# Resolution Limited

Annual report and accounts 2011

# Value driven restructuring in financial services

# Good progress towards building a sustainable business

### Significant strategic momentum in 2011

- Strategic and financial clarity on value creation from underlying acquired businesses
- Run-rate synergies ahead of target, £45 million achieved; material outsourcing de-risks costs
- VNB of £151 million with improvements driven primarily by cost savings
- New business platforms delivering returns at or above targets
- Capital optimisation programme delivered £281 million of synergies against £235 million guidance
- Creation of investment management business announced
- £476 million of cash returned to shareholders through dividends and share buy-back

### Good progress in the UK, International impacted by weak markets

- IFRS operating profit before tax of £681 million (2010: £275 million) (including the benefit of £404 million of one-off items from management actions)
- MCEV operating profit before tax of £517 million (2010: £412 million) (including £140 million of positive one-off assumption changes)
- UK operations made good progress reflecting actions on capital and costs
- International operations impacted by difficult markets and modelling improvements
- Lombard affected by tough markets but increased market share in difficult year for sector
- Full year dividend per share of 19.89 pence, up 10%

### Prudent cash levels and resilient capital position maintained

- Sustainable free surplus generation of £291 million contributed to achievement of £400 million distributable cash target
- Overall cash generation impacted by investment markets, but £400 million buffer maintained
- Balance sheet retains low exposure to higher risk European sovereign and corporate debt
- Robust IGCA surplus of £2.1 billion representing a surplus of 219%

### Looking forward

- Further update on cash return no later than 2012 interim results
- Base case exit plan to divide underlying business into two separately listed businesses

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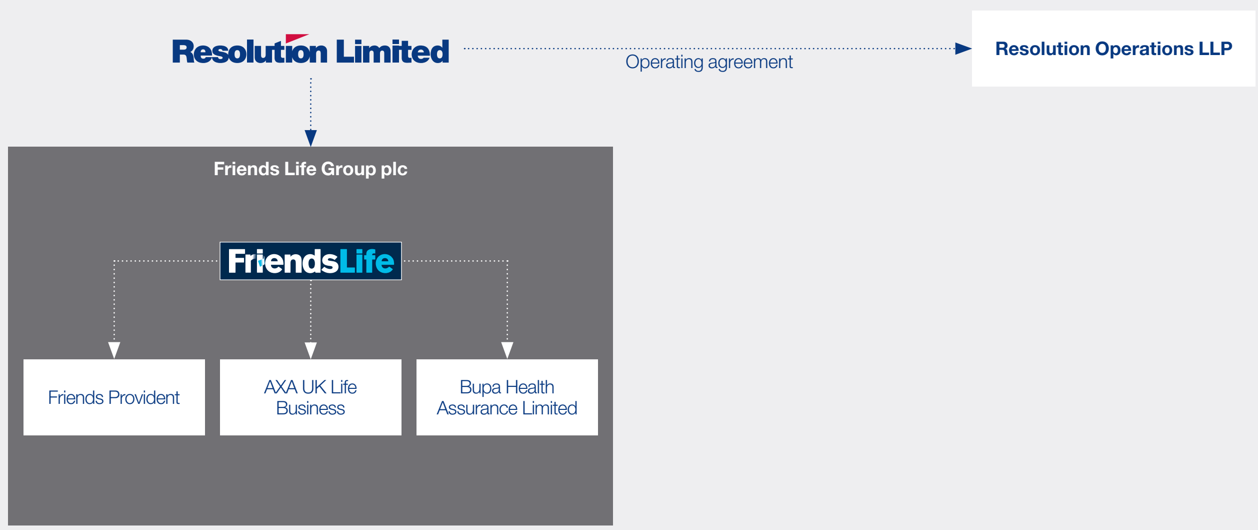
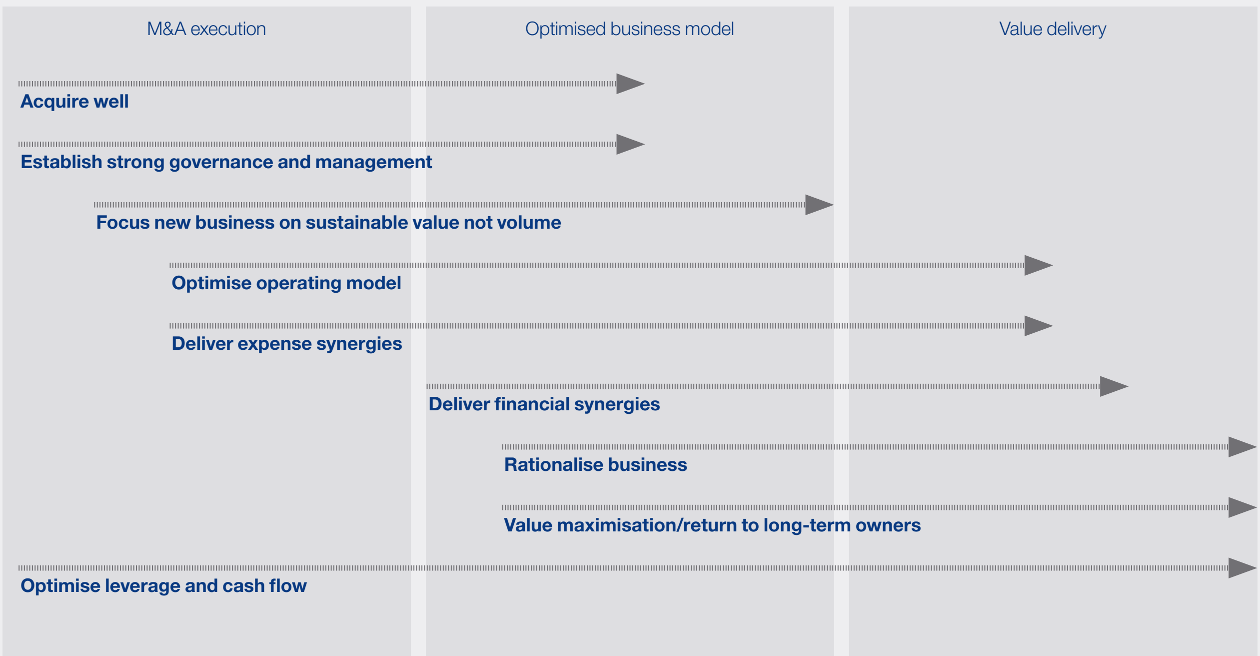
# Who we are

Resolution Limited was incorporated in Guernsey to provide public markets with a series of restructuring opportunities in the financial services industry within UK and Western Europe. The Company's current restructuring project is the UK Life Project. The Company decided in January 2012 that it would not commence a further restructuring project until completion of the UK Life Project.

**Our structure today**




**What we do**



# Overview

# Chairman's statement

**Final dividend**
13.42p
**+7%**

**Total dividend**
19.89p
**+10%**

2011 was an important year for Resolution Limited. It made significant progress driving value from the businesses acquired in its UK Life Project. The Company is committed to returning surplus cash not required by the business to shareholders subject to market conditions and receiving the appropriate regulatory approvals.

## Overview

In 2011, Resolution Limited (the "Company") moved from the acquisition phase of its UK Life Project to the integration phase which is primarily focused on delivering value from the acquired businesses. The Company also confirmed that it would not undertake any additional projects until after completion of the UK Life Project.

The Company has sought to articulate a clear strategy for the enlarged Friends Life business to demonstrate to shareholders how it proposes to achieve the overarching goals of the UK Life Project of building a sustainable business and achieving cash returns to shareholders. In market updates on strategy in February, June and November, the Company, among other things:

- set out its plans to create value in the UK Life Project with a focus on three product areas for new business and with measurable financial targets for costs, cash flow and returns for the enlarged group;
- announced the results of its work on the cash and capital position of Friends Life and the commencement of a £250 million share buy-back which completed in October 2011;
- provided a detailed update on Friends Life's business units that focused on the execution of strategy and delivery of the financial targets; and
- announced a transformational outsourcing agreement; the intention to create an in-house asset manager; and the creation of separate 'Heritage' and 'Go to Market' business units for existing business and new business to increase management accountability.

The Operating Report that follows this statement will provide a more comprehensive summary of these strategic updates.

The full year 2011 results highlight that incremental progress is being made towards achieving the Company's financial targets. The integration of the acquired businesses is substantially on track with the planned full year run-rate savings achieved by the end of 2011. The Group's new business strategy is focused on the three product areas of Protection, Corporate Benefits and Retirement Income in the UK market where the Group has the advantage of scale and where good margins should be achievable. Returns for new business written on the chosen platforms are attractive and close to or ahead of the targets for 2013. Actions taken within the UK businesses resulting in the benefits of capital synergies and the successful merger of funds have had a positive impact on the Group's cash delivery. The Friends Life group continues to make steady progress towards its target operating return on embedded value but much work is still needed to achieve the target.

The net Market Consistent Embedded Value ("MCEV") of the Group as at 31 December 2011 was £5,796 million.

## Cash returns to shareholders

At the time of the announcement of the full year 2010 results in March 2011, the Company gave guidance of its intention to increase the 2011 dividend to 18.85 pence per share, up 15% on the 2010 level.

On 7 June 2011, the directors announced that they had reviewed the Company's dividend policy and concluded that the aggregate value of the dividend payable by the Company on all shares in issue should not reduce as a result of the planned £250 million share buy-back in the second half of 2011 also announced that day. This meant that the proposed dividend per share was expected to increase as a result of the £250 million share buy-back. The share buy-back was completed on 26 October 2011. Accordingly, the proposed 2011 final dividend declared by the Board, consistent with the policy of dividends being paid one-third in respect of the interim dividend and two-thirds in respect of the final dividend, is 13.42 pence per share. This takes the dividend for 2011 to 19.89 pence per share.

The Board continues to review whether it is appropriate for the Company to move to a progressive dividend policy.

During the year, the Company generated cash of £393 million, broadly in line with its £400 million Distributable Cash Target. In addition, capital synergies of £281 million were achieved. However, these were more than offset by widening corporate bond spreads and negative equity returns. These economic variances reduced free surplus generated in the year by £352 million.

In keeping with the Company's prudent approach to capital management, it has determined that it would have been inappropriate to release capital over and above its declared dividend policy based on the resultant position at the end of 2011. The Company remains committed to the return of capital to shareholders, when prudent, and will keep the potential to do so under review. The ongoing consideration of capital returns will take into account the performance of markets since the year end and the impact of planned management actions to further optimise capital and address the impact of market volatility. The Company will update the market no later than the 2012 interim results announcement on its intentions with respect to the second stage of the capital return program announced in June 2011. The Operating Report and Business Review that follow this statement comment on the Group's cash and capital position in more detail.

## Exit

The February 2011 investor update summarised the exit options that the Company might consider in relation to the UK Life Project. These included: a cash sale, together or in parts; a direct listing as a standalone entity; a merger with another life company; or separation of the UK open business from the back book leading to separate sales or listings.

It remains the Company's intention to look for exit options involving mergers and acquisitions ("M&A") which would allow shareholders to benefit from the synergies arising from further consolidation. Whilst Resolution Operations LLP ("ROL") is actively investigating such opportunities on behalf of the Company, and has advised the Company that it believes that consolidation of the UK life industry will continue and that attractive transactions may be available, the Company considers it important to have a "self-managed" exit plan which is not reliant on M&A opportunities and could be implemented on a stand-alone basis. Such a self-managed exit plan will also form a benchmark against which M&A exit opportunities can be assessed.

The Company, with ROL, has considered the potential options and concluded that the most attractive self-managed exit plan would involve a division of Friends Life into two separately listed businesses:

- "OpenCo" – which would consist of the UK Go to Market business units, the overseas businesses, Sesame Bankhall Group, and associated support businesses; and
- "HeritageCo" – which would consist of the UK Heritage business and associated support businesses including Friends Life Investments, Friends Life's listed debt and the UK pension fund.

Accordingly the Company is now developing detailed implementation plans to ensure that such a division can be achieved by early 2014.

## M&A

The Board remains of the view that value can be created from further consolidation in the UK life sector.

ROL continues to explore, on behalf of the Company, M&A transactions which might take place during the course of the UK Life Project, or which might form the basis of M&A transactions to facilitate exit. The types of transactions which ROL might investigate on behalf of the Company are set out in the Operating Report that follows. In considering future M&A transactions during the UK Life Project, the Company will assess how any business to be acquired would be expected to enhance the financial performance, and hence the exit value, of either OpenCo or HeritageCo (or both), and hence how it might increase the expected returns made for shareholders on the UK Life Project overall.

On 20 November 2011, the Company responded to press speculation and confirmed that it investigated a possible acquisition of Phoenix Group Holdings but that talks had terminated.

## Relationship with Resolution Operations LLP

On 28 November 2011, the Company announced that it had agreed amendments to its Operating Agreement with ROL and various other arrangements with ROL and its affiliates. The changes enable ROL to pursue other restructuring opportunities in separate investment vehicles, subject to appropriate protections for the Company and its shareholders to minimise the risk of future conflicts.

Shareholders approved the revised terms of our arrangements with ROL and its affiliates on 13 January 2012. The amended Operating Agreement ensures the ongoing commitment of ROL to secure a successful outcome for shareholders from the UK Life Project.

## Governance

The Board has carried out a review of its performance and that of its principal committees during 2011, as recommended by the UK Corporate Governance Code, and has concluded that they are operating effectively. More details are set out in the Corporate governance report that follows. The Board welcomed the recommendations of Lord Davies's report "Women on Boards" and published a statement on the Company's website during the year. The Board is committed to ensuring that the Group's businesses encourage diversity in general in the development of their management teams.

The Company notes the recent publication of the FSA's consultation paper on amendments to the Listing Rules, Prospectus Rules, Disclosure Rules and Transparency Rules (CP12/2). The consultation paper includes proposals to require certain existing premium listed companies that have appointed an investment adviser to either unwind their investment advisory arrangements or re-designate as a standard listed company. The Company values highly its premium listing, along with the protections that premium listing provides for its shareholders. It will be responding in detail to the FSA's proposals shortly.

## Outlook

The current macroeconomic backdrop remains uncertain particularly in Europe and is expected to result in periodic volatility in investment markets. The regulatory environment is experiencing fundamental change as new measures aimed at enhancing financial stability are implemented. However, the Board is encouraged by the progress being made at Friends Life towards the achievement of the 2013 financial targets and is confident that those targets will be achieved.

Returns on the UK Life Project will reflect the level and volatility of investment markets in the period running up to exit. Subject to these being similar to current levels, the Board expects that the UK Life Project will achieve its targeted mid-teens returns.

The Board would like to acknowledge the efforts of all staff in the enlarged group and thank them for their contribution in what has been a demanding year for the business.

**Michael Biggs**
Chairman

26 March 2012

# Operating report by Resolution Operations LLP

## 1. Introduction

2011 was an important year for the Company. Against a backdrop of significant investment market volatility and a comprehensive regulatory agenda that impacts the UK life sector not least in terms of time commitment and cost, the Company provided three significant investor updates in March, June and November on its UK Life Project. These aimed to provide strategic clarity and set out financial targets for the Friends Life business. Resolution Operations LLP ("ROL") is pleased to report that steady progress is being made towards the delivery of these targets but much work remains to be done.

This Operating Report will provide an update on:

- strategy, including matters likely to impact progress such as the market environment and the changing regulatory landscape;
- the UK Life Project including details of updates provided throughout 2011 and the exit;
- the performance of the business over the year; and
- the outlook.

The Business Review that follows this report will examine in more detail the progress made against the financial targets and the chosen product areas for new business.

## 2. Strategy

The Company confirmed in June 2011 that the original focus of the Company, which was to undertake a number of financial services restructuring opportunities in the UK and Western Europe, would be narrowed to the delivery of the UK Life Project until its completion. ROL continues to advise the Company on its strategic aims for the UK Life Project, namely the creation of a sustainable business, or sustainable businesses, that meet customers' needs while also delivering cash returns to shareholders.

For Friends Life, the Company's strategic aims have translated, in the UK, to a narrowed new business focus on the three product areas of Protection, Corporate Benefits and Retirement Income where the Company believes it has a competitive advantage and scale, and a disciplined focus on the management of the back book. Friends Life expects to deliver value by no longer writing unprofitable business, writing more capital efficient business, leveraging its product solutions and cost-efficient platforms, controlling costs, improving persistency and increasing the retention of vesting amounts in annuities. The focus of the non-UK businesses, which include International and Lombard, is on costs, retention and leveraging their leading positions in higher return specialist markets.

### 2.1 Market environment

The first half of 2011 was characterised by volatility in investment markets that was driven by uncertainty about the strength and sustainability of global growth, a debt crisis in Europe and geopolitical unrest in North Africa and the Middle East. The global financial environment became even more stressed in the second half of 2011 following increased concerns about the impact of the sovereign debt crisis, the trajectory of global economic growth and the strength of some banking systems. Global financial stress increased with a retrenchment in cross-border bank lending and investors reallocated capital away from "risky" assets. As the price of traded bank equity fell, spreads on corporate bonds widened and cost of sovereign debt increased, wholesale funding pressures rose sharply and exacerbated concerns over global growth and sovereign solvency. The negative feedback loop from these events impacted the environment for life insurance companies and caused a sharp downward correction in the share prices of insurance stocks, reflecting investors' concerns that insurance companies were being negatively impacted by these economic conditions. Since the end of June 2011, the UK life sector, as measured by the FTSE 350 Life Insurance Index, fell almost 25% at its lowest in September 2011 and closed the year down almost 14%. Against this backdrop, the Group's capital position has been relatively resilient to market volatility. However, widening corporate bond spreads have negatively impacted International Financial Reporting Standards ("IFRS") and Market Consistent Embedded Value ("MCEV") total profits but this has been broadly in line with the Group's published sensitivities. The impact on the Group from movements in asset prices is discussed in greater detail in the Business Review that follows.

## 2.2 Regulatory environment

In 2011, the UK life sector continued to prepare itself for the impact of upcoming regulation in the form of Solvency II, the introduction of auto-enrolment and the Retail Distribution Review ("RDR"), among other regulatory initiatives.

The details of Solvency II, the new capital regime expected to replace the existing capital framework, disappointingly still remain unclear with a risk of further delays in the timing of implementation. The current legislative draft looks less favourable for the UK industry with the treatment of matching premium and contract boundaries, in particular, being more onerous than the last quantitative impact study (QIS5) undertaken by the industry.

The Company continues to expect that auto-enrolment will lead to market growth in corporate pensions. Friends Life expects that the opportunity from auto-enrolment, together with its corporate pensions offering with its investment in low cost systems, should see it well placed to generate new business from new and existing schemes.

RDR is expected to significantly impact the distribution environment. Friends Life believes that its strategic decision to stop selling single premium bonds, strong nil-commission offering in corporate pensions, good relationships with employee benefit consultants, and the opportunity to sell products in the workplace position it well for the introduction of RDR. Protection is outside the scope of the RDR regime and Friends Life's strong relationships with intermediaries and growing track record in tied distribution leaves it well placed in this product segment.

## 3. UK Life Project

Since the launch of its UK Life Project, the Company has acquired three businesses at a price of approximately 66.9% of net MCEV. It brought these three businesses together under the Friends Life brand, which was launched in March 2011. In 2011, the Company moved firmly into the integration and value delivery phases of its UK Life Project. In order to provide greater detail on its strategic intent for the enlarged group, the Company provided the market with three updates on its plans to extract value from the businesses acquired. This report will briefly summarise the strategic updates provided over the course of 2011.

### February – Delivering value

In February, the Company presented the results of the strategic review undertaken of the businesses acquired – namely, the Friends Provident business (November 2009), the AXA UK Life Business (September 2010) and Bupa Health Assurance business (January 2011). The Company indentified that the focus of its new business efforts would be on the product areas of Protection, Corporate Benefits and Retirement Income. In light of its detailed review of integration plans, the Company was also able to announce an increase in its expected cost synergies target from the acquired businesses from the £75 million of annualised cost synergies (before tax) announced on signing of the AXA transaction to £112 million per annum.

In addition, the Company identified clear financial targets that it expects its underlying businesses to meet by the end of 2013 and committed to regularly updating the market on progress in meeting them. These targets included new business strain reduction, new business internal rates of return ("IRR"), sustainable distributable cash and operating return on embedded value. The Company also highlighted that a number of options exist for it to exit the UK Life Project. The options outlined included: a cash sale, together or in parts of the Friends Life business; a direct listing of Friends Life as a standalone entity; separation of the UK open business from the UK back book leading to separate sales or listings; or merger with another life company.

One of the key strategic elements the Company identified in February as the subject of future market update was the cash and capital framework of the enlarged group where work was underway to deliver capital synergies by merging smaller acquired life companies; and evaluate the potential to transfer cash to the Group from the reattributed inherited estate that forms part of the AXA UK Life Business.

### March to June – Cash and capital update

The update in June outlined the key elements of the work completed and in progress on the cash and capital position of Friends Life. The Company announced its policy of returning excess cash released from Friends Life to shareholders to the extent that it was not expected to be required for further M&A opportunities in the short to medium term. The Company targeted a return of £500 million of excess cash to shareholders over the course of the second half of 2011 and the first half of 2012. It started this return of cash in 2011 with a £250 million on-market share buy-back which commenced immediately following the update. The Company also announced that it had planned management actions which were intended to deliver a further £235 million of capital synergies in Friends Life before the end of 2011 which would be required, along with necessary regulatory approval, before any return of the targeted further £250 million in 2012.

The Company reiterated Friends Life's Distributable Cash Target ("DCT") of £400 million per annum and noted that over time Friends Life is expected to be in a position where the DCT is met from sustainable sources (comprising surplus emerging from the in-force business plus required capital released through run-off less new business strain and associated required capital for new business). As part of the Group's wider cash and capital management work in 2011, the Company repaid a £400 million acquisition finance facility and issued £500 million of lower tier 2 debt in the public markets. The facility was drawn down in September 2010 to part fund the AXA UK Life Business acquisition and repaid in April 2011.

### July to November – Value delivery

Having provided a framework for cash and capital and clearly identified the 2013 target financial metrics for Friends Life, the Company announced with its interim results in August 2011 the split of the UK life business between the UK legacy in-force portfolios (the "Heritage" business unit) and the UK new business in the chosen product areas (the "Go to Market" business unit).

The purpose of the update on the UK Life Project in November was to reveal the creation of a sustainable business at Friends Life and showcase the management team at Friends Life. At the Company's presentation, management of Friends Life demonstrated the clear accountability for the Heritage and Go to Market business units in the UK. The update provided details on the market context for these business units and the strategy that each of the business units would execute in order to achieve the 2013 financial targets.

The Company also announced details of a significant outsourcing agreement with Diligenta that would deliver new synergies in the coming years and de-risk the achievement of the previously announced cost savings. The other key strategic initiative announced was the creation of an in-house asset manager, Friends Life Investments ("FLI"), in order to recapture fees currently being paid to external asset managers by bringing in-house the externally managed assets of the Group. While the initial focus of FLI is the management of fixed income assets backing annuities and shareholder funds, FLI is also exploring the potential to manage other fixed income portfolios within the Group.

### Summary

In 2011 the Company clearly identified the strategic direction for the acquired businesses, provided measurable financial targets that it expected Friends Life to achieve by 2013, articulated its cash and capital position and policy, commenced returning excess cash to shareholders, announced a major outsourcing agreement and creation of an in-house asset manager, and showcased the Friends Life UK business and management team. In summary, it was a busy year with much achieved in terms of shaping a sustainable business at Friends Life.

## 3.1 Path to achieving financial targets

As noted above, the Company set out targets for the Friends Life businesses in February 2011, particularly in relation to the financial performance of UK new business. These targets are challenging; but the financial performance of the UK new business has improved in line with our expectations during 2011.

For its UK Protection business, Friends Life has targeted reducing cash new business strain to £30 million per annum, increasing gross value of new business ("VNB") to £80 million per annum and achieving a new business IRR of 20% per annum. During 2011, Friends Life wrote £92 million of new protection annual premium equivalent ("APE"), of which £22 million was on the target platform. Business written on the target platform is already achieving the targeted financial metrics. The £22 million of new APE written on the target platform resulted in £22 million gross VNB and achieved a 20% IRR with cash new business strain of only £8 million. This gives considerable confidence that as the proportion of new protection business written on the target platform increases towards 100% through 2012 (reflecting the switch of all new independent financial adviser business to this platform in the fourth quarter of 2011 and the switch of new controlled business to the target platform during 2012), Friends Life will achieve its financial targets in relation to this key product area.

For its Corporate Benefits business, Friends Life has targeted reducing cash new business strain to £75 million per annum, gross VNB of £25 million per annum and a new business IRR in double figures by 2013. In 2011, Friends Life wrote £440 million of new corporate pensions APE, of which £356 million was on the target New Generation Pensions ("NGP") platform. Cash new business strain reduced from a 2010 baseline figure of £80 million to £51 million in 2011. Incremental improvement through the year was significant, with cash new business strain reduced to only £16 million in the second half of the year. Similarly, gross VNB increased from £5 million in the first half of 2011, to £10 million in the second half of the year, with the new business IRR achieved for the full year on the NGP platform being 9.4%. Only a modest improvement would be required from the performance achieved in the second half of 2011 in order to achieve our 2013 targets. If the impact of auto-enrolment is as positive to this product as some forecasts indicate it could be, there is potential for this business line to materially outperform the 2013 targets.

Finally, for its Retirement Income business Friends Life has targeted increasing retention rates on vesting pension funds to 50% and increasing gross VNB to £50 million per annum. Friends Life has made significant investments in capability in this area during 2011, however no changes to the original product propositions came on line during the year and retention rates were broadly unchanged from those achieved in 2010. Notwithstanding this, the retirement income business delivered gross VNB of £32 million in 2011 providing confidence that the £50 million per annum VNB target will be delivered, and potentially exceeded, in the years ahead.

## **3.1 Path to achieving financial targets** continued

Delivery against the VNB targets is critical to delivering Friends Life 10% per annum operating ROEV target, however it will not alone be sufficient. Short-term interest rates remain at historically low levels, depressing the return achieved on net worth and making the achievement of the 10% operating ROEV target more challenging than it would be in more "normal" conditions. In the absence of an increase in short-term interest rates and a sustained increase in equity markets, Friends Life will need to outperform against the 2013 VNB targets and the Company will need to undertake further work to optimise the Group's balance sheet in order to achieve a 10% operating ROEV.

In his statement, the Chairman comments on the Company's decision to adopt a base case self-managed exit plan involving separate listings for OpenCo and HeritageCo, and this is commented on further below. As the shape of these businesses evolves and is finalised, the Friends Life operating ROEV target will be broken down into separate targets for each business.

## 3.2 Cash and capital

Despite the volatile economic environment and fall in market returns during the year, Friends Life contributed £393 million of cash, broadly in line with the DCT of £400 million per annum. This amount comprises £291 million met from sustainable free surplus generation, with the balance of £102 million coming from other actions and working capital.

The £102 million included the £100 million of lower tier 2 debt raised by Friends Life in excess of the £400 million received to repay the acquisition finance facility. It also included the benefit of £281 million of capital synergies delivered against £235 million expected as a result of planned management actions. The benefits were offset by the impact of economic variances, in particular, by falling equity markets and widening corporate bond spreads, which reduced MCEV profits before tax by £600 million. Of this £600 million reduction, £352 million had a direct impact on free surplus effectively representing a reduction in the cash generated within the businesses during the year.

As a result of the actions taken to optimise Friends Life's capital position, including the delivered capital synergies, capital requirements on a Pillar 1 basis have reduced significantly. However, during the year, widening corporate bond spreads and the assessment of the overall level of economic risk, particularly in Europe, have significantly increased capital requirements on a Pillar 2 basis. Accordingly, Friends Life now needs to focus its capital management activities on both the Pillar 1 and Pillar 2 capital positions, as it is on the cusp of both bases biting.

The cash generation of the underlying business and the delivery of capital synergies were in line with the Company's expectations. However in light of the weak investment markets in the year and the increased volatility from the Pillar 2 basis now biting, the Company has determined that it would have been inappropriate to release capital over and above its declared dividend policy based on the position at the end of 2011. The Company will keep the potential to do so under review, taking account of the performance and stability of markets since the year end and the impact of planned management actions to further optimise capital and address the impact of market volatility. The Company will update the market no later than the 2012 interim results announcement on its intentions with respect to the second stage of the capital return program announced in June 2011.

Friends Life retains a strong Insurance Group Capital Adequacy position of £2,139 million, representing a surplus of 219% and continues to hold a cash buffer of £400 million after meeting its 2012 dividend and debt repayment and servicing costs.

## 3.3 Exit

As the Chairman has explained in his statement, the Company, advised by ROL, has concluded that in the absence of value accretive exit M&A opportunities, it needs to be ready to implement a self-managed exit plan. ROL has recommended, and the Company has approved, a base case exit plan which involves a division of Friends Life into two separately listed businesses:

- "OpenCo" – which would consist of the UK Go to Market business units, the International businesses, Sesame Bankhall Group, and associated support businesses; and
- "HeritageCo" – which would consist of the UK Heritage business and associated support businesses including FLI, Friends Life's listed debt and the UK pension fund.

The precise division of assets and liabilities between OpenCo and HeritageCo has not been finalised yet, and will be influenced to some extent by the final form of the Solvency II regime. We expect that OpenCo will be a high operating ROEV business with relatively modest cash generation (at least in the early years), whilst HeritageCo will be highly cash generative, but lower ROEV. We also expect that the embedded value of OpenCo will be in the range of £2 billion to £3 billion at exit.

The following gives an illustrative example of the financial metrics which OpenCo and HeritageCo might be capable of exhibiting based on Friends Life's 31 December 2011 MCEV of approximately £6 billion and assuming that, after allowing for any dis-synergies arising from separating into two separate businesses, Friends Life hits its cash generation and ROEV targets in 2013.

| | OpenCo | HeritageCo | Friends Life |
|---|---|---|---|
| Net MCEV | £2 billion | £4 billion | £6 billion |
| ROEV | 20% | 5% | 10% |
| Net Cash Generation | £0.1 billion | £0.3 billion | £0.4 billion |

The implementation of the Company's ongoing capital optimisation programme is expected to ensure that, by the end of 2013, the two UK business units (Go to Market and Heritage) will be divided into two separate life companies, capable of being exited independently. Friends Life has been re-aligning the majority of its resources to reflect the split between the UK Go to Market and Heritage businesses since the announcement of the creation of the Heritage business unit in August 2011. Together with ROL, it is now putting in place a programme to realign the majority of the remaining shared service and group functions to either OpenCo or HeritageCo over the next 18 months.

Detailed planning work has commenced to ensure that the Company is able to implement this plan by early 2014. As part of this planning, consideration is being paid to the interests of current and future holders of Friends Life's listed debt instruments including ensuring each business retains only an appropriate level of gearing in the context of its gross embedded value and its cash generation capability. In the case of HeritageCo, this includes having regard to the current in-force portfolio run off, in order to maintain an appropriate level of gearing in the absence of further closed fund transactions.

We believe that the separation of OpenCo and HeritageCo will create two businesses which will be attractive to different groups of investors, both debt and equity, and will be able to adopt different strategies following exit from the Company:

- OpenCo will be a fit for purpose life company playing in key markets in which it has competitive advantage; and
- HeritageCo will adopt a UK closed life fund consolidation strategy following exit.

The value that could be created from implementation of the self-managed exit plan will form a benchmark against which exit M&A opportunities can be assessed. Following completion of legal separation of the UK Go to Market and Heritage businesses at the end of 2013, we expect that the Company will be in a position to implement the self-managed exit plan and provide OpenCo and HeritageCo with separate listings in the second or third quarters of 2014. ROL therefore currently anticipates that the Company will have completed the UK Life Project by no later than the end of 2014.

### 3.4 M&A

Whilst the Company and ROL's main priority for the remainder of the UK Life Project will be to deliver the targeted financial performance for the UK life business and to prepare to implement a self-managed exit during 2014, we do not rule out the possibility of further M&A.

Such transactions could include:

- the acquisition of small bolt-on businesses which would enhance or accelerate the development of the UK Go to Market business unit; and
- further acquisitions of UK closed life funds at attractive prices to enhance HeritageCo.

As the Company has noted previously, it does not expect to undertake further transactions during the remainder of the period of the UK Life Project which would dilute the returns (either as a result of the price paid, or the impact on project duration) which it currently expects to be able to realise from the businesses already acquired. Nor would the Company expect to undertake transactions which required a material capital raise from existing shareholders unless the proposed impact on project returns was exceptionally strong (in which case we would expect to bring such transactions to shareholders for approval).

## 4. Business performance

The Business Review that follows this report will set out in detail the results under both IFRS and MCEV bases. The 2011 results are not directly comparable to the 2010 results as they include Friends Provident business and the AXA UK Life Business for 12 months, the Bupa Health Assurance business for 11 months and the Winterthur Life UK Limited business for two months.

The IFRS based operating profit before tax was £681 million and included £404 million of reserving changes and one-off items that included capital synergies, the impact of the outsourcing agreement with Diligenta and the impact of expense, persistency, morbidity and mortality experience in the year.

The MCEV operating profit before tax was £517 million and includes £140 million of operating assumption changes. These operating assumption changes relate primarily to the impact of the outsourcing agreement with Diligenta which allowed the expense benefit to be recognised in the MCEV operating profit.

The key highlights of the full year results include:

- steady progress with the integration of the acquired businesses with £45 million of run-rate savings achieved;
- sustainable free surplus of £291 million contributed to distributable cash target;
- management actions including delivery of capital synergies and the impact of the Diligenta outsourcing agreement have contributed positively to operating profit;
- steady progress is being made towards the achievement of the 2013 financial targets.

## 5. Outlook

Despite a difficult external environment, the Company has made steady progress against its strategic priorities and financial targets. The Company's priorities in 2012 remain the development of a sustainable underlying business. As the Company advances towards an exit from its UK Life Project, work will continue towards delivering the best return for shareholders. ROL remains confident that the Company will achieve its financial and strategic targets.

**John Tiner**
Chief Executive, Resolution Operations LLP

26 March 2012

# Business review

# Introduction

## Transformational year

2011 represented a transformational year for the Group as it transitioned from the acquisition phase of the UK Life Project towards the delivery of a focused and integrated life business.

The acquisition of Bupa Health Assurance Limited (since renamed Friends Life BHA Limited) ("BHA") in January 2011 brought with it a well regarded and efficient protection platform as well as a range of market leading Individual and Group Protection products. In addition, the second phase of the acquisition of the AXA UK Life Business was formally completed with the acquisition of Winterthur Life UK Limited ("WLUK") and disposal of the Guaranteed over Fifty ("GOF") and Trustee Investment Plan ("TIP") portfolios in November 2011.

In March 2011, the acquired businesses were rebranded as Friends Life. In August, the Group announced the restructuring, for management purposes, of the UK business into distinct 'Heritage' and 'Go to Market' businesses: Corporate Benefits, Protection and Retirement Income.

In November, the Group set out its intention to develop in-house asset management capabilities with the creation of Friends Life Investments ("FLI") to manage its significant portfolio of fixed income assets. It also announced a transformational 15 year outsourcing partnership with IT and customer service specialist, Diligenta. This outsourcing partnership has allowed the Group to increase its cost savings target from £112 million to £143 million (30% of UK 2010 baseline costs). On 1 March 2012, the new outsourcing partnership commenced with most of the Group's remaining UK Heritage service operations transferring across to Diligenta.

In December, the Group completed various Part VII transfers combining a number of smaller life companies into Friends Life Limited ("FLL"), restructuring the acquired businesses to maximise capital synergies and to continue the restructuring that supports the future direction of the business.

## Business performance

The UK operating result has shown significant improvement with good progress towards strategic objectives reflecting both the improved trading performance, as the businesses integrate, and a number of one-off items including the Diligenta outsourcing arrangement. For MCEV, these benefits were partly offset by the adverse net impact of revised persistency and morbidity assumptions of £73 million, in line with guidance given with the Interim Management Statement in November.

The Corporate Benefits and Protection businesses have demonstrated improvements in the value of new business ("VNB"), internal rate of return ("IRR") and new business strain ("NBS") with the focus on strategic products' platforms and expense reductions driving the overall development of these results and offsetting the impact of adverse pensions persistency. The Retirement Income business continues to exceed its targeted IRR although the VNB was reduced by adverse market conditions in the second half of the year. The performance of the UK Heritage business reflects the challenging market conditions, adverse persistency and provisions established in respect of the Retail Distribution Review ("RDR") partially offset by the positive impact of mortality and morbidity experience.

The good progress in the UK business was offset by a poor performance in the International business; despite a 6% increase in sales volumes, VNB and IRR reduced due to an increase in the proportion of the existing lower margin 'Premier' products in Asia and a lower proportion of higher margin German business sales. The continued review of the in-force portfolio, which commenced in the first half of 2011, highlighted further issues and the business's performance was also impacted adversely by the effect of economic markets through an increased cost of guarantees in respect of certain Overseas Life Assurance Business ("OLAB") products. The International management team has been strengthened, a strategic review is well advanced and the business is focused on improving profitability, driving through reductions in new business strain and is working to meet its cash generation target.

Lombard continued to perform well, but again results reflect the economic downturn in Europe, with some adverse impact on persistency as well as sales. Notwithstanding these difficult conditions, Lombard has outperformed its peers.

The following table shows the IRR performance of the key business lines compared with the targets set for 2013.

| IRR % (unless otherwise stated) | 2013 Target | **2011 Full year** | 2010 Full year baseline(i) | 2010 Full year |
|---|---|---|---|---|
| UK | n/a(ii) | **7.7** | 5.9 | 7.1 |
| International | 20+ | **12.7** | 15.4 | 15.4 |
| Lombard(iii) | 20+ | **>25.0** | >25.0 | >25.0 |
| Blended group new business IRR(iii) | 15+ | **10.0** | 8.6 | 11.2 |
| New business cash strain (£m) | 192 | **278** | 392 | 238 |

(i) 2010 full year baseline includes an estimate of 12 months BHA and AXA UK Life Business results.
(ii) Target IRRs for the Go to Market businesses are set out in the relevant sections of the UK operating review.
(iii) The 2011 Lombard IRR (and therefore the blended group IRR) now takes account of the Luxembourg regulatory regime in which DAC is an allowable asset.

## Market environment

As well as affecting the operational performance, the difficult economic environment in the year has negatively impacted IFRS and MCEV total profits, and cash generation. On an IFRS basis, income on shareholder assets and the value of annual management charges ("AMCs") have fallen and reserves for certain guarantees have increased, reducing the operating result. In addition, on an MCEV basis, the future value of in-force ("VIF") business has fallen, principally reflecting the reduced equity returns and widening of credit spreads giving rise to significant, but primarily unrealised, economic experience losses. This has had a corresponding impact on free surplus generation.

## Capital strength

The Group's robust capital position has been maintained during 2011 with a Friends Life Group plc ("FLG") IGCA surplus as at 31 December 2011 of £2.1 billion (31 December 2010: £2.3 billion). The movement in the year principally reflects:

- the surplus generated offset by economic impacts, primarily credit spreads;
- the impact of the BHA transaction; and
- dividends paid to Resolution Holdings (Guernsey) Limited ("RHG").

Significant capital synergies were delivered in the year, but much of this benefit has been eroded by widening credit spreads. The Group changed its capital policy in the year from 160% to 150% of Group Capital Resource Requirements (excluding WPICC), reflecting reduced integration risk. The reduction in Pillar 1 capital requirements and increases in Pillar 2 from market movements mean that the Group is now on the cusp of both Pillars biting and accordingly capital management actions in 2012 are focused on the management of both bases.

The Group's balance sheet remains strong and the shareholder exposure to the higher risk government debts of Spain, Portugal, Italy, Ireland and Greece remains low at £6 million (31 December 2010: £7 million).

## Dividends and return of capital

In accordance with previous commitments the final dividend is recommended to increase to 13.42 pence per share, resulting in a full year dividend of 19.89 pence per share. The full year dividend is an increase of 10% from 2010, reflecting the benefit of the £250 million share buy-back during the year.

The Group's available shareholder cash ("ASC") at 31 December 2011 was £853 million, including £350 million of dividends proposed by FLL in respect of 2011. FLG's contribution to its distributable cash target ("DCT") of £400 million per annum was £393 million, including £100 million of proceeds from its external LT2 debt issue that has been retained in the life companies. FLG generated sustainable free surplus of £291 million and one-off capital synergies of £281 million.

Whilst the overall cash generation of the business was in line with the Company's expectations, the weak investment markets in the year and resulting negative economic experience variances have offset the value of the capital synergies achieved. Accordingly, the Company has concluded that it would have been imprudent to make a further return of capital over and above the declared dividend policy based on the resultant 2011 position. The Company will update the market no later than the interim 2012 results announcement on its intentions with respect to the second stage of the capital return programme announced in June 2011.

The key performance indicators for the Group and an analysis of the IFRS and MCEV results are set out below followed by detailed segmental commentary, cash and capital information and an explanation of the principal risks and uncertainties for the Group and its approach to managing these.

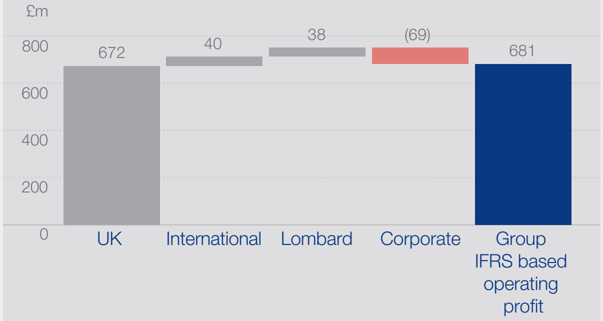
# Key performance indicators

The Group's results for 2011 include the post-acquisition results of the acquired businesses and are therefore not currently directly comparable from period to period where acquisitions have taken place in the year under review. The 2010 results included Friends Provident for 12 months and the AXA UK Life Business (including GOF and TIP but excluding WLUK) for four months while the 2011 results include Friends Provident and the AXA UK Life Business for 12 months, BHA for 11 months, GOF and TIP for 10 months and WLUK for two months.

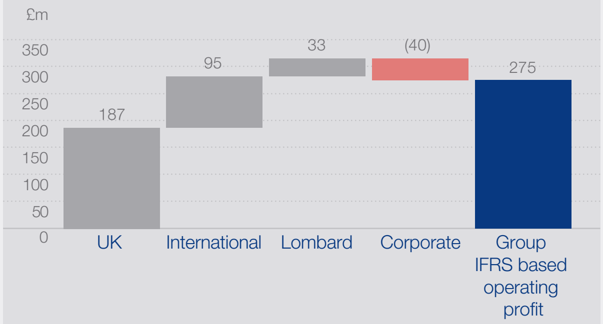
The Group uses the following key performance indicators.

## KPI: **IFRS based operating profit before tax**

**2011:**
£681 million



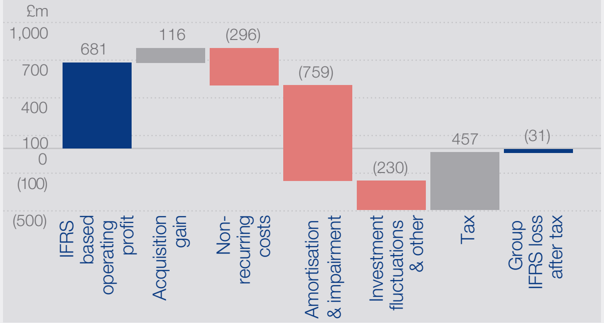

**2010:**
£275 million



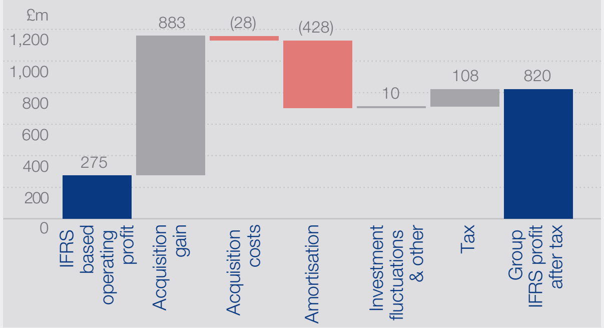

IFRS based operating profit before tax of £681 million (31 December 2010: £275 million) benefited from the increased scale of the UK business as well as the actions taken to release negative reserves, the Diligenta outsourcing transaction and other favourable assumption changes. These were offset by the adverse impact on operating profit of poor market conditions (reflected through reduced AMCs, higher cost of guarantees and reduced long-term investment return) and the inclusion of a full year's financing costs.

## KPI: **IFRS (loss)/profit after tax**

**2011:**
£(31) million



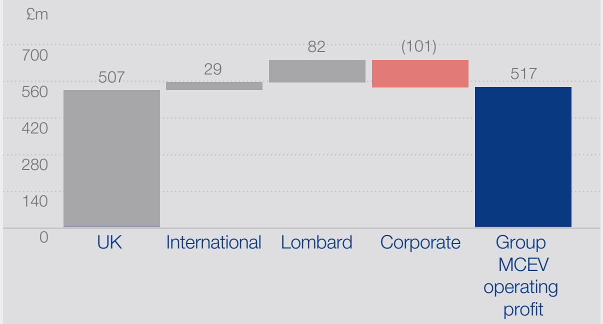

**2010:**
£820 million



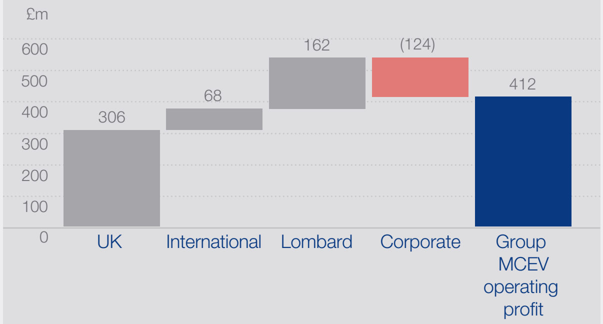

IFRS loss after tax of £(31) million (31 December 2010: £820 million profit) reflects investment market losses as well as the impact of one-off costs relating to separation and integration spend, the Diligenta outsourcing transaction and other project activity. Amortisation and impairment includes the one-off impact of adoption of negative reserves and a full year charge for the AXA UK Life Business. The result benefits from the gains recognised on the acquisition of BHA and WLUK whilst the prior year result reflects the much larger gain on the acquisition of the AXA UK Life Business.

## KPI: **MCEV operating profit before tax**

**2011:**
£517 million




**2010:**
£412 million



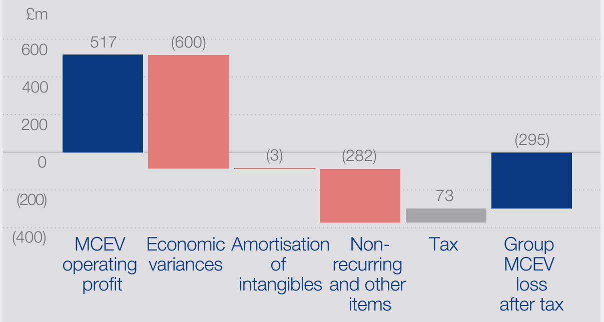

Segment results comprise covered and non-covered business.

MCEV(i) operating profit before tax of £517 million (31 December 2010: £412 million) reflects the increased scale of the UK operations, with improved VNB in the AXA UK Life Business, the benefit of future expense savings (secured in part through the Diligenta outsourcing transaction) partially offset by the adverse net impact of persistency and morbidity assumption changes (in line with previous guidance).

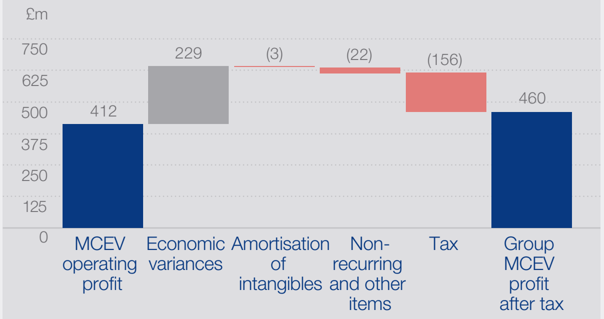
(i) The MCEV basis is in compliance with the European Insurance CFO Forum MCEV Principles ("MCEV Principles") (Copyright© Stichting CFO Forum Foundation 2008), issued in June 2008, and reissued in amended form in October 2009.

## KPI: **MCEV (loss)/profit after tax**

**2011:**
£(295) million



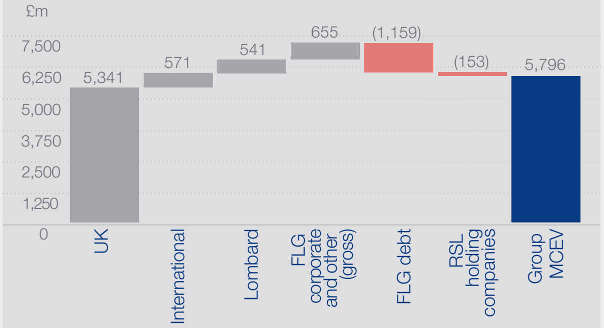

**2010:**
£460 million



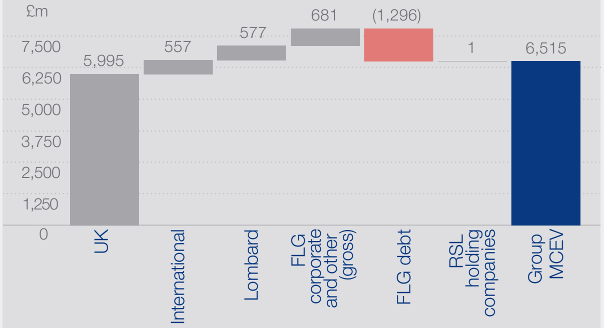

MCEV loss after tax of £(295) million (31 December 2010: £460 million profit) reflects adverse economic variances driven by the fall in investment markets in the period. The result also reflects the impact of non-recurring project costs including £124 million for the Diligenta outsourcing transaction.

## KPI: **Group embedded value on an MCEV basis**

**2011:**
£5,796 million




**2010:**
£6,515 million



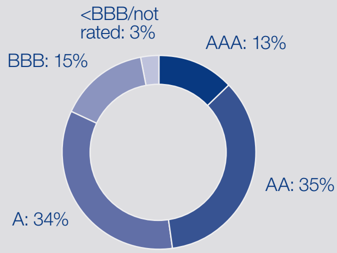

Group embedded value on an MCEV basis of £5,796 million (31 December 2010: £6,515 million) principally reflects the payment of the cash dividend to shareholders of £226 million, the return of capital of £250 million through the share buy-back programme and the loss for the year.

FLG operating ROEV(i) of 6.5% (31 December 2010: 8.3%) reflects the inclusion of the AXA UK Life Business for a full year but is showing progress through the Group's targeted reduction in new business strain and achievement of synergies. The increase in full year 2011 ROEV from the annualised half year ROEV of 4.5% reflects the progress made to date in migrating UK business to target platforms and securing future cost savings in part through completion of the Diligenta outsourcing transaction.

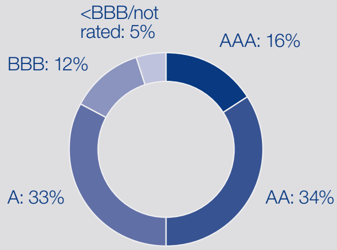
(i) FLG operating ROEV is calculated as the annualised MCEV operating return, after tax and financing, divided by the start of period net embedded value, and is adjusted to allow for the timing of significant capital movements such as dividends and acquisitions.

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

**2011:**
£8.6 billion

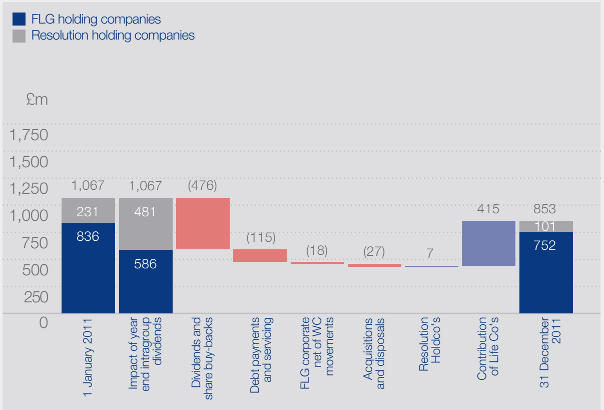



**2010:**
£8.2 billion



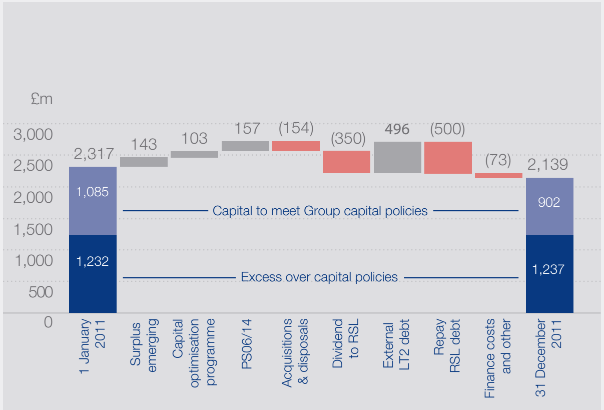

The Group has maintained high asset quality, with 97% of shareholder-related corporate debt and asset-backed securities at investment grade or above (2010: 95%). The Group has no significant shareholder exposure to sovereign debt or corporate bonds of higher risk European economies.

## KPI: **Available shareholder cash**




Group available shareholder cash of £853 million decreased by £214 million from 31 December 2010 (£1,067 million) reflecting the return of £476 million of cash to shareholders; £226 million through dividends and £250 million through the share buy-back programme. The life companies contributed £415 million to ASC underpinned by sustainable free surplus generation of £291 million. Full year free surplus generation was impacted by a number of one-off items including delivery of one-off capital synergies of £281 million (against a target of £235 million) and adverse economic experience of £352 million. Working capital increased in the year driven by the retention of free surplus to fund future integration activity (including the Diligenta outsourcing) and increased funding retained in the life companies in response to recent adverse economic conditions.

## KPI: **IGCA**




Estimated FLG IGCA surplus capital of £2.1 billion (31 December 2010: £2.3 billion) reflects the £350 million dividend paid to RHG and the acquisition of BHA, partially offset by surplus emergence in the year.

The estimated IGCA at the end of February increased to £2.2 billion, with the impact of positive investment performance partially offset by separation and integration spend.

# IFRS results

## IFRS profit

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 the Board considers that this better represents the underlying performance of the business and the way in which it is managed.

These results include the results of the acquired Friends Provident business, AXA UK Life Business, BHA and WLUK from the deemed dates of their acquisitions, which were 4 November 2009, 3 September 2010, 31 January 2011 and 7 November 2011 respectively. The results of the GOF and TIP portfolios are included for the period from 3 September 2010 until their disposal on 1 November 2011.

| £m | UK | Int'l | Lombard | Corporate | RSL 2011 | RSL 2010 |
|---|---|---|---|---|---|---|
| New business strain | (112) | (36) | (33) | – | (181) | (145) |
| In-force surplus | 402 | 97 | 73 | – | 572 | 466 |
| Long-term investment return | (5) | 1 | (1) | (21) | (26) | 13 |
| Principal reserving changes and one-off items | 416 | (12) | – | – | 404 | (13) |
| Development costs | (28) | (7) | (1) | – | (36) | (28) |
| FLG other income and charges | (1) | (3) | – | (7) | (11) | (3) |
| RSL other income and charges | – | – | – | (41) | (41) | (15) |
| **IFRS based operating profit/(loss) before tax** | 672 | 40 | 38 | (69) | 681 | 275 |
| Short-term fluctuations in investment return | | | | | (261) | 24 |
| | | | | | | |
| Acquisition accounting adjustments: | | | | | | |
| Amortisation and impairment of acquired in-force business | | | | | (675) | (364) |
| Amortisation of other acquired intangible assets | | | | | (84) | (64) |
| | | | | | | |
| Non-recurring items: | | | | | | |
| Gain on acquisition of businesses | | | | | 116 | 883 |
| Costs associated with the business acquisitions | | | | | (3) | (28) |
| Other non-recurring items | | | | | (293) | (68) |
| STICS interest adjustment to reflect IFRS accounting for STICS as equity | | | | | 31 | 31 |
| Returns on F&C Commercial Property Trust | | | | | – | 23 |
| IFRS (loss)/profit before shareholder tax | | | | | (488) | 712 |
| Shareholder tax | | | | | 457 | 108 |
| **IFRS (loss)/profit after tax** | | | | | (31) | 820 |

IFRS based operating profit for 2011 was £681 million comprising the operating profit of the life businesses of £750 million, £28 million of corporate costs for FLG and £41 million of corporate costs for the Resolution holding companies. This result includes £404 million of principal reserving changes and one-off items which comprised:

- £221 million one-off benefit in respect of PS06/14;
- £71 million release of expense reserves, including the benefit of the savings secured through the Diligenta outsourcing; and
- a further £124 million of positive UK assumption changes offset by £12 million adverse changes in International.

Excluding the impact of these items and the equivalent one-off changes in 2010 leads to an underlying IFRS based operating profit of £277 million for 2011 compared to £288 million for 2010. The increase in the size of the Group and the improvements to new business strain (reflecting cost reductions and transition to target platforms) have been offset by the adverse impact of market conditions on operating profit (resulting in lower annual management charges for UK business, higher cost of guarantees for certain International business and lower long-term investment return assumptions), the ongoing negative impact of the adoption of PS06/14 and the poor performance in International. Further details on the operating performance of the Group are included in the relevant business unit operating sections.

## Non-operating items

Investment market performance has been volatile throughout 2011 and deteriorated in the second half of the year. As a result negative short-term fluctuations in investment return amounted to £261 million, principally relating to variances against the expected return on assets backing the non-profit funds. The major movements comprise:

- adverse variances as a result of mismatches between the assets backing the Friends Life annuity portfolios and the related liabilities. These variances are a consequence of the Group's asset/liability matching approach which is typically undertaken on a realistic basis. As policyholder liabilities are reported in the results according to their treatment on a regulatory basis the differing approaches create a mismatch;
- credit default assumptions have been strengthened following the worsening of economic conditions during the second half of 2011 as evidenced by the significant widening of corporate bond spreads; and
- negative shareholder fluctuations of £46 million represent the difference between actual and expected investment returns, due to the Group's higher holding in cash combined with lower than expected rates of return.

Acquisition accounting adjustments, totalling £759 million, represent the amortisation and impairment of the intangible assets recognised on the acquisitions. These charges comprise £675 million of amortisation and impairment of acquired in-force business, and £84 million of amortisation of other intangible assets. The amortisation of acquired in-force business includes a one-off charge of £201 million (£130 million for the AXA UK Life Business, £71 million for BHA) reflecting the accelerated run-off of in-force surplus following the recognition of negative reserves in these businesses.

Non-recurring items include gains on acquisitions of £116 million. The completion of the BHA and WLUK acquisitions has resulted in gains of £68 million and £48 million respectively, offset by acquisition costs of £3 million.

The disposal of the GOF and TIP portfolios did not have a significant impact on the Group results.

Other non-recurring costs of £293 million include £84 million of costs relating to the 15 year outsourcing arrangement with Diligenta; and £209 million of other non-recurring costs. These comprise:

- separation and integration programme costs of £128 million;
- finance transformation costs of £55 million including Solvency II;
- capital optimisation project costs of £19 million; and
- other costs of £7 million.

The Diligenta impact of £84 million in 2011 reflects the reserving required for transition and service improvement costs in relation to in-force insurance contract business. In accordance with IFRS, no reserves have been established for the investment contracts business. Total implementation costs for both in-force insurance and investment business are expected to be £250 million with the remainder incurred over 2012 to 2014.

Interest payable on the FLG STICS of £31 million is included as a £26 million deduction to corporate long-term investment return in the operating profit analysis, and £5 million adverse investment fluctuation. 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.

A shareholder tax credit of £457 million is recognised in the period and is significantly higher than the loss before tax of £488 million would imply. The principal differences between the implied and actual shareholder tax credit relate to:

- £69 million one-off shareholder tax credit triggered by the change in pricing basis on certain unit-linked funds to reflect the fact these funds were contracting;
- £60 million shareholder tax credit relating to the reduction in the rate of UK corporation tax;
- £68 million and £48 million gains on the acquisitions of BHA and WLUK respectively, which are not taxable (the tax impact of this is £31 million); and
- £190 million shareholder credit for tax reliefs, expenses and exemptions predominantly in relation to the life insurance companies in the Group which are taxed on the "I minus E" basis, an element of which is matched by liabilities which are accounted for within policyholder liabilities and form part of the loss before tax.

The tax credit includes £194 million credit in respect of the amortisation and impairment of AVIF and other acquired intangibles in the year.

The £23 million return on F&C Commercial Property Trust in 2010 reflects the market return attributable to third parties for the period up to April 2010. This was the date at which FLG ceased to consolidate the results of this company, as holdings had been reduced to below the level requiring consolidation, hence there is no impact on the 2011 results.

## Summary IFRS balance sheet

| £m | RSL 31 December 2011 | RSL 31 December 2010 |
|---|---|---|
| Acquired value of in-force business | **4,437** | 4,685 |
| Other intangible assets | **410** | 455 |
| Financial assets | **103,636** | 99,445 |
| Cash and cash equivalents | **8,791** | 9,288 |
| Other assets | **8,132** | 8,492 |
| **Total assets** | **125,406** | 122,365 |
| Insurance and investment contracts | **112,455** | 107,492 |
| Loans and borrowings | | |
| – deferred consideration notes | **423** | 500 |
| – acquisition finance facility | **–** | 400 |
| – subordinated debt | **681** | 189 |
| – other | **91** | 123 |
| Other liabilities | **5,761** | 7,112 |
| **Total liabilities** | **119,411** | 115,816 |
| **IFRS net assets** | **5,995** | 6,549 |
| Equity attributable to equity holders of the parent | **5,672** | 6,227 |
| Attributable to non-controlling interests | **323** | 322 |
| **Total equity** | **5,995** | 6,549 |
| Shares in issue[(i)] | **1,373,527,605** | 1,443,985,079 |

(i) Adjusted to exclude 2,661,384 Resolution Limited shares held by subsidiaries at 31 December 2011 (31 December 2010: 8,579,292).

At 31 December 2011, IFRS total equity was £5,995 million (31 December 2010: £6,549 million), with equity attributable to equity holders of the parent of £5,672 million (31 December 2010: £6,227 million). IFRS net assets per share attributable to shareholders were £4.13 (31 December 2010: £4.31) based on shares in issue at the balance sheet date, excluding the Company's shares held by subsidiaries.

The Company's issued share capital has decreased reflecting the shares repurchased and cancelled under the share buy-back programme, changes in the shares held by subsidiaries and the impact of shares issued to satisfy the scrip element of the 2010 final dividend (14 million shares) and 2011 interim dividend (3 million shares). The return of capital to shareholders through the share buy-back programme commenced on 8 June 2011, was completed on 26 October 2011 and resulted in a reduction in issued share capital of 93 million shares with a total value of £250 million. There has been a reduction in the number and value of shares in the Company held by the life companies (£7 million compared to £20 million at 31 December 2010). In accordance with IFRS requirements, these shares have been excluded from the equity attributable to equity holders of the parent.

Financial assets are predominantly invested in listed shares, other variable yield securities and corporate bonds and asset-backed securities. Asset quality has been maintained with 96.9% of shareholder-related corporate bonds and asset-backed securities held at investment grade or above.

As part of the financing for the acquisition of the AXA UK Life Business, a £400 million short-term funding arrangement was put in place. This was repaid in April 2011 following the successful raising of £500 million external LT2 subordinated debt by FLG.

At 31 December 2011, the ratio of debt to IFRS equity attributable to equity holders of the parent, gross of debt, was 17.4% (31 December 2010: 16.3%), with the movement primarily reflecting the decrease in equity following the return of capital to shareholders.

# MCEV results

## MCEV profit

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 year, together with the effect of updating the previous year'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.

### Group MCEV profit

| £m | UK | Int'l | Lombard | Corporate | RSL(i) 2011 | RSL(ii) 2010 |
|---|---|---|---|---|---|---|
| Value of new business | 59 | 40 | 52 | – | 151 | 145 |
| Expected existing business contribution | 330 | 27 | 49 | (46) | 360 | 247 |
| Operating experience variances | (9) | (7) | (12) | – | (28) | 32 |
| Other operating variances | 9 | (20) | (2) | 19 | 6 | 65 |
| Operating assumption changes | 147 | (3) | (4) | – | 140 | (23) |
| Development costs | (28) | (7) | (1) | – | (36) | (28) |
| FLG other income and charges | (1) | (1) | – | (33) | (35) | (11) |
| RSL other income and charges | – | – | – | (41) | (41) | (15) |
| **Operating profit before tax** | **507** | **29** | **82** | **(101)** | **517** | 412 |
| Economic variances | | | | | (600) | 229 |
| Amortisation of non-covered business intangible assets | | | | | (3) | (3) |
| Costs associated with the business acquisitions | | | | | (3) | (28) |
| Non-recurring costs | | | | | (345) | (61) |
| Other non-recurring items and non-operating variances | | | | | 66 | 67 |
| **(Loss)/profit from continuing operations before tax** | | | | | **(368)** | 616 |
| Tax | | | | | 73 | (156) |
| **(Loss)/profit from continuing operations after tax** | | | | | **(295)** | 460 |

(i) 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 WLUK.

(ii) 2010 results include 12 months results for Friends Provident and four months for the AXA UK Life Business (including GOF and TIP but excluding WLUK).

Overall MCEV operating profit before tax for 2011 was £517 million compared to £412 million in 2010. Excluding the impact of one-off assumption changes for both periods gives an underlying operating profit of £377 million in 2011 and £435 million in 2010. Consistent with IFRS, the MCEV operating result has been negatively impacted by the poor performance in International and by adverse market performance with a reduction in certain longer term rates of return and a significant fall in Lombard results reflecting the challenging market conditions.

The VNB has increased from 2010 reflecting the benefit of the inclusion of a full year of sales for the AXA UK Life Business (with improvements in VNB driven primarily by cost savings), the acquisition of BHA, the impact of the Diligenta transaction (reflecting the contractualised reduction in future maintenance expenses for the new business written in 2011) offset by reduced sales and profitability in Lombard, resulting from the impact of adverse economic conditions.

The expected return on existing business has increased following the acquisition of the AXA UK Life Business (including WLUK) and BHA. However, the longer term rates of return applied to equities and properties have fallen since 2010. The longer term return for government bonds used to determine 2011 MCEV operating profit is based on the one-year risk free rate at 31 December 2010 of 1.14%, which is materially below the longer term rate that could be derived from the 10 year swap rate at 31 December 2010 of 3.70%. The use of the one year rate results in a lower expected return, and hence a lower MCEV operating profit, than that which would have been obtained had a longer term risk free rate been applied. It is estimated that applying the 10 year swap rate of 3.70% to government bonds would have increased operating profit by £49 million for the period. The Group is reviewing the appropriateness of the rate applied in its MCEV operating profit and may, subject to any changes in industry practice, adopt a higher rate, based on the 10 year swap rate, as this is more closely aligned with the underlying characteristics of the Group's business. Any change in rate will have no impact on overall embedded value, as any increase in operating profit is offset by a decrease in economic variances.

Operating experience variances and other operating variances were £22 million adverse in the year. This reflects the adverse impact of persistency in the UK and Lombard, the negative impact of modelling changes in the International business (primarily in respect of more accurate modelling of guarantees on paid-up policies) offset by positive mortality and morbidity experience and the benefit of the change in Group capital policy to hold a minimum of 150% (previously 160%) of Group Capital Resource Requirements (excluding WPICC). Further details of this change are included in the cash and capital section.

Operating assumption changes amount to £140 million benefit in the year, comprising £185 million benefit of the Diligenta outsourcing and positive mortality changes of £30 million offset by £73 million net adverse impact of the favourable morbidity and adverse persistency assumption changes including the establishment of a provision for the expected impact of the Retail Distribution Review, and £2 million of other adverse changes. This corresponds to the guidance given in the Group's Interim Management Statement in November 2011 which anticipated an adverse impact of £40 million to £70 million for operating assumption changes at 31 December 2011 in respect of persistency and morbidity.

Further details on the operating performance of the Group are included in the relevant business unit operating sections.

## 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 2011 had a £600 million adverse impact on results (2010: £229 million favourable). The main contribution to the adverse variance is a £419 million impact arising from the reduction in the value of future profits from annual management charges on unit-linked business (UK: £241 million, International and Lombard: £178 million). The volatile macroeconomic conditions have also resulted in corporate bond spreads widening in the second half of the year with credit default and illiquidity premium assumptions changed to take account of these conditions. These changes have resulted in a £239 million impact on the UK annuity business.

Other positive economic variances total £58 million and include the offsetting impacts of economic conditions on the time value of options and guarantees ("TVOG"), £52 million adverse, the change in market value of Group debt, £97 million favourable and £13 million of other minor, positive variances.

Costs of £3 million have been incurred relating to the acquisition of BHA and WLUK (31 December 2010: cost of acquisitions totalled £28 million).

Non-recurring costs total £345 million (31 December 2010: £61 million) and include £124 million of one-off costs relating to the outsourcing agreement with Diligenta, £209 million of non-recurring costs consistent with IFRS (as explained above) and £12 million specific to MCEV. The £12 million MCEV-specific costs relate primarily to the difference between the actual tax relief expected to be received on UK pensions business of 6.5% and the approach applied in MCEV where a notional tax gross up of 26.5% is applied to the net of tax figure, resulting in a higher cost, gross of notional tax, under MCEV than under IFRS.

Other non-recurring items and non-operating variances of £66 million include a benefit of £23 million from the capital optimisation project and £35 million benefit from the impact on the UK business of the Budget in April 2011.This includes the impact on the value of in-force business of changing the corporation tax rate from 27% to 26% with effect from 1 April 2011 and changing the ultimate corporation tax rate effective from 1 April 2014 from 24% to 23%. A further £8 million of non-operating profit was generated through activities including a restructuring within Lombard.

## MCEV balance sheet

| Gross life and pensions MCEV<br>£m | 31 December 2011 Net worth | 31 December 2011 VIF | 31 December 2011 Total | 31 December 2010 Total |
|---|---|---|---|---|
| UK | 2,456 | 2,885 | 5,341 | 5,995 |
| International | 69 | 502 | 571 | 557 |
| Lombard | 84 | 457 | 541 | 577 |
| FLG corporate | 564 | – | 564 | 620 |
| FLG other[(i)] | 91 | – | 91 | 61 |
| **Gross FLG MCEV** | 3,264 | 3,844 | 7,108 | 7,810 |
| FLG corporate – STICS | (327) | – | (327) | (393) |
| FLG corporate – lower tier 2 debt | (632) | – | (632) | (201) |
| FLG corporate – internal LT2 bond | (200) | – | (200) | (702) |
| **Net FLG MCEV** | 2,105 | 3,844 | 5,949 | 6,514 |
| RSL net assets (including internal LT2 bond) | 270 | – | 270 | 901 |
| RSL deferred consideration notes | (423) | – | (423) | (500) |
| RSL acquisition finance facility | – | – | – | (400) |
| **Net Group MCEV** | 1,952 | 3,844 | 5,796 | 6,515 |
| Shares in issue[(ii)] | | | 1,373,527,605 | 1,443,985,079 |

(i) Includes IFA distribution and management services businesses including the pension asset of FPPS.

(ii) Adjusted to exclude 2,661,384 Resolution Limited shares held by subsidiaries at 31 December 2011 (31 December 2010: 8,579,292).

At 31 December 2011, net Group MCEV was £5,796 million (31 December 2010: £6,515 million) giving MCEV per share of £4.22 based on shares in issue at the balance sheet date, adjusted to exclude shares held by subsidiaries. MCEV per share at 31 December 2010 was £4.51 on a comparable basis.

At the end of the period the ratio of debt to gross Group MCEV (excluding internal debt) was 19.3% (31 December 2010: 18.7%), primarily reflecting the reduction in MCEV arising from the return of capital to shareholders. The ratio of debt to gross FLG MCEV was 16.3% (31 December 2010: 16.6%).

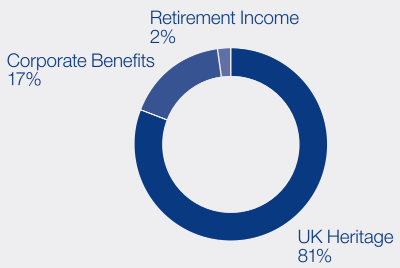
The Resolution holding companies' net worth, including internal and external debt, decreased by £154 million reflecting the payment of cash dividends of £226 million, the return of capital to shareholders of £250 million and corporate costs, offset in part by the receipt of a £350 million dividend from FLG.

The annualised FLG operating ROEV, after tax, for the year to 31 December 2011 is 6.5%. This represents steady progress when compared to the annualised 4.5% achieved at 30 June 2011 and 2010 baseline of 5.5%. The baseline operating ROEV includes the estimated full year impact of the AXA UK Life Business and BHA and assumes nil impact of operating variances and assumption changes. The operating ROEV at 31 December 2011 principally reflects the improvements made to the contribution of new business in the second half of the year as well as the benefit of year end assumption changes including the Diligenta outsourcing transaction. Low expected rates of return, particularly on shareholder assets, continue to provide a challenging environment in which to deliver improving returns.

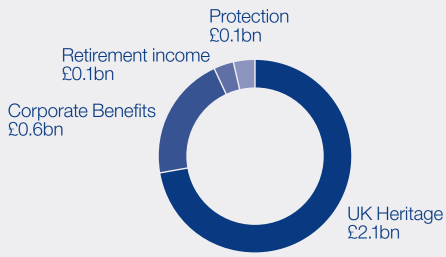
# UK operating review

In August 2011, the Group announced the creation of distinct 'Go to Market' and 'Heritage' UK business units, reflecting the Group's desire to improve the focus on both the profitable products and markets, and the existing in-force customer base. The Go to Market businesses are Corporate Benefits, Protection, and Retirement Income. They represent scale markets where good margins are generally available and where the Group has strong market positions enabling access to those margins. The Heritage business manages products not being marketed actively and the dedicated Heritage management team is focused on retention, cash and capital. The Heritage business unit forms the bulk of the UK business by assets and in-force value.

**UK AUM**
£88 billion




**UK VIF**
£2.9 billion




Key financial metrics for the UK businesses are shown below, further details are included in the financial results section:

| | **2011 Full year** | 2011 Half year | 2010 Full year |
|---|---|---|---|
| IFRS based operating profit before tax | **672** | 364 | 187 |
| MCEV operating profit before tax | **507** | 184 | 306 |
| Operating free surplus generation | **798** | 317 | 157 |

## Profitability of new business

| | **2011 Full year** | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | **Go to Market** | | | | | | |
| **£m (unless otherwise stated)** | **Heritage** | **Corporate Benefits** | **Protection** | **Retirement income** | **Total** | 2011 Half year | 2010 Full year baseline | 2010 Full year |
| VNB | **(4)** | **15** | **16** | **32** | **59** | 28 | 11 | 19 |
| New business cash strain | **(54)** | **(51)** | **(77)** | **13** | **(169)** | (98) | (303) | (149) |
| IRR (%) | **6.0** | **8.3** | **5.5** | **22.0** | **7.7** | 7.0 | 5.9 | 7.1 |
| APE | **157** | **440** | **92** | **32** | **721** | 372 | 677 | 472 |

The Group's new business strategy focuses on products and distribution channels in the UK market where the Group has a strong market position and the potential to access attractive returns. This strategy drives the focus of the Group's UK Go to Market business units whilst steps have been taken to exit or scale back sales in product lines where Friends Life will not be able to generate satisfactory returns (mainly individual pensions and investment bonds). The creation of a UK Heritage business unit will allow more active management of the products no longer actively marketed.

The activities undertaken to reduce costs through synergies and outsourcing as well as the transition of new business to the selected target platforms have significantly improved the contribution from new business. The contribution from UK new business was £59 million in the year and is significantly higher than the £11 million 2010 baseline.

A number of critical steps have now been taken as part of the drive to improve profitability to meet the Group's 2013 targets. The recognition of negative reserves in the acquired AXA UK Life Business and BHA protection books has significantly reduced new business cash strain. In addition, the focus on new business profitability across Friends Life has served to reduce cash strain down to £169 million in the year, representing a £134 million reduction on the £303 million 2010 baseline and demonstrates the significant progress made toward the target set out in early 2011 to reduce UK cash strain by £200 million.

A significant proportion of the Go to Market Protection and Corporate Benefits new business is now written on their respective target platforms. The profitability of the selected platforms is already close to or above the target 2013 returns with the target Corporate Benefits platform delivering 9.4% IRR (target: 10%) and the target Individual Protection platform delivering 20.0% IRR (target: 20%). The UK blended new business IRR has improved throughout the year with a progression from 5.9% in the 2010 full year baseline improving to 7.7% at the end of 2011. As a result, Friends Life remains confident of meeting the targeted product metrics by the end of 2013. The relevant sections below contain detailed commentary on the results for each component business within the UK operating segment.

## Cost savings

### Separation and integration

The separation and integration programme is progressing well with the BHA acquisition absorbed without interruption in January 2011. The BHA separation was completed at the end of January 2012 with the exit from Bupa transitional service arrangements ("TSAs").

The joint separation plans and operational service provision between AXA and Friends Life continues to work well, with 59% of transitional service arrangements exited by the end of 2011. Further arrangements have been exited early in 2012 and the separation from AXA IT infrastructure, the most significant component of the Friends Life and AXA separation agenda, is well advanced.

There have been five site closures announced to date, being Coventry, Manchester Spring Gardens, Basingstoke, Preston and London Crosswall (the former offices of BHA, where employees moved across to Friends Life's One New Change offices at the end of January 2012).

The integration projects remain on plan with £45 million run-rate savings achieved by the end of 2011 with cumulative costs of £67 million incurred to date (£58 million in 2011). This progress represents an acceleration of synergy delivery primarily across Customer Services and IT, and has been delivered through closing legacy products to new business as well as the initial impacts of announced site exits. Cumulative separation project costs of £72 million (£57 million incurred in 2011) are also in line with plan at this stage of the project.

### Diligenta

The Diligenta transaction complements the current outsourcing arrangements already in place with Capita. The service start date of this transformational transaction was 1 March 2012 when the remaining UK Heritage IT and Customer Services functions were outsourced thereby materially de-risking the future expense levels of the UK business together with significantly enhancing the level of synergies available. This certainty of future cost levels for a significant proportion of the business has been recognised in the operating results.

- IFRS based operating profit has benefited by £71 million in 2011 reflecting the release of maintenance expense reserves. Implementation costs of £84 million (which exclude costs relating to investment contracts in accordance with IFRS) have been reserved for and are presented within non-recurring costs. This results in a small net loss included in IFRS profit before tax of £13 million.
- In MCEV the recognition of the contractualised future expense savings has resulted in an uplift of £185 million in the MCEV operating result. In addition the certainty over lower ongoing maintenance expense levels has positively benefited VNB by £15 million taking the total benefit in MCEV operating profit to £200 million. Implementation costs of £124 million have been recognised as non-recurring costs in the 2011 result, reflecting the element attributable to the in-force book (for both insurance and investment contracts) at year end. As a result the outsourcing arrangement has a £76 million benefit to MCEV profit before tax.
- The Diligenta outsourcing benefits operating free surplus generation by £123 million as maintenance reserves are released, offset by £92 million costs of implementing the transaction. These impacts are in line with the MCEV result but are presented on a net of tax basis.

The Diligenta outsourcing is expected to generate annual cost savings of £60 million by 2015. Included in these expected savings is an amount of £29 million which relates to IT and Customer Service integration synergies that would otherwise have been delivered as part of the previously announced £112 million cost savings target. The contract, therefore, delivers additional expected cost savings of £31 million allowing the Group to increase the cost savings target to £143 million which will, in turn, drive improved profitability and lower new business strain. The previously committed element of the savings will still be delivered by the end of 2013 with the additional £31 million to be delivered by the end of 2015.

The total one-off costs of delivering the outsourcing arrangement are expected to be £250 million although £20 million of previously expected one-off costs will be avoided, resulting in net additional one-off cost of £230 million over 2011 to 2014. Combined with the £45 million of other run-rate savings delivered in 2011 and referred to above, a total of £105 million of savings has now been achieved or contractualised.

### Expenses

The Group has made good progress in reducing the UK cost base during 2011. UK acquisition and maintenance expenses totalled £441 million, which includes £14 million of temporary cost, primarily VAT on transitional service arrangements as part of the separation of the AXA UK Life Business from AXA UK, and £7 million of expenses incurred by the GOF and TIP businesses prior to their transfer back to AXA UK. Including a full year impact of WLUK expenses would increase 2011 underlying UK expenses from £420 million to £446 million. This represents a reduction on 2010 UK baseline expenses of £476 million on a comparable basis, including the effect of inflation during 2011. The full effect of the run-rate savings set out above will be realised in 2012.

## Cash delivery and capital optimisation

The Group's strategy to improve cash delivery is materially influenced by the actions taken within the UK business. The UK delivered operating free surplus of £798 million in the year to 31 December 2011 reflecting both the improved trading performance, as the businesses integrate, the Diligenta outsourcing transaction and a number of other one-off items.

### Capital optimisation

The recognition of negative reserves has materially reduced the cash strain of the Protection business and the business as a whole. The progress and control of new business strain is also a key lever in the Group's drive to improve cash generation. Further operational improvements will be delivered as the business focuses new business on the highly efficient Protection and Corporate Benefits strategic platforms whilst the outsourcing arrangement with Diligenta has enabled the UK Heritage business to variabilise its cost base, de-risking the inevitably detrimental effect of a fixed cost base on incremental business written on products that are no longer marketed.

The impact of adopting certain elements of PS06/14 guidance in the acquired BHA and AXA UK Life Business significantly benefited the 2011 IFRS based operating profit. The recognition of negative reserves, and resulting reduced capital requirements on protection products, has effectively accelerated the surplus generated on these products although lower in-force surplus releases are subsequently expected in future as a result. In addition, as the profit profile of these products has changed, the corresponding amortisation of deferred acquisition costs ("DAC") has likewise been accelerated. The resulting one-off benefit to IFRS based operating profit is £221 million in the year, with a corresponding benefit of £12 million to new business strain and a reduction of £40 million in the emerging in-force surplus in 2011. This reduction in in-force surplus is expected to reduce to £25 million to £30 million in 2012 based on current expectations of in-force run-off. The overall net impact on IFRS based operating profit for 2011 (excluding improvements in new business strain) is £181 million. IFRS based profit after tax remains largely unaffected, despite the increased one-off benefit as the earlier recognition of surplus is offset by the accelerated run-off of acquired value of in-force business.

The MCEV operating profit is not significantly affected by the recognition of negative reserves as the benefit realised is largely offset by the accelerated run-off of the value of in-force. A free surplus benefit of £161 million has been recognised with this enhancing operating free surplus generation.

Further capital efficiencies have been delivered in the second half of 2011 through the completion of a number of Part VII transfers. These have successfully transferred business from a number of smaller life companies into FLL. The completion of these transfers has reduced aggregate Pillar 1 capital requirements by around £113 million and released £181 million of surplus capital. Further Part VII transfers are planned for 2012 with these aiming to reduce the number of UK life companies from the current five down to two by the end of 2013.

# Financial results

## UK IFRS based operating profit

| £m | 2011 Full year(i) | 2011 Half year(ii) | 2010 Full year(iii) |
|---|---|---|---|
| New business strain | **(112)** | (66) | (89) |
| In-force surplus | **402** | 214 | 280 |
| Long-term investment return | **(5)** | 4 | 30 |
| Principal reserving changes and one-off items | **416** | 222 | (15) |
| Development costs | **(28)** | (10) | (21) |
| Other income and charges | **(1)** | – | 2 |
| **IFRS based operating profit before tax** | **672** | 364 | 187 |

(i) 2011 full year results comprise 12 months results for Friends Provident and the AXA UK Life Business, 11 months for BHA and two months for WLUK.
(ii) 2011 half year results comprise six months results for Friends Provident, six months for the AXA UK Life Business and five months for BHA.
(iii) 2010 full year results include 12 months results for Friends Provident and four months for the AXA UK Life Business.

In the year to 31 December 2011 the UK segment delivered IFRS based operating profit before tax of £672 million (31 December 2010: £187 million), representing an increase of £485 million on the prior year. The increase reflects the greater scale of the UK business, in particular a full 12 months of operating profit from the AXA UK Life Business, and improved performance including the recognition of management actions and other reserving benefits.

Despite these operating improvements, on an underlying basis, after removing principal reserving changes and one-off items, the full year profit of £256 million is lower than the annualised half year result of £284 million. This reduction principally reflects the impact of adverse economic conditions on in-force surplus generation, partially offset by reduced new business strain as the cost reductions and transition to target platforms take effect.

## UK 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 | 2011 Full year | 2011 Half year | 2010 Full year |
|---|---|---|---|
| Total UK new business cash strain | **(169)** | (98) | (149) |
| DAC/DFF adjustments | **60** | 33 | 59 |
| Other IFRS adjustments | **(3)** | (1) | 1 |
| **Total UK IFRS new business strain** | **(112)** | (66) | (89) |

New business cash strain has benefited from a number of factors in the year with good progress being made towards the target £200 million reduction in UK new business cash strain. IFRS new business strain of £112 million reflects some of these benefits with the principal driver of improvement, in the second half of the year, being a reduction in costs as Protection new business is transferred to the target platform.

The implementation of PS06/14 reserving changes and the recognition of negative reserves across the UK Protection portfolio means that DAC is no longer recognised on this business. This change in treatment offsets the reserving benefits which are apparent in cash strain and as a consequence the benefit to IFRS new business strain is reduced. DAC continues to be recognised on pensions and investments business and has moved in line with expectations given the current product mix and levels of new business.

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

| £m | **2011 Full year** | 2011 Half year | 2010 Full year |
|---|---|---|---|
| Total UK cash surplus | **354** | 207 | 268 |
| DAC/DFF adjustments | **(7)** | (1) | 8 |
| Other IFRS adjustments | **55** | 8 | 4 |
| **Total UK IFRS surplus** | **402** | 214 | 280 |

UK cash surplus generated in the year of £354 million (30 June 2011: £207 million) reflects the volatility in the macroeconomic environment in particular lower average equity markets and lower risk free rates. The lower level of equity markets resulted in a reduction in fees generated on unit-linked funds in the year as well as leading to an increase in reserves to reflect the impact of lower annual management charges in the future. In addition, the fall in risk free rates has resulted in an increased cost of product guarantees, whilst the basis changes to income protection morbidity removed the benefit of the half year positive variance from the full year surplus.

The IFRS in-force surplus of £402 million (30 June 2011: £214 million) reflects the negative economic impacts experienced during the period, partially offset by the reversal of the increased reserving level referred to above, which is not allowable on the IFRS basis. This is reflected in the proportionally higher size of other IFRS adjustments to the change in cash surplus compared to previous periods.

The £7 million net amortisation of DAC and deferred front end fees ("DFF") reflects the relatively small value of these costs that has been capitalised in the post-acquisition period. On the acquisition of the business, the existing capitalised deferred acquisition costs and deferred front end fees were eliminated and recognised within the acquired value of in-force ("AVIF"). In the post-acquisition period, as new business is written, the capitalisation of acquisition expenses and front end fees resumed and hence the amortisation charged against in-force surplus will increase each year for pensions and investments business.

## Longer term investment return

| £m | **2011 Full year** | 2011 Half year | 2010 Full year |
|---|---|---|---|
| Longer term return on life and pension shareholder funds – excluding debt | **70** | 35 | 76 |
| Longer term return on life and pension shareholder funds – debt | **(75)** | (31) | (46) |
| **Total** | **(5)** | 4 | 30 |

Longer term investment return has fallen in the second half of 2011 with a net loss of £5 million in the year driven by an increase in financing costs. This primarily reflects the increased debt held in the UK business with £500 million transferred from Friends Life holding companies in April 2011 and a further £200 million transferred in December 2011.

## Principal reserving changes and one-off items

Principal reserving changes and one-off items comprise a £221 million one-off benefit in respect of PS06/14, £71 million release of expense reserves, including the benefit of the savings secured through the Diligenta outsourcing, and a further £124 million of assumption changes primarily in respect of favourable mortality and morbidity experience and some positive persistency experience in protection.

## UK operating expenses

| £m | **2011 Full year** | 2011 Half year | 2010 Full year Baseline(i) | 2010 Full year |
|---|---|---|---|---|
| Acquisition | **178** | 89 | 220 | 130 |
| Maintenance | **263** | 130 | 256 | 140 |
| | **441** | 219 | 476 | 270 |
| Development | **28** | 10 | 23 | 21 |
| **Total** | **469** | 229 | 499 | 291 |

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

UK operating expenses, which exclude commission payments and non-recurring costs totalled £469 million in the year with acquisition and maintenance expenses amounting to £441 million. Acquisition and maintenance expenses remain the focus for the UK business in the drive to reduce expenses by £143 million (£112 million by the end of 2013) from a 2010 baseline of £476 million.

2011 expenses include two months of WLUK operating expenses whilst the baseline includes a full 12 months charge of £31 million.

Actions to reduce operating expenses have been progressing well with £45 million of run-rate savings being made to date. However given the timing of these savings only a £27 million benefit is reflected in the 2011 expense base. These include the implementation of the revised strategy announced in February 2011 resulting in streamlined UK sales and marketing functions and synergies from reorganisation of operations prior to outsourcing services to Diligenta. Offsetting this reduction are a number of temporary increases, including VAT on services provided by AXA UK and short-term increases in Finance and Governance functions to strengthen capabilities during integration, which will not recur beyond 2013 as the integration of the UK businesses completes.

Development costs of £28 million mainly comprise £7 million of spend on the new Corporate platform, £6 million investment into the Retirement Income strategy and £4 million in the development of auto-enrolment capabilities including the development of an auto-enrolment hub aimed at reducing the legislative burden on clients. Other development spend includes investment in data modelling for the Protection business as well as other smaller development projects.

## UK other income and charges

Other UK IFRS based operating loss of £1 million includes the £2 million trading profit generated by Sesame Bankhall Group ("SBG"). SBG is the UK's largest distributor of retail financial advice and operates three market leading brands. Sesame is the leading appointed representative network, Bankhall is the largest support service provider for directly regulated IFAs and PMS is the biggest mortgage club for intermediaries. In 2011 SBG retained its position as the UK's largest distributor of mortgages through intermediaries, with over £26.1 billion of mortgage applications (an increase of £1.9 billion on 2010). This represents a 13.8% share of the entire UK mortgage market (2010: 13.3%).

## UK operating segment – MCEV operating profit

| £m | **2011 Full year(i)** | 2011 Half year(ii) | 2010 Full year(iii) |
|---|---|---|---|
| Value of new business | **59** | 28 | 19 |
| Expected existing business contribution | **330** | 167 | 210 |
| Operating experience variances | **(9)** | (7) | 37 |
| Operating assumption changes | **147** | – | (41) |
| Other operating variances | **9** | 6 | 96 |
| Development costs | **(28)** | (10) | (21) |
| Life and pensions covered business operating profit before tax | **508** | 184 | 300 |
| Other income and charges | **(1)** | – | 6 |
| **Operating profit before tax** | **507** | 184 | 306 |

(i) 2011 full year results comprise 12 months results for Friends Provident and the AXA UK Life Business, 11 months for BHA and two months for WLUK.
(ii) 2011 half year results comprise six months results for Friends Provident, six months for the AXA UK Life Business and five months for BHA.
(iii) 2010 full year results include 12 months results for Friends Provident and four months for the AXA UK Life Business.

The UK MCEV Operating Profit before tax increased to £507 million (2010: £306 million), including a full year's contribution from the AXA UK Life Business and contribution from BHA from 31 January 2011.

## Value of new business

Value of new business has increased significantly from 2010, reflecting the inclusion of a full year's sales of the AXA UK Life Business, with improved profitability, and the inclusion of BHA sales from January 2011. Profitability has been improved through the realisation of cost synergies, transition of new business to the selected target platforms and the impact of the Diligenta transaction.

## Expected existing business contribution

The expected existing business contribution for UK 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.

The expected return on the value of in-force has increased following the acquisition of the AXA UK Life Business (including WLUK) and BHA. However, the longer term rates of return applied to equities and properties have fallen since 2010. The longer term return for cash and government bonds is based on the one-year risk free rate at 31 December 2010 of 1.14%.

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.

For assets such as cash and government bonds, management's expectation has been based on the one-year risk free rate, by reference to the swap yield curve. The rate applied for the 2011 results is based on the one-year risk free rate at 31 December 2010 of 1.14%, which is materially below the longer term rate that could be derived from the 10 year swap rate at 31 December 2010 of 3.70%.

| | Rates of return | |
|---|---|---|
| | **2011 %** | 2010 % |
| Reference rate (non annuity business) | **1.14** | 1.01 |
| Reference rate (annuity business) | **1.89** | 1.76 |
| Best estimate returns: | | |
| Corporate bonds | **2.45** | 2.98 |
| Cash/Government bonds | **1.14** | 1.01 |
| Equity | **6.70** | 7.30 |
| Property | **5.70** | 6.30 |

## Operating experience variances

Total operating experience variances in the UK amounted to a £9 million charge (31 December 2010: £37 million benefit) primarily reflecting adverse experience variances in respect of persistency, offset by favourable mortality and morbidity experience. Operating experience variances also included beneficial tax variances and adverse expense experience unrelated to the ongoing cost base.

## Operating assumption changes

Operating assumption changes amount to a positive £147 million in the year (2010: negative £41 million) and comprise:

- £185 million benefit from the impact on in-force business of the outsourcing deal with Diligenta. The arrangement with Diligenta has contractualised future expense savings with this benefit reflected in the MCEV maintenance expense assumptions;
- £73 million charge resulting from strengthened persistency assumptions partially offset by the impact of favourable assumption changes for morbidity (for which more details are set out below);
- £29 million benefit from aligning mortality assumptions for protection and annuity business to reflect recent experience in these products; and
- £6 million benefit from other minor changes.

In the Group's third quarter results it was highlighted that experience in relation to persistency and morbidity was being investigated. Guidance was given amounting to a net impact of £40 million–£70 million on the year end MCEV operating results. These investigations have since concluded, as part of the annual basis review, and resulted in a charge of £73 million recognised in the MCEV operating result. The £73 million impact comprises the following:

- £73 million adverse impact relating to persistency across certain group and individual pension books and lapse experience in the Group's investment bond portfolio;
- £82 million provision for RDR as the Group expects market conditions in advance of RDR implementation to drive an increase in short-term persistency experience reflecting the impact of continued 'churn' of new business by the commission-paying market; and
- £82 million benefit in respect of income protection morbidity assumptions, where recent experience supports a change to previous assumptions.

## Other operating variances

Other operating variances of £9 million positive (2010: £96 million) primarily reflects an increase in reinsurance retention levels.

In 2010 other operating variances included one-off benefits from a change in timing of modelled tax relief on group pensions business and a review of the tax asset relating to the re-attributed inherited estate of the AXA UK Life Business.

# UK Heritage

## Strategic implementation

The UK Heritage business unit is fundamentally different to the Go to Market propositions, with greater in-force scale, a large set of closed products, complex legacy systems and over four million customers. Consequently the business unit (which was created during the course of 2011) is focused on different value drivers. The three key value drivers for the Heritage business are:

- Management of an efficient cost base in line with business scale
- Minimisation of capital required for the business
- Retention of in-force business

Good progress is being made in establishing a dedicated management team focused on the Heritage business, consistent with the aim to be the UK's leading legacy business manager, with the knowledge and expertise to maximise the value created from these books. This team is led by Friends Life's Chief Commercial Officer, Evelyn Bourke.

The Heritage business has set out its plans to drive value with the following strategic themes being the starting point.

### Outsourcing

The Heritage business, absent further portfolio acquisitions, is not a self perpetuating business. As a result, management of the underlying cost base is critical to cash and profitability. The significant policy administration and IT outsourcing deal with Diligenta which commenced on 1 March 2012, together with the existing outsource arrangement with Capita, mean that materially all of Heritage policy administration is outsourced. The resulting certainty around administration costs reduces the risk of expense assumptions in the embedded value coming under pressure, as the cost base is now more variable and will decrease as the business runs off.

The outsourcing transaction also contractually secures and extends the synergies arising from the combination of the Friends Provident and AXA UK Life Business.

### Building an in-house asset manager

Building in-house asset management capability supports the aim of running to an efficient cost base with the expectation that assets can be managed more efficiently internally in the longer term. Friends Life Investments ("FLI") is due to launch in mid-2012, with the in-house capability presenting a significant opportunity to deliver more value from the existing book through optimised investment strategies at lower cost.

As announced in November 2011, the Group has £61 billion of externally managed assets which will reach the end of their contractual terms within the next nine years and are available for recapture. The potential fee recapture associated with these assets is in the order of £100 million per annum including VAT. In Phase 1, FLI will focus on the recapture of the core non-linked and shareholder assets of the Group. These assets are principally fixed income in nature. It is expected that the Group could recapture fees of the order of £10 million per annum (including VAT) from the £12 billion assets targeted in Phase 1. The Group has currently served notice on £8 billion of assets with £6 billion expected to transfer in the middle of the year. Phase 2 principally relates to fixed income assets currently managed in the Group's with-profit and unit-linked funds.

The Group already has significant expertise in fixed income and this was augmented with the recruitment of an experienced fixed interest team in January 2012.

To assist in minimising the additional headcount, the middle and back office support functions will be wholly outsourced. This will provide future scalability and flexibility whilst assuring cost certainty.

## Capital optimisation programme
There is a large capital optimisation programme underway to simplify the legal structure of the business and remove capital inefficiencies. Friends Life has five UK life companies within the group and the ultimate result of the programme will be to reduce this to two, broadly aligned to the Heritage business and Go to Market business lines. The Group expects to reach this end state during 2013.

## With-profits fund management
A programme to develop and implement a uniform risk management framework for the six with-profits funds within the Heritage business is currently underway. The result will be a consistent plan of management actions across the with-profits funds to mitigate the risk of volatile returns for shareholders whilst ensuring fair treatment of customers.

## Customer value management
Friends Life aims to actively engage with its customers to minimise avoidable policy lapses. Initiatives in place include both pro-active and reactive customer communication, aimed at retaining valuable customers within their existing product, or within the group as a post-retirement annuitant.

## Fund rationalisation
The Heritage business includes policies invested in a very wide universe of investment funds, as a legacy of the businesses that wrote the original policies. There are opportunities to increase efficiency and reduce risk over the medium term by significantly rationalising the number of funds and this process will begin during 2012.

# Scale

## Value of in-force business
The UK Heritage business represents a significant proportion of the Group's future in-force value. This is distributed across a range of products within the following broad categories.

| | £bn | % |
|---|---|---|
| With-profits | **0.5** | 21 |
| Pensions | **0.5** | 21 |
| Investments | **0.7** | 34 |
| Protection | **0.3** | 16 |
| Annuities | **0.1** | 7 |
| Other | **–** | 1 |
| **Total UK Heritage VIF 31 December 2011** | **2.1** | 100 |

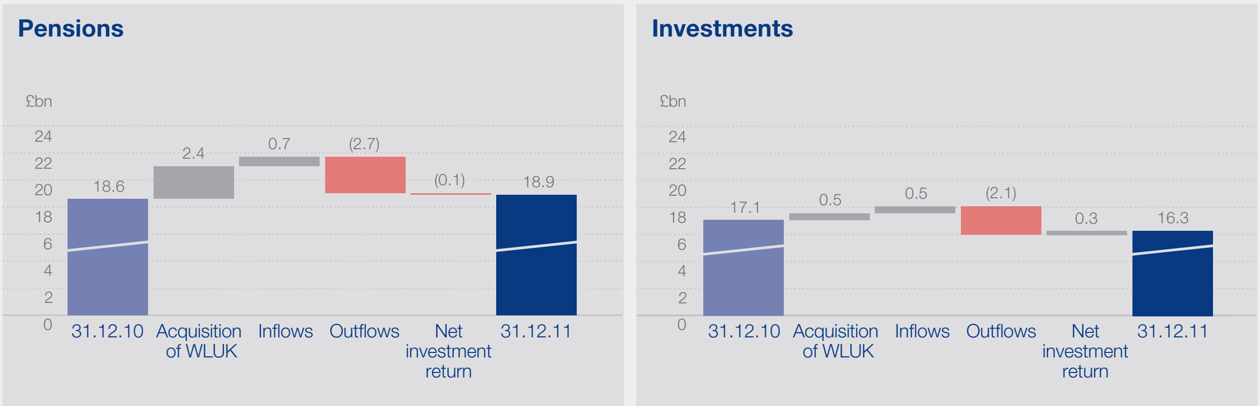
By product line, the primary drivers of future profit are expected to be:

- 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.
- With-profits: typically the value of the shareholders' 10% share of the cost of bonus on 90/10 with-profits business and the value of charges less expenses on other with-profits business. Relative to other products lines, these policies require significant regulatory capital on both bases.

## UK Heritage unit-linked assets under management

Unit-linked funds under management are a significant source of future revenue in the form of annual management charges less investment management fees and trail commission. In 2011, the Group has seen net outflows of both unit-linked pensions and investment business. Unit-linked pensions outflows in the year have been driven by individual pensions business whilst unit-linked investment business, primarily single premium bonds, reflects the maturing of this book with new business having been modest for some years. The Group no longer actively markets any bond products in line with the Group's announcement to withdraw from the individual bond market. Whilst net outflows are significant, the UK Heritage business expects to be able to manage these books of business within the current assumptions.

### Heritage unit-linked – funds under management




At 31 December 2010, total unit-linked pensions funds under management amounted to £30.6 billion. Following the creation of the UK Heritage business unit, £12.0 billion of these unit-linked pensions funds are now managed in the Corporate Benefits business unit.

## UK Heritage profit emergence

During 2011 approximately £0.3 billion of VIF has monetised. In the five-year period from 2012, around £1.0 billion of UK Heritage VIF is also expected to monetise, of which unit-linked business accounts for around £0.5 billion.

The table illustrates the VIF expected to emerge in future five-year periods.

| VIF run-off of Heritage business | £bn |
|---|---|
| Year 1–5 | 1.0 |
| Year 6–10 | 0.5 |
| Year 11–15 | 0.3 |
| Year 16–20 | 0.2 |
| Year 21+ | 0.1 |

## Key drivers

Cash generation from the in-force business is sensitive to a number of key drivers, including:

- investment performance of the assets, in particular on unit-linked funds and assets held in respect of shareholder backed pension annuities;
- lapse experience, which is a function of client behaviour in response to future uncertainties around the economic outlook and their particular situations, adviser behaviour and changes in UK fiscal and regulatory regimes;
- future claims experience on the Group's protection and annuity business which is a function of underlying mortality and morbidity trends, risk selection and claims management; and
- capital requirements as specified by the regulatory regime (e.g. Solvency II).

During 2011, cash generation was affected by the accelerated emergence of surplus on protection business through the adoption of negative reserves and operating cost savings in respect of servicing in-force business.

## New business

| £m (unless otherwise stated) | Heritage pensions | Heritage protection | Heritage investments | Heritage WP annuities | 2011 Full year | 2011 Half year |
|---|---|---|---|---|---|---|
| Value of new business | (17) | 11 | 3 | (1) | (4) | 8 |
| New business cash strain | (31) | (2) | (23) | 2 | (54) | (30) |
| IRR | 2.2% | >25% | 7.6% | 18.8% | 6.0% | 6.8 |
| APE | 108 | 7 | 34 | 8 | 157 | 87 |

The Heritage business unit specifically focuses on those products no longer actively marketed. It does not actively drive new business, but the book delivers a significant level of ongoing incremental business written across all product types.

The Group expects new business to reduce in the medium term. In particular new business strain relating to investments business is expected to reduce in future years due to the closure of bond products to new business during 2011.

The contribution from UK Heritage new business was a loss of £4 million in the full year results with this representing an adverse movement from a first half contribution of £8 million. This change is due to a number of factors:

- DWP rebate business contributed £7 million to pensions VNB in the first half of 2011, with this benefit not repeated in the second half of the year;
- as previously announced, the Group does not expect to be able to generate the required returns on the investment proposition. The closure of some investment product lines in the second half of the year has therefore reduced volumes with a corresponding reduction in contribution; and
- strengthening of lapse assumptions on bonds and individual pensions as a result of the year end investigation of experience.

## Go to Market: Corporate Benefits

The Go to Market Corporate Benefits business is being built on the efficient and scalable New Generation Pension ("NGP") platform and currently administers £15.4 billion of assets on behalf of over 15,000 corporate clients. In addition to the current products focused around both trust and contract-based pensions solutions, the launch of the corporate platform in January 2012, with schemes expected to be taken on in the second quarter, will extend the reach of the business into the wider workplace savings market providing complete savings solutions for customers.

The proposition remains highly regarded in the market, retaining first place in the Greenwich 2012 DC survey of leading employee benefits consultants ("EBCs"), and also being rated first in the 2011 NMG Corporate Wealth Programme.

## Market environment

Friends Life expects the corporate benefits market to grow strongly and to benefit from the ongoing structural shift from defined benefit to defined contribution schemes, auto-enrolment and demographic changes. However, although growth prospects remain good, the traditional UK industry model is structurally unattractive, delivering poor shareholder returns in a marketplace historically characterised by intense price driven competition, heavy intermediation and commission bias.

The current competitive intensity and "land grab" in advance of RDR is expected to subside post 2013 as the basis of competition switches from price and commission to a quality of proposition. As a result, the number of market competitors is expected to reduce as the competitive intensity takes its toll, particularly with providers who lack scale and who are unlikely to benefit from the uplift in volumes expected from auto-enrolment within the back book.

## Strategy implementation

Friends Life expects to compete in this environment and significant progress has been made in 2011 with the execution of the Go to Market strategy. The transition to a lower cost platform is reflected in improving business performance whilst new business momentum and pipeline into 2012 are evident.

Returns in the Corporate Benefits business have historically been low and the Group is focused on improving these through the following four key levers:

### Retain and develop existing schemes

Organic growth of the Corporate book will be driven through a focus on key clients and distributors, supported by a strong relationship management function already within the business. Friends Life expects to enhance this client growth with additional structural benefits from consolidation of schemes and closure of defined benefit plans, in addition to the Group's success in the Enhanced Transfer Value market. Worksite marketing and member education activities will drive further growth. This is already evidenced in the strong levels of new business generated in 2011 against a difficult economic backdrop.

### Selectively take on new schemes

The selective acquisition of new schemes will be driven by a limited number of key distribution relationships in Friends Life's target market. Within this, the focus is on mid to large schemes where Friends Life expects to be able to achieve its target returns and most efficiently deploy the new business team. The launch of the new corporate platform in 2012 will add a further strong proposition to Corporate Benefits market leading offering.

### Reduce costs

Friends Life remains focused on reducing costs across the organisation. Having already restructured the distribution function, work continues on building a lean front-office business. In addition, the migration of assets from the Embassy platform on to the market leading NGP platform will reduce operational costs further. The outsourcing deal with Diligenta provides further cost savings and certainty as the market enters a period of profound change.

### Position Friends Life for auto-enrolment and RDR

As the corporate market continues to develop, the Friends Life offering is moving in line with it. Friends Life recently announced a link with Tata Consultancy Services to develop an auto-enrolment hub to reduce the legislative burden on clients. This will further drive retention and growth in the existing book and the acquisition of new clients whilst taking advantage of the opportunity presented by auto-enrolment. The launch of the new corporate platform broadens the proposition from a retirement savings business into a wider workplace marketing business. Additionally, the removal of commission bias within the market with the advent of RDR in 2013 will enable the Corporate Benefits business to form relationships across the whole of the distribution landscape with minimal change to the offering.

The implementation of these elements will enhance new business IRRs and support the delivery of the 2013 new business financial targets set out early in 2011.

## Financial performance

| Corporate Benefits all platforms<br>£m (unless otherwise stated) | 2013<br>Full year<br>target | **2011<br>Full year** | 2011<br>Half year |
|---|---|---|---|
| VNB | 25 | **15** | 5 |
| New business cash strain | (75) | **(51)** | (35) |
| IRR | 10%+ | **8.3%** | 6.6% |
| APE | n/a | **440** | 219 |

The contribution from Corporate Benefits new business totalled £15 million in the year and shows a strong financial performance in the second half reflecting both improved mix of business and the delivery of synergy savings.

Overall returns have been enhanced by better than expected results on the acquired AXA UK Life Business platforms, primarily driven from cost savings. These business lines are now no longer loss making and will be migrated onto the target platform in 2012, realising further efficiencies and improvements in performance.

The profitability of business written on the target NGP platform remains robust, delivering £15 million of VNB and an IRR of 9.4%. Performance in the first half of the year included £3 million VNB in respect of DWP rebates which are weighted towards the first half of the year while the full year result takes account of the revised persistency assumptions, and the benefit of the Diligenta outsourcing transaction.

2011 saw strong overall volumes with APE of £440 million principally driven by increments and new entrants to existing schemes. Market concerns around the merger with the acquired AXA UK Life Business and a restructure of the sales team in January 2011 impacted adversely on new scheme wins, although performance picked up strongly throughout the year, with a good pipeline of new business in place for 2012.

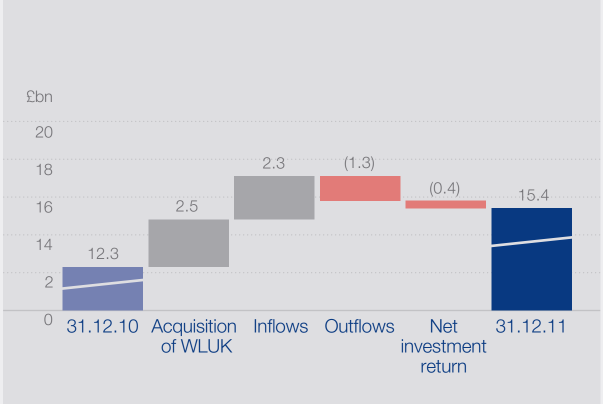
| Corporate Benefits target platform<br>£m (unless otherwise stated) | **2011<br>Full year** | 2011<br>Half year |
|---|---|---|
| VNB | **15** | 11 |
| New business cash strain | **(38)** | (23) |
| IRR | **9.4%** | 8.8% |
| APE | **356** | 176 |

This platform, which forms the core of the Go to Market business is expected to achieve the 10% target return during 2012 as the cost synergies and migration of business onto the more efficient NGP platform take effect.

## Corporate Benefits funds under management

Following the changes made to the Friends Life group management structure in 2011, the Corporate Benefits business manages a total of £15.4 billion customer assets including £2.5 billion of assets in respect of the acquired WLUK business administered on the Embassy system. These Embassy assets are due to migrate onto the NGP platform in 2012.

### Corporate Benefits – funds under management




(i) WLUK assets included from 7 November 2011 with movements included for the final two months of 2011
(ii) Corporate Benefits assets under management include £0.3 billion of unitised with-profits business managed on the NGP platform

Despite poor equity market conditions group pensions assets for the Corporate Benefits business now stand at £15.4 billion with net inflows in the year of £1.0 billion. Of this, net outflows of £0.2 billion related to the closed individual pension lines on the NGP platform, with the core Corporate Benefits business generating net inflows of £1.2 billion. This increase in assets, combined with the reduction in the cost base drives strong underlying business performance. Although overall assets have grown, there have also been significant outflows of business as a result of scheme losses. These have primarily been lost to commission paying providers and this level of outflow is not expected to continue after the RDR comes into effect. This recent experience has been recognised within the MCEV operating result with an additional provision of £82 million set up to allow for further short term adverse persistency impacts on VIF.

The outlook for 2012 is positive with a strong new business pipeline and the start of auto-enrolment for Friends Life's larger customers in the second half of the year. The development of an auto-enrolment proposition will support employers and aid further growth and client retention. The continued development towards these market changes is progressing well and the Group remains confident of achieving the 2013 financial targets.

## Go to Market: Protection

The Friends Life Protection business brings together the Friends Provident individual and group protection propositions with those acquired from the AXA UK Life Business and BHA. The Group now has comprehensive market coverage with the proposition operating across a wide range of distribution channels.

The individual protection business provides life, critical illness and income protection cover to individuals and businesses. These products are distributed through IFAs, banks, estate agents and leading brands such as Tesco, Virgin and the AA.

The group protection business provides group income protection, group life and group critical illness products, which are distributed through EBCs and IFAs. In July 2011 the acquired propositions were integrated and all new business is now written on the strategic platform.

### Market environment

The UK protection market is mature and concentrated, and has remained stable over the last five years generating in-force premiums in the region of £6.6 billion per annum. The developments made to date have placed Friends Life well into the top five market participants with the Group having significant scale in this market. Despite this position of relative strength the focus on profitability remains paramount with a selective approach to those channels and products which offer acceptable levels of return.

The protection market will be affected by a number of significant regulatory changes over the next two years including the RDR, gender neutral pricing, life tax changes and Solvency II.

Protection products are out of scope for the RDR, and the industry consensus view expects the market to experience a short-term 'bounce' as intermediaries manage their cash flow and transition their businesses. Friends Life supports this view and, supported by the breadth of the Group's distribution footprint, is well placed to benefit.

Changes regarding gender neutral pricing and life tax will have an effect on the price of protection, with this impact varying by provider. Friends Life operates a value based proposition focused on product quality, as opposed to commoditised volume players focused on price, and expects to be less sensitive to any general price increase in the market, allowing the business to communicate clearly and confidently to its target partners.

The impact of these changes has been factored into the Protection strategy from the start and the Group believes the protection business and the wider Friends Life protection proposition are well positioned to benefit from these changes.

### Strategy implementation

The acquisition of BHA has transformed the Group's protection product range and platform options. The implementation of the Go to Market Protection strategy is progressing well and focuses on the proposition's following key competitive advantages.

#### Customer solutions

The combination of the three acquired protection businesses has enhanced the Group's range of protection products with the business retaining the best elements of these. Building on this strength the Go to Market Protection business is able to offer a higher value customer offering, which enables the products to be priced at a premium. This includes:

- Market leading income protection and critical illness cover, with a breadth of illnesses covered;
- A flexible exemption based approach to underwriting, with pricing for exemptions and other innovative underwriting features such as tele-underwriting; and
- Value added benefits such as Bupa HealthLine and Best Doctors.

## Operational excellence

The strategy announced earlier in 2011 confirmed the selection of the low cost and efficient BHA platform, with good progress made to date in consolidating these platforms in the market. This development enabled the integration of the Group Protection proposition in July 2011 and culminated in the launch of the Friends Life Protect+ menu proposition in October 2011 for the Individual business. This has brought together the best features of the three historic intermediary propositions. The Protection business now has market leading individual critical illness and income protection offerings, both with a Defaqto five star rating, whilst loss making former Friends Provident and AXA UK Life Business intermediary products have been closed to new business. The transition to the Group's target end state will continue into 2012 with the controlled distribution partners due to migrate to the strategic platforms over the course of the year.

## Selective distribution

The business continues to build on the existing distribution partnerships whilst managing the performance of existing relationships. The active management of these relationships across the breadth of different channels de-risks the impact of changes to distribution as the market responds to the Retail Distribution Review.

Supporting this, the implementation of a new tripartite partnership between Friends Life, Sesame Bankhall Group and Connells, one of the UK's largest estate agencies and property services groups, has come into force in March 2012. The arrangement encompasses a new single tie arrangement between Friends Life and Connells as well as a long-term partnership between Sesame Bankhall Group and Connells.

## Financial expertise

The business has strong technical expertise in pricing, reinsurance and claims management enabling us to deliver good profitability and efficient use of capital. Leverage of this expertise will drive strategic change and deliver improved profitability in the targeted time scales.

Regulatory requirements, such as gender neutral pricing will cause changes in pricing for Individual Protection. There is a strategic focus on analysing business mix and price points in order to optimise business performance and profitability in the market during and after the changes. Reinsurance negotiations have already given increased margin flexibility and work with reinsurers continues in order to consider other innovations. Claims management is consolidated with technical and investigative expertise that works across the Individual and Group business. This expertise enables efficient claims management as well as innovations such as early intervention and early rehabilitation for Group Protection, giving both product differentiation and cost benefits.

## Financial performance

| Protection all platforms<br>£m (unless otherwise stated) | 2013<br>Full year<br>target | **2011**<br>**Full year** | 2011<br>Half year |
|---|---|---|---|
| Value of new business | 80 | **16** | (2) |
| New business cash strain | (30) | **(77)** | (43) |
| IRR | 20% | **5.5%** | 3.9% |
| APE | n/a | **92** | 50 |

Contribution from new business has improved significantly in the year with a total of £18 million contributed in the second half of 2011 versus a loss of £2 million in the first half of the year. The change in focus, towards the higher value critical illness and income protection products as well as the migration to the lower cost strategic platform have been the key drivers of this improvement. In addition new business contribution has also benefited from the changes made to assumptions on persistency and mortality reflecting recent favourable experience. These assumption changes are principally reflected in the business lines not yet transferred to the target platform with this level of performance expected to continue.

The new business strain continues to be reduced with strain in the second half of £34 million down on the £43 million recorded in the period to 30 June. The changes made to allow credit for negative reserves materially improved new business strain compared to 2010. New business strain is expected to continue to decrease in 2012 as profitability improves towards target.

Protection IRR has improved to 5.5% (30 June 2011: 3.9%) with the improvement in profitability expected to continue in 2012 as a full year impact from the changes made in the second half of 2011 and the migration of the controlled partners to the strategic platform during 2012 take effect.

Protection volumes in the second half of 2011 amount to £42 million APE (30 June 2011: £50 million) as the increase in pricing, launch of the "Protect+" proposition and targeted focus on critical illness and income protection marginally reduced volumes.

| Individual protection target platform £m (unless otherwise stated) | 2011 Full year | 2011 Half year |
|---|---|---|
| VNB | 22 | 9 |
| New business cash strain | (8) | (2) |
| IRR | 20.0% | >25.0% |
| APE | 22 | 10 |

The contribution generated from the individual protection target platform has continued to improve over 2011 with £22 million VNB generated on £22 million APE in the year. Further improvement in new business contribution is expected as volumes continue to migrate to the target platform. Profitability remains above the targeted level of 20% in the period although the transition to the target platform and changes in product mix may result in some fluctuation from period to period.

## Go to Market: Retirement Income

The Group has identified Retirement Income as a key strategic Go to Market business unit with this founded on the acquired elements of the Friends Provident and AXA UK Life Business. The Group expects the retirement income market to provide an excellent opportunity for the business to grow in what continues to be a growing and profitable market segment.

Historically the Group has generated sales from internal vestings with the vast majority of these reflecting the retirement of Friends Life pension policyholders. The Group's strategy for the annuity market was reviewed in 2011 and will target the creation of a more sophisticated proposition to vesting policyholders alongside the development of capabilities to support participation in the open market.

### Market environment

The annuity market continues to show underlying growth with 2011 market figures expected to show growth on 2010. Expectations for future growth in this market remain strongly positive, driven by the approaching retirement of the baby boomer generation as well as the continued movement from defined benefit to defined contribution pension products in the accumulation phase.

The removal of compulsory annuitisation, previously set at age 75, is widely expected to have a limited impact. The need for individuals to meet minimum income requirements before they can take advantage of this option is likely to restrict the additional flexibility to those individuals with large retirement funds.

Growth in the open market option ("OMO") market continues to benefit from the overall regulatory and industry drive to publicise the benefits of the OMO, including access to impaired annuities. The proportion of vesting pensions using the open market option continues to rise (57% in the third quarter of 2011). The share of vestings represented by impaired annuities also continues to rise and now stands at 29% of the annuity market (50% of open market annuities).

Competition within the annuity market has reduced over recent years as the number of providers looking to compete at the top of the open market has reduced and providers have looked to reflect the impact of expected higher capital requirements under Solvency II in their pricing.

### Strategy implementation

Friends Life is well placed to grow its share of the annuity market with the existing book generating £2 billion of maturing pensions each year. As previously announced, Friends Life's immediate objective is to retain a larger proportion of this vesting population with an aspiration in the longer term to become a top three provider in this segment. The improvement in retention rates is expected to be sufficient to achieve the Retirement Income new business financial targets with the potential entry into the OMO market being additive to these.

Implementation of the strategy will focus on building the enhanced range of capabilities including the following five key initiatives:

#### Development of sophisticated pricing and underwriting

The recruitment of an experienced Managing Director and Director of Longevity in the first half of 2011 will further advance the business's underwriting capabilities, allowing a highly targeted pricing approach.

## Optimising and developing the investment strategy

The announcement in November 2011 of the creation of an internal asset management business, FLI, which will, in particular, improve the management of fixed income assets in respect of annuity business. The development of FLI is progressing well with the recruitment of an experienced team of fixed income investors in January 2012. This team will enable the Group to deliver an investment strategy aimed at optimising returns and improving capital efficiencies on its annuity portfolio.

## Provision of a broader product proposition

Friends Life currently has a relatively narrow range of annuity products. The development and building of pricing and longevity capabilities will allow the proposition to extend into more complex lifestyle annuities.

## Improving customer engagement

2012 plans include the launch of an enhanced annuity product and the introduction of pilot initiatives to enhance customer engagement, phased throughout the year.

## Development of capabilities to support an open market offering

As a whole these developments will enhance the current vesting annuity proposition and will enable the Retirement Income business unit to achieve its financial targets. These developments will also underpin the development of an option for the business to enter the OMO market in the future.

## Financial performance

| £m (unless otherwise stated) | 2013 Full year target | **2011 Full year** | 2011 Half year |
|---|---|---|---|
| Value of new business | 50 | **32** | 17 |
| New business cash strain | n/a | **13** | 10 |
| IRR | 15%+ | **22.0%** | >25% |
| APE | n/a | **32** | 16 |

Annuity new business contributed £32 million of VNB in the year with the performance in the second half of the year being broadly consistent with the performance in the first six months of 2011 despite challenging macroeconomic conditions. IRR of 22.0% remains well above target level of 15% but has been adversely affected in the second half of 2011.

Retention rates, at around 25% of vesting funds, have been maintained over the year and, whilst the implementation of the strategic initiatives is expected to improve this position towards the targeted 50% level, this improvement is not expected to be seen until later in 2012.

2011 sales volumes of £32 million are in line with the performance seen in the first half of 2011 where sales of £16 million were achieved.

# International operating review

The International segment comprises:

- Friends Provident International Limited ("FPIL"), an Isle of Man based company manufacturing unit-linked regular contribution savings and single premium bond products with a focus on high net worth expatriate individuals via distribution hubs in Hong Kong, Singapore and Dubai;
- Overseas Life Assurance Business ("OLAB"), the overseas branch business of Friends Life Limited, benefiting from EU freedom of services rules which allow regulated EU insurers to trade anywhere within its borders;
- Financial Partners Business AG ("fpb"), a German distributor of OLAB unit-linked pensions business;
- a 30% interest in AmLife Insurance Berhad ("AmLife"), a Malaysian life insurance company, majority owned by AmBank Berhad, a major Malaysian banking group; and
- a 30% interest in AmFamily Takaful Berhad ("AmFamily") which was established in December 2011 as a Malaysian family takaful business.

| £m (unless otherwise stated) | **2011 Full year** | 2010 Full year |
|---|---|---|
| IFRS based operating profit before tax | **40** | 95 |
| MCEV operating profit before tax | **29** | 68 |
| Operating free surplus generation | **(17)** | 10 |
| VNB | **40** | 43 |
| New business cash strain | **(89)** | (83) |
| IRR | **12.7%** | 15.4% |
| APE (at actual exchange rates) | **252** | 238 |

The International results for 2011 have been impacted by a number of adverse one-off items and challenging market conditions. VNB and IRR have both been adversely affected by changes in business mix, operating assumption changes and modelling improvements despite higher sales. In addition, a full review of FPIL actuarial models and assumptions has taken place during the year as part of a business-wide controls improvement project. This has resulted in one-off charges, some of which were reported at half year, to operating profit on both the IFRS and MCEV bases, and also to operating free surplus generation. A strategic review of the business is well advanced and details of this will be included in a market update in the second half of 2012.

## Market environment

All core markets have delivered a resilient sales performance, in particular Asia, where demand remains strong, despite uncertainty in the International environment. The economic environment in Europe has been challenging and is expected to remain so in 2012.

The largest market is the North Asian region, predominantly Hong Kong. This is a relatively mature and competitive market, although it continues to grow strongly, with an established IFA distribution segment servicing affluent local nationals, corporate clients and expatriates. FPIL is one of the market leaders in offshore IFA distributed business with very strong distribution relationships, supported by strong service and leading propositions which include a wide choice of funds available through FPIL's range of unit-linked products. Quality of distribution relationships, service, commitment to overseas markets, systems capability and proposition development are fundamental to success in the region. The region has strong growth prospects for the future.

The South Asia region is serviced through Singapore. This region has continued to grow well although GDP growth in 2011 at 5%-6% is lower than 2010. Singapore continues to evolve as a wealth management hub to rival Hong Kong and offers good growth potential.

The United Arab Emirates and the wider Middle Eastern region are relatively under-developed in terms of market penetration, but with wealthy high net worth individuals in those markets and good growth prospects.

In Germany, the business participates, through OLAB, in the unit-linked individual pensions market, a growth segment where the business has a well regarded product set. Whilst the market environment is challenging in the short term, as low investment market confidence drives consumers towards traditional with-profits business, the unit-linked sector has good medium-term prospects through demand for private sector savings and investments and the move from state to private pensions provision. This market and the product choices offered by local players are still dominated by with-profits type investment products. However, the trend towards lower guaranteed rates of return continues to reduce the attractiveness of traditional product structures, whilst the impact of Solvency II is expected to limit market participants' ability to provide traditional with-profits product offerings. OLAB is well positioned to benefit from these changes as the German unit-linked pensions market continues to evolve.

AmLife participates in the Malaysian market through both an agency and the bancassurance channel. This is a fast moving market which is currently closed to further entrants through the rationing of available licences. AmFamily was established in 2011 but is not expected to contribute materially to results in 2012.

Overall the International business is well established to take advantage of the opportunities that will arise in growth markets.

## Strategy implementation

The Friends Life strategy is to grow the value of the International business and its component parts by improving its overall growth prospects and returns through diversification and focus on higher margin products. As the business grows, maintaining discipline over margins, the level of cash generation is expected to improve and the level of adverse one-off modelling impacts in this year's results is not expected to recur. The business has a target of achieving £20 million sustainable cash generation and 20% IRR by 2013.

The business has continued to invest in building capability, developing propositions and product structures to improve profitability and persistency. Investment has commenced in developing a new administration platform for the business with increased international capability and developing regional infrastructure in the core Hong Kong region. The roll-out of the new FPIL regular premium product is underway which is expected to improve profitability and IRR. It is planned to launch in Singapore and the Middle East in the second quarter of 2012, and in Hong Kong in the final quarter of this year. It will be available in all regions by the end of 2012.

The business is engaging in a strategic review and will give further details of its objectives and strategy at the International investor day in the second half of 2012.

## Financial performance

### New business profitability

| | Value of new business | |
|---|---|---|
| | **2011 Full year £m** | 2010 Full year £m |
| FPIL | **29** | 27 |
| OLAB | **7** | 12 |
| AmLife | **4** | 4 |
| | **40** | 43 |

The International VNB has reduced from £43 million to £40 million. FPIL VNB has benefited from higher sales but margins have been impacted by operating basis changes. The OLAB VNB has reduced due to the impact of lower persistency and economic conditions on the cost of guarantees on the German pension business, in combination with slightly lower sales and higher expenses. The AmLife VNB has been maintained despite the lower sales volumes.

The International IRR has reduced from 15.4% to 12.7%. This was in part due to changes in the mix of business sold, with a larger proportion of lower margin longer term Premier business sold in 2011 compared to 2010, proportionally lower single premium OLAB sales (which are generally higher margin) and the same operating basis changes as above.

The business has a target to deliver IRR of 20% by 2013. Improvements will be driven by the roll-out of the new FPIL regular premium Premier product as mentioned above, a focus on other high IRR product lines, and a review of the cost base as part of the strategic review.

## New business volumes

| APE by region (£m, actual exchange rates) | **2011 Full year** | 2010 Full year | % change |
|---|---|---|---|
| North Asia | **103** | 95 | 9 |
| South Asia | **26** | 19 | 35 |
| Middle East | **46** | 46 | (1) |
| Europe (excluding UK) | **32** | 35 | (11) |
| UK | **18** | 14 | 29 |
| Rest of the World | **21** | 19 | 11 |
| AmLife (Malaysia) | **6** | 10 | (38) |
| **APE total (at actual exchange rates)** | **252** | 238 | 6 |
| **APE total (at constant exchange rates)** | **257** | 238 | 8 |

The International business sales volumes continued the growth seen in the first half of 2011, with sales at actual exchange rates up 6%, driven by strong North and South Asian markets. UK sales have also increased from a low base and there has been modest growth in Germany within a difficult market. Other European sales are down. Sales at constant exchange rates increased by 8%.

This performance is reflected in the underlying businesses with FPIL sales at actual exchange rates increasing by 9% whilst OLAB sales decreased by 3%.

| Funds under management (£bn) | 1 January 2011 restated(i) | Inflows | Outflows | Net inflows/ (outflows) | Market and other movements | **31 December 2011** |
|---|---|---|---|---|---|---|
| FPIL | 5.3 | 1.1 | (0.5) | 0.6 | (0.3) | **5.6** |
| OLAB | 0.5 | 0.1 | (0.1) | – | – | **0.5** |
| AmLife | 0.1 | – | – | – | – | **0.1** |
| **International total** | 5.9 | 1.2 | (0.6) | 0.6 | (0.3) | **6.2** |

(i) Funds under management at 1 January 2011 have been restated to include OLAB unitised with-profit funds of £0.2 billion previously accounted for within the UK business segment.

Funds under management as at 31 December 2011 total £6.2 billion and have increased by 5% during the year. As a result of record levels of new business sales, the business has generated positive net inflows of £0.6 billion but these have been offset by market falls, particularly in the Far East, of £0.3 billion, mainly in the second half of the year.

## IFRS based operating profit

| | **2011 Full year £m** | 2010 Full year £m |
|---|---|---|
| New business strain | **(36)** | (28) |
| In-force surplus | **97** | 120 |
| Long term investment return | **1** | 1 |
| Principal reserving changes and one-off items | **(12)** | 2 |
| Development costs | **(7)** | (6) |
| Other | **(3)** | 6 |
| **IFRS based operating profit before tax** | **40** | 95 |

IFRS based operating profit has reduced by £55 million to £40 million mainly because of an £8 million increase in new business strain, a £23 million reduction in in-force surplus and £12 million of adverse principal reserving and one-off items (a £14 million adverse movement from the prior year). These items are explained below.

### New business strain

#### Reconciliation of new business cash strain to IFRS

| | **2011 Full year £m** | 2010 Full year £m |
|---|---|---|
| New business cash strain | **(89)** | (83) |
| DAC/DFF adjustments | **224** | 210 |
| Other IFRS adjustments | **(171)** | (155) |
| **IFRS new business strain** | **(36)** | (28) |

DAC adjustments relate to the deferral of acquisition costs including initial commission and enhanced allocations. DFF relates to the deferral of establishment charges on portfolio bond business. Both DAC and DFF adjustments have increased in line with sales volumes.

Other IFRS adjustments include the elimination of financial reinsurance (at a higher level in 2011), which is not permitted under IFRS. This line also includes the elimination from IFRS new business strain of actuarial funding and sterling reserves on investment business.

The net increase in IFRS new business strain of £8 million mainly results from higher sales and the impact of lower interest rates, which have increased reserving requirements.

## In-force surplus

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

| | 2011 Full year £m | 2010 Full year £m |
|---|---|---|
| In-force cash surplus | **79** | 106 |
| DAC/DFF adjustments | **1** | 7 |
| Other IFRS adjustments | **17** | 7 |
| **IFRS in-force surplus** | **97** | 120 |

In-force cash surplus has reduced by £27 million due to a combination of adverse economic variances, experience variances, and repayment of financial reinsurance, which have more than offset the growth in the back book.

The DAC/DFF adjustments have decreased because of a higher DAC run off due to the larger block of post-acquisition business compared to 2010. Other IFRS adjustments include the elimination of financial reinsurance (at a higher level in 2011).

The net decrease in IFRS surplus of £23 million primarily results from the falls in investment market levels leading to higher reserving required for return of premium guarantees on German pensions largely resulting from lower interest rates, and the higher DAC run-off on the larger post-acquisition book.

## Principal reserving changes and one-off items

Adverse principal reserving changes and one-off items amount to £12 million primarily comprise improved modelling of return of premium guarantee on paid-up policies in German pensions business.

## Operating expenses

| | 2011 Full year £m | 2010 Full year £m |
|---|---|---|
| Acquisition | **30** | 28 |
| Maintenance | **31** | 22 |
| Development | **7** | 6 |
| Other | **–** | 1 |
| **Total** | **68** | 57 |

International operating expenses, which exclude commission payments and non-recurring costs, have increased to £68 million from £57 million, as follows:

- acquisition costs reflect the marketing and proposition support for the growth in sales volumes;
- maintenance costs have increased as a result of increased customer service costs to support the larger in-force book, and strengthening the controls and governance infrastructure to meet the needs of the growing business; and
- development costs are higher due to the increased investment in the business, including the development of the German business and the commencement of a project to move to a significantly improved administration platform for the business.

## MCEV operating profit

| | 2011 Full year £m | 2010 Full year £m |
|---|---|---|
| Value of new business | **40** | 43 |
| Expected existing business contribution | **27** | 29 |
| Operating experience variances | **(7)** | 12 |
| Operating assumption changes | **(3)** | (2) |
| Other operating variances | **(20)** | (7) |
| Development costs | **(7)** | (6) |
| **Life and pensions covered business operating profit before tax** | **30** | 69 |
| Other income and charges | **(1)** | (1) |
| **Operating profit before tax** | **29** | 68 |

International MCEV operating profit has decreased from £68 million to £29 million principally as a result of adverse operating experience and other variances. These are explained below.

### Expected existing business contribution

The expected existing business contribution has decreased from £29 million to £27 million. The effect of the larger in-force book has been offset by the following lower rates of expected return. The value of the in-force book has increased to £502 million compared to £473 million at 31 December 2010.

| | Rates of return | |
|---|---|---|
| | **2011 %** | 2010 % |
| Reference rate | **1.14** | 1.01 |
| Best estimate returns: | | |
| Corporate bonds | **2.45** | 2.98 |
| Equity | **6.70** | 7.30 |
| Property | **5.70** | 6.30 |

### Operating experience variances

Operating experience variances were £7 million adverse. These include negative variances in respect of expenses and persistency, offset by positive mortality experience. In 2010 there were £12 million positive variances in respect of persistency, mortality and fund rebates.

### Operating assumption changes

Adverse operating assumption changes of £3 million reflect the net charge in respect of revisions to the assumptions for lapses for German pensions partial surrenders from paid-up policies, and various smaller other items, offset by a positive adjustment for fund manager rebate allowances. In 2010 there was a £2 million net charge in respect of strengthening investment expense assumptions, offset by positive changes across persistency and mortality.

### Other operating variances

Adverse other operating variances amounting to £20 million result from various modelling improvements mainly in respect of FPIL. The majority of these have arisen as a result of the completion of the review and validation exercise during the year of all FPIL actuarial models. In 2010 there was a charge of £7 million in respect of modelling and methodology improvements.

# Lombard operating review

Lombard is the leading pan-European life assurance business specialising in compliant estate planning solutions for high and ultra-high net worth individuals ("HNWIs"). Based in Luxembourg the business offers innovative solutions and superior service, through a well-established distribution network of private banks, high-end IFAs and independent specialist 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 all but minimal levels of life exposure reinsured. The business is well placed to benefit from increasing demands for fully compliant financial solutions for HNWIs.

| £m (unless otherwise stated) | 2011 Full year | 2010 Full year |
|---|---|---|
| IFRS based operating profit | 38 | 33 |
| MCEV operating profit | 82 | 162 |
| Operating free surplus generation | 9 | (12) |
| VNB | 52 | 83 |
| New business cash strain | (20) | (6) |
| IRR[i] | >25% | >25% |
| APE | 237 | 302 |

(i) The 2011 Lombard IRR now takes account of the Luxembourg regulatory regime in which DAC is an allowable asset.

IFRS based operating profit at £38 million is 15% above 2010, benefiting from higher in-force fee income, in line with higher levels of funds under management ("FUM") during the period whilst global operating expense level have been controlled.

MCEV operating profit is lower than 2010 as a result of lower VNB and certain negative operating experience variances, despite materially increased existing business contribution. 2010 operating profit also included £32 million benefit resulting from a review of Lombard's corporate structure which had resulted in the business's intermediation service company being repatriated from Jersey to Luxembourg and the reduction in the business's effective tax rate from 28.59% to 23.5%.

2011 sales volumes (APE) were £237 million, 22% below 2010, results being affected by significantly adverse macroeconomic conditions in Europe and the lack of strong external drivers to generate new business compared to previous years. In the current context, relative to most competitors, these results are strong. The last quarter of the year saw higher sales than in the fourth quarter of 2010 with fourth quarter 2011 APE of £100 million up from £89 million in the same period of 2010.

Funds under management have continued to grow significantly in 2011, despite the material fall of equity markets. FUM at 31 December 2011 reached €20.9 billion (£17.4 billion), 4.5% (€898 million) up on 2010 year end (€20.0 billion; £17.1 billion).

## Market environment

2011, and especially the second half of the year, has been characterised by significant adverse macroeconomic conditions in Europe, with falls in most equity markets, a sovereign debt crisis and uncertainties in respect of potential fiscal constraints in some European countries.

While Lombard's performance is not directly linked to investment markets this continued market uncertainty has led to clients postponing actions to structure their investments and manage intergenerational transfer of their wealth.

In contrast, 2010 was an exceptional period for the cross-border life insurance market with this being particularly evident in the first nine months of 2010, driven by significant external factors and there were no other similar event drivers in 2011.

Despite the European economic environment Lombard has performed relatively well in the year compared to its peers. New business sales performance in the Luxembourg life insurance market is down by 34% in 2011, significantly below levels achieved by Lombard. In this context, Lombard's market share increased from 16% in 2010 to 19% in 2011.

The current external environment remains highly uncertain across Europe, and there is no sign of short-term macroeconomic recovery. In these exceptional circumstances, we expect 2012 sales to remain affected. However, notwithstanding the challenging short-term market conditions, the longer term drivers of the demand for compliant "Privatbancassurance" solutions remain compelling.

## Strategy implementation

There are three core elements of Lombard's strategy and these have progressed in 2011:

- Strengthening of sales force: strengthen Lombard sales force in key markets with a 20% increase in sales consultants in place during 2011. This action, together with training and development initiatives and professionalisation of sales management, enhances Lombard's presence in key geographical markets;
- Investment in marketing and deepening partner relationships: expand and enhance marketing and product development capability to enable further valuable support to existing and potential partners. Lombard is undertaking due diligence exercises with selected key partners to continue the tailoring of its service offering to suit their precise needs and those of their clients (thereby enhancing Lombard's franchise and protecting margins); and
- Operating model: consistent with the needs of Lombard's partners and clients, this initiative is seeking to further improve the maintenance and servicing of policies whilst streamlining Lombard's operating model. This will contribute to enhancing competiveness and improving profitability whilst reducing business model risk.

It is envisaged that these initiatives will contribute to the delivery of the financial outcomes (strong growth in profitable new business and cash generation) with IRR above 20% by 2013 and £30 million dividend from 2014.

## Financial performance

Performance during the year has been impacted by a number of factors including:

- the absence of strong policy drivers to generate new business which Lombard experienced in the first half of 2010;
- Northern Europe primarily impacted by the negative economic environment and lower activity among IFAs especially in Belgium; and
- Market uncertainties in respect of a number of potential fiscal changes and significantly adverse macroeconomic conditions in Europe, resulting in clients delaying decisions and affecting investor confidence.

Despite these factors, five markets (Spain, Italy, Finland, France and Asia) showed volumes significantly above 2010 business levels in 2011. These improvements reflect the benefits from sales force enhancement and continued deepening of relationships with partners in these markets. The growth in these regions also highlights the strength of Lombard's geographic diversification compared with its competitors.

New business in Italy was supported by strong partnerships developed at the time of the tax amnesty ("Scudo fiscale"), combined with the increasing importance of life-assurance for long-term estate planning.

2011 has been characterised by a stronger diversification between markets and seasonality of new business is in line with 2010 with H1/H2 at 41%/59% (2010: 45%/55%).

Overall, business in 2011 is below 2010 levels, with sales volumes of £237 million APE, 22% below 2010. The lower volumes have directly affected the contribution from new business with VNB of £52 million although IRR at more than 25% remains above the target level.

APE performance per region is as follows:

| APE by region (actual exchange rates) | 2011 Full year £m | 2010 Full year £m | Change % |
|---|---|---|---|
| UK and Nordic | **52** | 72 | (28) |
| Northern Europe | **42** | 119 | (64) |
| Southern Europe | **115** | 94 | 22 |
| Rest of the World | **28** | 17 | 66 |
| **Total including large cases** | **237** | 302 | (22) |
| Of which: large cases (greater than €10 million) | **83** | 90 | (8) |
| **Total excluding large cases** | **154** | 212 | (27) |

APE seasonality since 2007 is as follows:

| | H1 APE £m | H2 APE £m | FY APE £m | H1/ H2 split (%) |
|---|---|---|---|---|
| 2007 | 65 | 134 | 199 | 33/67 |
| 2008 | 70 | 176 | 246 | 28/72 |
| 2009 | 47 | 226 | 273 | 17/83 |
| 2010 | 135 | 167 | 302 | 45/55 |
| 2011 | **97** | **140** | **237** | **41/59** |

## IFRS based operating profit

| | **2011 Full year £m** | 2010 Full year £m |
|---|---|---|
| New business strain | **(33)** | (28) |
| In-force surplus | **73** | 66 |
| Investment return and other items | **(1)** | (4) |
| Principal reserving changes and one-off items | **–** | – |
| Development costs | **(1)** | (1) |
| **IFRS based operating profit before tax** | **38** | 33 |

Lombard generated operating profit before tax of £38 million, 15% up on 2010 supported by increased income from the in-force book. The in-force surplus has benefited from significant net fund inflows in 2010 and 2011, more than offsetting negative investment return in 2011, and compensating for increased new business strain.

## New business strain and in-force surplus

### Reconciliation of new business strain to IFRS

| | **2011 Full year £m** | 2010 Full year £m |
|---|---|---|
| New business cash strain | **(20)** | (6) |
| DAC/DFF adjustments | **(13)** | (21) |
| Other IFRS adjustments | **–** | (1) |
| **IFRS new business strain** | **(33)** | (28) |

New business cash strain is higher than 2010 despite sales volumes being down on the prior year. This has been driven by a reduced benefit from year one annual management charges as lower sales volumes were written in the first nine months of the year. In addition the lower sales volumes in the year reduced the proportion of acquisition expense capitalised within cash strain.

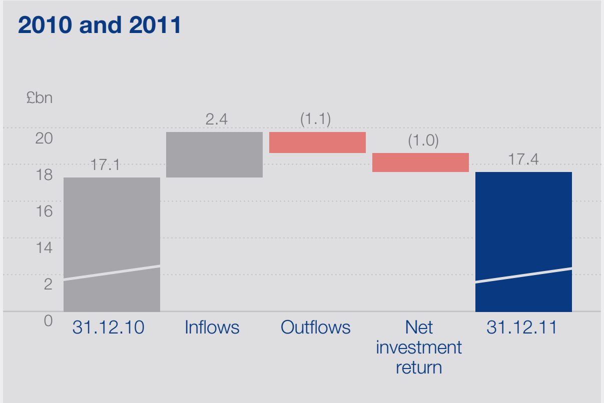
On an IFRS basis a lower proportion of acquisition costs can be deferred. As cost deferral in 2011 new business cash strain is lower than the prior year the corresponding reversal is also reduced in arriving at the IFRS new business strain.

## Reconciliation of in-force surplus to IFRS

| | 2011 Full year £m | 2010 Full year £m |
|---|---|---|
| In-force cash surplus | **41** | 30 |
| DAC/DFF adjustments | **32** | 36 |
| Other IFRS adjustments | **–** | – |
| **IFRS in-force surplus** | **73** | 66 |

In-force cash surplus is up 37% on 2010, benefiting from growth in the in-force book. Average funds under management have increased significantly between 2010 and 2011 despite negative market performance in the second half of 2011. Continued positive net fund inflows over the last two years have driven this growth with funds under management growing from £14.4 billion at the start of 2010 to £17.4 billion at the end of 2011.

### Lombard funds under management




## Operating expenses

| | 2011 Full year £m | 2010 Full year £m |
|---|---|---|
| Acquisition | **42** | 47 |
| Maintenance | **25** | 19 |
| Development | **1** | 1 |
| Other | **–** | 2 |
| **Total** | **68** | 69 |

The operating expenses of Lombard, which exclude both commission payments and non-recurring costs, are set out in the table above.

Lombard has maintained tight control of expense levels which, despite an increase in average funds under management of 13%, have remained in line with 2010.

Acquisition expenses were lower than 2010 as a result of lower sales volume which have translated into lower sales and partner incentives costs.

Development costs consist of expenses related to new product and market development.

## Lombard MCEV operating profit

| | 2011 Full year £m | 2010 Full year £m |
|---|---|---|
| Value of new business | **52** | 83 |
| Expected existing business contribution | **49** | 38 |
| Operating experience variances | **(12)** | (17) |
| Operating assumption changes | **(4)** | 20 |
| Other operating variances | **(2)** | 39 |
| Development costs | **(1)** | (1) |
| **Life and pensions covered business operating profit before tax** | **82** | 162 |

MCEV operating profit of £82 million is significantly below 2010, mainly driven by the lower contribution from new business whilst the result also reflects unfavourable experience variances.

### Expected existing business contribution

Expected existing business contribution has increased significantly year on year. The improvement reflects the higher opening in-force book as a result of significant net fund inflows delivered in 2010, despite rates of return being below those applied in the 2010 result.

| | Rates of return | |
|---|---|---|
| | 2011 % | 2010 % |
| Reference rate | **1.40%** | 1.32% |
| Best estimate returns: | | |
| Corporate bonds | **4.46%** | 4.72% |
| Equity | **6.46%** | 6.72% |

### Operating experience variances

Adverse operating experience variances of £12 million include a £7 million persistency charge relating to surrenders on the Belgian IFA book, as lapses deteriorated on this portfolio in the latter part of 2011. This is expected to be a short-term issue with this reflected in the revised assumptions.

Operating experience variances also include an accrual for the management long-term incentive plan (£6 million; 31 December 2010: £4 million).

### Operating assumption changes

Adverse operating assumption changes totalling £4 million include a £6 million persistency provision relating to surrenders within the Spanish book as adverse economic conditions and uncertainty in the Spanish market continue. In addition a £5 million provision has been put in place for short-term expected additional lapses within the Belgium IFA book. It is anticipated that this deterioration in lapses on this particular book will not persist longer term.

The above negatives are partially offset by a wider review of other lapse experience with a £5 million benefit, as well as improved mortality assumptions for £3 million.

Changes to expense assumptions of negative £1 million are in line with lower policy volumes achieved in 2011.

### Other operating variances

Other adverse operating variance amounted to £2 million in the year. In 2010 these included a £32 million benefit resulting from a review of Lombard's corporate structure which had resulted in the business's intermediation service company being repatriated from Jersey to Luxembourg and the reduction in the business's tax rate from 28.59% to 23.5%, as well as a £7 million benefit following a reassessment of the cost of non-hedgeable risk.

# Corporate operating review

## FLG corporate segment

The FLG corporate segment includes the corporate holding and principal service companies of the Friends Life group.

### Financing and interest costs

FLG has a number of debt instruments and the operating cost of financing these for the year ended 31 December 2011 are presented below.

In April 2011, FLG issued a £500 million external LT2 debt instrument with a coupon of 8.25% and a maturity of 2022; this is guaranteed on a subordinated basis by FLL. From the proceeds of this debt, £400 million was used by FLG to partially repay the internal LT2 debt issued to RHG. A further repayment of £100 million was made in May 2011, leaving an outstanding value of £200 million at 31 December 2011.

| £m | Market value of debt(i) | Finance cost(ii) | |
|---|---|---|---|
| | | IFRS | MCEV |
| £200 million internal LT2 subordinated debt 2020 | 200 | (33) | (33) |
| £162 million external LT2 subordinated debt 2021 | 182 | (24) | (10) |
| £500 million external LT2 subordinated debt 2022 | 450 | (29) | (17) |
| STICS 2003 | 142 | (12) | (8) |
| STICS 2005 | 185 | (14) | (11) |
| **Total** | | (112) | (79) |

(i) Market value is based on listed offer price, at 31 December 2011, excluding accrued interest and before tax on market valuation
(ii) Finance cost is operating profit impact, before tax

The interest cost included within operating profit differs between the two bases, reflecting the lower expected rate of return applied in the MCEV results.

In so much as these debts have been raised to support the ongoing growth and development of the life operating businesses the cash raised has been loaned to the UK operating segment. The external cost attributable to each segment is shown below.

| £m | IFRS | MCEV | |
|---|---|---|---|
| | | Covered | Non-covered |
| Corporate segment | (36) | (46) | (33) |
| UK operating segment | (76) | – | – |
| | **(112)** | **(46)** | **(33)** |

## FLG corporate IFRS based operating result

| £m | 2011 Full year | 2010 Full year |
|---|---|---|
| Investment return and other items excluding debt | 91 | 47 |
| Expected return on debt | (112) | (61) |
| Other corporate costs | (7) | (11) |
| **IFRS based operating loss before tax** | **(28)** | (25) |

The corporate result is primarily driven by the expected return on the debt held in the Group, offset by the investment return on shareholder assets. The increase in the expected return on debt reflects the additional £500 million external LT2 subordinated debt raised in April 2011 (followed by £500 million partial repayment of the internal LT2 subordinated debt with Resolution Holdings (Guernsey) Limited as described above). The increased investment return on other assets reflects the higher level of assets at holding company level driven by receipt of dividends from life companies in the year, partly offset by payment of dividends to RHG.

Other corporate costs of £7 million include £2 million of costs in relation to the FLG long-term incentive scheme. The current year charge reflects changes in the senior management team during the year. The additional net costs of £5 million relate primarily to corporate overhead costs, being holding company and Group costs incurred in supporting non-covered business.

## FLG corporate MCEV operating results

The corporate business unit consists of both non-covered and covered business. The non-covered element relates to the net assets of the FLG corporate holding and service companies whilst the covered element principally represents the net debt liabilities held at the Friends Life group level.

| £m | 2011 Full year | 2010 Full year |
|---|---|---|
| Expected existing business contribution on debt | (46) | (30) |
| Other operating variances | 19 | (63) |
| **Life and pensions covered business operating loss before tax** | **(27)** | (93) |
| Other income and charges | (33) | (16) |
| **Operating loss before tax** | **(60)** | (109) |

The Friends Life corporate segment includes the interest on the external STICS and external LT2 subordinated debt instruments at the reference rate and expected return over reference rate.

Other operating variances comprise a release of £19 million arising from the reduction in group capital management policy from 160% of Group Capital Resource Requirements (excluding WPICC) to 150% reflecting the continued progress on integration of the UK life businesses.

The interest on the £200 million (2010: £700 million) debt issued to RHG of £33 million is included within other income and charges as well as £1 million of corporate costs and £3 million of credit facility costs fees. These costs are partially offset by expected return on the pension asset of £6 million and interest income receipts of £4 million.

## Resolution corporate segment

The operating results of the Resolution holding companies are summarised in the table below. These are presented consistently in the IFRS financial statements and MCEV supplementary information.

| £m | 2011 Full year | 2010 Full year |
|---|---|---|
| Interest on internal LT2 subordinated debt issued by FLG | 33 | 18 |
| Financing and interest costs | (40) | (18) |
| Other operating items | (34) | (15) |
| **Total** | **(41)** | (15) |

FLG issued £700 million LT2 fixed rate unsecured loan notes to RHG in September 2010 to fund the acquisition of the AXA UK Life Business; £500 million was repaid in the first half of 2011. Interest received from FLG in the year was £33 million.

Financing and interest costs of £40 million are analysed in the following section.

Other operating items mainly comprise fees payable to ROL of £20 million, directors and professional fees and other corporate costs of £15 million, partly offset by £1 million of interest earned on cash based assets held by the Resolution holding companies.

### Financing and interest costs

External financing within Resolution holding companies is summarised in the following table:

| £m | 31 Dec 2011 carrying amount | 2011 Full year finance cost | 31 Dec 2010 carrying amount | 2010 Full year finance cost |
|---|---|---|---|---|
| Deferred consideration notes | 423 | 30 | 500 | 10 |
| Acquisition finance facility | – | 10 | 400 | 8 |
| **Total** | **423** | **40** | 900 | 18 |

The deferred consideration notes were issued in September 2010 in connection with the acquisition of the AXA UK Life Business. A scheduled repayment of £63 million was made in June 2011 and an additional accelerated repayment of £14 million was made in August 2011. The accelerated repayment was triggered by the incremental cash distributed to shareholders during the 2011 share buy-back programme.

The acquisition finance facility was a term loan facility agreement also issued in September 2010 to fund part of the consideration payable for the acquisition of AXA UK Life Business; this loan was repaid in April 2011.

# WLUK acquisition

## Completion of AXA UK Life Business acquisition

The acquisition of WLUK was completed with an effective acquisition date for accounting purposes of 7 November 2011. This marks the completion of the acquisition agreed with AXA UK, the first phase of which initiated in September 2010 with the acquisition of the AXA UK Life Business.

Due to the complex structure of the AXA UK Life Business the assets acquired included certain portfolios of insurance business (the GOF and TIP portfolios) which were to be retained by AXA UK. The terms of this transfer were agreed as part of the transaction and these portfolios were transferred back to AXA UK on 1 November 2011 via Part VII transfer for consideration, including interest, of £285 million.

Similarly the shares of WLUK, initially retained by AXA UK, were acquired by the Group for consideration of £248 million once the business lines to be retained by AXA UK had been removed. In completing this transaction, total consideration of £2,072 million (net of debt) represents 72.2% of the net acquired MCEV.

| | £m |
|---|---|
| Gross MCEV of acquired AXA UK Life Business (excluding WLUK) | 3,498 |
| Acquisition financing | (900) |
| Net MCEV of acquired AXA UK Life Business (excluding WLUK) | 2,598 |
| WLUK MCEV | 271 |
| **Total MCEV acquired** | **2,869** |
| | |
| AXA UK Life Business consideration (net of £900 million acquisition financing) | 1,824 |
| WLUK consideration | 248 |
| **Total consideration** | **2,072** |
| | |
| **Percentage of acquired MCEV** | **72.2%** |

The WLUK acquisition was completed following the agreed transfer, back to AXA UK, of the GOF and TIP portfolios. The net impact of these transactions on the IFRS and MCEV balance sheets was £(2) million and £23 million respectively.

## Net impact of WLUK and GOF/TIP transactions

| | IFRS £m | MCEV £m |
|---|---|---|
| Consideration received for GOF/TIP (including interest) | 285 | 285 |
| Less: GOF/TIP net assets (including interest) | (285) | (235) |
| Wrong pocket payments[i] | (50) | (50) |
| | (50) | – |
| Consideration paid for WLUK | (248) | (248) |
| WLUK net assets | 296 | 271 |
| | 48 | 23 |
| **Net impact of transactions[ii]** | **(2)** | **23** |

(i) Reflects net surplus emerging in the pre-transaction companies, prior to completion of the respective acquisition and disposal.

(ii) In IFRS, the £50 million wrong pocket payment is included in administrative expenses and the gain on the WLUK acquisition is included in other income. In MCEV, the gain on the WLUK acquisition is shown as a reserves movement. These are stated before acquisition costs of £3 million.

## WLUK IFRS acquisition balance sheet as at 7 November 2011 and gain on acquisition

| Assets | £m | Liabilities | £m |
|---|---|---|---|
| Intangible assets | 268 | Insurance and investment contract liabilities | 7,322 |
| Financial assets and cash | 6,955 | Other liabilities | 92 |
| Other current assets | 487 | | |
| **Total assets** | **7,710** | **Total liabilities** | **7,414** |

| | |
|---|---|
| **Net identifiable assets acquired** | **296** |
| Fair value of net assets acquired – cash paid | 248 |
| **Gain on the acquisition of WLUK (excluding transaction costs)** | **48** |

In accordance with IFRS the Group ascribed fair values to the AVIF and other intangible assets as well as placing a fair value on the assets acquired and liabilities assumed.

The AVIF has been calculated on the basis of assumptions which are consistent with those which have been used in the preparation of the MCEV results. The AVIF and other intangibles of £239 million and £29 million, respectively, are presented gross of tax.

## Acquisition of WLUK on a MCEV basis

On a MCEV basis, the amount attributable to ordinary shareholders at the acquisition date was £271 million and consideration paid was £248 million. A summarised balance sheet as at the date of acquisition is set out below.

| | £m | £m |
|---|---|---|
| Adjusted net assets | | 60 |
| Value of in-force business | | |
| – Certainty equivalent value | 241 | |
| – Time value of options and guarantees | (7) | |
| – Frictional costs of required capital | (8) | |
| – Cost of residual non-hedgeable risks | (15) | |
| | | 211 |
| **WLUK MCEV** | | **271** |

# Cash and capital

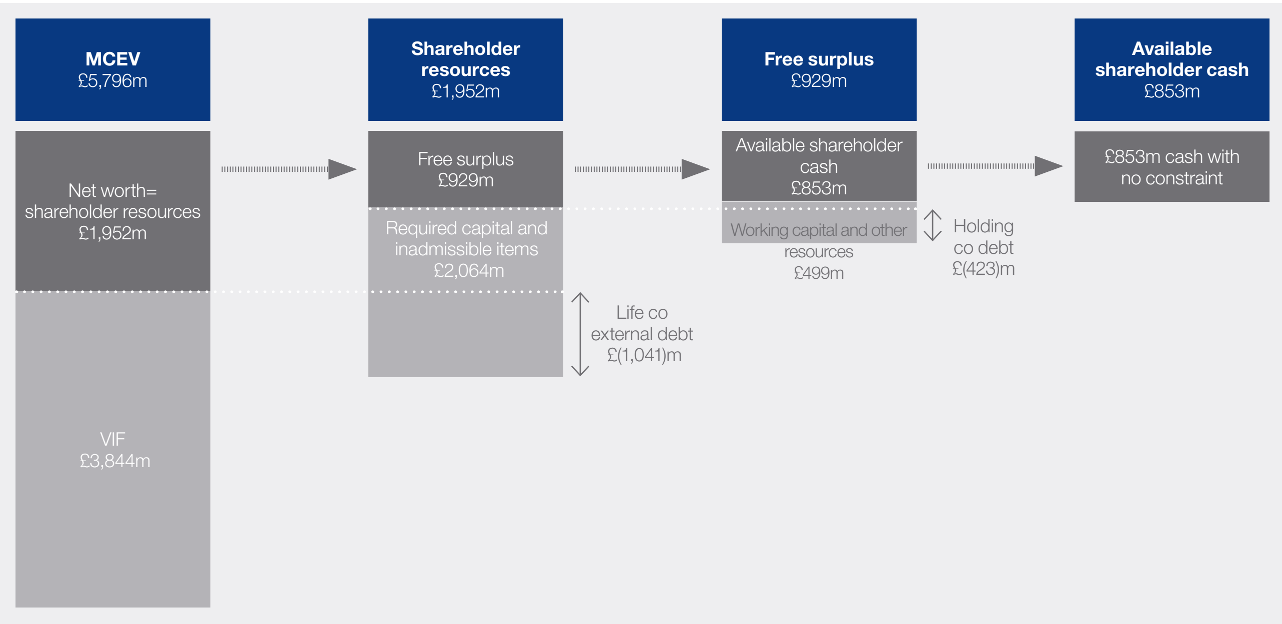
## Group cash delivery

Available shareholder cash ("ASC") at 31 December 2011 was £853 million, comprising £752 million in FLG and £101 million in Resolution holding companies. The contribution from FLG to the distributable cash target ("DCT") was £393 million, reflecting the free surplus generated in the period, £100 million of capital raised and retained in the life companies, net of other amounts retained for working capital and FLG holding company costs. DCT is defined as 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.

The sustainable free surplus generated in the period was £291 million, based on underlying free surplus of £395 million offset by development costs, finance costs and other operating activities and excluding the GOF and TIP results and the impact of one-off capital optimisation activities. Total free surplus generated in the year of £413 million included £161 million arising from the implementation of certain elements of PS06/14 and £181 million from the capital optimisation programme, giving total benefits of £342 million. £61 million of the benefit arising from the implementation of certain elements of PS06/14 in BHA was already assumed in the Group's valuation of BHA (for capital purposes); excluding this amount, capital synergies delivered were £281 million exceeded the target of £235 million announced previously. The Group continues to maintain a prudent buffer within ASC, in addition to working capital, of £400 million to cover the external dividend, financing and corporate costs at Resolution holding companies level.

## Cash management framework

The Group's cash 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 2011, reconcile to ASC.




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 Group's capital management policy of maintaining 150% (formerly 160%) of Group Capital Resource Requirements ("CRR") excluding WPICC, and at life company level, the higher of 150% of Pillar 1 CRR excluding WPICC and 125% of Pillar 2 CRR including Individual Capital Guidance. For other operating businesses and Friends Life holding companies, 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 £373 million, LT2 subordinated debt 2021 of £185 million and LT2 subordinated debt 2022 of £483 million. Deferred consideration notes ("DCNs") issued by the Company to AXA UK as part of the acquisition of the AXA UK Life Business are offset against free surplus.

ASC is stated after the deduction of regulatory and other restrictions on the availability of cash resources. ASC represents cash available to cover corporate costs, to service debt issued by Resolution holding companies and, subject to shareholder approval, to pay dividends, fund future acquisitions, or return to shareholders. The Group intends to maintain a prudence buffer, within ASC, of £400 million to cover the Company's dividend cost, DCN repayments and interest and Resolution holding companies corporate costs.

The key components and drivers of ASC for 2011 are detailed in the following sections.

## a) Value of in-force business and shareholder resources

The movement in the VIF and shareholder resources is summarised in the table below, adopting an MCEV style presentation on a net of tax basis. The movements in shareholder resources are further subdivided between required capital, including inadmissible assets and free surplus.

Analysis of movement in MCEV

| | | Shareholder resources | | |
|---|---|---|---|---|
| £m | Value in-force | Required capital | Free surplus | Total MCEV |
| Opening MCEV at 1 January 2011 | 4,202 | 1,585 | 728 | 6,515 |
| MCEV (loss)/ profit after tax | (493) | (215) | 413 | (295) |
| Impact of acquisition of BHA | 132 | 91 | (165) | 58 |
| Impact of acquisition of WLUK | 211 | 102 | (290) | 23 |
| Impact of sale of GOF/TIP | (196) | – | 196 | – |
| Other movements in net equity | – | (32) | 13 | (19) |
| Foreign exchange variances | (11) | (3) | (1) | (15) |
| Transfers to shareholders | – | – | (476) | (476) |
| Other capital flows | (1) | (9) | 15 | 5 |
| External LT2 subordinated debt issuance (net of issue costs) | – | (496) | 496 | – |
| **Closing MCEV at 31 December 2011** | **3,844** | **1,023** | **929** | **5,796** |

MCEV loss after tax for the period of £295 million comprises £413 million of free surplus generation offset by £215 million reduction in required capital and £493 million reduction in VIF. These movements are set out in more detail in the following section.

The value of BHA at acquisition was £226 million, comprising VIF of £132 million, required capital of £91 million and free surplus of £3 million. The consideration paid by FLG was £168 million, resulting in a gain on acquisition of £58 million. The net impact on free surplus was a reduction of £165 million reflecting the consideration paid net of the free surplus acquired.

The value of WLUK at acquisition was £271 million, comprising VIF of £211 million, required capital of £102 million and free surplus of negative £42 million. The consideration paid by Friends Life was £248 million, resulting in a gain on acquisition of £23 million. The net impact on free surplus was a reduction of £290 million reflecting the consideration paid net of the free surplus acquired.

The impact of the sale of the GOF and TIP portfolios was to reduce VIF by £196 million and generate £196 million of free surplus. Consideration of £285 million, including interest, increased free surplus but was partially offset by the disposal of £39 million of GOF and TIP free surplus and the £50 million payment from FLG to AXA UK, reflecting the surplus arising in the Group's period of ownership which was due to AXA UK. The reduction in VIF of £196 million represents the value of the VIF asset disposed of.

In aggregate, the impact of transaction activity on free surplus comprised £27 million outflow from Friends Life holding companies (comprising deferred consideration for the AXA UK Life Business acquisition in line with expectations) and £232 million funded by the life companies.

Other movements in net equity comprise actuarial losses on defined benefit pension schemes (£32 million) offset by the reduction in the adjustment to exclude intra-group holdings in the Company's shares (£13 million).

Transfers to shareholders comprise the cash dividends of £226 million and the impact of the share buy-back programme of £250 million. Other capital flows includes £5 million inflow reflecting the change in value of the Lombard share option scheme (as this is an equity-settled scheme, changes in value are shown as movements in equity) with other, offsetting, minor items.

The proceeds of the £500 million external LT2 subordinated debt issued by FLG (net of £4 million costs) were used to repay (via repayment of internal loans) the £400 million acquisition finance facility taken out by RHG to part fund the acquisition of the AXA UK Life Business and to inject £100 million into the life companies. A further £100 million of the internal loan between FLG and RHG was also repaid in the year. The external LT2 subordinated debt is offset against required capital as it supports the activities of the life businesses whereas the internal debt was, for FLG, offset against free surplus. Consequently the issue of the external LT2 subordinated debt and repayment of the internal debt results in an increase in free surplus and an offsetting reduction in required capital.

## b) Impact of MCEV profits on shareholder resources and free surplus

The table below sets out the impact of the MCEV profits generated in the period on the VIF, required capital and free surplus of the business. The analysis identifies the impact of underlying surplus generation, operating variances, including the implementation of certain aspects of PS06/14, and non-recurring and other non-operating items.

The analysis is shown on a net of tax basis.

| | | Shareholder resources | | |
|---|---|---|---|---|
| £m | Value in-force | Required capital | Free surplus | Total MCEV |
| Expected return from in-force business net of finance costs | (333) | (57) | 662 | 272 |
| Add back coupon on FLG external debt(i) | – | (24) | 58 | 34 |
| Investment in new business | 364 | 80 | (325) | 119 |
| **Underlying MCEV generation** | **31** | **(1)** | **395** | **425** |
| Development costs | – | – | (28) | (28) |
| Financing costs | – | 24 | (91) | (67) |
| Operating assumption changes | (86) | (16) | 204 | 102 |
| Impact of PS06/14 | (146) | (13) | 161 | 2 |
| FLG other operating items | (27) | (55) | 56 | (26) |
| **FLG operating result** | **(228)** | **(61)** | **697** | **408** |
| RSL income and charges | – | – | (41) | (41) |
| **Group operating result** | **(228)** | **(61)** | **656** | **367** |
| Economic variances | (300) | 199 | (352) | (453) |
| Capital optimisation programme | – | (181) | 181 | – |
| Non-recurring and non-operating variances | 35 | (172) | (72) | (209) |
| **Result after tax** | **(493)** | **(215)** | **413** | **(295)** |

(i) The expected return from in-force business is shown net of the expected return on FLG external LT2 subordinated debt. As the coupon on this debt of £58 million is included within the financing costs of £91 million, it has been added back to underlying MCEV generation to provide greater clarity on the impact of debt on free surplus generation.

The key driver of underlying MCEV generation is expected return from in-force business net of investment in new business; this is explained in more detail below. The underlying free surplus generation of £395 million and £365 million impact on free surplus of assumption changes and the adoption of certain elements of PS06/14 underpin the £697 million FLG operating free surplus generation in the period.

The impact on free surplus of FLG financing costs of £91 million, net of tax, comprises £23 million in respect of the external STICS issued by FLG, £35 million in respect of the existing external LT2 subordinated debt 2021 and new external LT2 subordinated debt 2022 issued by FLG and £33 million in respect of the internal LT2 debt issued by FLG to RHG. The receipt of the £33 million internal interest is included in the operating result for the Resolution holding companies.

Operating assumption changes relate to changes to expense assumptions following the implementation of the Diligenta outsourcing deal, and changes to persistency and morbidity assumptions.

The implementation of certain elements of PS06/14 resulted in accelerated recognition of free surplus; this has been largely offset by a reduction in future profits that were present in the VIF; the £2 million net MCEV profit represents the release of the associated cost of capital.

Other operating items relate to the impact of persistency and modelling changes on VIF and the positive impact on free surplus of mortality and morbidity experience variances, offset by FLG corporate costs.

Economic variances include £72 million for an increase in the market value of corporate debt within required capital. Adverse investment variances have reduced the VIF for unit-linked business in all operating segments, and reduced gilt yields have led to a corresponding increase in required capital for annuity and conventional business.

Non-recurring and non-operating items include the impact on VIF of the reduction in corporation tax (£26 million) offset by the impact on free surplus of separation and integration and Solvency II costs. In addition the change in Group capital policy has released £172 million of required capital, with an offsetting increase in free surplus.

## c) Free surplus – £929 million

The generation of free surplus, net of movements in required capital, underpins the declaration of future dividends. The table below expands the free surplus result after tax shown above and sets out the reserve movements.

| Movement in free surplus | £m |
|---|---|
| **1 January 2011** | **728** |
| In-force surplus(i) | **720** |
| New business | **(325)** |
| Development costs and other operational items | **28** |
| Finance costs | **(91)** |
| Operating assumption changes | **204** |
| PS06/14 impact | **161** |
| FLG operating free surplus generated in the period | **697** |
| RSL income and charges | **(41)** |
| Operating free surplus generated in the period | **656** |
| Economic variances | **(352)** |
| Capital optimisation programme | **181** |
| Change in Group capital policy | **172** |
| Other non-operating items | **(244)** |
| Total free surplus generated in the period | **413** |
| Capital/dividend flows | |
| BHA acquisition | **(165)** |
| WLUK acquisition | **(290)** |
| GOF/TIP disposal | **196** |
| Debt raising | **496** |
| Transfers to shareholders | **(476)** |
| Other capital movements | **27** |
| **31 December 2011** | **929** |

(i) Before deduction of coupon on FLG external LT2 subordinated debt of £58 million

Total free surplus of the Group amounts to £929 million at 31 December 2011 up from £728 million at the end of 2010. This reflects the free surplus generated in the period of £413 million, the impact of the acquisitions of BHA and WLUK in January 2011 and November 2011 respectively, the disposal of the GOF and TIP portfolios, debt raising and the return of capital to shareholders.

The transfers to shareholders of £476 million comprise £226 million of cash dividend and £250 million in respect of the share buy-back programme. Other capital movements reflect the favourable impact of £13 million reduction in the Company's shares held by subsidiaries, £5 million favourable movement in respect of the Lombard long-term incentive scheme and other minor movements arising from internal reorganisations.

Further information on in-force surplus and new business strain are shown below.

## 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 | MCEV free surplus | Movement in required capital | Tax and other items | Cash (strain)/ surplus |
|---|---|---|---|---|
| New business strain | (325) | 80 | (33) | (278) |
| In-force surplus[i] | 720 | (81) | (165) | 474 |
| | 395 | (1) | (198) | 196 |

(i) Movement in required capital for in-force surplus is shown before the impact of the £58 million coupon on FLG external LT2 subordinated debt

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 | MCEV free surplus | Movement in required capital, tax and other items | Cash strain/ surplus |
|---|---|---|---|
| New business strain | | | |
| UK | (218) | 49 | (169) |
| International | (88) | (1) | (89) |
| Lombard | (19) | (1) | (20) |
| **Total strain** | **(325)** | **47** | **(278)** |
| In-force surplus | | | |
| UK | 568 | (214) | 354 |
| International | 116 | (37) | 79 |
| Lombard | 36 | 5 | 41 |
| **Total surplus** | **720** | **(246)** | **474** |
| **Net strain/surplus** | **395** | **(199)** | **196** |

The Group has set a target for the UK business to reduce cash strain, the measure used to manage individual products, by £200 million, by the end of 2013. This target is set from a full year baseline of £392 million, of which the UK accounted for £303 million. The UK new business cash strain of £169 million for the year therefore represents a reduction of £134 million compared to this baseline. The targeted reduction of £200 million is expected to be achieved for the UK business through moving to target platforms, utilising negative reserves and other initiatives set out in the UK operating section. International and Lombard have not been set specific targets for reductions in new business strain, but are expected to deliver annual dividends of £30 million by the end of 2014 for Lombard and £20 million by the end of 2013 for International. Continued improvement in business performance, focused on managing new business strain in comparison to in-force surplus emergence is expected to deliver the dividend targets, subject to economic conditions.

## Analysis of FLG operating free surplus generation and sustainable DCT contribution by segment

| £m | UK | Int'l | Lombard | Corporate covered | Non-covered | Total |
|---|---|---|---|---|---|---|
| Expected return from in-force business net of finance costs | 568 | 116 | 36 | (58) | – | 662 |
| Add back coupon on FLG external debt | – | – | – | 58 | – | 58 |
| Investment in new business | (218) | (88) | (19) | – | – | (325) |
| **Underlying free surplus generation** | **350** | **28** | **17** | **–** | **–** | **395** |
| Development costs | (21) | (6) | (1) | – | – | (28) |
| Deduct coupon on external debt | – | – | – | (58) | – | (58) |
| Deduct GOF/ TIP result | (41) | – | – | – | – | (41) |
| Operating experience variances | (8) | (8) | (7) | – | – | (23) |
| Other operating variances (excluding PS06/14) | 95 | (14) | – | – | – | 81 |
| Other income and charges | – | – | – | – | (35) | (35) |
| **Sustainable DCT contribution** | **375** | **–** | **9** | **(58)** | **(35)** | **291** |
| Add back GOF/TIP result | 41 | – | – | – | – | 41 |
| Operating assumption changes | 221 | (17) | – | – | – | 204 |
| Impact of PS06/14 | 161 | – | – | – | – | 161 |
| **FLG operating free surplus generation** | **798** | **(17)** | **9** | **(58)** | **(35)** | **697** |

Sustainable DCT contribution of £291 million excludes £41 million generated from the GOF and TIP portfolios which is in the operating result for the period but which will not recur following the sale of these businesses.

## d) Working capital and other assets and liabilities

The £929 million of free surplus at 31 December 2011 comprises £853 million available shareholder cash and £499 million of working capital, illiquid and restricted assets, net of the deferred consideration notes of £423 million.

Working capital is held to cover known future requirements or reflects illiquid assets together with requirements to ensure sufficient flexibility to comply with the Group's capital policy.

The Group does not include free surplus within ASC until it is paid up to group holding companies or declared as a dividend.

An analysis of the movement in gross working capital in the period is shown below.

| £m | Working capital (gross) | RSL holding company debt | Net working capital |
|---|---|---|---|
| Opening position at 1 January 2011 | 561 | (900) | (339) |
| FLG free surplus for the period, net of transaction activity | 222 | – | 222 |
| Injection into life businesses from LT2 debt raise | 100 | – | 100 |
| Contribution from life companies to ASC | (415) | – | (415) |
| FLG corporate cash flows offset with working capital movements | 18 | – | 18 |
| Other movements | 13 | – | 13 |
| Repayment of acquisition finance facility | – | 400 | 400 |
| DCN repayment | – | 77 | 77 |
| **Group closing position at 31 December 2011** | **499** | **(423)** | **76** |

The movements in working capital primarily comprise the retention of FLG free surplus generated in the period of £454 million, offset by life company funding of transaction activity of £232 million, injection of £100 million from the FLG external LT2 subordinated debt issue, offset by £415 million contribution to ASC. The contribution to ASC comprises £350 million of dividends and £65 million of working capital set aside in the life companies to fund integration and separation activities. FLG corporate cash flows offset with working capital movements primarily relates to interest on the internal debt less tax relief payments from life companies to holding companies. Other movements comprise items impacting on free surplus in relation to foreign exchange, LTIP schemes and other minor items.

As at 31 December 2011, the key components of working capital are:

| £m | 2011 Full year | 2010 Full year |
|---|---|---|
| Amounts retained to support separation, integration and service company costs | **233** | 175 |
| Amounts retained to facilitate BHA acquisition | **–** | 77 |
| Long-term fund surplus currently unavailable to shareholders and restricted assets | **26** | 129 |
| Life company amounts retained for flexibility | **265** | 125 |
| Other operating businesses working capital | **(25)** | 55 |
| **Total working capital (gross of debt)** | **499** | 561 |

Working capital held by other operating businesses includes the net current liabilities of the Resolution holding companies.

## e) Available shareholder cash – £853 million

Available shareholder cash comprises £752 million of shareholder cash at Friends Life holding company level (including £350 million dividends proposed by FLL), together with £101 million held by Resolution holding companies.

| £m | |
|---|---|
| Friends Life holding companies cash | 402 |
| Proposed dividend from FLL | 350 |
| **Friends Life available shareholder cash** | **752** |
| Resolution holding companies cash | 101 |
| **Group available shareholder cash** | **853** |

The movements in ASC are summarised below:

| £m | |
|---|---|
| **1 January 2011** | **1,067** |
| Dividends and share buy-back settlements | **(476)** |
| Debt payments and servicing | **(115)** |
| Resolution holding companies corporate cash flows | **7** |
| FLG corporate cash flows offset with working capital movements | **(18)** |
| Impact of acquisitions and disposals | **(27)** |
| Contribution from life companies to ASC | **415** |
| **31 December 2011** | **853** |

The £476 million outflow in respect of dividends and share buy-back comprises £141 million cash in respect of the final 2010 dividend, £85 million cash in respect of the interim 2011 dividend and £250 million cash paid to corporate brokers in respect of the shares bought back in the period.

Debt payment and servicing costs comprise £77 million capital repayment on the DCNs, £34 million of finance costs and £4 million issue costs for the £500 million FLG external LT2 subordinated debt. The DCN repayment comprises £63 million scheduled repayment and an accelerated repayment of £14 million triggered by the incremental cash distributed to shareholders during the 2011 share repurchase programme. Finance costs of £34 million relates to interest on the DCNs and, prior to its repayment, the £400 million acquisition finance facility held in Resolution holding companies. Part of the £500 million LT2 subordinated debt issued by FLG in April was used to finance the repayment of the acquisition finance facility with the remaining £100 million injected into life companies as explained above.

Resolution holding companies cash flows comprise corporate costs offset by interest on the internal LT2 debt with FLG. The payment of this interest is included within working capital movements.

The movement in ASC in respect of acquisitions and disposals represents the cash flows from Friends Life holding companies for the WLUK and GOF/TIP transactions; this is in line with the deferred consideration for the acquisition of the AXA UK Life Business.

The contribution from life companies to ASC and FLG corporate cash flows offset with working capital movements are as explained in the working capital analysis above.

## Distributable cash target

The Company has set a DCT of £400 million per annum at Friends Life group level for 2011 and onwards, after interest costs and without reducing the MCEV of Friends Life group (excluding investment variances and non-recurring items). The DCT is satisfied by the payment of dividends from the life operating companies to the Friends Life holding companies. DCT generation in the year is given in the table below.

| £m | | |
|---|---|---|
| FLG ASC at 1 January 2011 | | 836 |
| Capital raised | | 500 |
| Internal transfers[(i)] | | (950) |
| Contribution from life companies | 415 | |
| FLG corporate cash costs | (18) | |
| Debt issue costs | (4) | |
| **DCT contribution** | | **393** |
| Deferred transaction costs | | (27) |
| **FLG ASC at 31 December 2011** | | **752** |

(i) Internal transfers comprise £500 million debt repayments to RHG, £100 million injection into life companies and £350 million dividends to RHG

The DCT contribution shown above of £393 million exceeds the sustainable DCT contribution of £291 million primarily reflecting the inclusion of the £100 million debt raised externally and retained in the life companies. This DCT contribution includes the benefits of capital synergies offset by the net adverse impact of non-operating items (including negative economic variances of £352 million and acquisition activity) as well as the increase in working capital held in the life companies.

Movement in ASC qualifies as DCT to the extent that it is not greater than the change in MCEV excluding economic impacts and one-off items. FLG MCEV operating profit, net of tax, was £408 million for the period, so DCT contribution is unrestricted at £393 million.

As announced in February 2011, the Group expects to reduce cash new business strain by £200 million by the end of 2013, and in addition to this, has targeted the delivery of £50 million of dividends from the overseas businesses by the end of 2014. The Group therefore expects the £400 million DCT to be met predominantly from operational cash flows and related releases of required capital, but until such time as this is achieved the delivery of the target will be dependent, in part, on the release of working capital and capital synergies. In 2011 the Group targeted a further £235 million of capital synergies, in addition to the £400 million DCT. Of the £161 million of free surplus generated in the period through the implementation of certain elements of PS06/14, £100 million relates to the AXA UK Life Business and contributed towards the £235 million to be generated from capital synergies. The additional capital synergies generated in BHA were already assumed in the Group's valuation of BHA (for capital purposes) and do not form part of the incremental capital synergies targeted. The remaining element of the capital synergies were achieved on completion of the Part VII transfers in November 2011.These moved business from smaller life companies into FLL and generated £181 million of excess capital over capital policies, £46 million above expectation. This takes the total impact of capital synergies on free surplus to £281 million in the year.

## Targeted cash return

As announced on 7 June 2011, the Group is targeting a return of £500 million of excess capital to shareholders. The first £250 million of this return was started on 8 June 2011 and successfully completed on 26 October 2011. During this period, the Company purchased 93 million of its own ordinary shares at prices between 229 pence per share and 313 pence per share; all of these shares have been cancelled.

The Company has concluded that it would have been inappropriate to commence an immediate return of the second tranche of £250 million based on the year end cash and capital position which was significantly impacted by weak investment markets during the year. The potential to do so in the future will be kept under review, taking into account the ongoing performance of markets and the impact of planned management actions. The Company will update the market no later than the interim 2012 results announcement on its intentions with respect to the second stage of the capital return programme announced in June 2011.

## Group capital management

The Friends Life group manages its capital on both regulatory and economic capital bases, focusing primarily on capital efficiency and the ease with which cash and capital resources can be transferred between entities. In managing capital, the Friends Life group considers the following:

- establishing targets for the main UK life companies at the greater of 150% of Pillar 1 CRR (excluding WPICC) and 125% of Pillar 2 CRR including ICG – the capital required to mitigate the risk of insolvency to a 99.5% confidence level over a one year period;
- at the FLG level, to hold sufficient capital to meet 150% (formerly 160%) of the Group CRR (excluding WPICC);
- maintaining financial strength within 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;
- managing, in particular, the with-profits business of the Group in accordance with agreed risk appetites and all regulatory requirements;
- transfers from long-term business funds and dividends from entities that support the cash generation requirements of the Group, balanced with the need to maintain appropriate capital within the businesses for the reasons outlined above.

The Group's capital policy has been to maintain sufficient Group capital resources to cover 160% of Group CRR. This coverage ratio was put in place at the time of the AXA UK Life Business acquisition and has now been reduced to 150%, reflecting the good progress made towards integrating these businesses.

As part of the integration of the AXA UK Life Business, a number of initiatives have been undertaken including fund mergers and the optimisation of the corporate structure, to ensure capital efficiency and to maximise the fungibility of capital resources. Further activities are being implemented in 2012 in order to create additional efficiencies in the Group's capital structure.

In 2010, the Group undertook the five yearly test of the FLC reattributed inherited estate ("RIE") with this resulting in a transfer of £1,010 million to the shareholders' fund. As at 31 December 2011, a further £484 million has been transferred to the shareholders' fund, in line with the results of the end 2010 test and the surplus arising in the non-profit fund over the period. These assets will remain in the shareholders' fund to provide capital support to the with-profits funds to the extent required by the scheme, and to support with-profits and non-profit funds to the extent required by FLC's capital policy.

## Solvency II

The implementation of the EU Solvency II Directive, the proposed new EU insurance regulatory requirements, continues to be a key focus of attention for the Group. The aim of the new regulation is to place the management of risk at the heart of running a successful and sustainable insurance company. The Group has been closely following the emerging regulations and monitoring their potential impact on the Group balance sheet. There is still a lack of clarity over certain key issues, particularly in respect of the treatment of matching premium and contract boundaries, which could have a material impact on future capital requirements. The Group continues to be closely involved with the industry in lobbying on key areas where uncertainty remains.

Friends Life has established a Solvency II programme to manage the implementation of the new regulatory requirements. It is progressing well and the Group is well placed for the implementation of Solvency II. A key deliverable of the programme is an integrated financial reporting platform across acquired businesses.

## 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 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). This policy was changed at the end of 2011 from 160% of Group CRR (excluding WPICC) reflecting progress on the integration of the UK Life businesses.

The balance sheet remained strong at the Friends Life group level, with an IGCA surplus of £2.1 billion at 31 December 2011, with Group capital resources being 219% of Group CRR (excluding WPICC). Group capital resources were £1.2 billion in excess of the amount required to satisfy the Friends Life group capital policy of holding 150% of Group CRR (excluding WPICC).

The IGCA surplus would reduce by around £0.2 billion for a 40% fall in equity markets from 31 December 2011 levels and would reduce by slightly less if interest rates were to fall by 200bps across the yield curve. The IGCA surplus would reduce by approximately £0.5 billion if credit spreads were to rise by 200bps.

The movement in IGCA surplus over the period largely reflects the surplus emerging in the period of £403 million. This includes a £103 million benefit from the 2011 capital optimisation project ("COP"), £157 million benefit (on an IGCA basis) of negative reserves released for FLC and BHA business and is after adverse economic variances of £316 million.

The acquisition of BHA and WLUK less the disposal of the GOF and TIP portfolios has decreased the IGCA surplus by £154 million. The acquisition of BHA reduced IGCA surplus by £132 million (£169 million cost of investment offset by a £37 million IGCA surplus at the respective acquisition date). The acquisition of WLUK reduced IGCA surplus by £237 million (£248 million cost of investment offset by a £11 million IGCA surplus at the respective acquisition date) which is offset by £215 million increase from the disposal of the GOF and TIP portfolios.

The surplus is also impacted by financing and dividend costs, which include the £350 million of dividends paid to Resolution holding companies in the period. £500 million of the internal LT2 subordinated debt issued to RHG has been repaid during the period, following an external debt raising by FLG of £500 million LT2 subordinated debt, with £4 million of associated costs.

Finance costs and other movements include £58 million of interest costs on the external LT2 subordinated debt and £33 million of interest due on the internal LT2 debt with RHG, partially offset by the reduction in restricted intangible assets of £16 million and £2 million of other movements.

Management initiatives in the year to optimise the IGCA surplus position delivered a benefit of £157 million. This relates to the recognition of negative reserves in the acquired BHA and AXA UK Life businesses. This benefit applies to the base IGCA position with release of capital requirements at 100% whereas the free surplus impact of £161 million includes the release of FLG-level required capital at 150%. The Part VII transfers implemented in 2011 moved business from some of the smaller life companies into FLL which has reduced aggregate Pillar 1 capital requirements by £113 million, thereby increasing excess capital over capital policies by around £181 million. Further Part VII transfers are planned for 2012.

| Movement in IGCA surplus | £m |
|---|---|
| **1 January 2011** | **2,317** |
| Surplus emerging | **143** |
| COP 2011 | **103** |
| PS06/14 | **157** |
| BHA acquisition | **(132)** |
| WLUK acquisition/GOF TIP disposal | **(22)** |
| Dividend to RSL | **(350)** |
| External LT2 subordinated debt | **496** |
| Repay RSL debt | **(500)** |
| Finance costs and other movements | **(73)** |
| **31 December 2011** | **2,139** |

At 31 December 2011 the capital held to meet FLG capital policies was £902 million (1 January 2011: £1,085 million) and the excess over the capital policies was £1,237 million (1 January 2011: £1,232 million). The change in group capital policy from 160% of Group CRR to 150% of Group CRR increased capital in excess of capital policies by £172 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. Following actions taken in 2011 to transfer surplus long-term fund assets to shareholders, there are no remaining restrictions to the IGCA surplus in respect of surpluses in the non-profit funds (2010: £39 million restriction). The IGCA surplus excludes £385 million of UK with-profits funds surpluses. As the calculation is prepared to include the subsidiaries of the highest EEA parent company, the net assets of the Resolution holding companies are excluded.

## Management of the with-profits funds

### Friends Life Limited

Asset allocation within the With-Profits Fund is actively managed. For the first half of 2011 the strategic proportion of equities and property backing asset shares (equity backing ratio or "EBR") for the whole fund was set at 50%. Management actions allowed for within the risk management framework were revised and with effect from 30 June 2011 the strategic EBR was increased to 55% for the post-demutualisation business and was maintained at 50% for the pre-demutualisation business.

At 31 December 2011, the EBR was 48% for pre-demutualisation business (31 December 2010: 49%) and 53% for post-demutualisation business (31 December 2010: 49%).

There are no Market Value Reductions ("MVRs") currently in place for the fund.

The risk appetite and risk management framework of the With-Profits Fund are in line with FLL's commitment to fair treatment of all its customers and the published Principles and Practices of Financial Management underlying the Fund.

Non-profit business in the FLL With-Profits Fund, the majority of which is annuities, is backed by a mix of gilts and corporate bonds.

### Friends Life Company Limited

Asset allocation within the With-Profits Fund is actively managed. During 2011 the Group was able to continue to reduce MVRs on single premium bonds, and in early 2012 these were removed.

At 31 December 2011 the EBR was close to 66% (31 December 2010: 68%).

There have been no recent changes to investment policy. The fund maintains a stable asset allocation with a target EBR of 65% for assets other than those backing the realistic cost of guarantees, options and non-profit business. Guarantees and options remain backed by a combination of bonds and hedging derivatives (equity put options, interest rate swaps and swaptions). Cash is allocated to back current liabilities.

Non-profit business in the With-Profits Fund is backed by a mix of gilts and corporate bonds (some with credit default swap protection to hedge the default risk).

### Friends Life Assurance Society Limited

Asset allocation within the With-Profits Fund is actively managed. During 2011 the Group was able to continue to reduce MVRs on single premium bonds, and in early 2012 these were removed.

At 31 December 2011 the EBR was close to 52% (31 December 2010: 54%).

The investment policy of FLAS was reviewed in 2010. The strategy now is to target a stable EBR of 50% for assets backing policy asset shares. The allocation for assets backing guarantees and options comprises gilts and hedging derivatives (equity put options, sold equity futures, interest rate swaps and swaptions). The target allocation for assets backing the realistic with-profits estate is gilts only, although currently some property and corporate bond holdings still remain.

Non-profit business in the With-Profits Fund, 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).

### Winterthur Life UK Limited

Asset allocation within the With-Profits Fund is actively managed. MVRs may apply to certain products on a case-by-case basis.

At 31 December 2011 the EBR was close to 50%.

The investment policy of WLUK is to target a stable EBR of 50% for assets backing policy asset shares. The allocation for assets backing guarantees and options comprises gilts, corporate bonds and hedging derivatives (equity put and call options, sold equity futures, interest rate swaps and swaptions). The target allocation for assets backing the realistic with-profits estate is gilts only.

Non-profit business in the With-Profits Fund, the majority of which is annuities, is backed by a mix of gilts and corporate bonds.

Certain of the with-profit deferred annuity business in the Fund is backed by gilts and corporate bonds only.

## Asset quality and exposure

The Group's financial assets as at 31 December 2011, excluding cash, are summarised as follows:

| £bn | Unit-linked | With-profit | Non-profit | Shareholder | 31 December 2011 Total | 31 December 2010 Total |
|---|---|---|---|---|---|---|
| Shares, unit trusts and OEICs | 53.4 | 7.1 | 0.1 | – | 60.6 | 60.4 |
| Government securities | 8.5 | 8.5 | 2.2 | 0.3 | 19.5 | 16.1 |
| Corporate bonds and asset-backed securities | 5.7 | 9.0 | 7.2 | 0.3 | 22.2 | 21.5 |
| Derivatives | – | 0.8 | 0.1 | – | 0.9 | 0.4 |
| Deposits | 0.4 | – | – | – | 0.4 | 0.4 |
| Loans | – | – | – | – | – | 0.7 |
| **Total 31 December 2011** | 68.0 | 25.4 | 9.6 | 0.6 | 103.6 | – |
| Total 31 December 2010 | 65.5 | 24.3 | 8.3 | 1.4 | – | 99.5 |

The vast majority of the Group's exposure to sovereign debt holdings is to UK gilts. The Group has £6 million shareholder exposure (including shareholder fund exposure to non-profit and with-profit funds) to the higher risk government debts of Spain, Portugal, Italy, Ireland and Greece (31 December 2010: £7 million).

In addition the Group's shareholder exposure to various corporate securities issued by companies domiciled in Spain, Portugal, Italy, and Ireland is £370 million (31 December 2010: £444 million). The Group's shareholder exposure to Greek corporate securities is less than £1 million. 64% 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, 44% 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.

| £m | Total | Spain | Portugal | Italy | Ireland | Greece |
|---|---|---|---|---|---|---|
| Sovereign debt | 6 | – | – | 6 | – | – |
| | | | | | | |
| Corporate exposure | | | | | | |
| – Domestic banks | 65 | 29 | – | 33 | 3 | – |
| – Domestic non-bank financials | 26 | – | – | 13 | 13 | – |
| – Non-domestic banks | 40 | 40 | – | – | – | – |
| – Domestic non-financials | 205 | 64 | 10 | 108 | 23 | – |
| – Non-domestic non-financials | 34 | 34 | – | – | – | – |
| **Total 31 December 2011** | 376 | 167 | 10 | 160 | 39 | – |
| Total 31 December 2010[(i)] | 451 | 159 | 14 | 228 | 50 | – |

(i) Restated to include two non-domestic financials totalling £39 million

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

| £m<br>Seniority | Rating | UK | Euro | USA | France | PIIGS(i) | ROW | Shareholder Total |
|---|---|---|---|---|---|---|---|---|
| **Senior** | AAA | 28 | 561 | 18 | 17 | – | 6 | 630 |
| | AA | 19 | 57 | – | – | – | 29 | 105 |
| | A | 129 | 5 | 268 | 7 | 21 | 22 | 452 |
| | BBB | – | – | 14 | – | 3 | – | 17 |
| | Below BBB/NR | – | 3 | – | – | – | – | 3 |
| | **Senior Total** | **176** | **626** | **300** | **24** | **24** | **57** | **1,207** |
| **Secured** | AAA | 270 | – | – | 35 | 24 | – | 329 |
| | AA | 3 | – | – | – | – | – | 3 |
| | A | 5 | – | 10 | – | – | – | 15 |
| | BBB | 1 | – | 8 | – | – | – | 9 |
| | Below BBB/NR | – | – | – | – | – | 2 | 2 |
| | **Secured Total** | **279** | **–** | **18** | **35** | **24** | **2** | **358** |
| **Subordinated** | AA | – | 9 | – | – | – | – | 9 |
| | A | 194 | 30 | 33 | 16 | 36 | 84 | 393 |
| | BBB | 191 | 1 | 29 | 23 | 21 | 43 | 308 |
| | Below BBB/NR | 69 | – | – | – | – | – | 69 |
| | **Subordinated Total** | **454** | **40** | **62** | **39** | **57** | **127** | **779** |
| **Cash** | **Cash Total** | **669** | **267** | **324** | **235** | **39** | **207** | **1,741** |
| **Grand Total** | | **1,578** | **933** | **704** | **333** | **144** | **393** | **4,085** |

(i) Portugal, Ireland, Italy, Greece, Spain

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

| £bn | Unit-linked funds | With-profit funds | Non-profit funds | Shareholder funds | 31 December 2011 Total | 31 December 2010 Total |
|---|---|---|---|---|---|---|
| **Corporate bonds and asset-backed securities** | **5.7** | **9.0** | **7.2** | **0.3** | **22.2** | 21.5 |
| Less: policyholder exposure | 5.7 | 7.9 | – | – | **13.6** | 13.3 |
| Shareholder exposure | **–** | **1.1** | **7.2** | **0.3** | **8.6** | 8.2 |
| AAA | – | 0.2 | 0.8 | 0.1 | **1.1** | 1.3 |
| AA | – | 0.2 | 2.8 | – | **3.0** | 2.8 |
| A | – | 0.4 | 2.5 | 0.1 | **3.0** | 2.7 |
| BBB | – | 0.2 | 1.0 | 0.1 | **1.3** | 1.0 |
| Sub-BBB or rating not available | – | 0.1 | 0.1 | – | **0.2** | 0.4 |
| % Investment Grade | | | | | **96.9%** | 95.1% |

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.

There has been one default in the period, Titan ABS, with a market value loss of £1.7 million in 2011. No other defaults have been experienced in the year. 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 2011 was £0.6 billion (31 December 2010: £0.4 billion). This represents a haircut of 35% of the overall corporate bond spreads over gilts of equivalent term (31 December 2010: 46%).

## 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

A number of the Group's life businesses are attributed financial strength ratings.

| | Fitch | Moody's | Standard & Poor's |
|---|---|---|---|
| **Friends Life Limited** | A+ (strong) | A3 (strong) | A-(strong) |
| **Friends Life Company Limited** | A+ (strong) | A2 (strong) | A-(strong) |
| **Friends Life Assurance Society Limited** | A+ (strong) | A2 (strong) | NR |

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

# Principal risk and uncertainties

The Group actively manages its risk profile and the risk management framework drives the identification and mitigation of 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 2011 and an overview of its approach to managing these exposures:

## Economic conditions

The Group is exposed to volatile and uncertain economic conditions as these will give rise to changes in the values of the assets and liabilities of its insurance businesses. 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.

During 2011 there has been considerable instability within the Eurozone and this has impacted economic confidence in Europe, including the UK. The UK and a number of other countries face a significant risk of a double dip recession as both their governments and consumers attempt to substantially reduce their indebtedness. The UK housing market, the main driver for sales of protection business, has remained relatively depressed due to the economic uncertainty, insecure labour markets and limited availability of credit to potential purchasers. The UK market for pensions has generally been more resilient than other life assurance products due to the need for consumers to save for their retirement, but even this is not immune to market confidence factors. The Group's international businesses focus on the sale of savings and investment products to high net worth individuals and these are impacted by consumers having reduced funds for investment and reduced investment confidence. Economic conditions are expected to remain challenging and uncertain for some years, with extremely low levels of interest rates, volatile economic growth and insecure labour markets expected to continue at least in the short term.

The Group's business model is designed to mitigate the impact of market conditions through measures including the matching of assets and liabilities, the use of financial instruments to reduce the volatility of returns on assets, diversification in the product portfolio, and ensuring the operating companies within the Group are robustly 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 and in line with the Group's risk appetite 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.

## Integration and restructuring

The Group is exposed to the risk of failing to integrate and successfully restructure the financial services businesses that it acquires, and to achieve project specific objectives. As expected, the AXA UK Life Business acquisition, and to a lesser extent the BHA acquisition, led to a step change in this inherent risk and the focus of the Group's activity to manage the risk.

Substantial progress has been made in integrating the three acquired businesses with strategic decision-making now being driven by business plans, capital management, business performance and risk data produced on an integrated basis. There remains considerable work to be done to complete separation of the AXA UK Life Business from its previous parent group at operation level but this work is substantially on track.

Restructuring plans have been developed and are in the process of being implemented; these are based around bringing together in separate companies the UK Heritage business (within FLL) and the UK Go to Market propositions (within FLPL). The first phase of this work was completed in 2011 with a series of Part VII transfers used to transfer all of the BHA and FPLAL business and part of the FLPL business to FLL and leave the currently marketed corporate pension business within FLPL. Further business transfers and restructuring are expected in 2012 and 2013 to optimise the capital structure of the Group and prepare FLG for the "exit" stage of the UK Life Project.

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 robust 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.

## Completion of the UK Life Project

The Group's business model is founded on delivering the UK Life Project. The project is expected to have three phases – acquisition, restructuring and exit. The acquisition phase is considered to be substantially complete and the restructuring phase is ongoing. The Company is now seeking to develop options for its exit from the UK Life Project.

The Company intends to look for exit options involving M&A as these would be expected to allow shareholders to benefit from the synergies arising from further consolidation at exit. A key inherent risk in any such M&A is the ability to identify suitable target companies and to execute any transactions at a price consistent with delivering shareholder value. The Company also expects to develop a self-managed exit plan which is not reliant on M&A opportunities and could be implemented on a stand-alone basis.

The value achieved on exit will be subject to a number of factors, in particular the performance and expected future performance of the acquired and restructured businesses, the exit option pursued, the timing of exit and economic conditions and other factors affecting market values within the life insurance sector at the time of exit.

## Regulatory change and compliance

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 acquired businesses. 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.

The current framework of regulation in the UK and throughout the world continues to evolve due to national and, from a UK perspective, European requirements and in response to the ongoing turmoil in global financial markets. 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 burden of regulatory change facing the Group's insurance businesses continues to grow with preparation being required for compliance with UK government initiatives for auto-enrolment of employees in work-based pensions and reform of financial regulation, requirements for gender neutral pricing, proposals for Solvency II and IFRS Phase II and implementation of the Retail Distribution Review. In addition the FSA's consultation paper on changes to the listing rules for "externally managed companies" could, if implemented, require some change in the Company's governance model in order to enable it to maintain its UK premium listing. This could require negotiation with ROL regarding amendments to, or termination of the Company's Operating Agreement. The alternative option proposed by the FSA would be for the Company to redesignate as a standard listed company (which would make the Company ineligible for inclusion in the FTSE index).

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.

## Changes in taxation law

The Group may be affected by changes in tax legislation and interpretation of tax law. In addition to relevant corporation taxes, life insurance companies within the Group are subject to specific rules governing the taxation of policyholders, and amendment to these rules may impact the business. To mitigate the risk of taxation changes on its business, the Group engages with the relevant tax and legislative authorities and supports lobbying activity undertaken by industry groups.

From 1 January 2013, there is expected to be a major change in the UK corporate tax regime applicable to life insurance companies. Draft legislation was issued for consultation in December 2011 and is expected to be included in the Finance Bill due to be published on 29 March 2012. The Group's assessment is that the draft legislation proposed in the December consultation paper would not have a material adverse impact on the corporate tax position of the Group. However, until the legalisation is finalised, there remains a risk that changes to it could affect this assessment.

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 following a decision in 2005 by the European Court of Justice ("ECJ") to narrow the scope of the insurance intermediaries' exemption. The European Commission has made detailed proposals for change, but the proposals have not yet been accepted by the EU Council and it is not known when any changes might become law, what form those changes might take and what the impact, if any, will be on the Group. If agreement cannot be reached at EU level, the UK and other Member States that have not already changed their national laws to give effect to the ECJ decision may need to do so.

## Mortality and other assumption uncertainties

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 persistence rates, valuation interest rates, credit defaults and expense levels.

The continued economic uncertainty and FSA's Retail Distribution Review in the UK act to increase the risk of lapses of life and pensions business as intermediaries look to re-broke existing business ahead of the impending ban in the UK 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, but expects that lapse rates during 2012 will remain at similar levels to those experienced in 2011. The Group takes a prudent approach to evaluating the appropriate level of provisions and capital for these risks and the assumptions 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 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. The management of these risks is covered further in the full financial statements.

## FLG reliance on outsourcing

As part of the Group's strategy for increasing operational efficiency, opportunities are considered for outsourcing the administration of its insurance businesses. During 2011 the Friends Life group investigated extension of its current outsource model to the enlarged group (post the acquisition of the AXA UK Life Business and BHA). In November 2011 the Friends Life group materially extended its existing outsource arrangements in respect of IT and customer services by entering into a long-term contract with Diligenta. This had the effect of substantially increasing the reliance of the Friends Life group on outsource service providers.

The Group has comprehensive service level agreements in place with all its outsource partners and actively monitors the standards of delivery against these agreements in order to mitigate the operational risks posed by the outsourcing. 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 partners are actively monitored in order to manage the potential counterparty credit and continuity of service risks they pose.

## Reliance on ROL

The Group currently depends to a significant degree on ROL and key ROL personnel for the successful implementation of the Group's strategy, the provision of day-to-day oversight of the Friends Life group and the provision of certain other services to the Company in its role as a holding company. These services are provided in conjunction with the Board which independently approves every acquisition made by the Company and FLG's business plans for the acquired businesses.

The resources of ROL were increased in 2010 to reflect the growth in the Group's business and increased requirement for oversight of the acquired businesses. There was minimal change in the size and composition of the ROL team during 2011 in line with the stability in the scale of the Group's operational businesses and ongoing restructuring agenda.

The Company has sought to mitigate the risk of reliance on ROL by aligning the interest of the key members of the ROL team through an incentive structure which rewards the founders and staff for the capital value created by the UK Life Project. At the general meeting on 13 January 2012 it was decided that the Company would focus solely on the UK Life Project and changes to the Operating Agreement between the Company and ROL were approved to remove the prohibition on ROL providing services to any organisation other than the Company. There is a formal process of evaluating the performance of ROL against the services it has contracted to provide and this process will continue consistent with ROL's revised obligations under the Operating Agreement. The amendment to the Operating Agreement has extended the protections the Company has against termination of ROL's contract – now ROL may not terminate the agreement under which it provides services to the Company until completion of the UK Life Project (previously 10 December 2013) and then only subject to providing the Company with 12 months' written notice (except that the agreement may be terminated by ROL prior to completion of the UK Life Project (and on shorter notice) upon a change of control of the Company and in certain other limited circumstances). Conversely, the Company is not able to remove ROL in the absence of negligence or material default or similar until completion of the UK Life Project (previously 10 December 2013).

# Governance

# Report of the directors

The directors present their report together with the financial statements of the Company and its subsidiaries for the year ended 31 December 2011. These will be laid before shareholders at the Annual General Meeting ("AGM") to be held on 17 May 2012.

## Business review and results

The business review and results for the year are set out on pages 14 to 75. The Company's statement on corporate responsibility is set out on pages 107 to 109.

## Principal activities

The Company was incorporated in Guernsey to provide public markets with a series of restructuring opportunities in the financial services industry in the UK and Western Europe. In response to feedback from shareholders, it has since committed not to undertake any restructuring opportunities other than its current UK Life Project until the end of that project. During the year the Company completed the acquisition of BHA and WLUK and disposed of the GOF and TIP portfolios.

## Events after the balance sheet date

At a general meeting on 13 January 2012, the Company's shareholders approved changes to the Operating Agreement that governs the Company's relationship with ROL in light of the Company's commitment not to undertake any other restructuring project until the end of the UK Life Project. The changes to the arrangements with ROL and other members of The Resolution Group were set out in the shareholder circular dated 28 November 2011.

## Dividends

The directors have proposed a final dividend for 2011 of 13.42 pence per share (2010: 12.57 pence) payable on 21 May 2012 to shareholders on the register at the close of business on 20 April 2012.

The directors of the Company, at the date of approval of, and prior to the payment of a dividend are required to consider a solvency test under section 304 of the Companies (Guernsey) Law, 2008 (as amended). The directors have considered the solvency test requirements and are satisfied that they were met at the dates of approval and payment of the final dividend for 2010 and the 2011 interim dividend and at the date of approval of the proposed 2011 final dividend.

A scrip alternative is being offered in respect of the 2011 final dividend, which gives shareholders the opportunity to receive new ordinary shares in the Company instead of the cash dividend to which they would otherwise have been entitled.

## Share capital

The Company's share capital consists entirely of ordinary shares of no par value. Each share ranks equally and carries the same rights to vote and to receive dividends and other distributions declared, made or paid by the Company.

On 7 June 2011 the Company announced a £250 million share repurchase programme, which was completed on 26 October 2011, at an average price of 268.9 pence per share. As at 31 December 2011, the Company had authority from shareholders for the purchase of 145,256,437 of its own shares.

In order to allot equity securities, directors require express authorisation from shareholders. The authority can be granted for a period of five years. The Company follows UK best practice and seeks shareholder approval annually to allot the Company's securities. At the 2011 AGM, the directors were granted authority to allot up to an aggregate number of 484,188,123 shares in the Company, comprising approximately one-third of the Company's issued share capital, with additional authority being granted to issue shares by way of rights issue, comprising an additional one-third of issued share capital. Shareholders will be asked to renew this authority at the forthcoming AGM.

During the year the Company bought 92,990,516 shares, under the share purchase programme, and issued 16,615,134 new scrip shares. As a result, the issued ordinary share capital decreased by 76,375,382 shares. As at 31 December 2011, the issued ordinary share capital totalled 1,376,188,989 shares.

## Substantial shareholdings

As at 23 March 2012, the Company had been notified of the following substantial interests in the issued ordinary shares of the Company:

| | Number of Shares | % of Issued Capital |
|---|---|---|
| Lloyds Banking Group Plc | 137,024,974 | 9.96 |
| FMR LLC | 63,422,247 | 4.61 |
| Aviva Plc and its subsidiaries | 54,802,616 | 3.98 |
| Legal & General Group Plc | 52,660,432 | 3.83 |

## Rights and obligations of ordinary shares

All shareholders entitled to attend and vote at a general meeting of the Company may appoint a proxy or proxies to attend, speak and vote in their place. A member may appoint more than one proxy provided that each proxy is appointed to exercise the rights attached to a different share or shares by the shareholder. On a poll, every member present in person or proxy and entitled to vote shall have one vote for every ordinary share held.

## Directors

The current directors who served throughout the year are listed on pages 80 to 82. All directors will seek re-election at the forthcoming AGM in compliance with the UK Corporate Governance Code.

In accordance with the undertakings given to shareholders at the time of the acquisition of Friends Provident, shareholders are given the opportunity to provide an advisory vote on all new appointments to the FLG board. In addition, FLG directors will retire by rotation at the Company's AGM and shareholders will be able to provide an advisory vote on their re-election. This includes Clive Cowdery and John Tiner who will put themselves forward for annual re-election to their posts as directors of FLG.

Details of directors' elections and re-elections can be found in the Notice of AGM, available on the Company's website: www.resolution.gg

## Directors' interests

Directors' interests in the shares of the Company during the year are shown on page 99 in the Remuneration report.

## Board diversity

The Company recognises the importance of Lord Davies' report "Women on Boards" and welcomes it. The Board has been, and remains, committed to seeking opportunities for women within the Company and its subsidiaries. The Board is comprised solely of non-executive directors, and as a consequence, has no executive directors, no executive committee and therefore does not require an executive succession plan at Board level. The Board does not agree with a quota share approach to this important issue, but believes that a business-led approach to diversity will be more effective in creating leaders for the future.

The Board is culturally diverse and international in its composition and is committed to seeking opportunities to build greater gender diversity at all levels across the Group.

## Equal opportunities

The Group is committed to providing equal opportunities to all of its employees, irrespective of their gender, sexual orientation, marital status, race, nationality, ethnic origin, disability, age or religion. Policies have been implemented to ensure that this is practised at recruitment and continues throughout an individual's career. The Group encourages the recruitment, training, career development and promotion of its employees on the basis of aptitude and ability, without regard to disability.

## Employee involvement

The Group continued its culture of informing and involving employees in matters which concern them through various channels including the use of regular meetings between management and employees, knowledge management tools, the FLG intranet, and periodic in-house briefings. The number of employees of the Group as at 31 December 2011 was 5,733 (2010: 5,570).

## Directors' and officers' insurance

The Group maintains insurance cover for all directors, FLG directors and senior officers against liabilities which may be incurred by them while acting as directors and officers. The indemnities of the directors of the Company, whilst governed by Guernsey law, are broadly consistent with the scope of directors' indemnities that would be permitted under the UK Companies Act 2006.

## Political donations and contributions

The Company does not make any donations or contributions to political parties or organisations and no such payments were made during the year.

## Charitable donations

Details of the Group's charitable donations are contained in the Corporate responsibility report on pages 108 to 109.

## Auditor

Following the Audit and Risk Committee annual review, it was recommended that the Company's current external auditor, Ernst & Young LLP, be re-appointed. Ernst & Young LLP has expressed its willingness to continue in office in accordance with the Companies (Guernsey) Law, 2008 (as amended) and a resolution to re-appoint them as auditor will be proposed at the forthcoming AGM.

## Auditor's right to information

Each of the directors of the Company at the date of approval of this report confirms that:

- so far as each director is aware, there is no relevant audit information (as defined in the Companies (Guernsey) Law, 2008 (as amended)) of which the Company's auditor is unaware; and
- each of the directors has taken all the steps that he/she ought to have taken as a director to make him/her aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of the Companies (Guernsey) Law, 2008 (as amended).

## Secretary

The Secretary of the Company is Northern Trust International Fund Administration Services (Guernsey) Limited ("Northern Trust").

## Statement of directors' responsibilities

The directors are responsible for preparing the Annual Report and the consolidated financial statements in accordance with applicable Guernsey law and International Financial Reporting Standards ("IFRS") adopted for use in the European Union. The directors are required to prepare consolidated financial statements for each financial year that present fairly the financial position of the Group and the financial performance and cash flows of the Group for that period. In preparing those financial statements, the directors are required to:

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

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy the financial position of the Group at any time and to enable them to ensure that the financial statements comply with the Companies (Guernsey) Law, 2008 (as amended). They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

## Directors' responsibility statement pursuant to Disclosure and Transparency Rule 4

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 they face.

## Annual General Meeting

The next AGM of the Company will be held at 11.00 am on Thursday, 17 May 2012 at The St Pierre Park Hotel, St. Peter Port, Guernsey, Channel Islands and will be simultaneously broadcast to The Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE, United Kingdom.

Full details of the resolutions to be proposed at this year's AGM can be found in the Notice of AGM, available on the Company's website: www.resolution.gg

## Going concern statement

Notwithstanding the Company's incorporation in Guernsey, 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 the Company have adequate resources to continue to operate as a going concern for the foreseeable future and have prepared the financial statements on that basis. In assessing whether the going concern basis is appropriate, the directors have considered the information contained in the financial statements, the latest business plan, profit forecasts, the latest working capital forecasts and estimated forecast solvency of the regulated subsidiaries of the Group. These forecasts have been subject to sensitivity tests and the directors are satisfied that the Group and the Company have adequate resources to continue in operational existence for the foreseeable future.

Key information in respect of the Group's risk management framework, objectives and processes for mitigating risks including liquidity risk are set out in detail on pages 90 to 92.

## Future developments

An indication of likely future developments is set out in the Chairman's statement and the Operating report on pages 4 to 12.

By order of the Board

**Fergus Dunlop**
Director

26 March 2012

# Board of directors

The Board is the principal decision-making forum accountable to shareholders for the Company's performance and long-term success.

The Board focuses on areas that are important to the Company's shareholders – strategy, risk management, operational performance and regulatory matters.

## Michael Biggs

Chairman

- Chairman of Nomination Committee
- Member of Remuneration Committee

Prior to Mike's appointment as Chairman in October 2008, he was Chief Financial Officer of Resolution Life Group Limited and became Group Finance Director of Resolution plc upon the merger with Britannic Group plc in 2005. In March 2007, he was promoted to become Group Chief Executive Officer, a position which he held until that company's acquisition of Resolution plc in May 2008.

He began his career at Williams & Glyn's Bank before joining Arthur Andersen where he became a manager within the Financial Services part of the practice. In 1984, he took up a role as Manager of Finance at Hong Kong & Shanghai Banking Corporation in the UK. After three years, he left to become Group Financial Controller of Morgan Grenfell, leaving the bank in 1991 to join Norwich Union as Group Financial Controller. In 1995, he became General Manager of Norwich Union's international operations and was a member of the team that demutualised and floated Norwich Union in 1997. He was appointed Group Finance Director of Norwich Union in that year and, following the merger with CGU plc in 2000 that created CGNU plc, he was made Group Executive Director responsible for CGNU plc's UK general insurance business. Mike was promoted to Group Finance Director in 2001, a position he held until he chose to leave Aviva, the renamed CGNU plc business, at the end of 2003.

External appointments:

Mike has been invited to become Chairman of Direct Line Insurance Group plc subject to and following clearance by the FSA.

## Jacques Aigrain

Non-executive director

- Member of Nomination Committee
- Member of Remuneration Committee

Jacques has spent most of his professional career in the insurance and banking sectors. He joined Swiss Re in mid-2001, where he served as Chief Executive Officer. In this role, Jacques oversaw the growth of Admin Re, Swiss Re's closed-life operation in the UK and the US. He was also a member of Swiss Re's Executive Committee between 2001 and 2009, and previously held the positions of Deputy Chief Executive Officer and Head of Financial Services. During this time, Jacques was Chairman of the Geneva Association and a number of international advisory associations. Prior to joining Swiss Re, Jacques was at JP Morgan for 20 years, holding several senior positions in the bank's investment banking division, including Co-Head of Investment Banking Client Coverage. He was ultimately appointed a member of JP Morgan's Global Investment Bank Management Committee.

External appointments:

Jacques is currently serving on the supervisory boards of Deutsche Lufthansa AG, Swiss International Airlines and since May 2011, Lyondell Bassel NV. He is also Chairman of LCH Clearnet and Principal of J.A. Consulting SA.

## Gerardo Arostegui

Non-executive director

- Member of Nomination Committee
- Member of Remuneration Committee

Gerardo has extensive experience across the European insurance and asset management sectors. From 1985 until 2008 he worked for Aviva Spain, serving as its Chief Executive Officer throughout this period. During his 23-year career with Aviva, Gerardo led the creation, through acquisitions and organic growth, of one of the leading bancassurance businesses in Spain. Gerardo was also a member of the main Spanish insurance associations, including Unespa and Consorcio de Compensacion de Seguros. Between 1995 and 2001, Gerardo was President of Pool Espanol de Grandes Riesgos. Before joining Aviva Spain, he was Deputy General Manager at Tubacex SA, the Spanish stainless steel tubing company.

External appointments:

Gerardo is an independent director of Tubacex SA and Chairman of Qualitasa SLU and Tinsa Tasaciones Inmobiliarias.

## Mel Carvill

Non-executive director

- Member of Nomination Committee
- Member of Audit and Risk Committee

Mel has worked across a range of sectors in the European financial services industry, in a variety of different capacities. From 1985 until 2009 Mel worked at Generali where he held a number of senior positions in the group, including Head of Western Europe, Americas and Middle East, Head of M&A and Head of International Regulatory Affairs (2007–2009), Head of Corporate Development, Risk Management and Investor Relations (2005–2007), and Head of Corporate Finance (2000–2005). Mel was previously a Commissioner of the Guernsey Financial Services Commission, a position he held for nine years. Mel is a Fellow of the Institute of Chartered Accountants in England and Wales, holds the Advanced Diploma in Corporate Finance, and is an Associate of the Chartered Insurance Institute, a Chartered Insurer and a Fellow of the Securities Institute.

External appointments:

Mel is the founder and President of PPF Partners (a private equity firm), a joint venture with Generali and PPF Group. In addition, Mel holds a number of directorships within financial services companies operating in Europe, the Americas and Asia.

## Fergus Dunlop

Non-executive director

- Member of Audit and Risk Committee

Fergus has experience of institutional asset management for insurance companies in the UK, Germany and the Channel Islands. Between 2002 and 2007 he joint-owned and managed an advisory business in Munich for institutional investors. From 1997 to 2001, Fergus worked in institutional sales for Mercury Asset Management (later Merrill Lynch, now BlackRock) in Frankfurt. From 1987 to 1997 he was with SG Warburg/Mercury Asset Management in London, where he managed a joint venture with Munich Re.

External appointments:

Fergus is a non-executive director of Princess Private Equity Fund Limited, Schroder Oriental Income Fund Limited and Aqua Resources Fund Limited, all traded on the London Stock Exchange.

## Phil Hodkinson

Senior Independent Director

- Member of Nomination Committee
- Member of Audit and Risk Committee

Prior to his retirement in 2007, Phil held a number of senior executive positions in the UK financial services industry including Chief Executive Officer of Zurich Financial Services UK Life (1996–2001), Chairman of Clerical Medical and Insight Investment (2001–2005) and Group Finance Director of HBOS plc (2005–2007). Phil was also Chairman of the ABI's Raising Standards Accreditation Scheme (2001–2006), and is a Fellow of the Institute of Actuaries in England and Wales.

External appointments:

Phil is non-executive director of BT Group plc, Travelex Holdings Ltd, and a board member of HM Revenue & Customs. He is also a Trustee of BBC Children in Need, Action Medical Research and Business in the Community, and is Chairman of the Community Mark Independent Approvals Panel and BT Group's Equality of Access Board.

## Denise Mileham

Non-executive director

- Member of Nomination Committee
- Member of Audit and Risk Committee

Denise was previously an executive director of Kleinwort Benson (Channel Islands) Fund Services and Close Fund Services. At Kleinwort Benson, Denise acted as Deputy Head of Fund Services and as Head of Fund Administration. At Close Fund Services, she was a Director of New Business, running a team responsible for all aspects of new business, including marketing, sales and implementation of new business. She joined Rea Brothers in 1997 which was subsequently purchased by Close Brothers Group in 1999, where she worked for nine years before moving to Kleinwort Benson. In her earlier career Denise worked in the funds department of Barclay Trust before moving to Credit Suisse, where she undertook a number of roles, including Compliance Officer in the fund administration department. She has been a Fellow of the Securities and Investment Institute since 2006. She is a member of the Institute of Directors and the Guernsey Investment Fund Association, and is a member of its Technical Committee. She is a champion of the Women's Development Forum, a not-for-profit organisation dedicated to aiding the female workforce in Guernsey to unlock its potential.

External appointments:

Denise is currently a director of FPP Japan Fund Inc. and FPP (General Partner) Inc.

## Peter Niven

Non-executive director

- Member of Nomination Committee
- Member of Remuneration Committee

From 1993 until 2004, Peter was a senior executive with the Lloyds TSB Group, holding a number of senior positions including Chief Executive Officer of the Group's Offshore Financial Services Group, director of the Offshore Pension Fund, director of the Group's French banking subsidiary and director of numerous offshore trading companies. Peter is qualified as a Chartered Director and is a Fellow of the Chartered Institute of Bankers, a member of the Institute of Directors, the Guernsey International Insurance Company Managers Association and the Guernsey Investment Fund Association.

External appointments:

Peter is currently Chief Executive Officer of Guernsey Finance LBG. In addition, Peter holds a number of non-executive directorships, including five companies listed on the London and Channel Islands Stock Exchanges.

## Gerhard Roggemann

Non-executive director

- Chairman of Remuneration Committee

Gerhard is Non-executive Director of Friends Life Group plc and was previously a Non-executive Director of Friends Life FPG Limited (formerly Friends Provident Group plc). Gerhard has spent much of his professional career with financial services firm JP Morgan, where his positions included Managing Director of JP Morgan's German branch in Frankfurt and Regional Treasurer Asia Pacific located in Tokyo. He spent a total of 13 years on the management board of two German Landesbanks, joining the executive boards of Norddeutsche Landesbank in 1991, and of Westdeutsche Landesbank (WestLB AG) in 1996. Gerhard's previous board appointments include AXA Lebensversicherungs AG, AXA Kapitalanlagegesellschaft mbH, Deka Bank, Fresenius AG, Hapag Lloyd AG and VHV Holding AG.

External appointments:

Gerhard is currently the Vice Chairman of Hawkpoint Partners Europe. He is also Chairman of the Supervisory Board of GP Günter Papenburg AG, Deputy Chairman of the Supervisory Board of Deutsche Börse AG, a member of the Supervisory Boards of Deutsche Beteiligungs AG and of Fresenius SE & Co KGaA.

## Tim Wade

Non-executive director

- Chairman of Audit and Risk Committee

Tim was formerly a Managing Director of AMP Limited. Between 1997 and 2000, Tim was Chief Financial Officer of Colonial Limited, where he was closely involved in the rationalisation of the life insurance industry in Australia, having previously held the role of Chief Taxation Counsel (1994–1997). From 1984 until 1994, Tim worked at Arthur Andersen in Melbourne and Singapore where he became a Partner in 1992. Tim is qualified as a lawyer and an accountant, and has a long career in financial services around the world.

External appointments:

Tim is currently Chief Executive officer of Finance Pronto Limited, Non-executive Director and Chairman of the Audit Committee of Macquarie Bank International Limited and Monitise Plc, Non-executive Director and Chairman of the Credit and Remuneration Committees of Access Bank UK Limited, and a Governor of the Coeliac Society.

# Corporate governance report

## Chairman's introduction

I believe the governance structures established at incorporation and at the time of the acquisition of Friends Provident are sound foundations on which to build the governance framework for the enlarged group.

As Chairman, my role is to provide leadership of the Board and ensure that the directors as a group bring a wide range of experience and expertise to the Board's deliberations.

In addition, I am responsible for ensuring that first, appropriate and timely information is available to the Board in a clear and concise format, and second, that there is an environment in the boardroom which promotes and supports independent thinking, effective decision-making and constructive and effective challenge. To achieve this successfully requires the right board composition and I believe the Company is well served by its current Board of directors.

## Managing risk

One of the key areas of focus for the Board is management of risk. Risk analysis and evaluation is a key input to our decision-making process, including key strategic decisions related to acquisition opportunities and business planning.

The Board has set, and continues to refine, the effectiveness of its risk management framework for the Group. This is supported by the Company's Audit and Risk Committee and in the case of risk management within the Friends Life group by the FLG board and its Board Risk and Compliance Committee.

## Governance highlights in 2011

During 2011, the following governance matters have been dealt with:

- consideration of gender diversity on the Board, and issuing a statement on this in response to Lord Davies' report;
- an internally led board performance evaluation and the formulation of an action plan for implementation in 2012;
- continuing a rigorous training programme for directors, covering a range of relevant industry topics and legal updates including the Bribery Act 2010 and Solvency II; and
- recommendation by the Nomination Committee of the following FLG board appointments: Andy Briggs, Chief Executive Officer; Tim Tookey, Chief Financial Officer and Mary Phibbs and Peter Gibbs, independent non-executive directors.

## Governance priorities for 2012

We will continue to review and enhance the Group's governance practices in line with current best practice. In particular, during 2012, we will develop a diversity policy and establish objectives relating to its interpretation throughout the Group as well as reviewing the Group's governance structure in line with the strategy for advancing the UK Life Project towards completion.

I am confident that the leadership and governance provided by the Board will ensure that we remain in a position to continue to deliver our objectives and strategy. This strong leadership is supported by established and embedded governance practices, ethical standards, robust internal controls and the Group's remuneration policy. It is these governance practices that assist in achieving and protecting value for shareholders and building a sustainable business in the UK Life Project.

**Michael Biggs**
Chairman

26 March 2012

## Governance framework

The Company is firmly committed to high standards of governance and maintaining a sound framework through which the strategy and objectives of the Group are set, and the means of attaining these objectives and monitoring performance is determined.

Details of the Group's governance structure are given below.

### Resolution Limited

The Company was incorporated as a Guernsey limited liability company on 9 October 2008.

The Company's shares are premium listed on the Official List of the UK Listing Authority and are admitted to trading on the London Stock Exchange. The Company is therefore subject to UK Listing Authority Listing Rules, Disclosure and Transparency Rules, and Prospectus Rules (to the extent applicable to premium listed, non-EEA incorporated companies), as well as the UK City Code on Takeovers and Mergers and the UK Corporate Governance Code (the "Code") published in 2010 as adopted by the Financial Reporting Council.

The Company has outsourced some administrative functions and company secretarial services to Northern Trust International Fund Administration Services (Guernsey) Limited. All scheduled Board and Committee meetings are held outside the UK, and the substantial majority of meetings are held at the Company's office in Guernsey.

The Board is wholly comprised of non-executive directors, responsible for the establishment of the Company's objectives, business strategy and its overall supervision. All the directors are considered by the Board to be independent. Executive functions of the Company are provided by ROL under the Operating Agreement.

The Board has constituted the following Committees:

- Audit and Risk Committee;
- Remuneration Committee; and
- Nomination Committee.

These Committees provide support to the Board in discharging its responsibilities and committee membership is sourced exclusively from the directors of the Company. More information about the Committees and the Company's governance framework can be found on pages 85 to 106.

### Friends Life Group plc

FLG is an English incorporated holding company, owned by the Group, which was incorporated in November 2009 to hold the acquired Friends Provident business. Since then, the Group has also acquired the AXA UK Life Business and BHA which are also owned under FLG, and operate as an integrated group. Various companies owned by FLG are subject to regulation by government agencies in the jurisdiction in which they operate, which in the UK is the Financial Services Authority (the "FSA").

The FLG executive directors and their management team are responsible for the day-to-day management of the principal operating subsidiaries of the Group. They work closely with the Board and ROL.

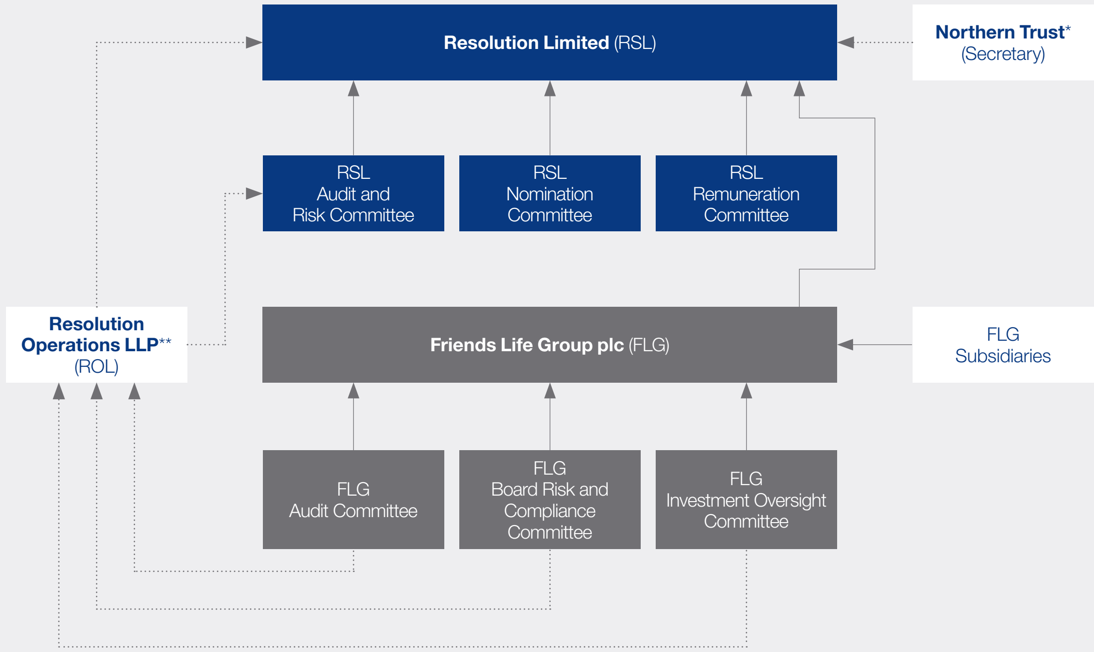
### Resolution Operations LLP

ROL is a UK registered limited liability partnership.
The Company has outsourced the management of most of its operational functions to ROL, in particular the identification and assessment of acquisition opportunities, the design and execution of the restructuring process for acquired businesses, operational services and general oversight of FLG. ROL is regulated and authorised by the FSA for the provision of investment advice.

Partners of ROL regularly attend board and board committee meetings of both the Company and FLG in order to discharge the responsibilities of ROL under the Operating Agreement.

A diagram illustrating the Company's governance framework, including its Committee structure, is set out below. The Group's risk management framework is described in detail on pages 90 to 92.

## Governance framework




* Northern Trust provides company secretarial and administration services to the Company under a corporate administration agreement.
** ROL provides services to the Company under the Operating Agreement. These services include oversight on behalf of the Company.

## How we meet our governance responsibilities in practice

The operation of the Company's Board and Committees is set out in more detail below.

### The Board of directors

The Company's Board is responsible for the overall leadership of the Group and for ensuring that it is appropriately managed and on track to achieve its objectives. The Board meets regularly to review the Group's operating and financial performance and to ensure that the Group is adequately resourced and effectively controlled. The Board acts in accordance with the powers vested in it by the Company's Articles of Incorporation and with the laws of Guernsey. A copy of the Company's Articles of Incorporation is available to view on the Company's website: www.resolution.gg

The Board regularly reviews the performance of the Group and its businesses against its business plan and receives regular reports from FLG and ROL on the Group's financial position, risk management, regulatory, operational and compliance controls and other material issues. Directors are regularly briefed on key business areas, to enhance their understanding of the business and provide the opportunity to review critically, question assumptions and, where appropriate, challenge strategies proposed. All Board and Committee meetings during the year were held in an open atmosphere with the Chairman encouraging constructive challenge and debate.

There is a formal schedule of matters reserved specifically for the Board's decision and terms of reference for its Committees. These matters are formally documented and regularly reviewed and updated to ensure that they remain appropriate. The key matters reserved for the Board include:

- long-term strategy, objectives and Group business plan;
- target return of the Company;
- review of operational reports (submitted by ROL);
- structure and capital;
- financial reporting and controls;
- internal controls and risk management;
- acquisitions, disposals and material contracts;
- board membership and appointments;
- financial statements;
- dividend policy; and
- governance matters.

During the year, significant matters considered by the Board included M&A activity, FLG's outsourcing arrangements and the ROL exclusivity arrangements and amendments to the Operating Agreement, which were approved by shareholders on 13 January 2012.

The Board has defined the Group's governance arrangements and operational framework, including delegations of authority, policy and the decision-making structure.

### Board composition

The Board comprises the Chairman, Michael Biggs; Phil Hodkinson, the senior independent director ("SID") and eight non-executive directors (see biographies at pages 80 to 82). All the directors are considered to be independent. Each director has been selected for their track record in the financial and insurance sectors and the appropriate balance of skills, knowledge and experience which they bring to the Board. They are collectively responsible for setting the Company's business strategy, providing oversight of the Group, ensuring that adequate controls are in place to determine and manage risk and deciding whether any acquisition or disposal should be made. Information on the process used to select candidates can be found in the report of the Nomination Committee on page 95.

### Board evaluation

With the aim of continuously improving the effectiveness of the Board and its Committees, the Board undertakes an annual review of its performance, and of the performance of the Chairman and each individual director. In 2009 and 2010, the review process was facilitated by an external adviser. The Board resolved to carry out an effectiveness review exercise itself in respect of 2011 with some assistance from the ROL Head of Secretariat. During the year, the Board took action based on proposals which had emerged from the 2010 evaluation process.

The review of Board and Committee performance in 2011 was led by the Chairman and, in respect of the Chairman's performance, by the SID. A series of themes and questions was proposed by the Chairman based on the outcome of the previous evaluation exercise and on matters having an impact on the performance of the Board during the year. These were debated by, and the conclusions recorded on behalf of, the Board, and resulted in an action plan for implementation in 2012. The Board concluded that it and its Committees operate effectively. The Chairman determined that each of the directors makes an active and valuable contribution to the governance of the Group.

## Meetings and attendance

The substantial majority of scheduled Board and Committee meetings take place in Guernsey at the Company's office. The Board meets eight times a year, and on occasion, additional meetings are scheduled to allow the directors to consider potential transactions and any pressing matters. The directors are expected to attend all meetings and to devote sufficient time to their duties as non-executive directors of the Company.

The table below shows Board and Committee attendance by the Company's directors during the year:

| | Scheduled Board | Additional ad hoc Board | Audit and Risk Committee | Nomination Committee | Remuneration Committee |
|---|---|---|---|---|---|
| Michael Biggs | 8(8) | 7(9) | n/a | 4(4) | 8(9) |
| Jacques Aigrain | 6(8) | 9(9) | n/a | 3(4) | 7(9) |
| Gerardo Arostegui | 8(8) | 6(9) | n/a | 4(4) | 9(9) |
| Mel Carvill | 8(8) | 6(9) | 8(8) | 4(4) | n/a |
| Fergus Dunlop | 7(8) | 8(9) | 8(8) | n/a | n/a |
| Phil Hodkinson | 7(8) | 5(9) | 7(8) | 3(4) | n/a |
| Denise Mileham | 8(8) | 6(9) | 8(8) | 4(4) | n/a |
| Peter Niven | 6(8) | 5(9) | n/a | 3(4) | 8(9) |
| Gerhard Roggemann | 7(8) | 7(9) | n/a | n/a | 9(9) |
| Tim Wade | 7(8) | 5(9) | 8(8) | n/a | n/a |

Note: The number of meetings held during the year is given in brackets.

## Board training

The Board participated in four scheduled training sessions during 2011 covering a range of relevant industry topics and legal updates including the Bribery Act 2010 and Solvency II. One of the sessions was jointly held with FLG's board. Individual training needs are kept under review by the Chairman who is responsible for the induction of new directors.

Every director has access to a secure, online repository of corporate information which is regularly updated by the Company Secretary and the ROL team. Members of the Board also have the right to consult an independent professional adviser whenever they deem it necessary for the proper discharge of their responsibilities.

## The Chairman

The Chairman, Michael Biggs, is primarily responsible for the leadership of the Board and ensuring that it is effective in its task of setting and directing the Company's strategy. This includes oversight of the Group, and acting as the Company's leading representative in all aspects of shareholder communications. Michael Biggs has been invited to become Chairman of Direct Line Insurance Group plc and the Board is satisfied that his time commitment to that company will not encroach on the performance of his duties as Chairman of the Board.

An annual review of the Chairman's performance is conducted by the SID.

## Senior Independent Director

In accordance with the UK Corporate Governance Code, the Board has appointed one of the non-executive directors to act as SID. The main responsibility of the SID is to be available to shareholders should they have concerns that they have been unable to resolve through normal channels, or when such channels would be inappropriate. Phil Hodkinson continues to serve as the SID having been appointed in March 2009.

## Communication with shareholders

The Company values its dialogue with both institutional and private investors. The Board's primary contact with institutional shareholders is through a combination of the Chairman and the ROL team. The Board takes a particular interest in ensuring that regular and informative communication takes place with the Company's shareholders to enable them to fully appreciate the risks and rewards of investing in the Company's shares. Frequent updates on shareholder sentiment are provided to the Board by ROL's Investor Relations team and the Company's brokers who feed back generally held views and any concerns raised by shareholders.

The Board ensures that dialogue with shareholders takes place regularly. Shareholders are provided with sufficient information to assess and understand the risks and rewards of exposure to the Company's shares. In addition, the Board is kept informed of any concerns raised by major shareholders. The SID is available to shareholders if concerns, raised by shareholders, are not resolved through the normal channels of communication.

The Company's primary channels of communication with shareholders are by way of its AGM, published and online versions of the Annual Report and Accounts, interim management statements and the Company's website: www.resolution.gg. Investor and analyst briefings, road shows and presentations for the Company's institutional investors are also organised regularly. The team held 133 meetings with investors during 2011.

During the year, the Board received extensive feedback from shareholders through direct interaction with the Chairman, reports provided following meetings with the Company's brokers, and partners and senior members of ROL. Views of shareholders were debated at Board meetings and, in particular, were taken into account in deciding to focus the Company exclusively on the UK Life Project.

Private shareholders are invited to write to the Chairman or any other director and express their views on any issues of concern at any time. The AGM provides an opportunity for private shareholders to put their questions to the Board in person.

## Constructive use of the AGM

Votes on all matters (except procedural issues) at the AGM are taken by way of poll, which means that every vote cast (whether by proxy or made in person) is counted.

The Company holds its AGM in Guernsey, with a simultaneous live broadcast to a venue in London. The broadcast between the two locations facilitates shareholder participation by enabling shareholders in either location to put questions to the Board in Guernsey, and members of the FLG board attending in London.

At the AGM, the Chairman presents an update on performance and current business activities. The Chairmen of the Audit and Risk, Nomination and Remuneration Committees are available at the AGM to take any relevant questions and all other directors attend, unless illness or other pressing commitment precludes them from doing so. The Company proposes a separate resolution on each substantially separate issue.

Representatives from the Company's Registrars, Computershare, attend in both locations to answer any queries and ensure that all valid proxy appointments received are properly recorded and counted. Shareholders who are unable to attend in person are able to vote electronically. Details of how to vote electronically are given on the Company's website: www.resolution.gg and included in the Notice of AGM.

## Statements of compliance with the UK Corporate Governance Code

The Company is committed to maintaining high standards of corporate governance and a sound framework through which the strategy and objectives of the Company are set.

The Company was compliant with the provisions of the Code throughout the year, except for the following areas:

- Principle A.2: there should be a clear division of responsibilities at the head of the Company between the running of the board and the executive responsibility for the running of the Company's business. No one individual should have unfettered powers of decision.

Due to the Company's structure and the existing Operating Agreement with ROL, the Company has a non-executive Chairman and does not have a Chief Executive Officer. The Chairman provides leadership of the Board. There are very clear divisions of responsibilities between the Chairman, SID and the non-executive directors. All of the day-to-day operations of the Group's business are undertaken by the FLG board comprised of a majority of independent non-executive directors.

Therefore the Board considers that no one individual has unfettered powers of decision.

- Supporting principle to Principle B.1: the board should include an appropriate balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.

The Board believes that it is sufficiently balanced with wholly independent non-executive directors. All decisions are made by the Board as a whole or through clear delegated authorities to the FLG board. As previously stated, there are clear lines of responsibility such that no individual or small group of individuals can dominate the Board's decision-making process.

- Code provision D.1.1: in designing schemes of performance-related remuneration for executive directors, the remuneration should follow the provisions in Schedule A to this Code.

The Company does not have any executive directors for whom the Board would design schemes. However, in reviewing and approving remuneration for the FLG executive directors, the Company follows the remuneration provisions in Schedule A.

## Guernsey corporate governance code

Corporate governance of Guernsey companies is overseen by the Guernsey Financial Services Commission, under the Commission's Finance Sector Code of Corporate Governance (the "Guernsey Code") which came into effect on 1 January 2012.

Companies which report against the UK Corporate Governance Code are deemed to meet the requirements of the Guernsey Code. The UK Corporate Governance Code can be found at www.frc.org.uk, and the Guernsey Code is available at www.gfsc.gg

## Risk management and internal control

### Summary

The Board is committed to ensuring that the highest standards of corporate governance are maintained throughout the Group in line with its desired risk awareness culture. It has established robust policies, processes and procedures for the identification and evaluation of the significant risks it faces and for managing those risks across the Group in line with the Group's risk appetite.

The Board has defined its approach to internal control through a number of governance documents and group policies. These set the framework within which the Group operates day-to-day. Specific policy requirements in respect of risk management and internal controls are embedded in the management of the business.

The Board is responsible for the Group's system of risk management and internal control, including financial, operational and compliance controls, and for reviewing its effectiveness. Due to the limitations that are inherent in any system of internal control, it is designed to manage rather than eliminate risk and can only provide reasonable, and not absolute, assurance against material misstatement or loss. In assessing what constitutes reasonable assurance, the Board has regard to materiality and to the relationship between the cost of, and benefit from, internal control systems.

FLG was established in 2009 as the intermediate holding company for businesses acquired under the Company's UK Life Project. The Board has delegated a number of matters to the FLG board. The FLG board has primary responsibility for ensuring that the Group's risk awareness culture and maintenance of a sound system of internal control and risk management are embedded throughout the Friends Life group.

### Risk management

The Board's philosophy underpinning the Group's risk management approach is that it should be designed, implemented and maintained in a manner that supports management's decision-making and helps management to deal effectively with uncertainty. To bring about this outcome the Board has established the following risk management aims, principles and framework.

### Risk management aims

The Group's approach to risk management includes a consistent and robust set of policies, systems, processes, procedures and controls that are aimed at:

- aligning risk appetite and strategy;
- seizing opportunities;
- enhancing risk mitigation decisions;
- reducing operational surprises and losses;
- identifying and managing multiple and cross-Group risks; and
- improving deployment of capital.

### Risk management principles

The Group's risk management approach deals with risks and opportunities affecting value creation or preservation and incorporates the following overall guiding principles:

- the Group has a risk awareness culture with risk management being delivered by the Board of directors, FLG directors and senior management and other personnel across the Group at every level;
- the Board sets and regularly reviews risk appetite, and in doing so, considers the Group's capacity to bear risk and its risk profile;
- the Group has an appropriately consistent, robust and shared set of policies, processes and procedures designed to assist the achievement of its business objectives, allowing for certain processes and procedures to vary across the Group where necessary for different business or operating environments;
- risk is actively considered in making business decisions, including setting strategy and business plans at operating subsidiary board, FLG board and Group level; and
- the process by which risk is identified and managed is kept constantly under review.

In view of the operation of a risk and compliance committee at the FLG board level, the Board is satisfied that a separate risk committee is not required at Group level.

### Risk management framework

The Group's risk management framework is intended to ensure a consistent approach to risk identification, evaluation and management across the Group.

## Group risk management

The Board is responsible for the establishment and maintenance of a sound system of risk management across the Group. In doing so it is supported by ROL in establishing, embedding and operating the risk management framework. The Board places reliance on the FLG board for the oversight of matters specifically delegated to it. Key activities of the Board in ensuring the ongoing effectiveness of the risk management framework and monitoring of risks against risk-appetite include:

- approving the Group's overall risk management framework;
- setting the Group's risk appetite;
- reviewing and overseeing management of the Group's risk profile; and
- receiving reports on, and reviewing the effectiveness of, risk management across the Group.

The Audit and Risk Committee reviews the Company's internal control and risk management systems to assist the Board in fulfilling its responsibilities relating to the effectiveness of those systems. This includes making recommendations to the Board in respect of its risk management framework, risk appetite, risk policies, and risk profile. It also, among other things, supports the Board in ensuring that the financial performance of the Company is properly monitored and reported on by reviewing the Company's financial statements.

During the year the Board agreed a set of quantitative appetite statements for the Group's solvency coverage, cash generation and return on MCEV and the sensitivity of these key metrics to stress conditions. These are complemented by a refined set of qualitative appetite statements to guide the management of operational and reputational risks faced by the Group. In its strategic decision-making the Group balances risk against return in line with the agreed appetite statements.

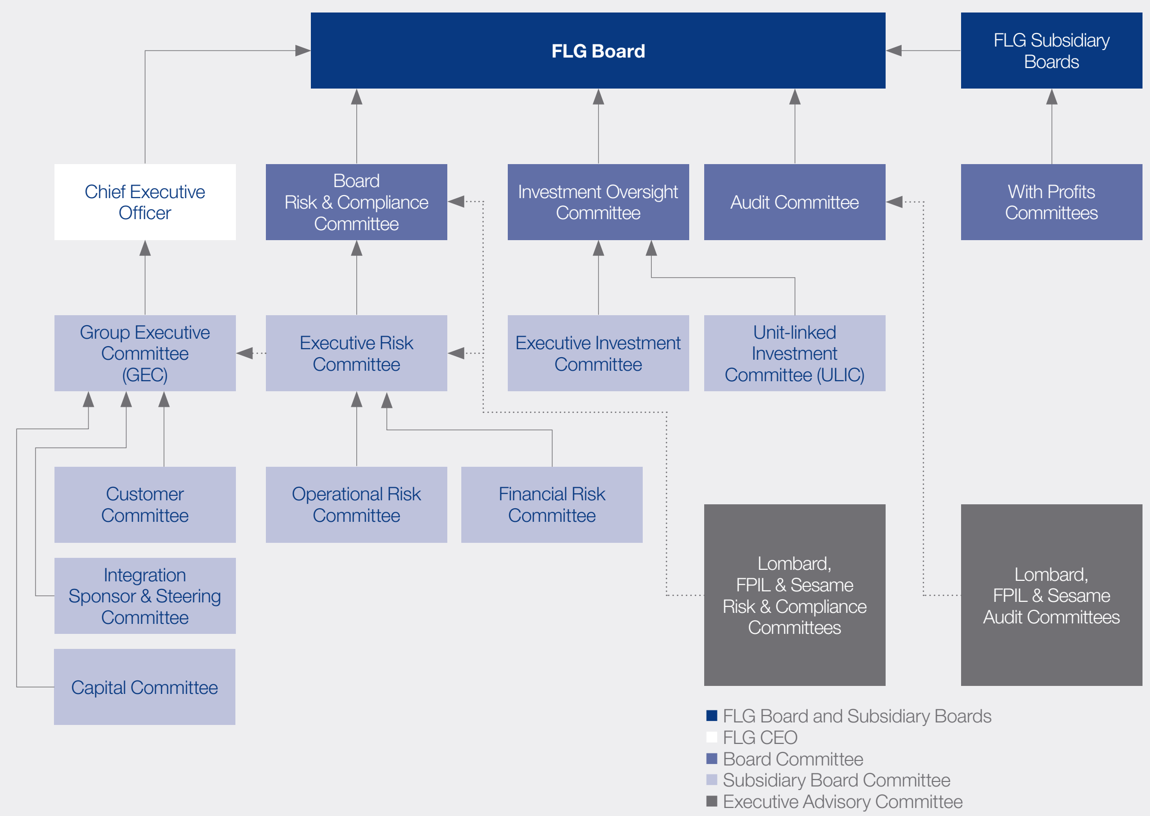
## Friends Life group risk management

The FLG board is responsible for the establishment and maintenance of a sound system of risk management throughout the Friends Life group based on the Company's risk appetite and group policies as adopted by the Board. This includes:

- approval of FLG's risk management policy and framework;
- review and approval of FLG's risk appetite;
- approval of FLG's risk profile; and
- receiving reports on, and reviewing the effectiveness of, risk management within FLG.

FLG's current governance structure for risk management is illustrated below.

### FLG's governance structure for risk management



To strengthen the focus on risk management, the FLG board delegates authority to approve FLG's risk framework and its risk management policies, and to endorse the risk frameworks of the operating subsidiaries to the FLG Board Risk and Compliance Committee ("BRCC"). During 2011 FLG's executive Financial Risk and Operational Risk Committees had oversight of the management of risks across FLG within their respective remits and reported directly to the BRCC.

In January 2012 an Executive Risk Committee ("ERC") was created to bring together consideration of financial and operational risks at executive level prior to their consideration by the BRCC. As illustrated in the governance structure on page 91 the work of the Operational Risk and Financial Risk Committees is now overseen by the ERC.

FLG operates a separate Audit Committee ("FLG AC") to which the group-wide internal audit function reports. The responsibilities of the FLG AC include reviewing the effectiveness of FLG's systems of internal control and financial reporting prior to review by the FLG board, recommending to the FLG board the adoption of group policies, the FLG board control manual (Corporate Governance Handbook) and any FLG group policies.

## Internal control

The Board is responsible for ensuring the maintenance of a sound system of internal control for the Group including:

- receiving reports on, and reviewing the effectiveness of, the Group's risk management and internal control processes to support its strategy and objectives;
- undertaking an annual assessment of these processes; and
- approving an appropriate statement for inclusion in the Annual Report and Accounts.

Through the annual review process, the Board continued to refine the set of group policies first adopted in 2009. The group policies cover the key risk areas that the Board has identified as most important to its business and set minimum standards by which the Board expects each part of the Group to operate, thereby creating a consistent framework for management and governance.

The group policies have been adopted by the FLG board and it oversees the compliance of FLG with the policies. FLG has processes in place to ensure that as new businesses are acquired and the group policies are updated, any gaps are identified and plans developed to address them.

Delegated authorities and the terms of reference of the Board Committees are subject to review following any material acquisition made by the Group, and at least annually, to ensure that they continue to reflect the needs of the Group as it expands.

The Group maintains internal audit, risk and compliance functions with specific responsibilities to audit and review risk management, internal control processes and structures across the Group.

The scope of these reviews and audits is based on assessments of the risk profile of the Company and its principal operating subsidiaries. The results are reported formally to executive management and the relevant committees of FLG and the Company. To ensure independence, the Group Internal Auditor reports to the Chairman of the Audit and Risk Committee in relation to internal audit issues.

The Board reviews this internal control framework on an ongoing basis. In doing so it takes account of internal audit reports, reports from the Group's external auditor and the regular reporting from ROL and FLG to the Board and Audit and Risk Committee.

In addition to relying on these ongoing reporting processes, the Board may commission independent internal control reviews of elements of its business. Typically, this includes reviews of the controls within newly acquired businesses at completion. Consistent with this, an independent review of the processes and controls within BHA was undertaken in 2011. The recommendations for improvement are now being taken forward by FLG.

As part of the half year and year end reporting processes, and consistent with the UK Corporate Governance Code, the Audit and Risk Committee, on behalf of the Board, conducted reviews of the effectiveness of the Group's system of internal control during 2011. The reviews covered all material controls, including financial, operational and compliance controls and risk management systems. As part of the process, members of the FLG and ROL senior management teams reviewed the internal control frameworks within their respective areas of responsibility, and completed written declarations on the status of those frameworks. Any exceptions identified were reported through the structure of risk committees at a local and business unit level with any potentially material exceptions being reported to the Audit and Risk Committee. Actions to address the exceptions identified continue to be monitored by the relevant local audit committee with oversight from the Audit and Risk Committee to ensure they are resolved within the planned timescales.

The Board therefore believes that a sound internal control framework has been in place during 2011, and up to the date of this document consisting of:

- delegated authorities;
- committee terms of reference;
- Group policies;
- risk, compliance and internal audit functions; and
- clearly defined senior management responsibilities.

During the year, the framework has been successful in identifying areas of potential weakness in systems and controls. Where further improvement could be made, timely action is taken to address these points. In line with the requirements of the UK Corporate Governance Code, the Board confirms that there is an ongoing process for identifying, evaluating and managing significant risks faced by the Group, which has been in place throughout the period covered by this report and up to 26 March 2012.

# Board Committee statements

## Audit and Risk Committee Chairman's Statement

This has been my second year as Chairman of the Audit and Risk Committee (the "Committee") and I would like to thank David Allvey, Chairman of the FLG Audit Committee ("FLG AC"), Derek Ross, Chairman of the FLG Board Risk and Compliance Committee ("BRCC"), my Committee colleagues and the hard-working finance and risk teams within ROL and FLG for their valued contribution to the work of the Committee.

The terms of reference of the Committee have been approved by the Board and set out the Committee's responsibility for supervising the integrity of the Group's financial information and for overseeing the assessment of the adequacy of the Group's financial controls and systems of risk management, which it assesses in line with the requirements of the UK Corporate Governance Code. All material controls, including financial, operational, compliance controls and risk management systems fall within the Committee's remit. The Committee's terms of reference can be found on the Company's website: www.resolution.gg

The composition of the Committee has not changed during the year. Committee meetings are scheduled eight times a year and additional meetings are held when necessary. For details of the number of meetings held during the year, and of directors' attendance, see the table on page 87.

The UK Corporate Governance Code requires that at least one member of the Committee should have recent and relevant financial experience. Three members of the Committee, Phil Hodkinson, Mel Carvill and I fulfil this requirement.

The terms of reference of the Committee have been approved by the Board and set out the Committee's responsibility for supervising the integrity of the Group's financial information and for overseeing the assessment of the adequacy of the Group's financial controls and systems of risk management, which it assesses in line with the requirements of the UK Corporate Governance Code.

During the year, the Committee considered the following, among other matters at its meetings:

- IFRS 4 and Solvency II implementation;
- integration of the AXA UK Life Business and BHA;
- the financial and risk impact of FLG's major outsourcing arrangements;
- setting of actuarial assumptions and bases;
- year end and half year reviews;
- reports from the Company's auditors;
- Turnbull and FSA compliance;
- implementation of policies and internal training roll-out on the Bribery Act 2010;
- enhancing and quantifying the Group's key financial risk appetite statements; and
- approval of various Group policies including data retention, change management, anti-financial crime and securities dealing.

The Committee meets with the Company's auditors in private at least twice a year and, at each meeting with the auditors, there is an opportunity to address any concerns or outstanding matters not picked up at formal Committee meetings. The ROL Chief Financial Officer, ROL Chief Risk Officer and Group Internal Auditor routinely attend Committee meetings, and the FLG Chief Executive Officer, FLG Chief Financial Officer, FLG CRO, FLG Group Actuarial Director and other appropriate specialist functional heads attend meetings at my request. To further strengthen communication between the Committee, the FLG AC and the BRCC, members of the Committee regularly attend FLG AC and BRCC meetings. In addition, I have had meetings with both external and internal auditors on a regular basis. The Committee also had oversight of the processes by which the obligation of individual directors to ensure that the auditor was made aware of all relevant information in connection with its audit was satisfactorily discharged.

The Group has a policy on auditor independence including the use of the external auditor for non-audit services, which is reviewed regularly. The policy follows guidance, published by the Auditing Practices Board, on the acceptance of non-audit work by audit firms to address the risks, actual or perceived, to the independence of auditors. The policy specifies a number of permissible services which include due diligence associated with acquisitions, disposals and securitisations, control and assurance reviews and actuarial assistance. Notwithstanding the service being a permissible one, consideration is given to the skills and experience of the audit firm and whether these characteristics make the firm the most suitable supplier, as well as the nature of the work and the potential fee in relation to the total audit fee. All non-audit fees are subject to approval by the Chairman of the FLG AC, me as Committee chairman, or the Committee as a whole, depending on the level of the fee.

Fees paid to the auditor for audit related and non-audit related services are analysed in note 7b on page 139. The main non-audit related services provided by the Company's auditor during the year were in respect of due diligence work for potential acquisitions and services as reporting accountants. The auditor was considered to be best placed to provide these services. The nature and level of all services provided by the external auditor is a factor taken into account by the Committee when it reviews the independence of the external auditor.

The Company is committed to creating a culture of openness where all employees within the Group are able to communicate concerns freely, without fear of detrimental treatment. The framework for this mandate is contained within a whistleblowing policy which sets out the mechanism for implementation and reporting. This policy falls within the remit of the Committee. The Company has appointed an independent third party who will initially document any concerns raised in complete confidence. The individual can also report directly to specified personnel within the Group, should they feel that it is more appropriate. The monitoring of compliance with this policy has been delegated to ROL.

The Committee confirms that it received sufficient, reliable and timely information from management to enable it to fulfil its responsibilities. A member of the Committee will be available at the AGM to respond to any shareholder questions on its activities.

**Tim Wade**
Chairman of the Audit and Risk Committee

26 March 2012

## Remuneration Committee

A separate report on the activities of the Committee and remuneration of directors can be found on pages 96 to 106.

## Nomination Committee Chairman's Statement

The terms of the Nomination Committee (the "Committee") have been approved by the Board and set out the Committee's responsibility for making recommendations on the structure, size and composition of the Board and FLG's board, for considering succession planning, identifying and nominating Board and FLG board candidates, reviewing the leadership needs of the Group and keeping up to date and fully informed of strategy and commercial changes affecting the Group.

The Committee also makes recommendations regarding formulating succession plans for executive and non-executive directors of the Group, Board and FLG board committee membership, and on the re-appointment and re-election of directors.

The composition of the Committee has not changed during the year. Committee meetings are scheduled twice a year and additional meetings are held when necessary. For details of the number of meetings held during the year, and of directors' attendance see the table on page 87.

The Committee's terms of reference can be found on the Company's website: www.resolution.gg

During the year, the Committee considered the following, amongst other matters, at its meetings:

- determined and recommended the appointment to the FLG board of Mary Phibbs and Peter Gibbs as non-executive directors, Andy Briggs as Chief Executive Officer and Tim Tookey as Chief Financial Officer;
- recommended that Tim Wade be elected, and all of the Company's other directors be re-elected, at the Company's AGM; and
- recommended the election to the FLG board of David Hynam, Andy Parsons, Belinda Richards and Karl Steinberg, and the re-election of other FLG directors at the Company's AGM.

A regular review is undertaken by the members of the Committee, FLG board and the FLG executive team to determine whether the Company's or FLG's board would benefit from the appointment of additional directors. Once a vacancy has been identified by the Committee, an external search and selection consultancy is engaged to facilitate the search for candidates. Once a shortlist has been put together, based on a candidate profile and role remit, and candidates have been interviewed by members of the Committee and, if relevant, by FLG's Chairman and ROL partners, a recommendation is made to the Board or the FLG board (as the case may be).

A statement on Board diversity is set out on page 78 of the Directors' report.

**Michael Biggs**
Chairman of the Nomination Committee

26 March 2012

# Remuneration report

## Remuneration Committee Chairman's statement

I am pleased to present the Remuneration Report for 2011, which has been a year of significant change in the personnel leading FLG. The Committee's priority for the year under review has been to ensure that the application of the Company's remuneration policy continues to encourage the delivery of results aligned with long-term sustainability and shareholder value. The Committee has been mindful that executive remuneration has been topical throughout 2011 and is likely to remain so in 2012. It is regularly advised on developments in best practice and has due regard to all relevant guidance (including the UK Corporate Governance Code, the ABI and NAPF guidelines, the FSA's Remuneration Code, Pillar III and CRD IV, and, of course, the recent BIS pronouncements) while seeking to set a remuneration policy which avoids paying more than is necessary and ensuring that variable pay is, so far as possible, directly linked to enhancing shareholder value.

I am grateful for the hard work of colleagues and advisers to the Remuneration Committee during the year and I would like to acknowledge the contribution of the FLG Remuneration Advisory Group ("RAG") for providing the Committee with advice in relation to matters relating to FLG remuneration. RAG comprises independent FLG non-executive directors and is chaired by Sir Malcolm Williamson, the FLG Chairman.

The Committee reviews the structure as well as the overall levels of director compensation, with particular attention to the mix of annual and long-term incentives. It also reviews forward-looking frameworks consistent with delivering the Group's objectives. These frameworks are assessed against market benchmarks to inform the Committee's decision-making when considering aggregate remuneration proposals from management. There have been no material changes to the remuneration frameworks during 2011.

During the year, in respect of executive directors' base salaries, the Committee has continued to have regard to median data for comparative roles. Other elements of the remuneration package are market consistent except that the long-term incentive plan ("LTIP") provides a focused incentive linked to the delivery of value to shareholders based on an Internal Rate of Return ("IRR") performance measure.

The operation of the Remuneration Committee was unchanged in the year. Key matters determined and/or reviewed included:

- remuneration packages of FLG's new Chief Executive Officer and new Chief Financial Officer, which are set out in this report, as well as those of other FLG senior executives;
- exit terms of departing FLG executives;
- LTIP awards;
- bonus payments under the FLG 2010 annual bonus plan;
- RAG terms of reference; and
- framework and performance measures for the FLG 2011 annual bonus plan.

No changes have been made to the fee structure for the non-executive directors of either RSL or FLG.

The Remuneration report has been prepared in line with best practice provisions set out in the UK Corporate Governance Code and taking into consideration Schedule 8 of the Large and Medium sized Companies and Groups (Accounts and Reports) Regulations 2008. The report is divided into the following sections:



The Group's auditor, Ernst & Young LLP, has audited the information contained in the tables on pages 99 to 106 of this report.

The Remuneration Report has been prepared by the Committee and has been approved by the Board for submission to shareholders.

**Gerhard Roggemann**
Chairman of the Remuneration Committee

26 March 2012

## Remuneration Committee overview

The Board has delegated authority to the Committee to provide governance and strategic oversight of remuneration matters within the Group and to determine the actual remuneration of certain individuals. The Committee's principal responsibilities are to:

- set, review and approve remuneration policy;
- determine the individual remuneration packages for the RSL Chairman, the FLG non-executive and executive directors and other FLG executives whose base salary exceeds £200,000 per annum or whose total target remuneration or the value of awards made on recruitment to secure the appointment of an individual exceed pre-set thresholds ("relevant individuals");
- design and determine targets for any performance measures applied to variable elements of the remuneration package operated by the Group, principally the annual bonus scheme and the LTIP;
- measure actual performance against performance measures and determine any consequent award to relevant individuals;
- set the policy for and scope of pension arrangements for relevant individuals;
- set the policy for terms and conditions to be included in service agreements or letters of appointment for relevant individuals;
- determine termination payments and compensation commitments for relevant individuals;
- monitor and reflect, where appropriate, changing market practice and governance requirements; and
- prepare and recommend to the Board the Remuneration Report of the Company.

Although not formally subject to the FSA's Remuneration Code (the "FSA Code"), the Committee acknowledges it is reflective of best practice and seeks to comply with its guidance for 2011.

In carrying out its duties in relation to directors' remuneration, the Committee takes into account the pay and employment conditions of employees in the Group, ensuring that remuneration arrangements are consistent with the Board's approach to, and do not increase the Group's exposure to, risk. For example, the Committee takes into account the overall employee pay review when determining any annual increases to FLG executive directors' salaries. The Committee is also guided by the strategic and financial priorities of the Group as outlined in other sections of the Annual Report and Accounts.

The experience of individual Committee members and the size of the Committee are appropriate to ensure that the Committee maintains its independence to oversee the remuneration policies of the Company. Representatives of ROL and FLG are invited to attend all or part of its meetings. No FLG group employee or RSL director is permitted to participate in discussions or decisions of the Committee relating to his or her own remuneration. Responsibility for determination of pay is set out in the table below:

| Director | Pay determined by |
|---|---|
| RSL Chairman | Remuneration Committee |
| RSL NEDs | RSL Chairman |
| FLG NEDs | Remuneration Committee |
| FLG executives (whose remuneration exceeds certain thresholds) | Remuneration Committee |

Details of Committee membership are set out in the Directors' biographies on pages 80 to 82. All members of the Committee are considered to be independent.

## Advisers

The Committee's work was supported by independent professional advice from Hewitt New Bridge Street. Following changes of personnel at Hewitt New Bridge Street, the Group transferred the appointment to FIT Remuneration Consultants LLP in August 2011. This transfer facilitated the Group's access to the same individuals who had been advising the Group at Hewitt New Bridge Street and reflected the Committee's and RAG's confidence in the quality of advice received, and the benefit of the individuals' detailed knowledge of the remuneration arrangements in the Group. FIT is a member of the Remuneration Consultants Group (the professional association for executive remuneration consultants) and adheres to its code of conduct.

Attendance at Committee meetings is shown in the table on page 87. In line with the requirements of the UK Corporate Governance Code, the Board undertook a review of the effectiveness of the Committee during the year and concluded that the Committee had discharged its responsibilities robustly and effectively. Further details of the performance evaluation process are given on page 86.

## Remuneration policy

The Company's remuneration policy is designed to attract, retain and incentivise high calibre executives, in a manner which aligns their interests with those of the Group and which supports the Company's commercial objectives. The remuneration philosophy is based on seven key principles:

- Alignment: the remuneration arrangements of individuals throughout the organisation should be aligned with the business strategy. Individuals should be focused on delivering the aims and objectives specific to their area of the business.
- Accountability: individual accountability is critical to business success and the remuneration arrangements must reward the desired business and personal behaviour.
- Time horizons: there must be an appropriate balance between short- and long-term remuneration, with a significant proportion of the remuneration of key individuals within FLG focused upon the success of the UK Life Project.
- Transparency: remuneration arrangements must be as transparent as possible, ensuring a clear line of sight to enable each individual to understand the link between their scope to influence the performance of the business, as appropriate to their role, their behaviours and their reward.
- Flexibility: remuneration must be sufficiently flexible to accommodate significant organisational change over time. Transactions within the UK Life Project may have a large impact on the organisation of the business (and, therefore, the behaviour required from individuals).
- Equity and fairness: remuneration arrangements cannot anticipate all potential events, therefore, the Committee retains discretion to make fair and equitable decisions about the remuneration of individuals.
- Shareholder awareness and shareholder value: the remuneration of executive and non-executive directors of both RSL and FLG is fully disclosed to shareholders in the Annual Report and Accounts, and the Remuneration Report is subject to a separate shareholder resolution at the AGM in accordance with the Code.

## Directors' share interests

With the exception of the interests disclosed in the table below, none of the Company's or FLG's directors has any interest in the share capital of the Company or any of its principal subsidiaries.

| | Number of ordinary shares held at 1 January 2011 (or date of joining the Board, if later) | Number of ordinary shares held at 31 December 2011 (or date of leaving the Board, if earlier) | % of issued share capital at 31 December 2011 |
|---|---|---|---|
| **Company directors** | | | |
| Jacques Aigrain | 77,999 | 80,066 | 0.006 |
| Gerardo Arostegui | 90,000 | 90,000 | 0.007 |
| Michael Biggs | 113,487 | 113,513 | 0.008 |
| Mel Carvill | 62,400 | 62,400 | 0.005 |
| Denise Mileham | 18,595 | 18,595 | 0.001 |
| Gerhard Roggemann[1] | 18,000 | 18,000 | 0.001 |
| Tim Wade | 40,000 | 40,000 | 0.003 |
| **FLG directors[2]** | | | |
| Evelyn Bourke | 170,277 | 170,848 | 0.012 |
| Andy Briggs[3] | – | 113,721 | 0.008 |
| Clive Cowdery | – | 240,000 | 0.017 |
| David Hynam | 270 | 270 | 0 |
| Trevor Matthews[4] | 764,003 | 844,935[4] | 0.061 |
| Andy Parsons | 697 | 743 | 0 |
| Robin Phipps | 2,100 | 2,100 | 0 |
| John Tiner | 2,829 | 2,829 | 0.0004 |
| Sir Malcolm Williamson | 47,738 | 51,078 | 0.003 |

1. Gerhard Roggemann also served as a director of FLG during 2011.
2. The FLG executive directors' interests disclosed above include any shares acquired pursuant to participation in the Share Incentive Plan (SIP), the operation of which is explained on page 106. Since the end of the year, Evelyn Bourke has acquired a further 142 shares under the SIP.
3. As part of his terms of joining, as reported on page 100, Andy Briggs received the first of three share transfers on 29 June 2011. 236,920 Resolution shares were allocated but, with his agreement, 123,199 shares were withheld to meet the Income Tax and National Insurance contributions liability so the net number of shares transferred was 113,721 Resolution shares.
4. Trevor Matthews left the FLG board on 2 June 2011.

## Share transfers (to compensate for awards foregone from previous employment)

| Director | Date of award[2] | Vesting date | Contractual entitlement to shares | Shares released during year | Market share price on vesting | Closing balance |
|---|---|---|---|---|---|---|
| Andy Briggs | 29 June 2011 | 29 June 2011 | 236,920 | (236,920) | 293.6p | – |
| | | 1 June 2012 | 236,920 | – | | 236,920 |
| | | 1 June 2013 | 236,920 | – | | 236,920 |
| **Total** | | | 710,760[1] | | | 473,840 |

Notes
1. As reported on page 99, Andy Briggs received the above awards as part of the terms of his joining, to compensate him for awards foregone on leaving his previous employer. The awards are subject to clawback if he resigns or is summarily dismissed before 31 May 2014.
2. A share value of £2.472 was used to determine Andy Briggs' award, based on the average share price when he agreed to join FLG, in January 2011.

## Deferred Share Award Plan

| Director | Date of award[1] | Opening balance 1 January 2011 | Shares awarded during year | Lapsed | Closing balance 31 December 2011 | Vesting date |
|---|---|---|---|---|---|---|
| Evelyn Bourke | 31 March 2011 | – | 4,579 | – | 4,579 | 31 Dec 2013 |
| David Hynam | 31 March 2011 | – | 27,299 | – | 27,299 | 31 Dec 2013 |
| Trevor Matthews | 31 March 2011 | | 80,904 | (80,904)[2] | – | n/a |
| Andy Parsons | n/a | – | – | – | – | n/a |

Notes
1. The Deferred Share Award Plan is the arrangement pursuant to which part of the annual bonus for any year is deferred into shares of the Company and made contingent on continuing employment for a period.
2. Trevor Matthews' awards lapsed on his resignation.
3. The market value of a share on 31 March 2011 was 295.9p.

## Resolution Limited arrangements

### Directors' letters of appointment

The Company's non-executive directors' appointments were confirmed by individual letters of appointment which include a six month notice provision. Details of the directors who served during the year can be found on pages 80 to 82. No compensation is payable to non-executive directors on leaving office. Non-executive directors of Resolution Limited do not have any entitlement to pensions, annual bonuses, share options or long-term incentives.

### Directors' fees

Resolution Limited's non-executive directors receive a fee in respect of the services they provide to the Company. These fees are determined by the RSL Chairman, in consultation with the Chief Executive Officer of ROL, who obtains independent advice from the Group's remuneration consultants. No changes to fee levels for the Company's non-executive directors were made during 2011. The Chairman continues to receive £360,000 per annum in respect of all of his duties, including chairmanship of the Nomination Committee and membership of the Remuneration Committee. All other non-executive directors receive a basic fee of £67,500 per annum, and additional fees for chairmanship or membership of committees as set out in the table below. An additional fee of £25,000 per annum is paid to the SID.

| Committee | Member's fee (£ p.a.) | Chairman's fee (£ p.a.) |
|---|---|---|
| Audit and Risk Committee | 25,000 | 50,000 |
| Remuneration Committee | 15,000 | 30,000 |
| Nomination Committee | 10,000 | N/A |

### Directors' emoluments (this information has been audited)

Resolution Limited non-executive directors' emoluments are set out below.

| | Fees 2011 £'000 | Fees 2010 £'000 |
|---|---|---|
| Jacques Aigrain | 93 | 83 |
| Gerardo Arostegui | 93 | 83 |
| Michael Biggs | 360 | 360 |
| Mel Carvill | 103 | 89 |
| Fergus Dunlop | 93 | 98 |
| Phil Hodkinson | 128 | 143 |
| Denise Mileham | 103 | 108 |
| Peter Niven | 93 | 102 |
| Gerhard Roggemann | 98 | 86 |
| Tim Wade | 118 | 73 |
| **Total** | **1,282** | **1,225** |

## FLG arrangements

### Fee levels for FLG non-executive directors (this information has been audited)

FLG's non-executive directors' fees have been set at a lower level than for the Resolution Limited non-executive directors, reflecting the status of FLG as a subsidiary. No changes to FLG non-executive directors' fee levels have been made during the year. The Chairman of FLG receives a fee of £300,000 per annum. All non-executive directors of FLG receive a basic fee of £60,000 per annum, and additional fees for chairmanship or membership of committees as follows:

| FLG board committee | Member's fee (£ p.a.) | Chairman's fee (£ p.a.) |
|---|---|---|
| Audit Committee | 25,000 | 45,000 |
| Board Risk and Compliance Committee | 15,000 | 30,000 |
| Investment Oversight Committee | 15,000 | 30,000 |

The FLG non-executive directors have consistent letters of appointment to those explained above in respect of the Resolution Limited directors and similarly have no entitlement to additional benefits.

### FLG non-executive directors' emoluments (this information has been audited)

| | Fees 2011 £'000 | Fees 2010 £'000 |
|---|---|---|
| David Allvey | 120 | 113 |
| Peter Gibbs | 35 | – |
| Nicholas Lyons | 115 | 96 |
| Mary Phibbs | 32 | – |
| Robin Phipps | 130[1] | 134 |
| Belinda Richards | 75 | 41 |
| Gerhard Roggemann | 60[2] | 103 |
| Derek Ross | 130 | 104 |
| Karl Sternberg | 90 | 54 |
| Sir Malcolm Williamson | 300 | 273 |
| **Total** | **1,087** | **918** |

Neither Clive Cowdery nor John Tiner received any fees in respect of their non-executive directorship of FLG.

1. Includes a fee of £30,000 received as Chairman of the FLG With-Profits Committee.

2. Gerhard Roggemann was a member of the FLG Audit Committee, Board Risk and Compliance Committee and Investment Oversight Committee until 30 June, 2010, when he ceased to be a member of those committees and became Chairman of the Company's Remuneration Committee.

## Executive directors' service agreements

The model service contract for executive directors of FLG now provides for 12 months' notice by either party. It includes express permission for the employer to terminate without notice and compensation in defined misconduct situations and, in other cases, provides for compensation in respect of fixed remuneration elements only. The Committee endorses the principles of mitigation and does not provide for an enhancement in the event of a change of control. Evelyn Bourke, David Hynam and Trevor Matthews are (or were) employed on legacy contracts, which provide for 12 months' notice by the employer and six months' notice by the director. They include express permission for the employer to terminate without notice and compensation in defined misconduct cases. In other cases, the contracts provide for compensation in respect of salary, benefits and bonus (to the termination date only) in lieu of notice. The employer has the ability to pay any such compensation in instalments taking into consideration any alternative employment obtained. Andy Parsons agreed to step up to the FLG board on an interim basis and has remained on his legacy contract. This provides for six months' notice by either party. It includes express permission for the employer to terminate without notice and compensation in defined misconduct cases. There are no payment in lieu of notice provisions so general principles would apply although the contract does specify the contractual redundancy payment to be paid on a redundancy dismissal.

A summary of the notice periods contained in the service contracts of FLG executive directors who served during the year is set out in the table below.

| Directors | | Date of contract | Notice period due from FLG | Notice period due from director |
|---|---|---|---|---|
| Andy Briggs | Chief Executive Officer (from 1 June 2011) | 27 September 2011 | 12 months | 12 months |
| Trevor Matthews | Chief Executive Officer (until 2 June 2011) | 30 July 2008 | 12 months | 6 months |
| Andy Parsons | Interim Executive Director – Finance | 7 September 2010 | 6 months | 6 months |
| Evelyn Bourke | Chief Commercial Officer | 1 May 2009 | 12 months | 6 months |
| David Hynam | Chief Operating Officer | 15 September 2010 | 12 months | 6 months |

During the year under review, Trevor Matthews resigned. Therefore, the protections set out in his contract explained in last year's directors' Remuneration report did not apply. Trevor Matthews was paid his fixed remuneration for the notice period, did not receive a bonus for 2011 and all LTIP awards and deferred shares lapsed.

## Executive director external appointments

With the specific approval of the FLG board, FLG executive directors may accept external appointments as non-executive directors of other companies and retain any related fees paid to them. With the exception of Evelyn Bourke, no FLG director received a fee in relation to external appointments in 2011. Fees of £34,258 were paid to and retained by Evelyn Bourke in respect of her directorship of The Children's Mutual for the year ended 31 December 2011.

## Executive director arrangements for 2011

This section of the report provides details of the remuneration of the executive directors of FLG during 2011, who were:

- Andy Briggs, Chief Executive Officer (appointed 1 June 2011)
- Evelyn Bourke, Chief Commercial Officer
- David Hynam, Chief Operating Officer
- Andy Parsons, Interim Executive Director – Finance
- Trevor Matthews, Vice Chairman (from 1 June 2011, formerly Chief Executive Officer, resigned 2 June 2011)

## 2011 base salary, benefits and bonus (this information has been audited)

| | Base Salary £'000 | Benefits in Kind £'000 | Pension Allowance £'000 | Total Annual Bonus[6] £'000 | Other £'000 | Total 2011 £'000 | Total 2010 £'000 |
|---|---|---|---|---|---|---|---|
| Evelyn Bourke | 450 | 14 | 64 | 333 | – | 861 | 729 |
| Andy Briggs | 352[1] | 20 | 70 | 353 | 237[2] | 1,032 | – |
| David Hynam | 400 | 13 | 54 | 539 | – | 1,006 | 1,080 |
| Trevor Matthews | 300[3] | 18 | 50 | – | 491[4] | 859 | 1,505 |
| Andy Parsons | 300 | 9 | 39 | 194 | 190[5] | 732 | 157 |

Notes

1. From 1 June 2011 based on a salary of £600,000 per annum.
2. On appointment, Andy Briggs received an award of £236,500 payable in cash and 236,920 Resolution Limited shares (which had a value of £585,666 when the conversion ratio was set on 24 January 2011 being the date he agreed to join FLG). He will receive a further £124,500 on each of the first and second anniversaries of his joining and a further 236,920 shares vesting on each of the two anniversaries. All of these sums were to compensate for awards lost from his previous employer as a result of his joining FLG. The Committee is satisfied that these payments were appropriate and not excessive and has protected the Company's position by providing for full clawback if Andy Briggs resigns or is summarily dismissed before the third anniversary of his joining. The cash amount paid on joining is included in the emoluments table. The outstanding share awards are included in the table on page 100. The outstanding cash sums will be included in subsequent emoluments at the time they are released to him.
3. Until 31 May 2011 based on salary of £720,000.
4. £441,475 was paid to Trevor Matthews as the fixed remuneration for his six month notice period. In addition, he received £49,655 as a payment in lieu of holidays. In addition, FLG settled £38,405 in legal fees incurred for his exit arrangements.
5. Andy Parsons was paid £190,000 pursuant to an arrangement made at the time of his transfer from AXA UK, which was disclosed last year.
6. The above table includes the full bonus earned in respect of the financial year, including any element which will be deferred into shares. The table on page 100 shows the amounts outstanding which have been deferred in respect of previous years. One-third of the bonus included in the above table will be similarly deferred.

## 2011 bonus arrangements

With the exception of Evelyn Bourke, 60% of the 2011 bonus entitlement has been assessed according to corporate performance targets, which are designed to support the objectives of the UK Life Project. Evelyn Bourke's 2011 bonus has a 50% weighting to these corporate performance measures. The balance of the bonus is determined by reference to performance against Individual Key Performance Indicators. These typically include financial, customer, risk management, people management and business improvement targets.

The Committee assessed performance against these criteria at the year end. The corporate performance measures, their relative weightings and performance against these measures are shown in the table opposite.

| Measure | Weighting | % achieved (Max 100%) |
|---|---|---|
| Cash generation before tax | 30% | 71.7% |
| IRR on New Business | 20% | 36.9% |
| MCEV operating profit before tax | 25% | 15.6% |
| Synergy Realisation | 15% | 100.0% |
| Total UK Expenses | 10% | 88.4% |
| **Total** | **100%** | **56.7%** |

The table below shows the degree of achievement of the 2011 bonus targets for each executive directors' 2011 bonus plus the actual bonus paid as a percentage of salary. Two-thirds of the 2011 bonus will be paid in cash with the remaining third payable in deferred shares.

| 2011 Bonus Element | Evelyn Bourke | Andy Briggs | David Hynam | Andy Parsons |
|---|---|---|---|---|
| Financials | 28.3% (Max 50%) | 34% (Max 60%) | 34% (Max 60%) | 34% (Max 60%) |
| Individual | 33.3% (Max 50%) | 33.3% (Max 40%) | 33.3% (Max 40%) | 20% (Max 40%) |
| **Total** | **61.7% (Max 100%)** | **67.3% (Max 100%)** | **67.3% (Max 100%)** | **54% (Max 100%)** |
| | | | | |
| 2011 Maximum Bonus (as a % of salary) | 120% | 150% | 200% | 120% |
| **2011 Actual Bonus (as a % of salary)** | **74%** | **101%** | **134.65%** | **64.8%** |

## 2012 bonus arrangements

The performance criteria for the 2012 annual bonus will be based on a balanced scorecard approach as set out in the table below:

| Type | Measure | 2012 Weighting |
|---|---|---|
| Financial | Cash generation before tax | 20% |
| | IRR on New Business | 15% |
| | MCEV operating profit before tax | 15% |
| | Group Operating Expenses | 10% |
| Customer | Customer Index | 8% |
| Colleague | Colleague Engagement | 6% |
| Risk & Control | Risk Index | 6% |
| Individual | Individual Key Performance Indicators | 20% |

The details above form the 2012 bonus arrangements for all FLG executive directors although, for Evelyn Bourke, the financial element will be partially linked to her divisional unit performance as well as Friends Life group performance. For the other executive directors, the financial element of their 2012 bonus will be solely based on the Friends Life group's performance.

## Summary of FLG executive director arrangements for 2012

| | Purpose | Policy | Operation |
|---|---|---|---|
| **FIXED ELEMENTS** | | | |
| Base salary | • To recruit and retain key employees | • To set base salaries competitively when assessed against companies of a similar size in terms of market capitalisation<br>• The Committee believes it is appropriate to consider all relevant factors when setting executive directors' salaries rather than simply following data but has due regard to median data for FTSE31-100 companies | • Paid monthly in cash |
| | • Reflect individual's role and responsibility within FLG | • Take into account FLG performance, and individual performance and responsibilities<br>• Review base salaries of executive directors in the context of the wider employee pay review | • Salary reviews will take place annually in April<br>• No base salary increases were implemented for executive directors in April 2011 or in April 2012 |
| Pension | • Provide a framework to save for retirement | • Provide market competitive post-retirement benefits within a defined contribution scheme | • All executive directors are eligible to participate in the FLG pension plan ('FPP')<br>• New Executive directors receive up to 20% of salary either into a registered pension or, at their choice, as a salary supplement (which is not taken into account for bonus or insured benefits purposes)<br>• Executive directors with a service contract pre-January 2011 participate in the FPP on the standard employee terms for salary up to the notional earnings cap (£129,600 for 2011/12 tax year) and 20% of any salary above the notional earnings cap |
| Benefits in Kind | • Provide other benefits valued by recipient | • Provide market competitive benefits in kind | • Car allowance, chauffeur expenses (for CEO only) and medical insurance |
| **VARIABLE ELEMENTS** | | | |
| Annual bonus | • Incentivise executives to achieve key goals on an annual basis | • Maximum awards are set broadly in line with FTSE 100 market practice | • Measured annually, with bonus levels determined by the Committee following the year end based on performance against set targets<br>• Paid in one tranche (less the deferred share award) in March following the year end<br>• Payments are subject to clawback in certain circumstances |
| | • To focus on the key financial metrics of the business and performance against a set of individual objectives | • Target bonus opportunities are 50% of the maximum award | • Performance assessed against a number of financial and strategic corporate targets as well as individual performance |
| | | | • The maximum bonus for the CEO has been increased to 175% of base salary<br>• The maximum bonus for the CFO (who joined in March 2012) is 150% of base salary<br>• For the COO, the bonus maximum was agreed on his appointment at 200%<br>• For the Chief Commercial Officer, the maximum is 120% |
| | | • One-third of any annual bonus paid to be deferred into shares for a period of three years | • 2012 criteria built around a balanced scorecard with 60% of opportunity linked to financial performance, 20% to non-financial KPIs and 20% linked to personal and strategic objectives |
| LTIP | • To act as the sole long-term incentive arrangement for the duration of the UK Life Project | • Awards entitle participants to the difference between the value realised from the UK Life Project and the aggregate cost of the acquisitions | • Initial awards were made in March 2010 |
| | • Incentivise key individuals over the longer term in a way which is aligned with the strategy of RSL and the delivery of value to shareholders | • The total value of the pool available for distribution to participants is 2% of the increase in value of the UK Life Project (the Company will also bear employers' NICs in addition to the 2%) | • Subsequent awards have been made to key individuals who joined FLG following the acquisition of the AXA UK Life Business<br>• "Bad leavers" lose unvested awards |
| | • Retain key individuals during the UK Life Project | • An IRR of 12% p.a. over the life of the UK Life Project must be achieved before any realised value is delivered to participants<br>• Top up awards may be made during the life of the plan to individuals identified as high performers and critical to the business | • Awards to new joiners will normally be pro-rated to take into account that they have joined part-way through the UK Life Project<br>• If an amount becomes due under an award, it will generally be paid in three tranches. One-third at the time the entitlement arises and the remaining two-thirds in equal instalments after 12 and 24 months<br>• Initial awards made to executive directors have ranged between 1.5% to 11% of the pool |

## Arrangements for Tim Tookey

Tim Tookey, who will take up his position as Chief Financial Officer of FLG on 30 March 2012, joined the board on 5 March 2012 with a salary of £650,000, standard benefits (consistent with other executive directors at FLG) and a maximum bonus potential of 150%. Although the Committee recognises that this salary is above the median for the FTSE31-100, Tim Tookey was previously with Lloyds Banking Group where his package was set by reference to FTSE20 companies. The Board felt that it was in the interests of shareholders to recruit an experienced Finance Director of the highest calibre for FLG and the Committee needed to set his package by reference to his previous levels of pay. Overall, his fixed remuneration was reduced slightly as a result of accepting the position with FLG.

In addition, to compensate Tim Tookey for the loss of awards from his previous employer which he forfeited as a result of joining FLG, he will receive £411,213 in cash and 141,116 Resolution shares on 28 March 2012, followed by further awards of Resolution shares on 5 March 2013 and 2014, of 96,037 and 331,348 shares respectively. All of these sums reflected a conservative valuation of the amounts he forfeited from his previous employer. These amounts will be subject to clawback if he voluntarily resigns or is subject to summary dismissal before the third anniversary of his joining.

## Long-term incentive plan ("LTIP")

A LTIP was established early in 2010, the key features of which are set out in the table on page 105. The LTIP creates a profit pool which is divided into a maximum of 10,000 units (under which 75% has been allocated to participants). Participants are allocated a number of units dependent on their role. The number of units awarded is disclosed in the table opposite. With the exception of Evelyn Bourke, those awards will be time pro-rated to reflect the length of service of the participant relative to the duration of the UK Life Project from November 2009 unless otherwise agreed. If exit from the UK Life Project is achieved through more than one transaction, then:

- no award will vest until the threshold under the LTIP rules is achieved; and
- awards will not be pro-rated to reflect an early disposal for participants who cease to be employees of the Group or the transferred business.

| FLG executive director | Total units | Notes |
|---|---|---|
| Andy Briggs* | 1,500 | 1,100 awarded on joining, and a further 400 agreed |
| Evelyn Bourke | 700 | |
| David Hyman | 500 | |
| Trevor Matthews | 1,000 | Lapsed and returned to pool |
| Andy Parsons | 150 | |
| Tim Tookey* | 1,200 | Award agreed but still to be made |

*The Committee agreed that the impact of pro-rating would not reduce the units vesting to less than 50% provided the individual remains employed and not under notice at exit.

Executive directors of FLG will not be entitled to participate in any other executive long-term remuneration arrangements.

## Share incentive plan (SIP)

During 2011, the Group continued to operate an HMRC approved SIP which is open to all employees including executive directors. The Company operates the Partnership Shares (whereby participants may purchase up to £1,500 worth of shares out of their pre-tax salary in a tax year) and Dividend Shares (whereby any dividends paid on shares held in the SIP may be delivered in the form of shares) elements only and the Company does not finance any gifts of shares although the legislation permits such additional awards.

## Performance graph

The performance graph is included to provide a guide to shareholders' return from a hypothetical £100 holding in the Company's shares from 1 January 2009 to 31 December 2011. The FTSE 100 has been chosen as being the most relevant comparator index.

**Total shareholder return index**


Source: Thomson Reuters

On behalf of the Board

**Gerhard Roggemann**
Chairman of the Remuneration Committee

26 March 2012

# Corporate responsibility

## Overview

The Board has reaffirmed its commitment to complying with industry best practice in corporate responsibility as the UK Life Project has progressed. The Corporate Responsibility Committee, led by the Board's SID, Phil Hodkinson, has responsibility for ensuring this commitment is met and has reported considerable progress in unifying policy and practice across the Group in 2011.

The Committee, which also comprises the ROL Head of Secretariat and the corporate responsibility director, met seven times during the year. Its main activities included updating the Group Corporate Responsibility Policy in line with developments in best practice, undertaking a materiality analysis to guide future strategy and steering the Group's corporate responsibility programme.

The Corporate Responsibility Policy was updated to reflect the Bribery Act and UN Special Representative John Ruggie's Guiding Principles for Business and Human Rights. The Policy forms part of the Company's risk management and internal control processes, and is overseen by the Audit and Risk Committee. Details of the materiality analysis and corporate responsibility programme are set out below.

Reflecting the Company's desire to meet best practice, Phil Hodkinson also represented the Company on the board of the leading business-led charity, Business in the Community.

## Materiality analysis

During 2011, the Company commissioned Forum for the Future ("Forum") to outline the environmental, social and governance trends that are likely to have a material impact on the Company's activities during the lifetime of its restructuring project. Forum is a leading not-for-profit organisation working globally with business and government to create a sustainable future.

Forum concluded that many of the trends it identified could not simply be labelled "CR" as they directly impacted the Company's core strategy, noting that "customers expect evidence of value for money, institutional investors focus more on long term drivers of value, governments require more innovative solutions to help build a more resilient society, new technology enables more active communication, and stakeholders demand greater transparency of companies' operations".

The Corporate Responsibility Committee has incorporated the outcome of this materiality analysis into the Company's strategic corporate responsibility framework, which guides the format of the remainder of this report.

## Corporate responsibility within the business

Encouraging corporate responsibility best practice in acquired and restructured businesses is part of the Company's strategy for maximising their value. Set out below are a commentary and key performance indicators for the Group's first year as a combined business.

### Customers

Throughout the UK Life Project, the Group has ensured that it has maintained the same high quality of service to its five million customers and has been guided by the principles of Treating Customers Fairly, a regulatory initiative, which is implemented under the auspices of the FLG Customer Committee.
The Company seeks to add value to members of income protection and pension schemes through additional services including partnerships with the leading charities, MIND and Life Academy, to help members better understand what they have and where they can go for further information. The Group has also continued to offer socially responsible investment solutions for customers who wish to invest in line with their ethical principles.

### People

Following the creation of FLG, a review was undertaken to standardise employment policies covering flexible working provisions, diversity, health, and well-being. In support of the financial and personal well-being of employees and contractors working on the Group's sites in the UK, the Board committed to adopt the Living Wage. The Living Wage aims to take account of real living costs for essential goods and services, as opposed to the national minimum wage, which is a legal price floor set by the Government. Towards the end of last year, a major partnership with the UK-based outsourcing specialist, Diligenta, was announced. The 15 year outsourcing agreement will reduce costs and provide greater clarity and certainty over service delivery. It is expected that 1,900 employees will transfer to Diligenta under The Transfer of Undertakings (Protection of Employment) Regulations, which preserve, as far as is practicable, their existing terms and conditions of employment. An outsourcing charter with the union Unite provides a framework for managing such structural change. The Group conducts annual employee opinion surveys to measure employee engagement, and the survey results in 2011 were lower than the industry benchmark. This was expected during a year which saw significant ongoing change across the business. The FLG executive management team is aiming to increase the engagement index in future surveys.

## Environment

In 2011, the Group was re-accredited against the Carbon Trust Standard, reflecting its long-term commitment to carbon management. This included a behaviour change programme in association with the charity Global Action Plan, which enables employees to drive environmental improvements. Also, for the first time, emissions associated with business air travel were offset. The Group participated in the Carbon Disclosure Project, both as a signatory and as a reporting company. The overall carbon footprint for the Group was established as 27,100 tonnes $CO_2$, which equates to an intensity of 0.18 tonnes per $m^2$ or 4.72 tonnes per employee. Besides energy consumption, the Company seeks to manage waste and water. In 2011, 56% of waste was recycled, the remaining 2,160 tonnes going to landfill. Total water consumption was 89,900 $m^3$, which equates to an intensity measure of 15,600 litres of water per employee.

## Community

The total community investment in 2011 was £1,487,000, measured according to London Benchmarking Group guidelines. Employees volunteered 6,000 hours in company time and raised over £40,000 for the Company's charitable partner Macmillan Cancer Support.

## Responsible investment

The Group has £108 billion of funds under management. The Group is aware of its duty to invest responsibly and ensure that the management of ethical, social and governance ("ESG") factors are incorporated into the investment decision-making process. Such factors are now embraced by the UK Stewardship Code, which encourages asset managers to research and analyse ESG factors, engage in dialogue with companies to encourage responsible business practice and vote all shareholdings. Both the Group's major asset management houses are signatories to the Code.

## Participation in industry initiatives, public policy and regulation

The life assurance industry is facing a period of unprecedented change. Issues such as increased longevity, the lack of a savings culture, high levels of household debt and the fragile economic conditions continue to contribute to a challenging operating environment. It is essential that the Government and industry collaborate to try to find solutions to these long-term public policy issues. During the year, the Group worked with the Government directly through ministerial meetings, conferences and participation in Select Committee hearings, and indirectly through various trade bodies most notably the ABI. In 2011 a large number of government consultations concluded, paving the way for significant developments in 2012, including the introduction of the Retail Distribution Review, changes to the regulatory architecture, auto-enrolment and the introduction of the Financial Services Bill.

# Governance and transparency

## Governance of With-Profit Funds

Various safeguards exist to maintain an appropriate balance between the interests of with-profit policyholders and shareholders. As required by the industry regulator, the Group publishes Principles and Practices of Financial Management ("PPFM") which set out how it will ensure fairness between these with-profits policyholders and shareholders. An FLG With-Profits Committee, chaired by Robin Phipps, a non-executive director of FLG, is responsible for overseeing adherence to PPFM and that discretion in the management of the Group's with-profits funds is exercised consistent with treating customers fairly. The With-Profits Committee reports annually to the FLG board, and publishes its report on FLG's website.

## Taxation

The Company recognises that the taxation of Company profits and its activities in each of the countries in which it operates helps to fund the infrastructure and welfare support systems of those communities. Taxation thus represents an important contribution by the Group to those communities.

The decision to establish the Company as a Guernsey based company, with its head office in St Peter Port, was based primarily on the grounds that the modern, robust solvency laws of Guernsey offer the Company greater flexibility both to buy and to sell operations in a manner consistent with its strategy at the time than would be possible in many other jurisdictions, including the UK.

Despite the generally low tax rate currently applicable to Guernsey companies, the Company's being resident in Guernsey does not reduce the tax paid by its operating businesses, which are based predominantly in the UK and elsewhere in the EU. The Friends Life group, which produces 99% of total Group profits, continues to pay tax on profits in the UK and elsewhere in the EU in the same way today as it did prior to acquisition. According to the Company's analysis, being based in Guernsey rather than the UK will result in the same or more tax being paid in the UK in respect of 2011.

## Guernsey Community

The Company has established a Community Committee in Guernsey, led by Peter Niven, a Non-executive Director. The Committee ensures the Company plays an active role in the community and contributes positively to the local economy. The Committee has agreed to support Floral Guernsey for the next three years.

Separately, the Group also donated to the Disaster Emergency Committee's East Africa Appeal following the region's worst droughts for 60 years, and supported Changing Faces, the UK-based charity giving support and information to people with disfigurements.

In addition, funds were donated to Young People Guernsey, a Guernsey charity that provides information, advice and counselling to young people aged 11–16 years, in conjunction with Barnardo's.

The activities described in this report do not include the work of the Friends Provident Foundation or the Resolution Foundation, both of which operate independently of the Group.

## Measurement

The Company maintained its membership of FTSE4Good, achieving an overall rating of 94%. The Company also participated in the Dow Jones Sustainability Index and scored 11 percentage points above the industry average, though still 12 percentage points away from qualifying for the Index. This reflected an increase on both the number of entries and the level of competition. The Company is currently analysing how it might improve its ratings.

## Assurance

The carbon emissions and community investment data has been independently verified. AECOM Sustainable Development Group has undertaken verification based on the process outlined in the Greenhouse Gas Protocol and includes a rigorous examination of the methods used to record, collate, calculate and audit greenhouse gas emissions reporting. Corporate Citizenship, the global consultancy, has also provided assurance to the Company's community investment data in accordance with the London Benchmarking Group model. The work undertaken by Forum for the Future has also provided assurance to the Board that the corporate responsibility programme is consistent with the principles of relevance and inclusivity.

More information is available on the Company's website: www.resolution.gg

# IFRS financial statements

# Independent auditor's report to the members of Resolution Limited

We have audited the Group consolidated financial statements of Resolution Limited for the year ended 31 December 2011 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of IFRS based operating profit, the consolidated statement of financial position, the consolidated statement of changes in equity, the consolidated statement of cash flows and the related notes 1 to 41. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards as adopted by the European Union (IFRS).

This report is made solely to the Company's members, as a body, in accordance with the provisions of our engagement letter dated 8 July 2011 and Section 262 of the Companies (Guernsey) Law, 2008. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

## Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 79, the Directors are responsible for the preparation of the Group financial statements and for being satisfied that they give a true and fair view. The Directors are responsible for the preparation of the Corporate governance report and Remuneration report.

Our responsibility is to audit and express an opinion on the Group financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Notwithstanding the Company's incorporation in Guernsey, the Company has also instructed us to:

- review the Directors' statement on going concern which, for a listed UK-incorporated company, is specified for review by the Listing Rules of the Financial Services Authority; and
- audit the section of the Directors' remuneration report that has been described as audited and state whether it has been properly prepared in accordance with the basis of preparation described therein.

## Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

## Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Group's affairs as at 31 December 2011 and of its loss for the year then ended;
- have been properly prepared in accordance with IFRS; and
- have been prepared in accordance with the requirements of the Companies (Guernsey) Law, 2008.

## Opinion on other matters

In our opinion the part of the Directors' remuneration report that has been described as audited has been properly prepared in accordance with the basis of preparation as described therein.

We have reported separately on the parent company financial statements of Resolution Limited for the year ended 31 December 2011.

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

We have nothing to report in respect of the following:

Under the Companies (Guernsey) Law, 2008 we are required to report to you if, in our opinion:

- proper accounting records have not been kept; or
- the financial statements are not in agreement with the accounting records; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review the part of the Corporate Governance Statement relating to the Company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review; and

The Directors' statement, set out on page 79, in relation to going concern, which the Company has requested that we review.

**John Headley**
for and on behalf of Ernst & Young LLP
London
26 March 2012

1. The maintenance and integrity of Resolution Limited's website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# Consolidated income statement

**For the year ended 31 December 2011**

| | Notes | 2011[ii] £m | 2010[iii] £m |
|---|---|---|---|
| **Revenue** | | | |
| Gross earned premiums | 3 | **2,128** | 1,288 |
| Premiums ceded to reinsurers | 3 | **(599)** | (241) |
| Net earned premiums | 3 | **1,529** | 1,047 |
| Fee and commission income and income from service activities | | **771** | 751 |
| Investment return | 4 | **1,804** | 8,426 |
| **Total revenue** | | **4,104** | 10,224 |
| **Other income** | 3 | **134** | 891 |
| **Claims, benefits and expenses** | | | |
| Gross claims and benefits paid | 5 | **(3,859)** | (2,004) |
| Amounts receivable from reinsurers | 5 | **643** | 322 |
| **Net claims and benefits paid** | 5 | **(3,216)** | (1,682) |
| Change in insurance contracts liabilities | | **216** | (891) |
| Change in investment contracts liabilities | 29 | **495** | (5,863) |
| Transfer from/(to) unallocated surplus | | **484** | (4) |
| Movement in net asset value attributable to unit-holders | 32 | **48** | (139) |
| **Movement in policyholder liabilities** | | **1,243** | (6,897) |
| Acquisition expenses | 6 | **(591)** | (392) |
| Administrative and other expenses | 7 | **(1,776)** | (1,061) |
| Finance costs | 10 | **(165)** | (127) |
| **Total claims, benefits and expenses** | | **(4,505)** | (10,159) |
| Share of loss of associates and joint venture | 18 | **(1)** | – |
| **(Loss)/profit before tax from continuing operations** | | **(268)** | 956 |
| Policyholder tax | 11 | **(220)** | (244) |
| **(Loss)/profit before shareholder tax from continuing operations** | | **(488)** | 712 |
| Total tax credit/(charge) | 11 | **237** | (136) |
| Policyholder tax | 11 | **220** | 244 |
| Shareholder tax | 11 | **457** | 108 |
| **(Loss)/profit for the year** | | **(31)** | 820 |
| Attributable to: | | | |
| Equity holders of the parent[i] | | **(62)** | 765 |
| Non-controlling interests | | **31** | 55 |
| **(Loss)/profit for the year** | | **(31)** | 820 |

| Earnings per share from continuing operations | | 2011 pence | 2010 pence |
|---|---|---|---|
| Basic earnings per share | 13 | **(4.35)** | 81.10 |
| Diluted earnings per share | 13 | **(4.35)** | 80.47 |

(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 WLUK from 7 November 2011.
(iii) The consolidated income statement for the year ended 31 December 2010 includes the results of the acquired AXA UK Life Business from 3 September 2010.

The notes on pages 118 to 214 form an integral part of these financial statements

# Consolidated statement of comprehensive income

**For the year ended 31 December 2011**

| 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)** |
| Shadow accounting(ii) | **(1)** | **–** | **(1)** |
| 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)** |

| For the year ended 31 December 2010 | Equity holders of the parent £m | Non-controlling interests £m | Total £m |
|---|---|---|---|
| Profit for the year | 765 | 55 | 820 |
| Actuarial losses on defined benefit schemes | (46) | – | (46) |
| Foreign exchange adjustments(i) | (6) | – | (6) |
| Shadow accounting(ii) | (3) | – | (3) |
| Aggregate tax effect of above items | 25 | – | 25 |
| Other comprehensive loss, net of tax | (30) | – | (30) |
| Total comprehensive income, net of tax | 735 | 55 | 790 |

(i) Foreign exchange adjustments relate to the translation of overseas subsidiaries.
(ii) Shadow accounting relates to £2 million (2010: £3 million loss) in respect of foreign exchange adjustments on translation of overseas subsidiaries held by the with-profits fund of FLL and £3 million loss (2010: nil) in respect of revaluation of owner-occupied properties.

# Consolidated statement of IFRS based operating profit

**For the year ended 31 December 2011**

| | Notes | 2011 £m | 2010 £m |
|---|---|---|---|
| **(Loss)/profit before tax from continuing operations** | 3 | **(268)** | 956 |
| Policyholder tax | 11 | **(220)** | (244) |
| Returns on Group-controlled funds attributable to third parties | | **–** | (23) |
| **(Loss)/profit before tax excluding returns generated within policyholder funds** | | **(488)** | 689 |
| Non-recurring items | 3 | **180** | (787) |
| Amortisation and impairment of acquired value of in-force business | 14 | **675** | 364 |
| Amortisation of other acquired intangible assets | 14 | **84** | 64 |
| Interest payable on STICS | 37 | **(31)** | (31) |
| Short-term fluctuations in investment return | | **261** | (24) |
| **IFRS based operating profit before tax** | | **681** | 275 |
| Tax on operating profit | | **38** | 16 |
| **IFRS based operating profit after tax attributable to equity holders of the parent**(i) | | **719** | 291 |

| Earnings per share | | 2011 pence | 2010 pence |
|---|---|---|---|
| Operating earnings per share | 13 | **50.43** | 30.85 |

(i) IFRS based operating profit excludes: (a) investment variances from expected investment return for non-linked business which is calculated on a long-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. Further details of the calculation of the long-term rate of return are included in note 4 (b). 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 2011**

| As at 31 December | Notes | 2011 £m | 2010 £m |
|---|---|---|---|
| **Assets** | | | |
| Pension scheme surplus | 8 | **20** | 22 |
| Intangible assets | 14 | **4,847** | 5,140 |
| Property and equipment | 15 | **58** | 46 |
| Investment properties | 16 | **3,015** | 3,189 |
| Investments in associates and joint venture | 18 | **37** | 32 |
| Deferred tax assets | 22 | **–** | 4 |
| Financial assets | 19 | **103,636** | 99,445 |
| Deferred acquisition costs | 20 | **643** | 358 |
| Reinsurance assets | 21 | **3,213** | 2,637 |
| Current tax assets | | **6** | 22 |
| Insurance and other receivables | 23 | **1,140** | 976 |
| Cash and cash equivalents | 24 | **8,791** | 9,288 |
| Assets of operations classified as held for sale | 39 | **–** | 1,206 |
| **Total assets** | | **125,406** | 122,365 |
| **Liabilities** | | | |
| Insurance contracts | 26 | **37,264** | 35,081 |
| Unallocated surplus | | **652** | 1,098 |
| Financial liabilities: | | | |
| – investment contracts | 29 | **75,191** | 72,411 |
| – loans and borrowings | 30 | **1,195** | 1,212 |
| – amounts due to reinsurers | 31 | **1,800** | 1,666 |
| Net asset value attributable to unit-holders | 32 | **1,173** | 1,173 |
| Provisions | 33 | **228** | 221 |
| Deferred tax liabilities | 22 | **872** | 1,115 |
| Current tax liabilities | | **20** | 11 |
| Insurance payables, other payables and deferred income | 34 | **1,016** | 903 |
| Liabilities of operations classified as held for sale | 39 | **–** | 925 |
| **Total liabilities** | | **119,411** | 115,816 |
| **Equity attributable to equity holders of the parent** | | | |
| – Share capital | 35 | **4,128** | 4,317 |
| – Other reserves | 36 | **1,544** | 1,910 |
| | | **5,672** | 6,227 |
| Attributable to non-controlling interests | 37 | **323** | 322 |
| **Total equity** | | **5,995** | 6,549 |
| **Total equity and liabilities** | | **125,406** | 122,365 |

The financial statements were approved by the Board of directors on 26 March 2012.

**Fergus Dunlop**
Director

# Consolidated statement of changes in equity

**For the year ended 31 December 2011**

| | Attributable to equity holders of the parent | | | | |
|---|---|---|---|---|---|
| For the year ended 31 December 2011 | 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 | – | 6 | 6 | – | 6 |
| **At 31 December 2011** | **4,128** | **1,544** | **5,672** | **323** | **5,995** |

| | Attributable to equity holders of the parent | | | | |
|---|---|---|---|---|---|
| For the year ended 31 December 2010 | Share capital £m | Other reserves £m | Total £m | Non-controlling interests £m | Total £m |
| At 1 January 2010 | 2,349 | 1,306 | 3,655 | 615 | 4,270 |
| Profit for the year | – | 765 | 765 | 55 | 820 |
| Other comprehensive loss | – | (30) | (30) | – | (30) |
| Total comprehensive income | – | 735 | 735 | 55 | 790 |
| Dividends paid | | (144) | (144) | (7) | (151) |
| Interest paid on STICS | – | – | – | (31) | (31) |
| Appropriations of profit | – | (144) | (144) | (38) | (182) |
| Tax relief on STICS interest | – | 9 | 9 | – | 9 |
| Shares issued in lieu of dividend | 9 | – | 9 | – | 9 |
| Disposals of businesses | – | – | – | (310) | (310) |
| Issue of share capital | 1,979 | – | 1,979 | – | 1,979 |
| Share-based payments | – | 4 | 4 | – | 4 |
| Own shares held by the Group | (20) | – | (20) | – | (20) |
| At 31 December 2010 | 4,317 | 1,910 | 6,227 | 322 | 6,549 |

# Consolidated statement of cash flows

**For the year ended 31 December 2011**

| For the year ended 31 December | Notes | 2011 £m | 2010 £m |
|---|---|---|---|
| **Operating activities** | | | |
| (Loss)/profit for the year | | **(31)** | 820 |
| Adjusted for: | | | |
| – other income | | **(116)** | (891) |
| – net realised and unrealised losses/(gains) on assets at fair value | | **1,595** | (6,379) |
| – finance costs | | **165** | 127 |
| – amortisation and impairment of intangible assets | | **759** | 428 |
| – depreciation of property and equipment | | **4** | 4 |
| – movement in deferred acquisition costs | | **(285)** | (312) |
| – total tax (credit)/charge | | **(237)** | 136 |
| – purchase of shares and other variable yield securities | | **(22,585)** | (21,985) |
| – sale of shares and other variable yield securities | | **22,705** | 19,029 |
| – purchase of loans, debt securities and other fixed income securities | | **(33,973)** | (33,869) |
| – sale of loans, debt securities and other fixed income securities | | **34,380** | 34,880 |
| – purchase of investment properties | | **(43)** | (67) |
| – sale of investment properties | | **305** | 81 |
| – (decrease)/increase in insurance contract liabilities | | **(101)** | 925 |
| – (decrease)/increase in investment contract liabilities | | **(2,057)** | 7,372 |
| – (decrease)/increase in unallocated surplus | | **(484)** | 2 |
| – decrease in provisions | | **(1)** | (3) |
| – net movement in receivables and payables | | **(51)** | 667 |
| **Pre-tax cash (outflow)/inflow from operating activities** | | **(51)** | 965 |
| Tax (paid)/received | | **(25)** | 15 |
| **Net cash (outflow)/inflow from operating activities** | | **(76)** | 980 |
| **Investing activities** | | | |
| Acquisition of subsidiaries, net of cash acquired | | **12** | 969 |
| 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 | | **(17)** | (1) |
| **Net cash inflow from investing activities** | | **270** | 964 |
| **Financing activities** | | | |
| Proceeds from issue of ordinary share capital | | **–** | 1,979 |
| Share repurchase | | **(250)** | – |
| Proceeds from issue of long-term debt | | **496** | 428 |
| Repayment of long-term debt | | **(477)** | (123) |
| Finance costs | | **(131)** | (113) |
| STICS interest | | **(31)** | (31) |
| Net movement in other borrowings, net of expenses | | **(36)** | 15 |
| Dividends paid to equity holders of the parent | | **(226)** | (135) |
| Proceeds from increase in non-controlling interests | | **1** | – |
| Dividends paid to non-controlling interests | | **–** | (7) |
| Net cash (outflow)/inflow from financing activities | | **(654)** | 2,013 |
| **(Decrease)/increase in cash and cash equivalents** | | **(460)** | 3,957 |
| Balance at beginning of year | 24 | **9,288** | 5,386 |
| Exchange adjustments on the translation of foreign operations | | **(37)** | (55) |
| **Balance at end of year** | | **8,791** | 9,288 |

# Notes to the consolidated accounts

## 1. Accounting policies

### 1.1 Basis of preparation

The financial statements of the Company as at and for the year ended 31 December 2011 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.

On 31 January 2011, the Group, through its subsidiary FLL, acquired all of the share capital of BHA. The consolidated income statement therefore includes the results of BHA from that date.

On 7 November 2011, the Group, through its subsidiary FLG, acquired control of WLUK. The consolidated income statement therefore includes the results of WLUK from that date. The acquisition of WLUK was agreed with AXA UK in 2010 at the same time as the acquisition of FASLH was negotiated. However, the share capital of WLUK was not legally acquired by the Group until 2011 as the purchase was contingent upon a transfer under Part VII of FSMA of AXA UK's retained business out of WLUK and approval for the change of control in WLUK being received. These substantive conditions for the acquisition were fulfilled in November 2011 enabling the Group to acquire WLUK's share capital.

Under the terms of the FASLH acquisition in 2010, certain portfolios of business legally owned by the Group as a result of the acquisition were transferred back to AXA UK under Part VII of FSMA. These portfolios were therefore classified as held for sale for the year ended 31 December 2010. In October 2011 the Part VII transfers were successfully completed.

The 2010 comparatives include the results of the acquired AXA UK Life Business from 3 September 2010.

During November 2011 all of the business of FPLAL and BHA and certain portfolios of the business of FLPL were transferred into FLL, their immediate parent company, under Part VII of FSMA. The purpose of this internal group reorganisation was to realise capital and operating synergies for the Friends Life group. Prior to the Part VII transfers the with-profit liabilities of FPLAL, which were less than £500 million, were reported in the consolidated financial statements of the Group on a non-realistic basis. Subsequent to the transfer, these with-profit liabilities have become liabilities of FLL and are required to be reported on a realistic basis. This change does not impact equity attributable to equity holders of the parent in the consolidated financial statements of the Group but does impact the split of the with-profit liabilities between insurance contracts, investment contracts and unallocated surplus. Aside from this change, the Part VII transfers have not generated any other significant impacts on the consolidated financial statements.

The consolidated financial statements as at and for the year ended 31 December 2011 have been prepared in accordance with IFRS as adopted by the European Union ("IFRS").

The presentation currency of the Group is Sterling. Unless otherwise stated the amounts shown in the consolidated financial statements are in millions of pounds Sterling (£ million).

The preparation of the financial statements under IFRS requires management to make judgements, estimates and assumptions that affect the application of policies and the reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods. Further information on the use of judgement, estimates, and assumptions is set out in note 2.

The International Accounting Standards Board ("IASB") issued the following interpretation which is effective for annual periods beginning on or after 1 July 2010:

- IFRIC 19: *Extinguishing financial liabilities with equity instruments*. This interpretation does not have a material impact on the Group.

The IASB issued the following changes to standards and interpretations which are effective for accounting periods beginning on or after 1 January 2011:

- IAS 24 (revised): *Related party disclosures*. The revised standard clarifies and simplifies the definition of a related party and does not have a material impact on the Group; and
- Annual improvements to IFRSs (May 2010). In accordance with the improvement to IFRS 7: *Financial Instruments: Disclosures,* the Group has disclosed details of collateral held by the Group to mitigate credit risk.

The IASB issued the following change to IFRS 7 which is effective for accounting periods beginning on or after 1 July 2011 and has been early adopted by the Group:

- IFRS 7: *Financial Instruments: Disclosures*. The amendment enhances the disclosure requirements in relation to transferred financial assets to require information as to any residual risks that remain from an entity's continuing involvement with such assets. Adoption of this amendment has not had a material impact on the Group.

## 1. Accounting policies continued

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 2012, but where earlier adoption is permitted. They have not been early adopted by the Group in 2011 as they are yet to be endorsed by the European Union ("EU"). 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;
- 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;
- 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; 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.

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 are effective for annual periods beginning on or after 1 July 2012;
- 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. This amendment is effective for annual periods beginning on or after 1 January 2012; and
- IAS 19: *Employee Benefits*. The amendment eliminates the option to defer the recognition of gains and losses, known as the "corridor method". This amendment is effective for accounting 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 balance sheet 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.

### 1.2 Accounting policies

The principal accounting policies set out below have been consistently applied in these consolidated financial statements.

#### 1.2.1 Business combinations

Business combinations are accounted for under IFRS 3: *Business combinations*, as revised in 2008 and amended in 2010, using the purchase method. The cost of a business combination is measured as the fair value of the consideration transferred. Identifiable assets acquired, including intangible assets arising on acquisition, and liabilities assumed in a business combination are measured initially at their fair value at the business combination date. Any excess of the cost of the business combination over the fair value of the net assets acquired is recognised in the balance sheet as goodwill. To the extent that the fair value of the acquired entity's net assets is greater than the cost of the acquisition, a gain is recognised immediately in the income statement. Acquisition related costs are expensed as incurred except insofar as they relate to the raising of debt or equity when such expenses are capitalised.

## 1. Accounting policies continued

### a) Subsidiaries
Subsidiaries are all entities (including special purpose entities) over which the Group has the power, directly or indirectly, to govern the financial and operating policies so as to obtain economic benefits, generally accompanying a shareholding of more than one half of the voting rights. Potential voting rights that are presently exercisable or convertible are also taken into account. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date on which control ceases. Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

Open-ended investment companies ("OEICs") and unit trusts where the Group has a percentage holding in excess of 50% are consolidated under IAS 27: *Consolidated and separate financial statements.* Where the OEIC or unit trust qualifies as a special purpose vehicle, they are consolidated under SIC 12: *consolidation – special purpose entities* as the Group obtains the majority of the benefits. In addition other investment vehicles such as limited partnerships where the Group obtains the majority of the benefits and is exposed to the majority of risks are consolidated under SIC 12. The units not owned by the Group are treated as a liability referred to as "net asset value attributable to unit holders".

The consolidated financial statements incorporate the assets, liabilities, results and cash flows of the Company and its subsidiaries. The results of subsidiaries acquired or sold during the period are included in the consolidated results from the date of acquisition or up to the date of disposal. Intra-group balances and income and expenses arising from intra-group transactions are eliminated in preparing the consolidated financial statements.

Profits or losses arising from changes in holdings in subsidiaries that do not impact the Group's control over that subsidiary are recognised directly in the statement of comprehensive income.

### b) Associates and joint ventures
Associates are all entities over whose operating policies the Group has significant influence but not control, generally arising from holding between 20% and 50% of the voting rights. Investments in associates are accounted for by the equity method of accounting and are initially recognised at cost. The Group's investment in associates includes goodwill (net of any impairment loss) identified on acquisition.

Joint ventures are those entities where the terms of the contractual agreement ensure that the parties involved jointly control the entity, notwithstanding that the Group's share of the underlying assets and liabilities may be more or less than 50%. The Group recognises its interests in joint ventures using the equity method.

Under the equity method, an investment is included as a single line item in the consolidated balance sheet as the Group's share of the fair value of the investee undertaking's net assets plus goodwill, which equates to the cost of the investment plus the Group's share of post-acquisition reserves. The Group's share of post-tax profits or losses is presented as a single line item in the consolidated income statement, adjusted for the effect of measuring assets and liabilities to fair value on acquisition.

### c) Classification of a non-current asset or disposal group as held for sale
Where the Group holds a non-current asset or disposal group which is held exclusively with a view to its disposal in the near future, then it is classified as an asset held for sale.

An asset or disposal group is classified as held for sale when:

- management is committed to a plan to sell;
- the asset is available for immediate sale;
- an active programme to locate a buyer is initiated;
- the sale is highly probable, within 12 months of classification as held for sale (subject to limited exceptions);
- the asset is being actively marketed for sale at a sales price reasonable in relation to its fair value; and
- actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

Non-current assets or disposal groups that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.

Non-current liabilities are presented separately on the statement of financial position.

## 1.2.2 Product classification

### a) Insurance contracts
Contracts under which the Group accepts significant insurance risk from another party (the policyholder), by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder, are classified as insurance contracts. Under IFRS 4: *Insurance contracts,* insurance risk is risk other than financial risk. Financial risk is the risk of a possible future change in one or more of: a specified interest rate, security price, commodity price, foreign exchange rate, index of price or rates, a credit rating or credit index or other variable. Insurance contracts may also transfer some financial risk.

Once a policyholder contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly during this period. As a general guideline, the Group defines as significant insurance risk the possibility of having to pay benefits on the occurrence of an insured event that are more than 5% greater than the benefits payable if the insured event did not occur.

## 1. Accounting policies continued

### b) Investment contracts

Policyholder contracts not considered insurance contracts under IFRS 4 are classified as investment contracts. Contracts classified as investment contracts are either unit-linked or contracts with Discretionary Participation Features ("DPF") with no significant insurance risk. The latter are mainly unitised with-profits contracts.

A contract with DPF is a contractual right held by a policyholder to receive, as a supplement to guaranteed minimum payments, additional payments:

- that are likely to be a significant portion of the total contractual payments; and
- whose amount or timing is contractually at the discretion of the issuer and that are contractually based on:
  - the performance of a specified pool of contracts, or a specified type of contract; or
  - realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
  - the profit or loss of the company that issues the contracts.

### 1.2.3 Segment reporting

Operating and reportable segments are presented in a manner consistent with the internal reporting information provided to the chief operating decision-maker.

An operating segment is a component of the Group that engages in business activities from which it earns revenues and incurs expenses. Minor operating segments are combined to derive the Group's reportable segments in accordance with the requirements of IFRS 8: *Operating segments*.

Revenue information for geographical segment reporting is based on the geographical location of the customer.

Non-current assets and liabilities for geographical segment reporting are based on the location of those assets and liabilities.

### 1.2.4 Foreign currency translation

### a) Foreign currency transactions

Transactions in foreign currencies are translated to the functional currency of each company in the Group at the foreign exchange rates ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to the functional currency at the exchange rate ruling at the balance sheet date, and any exchange differences arising are taken to the income statement. Non-monetary assets and liabilities measured at historical cost in a foreign currency are translated using the exchange rate at the date of the transaction and are not subsequently restated. Non-monetary assets and liabilities stated at fair value in a foreign currency are translated at the rate on the date the fair value was determined.

When a gain or loss on a non-monetary item is recognised directly in equity, any exchange component of that gain or loss is recognised directly in equity. Conversely, when a gain or loss on a non-monetary item is recognised in the income statement, any exchange component of that gain or loss is recognised in the income statement. Foreign exchange adjustments recognised in equity are reported in the Group's foreign currency translation reserve within retained earnings and reported in the statement of comprehensive income.

### b) Overseas subsidiaries and associates

The assets and liabilities of overseas subsidiaries and associates, including goodwill and intangible assets attributable to the acquisition of the overseas subsidiary or associate, and fair value adjustments arising on consolidation, are translated to Sterling (the presentational currency of the Group) at foreign exchange rates ruling at the balance sheet date. The revenues and expenses of overseas subsidiaries and associates are translated to Sterling at average foreign exchange rates for the period.

Foreign exchange differences arising on the translation to Sterling are classified as equity movements and recognised in the Group's foreign currency translation reserve, and reported in the statement of comprehensive income. These exchange differences are recognised in the income statement in the period in which the overseas subsidiary or associate is sold.

### 1.2.5 Revenue recognition

### a) Premiums

Premium income in respect of single premium insurance policies, new generation group pensions business and pensions business not subject to contractual regular premiums, is accounted for when the premiums are received.

For all other insurance contracts, premium income is accounted for in the year in which it falls due.

### b) Fee and commission income and income from service activities

Investment contract policyholders are charged for policy administration services, investment management services and for surrenders. Investment management services comprise primarily fees and charges from unit-linked investment contracts issued by the life and pensions business. Fees earned on investment management contracts relate to the sale and management of retail investment products and from managing investments in the institutional market.

These fees and charges are recognised as revenue in the accounting period in which the services are rendered.

Front-end fees charged at the inception of certain investment contracts are recognised as income over the expected term of the contract on a straight-line basis with the unrecognised amount at the end of the year presented as a liability.

## 1. Accounting policies continued

Regular fees charged to the policyholder periodically (monthly, quarterly or annually), are recognised on a straight-line basis over the period that the service is rendered.

A number of contracts have performance fees based on an agreed level of performance over a set period. Performance fees are recognised when the quantum of the fee can be estimated reliably. Generally this is where the performance period ends on or before the reporting date or where there is a period of less than six months remaining to the end of the performance period and there is evidence at the reporting date which suggests that current performance will be maintained.

#### c) Investment income

All income received from investments is recognised in the income statement and includes dividends, interest, rental income, the movement in financial assets and investment properties, at fair value through profit or loss, and realised losses and gains on assets classified as available-for-sale.

Dividend income from listed and unlisted securities is recognised as revenue when the right to receive payment is established. For listed securities this is the date the security is listed as ex-dividend.

Interest income is recognised in the income statement as it accrues, taking into account the relevant coupon rate, and applicable floating rate or, for loan assets at amortised cost, the effective interest rate method. Interest income includes the amortisation of any discount or premium.

Rental income from investment properties under operating leases is recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives received are recognised in the income statement as an integral part of the total lease income.

Determination of gains and losses and the movement in financial assets and investment properties at fair value through profit or loss are explained in their respective accounting policies.

### 1.2.6 Expense recognition

#### a) Claims and benefits paid

Insurance claims reflect the cost of all claims incurred during the year on insurance contracts, including claims handling costs. Death claims and surrenders are recognised on the basis of notifications received. Maturities and annuity payments are recorded when due. Claims and benefits recorded are accrued to the policyholder and included within insurance and investment contract liabilities, as appropriate.

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

Reinsurance recoveries are accounted for in the same period as the related claim.

#### b) Finance costs

The interest expense recognised in the income statement under finance costs, is calculated using the effective interest rate method. Interest accrued on variable rate interest-bearing loans and borrowings is recognised under insurance payables, other payables and deferred income and not included in the carrying value of interest-bearing loans and borrowings.

#### c) Operating lease payments

Payments made under operating leases are recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives paid are recognised in the income statement over the period of the lease.

#### d) Expenses related to investment properties

Expenses related to investment properties are treated as administrative expenses and are recognised when incurred.

### 1.2.7 Impairment

The Group assesses at each reporting date whether there is an indication that an asset (other than those assets recognised at fair value) may be impaired.

If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash generating unit's ("CGU") fair value less costs to sell and its value in use, and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Impairment losses on continuing operations are recognised in the income statement in those expense categories consistent with the function of the impaired asset.

# 1. Accounting policies continued

An assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the recoverable amount of the asset is estimated. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case, the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years. Such a reversal is recognised in the income statement unless the asset is carried at a revalued amount, in which case the reversal is treated as a revaluation increase. After such a reversal the depreciation charge is adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

Further detail on the impairment testing of goodwill is provided in accounting policy 1.2.8 below.

## 1.2.8 Intangible assets

Intangible assets acquired separately from a business are carried initially at cost. An intangible asset acquired as part of a business combination is recognised outside goodwill if the asset is separable or arises from contractual or other legal rights and its fair value can be measured reliably.

### a) Goodwill

Goodwill arising on business combinations is the future economic benefit arising from assets that are not capable of being individually identified and separately recognised. After initial recognition, goodwill is stated at cost less any accumulated impairment losses. Goodwill is not amortised but is assessed for possible impairment annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired.

For the purpose of impairment testing, goodwill is allocated to the related CGUs. Where the recoverable amount of the CGU is less than its carrying amount, including the related goodwill, an impairment loss is recognised in the income statement. The carrying amount of goodwill allocated to a CGU is taken into account when determining the gain or loss on disposal of the unit, or of an operation within it. Each CGU to which goodwill is allocated represents the lowest level within the Group at which the goodwill is monitored for internal management purposes and is not larger than any of the Group's primary or secondary segments used for segment reporting.

In a business combination, where the purchase consideration is lower than the fair value of the net assets acquired, a gain on acquisition arises, sometimes referred to as negative goodwill. Such a gain on acquisition is recognised in the income statement in the period in which it arises.

### b) Acquired value of in-force business ("AVIF")

On acquisition of a portfolio of insurance contracts and/or investment contracts, either directly or through the acquisition of a subsidiary undertaking, the net present value of the Group's interest in the expected pre-tax cash flows of the in-force business is capitalised in the statement of financial position as an intangible asset. AVIF is amortised over the anticipated lives of the related contracts which typically vary between five and 35 years, with the amortisation profile being in accordance with expected profit emergence from the contracts.

### c) Other intangible assets

Customer relationships, distribution relationships and brands acquired are capitalised at cost, being the fair value of the consideration paid. Software is capitalised on the basis of the costs incurred to acquire and bring it into use.

These intangible assets have finite useful lives and are consequently carried at cost less accumulated amortisation and impairment. Amortisation is calculated using the straight-line method to allocate the cost over the estimated useful lives of the intangible assets with ranges as shown below:

| | Years |
|---|---|
| Customer relationships | 8–12 |
| Distribution relationships | 5–10 |
| Brands | 10–15 |
| Computer software | 3–4 |

Subsequent expenditure on other intangible assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

## 1.2.9 Property and equipment

### a) Owned assets

Land and buildings are initially recognised at cost and subsequently measured at fair value. Revaluations are performed annually by independent valuers, who hold a recognised and relevant professional qualification and have recent experience in the location and category of properties being valued. Valuations are performed with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair values at the balance sheet date. The fair value is the amount for which a property could be exchanged between knowledgeable and willing parties in an arm's length transaction.

Properties occupied by the Group are held at fair value on the basis of open market value at the date of revaluation. Revaluation surpluses, and their reversal, are recognised in accumulated revaluation surplus in shareholders' equity. Revaluation losses, and their reversal, are recognised in the income statement.

Equipment is recognised at cost less accumulated depreciation and impairment losses.

## **1. Accounting policies** continued

### b) Depreciation

Depreciation is charged so as to write off the cost of certain assets net of the estimated residual value, using the straight-line method, over the estimated useful life of the asset, as follows:

| | Years |
|---|---|
| Motor vehicles | 3–4 |
| Computer hardware and related software | 1–4 |
| Fixtures, fittings and office equipment | 3–10 |

Residual values and useful lives are reviewed at each financial year end and adjusted if appropriate.

### c) Disposal and derecognition

An item of property and equipment is derecognised upon disposal or when no further future economic benefits are expected from its use. Any gain or loss arising on derecognition of the asset is included in the income statement in the year the asset is derecognised.

Any revaluation reserve relating to the particular asset being disposed of or no longer in use is transferred to retained earnings.

## 1.2.10 Investment properties

Investment properties is comprised of land and/or buildings that are not occupied by the Group and are held either to earn rental income or for capital appreciation, or for both.

In accordance with IAS 17: *Leases,* properties held by the Group under operating leases are classified as investment properties when the properties otherwise meet the definition of investment properties.

Investment property is initially included in the balance sheet at cost and subsequently measured at its fair value, which is supported by market evidence, based on annual valuations by independent valuers who hold a recognised and relevant professional qualification and have recent experience in the location and category of investment property being valued. Movements in the fair value of investment properties are taken to the income statement in the period in which they arise.

## 1.2.11 Financial assets

The Group classifies its financial assets as either financial assets at fair value through profit or loss, or as loans. Loans are carried in the statement of financial position at amortised cost less impairment losses, or fair value where certain conditions in IAS 39*: Financial instruments: recognition and measurement* are met, such as the elimination or significant reduction in accounting mismatches.

Purchases and sales of financial assets are recognised on the date the Group commits to purchase or sell the asset, generally the trade date.

A transfer of a financial asset is accounted for as a derecognition only if substantially all of the asset's risks and rewards of ownership are transferred, or, control of the asset is transferred to a party external to the Group. Control is deemed to have been transferred if the transferee has the practical ability to sell the asset unilaterally without needing to impose additional restrictions on any subsequent transfer.

### a) Financial assets at fair value through profit or loss

Financial assets at fair value through profit or loss comprise assets which are designated as such on initial recognition, and derivatives, which are classified as held for trading in accordance with IAS 39: *Financial instruments: recognition and measurement*.

Financial assets are designated upon initial recognition at fair value through profit and loss as they are managed individually or together on a fair value basis.

All financial assets at fair value through profit or loss are measured at fair value. The fair value on initial recognition is generally the consideration given, excluding any transaction costs directly attributable to their acquisition which are expensed. Movements in fair value are taken to the income statement as investment return in the period in which they arise. Financial assets carried at fair value are initially recognised at fair value and subsequently remeasured at fair value based on quoted bid prices where such prices are available from a third party in a liquid market. If quoted bid prices are unavailable, the fair value of the financial asset is estimated using cash flow models.

Fair values for unlisted securities are derived from cash flow or other models designed to reflect the specific circumstances of the issuer. Securities for which fair value cannot be measured reliably are recognised at cost less impairment.

Where derivatives qualify for hedge accounting, recognition of any resultant gain or loss depends on the nature of the item being hedged and of the hedge.

## 1. Accounting policies continued

### b) Loans

Loans are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans are measured on initial recognition at the fair value of the consideration given plus incremental costs that are incurred on the acquisition of the investment. Subsequent to initial recognition, loans are either measured at amortised cost using the effective interest rate method with any difference between cost and redemption value being amortised through the income statement over the period of the borrowings, or, if they meet the criteria for designation at fair value through profit or loss, and are so designated on initial recognition, they are measured at fair value.

The amortised cost is the present value of estimated future cash flows discounted at the effective interest rate at the date of acquisition or origination of the loan.

The carrying value of a loan is reviewed for impairment in accordance with IAS 39 at each reporting date. If there is objective evidence of impairment, for example there is a default or delinquency in payment, the impairment loss is calculated and recognised.

### 1.2.12 Acquisition costs

For both insurance contracts and investment contracts with DPF, acquisition costs comprise all direct and indirect costs arising from writing the contracts, which are incurred during a financial period. Acquisition costs are amortised over the life of the contracts where their recovery has not been reflected in the valuation of policyholder liabilities, but only to the extent that they are recoverable out of future margins.

The rate of amortisation of acquisition costs on such contracts is proportional to the future margins expected to emerge in respect of the related policies, over the life of those policies.

For investment contracts without DPF, acquisition costs comprise all incremental costs that are directly related to the writing of the contract, which are incurred during a financial period, and are amortised on a straight-line basis over the lifetime of the contract if they are recoverable out of future margins.

### 1.2.13 Reinsurance

Amounts due to and from reinsurers are accounted for in accordance with the relevant reinsurance contract. Premiums ceded and claims reimbursed are individually presented on a gross basis.

Contracts that do not give rise to a significant transfer of insurance risk to the reinsurer are considered financial reinsurance and are accounted for and disclosed in a manner consistent with financial instruments.

### 1.2.14 Taxation

#### a) Current tax

Taxation is based on profits and income for the period as determined in accordance with the relevant tax legislation, together with adjustments to provisions for prior periods.

Tax payable is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

The tax charge is analysed between tax in respect of income and investment return on the policyholders' interest in the with-profits and linked fund assets, representing policyholders' tax, with the balance being tax on equity holders' investment return and profits, representing shareholders' tax.

#### b) Deferred tax

Deferred tax is the tax expected to be payable or recoverable on temporary differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax basis used in the computation of taxable profit. This is accounted for using the balance sheet liability method and the amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities. The tax rates used are the rates that have been enacted or substantively enacted by the balance sheet date.

Deferred taxation is recognised in the income statement for the period, except to the extent that it is attributable to items that are recognised in the same or a different period outside the income statement, in which case the deferred tax will be recognised in other comprehensive income or equity, as applicable. Deferred tax liabilities are recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable future profits will be available against which deductible temporary differences can be utilised.

### 1.2.15 Insurance and other receivables

Insurance and other receivables are recognised when due and measured on initial recognition at the fair value of the amount receivable plus incremental costs. Subsequent to initial recognition, these receivables are measured at amortised cost using the effective interest rate method.

### 1.2.16 Cash and cash equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less, and bank overdraft facilities repayable on demand to the extent that they form an integral part of the Group's cash management.

## 1. Accounting policies continued

### 1.2.17 Financial liabilities

The Group classifies financial liabilities as either financial liabilities at fair value through profit or loss or financial liabilities carried at amortised cost. The amortised cost of a financial liability is the amount at which the financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest rate method of any difference between that initial amount and the maturity amount.

Financial liabilities at fair value through profit or loss, such as investment contracts, are designated on initial recognition when one of the following criteria is satisfied:

- it eliminates or significantly reduces an accounting mismatch caused by financial assets and financial liabilities being measured on a different basis; and
- the financial liability contains or may contain an embedded derivative.

A financial liability is recognised when, and only when, the Group becomes a party to the contractual provisions of a financial instrument.

A financial liability is derecognised when, and only when, the obligation specified in the contract is discharged, or cancelled or expires.

### 1.2.18 Insurance contracts

For UK operations, insurance contract liabilities are calculated based on the relevant Financial Services Authority ("FSA") rules contained in the Prudential Sourcebook for Insurers. For overseas operations, insurance contract liabilities are calculated on recognised actuarial principles, based on local regulatory requirements.

For the conventional with-profits policies in FLL, WLUK, Friends Life Company Limited ("FLC") and Friends Life Assurance Society Limited ("FLAS"), the liabilities to policyholders include both declared and constructive obligations for future bonuses not yet declared (excluding the shareholders' share of future bonuses) and include the cost of options and guarantees measured on a market consistent basis. The basis of calculation does not recognise deferred acquisition costs, but allows for future profits of non-profit and unit-linked business written in the with-profits fund to be recognised.

For the year ended 31 December 2010, the calculation of the liabilities to policyholders in respect of conventional with-profits contracts in FPLAL included an implicit provision for future regular bonuses, but not final bonuses, by means of a reduction in the valuation interest rate and an assessment of options and guarantees on a deterministic basis. As disclosed in the basis of preparation, following the Part VII transfer of these liabilities into FLL, the liabilities are, for the year ended 31 December 2011, calculated on a realistic basis consistent with the approach described above for conventional with-profits policies in FLL.

The calculation of liabilities to policyholders for non-profit contracts includes explicit allowance for future expenses and allows for lapses where appropriate.

The value of unit-linked insurance contract liabilities includes provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to policyholders.

As an insurance special purpose vehicle, Friends Annuities Limited ("FAL") is not required to value liabilities on an FSA basis. The valuation is, however, undertaken on a prudent basis which is generally similar to an FSA basis. The assumptions include a margin to allow for adverse variation of experience to assumptions.

The Group applies shadow accounting in relation to certain insurance contract liabilities, which are supported by owner-occupied properties and overseas subsidiaries, on which unrealised gains and losses are recognised in equity. Adjustments are made to the insurance contract provisions to reflect the movements that would have arisen if the unrealised gains and losses had been recognised in the income statement. The corresponding change in the value of these insurance contract liabilities is recognised in equity.

The Group carries out an annual liability adequacy test on its insurance contract liabilities less related deferred acquisition costs and other related intangible assets to ensure that the carrying amount of its liabilities is sufficient in light of estimated future cash flows. Where a shortfall is identified, an additional provision is made.

### 1.2.19 Investment contracts

Investment contracts are either unit-linked or contracts with DPF (mainly unitised with-profits contracts that have no significant insurance risk).

A unit-linked investment contract is recognised at fair value through profit or loss. The fair value is calculated as the number of units allocated to policyholders in each of the unit-linked funds multiplied by the bid price of the units which reflects the fair value of the assets in the fund at the balance sheet date. In addition to this the fair value of the investment contract liability includes a provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to the policyholders. Provision is made for renewal commissions at the inception of an investment contract as intermediaries are not required to perform any service once the policy is incepted.

Investment contracts with DPF held within the with-profits funds (which are mainly unitised with-profits contracts) are measured on a basis that is consistent with a measurement basis for insurance contracts held within those funds.

## 1. Accounting policies continued

### 1.2.20 Unallocated surplus

The unallocated surplus in the with-profits funds is presented as a liability and comprises all amounts available for allocation, either to policyholders or to shareholders, the allocation of which has not been determined at the balance sheet date.

Insurance and investment contract liabilities within with-profits funds are measured on a realistic basis and therefore include amounts attributable in respect of future bonuses. Such amounts are estimated in accordance with the published Principles and Practices of Financial Management ("PPFM") and represent a constructive obligation. The realistic liabilities include an estimate of the fair value of policyholder options and guarantees. The unallocated surplus within the with-profits funds represents the excess of assets of the fund relative to the realistic liabilities and other current liabilities not included within the realistic liability measurement. The unallocated surplus can be considered to represent the working capital of the funds combined with the value of future transfers to shareholders from the with-profits funds.

For the year ended 31 December 2010, for FPLAL, the unallocated surplus represented the value of future regular and final bonus payments to policyholders. Following the Part VII transfer of FPLAL with-profit liabilities into FLL completed during the year, these liabilities are now calculated on a realistic basis. Therefore, the calculation of the unallocated surplus in respect of the ex-FPLAL with-profit fund is consistent with the other with-profit funds of the Group as at 31 December 2011.

### 1.2.21 Interest-bearing loans and borrowings

Borrowings are recognised initially at fair value, which is generally the cash consideration received, net of transaction costs incurred, and subsequently stated at amortised cost.

Any difference between the proceeds, net of transaction costs, and the redemption value is recognised in the income statement over the period of the borrowings, using the effective interest rate method.

### 1.2.22 Provisions and contingent liabilities

A provision is recognised when the Group has a present legal or constructive obligation, as a result of a past event, which is likely to result in an outflow of resources and where a reliable estimate of the amount of the obligation can be made. If the effect is material, the provision is determined by discounting the expected future cash flows at a pre-tax risk-free rate and, where appropriate, the risks specific to the liability.

The Group recognises a provision for onerous contracts when the expected benefits to be derived from the contracts are less than the related unavoidable costs.

Contingent liabilities are disclosed if there is a possible future obligation as a result of a past event or if there is a present obligation as a result of a past event but either a payment is not probable or the amount cannot be reliably estimated.

### 1.2.23 Insurance payables, other payables and deferred income

Insurance and other payables are recognised when due and measured on initial recognition at the fair value of the consideration payable. Subsequent to initial recognition, payables are measured at amortised cost using the effective interest rate method.

### 1.2.24 Financial instruments treated as equity

A financial instrument is treated as equity if:

- there is no contractual obligation to deliver cash or other financial assets or to exchange financial assets or liabilities on terms that may be unfavourable; and
- the instrument is not a derivative and contains no contractual obligations to deliver a variable number of shares or is a derivative that will be settled only by the Group exchanging a fixed amount of cash or other assets for a fixed number of the Group's own equity instruments.

Incremental external costs which are directly attributable to the issue of new shares are shown in equity as a deduction, net of tax, from the proceeds of the issue.

### 1.2.25 Dividends

Dividends approved by ordinary shareholders are recognised as a liability on the date of approval and dividends declared by directors are recognised on the date of payment. Dividends are charged directly to equity.

# **1. Accounting policies** continued

## 1.2.26 Employee benefits

### a) Pension obligations

*(i) Defined benefit schemes*
Pension schemes are in operation for employees of certain subsidiary undertakings. A significant proportion of employees belong to a funded defined benefit type scheme with uninsured assets. The schemes provide benefits based on final pensionable salary. The assets of the schemes are held in separate trustee administered funds.

The pension asset or liability recognised in the balance sheet is the present obligation of the employer, which is the estimated present value of future benefits that employees have earned in return for their services in the current and prior years, less the value of the plan assets in the schemes. A pension surplus is recognised to the extent it is recoverable through refunds or expected reductions in future contributions. The rate used to discount pension obligations is determined by reference to market yields at the end of the reporting period on high quality corporate bonds. A qualified actuary performs the calculation of the present value of the defined benefit obligation annually using the projected unit credit method.

The pension costs for the schemes are charged to the income statement and consist of current service cost, past service cost, interest cost on scheme liabilities, the effect of any settlements and curtailments and the expected return on pension assets. Past service costs are recognised in the income statement on a straight-line basis over the period in which the increase in benefits vest.

The actuarial gains and losses, which arise from any new actuarial valuation or from updating the latest actuarial valuation to reflect conditions at the balance sheet date and any restrictions to recognised surpluses, are taken to the statement of comprehensive income for the period.

*(ii) Defined contribution schemes*
Contributions made to these schemes are charged to the income statement as they become payable in accordance with the rules of the scheme.

*(iii) Other long-term employee benefits*
Other long-term employee benefits are recognised at the discounted present value of the defined benefit obligation at the balance sheet date. The obligation is calculated using the unit credit method. Movements in the value of the obligation are charged to the income statement.

*(iv) Termination benefits*
Termination benefits are recognised as a liability and an expense when the Group is demonstrably committed to terminating the employment of an employee before the normal retirement date, or to provide benefits as a result of an offer made to encourage voluntary redundancy.

### b) Share-based payment schemes
The Company offers the following share-based payment schemes for its employees:

*(i) Lombard incentive scheme*
Lombard International Assurance SA (“Lombard”), a subsidiary undertaking, provides an incentive scheme to eligible employees that entitles the participants, subject to achievement of performance conditions, to shares in Resolution Limited.

The fair value of awards made under this equity-settled scheme was measured at the acquisition date and is being expensed on a straight-line basis over the vesting period in the income statement. A corresponding amount is credited to equity. The fair value is measured using scenario-based modelling techniques that take into account the terms and conditions upon which these shares would be issued.

At each balance sheet date, the Group revises its estimate of the number of shares that are expected to be issued. It recognises the impact of the revision of original estimates, if any, in the income statement, with a corresponding adjustment to equity over the remaining vesting period.

Lombard also provides an incentive scheme to its sales personnel and middle management that entitles the participants to cash pay-outs subject to Lombard’s value as at 31 December each maturity year. The fair value of the scheme is measured at each year end and expensed over the vesting period and a corresponding liability is included in the Group statement of financial position.

*(ii) FLG long-term incentive plan*
During 2010, the Company introduced a long-term incentive plan (“LTIP”) to incentivise key individuals in the business by entitling them to a percentage share in the difference between the value realised on the completion of the UK Life Project and the aggregate cost of the acquisitions.

The scheme is a cash-settled share-based payment scheme and the fair value of the awards in issue, being the relevant percentage of the gain expected to arise on completion of the UK Life Project, is measured at each reporting date, with any changes in fair value being recognised in the income statement for the period.

*(iii) Sesame Bankhall Group incentive scheme*
A new scheme was introduced in 2011 whereby key management of SBG has been incentivised through a scheme that entitles them to a share in the growth of SBG. The scheme is a cash-settled scheme and the fair value of the awards in issue is measured at each reporting date.

## 2. Use of judgements, estimates and assumptions

The Group makes judgements in the application of critical accounting policies that affect the reported amounts of assets and liabilities. The Group also makes key assumptions about the future and other sources of uncertainty. These are continually evaluated and based on historical experience and other factors, including expectations of future events that are considered to be reasonable under the circumstances.

### a) Product classification

IFRS 4: *Insurance contracts* requires contracts to be classified as either "insurance contracts" or "investment contracts" based on the significance of insurance risk present in the contract with consequential impacts on the accounting policies applied to the valuation of policyholder liabilities, deferral of acquisition costs and pattern of revenue recognition.

### b) Liabilities arising from insurance contracts and investment contracts with DPF

Determination of the ultimate liabilities of insurance contracts or investment contracts with DPF arising is a critical accounting estimate. There are several sources of uncertainty that need to be considered in determining the key assumptions made in estimating the liabilities that the Group will ultimately pay on claims made and on maturity of the policies.

The most significant assumptions are:

- mortality, morbidity and persistency assumptions;
- for with-profits policies, the stochastic models used to value liabilities are sensitive to risk-free rates, assumed asset volatilities and the assumed correlation between asset volatilities. Risk-free rates are set in accordance with current market gilt rates;
- valuation interest rate for annuities in payment – fixed-interest assets, predominantly corporate bonds, are held to match the expected benefit outgo of the annuity portfolio. The excess yields on corporate bonds over that on gilts are called bond spreads and these reflect compensation for the higher risk of default (credit risk premium) and lower liquidity (credit default allowance or illiquidity premium) compared to gilts. One of the key judgements is the assessment of how much of the spread is attributable to credit. The credit default allowance is derived by deducting an allowance for defaults (based on an analysis of historical defaults) from the total bond spread. This approach is consistent with current industry practice;
- other valuation interest rates have been calculated by reference to changes in consistent economic indices. The impact of all interest rate changes on liabilities is included within the impact of economic basis changes in note 27. The impact of these liability changes on surplus is generally to offset some or all of the corresponding impact on the value of fixed-interest assets backing the liabilities;
- for guaranteed annuity options (one of the principal guarantees written by the Group) the cost depends on assumptions such as the level of policy discontinuance and the tax-free cash take-up rate; and
- changes in assumptions behind the valuation techniques for assets that are not quoted in active markets could have a significant impact on the value of assets that are backing insurance and investment contract liabilities, and therefore could have a subsequent impact on the valuation of the liability itself.

### c) AVIF and other intangible assets

The determination of the present value of future profits on a portfolio of long-term insurance and investment contracts, acquired through the purchase of a subsidiary, and recognised as an intangible asset, is subject to judgement and estimation. The Group's policy is to calculate AVIF balances arising on acquisition by reference to a market consistent embedded value methodology. Details of the assumptions utilised in calculating the present value of future profits are provided in note 10 to the MCEV financial statements.

Information relating to the methods used to value other intangible assets is set out in note 14.

### d) Fair value determination of financial instruments at fair value through profit and loss

Financial assets are designated at fair value where they are managed on a fair value basis or at amortised cost. Financial liabilities such as investment contracts are designated at fair value to eliminate mismatch with corresponding assets which are managed on a fair value basis.

Fair values of financial instruments that are quoted in active markets are based on bid prices for the assets held. When independent prices are not available, fair values are determined by using valuation techniques which refer to market observable data. These include comparison with similar instruments when market observable prices are available.

## 2. Use of judgements, estimates and assumptions continued

Corporate bond valuations are generally obtained from brokers and pricing services. Where the number of transactions has declined under the current market conditions, valuations have become more subjective. Bond prices provided by pricing services are based on the best estimate of market price determined by market makers based on a variety of factors and are considered to be observable prices. In determining fair value, market makers will take into account transactions they have observed in identical or similar assets as well as movements in market indices and any other factors that they regard as relevant. In some cases, consensus prices have been based on fewer, and potentially more historic, transactions.

Fair values of private equity investments are based on the revaluation of the underlying investments using International Private Equity and Venture Capital Valuation guidelines.

The valuations use earnings multiples reflecting similar multiples applying to quoted investments.

Methods considered when determining fair values of unlisted shares and other variable securities include discounted cash flow techniques and net asset valuation.

The value of derivative financial instruments is estimated by applying valuation techniques, using pricing models or discounted cash flow methods. Where pricing models are used, inputs – including future dividends, swap rates and volatilities – based on market data at the balance sheet date are used to estimate derivative values. Where discounted cash flow techniques are used, estimated future cash flows and discount rates are based on current market swap rates at the valuation date.

For units in unit trusts and shares in open-ended investment companies, fair value is by reference to published bid values.

Participation in investment pools mainly relates to property investments. Property is independently valued in accordance with the Royal Institute of Chartered Surveyors' guidelines ("RICS Red Book") on the basis of open market values as at each year end.

An analysis of financial assets by category is disclosed in note 19.

### e) Staff pension schemes assumptions

In assessing the pension benefit obligation, assumptions are made as to the life expectancy of all current, deferred and retired members, rates of increases of salaries and pensions, and interest and inflation rates. Material assumptions used and sensitivities are explained in detail in note 8. Estimates are made for the recoverability of any surplus through expected refunds or reductions in contributions and the surplus will be restricted accordingly.

### f) Deferred tax assets and liabilities

In assessing deferred tax assets, an estimate of probable future taxable profits is made, against which the temporary differences, being the carry forward of excess tax expenses, and tax losses are utilised. These involve management's best estimate based on past profit experience, adjusted for possible future deviations that management considers might occur.

The principal deferred tax liabilities relate to deferred tax on purchased value of in-force business which are subsequently being amortised in line with the run-off of the underlying assets. The deferred tax liability was calculated using detailed actuarial forecast cash flows.

Details of deferred tax assets recognised are in note 22.

### g) Fair value determination of investment properties and owner-occupied properties

Investment properties and properties occupied by the Group are measured at fair value at least annually at the balance sheet date. Fair values are measured by external independent valuers on the basis of open market value using methods set out in the RICS Red Book.

The valuations used are based on valuation techniques using multiples of future rental incomes. The rental multiples are based on multiples observed in recent similar transactions in the market. Key assumptions include occupancy and rental income.

## 3. 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, net income, products and services for the year ended 31 December 2011 includes BHA from 31 January and WLUK from 7 November. The segmental information for the year ended 31 December 2010 includes twelve months for the acquired Friends Provident business and four months for the acquired AXA UK Life Business.

The Group's management and internal reporting structure is based on the following operating segments which all meet the definition of a reportable segment under IFRS 8: *Operating segments*:

- UK comprising the former Friends Provident UK life and pensions business, the acquired AXA UK Life Business (including WLUK), BHA, Sesame Bankhall and, for the period prior to 19 March 2010 when it was disposed, Pantheon Financial Limited;
- International 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 2011** | **UK £m** | **Int'l £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** |

| Year ended 31 December 2010 | UK £m | Int'l £m | Lombard £m | FLG corporate £m | RSL corporate £m | Total £m |
|---|---|---|---|---|---|---|
| Life and pensions operating profit | 176 | 94 | 38 | – | – | 308 |
| Longer term shareholder investment return | 30 | 1 | (4) | (14) | – | 13 |
| Other income/(expense) | 2 | 6 | – | (11) | (15) | (18) |
| Development costs | (21) | (6) | (1) | – | – | (28) |
| IFRS based operating profit/(loss) before tax | 187 | 95 | 33 | (25) | (15) | 275 |
| Tax on operating profit | | | | | | 16 |
| IFRS based operating profit after tax attributable to ordinary shareholders | | | | | | 291 |
| Operating earnings per share (pence) | | | | | | 30.85 |

## 3. Segmental information continued

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

| Year ended 31 December 2011 | UK £m | Int'l £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(i) | (178) | (1) | (1) | – | – | (180) |
| Amortisation and impairment of acquired value of in-force business | (483) | (126) | (66) | – | – | (675) |
| Amortisation of other acquired 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)** |

| Year ended 31 December 2010 | UK £m | Int'l £m | Lombard £m | FLG corporate £m | RSL corporate £m | Total £m |
|---|---|---|---|---|---|---|
| IFRS based operating profit/(loss) before tax | 187 | 95 | 33 | (25) | (15) | 275 |
| Non-recurring items(ii) | (121) | (6) | – | 928 | (14) | 787 |
| Amortisation of acquired present value of in-force business | (169) | (123) | (72) | – | – | (364) |
| Amortisation of other acquired intangible assets | (27) | (8) | (28) | (1) | – | (64) |
| Interest payable on STICS | 31 | – | – | – | – | 31 |
| Short-term fluctuations in investment return(iii) | 28 | 2 | 1 | (7) | – | 24 |
| Profit/(loss) before tax excluding returns generated within policyholder funds | (71) | (40) | (66) | 895 | (29) | 689 |
| Policyholder tax | 244 | – | – | – | – | 244 |
| Returns on Group-controlled funds attributable to third parties | 23 | – | – | – | – | 23 |
| Profit/(loss) before tax from continuing operations | 196 | (40) | (66) | 895 | (29) | 956 |

(i) UK non-recurring items 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. Further details are set out in note 39. This is offset by £293 million of non-recurring costs comprising £128 million of separation and integration costs in respect of the UK Life Project, £55 million in respect of Solvency II and finance system developments, £84 million of reserve impacts in respect of the outsourcing arrangement with Diligenta and £26 million of other costs.

(ii) Corporate non-recurring items include £883 million in respect of the gain on acquisition of AXA UK Life Business. Further details are set out in note 39. Non-recurring costs of £96 million comprise £34 million of separation and integration costs in respect of the acquired AXA UK Life Business, £28 million in respect of expensed acquisition costs, £24 million in respect of Solvency II and other finance transformation costs and £10 million of other items. Segment results also include £80 million of non-recurring items comprising recharges to the life companies for pension scheme contributions. The net impact of the recharge for the Group is nil.

(iii) Includes shareholder investment return short-term fluctuations (see note 4(d)) 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.

## 3. Segmental information continued

### (iii) Revenue and expenses

| For the year ended 31 December 2011 | UK £m | Int'l £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 to 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** | (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 fee income and loan interest. Inter-segment transactions are undertaken on an arm's length basis.
(iii) Includes gains on acquisitions of BHA (£68 million) and WLUK (£48 million).

## 3. Segmental information continued

| For the year ended 31 December 2010 | UK £m | Int'l £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 | 3,457 | 1,063 | 3,021 | – | – | – | 7,541 |
| Investment contract premiums[i] | (2,181) | (1,051) | (3,021) | – | – | – | (6,253) |
| Gross earned premiums | 1,276 | 12 | – | – | – | – | 1,288 |
| Premiums ceded to reinsurers | (240) | (1) | – | – | – | – | (241) |
| Net earned premiums | 1,036 | 11 | – | – | – | – | 1,047 |
| Fee and commission income | 373 | 266 | 111 | 1 | – | – | 751 |
| Investment return | 6,477 | 569 | 1,374 | 22 | 20 | (36) | 8,426 |
| Total revenue | 7,886 | 846 | 1,485 | 23 | 20 | (36) | 10,224 |
| Inter-segment revenue | 3 | 1 | – | 14 | 18 | (36) | – |
| Total external revenue | 7,883 | 845 | 1,485 | 9 | 2 | – | 10,224 |
| Other income[iii] | 8 | – | – | 883 | – | – | 891 |
| Net claims and benefits paid | (1,678) | (4) | – | – | – | – | (1,682) |
| Movement in insurance and investment contract liabilities | (4,768) | (694) | (1,292) | – | – | – | (6,754) |
| Transfer to unallocated surplus | (2) | (2) | – | – | – | – | (4) |
| Movement in net assets attributable to unit-holders | (139) | – | – | – | – | – | (139) |
| Acquisition expenses | (329) | (15) | (48) | – | – | – | (392) |
| Administrative and other expenses | (670) | (169) | (208) | 18 | (32) | – | (1,061) |
| Finance costs | (108) | (6) | (3) | (29) | (17) | 36 | (127) |
| Total claims, benefits and expenses | (7,694) | (890) | (1,551) | (11) | (49) | 36 | (10,159) |
| Inter-segment expenses | (3) | (1) | – | (32) | – | 36 | – |
| Total external claims, benefits and expenses | (7,691) | (889) | (1,551) | 21 | (49) | – | (10,159) |
| Share of profits of associate and joint venture | (4) | 4 | – | – | – | – | – |
| Profit/(loss) before tax from continuing operations | 196 | (40) | (66) | 895 | (29) | – | 956 |
| Policyholder tax | (244) | – | – | – | – | – | (244) |
| Shareholder tax | 99 | 7 | 21 | (19) | – | – | 108 |
| Segmental result after tax | 51 | (33) | (45) | 876 | (29) | – | 820 |

(i) Accounted for as deposits under IFRS.
(ii) Eliminations include inter-segment fee income and loan interest. Inter-segment transactions are undertaken on an arm's length basis.
(iii) Includes £883 million in respect of the gain on acquisition of the AXA UK Life Business.

## 3. Segmental information continued

### (iv) Products and services

| For the year ended 31 December 2011 | Protection £m | Investment £m | Annuities £m | Individual pensions £m | Group pensions £m | Other(i) £m | Total £m |
|---|---|---|---|---|---|---|---|
| Gross earned premiums | 1,109 | 491 | 407 | 63 | 58 | – | 2,128 |
| Net earned premiums | 876 | 489 | 46 | 61 | 57 | – | 1,529 |
| Fee and commission income | 3 | 294 | – | 246 | 19 | 209 | 771 |
| **Total external revenue** | 879 | 783 | 46 | 307 | 76 | 209 | 2,300 |

| For the year ended 31 December 2010 | Protection £m | Investment £m | Annuities £m | Individual pensions £m | Group pensions £m | Other(i) £m | Total £m |
|---|---|---|---|---|---|---|---|
| Gross earned premiums | 598 | 312 | 327 | 42 | 9 | – | 1,288 |
| Net earned premiums | 480 | 310 | 207 | 41 | 9 | – | 1,047 |
| Fee and commission income | (3) | 423 | – | 145 | 6 | 180 | 751 |
| Total external revenue | 477 | 733 | 207 | 186 | 15 | 180 | 1,798 |

(i) Other includes revenue streams from Sesame Bankhall and Pantheon (for the period prior to its disposal on 19 March 2010).

### (v) Assets and liabilities

| As at 31 December 2011 | UK £m | Int'l £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 |

| As at 31 December 2010 | UK £m | Int'l £m | Lombard £m | FLG corporate £m | RSL corporate £m | Elimination of inter-segment amounts(i) £m | Total £m |
|---|---|---|---|---|---|---|---|
| Segment assets | 96,551 | 7,184 | 17,930 | 1,325 | 911 | (1,568) | 122,333 |
| Investments in associate and joint venture | 5 | 27 | – | – | – | – | 32 |
| Total assets | 96,556 | 7,211 | 17,930 | 1,325 | 911 | (1,568) | 122,365 |
| Total liabilities | 91,237 | 6,814 | 17,487 | 936 | 910 | (1,568) | 115,816 |
| Other segment information: | | | | | | | |
| – Capital expenditure | 1 | – | 4 | 1 | – | – | 6 |
| – Depreciation | 1 | – | 1 | 2 | – | – | 4 |
| – Amortisation | 196 | 131 | 100 | 1 | – | – | 428 |

(i) Eliminations mainly comprise intercompany loans.

## 3. Segmental information continued

### (c) Geographical segmental information

In presenting geographical segment information, segment 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 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 |

| For the year ended 31 December 2010 | UK £m | Rest of the World £m | Total £m |
|---|---|---|---|
| Gross earned premiums | 1,276 | 12 | 1,288 |
| Fee and commission income | 398 | 353 | 751 |
| Revenue from external customers | 1,674 | 365 | 2,039 |
| Investment return | | | 8,426 |
| Premiums ceded to reinsurers | | | (241) |
| Total revenue | | | 10,224 |

## 4. Investment return

### a) Analysis of investment return

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Interest income: | | |
| – assets at fair value through profit or loss | 1,733 | 1,196 |
| – loans and receivables | 27 | 25 |
| Expected return on pension scheme assets, net of interest cost | 6 | 5 |
| Dividend income | 1,443 | 701 |
| Rental income | 190 | 120 |
| Movement in fair value: | | |
| – investment properties | 45 | 143 |
| – financial assets or financial liabilities at fair value through profit or loss: | | |
| – financial derivative instruments | 173 | (134) |
| – financial assets designated on initial recognition | (1,813) | 6,370 |
| **Total investment return** | 1,804 | 8,426 |

## 4. Investment return continued

### b) Longer term investment return – IFRS based operating profit

The longer term investment return used in arriving at IFRS based operating profit before tax is calculated in respect of equity and fixed interest investments of shareholder funds and surplus assets held within long-term funds, by applying the longer term rate of return for each investment category to the quarterly weighted average of the corresponding assets, after adjusting for the effect of any short-term market movements. The longer term rates of return are based on assumed gilt and cash returns, adjusted where appropriate to reflect the additional risks associated with the type of investment. The directors have determined the assumptions to be applied as follows:

| | 2011 % | 2010 % |
|---|---|---|
| Equities | **6.70** | 7.30 |
| Government fixed interest | **3.70** | 4.30 |
| Other fixed interest | **5.00** | 6.05 |
| Cash (life and pensions business) | **3.70** | 4.30 |
| Cash (corporate) | **1.14** | 1.01 |

The expected rate of return applied to cash held in the life and pensions businesses reflects the annualised swap curve spot rate, based on the term of the gilt portfolio (typically around 10 years). The rate applied to the cash held at corporate level is the one year spot rate reflecting the typically short-term nature of those cash balances.

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

| | 2011 £m | 2010 £m |
|---|---|---|
| Longer term investment return: | **(26)** | 13 |
| – After the impact of a 1% increase in the longer term rates of investment return | **(1)** | 30 |
| – After the impact of a 1% decrease in the longer term rates of investment return | **(50)** | (6) |

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

| | 2011 £m | 2010 £m |
|---|---|---|
| Actual investment return attributable to shareholders | **(72)** | 3 |
| Longer term shareholder investment return | **26** | (13) |
| **Deficit of actual shareholder return over longer term return** | **(46)** | (10) |

Short-term fluctuations in investment return reported in IFRS based operating profit comprise £(46) million deficit of actual shareholder return over longer term return, investment variances arising from the mismatching of fixed-interest asset and the liabilities they are backing as well as the impact of credit default assumptions. The latter variance reflects profit or losses in excess of the expected investment return on the assets and the impact of the corresponding economic assumption changes on the liabilities.

## 5. Net claims and benefits paid

| For year ended 31 December 2011 | Gross claims and benefits paid £m | Amounts receivable from reinsurers £m | Total net claims and benefits paid £m |
|---|---|---|---|
| Protection | 1,435 | (163) | 1,272 |
| Investment | 1,023 | (1) | 1,022 |
| Individual pensions | 680 | (1) | 679 |
| Group pensions | 29 | – | 29 |
| Annuities | 692 | (478) | 214 |
| **Total** | 3,859 | (643) | 3,216 |

| For year ended 31 December 2010 | Gross claims and benefits paid £m | Amounts receivable from reinsurers £m | Total net claims and benefits paid £m |
|---|---|---|---|
| Protection | 694 | (81) | 613 |
| Investment | 460 | (1) | 459 |
| Individual pensions | 488 | (1) | 487 |
| Group pensions | 18 | – | 18 |
| Annuities | 344 | (239) | 105 |
| Total | 2,004 | (322) | 1,682 |

## 6. Acquisition expenses

| For year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Commission | 383 | 317 |
| Other acquisition expenses | 493 | 355 |
| Deferral | (369) | (294) |
| Amortisation of deferred acquisition costs | 84 | 14 |
| **Net acquisition expenses** | 591 | 392 |

## 7. Administrative and other expenses

### a) Analysis of administrative and other expenses

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Amortisation and impairment of intangible assets | **759** | 428 |
| Employee remuneration | **189** | 132 |
| Auditor's remuneration (7b) | **11** | 10 |
| Investment expenses and charges | **246** | 185 |
| Investment property expenses | **9** | 4 |
| IT costs | **45** | 28 |
| Operating lease rentals, land and buildings | **22** | 14 |
| Renewal commission | **56** | 36 |
| Non-recurring costs (7c) | **212** | 96 |
| Other administrative expenses | **227** | 128 |
| **Total administrative and other expenses** | **1,776** | 1,061 |

### b) Auditor's remuneration

During the year the Group obtained the following services from the Group's auditor, Ernst & Young LLP, at costs as detailed in the table below.

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Fees payable for the audit of the Group's financial statements | **0.2** | 0.2 |
| Fees for the audit of subsidiaries pursuant to legislation | **4.9** | 4.5 |
| Other assurance services pursuant to legislation: | | |
| – audit related | **1.1** | 0.8 |
| – services as reporting accountants | **–** | 2.0 |
| Corporate finance transactions | **3.0** | 3.4 |
| Services relating to taxation | **0.1** | – |
| Other services: | | |
| – audit related assurance | **0.2** | 0.6 |
| – other assurance | **0.5** | 0.3 |
| – audit of Market Consistent Embedded Value ("MCEV") supplementary information | **0.5** | 0.5 |
| – other | **0.1** | 0.1 |
| | **10.6** | 12.4 |

The 2010 auditor's remuneration includes £2 million of fees related to services as reporting accountants that were capitalised against proceeds arising from the rights issue and hence were not included in administrative and other expenses.

### c) Non-recurring costs

Non-recurring costs include charges related to separation and integration activities concerning the acquired AXA UK Life Business, transaction costs associated with the acquisitions of BHA and WLUK, and expenditure on enhancing systems and reporting processes including Solvency II costs.

## 8. Staff pension schemes

### a) Introduction

The Friends Life group operates a defined benefit scheme: the Friends Provident Pension Scheme ("FPPS"). In addition, defined contribution schemes are operated by Friends Provident Management Services Limited ("FPMS"), Friends Provident International Limited ("FPIL") and Sesame Bankhall Group. Lombard does not operate a pension scheme.

On an IAS 19 basis, a gross surplus of £52 million has been recognised in respect of the FPPS at 31 December 2011 (£66 million surplus at 31 December 2010). The latest funding agreement was entered into in June 2010. This agreement was based on an actuarial 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. An updated triennial valuation has been carried out as at 30 September 2011 and the results of this are currently being considered by the Trustee. The valuation, once approved, will serve to assist the Trustee and the Group in determining future levels of funding.

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 £32 million has been recognised (£44 million at 31 December 2010), reflecting the 35% tax that would arise on any notional refund in respect of the resultant IAS 19 surplus of £92 million (£40 million deficit reduction contributions plus the current surplus of £52 million). A deferred tax asset of £10 million (2010: £16 million) has also been recognised to reflect tax relief at a rate of 25% (2010: 27%) that is expected to be available on the deficit reduction contributions, once paid into the scheme.

Employees of the acquired AXA UK Life Business (including WLUK) and BHA have been placed into new defined contribution arrangements for service accruing after the acquisition date. The pension obligation for service accruing up to the date of the acquisition is 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

The FPPS is a UK defined benefit scheme to which some of the Group's UK life and pensions employees from the acquired Friends Provident business belong. The scheme's assets, which are administered by three external investment managers, are held under the control of the Trustee and used to secure benefits for the members of the scheme and their dependants in accordance with the Trust Deed and Rules.

The Trustee board consists of a chairman who is appointed by the employer and six additional directors of which three are employer-appointed directors, two member-selected directors and one pensioner-selected director.

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

| As at 31 December | **2011 £m** | 2010 £m |
|---|---|---|
| **Amounts recognised in the consolidated statement of financial position** | | |
| IAS 19 pension surplus (excluding deficit reduction contribution) | **52** | 66 |
| Authorised payments surplus charge at 35% of available surplus following deficit reduction contributions | **(32)** | (44) |
| **Net pension scheme surplus (excluding deficit reduction contribution)** | **20** | 22 |

## 8. Staff pension schemes continued

### Movement in IAS 19 pension surplus

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| **Pension surplus at 1 January** | **66** | 59 |
| Current service cost(i) | **(7)** | (13) |
| Interest cost(i) | **(57)** | (55) |
| Expected return on pension assets(i) (ii) | **63** | 60 |
| Augmentations and termination benefits(i) | **–** | (3) |
| Employer contributions | **33** | 41 |
| Actuarial losses | **(46)** | (23) |
| **Pension surplus at 31 December (excluding authorised payments surplus charge)** | **52** | 66 |
| | | |
| Deficit reduction contributions | **40** | 60 |
| **Available surplus subject to authorised payments surplus charge** | **92** | 126 |

(i) Recognised in the consolidated income statement. The total loss recognised in the income statement for the year ended 31 December 2011 is £1 million (2010: loss of £11 million).
(ii) The actual return on plan assets was £185 million (2010: £104 million).

### Analysis of net pension surplus and related deferred tax asset

| 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** |

| As at 31 December 2010 | Pension surplus £m | Deferred tax £m |
|---|---|---|
| Gross IAS 19 pension surplus and related deferred tax liability | 66 | (18) |
| Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus) | (44) | – |
| Restriction of liability to authorised payments surplus charge | – | 18 |
| Tax relief available on deficit reduction contributions | – | 16 |
| Net pension surplus and related deferred tax asset | 22 | 16 |

## **8. Staff pension schemes** continued

### Amounts recognised in the consolidated statement of comprehensive income

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Actuarial losses | **(46)** | (23) |
| Reverse authorised payments surplus charge on opening surplus | **44** | 21 |
| Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus) | **(32)** | (44) |
| **Actuarial losses on defined benefit schemes** | **(34)** | (46) |
| Taxation | **2** | 25 |
| **Actuarial losses on defined benefit schemes after tax** | **(32)** | (21) |

A tax charge of £6 million (2010: £16 million credit) in respect of deficit reduction contributions and credits of £8 million (2010: £9 million) in respect of other movements in the pension scheme are included in the aggregate tax line of the consolidated statement of comprehensive income.

### c) FPPS additional disclosures

### i) Principal assumptions used by the Scheme Actuary in calculating the scheme liabilities

| For the year ended 31 December | 2011 % | 2010 % |
|---|---|---|
| Rate of increase in salaries(i) | **3.00** | 1.50 |
| Rate of increase in pensions in payment | **Relevant RPI inflation swap curve** | Relevant RPI inflation swap curve |
| Discount rate for active and deferred members | **5.03** | 5.60 |
| Discount rate for pensioners | **4.76** | 5.42 |

(i) Fixed rate of salary increases assumed for three years of 3% (2010: 1.50%) then salary increases at National Average Earnings (assumed RPI + 1%).

The 2011 inflation rate assumptions for revaluation of deferred pensions in excess of Guaranteed Minimum Pensions ("GMPs") have been based on the consumer price index as the statutory inflation index. In 2010, the basis for determining inflation rate assumptions for deferred pensions in excess of GMPs was amended from the retail price index to the consumer price index resulting in the recognition of a £29 million actuarial gain. The inflation rate assumptions for pensions in payment in excess of GMPs continue to be based on the retail price index under the scheme rules subject to the relevant LPI cap and floor of zero.

### ii) Mortality assumptions

Mortality assumptions are a proportion of the "SAPS-All" series mortality tables published by the Continuous Mortality Investigations ("CMI"), with proportions varying by sex and by status determined from an analysis of the member's postcodes and annual pension amounts:

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

In addition, allowance is made for future improvements in mortality according to each individual's year of birth through the use of the CMI's 2011 projection method, with a long-term trend parameter of 1.5% p.a. The mortality assumptions used have been updated from those used in 2010 with changes to both the initial mortality rates assumed and the rate at which longevity is expected to improve in the future.

The mortality assumptions provide the following average life expectancies of future members, currently aged 45 retiring at the age of 60, and current pensioners aged 70.

## 8. Staff pension schemes continued

| For the year ended 31 December | 2011 years | 2010 years |
|---|---|---|
| Expected age at death of future male pensioner | **90** | 91 |
| Expected age at death of future female pensioner | **92** | 92 |
| Expected age at death of current male pensioner | **89** | 88 |
| Expected age at death of current female pensioner | **90** | 90 |

The present value of providing an annuity of £1 per annum for members aged 60, based on the above assumptions, is as follows:

| Cost of annuities | 2011 £ | 2010 £ |
|---|---|---|
| Male annuity | **25.36** | 23.49 |
| Female annuity | **24.72** | 22.95 |

These rates assume a monthly payments model with a discount rate of 5.03% (2010: 5.60%). The rates also assume two-thirds of the members' benefit will be paid to the spouse on the death of the member. A guarantee is provided for pensioners who die within five years of retiring and pensions in excess of the GMPs accrued up to 31 December 2010 will increase in line with the LPI to a maximum 5% and accrued from 1 January 2011 will increase in line with the LPI to a maximum 2.5%.

| Cost of annuities | 2011 % of total membership | 2010 % of total membership |
|---|---|---|
| Active members | **10** | 12 |
| Deferred members | **63** | 62 |
| Pensioners | **27** | 26 |
| | **100** | 100 |

The sensitivities regarding the principal assumptions used to measure the scheme liabilities are set out below:

| Assumption | Change in assumption | Impact on scheme liabilities |
|---|---|---|
| Inflation | Increase/decrease by 0.5% | Increase/decrease by 8.5% |
| Salaries | Increase/decrease by 0.5% | Increase/decrease by 0.9% |
| Pensions | Increase/decrease by 0.5% | Increase/decrease by 7.7% |
| Discount rate | Increase/decrease by 0.5% | Decrease/increase by 10.7% |
| Rate of mortality | Increase/decrease by 1 year | Increase/decrease by 2.5% |

### iii) Changes in the present value of obligations of defined benefit scheme

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| **Present value of obligations at 1 January** | **1,047** | 953 |
| Current service cost | **7** | 13 |
| Interest cost | **57** | 55 |
| Contributions by plan participants | **1** | 1 |
| Actuarial loss | **168** | 67 |
| Benefits paid | **(38)** | (45) |
| Termination benefits | **–** | 1 |
| Augmentation | **–** | 2 |
| **Present value of obligations at 31 December** | **1,242** | 1,047 |

## **8. Staff pension schemes** continued

### iv) Analysis of defined benefit obligations

The profile of the obligations is analysed as follows:

| | 2011 £m | 2010 £m |
|---|---|---|
| Active members | **228** | 208 |
| Deferred members | **495** | 389 |
| Pensioners | **519** | 450 |
| Wholly or partly funded plans | **1,242** | 1,047 |

### v) Changes in present value of defined benefit plan assets

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| **Fair value of plan assets at 1 January** | **1,113** | 1,012 |
| Expected return on plan assets | **63** | 60 |
| Actuarial gains | **122** | 44 |
| Employer contributions | **33** | 41 |
| Contributions by plan participants | **1** | 1 |
| Benefits paid | **(38)** | (45) |
| **Fair value of plan assets at 31 December** | **1,294** | 1,113 |

At 31 December 2011, there were no investments in internal linked funds (2010: £nil).

### vi) Assets in the defined benefit scheme and the expected rate of return

| | Expected rate of return 2011 % | Value 2011 £m | Expected rate of return 2010 % | Value 2010 £m |
|---|---|---|---|---|
| Equities | **5** | **180** | 7 | 192 |
| Liability-driven investment pools | **5** | **398** | 6 | 284 |
| Fixed interest (LDI in specie) | **5** | **173** | 6 | 148 |
| Insured assets | **5** | **513** | 5 | 447 |
| Cash | **2** | **30** | 3 | 42 |
| Total market value of assets | | **1,294** | | 1,113 |
| Present value of scheme liabilities | | **(1,242)** | | (1,047) |
| **Surplus in the scheme** | | **52** | | 66 |

The expected return on net pension scheme assets is calculated using the assumptions and the market value of pension scheme assets as stated in the table above for the preceding year.

## 8. Staff pension schemes continued

### vii) History of experience gains and losses of defined benefit scheme

| | 2007 £m | 2008 £m | 2009 £m | 2010 £m | **2011 £m** |
|---|---|---|---|---|---|
| Present value of defined benefit obligation | (971) | (912) | (953) | (1,047) | **(1,242)** |
| Fair value of plan assets | 976 | 1,025 | 1,012 | 1,113 | **1,294** |
| Surplus | 5 | 113 | 59 | 66 | **52** |
| Difference between the expected and actual return on scheme assets | | | | | |
| – Amount | 14 | (17) | (66) | 36 | **122** |
| – Percentage of closing scheme assets | 1% | (2%) | (7%) | 3% | **9%** |
| Experience gains and losses on scheme liabilities | | | | | |
| – Amount | 24 | (17) | (5) | 3 | **11** |
| – Percentage of the present value of the scheme liabilities | 2% | (2%) | (1%) | 0% | **1%** |
| Total amount recognised in the statement of comprehensive income | | | | | |
| – Amount | 32 | 85 | (77) | (46) | **(34)** |
| – Percentage of the present value of the scheme liabilities | 3% | 9% | (8%) | (4%) | **(3%)** |

The table above is provided for information purposes as the FPPS has been in existence for longer than the 26 months since the Group acquired Friends Provident on 4 November 2009.

### viii) Future funding

As stated in section (a) above, the results of an updated triennial valuation as at 30 September 2011 are being considered by the Trustee. From 1 July 2007, the scheme has been closed to new members.

Existing member contributions were 6% in 2009, 2010, and first quarter 2011, and 7% from April 2011, for benefits with a pension age of 60, and 2% for benefits with a pension age of 65. The Group increased its contributions from 20% to 25% in 2009 and paid an extra 1% in 2010 and first quarter 2011 for pension age 60 members, as their rate was held at 6% in 2010 and first quarter 2011 and the increase to 7% delayed until April 2011.

Following a previous review of the key employment benefits and following consultation, the Group has amended the provision of defined benefits under the FPPS from 1 January 2011 as follows:

- the future service accrual rate has been reduced from one-sixtieth to one-eightieth for each year of pensionable service;
- the inflation limit on increases to pensions in deferment and payment reduced from 5% to the statutory level of 2.5% for future service;
- final pensionable salary is being phased in to become a three-year average for all pensionable service (with pensionable salary becoming fixed at 1 April each year). For past service, final pensionable salary will be not less than the rate of pensionable salary at 31 December 2010 and not less than the rate of pensionable salary as at 31 March 2011; and
- member contributions for pension age 60 benefits became 7% from 1 April 2011 and for pension age 65 benefits 2%.

The Group has reduced its future service contribution to 15% from October 2011 following the previous review, although this rate is subject to the current triennial review as at 30 September 2011.

A Statement of Funding Principles was agreed by the Group and the Trustee in June 2010. That statement provides the principles around assumption setting, in particular, choosing the discount rate, future price inflation, future pension increases, rates of mortality, future pay increases, employee turnover, pension commencement age, and typical partner or dependant information and assumes:

- the discounted value of the annuity contract with Aviva Annuity UK Limited ("Aviva") will exactly match the discounted liabilities for pensioners insured under the contract. The pensions in payment up to 30 June 2011 have now been reassured by the Trustees to Aviva under a buy-in annuity contract where the premium progressively transfers from the Trustee to Aviva over the duration of the contract;
- the strategic allocation to matched assets will normally be maintained at around 75% of non-insured assets and provide a return equal to the yield available on swaps contracts of a tenor that matches the liability cash flows;

## 8. Staff pension schemes continued

- the strategic allocation to return seeking assets will normally be maintained at around 25% of non-insured assets and provide a return that is 3% in excess of the return on the matched assets; and
- the discounted value of non-insured liabilities will be broadly equal to swaps plus 0.75% in excess of the yields available on swaps contracts of the appropriate tenor.

In addition the Trustee has the following objectives for investments, as set out in the Statement of Investment Principles:

- to achieve and maintain a minimum funding level of 100% on a long-term ongoing basis; and
- to agree the cost of providing the benefits and consult the Employer on any material changes that may be required to the agreed funding arrangements in light of experience.

Amounts paid to FPPS in the past three years and expected future payments over the next three years, subject to the triennial review as at 30 September 2011, are as follows:

| | £m |
|---|---|
| **FPPS contributions paid** | |
| 2009 | 28 |
| 2010 | 41 |
| 2011 | 33 |
| **FPPS contributions expected to be paid** | |
| 2012 | 25 |
| 2013 | 25 |
| 2014 | 4 |

### ix) Risk management

The Trustee has established a separate Risk and Investment Subcommittee which is responsible for assisting the Trustee in investment policy and monitoring the Scheme's investments. The Risk and Investment Subcommittee seeks advice from the investment adviser and believes it has sufficient skills and expertise to make investment decisions based on this advice.

The Trustee sets general investment policy but delegates day-to-day responsibility for the selection of specific investments (other than investments in respect of members' voluntary contributions) to the Investment Manager.

The Trustee has set performance and risk targets for the Investment Manager on non-insured assets. The performance objectives are long term (five years), however, the Trustee monitors the Investment Manager on a regular basis in order to ensure that it is on track to meet its long-term objectives.

#### Interest rate and inflation risk

The Trustee originally adopted a Liability-Driven Investment ("LDI") strategy in 2003 to reduce exposure to interest rate and inflation risk. This strategy was extended in 2008 to reduce exposure to a wider range of risks in respect of pension in payment through investing in an insured bulk annuity buy-in contract that now covers pensions in payment up to 30 June 2011. The trustee also invests in a pooled LDI product managed by F&C Asset Management ("F&C") to reduce exposure to interest rate and inflation risk for some non insured liabilities. Within F&C's pooled product, the Trustee now has a bespoke pool in which the Trustee is the sole investor.

Within the bespoke LDI pool, F&C manage a LIBOR sub-fund of fixed interest securities together with interest rate and inflation swaps that can have durations of up to 50 years. The LDI product is collateralised daily and is managed within a controlled leverage range by F&C; the LDI pools have a weekly investment valuation. The flexibility of F&C's LDI product will mean that the scheme can review the liabilities periodically to ensure the interest rate and inflation sensitivities are well matched based on the latest cash flow data for non-insured members.

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

The buy-in annuity contract mitigates a wider range of risks than the original LDI strategy and for the pensions in payment that have been progressively insured up to 30 June 2011, covers market and longevity risk in addition to interest rate and inflation risk.

#### Market risk

The Trustee, with the full support of the Group, has agreed and implemented a strategic asset allocation to return-seeking assets of 25% of the non-insured fund.

## 8. Staff pension schemes continued

### Longevity risk

The Trustee, with the full support and involvement of the Group, first invested 37% of the scheme's assets in a bulk annuity contract with Aviva Annuity UK Limited as a buy-in investment in 2008 with a further tranches of investment in 2009, 2010 and 2011. The contract between the Trustee and Aviva now reassures benefits for pensioners in payment up to 30 June 2011 and includes a facility for the Trustee to invest further tranches of benefits in 2012 and 2013.

The contract is an investment of the Trustee and includes additional security to that of a standard bulk annuity contract with an insurance company. The ownership of the scheme's assets are being drip fed to Aviva over the duration of the contract. This additional protection has been negotiated by the Trustee to mitigate the risk of any decline in the financial strength of Aviva as the counterparty under the contract. These assets have been set up under a ring-fenced Trustee Investment Plan that is managed by Aviva and with the title to those assets secured in the Trustee's name through a safekeeping custody account set up with Citibank. These ring-fenced assets would only be accessed by the Trustee in the event of Aviva failing to meet its obligations under this long-term contract.

### Currency risk

From December 2009 the Trustee has invested its return-seeking assets through two new managers, Aberdeen Unit Trust Managers Limited and Walter Scott & Partners Limited in their global equity pooled funds. These managers take account of currency risks within their pooled fund vehicles.

### Operational risk

The investment managers do not directly hold the scheme's securities for non-insured assets. These non-insured assets are held in separate accounts with custodians, as appointed by the Investment Manager for pooled vehicles or by the Trustee for non-pooled investments. Special arrangements noted above apply to insured assets under the Aviva contract.

### d) Other pension schemes

The Group operated four defined contribution schemes: the schemes operated by Friends Provident, FPI, Sesame Group and as mentioned in section (a), the scheme set up for employees of the AXA UK Life Business and BHA. Contributions for the year were £3.3 million, £0.9 million, £0.8 million and £10.2 million (2010: £2.8 million, £1.2 million, £0.8 million and £2.8 million) respectively. Lombard does not operate a staff pension scheme.

The defined contribution scheme for former Friends Provident employees who have joined since July 2007 and the defined contribution scheme for former AXA, BHA employees and Friends Life new joiners are operated under the same Group Personal Pension Plan with Friends Life as the product provider. Although described as different defined contribution schemes, the Group Personal Pension Plan covers both schemes including the different sections. The range of amounts the Group contributes depends on the contribution structure for each section. Typically the Group contributes in a range between 7.3% and 13% depending on the employees' contributions and whether they are paid via salary sacrifice.

## 9. Share-based payments

### Lombard International Assurance SA

### i) Equity based scheme

Lombard senior management have been incentivised through a scheme that entitles them to share in the growth in value in Lombard. The scheme is an equity-settled share-based payment scheme. Subject to achievement of performance conditions, the scheme entitles participants to shares in Resolution Limited. The Plan lasts for six years, with 25% of the value accruing on the third, fourth, fifth and sixth anniversary of the Plan, with an effective start date of 1 January 2009. Scheme participants purchase shares in Lombard when they join the scheme. As at 31 December 2011, the scheme participants have purchased 1.6 million shares (2010: 1.4 million).

## 9. Share-based payments continued

The scheme's fair value on the commencement date was the best estimate of the cost of the scheme. It was valued based on probability weighted performance scenarios using the level of sales to estimate the number of awards expected to vest. This initially resulted in a fair value of £10 million to be expensed over the six year term of the scheme.

During 2010, the terms of the scheme were modified resulting in the fair value of the scheme increasing from £10 million to £22 million. This increases the total expense by £12 million spread over the years 2010 to 2015. The incremental value was also calculated using probability weighted performance scenarios.

A charge of £6 million has been recognised in the income statement in respect of this scheme (2010: £4 million) with a corresponding increase to equity.

### ii) Cash based scheme

Lombard middle management are incentivised through a scheme that entitles them to cash payments, based on a valuation of the Lombard business as at 31 December each maturity year. The first allocations were granted to participants in April 2010 and the first pay-outs, subject to the scheme performance conditions being achieved, will occur in 2013. A second allocation was made in April 2011.

In order to estimate the required provision, as each tranche of scheme has duration of three years, stochastic modelling techniques (based on option pricing methodology) are used to calculate both the intrinsic value and the time value of the liability under the scheme.

A charge of £1 million has been recognised in the income statement (2010: £1 million) and a corresponding liability is included in the Group statement of financial position. The total provision as at 31 December 2011 is £2 million (2010: £1 million).

### Friends Life group

FLG introduced a LTIP in 2010 to incentivise key individuals in the business by entitling them to a percentage share in the difference between the value realised on the completion of the UK Life Project and the aggregate cost of the acquisitions.

The scheme is a cash-settled share-based payment scheme and the fair value of the awards in issue, being the relevant percentage of the gain expected to arise on completion of the UK Life Project, is measured at each reporting date, with any changes in fair value being recognised in the income statement for the period.

The gain expected to arise has been estimated using forecasts and scenario-based modelling of likely outcomes based on varying levels of profitability of the business. This is reassessed at each reporting date.

The total number of units capable of being awarded is 10,000, and awards are allocated in single units of 1/10,000th of this number. The number of awards issued in the period was 2,975 and 1,150 were forfeited (2010: 3,525 and 25 respectively). At 31 December 2011 there were 5,325 (2010: 3,500) awards in issue and a charge of £2 million (2010 £5 million) has been recognised in the income statement with a corresponding liability recognised in the statement of financial position. The total provision as at 31 December 2011 is £7 million (2010: £5 million).

### Sesame Bankhall Group

Key management of the SBG have been incentivised through a scheme that entitles them to a share in the growth of SBG. The scheme is a cash-settled scheme. Subject to service conditions, the scheme entitles participants to cash that equates to 20% of the value of growth in share values of Friends Life Distribution Limited ("FLDL"); the immediate parent of the SBG companies. The plan commenced on 6 May 2011 and lasts for five years, with one-third of the value accruing on each of the dates 31 December 2014, 31 December 2015 and 31 December 2016. Scheme participants purchase shares in FLDL when they join the scheme. As at 31 December 2011, the scheme participants have purchased 0.5 million shares (2010: nil).

The fair value of obligations under the scheme is estimated at each reporting date, and is recognised over the course of the vesting period. The scheme has been valued based upon profit projections to 2015, resulting in a fair value of the obligation as at 31 December 2011 of £20 million.

A charge of £3 million has been recognised in the income statement in respect of this scheme and a corresponding liability is included in the Group statement of financial position.

## 10. Finance costs

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Subordinated loan interest | 46 | 17 |
| Debenture loan interest | – | 11 |
| Deferred consideration notes interest | 30 | 10 |
| Interest paid to reinsurers | 60 | 68 |
| Interest on acquisition finance facility | 10 | 8 |
| Interest paid to credit institutions | 19 | 13 |
| **Total finance costs** | **165** | **127** |

Interest expense is calculated using the effective interest rate method.

## 11. Taxation

### (a) Tax recognised in the income statement

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| **Current tax** | | |
| UK corporation tax at 26.5% (2010: 28%) | 52 | 16 |
| Adjustments in respect of prior periods | (11) | (15) |
| Overseas taxation | 18 | 6 |
| **Total current tax charge** | **59** | **7** |
| **Deferred tax** | | |
| Origination and reversal of temporary differences | (322) | 121 |
| Adjustments in respect of prior periods | 26 | 8 |
| **Total deferred tax (credit)/charge** | **(296)** | **129** |
| **Total tax (credit)/charge** | **(237)** | **136** |
| Analysis: | | |
| – policyholder tax | 220 | 244 |
| – shareholder tax | (457) | (108) |
| **Total tax (credit)/charge** | **(237)** | **136** |

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 in a phased decrease in the rate of corporation tax to 26% on 1 April 2011 and 25% on 1 April 2012. Under IFRS, deferred tax is calculated using rates substantively enacted by the balance sheet date and as such the reduction to a 25% rate has been taken into account in deferred tax balances. Further incremental rate reductions have been announced but not substantively enacted by the balance sheet date. For further information please refer to note 41.

## 11. Taxation continued

### (b) Factors affecting tax charge for period

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| **(Loss)/profit before tax from continuing operations** | **(268)** | 956 |
| (Loss)/profit before tax from continuing operations determined with reference to the standard rate of corporation tax in the UK of 26.5% (2010: 28%) | **(71)** | 268 |
| Effects of: | | |
| – non-taxable income | **(232)** | (115) |
| – deductions not allowable for tax purposes | **22** | 46 |
| – tax on reserving adjustments | **41** | 7 |
| – overseas tax | **(6)** | – |
| – utilisation of excess expenses brought forward | **–** | (8) |
| – valuation of tax losses | **(123)** | (43) |
| – with-profits minority interest[i] | **–** | (8) |
| – adjustments in respect of prior periods | **(8)** | (7) |
| – non-taxable gain on acquisition | **(31)** | (247) |
| – reduction in corporation tax rate from 27% to 25% (2010: 28% to 27%) | **(60)** | (8) |
| – non-taxable result of Resolution Holding Companies | **11** | 7 |
| – policyholder tax | **220** | 244 |
| **Total tax (credit)/charge** | **(237)** | 136 |

(i) The effect of with-profits minority interest in 2010 related to tax on F&C Commercial Property Trust prior to deconsolidation.

## 12. Appropriations of profit

### a) Dividends paid on ordinary shares

A final dividend in respect of 2010 of 12.57 pence per ordinary share was paid on 28 May 2011 comprising £141 million of cash and £41 million of shares issued in lieu of dividends. An interim dividend of 6.47 pence per ordinary share was paid on 7 October 2011 comprising £85 million of cash and £7 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. Also as required by IFRS, the costs of these dividends are taken directly to reserves. Subject to the approval of shareholders at the annual general meeting on 17 May 2012, a dividend of 13.42 pence per share will be paid on 21 May 2012 amounting to £185 million. Accordingly, this amount is not reflected in these financial statements.

### b) Step-up Tier 1 Insurance Capital Securities interest

The Step-up Tier 1 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 2011, interest of £14 million (2010: £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%, and interest of £17 million (2010: £17 million) was paid on 30 June 2011.

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

## 13. Earnings per share

### a) Basic and operating earnings per share from continuing operations

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

| For the year ended 31 December | 2011 Earnings £m | 2011 Pence per share | 2010 Earnings £m | 2010 Pence per share |
|---|---|---|---|---|
| **(Loss)/profit after tax attributable to equity holders of the parent** | **(62)** | **(4.35)** | 765 | 81.10 |
| Short-term fluctuations in investment return | **261** | **18.31** | (24) | (2.54) |
| Non-recurring items | **180** | **12.62** | (787) | (83.43) |
| Amortisation and impairment of acquired intangible assets | **759** | **53.23** | 428 | 45.37 |
| Tax credit on items excluded from operating profit | **(419)** | **(29.38)** | (91) | (9.65) |
| **IFRS based operating profit after tax attributable to equity holders of the parent** | **719** | **50.43** | 291 | 30.85 |

### b) Diluted basic earnings per share from continuing operations

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

| For the year ended 31 December 2010 | Earnings £m | Weighted average number of shares number | Pence per share |
|---|---|---|---|
| Profit after tax attributable to ordinary shareholders of the parent | 765 | 943,284,481 | 81.10 |
| Dilution | – | 7,347,287 | (0.63) |
| Diluted profit after tax attributable to ordinary shareholders of the parent | 765 | 950,631,768 | 80.47 |

### c) Weighted average number of ordinary shares

| 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** |

## 13. Earnings per share continued

### c) Weighted average number of ordinary shares continued

| For the year ended 31 December 2010 | Actual | Weighted |
|---|---|---|
| Issued ordinary shares at beginning of period | 2,412,451,145 | 2,412,451,145 |
| Effect of: | | |
| – scrip dividend (final 2009) | 5,753,268 | 3,436,198 |
| – share consolidation | (2,337,597,599) | (2,335,357,765) |
| – rights issue | 1,370,315,835 | 865,193,173 |
| – scrip dividend (interim 2010) | 1,641,722 | 382,319 |
| – own shares held by the Group | (8,579,292) | (2,820,589) |
| Number of ordinary shares at end of period | 1,443,985,079 | 943,284,481 |

## 14. Intangible assets

Movements in intangible assets are as follows:

| 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[i] | 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 period[ii] | 604 | 84 | 688 |
| Impairment charge[ii] | 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 |

## 14. Intangible assets continued

| For the year ended 31 December 2010 | AVIF £m | Other £m | Total £m |
|---|---|---|---|
| Cost | | | |
| At 1 January 2010 | 2,938 | 382 | 3,320 |
| Acquisition of AXA UK Life Business | 2,192 | 150 | 2,342 |
| Other additions | – | 4 | 4 |
| Foreign exchange adjustments | (23) | (8) | (31) |
| At 31 December 2010 | 5,107 | 528 | 5,635 |
| | | | |
| Amortisation | | | |
| At 1 January 2010 | 59 | 10 | 69 |
| Amortisation charge for the period | 364 | 64 | 428 |
| Foreign exchange adjustments | (1) | (1) | (2) |
| At 31 December 2010 | 422 | 73 | 495 |
| Carrying amounts at 31 December 2010 | 4,685 | 455 | 5,140 |

(i) Acquisitions in 2011 related to BHA and WLUK, see note 39.
(ii) Amortisation and impairment charges are included within administrative and other expenses in the consolidated income statement.

A detailed exercise was undertaken to identify intangible assets as part of the acquisition of BHA on 31 January 2011 and WLUK on 7 November 2011. As a result of the BHA review it was decided that the acquired business represented an additional cash generation unit ("CGU"). Intangible assets identified within BHA related to acquired value of in-force business ("AVIF") and software totalling £180 million. Intangible assets identified within WLUK related to AVIF and distribution channels and customer relationships totalling £268 million and are included in the UK – AXA UK Life Business CGU.

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 as set out in note 1.2.8.

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 the course of the year, a rebranding exercise was carried out to change all inherited brands to "Friends Life".

## 14. Intangible assets continued

### (a) AVIF

On acquisition of a portfolio of insurance contracts and/or investment contracts, either directly or through the acquisition of a subsidiary undertaking, the net present value of the Group's interest in the expected pre-tax cash flows of the in-force business is capitalised in the balance sheet as the "AVIF". AVIF is shown gross of policyholder and shareholder tax of £995 million (2010: £1,076 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.

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 3) is set out below:

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

| As at 31 December 2010 | Cost £m | Amortisation £m | Net book value £m |
|---|---|---|---|
| UK | 3,496 | (196) | 3,300 |
| International | 995 | (132) | 863 |
| Lombard | 616 | (94) | 522 |
| Total | 5,107 | (422) | 4,685 |

### (b) Other intangibles

Other intangibles are made up of the following:

| 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** |

| As at 31 December 2010 | Cost £m | Amortisation £m | Net book value £m |
|---|---|---|---|
| Distribution channels and customer relationships | 419 | (54) | 365 |
| Brand | 49 | (10) | 39 |
| Software | 47 | (9) | 38 |
| Goodwill | 13 | – | 13 |
| Total | 528 | (73) | 455 |

## 14. Intangible assets continued

### (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 income statement. As at 31 December 2011, 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.

#### Impact of negative reserves

As explained in note 26, the benefit of negative reserving has been offset by an acceleration of AVIF amortisation of £130 million in the AXA UK Life Business CGU and by an impairment charge against AVIF of £71 million in the BHA CGU. This is included within administrative and other expenses in the consolidated income statement.

The impairment arose from the implementation of negative reserves, which resulted in an earlier recognition of surplus and the recoverable amount of the AVIF being assessed to be lower than the carrying value. The AVIF asset which has been impaired is included in the UK segment (disclosed in note 3).

For the purpose of the AVIF impairment test, the calculation of the recoverable amount is consistent with its measurement at initial recognition and is based on a current adjusted MCEV VIF balance for pre-acquisition business only, which represents a reasonable basis for determining future profits generated by the asset acquired.

## 15. Property and equipment

| For the year ended 31 December 2011 | Owner occupied properties £m | Computer equipment £m | Fixtures, fittings and office equipment £m | Total £m |
|---|---|---|---|---|
| **Cost** | | | | |
| At 1 January 2011 | 38 | 7 | 5 | 50 |
| Acquisition through business combinations | 3 | – | – | 3 |
| Other additions | 5 | 1 | 10 | 16 |
| Revaluation | (3) | – | – | (3) |
| **At 31 December 2011** | 43 | 8 | 15 | 66 |
| **Depreciation** | | | | |
| At 1 January 2011 | – | 3 | 1 | 4 |
| Depreciation charge | – | 1 | 3 | 4 |
| **At 31 December 2011** | – | 4 | 4 | 8 |
| **Carrying amounts at 31 December 2011** | 43 | 4 | 11 | 58 |

## **15. Property and equipment** continued

| For the year ended 31 December 2010 | Owner occupied properties £m | Computer equipment £m | Fixtures, fittings and office equipment £m | Total £m |
|---|---|---|---|---|
| Cost | | | | |
| At 1 January 2010 | 39 | 7 | 2 | 48 |
| Acquisition through business combinations | – | – | 2 | 2 |
| Other additions | – | – | 2 | 2 |
| Disposals | (1) | – | (1) | (2) |
| At 31 December 2010 | 38 | 7 | 5 | 50 |
| Depreciation | | | | |
| At 1 January 2010 | – | 1 | – | 1 |
| Depreciation charge | – | 2 | 2 | 4 |
| Disposals | – | – | (1) | (1) |
| At 31 December 2010 | – | 3 | 1 | 4 |
| Carrying amounts at 31 December 2010 | 38 | 4 | 4 | 46 |

If owner-occupied properties were measured on a depreciated cost basis, the carrying amount would be £50 million (2010: £41 million).

## **16. Investment properties**

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| **At 1 January** | **3,189** | 1,546 |
| Purchases | **43** | 67 |
| Acquisitions through business combinations | **43** | 2,292 |
| Disposals | **(305)** | (859) |
| Fair value adjustments | **45** | 143 |
| **At 31 December** | **3,015** | 3,189 |

Of the total, £1,327 million (2010: £1,358 million) is held in with-profits funds and £1,688 million (2010: £1,831 million) in unit-linked funds.

## 17. Principal Group undertakings

Principal subsidiary undertakings of the Group as at 31 December 2011 are shown below.

Unless otherwise stated, they are undertakings incorporated in England and Wales and have only one class of issued ordinary shares. The voting rights are equal to the percentage holdings unless otherwise stated.

In addition to the companies shown below, the Company also holds investments in a number of other subsidiary undertakings, which in the directors' opinion do not significantly affect the consolidated financial statements. A full list of FLG group subsidiaries will be annexed to FLG's annual return filed at Companies House.

| Subsidiary undertaking | Activity | % held |
|---|---|---|
| **Corporate** | | |
| Resolution Holdco No.1 LP[(i) (ii)] | Holding company | 99.99 |
| Resolution Holdings (Guernsey) Limited[(iii)] | Holding company | 100 |
| Friends ASLH Limited | Holding company | 100 |
| Friends Life FPG Limited | Holding company | 100 |
| Friends Life FPL Limited | Holding company | 100 |
| Friends Life Group plc | Holding company | 100 |
| **Life and Pensions** | | |
| Friends Annuities Limited | Insurance | 100 |
| Friends Life and Pensions Limited | Insurance | 100 |
| Friends Life Assurance Society Limited | Insurance | 100 |
| Friends Life Company Limited | Insurance | 100 |
| Friends Life Limited | Insurance | 100 |
| Friends Provident International Limited[(iv)] | Insurance | 100 |
| Lombard International Assurance SA[(v)] | Insurance | 99.23 |
| Winterthur Life UK Limited[(vi)] | Insurance | 100 |
| Friends Life Services Limited | Management services | 100 |
| Friends Provident Management Services Limited | Management services | 100 |
| **Other** | | |
| Sesame Bankhall Group Limited | IFA distribution business | 100 |

(i) Held directly by Resolution Limited (all other companies are held indirectly)
(ii) Guernsey Limited partnership
(iii) Incorporated in Guernsey
(iv) Incorporated in Isle of Man.
(v) Incorporated in Luxembourg. The Group's holding in 2010 was 99.24%.
(vi) FSA change of control was granted on 7 November 2011. The acquisition was completed on 30 November 2011.

## 18. Investments in associates and joint venture

### a) Associates

| | 2011 £m | 2010 £m |
|---|---|---|
| **Carrying amount of investments** | **32** | 27 |

Investments in associated undertakings include the Group's investment in AmLife Insurance Berhad, a Malaysian based life assurance business. The Group's interest in the ordinary share capital of AmLife is 30%. In addition, on 17 January 2011, Friends Life FPL Limited subscribed to 30% of the ordinary share capital of a newly formed company, AmFamily Takaful Berhad, a life assurance company incorporated in Malaysia, for RM 30 million (£6 million). The Takaful business is the Islamic alternative to conventional life insurance business which complies with Sharia law.

Under the terms of the Shareholders' Agreements in respect of both businesses, should either shareholder wish to dispose of its shareholding, they are obliged by the pre-emption rights to first offer its shares to the other shareholder. In the event that the other shareholder does not wish to purchase the shares and a third party purchaser cannot be found, the vendor can force the other shareholder to buy them by way of a put option. The value of such a put option has not been determined or reflected in the financial statements as the conditions that could warrant the exercise of the option did not exist at the balance sheet date.

The Group's share of the total assets, liabilities, revenues and profits of its associates is as follows:

| | 2011 £m | 2010 £m |
|---|---|---|
| Current assets | **32** | 9 |
| Non-current assets | **39** | 71 |
| Current liabilities | **(17)** | (15) |
| Non-current liabilities | **(22)** | (38) |
| **Net assets** | **32** | 27 |
| **Revenue** | **27** | 41 |
| **(Loss)/profit before tax** | **(1)** | 4 |

### b) Joint venture

| | 2011 £m | 2010 £m |
|---|---|---|
| **Carrying amount of investment** | **5** | 5 |

This investment is in Tenet Group Limited, an Independent Financial Advisor ("IFA") firm which comprises two IFA networks, and a compliance network and intermediary operating in the mortgage and general insurance sectors. The Group's interest in the ordinary share capital of Tenet Group Limited is 23.67% (2010: 21.25%). The Group's share of assets, liabilities, revenue and profits is as follows:

| | 2011 £m | 2010 £m |
|---|---|---|
| Current assets | **9** | 9 |
| Current liabilities | **(2)** | (2) |
| Non-current liabilities | **(2)** | (2) |
| **Net assets** | **5** | 5 |
| **Revenue** | **20** | 15 |
| **Profit before tax** | **–** | – |

## 19. Financial assets

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

| As at 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Fair value through profit or loss (note 19(a)) | | |
| Designated on initial recognition | **102,756** | 98,312 |
| Held for trading | **875** | 456 |
| Loans at amortised cost (note 19(f)) | **5** | 677 |
| **Total financial assets** | **103,636** | 99,445 |

Derivative financial instruments are classified as held for trading in accordance with IAS 39: *Financial instruments: Recognition and measurement*. 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 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 matures on 31 July 2012. UK government securities were loaned and the assets remain on balance sheet as substantially all the risks and rewards of ownership are retained by the Group. The Group holds collateral in respect of these arrangements.

| As at 31 December 2010 | With-profits £m | Unit-linked £m | Non-linked annuities £m | Non-linked other £m | Shareholder £m | Total £m |
|---|---|---|---|---|---|---|
| Shares and other variable yield securities | 8,108 | 52,003 | – | 241 | 8 | 60,360 |
| Debt securities and other fixed income securities: | | | | | | |
| – Government securities | 6,937 | 7,644 | 659 | 716 | 189 | 16,145 |
| – Corporate bonds | 8,885 | 5,445 | 5,634 | 922 | 569 | 21,455 |
| Derivative financial instruments | 393 | 24 | 39 | 5 | (5) | 456 |
| Deposits with credit institutions | 3 | 349 | – | – | – | 352 |
| Total financial assets held at fair value | 24,326 | 65,465 | 6,332 | 1,884 | 761 | 98,768 |

As at 31 December 2011, the fair value of the collateral received from counterparties was £850 million (2010: £306 million). No collateral received from the counterparties has been sold or re-pledged. The fair value of loans is considered to be the same as their carrying value.

The above unit-linked column and with-profits column include £1,129 million (2010: £964 million) of financial assets (£818 million of shares, £219 million of government securities and £92 million of corporate bonds) relating to the minority interests in the OEICs that have been consolidated as the Group holding is 50% or more.

## **19. Financial assets** continued

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 £93,863 million (2010: £87,707 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 £3,060 million (2010: £2,505 million) and 94% (2010: 92%) of these are at investment grade as set out in note 28.

### 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 certain corporate bonds, 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 as follows:

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. Valuation 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.

The requirements of IFRS 7 also require financial liabilities at fair value to be categorised into Level 1, 2 or 3 hierarchies. Financial liabilities at fair value 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.

## 19. Financial assets continued

The Group has financial liabilities which contain discretionary participation features of £9,426 million (2010: £9,123 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 fees).

| | 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 |

## **19. Financial assets** continued

| As at 31 December 2010 | Including unit-linked Level 1 £m | Level 2 £m | Level 3 £m | Total £m | Excluding unit-linked Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|---|---|---|---|
| Financial assets held at fair value | | | | | | | | |
| Shares and other variable yield securities | 48,119 | 8,892 | 3,349 | 60,360 | 7,103 | 271 | 983 | 8,357 |
| Debt securities and other fixed income securities: | | | | | | | | |
| – government securities | 16,094 | 51 | – | 16,145 | 8,500 | 1 | – | 8,501 |
| – corporate bonds (including ABS) | 12,317 | 8,035 | 1,103 | 21,455 | 9,601 | 6,051 | 358 | 16,010 |
| Derivative financial instruments | 54 | 402 | – | 456 | 51 | 381 | – | 432 |
| Deposits with credit institutions | 351 | 1 | – | 352 | 3 | – | – | 3 |
| Total financial assets held at fair value | 76,935 | 17,381 | 4,452 | 98,768 | 25,258 | 6,704 | 1,341 | 33,303 |
| Financial liabilities held at fair value | | | | | | | | |
| Unit-linked investment contracts | – | 62,492 | – | 62,492 | – | – | – | – |
| Amounts due to reinsurers | – | 1,666 | – | 1,666 | – | 1,666 | – | 1,666 |
| Net asset value attributable to unit-holders | 1,173 | – | – | 1,173 | 11 | – | – | 11 |
| Derivative financial instruments | 27 | 138 | – | 165 | 27 | 127 | – | 154 |
| Total financial liabilities held at fair value | 1,200 | 64,296 | – | 65,496 | 38 | 1,793 | – | 1,831 |

# 19. Financial assets continued

## c) Transfers between Level 1 and Level 2

During the year, £452 million (2010: £958 million) of shares and other variable yield securities were transferred from Level 1 to Level 2 and £1,413 million (2010: £735 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 and market activity. 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. Transfers out of Level 3 arise due to availability of prices in an active market and the refinement of methodology that took place during 2010.

| | 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 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)** |

| | 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 2010 | 4,720 | – | 688 | 5,408 |
| Acquisition through business combinations | 529 | – | 213 | 742 |
| Total gains in income statement | 394 | – | 180 | 574 |
| Purchases | 1,100 | – | 216 | 1,316 |
| Sales | (889) | – | (99) | (988) |
| Net transfer to Level 1 and Level 2 | (2,477) | – | (58) | (2,535) |
| Foreign exchange adjustments | (28) | – | (37) | (65) |
| At 31 December 2010 | 3,349 | – | 1,103 | 4,452 |
| Total gains or losses for the year included in profit or loss for assets held at 31 December 2010 | 184 | – | 139 | 323 |

## 19. Financial assets continued

### e) Level 3 sensitivity analysis

| As at 31 December | 2011 Carrying amount £m | 2011 Effect of reasonably possible alternative assumptions £m | 2010 Carrying amount £m | 2010 Effect of reasonably possible alternative assumptions £m |
|---|---|---|---|---|
| Unit-linked investments | 2,835 | – | 3,111 | – |
| Shares and other variable yield securities | 1,124 | 224 | 983 | 196 |
| Government bonds | 5 | 1 | – | – |
| Corporate bonds (including ABS) | 510 | 51 | 358 | 36 |
| **Total Level 3 financial assets** | **4,474** | **276** | **4,452** | **232** |

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 | 2011 £m | 2010 £m |
|---|---|---|
| Mortgage loans | 2 | 61 |
| Other loans | 3 | 616 |
| **Total loans** | **5** | **677** |

Loan assets of £600 million which were held at 31 December 2010 were repaid in March 2011.

# 19. Financial assets continued

## g) Assets backing unit-linked liabilities

The carrying value of policyholder liabilities relating to unit-linked business is shown in note 27(b). These liabilities are classified as either insurance or investment contracts. The net assets backing these liabilities are included within the relevant balances in the consolidated statement of financial position and are analysed as follows:

| As at 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Shares and other variable yield securities | **53,487** | 52,003 |
| Debt securities and other fixed-income securities | **14,172** | 13,089 |
| Derivative financial instruments | **7** | 24 |
| Deposits with credit institutions | **381** | 349 |
| Total financial assets held at fair value | **68,047** | 65,465 |
| Investment properties | **1,688** | 1,831 |
| Insurance and other receivables | **875** | 268 |
| Cash and cash equivalents | **4,779** | 4,991 |
| **Total assets** | **75,389** | 72,555 |
| Other payables | **(124)** | (194) |
| Net asset value attributable to unit-holders(i) | **(1,137)** | (1,097) |
| **Total unit-linked net assets** | **74,128** | 71,264 |

(i) This removes the impact, for the purposes of this analysis, of consolidation adjustments in respect of OEICs which the Group is deemed to control.

# 20. Deferred acquisition costs

| For the year ended 31 December 2011 | Insurance contracts £m | Investment contracts £m | Total £m |
|---|---|---|---|
| **At 1 January** | **34** | **324** | **358** |
| Incurred and deferred in the period | **63** | **306** | **369** |
| Amortisation | **(7)** | **(77)** | **(84)** |
| **At 31 December** | **90** | **553** | **643** |

| For the year ended 31 December 2010 | Insurance contracts £m | Investment contracts £m | Total £m |
|---|---|---|---|
| At 1 January | – | 46 | 46 |
| Incurred and deferred in the period | 40 | 254 | 294 |
| Amortisation charge to the income statement | (6) | (8) | (14) |
| Other movements(i) | – | 32 | 32 |
| At 31 December | 34 | 324 | 358 |

(i) Other movements relate to foreign exchange movements and enhanced unit allocations.

Included in the carrying values above, £570 million (2010: £326 million) is expected to be recovered more than 12 months after the balance sheet date. Acquisition expenses that do not meet the criteria for deferral are expensed directly as incurred.

## 21. Reinsurance assets

| For the year ended 31 December | 2011 Total £m | 2010 Total £m |
|---|---|---|
| **At 1 January** | **2,637** | 1,972 |
| Acquired through business combinations | **485** | 640 |
| Premiums | **599** | 241 |
| Claims | **(643)** | (322) |
| Other movements | **135** | 106 |
| **At 31 December** | **3,213** | 2,637 |

No significant gain or loss arose on reinsurance contracts incepted in the period. The Group takes out reinsurance on its insurance contracts, but not its investment contracts.

Included in the carrying values above, £2,991 million (2010: £2,485 million) is expected to be recovered more than 12 months after the balance sheet date.

Reinsurance assets are valued using the same methods and bases as those used to value the underlying liabilities that are being reinsured.

## 22. Deferred tax assets and liabilities

### a) Recognised deferred tax assets and liabilities

Deferred tax assets and liabilities are attributable to the following:

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| As at 31 December | Assets £m | Liabilities £m | Net £m | Assets £m | Liabilities £m | Net £m |
| Property and equipment | **32** | **–** | **32** | 51 | – | 51 |
| AVIF | **–** | **(995)** | **(995)** | – | (1,076) | (1,076) |
| Other intangible assets | **–** | **(82)** | **(82)** | – | (100) | (100) |
| Unrealised gains on investments | **–** | **(215)** | **(215)** | – | (339) | (339) |
| Employee benefits | **10** | **–** | **10** | 16 | – | 16 |
| Deferred acquisition costs | **–** | **(25)** | **(25)** | 110 | – | 110 |
| Tax value of recognised tax losses | **467** | **–** | **467** | 289 | – | 289 |
| Short-term temporary differences | **–** | **(64)** | **(64)** | – | (62) | (62) |
| **Deferred tax assets/(liabilities)** | **509** | **(1,381)** | **(872)** | 466 | (1,577) | (1,111) |
| **Offset of deferred tax (liabilities)/assets** | **(509)** | **509** | **–** | (462) | 462 | – |
| **Net deferred tax assets/(liabilities)** | **–** | **(872)** | **(872)** | 4 | (1,115) | (1,111) |

At 31 December 2011, all deferred tax assets have been offset against deferred tax liabilities. At 31 December 2010, £4 million of deferred tax assets could not be offset against deferred tax liabilities and were presented gross in the statement of financial position.

## 22. Deferred tax assets and liabilities continued

### b) Movement in temporary differences during the period

| For the year ended 31 December 2011 | At 1 January 2011 £m | Recognised in income £m | Recognised in other comprehensive income £m | Foreign exchange £m | Acquired in year £m | Disposals in year £m | At 31 December 2011 £m |
|---|---|---|---|---|---|---|---|
| Property and equipment | 51 | (19) | – | – | – | – | 32 |
| AVIF(i) | (1,076) | 169 | – | 12 | (100) | – | (995) |
| Other intangible assets | (100) | 27 | – | – | (9) | – | (82) |
| Unrealised gains on investments | (339) | 122 | – | – | 2 | – | (215) |
| Employee benefits | 16 | (8) | 2 | – | – | – | 10 |
| Deferred acquisition costs | 110 | (135) | – | – | – | – | (25) |
| Tax value of recognised tax losses | 289 | 139 | – | – | 39 | – | 467 |
| Short-term temporary differences | (62) | 1 | – | – | (3) | – | (64) |
| **Net deferred tax (liabilities)/assets** | **(1,111)** | **296** | **2** | **12** | **(71)** | **–** | **(872)** |

| For the year ended 31 December 2010 | At 1 January 2010 £m | Recognised in income £m | Recognised in other comprehensive income £m | Foreign exchange £m | Acquired in year £m | Disposals in year £m | At 31 December 2010 £m |
|---|---|---|---|---|---|---|---|
| Property and equipment | 40 | (2) | – | – | 11 | 2 | 51 |
| AVIF(i) | (594) | 89 | – | 7 | (578) | – | (1,076) |
| Other intangible assets | (87) | 15 | – | – | (28) | – | (100) |
| Unrealised gains on investments | (12) | (196) | – | – | (131) | – | (339) |
| Employee benefits | 1 | (10) | 25 | – | – | – | 16 |
| Deferred acquisition costs | (1) | (33) | – | – | 144 | – | 110 |
| Tax value of recognised tax losses | 142 | 11 | – | – | 135 | 1 | 289 |
| Short-term temporary differences | (12) | (3) | – | – | (47) | – | (62) |
| Net deferred tax (liabilities)/assets | (523) | (129) | 25 | 7 | (494) | 3 | (1,111) |

(i) The £12 million (2010: £7 million) represents exchange movements relating to AVIF deferred tax.

### c) Unrecognised deferred tax assets and liabilities

Deferred tax assets of £57 million (2010: £47 million) have not been recognised as it is probable that there will not be sufficient suitable profits emerging in future periods against which to relieve them.

## 22. Deferred tax assets and liabilities continued

### d) Post balance sheet events

HMRC have stated that draft legislation in respect of the new UK tax regime applicable to life insurance business is to be published in the Finance Bill on 29 March 2012. This follows the significant announcements previously made in the 2011 Budget and initial draft legislation published for consultation on 6 December 2011. The legislation is expected to take effect from 1 January 2013.

The Group has made a preliminary analysis of the impact of the new legislation on the deferred tax assets and liabilities as at 31 December 2011. The net overall impact is an additional deferred tax asset of £10 million, arising from the items described below.

Under the new tax regime, losses in respect of the Group's pension business will be measured at the full corporation tax rate (currently measured at the basic rate of income tax). The tax value of losses would increase by £34 million (based on the latest substantively enacted corporation tax rate of 25%). This is offset by the loss of the deferred tax asset of £7 million in respect of life assurance trade losses to the extent that these do not exceed pension business losses in the same entity.

Application of the draft transitional provisions would result in a further deferred tax liability of £17 million, which would unwind over 10 years, in accordance with the transitional provisions. This relates to the with-profits fund deficit in FLL which arose in 2002.

Other deferred tax assets and liabilities of the Group as at 31 December 2011 are not expected to be materially affected by the new legislation.

## 23. Insurance and other receivables

| As at 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Receivables arising out of direct insurance operations: | | |
| – policyholders | 80 | 46 |
| – agents, brokers and intermediaries | 31 | 35 |
| Investment income receivables | 167 | 158 |
| Investments sold for subsequent settlement | 41 | 14 |
| Prepayments and accrued income | 551 | 536 |
| Other receivables | 270 | 187 |
| **Total insurance and other receivables** | **1,140** | 976 |

£59 million (2010: £46 million) of insurance and other receivables are expected to be recovered more than 12 months after the balance sheet date. The carrying value of each item approximates fair value.

## 24. Cash and cash equivalents

| As at 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Bank and cash balances | 3,583 | 3,252 |
| Short-term deposits | 5,208 | 6,036 |
| **Total cash and cash equivalents** | **8,791** | 9,288 |

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

| As at 31 December | 2011 £m | 2010 £m |
|---|---|---|
| OEICs | 211 | 150 |
| Long-term funds | 7,130 | 7,832 |
| | 7,341 | 7,982 |

## 25. Terms and conditions of insurance and investment contracts

The main types of insurance and investment contracts that the Group currently has in-force are life assurance and pensions. These contracts may include guarantees and options.

### a) Life assurance

Protection business (other than whole life products) – these insurance contracts consist mainly of regular premium term assurance, critical illness and income protection products, which pay out a fixed amount (the sum assured) on ill health or death. The premium rate is usually guaranteed for the lifetime of the contract. For most policies this payout will be a single amount, whereas income protection products provide a regular income upon incapacity either for the length of illness or to the end of the contract if earlier, depending on the specific policyholder terms. Most contracts have no surrender value.

Endowments and whole life products – these insurance contracts both provide benefits upon death or, in the case of endowments, at a preset maturity date if earlier. These policies usually have a surrender value. The amount payable on death is subject to a guaranteed minimum amount. The maturity value usually depends on the investment performance of the underlying assets. For with-profits business, it is underpinned by a minimum guarantee, which may be increased by the addition of bonuses.

Single premium bonds – these are unit-linked or unitised with-profits investment contracts that have no maturity date. On death, the amount paid is 100%–105% of the value of the units. On surrender the value of units is paid, sometimes in the first few years less a surrender penalty. For with-profits contracts a final bonus may be payable on death or surrender, or if markets are depressed a market value reduction may be applied to surrender values.

### b) Pensions

Individual and group pensions – these contracts generally provide a cash sum at retirement. If death occurs before retirement, they generally return the value of the fund accumulated or in some cases premiums paid are returned. Contracts with guaranteed cash and annuity options (see below) are defined as insurance contracts but in the absence of these guarantees products are normally defined as investment contracts.

Annuities in payment – these insurance contracts are typically single premium products, which provide for a regular payment to the policyholder whilst they and/or their spouse are still alive. Payments are generally either fixed or increased each year at a specified rate or in line with the rate of inflation. Most contracts guarantee an income for a minimum period usually of five years, irrespective of death.

### Guarantees and options

The main guarantees and options included within the Group's insurance contracts, the majority of which arise within FLL, FLC, FLAS and WLUK with-profits funds, are as follows:

- Guaranteed cash and annuity options – most conventional deferred annuity contracts have benefit options expressed in terms of cash and annuity payments with a guaranteed conversion rate, allowing the policyholder the option of taking the more valuable of the two at retirement;
- Guarantees in respect of bonus additions – bonuses added to with-profits policies increase the guaranteed minimum benefit that policyholders are entitled to at maturity. These are set at a level that takes account of expected market fluctuations, such that the cost of the guarantee is generally met by the investment performance of the assets backing the policyholder liability. However in circumstances where there has been a significant fall in investment markets, the guaranteed maturity benefits may exceed asset shares and these guarantees become valuable to the policyholder. Also, for unitised with-profits policies, it is guaranteed that the value of units will not fall provided the policy is held until maturity or another guaranteed date, and for some older product classes, the value of units rises at a minimum guaranteed rate;
- Guaranteed surrender bases – certain older products have a guaranteed basis for calculating surrender values. In all these cases the basis includes an element of final bonus which can be reduced or taken away. The guaranteed basis typically applies over a period of 15 years but in most cases policies are approaching the end of this period. The effect of the guaranteed surrender basis is to extend the guarantee in respect of bonus additions so that they apply over an extended period and not just at the maturity date;
- Guaranteed minimum pensions – certain policies secured by transfer values from pension schemes provide a guarantee that the pension at retirement will not be less than the Guaranteed Minimum Pension ("GMP") accrued as a result of contracting out of the State Earnings Related Pension Scheme or State Second Pension; and
- Guaranteed return of premiums – certain pension contracts provide a guarantee for the return of premiums at maturity date. For some contracts the guarantee continues to apply when policies are paid up.

## 26. Insurance contracts

### a) Changes in insurance contracts liabilities

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

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| **At 1 January** | **35,081** | 12,107 |
| Acquired through business combinations | **2,284** | 22,050 |
| Increase in liability from premiums | **1,887** | 1,209 |
| Release of liability due to recorded claims | **(3,747)** | (2,050) |
| Unwinding of discount | **517** | 320 |
| Change in assumptions: | | |
| – Economic | **1,076** | (241) |
| – Non-economic | **(667)** | 42 |
| Other movements including net investment return | **833** | 1,644 |
| **At 31 December** | **37,264** | 35,081 |

Included in the carrying amount above is £32,790 million (2010: £30,782 million) which is expected to be settled more than 12 months after the balance sheet date.

During the period, FLC and the acquired BHA business revised their reserving methodology by allowing for negative reserves on protection business as allowed for in the FSA Policy Statement 06/14. This resulted in:

- a reduction in policyholder liabilities of £243 million and a write-off of DAC on protection business of £22 million in FLC resulting in a one-off benefit to IFRS based operating profit of £221 million;
- an acceleration of AVIF amortisation of £130 million in FLC and an AVIF impairment of £71 million in the acquired BHA business resulting in a one-off adverse impact on non-operating profit of £201 million; and
- a reduction in the emerging surplus and new business strain of £28 million.

The net impact on profit before tax was a loss of £8 million.

During the year, the insurance business of FPLAL and BHA, and certain insurance policies of FLPL, were transferred to FLL by way of transfer under Part VII of the Financial Services and Markets Act 2000.

A liability adequacy test was carried out at portfolio level and resulted in no additional provision in 2011 (2010: £nil).

It should be noted that changes in the financial assets backing the liabilities are typically largely offset by corresponding changes in the economic assumptions. In addition, assumption changes on with-profits contracts will result in changes in the unallocated surplus, and not in retained earnings.

### b) Method used for reserving for both insurance contracts and investment contracts with DPF

The liability for insurance contracts and investment contracts with DPF is calculated on the basis of recognised actuarial methods having due regard to actuarial principles and best practice. The methodology takes into account risks and uncertainties of the particular classes of long-term business written.

Calculations are generally made on an individual policy basis; however in addition there are some global provisions which are calculated using statistical or mathematical methods. The results are expected to be approximately the same as if the individual insurance/investment contract liability was calculated for each contract.

## 26. Insurance contracts continued

### c) With-profits contracts

Options and guarantees are features of life assurance and pensions contracts that confer potentially valuable benefits to policyholders. They are not unique to with-profits funds and can arise in non-participating funds. They can expose an insurance company to two types of risk: insurance (such as mortality/morbidity) and financial (such as market prices/interest rates). The value of an option or guarantee comprises two elements: the intrinsic value and the time value. The intrinsic value is the amount that would be payable if the option or guarantee was exercised immediately. The time value is the additional value that reflects the possibility of the intrinsic value increasing in future, before the expiry of the option or guarantee. Under FSA rules all options and guarantees must be valued and included in policyholder liabilities. For funds within the FSA's realistic capital methodology, options and guarantees are valued on a market consistent stochastic basis that takes into account both the time value and the intrinsic value of the options and guarantees.

All material options and guarantees are valued stochastically and included in the liabilities. There are two main types of guarantees and options within the with-profits funds: maturity guarantees and guaranteed annuity options. Maturity guarantees are in respect of conventional with-profits business and unitised with-profits business and represent the sum assured and reversionary bonuses declared to date. For certain with-profits pension policies there are options guaranteeing the rates at which annuities can be purchased. The cost of the maturity guarantees and guaranteed annuity options have been calculated as:

| | | 31 December 2011 £m | 31 December 2010 £m |
|---|---|---|---|
| Maturity guarantees | FLL with-profits fund | **439** | 311 |
| | FLC new with-profits fund | **331** | 246 |
| | FLC old with-profits fund | **92** | 65 |
| | FLAS with-profits fund | **391** | 291 |
| | WLUK with-profits fund | **137** | – |
| Guaranteed annuity options | FLL with-profits fund | **609** | 475 |
| | FLC new with-profits fund | **266** | 173 |
| | FLC old with-profits fund | **86** | 47 |
| | FLAS with-profits fund | **166** | 120 |
| | WLUK with-profits fund | **12** | – |

### d) Process used for assumptions

#### i) Economic assumptions

Details regarding the economic assumptions used in the stochastic model for the valuation of with-profits policyholder liabilities are set out below.

The cost of with-profits guarantees is most sensitive to the assumed volatility of future returns on asset shares, the level of future interest rates and the rates of discontinuance on these policies. The guarantee cost in respect of guaranteed annuity options is most sensitive to the level of future interest rates, future mortality rates, assumed rates of discontinuance and early retirements, and the assumptions relating to the exercise of the tax free cash option on these policies. Further details on these assumptions are provided below.

The cost of the with-profit guarantees is assessed using a market consistent stochastic model (using a Barrie & Hibbert model as the economic scenario generator) and is calculated using 2,000 simulations.

The model is calibrated using the gilt risk-free curve assuming interest rates of between 0.2% and 3.4% per annum and implied volatilities in the market as shown in the table on the following page.

## **26. Insurance contracts** continued

### Swaption implied volatilities – FLL

| Option term | 31 December 2011 swap term 10 years | 15 years | 20 years | 25 years |
|---|---|---|---|---|
| UK Sterling | | | | |
| 10 years | **18%** | **18%** | **18%** | **18%** |
| 15 years | **15%** | **16%** | **16%** | **16%** |
| 20 years | **14%** | **14%** | **14%** | **14%** |
| 25 years | **13%** | **13%** | **13%** | **13%** |

| Option term | 31 December 2010 swap term 10 years | 15 years | 20 years | 25 years |
|---|---|---|---|---|
| UK Sterling | | | | |
| 10 years | 15% | 15% | 14% | 14% |
| 15 years | 15% | 14% | 13% | 13% |
| 20 years | 13% | 13% | 12% | 12% |
| 25 years | 12% | 12% | 11% | 11% |

### Swaption implied volatilities – FLC and FLAS

| Option term | 31 December 2011 swap term 10 years | 15 years | 20 years | 25 years |
|---|---|---|---|---|
| UK Sterling | | | | |
| 10 years | **18%** | **18%** | **18%** | **18%** |
| 15 years | **16%** | **16%** | **16%** | **16%** |
| 20 years | **15%** | **15%** | **15%** | **15%** |
| 25 years | **14%** | **14%** | **14%** | **14%** |

| Option term | 31 December 2010 swap term 10 years | 15 years | 20 years | 25 years |
|---|---|---|---|---|
| UK Sterling | | | | |
| 10 years | 14% | 14% | 14% | 14% |
| 15 years | 14% | 14% | 13% | 13% |
| 20 years | 14% | 13% | 13% | 13% |
| 25 years | 13% | 13% | 13% | 13% |

### Swaption implied volatilities – WLUK

| Option term | 31 December 2011 swap term 10 years | 15 years | 20 years | 25 years |
|---|---|---|---|---|
| UK Sterling | | | | |
| 10 years | **18%** | **18%** | **18%** | **19%** |
| 15 years | **16%** | **16%** | **16%** | **16%** |
| 20 years | **15%** | **15%** | **15%** | **15%** |
| 25 years | **14%** | **14%** | **14%** | **14%** |

## 26. Insurance contracts continued

For equity capital return and property total return, implied volatilities are shown in the table below:

### FLL

| | 31 December 2011 | | 31 December 2010 | |
|---|---|---|---|---|
| Option term | Equities | Property | Equities | Property |
| 5 years | 27% | 15% | 27% | 16% |
| 10 years | 27% | 15% | 28% | 16% |
| 15 years | 27% | 15% | 28% | 16% |

### FLC

| | 31 December 2011 | | 31 December 2010 | |
|---|---|---|---|---|
| Option term | Equities | Property | Equities | Property |
| 5 years | 28% | 15% | 28% | 15% |
| 10 years | 28% | 15% | 29% | 16% |
| 15 years | 29% | 15% | 31% | 16% |

### FLAS

| | 31 December 2011 | | 31 December 2010 | |
|---|---|---|---|---|
| Option term | Equities | Property | Equities | Property |
| 5 years | 29% | 15% | 29% | 15% |
| 10 years | 29% | 15% | 30% | 16% |
| 15 years | 31% | 15% | 31% | 16% |

### WLUK

| | 31 December 2011 | | 31 December 2010 | |
|---|---|---|---|---|
| Option term | Equities | Property | Equities | Property |
| 5 years | 30% | 15% | – | – |
| 10 years | 30% | 15% | – | – |
| 15 years | 30% | 15% | – | – |

The cost of guarantees also depends on management actions that would be taken under various scenarios. For WLUK and FLL, the regular bonus rate is set each year such that, by maturity, guaranteed benefits are targeted as a predefined proportion of the total asset share, leaving the remaining portion of the asset share to be paid as a final bonus. This management action is in line with the Companies' PPFMs.

For FLAS, the regular bonus rates are derived from the gross redemption yields on gilts with deductions for guaranteed interest rates, tax, expenses, shareholder transfers and a contingency margin. The remaining portion of the asset share is paid as a final bonus. The management action is in line with the Company's PPFM.

For FLC, the regular bonus rates are derived from the expected underlying yields on the assets with deductions for guaranteed interest rates, tax, expenses, shareholder transfers and a contingency margin. The remaining portion of the asset share is paid as a final bonus. The management action is in line with the Company's PPFM.

The guarantee cost in respect of guaranteed annuity options is assessed using a market consistent stochastic model and values both the current level of the guaranteed annuity rate benefit (allowing for future improvements in annuitant mortality) and the time value due to uncertainty in future interest rates. The guarantee cost in each scenario is the value of the excess annuity benefit provided by the options, relative to an annuity purchased in the open market. In estimating the future open market annuity rate, the model allows for stochastic variation in interest rates and for future mortality improvements. The stochastic interest rate assumption reflects that implied by current market interest rate derivative prices. Future annuitant mortality within the FLL with-profits balance sheet has been derived from the premium basis at which annuities can be purchased from FLPL, which allows for future mortality improvements.

## 26. Insurance contracts continued

### ii) Non-economic assumptions

The provision for insurance contracts and investment contracts with DPF liabilities is sensitive to the principal assumptions in respect of mortality, morbidity and maintenance expenses (except for net premium valuations), persistency and guaranteed annuity option take-up rates, although the relative sensitivity will vary depending on the insurance or investment contract.

Long-term estimates of future mortality and morbidity assumptions are based on standard tables wherever possible but adjusted to reflect the Group's own experience. Expense assumptions are based on recent experience for FLL. For FLC, FLAS, FAL and WLUK the provision for future expenses covers the expected level of servicing fees payable to FLSL under the Management Services Agreement, fees payable to investment managers and further amounts in respect of other expenses.

Experience investigations for mortality, morbidity, persistency, guaranteed annuity option take-up rates and maintenance expenses are performed at least annually for major product classes. Where industry analysis indicates that changes in expected future mortality/morbidity or other assumptions factor patterns mean that claim costs are likely to rise in the future, then this is taken into account in the liability calculation.

No benefit is taken in regulatory reserves where industry analysis indicates that future trends are likely to reduce claim costs in the future. For FLC and FLAS with-profits funds the benefit from a prudent view of expected future mortality improvements is taken on non-profit protection business in the realistic balance sheet. Improving mortality has been assumed when valuing annuities and deteriorating morbidity has been assumed when valuing some critical illness business. Assumptions, for policies other than with-profits, are generally intended to be a prudent estimate of future experience.

The guaranteed annuity options cost also depends upon other factors such as policy discontinuance and the take up rate for the options. The factors are based on recent experience adjusted to reflect industry benchmarks and to anticipate trends in policyholder behaviour. A summary of the key assumptions is as follows:

Policy discontinuances: lapse, early retirement and paid-up rates vary by policy type and period and have been based on recent experience.

Policy lapses and paid up rates are generally in the ranges shown below:

### FLL with-profits fund

| | 2011<br>% pa | 2010<br>% pa |
|---|---|---|
| Pensions – lapses | **1 to 8** | 1 to 5 |
| Life – lapses | **3 to 15** | 3 to 15 |
| Mortgage endowments – lapses | **5 to 10** | 14 |
| With-profits bonds – lapses | **11.5** | 20 |
| Pensions – paid-up | **4 to 17** | 4 to 17 |
| Life – paid-up | **0.5 to 2** | 0.5 to 2 |

### FLC new with-profits fund

| | 2011<br>% pa | 2010<br>% pa |
|---|---|---|
| Pensions – lapses | **4 to 11.5** | 2 to 6.5 |
| Life – lapses | **5.5 to 6** | 2.5 to 13 |
| Mortgage endowments – lapses | **3.5 to 6.5** | 6 to 13 |
| With-profits bonds – lapses | **7.5 to 8.5** | 10 |
| Pensions – paid-up | **4.5 to 12** | 5 |
| Life – paid-up | **0.5 to 1** | 1 |

## 26. Insurance contracts continued

### FLC old with-profits fund

| | 2011 % pa | 2010 % pa |
|---|---|---|
| Pensions – lapses | **4 to 11.5** | 2 to 6.5 |
| Life – lapses | **5.5 to 6** | 2.5 to 13 |
| Mortgage endowments – lapses | **3.5 to 6.5** | 6 to 13 |
| With-profits bonds – lapses | **7.5 to 8.5** | 10 |
| Pensions – paid-up | **4.5 to 12** | 5 |
| Life – paid-up | **0.5 to 1** | 1 |

### FLAS with-profits fund

| | 2011 % pa | 2010 % pa |
|---|---|---|
| Pensions – lapses | **5.5 to 10** | 1.5 to 8 |
| Life – lapses | **5.5 to 10** | 2.5 to 11 |
| Mortgage endowments – lapses | **2.5 to 3.5** | 3 to 11 |
| With-profits bonds – lapses | **7.5 to 8.5** | 10 |
| Pensions – paid-up | **5 to 12** | 5 |
| Life – paid-up | **1 to 2** | 1 |

### WLUK with-profits fund

| | 2011 % pa | 2010 % pa |
|---|---|---|
| Pensions – lapses | **2 to 3** | – |
| Life – lapses | **3 to 8** | – |
| Mortgage endowments – lapses | **2 to 8** | – |
| With-profits bonds – lapses | **5 to 9** | – |

Early retirement rates vary by age band and policy type and are set based on recent experience.

Tax free cash option: where a guaranteed annuity option is more valuable than the cash equivalent it is assumed that 18% to 27% (2010: 18% to 27%) of the benefit of the option is taken tax-free depending on the type of business. This is based on recent experience.

There are also guarantees and options in respect of some of the other life assurance business within the Group, but these are not considered to be material to the Group's future cash flows. In addition, they have largely been matched with suitable assets and there is no material exposure to market or interest rate changes. Provisions have been established using deterministic scenarios based on prudent assumptions.

### e) Valuation interest rates

As explained above, with-profits business within FLL, FLC, WLUK and FLAS is valued in accordance with the FSA's realistic reporting regime.

During the year, the new FPLAL closed fund was transferred from FPLAL to FLL due to an intra-group reorganisation. Its valuation has therefore changed in accordance with the FSA's realistic reporting regime. The effect of this has been to increase reported liabilities by £23 million.

## 26. Insurance contracts continued

Valuation interest rates for other than conventional with-profits business are shown in the table below. Where business has been transferred to FLL from FPLAL in 2011 this has been noted.

| | Company | Class of Business | 31 December 2011 % | 31 December 2010 % |
|---|---|---|---|---|
| Life | FLL (FPLP and FPLAL in 2010) | Endowment and Whole Life in non-profit funds | 1.90 | 2.80 |
| | | Protection | 1.90 | 2.80 |
| | | Endowment and Whole Life in with-profit funds | 2.30 | 2.60 |
| | FLC | Over 50 Plan in non-profit funds | 1.80 | 2.05 |
| | | Over 50 Plan in with-profit funds | 1.80 | 2.40 |
| | | Additional life reserves | 1.90 | 2.65 |
| | | Other conventional life in non-profit funds | 1.90 | 2.05 |
| | | Other conventional life in with-profit funds | 1.85 | 2.40 |
| | | Life annuities from FLAS | 2.40 | 3.00 |
| | | Unit-linked life | 1.90 | 3.10 |
| | FLAS | Conventional life | 2.35 | 2.90 |
| | | Unit-linked life | 2.35 | 2.90 |
| | WLUK | With-profits fund immediate annuities | 1.70 | – |
| | | Life (other) | 2.30 | – |
| | | Non-profit fund life | 2.10 | – |
| Income Protection | FLL (FPLP and FPLAL in 2010) | Income Protection | 1.90 | 3.00 |
| | FLC | Permanent Health Insurance | 2.40 | 4.40 |
| Pensions | FLL (FPLP and FPLAL in 2010) | Annuities in payment | 3.57–4.09 | 4.46–4.81 |
| | | Protection | 2.40 | 3.50 |
| | | Individual and Group pensions in non-profit funds | 2.40 | 3.50 |
| | | Individual and Group pensions in with-profit funds | 2.90 | 3.30 |
| | FLC | Unit-linked pensions | 2.40 | 3.85 |
| | | Conventional pensions in non-profit funds | 2.40 | 2.55 |
| | | Conventional pensions in with-profit funds | 2.30 | 3.00 |
| | | Additional pensions reserves | 2.40 | 3.30 |
| | FLAS | Conventional Pensions | 3.05 | 3.80 |
| | | Unit-linked pensions | 2.95 | 3.65 |
| | FAL | FLC annuities reinsured December 2007 | 3.60 | 4.25 |
| | | FLAS annuities reinsured July 2009 | 3.40 | 4.00 |
| | | FLC index-linked annuities reinsured December 2007 | (0.25) | 0.20 |
| | | FLAS index-linked annuities reinsured July 2009 | (0.40) | 0.60 |
| | WLUK | With-profits fund pensions (immediate annuities) | 2.10 | – |
| | | Non-profit fund pensions (immediate annuities) | 3.20 | – |
| | | Non-profit fund pensions (other) | 2.90 | – |
| | | With-profits fund with profit business deferred | 2.05 | – |
| | | With-profit fund with profit business other | 2.90 | – |

## 26. Insurance contracts continued

Within FLL and FLC, certain products can have positive or negative reserves. The interest rate used for these products is 1.4% (2010: 2.3%) or 3.5% (2010: 5%) depending on which is more onerous.

### f) Mortality, morbidity and lapse rates

Insurance contract liabilities allow for mortality and morbidity risk by making assumptions about the proportion of policyholders who die or become sick. Allowance for future mortality has been made using the following percentages of the standard published tables below:

| | | **31 December 2011** | 31 December 2010 |
|---|---|---|---|
| Term assurances – FLL (FPLP and | Smoker male | **83% TMS00(5)** | 93% TMS00(5) |
| | Smoker female | **77% TFS00(5)** | 88% TFS00(5) |
| | Non-smoker male | **99% TMN00(5)** | 93% TMN00(5) |
| | Non-smoker female | **72% TFN00(5)** | 86% TFN00(5) |
| Term assurances – FLC/FLAS | Smoker male | **90% TMS00(5)** | 102% TMS00(5) |
| | Smoker female | **84% TFS00(5)** | 114% TFS00(5) |
| | Non-smoker male | **108% TMN00(5)** | 96% TMN00(5) |
| | Non-smoker female | **78% TFN00(5)** | 102% TFN00(5) |
| Term assurance – WLUK | Smoker male | **150% TM92** | – |
| | Smoker female | **165% TF92** | – |
| | Non-smoker male | **80% TM92** | – |
| | Non-smoker female | **90% TF92** | – |
| Critical illness | FLL (FPLP and FPLAL in 2010) | **CIBT02(i)** | CIBT02(i) |
| Critical illness | FLC/FLAS | **CIBT02(ii)** | CIBT02(ii) |
| Other life assurances | FLL (FPLP and FPLAL in 2010) | **120% AM/FC00ult** | 120% AM/FC00ult |
| Other life assurances | FLC/FLAS male | **140% AMC00** | 140% AMC00 |
| | FLC/FLAS female | **125% AFC00** | 125% AFC00 |
| Unitised policies | Life – FLL (FPLP and FPLAL in 2010) | **130% AM/FC00ult** | 130% AM/FC00ult |
| | Other –FLL (FPLP and FPLAL in 2010 | **110% AM/FC00ult** | 110% AM/FC00ult |
| Unitised policies | Life/Other – FLC/FLAS male | **105% AMC00ult** | 105% AMC00ult |
| | Life/Other – FLC/FLAS female | **120% AFC00ult** | 120% AFC00ult |
| Pensions | FLL/FLPL (FPLP and FPLAL in 2010) male | **65% AM/FC00ult** | 65% AM/FC00ult |
| | FLL/FLPL (FPLP and FPLAL in 2010) female | **55% AM/FC00ult** | 55% AM/FC00ult |
| | FLC/FLAS male | **90.91% A67/70ult-1** | 90.91% A67/70ult-1 |
| | FLC/FLAS female | **90.91% AF80ult-1** | 90.91% AF80ult-1 |
| Individual income protection | FLL (FPLP and FPLAL in 2010) | **60% AM/F80ult(iii)** | 60% AM/F80ult(iii) |
| | FLC/FLAS | **100% AM/AF92(iv)** | 100% AM/AF92(iv) |
| Annuities in payment | FLL/FLPL (FPLP and FPLAL in 2010) | **PCMA/PCFA00(v)(vi)** | RM/FV00(v)(vii) |
| | FLL/FLPL (FPLP and FPLAL in 2010) group | **PCMA/PCFA00(v)(vi)** | PCMA/PCFA00(v)(vii) |
| | FLC/FAL pension annuities male | **92% PCMA00(vi)** | 93% PCMA00(vii) |
| | FLC/FAL pension annuities female | **87.4% PCFA00(vi)** | 90.5% PCFA00(vii) |
| | FLAS pension annuities male | **89.7% PCMA00(vi)** | 90.5% PCMA00(vii) |
| | FLAS pension annuities female | **92% PCFA00(vi)** | 90.5% PCFA00(vii) |
| Immediate annuities – WLUK | Male | **98.9% PCMA00(vi)** | – |
| | Female | **98.9% PCFA00(vi)** | – |

## 26. Insurance contracts continued

(i) The percentages of the table used differ by sex and smoker status. Future deterioration in morbidity is allowed for by assuming claim rates increase by 1.25% per annum and 1.50% per annum for males and females respectively.
(ii) The percentages of the table used differ by sex, smoker status and sales group. Future deterioration in morbidity is allowed for by assuming claim rates increase by:
a) 0.75% per annum and 1.50% per annum for males and females respectively for standalone critical illness
b) 0.50% per annum and 1.00% per annum for males and females respectively for accelerated critical illness
(iii) Individual income protection sickness and recovery rates are based on percentages of CMI 12 (male and female) published tables. Rates differentiate by smoker status, deferred period and occupational class.
(iv) Individual income protection sickness and recovery rates are based on percentages of CMIR 12 (male and female) published tables. Rates differentiate by smoker status, deferred period and occupational class.
(v) Age related percentages of the mortality tables are used.
(vi) Future improvements in mortality are based on the following percentages of the CMI's core model CMI_2011:
a) Males – with long-term rate of 2% per annum
b) Females – with long-term rate of 2% per annum
(vii) Future improvements in mortality are based on the following percentages of the CMI's Medium Cohort
a) Males – 100% subject to a minimum improvement of 2.1% per annum
b) Females – 75% subject to a minimum improvement of 1.8% per annum

For protection business, lapse rates are based on recent experience with a prudent margin.

In determining liabilities for with-profits business, it is assumed that a proportion of policies is discontinued (surrendered, lapsed or converted paid-up) in each future year. The relevant rates vary by product and duration.

### g) Apportionment of surplus between shareholders and with-profits policyholders

Shareholders are entitled to 100% of surplus emerging from companies within the Group, with the exception of surplus emerging in the with-profits funds.

The Group has six with-profits funds of which three (FLL, FLC new with-profits and FLC old with-profits) are open to new business and three (WLUK, new FPLAL Closed Fund and FLAS) are closed to new business.

Shareholders are entitled to one-ninth of the cost of bonuses added to policies, except for:

- within the FLL with-profits fund, surplus arising on pre-demutualisation non-profit and unitised business (excluding the investment element) arises within the with-profits fund but assets of the with-profit fund equal to 60% of the surplus arising are transferred to shareholders;
- within the FLL with-profits fund, post demutualisation policyholders are only entitled to surplus from the return on their investments; other sources of surplus are wholly-owned by shareholders including policies written by FPLAL and FLPL, where the investment element is reinsured to the FLL with-profits fund;
- within the new FPLAL closed fund, policyholders are entitled to all the surplus of that fund. In addition, FLL has a closed unitised with-profits fund. Shareholders are entitled to all profits from the unitised with-profits fund other than investment profits, which are wholly-owned by with-profits policyholders. The investment element of the contract is wholly reinsured to the FLL with-profits fund;
- certain unitised with-profits policies in WLUK are written in the non-profit fund and reassured to the with-profits fund; and
- certain policies in FLC with guaranteed bonus rates, where the shareholders do not receive one-ninth of guaranteed bonuses.

The effect of the fund structure is that investment risk, in respect of assets backing with-profits policies is largely borne by policyholders; shareholders bear 10% of the investment risk from conventional with-profits policies, other than within the new FPLAL closed fund.

Expense risk is borne by shareholders, other than within the new FPLAL closed fund. Increases to expenses that can be charged to the WLUK with-profits fund are capped in line with RPI inflation.

# 27. Capital

## a) Overview

The Group manages its capital resources on both regulatory and economic capital bases, focusing primarily on capital efficiency and the ease with which cash and capital resources can be transferred between entities.

The capital management objectives are:

- to maintain capital resources for life operations at the greater of the CRR as required by local solvency rules and CRR as required by the local capital management policy;
- to hold capital resources for FLG that meet a minimum of 150% (2010: 160%) of the Group CRR (excluding WPICC);
- to maintain financial strength within the Group and regulated entities sufficient to support new business growth targets, and to satisfy the requirements of the policyholders, regulators and stakeholders including rating agencies;
- to retain financial flexibility by maintaining strong liquidity to cover expected and unexpected events, which includes access to an undrawn facility with a consortium of banks;
- to manage the with-profits business of the Group in accordance with agreed risk appetites and all statutory requirements; and
- to ensure that transfers from long-term business funds and dividends from entities that support the cash generation requirements of the Group are balanced with the need to maintain appropriate capital within the Group and regulated entities.

The operations of the Group are subject to regulatory requirements within the countries where it operates. Such regulations specify that a minimum amount of required capital must be maintained at all times throughout the financial year.

Under FSA rules, the UK life operations are also required to perform a private individual capital assessment ("ICA") of the economic capital required to mitigate the risk of insolvency to a minimum of a 99.5% confidence level over a one year period. The FSA review the ICA and may impose additional capital requirements by way of individual capital guidance ("ICG").

In addition to the regulatory requirements for individual life operations, the Group must comply with the requirements of the Insurance Groups Directive.

The Group and the regulated entities within it have met all of these requirements throughout the financial year.

An internal reorganisation has taken place during the year with the objective of realising capital and operating synergies in the Friends Life group. In this regard, the following business transfers have taken place in the period under the provisions of Part VII of the Financial Services and Markets Act 2000:

- all of FPLAL was transferred to FLL and its with-profit fund renamed as "New FPLAL Closed Fund";
- BHA was transferred to FLL; and
- part of the FLPL business transferred to FLL.

In addition, the Group completed the acquisition of WLUK in November 2011, including its with-profits business.

The format of the capital statement has been revised to reflect these changes and a number of additional refinements have been made to enhance the clarity and comparability of the disclosures provided. These refinements include an amendment to the basis of reporting of the capital resources and capital resource requirements for UK realistic basis with-profits funds, such that the amounts are now consistent with the presentation adopted in the FSA regulatory returns (these figures were reported separately in the prior period financial statements). In addition, all group entities are now reported within the capital statement whereas previously only life operations were disclosed. These changes have facilitated the inclusion within the capital statement of a reconciliation of local basis regulatory surpluses to Friends Life group's Capital Adequacy surplus calculated in accordance with the Insurance Groups Directive ("IGCA surplus").

Where appropriate, the presentation of prior year comparative information has been amended to be consistent with the revised 2011 disclosures. There is no impact on the previously reported 2010 IGCA surplus for the Group or the entity Pillar 1 solvency positions as a result of the revised presentation.

The formal procedures for identifying and assessing risks that could affect the capital position of the Group are described in the risk management policies set out in note 28.

## 27. Capital continued

### b) Capital statement

The Group capital statement is set out below and incorporates the following:

- a statement showing local basis capital resources and the related capital requirement. For UK life operations, the capital statement shows capital resources and regulatory capital resource requirements as specified by FSA rules. For overseas life operations, capital resources and requirements are calculated according to local regulatory requirements;
- a reconciliation from the local basis regulatory surpluses to the Friends Life group's IGCA surplus, calculated in accordance with the valuation rules of the Insurance Groups Directive; and
- an analysis of policyholders' liabilities on an IFRS basis.

| As at 31 December 2011 | Total UK with-profits funds £m | UK shareholder and non-profit funds £m | Overseas life operations £m | Total life operations £m | Other operations and consolidation adjustments £m | Total £m |
|---|---|---|---|---|---|---|
| **Shareholders' equity** | | | | | | |
| Outside long-term fund | – | 528 | 92 | 620 | 3,197 | 3,817 |
| Inside long-term fund | – | 1,782 | 73 | 1,855 | – | 1,855 |
| | – | 2,310 | 165 | 2,475 | 3,197 | 5,672 |
| **Other qualifying capital** | | | | | | |
| Innovative tier one capital | – | 511 | – | 511 | (23) | 488 |
| Subordinated debt(i) | – | 700 | 2 | 702 | 162 | 864 |
| Preference shares | – | 300 | – | 300 | (300) | – |
| Unallocated surplus | 652 | – | – | 652 | – | 652 |
| | 652 | 3,821 | 167 | 4,640 | 3,036 | 7,676 |
| **Regulatory adjustments** | | | | | | |
| Assets | (384) | (1,597) | (15) | (1,996) | (4,143) | (6,139) |
| Liabilities | 3,962 | 208 | 25 | 4,195 | 1,613 | 5,808 |
| **Available capital resources** | 4,230 | 2,432 | 177 | 6,839 | 506 | 7,345 |
| **Capital requirement** | | | | | | |
| UK realistic basis | 3,913 | – | – | 3,913 | – | 3,913 |
| Other regulatory bases | – | 728 | 87 | 815 | 23 | 838 |
| | 3,913 | 728 | 87 | 4,728 | 23 | 4,751 |
| **Local basis capital resources over capital requirement** | | | | | | 2,594 |
| **IGCA valuation adjustments** | | | | | | |
| Restricted assets(ii) and shareholders capital support of the with-profits funds | | | | | | (460) |
| Assets in excess of market risk and counterparty limits | | | | | | 5 |
| **FLG IGCA surplus** | | | | | | 2,139 |
| **Analysis of policyholders' liabilities** | | | | | | |
| With-profits | 20,409 | – | 161 | 20,570 | – | 20,570 |
| Unit-linked | 22 | 49,765 | 24,294 | 74,081 | – | 74,081 |
| Non-participating | 6,854 | 10,974 | (24) | 17,804 | – | 17,804 |
| **Total policyholder liabilities as shown in the consolidated statement of financial position** | 27,285 | 60,739 | 24,431 | 112,455 | – | 112,455 |

(i) Includes £200 million of debt issued by FLG to RHG.
(ii) Long-term fund surplus capital over and above capital requirements is excluded from capital resources on an IGCA basis.

## 27. Capital continued

### UK with-profits funds

| As at 31 December 2011 | FLL £m | New FPLAL closed fund £m | FLC new £m | FLC old £m | FLAS £m | WLUK £m | Total £m |
|---|---|---|---|---|---|---|---|
| **Other qualifying capital** | | | | | | | |
| Unallocated surplus | 251 | 3 | 133 | 59 | 173 | 33 | 652 |
| **Regulatory adjustments** | | | | | | | |
| Assets | (23) | – | (120) | (17) | (174) | (50) | (384) |
| Liabilities | 1,298 | 24 | 1,110 | 280 | 1,150 | 100 | 3,962 |
| **Available capital resources** | 1,526 | 27 | 1,123 | 322 | 1,149 | 83 | 4,230 |
| | | | | | | | |
| **Capital requirement** | | | | | | | |
| UK realistic basis | 1,236 | 27 | 1,197 | 322 | 1,038 | 93 | 3,913 |
| | 1,236 | 27 | 1,197 | 322 | 1,038 | 93 | 3,913 |
| **Local basis capital resources over capital resources requirement** | | | | | | | 317 |
| | | | | | | | |
| **Analysis of policyholders' liabilities** | | | | | | | |
| With-profits | 8,553 | 184 | 4,872 | 1,245 | 4,657 | 898 | 20,409 |
| Unit-linked | – | – | – | – | 22 | – | 22 |
| Non-participating | 2,371 | 91 | 826 | 129 | 3,421 | 16 | 6,854 |
| **Total** | 10,924 | 275 | 5,698 | 1,374 | 8,100 | 914 | 27,285 |

## **27. Capital** continued

| As at 31 December 2010 | Total UK with-profits funds £m | UK shareholder and non-profit funds £m | Overseas life operations £m | Total life operations £m | Other operations and consolidation adjustments £m | Total £m |
|---|---|---|---|---|---|---|
| Shareholders' equity | | | | | | |
| Outside long-term fund | – | 1,618 | 77 | 1,695 | 2,275 | 3,970 |
| Inside long-term fund | – | 2,173 | 84 | 2,257 | – | 2,257 |
| | – | 3,791 | 161 | 3,952 | 2,275 | 6,227 |
| Other qualifying capital | | | | | | |
| Innovative tier one capital | – | 511 | – | 511 | (23) | 488 |
| Subordinated debt(i) | – | – | 7 | 7 | 857 | 864 |
| Preference shares | – | 300 | – | 300 | (300) | – |
| Unallocated surplus | 1,098 | – | – | 1,098 | – | 1,098 |
| | 1,098 | 4,602 | 168 | 5,868 | 2,809 | 8,677 |
| Regulatory adjustments | | | | | | |
| Assets | (532) | (2,342) | (25) | (2,899) | (4,310) | (7,209) |
| Liabilities | 3,993 | 560 | 14 | 4,567 | 1,657 | 6,224 |
| Available capital resources | 4,559 | 2,820 | 157 | 7,536 | 156 | 7,692 |
| Capital requirement | | | | | | |
| UK realistic basis | 3,808 | – | – | 3,808 | – | 3,808 |
| Other regulatory bases | 24 | 760 | 84 | 868 | 24 | 892 |
| | 3,832 | 760 | 84 | 4,676 | 24 | 4,700 |
| Local basis capital resources over capital requirement | | | | | | 2,992 |
| IGCA valuation adjustments | | | | | | |
| Restricted assets(ii) and shareholders capital support of the with-profits funds | | | | | | (875) |
| Assets in excess of market risk and counterparty limits | | | | | | 198 |
| Non designated state capital resources requirement | | | | | | 2 |
| FLG IGCA surplus | | | | | | 2,317 |
| Analysis of policyholders' liabilities | | | | | | |
| With-profits | 20,312 | – | – | 20,312 | – | 20,312 |
| Unit-linked | 25 | 48,877 | 23,286 | 72,188 | – | 72,188 |
| Non-participating | 6,156 | 8,762 | 74 | 14,992 | – | 14,992 |
| Total policyholder liabilities as shown in the consolidated statement of financial position | 26,493 | 57,639 | 23,360 | 107,492 | – | 107,492 |

(i) Includes £700 million of debt issued by FLG to RHG.
(ii) Long-term fund surplus capital over and above capital requirements is excluded from capital resources on an IGCA basis.

## 27. Capital continued

### UK with-profits funds

| As at 31 December 2010 | FLL £m | New FPLAL closed fund £m | FLC new £m | FLC old £m | FLAS £m | Total £m |
|---|---|---|---|---|---|---|
| Shareholders' equity | – | – | – | – | – | – |
| Outside long-term fund | – | – | – | – | – | – |
| Inside long-term fund | – | – | – | – | – | – |
| Other qualifying capital | | | | | | |
| Unallocated surplus | 216 | 74 | 454 | 126 | 228 | 1,098 |
| | 216 | 74 | 454 | 126 | 228 | 1,098 |
| Regulatory adjustments | | | | | | |
| Assets | (15) | – | (161) | (22) | (334) | (532) |
| Liabilities | 1,400 | – | 1,006 | 263 | 1,324 | 3,993 |
| Available capital resources | 1,601 | 74 | 1,299 | 367 | 1,218 | 4,559 |
| | | | | | | |
| Capital requirement | | | | | | |
| UK realistic basis | 1,284 | – | 1,121 | 317 | 1,086 | 3,808 |
| Other regulatory bases | – | 24 | – | – | – | 24 |
| | 1,284 | 24 | 1,121 | 317 | 1,086 | 3,832 |
| Local basis capital resources over capital requirement | | | | | | 727 |
| Analysis of policyholders' liabilities | | | | | | |
| With-profits | 9,147 | 176 | 5,049 | 1,239 | 4,701 | 20,312 |
| Unit-linked | – | – | – | – | 25 | 25 |
| Non-participating | 2,318 | 54 | 528 | 77 | 3,179 | 6,156 |
| Total | 11,465 | 230 | 5,577 | 1,316 | 7,905 | 26,493 |

### Restrictions on availability of capital

The available capital in a regulated entity is generally subject to restrictions as to its availability to meet capital requirements elsewhere in the Group. The principal restrictions are:

#### UK with-profit funds

- FLL: shareholders are entitled to one-ninth of the amount distributed to conventional with-profits policyholders in the form of bonuses. In addition, shareholders are entitled to 60% of the surplus arising in respect of the pre demutualisation non-profit and unitised business written in the fund (excluding the investment element); the remaining 40% belongs to with-profits policyholders. Also, post-demutualisation policyholders are only entitled to surplus from the return on their investments; other sources of surplus are wholly owned by shareholders.
- New FPLAL closed fund: the surplus in the closed with-profits fund may only be distributed to policyholders.
- FLC and FLAS: shareholders are entitled to one-ninth of the amount distributed to policyholders in the form of bonuses.
- WLUK: shareholders are entitled to one-ninth of the amount distributed to policyholders in the form of bonuses, with the following exception: an element of the WLUK with-profits policies were written in the non-profit fund. For these, the shareholder receives the management charges in the non-profit fund. WLUK has a Segregated Sub Fund ("SSF") that can be called upon to protect certain policyholders from having their asset shares reduced, where those policies were written by the Colonial business prior to its merger with Winterthur. Such protection will occur whenever the annual inherited estate test shows that the with-profit fund assets are too low in relation to its liabilities, and takes the form of a permanent transfer of funds from the SSF into the with-profit fund. Any unused SSF will gradually be released to the shareholder, as the mathematical reserves of the protected Colonial policies run-off. Following the annual inherited estate test at 31 December 2011, the SSF had net assets of £23 million and £3 million of this was released to the shareholders' fund.

## **27. Capital** continued

### Non-participating business

For non-participating business, surplus can generally be distributed to shareholders subject to meeting regulatory requirements and other capital management objectives of the business and subject to restrictions set out in the scheme governing the FLC Inherited Estate, as summarised below.

### Re-attributed inherited estate

FLC contains a reattributed inherited estate (''RIE'') which was transferred to the FLC non-profit funds as part of a Part VII scheme which took effect on 1 April 2001, transferring business into FLC. The scheme rules, as approved by the High Court, require that a test be undertaken every five years to determine whether it is possible to transfer any of the RIE from the FLC non-profit funds to the FLC shareholders' fund or to distribute any of the inherited estate in the FLC old with-profits fund in the form of special bonuses. The latest five yearly test was undertaken as at 31 December 2010 and the RIE was £2,437 million of which £1,010 million was transferred to the shareholders' fund. At 31 December 2011 a further £484 million is being transferred to the shareholders' fund.

### c) Movement in available capital

At 31 December 2011, total available capital resources in the life operations have decreased during the year by £697 million to £6,839 million (2010: £4,468 million increase to £7,536 million), as shown below.

| For the year ended 31 December 2011 | UK Total with-profits funds £m | UK shareholders' and non-profit funds £m | Overseas life operations £m | Total life operations £m |
|---|---|---|---|---|
| **At 1 January 2011** | 4,559 | 2,820 | 157 | 7,536 |
| Opening adjustment: acquired/divested business | 82 | (13) | – | 69 |
| Value of new business | – | (154) | (90) | (244) |
| Expected existing business contribution | 248 | 538 | 149 | 935 |
| Experience variances and development costs | 3 | 2 | (25) | (20) |
| Operating assumption changes | (21) | 207 | (17) | 169 |
| Other operating items | – | 185 | 13 | 198 |
| Economic variance and other non-operating items | (641) | (364) | (54) | (1,059) |
| Other capital and dividend flows | – | (789) | 45 | (744) |
| Foreign exchange variances | – | – | (1) | (1) |
| **At 31 December 2011** | 4,230 | 2,432 | 177 | 6,839 |

### Analysis of with-profits funds

| For the year ended 31 December 2011 | FLL £m | New FPLAL closed fund £m | FLC new £m | FLC old £m | FLAS £m | WLUK | Total with-profits funds £m |
|---|---|---|---|---|---|---|---|
| **At 1 January 2011** | 1,601 | 74 | 1,299 | 367 | 1,218 | – | 4,559 |
| Opening adjustment: acquired/divested business | – | – | – | – | – | 82 | 82 |
| Expected existing business contribution | (62) | – | 134 | 45 | 129 | 2 | 248 |
| Experience variances and development costs | 1 | (5) | 5 | 1 | 3 | (2) | 3 |
| Operating assumption changes | 6 | 1 | (25) | (21) | 18 | – | (21) |
| Economic variance and other non-operating items | (20) | (43) | (290) | (70) | (219) | 1 | (641) |
| **At 31 December 2011** | 1,526 | 27 | 1,123 | 322 | 1,149 | 83 | 4,230 |

## 27. Capital continued

| For the year ended 31 December 2010 | UK Total with-profits funds £m | UK shareholders and non-profit funds £m | Overseas life operations £m | Total life operations £m |
|---|---|---|---|---|
| At 1 January 2010 | 1,367 | 1,596 | 105 | 3,068 |
| Opening adjustment: acquired/divested business | 2,460 | 1,558 | – | 4,018 |
| Value of new business | – | (122) | (88) | (210) |
| Expected existing business contribution | 416 | 332 | 156 | 904 |
| Experience variances and development costs | – | (29) | (8) | (37) |
| Operating assumption changes | (96) | (34) | (2) | (132) |
| Other operating items | (10) | 32 | – | 22 |
| Economic variance and other non-operating items | 472 | 20 | 1 | 493 |
| Capital and dividend flows | (50) | (533) | (7) | (590) |
| At 31 December 2010 | 4,559 | 2,820 | 157 | 7,536 |

### Total with-profits funds

| For the year ended 31 December 2010 | FLL £m | New FPLAL closed fund £m | FLC new £m | FLC old £m | FLAS £m | Total with-profits funds £m |
|---|---|---|---|---|---|---|
| At 1 January 2010 | 1,293 | 74 | – | – | – | 1,367 |
| Opening adjustment: acquired/divested business | – | – | 1,006 | 464 | 990 | 2,460 |
| Expected existing business contribution | 439 | 3 | 21 | (151) | 104 | 416 |
| Operating assumption changes | (93) | (3) | – | – | – | (96) |
| Other operating items | (10) | – | – | – | – | (10) |
| Economic variance and other non-operating items | – | – | 274 | 71 | 127 | 472 |
| Capital and dividend flows | (28) | – | (2) | (17) | (3) | (50) |
| At 31 December 2010 | 1,601 | 74 | 1,299 | 367 | 1,218 | 4,559 |

### d) Intra-group capital arrangements

The FLL non-profit fund provided a contingent loan of £54 million (2010: £62 million) inclusive of accrued interest and with a facility for a further £19 million (2010: £38 million) to the FLL with-profits fund, repayable out of future surpluses in the with-profits fund, subject to certain restrictions.

There is a financing arrangement in the form of reinsurance of certain business written by FLAS which was transferred into FLC from Sun Life Pensions Management Limited ("SLPM") through a Part VII Scheme in 2007. The net amount of financing outstanding at December 2011 was £44 million (2010: £61 million).

In December 2007 FLC issued £300 million of contingent loan notes, which were purchased by FASLH and the outstanding balance subsequently transferred to FLL during 2011 as part of a Group reorganisation. Repayment is contingent on surplus arising on the business transferred in to FLC from SLPM, Sun Life Unit Assurance Ltd and PPP Lifetime Care plc. FLC repaid £87 million of capital during the year leaving a remaining loan balance of nil (2010: £87 million).

FLL has guaranteed the £210 million (2010: £210 million) STICS issued in 2003 and the £268 million (2010: £268 million) STICS issued in 2005 by FPG, but now transferred to FLG. FLL has also guaranteed the £162 million subordinated debt issued by FPG in May 2009 but now transferred to FLG.

On 14 September 2010, FLG issued fixed rate unsecured loan notes, due in 2020, to Resolution Holdings (Guernsey) Limited ("RHG") another Group company, with an agreed principal amount of £700 million. On 21 April 2011, FLG issued a £500 million external Lower Tier 2 ("LT2") debt instrument with a coupon of 8.25% and a maturity of 2022. FLG repaid £400 million of the £700 million internal fixed rate unsecured loan notes on 21 April 2011, and a further £100 million on 31 May 2011. The £500 million external LT2 debt is guaranteed on a subordinated basis by FLL.

## 27. Capital continued

As required by the 2001 Part VII Scheme ("the Scheme") under which business was transferred into FLC, the FLC non-profit funds are available to provide financial support to the FLC with-profit funds on either a temporary or permanent basis. Following the distribution of part of the RIE to shareholders after completion of the 31 December 2010 five yearly test, it was agreed that the shareholder would provide support up to a total of £406 million. In the case of a temporary transfer, assets and related investment income remain attributable to the shareholder as they will be returned when they are no longer required to support the capital requirements of the with-profits funds, under the stringent tests set out in the Scheme. If all or part of the assets transferred are unlikely to be returned in the foreseeable future (taking into consideration the duration of the in force with-profits policies), then the relevant part of the transfer would be designated permanent resulting in an income statement charge to the shareholder. Under the rules of the Scheme a test must be performed once in every 12 month period and may result in a transfer being made to the with-profit funds. As at 31 December 2011 the transfer to the with-profits funds was nil (2010: nil).

### (e) Policyholder liabilities

The assumptions which have the greatest effect on policyholder liabilities (including options and guarantees) and the process used to determine those assumptions are summarised in note 26. The terms and conditions of options and guarantees relating to life assurance contracts are disclosed in note 25.

The sensitivity of policyholder liabilities to changes in market conditions and to key assumptions and other variables are disclosed in note 28.

## 28. Risk management objectives and policies for mitigating risks

### Overview

The Group, in the course of doing business, is exposed to the following categories of risk:

- financial risks: these are risks relating to the financial management of the business, the economy and other external events which result in the Group being unable to meet its financial obligations, and include market, credit, liquidity and insurance risks;
- strategic risks: these are risks related to the Group's business strategy and decision making, and include risks associated with mergers and acquisitions activity and the composition of the Group's capital structure;
- operational risks: these are risks of losses arising from inadequate or failed internal processes, personnel or systems, or from external events. Operational risks include regulatory, financial crime, people, legal, outsourcing, information technology and business protection risks; and
- group risks: these are risks of losses due to the activities of a Group member, including any business unit or subsidiary.

This note presents information about the Group's exposure to financial risks and the Group's objectives, policies and processes for measuring and managing these risks. Further quantitative disclosures are included throughout these consolidated financial statements.

### a) Quantitative risk exposure

The Group's quantitative exposure to a range of financial risks is illustrated in the MCEV sensitivity analysis below, where the impacts of reasonably possible changes in risk variables are disclosed. The basis of preparation and limitations of the MCEV methodology are provided in the MCEV supplementary information.

#### Life and pensions

The tables on the following page show the sensitivity of the embedded value for covered business and the contribution from new business to changes in assumptions at year end 2011 and 2010, split by UK and International (including Lombard).

The sensitivities shown reflect movement in Life and Pensions MCEV only.

In calculating each sensitivity, it is assumed that other future experience assumptions remain unchanged, except where changes in economic conditions 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.

## 28. Risk management objectives and policies for mitigating risks continued

| 2011 Sensitivities | Change in MCEV (net of tax) UK and corporate £m | Lombard and Int'l £m | Total £m | Change in VNB (gross of tax) UK £m | Lombard and Int'l £m | Total £m |
|---|---|---|---|---|---|---|
| Base MCEV and VNB (per note 11 of the supplementary information) | 4,300 | 1,112 | 5,412 | 59 | 92 | 151 |
| **Market and credit risk** | | | | | | |
| 100bps increase in reference rates | (83) | (2) | (85) | (8) | (3) | (11) |
| 100bps decrease in reference rates | 70 | 8 | 78 | 8 | 2 | 10 |
| Removal of illiquidity premium for immediate annuities | (607) | – | (607) | (27) | – | (27) |
| 10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield(i) | (188) | (55) | (243) | n/a | n/a | n/a |
| 25% increase in equity and property volatility at the valuation date | (32) | – | (32) | n/a | n/a | n/a |
| 25% increase in swaption implied volatility at the valuation date | (4) | – | (4) | n/a | n/a | n/a |
| 100bps increase in corporate bond spreads(ii) | (256) | (18) | (274) | (7) | – | (7) |
| 100bps decrease in corporate bond spreads(ii) | 238 | 19 | 257 | 1 | – | 1 |
| 10% adverse movement in Sterling/overseas exchange rate(iii) | (43) | (115) | (158) | n/a | n/a | n/a |
| 10% fall in value in unit-linked funds | (220) | (93) | (313) | n/a | n/a | n/a |
| **Insurance and other risk** | | | | | | |
| Reduction to EU minimum capital or equivalent(iv) | 41 | – | 41 | 2 | – | 2 |
| 10% reduction in maintenance expenses | 147 | 44 | 191 | 10 | 7 | 17 |
| 10% proportionate reduction in lapse rates | 90 | 45 | 135 | 11 | 8 | 19 |
| 10% proportionate reduction in paid-up rates | 13 | 7 | 20 | 4 | 2 | 6 |
| 5% reduction in mortality and morbidity (excluding annuities): | | | | | | |
| Before reinsurance | 287 | 6 | 293 | 13 | 1 | 14 |
| After reinsurance | 52 | 5 | 57 | 4 | – | 4 |
| 5% reduction in annuitant mortality/morbidity: | | | | | | |
| Before reinsurance | (27) | – | (27) | (3) | – | (3) |
| After reinsurance | (68) | – | (68) | (3) | – | (3) |
| Effect of end of period assumptions on VNB | – | – | – | 8 | 6 | 14 |

(i) The movement in UK embedded value from a reduction in market values comprises a nil million (2010: £3 million) fall in the value of shareholders' net worth and a £188 million (2010: £189 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 35bps (2010: 30bps) for in-force business and 35bps (2010: 40bps) for the value of new business.
(iii) Currency risk is expressed in terms of total overseas exposure; the Group's principal currency exposures other than Sterling are the Euro and US Dollar.
(iv) Required capital is set at the greater of regulatory capital and requirements arising from internal capital management policies. In aggregate, the required capital is higher than the regulatory requirement by £902 million (2010: £1,093 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.

## 28. Risk management objectives and policies for mitigating risks continued

| 2010 Sensitivities | Change in MCEV (net of tax) UK and corporate £m | Change in MCEV (net of tax) Lombard and Int'l £m | Change in MCEV (net of tax) Total £m | Change in VNB (gross of tax) UK £m | Change in VNB (gross of tax) Lombard and Int'l £m | Change in VNB (gross of tax) Total £m |
|---|---|---|---|---|---|---|
| Base MCEV and VNB (per note 11 of the supplementary information) | 5,336 | 1,134 | 6,470 | 19 | 126 | 145 |
| **Market and credit risk** | | | | | | |
| 100bps increase in reference rates | (115) | (13) | (128) | (7) | 2 | (5) |
| 100bps reduction in reference rates | 122 | 5 | 127 | 2 | (3) | (1) |
| Removal of illiquidity premium for immediate annuities | (425) | – | (425) | (20) | – | (20) |
| 10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield | (192) | (66) | (258) | n/a | n/a | n/a |
| 25% increase in equity and property volatility at the valuation date | (22) | – | (22) | n/a | n/a | n/a |
| 25% increase in swaption implied volatility at the valuation date | (4) | – | (4) | n/a | n/a | n/a |
| 100bps increase in corporate bond spreads | (283) | (16) | (299) | (9) | – | (9) |
| 100bps decrease in corporate bond spreads | 298 | 16 | 314 | 8 | – | 8 |
| 10% reduction in Sterling/overseas exchange rate | (34) | (62) | (96) | n/a | n/a | n/a |
| **Insurance and other risk** | | | | | | |
| Reduction to EU minimum capital or equivalent | 79 | 3 | 82 | 3 | – | 3 |
| 10% reduction in maintenance expenses | 162 | 31 | 193 | 8 | 6 | 14 |
| 10% reduction in lapses | 85 | 57 | 142 | 7 | 9 | 16 |
| 10% reduction in paid-up rates | 13 | 4 | 17 | 4 | 2 | 6 |
| 5% reduction in mortality and morbidity (excluding annuities): | | | | | | |
| Before reinsurance | 227 | 6 | 233 | 8 | – | 8 |
| After reinsurance | 62 | 2 | 64 | 2 | – | 2 |
| 5% reduction in annuitant mortality/morbidity: | | | | | | |
| Before reinsurance | (6) | – | (6) | (2) | – | (2) |
| After reinsurance | (49) | – | (49) | (2) | – | (2) |

## 28. Risk management objectives and policies for mitigating risks continued

### b) Market risk

Market risk is defined within the Group's Investment Risk Policy as: "The risk that movement in market factors impacts adversely on the value of, or income from, shareholder or policyholder funds".

Market risk can be categorised into the following risk drivers which correspond to the sub-modules through which they are modelled within Friends Life's internal model. These are equity risk, property risk, yield risk, corporate bond credit risk, volatility risk and foreign exchange risk

Market risk arises on guarantees and options offered on certain of the Group's products. As described within the section on policyholder liabilities (see note 25 and 26), the Group is exposed to guarantees on bonus additions that become more valuable as investment values fall and where the cost of hedging increases. In addition, the Group is exposed to guaranteed cash and annuity options on certain pension policies that become more valuable as interest rates fall and where the cost of hedging increases. The Group is also exposed to guaranteed surrender bases on certain older products.

Shareholders' earnings are further exposed to market risk to the extent that the income from policyholder funds is based on the value of financial assets held within those unit-linked or with-profits funds.

The Group manages market risk attaching to assets backing specific policyholder liabilities and to assets held to deliver income and gains for the shareholder. Within the unit-linked funds and with-profits funds, the Group manages market risk so as to provide a return in line with the expectations of policyholders. The principal objective for shareholder assets is to manage them so that they meet the capital requirements of the Group, and support its future strategic and operational objectives.

The FLG board sets appetite for market risk for each of the different asset classes taking account of the risk appetite set by the Board. Consideration is given to the objectives of the asset pools to which they relate and the nature of the liabilities backed by those assets.

The following summarises the key actions undertaken by the Group to manage market risk:

The FLG board has adopted a Market Risk Policy which augments for market risk the provisions of the Group Investment Risk Policy. The Market Risk Policy sets out how market risk should be managed within FLG and is primarily owned by the FLG Chief Investment Officer. As part of FLG's annual refresh of risk policies (which is conducted in parallel with the Board's annual review of Group policies), the FLG Chief Risk Officer, supported by the FLG Head of Financial Risk, is responsible for ensuring that the Market Risk Policy is reviewed.

FLG's Market Risk Policy is further embedded in the business through the operation of investment limits. These specify the permitted asset classes for investment, the limits for exposures to asset classes including bond exposures, cash exposures, derivative exposures, equity and other exposures, and also limits in relation to interest rate risk, inflation risk, foreign exchange risk, implied equity and interest rate volatility. The relevant limits are also reflected in investment guideline documents which are maintained for each fund.

To support the setting of investment limits, the Asset and Liability Management ("ALM") function within FLG is responsible for carrying out strategic asset allocation studies on each block of business within a three year life cycle. This review considers risk appetite, capital requirements and other metrics.

The FLG Investment Oversight Committee, which is a sub-committee of the FLG board oversees investment policy and strategy, which the Group controls primarily through the use of investment fund mandates. Day-to-day implementation of investment policy and strategy is managed predominantly by F&C in respect of the Friends Provident business acquired in 2009 (all subsidiaries excluding the AXA UK Life Business) and by AXA Investment Management UK Limited ("AXA IM") in respect of the AXA UK Life Business, including WLUK, in line with these approved mandates.

Mandates are set for each fund within each of the insurance legal entities within the Group taking account of the relevant factors outlined above. Unit-linked funds are managed in line with their underlying objectives as set out in policyholder contracts. The mandates seek to limit exposure to market risk by using some or all of the following mechanisms:

- restrictions on the asset classes held;
- restrictions on the maximum exposure to any one issuer; and
- defined sector, country or regional limits.

F&C and AXA IM managed funds may hold equity derivatives to facilitate efficient portfolio management where their use is provided for in the relevant fund mandates. Currency forwards and other derivatives may also be held to manage currency risk, but only if permitted by individual fund mandates. The Group may seek to reduce investment risk by holding derivatives (without disproportionately increasing other types of risk).

## 28. Risk management objectives and policies for mitigating risks continued

Non-F&C and AXA IM managed unit-linked funds may use derivatives for the purposes of efficient portfolio management and risk reduction in accordance with policyholder contracts and marketing literature relevant to the funds.

In addition to the mandates, the Group undertakes a programme of asset/liability management. For example, in order to manage the impact of interest rate changes on profit, corporate bonds and gilts are held to match the duration, profile and cash flows of annuity and permanent health insurance policies.

In order to manage the exposure arising from guarantees and options, the Group has purchased a number of derivatives, including interest rate swaps, equity put options, currency forwards, inflation swaps, interest rate swaptions, and equity futures to manage exposures to movements in equity prices or interest rates. Hedge accounting has not been applied to these derivatives, as movements in the fair value of these instruments will be offset by the movement in the valuation of the liability. As noted, the majority of these guarantees arise within the Group's with-profits funds and so any net fair value movement will be reflected in the unallocated surplus rather than within shareholders' funds. In addition, derivatives are used to manage guarantees in respect of non-profit business.

The following provides additional information on the exposure to equity and property risk, credit risk, foreign exchange risk, interest rate risk and volatility risk:

### i) Equity and property risk

Equity and property risk, are accepted in accordance with agreed risk appetite in order to achieve the desired level of return from policyholder assets.

Asset allocation within the With-Profits Fund is actively managed. For the first half of 2011 the strategic proportion of equities and property backing asset shares (equity backing ratio or "EBR") for the whole fund was set at 50%. Management actions allowed for within the risk management framework were revised and with effect from 30 June 2011 the strategic EBR was increased to 55% for the post-demutualisation business and was maintained at 50% for the pre-demutualisation business. At 31 December 2011, the EBR was 48% for pre-demutualisation business (31 December 2010: 49%) and 53% for post-demutualisation business (31 December 2010: 49%). These actions reflect the perceived risk appetite of the With-Profits Fund and are in line with the Group's commitment to fair treatment of all its customers and the published Principles and Practices of Financial Management.

The proportion of equity and property backing asset shares in the FLAS with-profits fund is managed on a basis which targets a stable proportion over time. This approach is also taken to WLUK policies with equity participation, although as policies get close to maturity their allocation is moved towards short-term fixed interest investments, and thus the overall equity and property proportion is likely to fall over time. For the FLC with-profits fund, asset allocation varies for different policies depending on how close they are to maturity, and thus the overall equity and property proportion within the fund is expected to gradually reduce over time.

For with-profits and unit-linked policies, the policyholders bear the majority of the investment risk and any change in asset values is matched by a broadly equivalent change in the realistic liability. However, in some cases, the Group has issued policies containing return of premium guarantees and in severe adverse investment conditions these guarantees may become in the money, leading to shareholders bearing the investment risk associated with the policy. In addition, charges that are expressed as a percentage of fund values are impacted by movements in asset values and therefore falling values still have an adverse effect on shareholders and in very adverse circumstances shareholders may be obliged to provide additional support to the with-profits funds.

In their decision-making on equity investments, F&C and AXA IM assess the extent of equity risk required or allowed by the fund as set out in the fund objectives and relative to defined performance benchmarks. The management of equity investments by non-F&C and AXA IM fund managers is performed in accordance with the objectives of the fund as set out in policy contracts and marketing literature.

Throughout 2011 there has been no material exposure to equity risk within any of the shareholders' funds.

### ii) Foreign exchange risk

The Group is exposed to foreign exchange risk through its investment in foreign operations, fee income derived from financial instruments denominated in currencies other than its measurement currency (pounds Sterling), and revenues receivable in foreign currency. Consequently, the Group is exposed to the risk that the exchange rate of its measurement currency relative to other currencies may change in a manner that has an adverse effect on the value of the Group's financial assets and liabilities. The risk is accepted as being within the Group's agreed risk appetite given the relative materiality of the exposure.

The net exposure to foreign exchange risk through investment in overseas equities is currently small, and exposure through debt securities is limited due to the restrictions placed in investment mandates. For unit-linked contracts and with-profits policies (to the extent that currency risk on overseas equities held by the with-profits funds are only partially hedged), currency risk is borne by the policyholder. As noted above, the shareholders are subject to currency risk only to the extent that income from policyholder funds is based on the value of the financial assets held in those funds. The liability for non-linked insurance contracts in currencies other than Sterling is immaterial.

## 28. Risk management objectives and policies for mitigating risks continued

### iii) Interest rate risk

The Group is exposed to fair value interest rate risk where changes to interest rates result in changes to fair values rather than cash flows, for example fixed interest rate loans and assets. Conversely, floating rate loans expose the Group to cash flow interest rate risk. The Group makes use of derivatives to manage interest rate risk. In the case of swaps the Group holds both:

- receiver interest rate swaps (where fixed payments are received in return for floating payments being paid) – increases to interest rates increase cash flows payable and reduce fair value; and
- payer interest rate swaps (where floating payments are received in return for fixed payments being paid) – reductions to interest rates reduce cash flows receivable and reduce fair value.

Both types of swaps are held in order to reduce the net asset-liability rate risk which would otherwise arise.

Bond-related performance benchmarks within fund mandates are generally set so that asset profiles broadly match liability profiles and hence the interest rate risk is minimised. However in FAL assets have been invested deliberately in bonds with a shorter duration than the company's liabilities. Interest rate swaps have then been put in place to reduce the reinvestment risk which would otherwise arise.

Day-to-day investment decisions around the management of interest rate risk and its impact on the value of FLL's investments are largely undertaken on behalf of FLL by F&C, within the boundaries set by fund mandates. In its decision-making on gilt and corporate bond investments, F&C will assess the extent of interest rate risk allowed by the fund as set out in the fund objectives and relative to the defined performance benchmarks.

Management of interest rate risk for the investments managed by AXA IM is largely undertaken by FLG's ALM function, which is responsible for monitoring and managing net asset-liability interest rate risk across all of the FLG businesses.

The Group may also be exposed to interest rate risk on its strategic investments, and on any debt issuance. As part of any proposal for strategic investment or debt capital raising, the interest rate risk to which the Group is exposed will be given careful consideration as one of the factors impacting on the final recommendation. Ultimate approval for any strategic investments or debt raising rests with the Board.

### iv) Volatility risk

The Group is exposed to the risk of loss or of adverse change in its financial position arising from changes in the market implied volatility used to value its realistic liabilities.

Swaptions and equity put options are held to mitigate interest rate volatility and implied equity volatility risk impacting the value of guarantees offered by the Group's insurance businesses.

### c) Credit risk

Credit risk includes the following seven elements:

- investment credit risk – financial loss arising from a change in the value of an investment due to a rating downgrade, default, or widening of credit spread. Changes in credit spreads are also affected by the liquidity of the stock and market expectations in respect of whether any option embedded within it will be exercised, but since the liquidity and effects related to embedded options are usually closely related to credit risk, these risks are managed as credit risk;
- derivative counterparty risk – financial loss arising from a derivative counterparty's default, or the deterioration of the derivative counterparty's financial position;
- reinsurance counterparty risk – financial loss arising from a reinsurer's default, or the deterioration of the reinsurer's financial position;
- deposit risk – financial loss arising from a deposit institution's default, or the deterioration of the deposit institution's financial position;
- loan risk – financial loss arising from a debtor's inability to repay all, or part, of its loan obligations or the deterioration of the debtor's financial position;
- country risk – financial loss arising from economic agents in a sovereign foreign country, including its government, being unable or unwilling to fulfil their international obligations due to a shortage of foreign exchange or another common reason such as currency inconvertibility; and
- settlement risk – financial loss arising from the failure or substantial delay of an expected settlement in a transfer system to take place, due to a party other than the Group defaulting/not delivering on its settlement obligations.

## 28. Risk management objectives and policies for mitigating risks continued

The life and pensions businesses will take on investment credit risk and loan risk when it is deemed financially beneficial to do so in support of their financial objectives.

The Group is exposed to investment credit risk on its investment portfolio (in line with the Group's risk appetite), primarily from investments in corporate bonds and asset backed securities. Creditworthiness assessment for new and existing investments is largely undertaken on behalf of the Group by F&C and AXA IM. In their decision making, F&C or AXA IM (as appropriate) assesses the extent of investment credit risk allowed by each fund as set out in the fund mandates and relative to defined performance benchmarks.

The majority of the Group's corporate bond portfolio is highly rated (see table on page 193).

Derivatives purchased over the counter have the potential to expose the Group to substantial credit risk but this risk is significantly reduced through collateral arrangements with counterparties. FLG's ALM function is responsible for recommending derivative strategies to the FLG board, and assisting other finance teams to put in place the appropriate internal management processes. The Group endeavours only to transact over the counter derivatives with highly rated counterparties.

The Group is exposed to reinsurance counterparty risk of three different types:

- as a result of debts arising from claims made but not yet paid by the reinsurer;
- from reinsurance premium payments made to the reinsurer in advance; and
- as a result of reserves held by the reinsurer which would have to be met by the Group in the event of default.

In addition, there is potential for the Group's credit risk exposure to increase significantly under adverse insurance risk events, e.g. if one of the insurance companies within the Group received a large number of claims for which it needed to recover amounts from its reinsurers. In order to mitigate reinsurance counterparty risk, the Group gives consideration to the credit quality of a reinsurer before incepting a reinsurance treaty. To facilitate this process, a list of acceptable reinsurers is maintained.

The Group is exposed to credit risk on the balances deposited with banks in the form of cash, certificates of deposit and money market instruments. Money market instruments issued by parties other than banks such as commercial paper are also covered under this heading. The primary risk is borrower quality; this is mitigated by limiting holdings in any one issuer.

In certain, limited circumstances, Lombard is exposed to deposit risk:

- of custodian banks relating to unit-linked policyholder cash positions; and
- for cash amounts held on behalf of unit-linked policyholders for premium proceeds with respect to policies not yet issued, and withdrawal/surrenders/death claim proceeds not yet paid to beneficiaries.

Companies in the Group are exposed to loan risk in several different areas, the most material of which are:

- loans to Independent Financial Advisors ("IFAs") as part of strategic investments;
- other strategic loans;
- loans to appointed representatives;
- loans to brokers;
- agency debt (including debt arising as a result of clawback of commission);
- policyholder debt; and
- rental income due.

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

The Group is exposed to country risk in a number of key areas, the most significant of which is bonds issued by foreign governments in non-domestic currency. The mandates that govern all F&C and AXA IM managed funds restrict the purchase of foreign government bonds to only those that exceed a minimum level of creditworthiness.

The management of country risk on the creditworthiness of the investments is largely undertaken on behalf of the Group by F&C and AXA IM. Counterparties are assessed on an individual basis, including the counterparty's sensitivity to a sovereign debt crisis in its country of domicile.

## 28. Risk management objectives and policies for mitigating risks continued

Settlement risk is a form of credit risk that arises at the settlement of a transaction, as a result of a counterparty failing to perform its obligations. The Group is exposed to settlement risk in the following key areas:

- bank transfers, including foreign exchange transactions;
- the purchase or sale of investments;
- the purchase or sale of property;
- the purchase, sale or expiry of exchange-traded derivatives or the transfer of periodic payments under these contracts; and
- the settlement of derivative contracts.

### Objectives in managing credit risk

To mitigate credit risk:

- investment mandates for many funds have a prescribed minimum credit rating of bonds that may be held and generally prohibit investment in bonds of below specified minimum ratings, subject to some discretion where assets are downgraded. Investing in a diverse portfolio reduces the impact from individual companies defaulting;
- counterparty limits are set for investments, cash deposits, foreign exchange trade exposure and stock lending;
- all over the counter derivative transactions are covered by collateral, with minor exceptions;
- the Group regularly reviews the financial security of its reinsurers; and
- in some cases, derivatives are held to protect against the risk of credit default or internal hedge solutions have been implemented.

The exposure to individual counterparties is limited to specific percentages of total non-linked assets in the long term fund, based on regulatory categorisation of counterparties.

Concentrations of credit risk might exist where the Group has significant exposure to a group of counterparties with similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic and other conditions.

Lombard deposits cash amounts with custodian banks. The deposit risk is managed by diversification across a number of custodian banks, holdings via diversified monetary collective funds, longer term balances being held in highly rated and/or state-backed custodian banks and via, in some cases, clients' acceptance of the risk in general policy conditions.

An indication of the Group's exposure to credit risk is the quality of the investments and counterparties with which it transacts. The Group is most exposed to credit risk on debt and other fixed-income securities, derivative financial instruments, deposits with credit institutions, reinsurance arrangements and cash and cash equivalents. Debt and other fixed-income securities mainly comprise government bonds and corporate bonds. The Group monitors the quality of its corporate bonds and sovereign debt holdings.

The following table gives an indication of the level of creditworthiness of those categories of assets which are neither past due nor impaired and are most exposed to credit risk using principally ratings prescribed by Standard & Poor's and Moody's. Assets held within unit-linked funds have been excluded from the table below as the credit risk on these assets is borne by the policyholders rather than the shareholders. The carrying amount of assets included in the statement of financial position represents the maximum credit exposure.

| As at 31 December 2011 | AAA £m | AA £m | A £m | BBB £m | BB £m | B £m | Not rated £m | Total £m | Collateral held £m |
|---|---|---|---|---|---|---|---|---|---|
| Corporate bonds | 2,081 | 3,189 | 4,328 | 3,360 | 212 | 33 | 227 | 13,430 | – |
| Asset-backed securities | 819 | 907 | 705 | 431 | 135 | 14 | 49 | 3,060 | – |
| Derivative financial instruments | – | 68 | 800 | – | – | – | – | 868 | 643 |
| Reinsurance assets | – | 3,129 | 83 | – | – | – | 1 | 3,213 | – |
| Deposits with credit institutions | – | – | – | – | – | – | – | – | – |
| Cash and cash equivalents | 1,278 | 1,079 | 1,631 | 19 | – | – | 5 | 4,012 | – |
| Insurance and other receivables | – | – | – | – | – | – | 265 | 265 | – |
| **Total** | 4,178 | 8,372 | 7,547 | 3,810 | 347 | 47 | 547 | 24,848 | 643 |
| % | 17% | 34% | 31% | 15% | 1% | 0% | 2% | 100% | – |

## 28. Risk management objectives and policies for mitigating risks continued

| As at 31 December 2010 | AAA £m | AA £m | A £m | BBB £m | BB £m | B £m | Not rated £m | Total £m | Collateral held £m |
|---|---|---|---|---|---|---|---|---|---|
| Corporate bonds | 2,876 | 3,196 | 4,147 | 2,645 | 315 | 57 | 269 | 13,505 | – |
| Asset-backed securities | 560 | 825 | 622 | 289 | 110 | 2 | 97 | 2,505 | – |
| Derivative financial instruments | 46 | 141 | 245 | – | – | – | – | 432 | 306 |
| Reinsurance assets | – | 2,349 | 287 | – | – | – | 1 | 2,637 | – |
| Deposits with credit institutions | – | 3 | – | – | – | – | – | 3 | – |
| Cash and cash equivalents | 2,004 | 988 | 1,225 | 36 | – | – | 6 | 4,259 | – |
| Insurance and other receivables | – | – | – | – | – | – | 976 | 976 | – |
| Total | 5,486 | 7,502 | 6,526 | 2,970 | 425 | 59 | 1,349 | 24,317 | 306 |
| % | 23% | 31% | 27% | 12% | 2% | 0% | 5% | 100% | |

The Group holds collateral in respect of over the counter derivatives. Such collateral held by the Group consists of gilts, non-sterling government bonds and cash. Collateral is valued at bid price.

The direct exposure of the Group to the debt of the governments and companies of Ireland, Portugal, Italy and Spain (being countries where the risk of credit default is perceived as higher) in shareholder and annuity funds at 31 December 2011 and 2010 is set out in the table below (to the nearest £million). There is no exposure to Greece. Where the Group holds securities issued by financial companies, it has considered the company's financial strength and the ability of the domicile government to provide financial support in the event of stress.

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| **As at 31 December** | **Govt. debt £m** | **Corporate debt £m** | **Total £m** | Govt. debt £m | Corporate debt £m | Total £m |
| Ireland | **–** | **39** | **39** | – | 50 | 50 |
| Portugal | **–** | **10** | **10** | – | 14 | 14 |
| Italy | **6** | **154** | **160** | 7 | 221 | 228 |
| Spain | **–** | **167** | **167** | – | 159 | 159 |
| **Total** | **6** | **370** | **376** | 7 | 444 | 451 |

The following table shows the amounts of insurance receivables and loans that were impaired and the amounts of insurance receivables and loans that were not impaired but either past due or not past due at the end of the year. No other financial assets were either past due or impaired at the end of the year. However, some issuers of subordinated bonds in which the Group has holdings have suspended or announced that they intend to suspend the payment of coupons. Assets held in unit-linked funds have been excluded from the table.

| | 2011 | | 2010 | |
|---|---|---|---|---|
| **As at 31 December** | **Insurance receivables** | **Loans** | Insurance receivables | Loans |
| Financial assets that are neither past due nor impaired | **91.55%** | **100%** | 93.34% | 100% |
| Financial assets that are past due: | | | | |
| 0 – 3 months past due | **4.44%** | | 0.53% | |
| 3 – 6 months past due | **0.22%** | | 0.13% | |
| 6 – 12 months past due | **3.14%** | | 0.13% | |
| Impaired financial assets for which provision is made | **0.65%** | | 5.87% | |
| **Total before provision for impairment (£m)** | **923** | **5** | 751 | 677 |

## 28. Risk management objectives and policies for mitigating risks continued

For the majority of over the counter derivative transactions undertaken by the Group, collateral is received from the counterparty if the sum of all contracts held with the counterparty is in-the-money (i.e. it is being valued as an asset). The Group has a legal right to this collateral if the counterparty does not meet its obligations but has no economic benefit from holding the assets and the counterparty may substitute at any time the collateral delivered for another asset of the same value and quality. It is repayable if the contract terminates or the contract's fair value falls. Contractual agreements between the Group and each counterparty exist to protect the interests of each party, taking into consideration minimum threshold, asset class of collateral pledged and the frequency of valuation. At 31 December 2011, the fair value of such collateral held was £643 million (2010: £306 million). No collateral received from any counterparty has been sold or repledged (2010: nil).

Reinsurance assets include an amount of £1,800 million (2010: £1,666 million) which relates to a reinsurance agreement with Swiss Re, as set out in note 31. The asset is secured by a collateral arrangement with HSBC offering protection should any counterparty supporting the reinsurance agreement default. An Investment Management Agreement is in place between FLL and Swiss Re to govern the suitability of collateral assets. As at 31 December 2011, the value of such collateral was £1,807 million (2010: £1,674 million).

The value of the reinsurance and underlying collateral are reviewed annually to ensure that the future payments received from the loan note continue to match the best estimate liability cash flows.

### d) Liquidity risk

Liquidity risk is the risk that an entity, although solvent, either does not have sufficient financial resources available to it in order to meet its obligations when they fall due, or can secure them only at excessive cost.

The Group faces two key types of liquidity risk:

- shareholder liquidity risk (liquidity within funds managed for the benefit of shareholders, including shareholders' interests in long-term funds); and
- policyholder liquidity risk (liquidity within funds managed for the benefit of policyholders).

The Group will meet shareholder liquidity needs arising in a number of key areas. For example:

- the ability to support the liquidity requirements arising from new business;
- the capacity to maintain dividend payments/loan repayments and interest etc;
- the ability to deal with the liquidity implications of strategic initiatives, such as merger and acquisition activity;
- the capacity to provide financial support across the Group; and
- the ability to fund its day-to-day cash flow requirements.

The overall objective of shareholder liquidity risk management is to ensure that there is sufficient liquidity over short (up to one year) and medium time horizons to meet the needs of the business.

For policyholder funds, liquidity needs arise from a number of potential areas, including:

- a short-term mismatch between cash flows arising from assets and cash flow requirements of liabilities;
- having to realise assets to meet liabilities during stressed market conditions;
- investments in illiquid assets such as property and private placement debt;
- higher than expected levels of lapses/surrenders caused by economic shock, adverse reputational issues or other events; and
- higher than expected payments of claims on insurance contracts.

The overall objective of policyholder liquidity risk management is to ensure that sufficient liquid funds are available to meet cash flow requirements under all but the most extreme scenarios (the exception being the property funds where a six month notice period may be required for switches and withdrawals).

## 28. Risk management objectives and policies for mitigating risks continued

Liquidity risk is managed in the following way:

- forecasts are prepared regularly to predict required liquidity levels over both the short and medium term;
- a credit facility with a syndicate of banks exists to enable cash to be raised in a relatively short time-span;
- credit risk of cash deposits is managed by applying counterparty limits and imposing restrictions over the credit ratings of third parties with whom cash is deposited;
- assets of a suitable maturity and marketability are held to meet policyholder liabilities as they fall due;
- the implementation of temporary restrictions on the withdrawal of funds such as extension of the notice periods of switches and restrictions of withdrawals from property funds; and
- in connection with potential future acquisitions the Group may fund such transactions by the issuance of new shares, rights issues, debt funding, use of existing internal resources or a combination thereof.

The Group benefits from a £500 million (2010: £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. 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 10 business days from the date of notice. As at the date of this report, the facility remains undrawn.

The following table details the undiscounted contractual net cash flows in respect of financial and insurance liabilities. Where contracts have a surrender value (ie the policy is theoretically payable on demand), the current surrender value is disclosed within the "within one year or payable on demand" column.

| | | Contractual undiscounted cash flows | | |
|---|---|---|---|---|
| Year ended 31 December 2011 | Carrying value £m | Within 1 year or payable on demand £m | 1–5 years £m | More than 5 years £m |
| **Non-derivative financial liabilities** | | | | |
| Insurance contracts | 37,264 | 21,297 | 3,458 | 17,031 |
| Investment contracts | 75,191 | 75,191 | – | – |
| Loans and borrowings: | | | | |
| – Principal | 1,195 | 123 | 271 | 801 |
| – Interest | – | 94 | 336 | 346 |
| Due to reinsurers | 1,800 | 118 | 457 | 1,861 |
| Net asset value attributable to unit-holders | 1,173 | 1,173 | – | – |
| Insurance payables and other payables | 667 | 634 | 10 | 23 |
| **Derivative financial liabilities** | | | | |
| Interest rate swaps | 114 | 2 | 17 | 95 |
| Inflation rate swaps | 50 | – | – | 50 |
| Futures backing equities | 24 | 24 | – | – |
| Credit default swaps | 2 | – | 1 | 1 |
| Cross-currency swaps | 63 | – | 11 | 52 |
| Futures – fixed-interest | 21 | 21 | – | – |
| Forward currency contracts | 13 | 13 | – | – |

## 28. Risk management objectives and policies for mitigating risks continued

| Year ended 31 December 2010 | Carrying value £m | Contractual undiscounted cash flows: Within 1 year or payable on demand £m | 1–5 years £m | More than 5 years £m |
|---|---|---|---|---|
| Non-derivative financial liabilities | | | | |
| Insurance contracts | 35,081 | 20,465 | 2,786 | 16,719 |
| Investment contracts | 72,411 | 72,411 | – | – |
| Loans and borrowings: | | | | |
| – Principal | 1,212 | 186 | 653 | 373 |
| – Interest | – | 87 | 348 | 401 |
| Due to reinsurers | 1,666 | 119 | 464 | 2,009 |
| Net asset value attributable to unitholders | 1,173 | 1,173 | – | – |
| Insurance payables and other payables | 710 | 657 | 23 | 30 |
| Derivative financial liabilities | | | | |
| Interest rate swaps | 75 | – | 18 | 57 |
| Cross-currency swaps | 23 | 23 | – | – |
| Credit default swaps | 4 | – | 1 | 3 |
| Contractual undiscounted cash flows – cross-currency swaps | 46 | – | 10 | 36 |
| Futures – fixed-interest | 2 | 2 | – | – |
| Forward currency contracts | 15 | 15 | – | – |

Amounts expected to be settled from the unallocated surplus are excluded from the analysis above as there is no contractual obligation to settle the liability. Of the carrying amount on the balance sheet in respect of the unallocated surplus, £586 million (2010: £1,051 million) is expected to be settled more than 12 months after the balance sheet date.

### e) Insurance risk

Insurance risk consists of the following areas:

- mortality risk – risk of loss arising due to policyholder death experience being different from expectations; or for annuities, risk of annuitants living longer than expected (called annuity longevity risk);
- morbidity risk – risk of loss arising due to policyholder health experience being different from expectations;
- persistency risk – risk of loss arising from lapse experience being different from expectations;
- expense risk – risk of loss due to expense experience being different from expectations; and
- option risk – risk of loss arising from experience of take-up of options and guarantees being different from expectations.

The Group's life and pensions businesses actively pursue mortality risk, longevity risk and morbidity risk in those areas where it believes it has a competitive advantage in managing these risks to generate shareholder value (without compromising the interests of policyholders, and the need to treat customers fairly). Persistency risk, expense risk and option risk are taken on when it is deemed financially beneficial for the organisation to do so, or where the taking of these risks is in support of the Group's strategic objectives.

Underpinning the Group's management of insurance risk is:

- adherence to an approved underwriting policy that takes into account the level of risk that the Group is prepared to accept;
- controls around the development of products and their pricing; and
- regular analysis of actual mortality, morbidity and lapse experience which feeds into the development of products and policies. If the analysis changes expectations of future liability cash flows, periodic adjustments are made to asset cash flows to maintain the asset liability match.

## 28. Risk management objectives and policies for mitigating risks continued

Risks in excess of agreed underwriting limits may be reinsured. The Group's objective is to purchase reinsurance in the most cost-effective manner from reinsurers whose creditworthiness is deemed appropriate.

Substantially all insurance contracts, and the majority of the combined insurance and investment contract portfolio, are written in the UK and so results are sensitive to changes in the UK insurance market and tax regime. Otherwise the Group sells a diverse range of products to a diverse group of people.

Note 26 describes the main insurance contracts written by the Group and the basis of setting assumptions in measuring insurance liabilities which will take into account the risks above. The following sections describe how policy cash flow risks are managed.

### i) Mortality and morbidity risk

*Life assurance*
Most insurance policies other than annuities and deferred annuity policies include life assurance. When pricing policies, an assumption is made as to the likelihood of death during the policy term and this assumption is reviewed as part of the annual valuation of policies. To the extent that actual mortality experience is worse than that anticipated in pricing (and subsequently in the insurance liability valuation) a loss will be made. The risk is greater for those policies such as term assurance where the maturity or surrender benefit is small in relation to the death benefit. Other policies which have a savings element, such as endowment assurance, have significant liabilities relating to the maturity benefit, particularly as the policy approaches maturity. Contractual terms for unit-linked and unitised with-profits products include provision for increases in mortality charges.

*Critical illness*
The Group writes a number of critical illness policies that pay out in the event of a policyholder's ill-health. As for life assurance, the amount payable on ill-health can be significantly higher than the amount payable if the policy is surrendered.

*Income protection*
The two main risks related to income protection are an increase in the frequency of claims (the inception rate) and an increase in the average length of the claim (a reduction in recovery rate). Most income protection policies are regular premium with the premium and cover fixed at inception. Some group policies allow premiums to be reviewed but the premium rates are usually guaranteed for two years.

*Annuities*
If annuitants live longer than expected on average, profits will reduce. In most cases there is an initial guarantee period in which, in the event of death, annuity payments continue to be made to dependants or the policyholder's estate and many policies are written so that when the first life dies the benefit continues, often at a reduced level. These features tend to reduce the volatility of results to random fluctuations in experience but not the impact of a general increase in longevity.

Deferred annuities are subject to a similar risk from the impact of longevity, the only difference being that the risk of adverse impact is greater given that the annuity is payable further into the future. However, most of these policies are with-profits and the impact would be offset by a reduction in the unallocated surplus, with relatively little resulting impact on shareholder profits.

Annuity risk was reduced through a reinsurance agreement with Swiss Re put in place in April 2007. The agreement covers annuity contracts written between July 2001 and December 2006 within FLPL. The Swiss Re agreement covers annuity contracts valued at £1,800 million at 31 December 2011 (2010: £1,666 million).

Longevity risk within FLC and the FLAS with-profits funds was reduced by a three stage project during 2009 and 2010 to reinsure the annuity business with external parties. The agreement reinsures 95% of the longevity risk in respect of £3 billion of annuity liabilities in FLC and a further £2 billion of annuity liabilities in FLAS.

### ii) Persistency and policyholder behaviour risk

Persistency experience varies over time as well as from one type of contract to another. Factors that will cause lapse rates to vary over time include changes in investment performance of the assets underlying the contract where appropriate, regulatory changes that make alternative products more attractive (or incentivise advisors to be more or less active in recommending policyholders to switch provider), customer perceptions of the insurance industry in general and the Group in particular, and the general economic environment.

The valuation of the Group's guarantees and options is described in note 26. As stated in that note, the cost of guaranteed annuity options is dependent on decisions made by policyholders such as policy discontinuance and tax-free cash take-up.
These assumptions are set by reference to recent experience.

## 28. Risk management objectives and policies for mitigating risks continued

### iii) Expense risk

Although under IFRS 4 expense risk is not a component of insurance risk, it is an important policy cash flow risk in the context of insurance and investment contracts.

The whole of the impact of changes in expense levels is borne by shareholders with the following exceptions:

- the charges made to the FLL FP with-profits fund for managing policies are due to be reviewed in 2014 to reflect market rates at that time. Pre-demutualisation with-profits policyholders will bear the impact of any resulting changes to charges;
- new FPLAL closed fund with-profits policyholders bear the full expense risk for the fund; and
- FLC, FLAS and WLUK with-profits funds have a fee agreement with FLSL, under which increased expenses may be passed on to the funds provided independent review of the proposed expenses shows they are in line with market rates.

Contractual terms for unit-linked and unitised with-profits products include provision for increases in charges. Certain expenses (such as fees and commissions) are fixed at the time a contract is written.

Friends Life follows a heavily outsourced operating model which assists in the management of expense risk by contractualising and variabilising the cost base. During 2011, Friends Life announced a major deal to outsource further parts of its operations to Diligenta and service commenced on 1 March 2012. While such deals seek to deliver cost savings and greater certainty in relation to expenses, risks nevertheless remain that expense savings will not emerge as expected.

## 29. Investment contracts

Movement in investment contracts liabilities

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| **At 1 January** | **72,411** | 40,495 |
| Acquired through business combinations | **5,195** | 25,031 |
| Premiums | **6,775** | 6,253 |
| Claims | **(7,323)** | (4,527) |
| Investment return, annual management charges and other expenses | **(1,509)** | 5,648 |
| Foreign exchange adjustments | **(358)** | (489) |
| **At 31 December** | **75,191** | 72,411 |
| Analysed as follows: | | |
| Unit-linked contracts | **65,259** | 62,492 |
| Policies with DPF | **9,457** | 9,123 |
| Other | **475** | 796 |
| **Total investments contract liabilities** | **75,191** | 72,411 |

None of the movement in liabilities is attributable to changes in credit risk of the liabilities. Investment return of £495 million loss (2010: £5,863 million profit) is included within the income statement arising from movements in investment contract liabilities.

Included in the carrying amount above, £69,455 million (2010: £66,973 million) is expected to be settled more than 12 months after the balance sheet date.

## 30. Loans and borrowings

The Group's loans and borrowings are as follows:

| | Coupon % | 2011 £m | 2010 £m |
|---|---|---|---|
| **Subordinated liabilities:** | | | |
| Lombard undated subordinated loans | Various | **2** | 3 |
| £162 million LT2 subordinated debt 2021 | 12.00 | **183** | 186 |
| £500 million LT2 subordinated debt 2022 | 8.25 | **496** | – |
| **Deferred consideration notes** | | | |
| Series A deferred consideration notes | 6.00 | **232** | 300 |
| Series B deferred consideration notes | 7.25–6.50 | **191** | 200 |
| **Reinsurance:** | | | |
| Lombard financial reinsurance treaties | Various | **8** | 15 |
| Friends Provident International financial reinsurance treaties | Various | **64** | 29 |
| **Other:** | | | |
| Acquisition finance facility | Various | **–** | 400 |
| Amounts owed to credit institutions (overdrafts) | | **19** | 79 |
| **Total loans and borrowings** | | **1,195** | 1,212 |

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 is £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 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. The fair value of this subordinated debt is £450 million.

### Deferred consideration notes

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

The original terms of the Series A DCNs 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 remains at 6% throughout the loan period.

The original terms of the Series B DCNs 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 September 2015. Thereafter, the rate remains 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 will be made on 31 May 2018.

In addition to the scheduled repayments of principal described above, the Company may at any time redeem the DCNs in full or in part and is required to repay the DCNs in full or in part on occurrence of certain specified events.

The DCN agreements provide that if the Company pays cash distributions to its shareholders above a prescribed threshold in any calendar year, this will trigger an acceleration in the repayment of the outstanding principal. This accelerated repayment will then be deducted proportionately from all future scheduled principal repayments. During the year, in addition to the scheduled repayment of £62.5 million, an accelerated repayment of £14.4 million was made. The accelerated repayment was triggered by the incremental cash distributed to shareholders during the 2011 share repurchase programme therefore, the scheduled future repayments in the Series A DCNs are reduced to £58 million per annum for the next four years; on the Series B DCNs, they are reduced to £2.4 million per annum until 2015, and to £60.5 million per annum for the following three years to 2018.

## 30. Loans and borrowings continued

### Financial reinsurance

FLL has two 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 and 2011 respectively. The total amount owed to Munich Re under these financial reinsurance arrangements as at 31 December 2011 was £40 million (31 December 2010: £29 million).

On 30 June 2011, FPIL entered into a financial reinsurance agreement with Munich Re to finance new Hong Kong Premier regular premium savings business written since 1 January 2011. The amount owed to Munich Re as at 31 December 2011 was £24 million.

### Other

On 24 June 2010, RHG and the Company entered into an acquisition finance term loan facility agreement with Barclays Bank plc and Royal Bank of Canada to fund part of the consideration payable for the AXA UK Life Business. The acquisition finance facility was issued on 13 September 2010 with a maturity date extendable to 30 June 2012. On 21 April 2011, the loan was fully repaid with funds provided by the £500 million LT2 subordinated debt 2022 referred to above.

Amounts owed to credit institutions (overdrafts) includes £7 million (2010: £23 million) relating to credit balances held within OEICS that have been consolidated as the Group holding is 50% or more. Such overdrafts are fully repayable out of the assets of the OEICS.

FLG benefits from a £500 million (2010: £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 | 2011 £m | 2010 £m |
|---|---|---|
| Within one year or on demand | 123 | 586 |
| Between one and two years | 79 | 63 |
| Between two and three years | 67 | 63 |
| Between three and four years | 63 | 63 |
| Between four and five years | 61 | 63 |
| In more than five years | 802 | 374 |
| **Total loans and borrowings** | **1,195** | 1,212 |

Included in the carrying amount above, £1,072 million (2010: £626 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 £105 million (2010: £59 million).

## 31. Amounts due to reinsurers

During April 2007, FLPL entered into a reinsurance treaty with Windsor Life Assurance Company Limited, a subsidiary of Swiss Re. The agreement, which took effect from 1 January 2007, reinsures the mortality and investment risk, but not expense risk, of 100% of FLPL's in-force post-demutualisation annuity books as at 31 December 2006. Business written after 31 December 2006 is not reinsured under the treaty. The liability due to Swiss Re represents future reassurance premiums payable and is accounted for as a financial liability at fair value through profit or loss, thereby avoiding a mismatch with the assets backing the liability. Reassurance premium payments are funded from the fixed return on an investment in a collateralised HSBC Amortising Note, purchased with a transfer of the assets previously backing the annuity policies.

Included in the carrying amount of £1,800 million (2010: £1,666 million) is £1,682 million (2010: £1,548 million) that is expected to be settled more than 12 months after the balance sheet date.

## 32. Net asset value attributable to unit-holders

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

| For the year ended 31 December | 2011 £m | 2010 £m |
|---|---|---|
| **At 1 January** | **1,173** | 668 |
| Acquired through business combinations | **(28)** | 377 |
| Share of total return in the period | **(48)** | 139 |
| Share of distributions in the period | **(27)** | (20) |
| Amount paid on issue of shares | **546** | 474 |
| Disposals | **(52)** | (29) |
| Amount received on cancellation of shares | **(391)** | (436) |
| **At 31 December** | **1,173** | 1,173 |

The carrying value of net asset value attributable to unit-holders approximates fair value. The amount acquired through business combinations in 2011 represents WLUK's investments that were classed as third-party interests at 31 December 2010 but which, following the acquisition of WLUK in 2011, are no longer externally held.

## 33. Provisions

| For the year ended 31 December 2011 | Review of mortgage endowment and pension sales £m | Separation and integration costs £m | Other £m | Total £m |
|---|---|---|---|---|
| **At 1 January 2011** | **9** | **14** | **198** | **221** |
| Acquired through business combinations | **3** | **–** | **5** | **8** |
| Charged in the period | **11** | **19** | **48** | **78** |
| Released in the period | **–** | **(2)** | **(30)** | **(32)** |
| Utilised in the period | **(12)** | **(14)** | **(21)** | **(47)** |
| **At 31 December 2011** | **11** | **17** | **200** | **228** |

| For the year ended 31 December 2010 | Review of mortgage endowment and pension sales £m | Separation and integration costs £m | Other £m | Total £m |
|---|---|---|---|---|
| At 1 January 2010 | 14 | – | 58 | 72 |
| Acquired through business combinations | – | – | 155 | 155 |
| Charged in the period | 6 | 14 | 29 | 49 |
| Released in the period | (1) | – | (7) | (8) |
| Utilised in the period | (10) | – | (37) | (47) |
| At 31 December 2010 | 9 | 14 | 198 | 221 |

Included in the carrying amount above, £150 million (2010: £172 million) is expected to be settled more than 12 months after the balance sheet date.

### a) Review of mortgage endowment and pension sales

Provision has been established for the estimated likely cost of redress, including administrative costs, arising from the review of the suitability of mortgage endowment policies and from the review of pension sales. In addition to the accounting provision of £11 million (2010: £9 million), an actuarial reserve of £5 million (2010: £5 million) was held in respect of estimated further complaints.

## 33. Provisions continued

### b) Separation and integration costs

As part of the respective purchase agreements, the Group will incur various costs to separate the businesses purchased from AXA UK plc, Bupa Investments Limited and its parent, Bupa Finance plc, and to integrate the businesses within the Group. At the year end, the Group has provided £4 million (2010: £10 million) for separation costs where the Group has an onerous commitment to separation activities and the separation plans are sufficiently progressed. In addition, £13 million (2010: £4 million) has been provided against reorganisation activities where the FLG board has approved the plans.

### c) Other

Other provisions reflect the addition of £5 million (2010: £155 million) arising directly from the acquisitions. The balance of £200 million (2010: £198 million) includes lapse provisions within Sesame Bankhall of £21 million (2010: £19 million), provisions for vacant property of £19 million (2010: £16 million), and £145 million (2010: £144 million), in respect of potential costs that may be incurred by the acquired AXA UK Life Businesses. These include provisions for policyholder compensation in the normal course of business other than in respect of pension and endowment sales, bad debts, commission clawbacks and non-income tax related repayments. It also includes a provision related to certain aspects of the administration by the acquired AXA UK Life Business of defined benefit pension schemes.

## 34. Insurance payables, other payables and deferred income

| As at 31 December | 2011 £m | 2010 £m |
|---|---|---|
| Creditors arising out of direct insurance operations | 70 | 94 |
| Creditors arising out of reinsurance operations | 55 | 64 |
| Accruals and deferred income | 225 | 171 |
| Investments purchased for subsequent settlement | 20 | 138 |
| Deferred front-end fees | 38 | 28 |
| Derivative contracts | 287 | 165 |
| Other payables | 321 | 243 |
| **Total insurance payables, other payables and deferred income** | **1,016** | 903 |

Included in the carrying amount above, £260 million (2010: £85 million) is expected to be settled more than 12 months after the balance sheet date. All insurance payables, other payables and deferred income balances are carried at cost, which approximates to fair value, with the exception of derivative contract liabilities which are carried at fair value.

## 35. Share capital

The authorised share capital of the Company is represented by an unlimited number of ordinary shares of no par value.

| | 2011 | | 2010 | |
|---|---|---|---|---|
| Issued and fully paid | Number of shares (million) | £m | Number of shares (million) | £m |
| Shares of no par value fully paid | 1,376.2 | 4,135 | 1,452.6 | 4,413 |
| Transaction costs, net of income tax | – | – | – | (76) |
| Own shares held by the Group | (2.7) | (7) | (8.6) | (20) |
| **Total at 31 December** | **1,373.5** | **4,128** | 1,444.0 | 4,317 |

## 35. Share capital continued

### Changes to share capital during 2011

| Issued and fully paid | 31 December 2011 Number of shares (million) | 31 December 2011 Share capital £m |
|---|---|---|
| **Opening share capital** | **1,452.6** | **4337** |
| Own shares held by the Group | (8.6) | (20) |
| **Adjusted opening share capital** | **1,444.0** | **4,317** |
| Shares in respect of scrip dividend (final 2010) | 13.6 | 41 |
| Share repurchase | (93.0) | (250) |
| Shares issued in respect of scrip dividend (interim 2011) | 3.0 | 7 |
| Reduction in own shares held by the Group | 5.9 | 13 |
| **Closing share capital** | **1,373.5** | **4,128** |

In October 2011, the Company completed a repurchase exercise of 93.0 million shares. The total value of shares repurchased and cancelled was £250 million.

All ordinary shares in issue in the Company rank parri passu and carry the same voting rights and rights to receive dividends and other distributions declared or paid by the Company.

## 36. Other reserves

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

| For the year ended 31 December 2011 | Capital reserve £m | Retained earnings £m | Foreign currency translation reserve £m | Total £m |
|---|---|---|---|---|
| **1 January 2011** | **1** | **1,923** | **(14)** | **1,910** |
| Loss for the period | – | (62) | – | (62) |
| Actuarial loss on defined benefit scheme (net of tax) | – | (32) | – | (32) |
| Tax relief on STICS interest | – | 7 | – | 7 |
| Foreign exchange adjustments (net of tax) and other items | – | (1) | (10) | (11) |
| Share-based payments | – | 6 | – | 6 |
| Dividends | – | (274) | – | (274) |
| **At 31 December 2011** | **1** | **1,567** | **(24)** | **1,544** |

## 36. Other reserves continued

| For the year ended 31 December 2010 | Capital reserve £m | Retained earnings £m | Foreign currency translation reserve £m | Total £m |
|---|---|---|---|---|
| 1 January 2010 | 1 | 1,310 | (5) | 1,306 |
| Profit for the period | – | 765 | – | 765 |
| Actuarial loss on defined benefit scheme (net of tax) | – | (21) | – | (21) |
| Tax relief on STICS interest | – | 9 | – | 9 |
| Foreign exchange adjustments (net of tax) and other items | – | – | (9) | (9) |
| Share-based payments | – | 4 | – | 4 |
| Dividends | – | (144) | – | (144) |
| At 31 December 2010 | 1 | 1,923 | (14) | 1,910 |

## 37. Non-controlling interests

| **As at 31 December** | **2011 £m** | 2010 £m |
|---|---|---|
| 2003 STICS | **135** | 135 |
| 2005 STICS | **183** | 183 |
| Other | **5** | 4 |
| **Total non-controlling interests** | **323** | 322 |

The STICS are carried at their fair value at the date of acquisition.

### a) Step-up tier 1 insurance capital securities

As a result of the acquisition of Friends Provident, the Group has external STICS which at the date of acquisition were an obligation of a subsidiary undertaking. These securities are described as the 2003 STICS and the 2005 STICS, respectively, reflecting the year in which they were issued.

Under IFRS, the STICS are accounted for as equity as there is no requirement to settle the obligation in cash or another financial asset. Consistent with this equity classification, interest on these instruments is not treated as an expense but as an appropriation of profit. However, given the operating nature of the interest payments on these securities, the Group has deducted the interest on the securities in computing the operating profit for the Group. No ordinary dividend can be paid if the STICS dividend is not paid. The STICS are presented in the financial statements as a non-controlling interest.

A summary of the principal terms of the STICS is set out in the following paragraphs.

## **37. Non-controlling interests** continued

### 2003 STICS

On 21 November 2003, Friends Life FPG Limited ("FPG") issued £300 million of STICS of which £210 million were outstanding at the date of acquisition, as noted below. If they pay out, they bear interest from November 2003 to November 2019 at a rate of 6.875% with interest payable in equal instalments in arrears on 21 May and 21 November of each year. The remaining STICS have no maturity date but will be redeemable at the option of FPG on 21 November 2019, thereafter on the coupon payment date falling on or nearest successive fifth anniversaries of this date. The STICS are perpetual securities and are not redeemable at the option of the holders at any time. The STICS are irrevocably guaranteed on a subordinated basis by FLL. The guarantee is intended to provide holders with rights against FLL in respect of the guaranteed payments which are as near as possible equivalent to those they would have had if the STICS had been directly issued preference shares of FLL. For each coupon period after 20 November 2019, the STICS will bear interest that is reset every five years.

### 2005 STICS

On 27 June 2005, FPG issued £500 million of STICS of which £268 million were outstanding at the date of acquisition, as noted below. They bear interest, if they pay out, from 30 June 2005 to 30 June 2015 at a rate of 6.292% with interest payable in arrears on 30 June of each year. The remaining STICS have no maturity date but will be redeemable in whole or part at the option of FPG on 1 July 2015, thereafter on every fifth anniversary of this date. The STICS are perpetual securities and are not redeemable at the option of the holders at any time. The STICS are guaranteed on a limited and subordinated basis by FLL. For each coupon period after 1 July 2015, the STICS will bear interest that is reset every five years.

### Changes since issue

On 21 May 2009, FLG carried out a financial restructuring by exchanging £90 million of the 2003 STICS and £232 million of the 2005 STICS for £162 million 12% Sterling denominated fixed-rate LT2 subordinated debt due 2021, irrevocably guaranteed on a subordinated basis by FLL. The LT2 subordinated debt was valued at fair value at the date that Friends Provident was acquired by the Company and is subsequently measured at amortised cost using the effective interest method.

In 2010, as a result of the Group's early adoption and application of IFRS 3 (revised): *Business Combinations*, the STICS were restated to their fair value as at the date of acquisition (previously they were carried at nominal value less cost and interest adjustments), with the 2009 comparative adjusted accordingly. This resulted in a reduction in the carrying value of £165 million.

On 15 December 2010, in connection with a simplification of group debt capital structure, FLG was substituted for FPG as the principal obligor. The STICS and LT2 subordinated debt continue to be guaranteed by FLL on the same terms and subject to the same conditions as prior to the substitution, and continue to be admitted to listing on the Official List of the UK Listing Authority and to trading on the regulated market of the London Stock Exchange.

### **b) Other**

Other non-controlling interest mainly relates to investments made by the senior managers of Lombard in that company. The investments comprise holdings in Class B, C and D ordinary shares which generally do not have rights to receive a share of the annual profits of Lombard. The carrying value at 31 December 2011 is £5 million (31 December 2010: £4 million), and the increase in the year reflects new joiners to the scheme. In addition, RCAP Guernsey LP (a Guernsey Limited partnership) holds a 0.01% capital interest in Resolution Holdco No.1 LP.

## **38. Contingent liabilities and commitments**

### **a) Contingent liabilities**

In the normal course of its business, the Group is subject to matters of litigation or dispute. 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.

## 38. Contingent liabilities and commitments continued

### b) Commitments

### Operating leases where the Group is lessee

The Group leases a number of properties under operating leases. These leases typically run for a period of 50 years, with an option of renewal at the end of the lease. Lease terms include annual escalation clauses to reflect current market conditions.

The future minimum rentals payable under non-cancellable leases are as follows:

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| | Land and buildings £m | Other £m | Total £m | Land and buildings £m | Other £m | Total £m |
| Within one year | 6 | 1 | 7 | 7 | 1 | 8 |
| Between one and five years | 15 | 1 | 16 | 17 | 1 | 18 |
| In more than five years | 19 | – | 19 | 26 | – | 26 |
| **Total operating lease payables** | **40** | **2** | **42** | 50 | 2 | 52 |

### Other commitments

The Group has investment property commitments of £20 million (2010: £24 million) relating to ongoing construction, renovation costs and costs of acquiring existing properties.

The Group has potential commitments of £335 million (2010: £517 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 2011 there are still funds that have yet to be utilised that, under the agreements, are still available to the private equity managers and hence classify as potential commitments.

The Group has entered into a number of outsourcing arrangements which have resulted in financial commitments amounting to £1,798 million as at 31 December 2011 (31 December 2010: £510 million). The average weighted years remaining on these outsourcing contracts is 15 years as at 31 December 2011 (31 December 2010: 15 years). Included within these amounts is the £1.3 billion outsourcing arrangement with Diligenta announced in November 2011.

## 39. Business combinations

During the year the Group made two acquisitions. For both acquisitions, the values of assets acquired and liabilities assumed, recognised on acquisition are their estimated fair values. No contingent liabilities have been recognised on acquisition.

In determining the fair value of AVIF, the Group applied pre-tax discount rates to the associated cash flows for each acquired business of 6.7% for BHA and 9.0% for WLUK.

In determining the fair value of distribution and customer relationships acquired the Group applied pre-tax discount rates of 6.7% for BHA and 10.0% for WLUK to the associated cash flows for each intangible asset.

The gain of £116 million recognised as a result of the two acquisitions is attributable to the purchase price being at a discount to the fair value of the net assets acquired which is based on the market consistent embedded value of WLUK and BHA. The gain is reported within other income in the consolidated income statement.

## 39. Business combinations continued

### a) Acquisition of Bupa Health Assurance Limited

In January 2011, the Group through its subsidiary, FLL, acquired 100% of the shares in BHA, a life insurance company, from Bupa Investment Limited and its parent Bupa Finance plc. The Group acquired control of BHA on 31 January 2011, the date at which the last substantive condition to legal completion was satisfied, and has consolidated it from that point. The gross consideration paid in cash was £168 million compared to an announced price in October 2010 of £165 million. The increase in price reflects an additional £3 million of capital injected into BHA in December 2010 by British United Provident Association Limited.

In the period from the acquisition to 31 December 2011, BHA contributed revenue of £96 million and made a loss after tax of £11 million. If the acquisition had occurred on 1 January 2011, management estimate that consolidated revenue would have been £104 million, and the consolidated loss after tax for the year would have been £12 million. In determining these amounts, management has assumed that the fair value adjustments which arose on the date of acquisition would have been the same if the acquisition had occurred on 1 January 2011.

The following summarises the consideration transferred, and the recognised amounts of assets acquired and liabilities assumed at the acquisition date:

| | £m |
|---|---|
| Cash paid | 168 |
| **Fair value of purchase consideration** | **168** |
| Fair value of net assets acquired | (236) |
| **Excess of the interest in the fair value of assets acquired over cost** | **(68)** |

The consolidated income statement includes £1 million within administrative and other expenses in relation to stamp duty payable on the shares acquired.

| Identifiable assets acquired and liabilities assumed | Recognised values on acquisition £m |
|---|---|
| Intangible assets: | |
| Acquired value of in-force business | 172 |
| Other intangible assets | 8 |
| Financial assets | 83 |
| Reinsurance assets | 83 |
| Cash and cash equivalents | 90 |
| Current assets | 30 |
| **Total identifiable assets** | **466** |
| Insurance liabilities | 157 |
| Deferred tax liability | 48 |
| Other liabilities | 25 |
| **Total identifiable liabilities** | **230** |
| **Net identifiable assets acquired and liabilities assumed** | **236** |
| **Attributable to equity holders of the parent** | **236** |

## 39. Business combinations continued

### b) Acquisition of Winterthur Life UK Limited

In November 2011, the Company acquired 100% of the shares in WLUK, a life insurance company, from AXA UK. The acquisition of WLUK was agreed with AXA UK in 2010 at the same time as the acquisition of FASLH was negotiated. However, the share capital of WLUK was not legally acquired by the Group until 2011 as the purchase was contingent upon a transfer under Part VII of FSMA of AXA UK's retained business out of WLUK and FSA approval for the change of control of WLUK being received. The Group acquired control of WLUK on 7 November 2011, the date at which the last substantive condition to legal completion was satisfied, and has consolidated it from that point.

In the period from the acquisition to 31 December 2011, WLUK contributed revenue of £(1) million (reflecting a negative investment return of £22 million) and made a loss after tax of £1 million. If the acquisition had occurred on 1 January 2011, management estimate that consolidated revenue would have been £(32)million, and the consolidated loss after tax for the year would have been £7 million. In determining these amounts, management has assumed that the fair value adjustments which arose on the date of acquisition would have been the same if the acquisition had occurred on 1 January 2011.

The following summarises the consideration transferred, and the recognised amounts of assets acquired and liabilities assumed at the acquisition date:

| | £m |
|---|---|
| Cash paid | 248 |
| **Fair value of purchase consideration** | **248** |
| Fair value of net assets acquired | (296) |
| **Excess of the interest in the fair value of assets acquired over cost** | **(48)** |

The consolidated income statement includes £2 million within administrative and other expenses in relation to stamp duty payable on the shares acquired.

| | Recognised values on acquisition £m |
|---|---|
| Intangible assets: | |
| Acquired value of in-force business | 239 |
| Distribution and customer relationships | 29 |
| Property and equipment | 3 |
| Investment properties | 43 |
| Financial assets | 6,617 |
| Reinsurance assets | 402 |
| Current tax assets | 1 |
| Insurance and other receivables | 38 |
| Cash and cash equivalents | 338 |
| **Total identifiable assets** | **7,710** |
| Insurance liabilities | 2,127 |
| Investment contracts | 5,195 |
| Unallocated surplus | 38 |
| Provision for other risks and charges | 8 |
| Deferred tax liabilities | 23 |
| Insurance payables, other payables and deferred income | 23 |
| **Total identifiable liabilities** | **7,414** |
| **Net identifiable assets acquired and liabilities assumed** | **296** |
| **Attributable to equity holders of the parent** | **296** |

## 39. Business combinations continued

### c) Acquisition of AXA UK Life Business in the prior year

On 3 September 2010, the FSA approved the change of control to the Group of FASLH, the AXA UK Life Business. As the sale and purchase agreement in relation to FASLH became unconditional upon obtaining the FSA approval, the Group acquired control of FASLH on 3 September 2010 and has consolidated it from that point. On 15 September 2010, the Group legally completed the purchase of 100% of the shares and voting rights of FASLH.

In the period from the acquisition to 31 December 2010, FASLH contributed revenue of £3,339 million and a profit after tax of £1 million. If the acquisition had occurred on 1 January 2010, management estimate that consolidated revenue would have been £6,670 million, and consolidated profit after tax for the year would have been £109 million. In determining these amounts, management has assumed that the fair value adjustments which arose on the date of acquisition would have been the same if the acquisition had occurred on 1 January 2010.

The following summarises the major classes of consideration transferred, and the recognised amounts of assets acquired and liabilities assumed at the acquisition date:

| | £m |
|---|---|
| Cash paid | **2,224** |
| Deferred consideration notes | **500** |
| **Fair value of consideration excluding acquisition expenses incurred at acquisition** | **2,724** |
| Fair value of net assets acquired | **3,607** |
| **Excess of the interest in the fair value of assets acquired over cost** | **883** |

The gain of £883 million recognised as a result of the acquisition was attributable to the purchase price being at a discount to the fair value of the net assets acquired which was based on the MCEV of the AXA UK Life Business plus the value of customer and distribution intangibles relating to future business with existing customers and distribution channels at the acquisition date.

### d) Disposal of operations

Under the terms of the agreement to acquire the AXA UK Life Business in 2010, two acquired portfolios of business, the Guaranteed Over Fifties ("GOF") and Trustee Investment Plan ("TIP") portfolios, were required to be transferred back to AXA at a future date following completion of a transfer under Part VII of FSMA. Accordingly the assets and liabilities related to these portfolios were classified as held for sale as at 31 December 2010.

The major classes of assets and liabilities of the GOF and TIP portfolios as at 31 December 2010 are disclosed in the table below:

| | £m |
|---|---|
| Intangible assets – AVIF | 269 |
| Deferred tax assets | 20 |
| Financial assets | 904 |
| Cash and cash equivalents | 13 |
| **Assets of operations classified as held for sale** | 1,206 |
| Insurance contracts | 21 |
| Investment contracts | 904 |
| **Liabilities of operations classified as held for sale** | 925 |
| **Net assets of operations classified as held for sale** | 281 |

## 39. Business combinations continued

The transfer of the GOF and TIP portfolios was completed on 1 November 2011. Disposal proceeds received relating to this transaction were £285 million. The difference between the proceeds received and the net assets classified as held for sale at 31 December 2010 was £4 million, and has been recognised as income in the consolidated income statement for the year. It can be summarised as follows:

| | 2011 £m |
|---|---|
| Net assets classified as held for sale at 31 December 2010 | **281** |
| Accrued interest received on disposal proceeds | **4** |
| **Proceeds received as above** | **285** |

The income statement of the GOF and TIP portfolios has been consolidated on a line-by-line basis up to the date of disposal in the financial statements. The table below shows the income statement of the held for sale business:

| | 2011 £m | 2010 £m |
|---|---|---|
| Gross earned premiums | **71** | 29 |
| Gross claims and benefits paid | **(15)** | (5) |
| Change in insurance contracts liabilities | **2** | 7 |
| Acquisition expenses | **–** | (19) |
| Administrative and other expenses | **(51)** | (15) |
| **Profit before tax** | **7** | (3) |

### e) Disposal of subsidiaries in the prior year

### i) Disposal of Pantheon Financial Limited

On 19 March 2010 the Group disposed of 100% of the share capital of Pantheon Financial Limited which formed part of the UK operating segment.

Details of the transaction are as follows:

| Assets and liabilities in disposal | £m |
|---|---|
| Cash and cash equivalents | 3 |
| Other net assets and liabilities | (3) |
| **Net assets on disposal:** | – |
| Gain included in profit from continuing operations | – |
| Consideration received | – |
| Cash and cash equivalents in disposal | (3) |
| **Cash flow from disposal of subsidiary, net of cash disposed** | (3) |

## **39. Business combinations** continued

### ii) Reduction of holding in F&C Commercial Property Trust plc ("F&C CPT")

On 23 April 2010 the Group reduced its holding in F&C CPT from 50.3% to 34.16%. The retained holding has been recognised as a financial asset at fair value through the income statement. Until 23 April 2010, F&C CPT was treated as a subsidiary of the Group and all its assets and liabilities were consolidated on a line-by-line basis. Loss of control arose when the holding was reduced resulting in de-recognition of assets and liabilities. The carrying amounts de-recognised are set out in the table below. As at 31 December 2010, F&C CPT was not treated as an associate as the Group had ceased to have significant influence over this trust.

| Assets and liabilities in disposal | £m |
|---|---|
| Investment properties | 767 |
| Financial assets | 6 |
| Cash and cash equivalents | 97 |
| Insurance and other receivables | (4) |
| Interest-bearing loans and borrowings | (219) |
| Insurance payables, other payables and deferred income | (23) |
| **Net assets on disposal:** | 624 |
| Non-controlling interest in assets and liabilities in disposal | (309) |
| Fair value of investment retained | (214) |
| Gain included in profit from continuing operations | – |
| Consideration received (cash) | 101 |
| Cash and cash equivalents in disposal | (97) |
| **Cash flow from disposal of subsidiary, net of cash disposed** | 4 |

## **40. Related parties**

In the ordinary course of business, the Group and its subsidiary undertakings carry out transactions with related parties, as defined by IAS 24: *Related party disclosures*. Material transactions for the year are set out below.

The principal subsidiary undertakings of the Group and its interest in associates and joint venture are shown in notes 17 and 18 respectively.

### **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:

| | **2011 Number** | **2011 £m** | 2010 Number | 2010 £m |
|---|---|---|---|---|
| Short-term employee benefits | **16** | **6** | 11 | 1 |
| Post-employment benefits (excluding defined benefit scheme) | **–** | **–** | – | – |
| Share-based payments | **–** | **–** | – | – |
| **Total key management personnel compensation charged to the income statement** | **16** | **6** | 11 | 1 |
| Post-employment benefits: defined benefit schemes | **–** | **–** | – | – |
| **Total key management personnel compensation** | **16** | **6** | 11 | 1 |

The compensation paid to ROL is disclosed in note 40 (b) below.

## 40. Related parties continued

### b) Other related parties

Details of the Group's pension schemes are provided in note 8.

Transactions made between the Group and related parties were made in the normal course of business. Loans from related parties are made on normal arm's length commercial terms.

The Company has entered into certain contracts with related parties as described below:

- an Operating Agreement with ROL, as a result of which the Company has outsourced most of its operating functions to ROL. Under this agreement, the Company pays an annual fee to ROL based on 0.5% of the value of the Company (subject to a minimum payment of £10 million), plus amounts for additional accounting services and, with effect from 1 October 2011, certain company secretarial services. The total fee charged for the year was £20 million, of which £2 million has been incurred by the Company, with the balance incurred by its direct subsidiary, Resolution Holdco No.1 L.P. An accrual of £0.2 million in respect of ROL fees payable has been recognised in the Company's statement of financial position as at 31 December 2011.
  The Operating Agreement remains in force until terminated by written notice by either party. Certain changes to the Operating Agreement took effect following shareholder approval on 13 January 2012. Under the terms of the revised agreement, subject to certain exceptions, notice to terminate may not expire until the later of 1 December 2013 and the date 12 months after the Company has publicly declared the UK Life Project complete. The amounts payable to ROL by the Company in any year will be reduced by a maximum of £2 million where ROL provides advisory and operating services to other entities in that year. Subject to certain conditions, ROL is also entitled under the new agreement to receive up to an aggregate of £20 million from the Company to fund development work for certain projects undertaken outside the Company. 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 all its shareholders) if ROL successfully launches a new project. Any project costs which are repaid to the Company will replenish the amount of Company funding that may be available to ROL to fund other project costs. The Company has advanced £1 million to ROL for development work for non-UK life projects over the course of 2011. The funding was advanced on the basis that, following the amendments to the Operating Agreement, these amounts will count towards the aggregate £20 million project funding cap, reducing the amount available and that the funding plus a cash return of 100% on such funding will be payable to the Company in the event that the relevant projects are successfully launched. Further amendments and/or the termination of the operating agreement may be required if the FSA proposals for "externally managed companies" set out in consultation paper CP12/2 are implemented. See note 41 for details
- RCAP Guernsey LP, a limited partnership in which members of ROL are limited partners, acquired shares in the Company for a consideration of £20 million in its initial public offering. At the time of the initial public offering the Company entered into a lock-up deed with RCAP GP Limited, acting in its capacity as general partner of RCAP Guernsey LP, restricting the sale of the shares held by RCAP Guernsey LP for a period of three years. Following the Company's acquisition of the AXA UK Life Business, a further £8 million was invested in the company's shares by RCAP Guernsey LP as part of the rights issue. The sale of these shares was not restricted by the lock-up deed. The lock-up deed expired on 10 December 2011. With effect from 13 January 2012, the provisions of a new lock-up deed between the Company, RCAP GP Limited, acting in its capacity of general partner of RCAP Guernsey LP, and Resolution Capital Limited, a limited partner of RCAP Guernsey LP and member of ROL, took effect. Under the new lock-up deed, members of the Resolution Group (which includes ROL, RCAP Guernsey LP, Resolution Capital Limited and their respective undertakings – for the avoidance of doubt, it does not include the Company or any of its subsidiaries) are restricted from selling or providing as security for a loan any of their shares in the Company (including the shares acquired as part of the AXA UK Life Business acquisition-related rights issue) until completion of the UK Life Project. This restriction is subject to customary exceptions. In addition, some of the shares may be sold or provided as security for a loan for the purpose of the Resolution Group co-investing in any new entity which it may advise provided that, immediately thereafter, the remaining shares are not less in value than the largest investment made by the Resolution Group (using the proceeds of the sold or secured shares) in such entities;

## 40. Related parties continued

- as shown in note 17, the Company has a 99.99% interest in, and is the general partner in, Resolution Holdco No. LP, a Guernsey limited partnership. RCAP Guernsey LP, a member of the Resolution Group, is a limited partner in Resolution Holdco No.1 LP. RCAP Investments SARL, another member of the Resolution Group, was previously also a limited partner of Resolution Holdco No.1 LP but transferred its interest to RCAP Guernsey LP in November 2011 with the consent of the Company (acting in its capacity of general partner of Resolution Holdco No.1 LP). The Company entered into the limited partnership for the purpose of making acquisitions for the UK Life Project and rewarding the Resolution Group for value created in the limited partnership from those acquisitions;
- a trade mark licence agreement with Resolution (Brands) Limited, a company wholly owned by Clive Cowdery, a member of ROL and RCAP Guernsey LP, under which the Group has paid a fee of £110,143 for the use of the "Resolution" brand in respect of the year commencing 4 December 2011 (2010: £104,500). The fee payable under the trade mark license agreement increases annually in line with the retail price index from a base fee of £100,000 in respect of the year commencing 4 December 2008; ROL was involved in the provision of certain capital raising services to the Group in connection with the financing of the AXA UK Life Business acquisition in 2010. In consideration for these services, Resolution Holdco No.1 LP paid an aggregate fee of £4.5 million, of which £3.75 million was paid upon completion of the acquisition in 2010 and the remaining £0.75 million was paid in April 2011 following the issue by FLG of the external lower tier 2 subordinated debt 2022. Independent financial advice was provided to the Board in connection with the terms of the appointment of ROL in respect of the financing of the acquisition and confirmation was provided to the UK Listing Authority by the advisor that it considered that the terms of such appointment were fair and reasonable as far as shareholders are concerned; and
- Own shares held by subsidiary undertakings of the Company with a fair value of £20 million have been acquired as part of the share repurchase programme.

## 41. Post balance sheet events

### Changes in the rate of corporation tax

The Chancellor delivered his Budget on 21 March 2012, which announced a further 1% reduction in the rate of corporation tax, effective from 1 April 2012, in addition to the incremental 1% rate reductions previously announced which will take effect on 1 April 2013 and 1 April 2014. The corporation tax rate is therefore expected to be 24% from 1 April 2012, 23% from 1 April 2013 and 22% from 1 April 2014. The benefit to the Group's net assets from the further 3% decrease in the rate is estimated to be approximately £94 million in total and will be recognised when the legislation is substantively enacted.

### CP12/2

The FSA issued a consultation paper (CP12/2) in January 2012. One of the proposals included in the consultation paper is that premium listed companies such as the Company, which have appointed an investment adviser to provide a wide range of services to the Company would cease to be eligible for premium listing unless their arrangements with the investment adviser are unwound. This proposal, if implemented, may require the Company to terminate early or substantially amend its arrangements with ROL and may, in turn, lead the Company to incur significant costs if its premium listing were to be maintained.

# MCEV financial statements

# Statement of directors' responsibilities in respect of the Market Consistent Embedded Value (MCEV) basis

The directors of Resolution Limited have chosen to prepare supplementary information in accordance with European Insurance CFO Forum ("MCEV principles"), issued in October 2009. When compliance with the MCEV Principles is stated, those principles require the directors to prepare supplementary information in accordance with the methodology contained in the MCEV Principles and to disclose and explain any non-compliance in the guidance included in the MCEV Principles.

In preparing the MCEV supplementary information, the directors have:

- done so in accordance with the MCEV Principles and fully complied with the guidance included therein;
- determined assumptions on a realistic basis, having regard to past, current and expected future experience and to any relevant external data, and then applied them consistently;
- made estimates that are reasonable and consistent; and
- described the basis on which business that is non-covered has been included in the supplementary information, including any material departures from the accounting framework applicable to the Group consolidated IFRS financial statements.

By order of the Board

**Fergus Dunlop**
Director

26 March 2012

# Independent auditor's report to the directors of Resolution Limited on the consolidated Market Consistent Embedded Value (MCEV) financial statements

We have audited the consolidated MCEV financial statements of Resolution Limited for the year ended 31 December 2011, which comprise the consolidated income statement – MCEV basis, the earnings per share – MCEV basis, the consolidated statement of comprehensive income – MCEV basis, the consolidated statement of changes in equity – MCEV basis, the consolidated statement of financial position – MCEV basis, the Group MCEV analysis of earnings and the related notes 1 to 13. The consolidated MCEV financial statements have been prepared by the directors of Resolution Limited in accordance with the Market Consistent Embedded Value Principles issued in October 2009 by the CFO Forum ("the CFO Forum Principles") and the basis of preparation set out on pages 223 to 226.

## Directors' responsibilities for the consolidated MCEV financial statements

The directors are responsible for the preparation of these consolidated MCEV financial statements in accordance with the basis of preparation set out on pages 223 to 226 and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

## Auditor's responsibility

Our responsibility is to express an opinion on the consolidated MCEV financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require us to comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated MCEV financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated MCEV financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated MCEV financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation of the consolidated MCEV financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the consolidated MCEV financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

## Opinion

In our opinion the consolidated MCEV financial statements for the year ended 31 December 2011 are prepared, in all material respects, in accordance with the CFO Forum principles and the basis of preparation set out on pages 223 to 226.

## Basis of accounting and restriction on use

Without modifying our opinion, we draw attention to note 1 to the consolidated MCEV financial statements, which describes the basis of preparation. The consolidated MCEV financial statements are prepared by Resolution Limited in accordance with the CFO Forum Principles. As a result, the consolidated MCEV financial statements may not be suitable for another purpose. This report, including the opinion, has been prepared for and only for the Company's directors as a body in accordance with our letter of engagement dated 8 July 2011 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

## Other matter

We have reported separately on the statutory Group IFRS financial statements of Resolution Limited for the year ended 31 December 2011. The information contained in the consolidated MCEV financial statements should be read in conjunction with the financial statements prepared on an IFRS basis.

**Ernst & Young LLP**
London

26 March 2012

1. The maintenance and integrity of Resolution Limited's website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# Consolidated income statement – MCEV basis

**For the year ended 31 December 2011**

| | Notes | RSL 2011[ii] £m | RSL 2010[ii] £m | FLG 2011[ii] £m | FLG 2010[ii] £m |
|---|---|---|---|---|---|
| **Life and pensions** | | | | | |
| Value of new business | 6 | **151** | 145 | 151 | 145 |
| Expected existing business contribution | | **360** | 247 | 360 | 247 |
| Operating experience variances | | **(28)** | 32 | (28) | 32 |
| Operating assumption changes | | **140** | (23) | 140 | (23) |
| Other operating variances | | **6** | 65 | 6 | 65 |
| Development costs | 10 | **(36)** | (28) | (36) | (28) |
| Life and pensions covered business operating profit before tax | 3 | **593** | 438 | 593 | 438 |
| Other income and charges | | **(35)** | (11) | (35) | (11) |
| **Life and pensions operating profit before tax** | | **558** | 427 | 558 | 427 |
| Corporate income and charges | | **(41)** | (15) | – | – |
| **Operating profit before tax** | | **517** | 412 | 558 | 427 |
| Economic variances | 3 | **(600)** | 229 | (600) | 229 |
| Amortisation of non-covered business acquired intangible assets | 3 | **(3)** | (3) | (3) | (3) |
| Non-recurring items and non-operating variances | 3 | **(282)** | (22) | (282) | (8) |
| **(Loss)/profit from continuing operations before tax** | | **(368)** | 616 | (327) | 645 |
| Tax on operating profit | | **(150)** | (96) | (150) | (96) |
| Tax on other activities | | **223** | (60) | 223 | (60) |
| **(Loss)/profit for the year[i]** | | **(295)** | 460 | (254) | 489 |

(i) (Loss)/profit 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 and the results of WLUK from 7 November 2011. The results for the year ended 31 December 2010 include the results of the acquired AXA UK Life Business from 3 September 2010.

The notes on pages 223 to 260 form an integral part of these financial statements.

# Earnings per share – MCEV basis

**For the year ended 31 December 2011**

| | Notes | RSL 2011 Pence | RSL 2010 Pence |
|---|---|---|---|
| **Earnings per share** | | | |
| Operating earnings per share on MCEV basis after tax, attributable to equity holders of the parent | | | |
| – Basic | 4 | **25.74** | 33.50 |
| – Diluted | | **25.74** | 33.24 |
| Earnings per share on MCEV basis after tax, attributable to equity holders of the parent | | | |
| – Basic | 4 | **(20.69)** | 48.77 |
| – Diluted | 4 | **(20.69)** | 48.39 |

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 2011**

| | RSL 2011 £m | RSL 2010 £m | FLG 2011 £m | FLG 2010 £m |
|---|---|---|---|---|
| **(Loss)/profit for the year** | **(295)** | 460 | (254) | 489 |
| Actuarial losses on defined benefit pension schemes, net of tax | **(32)** | (22) | (32) | (22) |
| Foreign exchange adjustments | **(15)** | (11) | (15) | (11) |
| **Other comprehensive loss for the year, net of tax** | **(47)** | (33) | (47) | (33) |
| **Total comprehensive (loss)/income for the year**[i] | **(342)** | 427 | (301) | 456 |

(i) Total comprehensive (loss)/income for the year is attributable to equity holders of the parent.

# Consolidated statement of changes in equity – MCEV basis

**For the year ended 31 December 2011**

| | RSL 2011 £m | RSL 2010 £m | FLG 2011 £m | FLG 2010 £m |
|---|---|---|---|---|
| **Opening ordinary shareholders' equity** | **6,515** | 3,488 | 6,514 | 3,181 |
| 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) | – |
| Acquired value of AXA UK Life Business as at 3 September 2010 | **–** | 3,498 | – | 3,498 |
| Cost of acquisition of AXA UK Life Business[(i)] | **–** | (2,724) | – | (2,724) |
| Total comprehensive (loss)/income for the year | **(342)** | 427 | (301) | 456 |
| Issue of share capital (net of capitalised expenses and movement in RSL shares held by subsidiaries) | **61** | 1,967 | – | 2,165 |
| Share repurchase | **(250)** | – | – | – |
| Dividends on equity shares | **(274)** | (144) | (350) | (65) |
| Share-based payments | **5** | 3 | 5 | 3 |
| (Decrease)/increase in MCEV reserves for the year | **(719)** | 3,027 | (565) | 3,333 |
| **Closing ordinary shareholders' equity** | **5,796** | 6,515 | 5,949 | 6,514 |

(i) Transaction costs of £3 million relating to the acquisitions of BHA and WLUK are included in non-recurring items and non-operating variances in 2011. All transaction costs were incurred in FLG. 2010 transaction costs of £28 million were incurred in respect of the acquisition of the AXA UK Life Business, of which £14 million was incurred in FLG.

# Consolidated statement of financial position – MCEV basis

**At 31 December 2011**

| | RSL<br>2011<br>£m | RSL<br>2010<br>£m | FLG<br>2011<br>£m | FLG<br>2010<br>£m |
|---|---|---|---|---|
| **Assets** | | | | |
| Pension scheme surplus | **20** | 22 | 20 | 22 |
| VIF covered business excluding assets of operations classified as held for sale | **3,844** | 3,966 | 3,844 | 3,966 |
| Intangible assets | **25** | 29 | 25 | 29 |
| Property and equipment | **58** | 46 | 58 | 46 |
| Investment properties | **3,015** | 3,189 | 3,015 | 3,189 |
| Investment in associates and joint venture | **31** | 27 | 31 | 27 |
| Financial assets | **103,636** | 99,445 | 103,643 | 99,465 |
| Deferred acquisition costs | **105** | 119 | 105 | 119 |
| Reinsurance assets | **3,213** | 2,637 | 3,213 | 2,637 |
| Current tax assets | **6** | 22 | 6 | 22 |
| Insurance and other receivables | **1,175** | 1,024 | 1,175 | 1,023 |
| Cash and cash equivalents | **8,791** | 9,288 | 8,690 | 9,057 |
| Assets of operations classified as held for sale | | | | |
| – VIF covered business | **–** | 236 | – | 236 |
| – other assets | **–** | 970 | – | 970 |
| **Total assets** | **123,919** | 121,020 | 123,825 | 120,808 |
| **Liabilities** | | | | |
| Insurance contracts | **37,326** | 35,142 | 37,326 | 35,142 |
| Unallocated surplus | **640** | 1,090 | 640 | 1,090 |
| Financial liabilities | | | | |
| – investment contracts | **74,224** | 71,535 | 74,224 | 71,535 |
| – loans and borrowings | **1,440** | 1,599 | 1,201 | 1,399 |
| – amounts due to reinsurers | **1,800** | 1,666 | 1,800 | 1,666 |
| Net asset value attributable to unit-holders | **1,173** | 1,173 | 1,173 | 1,173 |
| Provisions | **230** | 221 | 230 | 221 |
| Deferred tax liabilities | **304** | 270 | 304 | 270 |
| Current tax liabilities | **20** | 11 | 20 | 11 |
| Insurance payables, other payables and deferred income | **961** | 869 | 953 | 858 |
| Liabilities of operations classified as held for sale | **–** | 925 | – | 925 |
| **Total liabilities** | **118,118** | 114,501 | 117,871 | 114,290 |
| **Equity attributable to:** | | | | |
| – Equity holders of the parent | **5,796** | 6,515 | 5,949 | 6,514 |
| – Non-controlling interests | **5** | 4 | 5 | 4 |
| **Total equity** | **5,801** | 6,519 | 5,954 | 6,518 |
| **Total equity and liabilities** | **123,919** | 121,020 | 123,825 | 120,808 |

# Group MCEV analysis of earnings

**For the year ended 31 December 2011**

| | FLG | | | RSL (ex. FLG)(i) | RSL | RSL | FLG |
|---|---|---|---|---|---|---|---|
| | 2011 | | | 2011 | 2011 | 2010 | 2010 |
| | Covered business £m | Non-covered business £m | Total £m | Non-covered business £m | Total £m | Total £m | Total £m |
| Opening Group MCEV | 6,470 | 44 | 6,514 | 1 | 6,515 | 3,488 | 3,181 |
| Opening adjustments: | | | | | | | |
| capital and dividend flows | – | – | – | – | – | 1,979 | 2,165 |
| acquired businesses: | | | | | | | |
| – acquired value of BHA | 226 | – | 226 | – | 226 | – | – |
| – cost of acquisition of BHA(ii) | (168) | – | (168) | – | (168) | – | – |
| – acquired value of WLUK | 271 | – | 271 | – | 271 | – | – |
| – cost of acquisition of WLUK(ii) | – | (248) | (248) | – | (248) | – | – |
| – acquired value of AXA UK Life Business | – | – | – | – | – | 3,498 | 3,498 |
| – cost of acquisition of AXA UK Life Business(ii) | – | – | – | – | – | (2,724) | (2,724) |
| **Adjusted opening Group MCEV** | 6,799 | (204) | 6,595 | 1 | 6,596 | 6,241 | 6,120 |
| Operating MCEV earnings | 443 | (35) | 408 | (41) | 367 | 316 | 331 |
| Non-operating MCEV earnings | (661) | (1) | (662) | – | (662) | 144 | 158 |
| **Total MCEV earnings** | (218) | (36) | (254) | (41) | (295) | 460 | 489 |
| Other movements in IFRS net equity | – | (32) | (32) | 13 | (19) | (42) | (22) |
| Closing adjustments: | | | | | | | |
| – capital and dividend flows | (1,204) | 859 | (345) | (126) | (471) | (133) | (62) |
| – foreign exchange variances | (15) | – | (15) | – | (15) | (11) | (11) |
| – transfer of GOF and TIP businesses to AXA UK plc | 50 | (50) | – | – | – | – | – |
| **Closing Group MCEV** | 5,412 | 537 | 5,949 | (153) | 5,796 | 6,515 | 6,514 |

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

(ii) Transaction costs of £3 million relating to the acquisitions of BHA and WLUK are included in non-recurring items and non-operating variances in 2011. All transaction costs were incurred in FLG. Transaction costs of £28 million were incurred in 2010 in respect of the acquisition of the AXA UK Life Business, of which £14 million was incurred in FLG.

# Notes to the MCEV results

**For the year ended 31 December 2011**

## 1. Basis of preparation

### Introduction

Resolution Limited is presenting the results and financial position for its life and pensions business on the MCEV basis and for its other businesses on the IFRS basis. The MCEV basis is in compliance with the European Insurance CFO Forum MCEV Principles(i) ("the MCEV Principles"), issued in June 2008, and re-issued in amended form in October 2009. In accordance with guidance issued by the CFO forum in September 2011, no allowance has been made for the impacts of the developing Solvency II regulatory regime.

On 31 January 2011 the Group, through its subsidiary FLL, acquired all of the share capital of BHA. The consolidated income statement therefore includes the results of BHA from that date.

On 7 November 2011 the Group, through its subsidiary FLG, acquired all of the share capital of WLUK. This was subsequently transferred to FLL. The consolidated income statement therefore includes the results of WLUK from that date.

In addition, under the terms of the 2010 acquisition of the AXA UK Life Business, the GOF and TIP portfolios of business legally owned by the Group as a result of the acquisition were transferred back to AXA UK plc during the year. These portfolios were classified as held for sale as at 31 December 2010 and their disposal was completed on 1 November 2011.

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

The MCEV results were approved by the Board of directors on 26 March 2012.

### 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 the 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 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 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 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 the Company, 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 are all non-covered business.

While the management services businesses are classified as non-covered, the expenses and cash flows of those businesses are linked to the life and pensions businesses via service 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.

## **1. Basis of preparation** continued

### Segmental reporting under MCEV

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

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

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, the external LT2 subordinated debt 2021, the external LT2 subordinated debt 2022, 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 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.

## 1. Basis of preparation continued

### 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 administration and other services to the extent that they relate to covered business. This is referred to as the "look-through" into 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 FLG, 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 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 Realistic Balance Sheet model. The TVOG would be markedly higher without the hedging activities and management actions currently undertaken.

Only modest amounts of new with-profits business are written and the guarantee levels offered are lower, hence there is no material impact in respect of the TVOG on the value of new business.

*Frictional costs of required capital*

The value of in-force covered business includes a deduction for the additional costs to an investor of holding the assets backing required capital through investment in a life company, rather than investing in the asset directly. These additional frictional costs comprise taxation and investment expenses on the assets backing the required capital.

The frictional costs of required capital are calculated as the difference between the market value of assets backing required capital and the present value of future releases of that capital allowing for future investment return (net of frictional costs) on that capital. The calculation allows for the run-off of the required capital over time using projections of the run-off of the underlying risks and regulatory requirements.

Details of the level of required capital are set out in note 10.

## 1. Basis of preparation continued

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

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

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 the AXA UK Life Business, WLUK and BHA from the dates of the respective acquisitions.

All of the Group's covered business is wholly contained within the 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.

| | FLG | | | | | | RSL | |
|---|---|---|---|---|---|---|---|---|
| | Covered business | | | | | | | |
| Year ended 31 December 2011, 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 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 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 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 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 MCEV** | 821 | 747 | 3,844 | 5,412 | 537 | 5,949 | (153) | 5,796 |

(i) Transaction costs of £3 million relating to the acquisitions of BHA and WLUK are included in non-recurring items and non-operating variances in 2011. All transaction costs were incurred in FLG.

## 2. Analysis of MCEV earnings continued

| | FLG | | | | | | RSL | |
|---|---|---|---|---|---|---|---|---|
| | Covered business | | | | | | | |
| Year ended 31 December 2010, 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 MCEV | 812 | 362 | 1,873 | 3,047 | 134 | 3,181 | 307 | 3,488 |
| Opening adjustments: | | | | | | | | |
| – capital and dividend flows | – | – | – | – | 2,165 | 2,165 | (186) | 1,979 |
| – acquired businesses(i) | 30 | 1,409 | 1,904 | 3,343 | 155 | 3,498 | – | 3,498 |
| – cost of acquisition | – | – | – | – | (2,724) | (2,724) | – | (2,724) |
| Adjusted opening MCEV | 842 | 1,771 | 3,777 | 6,390 | (270) | 6,120 | 121 | 6,241 |
| Value of new business | (245) | 31 | 331 | 117 | – | 117 | – | 117 |
| Expected existing business contribution: | | | | | | | | |
| – expected existing business contribution: reference rate | 13 | (3) | 30 | 40 | – | 40 | – | 40 |
| – expected existing business contribution: in excess of reference rate | 5 | (8) | 162 | 159 | – | 159 | – | 159 |
| Transfers from VIF and required capital to free surplus | 386 | (32) | (354) | – | – | – | – | – |
| Operating experience variances and development costs | 4 | (38) | 30 | (4) | – | (4) | – | (4) |
| Operating assumption changes | (42) | 5 | 20 | (17) | – | (17) | – | (17) |
| Other operating variances | 36 | (3) | 13 | 46 | (10) | 36 | (15) | 21 |
| Operating MCEV earnings | 157 | (48) | 232 | 341 | (10) | 331 | (15) | 316 |
| Economic variances | 104 | (61) | 131 | 174 | (2) | 172 | – | 172 |
| Other non-operating items | 288 | (406) | 70 | (48) | 34 | (14) | (14) | (28) |
| Total MCEV earnings | 549 | (515) | 433 | 467 | 22 | 489 | (29) | 460 |
| Other movements in IFRS net equity | – | – | – | – | (22) | (22) | (20) | (42) |
| Closing adjustments: | | | | | | | | |
| – capital and dividend flows | (416) | 37 | 3 | (376) | 314 | (62) | (71) | (133) |
| – foreign exchange variances | 2 | (2) | (11) | (11) | – | (11) | – | (11) |
| Closing MCEV | 977 | 1,291 | 4,202 | 6,470 | 44 | 6,514 | 1 | 6,515 |

(i) Transaction costs of £28 million were incurred in 2010 in respect of the acquisition of the AXA UK Life Business, of which £14 million was incurred in FLG.

## 3. Segmental analysis of MCEV earnings

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

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

| | FLG | | | | | | RSL | |
|---|---|---|---|---|---|---|---|---|
| | Covered business | | | | | | | |
| Year ended 31 December 2011, gross of tax | UK £m | Int'l £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 | 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.

## 3. Segmental analysis of MCEV earnings continued

| Year ended 31 December 2010, gross of tax | FLG Covered business UK £m | FLG Covered business Int'l £m | FLG Covered business Lombard £m | FLG Covered business FLG corporate £m | FLG Non-covered business £m | FLG Total £m | RSL (ex. FLG)[i] Non-covered business £m | RSL Total £m |
|---|---|---|---|---|---|---|---|---|
| Value of new business | 19 | 43 | 83 | – | – | 145 | – | 145 |
| Expected existing business contribution | 210 | 29 | 38 | (30) | – | 247 | – | 247 |
| Operating experience variances | 37 | 12 | (17) | – | – | 32 | – | 32 |
| Operating assumption changes | (41) | (2) | 20 | – | – | (23) | – | (23) |
| Other operating variances | 96 | (7) | 39 | (63) | – | 65 | – | 65 |
| Development costs | (21) | (6) | (1) | – | – | (28) | – | (28) |
| Life and pensions covered business operating profit/(loss) before tax | 300 | 69 | 162 | (93) | – | 438 | – | 438 |
| Other income and charges | – | – | – | – | (11) | (11) | – | (11) |
| Life and pensions operating profit/(loss) before tax | 300 | 69 | 162 | (93) | (11) | 427 | – | 427 |
| Corporate income and charges | – | – | – | – | – | – | (15) | (15) |
| Operating profit/(loss) before tax | 300 | 69 | 162 | (93) | (11) | 427 | (15) | 412 |
| Economic variances | 276 | 25 | 33 | (103) | (2) | 229 | – | 229 |
| Other non-operating items | (48) | (1) | 1 | (20) | 57 | (11) | (14) | (25) |
| Profit/(loss) before tax | 528 | 93 | 196 | (216) | 44 | 645 | (29) | 616 |
| Attributed tax on operating profits | (81) | (4) | (39) | 27 | 1 | (96) | – | (96) |
| Attributed tax on other activities | (59) | (1) | (7) | 30 | (23) | (60) | – | (60) |
| Profit/(loss) after tax | 388 | 88 | 150 | (159) | 22 | 489 | (29) | 460 |

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

### UK covered business

The 2011 life and pensions covered business operating profit before tax for the UK segment was £508 million (2010: £300 million). The 2010 UK results did not include WLUK and BHA, and only included the results of the AXA UK Life Business from 3 September 2010.

### 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 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 75bps at the beginning of the year.

## 3. Segmental analysis of MCEV earnings continued

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

The total expected contribution of £330 million (2010: £210 million) is comprised of £295 million (2010: £177 million) from applying expected rates of return to the value of in-force at the start of the period and £35 million (2010: £33 million) of expected return on shareholders' net assets.

The expected contribution from value of in-force reflects the expected return on the opening value of in-force of £3,271 million at 1 January 2011 adjusted for the value of in-force of the acquired BHA and WLUK businesses during the year (2010: opening value of in-force of £1,091 million at 1 January 2010, adjusted for the value of in-force of the acquired AXA UK Life Business during the year).

The UK contribution on shareholders' net worth of £35 million (2010: £33 million) includes £3 million from the expected return on shareholders' net assets in the BHA and WLUK businesses.

### Operating experience variances

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

Operating experience variances totalled £(9) million (2010: £37 million) and comprise the following elements:

- £40 million benefit from tax variances, primarily as a result of the availability of tax relief to offset tax arising on the recognition of regulatory surplus in the non-profit and with-profit funds, where such tax relief was not anticipated in the MCEV, or was achieved earlier than anticipated;
- £17 million benefit from better than assumed mortality experience in particular on the life protection business;
- £9 million benefit from better than assumed morbidity experience, in particular on the income protection business;
- £(18) million charge from actual expenses being higher than long-term expense assumptions, the majority of which relates to maintenance costs incurred during the year that will not form part of the ongoing cost base, partially offset by an investment expense under-run;
- £(54) million charge in respect of worse than expected persistency experience primarily on corporate pensions business, arising from a combination of scheme withdrawals, amendments to charging structures on existing schemes and premium reductions. At 31 December 2010 there was a provision of £37 million to cover short-term adverse persistency experience in the corporate pensions business. £26 million of this provision has been used to meet the adverse variance over 2011 and the remainder released following the strengthening of the long-term persistency assumptions; and
- £(3) million net charge from other sources.

### Operating assumption changes

Operating assumption changes of £147 million in the year (2010: £(41) million) is comprised of:

- £185 million benefit from the impact on in-force business of the contractual future expense savings within the outsourcing arrangement with Diligenta. The arrangement with Diligenta has contractualised future expense savings with this benefit reflected in the MCEV maintenance expense assumptions (further detail is provided in note 10);
- £82 million benefit from changes to morbidity assumptions following completion of the latest experience review;
- £29 million benefit from updating mortality assumptions for protection and annuity business to reflect recent experience in these products;
- £(82) million charge from setting up a short-term provision for expected worsening of persistency in the run-up to the implementation of the RDR;
- £(73) million charge resulting from a strengthening of the long-term persistency assumptions on corporate pensions business; partially offset by the release of short-term adverse experience provisions brought forward and not utilised during the year; and
- £6 million benefit from other changes.

## 3. Segmental analysis of MCEV earnings continued

### Other operating variances

Other operating variances of £9 million (2010: £96 million) is comprised of:

- £11 million benefit from the impact of an increase in reinsurance retention levels on protection business in BHA following its integration with the UK business;
- £9 million benefit from various modelling changes and the impact of adopting certain elements of PS06/14 guidance on protection business within the AXA UK Life Business and BHA;
- £(12) million charge from updating the cost of non-hedgeable risk; and
- £1 million benefit from other changes.

### Development costs

The total development costs of £28 million (2010: £21 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 development of the corporate benefit, protection and retirement income business units.

### International covered business

The life and pensions covered business operating profit before tax for the International segment was £30 million in 2011 (2010: £69 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 £27 million (2010: £29 million) reflects £24 million (2010: £27 million) from the expected return on the opening value of in-force of £473 million (2010: £398 million) and £3 million (2010: £2 million) from the expected return on shareholders' net assets.

### Operating experience variances

Operating experience variances of £(7) million (2010: £12 million) is comprised of:

- £(5) million charge from adverse persistency experience on certain OLAB and AmLife products, partially offset by better than expected experience on FPIL business;
- £(5) million charge from actual expenses being higher than long-term expense assumptions reflecting maintenance expense overruns and other project costs;
- £4 million benefit from better than assumed mortality experience; and
- £(1) million charge from other operational elements and other minor variances.

### Operating assumption changes

Operating assumption changes of £(3) million in the year (2010: £(2) million) is comprised of:

- £18 million benefit from changes to fund manager rebate allowances partially offset by changes to commission and allocation assumptions;
- £(9) million charge from increased partial withdrawal assumptions partially offset by changes in lapse assumptions for FPIL business;
- £(13) million charge from the recognition of a short-term provision for adverse persistency and a change in assumptions on return of premium guarantees; and
- £1 million benefit from minor changes to the persistency and mortality assumptions.

## 3. Segmental analysis of MCEV earnings continued

### Other operating variances
Other net adverse operating variances amounting to £(20) million in the year (2010: £(7) million) principally reflect enhancements to internal models following internal review and a model improvement project, including enhancements to the modelling of partial withdrawals on regular premium contracts.

### Development costs
Development costs of £7 million (2010: £6 million) include £3 million in respect of the development of the International Platform and £3 million (2010: £3 million) in relation to the ongoing development of the German pensions proposition.

### Lombard covered business

The life and pensions covered business operating profit before tax for the Lombard segment was £82 million (2010: £162 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 £49 million (2010: £38 million) reflects the expected return on the opening value of in-force of £497 million (2010: £378 million).

### Operating experience variances
Operating experience variances of £(12) million (2010: £(17) million) is comprised of:

- £3 million benefit from better than expected mortality experience;
- £(6) million charge resulting from persistency experience being worse than anticipated, notably in respect of the level of surrenders on the Belgian IFA business;
- £(2) million charge from expenses being higher than long-term expense assumptions;
- £(6) million charge from share-based payments representing the fair value charge of the Lombard long-term incentive plan; and
- other minor variances totalling £(1) million.

### Operating assumption changes
Operating assumption changes of £(4) million in the year (2010: £20 million) is comprised of:

- £(11) million charge from the recognition of short-term adverse persistency provisions in respect of Belgian and Spanish business;
- £(1) million charge from an increase in long-term maintenance expense assumptions; and
- £8 million benefit from changes in long-term lapse and mortality assumptions following an experience review.

### Other operating variances
Other operating variances of £(2) million (2010: £39 million) relate to changes to the cost of non-hedgeable risk.

### Development costs
Development costs of £1 million (2010: £1 million) were incurred in relation to the development of new products throughout the year.

### FLG corporate covered business

FLG corporate includes the external STICS, 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 £(46) million (2010: £(30) million) represents the expected interest costs arising on the debt held within the FLG life and pensions covered business.

The other operating variances are a £19 million benefit as a result of the change to the Group capital management policy to hold 150% (2010: 160%) of the Group Capital Resource Requirement excluding WPICC.

## 3. Segmental analysis of MCEV earnings continued

### Non-covered business

FLG non-covered business reported an operating loss of £(35) million (2010: £(11) million) due to the interest payable on the internal LT2 subordinated debt 2020 issued to Resolution holding companies, costs relating to the FLG long-term incentive plan, holding company costs and credit facility fees partially offset by the expected return on non-covered assets.

The Resolution holding companies reported an operating loss of £(41) million (2010: £(15) million). The loss comprises £(40) million of finance costs and £(35) 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 £34 million, comprising £33 million on the internal LT2 subordinated debt 2020 issued by FLG and £1 million on largely cash-based assets.

### Economic variances

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

Adverse macroeconomic factors, notably in the second half of the year, including volatile equity markets and widening corporate bond credit spreads have triggered a deterioration in investment market performance in 2011.

As a result, total adverse economic variances of £(600) million (2010: £229 million benefit) have been recognised, and comprise:

- £(239) million in respect of the UK annuity business, reflecting an increase in corporate bond credit spreads, partially offset by an increase in the illiquidity premium assumption to 90bps (2010: 75bps);
- £(241) million impact of adverse investment returns on the value of future profits from annual management charges on the UK unit-linked business;
- £(178) million from the International and Lombard segments, mainly as a result of adverse investment returns on unit-linked business;
- £(52) million due to changes in the allowance for TVOG, primarily from updating economic assumptions to reflect current conditions;
- £97 million benefit arising from a decrease in the market value of debt; and
- £13 million from other impacts.

### Other non-operating items

The total other non-operating variances of £(285) million (2010: £(25) million) comprise:

- £(124) million in respect of the up front costs as part of the outsourcing agreement with Diligenta (discussed in note 10);
- £(128) million of non-recurring project costs within the covered business in respect of the separation and integration of UK businesses;
- £(55) million of non-recurring project costs within the covered business in respect of finance reporting improvements and Solvency II costs;
- £(19) million of capital restructuring costs as part of an internal group reorganisation to realise capital and operating synergies within the Friends Life group, and the costs of the RIE five year test (see note 10);
- £(17) million from other non-recurring items, including £(3) million of acquisition costs in relation to stamp duty on the acquisition of BHA and WLUK and £(2) million from non-covered business;
- £23 million benefit from the reduced cost of capital resulting from the Friends Life group internal reorganisation; and
- £35 million from taxation principally reflecting the reduction in corporation tax rate announced in March 2011. The corporation tax rate has been assumed to be reduced by 1% to 25% in April 2012, and then by 1% each year until it reaches the ultimate rate of 23% from April 2014.

A charge of £41 million has been recognised in the UK segment relating to the cost of capital previously held in the FLG corporate segment. An offsetting item of positive £41 million is recognised in the FLG corporate segment. These movements reflect the change during the year in the balance between life company subsidiary capital requirements and Group capital requirements.

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.

## 4. Earnings per share

### Basic and operating earnings per share

| 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** |

| Year ended 31 December 2010 | Earnings £m | Per share Pence |
|---|---|---|
| Profit after tax attributable to ordinary equity holders of the parent | 460 | 48.77 |
| Economic variances | (229) | (24.28) |
| Amortisation of non-covered business acquired intangible assets | 3 | 0.32 |
| Non-recurring items and non-operating variances | 22 | 2.33 |
| Tax credit on items excluded from operating profit | 60 | 6.36 |
| Operating profit after tax attributable to ordinary equity holders of the parent | 316 | 33.50 |

### Diluted earnings per share from continuing operations

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

| Year ended 31 December 2010 | £m | Weighted average number of shares Number | Per share Pence |
|---|---|---|---|
| Profit after tax attributable to ordinary shareholders of the parent | 460 | 943,284,481 | 48.77 |
| Dilution | – | 7,347,287 | (0.38) |
| Diluted profit after tax attributable to ordinary shareholders of the parent | 460 | 950,631,768 | 48.39 |

## **4. Earnings per share** continued

### Weighted average number of ordinary shares

| | 2011<br>Actual | 2011<br>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** |

| | 2010<br>Actual | 2010<br>Weighted |
|---|---|---|
| Issued ordinary shares at beginning of period | 2,412,451,145 | 2,412,451,145 |
| Effect of: | | |
| – scrip dividend (final 2009) | 5,753,268 | 3,436,198 |
| – share consolidation | (2,337,597,599) | (2,335,357,765) |
| – rights issue | 1,370,315,835 | 865,193,173 |
| – scrip dividend (interim 2010) | 1,641,722 | 382,319 |
| – own shares held by the Group | (8,579,292) | (2,820,589) |
| Number of ordinary shares at end of period | 1,443,985,079 | 943,284,481 |

## 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 2011 £m | RSL 2010 £m | FLG 2011 £m | FLG 2010 £m |
|---|---|---|---|---|
| **Equity attributable to ordinary shareholders on an IFRS basis** | **5,672** | 6,227 | 5,825 | 6,226 |
| Less items only included on an IFRS basis (net of tax): | | | | |
| – IFRS reserving and other IFRS adjustments | **463** | 507 | 463 | 507 |
| – Deferred front end fees | **33** | 24 | 33 | 24 |
| – Deferred acquisition costs | **(500)** | (201) | (500) | (201) |
| – Acquired present value of in-force ("AVIF") | **(3,442)** | (3,608) | (3,442) | (3,608) |
| – Other intangible assets | **(305)** | (332) | (305) | (332) |
| Other[(i)] | **–** | (236) | – | (236) |
| Add items only included on a MCEV basis (net of tax): | | | | |
| – Adjustment for long-term debt to market value | **31** | (68) | 31 | (68) |
| **Net worth on a MCEV basis** | **1,952** | 2,313 | 2,105 | 2,312 |
| Value of in-force covered business[(i)] | **3,844** | 4,202 | 3,844 | 4,202 |
| **Equity attributable to ordinary shareholders on a MCEV basis** | **5,796** | 6,515 | 5,949 | 6,514 |

(i) As at 31 December 2010, the GOF and TIP portfolios were classified as held for sale assets and liabilities in both the Group's IFRS and MCEV statements of financial position with a net value of £281 million. Within the MCEV statement of financial position the held for sale assets were further split between the value of in-force covered business of £236 million and other assets. Within the MCEV supplementary information, the value of in-force covered business for the GOF and TIP portfolios was included in the Group's total value of in-force covered business of £4,202 million as at 31 December 2010. There were no held for sale assets and liabilities as at 31 December 2011.

## 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 and 2010 tables below exclude new business in relation to the GOF and TIP businesses disposed of during the period.

### New business value

| | New business premiums | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Year ended 31 December 2011 | 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 | | | | | | | | |
| – Corporate benefits | 538 | 442 | 496 | 4.2 | 2,384 | (2) | (3) | (0.1) |
| – Group protection | – | 22 | 22 | 6.0 | 132 | 5 | 7 | 5.3 |
| UK Individual | | | | | | | | |
| – Individual protection | 47 | 75 | 80 | 6.3 | 520 | 16 | 22 | 4.2 |
| – Individual pensions | 357 | 16 | 52 | 3.9 | 420 | 1 | 1 | 0.2 |
| Annuities(ii) | 374 | – | 37 | – | 374 | 21 | 29 | 7.8 |
| Investments | 342 | – | 34 | – | 339 | 2 | 3 | 0.9 |
| **UK total** | 1,658 | 555 | 721 | 4.5 | 4,169 | 43 | 59 | 1.4 |
| International | 648 | 187 | 252 | 5.1 | 1,603 | 36 | 40 | 2.5 |
| Lombard | 2,372 | – | 237 | – | 2,372 | 40 | 52 | 2.2 |
| **Non-UK 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 shown in the table above has been valued assuming an illiquidity premium of 75bps over the eight months to 31 August 2011 and 90bps from 1 September to 31 December 2011.

## 6. New business continued

### New business value

| Year ended 31 December 2010 | 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 | | | | | | | | |
| – Corporate benefits | 273 | 303 | 330 | 4.2 | 1,535 | (4) | (5) | (0.3) |
| – Group protection | – | 6 | 6 | 5.3 | 32 | – | – | – |
| UK Individual | | | | | | | | |
| – Individual protection | 19 | 50 | 52 | 6.1 | 323 | (9) | (13) | (4.0) |
| – Individual pensions | 226 | 9 | 31 | 7.9 | 297 | 5 | 7 | 2.4 |
| Annuities(ii) | 290 | – | 29 | – | 290 | 19 | 26 | 9.0 |
| Investments | 239 | – | 24 | – | 239 | 3 | 4 | 1.7 |
| UK total | 1,047 | 368 | 472 | 4.6 | 2,716 | 14 | 19 | 0.7 |
| International | 515 | 186 | 238 | 4.8 | 1,405 | 40 | 43 | 3.0 |
| Lombard | 3,022 | – | 302 | – | 3,022 | 63 | 83 | 2.7 |
| Non-UK total | 3,537 | 186 | 540 | 4.8 | 4,427 | 103 | 126 | 2.8 |
| Total | 4,584 | 554 | 1,012 | 4.6 | 7,143 | 117 | 145 | 2.0 |

(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 75bps over the 12 months to 31 December 2010.

The pre-tax VNB has increased to £151 million in 2011 (2010: £145 million). This increase reflects the growth in the UK pre-tax VNB to £59 million (2010: £19 million) which has been impacted by the following factors:

- The inclusion of a full year of sales for the AXA UK Life Business;
- The acquisition of BHA in January 2011;
- The £15 million positive impact of the Diligenta outsourcing agreement which has lowered the contractual future servicing costs of new business; and
- The activities undertaken to reduce costs and focus on those products that offer the most attractive returns.

Partially offsetting the growth in the UK is a £31 million decrease in the Lombard pre-tax VNB, reflecting reduced sales and lower margins, principally driven by the impact of economic conditions (see below for further details).

### Revised UK business unit structure

In August 2011, the Company announced the creation of four UK business units at Friends Life:

- The three UK Go to Market businesses of Corporate Benefits, Protection and Retirement Income which align with the product areas the UK business will focus on for active marketing; and
- UK Heritage which will manage the requirements of customers with products that are no longer being actively marketed, alongside those with legacy products that have previously been closed to new business.

The 2011 table below shows the new business value under this revised business unit structure.

## **6. New business** continued

### New business value presented in accordance with the revised UK business unit structure

| 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 % |
|---|---|---|---|---|---|---|---|---|
| Corporate Benefits | 574 | 382 | 440 | 4.0 | 2,103 | 11 | 15 | 0.7 |
| Protection | – | 92 | 92 | 6.1 | 563 | 12 | 16 | 2.8 |
| Retirement Income(ii) | 321 | – | 32 | – | 321 | 23 | 32 | 10.0 |
| UK Heritage | 763 | 81 | 157 | 5.2 | 1,182 | (3) | (4) | (0.3) |
| **UK total** | 1,658 | 555 | 721 | 4.5 | 4,169 | 43 | 59 | 1.4 |
| International | 648 | 187 | 252 | 5.1 | 1,603 | 36 | 40 | 2.5 |
| Lombard | 2,372 | – | 237 | – | 2,372 | 40 | 52 | 2.2 |
| **Non-UK 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 from 1 September 2011 to 31 December 2011.

### UK
The pre-tax VNB from the UK segment was £59 million (2010: £19 million), comprising:

- UK Corporate Benefits VNB of £15 million, reflecting strong overall volumes and improving margins in the second half of 2011 arising from the delivery of cost synergies;
- UK Protection VNB of £16 million, a significant improvement in VNB in the second half of the year, 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 £32 million reflecting the profitable new annuity business which has continued to be written despite challenging macroeconomic conditions; and
- UK Heritage VNB of £(4) million which specifically focuses on products no longer actively marketed, and reflects the closure of certain products lines and the impact of year end basis changes.

### International
International pre-tax VNB was £40 million (2010: £43 million) with the decrease due to a compression in margins and the adverse impact of modelling refinements on the VNB, partially offset by an overall increase in sales volumes.

FPIL VNB has benefited from higher sales but comparative margins have been impacted by operating basis changes. The OLAB VNB has reduced due to the impact of lower persistency and economic conditions on the cost of guarantees on the German pension business, in combination with slightly lower sales in comparison to 2010. The AmLife VNB has been maintained despite lower sales volumes.

### Lombard
Lombard pre-tax VNB of £52 million (2010: £83 million) has reduced in 2011 as a result of both lower sales volumes and margins combined with a relatively unchanged cost base. Performance during the year has being impacted by a number of factors including:

- the absence of strong fiscal policy drivers to generate new business which Lombard experienced in the first half of 2010;
- northern Europe primarily impacted by the negative economic environment and lower activity among IFAs especially in Belgium; and
- market uncertainties in respect of a number of potential fiscal changes and significantly adverse macroeconomic conditions in Europe, resulting in clients delaying decisions and affecting investor confidence.

## 6. New business continued

### New business performance metrics

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

The IRR provides a measure of the return to shareholders on this initial capital investment. It is equivalent to the discount rate at which the present value of the after-tax cash flows expected to be earned over the lifetime of the business written is equal to the initial capital invested, including setting aside the required capital, to support the writing of the business.

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

The value of new business is shown after the effects of the frictional costs of holding required capital, and after the effect of the costs of residual non-hedgeable risks on the same basis as for the in-force covered business.

### New business key performance metrics

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| | 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 | | | | | | |
| – Corporate benefits | (3) | 5.7 | 14 | (5) | 6.2 | 14 |
| – Group protection | 7 | 7.4 | 11 | – | 4.7 | 16 |
| UK Individual | | | | | | |
| – Individual protection | 22 | 6.8 | 10 | (13) | 2.7 | 16 |
| – Individual pensions | 1 | 7.2 | 11 | 7 | 14.2 | 7 |
| Annuities | 29 | 20.5 | 7 | 26 | 20.0 | 7 |
| Investments | 3 | 7.6 | 9 | 4 | 9.4 | 8 |
| **UK total** | 59 | 7.7 | 11 | 19 | 7.1 | 12 |
| International | 40 | 12.7 | 7 | 43 | 15.4 | 6 |
| Lombard(i) | 52 | >25 | 4 | 83 | >25 | 4 |
| **Non-UK total** | 92 | 16.3 | 6 | 126 | 19.4 | 5 |
| **Total**(i) | 151 | 10.0 | 10 | 145 | 11.2 | 9 |

(i) The 2011 Lombard IRR (and therefore the blended group IRR) now takes account of the Luxembourg regulatory regime in which DAC is an allowable asset.

## **6. New business** continued

### New business key performance metrics presented in accordance with the revised UK business unit structure

| Year ended 31 December 2011 | Pre-tax VNB £m | Internal rate of return on new business % | Cash payback on new business Years |
|---|---|---|---|
| UK Corporate Benefits | 15 | 8.3 | 12 |
| UK Protection | 16 | 5.5 | 12 |
| UK Retirement Income | 32 | 22.0 | 7 |
| UK Heritage | (4) | 6.0 | 13 |
| **UK total** | 59 | 7.7 | 11 |
| International | 40 | 12.7 | 7 |
| Lombard(i) | 52 | >25 | 4 |
| **Non-UK total** | 92 | 16.3 | 6 |
| **Total(i)** | 151 | 10.0 | 10 |

(i) The 2011 Lombard IRR (and therefore the blended Friends Life group IRR) now takes account of the Luxembourg regulatory regime in which DAC is an allowable asset.

## 7. Segmental analysis of Group MCEV

| At 31 December | 2011 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 | 2010 Total £m |
|---|---|---|---|---|---|---|---|---|---|---|
| UK | 790 | 1,666 | 2,456 | 3,276 | (100) | (109) | (182) | 2,885 | 5,341 | 5,995 |
| International | 18 | 51 | 69 | 525 | (1) | (4) | (18) | 502 | 571 | 557 |
| Lombard | 13 | 71 | 84 | 484 | – | (4) | (23) | 457 | 541 | 577 |
| FLG corporate (ex.external STICS and external LT2 subordinated debt 2021, 2022) | | | | | | | | | | |
| – IFA and distribution | 61 | – | 61 | – | – | – | – | – | 61 | 22 |
| – Pension asset of FPPS | 30 | – | 30 | – | – | – | – | – | 30 | 39 |
| – Other | 646 | (82) | 564 | – | – | – | – | – | 564 | 620 |
| **Gross MCEV of FLG(i)** | **1,558** | **1,706** | **3,264** | **4,285** | **(101)** | **(117)** | **(223)** | **3,844** | **7,108** | 7,810 |
| FLG corporate – external STICS | – | (327) | (327) | – | – | – | – | – | (327) | (393) |
| FLG corporate – external LT2 subordinated debt 2021, 2022 | – | (632) | (632) | – | – | – | – | – | (632) | (201) |
| FLG corporate – internal LT2 subordinated debt 2020 | (200) | – | (200) | – | – | – | – | – | (200) | (702) |
| **Net MCEV of FLG** | **1,358** | **747** | **2,105** | **4,285** | **(101)** | **(117)** | **(223)** | **3,844** | **5,949** | 6,514 |
| Resolution(ii) corporate net assets | 270 | – | 270 | – | – | – | – | – | 270 | 901 |
| Resolution Limited DCNs | (423) | – | (423) | – | – | – | – | – | (423) | (500) |
| Resolution(ii) acquisition finance facility | – | – | – | – | – | – | – | – | – | (400) |
| **Net Group MCEV of Resolution Limited attributable to equity holders of parent** | **1,205** | **747** | **1,952** | **4,285** | **(101)** | **(117)** | **(223)** | **3,844** | **5,796** | 6,515 |

(i) For the purposes of this table "Gross" refers to the MCEV gross of the clean market value of the external STICS, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022. The accrued interest and tax adjustment on market valuation is included in the gross MCEV of FLG corporate.
(ii) Resolution holding companies.

## **7. Segmental analysis of Group MCEV** continued

### i) Net worth

The external STICS, 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 2011 is stated after recognition of provisions of £65 million (2010: £26 million) net of tax from the UK, in respect of worsening persistency in the run-up to the implementation of the RDR, and £10 million (2010: £4 million) from Lombard set up as a short-term persistency provision in respect of the Spanish and Belgian markets.

### iii) TVOG

The TVOG at 31 December 2011 of £101 million (31 December 2010: £38 million), is split between £69 million (31 December 2010: £12 million) market risk and £32 million (31 December 2010: £26 million) non-market risk. The non-market risk includes lapses, annuitant longevity, and operational risk within the with-profits funds. The allowance for non-market risk is made by consideration of the impact of extreme scenarios from the Group's economic capital model. The increase in TVOG is principally driven by updating the assumptions to reflect current economic conditions.

### 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% of 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 (2010: 160% of Group CRR excluding WPICC). The cost of holding any additional capital is shown in the FLG corporate segment. The Group's capital management policy was amended in the period, resulting in the recognition of a £19 million gain in the FLG corporate segment, reflecting the lower cost of capital.

### v) CNHR

The cost of residual non-hedgeable risk of £223 million (31 December 2010: £184 million) is presented as an equivalent annual cost of capital charge of 2% (31 December 2010: 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.

## 8. Segmental analysis of Group MCEV earnings

The following tables show a further breakdown of the 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 2011 | UK £m | Int'l £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 | 5,995 | 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 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.

The opening adjustments consist of the purchases of BHA and WLUK.

Other movements in IFRS net equity of £(19) million (2010: £(42) million) reflect £(32) million in respect of actuarial losses on defined benefit pension schemes and £13 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 £(471) million comprises:

- £(226) million outflow in respect of dividends to equity holders of Resolution Limited, net of the impact of scrip dividends in the year;
- £(250) million outflow in respect of the share repurchase programme which completed in October 2011; and
- £5 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.

## 8. Segmental analysis of Group MCEV earnings continued

The closing adjustments in respect of the GOF and TIP business transfer represent:

- an increase in the MCEV for covered business of £50 million following the transfer. This increase comprises a £246 million increase in free surplus in the UK business, representing the consideration received from AXA UK plc after deduction of the value of the shareholders' net worth transferred. This is partially offset by a £(196) million reduction in VIF in the UK business, reflecting the VIF asset of the GOF and TIP business transferred to AXA UK plc; and
- a decrease in the MCEV for non-covered business of £50 million, representing the value of the payment from FLG to AXA UK plc to account for the surplus attributable to the GOF and TIP portfolios that arose during the period between 3 September 2010 and 1 November 2011 (respectively the dates of acquisition and disposal of the GOF/TIP portfolios).

| | FLG | | | | | | RSL | |
|---|---|---|---|---|---|---|---|---|
| | Covered business | | | | | | RSL (ex.FLG)[i] | |
| Year ended 31 December 2010 | UK £m | Int'l £m | Lombard £m | FLG corporate £m | Non-covered business £m | Total £m | Non-covered business £m | Total £m |
| Opening Group MCEV | 2,687 | 471 | 440 | (551) | 134 | 3,181 | 307 | 3,488 |
| Opening adjustments | 3,343 | – | – | – | (404) | 2,939 | (186) | 2,753 |
| Adjusted opening Group MCEV | 6,030 | 471 | 440 | (551) | (270) | 6,120 | 121 | 6,241 |
| Operating MCEV earnings | 219 | 65 | 123 | (66) | (10) | 331 | (15) | 316 |
| Non-operating MCEV earnings | 169 | 23 | 27 | (93) | 32 | 158 | (14) | 144 |
| Total MCEV earnings | 388 | 88 | 150 | (159) | 22 | 489 | (29) | 460 |
| Other movements in IFRS net equity | – | – | – | – | (22) | (22) | (20) | (42) |
| Closing adjustments: | | | | | | | | |
| – capital and dividend flows | (423) | (7) | 3 | 51 | 314 | (62) | (71) | (133) |
| – foreign exchange variances | – | 5 | (16) | – | – | (11) | – | (11) |
| Closing Group MCEV | 5,995 | 557 | 577 | (659) | 44 | 6,514 | 1 | 6,515 |

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

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

| As at 31 December 2011 | 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** | | | | | | | | | | |
| With-profits funds | 447 | 189 | 110 | 72 | 40 | 20 | 10 | 4 | 2 | – |
| Protection | 509 | 241 | 124 | 80 | 40 | 16 | 6 | 1 | 1 | – |
| Investments | 718 | 385 | 180 | 89 | 42 | 16 | 5 | 1 | – | – |
| Pensions | 1,028 | 431 | 297 | 169 | 82 | 34 | 12 | 3 | – | – |
| Annuities | 183 | 15 | 30 | 30 | 27 | 28 | 24 | 16 | 9 | 4 |
| **UK total** | 2,885 | 1,261 | 741 | 440 | 231 | 114 | 57 | 25 | 12 | 4 |
| **Non-UK** | | | | | | | | | | |
| International | 502 | 270 | 123 | 69 | 30 | 9 | 1 | – | – | – |
| Lombard | 457 | 178 | 105 | 72 | 44 | 26 | 15 | 9 | 5 | 3 |
| **Non-UK total** | 959 | 448 | 228 | 141 | 74 | 35 | 16 | 9 | 5 | 3 |
| **Total VIF** | 3,844 | 1,709 | 969 | 581 | 305 | 149 | 73 | 34 | 17 | 7 |

Below is the maturity profile for UK Heritage and Go to Market businesses reflecting the revised structure of the UK business.

| As at 31 December 2011 | 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** | | | | | | | | | | |
| UK Go to Market | 757 | 284 | 192 | 120 | 72 | 43 | 25 | 12 | 6 | 3 |
| UK Heritage | 2,128 | 977 | 549 | 320 | 159 | 71 | 32 | 13 | 6 | 1 |
| **UK total** | 2,885 | 1,261 | 741 | 440 | 231 | 114 | 57 | 25 | 12 | 4 |

## 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 to provide rates appropriate to the duration of the liabilities.

| | Reference rate – risk-free | |
|---|---|---|
| | **2011 %** | 2010 % |
| **UK** | | |
| Long-term rate | **2.40** | 3.70 |
| Swap yield curve | | |
| – Term 1 year | **1.35** | 1.14 |
| – Term 5 years | **1.57** | 2.69 |
| – Term 10 years | **2.36** | 3.70 |
| – Term 15 years | **2.78** | 4.09 |
| – Term 20 years | **3.00** | 4.15 |
| **International long-term rate** | **2.40** | 3.70 |
| **Lombard long-term rate** | **2.55** | 3.46 |

#### Reference rate – illiquidity premium adjustment

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

In this regard, the methodology adopted for the valuation of immediate annuities in the UK 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. There are two main approaches being commonly used to determine the illiquidity premium within the life insurance industry:

- 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 bonds spreads have increased significantly over the year and the illiquidity premium has been increased from 75bps to 90bps, applicable from 1 September 2011, in line with these observed increases. The VNB calculation utilises the average illiquidity premium over the year and so will include 75bps for the business written in the first eight months of the year and 90bps for the business written after that. The MCEV economic variances are based on the assumptions at the end of the year and so use an illiquidity premium of 90bps.

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

## 10. MCEV assumptions continued

The reference rate has been adjusted as set out in the table below.

| | Embedded value | | New business | |
|---|---|---|---|---|
| | **2011** | 2010 | **2011** | 2010 |
| UK illiquidity premium | **90bps** | 75bps | **80bps**[(i)] | 75bps |

(i) average illiquidity premium which changed 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 (2010: 3%) and 2% for property (2010: 2%).

For cash and government bonds no excess over the one-year risk-free reference rate has been assumed. For corporate bonds, the return is based on the excess of actual corporate bond spreads on the reporting date, less an allowance for defaults, over the one-year risk-free reference rate.

For annuity business the excess return reflects the excess of the bond portfolio over the reference rate including the illiquidity premium adjustment.

### Expense inflation

Maintenance expenses for UK and International business (excluding Lombard) are assumed to increase in the future at a rate of 1% (2010: 1%) per annum in excess of the assumed long-term rate of inflation. This is derived from the difference between the risk-free rate of return based on the FT Actuaries 15 year gilt index and the average of the FTSE Actuaries over five-year index-linked gilt yield at 5% and 0% inflation.

Maintenance expenses for Lombard are assumed to increase in the future at a rate of 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 | |
|---|---|---|
| | **2011 %** | 2010 % |
| UK | **3.70** | 4.4 |
| International | **3.70** | 4.4 |
| Lombard | **2.95** | 3.0 |

## **10. MCEV assumptions** continued

### Exchange rates

The results and cash flows of all businesses, except Lombard, AmLife and AmFamily, are calculated in Sterling. The results and cash flows for Lombard are calculated in Euros and those of AmLife and AmFamily in Malaysian Ringgits, and converted to Sterling at the following rates:

| | Exchange rates | |
|---|---|---|
| | **2011** | 2010 |
| Closing exchange rate | | |
| – Euro | **0.835** | 0.857 |
| – Malaysian Ringgit | **0.203** | 0.207 |
| Average exchange rate | | |
| – Euro | **0.869** | 0.859 |
| – Malaysian Ringgit | **0.204** | 0.200 |

### 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:

- FLL With-Profits Fund ("FLL WPF")
- FLAS With-Profits Fund ("FLAS WPF")
- FLC Old With-Profits Fund ("FLC OWPF")
- FLC New With-Profits Fund ("FLC NWPF")
- WLUK With-Profits Fund ("WLUK WPF")

In addition it is assumed that the shareholder interest in the non-profit business of the FLL WPF continues at the current rate of 60% of future profits.

FLC contains the Reattributed Inherited Estate ("RIE") which was transferred to the FLC NPFs as part of the reattribution of the FAELLAS inherited estate. The reattribution was implemented as part of an intra-group Part VII scheme ("the Scheme") transferring business into FLC. The Scheme took effect on 1 April 2001 and was amended as part of a subsequent transfer of mainly unit-linked business into FLC on 1 January 2007 (the "2006 Scheme").

With-profits policies where policyholders had elected to take part in the reattribution were transferred to the FLC NWPF. With-profits policies which were not so elected were transferred to the FLC OWPF with a proportionate share of the FAELLAS inherited estate.

The Scheme rules require that a test be undertaken every five years to determine whether it is possible to transfer any of the RIE from the FLC NPFs to the FLC shareholders' fund or to distribute any of the inherited estate retained in the FLC 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 RIE in the FLC NPFs is predominately in the form of the VIF of non-profit business written within those funds. To the extent that this VIF emerges into cash during the five-year period commencing 31 December 2010, the cash may be available to be transferred to the FLC shareholders' fund subject to passing the relevant financial strength tests and subject to an overall cap on such further transfers of £928 million prior to the next five-year testing as at 31 December 2015. At 31 December 2011, a further £484 million is being transferred to the shareholders' fund. The MCEV as at 31 December 2011 allows for the best estimate projections of further amounts to be transferred in future.

## 10. MCEV assumptions continued

### 10.2 Economic assumptions – stochastic calculations

#### Model
The time value of financial options and guarantees is determined using a Barrie & Hibbert economic scenario generator and is calculated using 2,000 simulations. The 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. Correlations between the asset classes are derived from historic data.

#### Swaption implied volatilities

| | 2011 Swap term | | | | 2010 Swap term | | | |
|---|---|---|---|---|---|---|---|---|
| Option term | 10 yrs % | 15 yrs % | 20 yrs % | 25 yrs % | 10 yrs % | 15 yrs % | 20 yrs % | 25 yrs % |
| **UK Sterling** | | | | | | | | |
| 10 years | **17.6** | **17.6** | **17.8** | **17.9** | 15.3 | 14.7 | 14.3 | 14.0 |
| 15 years | **15.4** | **15.6** | **15.8** | **15.8** | 14.5 | 13.9 | 13.5 | 13.1 |
| 20 years | **14.1** | **14.3** | **14.3** | **14.2** | 13.1 | 12.6 | 12.1 | 11.7 |
| 25 years | **13.3** | **13.2** | **13.0** | **12.7** | 12.3 | 11.8 | 11.3 | 10.8 |

#### Equity and property implied volatilities
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% (2010: 15%) and a running yield of 4.3% (2010: 4.7%). Sample implied volatilities are shown in the table below.

| | 2011 | | 2010 | |
|---|---|---|---|---|
| Option term | Equity % | Property % | Equity % | Property % |
| 5 years | **26.9** | **14.8** | 27.4 | 15.9 |
| 10 years | **27.0** | **15.1** | 27.7 | 16.2 |
| 15 years | **27.3** | **14.6** | 28.0 | 16.4 |

### 10.3 Other assumptions

#### Required capital
Required capital under MCEV amounted to £747 million (2010: £1,291 million).

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% of Pillar 1 CRR excluding WPICC and 125% of Pillar 2 CRR including any Individual Capital Guidance. In addition the Group's capital management policy is to hold 150% (2010: 160%) of Group CRR excluding WPICC, and the cost of holding any additional capital is shown within the FLG corporate covered business segment.

## **10. MCEV assumptions** continued

### 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 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 whole calendar year, and hence the rate applicable for 2011 reflects the reduction in corporation tax that took effect from April 2011.

For non-covered business, attributed tax is consistent with the IFRS financial statements.

| | Tax rates | |
|---|---|---|
| | **2011 %** | 2010 % |
| UK | **26.5** | 28.0 |
| International | | |
| – OLAB (UK) | **26.5** | 28.0 |
| – FPIL (Isle of Man) | **0.0** | 0.0 |
| – AmLife and AmFamily (Malaysia) | **25.0** | 25.0 |
| Lombard | **23.5** | 23.5 |

The PVFP for UK and OLAB business includes allowance for the annual reductions in corporation tax announced in the Emergency Budget in June 2010 and the further reduction of 1% announced in the Budget in March 2011. The MCEV allows for anticipated future annual reductions in corporation tax from 26% to 23% (2010: 27% to 24%) over the period to 2014 and for an ultimate rate of 23% (2010: 24%) from April 2014.

The tax assumptions used within the MCEV do not take account of the additional 1% reduction in corporation tax announced on 21 March 2012. As a result of this change, the corporation tax rate is therefore expected to be 24% from 1 April 2012, 23% from 1 April 2013 and 22% from 1 April 2014. The impact of this change is estimated to be an increase in the MCEV of £25 million as at 31 December 2011.

VAT in the UK of 20.0% (2010: 20.0%) has been included on relevant investment management expenses and 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 will come into effect from 1 January 2013 and an £88 million provision (gross of tax and including £6 million recognised in the WLUK acquisition balance sheet) has been recognised to cover negative variances expected on initial commission business pre-RDR in 2012 where long-term assumptions are expected to be temporarily inadequate.

Future improvements in annuitant mortality have been assumed to be in accordance with the projections published by the Continuous Mortality Investigation ("CMI") in 2011, with a long-term rate of 1.25% per annum. In the prior year, future improvements were assumed to be in accordance with the "medium cohort" projections (with certain amendments) published by the CMI in 2002, with a minimum annual rate of improvement in future mortality of 1.5% per annum for males and 1.25% per annum for females.

## 10. MCEV assumptions continued

### 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.

Future projected short-term expense overruns in the Lombard business have been allowed for by reducing the PVFP by £1 million for a projected overrun to 2013 (2010: £2 million for a projected overrun to 2012).

In November 2011 Friends Life announced a 15 year agreement with Diligenta to outsource IT and Programmes and in-house Customer Service functions – along with HR, Finance and Business Risk services that support IT and Programmes and Customer Services. This agreement will result in significant longer term cost reductions and has resulted in an overall increase in MCEV of £76 million in 2011. The maintenance expense assumptions for the business units allow for the agreed service fees with Diligenta which results in a positive operating assumption change of £185 million and a positive impact on VNB of £15 million. In addition allowance is made for the initial significant development expenditure of £(124) million, considered to be non-recurring and shown within other non-operating items.

Other one-off costs shown within non-recurring items can be categorised as:

- Finance transformation and Solvency II project costs;
- Separation and integration costs;
- Capital restructuring costs; or
- Corporate acquisitions/disposal costs.

Any other one-off costs that do not fall into these categories are treated as operating exceptional costs within operating experience variances.

The MCEV makes provision for certain development costs to the extent that these are known with sufficient certainty and in line with current plans.

Development costs of £36 million (2010: £28 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 2011 £m** | FLG 2010 £m |
|---|---|---|
| UK | **28** | 21 |
| International | **7** | 6 |
| Lombard | **1** | 1 |
| **Total** | **36** | 28 |

### Non-hedgeable risks

A charge equivalent to 2% (2010: 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.

## **10. MCEV assumptions** continued

### Other assumptions

The external STICS, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 are included within the MCEV at market value, based on listed ask price.

| 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 |
|---|---|---|---|---|---|
| 2003 STICS | 210 | 142 | 2 | 17 | 161 |
| 2005 STICS | 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** |

| 31 December 2010 | 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 |
|---|---|---|---|---|---|
| 2003 STICS | 210 | 172 | 2 | 9 | 183 |
| 2005 STICS | 268 | 221 | 8 | 10 | 239 |
| LT2 subordinated debt 2021 | 162 | 201 | 12 | (15) | 198 |
| Total | 640 | 594 | 22 | 4 | 620 |

(i) The value of debt included in the FLG corporate category is the market value of debt, including accrued interest, and the tax asset/liability on the market value adjustment.

The deferred consideration notes, issued in September 2010 in connection with the acquisition of the AXA UK Life Business, are included within the MCEV at face value. The value at 31 December 2011 is £423 million (2010: £500 million).

The acquisition finance facility was a term loan facility agreement also issued in September 2010 to fund part of the consideration payable for the acquisition of the AXA UK Life Business; this loan was repaid in April 2011. The value at 31 December 2010 was £400 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.

| | FLG covered business | | | | |
|---|---|---|---|---|---|
| Change in MCEV (net of tax) in 2011 | UK £m | Int'l £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) |

(i) The movement in UK embedded value from a reduction in market values comprises a nil (2010: £3 million) fall in the value of shareholders' net worth and a £188 million (2010: £189 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 35bps (2010: 30bps) for in-force business and 35bps (2010: 40bps) for the value of new business.

(iii) Currency risk is expressed in terms of total overseas exposure; the Group's principal currency exposures other than Sterling are the Euro and US Dollar.

(iv) Required capital is set at the greater of regulatory capital and requirements arising from internal capital management policies. In aggregate, the required capital is higher than the regulatory requirement by £902 million (2010: £1,093 million). This sensitivity shows the impact on embedded value of using the lower regulatory capital requirement.

## **11. Sensitivity analysis** continued

| Change in MCEV (net of tax) in 2010 | FLG covered business UK £m | Int'l £m | Lombard £m | FLG corporate £m | Total £m |
|---|---|---|---|---|---|
| Base MCEV | 5,995 | 557 | 577 | (659) | 6,470 |
| Market risk | | | | | |
| 100bps increase in reference rates | (144) | (7) | (6) | 29 | (128) |
| 100bps decrease in reference rates | 153 | 4 | 1 | (31) | 127 |
| Removal of illiquidity premium for immediate annuities | (425) | – | – | – | (425) |
| 10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield(i) | (192) | (20) | (46) | – | (258) |
| 25% increase in equity/property volatility at the valuation date | (22) | – | – | – | (22) |
| 25% increase in swaption implied volatility at the valuation date | (4) | – | – | – | (4) |
| 100bps increase in corporate bond spreads(ii) | (312) | – | (16) | 29 | (299) |
| 100bps decrease in corporate bond spreads(ii) | 329 | – | 16 | (31) | 314 |
| 10% adverse movement in Sterling/overseas exchange rate(iii) | (34) | (15) | (47) | – | (96) |
| Insurance and other risk | | | | | |
| Reduction to EU minimum capital or equivalent(iv) | 34 | 1 | 2 | 45 | 82 |
| 10% decrease in maintenance expenses | 162 | 8 | 23 | – | 193 |
| 10% proportionate decrease in lapse rates | 85 | 15 | 42 | – | 142 |
| 10% proportionate decrease in PUP rates | 13 | 4 | – | – | 17 |
| 5% decrease in mortality/morbidity – life assurance | | | | | |
| – Before reinsurance | 227 | 4 | 2 | – | 233 |
| – After reinsurance | 62 | 2 | – | – | 64 |
| 5% decrease in mortality/morbidity – annuity business | | | | | |
| – Before reinsurance | (6) | – | – | – | (6) |
| – After reinsurance | (49) | – | – | – | (49) |

(i) to (iv) see previous page.

## 11. Sensitivity analysis continued

| Change in value of new business (gross of tax) in 2011 | FLG covered business UK £m | Int'l £m | Lombard £m | Total £m |
|---|---|---|---|---|
| **Base value of new business** | 59 | 40 | 52 | 151 |
| **Market risk** | | | | |
| 100bps increase in reference rates | (8) | (3) | – | (11) |
| 100bps decrease in reference rates | 8 | 3 | (1) | 10 |
| Removal of illiquidity premium for immediate annuities | (27) | – | – | (27) |
| 100bps increase in corporate bond spreads[i] | (7) | – | – | (7) |
| 100bps decrease in corporate bond spreads[i] | 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 |

(i) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 35bps (2010: 30bps) for in-force business and 35bps (2010: 40bps) for the value of new business.

## 11. Sensitivity analysis continued

| Change in value of new business (gross of tax) in 2010 | FLG covered business UK £m | Int'l £m | Lombard £m | Total £m |
|---|---|---|---|---|
| Base value of new business | 19 | 43 | 83 | 145 |
| Market risk | | | | |
| 100bps increase in reference rates | (7) | (1) | 3 | (5) |
| 100bps decrease in reference rates | 2 | 1 | (4) | (1) |
| Removal of illiquidity premium for immediate annuities | (20) | – | – | (20) |
| 100bps increase in corporate bond spreads(i) | (9) | – | – | (9) |
| 100bps decrease in corporate bond spreads(i) | 8 | – | – | 8 |
| Insurance and other risk | | | | |
| Reduction to EU minimum capital or equivalent | 3 | – | – | 3 |
| 10% decrease in maintenance expenses | 8 | 2 | 4 | 14 |
| 10% proportionate decrease in lapse rates | 7 | 2 | 7 | 16 |
| 10% proportionate decrease in PUP rates | 4 | 2 | – | 6 |
| 5% decrease in mortality/morbidity – life assurance | | | | |
| – Before reinsurance | 8 | – | – | 8 |
| – After reinsurance | 2 | – | – | 2 |
| 5% decrease in mortality/morbidity – annuity business | | | | |
| – Before reinsurance | (2) | – | – | (2) |
| – After reinsurance | (2) | – | – | (2) |

(i) see previous page.

## 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:

| | MCEV classification | | | | | Total MCEV by IFRS segments |
|---|---|---|---|---|---|---|
| FLG for the year ended 31 December 2011 | UK £m | Int'l £m | Lombard £m | FLG corporate £m | Non-covered business £m | £m |
| **IFRS segment** | | | | | | |
| UK | **5,341** | **–** | **–** | **–** | **63** | **5,404** |
| International | **–** | **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** |

| | MCEV classification | | | | | Total MCEV by IFRS segments |
|---|---|---|---|---|---|---|
| FLG for the year ended 31 December 2010 | UK £m | Int'l £m | Lombard £m | FLG corporate £m | Non-covered business £m | £m |
| IFRS segment | | | | | | |
| UK | 5,995 | – | – | – | 22 | 6,017 |
| International | – | 557 | – | – | – | 557 |
| Lombard | – | – | 577 | – | 6 | 583 |
| FLG corporate | – | – | – | (659) | 16 | (643) |
| Total MCEV (by MCEV segments) | 5,995 | 557 | 577 | (659) | 44 | 6,514 |

## 13. FLG annualised return on embedded value

| | 2011 % p.a. | 2010 % p.a. |
|---|---|---|
| Value of new business | **2.0** | 3.3 |
| Expected existing business contribution(i) | **5.3** | 5.6 |
| Operating experience variances | **(0.4)** | 0.8 |
| Operating assumption changes | **1.8** | (0.5) |
| Other operating variance | **0.1** | 1.1 |
| Development costs | **(0.4)** | (0.6) |
| Other income and charges(ii) | **–** | 0.2 |
| **MCEV operating profit before tax and financing** | **8.4** | 9.9 |
| Impact of financing | **0.5** | 0.7 |
| Attributed tax charge on MCEV operating profit | **(2.4)** | (2.3) |
| **MCEV operating profit after tax** | **6.5** | 8.3 |
| Economic variances | **(9.5)** | 4.7 |
| Other non-operating items | **(4.5)** | 0.1 |
| Attributed tax on other activities | **3.5** | (1.3) |
| **MCEV (loss)/profit after tax** | **(4.0)** | 11.8 |
| Actuarial losses on defined benefit pension schemes | **(0.6)** | (0.6) |
| Foreign exchange adjustments | **(0.2)** | (0.3) |
| **Total return on MCEV over the period** | **(4.8)** | 10.9 |

(i) Excludes expected impact of financing of covered debt of £46 million for 2011 (2010: £30 million).
(ii) Excludes £33 million impact of financing of non-covered debt of £200 million for 2011 (2010: £18 million).

The table above provides an analysis of the return on embedded value. The starting FLG embedded value for 2011 is £6,514 million, net of the market-consistent value of debt instruments of £1,296 million at 31 December 2010. The starting FLG embedded value for 2010 is £3,181 million, net of the market consistent value of debt instruments of £557 million. The 2011 embedded value has been 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.

# Additional information

# Definitions

## Definitions

**AmFamily** means AmFamily Takaful Berhad

**AmLife** means AmLife Takaful 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 embedded value at the start of 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.

**AXA UK Life Business** 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 WLUK 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.

**Contribution from new business** is the present value of future cash flows expected to arise from the new business sold during the year. It is calculated using economic assumptions at the beginning of the period, and is quoted after the cost of required capital, share-based payments and including an apportionment of fixed acquisition expenses across products.

**Equity Backing Ratio** ("EBR") is the proportion of equities and property backing assets shares.

**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 WLUK from November 2011

**Friends Life holdings companies** means Friends Life Group plc, Friends Life FPG Limited and Friends Life FPL Limited.

**Go to Market business** means Friends Life's UK Corporate Benefits, Protection and Retirement Income businesses.

**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 is the equity attributable to equity holders of the parent as shown in the consolidated statement of financial position – MCEV basis.

**Heritage business** 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 capital resources** are 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 on new business** ("IRR") 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 Contribution from new business. IRR assumes best estimate investment returns after an allowance for default risk, whereas Contribution from new business assumes (market consistent) risk-free rates. IRR also takes into account the funding and release of regulatory capital requirements.

**Margins** are defined as the pre-tax contribution from new business generated by each product type, divided by the new business volume for that product.

**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.

**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.

**Resolution holding companies** means the Company, Resolution Holdco No.1 LP and Resolution Holdings (Guernsey) Limited.

**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.

**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.

**UK Life Project** means the Company's current restructuring project in the life assurance and asset management sectors.

# Abbreviations

## 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 |
| **CNHR** | Cost of Non-Hedgeable Risk |
| **COP** | Capital Optimisation Project |
| **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 |
| **F&C** | F&C Asset Management plc |
| **F&C CPT** | F&C Commercial Property Trust |
| **FAELLAS** | Friends AELLAS Limited (formerly known as AXA Equity & Law Life Assurance Society plc) |
| **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) |
| **FLPL** | Friends Life and Pensions Limited |
| **FLSL** | Friends Life Services Limited (formerly known as AXA Sun Life Services plc) |
| **FPG** | Friends Life FPG Limited. |
| **FPIL** | Friends Provident International Limited |
| **FPL** | Friends Life FPL Limited |
| **FPLAL** | Friends Provident Life Assurance Limited |
| **FPMS** | Friends Provident Management Services Limited |
| **FPPS** | Friends Provident Pension Scheme |
| **FRS** | Financial Reporting Standards |
| **FSA** | Financial Services Authority |
| **FSMA** | Financial Services and Markets Act 2000 |
| **FSLPM** | Friends SLPM Limited (formerly known as Sun Life Pensions Management Limited) |
| **FSLUA** | Friends SLUA Limited (formerly known as Sun Life Unit Assurance Limited) |
| **FUM** | Funds Under Management |
| **GMP** | Guaranteed Minimum Pension |
| **GOF** | Guaranteed Over Fifties |
| **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 |
| **IRR** | Internal Rate of Return |
| **LDI** | Liability Driven Investment |
| **LTIP** | FLG Long-Term Incentive Plan |
| **LT2** | Lower Tier 2 |
| **MCEV** | Market Consistent Embedded Value |
| **MEEM** | Multi-purpose Excess Earnings Method |
| **MVR** | Market Value Reduction |
| **NBS** | New Business Strain |
| **NGP** | New Generation Pension |
| **NPF** | Non-Profit Fund |
| **NWPF** | New With-Profits Fund |
| **OCI** | Other Comprehensive Income |
| **OEIC** | Open Ended Investment Company |
| **OLAB** | Overseas Life Assurance Business |
| **OMO** | Open Market Option |
| **OWPF** | Old With-Profits Fund |
| **PPFM** | Principles and Practices of Financial Management |

| | |
|---|---|
| **PVFP** | Present Value of Future Profits |
| **PVNBP** | Present Value of New Business Premiums |
| **RAG** | FLG Remuneration Advisory Group |
| **RCM** | Risk Capital Margin |
| **RDR** | Retail Distribution Review |
| **RHG** | Resolution Holdings (Guernsey) Limited |
| **RICS** | Royal Institution of Chartered Surveyors |
| **RIE** | Reattributed Inherited Estate |
| **RM** | Malaysian Ringgits |
| **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 |
| **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 |
| **VIF** | Value of In-Force |
| **VNB** | Value of New Business |
| **WLUK** | Winterthur Life UK Limited |
| **WPF** | With-Profit Fund |
| **WPICC** | With Profits Insurance Capital Component |

# Shareholder information

## Annual General Meeting

The AGM will be held at The St Pierre Park Hotel, St. Peter Port, Guernsey, Channel Islands, with a simultaneous broadcast in the Mountbatten Room at The Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE, United Kingdom at 11.00 am on 17 May 2012. Shareholders will receive a separate circular containing a notice of the meeting and detailing the resolutions being proposed.

## Registrars

### Ordinary shareholders

If you hold your shares in certificated form or in CREST, and your Shareholder Reference Number commences with a "C" or a "G", the Company's registrar can be contacted at:

Computershare Investor Services (Jersey) Limited
Queensway House
Hilgrove Street
St. Helier
Jersey
JE1 1ES

Shareholder helpline: +44 (0) 870 707 1444
Email: info@computershare.co.je

### Resolution Share Account holders

If you hold your shares in the Resolution Share Account, and your Shareholder Reference Number commences with an "I", the Company's registrar can be contacted at:

Computershare Investor Services PLC
The Pavilions
Bridgwater Road
Bristol
BS99 6ZY

Shareholder helpline: +44 (0) 870 707 1444
Email: web.queries@computershare.co.uk

### Electronic communications

By providing your email address you will no longer receive paper copies of shareholder communications that are available electronically. Instead, you will receive emails advising you when and how to access documents online.

Computershare's Investor Centre is a free online service that provides shareholders with a wide variety of self-service tools to help track and manage their personal holdings in the companies they service. Investor Centre allows shareholders to manage their holdings in several different companies simultaneously.

If you currently do not receive communications electronically but would like to, please register your email address online at www.resolution.gg by going to the Investor Relations page and clicking on the "Shareholder Information" link on the left-hand side of the screen, then click on the "Register for E-communications" link on the right-hand side of the screen.

### Scrip dividend

The Company will be offering a scrip dividend in respect of the final dividend for the year ended 31 December 2011. Full details of the Scrip Dividend Scheme, including how to join, are available at www.resolution.gg by going to the Investor Relations page and clicking on the "Dividend Timetable" link on the left-hand side of the screen.

Alternatively, you can request a mandate from Computershare by writing to them at either their Jersey or Bristol addresses, or by contacting them on +44 (0) 870 707 1444.

### Share price information

The middle market price of the Company's ordinary shares on 31 December 2011 was 251.4 pence and the range during the year was 229.5 pence to 361.1 pence.

The ISIN code of the Company's ordinary shares is GG00B62W2327 and the SEDOL (Stock Exchange Daily Official List) number is B62W232.

Share price information on Resolution Limited is available in the financial press and on the Company's website www.resolution.gg

### Analysis of registered shareholder accounts 31 December 2011

| Size of shareholding | Number of shares | % of total number of shares |
|---|---|---|
| 1–1,000 | 3,884,265 | 0.2822 |
| 1,001–5,000 | 6,548,826 | 0.4759 |
| 5,001–10,000 | 2,506,874 | 0.1821 |
| 10,001–100,000 | 15,291,896 | 1.1112 |
| 100,001–500,000 | 50,538,508 | 3.6724 |
| 500,001–1,000,000 | 55,592,132 | 4.0396 |
| 1,000,001–10,000,000 | 452,085,501 | 32.8505 |
| 10,000,001–1,000,000,000 | 789,740,987 | 57.3861 |
| **Total** | **1,376,188,989** | **100** |

### Financial calendar

| | |
|---|---|
| First quarter interim management statement | 9 May 2012 |
| Annual General Meeting | 17 May 2012 |
| Interim results 2012 | 15 August 2012 |

### Half year report

The Company will no longer produce hard copies of the half year report. In future, the half year report will be available on the Company's website www.resolution.gg

## 2011 final dividend

| | |
|---|---|
| Ex-dividend date | 18 April 2012 |
| Dealing days for calculating the price of the new shares to be offered pursuant to scrip dividend scheme for the dividend | 18 April to 24 April 2012 |
| Record date | 20 April 2012 |
| Final time and date for receipt of the mandate forms and dividend election input messages | 5.00 pm, 4 May 2012 |
| Payment of dividend and first day of dealing in the new shares | 21 May 2012 |

## Registered office
Trafalgar Court
Les Banques
St. Peter Port
Guernsey
GY1 3QL

## Registered number
Incorporated in Guernsey with registered number 49558

## Company Secretary
Northern Trust International
Fund Administration Services
(Guernsey) Limited

Trafalgar Court
Les Banques
St. Peter Port
Guernsey
GY1 3QL

## Operator and investment adviser
Resolution Operations LLP
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London
W1S 2ET

## Auditors
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London
SE1 2AF

## Principal banker
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Guernsey
GY1 3NF

## PR advisor
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EC4N 6LY

## Sponsor and corporate broker
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