reduction in new business strain, following a focus on target new business platforms and lower costs, partially offset by lower expected returns than 2011 due to lower interest rates and the higher internal debt costs paid to the Corporate segment.

A split of the £300 million IFRS based operating profit between the Heritage and UK divisions has been estimated as a £332 million profit and a £(32) million loss respectively. An estimate of this split is not available for the comparative period.

New business strain and in-force surplus

Details of new business strain and in-force surplus for the UK business are set out below.

Reconciliation of new business cash strain to IFRS new business strain

£m	**2012 Full year**	2012 Half year	2011 Full year
New business cash strain	**(91)**	(60)	(169)
DAC/DFF adjustments	**35**	19	60
Other IFRS adjustments	**(3)**	–	(3)
IFRS new business strain	**(59)**	(41)	(112)

In the year, IFRS new business strain has been reduced by 47% to £59 million (31 December 2011: £112 million) reflecting the Group's actions to reduce acquisition expenses. The reduction in IFRS new business strain is principally driven by the underlying new business cash strain which is detailed in the respective UK and Heritage reviews that follow.

Deferred acquisition costs ("DAC") are recognised on pensions and investment new business with the lower level of deferral compared to 2011 reflecting the reduced commissions paid following the decision to stop selling investment bonds during 2011.

Reconciliation of in-force cash surplus to IFRS in-force surplus

£m	**2012 Full year**	2012 Half year	2011 Full year
In-force cash surplus	**395**	166	354
DAC/DFF adjustments	**(12)**	(1)	(7)
Other IFRS adjustments	**12**	31	55
IFRS in-force surplus	**395**	196	402

The overall contribution to in-force surplus of the acquired Friends Life WL Limited ("FLWL") business formerly Winterthur Life UK Limited ("WLUK") business is £28 million in 2012 following the acquisition of this business in November 2011. This contribution is offset in the IFRS in-force surplus by a reduction in other IFRS adjustments mainly relating to the reversal of investment contract reserve movements which are not allowable under IFRS and some adverse experience variances.

Long-term investment return

£m	**2012 Full year**	2012 Half year	2011 Full year
Long-term return on life and pension shareholder funds – excluding debt	**68**	27	70
Long-term return on life and pension shareholder funds – debt	**(108)**	(53)	(75)
Total	**(40)**	(26)	(5)

The decrease in long-term investment return in the UK business reflects the increased cost of debt compared to 2011. The increase in debt costs in 2012 (£33 million) reflects a full year's interest charge on the internal LT2 subordinated debt issued by FLL to Friends Life holding companies in 2011 (with £500 million issued in April 2011 and a further £200 million issued in December 2011). The benefit of the interest received is reflected in the Corporate segment's operating result.

Principal reserving changes and one-off items

Principal reserving changes and one-off items of £47 million include £30 million of assumption changes, largely related to expense assumptions, including the benefit of reduced investment fees following the set up of FLI. Other one-off items of £17 million include modelling changes and revised transfers on guaranteed annuity options triggered by the vesting of pensions business within the with-profits funds.

Operating expenses

In November 2012, the Group announced an increase in the cost savings target to £160 million by the end of 2015 (previously £143 million), with savings to be achieved by the end of 2013 also increased to £126 million (previously £112 million). At the end of 2012, the UK and Heritage divisions have achieved run-rate saving of £86 million (31 December 2011: £45 million) with a further £54 million secured through contractual arrangements with outsource providers.

The delivery of the £126 million run-rate savings target requires a further £40 million to be achieved in 2013. The Group expects these run-rate cost savings to be delivered equally from both savings already contractualised and savings embedded in the 2013 operating budgets. In 2014 and 2015, the delivery of the £160 million target is expected to be achieved entirely through the contractualised savings already secured.

£m	**2012 Full year**	2012 Half year	2011 Full year	2010 Full year baseline(i)
Acquisition	**150**	77	178	220
Maintenance	**293**	141	263	256
	443	218	441	476
Development	**42**	18	28	23
Total	**485**	236	469	499

(i) 2010 full year baseline includes an estimate of 12 months operating expenses for AXA UK Life Business, BHA and the acquired WLUK business.

UK and Heritage divisions total operating expenses, which exclude commission payments and non-recurring costs, amounted to £485 million in 2012.

Acquisition and maintenance costs amounted to £443 million in the year, in line with 2011. After adjusting for the inclusion of the acquired WLUK and BHA businesses (£22 million), inclusion of FLI (£8 million) and inflation (£13 million), costs in the year have been reduced by £41 million principally reflecting the in year cost savings achieved.

The £8 million costs incurred in relation to the set up and ongoing running costs of FLI have been more than offset by a higher benefit from lower ongoing investment management costs in principal reserving changes and one-off items.

The higher level of development spend includes circa 40% relating to preparations for the significant volume of regulatory change such as the Retail Distribution Review, auto-enrolment and gender neutral pricing. Development costs also include expenditure associated with the corporate platform 'My Money' as well as the Retirement Income strategy.

UK and Heritage divisions MCEV operating profit

£m	**2012 Full year**	2012 Half year	2011 Full year(i)
Value of new business	**144**	67	59
Expected existing business contribution	**342**	170	330
Operating experience variances	**(21)**	3	(9)
Operating assumption changes	**62**	9	147
Other operating variances	**19**	19	9
Development costs	**(42)**	(18)	(28)
Life and pensions covered business operating profit before tax	**504**	250	508
Other income and charges	**(2)**	(1)	(1)
Operating profit before tax	**502**	249	507

(i) Full year 2011 results comprise 12 months results for Friends Provident and the AXA UK Life Business, 11 months for BHA, ten months for GOF and TIP and two months for the acquired WLUK business.

The UK and Heritage MCEV operating profit of £502 million is in line with the £507 million reported in 2011 and reflects the good performance and material increase in value of new business in the UK and Heritage division.

A split of the £502 million MCEV operating profit between the Heritage and UK divisions has been estimated as £359 million and £143 million respectively. An estimate of this split is not available for the comparative period.

Value of new business

The contribution from new business has improved significantly with the £144 million reported in 2012 representing a 144% increase on 2011. The improvement in new business profitability has been driven by strong customer propositions and distribution relationships, underpinned by the ongoing delivery of cost savings, including those resulting from the March 2012 outsourcing to Diligenta, as well as the ongoing drive to increase the proportion of business written on the target new business platforms.

Expected existing business contribution

The expected existing business contribution for the UK and Heritage divisions includes the expected return on the value of in-force business, the expected return on shareholders' net assets and an allowance for the release of the cost of non-hedgeable risk capital as the business matures.

Expected return comprises two components:

- expected earnings on all opening assets assuming a reference rate based on the one-year swap return set at the beginning of the period, plus an illiquidity premium which is applied to annuity business only; and
- additional expected earnings consistent with management's long-term expectation of the asset returns on the business.

The expected return on the value of in-force has remained broadly stable compared to 2011. The lower expected long-term rates of return continue to adversely impact the expected existing business contribution with the rates applied to equities having fallen materially. This reflects a fall in the ten year risk free swap rate, used as a reference rates for equities, to 2.4% at 31 December 2011 (31 December 2010: 3.7%). This reduction has however been partially offset by an increase in the reference rate used for cash, gilts and corporate bonds, reflecting the higher one year swap rates and the widening of corporate bond spreads observed in 2011.

The WLUK business, acquired in November 2011 and therefore only a two-month component of the 2011 result, contributed £14 million to the expected existing business contribution in 2012.

	Rates used for expected return contribution		
%	2013	**2012**	2011
Reference rate (non annuity business)	0.67	**1.35**	1.14
Reference rate (annuity business)	1.42	**2.25**	1.89
Best estimate returns:			
Corporate bonds	1.89	**2.98**	2.45
Cash/Government Bonds	0.67	**1.35**	1.14
Equity	4.90	**5.40**	6.70
Property	3.90	**4.40**	5.70

Operating experience variances

As reported in the 2011 year end results, the Group established a provision of £88 million in respect of short-term adverse corporate pensions persistency experience, in the lead up to RDR implementation. The Group expects this experience to be driven by increased 'churn' of new business by the commission-paying market. Actual 2012 experience has been broadly in line with expectations, with a small negative impact of £(10) million compared to assumptions; £55 million of the provision has been utilised in the year leaving £33 million remaining as at 31 December 2012.

Operating experience variances of £(21) million also include the £(6) million cost of setting up FLI with other net experience variances of £(5) million including better than expected mortality and morbidity experience, offset by a number of smaller tax and expense variances.

Operating assumption changes

Favourable operating assumption changes of £62 million have been included principally resulting from improved mortality experience on investment bond and life protection business (£32 million) and reduced expense assumptions (£35 million), including the benefit of reduced investment fees following the set up of FLI.

Other operating variances

Favourable other operating variances of £19 million principally relate to the benefit from the release of unit-linked tax loss provisions as a result of updated fund growth estimates partially offset by refinements to models across the UK and Heritage divisions.

3.2 Heritage division

2012 operational highlights

- **New Heritage management team now in place** and focused on driving cash generation.
- **Outsourcing deal with Diligenta implemented in March 2012** and progressing well.
- **Capital optimisation programme delivered £101 million of capital benefits**. The completion of Part VII transactions in 2012 have further optimised the capital structure of the Group.
- **Friends Life Investments now managing £11 billion of fixed interest assets.** Potential for further asset recaptures during 2013.

Market environment

The end of 2012 has been a significant time for regulatory change for the UK life and pensions market, with the Heritage division's broad range of products being impacted by the Retail Distribution Review, gender neutral pricing and auto-enrolment of pensions. Preparations for these have been completed, with commercial judgement being applied to the need for product and system investment, taking account of the scale of products and planned migration of product servicing to new outsourced platforms.

Strategy

The Heritage division serves over four million customers. It manages a significant proportion of the value of in-force of the Group, relating to a large suite of products that are no longer actively marketed and are administered on complex legacy systems. Consequently the business is very different to that of the UK division. A dedicated management team focused on the

Heritage business has been established, with the aim to be the United Kingdom's leading legacy business manager with the knowledge and expertise to maximise the value created from legacy books.

The value drivers for the Heritage division are:

- operational excellence – focused customer service within an efficient cost base in line with business scale;
- capital efficiency – minimisation of capital required for the business;
- strong product management – maximisation of value generated and retention of business;
- robust financial risk and balance sheet volatility management; and
- in-house asset management – utilising the recently created internal asset management capability to maximise returns and lower costs.

The Heritage division has previously identified a number of strategic themes to begin to harness these value drivers. Progress on the themes prioritised in 2012 is set out below. The Heritage business expects to address the remaining strategic themes, fund rationalisation and customer value management, over a longer timeframe.

Outsourcing

The significant policy administration and IT outsourcing deal with Diligenta which commenced on 1 March 2012 continues to operate in line with expectations. Combined with the existing outsource arrangement with Capita, materially all of Heritage policy administration is now outsourced. This means a considerable part of the Heritage cost base is now directly variable, and will decrease as policies run off. The resulting certainty around administration costs reduces the risk of expense assumptions in the embedded value coming under pressure.

Since the initial transfer of 1,900 staff to Diligenta, implementation of the deal has continued to progress well. In addition, the customer services work of circa 400 full time employees ("FTE") transitioned seamlessly from WIPRO (an existing outsource provider) to TCS (the Indian parent company of Diligenta) in May, again on schedule and with no disruption to service. This was followed in September by a further transfer of circa 150 FTE from AXA Business Services (another existing outsource provider) to TCS, on schedule and with no disruption to service. The IT application and support work of circa 200 FTE also transferred to TCS from WIPRO over the year.

Building an in-house asset manager

Friends Life Investments successfully launched in July 2012 and has £11 billion of fixed interest assets under management at 31 December 2012, through recaptures of £6 billion of assets in July 2012, £3 billion in September 2012 and £2 billion in December 2012. The formation of FLI supports the aspiration of delivering increased value from the existing book through optimised investment strategies at lower cost, for both the Heritage and UK divisions.

The reduction in overall fees payable to FLI compared with those charged by third party asset managers, has benefited MCEV operating profit by £11 million. FLI itself has broken even for the year to 31 December 2012, before set up costs of £6 million.

The 2012 recaptures have focused on fixed interest assets within the Group's core non-linked and shareholder funds. FLI is set to continue growing and anticipates the recapture of a further £7 billion of assets in 2013 focused on fixed income assets managed in the Group's with-profits funds.

To continue to achieve maximum business efficiency, FLI adopts an outsource model for its middle and back office support functions, which provides the benefit of future scalability and flexibility while achieving certainty on costs.

Capital optimisation programme and with-profits fund management

The 2012 capital optimisation programme ("COP") aimed to align the business with the separate UK and Heritage divisions while removing solvency capital inefficiencies, constraints and taking advantage of cost savings. The project largely achieved this through the Part VII transfer of the majority of the acquired AXA UK Life Business into FLL, including three with-profits funds. This has resulted in an increase in free surplus of £101 million, largely as a result of reduced capital requirements and removed capital restrictions. In addition, the capital optimisation programme in 2012 has enabled further simplification of the arrangements for managing the with-profits funds, together with improved risk management of these funds. These actions resulted in the additional release to free surplus of £88 million.

In addition, the programme to develop and implement a uniform capital management framework for the six with-profits funds within the Heritage business is currently underway.

Financial performance

Value of in-force business

The Heritage business represents a significant proportion of the Group's in-force value and regulatory capital. This is distributed across a range of products within the following broad categories:

	£bn	%
Pensions	**0.5**	22
Investments	**0.6**	26
Annuities	**0.2**	8
Protection	**0.5**	22
With-profits	**0.5**	22
Total Heritage VIF at 31 December 2012	**2.3**	100

By product line, the primary drivers of future profit and cash are expected to be:

- unit-linked pensions and investments: the value of charges (mostly annual management charges) less costs of administration and any renewal or trail commission. Profits are therefore sensitive to the levels of investment markets and, to a lesser extent, lapse and expense experience. Relative to other product lines, these policies require little regulatory capital on both Pillar 1 and Pillar 2 bases;
- annuities: the value of the investment margins expected on the assets and the release of reserving margins, in particular in relation to longevity. Profits are affected by changes in long-term longevity assumptions and the return achieved on the assets. Relative to other product lines, these policies require significant regulatory capital on both Pillar 1 and Pillar 2 bases;
- protection: the value of the margins assumed in the premiums less the best estimate expected costs of claims, expenses and renewal commission. Relative to other product lines, these policies require modest amounts of regulatory capital on a Pillar 2 basis but more significant amounts on a Pillar 1 basis; and
- with-profits: typically the value of the shareholders' share of the cost of bonus on 90/10 with-profits business and the value of charges less expenses on other with-profits business (primarily legacy non-profits business written in the with-profits funds). Relative to other products lines, these policies require significant regulatory capital on both bases, albeit provided in the main by the with-profits funds themselves.

Heritage unit-linked funds under management

The operating performance during 2012 indicates that the lapse experience of the book is performing broadly in line with the business's assumptions other than for unit-linked group pensions, where lapse experience has been worse than expected in the long term due to increased scheme re-broking activity prior to RDR becoming effective on 1 January 2013 and the new auto-enrolment requirements in 2012-14. This worsened experience is largely covered by a provision set aside for this purpose in 2011.

Heritage unit-linked funds under management were down 4% due to net outflows relating to the maturity of products and in line with expectations of the Heritage division's business run-off strategy.

£bn	Pensions	Investments	Total
1 January 2012	**18.9**	**16.3**	**35.2**
Inflows	1.2	0.3	1.5
Outflows	(3.0)	(1.9)	(4.9)
Net investment return	1.2	0.7	1.9
31 December 2012	**18.3**	**15.4**	**33.7**

New business

£m (unless otherwise stated)	**2012 Full year**	2012 Half year	2011 Full year
Value of new business	**2**	4	(4)
New business cash strain	**(40)**	(20)	(54)
IRR	**4.6%**	4.2%	6.0%
APE	**102**	60	157

The Heritage division specifically focuses on those products no longer actively marketed. Despite not actively seeking new business the Heritage book delivers a significant level of ongoing incremental business written across all product types.

New business cash strain at £(40) million is 26% lower than in 2011 reflecting the closure of bond products to new business in the second half of 2011.

The contribution from UK Heritage new business in 2012 was a value of new business profit of £2 million compared to £(4) million in 2011. This change reflects:

- an increase in Department of Work and Pensions ("DWP") rebate business in what is the final year of this business (due to regulatory changes); offset by
- the closure of bond products referred to above, leading to a reduction in sales and value generated.

In future years, the value of new business for Heritage is expected to be lower given that DWP rebate business will no longer be written. The value of new business for DWP rebate business in 2012 was £13 million.

Outlook

The key priorities for the Heritage division in 2013 include continuous delivery of service improvements with Diligenta, the continued expansion of Friends Life Investments by recapturing additional assets, an additional Part VII transfer to further align the Group structure with the UK and Heritage divisions and the delivery of additional capital efficiency savings, including further risk management of with-profits funds.

3.3 UK division

2012 operational highlights

- **Value of new business up 125% to £142 million** representing good progress towards the £155 million 2013 target.
- **New business cash strain down 56%** with continued strong performance in the second half of 2012 driven by the protection business.
- **APE up 19% at £669 million, with good Corporate Benefits sales reflecting a strong post-merger pipeline and successful workplace marketing.** Preparations complete for auto-enrolment and RDR.
- **Successful completion of Protection platform migrations following migration of strategic partners in the fourth quarter of 2012; virtually 100% of new business on target platform from 2013.**
- **Strong new business margins and volume growth have led to Retirement Income exceeding 2013 targets in 2012.**
- **Corporate Benefits funds under management up 16% to £17.8 billion** with net inflows of £0.4 billion.

Structure

The UK division comprises three business lines:

- Corporate Benefits specialising in Trust-Based and Contract-Based Employer-Sponsored pension schemes;
- Protection specialising in Individual and Group Life Cover, Critical Illness and Income Protection products; and
- Retirement Income specialising in Retirement Annuity and other retirement products.

The division brings together the UK-based, market-facing businesses and will enable better operational efficiencies and management of costs and capital between these business lines as Friends Life rationalises and optimises pricing, capital and channel management functions. Additionally the UK division expects to take advantage of the natural synergies between Corporate Benefits and Retirement Income in the savings and retirement life-cycle and between Protection and Corporate Benefits in the management of our corporate customers.

Market environment

The UK businesses operate in markets with distinct features and different recent regulatory and economic impacts. Themes for 2012 include the poor UK economic backdrop, preparations for the introduction of RDR (principally affecting Corporate Benefits), the introduction of auto-enrolment and the implementation of gender neutral pricing (affecting Protection and Annuity business).

Corporate Benefits operates in a large, fast-growing but relatively low-margin market with intense price competition and, until the introduction of the RDR at the start of 2013, the influence of commission on sales. Market activity has focused on the preparation for auto-enrolment which was introduced in the UK in the latter part of 2012; Friends Life has completed these preparations.

The UK protection market is mature, and has remained relatively stable over the last few years despite the turbulent macro-economic climate. Implementation of gender neutral pricing (on 21 December 2012) and life tax reforms (on 1 January 2013) have generally resulted in a rise in average market prices although impacts have varied by product. In the lead up to these regulatory changes there has been a noticeable boost to protection volumes as customers choose to buy policies in advance of the expected price increases.

The annuity market continues to grow, with sales in the first three quarters of 2012 up 21% on the full year 2011, driven by demographic trends in particular the retirement of the baby boomer generation. Sales in the open market continue to show a trend towards enhanced annuities which account for more than half of total open market sales.

Strategy

Friends Life presented its strategic agenda at an investor briefing in November 2011 and good progress has been made across the UK business in progressing this agenda.

Corporate Benefits

The Friends Life Corporate Benefits business has made strong progress and seen profitability improve as a result of developments in a number of key areas. Client Relationship Managers and workplace marketing operations continue to focus on key clients and distributors. These relationships have been leveraged to deliver a much improved value of new business from increments or new entrants to the existing portfolio. Cost reduction has been achieved through focusing on the business's more efficient, cost-effective target platforms, including the new, "My Money" Corporate Wrap platform, the deployment of a small, focused new sales team and the benefits secured from the outsourcing deal with Diligenta. These have contributed to increased value generation in 2012.

Friends Life is ready for the opportunities presented by the regulatory and market changes; for example, good progress has been made on the development and launch of the auto-enrolment hub which will seek to ease the legislative and administrative burden on employers for the significant volumes of business expected from this change over the next few years. Finally, Friends Life has continued to selectively write profitable new business within its target range of mid to large schemes; these have been and will continue to be primarily written through a small number of key distribution relationships. Friends Life has observed increased pressure on pricing during 2012, reflecting the competition for commission-paying business before RDR closed this opportunity at the end of 2012 and, as a result, a more normal environment is expected in the future. Indeed, as a business which does not currently pay commission in respect of new schemes, Friends Life expects a greater number of opportunities from 2013 from when it can compete for all business having previously chosen not to tender for initial commission-paying business.

Protection

The Protection business has achieved a successful transformation over the last two years, with significant improvements in efficiency, proposition quality and distribution footprint. Ongoing profitable volume has been secured with increased distribution in strategic segments of estate agency and intermediary panel partners.

The strategy of migrating all new business capability to the low cost target platforms was completed in the fourth quarter of 2012 with the migration of strategic partners such as Countrywide and AXA and banking partners including the co-operative bank and National Australia Group. Following the migration of Individual IFA and Group Protection business in 2011, 82% of Protection new business sales in 2012 were written on the target platforms and this figure will rise to virtually 100% from January 2013.

The quality of the highly regarded protection proposition, particularly for Income Protection and Critical Illness, was demonstrated in 2012 by further improvements to both Group and Individual propositions. Examples include extending the coverage of the award-winning Individual Critical Illness product, and supporting early intervention and rehabilitation for potential long-term absences with the Group Income Protection product. The Group has also launched innovative propositions such as the new range of simple access products to equip Friends Life to meet the needs of a wide range of distribution partners following the implementation of RDR at the end of 2012.

Friends Life Individual Protection successfully implemented the distribution partnership with Connells in 2012 and is continuing to develop a selective range of profitable distribution relationships. These have extended Friends Life's distribution capabilities through a variety of channels and partnerships. For example, the growth of the partnerships with Connells and Countrywide has further developed the Group's leading position in the estate agent sector.

Retirement Income

The Retirement Income strategy presented in November 2011 identified five key strategic initiatives. The focus in 2012 was on broadening the product proposition and developing more sophisticated pricing and underwriting, culminating in the launch of the lifestyle and medical underwriting options towards the end of the first half of 2012.

The focus in 2013 will switch to the remaining three initiatives to capitalise on the work completed in 2012. Capabilities, including market testing, for an open market offering are well advanced for a possible launch in the second half of 2013. Investment into new asset classes in 2013 will improve both shareholder returns and our ability to compete in the open market. Equally important to these two initiatives is improving customer engagement to raise awareness of the broader proposition which can enhance their income for life.

Progress on the strategic initiatives taken together with positive results from the initial roll-out of the broader product proposition provide confidence over delivery of the 2013 financial commitments for Retirement Income.

Financial performance

The UK division delivered improved new business results with new business sales up 19% and the value of new business up 125% on 2011, new business cash strain down 56% and a strongly improving IRR of 13.3%.

£m (unless otherwise stated)	2013 Full year target	**2012 Full year**	2012 Half year	2011 Full year
VNB	155	**142**	63	63
Corporate Benefits	25	**21**	10	15
Protection	80	**62**	28	16
Retirement Income	50	**59**	25	32
New business cash strain	n/a	**(51)**	(40)	(115)
Corporate Benefits	(75)	**(57)**	(32)	(51)
Protection	(30)	**(27)**	(23)	(77)
Retirement Income	n/a	**33**	15	13
IRR	n/a	**13.3%**	11.2%	8.4%
Corporate Benefits	10%+	**7.2%**	6.8%	8.3%
Protection	20%	**13.8%**	9.8%	5.5%
Retirement Income	15%+	**25%+**	25%+	22.0%
APE	n/a	**669**	354	564
Corporate Benefits		**535**	291	440
Protection		**90**	44	92
Retirement Income		**44**	19	32

Corporate Benefits

Corporate Benefits again delivered improved new business results with value of new business of £21 million, up 40% on 2011. This result reflects the increased level of business written (up 22% to £535 million APE, including 12% from the acquired WLUK business) in addition to the benefit delivered by the Diligenta outsourcing deal. New sales include £26 million APE on My Money, the new corporate platform launched on 31 January 2012. The proportion of new business volumes on the target NGP and My Money platforms continues at circa 80% and will increase in due course when the business is transitioned from the Embassy administration platform.

New business cash strain of £57 million reflects the higher sales volumes in 2012 offset by cost reductions. These strong volumes have resulted from the healthy pipeline of business built up following the successful merger of the Friends Provident and AXA UK Life Business and the recognition of the quality of the Friends Life proposition. In addition, the workplace marketing operation has had a successful year through the attention given to key relationships by the Client Relationship Management team.

Cost savings and increased volumes continue to drive the IRR on Corporate Benefits business with an IRR of 7.2% for 2012, up from 6.8% in the first half of the year. When compared to the full year 2011, the increasing IRR trajectory has been offset by the lower IRR on the transferred-in WLUK business (which is not yet on target platform). Friends Life expects the favourable underlying IRR trajectory to continue and for 2013 market commitments to be achieved through continued cost savings, pricing discipline and the benefits from additional volumes of auto-enrolment business. Reflecting this, Corporate Benefits continued to move away from high volume low margin business lines with £34 million APE written in such lines in 2012.

The Group expects an increase in new business activity as a result of both auto-enrolment itself and auto-enrolment consultancy activity triggering scheme reviews. This is expected to result in a change in market focus with the quality providers, with comprehensive auto-enrolment solutions, taking market share.

Corporate Benefits funds under management

£bn	
1 January 2012	**15.4**
Inflows	2.6
Outflows	(2.2)
Net investment return	2.0
31 December 2012	**17.8**

Fund inflows of £2.6 billion in 2012 and healthy investment returns have resulted in a strong increase in total funds under management. Outflows have been higher than in recent years, as expected, with the re-broking of business in the lead up to RDR a key factor.

A provision was made at the end of 2011 to allow for an expected peak of adverse persistency experience driven by corporate pensions business being re-broked prior to the rule changes taking place from 1 January 2013 as a result of RDR. Experience of scheme losses to commission-paying providers in 2012 is broadly in line with expectations with some £33 million of provision retained to cover any continuation of this experience across the UK and Heritage divisions into the first half of 2013.

Protection

The successful delivery of improved financial returns for the Protection business has been driven by the migration of new business capability to the efficient target platforms. The value of new business of £62 million compares to £16 million in 2011, with other contributing factors including increased pricing focus on value over volume, and an improved product mix towards the more profitable Critical Illness and Income Protection products. New business cash strain reduced primarily due to the cost efficiencies resulting from migration of business to the target platforms. In addition, harmonisation of modelling across the Friends Life companies in the fourth quarter has improved both new business cash strain and IRR for the full year.

Group Protection has continued to achieve growth in sales in the higher margin Group Income Protection and Group Critical Illness product segments during 2012. New business APE for Group Protection overall has increased by nearly 50%, from £22 million in 2011 to £32 million in 2012.

Retirement Income

Annuity new business contributed £59 million of VNB in 2012 compared to a 2011 contribution of £32 million and thus has already exceeded its 2013 target profitability. Uncertainty in fixed income markets throughout 2012 led to cautious pricing levels that resulted in strong new business margins.

Sales volumes of £44 million in 2012 reflect stable retention rates and the acquisition of the WLUK business in November 2011 which together resulted in sales up 38% in APE terms.

New business cash strain has also benefited from the cautious pricing levels and strong volumes resulting in a cash release of £33 million compared to a contribution of £13 million in 2011.

The fourth quarter results include the full year impact of a modelling change relating to policies with guaranteed annuity options. The new business results now include the premium in respect of the cost of the guarantee in addition to the maturing fund value. This change will result in an ongoing benefit and affects all new business metrics.

The full year 2012 results exceed the 2013 targets reflecting the benefits from the strategic focus on Retirement Income. The challenge in 2013 will be to deliver improved financial results against a backdrop of increasing market competitiveness as the evolution towards a more open and sophisticated marketplace continues.

Outlook

Despite the challenging economic background, Friends Life remains optimistic about the outlook following good progress in delivering its strategic agenda and a successful positioning of the UK division business lines as the Group enters 2013. Friends Life will continue the development and promotion of the My Money platform to achieve scale on this platform and seek to take advantage of the opportunities arising as a result of the ongoing shift from defined benefit to defined contribution schemes, demographic changes and auto-enrolment. In 2013, the UK division expects an initial 150,000 additional members through the introduction of auto-enrolment. Of the schemes administered by Corporate Benefits and due to stage in 2013, some 60% are expected to enrol with the Group.

The Protection business continues to target growth in profitable segments of both the Individual and Group Protection markets, particularly through its highly regarded Critical Illness and Income Protection propositions. It will also continue to build selected strategic relationships to take advantage of opportunities in the post-RDR environment. The Retirement Income business will promote the new enhanced annuity propositions to a significant proportion of Friends Life customers as they prepare for retirement.

4 International division

2012 operational highlights

- Strategic review of International division completed; confirm exit of businesses now considered non-core.
- FPI to cease writing new regular premium business in Germany and Sweden, has ceased writing Corporate pensions, and is no longer selling to Japanese nationals.
- Sale of Malaysian joint venture, AmLife, completed on 4 January 2013 for cash consideration of £50 million.
- Lombard increasing focus on Private Bank distribution in Europe and exploring opportunities for targeted expansion in high net worth markets in Asia.
- International division dividend targets reiterated; Lombard paid its first ever dividend to Group of £4 million in November 2012.

New business

- International VNB reduced to £50 million in 2012 (31 December 2011: £92 million) reflecting the strategic change in Lombard's new business mix towards the private bancassurance channel and a £(27) million impact from poor German performance, worsening guarantee costs in Germany and market exits in FPI.
- Lombard APE up 7% in constant currency to £254 million (£238 million actual currency) reflecting strong growth across a number of regions.
- International FUM of £25.6 billion (2011: £23.6 billion) reflects net inflows of £1.3 billion as well as positive market movements in the year.

Financial performance

- International IFRS based operating loss of £(9) million (31 December 2011: £78 million profit) impacted by £(82) million of one-off charges as a result of strategic review impacts and higher guarantee costs.
- International MCEV operating profit of £1 million (31 December 2011: £111 million profit) reflecting the £(94) million impact (being £(140) million in FPI, offset by £46 million in Lombard) of the strategic review and related basis changes. Impact in line with the £50-£100 million guidance provided at November 2012.
- International sustainable free surplus of £(28) million (2011: £8 million) includes restructuring costs in FPI and Lombard and a £(21) million impact from the strategic review, reflecting an increase in the cost of German guarantees and higher financial reinsurance costs in FPI.

Structure

The International division comprises two business units, Lombard and FPI.

Lombard is the leading pan-European specialist in compliant estate and succession planning solutions for high and ultra-high net worth individuals ("HNWIs") using life assurance. Based in Luxembourg, the business offers innovative solutions and superior service through a well-established distribution network of private banks and independent financial advisers to HNWIs across Europe and selected markets in Latin America and Asia. Solutions offered by Lombard are typically based on single premium, whole of life, unit-linked life assurance structures with limited levels of reinsured life cover. The business is well placed to benefit from increasing demand for fully compliant structured solutions for HNWIs that are both robust and portable.

FPI sells unit-linked savings, single premium bonds and protection products with a focus on affluent domestic and affluent expatriates via branches in Hong Kong, Singapore and Dubai, as well as serving UK customers with offshore products. It also sells insurance products under the EU freedom of services rules which allow regulated EU insurers to trade anywhere within its borders, known as Overseas Life Assurance Business or "OLAB". OLAB new business is largely regular premium German pensions business sold by the Group's German distributor, Financial Partners Business AG ("fpb"). Until 4 January 2013, the FPI business also included a 30% interest in AmLife, a Malaysian life insurance company, and AmFamily, a Malaysian family takaful business. Both businesses were majority owned by AmBank Berhad, a major Malaysian banking group. The Group's interests were sold to AmBank on 4 January 2013. The Group's share of the results of AmLife are included in the result of FPI in 2012.

International strategy

The International strategy was presented to the market in November 2012. The new strategy is expected to enhance value creation through a sustainable portfolio of international businesses in regions with sound regulatory frameworks, focusing on profitable growth and cash generation. The priorities of the division are to:

- selectively grow the business and generate an IRR of new business of 20% for the division as a whole (core International division IRR of 15.1% at 31 December 2012);
- improve the efficiency of the back-office; and
- increase the dividends to £50 million by 2015 (£33 million in 2013).

Lombard is a strong business which has achieved sufficient scale to pay dividends, with £4 million paid in November 2012. It will look to grow profitably, expanding its reach further into Privatbancassurance and selected other geographical markets, including Asia. FPI, however, is in a turnaround situation with its core business being repositioned whilst other parts are exited. FPI will focus on two core markets (1) the global expat market and (2) domestic affluent customers in key selected markets, principally Hong Kong, Singapore and Dubai. It will close to new business in markets that are unprofitable, sub-scale or which do not fit with its new risk and value-focused strategy. As a result, the company is no longer accepting business from Japanese nationals, has closed to corporate pensions business and some product lines in the European business and has sold the 30% stake in the Malaysian joint venture, AmLife.

In November 2012, the Group announced that FPI's participation in Germany was under review. This review has been completed and, as a result, the Group will withdraw from writing new regular premium pensions business in Germany in 2013. It will continue to service the existing customers and it will focus on profitably growing its distribution business, fpb. The Group expects a modest amount of operating performance drag as it undertakes an orderly withdrawal from these business lines.

Market environment

The business continues to face challenging economic and market conditions in most of its key markets. The macroeconomic environment in Europe remains uncertain. Although Lombard's sales are not directly linked to stock market performance, these uncertain market conditions have a corresponding effect on client confidence. In addition, frequent changes to tax legislation in a number of Lombard's core markets, including Spain, Italy, Belgium, and France have added to the uncertainty. Against this challenging backdrop, and in the absence of strong external drivers to generate new business, Lombard's sales volume in 2012 was relatively strong. Notwithstanding the challenging short-term market conditions, the longer term drivers of the demand for individually structured Privatbancassurance solutions remain compelling.

North Asia is the largest market FPI participates in and is a relatively mature and competitive market. The region has strong medium-term growth prospects, however in the short term, due to the volatility of the investment markets, there is a shift towards non-linked business. The affluent market is increasingly competitive with more companies offering a wealth proposition in the region.

The South East Asia region is centred in Singapore. Singapore continues to evolve as a wealth management hub and offers good long-term growth potential, both for FPI and for Lombard although the current economic uncertainty is still expected to constrain growth in the short term.

The United Arab Emirates and the wider Middle East region are relatively immature local markets, however they have a large number of high net worth expatriates and continue to provide good growth prospects.

Operating review

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

£m	**2012 Full year**	2012 Half year	2011 Full year
Lombard	**28**	10	38
FPI	**(37)**	21	40
IFRS based operating (loss)/profit before tax	**(9)**	31	78
Lombard	**104**	25	82
FPI	**(103)**	18	29
MCEV operating profit before tax	**1**	43	111
Lombard	**(4)**	(3)	9
FPI	**(24)**	7	(1)
Sustainable free surplus	**(28)**	4	8

The International division results include a good result from Lombard and good performance from the core FPI business, given the challenging market conditions. However, the overall results for the division reflect the poor performance of the German business and the costs of restructuring FPI.

The International division's IFRS based operating loss of £(9) million in 2012 largely reflects one-off impacts from the strategic review totalling £(82) million. The majority of this relates to the OLAB business and reflects assumption changes as a result of the strategic review and the poor performance in this business, as well as an increase in the cost of German guarantees due to improved modelling and changes to assumptions.

International MCEV operating profit of £1 million includes a loss of £(103) million for the FPI business which has been significantly affected in the second half of 2012 by £(140) million relating to the strategic review and associated basis changes, primarily reflecting the impact on OLAB business. The £(140) million adverse impact is partially offset by £46 million of benefits recognised on the cost reduction programme in Lombard. In total, these impacts amount to £(94) million and are within the £(50)-£(100) million guidance provided in November 2012.

Sustainable free surplus of £(28) million includes the £(21) million impact of the International strategic review, principally reflecting higher financial reinsurance costs and adverse impacts from increases in the cost of German guarantees in FPI. In addition, the reduction includes the £(12) million costs of executing the strategic review across both FPI and Lombard.

Outlook

Notwithstanding the poor performance of the German business, the Group is confident that the actions taken following the strategic review of the International division will result in more focused businesses capable of profitable and cash generative growth. As such, the Group remains confident that the International businesses will deliver their dividend targets in 2013 and beyond.

4.1 Lombard operating review

£m (unless otherwise stated)	**2012 Full year**	2012 Half year	2011 Full year
IFRS based operating profit	**28**	10	38
MCEV operating profit	**104**	25	82
Sustainable free surplus	**(4)**	(3)	9
Dividends paid to Group	**4**	–	–
Funds under management (£bn)	**18.9**	17.8	17.4

Overall and despite turbulence in the Euro-zone throughout most of 2012, Lombard's operating performance has been good. Whilst significant macroeconomic uncertainty persisted and there were important changes in the tax and legal framework of several key markets in which Lombard operates, Lombard has continued to deliver strong growth in MCEV operating profits and funds under management in 2012. Funds under management totalled £19 billion (€23 billion) at 31 December 2012 (an increase of 11% on a constant currency basis). The results were also impacted by the weakening of the Euro against GBP by 3% in the year.

New business profitability

£m (unless otherwise stated)	**2012 Full year**	2012 Half year	2011 Full year
VNB	**45**	12	52
New business cash strain	**(19)**	(12)	(20)
IRR[(i)]	**23%**	14%	>25%
APE	**238**	95	237
APE in constant currency	**254**	99	237

(i) Since 2011, Lombard IRR has taken into account the Luxembourg regulatory regime in which DAC is an allowable asset.

The sales performance has been strong with APE up 7% on a constant currency basis. Several markets have performed strongly with Southern Europe, UK, Belgium (Privatbancassurance sales) and Latin America generating volumes above 2011 levels. Growth in these regions also highlights the strength of Lombard's brand and geographic diversity.

In line with Lombard's strategy, the mix of new business sales is increasingly coming from private banks (57% in 2012 compared with 39% in 2011) rather than IFAs. Whilst margins on the revised business distribution mix are lower, in the longer term Lombard expects increasing the access to the Privatbancassurance market will provide more potential and stability for new business generation. As a result of the different mix, the value of new business in 2012 is 13% below 2011. The IRR and contribution from new business has similarly been affected by mix, whilst cash strain has remained stable despite the sales volume increase.

Seasonality of new business is in line with 2011 with the ratio of business between the first half and second half of the year at 40%/60% (2011: 41%/59%).

APE performance by region is as follows:

APE by region (actual exchange rates, £m unless otherwise stated)	**2012 Full year**	2011 Full year
UK and Nordic	**54**	52
Northern Europe	**35**	42
Southern Europe	**123**	115
Rest of world	**26**	28
Total including large cases	**238**	237
Of which: large cases (greater than €10 million)	**102**	83
Total excluding large cases	**136**	154

IFRS based operating profit

£m	2012 Full year	2012 Half year	2011 Full year
New business strain	**(30)**	(18)	(33)
In-force surplus	**60**	28	73
Investment return and other items	**–**	–	(1)
Development costs	**(2)**	–	(1)
IFRS based operating profit before tax	**28**	10	38

Lombard generated an IFRS based operating profit before tax of £28 million in 2012, 26% down on 2011. The year on year decrease is principally due to £11 million of one-off restructuring costs. Excluding restructuring costs, IFRS based operating profit is £39 million, 3% above 2011 and benefited from the continued growth in FUM whilst maintaining a strong focus on cost management.

New business strain: reconciliation of new business cash strain to IFRS

£m	2012 Full year	2012 Half year	2011 Full year
New business cash strain	**(19)**	(12)	(20)
DAC/DFF adjustments	**(11)**	(6)	(13)
IFRS new business strain	**(30)**	(18)	(33)

IFRS new business strain is lower than that in 2011 principally reflecting the weakening Euro over 2012 partially offset by a reduced benefit from first year annual management charges as a result of mix as well as seasonality of sales.

In-force surplus: reconciliation of in-force cash surplus to IFRS

£m	2012 Full year	2012 Half year	2011 Full year
In-force cash surplus	**28**	11	41
DAC/DFF adjustments	**32**	17	32
IFRS in-force surplus	**60**	28	73

Despite growth in the in-force book and the continued tight control of maintenance expenses, the in-force cash surplus is down 18% on 2011, mainly due to £(11) million of one-off restructuring costs incurred as part of the strategic review.

Funds under management

Average FUM has continued to increase in 2012. Continued positive net fund inflows over the last two years and positive investment return in 2012 have driven FUM which has grown from £17.4 billion (€20.9 billion) at the end of 2011 to £18.9 billion (€23.3 billion) at 31 December 2012.

	€bn	£bn
1 January 2012	**20.9**	**17.4**
Inflows	2.9	2.4
Outflows	(2.0)	(1.6)
Net investment return	1.5	1.2
Foreign exchange	–	(0.5)
31 December 2012	**23.3**	**18.9**

Operating expenses

£m	**2012 Full year**	2012 Half year	2011 Full year
Acquisition	**41**	20	42
Maintenance	**34**	21	25
	75	41	67
Development	**2**	–	1
Total	**77**	41	68

Operating expenses exclude both commission payments and non-recurring costs.

Included in maintenance expenses are costs of £11 million related to the strategic review of the business. Adjusting for these one-off costs, expenses are 3% below 2011.

MCEV operating profit

£m	**2012 Full year**	2012 Half year	2011 Full year
Value of new business	**45**	12	52
Expected existing business contribution	**35**	18	49
Operating experience variances	**(23)**	(10)	(12)
Operating assumption changes	**36**	5	(4)
Other operating variances	**13**	–	(2)
Development costs	**(2)**	–	(1)
Life and pensions covered business operating profit before tax	**104**	25	82

MCEV operating profit is up 27% on 2011 as positive operating assumption changes, largely resulting from the strategic reorganisation (£46 million), have been partially offset by the lower contribution from new business, as mix effects are reflected, and lower expected returns on existing business contribution.

Expected existing business contribution

Lower expected existing business contribution reflects the lower opening in-force book together with reduced economic assumptions.

	Rates used for expected return contribution		
%	2013	**2012**	2011
Reference rate	2.13	**1.61**	1.40
Best estimate returns:			
Corporate bonds	3.13	**3.55**	4.46
Equity	5.13	**5.55**	6.46

Operating experience variances

Adverse operating experience of £(23) million arises from the investment made in improving the efficiency of back-office operations. These are more than offset by reduced expense assumption changes reflecting the efficiencies gained and reduction in staff numbers. In addition, the result reflects the impact of some negative lapse experience in the Belgium and Spanish markets.

Operating assumption changes

In line with guidance provided in November 2012, operating assumption changes include a £46 million benefit reflecting savings and efficiencies arising from the strategic reorganisation and the resulting lower expenses in this business.

Other operating assumption changes resulting from the normal annual review of the basis include a marginal strengthening of lapse assumptions and a provision made for anticipated short-term lapse experience in the Belgium and Asian markets (£(14) million), partially offset by a weakening of mortality assumptions reflecting improved longevity trends of Lombard's high net worth policyholders (£4 million).

Other operating variances

Other positive operating variances principally arise from tax benefits from a lower tax rate for the Lombard companies.

4.2 FPI operating review

£m	**2012 Full year**	2011 Full year
IFRS based operating result	**(37)**	40
MCEV operating result	**(103)**	29
Sustainable free surplus	**(24)**	(1)

The results of the FPI business have been dominated by the impact of one-off charges relating to market exits and assumption changes, principally in the non-core businesses. The FPI results are shown in the IFRS and MCEV sections below split between the core and non-core business with additional detail shown at the end of this section. The core businesses are those which are the focus of strategic growth plans in 2013 and beyond, excluding AmLife and OLAB (mainly Germany).

The outcome of the strategic review and assumption changes are reflected across each of the operating bases with the impacts on each shown below:

Full year 2012 impacts £m	**IFRS based operating profit**	**MCEV operating profit**	**Sustainable free surplus**
German guarantees	**(29)**	**(16)**	**(11)**
OLAB strategic review	**(68)**	**(41)**	**(14)**
Basis review changes	**15**	**(78)**	**4**
Japan	**–**	**(5)**	**–**
	(82)	**(140)**	**(21)**
Comprising:			
Assumption changes	**(70)**	**(111)**	–
Other line impacts	**(12)**	**(29)**	**(21)**

In November 2012 the Group guided towards a £(50)-£(100) million MCEV impact, with this being net of a £46 million positive change in Lombard. The stand alone impact in FPI amounts to £(140) million. The charge largely relates to revisions to expense assumptions, persistency experience and the increased cost of guarantees in the German business with these principally a result of the Group's decision to withdraw from a number of markets and the removal of expense overruns previously deemed to be short term in nature. At a business unit level, the impacts stem from FPI's OLAB business, principally Germany, which now has an embedded value of £100 million at the end of 2012. The Group has also decided to cease writing new business to Japanese nationals with this resulting in a £5 million provision against the MCEV of this business (31 December 2012: £59 million).

New business profitability

£m (unless otherwise stated)	**2012 Full year**	2012 Half year	2011 Full year
VNB	**5**	18	40
New business cash strain	**(104)**	(48)	(89)
IRR	**5.4%**	10.5%	12.7%
APE	**202**	104	252

Sales volumes are 20% lower than in 2011, driven mainly by a significant reduction in FPI regular premium business. This has been due to strategic exits (particularly new business with Japanese nationals), maintenance of pricing discipline and increased controls around business acceptance. Single premium business is below last year's level in most regions due to reduced investor confidence, although the UK offshore business has performed well. Protection business was also particularly strong, especially in the first half year, as a result of IFAs moving away from savings to risk products sales.

The value of new business and IRR have been impacted by this reduction in volumes, changes in assumptions relating to worsening volume and persistency experience mostly in the German business and the impact of interest rate movements and assumption changes on the cost of embedded German guarantees. These impacts more than offset improvements from new regular premium products.

New business cash strain is higher than 2011 despite reduced volumes due to increases in the cost of German guarantees, the impact of assumption changes relating to the OLAB business and negative economic impacts, largely due to lower interest rates.

The table below shows the new business profitability of the remaining core FPIL business excluding AmLife and OLAB business.

Core and non-core new business metrics

£m (unless otherwise stated)	2012 Full year Core	2012 Full year Non-core	2011 Full year Core	2011 Full year Non-core
VNB	**17**	**(12)**	22	18
New business cash strain	**(37)**	**(67)**	(51)	(38)
IRR	**11%**	**2%**	13%	11%
APE	**146**	**56**	165	87

Core FPI VNB decreased by 23%, reflecting the decrease in volume but also increased acquisition expenses from improvements to new business infrastructure and controls. Sales volumes of £146 million have decreased by 12%, principally as a result of the challenging savings market environment in Asia. The ratio of new business cash strain to APE has improved to 25% (31 December 2011: 31%), despite expense increases as a result of new product structures introduced in 2012. IRR is negatively impacted by these volume reductions and the increase in expenses.

IFRS based operating result

£m	**2012 Full year**	2012 Half year	2011 Full year
New business strain	**(53)**	(24)	(36)
In-force surplus	**95**	51	97
Long-term investment return	**–**	–	1
Principal reserving changes and one-off items	**(70)**	–	(12)
Development costs	**(6)**	(4)	(7)
Other	**(3)**	(2)	(3)
IFRS based operating (loss)/ profit before tax	**(37)**	21	40

IFRS based operating result has reduced to a loss of £(37) million in 2012 due to the impact of £(82) million of one-off charges largely related to the strategic review of the OLAB business and an increase in the cost of the German guarantees. The impact of these items is included within new business strain (£(12) million) and in principal reserving changes and one-off items (£(70) million).

Core and non-core impacts

£m	Core	Non-core	**2012 Full year**
IFRS based operating profit/(loss) before tax	58	(95)	**(37)**
Principal reserving changes and one-off items	(4)	74	**70**
Adjusted IFRS based operating profit/(loss) before tax	54	(21)	**33**

On an adjusted basis, after removing the impact of principal reserving changes on the results, the 2012 FPI IFRS based operating result equates to a £33 million profit. This result highlights the poor performance within the non-core businesses. Going forward, and notwithstanding the actions taken to date to stabilise the results in these businesses, the Group continues to expect the non-core businesses to act as a drag on the combined FPI operating performance. The Group expects this operating drag to continue while the actions taken to withdraw from these markets are completed.

New business strain: reconciliation of new business cash strain to IFRS

£m	**2012 Full year**	2012 Half year	2011 Full year
New business cash strain	**(104)**	(48)	(89)
DAC/DFF adjustments	**175**	81	224
Other IFRS adjustments	**(124)**	(57)	(171)
IFRS new business strain	**(53)**	(24)	(36)

New business cash strain is higher than in 2011 reflecting increased reserves due to the higher cost of German guarantees and higher protection sales, a lower benefit from financial reinsurance partially offset by positive mortality assumption changes.

DAC adjustments relate to the deferral of acquisition costs including initial commission and enhanced unit allocations. DFF adjustments relate to the deferral of set up charges on portfolio bond business. Reduced sales volumes in the year have resulted in a reduction in the level of this adjustment.

Other IFRS adjustments include the elimination of positive actuarial funding and Sterling reserve impacts on investment contract business which have reduced because of the lower sales volumes. The financial reinsurance benefit within new business cash strain is also removed through these adjustments as it is not allowable under IFRS.

The net increase in IFRS new business strain of £17 million includes £12 million mainly from strategic review impacts and higher guarantee costs. The remainder relates to increased reserving requirements on protection products due to the effect of lower valuation interest rates and higher volumes.

In-force surplus: reconciliation of in-force cash surplus to IFRS

£m	**2012 Full year**	2012 Half year	2011 Full year
In-force cash surplus	**68**	49	79
DAC/DFF adjustments	**(16)**	(3)	1
Other IFRS adjustments	**43**	5	17
IFRS in-force surplus	**95**	51	97

In-force cash surplus of £68 million (2011: £79 million) reflects higher financial reinsurance payments, strategic review costs of £(5) million partially offset by an increased surplus from the larger in-force book.

The DAC/DFF adjustments have increased due to the larger in-force book of business and modelling improvements.

Other IFRS adjustments include the elimination of movements on Sterling reserves and actuarial funding on investment business as well the removal of the financial reinsurance repayments which are incurred in the in-force cash surplus. The increased adjustment in 2012 compared to the prior year primarily relates to the higher financial reinsurance payments in in-force cash surplus.

The net decrease in IFRS in-force surplus of £2 million primarily results from higher profits (net of DAC) from the larger in-force book, offset by strategic review costs.

Funds under management

£bn	**1 January 2012**	**Inflows**	Outflows	Market and other movements	**31 December 2012**
FPIL	**5.6**	1.1	(0.6)	–	**6.1**
OLAB	**0.5**	0.1	(0.1)	–	**0.5**
AmLife	**0.1**	–	–	–	**0.1**
FPI total	**6.2**	1.2	(0.7)	–	**6.7**

Funds under management as at 31 December 2012 have increased to £6.7 billion. The business has generated positive net inflows of £0.5 billion before market movements.

Principal reserving changes and one-off items

Principal reserving changes of £(70) million comprise £(59) million impact of the OLAB strategic review, £(15) million relating to the increase in the cost of German guarantees offset by £4 million of positive mortality basis changes in relation to other parts of FPI's business.

Operating expenses

£m	**2012 Full year**	2012 Half year	2011 Full year
Acquisition	**33**	17	30
Maintenance	**34**	17	31
	67	34	61
Development	**6**	4	7
Total	**73**	38	68

Operating expenses, which exclude commission payments and non-recurring costs, have increased to £73 million from £68 million in 2011. Acquisition costs have increased largely as a result of actions to strengthen the controls and governance infrastructure while maintenance costs include one-off strategic review costs of £(5) million.

MCEV operating result

£m	**2012 Full year**	2012 Half year	2011 Full year
Value of new business	**5**	18	40
Expected existing business contribution	**23**	12	27
Operating experience variances	**(12)**	(8)	(7)
Operating assumption changes	**(107)**	–	(3)
Other operating variances	**(5)**	–	(20)
Development costs	**(6)**	(4)	(7)
Life and pensions covered business operating (loss)/ profit before tax	**(102)**	18	30
Other income and charges	**(1)**	–	(1)
Operating (loss)/profit before tax	**(103)**	18	29

MCEV operating loss principally reflects £(107) million of assumption changes and a £(35) million reduction in VNB compared to the prior year. Assumption changes and VNB reductions relate largely to revisions to actuarial assumptions reflecting the outcome of the OLAB strategic review and recent poor German business performance including the increased cost of guarantees (£(27) million within the value of new business, £(111) million operating assumption changes and £(2) million other operating variances). Operating assumption changes include £4 million favourable assumption changes in respect of AmLife.

Core and non-core impacts

£m	Core	Non-core	**2012 Full year**
MCEV operating loss before tax	(2)	(101)	**(103)**
Operating assumption changes	21	86	**107**
Adjusted MCEV operating profit/(loss) before tax	19	(15)	**4**

On an adjusted basis, after removing the impact of assumption changes on the results, the 2012 FPI MCEV operating result equates to a £4 million profit. This compares to a £29 million operating result in 2011 with the underperformance in 2012 principally driven by the loss from the non-core businesses. Despite the actions taken to date the Group continues to anticipate some drag on FPI's MCEV operating performance as the Group completes the withdrawal from these markets, notably German product manufacture. The embedded value of the non-core businesses amounts to £202 million (including AmLife).

Expected existing business contribution

The expected existing business contribution has reduced from £27 million to £23 million. The effect of the larger opening in-force book has been offset by lower rates of expected return on equity and property assets.

	Rates used for expected return contribution		
%	2013	**2012**	2011
Reference rate	0.67	**1.35**	1.14
Best estimate returns:			
Corporate bonds	2.40	**2.98**	2.45
Equity	4.90	**5.40**	6.70
Property	3.90	**4.40**	5.70

Operating experience variances

Adverse operating experience variances of £(12)million include £(5) million of one-off costs of restructuring following the strategic review, £(4) million relating to worsening persistency in the FPI regular premium savings product, £(3) million relating to other items.

Operating assumption changes

Operating assumption changes of £(107) million relate to revisions to assumptions to reflect the outcome of the strategic review and recent business performance. Changes in the approach to setting assumptions which are now based on planned levels of expenditure rather than a long-term trajectory, with allowance for short-term overruns, have led to a significant increase in per policy expenses and a £(27) million impact on MCEV. In addition to the base assumptions, the impact of deteriorating experience in non-core business and the decision to close certain lines to new business has resulted in a further negative impact of £(77) million. Small offsetting assumption changes of £(3) million reflect updates for mortality, persistency and fund rebate assumptions on core business.

Other operating variances

Other operating variances of £(5) million include £(2) million relating to the increase in German guarantee provisions as a result of improvements in modelling and £(3) million in relation to changes in the cost of non-hedgeable risk.

FPI additional information

IFRS based operating profit

Year ended 31 December 2012 £m	FPIL (excl Japan new business)	Japan (new business impact)	**Total FPIL**	OLAB	AmLife	**Total FPI**
New business strain	(23)	(2)	**(25)**	(28)	–	**(53)**
In-force surplus	82	–	**82**	13	–	**95**
Principal reserving changes and one-off items	4	–	**4**	(74)	–	**(70)**
Development costs	(5)	–	**(5)**	(1)	–	**(6)**
Other	–	–	**–**	–	(3)	**(3)**
IFRS based operating result before tax	**58**	**(2)**	**56**	**(90)**	**(3)**	**(37)**
– core	58	–	**58**	–	–	**58**
– non-core	–	(2)	**(2)**	(90)	(3)	**(95)**
IFRS based operating result before tax	**58**	**(2)**	**56**	**(90)**	**(3)**	**(37)**

MCEV operating profit

Year ended 31 December 2012 £m	FPIL (excl Japan new business)	Japan (new business impact)	**Total FPIL**	OLAB	AmLife	**Total FPI**
Value of new business	17	4	**21**	(19)	3	**5**
Expected existing business contribution	18	–	**18**	3	2	**23**
Operating experience variances	(5)	–	**(5)**	(1)	(6)	**(12)**
Operating assumption changes	(21)	(7)	**(28)**	(83)	4	**(107)**
Other operating variances	(5)	–	**(5)**	–	–	**(5)**
Development costs	(5)	–	**(5)**	(1)	–	**(6)**
Other	(1)	–	**(1)**	–	–	**(1)**
MCEV operating result before tax	**(2)**	**(3)**	**(5)**	**(101)**	**3**	**(103)**
– core	(2)	–	**(2)**	–	–	**(2)**
– non-core	–	(3)	**(3)**	(101)	3	**(101)**
MCEV operating result before tax	**(2)**	**(3)**	**(5)**	**(101)**	**3**	**(103)**

Sustainable free surplus

Year ended 31 December 2012 £m	FPIL (excl Japan new business)	Japan (new business impact)	**Total FPIL**	OLAB	AmLife	**Total FPI**
Expected return from in-force business	78	–	**78**	10	5	**93**
Investment in new business	(39)	(16)	**(55)**	(46)	–	**(101)**
Development costs	(4)	–	**(4)**	(1)	–	**(5)**
Operating experience variances	(5)	–	**(5)**	–	(4)	**(9)**
Other operating variances	–	–	**–**	(2)	–	**(2)**
Sustainable free surplus contribution	**30**	**(16)**	**14**	**(39)**	**1**	**(24)**
– core	30	–	**30**	–	–	**30**
– non-core	–	(16)	**(16)**	(39)	1	**(54)**
Sustainable free surplus contribution	**30**	**(16)**	**14**	**(39)**	**1**	**(24)**

5 Corporate review

The Corporate segment includes the corporate holding and service companies of the Group.

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 2012 are presented below.

£m	Principal	Clean market value of debt[i]	Finance cost[ii] IFRS	MCEV
Existing (total debt: £1,494m):				
LT2 subordinated debt 2021	162	215	(22)	(13)
LT2 subordinated debt 2022	500	554	(37)	(33)
UT2 reset perpetual subordinated debt[iii]	354	378	(4)	(4)
STICS 2003	210	193	(10)	(11)
STICS 2005	268	250	(12)	(14)
Repaid in the year:				
Deferred consideration notes[iv]	363	363	(23)	(23)
Total			**(108)**	**(98)**

(i) Market value is based on listed ask price, at 31 December 2012, excluding accrued interest.
(ii) Finance cost is operating profit impact, before tax.
(iii) On 8 November 2012 the Group issued a $575 million US Dollar denominated reset perpetual subordinated debt instrument. The principal and clean market values represent Sterling equivalent values as at 31 December 2012.
(iv) On 20 November 2012 the Group repaid the remaining £363 million of deferred consideration notes from AXA Group.

The finance cost included within operating profit differs between the two bases, reflecting the short-term expected rate of return applied in the MCEV results.

On 8 November 2012, the Group issued a $575 million (£356 million) US Dollar denominated reset perpetual subordinated debt instrument, utilising the funds to repay the remaining £363 million of medium-term funding from AXA Group, originally provided on the acquisition of the AXA UK Life Business.

In so much as debt issued by holding companies supports the ongoing growth and development of the life operating businesses, the cash raised has been loaned to the UK and Heritage divisions. The cost attributable to each division is shown below.

£m	IFRS	MCEV Covered	MCEV Non-covered
Corporate segment	–	(75)	(23)
UK and Heritage divisions	(108)	–	–
	(108)	**(75)**	**(23)**

Corporate IFRS based operating result

£m	**2012 Full year**	2012 Half year	2011 Full year
Investment return and other items excluding external debt	**118**	58	91
Expected return on FLG debt	**(101)**	(49)	(112)
Net debt related costs in RSL[i]	**(7)**	(4)	(7)
Other corporate net costs	**(27)**	(10)	(41)
IFRS based operating loss before tax	**(17)**	(5)	(69)

(i) net finance costs within the Resolution holding companies, reflecting the receipt of interest from FLG and payment of DCN interest.

The Corporate result is principally driven by the expected return expense attributed to external debt liabilities of the Group and corporate costs, offset by internal asset income. The increase in investment return reflects the longer period of interest accrual on the debts issued to the UK and Heritage divisions in April and December 2011. The year on year fall in expected return on external debt is a result of the lower opening market value of the external debt liabilities, on which the expected return is calculated.

Net finance costs of £(7) million were paid by the Resolution holding companies in 2012 reflecting the payment of interest on the DCNs, partially offset by the income on the internal LT2 with FLG.

Other corporate net costs of £(27) million comprise fees payable to ROL of £(18) million and other corporate costs.

Corporate MCEV operating results

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

£m	**2012 Full year**	2012 Half year	2011 Full year
Expected existing business contribution on debt	**(75)**	(35)	(46)
Other operating variances	**–**	–	19
Life and pensions covered business operating loss before tax	**(75)**	(35)	(27)
Other income and charges	**(46)**	(22)	(74)
Operating loss before tax	**(121)**	(57)	(101)

The expected existing business contribution on debt has increased by £29 million to £75 million in 2012 reflecting the additional interest expense on the £356 million UT2 reset perpetual subordinated debt issued in November 2012, a full 12 months interest cost on the £500 million LT2 (raised in April 2011) combined with a significant increase in the short-term rate of return applied to the corporate debt. The impact of the higher interest cost on the £500 million LT2 debt is however offset by an equal and opposite £17 million reduction in other income and charges, reflecting the reduced interest costs incurred by the non-covered businesses.

Other income and charges include the £(23) million interest paid on the DCNs that were repaid in November 2012. The remaining costs principally comprise fees payable to ROL of £(18) million in addition to other corporate costs.

6 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 2012 remains strong with available shareholder cash ("ASC") of £850 million and an FLG IGCA surplus of £2.0 billion resulting in a coverage ratio, excluding with-profits insurance capital component ("WPICC")[(i)], of 214%. At 31 December 2012 the estimated economic capital surplus[(ii)] at the FLG level was £3.4 billion corresponding to a coverage ratio of 182%.

6.1 Capital management

Principles

The capital management policies ("CMPs") that the Group has established remain in place and are set out in detail below. In addition to the CMPs, the Group also considers the following when managing capital:

- the maintenance of financial strength within the life operating companies sufficient to support new business growth targets, including rating agency requirements;
- the need to have strong liquidity to cover expected and unexpected events, which includes access to an undrawn facility with a consortium of banks;
- management of the with-profits business of the Group in accordance with agreed risk appetites and all regulatory requirements; and
- the availability of transfers from long-term business funds and dividends from entities that support the cash generation requirements of the Group.

Capital management policies and monitoring buffers

The Group's CMPs that apply at a life company level and at the Group level are set out below.

Life companies CMP:

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

- 150% of Pillar 1 requirements, excluding WPICC, FPIL and Lombard; and
- 125% of Pillar 2 requirements, including any Individual Capital Guidance ("ICG") and specifically excluding FPIL and Lombard.

The CMPs of the other main life companies in the Group (including FPIL and Lombard) are aligned with that of FLL. The International businesses, whilst not regulated by the FSA, are each included in the FLG IGCA surplus and the FLG economic capital surplus on an equivalent Pillar 1 or Pillar 2 basis respectively.

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

Group CMP:

A capital management policy also operates at FLG level, as FLG is the ultimate European Economic Area ("EEA") parent insurance undertaking. The CMP at FLG 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 FLG holding company level sufficient to pay at least the next year's gross annual FLG interest cost (currently £120 million per annum) and any repayments of principal that fall due on FLG debt in the next year.

(i) WPICC represents the difference between the surplus capital calculated on a regulatory basis and that on a realistic basis, in accordance with FSA rules, and is excluded from both capital resources and capital resources requirements under the CMP.

(ii) The economic capital position at 31 December 2012 of FLG and its subsidiaries (including FLL on an economic capital basis, see (iii) below) is estimated and unaudited.

(iii) Economic capital is based on the individual Pillar 2 capital assessments for the UK life companies. FLL's economic capital is derived from consolidating the individual life companies' Pillar 2 capital requirements including making appropriate allowance for the diversification of risk between the companies. Pillar 2 strictly only applies at individual life company level and is the Individual Capital Assessment "ICA" determined by management including any amounts set by the FSA as ICG.

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 in the Friends Life holding companies together with amounts for working capital in both the holding companies and the life companies. The key monitoring buffers held are set out below (note that these are not additive requirements):

- working capital to cover specific monitoring buffers, over and above the CMP (excluding the additional requirement in FLL to hold capital to cover one year of debt servicing costs and any expected debt repayments), to enable all appropriate capital requirements to be met. The monitoring buffers are as follows:
  - for FLL (excluding FPIL and Lombard): 20% of Pillar 1 requirements (excluding WPICC, FPIL and Lombard) and 10% of economic capital requirements (including any ICG and excluding FPIL and Lombard); and
  - for FLG: 10% of IGCA requirements (excluding WPICC).
- a £400 million prudence buffer within the ASC is designed to cover one year's external dividend costs, debt interest and corporate costs.

Consideration of return of capital

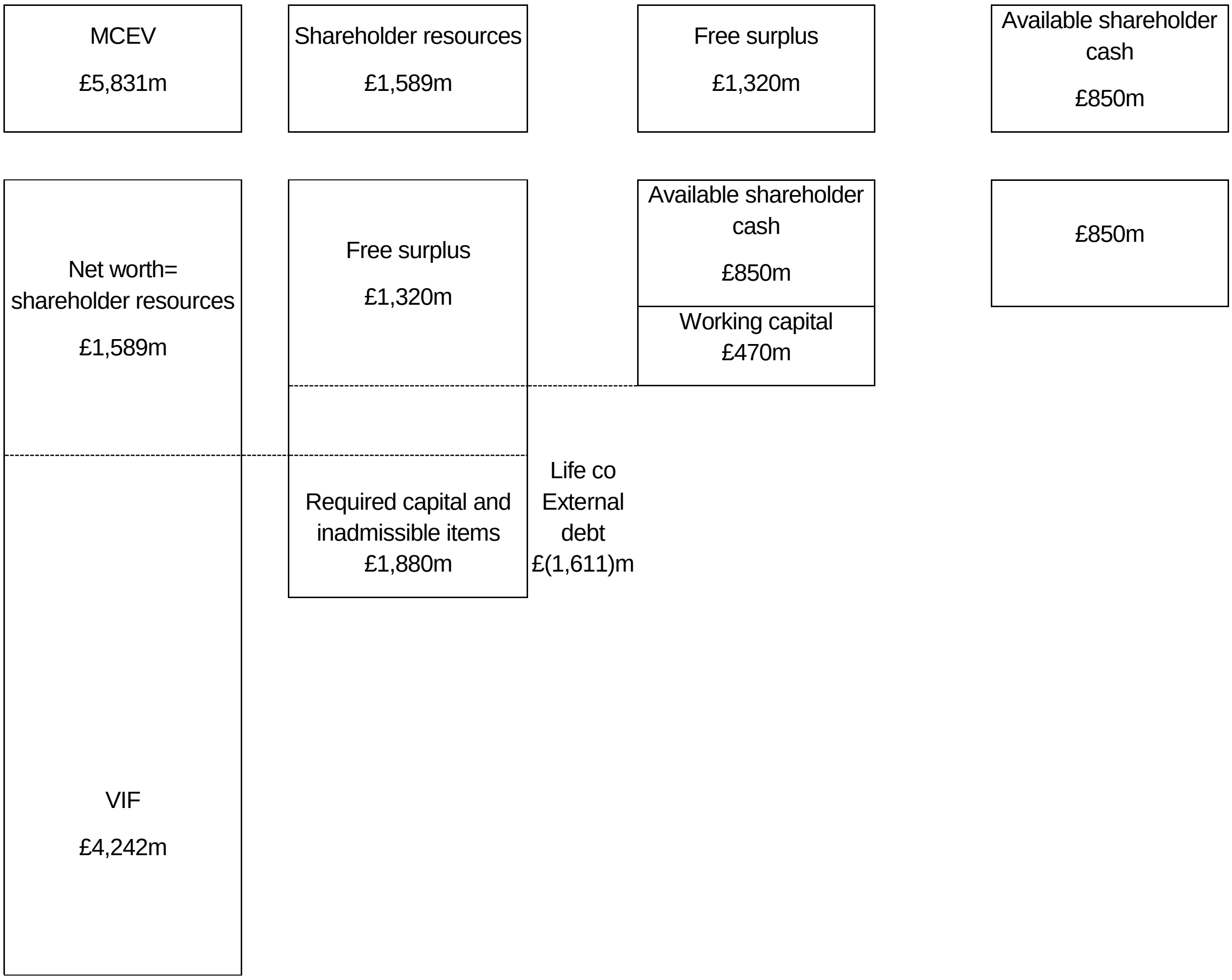
IGCA is currently the biting solvency constraint for the Group, with the FLG economic capital surplus, net of CMP and working capital, approximately £1.4 billion stronger than the equivalent IGCA surplus. This reflects actions taken in 2012 to improve the economic capital position of FLL (excluding FPIL and Lombard), including:

- enhanced economic capital modelling capabilities resulting in the identification and release of unintended prudence margins at the life company level;
- implementation of equity hedges within certain with-profits funds;
- selective de-risking of corporate bond portfolios backing shareholder business; and
- improved UK financial systems and controls resulting in a release of operational risk capital.

The Group continues to take actions to optimise its capital position. However, the current weak and uncertain economic environment remains a concern and the Group continues to believe that the economic uncertainty has the potential to materially increase investment volatility and corporate bond spreads. Whilst the Group has a highly rated corporate bond portfolio, with minimal direct exposure to higher risk sovereign debt, an increase in corporate bond spreads would have a material impact on the capital position. The relative sensitivities of IGCA and economic capital to a widening of corporate bond spreads indicate that there remains the potential for the biting constraint on capital to change in stressed scenarios. When combined with the uncertain economic environment these are key factors in the Group's capital management activities and also underpinned the Group's decision in July 2012 to cancel the second £250 million return of capital to shareholders.

The Group's cash and capital management framework is based on the movement in MCEV, reflecting the basis of MCEV as the discounted value of expected future cash flows on a market consistent basis. The chart below shows how the core components of MCEV within this framework, and their respective values as at 31 December 2012, reconcile to ASC.

6.2 Cash and capital management framework



The total MCEV is split between the net worth, or shareholder resources, and the VIF. Shareholder resources comprise the free surplus, required capital and inadmissible assets of the business. Required capital is based on the most onerous CMP for the Group, currently the IGCA. For Resolution and 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). VIF comprises the value of the future cash flows arising from the policies currently in-force.

External debt issued by FLG is offset against required capital in the life businesses as this debt has been guaranteed by life operating companies and has been used to support their activities. This debt comprises STICS of £458 million, LT2 subordinated debt 2021 of £211 million, LT2 subordinated debt 2022 of £562 million, and £380 million of UT2 reset perpetual subordinated debt and the associated currency swap (debt values include accrued interest and the tax impact of any market valuation).

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.

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

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

£m (net of tax)	Value in-force	Shareholder resources Required capital	Free surplus	Total MCEV
Opening MCEV at 1 January 2012	3,844	1,023	929	5,796
Free surplus generated in the year	409	(356)	215	268
Capital and dividend flows	1	(359)	169	(189)
Other reserve movements	(12)	(39)	7	(44)
Closing MCEV at 31 December 2012[(i)]	**4,242**	**269**	**1,320**	**5,831**

(i) Required capital at 31 December 2012 includes £229 million in respect of non-covered business required capital and inadmissible assets which are classified as free surplus in MCEV.

The free surplus generated in the year of £215 million is explained in section 2.3.

The capital and dividend flows contribution to free surplus of £169 million comprises £348 million net proceeds from the issue of the UT2 reset perpetual subordinated debt, £14 million in respect of other internal debt movements offset by the external dividend payments of £(193) million. Other free surplus reserve movements of £7 million relate to the reduction in the Company shares held by subsidiaries.

The required capital and inadmissible assets have fallen from £1,023 million to £269 million over 2012. This reflects £(229) million from the increase in value of the FLG external debt, which is offset against required capital, £101 million of reduced capital requirements following the implementation of the Part VII transfers in 2012 and £(356) million reduction following the issue of the UT2 reset perpetual subordinated debt. This is included within the £(359) million capital movements as it has been guaranteed by the life businesses. Other reserve movements in required capital include the adverse impact of foreign exchange movements and actuarial losses on the Group's pension scheme.

Working capital and other assets and liabilities

The working capital at 31 December 2012 of £470 million has reduced from £499 million at 31 December 2011.

Working capital comprises:

- amounts required to meet current estimates of future non-recurring costs, offset by related benefits that are expected in the short term;
- an appropriate monitoring buffer to facilitate ongoing compliance with the Group's Capital Management Policies;
- amounts to cover the necessary funding to protect against any temporary shortfall in delivery of cash generation relative to Group targets; and
- restricted assets (eg. illiquid or intangible assets) included within free surplus.

The largest components are the monitoring buffer (£175 million) and amounts set aside to meet non-recurring costs (£151 million).

Working capital is held in both the life companies and the holding companies. Working capital held in the life companies has decreased in the year, reflecting utilisation of working capital to fund non-recurring spend in the year, partially offset by identification of additional working capital requirements in respect of increased future separation and integration costs as announced in November 2012. The amount of working capital held in the holding companies has increased over the year, primarily relating to the provision for deficit reduction contributions for the Group's pension scheme.

Available shareholder cash

Available shareholder cash of £850 million comprises £714 million of shareholder cash at Friends Life holding company level (including £250 million final dividend proposed by FLL), together with £136 million held by Resolution holding companies. Details on ASC movements are set out in section 2.3.

(£m)	**31 December 2012**	31 December 2011
Friends Life holding companies cash	**464**	402
Proposed dividend from FLL	**250**	350
Friends Life available shareholder cash	**714**	752
Resolution holding companies cash	**136**	101
Available shareholder cash	**850**	853

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

£m	**31 December 2012**	31 December 2011
Settlement of final dividend	**200**	185
Prudence buffer in accordance with Group policy	**400**	400
Non-specified ASC holdings	**250**	268
Available shareholder cash	**850**	853

The ASC balance as at 31 December 2012 is held to cover the costs of the 2012 final dividend and to maintain a prudence buffer, within FLG ASC, of £400 million which is designed to cover an additional year of the Company's dividend cost, debt interest and Resolution holding companies corporate costs. This prudence buffer is also designed to cover the Group CMP requirement to hold cash at FLG sufficient to meet one year of FLG's debt servicing costs. As this is expected to be met from capital retained in the life companies, this is not considered to be a restriction on the availability of FLG cash.

Emergence of cash

The Group set a Distributable Cash Target ("DCT") of £400 million per annum at FLG level, after interest costs and without reducing the MCEV of Friends Life group (excluding investment variances and non-recurring items). The DCT is satisfied by dividends from the life operating companies to the Friends Life holding companies. Dividends declared by life companies in respect of 2012 were £354 million and FLG MCEV operating profit after tax (a proxy for the amount which could be repaid without reducing the FLG MCEV, based on the definition above) was £290 million, including the impact of the International strategic review and related basis changes.

Since the DCT was set in 2010, returns on shareholder assets, in particular interest rates have fallen significantly and reduce the emergence of surplus from the in-force book. As at 30 June 2012 this was estimated to have reduced the emergence of surplus by approximately £50 million per annum, and the position has not materially changed since then. Whilst the DCT remains a target, it is recognised that until economic conditions improve this target will only be achievable from sustainable sources in the medium term.

The emergence of surplus from the UK and Heritage divisions' in-force book over the next five years has been estimated in the table below.

These unaudited estimates are undiscounted and are based on operating, economic and tax assumptions at 31 December 2012 and only relate to the UK and Heritage divisions' in-force business. The economic assumptions underlying the estimates are in line with those assumed in the calculation of expected return within MCEV. Hence, for example, an equity return of 4.9% p.a. and a property return of 3.9% p.a. has been assumed.

Actual emergence of surplus in any particular year will differ from that expected as a result of operating experience variances, assumption changes, development costs, and crucially, the level of new business strain.

UK & Heritage Estimated expected return from in-force business	Estimated free surplus emergence £m
2012 actual (i)	505
2013	500
2014	475
2015	475
2016	450
2017	400

(i) Excludes £34 million return on shareholder net assets.

6.3 Economic capital position

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

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

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

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

As noted in the "Capital management policies and monitoring buffers" section above, a number of actions have been taken in the year to improve the FLL economic capital position, and as a result, the estimated FLG economic capital surplus as at 31 December 2012 is strong at £3.4 billion (a coverage ratio of 182%).

The estimated sensitivities of economic capital surplus to market shocks were provided as part of the half year report and remain appropriate. In summary the sensitivities showed that economic capital surplus would have reduced by:

- an estimated £0.4 billion in the event of a 40% fall in equity markets;
- an estimated £0.1 billion in the event of a 200bps fall in interest rates; and
- an estimated £1.0 billion in the event of a widening of corporate bond spreads of 200bps (of which one-third is assumed to relate to defaults).

6.4 Insurance Groups Capital Adequacy

In addition to individual company requirements FLG, as the ultimate European Economic Area ("EEA") parent insurance undertaking, is required to meet the IGCA requirements of the Insurance Groups Directive. IGCA is monitored at FLG level and does not include the assets or liabilities of the Resolution holding companies. The Group's capital policy is to maintain sufficient Group capital resources to cover 150% of Group CRR (excluding WPICC).

The balance sheet remains strong at FLG level, with an IGCA surplus of £2.0 billion at 31 December 2012, with Group capital resources being 214% of Group CRR (excluding WPICC of £3.4 billion).

Group capital resources were £1.1 billion in excess of the amount required to satisfy the FLG CMP. The IGCA surplus would reduce by around £0.1 billion for a 40% fall in equity markets or £0.2 billion if interest rates were to fall by 200bps across the yield curve from 31 December 2012 levels. The IGCA surplus would reduce by approximately £0.4 billion if corporate bond spreads were to rise by 200bps (of which one-third is assumed to relate to defaults).

The movement in IGCA surplus over the period largely reflects the £500 million dividend paid to Resolution holding companies partially offset by the generation of surplus and the debt refinancing. The surplus emerging of £300 million reflects the £526 million of in-force surplus partially offset by £(251) million of new business strain, positive economic variances of £146 million, and adverse other non-operating items of £(121) million (mainly non-recurring costs).

Included within the £300 million surplus emerging are benefits from COP 2012 management initiatives. The Part VII transfers implemented in the year have reduced Pillar 1 capital resources requirements by £68 million. The Part VII has also enabled the simplification of the arrangements for managing the FLC With-Profits Funds which generated a benefit of £103 million. The benefit to IGCA differs from free surplus impacts as free surplus includes the release of required capital at 150% (whereas IGCA is at 100%) but excludes the benefit of a release of with-profits fund support arrangements (as these did not previously restrict free surplus).

The surplus is also impacted by the external debt reorganisation in the period. The outstanding £200 million of internal LT2 subordinated debt issued to RHG has been repaid, following the external debt raising by FLG of £356 million UT2 subordinated debt, with £8 million of associated costs.

Finance costs and other movements comprise £(73) million of interest costs on the external LT2 subordinated debt, UT2 subordinated debt and STICS, partially offset by positive other reserve movements of £6 million.

Movement in IGCA surplus	£m
1 January 2012	**2,139**
Surplus emerging	300
Issue of external UT2 subordinated debt, net of costs	348
Repayment of RHG debt	(200)
Dividend to RSL	(500)
Finance costs and other movements	(67)
31 December 2012	**2,020**

At 31 December 2012 the capital held to meet FLG CMPs was £889 million (1 January 2012: £902 million) and the excess over the CMPs was £1,131 million (1 January 2012: £1,237 million).

The IGCA surplus is a prudent measure and excludes surplus capital not immediately available to shareholders, such as surplus capital held in long-term funds to the extent that this is not needed to cover the capital resource requirements of the long-term fund concerned. At 31 December 2012 the IGCA surplus excludes £23 million of long-term fund surpluses and excludes £443 million of UK with-profits funds surpluses.

As part of the simplification of the governance structure, the Company's head office, for regulatory financial resources rules purposes, is expected to move to the UK at which point the Company will be deemed to be the ultimate EEA parent undertaking of the Group. As a result the assets and liabilities of Resolution Limited and the other Resolution holding companies based in Guernsey will in the future be taken into account in calculating the IGCA surplus. At 31 December 2012 this would have increased the IGCA surplus to £2.2 billion, and to a coverage ratio of 221%.

6.5 Management of the with-profits funds

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

%	Target fund hedging ratio[i]	**Target EBR level**	**2012 Full year**	2011 Full year
Friends Life FP With-Profits Fund (pre-demutualisation business)	100%	**45**	**47**	48
Friends Life FP With-Profits Fund (post-demutualisation business)	100%	**55**	**57**	53
Friends Life FLC Old With-Profits Fund	60%	**60**	**60**	66
Friends Life FLC New With-Profits Fund	60%	**60**	**60**	66
Friends Life FLAS With-Profits Fund	75%	**50**	**51**	52
Friends Life WL With-Profits Fund	100%	**50**	**51**	48

(i) The target fund hedging ratio is the proportion of guarantees in the fund which are hedged against equity risk

These apply to the funds backing the majority of asset shares, although sub-funds within these may have different allocations. For Friends Life WL Limited, the benchmark applies to products with equity participation; there are some products invested wholly or partly in a purely fixed interest asset mix and these are not allowed for in the figures shown above.

The allocation for assets backing guarantees and options within the with-profits funds comprises a range of assets including gilts, bonds and hedging derivatives (equity put and call options, sold equity futures, interest rate swaps and swaptions). These apply to the funds as a whole and within companies individual policies may have different allocations.

Non-profit business in the with-profits funds, the majority of which is annuities, is backed by a mix of gilts and corporate bonds (some with credit default swap protection to hedge the default risk).

6.6 Asset quality and exposure

The Group's financial assets as at 31 December 2012, excluding cash, are summarised as follows:

£bn	Unit-linked	With-profits	Non-profit	Shareholder	31 December 2012 Total	31 December 2011 Total
Shares, unit trusts and OEICs	**57.0**	**6.8**	**0.1**	**–**	**63.9**	60.6
Government securities	**7.6**	**8.9**	**2.1**	**0.1**	**18.7**	19.5
Corporate bonds and asset-backed securities	**5.9**	**8.5**	**7.9**	**0.1**	**22.4**	22.2
Derivatives	**–**	**0.7**	**0.1**	**–**	**0.8**	0.9
Deposits	**0.2**	**–**	**–**	**–**	**0.2**	0.4
Total 31 December 2012	**70.7**	**24.9**	**10.2**	**0.2**	**106.0**	–
Total 31 December 2011	68.0	25.4	9.6	0.6	**–**	103.6

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

£bn	Unit-linked funds	With-profits funds	Non-profit funds	Shareholder funds	31 December 2012 Total	31 December 2011 Total
Corporate bonds and asset-backed securities	**5.9**	**8.5**	**7.9**	**0.1**	**22.4**	22.2
less: policyholder exposure	**5.9**	**7.3**	**–**	**–**	**13.2**	13.6
Shareholder exposure	**–**	**1.2**	**7.9**	**0.1**	**9.2**	8.6
AAA		**0.2**	**1.1**	**–**	**1.3**	1.1
AA		**0.2**	**2.8**	**–**	**3.0**	3.0
A		**0.5**	**2.8**	**0.1**	**3.4**	3.0
BBB		**0.2**	**1.0**	**–**	**1.2**	1.3
Sub-BBB or rating not available		**0.1**	**0.2**	**–**	**0.3**	0.2
% Investment grade					**96.7%**	96.9%

Over 96% of the corporate bond and asset-backed securities to which the shareholder funds are exposed are investment grade. The Group controls its exposures to corporate issuers by rating, type of instrument and type of issuer. The sub-investment grade bonds held in investment portfolios are monitored closely in order to maximise exit values. Where asset-backed securities and other complex securities are held, the Group monitors closely its exposures to ensure that the relevant structure, liquidity and tail credit risks are well understood and controlled.

No defaults have been experienced in the year to 31 December 2012. The Group holds default reserves to cover the risk of defaults and credit rating downgrades on corporate bonds that back all annuity business within Friends Life group. The reserves reflect assumed defaults over the outstanding terms to maturity of the bonds. The shareholder share of default reserves at 31 December 2012 was £0.5 billion (31 December 2011: £0.6 billion). This represents a haircut of 43% of the overall corporate bond spreads over gilts of equivalent term (31 December 2011: 35%).

The vast majority of the Group's exposure to sovereign debt holdings is to UK gilts. The Group has £7 million shareholder exposure (including shareholder fund exposure to non-profit and with-profits funds) to the higher risk government debts of Spain, Portugal, Italy, Ireland and Greece (31 December 2011: £6 million).

In addition the Group's shareholder exposure to various corporate securities issued by companies domiciled in Spain, Portugal, Italy, and Ireland is £334 million (31 December 2011: £370 million). The Group's shareholder exposure to Greek corporate securities is less than £1 million. Some 61% by value of these corporate securities are issued by non-financial companies, which are in many cases less exposed to their domicile economy than to other countries. Where the Group holds securities issued by financial companies, 21% of these are not linked to the institution's domestic economy. In all cases the company's financial strength and the ability of the domicile government to provide financial support in the event of stress has been considered.

Sovereign and corporate exposure to these countries is shown below.

£m	**Total**	Spain	Portugal	Italy	Ireland	Greece
Sovereign debt	**7**	–	–	7	–	–
Corporate exposure	**334**	146	5	145	38	–
Total 31 December 2012	**341**	146	5	152	38	–
Total 31 December 2011	376	167	10	160	39	–

The Group's shareholder exposure to bank debt securities across the various geographic regions is shown below.

£m Seniority	Rating	UK	Euro	USA	France	PIIGS(i)	ROW	Shareholder Total
Senior	AAA	15	56	–	–	–	3	74
	AA	40	94	13	16	–	59	222
	A	199	1	295	8	–	25	528
	BBB	2	–	–	–	13	–	15
	Below BBB/NR	–	3	–	–	–	–	3
	Senior Total	**256**	**154**	**308**	**24**	**13**	**87**	**842**
Secured	AAA	415	–	–	32	54	13	514
	AA	–	–	–	–	–	–	–
	A	26	–	–	–	–	–	26
	BBB	4	–	11	–	–	–	15
	Below BBB/NR	–	–	13	–	–	–	13
	Secured Total	**445**	**–**	**24**	**32**	**54**	**13**	**568**
Subordinated	AA	–	–	–	–	–	19	19
	A	172	4	14	15	7	20	232
	BBB	235	22	46	23	19	21	366
	Below BBB/NR	84	4	–	–	7	13	108
	Subordinated Total	**491**	**30**	**60**	**38**	**33**	**73**	**725**
Cash	**Cash Total**	**799**	**346**	**855**	**342**	**–**	**334**	**2,676**
Grand Total		**1,991**	**530**	**1,247**	**436**	**100**	**507**	**4,811**

(i) Portugal, Ireland, Italy, Greece, Spain.
The disclosure above excludes a £1.8 billion collateralised HSBC Amortising Note set up as part of an annuity reinsurance transaction which took effect 1 January 2007.

6.7 Liquidity

The liquidity of the Group remains strong

FLG has an undrawn £500 million funding facility with a consortium of banks. This facility is due to run until June 2013 but can be extended at the option of FLG for a further two years.

Financial strength ratings

The following principal life business is attributed financial strength ratings. Following the corporate restructure activities undertaken as part of the capital optimisation programme, the Friends Life Company Limited and Friends Life Assurance Society Limited ratings have been removed.

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

The Group targets financial strength ratings in the single A range and expects them to remain there for the foreseeable future.

7 Principal risks and uncertainties

The Group actively manages its risk profile and the risk management framework drives the identification and mitigation of group, strategic, financial and operational risks to support the achievement of its objectives. The formalised risk management framework which the Company has developed to guide the management of risk is further described within the Governance section of the Annual Report and Accounts. A more detailed review of the Group's exposures to market, credit, liquidity and insurance risks together with the framework and instruments for their management are included in the notes to the accounts.

Following is a list of the principal inherent risks and uncertainties the Group was exposed to during 2012 and an overview of its approach to managing these exposures:

Economic conditions

Description

Changes in economic conditions give rise to changes in the values of the assets and liabilities of the Group's insurance businesses and may reduce the profitability of these businesses and/or their financial strength. Adverse or uncertain economic conditions also impact the willingness of consumers to buy and continue to hold the Group's products. The Group is particularly impacted by conditions in the UK and other European countries as a result of its operations and investment assets being focused in these countries.

Management

The Group's business model seeks to mitigate the impact of market conditions through measures including the matching of assets and liabilities, diversifying between asset classes and within asset classes and using derivatives to reduce the volatility of returns on assets, diversification of the product portfolio, and ensuring the operating companies within the Group are strongly capitalised. The Group also actively monitors changes in the economic environment to enable proactive management of impacts to relevant markets. Its exposure to sovereign debt from all but the strongest countries in the Eurozone is modest, is in line with the Group's risk appetite and has been managed down further in recent years. 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. However it seeks to mitigate these risks by adopting a conservative investment policy with investment skewed towards bonds with high credit ratings.

Sustained low interest rates

Description

The Group's insurance businesses can be adversely affected by sustained low interest rates as well as certain interest rate fluctuations. The Group's insurance businesses, including shareholders' funds are invested in a variety of investments including government debt, cash instruments and corporate bonds. In times of low interest rates the yields on these instruments typically decrease. This can mean that when the instruments mature, the sums realised are reinvested into instruments with lower yields, which, in turn, decrease investment returns. Sustained low interest rates could therefore have a material adverse effect on the business, results of operations and/or financial condition of the Group and could adversely impact the ability to generate free surplus and ultimately pay dividends to shareholders.

Management

The Group seeks to match the duration and return profile of its assets and liabilities in order to manage its exposure to interest rate movements. In the annuity books this is achieved by investing in bonds of appropriate duration and through swap overlays.

Within with-profits funds a combination of physical bonds, swap overlays and swaptions are used to manage the interest rate risk. The level of hedging is optimised in line with risk appetite and so that it does not result in an unacceptable increase in other categories of risk.

Other mitigants to a low interest rate environment are being investigated including review of the Group's investment strategy for shareholder assets which currently has a large cash exposure. Approaches such as diversification of the 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.

Integration and restructuring

Description

The Group is exposed to the risk of failing to integrate and successfully restructure the financial services businesses that it has acquired.

Management

Substantial progress has been made in integrating the three acquired businesses with strategy, planning, and monitoring of risk and business performance being undertaken on an integrated basis.

Restructuring of the business to improve its capital efficiency and bring together in separate companies the business of the Heritage Division (within FLL) and the UK Division (within FLPL) is progressing to plan with the business transfers planned for 2012 completed during the year and the 2013 plans on track. There is one major component to complete before separation of the acquired AXA UK Life Business from its previous parent group is achieved at operational level. This work has been replanned and is now expected to complete in 2013.

The scale of the separation, integration and restructuring agenda, particularly when taken with the substantial regulatory change agenda faced by the Group (see below) poses particular challenges. Through the business planning process the Group determines the volume of change initiatives that can be delivered and prioritises initiatives for inclusion. The Group operates project management disciplines to identify and manage the interdependencies between initiatives, to set and monitor budgets, to manage the deployment of resources and to monitor delivery of outputs. In this way the Group aims to manage the risks of the change programme within its appetite.

Regulatory and taxation change and compliance

Description

The Group operates in a highly regulated financial services market both in the UK and internationally which has a significant impact and influence on both strategic decisions and ongoing day-to-day management of the business. Unanticipated 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. It is impossible to fully predict the nature of the regulatory changes which may occur in the future or the impact that such changes may have on the Group and its strategic objectives.

The Group may be affected by changes in tax legislation and interpretation of tax law, whether the changes impact the taxation of the companies in the Group at corporate level, or the taxation of the policyholders. In particular, the new corporate tax regime applicable to life insurers from 1 January 2013 continues the “I minus E” basis of taxation for relevant life business in the operating life companies, and while the Group assumes the continuation of that basis in the future, any change in that basis may have a significant impact on the Group.

Management

The Group successfully completed its preparation for regulatory driven requirements introduced in 2012 such as gender neutral pricing and the Retail Distribution Review. Systems have been developed to support the Group's occupational pension scheme customers in meeting the requirements of Auto Enrolment and further automation of the processes is planned during 2013 in order that the group is able to meet the needs of the increasing numbers of schemes that will become subject to Auto Enrolment requirements in late 2013 and 2014. As with any major change in UK regulatory requirements, it is expected that FSA (or its successors PRA and FCA) will want to review firms’ interpretation of these new requirements and test that compliance has been achieved. Accordingly the Group expects its implementation of these new regulatory requirements to be reviewed over coming months.

It is expected that various regulatory bodies will begin thematic reviews in 2013, such as annuity pricing and unit linked pricing, the Group will adhere to these reviews as required.

The planned simplification of the Group’s governance arrangements from the end of March will address the changes made to the UK listing rules in respect of “externally managed companies” and which could otherwise have threatened the continuation of the Company’s premium listing.

The Group continues to monitor and prepare for the future regulatory developments such as the impending transfer of UK regulatory responsibilities for insurers from the FSA to dual prudential and conduct regulators, and longer term initiatives such as Solvency II and IFRS Phase II.

The Group bases its business strategy on prevailing regulation and known and planned change. To mitigate the risk of legislation or regulation adversely impacting its business, the Group and its operational businesses engage with regulatory and legislative authorities and support lobbying activity conducted by relevant industry groups. The Group has processes in place to identify regulatory and legislative change and to monitor the timely implementation of new requirements.

Principal valuation assumptions

Description

The writing of life assurance and pension business by the Group's insurance businesses necessarily requires the setting of assumptions for future experience of factors such as mortality and longevity, lapse and persistency rates, valuation interest rates, credit defaults and expense levels. Experience may vary from the rates assumed impacting the financial performance of the Group.

Management

During 2012, the continued economic uncertainty and impending introduction in the UK of FSA's Retail Distribution Review acted to increase the risk of lapses of life and pensions business as intermediaries looked to re-broke existing business ahead of the impending ban on the payment of commission and in the face of a scarcity of new business. The Group has in place customer value management activities to mitigate this risk and anticipates that over the course of 2013 that it will see some improvement in lapse rates following the implementation of the Retail Distribution Review.

The Group takes a prudent approach to evaluating the appropriate level of provisions and capital for each of its risks and the assumptions made are subject to rigorous and ongoing review. However events causing a substantial change in mortality/morbidity experience, lapse rates or other reserving assumptions could require assumptions to be recalibrated and could impact the profitability, earnings and capital position of the Group. Stress and scenario testing is used to validate the appropriateness of key assumptions to single events and combinations of extreme events including economic conditions, investment performance, lapse and mortality/morbidity events.

Outsourcing

Description

As part of the Group's strategy for increasing operational efficiency, it makes use of outsourcing. In March 2012 Friends Life group's outsource arrangements in respect of IT and customer services were materially extended by the coming into effect of a long-term contract with Diligenta. This substantially increased the reliance of the Friends Life group on outsource service providers. The risks of outsourcing include the risk that the outsourcer is or becomes unable to provide the expected services or does not provide them to the standards and quality expected.

In addition, the Group's insurance businesses currently benefit from the exemption from VAT of certain costs incurred under outsourcing contracts into which they have entered. The VAT exemption is subject to possible change and if narrowed could have the effect of increasing the costs of some of the outsourced services the Group has contracted to receive.

Management

The Group has comprehensive service level agreements in place with all its outsource service providers and actively monitors the standards of delivery against these agreements in order to mitigate the operational risks posed by the outsourcing. In relation to the newest partner, a dedicated team is overseeing Diligenta's delivery of a Service Improvement Plan in accordance with its contractual obligations. In addition, the financial strength and strategic position of the Group's major outsource service providers are actively monitored in order to manage the potential counterparty credit and continuity of service risks they pose.

The Group monitors discussions at European and UK level regarding the VAT exemption for outsourced services. However it remains uncertain when any changes might be made to the law, what form those changes might take, and hence what impact, if any, they might have on the Group.

Directors' responsibility statement pursuant to Disclosure and Transparency Rule 4 (extracted from the 2012 Annual Report and Accounts)

The Annual Report and Accounts contains the following statements regarding responsibility for the financial statements and the business review included in the Annual Report and accounts.

"Each of the directors confirms that to the best of their knowledge:

- The financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit and loss of the Group; and
- The business review included in the Annual Report and Accounts includes a fair review of the development and performance of the business and the position of the Group, together with a description of the principal risks and uncertainties that it faces."

By order of the Board

Fergus Dunlop

Director

25 March 2013

IFRS financial statements

Consolidated income statement

For the year ended 31 December 2012

	Notes	2012 £m	2011[ii] £m
Revenue			
Gross earned premiums	2	**1,906**	2,128
Premiums ceded to reinsurers	2	**(602)**	(599)
Net earned premiums	2	**1,304**	1,529
Fee and commission income and income from service activities		**749**	771
Investment return		**9,077**	1,804
Total revenue		**11,130**	4,104
Other income	2	**–**	134
Claims, benefits and expenses			
Gross claims and benefits paid		**(4,175)**	(3,859)
Amounts receivable from reinsurers		**680**	643
Net claims and benefits paid		**(3,495)**	(3,216)
Change in insurance contracts liabilities		**8**	216
Change in investment contracts liabilities		**(5,052)**	495
Transfer (to)/from unallocated surplus		**(4)**	484
Movement in net asset value attributable to unit holders		**(118)**	48
Movement in policyholder liabilities		**(5,166)**	1,243
Acquisition expenses		**(614)**	(591)
Administrative and other expenses		**(1,629)**	(1,776)
Finance costs		**(157)**	(165)
Total claims, benefits and expenses		**(11,061)**	(4,505)
Share of loss of associates and joint venture		**(3)**	(1)
Profit/(loss) before tax from continuing operations		**66**	(268)
Policyholder tax	3	**(258)**	(220)
Loss before shareholder tax from continuing operations		**(192)**	(488)
Total tax (charge)/credit	3	**(107)**	237
Policyholder tax	3	**258**	220
Shareholder tax	3	**151**	457
Loss for the year		**(41)**	(31)
Attributable to:			
Equity holders of the parent[i]		**(72)**	(62)
Non-controlling interests		**31**	31
Loss for the year		**(41)**	(31)

Earnings per share from continuing operations		2012 pence	2011 pence
Basic earnings per share	5	**(5.17)**	(4.35)
Diluted earnings per share	5	**(5.17)**	(4.35)

(i) All profit attributable to equity holders of the Company is from continuing operations.
(ii) The consolidated income statement for the year ended 31 December 2011 includes the results of BHA from 31 January 2011 and the results of FLWL from 7 November 2011 and the business of the GOF and TIP portfolios up to 1 November 2011.

Consolidated statement of comprehensive income

For the year ended 31 December 2012

For the year ended 31 December 2012	Equity holders of the parent £m	Non-controlling interests £m	Total £m
(Loss)/profit for the year	**(72)**	**31**	**(41)**
Actuarial losses on defined benefit schemes	**(42)**	**–**	**(42)**
Foreign exchange adjustments(i)	**(17)**	**–**	**(17)**
Revaluation of owner occupied properties	**(2)**	**–**	**(2)**
Shadow accounting(ii)	**7**	**–**	**7**
Aggregate tax effect of above items	**7**	**–**	**7**
Other comprehensive loss, net of tax	**(47)**	**–**	**(47)**
Total comprehensive (loss)/income, net of tax	**(119)**	**31**	**(88)**

For the year ended 31 December 2011	Equity holders of the parent £m	Non-controlling interests £m	Total £m
(Loss)/profit for the year	(62)	31	(31)
Actuarial losses on defined benefit schemes	(34)	–	(34)
Foreign exchange adjustments(i)	(10)	–	(10)
Revaluation of owner occupied properties	(3)	–	(3)
Shadow accounting(ii)	2	–	2
Aggregate tax effect of above items	2	–	2
Other comprehensive loss, net of tax	(43)	–	(43)
Total comprehensive (loss)/income, net of tax	(105)	31	(74)

(i) Foreign exchange adjustments relate to the translation of overseas subsidiaries and associates.
(ii) Shadow accounting comprises £2 million (31 December 2011: £3 million) relating to the revaluation of owner occupied properties and £5 million (31 December 2011: loss of £(1) million) in respect of foreign exchange adjustments on translation of overseas subsidiaries held by the with-profits fund of Friends Life Limited ("FLL").

Consolidated statement of IFRS based operating profit

For the year ended 31 December 2012

	Notes	**2012 £m**	2011 £m
Profit/(loss) before tax from continuing operations	2	**66**	(268)
Policyholder tax	3	**(258)**	(220)
Loss before shareholder tax excluding returns generated within policyholder funds		**(192)**	(488)
Non-recurring items	2	**258**	180
Amortisation and impairment of acquired present value of in-force business	6	**417**	675
Amortisation and impairment of other acquired intangible assets	6	**97**	84
Interest payable on STICS	2	**(31)**	(31)
Short-term fluctuations in investment return		**(275)**	261
IFRS based operating profit before tax		**274**	681
Tax on operating profit		**2**	38
IFRS based operating profit after tax attributable to equity holders of the parent[(i)]		**276**	719

Earnings per share		**2012 Pence**	2011 Pence
Operating earnings per share	5	**19.84**	50.43

(i) IFRS based operating profit excludes: (a) investment variances from expected investment return for non-linked business which is calculated using a longer term rate of return; (b) returns attributable to non-controlling interests in policyholder funds; (c) significant non-recurring items; and (d) amortisation and impairment of present value of acquired in-force business and other intangible assets and is stated after policyholder tax and the deduction of interest payable on STICS. Given the long-term nature of the Group's operations, IFRS based operating profit is considered to be a better measure of the performance of the Group and this measure of profit is used internally to monitor the Group's IFRS results.

Consolidated statement of financial position

At 31 December 2012

As at 31 December	Notes	2012 £m	2011 £m
Assets			
Pension scheme surplus	8	**33**	20
Intangible assets	6	**4,321**	4,847
Property and equipment		**53**	58
Investment properties		**2,735**	3,015
Investment in associates and joint venture		**4**	37
Financial assets	7	**105,990**	103,636
Deferred acquisition costs		**838**	643
Reinsurance assets		**3,153**	3,213
Current tax assets		**8**	6
Insurance and other receivables		**1,125**	1,140
Cash and cash equivalents		**9,449**	8,791
Net assets of operations classified as held for sale		**30**	–
Total assets		**127,739**	125,406
Liabilities			
Insurance contracts		**37,232**	37,264
Unallocated surplus		**656**	652
Financial liabilities:			
– investment contracts		**78,184**	75,191
– loans and borrowings	9	**1,099**	1,195
– amounts due to reinsurers		**1,767**	1,800
Net asset value attributable to unit-holders		**754**	1,173
Provisions		**278**	228
Deferred tax liabilities		**893**	872
Current tax liabilities		**21**	20
Insurance payables, other payables and deferred income		**1,157**	1,016
Total liabilities		**122,041**	119,411
Equity attributable to equity holders of the parent			
– Share capital		**4,225**	4,128
– Other reserves		**1,152**	1,544
		5,377	5,672
Attributable to non-controlling interests		**321**	323
Total equity		**5,698**	5,995
Total equity and liabilities		**127,739**	125,406

The financial statements were approved by the Board of Directors on 25 March 2013.

Consolidated statement of changes in equity

For the year end 31 December 2012

For the year ended 31 December 2012	Attributable to equity holders of the parent Share capital £m	 Other reserves £m	 Total £m	Non-controlling interests £m	Total £m
At 1 January 2012	**4,128**	**1,544**	**5,672**	**323**	**5,995**
(Loss)/profit for the year	**–**	**(72)**	**(72)**	**31**	**(41)**
Other comprehensive loss	**–**	**(47)**	**(47)**	**–**	**(47)**
Total comprehensive (loss)/income	**–**	**(119)**	**(119)**	**31**	**(88)**
Dividends paid	**–**	**(283)**	**(283)**	**–**	**(283)**
Interest paid on STICS	**–**	**–**	**–**	**(31)**	**(31)**
Appropriations of profit	**–**	**(283)**	**(283)**	**(31)**	**(314)**
Tax relief on STICS interest	**–**	**7**	**7**	**–**	**7**
Shares issued in lieu of dividend	**90**	**–**	**90**	**–**	**90**
Reduction in own shares held by the Group	**7**	**–**	**7**	**–**	**7**
Share-based payments(i)	**–**	**3**	**3**	**(2)**	**1**
At 31 December 2012	**4,225**	**1,152**	**5,377**	**321**	**5,698**

For the year ended 31 December 2011	Attributable to equity holders of the parent Share capital £m	 Other reserves £m	 Total £m	Non-controlling interests £m	Total £m
At 1 January 2011	4,317	1,910	6,227	322	6,549
(Loss)/profit for the year	–	(62)	(62)	31	(31)
Other comprehensive loss	–	(43)	(43)	–	(43)
Total comprehensive (loss)/income	–	(105)	(105)	31	(74)
Dividends paid	–	(274)	(274)	–	(274)
Interest paid on STICS	–	–	–	(31)	(31)
Appropriations of profit	–	(274)	(274)	(31)	(305)
Tax relief on STICS interest	–	7	7	–	7
Shares issued in lieu of dividend	48	–	48	–	48
Reduction in own shares held by the Group	13	–	13	–	13
Share repurchase	(250)	–	(250)	–	(250)
Shares issued during the year	–	–	–	1	1
Share-based payments(i)	–	6	6	–	6
At 31 December 2011	4,128	1,544	5,672	323	5,995

(i) The other reserves movement for share-based payment transactions is £3 million for the year (31 December 2011: £6 million) and comprises £(4) million in respect of the cost of Company shares acquired to settle obligations arising from Lombard long-term incentive plan ("LTIP") awards that have vested in the period (31 December 2011: £nil), offset by the reserves credit for the resultant reduction in Lombard non-controlling interest of £2 million (31 December 2011: £nil) and the LTIP charge for the period of £4 million (31 December 2011: £6 million), offset by a payment of £(1) million to purchase shares in the market. In addition there is a £2 million charge in respect of the deferred share award plan ("DSAP") and the Friends Life group share awards plan.

Consolidated statement of cash flows

For the year ended 31 December 2012

For the year ended 31 December	2012 £m	2011 £m
Operating activities		
Loss for the year	**(41)**	(31)
Adjusted for:		
– other income	**–**	(116)
– net realised and unrealised (gains)/losses on assets at fair value	**(5,630)**	1,595
– finance costs	**157**	165
– amortisation and impairment of intangible assets	**514**	759
– depreciation of property and equipment	**5**	4
– movement in deferred acquisition costs	**(195)**	(285)
– total tax charge/(credit)	**107**	(237)
– purchase of shares and other variable yield securities	**(22,536)**	(22,585)
– sale of shares and other variable yield securities	**23,045**	22,705
– purchase of loans, debt securities and other fixed income securities	**(23,841)**	(33,973)
– sale of loans, debt securities and other fixed income securities	**26,166**	34,380
– purchase of investment properties	**(51)**	(43)
– sale of investment properties	**228**	305
– decrease in insurance contract liabilities	**(32)**	(101)
– increase/(decrease) in investment contract liabilities	**3,532**	(2,057)
– increase/(decrease) in unallocated surplus	**4**	(484)
– increase/(decrease) in provisions	**50**	(1)
– net movement in receivables and payables	**(214)**	(51)
Pre-tax cash inflow/(outflow) from operating activities	**1,268**	(51)
Tax paid	**(70)**	(25)
Net cash inflow/(outflow) from operating activities	**1,198**	(76)
Investing activities		
Acquisition of subsidiaries, net of cash acquired	**–**	12
Disposal of held for sale assets, net of cash transferred	**–**	285
Investment in associate	**–**	(6)
Additions to internally generated intangible assets	**(4)**	(4)
Net additions of property and equipment	**(2)**	(17)
Net cash (outflow)/inflow from investing activities	**(6)**	270
Financing activities		
Shares purchased in settlement of incentive schemes	**(4)**	–
Proceeds from issue of non-controlling interests	**–**	1
Share repurchase	**–**	(250)
Proceeds from increase in long-term debt	**349**	496
Repayment of long-term debt	**(423)**	(477)
Finance costs	**(170)**	(131)
STICS interest	**(31)**	(31)
Net movement in other borrowings, net of expenses	**(20)**	(36)
Dividends paid to equity holders of the parent	**(193)**	(226)
Net cash outflow from financing activities	**(492)**	(654)
Increase/(decrease) in cash and cash equivalents	**700**	(460)
Balance at beginning of year	**8,791**	9,288
Exchange adjustments on the translation of foreign operations	**(42)**	(37)
Balance at end of year	**9,449**	8,791

Notes to the consolidated accounts

For the year ended 31 December 2012

1. Basis of preparation

The financial statements of the Company as at and for the year ended 31 December 2012 comprise the consolidated financial statements of the Company and its subsidiaries (together referred to as "the Group") and the Group's interests in associates and jointly controlled entities.

The 2011 comparatives include the results of:

- the business of GOF and TIP portfolios up to the date of transfer back to AXA UK on 1 November 2011;
- the business of BHA from the date of acquisition on 31 January 2011; and
- the business of FLWL from the date of acquisition on 7 November 2011.

The consolidated financial statements as at and for the year ended 31 December 2012 have been prepared in accordance with IFRS as adopted by the European Union ("IFRS"). They have been prepared under the historical cost convention, as modified by the revaluation of investment property, financial assets and financial liabilities (including derivative instruments) at fair value through profit or loss.

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).

These financial statements have been prepared on a going concern basis. 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 are satisfied that the Group and 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.

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.

The International Accounting Standards Board ("IASB") issued the following amendment effective from 1 January 2012. It does not have a material impact on the Group:

- IAS 12: *Income taxes*. This amendment introduces a rebuttable assumption that where certain assets (including investment property and intangible assets) are measured at either fair value or under a revaluation model, deferred tax should be calculated on the assumption that the asset will be sold at its carrying amount.

There are no IFRIC interpretations that are effective for the first time for the financial year beginning on 1 January 2012 that have a material impact on the Group.

Below is a list of new standards and changes to existing standards that have been issued by the IASB with effective dates for accounting periods beginning on or after 1 January 2013, but where earlier adoption is permitted. They have not been early adopted by the Group in 2012 as they are yet to be endorsed by the European Union ("EU"), unless otherwise stated. The impact of these new requirements is currently being assessed by the Group.

New standards:

- IFRS 9: *Financial instruments: classification and measurement*. This IFRS reflects the first phase of the IASB's work on the replacement of IAS 39*: Financial Instruments: Recognition and Measurement,* and relates to the classification and measurement of financial assets as defined in IAS 39. The adoption of IFRS 9 will have a material impact on the classification and measurement of the Group's financial assets;
- IFRS 10: *Consolidated financial statements.* This IFRS provides a single consolidation model that identifies control as the basis for consolidation for all types of entities. It replaces the requirements in IAS 27: *Consolidated and Separate Financial Statements* and SIC 12: *Consolidation – Special Purpose Entities.* IFRS 10 is effective for annual periods beginning on or

after 1 January 2013. This standard has been endorsed by the EU for annual periods beginning on or after 1 January 2014, at the latest;

- IFRS 11: *Joint Arrangements.* This IFRS establishes principles for the financial reporting by parties to a joint arrangement. It supersedes the requirements in IAS 31: *Interests in Joint Ventures* and SIC 13: *Jointly Controlled Entities – Non-Monetary Contributions by Venturers.* IFRS 11 is effective for annual periods beginning on or after 1 January 2013. This standard has been endorsed by the EU for annual periods beginning on or after 1 January 2014, at the latest;
- IFRS 12: *Disclosure of Interests in Other Entities.* This IFRS combines, enhances and replaces disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities. IFRS 12 is effective for annual periods beginning on or after 1 January 2013. This standard has been endorsed by the EU for annual periods beginning on or after 1 January 2014, at the latest; and
- IFRS 13: *Fair Value Measurement.* This IFRS defines fair value and sets out in a single IFRS a framework for measuring fair value and requires disclosures about fair value measurements. IFRS 13 is effective for annual periods beginning on or after 1 January 2013 and has been endorsed by the EU.

Amendments to existing standards:

- IAS 1: *Presentation of Financial Statements.* The amendments require companies to group together items within other comprehensive income ("OCI") that may be reclassified to the profit or loss section of the income statement and reaffirm existing requirements that items in OCI and profit or loss should be presented as either a single statement or two consecutive statements. These amendments have been endorsed by the EU and are effective for annual periods beginning on or after 1 July 2012;
- IAS 19: *Employee Benefits.* The amendments are to eliminate the corridor approach and recognise all actuarial gains and losses in OCI as they occur; to immediately recognise all past service costs; and to replace interest cost and expected return on plan assets with a net interest amount, calculated by applying the discount rate to net defined benefit liability/ asset. Elimination of the corridor approach will have no impact on the results of the Group, as the existing policy is to recognise all actuarial gains and losses in OCI as they occur. These amendments have been endorsed by the EU and are effective for accounting periods beginning on or after 1 January 2013;
- IFRS 7: *Financial instruments: Disclosures.* This amendment includes new disclosures to facilitate comparison between those entities that prepare IFRS financial statements and those that prepare financial statements in accordance with US GAAP. These amendments have been endorsed by the EU and are effective for accounting periods beginning on or after 1 January 2013;
- Amendments to IFRS 10, 11 and 12 transition guidance: these amendments provide additional transition reliefs to IFRS 10, 11 and 12, limiting the requirement to provide adjusted comparative information to only the preceding comparative period. For disclosures related to unconsolidated structured entities, the amendments will remove the requirement to present comparative information for periods before IFRS 12 is first applied. These amendments are effective for annual reporting periods beginning on or after 1 January 2013;
- Amendments to IAS 32: *Financial instruments: presentation.* These amendments are to the application guidance in IAS 32 and clarify some of the requirements for offsetting financial assets and financial liabilities on the balance sheet. These amendments are effective for annual reporting periods beginning on or after 1 January 2014;
- Improvements to IFRS 2009 to 2011: These annual improvements address six issues to five standards in the 2009-2011 reporting cycle. They include changes to IFRS 1: *First time adoption*, IAS 1: *Financial statement presentation*, IAS 16: *Property, plant and equipment*, IAS 32: *Financial instruments: Presentation*, and IAS 34: *Interim financial reporting.* These improvements are effective for annual periods beginning on or after 1 January 2013.

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 balance sheet 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.

2. Segmental information

a) Summary

Segmental information is presented on the same basis as internal financial information used by the Group to evaluate operating performance. Segmental information relating to revenue and net income for the year ended 31 December 2012 includes a full year of all acquired subsidiaries. The segmental information relating to revenue and net income for the year ended 31 December 2011 includes BHA from 31 January 2011, FLWL from the date of acquisition on 7 November 2011 and the business of the GOF and TIP portfolios up to the date of their disposal on 1 November 2011.

The Group's management and internal reporting structure is based on the following operating segments:

- UK and Heritage comprising the former Friends Provident UK life and pensions business, the acquired AXA UK Life Businesses (including FLWL), BHA, Sesame Bankhall ("SBG") and FLI;
- FPI comprising FPIL, the overseas life assurance business within the UK life and pensions subsidiaries and the Group's share of AmLife and AmFamily; and
- Lombard.

Corporate functions are not strictly an operating segment, but are reported to management and are provided in the analysis below to reconcile the Group's reportable segments to total profit.

b) Operating segment information

(i) IFRS based operating profit

Year ended 31 December 2012	**UK & Heritage £m**	**FPI £m**	**Lombard £m**	**FLG corporate £m**	**RSL corporate £m**	**Total £m**
Life and pensions operating profit/(loss)	**383**	**(28)**	**30**	**–**	**–**	**385**
Longer term shareholder investment return	**(40)**	**–**	**–**	**17**	**–**	**(23)**
Other expense	**(1)**	**(3)**	**–**	**(6)**	**(28)**	**(38)**
Development costs	**(42)**	**(6)**	**(2)**	**–**	**–**	**(50)**
IFRS based operating profit/(loss) before tax	**300**	**(37)**	**28**	**11**	**(28)**	**274**
Tax on operating profit						**2**
IFRS based operating profit after tax attributable to ordinary shareholders						**276**
Operating earnings per share (pence)						**19.84**

Year ended 31 December 2011	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	RSL corporate £m	Total £m
Life and pensions operating profit	706	49	40	–	–	795
Longer term shareholder investment return	(5)	1	(1)	(21)	–	(26)
Other expense	(1)	(3)	–	(7)	(41)	(52)
Development costs	(28)	(7)	(1)	–	–	(36)
IFRS based operating profit/(loss) before tax	672	40	38	(28)	(41)	681
Tax on operating profit						38
IFRS based operating profit after tax attributable to ordinary shareholders						719
Operating earnings per share (pence)						50.43

(ii) Reconciliation of IFRS based operating result before tax to profit before tax from continuing operations

Year ended 31 December 2012	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	RSL corporate £m	Total £m
IFRS based operating profit/(loss) before tax	**300**	**(37)**	**28**	**11**	**(28)**	**274**
Non-recurring items[(i)(ii)]	**(273)**	**–**	**(1)**	**18**	**(2)**	**(258)**
Amortisation and impairment of acquired value of in-force business	**(268)**	**(94)**	**(55)**	**–**	**–**	**(417)**
Amortisation and impairment of other intangible assets	**(46)**	**(22)**	**(28)**	**(1)**	**–**	**(97)**
Interest payable on STICS	**31**	**–**	**–**	**–**	**–**	**31**
Short-term fluctuations in investment return[(iii)]	**298**	**(4)**	**(1)**	**(18)**	**–**	**275**
Profit/(loss) before policyholder and shareholder tax	**42**	**(157)**	**(57)**	**10**	**(30)**	**(192)**
Policyholder tax	**258**	**–**	**–**	**–**	**–**	**258**
Profit/(loss) before tax from continuing operations	**300**	**(157)**	**(57)**	**10**	**(30)**	**66**

Year ended 31 December 2011	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	RSL corporate £m	Total £m
IFRS based operating profit/(loss) before tax	672	40	38	(28)	(41)	681
Non-recurring items[(iv)]	(178)	(1)	(1)	–	–	(180)
Amortisation and impairment of acquired value of in-force business	(483)	(126)	(66)	–	–	(675)
Amortisation of other intangible assets	(45)	(8)	(30)	(1)	–	(84)
Interest payable on STICS	31	–	–	–	–	31
Short-term fluctuations in investment return[(iii)]	(247)	(10)	(1)	(3)	–	(261)
Loss before policyholder and shareholder tax	(250)	(105)	(60)	(32)	(41)	(488)
Policyholder tax	220	–	–	–	–	220
Loss before tax from continuing operations	(30)	(105)	(60)	(32)	(41)	(268)

(i) UK and Heritage non-recurring items for the year ended 31 December 2012 include £(124) million of costs in respect of the separation and integration program, £(75) million in respect of Solvency II and finance system developments, £(82) million of costs in respect of the transition and service improvement elements of the outsourcing arrangement with Diligenta offset partially by £31 million release of reserves, non-recurring costs of £(17) million related to the capital optimisation programme and other non-recurring costs of £(6) million. Lombard non-recurring costs relate to £1 million of Solvency II costs.

(ii) Non-recurring items of £16 million across both FLG and RSL corporate include a curtailment gain of £32 million arising on the defined benefit pension scheme, of which £22 million relates to the closure of the scheme to future service accrual and £10 million to reduced future anticipated costs due to the Diligenta outsourcing arrangement. This is partially offset by £(16) million of costs in relation to the transition of ROL, with £(14) million recognised within FLG corporate and £(2) million recognised within RSL corporate. The transition costs include £(10) million mainly in relation to the costs of transferring an operating agreement, under which the Company outsources most of its operations, from ROL to the Group, and the recognition of an onerous lease provision in respect of the ROL offices to be taken on by the Group; a further £(6) million relates to restructuring activities. It is expected that the majority of this expenditure will be incurred in 2013.

(iii) Includes shareholder investment return short-term fluctuations and investment variances arising from the mismatching of fixed-interest assets and the liabilities they are backing as well as the impact of credit default assumptions. This latter variance reflects profits or losses in excess of the expected investment return on the assets and the impact of the corresponding economic assumption changes on the liabilities. In 2012, this includes £99 million benefit from the release of unit-linked tax loss provisions as a result of updated fund growth estimates.

(iv) UK and Heritage non-recurring items for the year ended 31 December 2011 include £68 million (£67 million net of stamp duty expenses) in respect of the gain on acquisition of BHA and £48 million (£46 million net of stamp duty expenses) in respect of the gain on acquisition of WLUK. This is offset by £(293) million of non-recurring costs comprising £(133) million of separation and integration costs in respect of the acquired businesses, £(55) million in respect of Solvency II and other finance system developments, £(84) million of reserve impacts in respect of the outsourcing arrangement with Diligenta and £(21) million of other costs.

(iii) Revenue and expenses

For the year ended 31 December 2012	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	RSL corporate £m	Elimination of inter-segment amounts[(ii)] £m	Total £m
Gross earned premiums on insurance and investment contracts	**5,985**	**1,268**	**2,377**	**–**	**–**	**–**	**9,630**
Investment contract premiums[(i)]	**(4,197)**	**(1,150)**	**(2,377)**	**–**	**–**	**–**	**(7,724)**
Gross earned premiums	**1,788**	**118**	**–**	**–**	**–**	**–**	**1,906**
Premiums ceded to reinsurers	**(597)**	**(5)**	**–**	**–**	**–**	**–**	**(602)**
Net earned premiums	**1,191**	**113**	**–**	**–**	**–**	**–**	**1,304**
Fee and commission income	**569**	**75**	**105**	**–**	**–**	**–**	**749**
Investment return	**7,584**	**305**	**1,154**	**111**	**17**	**(94)**	**9,077**
Total revenue	**9,344**	**493**	**1,259**	**111**	**17**	**(94)**	**11,130**
Intersegment revenue	**1**	**–**	**–**	**77**	**16**	**(94)**	**–**
Total external revenue	**9,343**	**493**	**1,259**	**34**	**1**	**–**	**11,130**
Net claims and benefits paid	**(3,477)**	**(18)**	**–**	**–**	**–**	**–**	**(3,495)**
Movement in insurance and investment contract liabilities	**(3,631)**	**(347)**	**(1,066)**	**–**	**–**	**–**	**(5,044)**
Transfer to unallocated surplus	**(1)**	**(3)**	**–**	**–**	**–**	**–**	**(4)**
Movement in net assets attributable to unit-holders	**(118)**	**–**	**–**	**–**	**–**	**–**	**(118)**
Acquisition expenses	**(483)**	**(89)**	**(42)**	**–**	**–**	**–**	**(614)**
Administrative and other expenses	**(1,195)**	**(183)**	**(207)**	**(20)**	**(24)**	**–**	**(1,629)**
Finance costs	**(138)**	**(8)**	**(1)**	**(81)**	**(23)**	**94**	**(157)**
Total claims, benefits and expenses	**(9,043)**	**(648)**	**(1,316)**	**(101)**	**(47)**	**94**	**(11,061)**
Intersegment expenses	**(77)**	**(1)**	**–**	**(16)**	**–**	**94**	**–**
Total external claims, benefits and expenses	**(8,966)**	**(647)**	**(1,316)**	**(85)**	**(47)**	**–**	**(11,061)**
Share of loss of associates and joint venture	**(1)**	**(2)**	**–**	**–**	**–**	**–**	**(3)**
Profit/(loss) before tax from continuing operations[(iii)]	**300**	**(157)**	**(57)**	**10**	**(30)**	**–**	**66**
Policyholder tax	**(258)**	**–**	**–**	**–**	**–**	**–**	**(258)**
Shareholder tax	**121**	**26**	**22**	**(18)**	**–**	**–**	**151**
Segmental result after tax	**163**	**(131)**	**(35)**	**(8)**	**(30)**	**–**	**(41)**

(i) Accounted for as deposits under IFRS.
(ii) Eliminations include inter-segment loan interest. Inter-segment transactions are undertaken on an arm's length basis.
(iii) Profit before tax from continuing operations is shown gross of intersegment revenues and expenses.

For the year ended 31 December 2011	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	RSL corporate £m	Elimination of inter-segment amounts[ii] £m	Total £m
Gross earned premiums on insurance and investment contracts	5,270	1,260	2,373	–	–	–	8,903
Investment contract premiums[i]	(3,225)	(1,177)	(2,373)	–	–	–	(6,775)
Gross earned premiums	2,045	83	–	–	–	–	2,128
Premiums ceded to reinsurers	(598)	(1)	–	–	–	–	(599)
Net earned premiums	1,447	82	–	–	–	–	1,529
Fee and commission income	546	114	110	1	–	–	771
Investment return	2,657	(400)	(461)	57	34	(83)	1,804
Total revenue	4,650	(204)	(351)	58	34	(83)	4,104
Inter segment revenue	2	1	–	47	33	(83)	–
Total external revenue	4,648	(205)	(351)	11	1	–	4,104
Other income[iii]	134	–	–	–	–	–	134
Net claims and benefits paid	(3,209)	(7)	–	–	–	–	(3,216)
Movement in insurance and investment contract liabilities	(183)	346	548	–	–	–	711
Transfer from unallocated surplus	490	(6)	–	–	–	–	484
Movement in net assets attributable to unit-holders	48	–	–	–	–	–	48
Acquisition expenses	(497)	(47)	(47)	–	–	–	(591)
Administrative and other expenses	(1,348)	(177)	(208)	(8)	(35)	–	(1,776)
Finance costs	(115)	(9)	(2)	(82)	(40)	83	(165)
Total claims, benefits and expenses	(4,814)	100	291	(90)	(75)	83	(4,505)
Inter segment expenses	(47)	(3)	–	(33)	–	83	–
Total external claims, benefits and expenses	(4,767)	103	291	(57)	(75)	–	(4,505)
Share of loss of associates and joint venture	–	(1)	–	–	–	–	(1)
Loss before tax from continuing operations[ii]	(30)	(105)	(60)	(32)	(41)	–	(268)
Policyholder tax	(220)	–	–	–	–	–	(220)
Shareholder tax	437	(4)	29	(5)	–	–	457
Segmental result after tax	187	(109)	(31)	(37)	(41)	–	(31)

(i) Accounted for as deposits under IFRS.
(ii) Eliminations include inter segment loan interest. Intersegment transactions are undertaken on an arm's length basis.
(iii) Includes gains on acquisitions of BHA (£68 million) and FLWL (£48 million).
(iv) Loss before tax from continuing operations is shown gross of intersegment revenue and expenses.

(iv) Products and services

For the year ended 31 December 2012	Gross earned premiums £m	Net earned premiums £m	Fee and commission income £m	Total external revenue[i] £m
UK and Heritage				
Corporate benefits	**30**	**24**	**98**	**122**
Protection	**224**	**144**	**–**	**144**
Retirement income	**321**	**321**	**–**	**321**
Heritage:				
– With-profits	**397**	**344**	**3**	**347**
– Pensions	**71**	**(15)**	**178**	**163**
– Investments	**139**	**132**	**79**	**211**
– Protection	**426**	**278**	**(5)**	**273**
– Annuities	**180**	**(37)**	**6**	**(31)**
– Other	**–**	**–**	**210**	**210**
FPI				
– Investment	**92**	**90**	**68**	**158**
– Protection	**26**	**23**	**–**	**23**
– Other	**–**	**–**	**7**	**7**
Lombard				
– Investment	**–**	**–**	**105**	**105**
Total	**1,906**	**1,304**	**749**	**2,053**

(i) Total external revenue does not include investment return of £9,077 million (2011: £1,804 million).

For the year ended 31 December 2011	Gross earned premiums £m	Net earned premiums £m	Fee and commission income £m	Total external revenue £m
UK and Heritage				
Corporate benefits	80	80	69	149
Protection	155	90	–	90
Retirement income	273	273	–	273
Heritage:				
– With-profits	688	537	34	571
– Pensions	169	161	177	338
– Investments	120	112	71	183
– Protection	543	397	–	397
– Annuities	17	(203)	11	(192)
– Other	–	–	184	184
FPI				
– Investment	70	69	101	170
– Protection	13	13	–	13
– Other	–	–	13	13
Lombard				
– Investment	–	–	110	110
– Corporate	–	–	1	1
Total	2,128	1,529	771	2,300

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.

(v) Assets and liabilities

As at 31 December 2012	**UK & Heritage £m**	**FPI £m**	**Lombard £m**	**FLG corporate £m**	**RSL corporate £m**	**Elimination of inter-segment amounts[(i)] £m**	**Total £m**
Segment assets	**99,255**	**8,306**	**19,485**	**1,966**	**136**	**(1,443)**	**127,705**
Investments in associates held for sale and joint venture	**4**	**30**	**–**	**–**	**–**	**–**	**34**
Total assets	**99,259**	**8,336**	**19,485**	**1,966**	**136**	**(1,443)**	**127,739**
Total liabilities	**95,169**	**8,014**	**19,116**	**1,182**	**3**	**(1,443)**	**122,041**
Other segment information:							
– Capital expenditure	**1**	**–**	**4**	**2**	**–**	**–**	**7**
– Depreciation	**1**	**–**	**2**	**2**	**–**	**–**	**5**
– Amortisation	**314**	**97**	**83**	**1**	**–**	**–**	**495**
– Impairment	**–**	**19**	**–**	**–**	**–**	**–**	**19**

As at 31 December 2011	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	RSL corporate £m	Elimination of inter-segment amounts[(i)] £m	Total £m
Segment assets	99,262	7,450	18,190	1,725	294	(1,552)	125,369
Investments in associates and joint venture	5	32	–	–	–	–	37
Total assets	99,267	7,482	18,190	1,725	294	(1,552)	125,406
Total liabilities	94,551	7,189	17,773	1,003	447	(1,552)	119,411
Other segment information:							
– Capital expenditure	7	–	4	9	–	–	20
– Depreciation	1	–	1	2	–	–	4
– Amortisation	458	134	95	1	–	–	688
– Impairment	71	–	–	–	–	–	71

(i) Eliminations mainly comprise intercompany loans.

c) 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 2012	**UK £m**	**Rest of the world £m**	**Total £m**
Gross earned premiums	**1,785**	**121**	**1,906**
Fee and commission income	**587**	**162**	**749**
Revenue from external customers	**2,372**	**283**	**2,655**
Investment return			**9,077**
Premiums ceded to reinsurers			**(602)**
Total revenue			**11,130**

For the year ended 31 December 2011	UK £m	Rest of the world £m	Total £m
Gross earned premiums	2,042	86	2,128
Fee and commission income	566	205	771
Revenue from external customers	2,608	291	2,899
Investment return			1,804
Premiums ceded to reinsurers			(599)
Total revenue			4,104

3. Taxation

(a) Tax recognised in the consolidated income statement

For the year ended 31 December	**2012 £m**	2011 £m
Current tax		
UK corporation tax at 24.5% (2011: 26.5%)	**68**	52
Adjustments in respect of prior periods	**(4)**	(11)
Overseas taxation	**11**	18
Total current tax charge	**75**	59
Deferred tax		
Origination and reversal of temporary differences	**31**	(322)
Adjustments in respect of prior periods	**1**	26
Total deferred tax charge/(credit)	**32**	(296)
Total tax charge/(credit)	**107**	(237)
Analysis:		
– policyholder tax	**258**	220
– shareholder tax	**(151)**	(457)
Total tax charge/(credit)	**107**	(237)

Policyholder tax is tax on the income and investment returns charged to policyholders of linked and with-profits funds. Shareholders' tax is tax charged to shareholders on the profits of the Group.

During the year legislation was enacted to bring a decrease in the rate of corporation tax from 24% on 1 April 2012 to 23% on 1 April 2013. Under IFRS, deferred tax is calculated using rates substantively enacted by the balance sheet date and as such the reduction to a 23% rate has been taken into account in deferred tax balances. The average rate of corporation tax for the full calendar year is 24.5%.

Further incremental rate reductions were announced in the Chancellor's Autumn Statement on 5 December 2012 and Budget on 20 March 2013. These will reduce the rate to 21% from 1 April 2014 and to 20% from 1 April 2015. The benefit to the Group's net assets arising from these further reductions is estimated to be approximately £90 million in total and will be recognised upon substantive enactment of the legislation.

b) Factors affecting tax charge for year

For the year ended 31 December	2012 £m	2011 £m
Profit/(loss) before tax from continuing operations	**66**	(268)
Profit/(loss) before tax from continuing operations determined with reference to the average rate of corporation tax in the UK of 24.5% (2011: 26.5%)	**16**	(71)
Effects of:		
– non-taxable income	**(120)**	(232)
– deductions not allowable for tax purposes	**26**	22
– tax on reserving adjustments	**24**	41
– overseas tax	**(10)**	(6)
– valuation of tax losses	**(75)**	(123)
– valuation of unrealised capital losses	**43**	–
– adjustments in respect of prior periods	**(2)**	(8)
– non-taxable gain on acquisition	**–**	(31)
– reduction in corporation tax rate to 24% (2011: 25%)	**(61)**	(60)
– non-taxable result of Resolution holding companies	**8**	11
– policyholder tax	**258**	220
Total tax charge/(credit)	**107**	(237)

4. Appropriations of profit

a) Dividends paid on ordinary shares

A final dividend in respect of 2011 of 13.42 pence per ordinary share was paid on 21 May 2012 comprising £150 million of cash and £35 million of shares issued in lieu of dividends. As required by IFRS, the costs of these dividends are taken directly to reserves. An interim dividend of 7.05 pence per ordinary share was paid on 5 October 2012 comprising £43 million of cash and £55 million of shares issued in lieu of dividends.

As required by IAS 10: *Events after the balance sheet date*, dividends declared after the balance sheet date are not accrued in these accounts. Subject to the approval of shareholders at the annual general meeting on 16 May 2013, a dividend of 14.09 pence per share will be paid on 20 May 2013 amounting to £200 million. Accordingly, this amount is not reflected in these financial statements. The scrip dividend alternative is being discontinued in respect of the 2012 final dividend. Shareholders will be offered a DRIP in its place.

b) Step-up tier one Insurance Capital Securities interest

The Step-up tier one Insurance Capital Securities ("STICS") are accounted for as equity instruments under IFRS and consequently the interest on the STICS is recorded in the financial statements as though it were a dividend.

Interest on the 2003 STICS is paid in equal instalments in May and November each year at a rate of 6.875%. During the year ended 31 December 2012, interest of £14 million (2011: £14 million) was paid to the 2003 STICS holders.

Interest on the 2005 STICS is paid annually in June at a rate of 6.292%. During the year ended 31 December 2012, interest of £17 million (2011: £17 million) was paid to the 2005 STICS holders.

These interest payments are shown as movements in reserves in these financial statements together with the related tax relief.

5. Earnings per share

a) Basic and operating earnings per share from continuing operations

Earnings per share have been calculated based on the 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. The directors consider that operating earnings per share provides a better indication of the performance of the Group.

For the year ended 31 December	2012 Earnings £m	2012 Pence per share	2011 Earnings £m	2011 Pence per share
Loss after tax attributable to equity holders of the parent	**(72)**	**(5.17)**	(62)	(4.35)
Add back:				
short-term fluctuations in investment return	**(275)**	**(19.76)**	261	18.31
non-recurring items	**258**	**18.54**	180	12.62
amortisation and impairment of acquired intangible assets	**514**	**36.94**	759	53.23
tax credit on items excluded from operating profit	**(149)**	**(10.71)**	(419)	(29.38)
Operating profit after tax attributable to equity holders of the parent	**276**	**19.84**	719	50.43

b) Diluted basic earnings per share from continuing operations

There were no dilutive factors for the year ended 31 December 2012 or for the year ended 31 December 2011.

c) Weighted average number of ordinary shares

For the year ended 31 December 2012	Actual	Weighted
Issued ordinary shares at beginning of period	**1,376,188,989**	**1,376,188,989**
Own shares held by the Group	**(2,661,384)**	**(2,661,384)**
	1,373,527,605	**1,373,527,605**
Effect of:		
– scrip dividend (final 2011)	**15,484,945**	**9,477,125**
– scrip dividend (interim 2012)	**26,435,094**	**6,283,752**
– reduction in own shares held	**2,661,384**	**1,999,674**
Number of ordinary shares at end of period	**1,418,109,028**	**1,391,288,156**

For the year ended 31 December 2011	Actual	Weighted
Issued ordinary shares at beginning of period	1,452,564,371	1,452,564,371
Own shares held by the Group	(8,579,292)	(8,579,292)
	1,443,985,079	1,443,985,079
Effect of:		
– scrip dividend (final 2010)	13,639,313	8,183,588
– share repurchase	(92,990,516)	(31,044,327)
– scrip dividend (interim 2011)	2,975,821	717,458
– reduction in own shares held	8,579,292	4,324,903
– own shares held through acquisition	(2,661,384)	(393,739)
Number of ordinary shares at end of period	1,373,527,605	1,425,772,962

6. Intangible assets

Movements in intangible assets are as follows:

For the year ended 31 December 2012	AVIF £m	Other £m	Total £m
Cost			
At 1 January 2012	**5,521**	**560**	**6,081**
Additions	**–**	**4**	**4**
Foreign exchange adjustments	**(16)**	**(4)**	**(20)**
At 31 December 2012	**5,505**	**560**	**6,065**
Amortisation and impairment			
At 1 January 2012	**1,084**	**150**	**1,234**
Amortisation charge for the year(i)	**412**	**83**	**495**
Impairment charge for the year(i)(ii)	**5**	**14**	**19**
Foreign exchange adjustments	**(4)**	**–**	**(4)**
At 31 December 2012	**1,497**	**247**	**1,744**
Carrying amounts at 31 December 2012	**4,008**	**313**	**4,321**

For the year ended 31 December 2011	AVIF £m	Other £m	Total £m
Cost			
At 1 January 2011	5,107	528	5,635
Acquisition of subsidiaries(iii)	411	37	448
Other additions	–	4	4
Disposals	–	(5)	(5)
Foreign exchange adjustments	3	(4)	(1)
At 31 December 2011	5,521	560	6,081
Amortisation and impairment			
At 1 January 2011	422	73	495
Amortisation charge for the year(iv)	604	84	688
Impairment charge for the year(iv)	71	–	71
Disposals	–	(5)	(5)
Foreign exchange adjustments	(13)	(2)	(15)
At 31 December 2011	1,084	150	1,234
Carrying amounts at 31 December 2011	4,437	410	4,847

(i) Amortisation and impairment charges are included within administrative and other expenses in the consolidated income statement.
(ii) Includes a £12 million impairment of goodwill and £2 million impairment of distributor relationships in respect of Financial Business Partners AG ("fpb") part of the FPI segment. AVIF impairment of £5 million has been recognised within the Overseas Life Assurance Business in the FPI segment, as a result of assumption changes and worsening persistency.
(iii) Acquisitions in 2011 related to BHA and WLUK.
(iv) Includes £71 million impairment charge within UK-BHA and accelerated amortisation of £130 million within UK-AXA. This was due to a change in reserving methodology made in 2011 to allow for negative reserving on protection business.

In determining the fair value of identified intangible assets, appropriate valuation methodologies were applied, given the nature of the intangible assets acquired.

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.

For each type of asset, the useful economic life was determined, being the period over which the asset is expected to contribute directly or indirectly to future cash flows. The value of the assets will be amortised over the respective useful economic lives.

The "AXA" and "BUPA" brands and associated brands that existed within the acquired businesses have been retained by AXA UK plc and Bupa Finance plc respectively and as such no value has been attributed to them.

The "Friends" brand has been retained by the Group and during 2011, a rebranding exercise was carried out to change all inherited brands to "Friends Life".

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 consolidated statement of financial position as AVIF. AVIF is shown gross of policyholder and shareholder tax of £849 million (2011: £995 million), with the offsetting balance included in deferred taxation. The AVIF is based on the value of in-force business calculated on a market consistent embedded value basis.

a) AVIF

AVIF is allocated to CGUs, which represent the lowest level within the Group at which AVIF is monitored for internal management purposes. An analysis of AVIF by operating segments used for segmental reporting (see note 2) is set out below:

As at 31 December 2012	**Cost £m**	**Impairment £m**	**Amortisation £m**	**Net book value £m**
UK and Heritage	**3,907**	**(71)**	**(876)**	**2,960**
FPI	**1,014**	**(5)**	**(339)**	**670**
Lombard	**584**	**–**	**(206)**	**378**
Total	**5,505**	**(76)**	**(1,421)**	**4,008**

As at 31 December 2011	Cost £m	Impairment £m	Amortisation £m	Net book value £m
UK and Heritage	3,907	(71)	(608)	3,228
FPI	1,014	–	(250)	764
Lombard	600	–	(155)	445
Total	5,521	(71)	(1,013)	4,437

b) Other intangibles

Other intangibles are made up of the following:

As at 31 December 2012	**Cost £m**	**Amortisation and impairment £m**	**Net book value £m**
Distribution channels and customer relationships	**441**	**(174)**	**267**
Brand	**49**	**(28)**	**21**
Software	**58**	**(33)**	**25**
Goodwill	**12**	**(12)**	**–**
Total	**560**	**(247)**	**313**

As at 31 December 2011	Cost £m	Amortisation £m	Net book value £m
Distribution channels and customer relationships	444	(112)	332
Brand	49	(19)	30
Software	54	(19)	35
Goodwill	13	–	13
Total	560	(150)	410

c) Impairment

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.

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.

As at 31 December 2012, based on an impairment review of each of the CGUs, the directors are satisfied that none of the Group's intangible assets are impaired except as stated below.

Impairment of FPI intangible assets

FPI's OLAB operations, which principally operate in Germany, have experienced reduced business volumes during 2012. As a result of consequent assumption changes to expenses and worsening persistency, recoverable VIF has reduced below the carrying value of AVIF and an impairment charge of £5 million has been recognised.

The recoverable amount for goodwill and distributor relationships arising on the acquisition of fpb, the Group's distributor of German business, have been calculated based on forecast future cashflows. As a result of the expected reduced business volumes, the recoverable amount has been assessed as nil and the carrying values of £12 million for goodwill and £2 million for distributor relationships have been fully impaired.

7. Financial assets

The Group's financial assets are summarised by measurement category as follows:

As at 31 December	2012 £m	2011 £m
Fair value through profit or loss (note 7(a))		
Designated on initial recognition	**105,172**	102,756
Held for trading	**812**	875
Loans at amortised cost (note 7(f))	**6**	5
Total financial assets	**105,990**	103,636

Derivative financial instruments are classified as held for trading. All other financial assets recognised at fair value through profit and loss are designated as such on initial recognition.

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

As at 31 December 2012	With-profits £m	Unit-linked £m	Non-linked annuities £m	Non-linked other £m	Shareholder £m	Total £m
Shares and other variable yield securities	**6,801**	**56,940**	**–**	**125**	**13**	**63,879**
Debt securities and other fixed income securities:						
– Government securities	**8,903**	**7,617**	**1,018**	**1,074**	**79**	**18,691**
– Corporate bonds	**8,533**	**5,891**	**6,546**	**1,302**	**124**	**22,396**
Derivative financial instruments	**675**	**22**	**107**	**8**	**–**	**812**
Deposits with credit institutions	**–**	**206**	**–**	**–**	**–**	**206**
Total financial assets held at fair value	**24,912**	**70,676**	**7,671**	**2,509**	**216**	**105,984**

As at 31 December 2011	With-profits £m	Unit-linked £m	Non-linked annuities £m	Non-linked other £m	Shareholder £m	Total £m
Shares and other variable yield securities	7,106	53,487	–	108	9	60,710
Debt securities and other fixed income securities:						
– Government securities:						
– Loaned government securities(i)	–	–	–	198	–	198
– Other government securities	8,469	8,507	1,069	993	274	19,312
– Corporate bonds	9,020	5,665	5,969	1,214	287	22,155
Derivative financial instruments	762	7	97	9	–	875
Deposits with credit institutions	–	381	–	–	–	381
Total financial assets held at fair value	25,357	68,047	7,135	2,522	570	103,631

(i) On 11 May 2011, the Group provided a £200 million collateralised loan to Barclays Bank plc which matured on 31 August 2012. UK government securities were loaned and the assets remained on balance sheet at 31 December 2011 as substantially all the risks and rewards of ownership were retained by the Group.

As at 31 December 2012, the fair value of the collateral received from counterparties was £576 million (2011: £850 million). No collateral received from the counterparties has been sold or re-pledged.

The unit-linked column and with-profits column in the tables above include £744 million (2011: £1,129 million) of financial assets. These comprise £535 million of shares and other variable yield securities, £122 million of corporate bonds and £87 million of government securities (2011: £818 million of shares and other variable yield securities, £219 million of government securities and £92 million of corporate bonds) relating to the non-controlling interests in the OEICs that have been consolidated as the Group holding is 50% or more.

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 £96,900 million (2011: £93,863 million) are not expected to be realised for more than 12 months after the balance sheet date in line with the expected maturity of insurance/investment contract liabilities.

Asset-backed securities (excluding those held by the linked funds) amount to £3,940 million (2011: £3,060 million) and 96% (2011: 94%) of these are at investment grade.

b) Determination of fair value hierarchy

In accordance with the requirements of IFRS 7: *Financial Instruments: Disclosures*, financial assets 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 asset-backed securities), derivative financial instruments and deposits with credit institutions.

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 certificates of deposit and derivatives.

Level 3 – inputs 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 and private equity investments.

The majority of the Group's assets held at fair value are valued based on quoted market information or market observable data. Approximately 4% (5% excluding unit-linked assets) are based on valuation techniques where significant observable market data are not available or the price is not observable from current market transactions. However, the fair value measurement objective of these assets remains the same, that is, an exit price from the perspective of the Group.

The fair values of these 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 set out below:

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.

Private loans are valued using discounted cash flows, which are carried out by investment managers and reviewed by management. The interest rate used when calculating the present value is derived from the UK Gilts Curve, adjusting the spread by the movement in the most appropriate IBoxx GBP Corp Curve associated with the loan rating, where available. All spreads are reviewed on a quarterly basis and any spreads that appear inappropriate taking into consideration loan details (loan sector, maturity and rating), available market proxies, comparable instruments and underlying securities are recalibrated accordingly.

The Group has invested in a mortgage loan issued by AXA Equitable in the US. The mortgage loan is secured against the property. The loan is valued by external real estate advisors using discounted cash flows. The discount rate used in the calculation is determined by adding an appropriate spread (based on property type, prevailing interest rates and the current mortgage spread over US treasuries) to the yield of an appropriate US Treasury Bond with the maturity closest to the maturity of the loan. The loan is denominated in US Dollars. As at 31 December 2012, the loan was valued at £80 million (2011: £84 million).

Financial liabilities at fair value are categorised into level 1, 2 or 3 hierarchies. They include unit-linked contracts, amounts due to reinsurers, net asset value attributable to unit-holders (non-controlling interests in the OEICs that are consolidated) and derivative financial instruments. The classifications take into account the types of inputs used to determine the fair value measurements. For unit-linked funds this has been undertaken on a fund-by-fund basis. For the net asset value attributable to unit-holders, this has been analysed in the same proportion as the underlying consolidated investments categorisation.

The Group has financial liabilities which contain discretionary participation features of £9,543 million (2011: £9,426 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.

An analysis of 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 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).

	Including unit-linked				Excluding unit-linked			
As at 31 December 2012	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**
Financial assets held at fair value								
Shares and other variable yield securities	**53,459**	**7,608**	**2,812**	**63,879**	**5,156**	**555**	**1,228**	**6,939**
Debt securities and other fixed income securities:								
– government securities	**18,209**	**474**	**8**	**18,691**	**10,917**	**152**	**5**	**11,074**
– corporate bonds (including ABS)	**15,595**	**5,653**	**1,148**	**22,396**	**12,121**	**3,788**	**596**	**16,505**
Derivative financial instruments	**52**	**760**	**–**	**812**	**32**	**758**	**–**	**790**
Deposits with credit institutions	**206**	**–**	**–**	**206**	**–**	**–**	**–**	**–**
Total financial assets held at fair value	**87,521**	**14,495**	**3,968**	**105,984**	**28,226**	**5,253**	**1,829**	**35,308**
Financial liabilities held at fair value								
Unit-linked investment contracts	**–**	**67,428**	**–**	**67,428**	**–**	**–**	**–**	**–**
Amounts due to reinsurers	**–**	**1,767**	**–**	**1,767**	**–**	**1,767**	**–**	**1,767**
Net asset value attributable to unit-holders	**754**	**–**	**–**	**754**	**17**	**–**	**–**	**17**
Derivative financial instruments	**8**	**222**	**–**	**230**	**4**	**220**	**–**	**224**
Total financial liabilities held at fair value	**762**	**69,417**	**–**	**70,179**	**21**	**1,987**	**–**	**2,008**

	Including unit-linked				Excluding unit-linked			
As at 31 December 2011	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets held at fair value								
Shares and other variable yield securities	47,801	9,699	3,210	60,710	5,827	272	1,124	7,223
Debt securities and other fixed income securities:								
– government securities	19,220	285	5	19,510	10,913	85	5	11,003
– corporate bonds (including ABS)	11,952	8,944	1,259	22,155	9,420	6,560	510	16,490
Derivative financial instruments	67	808	–	875	60	808	–	868
Deposits with credit institutions	366	15	–	381	–	–	–	–
Total financial assets held at fair value	79,406	19,751	4,474	103,631	26,220	7,725	1,639	35,584
Financial liabilities held at fair value								
Unit-linked investment contracts	–	65,259	–	65,259	–	–	–	–
Amounts due to reinsurers	–	1,800	–	1,800	–	1,800	–	1,800
Net asset value attributable to unit-holders	1,173	–	–	1,173	36	–	–	36
Derivative financial instruments	44	243	–	287	26	239	–	265
Total financial liabilities held at fair value	1,217	67,302	–	68,519	62	2,039	–	2,101

c) Transfers between level 1 and level 2

During the year, £3,732 million (2011: £452 million) of corporate bonds, shares and other variable yield securities were transferred from level 1 to level 2 and £10,496 million (2011: £1,413 million) of corporate bonds, shares and other variable yield securities were transferred from level 2 to level 1. These movements arose from changes in the availability of current quoted prices, market activity and refinements to the liquidity assessment methodology applied for corporate bond classification and available quoted price methodology applied for the classification of shares and other variable yield securities. There were no significant transfers between level 1 and level 2 for other financial assets.

d) Financial instruments

The following table shows a reconciliation of Level 3 financial assets which are recorded at fair value.

	Shares and other variable yield securities £m	**Government bonds £m**	**Corporate bonds (including ABS) £m**	**Total financial assets held at fair value £m**
At 1 January 2012	**3,210**	**5**	**1,259**	**4,474**
Total gains/(losses) in consolidated income statement	**66**	**(1)**	**46**	**111**
Purchases	**1,262**	**–**	**305**	**1,567**
Sales	**(1,340)**	**–**	**(526)**	**(1,866)**
Net transfer (to)/from level 1 and level 2	**(349)**	**4**	**84**	**(261)**
Foreign exchange adjustments	**(37)**	**–**	**(20)**	**(57)**
At 31 December 2012	**2,812**	**8**	**1,148**	**3,968**
Total gains/(losses) for the year included in profit or loss for assets held at 31 December 2012	**57**	**(1)**	**37**	**93**

	Shares and other variable yield securities £m	Government bonds £m	Corporate bonds (including ABS) £m	Total financial assets held at fair value £m
At 1 January 2011	3,349	–	1,103	4,452
Acquisition through business combinations	3	–	26	29
Total (losses)/gains in consolidated income statement	(82)	–	11	(71)
Purchases	557	4	120	681
Sales	(582)	–	(86)	(668)
Net transfer (to)/from level 1 and level 2	(4)	1	104	101
Foreign exchange adjustments	(31)	–	(19)	(50)
At 31 December 2011	3,210	5	1,259	4,474
Total (losses)/gains for the year included in profit or loss for assets held at 31 December 2011	(158)	–	11	(147)

Transfers out of level 3 arise due to availability of prices in an active market and due to refinements to the liquidity assessment methodology applied for corporate bond classification.

e) Level 3 sensitivity analysis

		2012		2011
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	**2,139**	**–**	2,835	–
Shares and other variable yield securities	**1,228**	**246**	1,124	224
Government bonds	**5**	**1**	5	1
Corporate bonds (including ABS)	**596**	**60**	510	51
Total Level 3 financial assets	**3,968**	**307**	4,474	276

For unit-linked investments, the policyholders bear the investment risk and any change in asset values is matched by a broadly equivalent change in the liability. Shareholder profits from annual management charges levied on such funds will, however, vary according to the change in asset values leading to some limited investment risk.

For shares and other variable yield securities, where there is no active market the price at year end could reasonably be expected to be higher or lower by approximately 20%.

For government bonds and corporate bonds, it could reasonably be expected that the current prices could be higher or lower by approximately 10% to reflect changes in the credit ratings of the underlying bonds.

f) Loans

As at 31 December	**2012 £m**	2011 £m
Mortgage loans	**2**	2
Other loans	**4**	3
Total loans	**6**	5

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

g) Assets backing unit-linked liabilities

Policyholder liabilities relating to unit-linked business are classified as either insurance or investment contracts. The net assets backing these liabilities are included within the relevant balances in the consolidated statement of financial position and are analysed as follows:

As at 31 December	**2012 £m**	2011 £m
Shares and other variable yield securities	**56,940**	53,487
Debt securities and other fixed-income securities	**13,508**	14,172
Derivative financial instruments	**22**	7
Deposits with credit institutions	**206**	381
Total financial assets held at fair value	**70,676**	68,047
Investment properties	**1,451**	1,688
Insurance and other receivables	**723**	875
Cash and cash equivalents	**4,835**	4,779
Total assets	**77,685**	75,389
Net asset value attributable to unit-holders[(i)] and other payables	**(1,743)**	(1,261)
Total unit-linked net assets	**75,942**	74,128

(i) Represents consolidation adjustments in respect of OEICs, which the Group are deemed to control.

8. Staff pension schemes

a) Introduction

The Friends Life group operates a defined benefit scheme: the Friends Provident Pension Scheme ("FPPS"), which closed to active membership at 31 December 2012. On 1 January 2013, the Group set up a defined contribution scheme for UK employees as part of the "My Money" savings and investments platform called the Flexible Retirement Account ("FRA"). Employer contributions are typically in the range 6.3% to 13.2% depending on contribution levels selected by members and has a minimum employer plus member contribution level of 9% of pensionable salary (basic annual salary up to a defined earnings cap). The FRA will be used for auto-enrolment from the Group's UK staging date of May 2013. FPIL and Sesame Bankhall Group operate defined contribution arrangements. Lombard does not operate a pension scheme.

Employees of the acquired AXA UK Life businesses (including FLWL) and BHA have been placed into new defined contribution arrangements for service accruing after the acquisition date. The pension obligations for service accruing up to the date of the acquisition are not borne by the Group, as these obligations have remained with AXA UK plc and Bupa Finance plc respectively.

b) FPPS defined benefit scheme overview

On an IAS 19: *Employee Benefits* basis, a gross surplus of £62 million has been recognised in respect of the FPPS at 31 December 2012 (2011: £52 million). A deficit reduction plan was entered into in June 2010 based on the triennial valuation as at 30 September 2008, which showed a deficit on a funding basis of £65 million. Deficit reduction contributions of £20 million per annum for the next four years were subsequently agreed with the Trustee and commenced in July 2010. The latest triennial valuation of the scheme was performed as at 30 September 2011 and showed a deficit on a funding basis of £185 million. This valuation is performed to assist the Group and Trustee in agreeing future levels of funding and as at the balance sheet date an additional deficit reduction plan was being considered by the Group and Trustee.

In January 2013, Friends Life Management Services Limited, a group company, agreed a new deficit reduction plan with the Trustee of the FPPS based on the results of the triennial valuation performed as at 30 September 2011. The plan sets out a new schedule of deficit reduction contributions of £175 million, in addition to a £20 million contribution paid in July 2012 following the triennial valuation date, plus a further contribution of £20 million already scheduled for July 2013 under the previous deficit reduction plan. The new recovery plan commenced in January 2013 with a payment of £1.5 million, and a further £1.5 million scheduled in July 2013 in addition to the £20 million previously agreed. These will be followed by payments of £21.5 million per annum by 31 July each year for the next eight years from 2014 to 2021.

The agreement of the deficit reduction plan is a non-adjusting post balance sheet event and is not recognised in the results as at 31 December 2012. The impact post agreement in January 2013 is to increase the authorised payments surplus charge by £61 million, resulting in a gross reduction of the pension asset by the same amount. The agreement of the deficit reduction plan will also reduce the IGCA surplus by £89 million, before any applicable tax relief.

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. An additional liability of £29 million has been recognised at 31 December 2012 (2011: £32 million), reflecting the 35% tax that would arise on any notional refund in respect of the resultant IAS 19 surplus of £82 million (£20 million deficit reduction contributions plus the current surplus of £62 million). A deferred tax asset of £5 million (2011: £10 million) has also been recognised to reflect tax relief at a rate of 23% (2011: 25%) that is expected to be available on the deficit reduction contributions, in future periods.

On 28 September 2012, following formal consultation, the Group confirmed its decision to close the FPPS to active membership effective from 31 December 2012. Former active members of the FPPS will no longer contribute to, or build up future benefits in, the FPPS. UK staff have been offered membership of a FRA under Friends Life My Money savings and investment platform from 1 January 2013. The FRA is a Personal Pension Plan. The curtailment gain in respect of the FPPS on an IAS 19 basis on closure is £22 million. The changes reduce the Group's future balance of costs; reduce the risks associated with the scheme and ensure fairness to the majority of UK colleagues who are also provided with membership of FRA from 1 January 2013.

A further curtailment gain in respect of the FPPS on an IAS 19 basis of £10 million results from the outsourcing agreement entered into with Diligenta, under which a number of staff who transferred employment become deferred members of the scheme.

Both curtailments relate to reduced future anticipated costs of funding as these deferred benefits are no longer linked to final salary.

An analysis of the amounts recognised in the financial statements in respect of the FPPS is set out below.

As at 31 December	2012 £m	2011 £m
Amounts recognised in the consolidated statement of financial position		
IAS 19 pension surplus (excluding deficit reduction contributions)	**62**	52
Authorised payments surplus charge (penal tax) at 35% of available surplus following deficit reduction contributions	**(29)**	(32)
Net pension scheme surplus (excluding deficit reduction contributions)	**33**	20

Movement in IAS 19 pension surplus

For the year ended 31 December	2012 £m	2011 £m
Pension surplus at 1 January	**52**	66
Service cost(i)	**(7)**	(7)
Interest cost(i)	**(60)**	(57)
Expected return on pension assets(i) (ii)	**63**	63
Curtailment gain(i) (iii)	**32**	–
Employer contributions	**27**	33
Actuarial losses	**(45)**	(46)
Pension surplus at 31 December (excluding authorised payments surplus charge)	**62**	52
Deficit reduction contributions, agreed as at 31 December	**20**	40
Available surplus subject to authorised payments surplus charge	**82**	92

(i) Recognised in the consolidated income statement. The total profit recognised in the income statement for the year ended 31 December 2012 is £28 million (2011: loss of £1 million).
(ii) The actual return on plan assets for the year ended 31 December 2012 is £64 million (31 December 2011: £185 million).
(iii) The curtailment gain arises as a result of the closure of the FPPS to future service accrual and the outsourcing agreement entered into with Diligenta.

Analysis of net pension surplus and related deferred tax asset

As at 31 December 2012	Pension surplus £m	Deferred tax £m
Gross IAS 19 pension surplus and related deferred tax liability	**62**	**(14)**
Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus)	**(29)**	**–**
Restriction of liability to authorised payments surplus charge	**–**	**14**
Tax relief available on deficit reduction contributions	**–**	**5**
Pension surplus and related deferred tax asset	**33**	**5**

As at 31 December 2011	Pension surplus £m	Deferred tax £m
Gross IAS 19 pension surplus and related deferred tax liability	52	(13)
Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus)	(32)	–
Restriction of liability to authorised payments surplus charge	–	13
Tax relief available on deficit reduction contributions	–	10
Net pension surplus and related deferred tax asset	20	10

Amounts recognised in the consolidated statement of comprehensive income

For the year ended 31 December	2012 £m	2011 £m
Actuarial losses	**(45)**	(46)
Reverse authorised payments surplus charge on opening surplus	**32**	44
Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus)	**(29)**	(32)
Actuarial losses on defined benefit schemes	**(42)**	(34)
Taxation	**7**	2
Actuarial losses on defined benefit schemes after tax	**(35)**	(32)

A tax charge of £(5) million (2011: £(6) million) in respect of deficit reduction contributions and credits of £12 million (2011: £8 million) in respect of other movements in the pension scheme are included in the aggregate tax line of the consolidated statement of comprehensive income.

9. Loans and borrowings

The Group's loans and borrowings are as follows:

	Coupon %	2012 £m	2011 £m
Subordinated liabilities:			
Lombard undated subordinated loans	Various	**1**	2
Friends Life Group plc £162 million LT2 subordinated debt due 2021	12.00	**181**	183
Friends Life Group plc £500 million LT2 subordinated debt due 2022	8.25	**496**	496
Friends Life Group plc $575 million UT2 reset perpetual subordinated debt	7.875	**346**	–
Deferred consideration notes:			
Series A deferred consideration notes	6.00	**–**	232
Series B deferred consideration notes	7.25–6.50	**–**	191
Reinsurance:			
Lombard financial reinsurance treaties	Various	**4**	8
International financial reinsurance treaties	Various	**57**	64
Other:			
Amounts owed to credit institutions (overdrafts)		**14**	19
Total loans and borrowings		**1,099**	1,195

Unless otherwise stated below, the carrying values of interest bearing loans and borrowings closely approximate fair value.

Subordinated liabilities

The FLG LT2 subordinated debt 2021 is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost based on the fair value at the date of acquisition of Friends Provident by FLG. The fair value of this subordinated debt at 31 December 2012 is £215 million (2011: £182 million).

On 21 April 2011, FLG issued a £500 million LT2 subordinated debt instrument with a coupon of 8.25% and a maturity of 2022, which is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost being £500 million principal less capitalised issue costs of £4 million (2011: £4 million). The fair value of this subordinated debt at 31 December 2012 is £554 million (2011: £450 million).

On 8 November 2012, FLG issued a US$575 million UT2 reset perpetual subordinated debt instrument with a coupon of 7.875%, which is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost being the US$575 million principal translated at the effective exchange rate less capitalised issue costs of £8 million. The debt does not have a fixed repayment date but is callable in six years' time (initial call in November 2018) and on every subsequent interest payment date from the initial call date. With effect from the initial call date, and for so long as the debt is outstanding, the interest coupon will be reset every six years at a rate equal to the six year US dollar mid swap rate plus a margin of 6.828%. The fair value of this subordinated debt at 31 December 2012 is £378 million. A derivative instrument was entered into on 8 November 2012 to manage the risks associated with fluctuations in exchange rates on the issue of this debt.

Deferred consideration notes

On 15 September 2010, the Company issued fixed rate, unsecured loan notes with an aggregate principal amount of £500 million to AXA UK plc in connection with the acquisition of the AXA UK Life Business. The deferred consideration notes ("DCNs") constituted senior, unsecured and unsubordinated obligations of the Company.

The original terms of the Series A notes were that they be redeemed by payment of £60 million on 30 September each year from 2011 to 2015. A deed of amendment was made on 2 June 2011 changing the annual payment date from 30 September to 31 May each year from 2011 to 2015. The Series A coupon rate was to remain at 6% throughout the loan period.

The original terms of the Series B notes were that they be redeemed by payment of £2.5 million on 30 September each year from 2011 to 2015, followed by payments of £62.5 million on each of the subsequent three anniversaries to 2018. The Series B coupon rate commenced at 7.25% and was to reduce in incremental amounts annually on 30 September each year to a rate of 6.50% on 30 September 2015. Thereafter, the rate was to remain fixed at 6.50% for the three years to the final repayment date of 30 September 2018. A deed of amendment was made on 2 June 2011 changing the annual payment date (and annual date for reducing the rate of interest) from 30 September to 31 May each year. The final repayment was expected to be made on 31 May 2018.

In addition to the scheduled repayments of principal described above, the Company was required to vary the amounts repaid on occurrence of certain specified events. In 2011, such a variation was triggered by the share repurchase programme undertaken by the Company. This resulted in the settlement of an accelerated principal repayment of £14.4 million in addition to the scheduled repayment of £62.5 million in aggregate for both the Series A and Series B notes. Scheduled future repayments, i.e. from 31 May 2012 onwards, were thereafter reduced to £60.4 million until 2015, and to £60.5 million for the following three years to 31 May 2018.

The terms of the DCNs also allowed for the Company to redeem the DCNs in part or in full at any time and, following the scheduled payment of £60.4 million made in May 2012, the Company made a full repayment of £362.7 million on 20 November 2012, representing the outstanding principal on both the Series A and Series B notes at that time.

Financial reinsurance

FLL has three financial reinsurance contracts with Munich Reinsurance Company UK Limited ("Munich Re") to finance new German unit-linked pensions business written in the years ended 31 December 2010, 2011 and 2012 respectively. The total amount owed to Munich Re under these financial reinsurance arrangements as at 31 December 2012 was £37 million (2011: £40 million).

During 2012, FPIL entered into a financial reinsurance agreement with Munich Re to finance new Rest of World Premier regular premium savings business written between 1 January 2012 and 31 December 2012. The total amount owed to Munich Re under this financial reinsurance agreement as at 31 December 2012 was £20 million (2011: £nil).

In 2011, FPIL entered into a financial reinsurance agreement with Munich Re to finance new Hong Kong Premier regular premium savings business written between 1 January 2011 and 31 December 2011. The total amount owed to Munich Re under this financial reinsurance agreement as at 31 December 2012 was £nil (2011: £24 million).

Other

Amounts owed to credit institutions (overdrafts) include £4 million (2011: £7 million) relating to overdrafts held within the OEICS that have been consolidated as the Group's holding is 50% or more. Such overdrafts are fully repayable out of the assets of the OEICS.

FLG benefits from a £500 million (2011: £500 million) multi-currency revolving credit facility with Barclays Bank plc, Royal Bank of Canada, HSBC Bank plc and The Royal Bank of Scotland plc, with Barclays Bank plc as agent, entered into on 24 June 2010. The facility is guaranteed by FLL. If a third party, who does not presently have control of the Group, acquires such control, the Group must notify the agent immediately. In this circumstance, the lenders are not obliged to fund utilisation and may notify the agent to cancel their commitments under the facility. This would have the effect of rendering all of their loans repayable within ten business days from the date of notice. As at the date of this report, the facility remains undrawn.

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

As at 31 December	2012 £m	2011 £m
Within one year or on demand	**61**	123
Between one and two years	**14**	79
Between two and three years	**8**	67
Between three and four years	**2**	63
Between four and five years	**2**	61
In more than five years	**1,012**	802
Total loans and borrowings	**1,099**	1,195

Included in the carrying amount above, £1,038 million (2011: £1,072 million) is expected to be settled more than 12 months after the balance sheet date.

Total interest expense for financial liabilities not measured at fair value through profit or loss, which arises solely from interest-bearing loans and borrowings, is £92 million (2011: £105 million).

10. Contingent liabilities and commitments

a) Contingent liabilities

In the normal course of its business, the Group is subject to matters of litigation or dispute and interpretation of tax law. While there can be no assurances, at this time the directors believe, based on the information currently available to them, that it is not probable that the ultimate outcome of any of these matters will have a material adverse effect on the financial condition of the Group.

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:

	2012			2011 (restated)		
	Land and buildings £m	**Other £m**	**Total £m**	Land and buildings £m	Other £m	Total £m
Within one year	**14**	**1**	**15**	16	1	17
Between one and five years	**54**	**1**	**55**	57	1	58
In more than five years	**101**	**–**	**101**	100	–	100
Total operating lease payables	**169**	**2**	**171**	173	2	175

Restatement of prior period figures

The future minimum rentals payable under all non-cancellable leases has been restated for 2011 to reflect all future payments on leases as summarised according to the categories below. Previous disclosures included the annual commitment only.

	As reported £m	**Restated £m**
Within one year	7	17
Between one and five years	16	58
In more than five years	19	100
Total operating lease payables	42	175

Other commitments

The Group has investment property commitments of £6 million (2011: £20 million) relating to ongoing construction, renovation costs and costs of acquiring existing properties.

The Group has potential commitments of £218 million (2011: £335 million) to venture capital vehicles (partnerships and similar vehicles) that allow exposure to private equity investments in UK, US and European markets. All investments are held under agreements between the private equity managers and the Group which have committed the Group to providing an agreed maximum level of funding to the managers to invest. As at 31 December 2012 there are still funds that have yet to be utilised that, under the agreements, are still available to the private equity managers and hence are classified as potential commitments.

The Group has entered into a number of outsourcing arrangements which have resulted in financial commitments amounting to £1,641 million as at 31 December 2012 (2011: £1,798 million). The average weighted years remaining on these outsourcing contracts is 14 years as at 31 December 2012 (31 December 2011: 15 years). Included within these amounts is £1,274 million (2011: £1,393 million) relating to the outsourcing arrangement with Diligenta announced in November 2011.

11. 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.

a) Key management personnel compensation

Key management personnel consists of directors of Resolution Limited, executive directors of FLG, and Resolution Operations LLP ("ROL") as a body corporate.

The Company does not employ any staff. Each of the directors, who are treated as key management personnel for the purpose of IFRS, receive directors' fees under a service agreement. The Company has also appointed ROL as its investment advisor and to provide it with certain head office functions. In aggregate the compensation paid to key management, excluding the fee paid to ROL, is as set out below for key management in place at 31 December 2012:

	2012 Number	**2012 £m**	2011 Number	2011 £m
Short-term employee benefits	**16**	**6**	16	6
Post-employment benefits (excluding defined benefit scheme)	**–**	**–**	–	–
Share-based payments	**–**	**–**	–	–
Total key management personnel compensation charged to the income statement	**16**	**6**	16	6
Post-employment benefits: defined benefit schemes	**–**	**–**	–	–
Total key management personnel compensation	**16**	**6**	16	6

There were £nil balances outstanding at the year end with key management (2011: £nil). Short-term employee benefits include £0.3 million of payments for loss of office, expected to be paid in 2013 but for which a constructive obligation exists as part of the restructuring exercise.

As a result of the simplification of the governance structure announced on 10 December 2012, certain changes to the board are expected to be made in 2013. The changes will result in a unified membership of the Boards of the Company and FLG, the main UK holding company for its regulated insurance group.

The compensation paid to ROL is disclosed in note 11 (b) below.

b) Other related parties

With effect from 13 January 2012, the Company entered into an amended Operating Agreement with ROL. On 10 December 2012 the Company entered into a business sale agreement with ROL in respect of the provision of services pursuant to the terms of the Operating Agreement. The agreement is expected to complete on 27 March 2013 and will end the relationship with ROL. The cost of transferring the operating agreement from ROL to the Group and the recognition of an onerous provision in respect of the ROL offices to be taken over by the Group have been recognised (£10 million). The contract with ROL will be novated to FLMS. Notwithstanding the announcement the amended Operating Agreement remained in place throughout 2012. Under the amended Operating Agreement:

- the Company continued to outsource the majority of its operating functions to ROL. The Company paid ROL an annual operating fee based on 0.5% of the non-cash value of the Company (subject to (i) a minimum payment of £10 million and (ii) a maximum reduction in any year of up to £2 million if ROL manages, advises or provides similar services to any new projects outside the UK Life Project). In addition, the Company paid ROL amounts for additional accounting services and certain company secretarial services. The total amount charged under the Operating Agreement for the twelve months ended 31 December 2012 was £18 million (2011: £20 million), of which £2 million (2011: £2 million) was incurred by the Company and £16 million (2011 £18 million) was incurred by Resolution Holdco No. 1 LP (a direct wholly owned subsidiary of the Company). An accrual of £0.1 million (2011: £0.2 million) in respect of ROL fees payable has been recognised in the Company's statement of financial position as at 31 December 2012; and

- subject to certain conditions, the Company may advance funds up to an aggregate of £20 million to ROL for development work on new projects outside the UK Life Project. The amounts advanced by the Company are reimbursable by ROL, together with an appropriate investment return (which, subject to the Company's agreement may be paid in cash or take the form of another benefit to the Company or its shareholders) if ROL successfully launches a new project. Any amounts that are reimbursed by ROL replenish the aggregate amount of funding that may be advanced to ROL to fund development work on new projects. The total amount of funding advanced under the Operating Agreement to ROL for development work on new projects is £1 million (2011: £1 million). On 10 December 2012, the Company announced that ROL had agreed not to request any further funding of new projects.

With effect from 13 January 2012, the Company entered into a new Lock-Up Agreement with RCAP GP Limited (acting in its capacity as general partner of RCAP Guernsey LP) and Resolution Capital Limited (a limited parent of RCAP Guernsey LP and a member of ROL). Under the Lock-Up Agreement:

- subject to certain customary exceptions, members of the Resolution Group (which includes ROL, RCAP Guernsey LP and Resolution Capital Limited and, for the avoidance of doubt, does not include the Company or any of its subsidiary undertakings) are restricted from selling or pledging as security for a loan any of their shares in the Company held as at 13 January 2012 until completion of the UK Life Project. The total number of locked-up shares is 8,247,184; the Resolution Group may sell or pledge as security for a loan certain of the locked-up shares for the purpose of co-investing in a new project, provided that the value of the remaining locked-up shares is not less than the largest investment made by the Resolution Group in any new project using the proceeds of a sale or pledge of locked-up shares (taking into account the new project itself).

On 27 March 2013, consistent with the terms of the existing agreements between the Company and the Resolution Group, the shares in the Company held by the Resolution Group will cease to be subject to the lock-up agreement. Resolution Capital Limited and Clive Cowdery (a member of ROL and RCAP Guernsey LP, sole shareholder of Resolution Capital Limited and a director of FLG) have both confirmed that Resolution Capital Limited will not sell these shares until at least December 2013.

The Company has a 99.99% interest in, and is the general partner in, Resolution Holdco No.1 LP, a Guernsey limited partnership. RCAP Guernsey LP, a member of the Resolution Group, is a limited partner in Resolution Holdco No.1 LP. The Company entered into the limited partnership for the purpose of making acquisitions and rewarding the Resolution Group for value created in the limited partnership from those acquisitions. This arrangement is not time limited.

The Company is a party to a trade mark licence agreement with Resolution (Brands) Limited, a company wholly owned by Clive Cowdery, under which the Group has paid a fee of £113,668 for the use of the "Resolution" brand in respect of the year commencing 4 December 2012 (2011: £110,143). The existing Trademark Licence with Resolution (Brands) Limited will remain in force substantially on its current terms, except that from 27 March 2013 there will be an annual termination right and no fee for use of the brand.

Own shares held by subsidiary undertakings of the Company with a fair value £20 million were acquired as part of the share repurchase programme in 2011. In 2012 no such share repurchase programme took place.

12. Post balance sheet events

Disposal of AmLife

On 4 January 2013 the Company disposed of its entire holding of 30% of the ordinary share capital of both AmLife Insurance Berhad and AmFamily Takaful Burhad (collectively "AmLife") to AmBank Group of Malaysia for RM 245 million (£50 million) resulting in a profit on disposal of £20 million. Prior to sale, AmLife was held within the FPI operating segment.

FPPS defined benefit scheme deficit reduction funding

In January 2013 FLMS, a group company, agreed a new deficit reduction plan with the Trustee of the FPPS based on the results of the triennial valuation performed as at 30 September 2011. The plan sets out a new schedule of deficit reduction contributions of £175 million, in addition to a £20 million contribution paid in July 2012 following the triennial valuation date, plus a further contribution of £20 million already scheduled for July 2013 under the previous deficit reduction plan. The new recovery plan commenced in January 2013 with a payment of £1.5 million, and a further £1.5 million scheduled in July 2013 in addition to the £20 million previously agreed. These will be followed by payments of £21.5 million per annum by 31 July each year for the next eight years from 2014 to 2021.

The agreement of the deficit reduction plan is a non-adjusting post balance sheet event and is not recognised in the results as at 31 December 2012. The impact post agreement in January 2013 is to increase the authorised payments surplus charge by £61 million resulting in a gross reduction of the pension asset by the same amount. The agreement of the deficit reduction plan will also reduce the IGCA surplus by £89 million, before any applicable tax relief (see note 8).

Arrangements with ROL

On 10 December 2012 the Company announced a simplification of its governance structure. Amongst the changes included in the announcement were that the arrangements between ROL and the Company are expected to come to an end with effect from 27 March 2013. At this date, business activities that relate to the services currently provided by ROL and the 24 ROL employees who provide these services will transfer to the Resolution Group. ROL will cease to provide services to the Company, and the Operating Agreement will be transferred from ROL to the Group, at the same time. The contract with ROL will be novated to FLMS. The Company also expects to unify membership of the boards of the Company and Friends Life Group plc, the main UK holding company for its regulated insurance group, in 2013.

Dividend Reinvestment Plan ("DRIP")

On 21 March 2013, the Board determined that the scrip dividend alternative would be discontinued in respect of the 2012 final dividend. Shareholders will be offered a DRIP in its place.

Changes in the rate of corporation tax

The Chancellor delivered his Budget on 20 March 2013. The impact of the further 1% rate reduction in corporation tax (which is in addition to the 1% reduction announced in the Autumn Statement on 5 December 2012) has been assessed in note 3. The Group is reviewing the detail of the other announcements and the preliminary view is that they are not expected to have a significant impact.

MCEV financial statements

Consolidated income statement – MCEV basis

For the year ended 31 December 2012

	Notes	RSL 2012 £m	RSL 2011[ii] £m	FLG 2012 £m	FLG 2011[ii] £m
Life and pensions					
Value of new business	6	**194**	151	**194**	151
Expected existing business contribution		**325**	360	**325**	360
Operating experience variances		**(56)**	(28)	**(56)**	(28)
Operating assumption changes		**(9)**	140	**(9)**	140
Other operating variances		**27**	6	**27**	6
Development costs	10	**(50)**	(36)	**(50)**	(36)
Life and pensions covered business operating profit before tax	3	**431**	593	**431**	593
Other income and charges		**(21)**	(35)	**(21)**	(35)
Life and pensions operating profit before tax		**410**	558	**410**	558
Corporate income and charges		**(28)**	(41)	**–**	–
Operating profit before tax		**382**	517	**410**	558
Economic variances	3	**154**	(600)	**154**	(600)
Amortisation and impairment of non-covered business acquired intangible assets	3	**(15)**	(3)	**(15)**	(3)
Non-recurring items and non-operating variances	3	**(127)**	(282)	**(125)**	(282)
Profit/(loss) from continuing operations before tax		**394**	(368)	**424**	(327)
Tax on operating profit		**(120)**	(150)	**(120)**	(150)
Tax on other activities		**(6)**	223	**(6)**	223
Profit/(loss) for the year[i]		**268**	(295)	**298**	(254)

(i) Profit/(loss) for the year is attributable to equity holders of the parent.
(ii) The consolidated income statement for the year ended 31 December 2011 includes the results of BHA from 31 January 2011, FLWL from 7 November 2011 and the business of the Guaranteed Over Fifties (“GOF”) and Trustee Investment Plan (“TIP”) portfolios up to the date of disposal on 1 November 2011.

Earnings per share – MCEV basis

For the year ended 31 December 2012

	Notes	RSL 2012 Pence	RSL 2011 Pence
Earnings per share			
Operating earnings per share on MCEV basis after tax, attributable to equity holders of the parent			
Basic and diluted	4	**18.83**	25.74
Earnings per share on MCEV basis after tax, attributable to equity holders of the parent			
Basic and diluted	4	**19.26**	(20.69)

MCEV operating profit arises from continuing operations, incorporates an expected investment return and excludes:

(i) amortisation and impairment of non-covered business acquired intangible assets;
(ii) the effect of economic variances (including the impact of economic assumption changes); and
(iii) significant non-recurring items and non-operating items.

Given the long-term nature of the Group's operations, operating profit is considered to be a better measure of the performance of the Group and this measure of profit is used internally to monitor the Group's MCEV results.

Consolidated statement of comprehensive income – MCEV basis

For the year ended 31 December 2012

	RSL	RSL	**FLG**	FLG
	2012 £m	2011 £m	**2012 £m**	2011 £m
Profit/(loss) for the year	**268**	(295)	**298**	(254)
Actuarial losses on defined benefit pension schemes, net of tax	**(35)**	(32)	**(35)**	(32)
Foreign exchange adjustments	**(16)**	(15)	**(16)**	(15)
Other comprehensive loss for the year, net of tax	**(51)**	(47)	**(51)**	(47)
Total comprehensive income/(loss) for the year[(i)]	**217**	(342)	**247**	(301)

(i) Total comprehensive income/(loss) 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 2012

	RSL	RSL	**FLG**	FLG
	2012 £m	2011 £m	**2012 £m**	2011 £m
Opening ordinary shareholders' equity	**5,796**	6,515	**5,949**	6,514
Acquired value of BHA as at 31 January 2011	**–**	226	**–**	226
Cost of acquisition of BHA[(i)]	**–**	(168)	**–**	(168)
Acquired value of WLUK as at 7 November 2011	**–**	271	**–**	271
Cost of acquisition of WLUK[(i)]	**–**	(248)	**–**	(248)
Total comprehensive income/(loss) for the year	**217**	(342)	**247**	(301)
Issue of share capital (including reduction in RSL shares held by subsidiaries)	**97**	61	**–**	–
Share repurchase	**–**	(250)	**–**	–
Dividends on equity shares	**(283)**	(274)	**(500)**	(350)
Share-based payments	**4**	5	**2**	5
Increase/(decrease) in MCEV reserves for the year	**35**	(719)	**(251)**	(565)
Closing ordinary shareholders' equity	**5,831**	5,796	**5,698**	5,949

(i) Transaction costs incurred in FLG relating to the acquisitions of BHA and WLUK are included in non-operating earnings in 2011 (£3 million, comprising £1 million in respect of BHA and £2 million in respect of WLUK).

Consolidated statement of financial position – MCEV basis

As at 31 December 2012

	RSL	RSL	**FLG**	FLG
	2012 £m	2011 £m	**2012 £m**	2011 £m
Assets				
Pension scheme surplus	**33**	20	**33**	20
VIF covered business excluding assets of operations classified as held for sale	**4,230**	3,844	**4,230**	3,844
Intangible assets	**9**	25	**9**	25
Property and equipment	**53**	58	**53**	58
Investment properties	**2,735**	3,015	**2,735**	3,015
Investment in associates and joint venture	**–**	31	**–**	31
Financial assets	**105,990**	103,636	**105,990**	103,643
Deferred acquisition costs	**88**	105	**88**	105
Reinsurance assets	**3,153**	3,213	**3,153**	3,213
Current tax assets	**8**	6	**8**	6
Insurance and other receivables	**1,133**	1,175	**1,133**	1,175
Cash and cash equivalents	**9,449**	8,791	**9,313**	8,690
Net assets of operations classified as held for sale	**43**	–	**43**	–
Total assets	**126,924**	123,919	**126,788**	123,825
Liabilities				
Insurance contracts	**37,294**	37,326	**37,294**	37,326
Unallocated surplus	**656**	640	**656**	640
Financial liabilities				
investment contracts	**77,276**	74,224	**77,276**	74,224
loans and borrowings	**1,641**	1,440	**1,641**	1,201
amounts due to reinsurers	**1,767**	1,800	**1,767**	1,800
Net asset value attributable to unit-holders	**754**	1,173	**754**	1,173
Provisions	**223**	230	**223**	230
Deferred tax liabilities	**362**	304	**362**	304
Current tax liabilities	**21**	20	**21**	20
Insurance payables, other payables and deferred income	**1,096**	961	**1,093**	953
Total liabilities	**121,090**	118,118	**121,087**	117,871
Equity attributable to:				
Equity holders of the parent	**5,831**	5,796	**5,698**	5,949
Non-controlling interests	**3**	5	**3**	5
Total equity	**5,834**	5,801	**5,701**	5,954
Total equity and liabilities	**126,924**	123,919	**126,788**	123,825

Group MCEV analysis of earnings

For the year ended 31 December 2012

	FLG 2012 Covered business £m	FLG 2012 Non-covered business £m	FLG 2012 Total £m	RSL (ex. FLG)[i] 2012 Non-covered business £m	RSL 2012 Total £m	RSL 2011 Total £m	FLG 2011 Total £m
Opening Group MCEV	**5,412**	**537**	**5,949**	**(153)**	**5,796**	6,515	6,514
Opening adjustments:							
acquired/divested businesses:							
acquired value of BHA	**–**	**–**	**–**	**–**	**–**	226	226
cost of acquisition of BHA[ii]	**–**	**–**	**–**	**–**	**–**	(168)	(168)
acquired value of WLUK	**–**	**–**	**–**	**–**	**–**	271	271
cost of acquisition of WLUK[ii]	**–**	**–**	**–**	**–**	**–**	(248)	(248)
Adjusted opening Group MCEV	**5,412**	**537**	**5,949**	**(153)**	**5,796**	6,596	6,595
Operating MCEV earnings	**325**	**(35)**	**290**	**(28)**	**262**	367	408
Non-operating MCEV earnings	**9**	**(1)**	**8**	**(2)**	**6**	(662)	(662)
Total MCEV earnings	**334**	**(36)**	**298**	**(30)**	**268**	(295)	(254)
Other movements in IFRS net equity	**–**	**(35)**	**(35)**	**7**	**(28)**	(19)	(32)
Closing adjustments:							
capital and dividend flows	**(807)**	**309**	**(498)**	**309**	**(189)**	(471)	(345)
foreign exchange variances	**(16)**	**–**	**(16)**	**–**	**(16)**	(15)	(15)
Closing Group MCEV	**4,923**	**775**	**5,698**	**133**	**5,831**	5,796	5,949

(i) RSL (ex. FLG) refers to the Resolution holding companies.
(ii) Transaction costs incurred in FLG relating to the acquisitions of BHA and WLUK are included in non-operating earnings in 2011 (£3 million, comprising £1 million in respect of BHA and £2 million in respect of WLUK).

Notes to the MCEV results

For the year ended 31 December 2012

1. Basis of preparation

Introduction

Resolution Limited is presenting the results and financial position for its life and pensions business on the MCEV basis and for its other businesses on the IFRS basis. The MCEV basis is in compliance with the European Insurance CFO Forum MCEV Principles(i) ("the MCEV Principles"), issued in June 2008, and re-issued in amended form in October 2009. In accordance with revised interim transitional guidance issued by the CFO forum in September 2012, no allowance has been made for the impacts of the developing Solvency II regulatory regime.

This MCEV supplementary information presents results for the Group and the Friends Life group.

The 2011 comparatives include the following:

- the business of the GOF and TIP portfolios up to the date of transfer back to AXA on 1 November 2011;
- the business of BHA from the date of acquisition on 31 January 2011; and
- the business of FLWL from the date of acquisition on 7 November 2011.

The MCEV results were approved by the Board of directors on 25 March 2013.

Segmental analysis and definitions

The segmentation and definitions adopted are consistent with those used in the prior year.

MCEV methodology

Overview

The MCEV basis of reporting is designed to recognise profit as it is earned over the term of a life insurance policy. The total profit recognised over the lifetime of the policy is the same as that recognised under the IFRS basis of reporting, but the timing of recognition is different.

Covered business

Covered business comprises all life and pensions business written by Friends Life group in the UK and through overseas life insurance subsidiaries and associates (collectively referred to as "life and pensions covered business").

The external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 are formally allocated to covered business on the basis that all obligations to make payments in respect of this debt are guaranteed by FLL. 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 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 asset of FPPS on an IAS 19 basis. FLG corporate net assets, certain holding company costs, RSL corporate net assets, the deferred consideration notes issued by Resolution Limited, (until the date of their repayment on 20 November 2012), the acquisition finance facility (until the date of its repayment in April 2011) and the internal LT2 subordinated debt 2020 issued by FLG to Resolution holding companies (until the date of its repayment in November 2012) are all non-covered business.

Whilst the management services businesses and FLI are classified as non-covered, the expenses and cash flows of those businesses are linked to the life and pensions businesses via service and investment management agreements. The cash flows of the companies are calculated on the "look-through" principle and are allowed for when setting appropriate expense and tax assumptions.

Segmental reporting under MCEV

The covered business within Friends Life group has been split into the following segments in line with IFRS reporting:

- UK and Heritage, which includes the life and pensions businesses within the UK from FLL, FLP, FLC, FAL, FLAS and FLWL;
- FPI, which includes FPIL, the overseas life assurance business within FLL and the 30% share in AmLife Insurance Berhad and AmFamily Takaful Berhad ("AmLife"); and
- Lombard.

On 4 January 2013 the Company disposed of its entire holding of 30% of the ordinary share capital of AmLife to AmBank Group of Malaysia for RM 245 million (£50 million) resulting in a profit on disposal of £7 million on an MCEV basis.

Corporate functions are not strictly an operating segment, but are reported to management, and are provided to reconcile the Group's reportable segments to the total result. FLG corporate includes the external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021, external LT2 subordinated debt 2022, internal LT2 subordinated debt 2020, FLG corporate costs and the cost of holding any required capital in excess of the operating segment capital policy.

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, including Department for Work and Pensions rebate premiums, 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.

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, excluding intangible assets relating to future new 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.

The non-economic assumptions include: the behaviour of customers (e.g. persistency), mortality, morbidity, the level of expenses required to maintain the book of business, tax and the regulatory environment. The assumptions are a reflection of best estimates of the likely behaviours, outcomes, or circumstances in the future. The estimates are made, typically, on an annual basis following experience investigations based on the data available at the time, both from the book of business and externally sourced information. The aim is to set assumptions at a level that reflects recent or current experience.

The PVFP includes the capitalised value of profits and losses arising in subsidiary companies providing investment management, administration and other services to the extent that they relate to covered business. This is referred to as the "look-through" into investment management and service company expenses. In addition expenses arising in holding companies that relate directly to acquiring or maintaining covered business have been allowed for.

In valuing shareholders' cash flows, allowance is made in the cash flow projections for taxes in the relevant jurisdiction affecting the covered business. Tax assumptions are based on best estimate assumptions, applying local corporate tax legislation and practice together with known future changes and taking credit for any deferred tax assets.

The economic assumptions are market consistent whereby, in principle, each cash flow is valued in line with the price of similar cash flows that are traded in the capital markets. For example, an equity cash flow is valued using an equity risk discount rate, and a bond cash flow is valued using a bond risk discount rate. If a higher return is assumed for equities, the equity cash flow is discounted at this higher rate.

In practice, for liabilities where the payouts are either independent or move linearly with market movements, a method known as the "certainty equivalent approach" has been applied whereby all assumed assets earn the reference rate and all cash flows are discounted using the reference rate. This gives the same result as applying the method in the previous paragraph.

Time value of financial options and guarantees ("TVOG")

The PVFP is based on a single deterministic projection of future economic assumptions. However, a single projection does not fully reflect the potential for extreme events and the resulting impact of options and guarantees on the shareholder cash flows. While the PVFP allows for the intrinsic value of an option or guarantee under a single set of economic assumptions, it does not reflect the potential range of future economic scenarios on the shareholder cash flows. Stochastic modelling techniques are used to assess the impact of potential future economic scenarios on an option or guarantee and to determine the average value of shareholder cash flows under a number of market consistent scenarios.

The TVOG is calculated as the difference between the average value of shareholder cash flows under a number of market consistent scenarios, and the intrinsic value under a single projection within the PVFP.

The material financial options and guarantees are those in the with-profits funds of the subsidiary life companies of Friends Life group, in the form of the benefits guaranteed to policyholders and the guaranteed annuity rates associated with certain policies. The risk to shareholders is that the assets of the with-profits funds are insufficient to meet these guarantees. While shareholders are entitled to only a small share of profits in the with-profits funds (e.g. via one-ninth of the cost of bonus), they can potentially be exposed to the full cost of fund assets being insufficient to meet policyholder guarantees. The TVOG has been assessed using a stochastic model derived from the current Realistic Balance Sheet ("RBS") model. This model has been calibrated to market conditions at the valuation date. Allowance has been made under the different scenarios for management actions, such as altered investment strategy, consistent with the RBS model. The TVOG would be markedly higher without the hedging activities and management actions currently undertaken. No allowance has been made for the impact of dynamic policyholder behaviour under the different scenarios, however the impact is not considered to be material for Friends Life group.

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.

Cost of residual non-hedgeable risks ("CNHR")

The main area of non-hedgeable risk relates to non-financial risks, such as insurance and operational risks, where no deep, liquid market exists to fully mitigate the risk. Allowance for non-financial risk is made directly within:

- the PVFP via an appropriate choice of best estimate assumptions and with the impact of variability of the risk on the level, and hence cost, of required capital; and
- the TVOG for the impact of variations of non-financial risks on the possibility of shareholders needing to meet the guarantees within the with-profits funds of the subsidiary life companies of Friends Life group.

The CNHR covers those non-hedgeable risks that are not already allowed for fully in the PVFP or in the TVOG. The most significant of these risks are those for which the impact of fluctuations in experience is asymmetric; where adverse experience has a higher impact on shareholder value than favourable experience and the best estimate assumptions do not reflect this asymmetry. The areas identified as having the potential for material asymmetry are operational risk, persistency risk and reinsurance counterparty default risk.

The CNHR has been calculated by considering the financial cost to shareholders of the impact of asymmetric risks and with regard to the results of risk-based capital modelling. The risk-based capital is calculated using internal models, consistent with those used in the Group's Individual Capital Assessment, with:

- a 99.5% confidence level over one year;
- allowance for diversification between non-hedgeable risks;
- no allowance for diversification between non-hedgeable and hedgeable risks; and
- no allowance for diversification between covered and non-covered business.

The CNHR impacts both the value of existing business and new business.

Participating business

Future regular bonuses on participating business are projected in a manner consistent with current bonus rates and expected future market consistent returns on assets deemed to back the policies.

Future terminal bonuses are assumed to be set at a level to exhaust all the assets deemed to back the policies over the future lifetime of the in-force with-profit policies.

The PVFP includes the shareholders' share of future profits from the with-profits funds, based on the assumed bonus rates.

There may be some extreme future economic scenarios in which total assets in each of the with-profits funds are not sufficient to pay all policyholder claims and the resulting shortfall would be met by shareholders. Stochastic modelling techniques are used to assess the impact of future economic scenarios on the with-profits funds' ability to pay all policyholder claims and to determine the average additional cost to shareholders arising from future projected shortfalls. This cost to shareholders has been included in the TVOG.

Consolidation adjustments

The effect of transactions and reinsurance arrangements between life insurance subsidiary companies has been included in the results split by segment in a consistent manner. No elimination is required on consolidation.

Goodwill and intangible assets

Goodwill and intangible assets relating to the non-covered business are included on an IFRS basis. Intangible assets recognised under IFRS relating to the value of future new business, such as distribution relationships and brand value, have been excluded from the Group MCEV.

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.

2. Analysis of MCEV earnings

The following tables show the movement in the MCEV of the Group including the results for BHA and FLWL from the dates of their respective acquisitions.

All of the Group's covered business is wholly contained within Friends Life 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 2012

	FLG						RSL	
	Covered business							
Net of tax	Free surplus £m	Required capital £m	VIF £m	MCEV £m	Non-covered business £m	Total £m	Non-covered business £m	Total £m
Opening Group MCEV	**821**	**747**	**3,844**	**5,412**	**537**	**5,949**	**(153)**	**5,796**
Value of new business	**(285)**	**97**	**340**	**152**	**–**	**152**	**–**	**152**
Expected existing business contribution:								
expected existing business contribution: reference rate	**26**	**(10)**	**57**	**73**	**–**	**73**	**–**	**73**
expected existing business contribution: in excess of reference rate	**9**	**(47)**	**215**	**177**	**–**	**177**	**–**	**177**
Transfers from VIF and required capital to free surplus	**560**	**(18)**	**(542)**	**–**	**–**	**–**	**–**	**–**
Operating experience variances and development costs	**(69)**	**(12)**	**(3)**	**(84)**	**–**	**(84)**	**–**	**(84)**
Operating assumption changes	**(67)**	**–**	**54**	**(13)**	**–**	**(13)**	**–**	**(13)**
Other operating items	**86**	**(37)**	**(29)**	**20**	**(35)**	**(15)**	**(28)**	**(43)**
Operating Group MCEV earnings	**260**	**(27)**	**92**	**325**	**(35)**	**290**	**(28)**	**262**
Economic variances	**119**	**(200)**	**197**	**116**	**1**	**117**	**–**	**117**
Other non-operating items	**(107)**	**(120)**	**120**	**(107)**	**(2)**	**(109)**	**(2)**	**(111)**
Total Group MCEV earnings	**272**	**(347)**	**409**	**334**	**(36)**	**298**	**(30)**	**268**
Other movements in IFRS net equity	**–**	**–**	**–**	**–**	**(35)**	**(35)**	**7**	**(28)**
Closing adjustments:								
capital and dividend flows	**(452)**	**(356)**	**1**	**(807)**	**309**	**(498)**	**309**	**(189)**
foreign exchange variances	**–**	**(4)**	**(12)**	**(16)**	**–**	**(16)**	**–**	**(16)**
Closing Group MCEV	**641**	**40**	**4,242**	**4,923**	**775**	**5,698**	**133**	**5,831**

For the year ended 31 December 2011

Net of tax	FLG Covered business Free surplus £m	FLG Covered business Required capital £m	FLG Covered business VIF £m	FLG Covered business MCEV £m	FLG Non-covered business £m	FLG Total £m	RSL Non-covered business £m	RSL Total £m
Opening Group MCEV	977	1,291	4,202	6,470	44	6,514	1	6,515
Opening adjustments:								
acquired value of BHA	3	91	132	226	–	226	–	226
cost of acquisition of BHA(i)	(168)	–	–	(168)	–	(168)	–	(168)
acquired value of WLUK	(42)	102	211	271	–	271	–	271
cost of acquisition of WLUK(i)	–	–	–	–	(248)	(248)	–	(248)
Adjusted opening Group MCEV	770	1,484	4,545	6,799	(204)	6,595	1	6,596
Value of new business	(325)	80	364	119	–	119	–	119
Expected existing business contribution:								
expected existing business contribution: reference rate	22	(8)	55	69	–	69	–	69
expected existing business contribution: in excess of reference rate	(46)	32	217	203	–	203	–	203
Transfers from VIF and required capital to free surplus	686	(81)	(605)	–	–	–	–	–
Operating experience variances and development costs	(51)	(4)	7	(48)	–	(48)	–	(48)
Operating assumption changes	204	(16)	(86)	102	–	102	–	102
Other operating items	242	(64)	(180)	(2)	(35)	(37)	(41)	(78)
Operating Group MCEV earnings	732	(61)	(228)	443	(35)	408	(41)	367
Economic variances	(353)	200	(300)	(453)	–	(453)	–	(453)
Other non-operating items	109	(352)	35	(208)	(1)	(209)	–	(209)
Total Group MCEV earnings	488	(213)	(493)	(218)	(36)	(254)	(41)	(295)
Other movements in IFRS net equity	–	–	–	–	(32)	(32)	13	(19)
Closing adjustments:								
capital and dividend flows	(682)	(521)	(1)	(1,204)	859	(345)	(126)	(471)
foreign exchange variances	(1)	(3)	(11)	(15)	–	(15)	–	(15)
transfer of GOF and TIP businesses to AXA UK plc	246	–	(196)	50	(50)	–	–	–
Closing Group MCEV	821	747	3,844	5,412	537	5,949	(153)	5,796

(i) Transaction costs incurred in FLG of £3 million relating to the acquisition of BHA and WLUK are included in other non-operating items in 2011.

The table below shows a further breakdown of the MCEV earnings. All of the Group's covered business is wholly contained within Friends Life group.

All earnings are shown on a gross of tax basis with attributed tax shown separately.

3 Segmental analysis of MCEV earnings

For the year ended 31 December 2012

	FLG						RSL	
	Covered business							
Gross of tax	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Non-covered business £m	Total £m	RSL (ex. FLG)[(i)] Non-covered business £m	Total £m
Value of new business	**144**	**5**	**45**	**–**	**–**	**194**	**–**	**194**
Expected existing business contribution	**342**	**23**	**35**	**(75)**	**–**	**325**	**–**	**325**
Operating experience variances	**(21)**	**(12)**	**(23)**	**–**	**–**	**(56)**	**–**	**(56)**
Operating assumption changes	**62**	**(107)**	**36**	**–**	**–**	**(9)**	**–**	**(9)**
Other operating variances	**19**	**(5)**	**13**	**–**	**–**	**27**	**–**	**27**
Development costs	**(42)**	**(6)**	**(2)**	**–**	**–**	**(50)**	**–**	**(50)**
Life and pensions covered business operating profit/(loss) before tax	**504**	**(102)**	**104**	**(75)**	**–**	**431**	**–**	**431**
Other income and charges	**–**	**–**	**–**	**–**	**(21)**	**(21)**	**–**	**(21)**
Life and pensions operating profit/(loss) before tax	**504**	**(102)**	**104**	**(75)**	**(21)**	**410**	**–**	**410**
Corporate income and charges	**–**	**–**	**–**	**–**	**–**	**–**	**(28)**	**(28)**
Operating profit/(loss) before tax	**504**	**(102)**	**104**	**(75)**	**(21)**	**410**	**(28)**	**382**
Economic variances	**459**	**(19)**	**17**	**(304)**	**1**	**154**	**–**	**154**
Other non-operating items	**(139)**	**1**	**(4)**	**–**	**2**	**(140)**	**(2)**	**(142)**
Profit/(loss) before tax	**824**	**(120)**	**117**	**(379)**	**(18)**	**424**	**(30)**	**394**
Attributed tax on operating profits	**(123)**	**23**	**(24)**	**18**	**(14)**	**(120)**	**–**	**(120)**
Attributed tax on other activities	**(77)**	**2**	**(3)**	**76**	**(4)**	**(6)**	**–**	**(6)**
Profit/(loss) after tax	**624**	**(95)**	**90**	**(285)**	**(36)**	**298**	**(30)**	**268**

(i) RSL (ex.FLG) refers to the Resolution holding companies.

For the year ended 31 December 2011

Gross of tax	FLG						RSL	
	Covered business						RSL (ex. FLG)[i]	
	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Non-covered business £m	Total £m	Non-covered business £m	Total £m
Value of new business	59	40	52	–	–	151	–	151
Expected existing business contribution	330	27	49	(46)	–	360	–	360
Operating experience variances	(9)	(7)	(12)	–	–	(28)	–	(28)
Operating assumption changes	147	(3)	(4)	–	–	140	–	140
Other operating variances	9	(20)	(2)	19	–	6	–	6
Development costs	(28)	(7)	(1)	–	–	(36)	–	(36)
Life and pensions covered business operating profit/(loss) before tax	508	30	82	(27)	–	593	–	593
Other income and charges	–	–	–	–	(35)	(35)	–	(35)
Life and pensions operating profit/(loss) before tax	508	30	82	(27)	(35)	558	–	558
Corporate income and charges	–	–	–	–	–	–	(41)	(41)
Operating profit/(loss) before tax	508	30	82	(27)	(35)	558	(41)	517
Economic variances	(519)	(58)	(120)	97	–	(600)	–	(600)
Other non-operating items	(329)	–	5	41	(2)	(285)	–	(285)
(Loss)/Profit before tax	(340)	(28)	(33)	111	(37)	(327)	(41)	(368)
Attributed tax on operating profits	(137)	–	(20)	7	–	(150)	–	(150)
Attributed tax on other activities	227	4	27	(36)	1	223	–	223
(Loss)/Profit after tax	(250)	(24)	(26)	82	(36)	(254)	(41)	(295)

(i) RSL (ex.FLG) refers to the Resolution holding companies.

UK and Heritage covered business

The life and pensions covered business operating profit before tax for the UK and Heritage segment was £504 million (2011: £508 million).

VNB

Further details of the calculation and analysis of the VNB are discussed in note 6.

Expected existing business contribution

The expected existing business contribution is the sum of two components:

- the expected earnings over the period assuming the opening assets earn the beginning of period reference rate; and
- the additional expected earnings (in excess of the beginning of period reference rate) consistent with management's long-term 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 90bps (2011: 75bps) at the beginning of the year.

The additional earnings are the excess over the reference rate and reflect management's long-term expectation of asset returns, based on assumed asset mix.

The total expected existing business contribution of £342 million (2011: £330 million) comprises £299 million (2011: £295 million) from applying expected rates of return to the value of in-force at the start of the period and £43 million (2011: £35 million) of expected return on shareholders' net assets.

The expected contribution from the value of in-force of £299 million (2011: £295 million) reflects the expected rates of return applied to the opening value of in-force of £2,885 million at 1 January 2012 (£3,271 million at 1 January 2011, adjusted for the value of in-force of the acquired BHA and FLWL businesses during the year).

The UK expected contribution on shareholders' net assets of £43 million (2011: £35 million) reflects the return based on the reference rate. The increase in the contribution reflects the increase in both the reference rate and the opening shareholder net assets.

Operating experience variances

Operating experience variances relate to variances between actual experience and that anticipated in the projection assumptions.

Operating experience variances totalled £(21) million (2011: £(9) million) and comprise the following elements:

- £(12) million charge from worse than expected persistency experience primarily as a result of the Retail Distribution Review ("RDR"). At 31 December 2011 there was a provision of £88 million to cover adverse persistency experience in the run up to the implementation of the RDR. £55 million of this provision has been used to partially offset the adverse experience during 2012;
- £(11) million charge from a number of small tax variances;
- £(2) million charge from actual expenses being higher than long-term expense assumptions and any short-term expense provisions, the majority of which relates to costs incurred during the year that will not form part of the ongoing cost base, such as costs associated with the establishment of Friends Life Investments ("FLI");
- £10 million benefit from better than assumed mortality experience, in particular on the life protection business;
- £3 million benefit from better than assumed morbidity experience, in particular on the income protection business; and
- £(9) million net charge from other sources.

Operating assumption changes

Operating assumption changes of £62 million in the year (2011: £147 million) comprise:

- £32 million benefit from updating mortality assumptions for protection and life bond business following the latest experience review;
- £19 million benefit from a reduction in long-term expenses, partially offset by a charge from establishing a provision to cover temporary expenses;
- £16 million benefit from reducing investment management fees charged to life funds by managing more asset portfolios internally via FLI, increasing the allocation to passively managed investment funds and some associated future VAT savings;
- £3 million benefit from updating long-term persistency assumptions for protection and investment bond business, partially offset by the strengthening of long-term persistency assumptions for personal pension business;
- £(7) million charge from the strengthening of morbidity assumptions on critical illness business to reflect recent experience, partially offset by a benefit from updating morbidity assumptions for income protection business; and
- £(1) million charge from other sources.

Other operating variances

Other operating variances of £19 million (2011: £9 million) comprise:

- £48 million benefit from the release of provisions in respect of tax losses on unit linked business following a review of methodology;
- £7 million benefit from the reduction in the cost of non-hedgeable risk resulting from an updated economic capital model;
- £5 million net benefit from the impact of annuity rebates between with-profits funds and shareholder funds;
- £5 million benefit from a revised reinsurance programme for the Group Life business;
- £(53) million charge from modelling changes following a number of modelling review programmes; and
- £7 million benefit from other sources.

Development costs

The total development costs of £(42) million (2011: £(28) million) relate to the 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 business strategy;

- the development of the corporate investment platform;
- the development of business systems in advance of the introduction of auto-enrolment; and
- the development of the business in advance of the RDR.

FPI covered business

The life and pensions covered business operating loss before tax for the FPI segment was £(102) million in 2012 (2011: £30 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 £23 million (2011: £27 million) comprises £21 million (2011: £24 million) which reflects the expected return on the opening value of in-force of £502 million at 1 January 2012 (2011: £473 million at 1 January 2011) and £2 million (2011: £3 million) from the expected return on shareholders' net assets. The decrease in the expected return on the value of in-force primarily reflects the lower expected rates of return on equity and property assets.

Operating experience variances

Operating experience variances of £(12) million (2011: £(7) million) comprise:

- £4 million benefit from mortality experience being better than expected;
- £(5) million charge from expenses being higher than anticipated, the majority of which relates to costs incurred during the period that will not form part of the ongoing cost base, in particular strategic review costs;
- £(3) million charge from the establishment of a mortgage protection mis-selling provision in AmLife;
- £(4) million charge from persistency experience being worse than anticipated on regular savings plans; and
- £(4) million charge from other operational experience.

Operating assumption changes

Operating assumption changes of £(107) million in the year (2011: £(3) million) comprise:

- £(65) million charge from strengthening long-term persistency assumptions across a number of territories;
- £(60) million charge from strengthening expense assumptions following the International strategic review including establishing a closure provision for OLAB;
- £9 million benefit from updating mortality assumptions; and
- £9 million benefit from an increase in management fund rebates.

Other operating variances

Other net adverse operating variances amounting to £(5) million in the year (2011: £(20) million) principally reflect enhancements to internal models following internal review, including enhancements to the modelling of return of premium guarantees and movements in the cost of non-hedgeable risk.

Development costs

Development costs of £(6) million (2011: £(7) million) include £(2) million in respect of the development of the International Platform.

Lombard covered business

The life and pensions covered business operating profit before tax for the Lombard segment was £104 million (2011: £82 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 £35 million (2011: £49 million) reflects the expected return on the opening value of in-force of £457 million at 1 January 2012 (2011: £497 million at 1 January 2011).

Operating experience variances

Operating experience variances of £(23) million (2011: £(12) million) comprise:

- £(11) million charge from the one-off costs of strategic development plans;
- £(9) million charge resulting from persistency experience being worse than anticipated. At 31 December 2011, an £11 million provision was established for short-term adverse persistency experience in the Spanish and Belgian markets. This provision has been released to partially offset the adverse experience on this business during 2012;
- £(9) million charge from share-based payments representing the fair value charge of the Lombard long-term incentive plans;
- £(3) million charge from worse than expected mortality; and
- £9 million benefit from a number of offsetting items including renegotiation of terms with reinsurers and custodian banks.

Operating assumption changes

Operating assumption changes of £36 million in the year (2011: £(4) million) comprise:

- £46 million benefit from a change in long-term expense assumptions, including £40 million from the implementation of the strategic development plans;
- £4 million benefit from updates to mortality assumptions to reflect experience; and
- £(14) million charge from the strengthening of long-term persistency assumptions following the latest experience review, and allowing for short-term expected adverse persistency in specific markets.

Other operating variances

Other operating variances of £13 million (2011: £(2) million) relate to the benefit from further corporate optimisation, partially offset by movements in the cost of non-hedgeable risk.

Development costs

Development costs of £(2) million (2011: £(1) million) related to the development of new products throughout the year.

FLG corporate covered business

FLG corporate includes the external STICS, the external UT2 subordinated debt with associated currency swap, the external LT2 subordinated debt 2021, the external LT2 subordinated debt 2022 and the cost of holding any required capital in excess of the operating segment capital policy.

The expected existing business contribution of £(75) million (2011: £(46) million) represents the expected interest costs arising on the debt held within the FLG life and pensions covered business with the increase driven by the issuance of the new UT2 subordinated debt and associated currency swap and market movements.

The other operating variances are £nil (2011: £19 million). The 2011 benefit arose as a result of the changes to the Group capital management policy to hold 150% (previously 160%) of the Group Capital Resource Requirement excluding WPICC.

Non-covered business

FLG non-covered business reported an operating loss of £(21) million (2011: £(35) million) due to the interest payable on the internal LT2 subordinated debt 2020 issued to Resolution holding companies and holding company costs, credit facility fees, partially offset by a £2 million benefit for the change in the expected cost of the FLG long-term incentive plan and expected return on non-covered assets of £6 million.

The Resolution holding companies reported an operating loss of £(28) million (2011: £(41) million). The loss comprises £(23) million of financing costs and £(21) million of administrative expenses reflecting fees payable to ROL, directors' emoluments and other legal and professional fees. Partially offsetting these amounts is interest income of £16 million on the internal LT2 subordinated debt 2020 issued by FLG that was repaid in November 2012.

Economic variances

Economic variances combine the impact of changes in economic assumptions with the investment return variances over the year.

Total economic variances of £154 million (2011: £(600) million) comprise:

- £306 million due to the narrowing of credit spreads;
- £157 million as a result of better than expected investment returns on equities;
- £(10) million of foreign exchange movements, primarily due to the strengthening of Sterling against the Euro;
- £(303) million from an increase in the market value of debt; and
- £4 million of other minor economic variances.

Other non-operating items

The total other non-operating items were £(142) million (2011: £(285) million) comprising:

- £(132) million of non-recurring project costs within the covered business in respect of separation and integration of UK and Heritage businesses;
- £(42) million of non-recurring project costs within the covered business in respect of Solvency II costs and financial reporting improvements, partially offset by the release of a £34 million Solvency II provision;
- £(40) 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) and curtailment gains on the defined benefits pension scheme from staff transfers;
- £(17) million of cost related to the capital optimisation programme;
- £(16) million of cost from the simplification of governance structure and transition from ROL to FLG;
- £(15) million charge from the impairment of non-covered business acquired intangible assets
- £22 million curtailment gains on the defined benefit scheme arising on the closure of the scheme to future accruals;
- £106 million from tax related non-operating items including a £70 million benefit on the UK value of in-force business of changing the ultimate corporation tax rate effective from April 2014 from 23% to 21%, following the Chancellor’s Autumn Statement in December 2012 and the benefits from the NLTR; and
- £(8) million of other non-recurring items.

4. Earnings per share

Earnings per share have been calculated based on the MCEV profit after tax and on the operating profit after tax, attributable to ordinary equity holders of the parent and the weighted average number of shares in issue. The directors consider that operating earnings per share provides a better indication of operating performance.

Basic and operating earnings per share

For the year ended 31 December 2012	**Earnings £m**	**Per share Pence**
Profit after tax attributable to ordinary equity holders of the parent	**268**	**19.26**
Economic variances	**(154)**	**(11.07)**
Amortisation and impairment of non-covered business acquired intangible assets	**15**	**1.08**
Non-recurring items and non-operating variances	**127**	**9.13**
Tax charge on items excluded from operating profit	**6**	**0.43**
Operating profit after tax attributable to ordinary equity holders of the parent	**262**	**18.83**

For the year ended 31 December 2011	Earnings £m	Per share Pence
Loss after tax attributable to ordinary equity holders of the parent	(295)	(20.69)
Economic variances	600	42.08
Amortisation of non-covered business acquired intangible assets	3	0.21
Non-recurring items and non-operating variances	282	19.78
Tax credit on items excluded from operating profit	(223)	(15.64)
Operating profit after tax attributable to ordinary equity holders of the parent	367	25.74

Diluted earnings per share from continuing operations

There were no dilutive factors for the years ended 31 December 2012 and 31 December 2011.

Weighted average number of ordinary shares

	2012 Actual	2012 Weighted
Issued ordinary shares at beginning of period	**1,376,188,989**	**1,376,188,989**
Own shares held by the Group at the beginning of the period	**(2,661,384)**	**(2,661,384)**
Effect of:		
scrip dividend (final 2011)	**15,484,945**	**9,477,125**
scrip dividend (interim 2012)	**26,435,094**	**6,283,752**
reduction in own shares held by the Group	**2,661,384**	**1,999,674**
Number of ordinary shares at end of period	**1,418,109,028**	**1,391,288,156**

	2011 Actual	2011 Weighted
Issued ordinary shares at beginning of period	1,452,564,371	1,452,564,371
Own shares held by the Group at beginning of period	(8,579,292)	(8,579,292)
Effect of:		
scrip dividend (final 2010)	13,639,313	8,183,588
share repurchase	(92,990,516)	(31,044,327)
scrip dividend (interim 2011)	2,975,821	717,458
reduction in own shares held by the Group	8,579,292	4,324,903
own shares acquired through the acquisition of WLUK	(2,661,384)	(393,739)
Number of ordinary shares at end of period	1,373,527,605	1,425,772,962

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:

	RSL 2012 £m	RSL 2011 £m	FLG 2012 £m	FLG 2011 £m
Equity attributable to ordinary shareholders on an IFRS basis	**5,377**	5,672	**5,244**	5,825
Less items only included on an IFRS basis (net of tax):				
IFRS reserving and other IFRS adjustments	**(32)**	463	**(32)**	463
Deferred front end fees	**47**	33	**47**	33
Deferred acquisition costs	**(708)**	(500)	**(708)**	(500)
Acquired present value of value in-force ("AVIF")	**(3,159)**	(3,442)	**(3,159)**	(3,442)
Other intangible assets	**(246)**	(305)	**(246)**	(305)
Add items only included on a MCEV basis (net of tax):				
Adjustment for long-term debt to market value	**310**	31	**310**	31
Net worth on a MCEV basis	**1,589**	1,952	**1,456**	2,105
Value of in-force covered business	**4,242**	3,844	**4,242**	3,844
Equity attributable to ordinary shareholders on a MCEV basis	**5,831**	5,796	**5,698**	5,949

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"). 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;
- Annual Premium Equivalent ("APE"). 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.

The value of new business is calculated using operating assumptions at the end of period for all products. The operating assumptions are consistent with those used to determine the embedded value.

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.

The 2011 tables below exclude new business in relation to the GOF and TIP businesses disposed of in November 2011.

New business value

	New business premiums							
Year ended 31 December 2012	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	**844**	**451**	**535**	**4.1**	**2,714**	**16**	**21**	**0.8**
UK Protection	**–**	**90**	**90**	**6.6**	**590**	**47**	**62**	**10.5**
UK Retirement Income(ii)	**436**	**–**	**44**	**–**	**436**	**44**	**59**	**13.5**
UK Heritage	**550**	**47**	**102**	**4.9**	**780**	**2**	**2**	**0.3**
UK and Heritage total	**1,830**	**588**	**771**	**4.6**	**4,520**	**109**	**144**	**3.2**
FPI	**633**	**139**	**202**	**4.9**	**1,315**	**8**	**5**	**0.4**
Lombard	**2,376**	**–**	**238**	**–**	**2,376**	**35**	**45**	**1.9**
International total	**3,009**	**139**	**440**	**4.9**	**3,691**	**43**	**50**	**1.4**
Total	**4,839**	**727**	**1,211**	**4.6**	**8,211**	**152**	**194**	**2.4**

(i) Defined as (PVNBP less total amount of single premiums)/(total annualised amount of regular premiums).
(ii) The value of new business for annuities shown in the table above has been valued assuming an illiquidity premium of 90bps from 1 January 2012 to 30 June 2012 and 80bps from 1 July 2012 to 31 December 2012.

New business value

Year ended 31 December 2011	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	574	382	440	4.0	2,103	11	15	0.7
UK Protection	–	92	92	6.1	563	12	16	2.8
UK Retirement Income[(ii)]	321	–	32	–	321	23	32	10.0
Heritage	763	81	157	5.2	1,182	(3)	(4)	(0.3)
UK and Heritage total	1,658	555	721	4.5	4,169	43	59	1.4
FPI	648	187	252	5.1	1,603	36	40	2.5
Lombard	2,372	–	237	–	2,372	40	52	2.2
International total	3,020	187	489	5.1	3,975	76	92	2.3
Total	4,678	742	1,210	4.7	8,144	119	151	1.9

(i) Defined as (PVNBP less total amount of single premiums)/(total annualised amount of regular premiums).
(ii) The value of new business for annuities included in the table above has been valued assuming an illiquidity premium of 75bps over the eight months to 31 August 2011 and 90bps over the four months from 1 September 2011 to 31 December 2011.

UK and Heritage

The pre-tax VNB from the UK and Heritage segment was £144 million (2011: £59 million), comprising:

- UK Corporate Benefits VNB of £21 million (2011: £15 million), reflecting the increase in volumes over the year, including the business from the acquired WLUK business in addition to the benefit delivered by the Diligenta outsourcing deal;
- UK Protection VNB of £62 million (2011: £16 million), a significant improvement in VNB reflecting the focus on higher value critical illness and income protection products as well as the migration to the lower cost strategic platform;
- UK Retirement Income VNB of £59 million (2011: £32 million), uncertainty in fixed income markets throughout 2012 led the cautious pricing levels that resulted in strong new business margins; and
- Heritage VNB of £2 million (2011: £(4) million) which specifically focuses on products no longer actively marketed.

FPI

FPI VNB was £5 million (2011: £40 million), mainly reflecting a reduction in new business volumes experienced over the year and the strengthening of basis assumptions following the strategic review.

Lombard

Lombard VNB of £45 million (2011: £52 million) has decreased despite volumes remaining stable. This reflects a changing product mix from IFA led business to Private Bank led business, with this shift expected to impact short-term margins whilst distribution channels mature.

New business performance metrics

New business written requires an initial capital investment to meet the set-up costs and capital requirements.

The internal rate of return ("IRR") provides a measure of the return to shareholders on this initial capital investment. It is equivalent to the discount rate at which the present value of the after-tax cash flows expected to be earned over the lifetime of the business written is equal to the initial capital invested, including setting aside the required capital, to support the writing of the business. The Lombard IRR (and therefore the blended Friends Life Group IRR) takes account of the Luxembourg regulatory regime in which DAC is an allowable asset.

The cash payback on new business is the time elapsed until the total of expected (undiscounted) cash flows is sufficient to recoup the initial capital invested, including the release of the required capital, to support the writing of new business.

New business key performance metrics

	2012			2011		
	Pre-tax VNB £m	**Internal rate of return on new business %**	**Cash payback on new business Years**	Pre-tax VNB £m	Internal rate of return on new business %	Cash payback on new business Years
UK Corporate Benefits	**21**	**7.2**	**12**	15	8.3	12
UK Protection	**62**	**13.8**	**6**	16	5.5	12
UK Retirement Income	**59**	**n/a(i)**	**n/a(i)**	32	22.0	7
Heritage	**2**	**4.6**	**14**	(4)	6.0	13
UK and Heritage total	**144**	**11.1**	**9**	59	7.7	11
FPI	**5**	**5.4**	**12**	40	12.7	7
Lombard	**45**	**22.5**	**5**	52	>25	4
International total	**50**	**9.0**	**9**	92	16.3	6
Total	**194**	**10.4**	**9**	151	10.0	10

(i) The strong new business margin means the initial capital investment in writing the new business is fully recouped by the single premium paid. This also means that an IRR for this business is not relevant.

For UK protection, the focus on higher value critical illness and income protection products combined with the migration to the lower cost strategic platform has driven the significant reduction in cash payback period to six years (2011: 12 years).

For FPI, the strengthening of basis assumptions following the strategic review has driven the increase in the cash payback period to 12 years (2011: seven years).

7. Segmental analysis of Group MCEV

	2012									2011
At 31 December	Free surplus £m	Required capital £m	Total net worth £m	PVFP £m	TVOG £m	Frictional costs £m	Non-hedgeable risks £m	Total VIF £m	Total £m	Total £m
UK and Heritage	**591**	**1,524**	**2,115**	**3,598**	**(123)**	**(109)**	**(174)**	**3,192**	**5,307**	5,341
FPI	**48**	**49**	**97**	**544**	**(3)**	**(4)**	**(22)**	**515**	**612**	571
Lombard	**2**	**78**	**80**	**564**	**–**	**(3)**	**(26)**	**535**	**615**	541
FLG Corporate(i)										
IFA and distribution	**39**	**–**	**39**	**–**	**–**	**–**	**–**	**–**	**39**	61
Pension asset of FPPS	**38**	**–**	**38**	**–**	**–**	**–**	**–**	**–**	**38**	30
Other	**698**	**(15)**	**683**	**–**	**–**	**–**	**–**	**–**	**683**	564
Gross MCEV of FLG(ii)	**1,416**	**1,636**	**3,052**	**4,706**	**(126)**	**(116)**	**(222)**	**4,242**	**7,294**	7,108
FLG corporate – external STICS	**–**	**(443)**	**(443)**	**–**	**–**	**–**	**–**	**–**	**(443)**	(327)
FLG corporate – external debt(iii)	**–**	**(1,153)**	**(1,153)**	**–**	**–**	**–**	**–**	**–**	**(1,153)**	(632)
FLG corporate – internal LT2 subordinated debt 2020	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	(200)
Net MCEV of FLG	**1,416**	**40**	**1,456**	**4,706**	**(126)**	**(116)**	**(222)**	**4,242**	**5,698**	5,949
Resolution(iv) corporate net assets	**133**	**–**	**133**	**–**	**–**	**–**	**–**	**–**	**133**	270
Resolution Limited DCNs	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	(423)
Net Group MCEV of Resolution Limited attributable to equity holders of parent	**1,549**	**40**	**1,589**	**4,706**	**(126)**	**(116)**	**(222)**	**4,242**	**5,831**	5,796

(i) FLG corporate excludes the external STICS, the external UT2 subordinated debt with associated currency swap, the external LT2 subordinated debt 2021 and the external LT2 subordinated debt 2022.

(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, the external LT2 subordinated debt 2021 and the external LT2 subordinated debt 2022. The accrued interest and tax adjustment on market valuation is included in the gross MCEV of FLG Corporate.

(iii) The FLG 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) Resolution holding companies.

i) Net worth

The external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 are included within the MCEV at market value, as detailed in note 10.

ii) PVFP

The PVFP at 31 December 2012 includes a deduction of £25 million net of tax (2011: £65 million) from UK and Heritage, as a provision against worsening persistency as a result of the Retail Distribution Review, and a £9 million (2011: £10 million) deduction in respect of a short-term persistency provision established in Lombard relating to specific markets.

iii) TVOG

The TVOG at 31 December 2012 of £126 million (31 December 2011: £101 million), is split between £90 million (31 December 2011: £69 million) market risk and £36 million (31 December 2011: £32 million) non-market risk. The non-market risks include lapses, annuitant longevity, and operational risk within the with-profits funds. The allowance for non-market risks is made by consideration of the impact of extreme scenarios from the Group's economic capital model. The increase in TVOG is a result of:

- improved modelling of guaranteed annuity options which results in an increase of £14 million; and
- the change in the economic conditions during 2012.

iv) Frictional costs of holding required capital

The projected required capital for life company subsidiaries is derived from the Group's capital management policy which is to hold the greater of 150% of Pillar 1 CRR excluding WPICC and 125% Pillar 2 CRR including any Individual Capital Guidance.

Additionally, the Group capital management policy in respect of FLG is to hold 150% of Group CRR excluding WPICC (31 December 2011: 150%). The cost of holding any additional capital is shown in the FLG corporate covered business segment.

v) CNHR

The cost of residual non-hedgeable risk of £222 million (31 December 2011: £223 million) is presented as an equivalent annual cost of capital charge of 1.5% (31 December 2011: 2%) on projected risk-based Group required capital for all non-hedgeable risk. In line with management's view of the business, allowance has been made for diversification benefits within the non-hedgeable risks of the covered business. The equivalent annual cost of capital charge is lower than reported in 2011 primarily due to significant falls in risk-free rates used to discount the capital charges in future years, hence lowering the equivalent percentage charge for a similar overall cost of non-hedgeable risk.

8. Segmental analysis of Group MCEV earnings

The following tables show a further breakdown of the Group MCEV earnings for each of the Group and Friends Life group respectively, comprising the MCEV earnings for the life and pensions covered business and the IFRS earnings for the respective non-covered businesses.

All figures are shown net of attributed tax.

	FLG						RSL	
	Covered business							
Year ended 31 December 2012	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Non-covered business £m	Total £m	RSL (ex.FLG)[i] Non-covered business £m	Total £m
Opening Group MCEV	**5,341**	**571**	**541**	**(1,041)**	**537**	**5,949**	**(153)**	**5,796**
Operating MCEV earnings	**381**	**(79)**	**80**	**(57)**	**(35)**	**290**	**(28)**	**262**
Non-operating MCEV earnings	**243**	**(16)**	**10**	**(228)**	**(1)**	**8**	**(2)**	**6**
Total Group MCEV earnings	**624**	**(95)**	**90**	**(285)**	**(36)**	**298**	**(30)**	**268**
Other movements in IFRS net equity	**–**	**–**	**–**	**–**	**(35)**	**(35)**	**7**	**(28)**
Closing adjustments:								
capital and dividend flows	**(658)**	**136**	**–**	**(285)**	**309**	**(498)**	**309**	**(189)**
foreign exchange variances	**–**	**–**	**(16)**	**–**	**–**	**(16)**	**–**	**(16)**
Closing Group MCEV	**5,307**	**612**	**615**	**(1,611)**	**775**	**5,698**	**133**	**5,831**

(i) RSL (ex. FLG) refers to the Resolution holding companies.

Other movements in IFRS net equity reflect £(35) million of actuarial losses on defined benefit pension schemes and £7 million in respect of the reduction in own shares held by the Group's subsidiaries during the year.

The total closing capital and dividend outflow of £(189) million comprises:

- £(193) million outflow in respect of dividends to equity holders of Resolution Limited net of the impact of scrip dividends in the year; and
- £4 million net inflow in respect of other items, including the impact on reserves of the fair value charge for the Lombard equity-settled incentive scheme.

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Year ended 31 December 2011	FLG Covered business UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Non-covered business £m	Total £m	RSL RSL (ex.FLG)[i] Non-covered business £m	Total £m
Opening Group MCEV	5,995	557	577	(659)	44	6,514	1	6,515
Opening adjustments:								
– acquired value of BHA	226	–	–	–	–	226	–	226
– cost of acquisition of BHA	(168)	–	–	–	–	(168)	–	(168)
– acquired value of WLUK	271	–	–	–	–	271	–	271
– cost of acquisition of WLUK	–	–	–	–	(248)	(248)	–	(248)
Adjusted opening Group MCEV	6,324	557	577	(659)	(204)	6,595	1	6,596
Operating MCEV earnings	371	30	62	(20)	(35)	408	(41)	367
Non-operating MCEV earnings	(621)	(54)	(88)	102	(1)	(662)	–	(662)
Total Group MCEV earnings	(250)	(24)	(26)	82	(36)	(254)	(41)	(295)
Other movements in IFRS net equity	–	–	–	–	(32)	(32)	13	(19)
Closing adjustments:								
–capital and dividend flows	(783)	39	4	(464)	859	(345)	(126)	(471)
–foreign exchange variances	–	(1)	(14)	–	–	(15)	–	(15)
–transfer of GOF and TIP businesses to AXA UK plc	50	–	–	–	(50)	–	–	–
Closing Group MCEV	5,341	571	541	(1,041)	537	5,949	(153)	5,796

(i) RSL (ex. FLG) refers to the Resolution holding companies.

9. Maturity profile of value of in-force business by proposition

At 31 December 2012	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 and Heritage										
UK Corporate Benefits	**629**	**243**	**170**	**112**	**62**	**29**	**10**	**3**	**–**	**–**
UK Protection	**223**	**84**	**49**	**37**	**27**	**15**	**7**	**3**	**1**	**–**
UK Retirement Income	**73**	**5**	**6**	**9**	**12**	**15**	**12**	**8**	**4**	**2**
Heritage	**2,267**	**989**	**521**	**321**	**192**	**109**	**62**	**35**	**20**	**18**
UK and Heritage total	**3,192**	**1,321**	**746**	**479**	**293**	**168**	**91**	**49**	**25**	**20**
International										
FPI[i]	**515**	**273**	**124**	**68**	**31**	**12**	**4**	**2**	**1**	**–**
Lombard	**535**	**201**	**124**	**84**	**52**	**32**	**20**	**11**	**7**	**4**
International total	**1,050**	**474**	**248**	**152**	**83**	**44**	**24**	**13**	**8**	**4**
Total VIF	**4,242**	**1,795**	**994**	**631**	**376**	**212**	**115**	**62**	**33**	**24**

(i) The FPI maturity profile includes £13 million VIF in years one to five in respect of AmLife, which was sold on 4 January 2013.

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 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 Friends Life group to such debt is minimal.

	Reference rate – risk-free	
	2012 %	2011 %
UK and Heritage		
Long-term rate	**1.90**	2.40
Swap yield curve		
Term 1 year	**0.67**	1.35
Term 5 years	**1.03**	1.57
Term 10 years	**1.93**	2.36
Term 15 years	**2.58**	2.78
Term 20 years	**2.94**	3.00
FPI long-term rate	**1.90**	2.40
Lombard long-term rate	**2.13**	2.55

Reference rate – Illiquidity premium adjustment

The updated MCEV Principles recognise that the inclusion of an illiquidity premium within the reference rate is appropriate where the liabilities are not liquid.

In this regard, the methodology adopted for the valuation of immediate annuities in the UK and Heritage uses a reference rate that has been increased above the swap yield curve to allow for an illiquidity premium. This reflects the fact that, for these products, the backing asset portfolio can be held to maturity and earns risk-free returns in excess of swaps. Any illiquidity premia in respect of assets backing other product types are recognised within the MCEV as and when they are earned.

The illiquidity premium has been evaluated by considering a number of different sources of information and methodologies. Two of the main approaches 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 and some deferred annuity business.

Corporate bond spreads have narrowed over 2012 back towards similar levels seen at the 2010 year end and the illiquidity premium has been decreased from 90bps to 80bps, applicable from 1 July 2012, and from 80bps to 75bps, applicable from 1 January 2013, in line with these observed movements. The VNB calculations use the average illiquidity premium over the year and so include 90bps for the business written in the first six months of the year and 80bps for the business written in the second six months of the year. The MCEV economic variances are based on the assumptions at the end of the year and so will be based on an illiquidity premium of 75 bps.

No illiquidity premium has been applied for any other covered business.

The reference rate has been adjusted for immediate and some deferred annuities as set out in the table below.

	Embedded value		New business	
	2012	2011	**2012**	2011
UK and Heritage immediate annuities	**75bps**	90bps	**85bps**(i)	80bps(ii)

(i) average illiquidity premium over 2012, illiquidity premium decreased from 90bps to 80bps from 1 July 2012.
(ii) average illiquidity premium over 2011, illiquidity premium increased from 75bps to 90bps from 1 September 2011.

Expected asset returns in excess of reference rates

Margins are added to the reference rates to obtain investment return assumptions for equity, property and corporate bonds. These risk premia reflect management's expectations of asset returns in excess of the reference rate from investing in different asset classes. As a market consistent approach has been followed, these investment return assumptions affect the expected existing business contribution and the economic variances within the analysis of MCEV earnings, but do not affect the opening or closing embedded values. In addition, they will affect the additional disclosures of the payback periods.

For equities and property, the excess is calculated as the difference between the long-term rate of return and the one-year risk-free reference rate. The long-term rate of return is derived using a 10-year swap rate plus a risk premium of 3% for equities (2011: 3%) and 2% for property (2011: 2%).

For cash and government bonds, no excess over the one-year risk-free reference rate has been assumed for UK and Heritage and FPI, Lombard assumes the long-term rate is achieved. For corporate bonds, the return is based on the excess of actual corporate bond spreads on the reporting date, less an allowance for defaults, over the one-year risk-free reference rate for UK and Heritage and FPI. For Lombard the corporate bond return is derived using the long-term rate plus a risk premium of 1% (2011: 1%).

For annuity business the excess return reflects the excess of the bond portfolio over the reference rate including the illiquidity premium adjustment.

Expense inflation

Maintenance expenses for UK and Heritage and FPI are assumed to increase in the future at a rate of 1% (2011: 1%) per annum in excess of the assumed long-term rate of inflation. Long-term inflation assumptions are set relative to gilt curves at appropriate durations.

Maintenance expenses for Lombard are assumed to increase in the future at a rate of 0.75% (2011: 0.75%) per annum in excess of the assumed long-term rate of inflation. This is derived from an inflation swap curve based on a Eurozone price index taking into account the run-off profile of the business.

	Expense inflation	
	2012 %	2011 %
UK and Heritage	**3.70**	3.70
FPI	**3.70**	3.70
Lombard	**3.00**	2.95

Exchange rates

The results and cash flows of all businesses, except Lombard and AmLife, are calculated in Sterling. The results and cash flows for Lombard are calculated in Euros and those of AmLife in Malaysian Ringgits, and converted to Sterling at the following rates:

	Exchange rates	
	2012	2011
Closing exchange rate		
Euro	**0.811**	0.835
Malaysian Ringgit	**0.201**	0.203
Average exchange rate		
Euro	**0.813**	0.869
Malaysian Ringgit	**0.204**	0.204

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 at the current rate of one-ninth of the cost of bonus:

- Friends Life FP With-Profits Fund ("FLFP WPF")
- Friends Life FLAS With-Profits Fund ("FLFLAS WPF")
- Friends Life FLC Old With-Profits Fund ("FLFLC OWPF")
- Friends Life FLC New With-Profits Fund ("FLFLC NWPF")
- Friends Life FLWL With-Profits Fund ("FLFLWL WPF")

In addition it is assumed that the shareholder interest in the non-profit business of the FLFP WPF continues at the current rate of 60% of future profits.

Following the Part VII transfer of business from FLC to FLL, the requirement to retain the FLC reattributed inherited estate ("RIE") to support FLFLC OWPF and FLFLC NWPF along with other previously existing with-profit fund support arrangements have been incorporated into one FLL Scheme effective from 28 December 2012.

The FLL Scheme rules require that a test be undertaken every five years to determine the level of shareholder capital support required for FLFLC OWPF and FLFLC NWPF. The test also determines whether it is possible to distribute any of the inherited estate retained in the FLFLC OWPF 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 28 December 2012 to the next five-year test date at 31 December 2015, the cash may be available to be transferred to the FLL shareholders' fund subject to passing the relevant financial strength tests. The MCEV allows for best estimate projections of the amounts to be transferred in future.

10.2 Economic assumptions – stochastic calculations

Model

The time value of financial options and guarantees and the OLAB return of premium guarantee are determined using a Barrie & Hibbert economic scenario generator and are calculated using 2,000 simulations. The with-profits model is consistent with the model used for the Realistic Balance Sheet and is calibrated to market conditions at the valuation date using the gilt risk-free curve and implied volatilities in the market. The OLAB return of premium guarantee model is calibrated to market conditions at the valuation date using a Euro swap curve and implied volatilities in the market. Correlations between the asset classes are derived from historic data.

Swaption implied volatilities – with-profits time value of financial options and guarantees

	2012 swap term				2011 swap term			
Option term	**10 yrs %**	**15 yrs %**	**20 yrs %**	**25 yrs %**	10 yrs %	15 yrs %	20 yrs %	25 yrs %
UK Sterling								
10 years	**18**	**17**	**16**	**15**	18	18	18	18
15 years	**18**	**17**	**16**	**16**	15	16	16	16
20 years	**16**	**16**	**15**	**15**	14	14	14	14
25 years	**16**	**16**	**16**	**15**	13	13	13	13

Swaption implied volatilities – OLAB return of premium guarantee

	2012 swap term			
Option term	**10 yrs %**	**15 yrs %**	**20 yrs %**	**25 yrs %**
Euro				
10 years	**24**	**24**	**23**	**20**
15 years	**27**	**26**	**24**	**20**
20 years	**26**	**24**	**21**	**17**
25 years	**23**	**20**	**18**	**15**

Equity and property implied volatilities – with-profits time value of financial options and guarantees

Equity volatility is calibrated to market implied volatility and is a reasonable fit to the implied volatility of the FTSE 100 put options held by the with-profits funds. Property holdings are modelled assuming an initial volatility of 15% (2011: 15%) and a running yield of 4.3% (2011: 4.3%). Sample implied volatilities are shown in the table below.

	2012		2011	
Option term	**Equity %**	**Property %**	Equity %	Property %
5 years	**24**	**15**	27	15
10 years	**26**	**15**	27	15
15 years	**27**	**15**	27	15

Equity implied volatilities – OLAB return of premium guarantee

Equity volatility is calibrated to put options on the EUROSTOXX50 index as an objective measure of market implied volatility. Sample implied "at-the-money" volatilities are shown in the table below.

	2012
Option term	Equity %
5 years	**25**
10 years	**25**
15 years	**25**

10.3 Other assumptions

Required capital

Required capital under MCEV amounted to £40 million (2011: £747 million). The reduction in required capital has mainly resulted from the issuance of the new UT2 subordinated debt and the increase in the market value of other external debt over the year.

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% (2011: 150%) of Group CRR excluding WPICC, and any cost of holding this additional capital is shown within the FLG corporate covered business segment.

Taxation

The opening and closing embedded values in respect of covered business are determined on an after tax basis. The tax assumptions used are based upon the best estimate of the actual tax expected to arise. The attributable tax charge and profit before tax are derived by grossing up the profit after tax at the appropriate tax rates for each of the UK, Isle of Man, Luxembourg and Malaysia. 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 FLG corporate. For UK and OLAB business the appropriate tax rate has been calculated as the average rate of corporation tax applicable over the period, and hence the rate applicable for 2012 reflects the reduction in corporation tax that took effect from April 2012.

For non-covered business, attributed tax is consistent with the IFRS financial statements.

	Tax rates	
	2012 %	2011 %
UK and Heritage	**24.5**	26.5
FPI		
OLAB (UK)	**24.5**	26.5
FPIL (Isle of Man)	**0.0**	0.0
AmLife (Malaysia)	**25.0**	25.0
Lombard	**22.5**	23.5

The PVFP for UK and Heritage and OLAB businesses includes an allowance for the annual reductions in corporation tax announced in the Emergency Budget in June 2010 and the further reductions of 1% announced in each of the Budgets in April 2011 and April 2012 and the Autumn Statement in December 2012. The MCEV allows for anticipated future annual reductions in corporation tax from 24% to 21% (2011: 26% to 23%) over the period to 2014 and for an ultimate rate of 21% (2011: 23%) from April 2014.

Legislation in respect of the new life tax regime was included in Finance Act 2012, which received Royal Assent on 17 July 2012. The new life tax regime took effect from 1 January 2013 and a best estimate of its effect is therefore included in MCEV, being a forward looking measure. There remains an element of risk and uncertainty in estimating its effects given that the legislation is newly introduced and some regulations and guidance remain outstanding and are expected to be issued during 2013; therefore the outcomes may be subject to change as a result of either legislative update or by development in interpretation.

The tax assumptions used within the MCEV do not take account of the additional 1% reduction in corporation tax, effective from 1 April 2015, announced on 20 March 2013. As a result of this change, the corporation tax rate is expected to be 22% from 1 April 2013, 21% from 1 April 2014 and 20% from 1 April 2015. The impact of this change is estimated to be an increase in the MCEV of £20m at 31 December 2012.

VAT in the UK of 20.0% (2011: 20.0%) less expected recoveries has been included on relevant investment management expenses and, where applicable, on outsourced administration contracts.

Demographic assumptions

Other assumptions (for example mortality, morbidity and persistency) are a reflection of the best estimate of the likely behaviours, outcomes or circumstances in the future. Typically the estimates are made on an annual basis following experience investigations based on the data available at the time both from the book of business and externally sourced information. The aim is to set assumptions at a level that reflects recent experience, unless there are reliable indicators that suggest their adoption would result in a significant variance compared to these assumptions in the future. In some instances, there may be little or no direct experience to use in setting assumptions and the future outcome is therefore uncertain.

The RDR came into effect from 1 January 2013 and an £88 million provision (gross of tax) was recognised as at 31 December 2011, to cover negative variances expected on initial commission business pre-RDR in 2012 where long-term assumptions were expected to be temporarily inadequate. Following the release of £55 million against adverse experience in 2012, this provision has been reduced to £33 million (gross of tax) as at 31 December 2012.

Future improvements in annuitant mortality have been assumed to be in accordance with the projections published by the Continuous Mortality Investigation (“CMI”) in 2011, with a long-term rate of 1.25% (2011: 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.

In June 2009 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. This agreement includes the rationalisation of IT systems and significant longer term cost reductions. 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 IT costs, which result in an overall expense overrun in FLSL.

Strategic development plans for the Lombard business have resulted in projected short-term expense overruns which have been allowed for by reducing the PVFP by £2 million for a projected overrun to 2013.

In November 2011 Friends Life announced a 15-year agreement with Diligenta to outsource IT 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 of £76 million in 2011. In addition, allowance was made in 2011 for the initial significant development expenditure of £(124) million, considered to be non-recurring and shown within other non-operating items in the 2011 results. During 2012, initial development costs of £(72) million, net of a curtailment gain on the pension scheme, have been incurred in relation to the Diligenta arrangement which have been partially offset by a £32 million utilisation of the £124 million provision set up in 2011. The net cost of £(40) million is shown in the consolidated income statement within other non-operating items.

Other one-off costs shown within non-recurring items can be categorised as:

- Solvency II and Finance Transformation project costs;
- Separation and Integration costs;
- Capital restructuring costs; or
- Corporate acquisitions/disposal costs.

Any other one-off costs that do not fall into these categories are treated as operating exceptional costs within operating experience variances.

The MCEV includes provision for certain development costs to the extent that these are known with sufficient certainty and in line with current plans.

Development costs of £50 million (2011: £36 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.

Development costs

	FLG 2012 £m	FLG 2011 £m
UK and Heritage	**42**	28
FPI	**6**	7
Lombard	**2**	1
Total	**50**	36

Non-hedgeable risks

A charge equivalent to 1.5% (2011: 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 2012	**Principal £m**	**Clean market value of debt £m**	**Accrued interest £m**	**Tax adjustment on market valuation £m**	**Value of debt included in FLG corporate[(i)] £m**
STICS 2003	**210**	**193**	**2**	**4**	**199**
STICS 2005	**268**	**250**	**8**	**1**	**259**
LT2 subordinated debt 2021	**162**	**215**	**12**	**(16)**	**211**
LT2 subordinated debt 2022	**500**	**554**	**29**	**(21)**	**562**
UT2 subordinated debt [(ii)]	**356**	**378**	**4**	**(8)**	**374**
Currency swap	**–**	**6**	**–**	**–**	**6**
Total	**1,496**	**1,596**	**55**	**(40)**	**1,611**

At 31 December 2011	Principal £m	Clean market value of debt £m	Accrued interest £m	Tax adjustment on market valuation £m	Value of debt included in FLG corporate[(i)] £m
STICS 2003	210	142	2	17	161
STICS 2005	268	185	8	19	212
LT2 subordinated debt 2021	162	182	12	(9)	185
LT2 subordinated debt 2022	500	450	29	4	483
Total	1,140	959	51	31	1,041

(i) The value of debt included in the FLG corporate category is the market value of debt, including accrued interest, and the deferred 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 the date of issue in November 2012.

The deferred consideration notes, issued in September 2010 in connection with the acquisition of the AXA UK Life Business, were repaid on 20 November 2012 (2011: £423 million).

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. The assumptions underlying the statutory reserving calculations remain unchanged in all sensitivities. There are no additional management actions or changes in policyholder behaviour assumed within any of the sensitivities.

Sensitivities shown in a single direction have broadly symmetrical impacts.

At 31 December 2012	FLG covered business				
Change in MCEV (net of tax)	UK & Heritage £m	FPI[vi] £m	Lombard £m	FLG corporate £m	Total £m
Base MCEV	**5,307**	**612**	**615**	**(1,611)**	**4,923**
Market risk					
100bps increase in reference rates	**(160)**	**(3)**	**–**	**107**	**(56)**
100bps decrease in reference rates	**156**	**19**	**(4)**	**(119)**	**52**
Removal of illiquidity premium for immediate annuities	**(544)**	**–**	**–**	**–**	**(544)**
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield[i]	**(181)**	**(23)**	**(37)**	**–**	**(241)**
25% increase in equity/property volatility at the valuation date	**(32)**	**–**	**–**	**–**	**(32)**
25% increase in swaption implied volatility at the valuation date	**(4)**	**–**	**–**	**–**	**(4)**
100bps increase in corporate bond spreads[ii]	**(310)**	**–**	**(11)**	**107**	**(214)**
100bps decrease in corporate bond spreads[ii]	**380**	**–**	**11**	**(119)**	**272**
10% adverse movement in Sterling/overseas exchange rate[iii]	**(30)**	**(39)**	**(53)**	**–**	**(122)**
10% fall in value of unit-linked funds	**(207)**	**(27)**	**(69)**	**–**	**(303)**
100bps increase in expense inflation	**(65)**	**(24)**	**(15)**	**–**	**(104)**
100bps decrease in expense inflation	**57**	**20**	**12**	**–**	**89**
Insurance and other risk					
Reduction to EU minimum capital or equivalent[iv]	**40**	**–**	**–**	**–**	**40**
10% decrease in maintenance expenses	**109**	**31**	**19**	**–**	**159**
10% proportionate decrease in lapse rates	**83**	**12**	**37**	**–**	**132**
10% proportionate decrease in PUP rates	**13**	**12**	**–**	**–**	**25**
5% decrease in mortality/morbidity – life assurance					
Before reinsurance[v]	**79**	**9**	**3**	**–**	**91**
After reinsurance	**38**	**6**	**2**	**–**	**46**
5% decrease in mortality/morbidity – annuity business					
Before reinsurance[v]	**(132)**	**–**	**–**	**–**	**(132)**
After reinsurance	**(67)**	**–**	**–**	**–**	**(67)**

i) The movement in UK and Heritage embedded value from a reduction in market values comprises a £nil million (2011: £nil million) fall in the value of shareholders' net worth and a £181 million (2011: £188 million) reduction in the value of in-force covered business.

(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 (2011: 35bps) for in-force business and 40bps (2011: 35bps) 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 £886 million (2011: £902 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.

(v) As part of the modelling development in 2012 the methodology for the "Before reinsurance" sensitivities has been harmonised within the UK and Heritage segment, resulting in reduced sensitivity to changes in mortality and morbidity compared to prior years.

(vi) The base MCEV for FPI includes £43 million in respect of AmLife, however the FPI sensitivities exclude AmLife due to its sale on 4 January 2013 and its immaterial impact.

At 31 December 2011	FLG covered business				
Change in MCEV (net of tax)	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Total £m
Base MCEV	5,341	571	541	(1,041)	5,412
Market risk					
100bps increase in reference rates	(130)	(5)	3	47	(85)
100bps decrease in reference rates	121	16	(8)	(51)	78
Removal of illiquidity premium for immediate annuities	(607)	–	–	–	(607)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield(i)	(188)	(23)	(32)	–	(243)
25% increase in equity/property volatility at the valuation date	(32)	–	–	–	(32)
25% increase in swaption implied volatility at the valuation date	(4)	–	–	–	(4)
100bps increase in corporate bond spreads(ii)	(303)	(4)	(14)	47	(274)
100bps decrease in corporate bond spreads(ii)	289	5	14	(51)	257
10% adverse movement in Sterling/overseas exchange rate(iii)	(43)	(46)	(69)	–	(158)
10% fall in value of unit-linked funds	(220)	(26)	(67)	–	(313)
Insurance and other risk					
Reduction to EU minimum capital or equivalent(iv)	41	–	–	–	41
10% decrease in maintenance expenses	147	21	23	–	191
10% proportionate decrease in lapse rates	90	12	33	–	135
10% proportionate decrease in PUP rates	13	7	–	–	20
5% decrease in mortality/morbidity – life assurance					
Before reinsurance	287	4	2	–	293
After reinsurance	52	3	2	–	57
5% decrease in mortality/morbidity – annuity business					
Before reinsurance	(27)	–	–	–	(27)
After reinsurance	(68)	–	–	–	(68)

At 31 December 2012	FLG covered business			
Change in value of new business (gross of tax)	UK & Heritage £m	FPI[iii] £m	Lombard £m	Total £m
Base value of new business	**144**	**5**	**45**	**194**
Market risk				
100bps increase in reference rates	**(6)**	**(2)**	**–**	**(8)**
100bps decrease in reference rates	**5**	**2**	**–**	**7**
Removal of illiquidity premium for immediate annuities	**(31)**	**–**	**–**	**(31)**
100bps increase in corporate bond spreads[i]	**(14)**	**–**	**–**	**(14)**
100bps decrease in corporate bond spreads[i]	**13**	**–**	**–**	**13**
100bps increase in expense inflation	**(7)**	**(5)**	**–**	**(12)**
100bps decrease in expense inflation	**6**	**4**	**–**	**10**
Insurance and other risk				
Reduction to EU minimum capital or equivalent	**2**	**–**	**–**	**2**
10% decrease in maintenance expenses	**8**	**6**	**2**	**16**
10% proportionate decrease in lapse rates	**13**	**–**	**5**	**18**
10% proportionate decrease in PUP rates	**5**	**1**	**–**	**6**
5% decrease in mortality/morbidity – life assurance				
Before reinsurance[ii]	**10**	**3**	**1**	**14**
After reinsurance	**5**	**1**	**–**	**6**
5% decrease in mortality/morbidity – annuity business				
Before reinsurance[ii]	**(4)**	**–**	**–**	**(4)**
After reinsurance	**(4)**	**–**	**–**	**(4)**
Impact of end of period assumptions on VNB	**4**	**(1)**	**–**	**3**

(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 (2011: 35bps) for in-force business and 40bps (2011: 35bps) for the value of new business.

(ii) As part of the modelling development in 2012 the methodology for the "Before reinsurance" sensitivities has been harmonised within the UK and Heritage segment.

(iii) The base value of new business for FPI includes £3 million in respect of AmLife.

At 31 December 2011 Change in value of new business (gross of tax)	FLG covered business UK & Heritage £m	 FPI £m	 Lombard £m	 Total £m
Base value of new business	59	40	52	151
Market risk				
100bp increase in reference rates	(8)	(3)	–	(11)
100bp decrease in reference rates	8	3	(1)	10
Removal of illiquidity premium for immediate annuities	(27)	–	–	(27)
100bps increase in corporate bond spreads	(7)	–	–	(7)
100bps decrease in corporate bond spreads	1	–	–	1
Insurance and other risk				
Reduction to EU minimum capital or equivalent	2	–	–	2
10% decrease in maintenance expenses	10	5	2	17
10% proportionate decrease in lapse rates	11	3	5	19
10% proportionate decrease in PUP rates	4	2	–	6
5% decrease in mortality/morbidity – life assurance				
Before reinsurance	13	1	–	14
After reinsurance	4	–	–	4
5% decrease in mortality/morbidity – annuity business				
Before reinsurance	(3)	–	–	(3)
After reinsurance	(3)	–	–	(3)
Impact of end of period assumptions on VNB	8	7	(1)	14

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 for FLG is shown in the tables below:

FLG **At 31 December 2012**	**MCEV classification** **UK & Heritage** **£m**	 **FPI** **£m**	 **Lombard** **£m**	 **FLG corporate** **£m**	 **Non-covered business** **£m**	**Total MCEV by IFRS segments** **£m**
IFRS segment						
UK and Heritage	**5,307**	**–**	**–**	**–**	**38**	**5,345**
FPI	**–**	**612**	**–**	**–**	**1**	**613**
Lombard	**–**	**–**	**615**	**–**	**5**	**620**
FLG corporate	**–**	**–**	**–**	**(1,611)**	**731**	**(880)**
Total MCEV (by MCEV segments)	**5,307**	**612**	**615**	**(1,611)**	**775**	**5,698**

FLG At 31 December 2011	MCEV classification UK & Heritage £m	 FPI £m	 Lombard £m	 FLG corporate £m	 Non-covered business £m	Total MCEV by IFRS segments £m
IFRS segment						
UK and Heritage	5,341	–	–	–	63	5,404
FPI	–	571	–	–	(2)	569
Lombard	–	–	541	–	3	544
FLG corporate	–	–	–	(1,041)	473	(568)
Total MCEV (by MCEV segments)	5,341	571	541	(1,041)	537	5,949

13. FLG annualised return on embedded value

	2012		2011	
	£m	**% p.a.**	£m	% p.a.
Value of new business	**194**	**2.8**	151	2.0
Expected existing business contribution[(i)]	**400**	**5.7**	406	5.3
Operating experience variances	**(56)**	**(0.8)**	(28)	(0.4)
Operating assumption changes	**(9)**	**(0.1)**	140	1.8
Other operating variances	**27**	**0.4**	6	0.1
Development costs	**(50)**	**(0.7)**	(36)	(0.4)
Other income and charges[(i)]	**(5)**	**(0.1)**	(2)	–
MCEV operating profit before tax and financing	**501**	**7.2**	637	8.4
Impact of financing	**(91)**	**–**	(79)	0.5
Attributed tax charge on MCEV operating profit	**(120)**	**(2.1)**	(150)	(2.4)
MCEV operating profit after tax	**290**	**5.1**	408	6.5
Economic variances	**154**	**2.7**	(600)	(9.5)
Other non-operating items	**(140)**	**(2.5)**	(285)	(4.5)
Attributed tax on other activities	**(6)**	**(0.1)**	223	3.5
MCEV profit/(loss) after tax	**298**	**5.2**	(254)	(4.0)
Actuarial losses on defined benefit pension schemes	**(35)**	**(0.5)**	(32)	(0.6)
Foreign exchange adjustments	**(16)**	**(0.3)**	(15)	(0.2)
Total return on MCEV over the year	**247**	**4.4**	(301)	(4.8)

(i) Impact of financing comprises the expected impact of financing of covered debt of £75 million for 2012 (2011: £46 million), and £16 million impact of financing of non-covered debt of £200 million until it was repaid in November 2012 (2011: £33 million). These amounts have been deducted from the expected existing business contribution and other income and charges respectively.

The table above provides an analysis of the return on FLG embedded value. The starting embedded value for 2012 is £5,949 million, net of the market-consistent value of debt instruments of £1,159 million. The 2012 embedded value has been adjusted to allow for the timing of dividend payments, the full repayment of the internal LT2 subordinated debt 2020 issued to Resolution holding companies by FLG and the new external UT2 subordinated debt and associated currency swap issued during the period.

The starting embedded value for 2011 was £6,514 million, net of the market-consistent value of debt instruments of £1,296 million. The 2011 embedded value was adjusted to allow for the timing of dividend payments, the acquisition of BHA, the acquisition of WLUK and the transfer of the GOF/TIP business to AXA UK, the partial repayment of the internal LT2 subordinated debt 2020 issued to Resolution holding companies by FLG, and the new external LT2 subordinated debt 2022 issued during the period.

The MCEV operating return before tax and financing is based on the gross MCEV (i.e. before the market-consistent value of debt). The return includes both covered and non-covered business. The impact of the financing item reflects the leverage on the return on embedded value created within FLG through the use of debt instruments, net of the cost of financing these instruments.

Appendices

Appendix 1: FPI additional information

Analysis of FPI segment

APE, PVNBP and VNB

Year ended 31 December 2012 £m	FPIL (exc Japan)	Japan	Total FPIL	OLAB	AmLife	Total FPI
New Business APE	146	25	171	26	5	**202**
New Business PVNBP	1,002	135	1,137	139	39	**1,315**
VNB	17	4	21	(19)	3	**5**

MCEV

As at 31 December 2012 £m	FPIL (exc Japan)	Japan	Total FPIL	OLAB	AmLife	Total FPI
Total MCEV	**410**	**59**	**469**	**100**	**43**	**612**

Operating expenses

Year ended 31 December 2012 £m	FPIL	OLAB	TOTAL
Acquisition	(23)	(10)	**(33)**
Maintenance	(26)	(8)	**(34)**
Development	(5)	(1)	**(6)**
Total	(54)	(19)	**(73)**

As AmLife is an associated undertaking, its operating expenses are excluded from the analysis above.

International division strategic review impacts

Year ended 31 December 2012 £m	MCEV operating profit			IFRS based operating profit	
	Value of new business	Other operating variances	Operating assumption changes	New business strain	Principal reserving changes & one-off items
OLAB (principally Germany)	(17)	(2)	(38)	(18)	(79)
Basis	(10)	-	(68)	6	9
Japan	-	-	(5)	-	-
Lombard	-	-	46	-	-
Total impact	**(27)**	**(2)**	**(65)**	**(12)**	**(70)**

Note: International strategic review includes the impact of the annual basis reviews in FPIL and OLAB. The annual basis reviews for Lombard and AmLife were not undertaken as part of the International strategic review.

Appendix 2: New business information

Analysis of Life and Pensions new business

- single new business premiums consist of those contracts under which there is no expectation of continuing premiums being paid at regular intervals;
- regular new business premiums consist of those contracts under which there is an expectation of continuing premiums being paid at regular intervals, including repeated or recurrent single premiums where the level of premiums is defined, or where a regular pattern in the receipt of premiums has been established;
- non-contractual increments under existing group pensions schemes are classified as new business premiums;
- transfers between products where open market options are available are included as new business; and
- regular new business premiums are included on an annualised basis.

Regular and single premiums

	Regular premiums			Single premiums		
	FY 2012 £m	FY[(i)] 2011 £m	Change %	**FY 2012 £m**	FY[(i)] 2011 £m	Change %
UK division						
– Corporate Benefits	**451**	382	18	**844**	574	47
– Protection	**90**	92	(2)	**–**	–	–
– Retirement Income	**–**	–	–	**436**	321	36
Heritage division	**47**	81	(42)	**550**	763	(28)
Total UK and Heritage	**588**	555	6	**1,830**	1,658	10
FPI	**139**	187	(26)	**633**	648	(2)
Lombard	**–**	–	–	**2,376**	2,372	–
Total International division	**139**	187	(26)	**3,009**	3,020	–
Total Life and Pensions	**727**	742	(2)	**4,839**	4,678	3

(i) Includes the trading results of the acquired WLUK business from 7 November 2011.

	Regular premiums			Single premiums		
	Q4 2012 £m	Q4[(i)] 2011 £m	Change %	**Q4 2012 £m**	Q4[(i)] 2011 £m	Change %
UK division						
– Corporate Benefits	**106**	102	4	**92**	98	(6)
– Protection	**25**	20	25	**–**	–	–
– Retirement Income	**–**	–	–	**157**	71	121
Heritage	**10**	19	(47)	**71**	158	(55)
Total UK and Heritage	**141**	141	–	**320**	327	(2)
FPI	**31**	43	(28)	**179**	135	33
Lombard	**–**	–	–	**1,189**	996	19
Total International division	**31**	43	(28)	**1,368**	1,131	21
Total Life and Pensions	**172**	184	(7)	**1,688**	1,458	16

(i) Includes the trading results of the acquired WLUK business from 7November 2011.

Group new business - APE

APE represents annualised new regular premiums plus 10% of single premiums.

	FY 2012 £m	FY[(i)] 2011 £m	Change %	**Q4 2012 £m**	Q4[(i)] 2011 £m	Change %
UK division						
– Corporate Benefits	**535**	440	22	**115**	112	3
– Protection	**90**	92	(2)	**25**	20	25
– Retirement Income	**44**	32	38	**16**	7	129
Heritage division	**102**	157	(35)	**17**	35	(51)
Total UK and Heritage	**771**	721	7	**173**	174	(1)
FPI	**202**	252	(20)	**49**	57	(14)
Lombard	**238**	237	–	**119**	99	20
Total International division	**440**	489	(10)	**168**	156	8
Total Life and Pensions	**1,211**	1,210	–	**341**	330	3

(i) Includes the trading results of the acquired WLUK business from 7November 2011.

Quarterly new business progression - APE

	Q4 2012 £m	Q3 2012 £m	Q2 2012 £m	Q1 2012 £m
UK division				
– Corporate Benefits	**115**	128	146	146
– Protection	**25**	22	25	18
– Retirement Income	**16**	9	10	9
Heritage division	**17**	25	36	24
Total UK and Heritage	**173**	184	217	197
FPI	**49**	49	53	51
Lombard	**119**	24	51	44
Total International division	**168**	73	104	95
Total Life and Pensions	**341**	257	321	292

FPI

APE by region (actual exchange rates)	FY 2012 £m	FY 2011 £m	Change %
North Asia	**56**	103	(46)
South Asia	**23**	26	(12)
Middle East	**46**	46	–
Europe (Excl UK)	**29**	32	(9)
UK	**21**	18	17
Rest of World	**22**	21	5
Malaysia (AmLife)	**5**	6	(17)
Total	**202**	252	(20)

Lombard

APE by region (actual exchange rates)	FY 2012 £m	FY 2011 £m	Change %
UK and Nordic	**54**	52	4
Northern Europe	**35**	42	(17)
Southern Europe	**123**	115	7
Rest of World	**26**	28	(7)
Total including large cases	**238**	237	–
Of which: Large cases (greater than €10m)	**102**	83	23
Total excluding large cases	**136**	154	(12)

New business APE at constant exchange rates

All amounts in currency in the tables above other than Sterling are translated into Sterling at a monthly average exchange rate. The estimated new business assuming constant currency rates would be as follows:

	FY 2012 £m	FY 2011 £m	Change %	Q4 2012 £m	Q4 2011 £m	Change %
FPI	**202**	252	(20)	**49**	57	(14)
Lombard	**254**	237	7	**128**	99	29

New Business - Present value of new business premiums ("PVNBP")

PVNBP equals new single premiums plus the expected present value of new regular premiums. Premium values are calculated on a consistent basis with the EV contribution to profits from new business. Start of period assumptions are used for the economic basis and end of period assumptions are used for the operating basis. A risk-free rate is used to discount expected premiums in future years. The impact of operating assumption changes across a whole reporting period will normally be reflected in the PVNBP figures for the final quarter of the period that the basis changes relate to. No change in operating assumptions will be reflected in the PVNBP for the first and third quarters, when the contribution to profits from new business is not published. All amounts in currency other than Sterling are translated into Sterling at a monthly average exchange rate.

	FY 2012 £m	FY(i) 2011 £m	Change %	Q4 2012 £m	Q3 2012 £m	Q2 2012 £m	Q1 2012 £m
UK division							
– Corporate Benefits	**2,714**	2,103	29	**550**	612	776	776
– Protection	**590**	563	5	**167**	141	164	118
– Retirement Income	**436**	321	36	**157**	92	96	91
Heritage division	**780**	1,182	(34)	**118**	201	292	169
Total UK and Heritage	**4,520**	4,169	8	**992**	1,046	1,328	1,154
FPI	**1,315**	1,603	(18)	**275**	343	356	341
Lombard	**2,376**	2,372	–	**1,189**	239	505	443
Total International division	**3,691**	3,975	(7)	**1,464**	582	861	784
Total Life and Pensions	**8,211**	8,144	1	**2,456**	1,628	2,189	1,938

(i) Includes the trading results of the acquired WLUK business from 7 November 2011.

Appendix 3: Free surplus reconciliation

In-force business expected return and investment in new business

At product level, in-force surplus and new business drivers are monitored on a “cash strain” and “cash surplus” basis which excludes movements in required capital and is stated before tax and other adjustments. Tax and other items include the cumulative adjustments for tax and long-term investment return which use different assumptions across the MCEV, regulatory (or “cash”) and IFRS bases. The reconciliation of MCEV free surplus to cash strain/surplus is set out below.

£m	New business strain	In-force surplus
Cash (strain)/ surplus	**(214)**	**491**
Movement in required capital	(97)	91
Tax and other items	26	86
MCEV free surplus	**(285)**	**668**

The following table provides a segmental analysis of in-force surplus and new business strain on both the MCEV free surplus and cash bases.

£m	Cash strain/ surplus	Movement in required capital	Tax and other items	MCEV free surplus
New business strain				
UK and Heritage	(91)	(86)	16	(161)
International	(123)	(11)	10	(124)
Total strain	**(214)**	**(97)**	**26**	**(285)**
In-force surplus				
UK and Heritage	395	87	57	539
International	96	4	29	129
Total surplus	**491**	**91**	**86**	**668**
Net surplus	**277**	**(6)**	**112**	**383**

Appendix 4: Value share

RCAP UK LP ("RCAP"), an entity established by current and former partners and employees of ROL, is entitled to share in the value created in the Company's subsidiary undertaking, Resolution Holdco No. 1 LP ("Holdco"), which owns the Friends Life group.

This arrangement was established at the time the Company was formed and, in broad terms, entitles RCAP, as an associate of the Company's original sponsor Resolution Capital Limited, to 10% of all distributions made from Holdco where the accumulated value of the deployed equity capital contributed into Holdco (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.

Deployed equity capital has been contributed to Holdco, 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 currently 4% per annum. There is no time limit applying to the value share arrangements which are also not affected by termination of the Operating Agreement.

Total gross equity deployed in Holdco is approximately £4,056 million and the accumulated value of net equity deployed (at 4% per annum and after the return of £715 million of capital returned to the Company to date) is approximately £3,752 million as shown below.

	Equity deployed (£m)		
Transaction	**RSL**	**RCAP**	**Total**
Friends Provident(i)	1,915.8	0.2	1,916.0
AXA UK Life Business(ii)	2,139.8	0.2	2,140.0
BHA(iii)	–	–	–
Total	**4,055.6**	**0.4**	**4,056.0**

Date	**Accumulated value of net Equity Deployed at 4% per annum (£m)**
31 December 2011	3,844
30 June 2012	3,758
31 December 2012	3,752

(i) See page 102 of Friends Provident Group plc acquisition prospectus for more details of equity deployed.
(ii) See page 89 of AXA UK Life Business acquisition prospectus for more details of equity deployed.
(iii) The acquisition of BHA was funded using existing FLG resources.

The Company's share price does not itself influence whether payments are made under the terms of the value share. This depends on the aggregate amount of distributions made to the Company by Holdco, including to fund payments to shareholders (dividends or returns of capital), or there being a relevant change of control event.

Definitions

AmFamily means AmFamily Takaful Berhad

AmLife means, collectively, AmFamily and AmLife Insurance Berhad

Annual Premium Equivalent ("APE") represents annualised new regular premiums plus 10% of single premiums.

Annualised operating return on embedded value is calculated as the MCEV operating profit after tax over the period divided by the net Group MCEV at the start of the period adjusted to allow for the timing of dividend payments and any acquisitions or disposals through the period. Where the period is not a full year, the calculated rate is then annualised.

Asset quality is the percentage of corporate bonds and asset-backed securities in the shareholder and non-profit funds at investment grade compared to the total of such assets in these funds.

Available shareholder cash ("ASC") represents cash available to cover corporate costs, to service debt issued by Resolution holding companies and, subject to shareholder approval, to pay dividends or return to shareholders. ASC reflects the deduction of working capital from free surplus.

AXA UK Life Businesses means the traditional and protection businesses, a majority of the corporate benefits business and a minority of the wealth management business carried on by AXA UK which were acquired by the Group in September 2010 and which includes FLWL from November 2011.

Board means the Resolution Limited Board.

Cash payback on new business is the time at which the value of the expected cash flows, after tax, is sufficient to have recouped the capital invested to support the writing of the business. The cash flows are calculated on the same assumptions and expense basis as those used for the contribution from new business.

Company means Resolution Limited.

Distributable Cash Target ("DCT") is the increase in FLG ASC after interest and before dividends to Resolution holding companies and is the amount that could be paid to Resolution holding companies without reducing the MCEV of FLG, excluding investment variances and non-recurring items.

Dividend coverage ratio is the expected total cost of dividends to shareholders in respect of the year compared to the dividends from life companies up-streamed in respect of the year.

Equity Backing Ratio ("EBR") is the proportion of equities and property backing asset shares.

Free surplus at the end of the year 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 ASC plus working capital.

Free surplus generated comprises the movement in free surplus over the period adjusted for capital, foreign exchange and other reserve movements.

Friends Life or Friends Life group means Friends Life Group plc (and its subsidiaries and subsidiary undertakings from time to time including Friends Provident from November 2009, the AXA UK Life Business from September 2010, BHA from January 2011 and FLWL from November 2011).

Friends Life holding companies means Friends Life Group plc, Friends Life FPG Limited and Friends Life FPL Limited.

Group means Resolution Limited and its subsidiaries and subsidiary undertakings from time to time. For the avoidance of doubt, neither the Group nor the Company form part of The Resolution Group.

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 business comprising products that are no longer actively marketed to new customers and legacy products that have previously been closed to new business.

IFRS based operating profit/(loss) is the profit (or loss) based on longer-term investment return excluding: (i) all investment return variances from expected investment return which is calculated on a long-term rate of return, (ii) policyholder tax, (iii) returns attributable to minority interests in policyholder funds (iv), significant non-recurring items, (v) amortisation and impairment of acquired intangible assets and present value of acquired in-force business; and is stated after deducting interest payable on STICS.

IFRS profit/(loss) after tax is the profit (or loss) after tax as shown in the consolidated income statement.

IGCA surplus is the Insurance Groups Capital Adequacy surplus capital as defined by the FSA 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 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 generated by each product type, divided by the PVNBP for that product.

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.

Northern Trust means Northern Trust International Fund Administration.

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 FSA. Pillar 2 requirements are not generally disclosed.

Present value of new business premiums ("PVNBP") represents new single premiums plus the expected present value of new business regular premiums expressed at the point of sale.

Required capital of the Group is based on the most onerous capital management policy for the Group, currently IGCA.

Resolution Holding companies means the Company, Resolution Holdco No. 1 LP and Resolution Holdings (Guernsey) Limited.

Resolution Operations LLP ("ROL") is a privately owned advisory and operating firm which, as part of the Resolution Group, has provided services to Resolution Limited within the framework of an operating agreement. Under a Business Sale Agreement with ROL, ROL will, on 27 March 2013, transfer to the Company business activities that relate to the services provided to the Company and the ROL employees who provide these services. At the same time, ROL will cease to provide services to the Company.

Shareholder resources are a measure of the tangible assets available to the life and pensions business and attributable to shareholders. The movement in shareholder resources provides a view of the sustainability of the business model. Shareholder resources are based on shareholders' invested net assets included within the embedded value, but adjusted to include securitisation and financial reinsurance balances and to exclude intangible assets relating to the value of future new business.

Sustainable Free Surplus ("SFS") is a component of free surplus generated comprising the expected return from in-force business, before financing costs, less amounts invested in new business. It does not include economic impacts or other one-off items.

The Resolution Group means Resolution Operations LLP, Resolution Financial Markets LLP, RCAP Guernsey LP, Resolution Capital Limited and their respective subsidiaries and subsidiary undertakings from time to time. For the avoidance of doubt, neither the Group nor the Company are part of The Resolution Group.

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.

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
AGM	Annual General Meeting
ALM	Asset and Liability Management
AMC	Annual Management Charge
APE	Annual Premium Equivalent
ASC	Available Shareholder Cash
AVIF	Acquired Value of In-Force
AXA IM	AXA Investment Management
BHA	Friends Life BHA Limited (formerly known as "Bupa Health Assurance Limited")
BRCC	FLG Board Risk and Compliance Committee
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CGU	Cash Generating Unit
CMI	Continuous Mortality Investigations
CMIR	Continuous Mortality Investigations Report
CMPs	Capital Management Policies
CNHR	Cost of Non-Hedgeable Risk
COP	Capital Optimisation Programme
CRO	Chief Risk Officer
CRR	Capital Resource Requirements
DAC	Deferred Acquisition Costs
DCN	Deferred Consideration Notes
DCT	Distributable Cash Target
DFF	Deferred Front End Fees
DPF	Discretionary Participation Features
EBC	Employee Benefit Consultant
EBR	Equity Backing Ratio
ECJ	European Court of Justice
EEA	European Economic Area
ERC	Executive Risk Committee
EU	European Union
FAL	Friends Annuities Limited (formerly known as AXA Annuity Company Limited)
FASLH	Friends ASLH Limited (formerly known as AXA Sun Life Holding Limited)
FLAS	Friends Life Assurance Society Limited (formerly known as Sun Life Assurance Society plc)
FLC	Friends Life Company Limited (formerly known as AXA Sun Life plc)
FLDL	Friends Life Distribution Limited
FLG	Friends Life Group plc (formerly known as Friends Provident Holdings (UK) plc). In respect of MCEV disclosures, FLG denotes Friends Life Group plc and its subsidiary undertakings in the period post-acquisition
FLG AC	FLG Audit Committee
FLI	Friends Life Investments
FLL	Friends Life Limited (formerly known as Friends Provident Life and Pensions Limited)
FLSL	Friends Life Services Limited (formerly known as AXA Sun Life Services plc)
fpb	Financial Business Partners AG
FPI	A segment within the International division comprising FPIL, OLAB and AmLife
FPIL	Friends Provident International Limited

FPL	Friends Life FPL Limited
FPLAL	Friends Provident Life Assurance Limited
FPMS	Friends Provident Management Services Limited
FLPL	Friends Life and Pensions Limited
FLWL	Friends Life WL Limited (formerly known as Winterthur Life UK Limited or WLUK)
FPPS	Friends Provident Pension Scheme
FRA	Flexible Retirement Account
FRS	Financial Reporting Standards
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
FTE	Full Time Equivalent
FUM	Funds Under Management
GMP	Guaranteed Minimum Pension
GOF	Guaranteed Over Fifties
HNWI	Higher Net Worth Individuals
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
IPEV	International Private Equity and Venture Capital
IRR	Internal Rate of Return
LDI	Liability Driven Investment
LTIP	Long-Term Incentive Plan
LT2	Lower Tier 2
MCEV	Market Consistent Embedded Value
MVR	Market Value Reduction
NBS	New Business Strain
NGP	New Generation Pension
NLTR	New Life Tax Regime
NPF	Non-Profit Fund
OCI	Other Comprehensive Income
OEIC	Open Ended Investment Company
OLAB	Overseas Life Assurance Business
OMO	Open Market Option
PBSE	Post-Balance Sheet Event
PIIGS	Portugal, Ireland, Italy, Greece and Spain
PPFM	Principles and Practices of Financial Management
PUP	Paid Up Policies
PVFP	Present Value of Future Profits
PVNBP	Present Value of New Business Premiums
RCM	Risk Capital Margin

RDR	Retail Distribution Review
RHG	Resolution Holdings (Guernsey) Limited
RICS	Royal Institution of Chartered Surveyors
RISC	Risk and Investment Sub-committee
RIE	Re-attributed Inherited Estate
ROEV	Return on Embedded Value
ROL	Resolution Operations LLP
RPI	Retail Prices Index
RSL	Resolution Limited. In respect of MCEV disclosures, RSL denotes Resolution Limited and its subsidiary undertakings
SBG	Sesame Bankhall Group
SFS	Sustainable Free Surplus
SID	Senior Independent Director
SSF	Segregated Sub Fund
STICS	Step-up Tier one Insurance Capital Securities
TIP	Trustee Investment Plan
TVOG	Time Value of financial Options and Guarantees
USGAAP	Generally Accepted Accounting Principles (United States)
UT2	Upper Tier 2
VIF	Value of In-Force
VNB	Value of New Business
WLUK	Friends Life WL Limited (formerly Winterthur Life UK Limited)
WPF	With-Profits Fund
WPICC	With Profits Insurance Capital Component