Annual report and accounts 2012

Securing the future

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

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

[i] Estimated, unaudited.

Continuing growth in new business

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

Good financial performance

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

Operating highlights

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

Simplified governance

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

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Chairman's statement

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

Mike Biggs, Chairman of Resolution Limited

Overview

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

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

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

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

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

Cash and capital

Dividend

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

Capital

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

Simplifying the governance structure

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

Progress on simplifying the governance structure

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

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

Details of the proposed composition of the board of directors of both the Company and FLG were announced on 19 October 2012. On 10 December 2012 the Company confirmed that, subject to implementation of the proposed amendments to the articles, changes to the Board membership would take effect by the end of March 2013. These amendments were approved by shareholders on 20 March 2013. Members of the Board are listed in the governance section on pages 69 to 75. The Company expects to appoint an additional independent non-executive director, not drawn from either of the existing boards, in due course and a search process is under way.

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

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

Outlook

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

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

Operating report

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

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

Andy Briggs, CEO designate of Resolution Limited

1. Executive summary

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

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

2. Strategy

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

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

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

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

3. Economic and regulatory environment

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

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

4. Business performance

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

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

4.1 Operating results

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

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

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

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

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

4.2 Cash and capital

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

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

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

4.3 Separation, integration and outsourcing

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

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

5. Outlook

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

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

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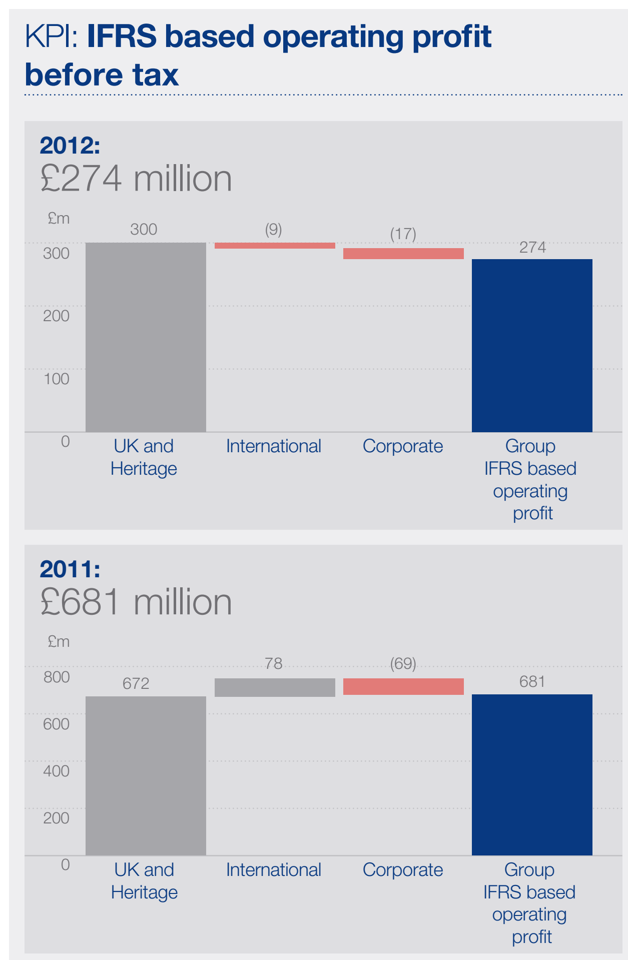
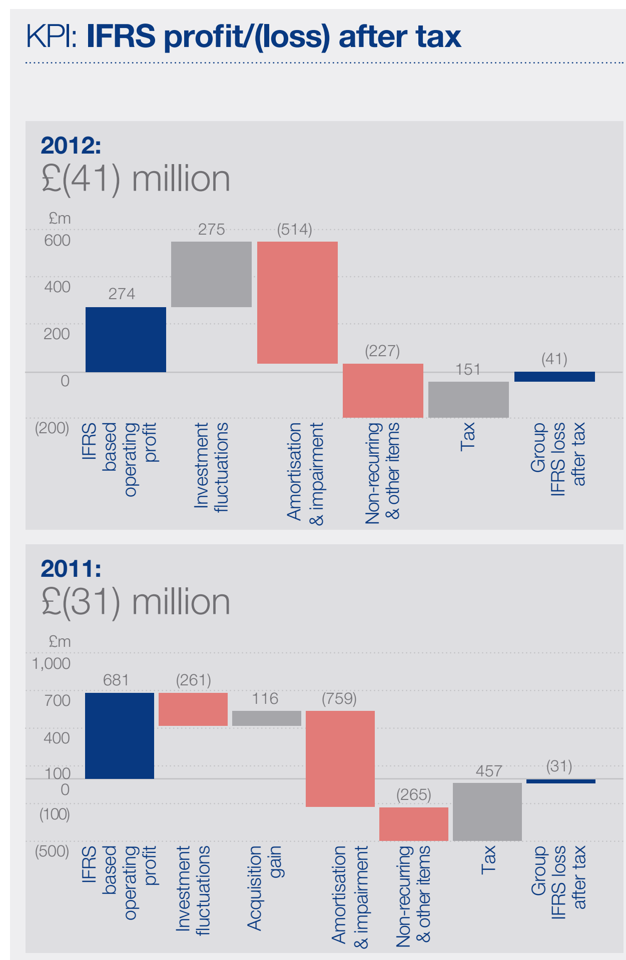
1 Key performance indicators

The Group uses the following key performance indicators:

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



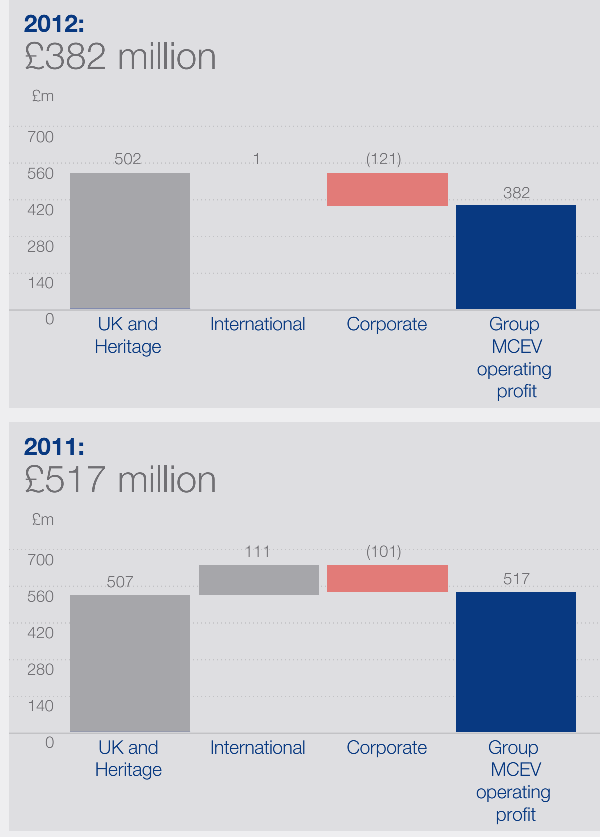
KPI: **IFRS profit/(loss) after tax**



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

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

KPI: **MCEV operating profit before tax**

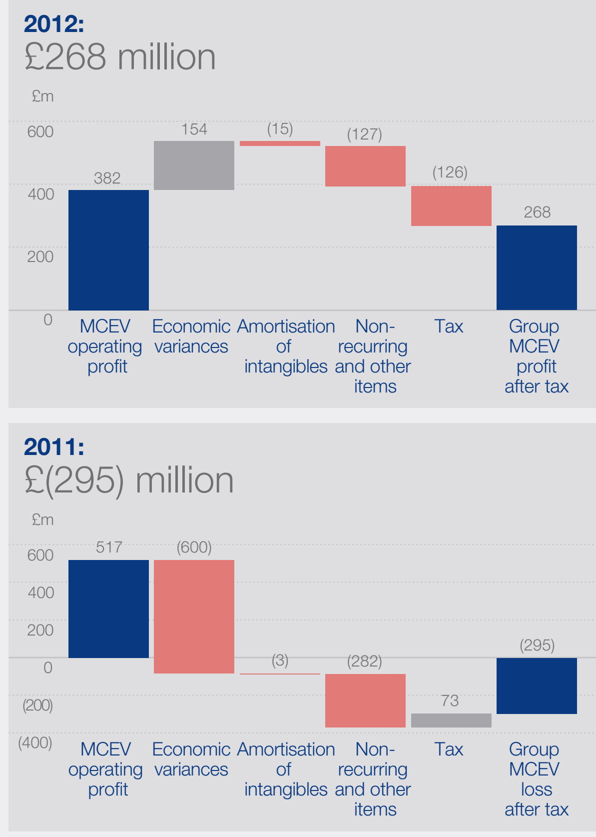


Segment results comprise covered and non-covered businesses.

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

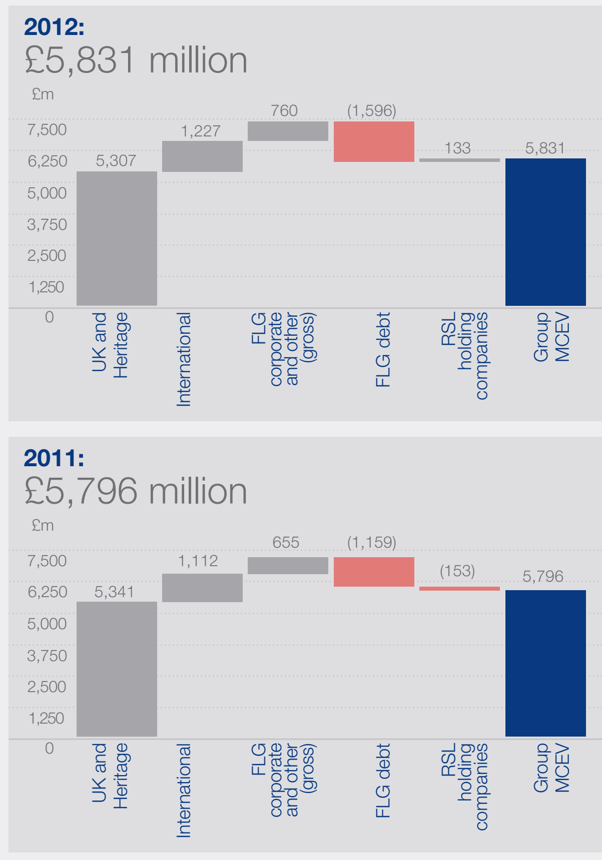
(i) The MCEV basis is in compliance with the European Insurance CFO Forum MCEV Principles ("MCEV Principles") (Copyright© Stichting CFO Forum Foundation 2008), issued in June 2008, and reissued in amended form in October 2009.

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



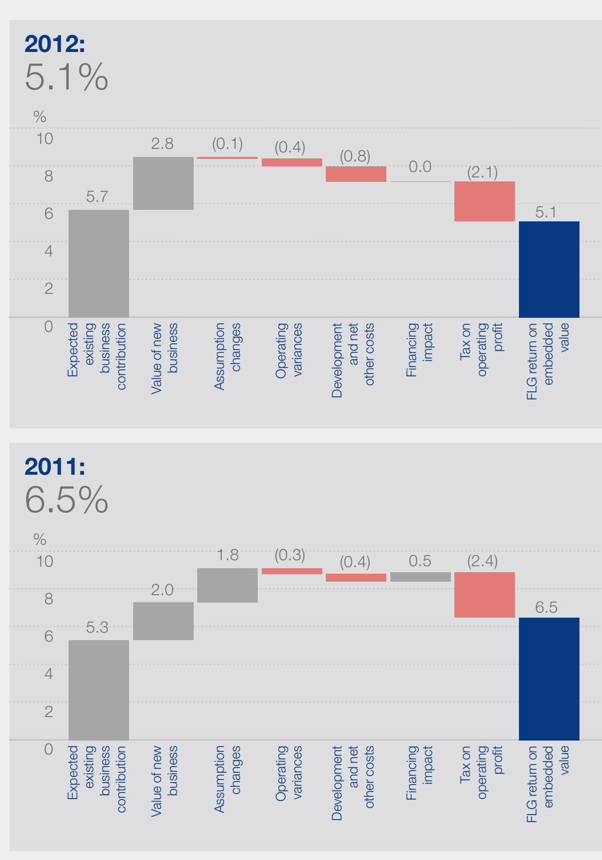
MCEV profit after tax of £268 million is significantly higher than the £(295) million loss reported in 2011 principally reflecting the recovery of equity markets and narrowing of corporate bond spreads in 2012.

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



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

KPI: **FLG return on embedded value**

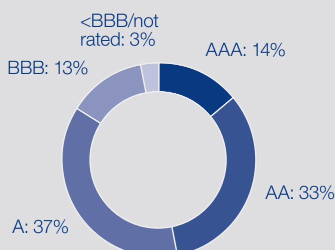


FLG[i] operating ROEV of 5.1% has been negatively impacted by the International division strategic review.

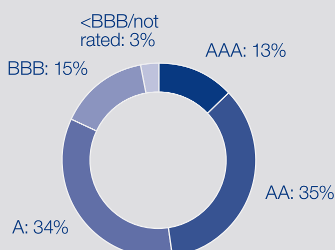
(i) FLG operating ROEV is calculated as the MCEV operating return, after tax and financing, divided by the start of period net embedded value, and is adjusted to allow for the timing of significant capital movements such as dividends and acquisitions.

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

2012:
£9.2 billion

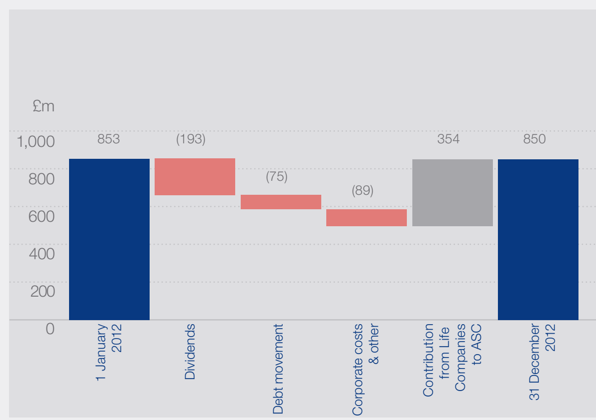


2011:
£8.6 billion



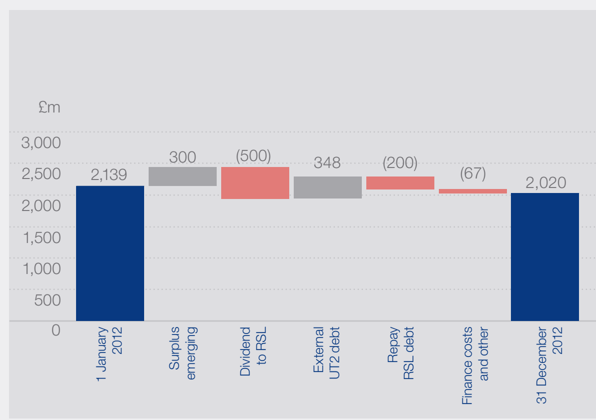
The Group has maintained high asset quality, with 97% of shareholder-related corporate debt and asset backed securities at investment grade or above (31 December 2011: 97%). The Group has no significant shareholder exposure to sovereign debt or corporate bonds of higher risk European economies. No defaults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

KPI: **Available shareholder cash**



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

KPI: **IGCA**



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

2 Group results

2.1 Group IFRS results

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

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

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

Operating profit

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

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

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

Non-operating items

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

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

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

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

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

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

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

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

Summary IFRS balance sheet

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

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

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

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

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

2.2 Group MCEV results

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

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

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

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

Operating profit

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

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

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

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

Non-operating items

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

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

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

MCEV balance sheet

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

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

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

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

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

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

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

2.3 Group free surplus generation

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

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

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

Sustainable free surplus

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

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

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

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

Non-sustainable items

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

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

Available shareholder cash

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

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

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

Dividends

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

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

3 UK and Heritage divisions

Structure

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

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

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

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

2012 operational highlights

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

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

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

3.1 UK and Heritage divisions, financial performance

UK and Heritage divisions IFRS based operating profit

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

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

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

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

New business strain and in-force surplus

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

Reconciliation of new business cash strain to IFRS new business strain

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

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

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

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

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

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

Long-term investment return

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

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

Principal reserving changes and one-off items

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

Operating expenses

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

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

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

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

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

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

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

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

UK and Heritage divisions MCEV operating profit

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

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

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

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

Value of new business

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

Expected existing business contribution

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

Expected return comprises two components:

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

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

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

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

Operating experience variances

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

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

Operating assumption changes

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

Other operating variances

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

3.2 Heritage division

2012 operational highlights

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

Market environment

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

Strategy

The Heritage division serves over four million customers. It manages a significant proportion of the value of in-force of the Group, relating to a large suite of products that are no longer actively marketed and are administered on complex legacy systems. Consequently the business is very different to that of the UK division. A dedicated management team focused on the Heritage business has been established, with the aim to be the United Kingdom's leading legacy business manager with the knowledge and expertise to maximise the value created from legacy books.

The value drivers for the Heritage division are:

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

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

Outsourcing

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

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

Building an in-house asset manager

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

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

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

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

Capital optimisation programme and with-profits fund management

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

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

Financial performance

Value of in-force business

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

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

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

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

Heritage unit-linked funds under management

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

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

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

New business

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

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

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

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

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

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

Outlook

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

3.3 UK division

2012 operational highlights

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

Structure

The UK division comprises three business lines:

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

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

Market environment

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

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

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

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

Strategy

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

Corporate Benefits

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

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

Protection

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

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

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

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

Retirement Income

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

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

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

Financial performance

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

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

Corporate Benefits

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

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

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

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

Corporate Benefits funds under management

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

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

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

Protection

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

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

Retirement Income

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

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

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

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

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

Outlook

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

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

4 International division

2012 operational highlights

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

New business

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

Financial performance

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

Structure

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

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

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

International strategy

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

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

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

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

Market environment

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

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

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

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

Operating review

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

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

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

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

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

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

Outlook

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

4.1 Lombard operating review

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

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

New business profitability

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

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

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

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

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

APE performance by region is as follows:

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

IFRS based operating profit

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

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

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

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

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

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

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

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

Funds under management

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

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

Operating expenses

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

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

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

MCEV operating profit

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

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

Expected existing business contribution

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

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

Operating experience variances

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

Operating assumption changes

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

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

Other operating variances

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

4.2 FPI operating review

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

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

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

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

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

New business profitability

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

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

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

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

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

Core and non-core new business metrics

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

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

IFRS based operating result

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

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

Core and non-core impacts

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Funds under management

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

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

Principal reserving changes and one-off items

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

Operating expenses

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

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

MCEV operating result

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

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

Core and non-core impacts

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

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

Expected existing business contribution

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

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

Operating experience variances

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

Operating assumption changes

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

Other operating variances

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

FPI additional information

IFRS based operating profit

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

MCEV operating profit

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

Sustainable free surplus

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

5 Corporate review

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

Financing and interest costs

The Group has a number of debt instruments and the operating costs of financing these for the year ended 31 December 2012 are presented below.

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

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

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

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

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

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

Corporate IFRS based operating result

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

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

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

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

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

Corporate MCEV operating results

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

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

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

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

6 Cash and capital

Introduction

The Group remains committed to the optimisation of capital within the business. The Group has established cash and capital frameworks which are used to evaluate and monitor excess cash and capital, driven by strong governance and subject to regulatory approval. The cash and capital position of the Group at 31 December 2012 remains strong with available shareholder cash ("ASC") of £850 million and an FLG IGCA surplus of £2.0 billion resulting in a coverage ratio, excluding with-profits insurance capital component ("WPICC")[i], of 214%. At 31 December 2012 the estimated economic capital surplus[ii] at the FLG level was £3.4 billion corresponding to a coverage ratio of 182%.

6.1 Capital management

Principles

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

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

Capital management policies and monitoring buffers

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

Life companies CMP:

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

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

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

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

Group CMP:

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

(i) WPICC represents the difference between the surplus capital calculated on a regulatory basis and that on a realistic basis, in accordance with FSA rules, and is excluded from both capital resources and capital resources requirements under the CMP.
(ii) The economic capital position at 31 December 2012 of FLG and its subsidiaries (including FLL on an economic capital basis, see (iii) below) is estimated and unaudited.
(iii) Economic capital is based on the individual Pillar 2 capital assessments for the UK life companies. FLL's economic capital is derived from consolidating the individual life companies' Pillar 2 capital requirements including making appropriate allowance for the diversification of risk between the companies. Pillar 2 strictly only applies at individual life company level and is the Individual Capital Assessment "ICA" determined by management including any amounts set by the FSA as ICG.

Capital monitoring buffers:

The Group has a robust monitoring system and in addition to the amounts held to meet its CMPs, it holds a prudence buffer in the Friends Life holding companies together with amounts for working capital in both the holding companies and the life companies. The key monitoring buffers held are set out below (note that these are not additive requirements):

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

Consideration of return of capital

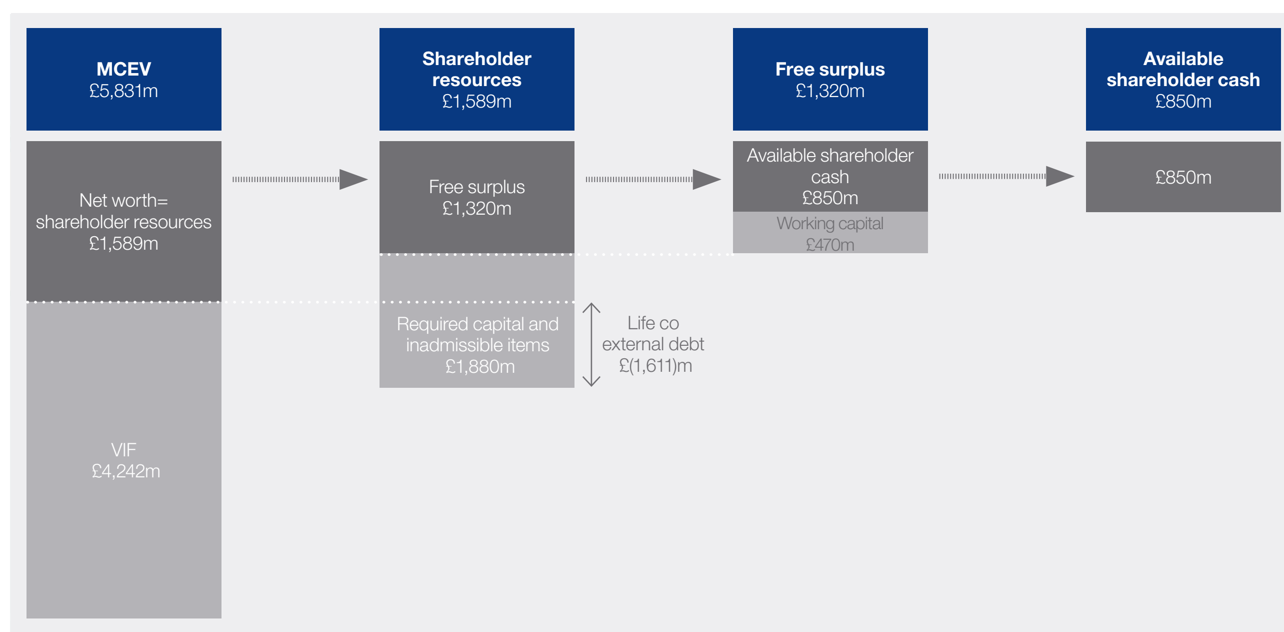
IGCA is currently the biting solvency constraint for the Group, with the FLG economic capital surplus, net of CMP and working capital, approximately £1.4 billion stronger than the equivalent IGCA surplus. This reflects actions taken in 2012 to improve the economic capital position of FLL (excluding FPIL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

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

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

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

6.2 Cash and capital management framework



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

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

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

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

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

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

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

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

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

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

Working capital and other assets and liabilities

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

Working capital comprises:

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

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

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

Available shareholder cash

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

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

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

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

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

Emergence of cash

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

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

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

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

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

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

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

6.3 Economic capital position

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

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

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

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

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

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

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

6.4 Insurance Groups Capital Adequacy

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

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

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

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

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

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

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

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

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

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

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

6.5 Management of the with-profits funds

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

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

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

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

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

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

6.6 Asset quality and exposure

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

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

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

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

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

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

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

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

Sovereign and corporate exposure to these countries is shown here with further detail provided in note 28 of the IFRS financial statements:

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

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

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

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

6.7 Liquidity

The liquidity of the Group remains strong.

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

Financial strength ratings

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

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

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

7 Principal risks and uncertainties

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

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

Risk	Description	Management
Economic conditions	Changes in economic conditions give rise to changes in the values of the assets and liabilities of the Group's insurance businesses and may reduce the profitability of these businesses and/or their financial strength. Adverse or uncertain economic conditions also impact the willingness of consumers to buy and continue to hold the Group's products. The Group is particularly impacted by conditions in the UK and other European countries as a result of its operations and investment assets being focused in these countries.	The Group's business model seeks to mitigate the impact of market conditions through measures including the matching of assets and liabilities, diversifying between asset classes and within asset classes and using derivatives to reduce the volatility of returns on assets, diversification of the product portfolio, and ensuring the operating companies within the Group are strongly capitalised. The Group also actively monitors changes in the economic environment to enable proactive management of impacts to relevant markets. Its exposure to sovereign debt from all but the strongest countries in the Eurozone is modest, is in line with the Group's risk appetite and has been managed down further in recent years. The Group faces significant credit risk exposure (both from credit default and credit spread widening) as a result of its use of corporate bonds to back non-profit business and for the investment of shareholder funds. However it seeks to mitigate these risks by adopting a conservative investment policy with investment skewed towards bonds with high credit ratings.
Sustained low interest rates	The Group's insurance businesses can be adversely affected by sustained low interest rates as well as certain interest rate fluctuations. The Group's insurance businesses, including shareholders' funds are invested in a variety of investments including government debt, cash instruments and corporate bonds. In times of low interest rates the yields on these instruments typically decrease. This can mean that when the instruments mature, the sums realised are reinvested into instruments with lower yields, which, in turn, decrease investment returns. Sustained low interest rates could therefore have a material adverse effect on the business, results of operations and/or financial condition of the Group and could adversely impact the ability to generate free surplus and ultimately pay dividends to shareholders.	The Group seeks to match the duration and return profile of its assets and liabilities in order to manage its exposure to interest rate movements. In the annuity books this is achieved by investing in bonds of appropriate duration and through swap overlays. Within with-profits funds a combination of physical bonds, swap overlays and swaptions are used to manage the interest rate risk. The level of hedging is optimised in line with risk appetite and so that it does not result in an unacceptable increase in other categories of risk. Other mitigants to a low interest rate environment are being investigated including review of the Group's investment strategy for shareholder assets which currently has a large cash exposure. Approaches such as diversification of the asset classes in which the Group invests are being considered as part of investigating the opportunities to increase the rate of return achieved without significantly increasing the investment risks taken.

Risk	Description	Management
Integration and restructuring	The Group is exposed to the risk of failing to integrate and successfully restructure the financial services businesses that it has acquired.	Substantial progress has been made in integrating the three acquired businesses with strategy, planning, and monitoring of risk and business performance being undertaken on an integrated basis. Restructuring of the business to improve its capital efficiency and bring together in separate companies the business of the Heritage Division (within FLL) and the UK Division (within FLPL) is progressing to plan with the business transfers planned for 2012 completed during the year and the 2013 plans on track. There is one major component to complete before separation of the acquired AXA UK Life Business from its previous parent group is achieved at operational level. This work has been replanned and is now expected to complete in 2013. The scale of the separation, integration and restructuring agenda, particularly when taken with the substantial regulatory change agenda faced by the Group (see below) poses particular challenges. Through the business planning process the Group determines the volume of change initiatives that can be delivered and prioritises initiatives for inclusion. The Group operates project management disciplines to identify and manage the interdependencies between initiatives, to set and monitor budgets, to manage the deployment of resources and to monitor delivery of outputs. In this way the Group aims to manage the risks of the change programme within its appetite.

Risk	Description	Management
Regulatory and taxation 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 business. Unanticipated changes in legal requirements (including taxation) and regulatory regimes, or the differing interpretation and application of regulation over time, may have detrimental effects on the Group. It is impossible to fully predict the nature of the regulatory changes which may occur in the future or the impact that such changes may have on the Group and its strategic objectives. The Group may be affected by changes in tax legislation and interpretation of tax law, whether the changes impact the taxation of the companies in the Group at corporate level, or the taxation of the policyholders. In particular, the new corporate tax regime applicable to life insurers from 1 January 2013 continues the "I minus E" basis of taxation for relevant life business in the operating life companies, and while the Group assumes the continuation of that basis in the future, any change in that basis may have a significant impact on the Group.	The Group successfully completed its preparation for regulatory driven requirements introduced in 2012 such as gender neutral pricing and the Retail Distribution Review. Systems have been developed to support the group's occupational pension scheme customers in meeting the requirements of Auto Enrolment and further automation of the processes is planned during 2013 in order that the Group is able to meet the needs of the increasing numbers of schemes that will become subject to Auto Enrolment requirements in late 2013 and 2014. As with any major change in UK regulatory requirements, it is expected that FSA (or its successors PRA and FCA) will want to review firms' interpretation of these new requirements and test that compliance has been achieved. Accordingly the Group expects its implementation of these new regulatory requirements to be reviewed over coming months. It is expected that various regulatory bodies will begin thematic reviews in 2013, such as annuity pricing and unit linked pricing, the Group will adhere to these reviews as required. The planned simplification of the Group's governance arrangements from the end of March will address the changes made to the UK listing rules in respect of "externally managed companies" and which could otherwise have threatened the continuation of the Company's premium listing. The Group continues to monitor and prepare for the future regulatory developments such as the impending transfer of UK regulatory responsibilities for insurers from the FSA to dual prudential and conduct regulators, and longer term initiatives such as Solvency II and IFRS Phase II. The Group bases its business strategy on prevailing regulation and known and planned change. To mitigate the risk of legislation or regulation adversely impacting its business, the Group and its operational businesses engage with regulatory and legislative authorities and support lobbying activity conducted by relevant industry groups. The Group has processes in place to identify regulatory and legislative change and to monitor the timely implementation of new requirements.

Risk	Description	Management
Principal valuation assumptions	The writing of life assurance and pension business by the Group's insurance businesses necessarily requires the setting of assumptions for future experience of factors such as mortality and longevity, lapse and persistency rates, valuation interest rates, credit defaults and expense levels. Experience may vary from the rates assumed impacting the financial performance of the Group.	During 2012, the continued economic uncertainty and impending introduction in the UK of FSA's Retail Distribution Review acted to increase the risk of lapses of life and pensions business as intermediaries looked to re-broke existing business ahead of the impending ban on the payment of commission and in the face of a scarcity of new business. The Group has in place customer value management activities to mitigate this risk and anticipates that over the course of 2013 that it will see some improvement in lapse rates following the implementation of the Retail Distribution Review. The Group takes a prudent approach to evaluating the appropriate level of provisions and capital for each of its risks and the assumptions made are subject to rigorous and ongoing review. However events causing a substantial change in mortality/morbidity experience, lapse rates or other reserving assumptions could require assumptions to be recalibrated and could impact the profitability, earnings and capital position of the Group. Stress and scenario testing is used to validate the appropriateness of key assumptions to single events and combinations of extreme events including economic conditions, investment performance, lapse and mortality/morbidity events.
Outsourcing	As part of the Group's strategy for increasing operational efficiency, it makes use of outsourcing. In March 2012 Friends Life group's outsource arrangements in respect of IT and customer services were materially extended by the coming into effect of a long-term contract with Diligenta. This substantially increased the reliance of the Friends Life group on outsource service providers. The risks of outsourcing include the risk that the outsourcer is or becomes unable to provide the expected services or does not provide them to the standards and quality expected. In addition, the Group's insurance businesses currently benefit from the exemption from VAT of certain costs incurred under outsourcing contracts into which they have entered. The VAT exemption is subject to possible change and if narrowed could have the effect of increasing the costs of some of the outsourced services the Group has contracted to receive.	The Group has comprehensive service level agreements in place with all its outsource service providers and actively monitors the standards of delivery against these agreements in order to mitigate the operational risks posed by the outsourcing. In relation to the newest partner, a dedicated team is overseeing Diligenta's delivery of a Service Improvement Plan in accordance with its contractual obligations. In addition, the financial strength and strategic position of the Group's major outsource service providers are actively monitored in order to manage the potential counterparty credit and continuity of service risks they pose. The Group monitors discussions at European and UK level regarding the VAT exemption for outsourced services. However it remains uncertain when any changes might be made to the law, what form those changes might take, and hence what impact, if any, they might have on the Group.

Governance

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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 2012. These will be laid before shareholders at the Annual General Meeting ("AGM") to be held on 16 May 2013.

Business review and results

The business review and results for the year are set out on pages 9 to 64. The Company's statement on corporate responsibility is set out on pages 105 to 108.

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. Since 2009, it has acquired Friends Provident plc, the majority of the AXA life insurance businesses in the UK and Bupa Health Assurance. These businesses have been rebranded and together form the Friends Life group ("FLG"). The Company announced on 28 November 2011 that it would not undertake additional restructuring projects, and would only focus on FLG. The Company's business model and strategy for FLG is unchanged ensuring that FLG is a successful and sustainable life insurance group with a clear and strong cash profile focused on maximisation of shareholder value.

Events after the balance sheet date

During the year, the Company announced that it was moving from an externally advised, project-based structure to a more conventional, simplified corporate structure. Work to effect the changes to the Company's governance arrangements continued beyond the year end and, prior to publication of this report, culminated in shareholder approval of changes to the Company's articles at a general meeting on 20 March 2013. As a result, additional UK based directors, including executive directors, will be appointed to the Board and ROL will cease to provide services to the Company on 27 March 2013. Changes to the composition of the Board will take effect from 28 March 2013.

Dividends

The directors have proposed a final dividend for 2012 of 14.09 pence per share (2011: 13.42 pence) payable on 20 May 2013 to shareholders on the register at the close of business on 19 April 2013.

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 2011 and the 2012 interim dividend and at the date of approval of the proposed 2012 final dividend.

The Company will introduce a dividend reinvestment plan ("DRIP") in time for the 2012 final dividend, to replace the existing scrip dividend scheme. The latest date for receipt of DRIP elections will be 26 April 2013. Full details of the DRIP, including how to join, can be found 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 page.

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.

As at 31 December 2012, the Company had authority from shareholders for the purchase of 137,618,898 of its own shares.

In order to allot shares, 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 shares. At the 2012 AGM, the directors were granted authority to allot up to an aggregate number of 458,729,663 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 issued 41,920,039 new scrip shares, and as a result, the issued ordinary share capital increased. As at 31 December 2012, the issued ordinary share capital totalled 1,418,109,028 shares.

Substantial shareholdings

As at 22 March 2013, 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	69,774,092	4.92
FMR LLC	69,566,228	4.99
Aviva Plc and its subsidiaries	54,802,616	3.98
Legal & General Group Plc	43,814,863	3.08

The percentages given above of the Company's issued share capital reflect the share capital at the time of notification. The Company's share capital increased during the year.

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 directors who served throughout the year are listed on pages 69 to 71.The Company's new Board will include the Group Chief Executive Officer Designate, Andy Briggs, Chief Financial Officer Designate, Tim Tookey and the Chairman Designate, Sir Malcolm Williamson. The new composition will be effective on 28 March 2013, and all the directors will seek election or re-election at the AGM on 16 May 2013, in compliance with the UK Corporate Governance Code, with the exception of the Chairman, Mike Biggs, who will stand down at the conclusion of the meeting. A number of the Company's directors who served during the year will resign from the Board on 28 March 2013.

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 96 in the Remuneration report.

Board diversity

During the year, the Board discussed and considered ways of increasing gender diversity on the Board and in the Group. Historically, the proportion of women directors has been low, both on the Board and on FLG's board. As stated previously, the Board does not agree with a quota approach to address the imbalance of female and male directors. The Board strongly believes that in order to increase gender diversity on the Board, and in business in general, initiatives which enable and encourage female employees to progress to senior management level, as part of executive director succession planning, will help address the current gender imbalance. For details of Group wide diversity initiatives refer to page 106 of the corporate responsibility ("CSR") report.

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 2012 was 3,861 (2011: 5,733).

Directors' and officers' insurance

The Group maintains insurance cover for all 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 who served during the year, while governed by Guernsey law, are consistent with the scope of directors' indemnities that would be permitted under the UK Companies Act 2006. From 28 March 2013, the indemnities of the directors of the Company will be governed by English law.

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 CSR report on pages 107 and 108.

Auditor

Following the Audit and Risk Committee annual review of the performance of the auditor, it was recommended that the Company's current 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").

With effect from 28 March 2013, the Secretary of the Company will be Victoria Hames.

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 it faces.

Annual General Meeting

The next AGM of the Company will be held at 11.00 am on Thursday16 May 2013 at 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 83 to 86.

Future developments

An indication of likely future developments is set out in the Chairman's statement and the Operating report on pages 3 to 8.

By order of the Board

Fergus Dunlop
Director

25 March 2013

Board of directors

Directors who served during the year

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 was acquired by Pearl Group 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 was appointed Chairman of Direct Line Insurance Group plc on 23 March 2012.

Mike will step down as Chairman and a non-executive director of the Company on 16 May 2013, after the conclusion of the AGM.

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.

Jacques will retire from the Board on 28 March 2013.

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.

Gerardo will retire from the Board on 28 March 2013.

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 and Schroder Oriental Income Fund Limited, both traded on the London Stock Exchange, and of Aqua Resources Fund Limited and Perella Weinberg Real Estate Fund II GP Limited

Fergus will retire from the Board on 28 March 2013.

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 and Travelex Holdings Ltd. 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 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.

Denise will retire from the Board on 28 March 2013.

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. Peter was Chief Executive Officer of Guernsey Finance LBG until June 2012.

External appointments:

Peter holds a number of non-executive directorships, including five companies listed on the London and Channel Islands Stock Exchanges.

Peter will retire from the Board on 28 March 2013.

Gerhard Roggemann

Non-executive director

- Chairman of Remuneration Committee

Gerhard is a 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 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 Senior Advisor and Vice Chairman of Canaccord Genuity Hawkpoint Ltd. 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.

Gerhard will retire from the Board on 28 March 2013.

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 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 Chair of the Board of Governors of the Coeliac Society.

Company's Board from 28 March 2013

Following approval of changes to the Company's articles by the shareholders at the general meeting on 20 March 2013 the Company's new Board composition will be effective from 28 March 2013.The biographies of the directors, whose elections and re-elections to the Board will be put to the Company's shareholders at the 2013 Annual General Meeting, are set out on pages 72 to 75.

Michael Biggs

Chairman

- Appointed in October 2008
- Chairman of Nomination Committee*
- Member of Remuneration Committee

Mike's biographical details are set out on page 69.

Sir Malcolm Williamson

Chairman Designate

- To be appointed in March 2013
- Member of Nomination Committee*
- Member of Remuneration Committee

Sir Malcolm has a wealth of experience in the insurance and financial services industry, having served as Chairman of Clydesdale Bank plc, National Australia Group Europe Limited, CDC Group plc, and Britannic Group plc. He was Deputy Chairman of Resolution plc until 2008, a non-executive director of G4S plc and JPMorgan Cazenove Holdings, Chairman of Signet Jewelers Limited and a member of the Board of Trustees for the International Business Leaders Forum. Prior to this, he was President and Chief Executive Officer of Visa International between 1998 and 2004 and Group Chief Executive of Standard Chartered plc from 1993 to 1998.

Sir Malcolm was appointed as a non-executive director of Friends Life Group plc in November 2009 and became Chairman in February 2010.

As announced on 21 January 2013, the Company has named Sir Malcolm its Chairman Designate, to succeed Mike Biggs when Mike steps down as Chairman at the conclusion of the Company's Annual General Meeting on 16 May 2013.

External appointments:

Sir Malcolm is the Chairman of Cass Business School's Strategy and Development Board and Invicta Card Services Limited. He is also Chairman of the Board of Trustees of The Prince of Wales Youth Business International Limited, and a trustee member of Youth Business America.

* Sir Malcolm will take over as Chairman of the Nomination Committee when he succeeds Mike Biggs as Chairman of the Company.

Andy Briggs

Group Chief Executive Officer

- To be appointed in March 2013

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

Andy was appointed as Group Chief Executive Officer of Friends Life Group plc in June 2011.

External appointments:

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

Tim Tookey

Chief Financial Officer

- To be appointed in March 2013

Tim held a number of senior positions at Lloyds Banking Group including Interim Group Chief Executive Officer for a short period between 2011 and 2012, Group Finance Director from 2008 to 2012, and Deputy Group Finance Director from 2006. Prior to his time at Lloyds Tim was Finance Director at Prudential UK, which he had joined in 2002. Tim was instrumental in the development of Heath Lambert, the insurance broker where he was Finance Director. Before his corporate roles, Tim qualified as a chartered accountant at KPMG.

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

Tim was appointed a director of Friends Life Group plc on 5 March 2012 and became Chief Financial Officer on 30 March 2012.

External appointments:

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

Phil Hodkinson

Senior Independent Director

- Appointed in October 2008
- Member of Audit, Nomination and Remuneration Committees

Phil's biographical details are set out on page 70.

David Allvey

Independent non-executive director

- To be appointed in March 2013
- Chairman of Risk and Compliance Committee
- Member of Audit, Nomination and Remuneration Committees

David has extensive experience in the financial services sector, having held senior executive positions in major international businesses including appointments as Group Finance director of BAT Industries and Barclays plc, and as Chief Operating Officer for Zurich Financial Services. David was a member of the UK Accounting Standards Board and has held directorships with Intertek Group plc, William Hill plc and Thomas Cook Group plc. In addition, he was Chairman of Arena Coventry Limited until May 2012.

David was appointed as an independent non-executive director of Friends Life Group plc in November 2009 and as Senior Independent Director in November 2010.

External appointments:

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

Mel Carvill

Independent non-executive director

- Appointed in February 2010
- Member of Nomination Committee
- Member of Risk and Compliance Committee

Mel's biographical details are set out on page 70.

Clive Cowdery

Non-executive director

- To be appointed in March 2013

Clive co-founded Scottish Amicable International/Rothschild International in 1992, a European cross-border insurance business based in Dublin. In 1998 Clive was appointed Chairman and Chief Executive of GE Insurance Holdings, leading Europe's largest credit insurer and the life and pensions operations in the UK and France. Clive was previously the Chief Executive of Resolution Life Group Limited, which he founded in 2003. Following the merger of Britannic Group plc and Resolution Life Group Limited in 2005, he was appointed Chairman of Resolution plc, which was acquired by Pearl Group in 2008.

Clive was appointed as a non-executive director of Friends Life Group plc in November 2009.

External appointments:

Clive is Chairman of the Resolution Foundation and a non-executive director of Prospect Publishing Limited and Capital Investments (SICAV) plc. Clive is the Founding Partner of Resolution Operations LLP.

Peter Gibbs

Independent non-executive director

- To be appointed in March 2013
- Member of Investment Oversight Committee

Peter has brought the benefit of significant knowledge of the financial services and asset management sectors to the boards of Friends Life Group plc and its asset management subsidiary Friends Life Investments Limited, for which Peter is the non-executive Chairman. Until its takeover by Investec in December 2011, Peter was the senior independent non-executive director of The Evolution Group plc, and a member of its Audit, Remuneration and Nomination Committees. Peter was also the non-executive Chairman of Turquoise, the pan-European trading platform, until 2009. Peter was Chief Investment Officer and Head of Region for the non-US Investment Management activities of Merrill Lynch, having spent his early career at Brown Shipley and Bankers Trust.

Peter was appointed as a non-executive director of Friends Life Group plc in July 2011.

External appointments:

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

Nick Lyons

Independent non-executive director

- To be appointed in March 2013
- Chairman of Remuneration Committee
- Member of Investment Oversight Committee
- Member of Risk and Compliance Committee

Nick was formerly a managing director of Lehman Brothers in London, where he headed the European Financial Institutions Group and held the role of Global Co-Head of recruitment, Training and Career Development on the European Operating Committee. Having also held executive positions at JP Morgan & Co and Salomon Brothers, Nick has a broad range of financial and insurance sector experience gained in large and complex international businesses. Nick was previously the Chairman of Miller Insurance Investment Limited and a non-executive director of Quayle Munro plc.

Nick was appointed as a non-executive director of Friends Life Group plc in February 2010.

External appointments:

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

Robin Phipps

Independent non-executive director

- To be appointed in March 2013
- Member of Risk and Compliance Committee

Robin has extensive knowledge of the life insurance and pensions industry, having been a member of the board of Legal & General Group plc from 1996 to 2007, holding the position of Group Director UK. Previously, he held various senior roles within Legal & General Group plc. He brought significant knowledge of the heritage Friends business to the FLG Board, having been a director of Friends Provident plc from November 2008 until its takeover by the Company in November 2009. Robin is also Chairman of the With-Profits Committee, a Committee of the boards of the life companies within the Friends Life group.

Robin was appointed as a non-executive director of Friends Life Group plc in November 2009, having been a director of Friends Provident plc from November 2008.

External appointments

Robin holds non-executive directorships at the Partnership Group of Companies and IFG Group plc.

Belinda Richards

Independent non-executive director

- To be appointed in March 2013
- Member of Nomination Committee
- Member of Risk and Compliance Committee

Belinda has a wealth of insight and experience in the financial and insurance sectors, having previously held the position of Vice Chairman at Deloitte LLP, where she was a senior Corporate Finance partner for ten years, and the Global Head of Merger Integration and Separation Advisory Services. Clients at Deloitte included a number of leading UK and global banks and insurance companies.

Belinda was appointed as a non-executive director of Friends Life Group plc in June 2010.

External appointments:

Belinda holds a non-executive directorship at Grainger plc, where she is Chairman of the Audit Committee and a member of the Remuneration and Risk and Compliance Committees.

Karl Sternberg

Independent non-executive director

- To be appointed in March 2013
- Chairman of Investment Oversight Committee
- Member of Audit Committee

Karl has brought the benefit of his considerable financial sector and investment experience to the Board of the Friends Life Group. He spent his early career at Mercury Asset Management and Barclays de Zoete Wedd, followed by twelve years at Morgan Grenfell which became part of Deutsche Asset Management, where he held a number of Chief Investment Officer roles in different regions. Karl was a founding partner and director of Oxford Investment Partners Limited, from which he resigned in January 2013.

Karl was appointed as a non-executive director of Friends Life Group plc in May 2010.

External appointments:

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

John Tiner

Non-executive director

- To be appointed in March 2013

John held a number of senior positions at the FSA, including as Chief Executive between 2003 and 2007, and as Managing Director of Consumer, Insurance and Investment Business from 2001 until 2003. At the FSA, John led the review which substantially overhauled regulation of the UK insurance industry and promoted financial capability to become a public policy priority. Before joining the FSA, John was a Managing Partner at Arthur Andersen, responsible for its worldwide financial services practice. John was also a member of the Committee of European Insurance and Occupational Pensions Regulators which steered the development of the Solvency II proposals.

John was appointed as a non-executive director of Friends Life Group plc in November 2009.

External appointments:

John is the Chief Executive of Resolution Operations LLP, a position from which he will step down on 31 March 2013. He also holds non-executive directorships with Credit Suisse Group AG and Lucida plc.

Tim Wade

Independent non-executive director

- Appointed in May 2010
- Chairman of Audit Committee
- Member of Risk and Compliance Committee

Tim's biographical details are set out on page 71.

Corporate governance report

Chairman's introduction

As Chairman, my role is to provide leadership to the Board, to ensure that the directors as a group contribute a wide range of experience and expertise to the Board's proceedings, and to ensure that the Board takes account of the views of the Company's shareholders.

The governance structures established on incorporation and at the time of the acquisition of Friends Provident were appropriate for the project-orientated business model of the Company. The Board has, however, reassessed the governance structure following its decision that the Company should focus on UK life insurance rather than project-based financial services consolidation, and to take into account the changing regulatory environment. As announced during the year, following shareholder consent to the necessary constitutional changes, a more conventional governance structure suited to delivering shareholder value and retaining the Company's premium listing will take effect from 28 March 2013.

Managing risk

One of the key areas of focus for the Board is management of risk. Risk analysis and evaluation is an embedded element of our decision-making process, including our key strategic decisions and business planning. The Board has set, and continually refines the effectiveness of, its risk management framework for the Group. During 2012, key components of this framework were the Company's Audit and Risk Committee, the FLG board and FLG's Board Risk and Compliance Committee. Tim Wade chaired the Audit and Risk Committee throughout 2012 and his statement appears on pages 87 to 88. With effect from 28 March 2013, the Board will constitute a new Audit Committee, to be chaired by Tim Wade, and a Risk and Compliance Committee, to be chaired by David Allvey, who has been FLG's SID, chairman of its Audit Committee and a member of its Board Risk and Compliance Committee, and who will join the Board on 28 March 2013.

In accordance with the Walker recommendations, there will be some cross-membership of the new Risk and Compliance and Audit committees to ensure that a robust link between the work of the committees is maintained. In addition, there will also be cross-membership of the Remuneration and Risk and Compliance Committees to ensure that the link between risk and remuneration continues to be considered.

Governance milestones in 2012

In January 2012, shareholders gave their consent to changes to the contractual relationship between the Company and ROL, to enable the Company to confine its business activities to those of its Friends Life group while continuing to benefit from ROL's development and oversight services. In August 2012, the intention was announced to streamline the boards of the Company and Friends Life Group plc, to end arrangements with ROL no later than 10 December 2013, and to in-source many of the services provided by ROL.

In October 2012, the FSA introduced new rules which mean that "externally managed companies" would be in breach of the Listing Rules for premium listed companies and may have their premium listing suspended or cancelled unless they change their external management arrangements by 31 December 2013. By virtue of having outsourced executive functions to ROL under an Operating Agreement, the Company would have fallen into the category of an externally managed company. On 20 March 2013, shareholders gave their consent to changes to the Company's Articles which has, among other things, enabled the appointment of executive management to the Board of directors. Andy Briggs and Tim Tookey are joining the Company's Board with effect from 28 March 2013 as Group Chief Executive Officer and Chief Financial Officer respectively. As a result of their appointment and the cessation of ROL's services under the Operating Agreement, the Company's premium listing will not be affected by the new Listing Rules.

During 2012, other governance matters dealt with included:

- recommendations by the Nomination Committee for the election or re-election of directors to the Board and FLG board, and for the common composition of the two boards from 28 March 2013;
- an internally led board performance evaluation and the formulation of an action plan for 2013;
- continuous training for the Board covering industry-specific topics and in-depth presentations by senior management;
- the formulation of a step plan for the development and implementation of a diversity policy; and
- CSR initiatives which are described in detail in the Corporate Responsibility report on pages 105 to 108.

Governance priorities for 2013

My first priority for the remainder of my term as Chairman is to lead the Board through the transition to the new governance structure, ensuring that the services previously provided by ROL are satisfactorily embedded in the organisation and that the newly constituted Board and its committees have a robust support infrastructure to enable them to manage the business of the Group for the benefit of all of its stakeholders.

I am confident that the balance of skills, expertise and experience of the members of the newly formed Board, supported by robust internal controls, ethical standards and the Group's remuneration policy, will put the directors in a position to provide the leadership and governance needed to deliver the Group's strategic objectives.

Michael Biggs
Chairman

25 March 2013

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 outsourced some administrative functions and company secretarial services to Northern Trust International Fund Administration Services (Guernsey) Limited. All scheduled Board and Committee meetings were held outside the UK, and the substantial majority of meetings were held at the Company's office in Guernsey during 2012. Following the completion of the governance restructuring in March 2013, it is anticipated that the majority of future meetings of the Board and its committees will take place in the UK.

The Board is responsible for the establishment of the Company's objectives, business strategy and its overall supervision. During 2012, the Board was wholly comprised of non-executive directors, all of whom, with the exception of the Chairman, are considered by the Board to have been independent. Executive functions of the Company have historically been provided by ROL but on 28 March 2013 Andy Briggs will be appointed to the Board as Group Chief Executive Officer and Tim Tookey will be appointed to the Board as Chief Financial Officer.

The Board was supported during the year by its three principal Committees, the Audit and Risk Committee, Remuneration Committee and Nomination Committee, which assisted the Board in discharging its responsibilities. As part of the governance restructuring due to be completed in March 2013, the Board intends to separate the responsibilities of the Audit and Risk Committee by constituting a new Audit Committee and a Risk and Compliance Committee. An Investment Oversight Committee has previously existed at FLG level, and will be constituted as a committee of the Board. All Committee members are non-executive directors of the Company. More information about the Committees and the Company's governance framework can be found on pages 77 to 104.

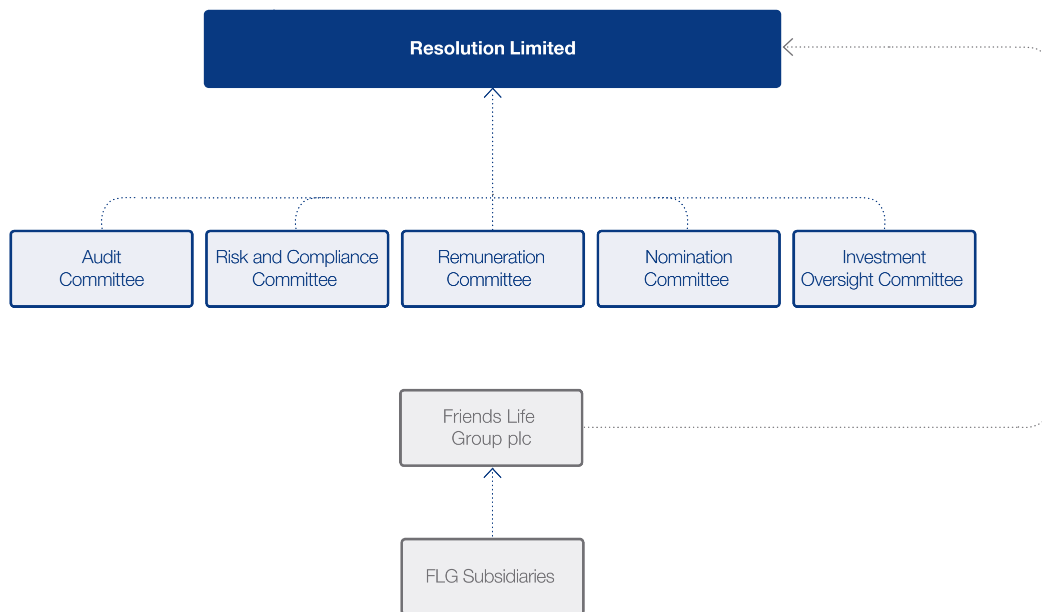
Friends Life Group plc

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 insurance and Bupa Health Assurance businesses which are also owned by 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 during 2012 in the UK was the FSA. During 2012, the executive directors and their management team have been responsible for the day-to-day management of the principal operating subsidiaries of the Group.

Resolution Operations LLP

Since 2008, the Company has outsourced the management of most of its operational functions to ROL, which is a UK registered limited liability partnership, regulated and authorised by the FSA for the provision of investment advice. During 2012, partners of ROL regularly attended board and board committee meetings of both the Company and FLG in order to discharge the responsibilities of ROL under the Operating Agreement. The services provided by ROL will cease on 27 March 2013.

A diagram illustrating the Company's governance framework, after the changes come into effect on 28 March 2013, appears below.



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 has received 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;
- 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;
- approval of financial statements;
- dividend policy; and
- governance matters.

During the year, significant matters considered by the Board included the repayment of the AXA Deferred Consideration Notes following the issuance by FLG of Reset Perpetual Subordinated Notes, the sale of the Group's stake in AmLife Insurance Berhad and AmFamily Takaful Berhad, and the governance restructuring, including the terms on which ROL's services under the Operating Agreement will cease.

Board composition

Until 28 March 2013, the Board will comprise the Chairman, Mike Biggs; the senior independent director ("SID"), Phil Hodkinson; and eight other non-executive directors. All of the directors, with the exception of the Chairman, are considered to be independent of management and free from any business relationship which could materially interfere with the exercise of their independent judgement. With effect from 28 March 2013, the Board will comprise the Chairman, Mike Biggs; the Chairman Designate, Sir Malcolm Williamson; the SID, Phil Hodkinson; the Group Chief Executive Officer, Andy Briggs; the Chief Financial Officer, Tim Tookey; and 10 further non-executive directors, of whom eight are independent (see biographies on pages 72 to 75). Mike Biggs will step down as Chairman and (subject to his election) Sir Malcolm Williamson will succeed him as Chairman at the conclusion of the Company's AGM on 16 May 2013.

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 89.

Board performance 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 review exercise was undertaken internally in respect of 2011 and again for 2012, in both cases with assistance from the ROL Head of Secretariat. During the year, the Board took action based on proposals which had emerged from the 2011 evaluation process.

The review of Board and committee performance in 2012 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 intended to be aggregated with actions arising from FLG's board evaluation process and implemented in 2013. The Board concluded that it and its committees operate effectively. The Chairman determined that each of the directors made an active and valuable contribution to the governance of the Group.

Meetings and attendance

During 2012, the substantial majority of scheduled Board and committee meetings took place in Guernsey at the Company's office. The Board schedules eight formal meetings a year. On occasion, additional meetings are convened 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. Following the change in the Board's composition on 28 March 2013, Board and committee meeting dates have been scheduled to accommodate the majority of directors, but due to some long-standing prior commitments, full attendance at all Board and committee meetings may not be possible for the remainder of 2013.

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(7)	n/a	2(2)	7(7)
Jacques Aigrain	7(8)	7(7)	n/a	2(2)	7(7)
Gerardo Arostegui*	7(8)	2(7)	n/a	1(2)	6(7)
Mel Carvill	8(8)	6(7)	7(7)	2(2)	n/a
Fergus Dunlop	8(8)	7(7)	7(7)	n/a	n/a
Phil Hodkinson	7(8)	7(7)	5(7)	1(2)	n/a
Denise Mileham	8(8)	7(7)	7(7)	2(2)	n/a
Peter Niven	8(8)	6(7)	n/a	2(2)	7(7)
Gerhard Roggemann	8(8)	7(7)	n/a	n/a	7(7)
Tim Wade	8(8)	7(7)	7(7)	n/a	n/a

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

* Gerardo Arostegui was unable to attend a number of meetings due to serious illness.

Board training

The Board's continuous training programme covered relevant industry and technical topics during 2012 and included detailed presentations from the chief executives of Lombard and of Sesame Bankhall Group including assurance on their principal risks, markets and strategy. 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 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. The current Chairman, Mike Biggs, agreed to lead the Board through the period of transition to the new governance structure. Mike will step down as Chairman at the conclusion of the Company's AGM on 16 May 2013. The proposed appointment of Sir Malcolm Williamson as Mike's successor was announced on 14 January 2013.

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 was appointed as SID in March 2009 and served throughout the year, and will continue to do so from 28 March 2013.

Communication with shareholders

The Company values its dialogue with both institutional and private investors. The Board's primary contact with institutional shareholders has been through a combination of the Chairman, the ROL team, and the Group Chief Executive Officer Designate and Chief Financial Officer Designate. When Andy Briggs and Tim Tookey are appointed to the Board, they will become the primary contacts for institutional shareholders. The Board takes a particular interest in ensuring that regular and informative communication takes place with the Company's shareholders to enable them to appreciate the risks and rewards of investing in the Company's shares.

Frequent updates on shareholder sentiment have been 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. Following the cessation of ROL's services under the operating agreement, the Investor Relations function will be carried on from within the Group.

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 122 meetings with investors during 2012.

During the year, the Board received extensive feedback from institutional shareholders through direct interaction with the Chairman and SID, reports provided following meetings with the Company's brokers, partners and senior executives of ROL, and the Group Chief Executive Officer Designate and Chief Financial Officer Designate. Views of shareholders were debated at Board meetings and, in particular, were taken into account in deciding to restructure the Group's governance arrangements.

Individual 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 individual 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 a poll, which means that every vote cast (whether by proxy or in person) is counted.

The Company held its 2012 AGM, and previous AGMs, in Guernsey, with a simultaneous broadcast to a venue in London. The broadcast between the two locations facilitated shareholder participation by enabling shareholders in either location to put questions to the Board in Guernsey, and to members of the FLG board in London. In order to encourage the participation of, and communication with, investors at AGMs, the Board intends to hold the 2013 AGM and future general meetings in London.

At previous AGMs, the Chairman, assisted by the ROL Chief Executive, presented an update on performance and current business activities. It is expected that, at future AGMs, the Group Chief Executive Officer will address the meeting on current operating performance and strategy. The chairmen of the Board's principal committees are available at AGMs to respond to relevant questions and all other directors attend unless illness or other pressing commitments preclude them from doing so. The Company proposes a separate resolution on each substantially separate issue.

Representatives of the Company's registrars, Computershare, attend AGMs to answer any registration 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 complied with the provisions of the Code throughout the year, although by reason of its historical governance structure, the following may be regarded as exceptions:

- **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 running of the Company's business. No one individual should have unfettered powers of decision.

Throughout 2012, the Company had a non-executive Chairman and no chief executive officer, having outsourced executive functions to ROL under the Operating Agreement. The Chairman leads the Board. There is a clear division of the responsibilities between the Chairman, SID and the other non-executive directors. The day-to-day operation of the Group's businesses is undertaken by the FLG board, which is comprised of a majority of independent non-executive directors. Therefore, the Board considers that no one individual has unfettered powers of decision. The governance restructuring expected to be completed on 28 March 2013 will bring the Company into compliance with the above principle.

- **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.

During the year, the Board was wholly comprised of independent non-executive directors, with the exception of the Chairman who, by definition, is not regarded to be independent. All decisions on matters reserved to it were made by the Board as a whole. Specific matters were decided by the Board's principal committees or, in accordance with delegated authority, by the FLG board. Therefore, the Board considers that no individual or small group of individuals can dominate the Board's decision taking. The governance restructuring expected to be completed on 28 March 2013 will bring the Company into compliance with the above supporting principle.

- **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 did not, throughout 2012, have any executive directors for whom the Board would design such schemes. However, in reviewing and approving remuneration for the FLG executive directors, the Remuneration Committee and Board have regard to the provisions in Schedule A to the UK Corporate Governance Code, as well as to the recommendations of the Walker review of corporate governance in banks and other financial entities.

The Company complies with the recommendation in the Code regarding notice of annual general meetings, by giving at least 20 working days' notice. The Company adopted new Articles of Incorporation ("Articles") on 20 March 2013. The new Articles provide for the Company's notice period for general meetings to be a minimum of 10 clear days' notice, which is the minimum period required under Guernsey law. This is a reduction in the notice period that the Company was required to provide shareholders under its previous Articles. The intended purpose of the change was to better align the Company's notice requirements with the requirements for UK listed companies when taking into account the practical effect of the different mandatory deemed receipt provisions for service of documents under the Companies Law. Section 523(8) of the Companies Law provides that documents are only deemed served outside the UK, Channel Islands and the Isle of Man after seven working days. The Company therefore needs to add this period to the minimum notice period required for convening general meetings.

Prior to the General Meeting to adopt the new Articles, a number of shareholders expressed concerns about the proposed reduction in the notice period for general meetings. Following the General Meeting, the Company reassured shareholders of its intention to comply with the highest standards of UK corporate governance and undertook to propose changes to the relevant provisions at the 2013 AGM to address shareholder concerns. Full details of the proposed change are included in the Company's Notice of AGM.

Guernsey corporate governance code

Guernsey companies which comply with the UK Corporate Governance Code are deemed to meet the requirements of the Guernsey Financial Services Commission's Finance Sector Code of Corporate Governance (the "Guernsey Code"), which came into effect on 1 January 2012.

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 Group is committed to ensuring that the highest standards of corporate governance are maintained and that a robust risk management framework is in place and aligned to the delivery of the Group's business strategy. The Board seeks to articulate its risk appetite and to hold senior management to account for operating the Group's businesses consistent with that risk appetite. The Group's risk functions provide oversight and support to line management in managing the Group's risk profile within the agreed risk appetite.

The Group is continuing to develop and embed its risk management framework. During the year it has reviewed its risk strategy and risk appetite in order to define these more clearly and to provide a more transparent linkage with the risk limits and metrics that the Group uses to manage its business. In addition the risk governance arrangements within FLG have been revised so that each of the Group's divisions has:

- a Divisional Risk Committee which oversees the full spectrum of risks faced by its businesses and which reports at executive level into the FLG Executive Risk Committee;
- a senior manager with lead responsibility for supporting effective risk management within the Division; and
- been allocated a senior manager of the Group Risk Function who will take the lead in overseeing and challenging the effectiveness of risk management within the Division.

The Group 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 management of the business.

The Board are 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.

Governance during the year

During the year the Board and Audit and Risk Committee have been responsible for setting the overall risk management framework of the Group, for monitoring the Group's risk profile and assessing the effectiveness of the Group's systems of internal control. In practice it has delegated to the FLG board and senior management responsibility for ensuring the businesses within the Group are operated in accordance with the Group's risk management and internal control framework and the risk profile is appropriately monitored and managed. This has helped to achieve more local and efficient governance of risk and assessment of control effectiveness within the operational business and enabled the leveraging of FLG expertise and resource in developing the Group's risk management framework.

Future risk management and control arrangements

The simplification of the Group's governance will remove the need for delegation of responsibilities between the Company's Board and the FLG board. Going forward, Risk and Compliance Committee of the Board will undertake the current risk management responsibilities of the Company's Audit and Risk Committee and FLG's Board Risk and Compliance Committee. This will simplify the accountability for the governance of risk within the Group but in practice is not expected to change the Group's overall philosophy and approach to risk management or its risk appetite.

Similarly under the simplified Group governance arrangements there will be a single Audit Committee that will be accountable for monitoring the effectiveness of the Group's internal systems and controls.

The Group expects to continue to develop its risk management framework, practices and processes during the coming year and to strive to further embed risk management within the day to day management of its businesses. Systems of internal control will continue to be actively assessed and monitored and action taken to address any weaknesses in controls that are identified.

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. As such the Group seeks to embed risk management within its business processes. To support this approach the Board has established the following risk management aims, principles and framework.

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 culture of active risk management with risk management being the responsibility of the Board, senior management and staff at every level within the Group. The Group's risk functions support effective risk management within the business through analysis, review, challenge and monitoring processes, but are not responsible for risk management;
- risk appetite is set and regularly reviewed by the Board. In setting this the Board considers the Group's capacity to bear risk, where it will best be rewarded for taking 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. Accordingly allowance is made for certain processes and procedures to vary across the Group where it is necessary to fit different business/operating environment dynamics;
- risk is actively considered in making business decisions, including setting strategy and business plans at subsidiary board, FLG and Group Board level; and
- the identification and management of risk is constantly reviewed as part of an ongoing process.

During the year the Audit and Risk Committee has overseen the Group's risk management arrangements and has been supported in this by the FLG Board Risk and Compliance Committee. Under the simplified structure it was not considered appropriate to retain a combined Audit and Risk Committee.

Risk management framework

The Group's risk management framework articulates the risk strategy and risk appetite for the Group and establishes clear policies, processes and procedures to ensure a consistent approach to risk identification, evaluation and management across the Group.

Risk strategy

The Group's risk strategy is aligned to its business strategy and expresses the Group's attitude towards and preference for or against the different risk types to which it is exposed. While it is not practical to eliminate certain risk types the Group's risk strategy seeks to articulate the risk types where a reduction in exposure would be cost effective and similarly to identify the risk types where it will be well rewarded for taking additional risk. FLG's risk strategy was most recently reviewed by its Board Risk and Compliance Committee in November 2012. As part of this review it was concluded that it should seek to take additional longevity, mortality and morbidity risk in line with the rewards in taking these risks and the expertise the group has in their management.

Risk appetite

The Group's risk appetite seeks to articulate the magnitude of different risk types the Group is prepared to take and which is consistent with its risk strategy. The risk appetite then provides a reference point against which the Group's risk profile can in practice be assessed. During the year work has been undertaken to review the Group's high level financial risk appetite statements to:

- ensure their calibration is appropriate and is consistent with the Group's business plans; and
- translate the statements into a series of more granular risk limits and allowances which can be used for risk monitoring.

Similarly the Group's operational risk appetite statements have been reviewed and updated. While these tend to be more qualitative statements they are used as the basis for identifying Key Risk Indicators (KRIs) that can be used to monitor the Group's performance relative to its risk appetite.

Risk policies

The Group has a well-established set of policies that set out how risk is managed within the Group. The policies are reviewed on an annual basis in order to ensure they remain fit for purpose in the light of development of the Group's business and the external environment in which it operates.

Risk assessment

Line management within the Group are responsible for continually reviewing and assessing the risks within their businesses. These assessments are subject to review and challenge by the FLG risk functions and recorded in a specialist database in order that the data can be reviewed and analysed further both for risk reporting purposes and as an input to the Group's calculation of its economic capital requirements. FLG has adopted the Basel categorisation for risks.

During the year, quarterly reports on the risk profile of the Group and FLG have been provided to the Audit and Risk Committee and the FLG Board Risk and Compliance Committee by ROL and the FLG Chief Risk Officer respectively.

Risk governance

During the year the Board, supported by the Audit and Risk Committee, has been responsible for ensuring that robust risk management practices operated within the Group. Given FLG owns the Group's operational businesses, in practice the Board and Audit and Risk Committee have largely delivered this responsibility by overseeing, with advice from ROL, the effectiveness of risk management within FLG. Accordingly the bulk of the Group's risk governance forums operate at FLG level and it is these that are described further below.

The Board has actively encouraged FLG management and the FLG board to contribute to the development of the Group's risk management framework through further analysis of the risk profile of its business and development of a fuller articulation of FLG's risk strategy, risk appetite and risk monitoring arrangements, consistent with the overall risk appetite set by the Board.

The planned simplification of the Group's governance structure will in effect combine the Board and FLG board reporting levels and result in the underpinning FLG risk governance framework reporting direct to the Board and new Risk Committee. As such the overall governance simplification is not expected to drive change in FLG's underlying risk governance framework.

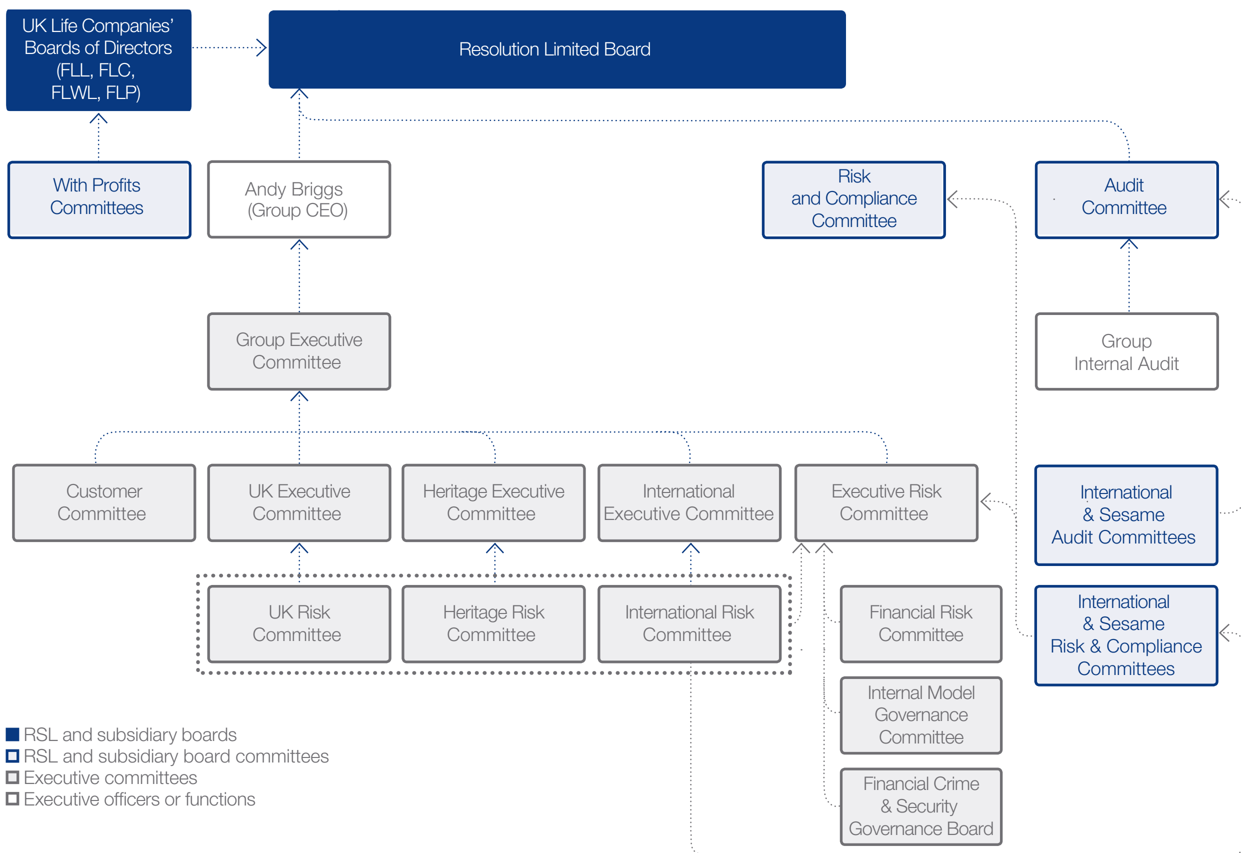
Friends Life group risk governance

The governance structure for risk management post the planned simplification of the Group's governance structure is illustrated below.

The main change in the risk governance arrangements that has been implemented since the publication of the 2011 Annual Report and Accounts is the creation of divisional risk committees reporting in to FLG's Executive Risk Committee in place of the Operational Risk Committee ("ORC"). The Financial Risk Committee ("FRC") remains in place until the assessments of the financial risks are fully embedded in the divisional risk committees, so for a period, risk monitoring will be undertaken by two committees.

As the names of the committees suggested, the ORC previously focused separately on operational risks but did so on a Group-wide basis. The new divisional risk committees in contrast consider on an integrated basis all types of risk within their respective divisions. As such they are expected to increase accountability for risk at local divisional and business unit levels; consistent with the Group's approach that line management, rather than the risk function, is responsible for ensuring effective risk management within their business. It was also considered beneficial for both operational and financial risks, as well as strategic and Group risk impacts to be overseen within the same committee in order that the overall picture and balance of the risk components is readily understood.

A diagram illustrating the Company's governance framework for risk management, after the changes come into effect on 28 March 2013, appears below.



Internal control

The Board is responsible for ensuring 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 the Friends Life group with the policies. FLG has processes in place to ensure that as changes in the Group policies are cascaded down to its subsidiary businesses, gap analyses are performed against any new requirements and plans developed to address any gaps identified.

Delegated authorities and the terms of reference of the Board committees are subject to review at least annually, to ensure they continue to reflect the needs of the Group.

The Group maintains internal audit, risk and compliance functions with specific responsibilities to audit and review risk management and internal control processes and structures across the Group. The scope of these reviews and audits are based on assessments of the risk profile of the Company and its principal subsidiaries, and the results are reported formally to executive management and the relevant committees within the Group. To ensure independence, the Group Internal Auditor has reported during the year and to date to the Chairman of the Audit and Risk Committee. The reporting line will be to the Chairman of the Audit Committee once the simplified governance structure is implemented.

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

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 2012. 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 through to the Audit and Risk Committee. Actions to address the exceptions identified will be monitored by the relevant local audit committee with oversight from the Group Audit Committee that will be constituted as part of the simplification of the Group's governance arrangements from the end of March 2013.

The Board therefore believes that a sound internal control framework has been in place during 2012, 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 25 March 2013.

Board Committee statements

Audit and Risk Committee Chairman's statement

This has been my third 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 in ROL and FLG for their valued contribution to the work of the Committee.

As reported elsewhere in the Annual Report, the Group's governance structure has been reviewed, and from 28 March 2013, the Committee will be replaced with an Audit Committee and a Risk and Compliance Committee, as announced on 8 February 2013. I will chair the Audit Committee and David Allvey will chair the Risk and Compliance Committee.

The new Audit Committee's members will be David Allvey, Phil Hodkinson and Karl Sternberg, in addition to me as Chairman, and the Risk and Compliance Committee will consist of Mel Carvill, Nick Lyons, Robin Phipps, Belinda Richards, and me, in addition to David Allvey as Chairman.

During 2012, a review of the Committee's obligations under its terms of reference was carried out. The terms of reference 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 carries out 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. In future, these matters will be the responsibility of the two new committees, as detailed above. The Committee's terms of reference can be found on the Company's website: www.resolution.gg. The terms of reference of the new Committees will be published on the Company's website after they have been approved by the new committees and the Board.

The composition of the Committee has not changed during the year. Regular Committee meetings are scheduled throughout the 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 80.

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.

Of the new Audit Committee's members, David Allvey, Phil Hodkinson and I have recent and relevant financial experience.

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

- Solvency II implementation;
- the financial and risk impact of FLG's major outsourcing arrangements;
- setting of actuarial assumptions and bases;
- year end audit and half year review;
- reports from the Company's auditors;
- Turnbull and regulatory compliance;
- enhancing and quantifying the Group's key financial risk appetite statements;
- approval of Group policies;
- Individual Capital Assessment for the Group's life companies ("ICA");
- Group business plan;
- compliance with the Company's tax residency;
- review of the Company's auditor;
- review of FLG's risk implementation plan following the appointment of its new Chief Risk Officer;
- regulatory interaction and issues; and
- consideration of reports from Group Internal Audit.

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 attended Committee meetings during the year, together with Tim Tookey, Chief Financial Officer Designate, Andy Briggs, Group Chief Executive Officer Designate, FLG Chief Risk Officer, and FLG Group Actuarial Director. Other appropriate specialist functional heads attended meetings at my request. To further strengthen communication between the Committee, the FLG AC and the BRCC, members of the Committee attend FLG AC and BRCC meetings while the FLG AC Chairman has also attended at a Committee meeting. In addition, I have had meetings with both external and internal auditors on a regular basis.

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. Even where the service is permissible, consideration is always 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 and non-audit services are analysed in note 7b on page 140. The main non-audit services provided by the Company's auditor during the year were in respect of audit related assurance services. The auditor was considered to be best placed to provide these services.

The Company intends to follow the Financial Reporting Council's guidance on auditor rotation contained in the 2012 UK Corporate Governance Code. The Company's auditor was appointed on the Company's incorporation in 2008.

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. As Chairman of the Committee during the year, I will be available at the AGM to respond to any shareholder questions on its activities, together with David Allvey, Chairman of the new Risk and Compliance Committee.

Tim Wade
Chairman of the Audit and Risk Committee

25 March 2013

Remuneration Committee

A separate report on the activities of the Committee and remuneration of directors can be found on pages 90 to 104.

Nomination Committee Chairman's statement

The terms of reference 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 did not change during the year, but will be changing with effect from 28 March 2013, as announced on 8 February 2013. I will chair the Committee until I step down as Chairman of the Company at the conclusion of the AGM on 16 May 2013, following which Sir Malcolm Williamson is expected to succeed me as Chairman of the Company and of the Nomination Committee. Other members of the Committee from 28 March 2013 will be David Allvey, Mel Carvill, Phil Hodkinson and Belinda Richards. For details of directors' biographical details see pages 69 to 75.

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 directors' attendance, see the table on page 80. The Committee's terms of reference can be found on the Company's website: www.resolution.gg

During the year, the Committee recommended:

- the re-election of all of the Company's directors at the Company's 2012 AGM;
- the election to the FLG board of Andy Briggs, Peter Gibbs, Mary Phibbs and Tim Tookey and the re-election of Clive Cowdery and John Tiner as directors of FLG at the Company's 2012 AGM;
- the composition of the Board and of the FLG board to take effect from 28 March 2013, as announced on 19 October 2012.

A regular review is undertaken by the members of the Committee and the executive team to determine whether the Board would benefit from the appointment of additional directors. If a vacancy is 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 other members of the Board, a recommendation is made to the Board.

Since the end of the year, the Committee has considered and made recommendations to the Board relating to:

- the appointment of the Chairman-designate;
- the membership of the Board's principal committees with effect from 28 March 2013; and
- the election and re-election of directors to be put to the Company's 2013 AGM.

A statement on Board diversity is set out on page 67 of the Directors' report.

Michael Biggs
Chairman of the Nomination Committee

25 March 2013

Remuneration report

Remuneration Committee Chairman's statement

I am pleased to present the remuneration report for the 2012 financial year, in my last year as Chairman of the Remuneration Committee (the "Committee").

The Company announced in August 2012 that it no longer considered its externally advised project based structure the best way of delivering shareholder value and that it would no longer pursue a specific exit event for its life insurance group, FLG. The resulting changes to the Company's governance structure, including Board composition, have impacted on the Committee's priorities in a number of ways, and have influenced the Company's remuneration policies as a result.

Overall, the Committee has concluded that while many aspects of the Company's remuneration arrangements continue to be appropriate, some limited amendments are proposed, including changes to FLG's long-term incentive plan together with the adoption of measures such as wider bonus claw-back provisions and the introduction of shareholding ownership guidelines for executive directors.

I am grateful for the hard work of colleagues and advisers to the Committee during the year and I want to thank the members of FLG's Remuneration Advisory Group ("RAG") for providing the Committee with advice on matters relating to FLG remuneration. The RAG comprises independent FLG non-executive directors and is chaired by Sir Malcolm Williamson, the FLG Chairman, and the Company's Chairman Designate.

Following the governance simplification of the Group, the Company will have a single Remuneration Committee in place of a dual committee structure to review the Group's remuneration matters. The new Remuneration Committee will be chaired by Nick Lyons, and other members will be David Allvey, Mike Biggs, Phil Hodkinson and Sir Malcolm Williamson. For directors' biographical details, see pages 69 to 75.

The Committee has considered developments in both regulation and best practice. While the final position regarding the Department for Business, Innovation & Skills ("BIS") proposed changes to the disclosure of executive remuneration is awaited, given the general changes in the remuneration policy introduced as part of the simplification of its governance structure, the Company has decided to adopt a number of the principal new disclosure provisions being proposed by BIS in preparing this report.

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. 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 National Association of Pension Fund guidelines, the FSA's Remuneration Code, Pillar III and CRD IV, and BIS guidance) 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.

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 remuneration proposals.

The Committee, together with the RAG, has carried out a comprehensive review of remuneration arrangements for executive directors and senior executives. This has included a full review of bonus and share plan design, performance measures, market practice and emerging trends in long-term incentive arrangements, and has taken into account the published guidelines of institutional shareholder bodies. The new Committee will build on that review during 2013 and is expected to submit proposals for a new long-term incentive plan to shareholders at the 2014 Annual General Meeting, as explained further in this report. The Committee's appointed remuneration adviser, FIT Remuneration Consultants LLP ("FIT"), has supported the review.

During the year, in respect of executive directors' base salaries, the Committee has continued to have regard to median data for comparative roles. For details of proposed salaries for 2013, see page 103.

For details of the new Board's executive directors' remuneration and non-executive director fees, see pages 101 to 104.

At the Company's 2013 Annual General Meeting ("AGM"), a resolution will be submitted for shareholder approval in respect of limited amendments to the Friends Life Group plc long-term incentive plan ("LTIP"). The changes are proposed in order to continue to properly incentivise the Group's senior executives in light of the move away from a project-based, exit driven structure. The LTIP was primarily designed to reward participants for value created on an exit from FLG, provided that a 12% internal rate of return had been achieved. As the strategy is no longer focused on an exit event, it is proposed to amend the LTIP rules so that the implicit need for an exit event is replaced with a market value based calculation to measure performance on three separate dates, without altering the level of stretch in the performance hurdle. There is no intention to grant further awards under the LTIP after 2013.

In addition, shareholders will also be asked to approve amendments to the Deferred Share Award Plan rules and the adoption of a new Sharesave Plan.

For details of share plans to be presented at the 2013 AGM see pages 98 and 99 and the Notice of Annual General Meeting.

Key matters determined and/or reviewed by the Committee during 2012 included:

- review of senior executive remuneration;
- exit terms of departing senior executives;
- amendments to the LTIP;
- initial work on the design of a new long-term incentive plan;
- shareholding ownership guidelines for executive directors;
- 2012 bonus payments; and
- review of the bonus plan's claw-back provisions.

These matters are described in more detail below.

At the Company's 2012 AGM, the Company secured the support of 90.4% of shareholders voting on the resolution to approve the Company's Remuneration report for 2011, with votes against at 9.6%. Abstentions represented 12.2% of votes cast. The Committee believes that this outcome represented an expression of broad shareholder support for the Company's remuneration policy.

The Committee maintains an active dialogue with its principal shareholders in relation to remuneration matters, a number of whom were consulted regarding the incentive arrangements being presented to the 2013 AGM for approval.

This report has been prepared in line with Schedule 8 of the Large and Medium sized Companies and Groups (Accounts and Reports) Regulations 2008, the best practice provisions set out in the UK Corporate Governance Code and taking into consideration, where feasible, the disclosure requirements of the proposed new BIS regulations.

The report is divided into the following sections:

Section	Page
Remuneration Committee overview	92
Remuneration policy	93
Executive directors	94
Directors' share interests	96
Non-executive directors	100
Performance graph	104

The Group's auditor, Ernst & Young LLP, has audited the information contained in the tables on pages 94 to 104 of this report.

The Remuneration report has been prepared by the Committee and has been approved by the Board for submission to shareholders. A resolution to approve the Remuneration report will be proposed at the AGM on 16 May 2013 and will be subject to an advisory vote.

Nick Lyons, in his capacity as Chairman of the Committee from 28 March 2013, will be available at the AGM to respond to any shareholder questions on the proposed incentive arrangements for 2013. The Chairman, Mike Biggs, who served on the Committee during the year, will also attend and will be able to answer questions on the Committee's activities in 2012.

Gerhard Roggemann
Chairman of the Remuneration Committee

25 March 2013

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 Company's 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 FLG 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"), with the exception of one small subsidiary, the Committee acknowledges that the FSA Code is reflective of best practice and the Company will seek to comply with its guidance for 2013 and in future.

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 employee or director, or the Chairman, 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
Chairman	Remuneration Committee
Non-executive directors	Chairman and ROL Chief Executive
FLG non-executive directors	Remuneration Committee
Relevant individuals	Remuneration Committee

Going forward, consistent with best practice, fees for the Company's non-executive directors will be determined by the Chairman in conjunction with the Board's executive directors.

Details of Committee membership are set out in the Directors' report on pages 69 to 71. All members of the Committee are considered to be independent, with the exception of Mike Biggs, who was independent on appointment.

During the course of 2013, the responsibilities of the new Committee will be reviewed in light of the Company's revised governance structure, and its revised terms of reference will be published on the Company's website, once approved.

Advisers

During the year, FLG's Human Resources and Business Services Director and Director of Performance and Reward attended Committee meetings and were invited to provide their views and advice.

The Committee's work was supported by independent professional advice from FIT. FIT is a member of the Remuneration Consultants Group (the professional association for executive remuneration consultants) and adheres to its code of conduct. FIT's fees in respect of 2012 were £60,000 incurred in advising the Committee and £109,000 for the RAG (in its role of reviewing initial proposals for consideration by the Committee). FIT undertook no other work for the Group.

Attendance at Committee meetings is shown in the table on page 80. 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 79.

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 behaviours.
- **Time horizons:** there must be an appropriate balance between short- and long-term remuneration.
- **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.
- **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 Committee engages appropriately with the Company's largest shareholders and their representative bodies. The Committee actively consulted and considered feedback from major shareholders prior to finalising the remuneration proposals being presented to shareholders for approval at the 2013 AGM, to ensure that the proposals are aligned with the delivery of shareholder value.

Summary of FLG executive director remuneration

	Purpose	Policy and maximum remuneration opportunity
FIXED ELEMENTS		
Base salary	To recruit and retain key employees Reflect individual's role and responsibility within FLG	To set base salaries competitively when assessed against companies of a similar size in terms of market capitalisation and complexity 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 and other FTSE 350 insurers The Committee also has regard to relativities between directors and employees. Average salary increases for employees in 2012 were 2.5% and for 2013 will be 2% Take into account FLG performance, and individual performance and responsibilities Review base salaries of executive directors in the context of the wider employee pay review
Pension	Provide a framework to save for retirement	Provide market competitive post-retirement benefits within a defined contribution scheme
Benefits in Kind	Provide other benefits valued by recipient	Provide market competitive benefits in kind
VARIABLE ELEMENTS		
Annual bonus	Incentivise executives to achieve key goals on an annual basis To focus on the key financial and non-financial metrics of the business and performance against a set of individual objectives	Maximum awards are set broadly in line with FTSE 100 market practice at 175% of base salary for the Group CEO and 150% for the CFO. The maximum bonus for the Group CEO will be reduced to 165% from 1 April 2013 in conjunction with his salary increase Target bonus opportunities are 50% of the maximum award One-third of any annual bonus paid is deferred into shares for a period of three years
LTIP	Incentivise key individuals over the longer term in a way which is aligned with the strategy of the Company and the delivery of value to shareholders	Participants are entitled to an award under the scheme if the value realised from FLG exceeds the amount of capital contributed into FLG (primarily to fund acquisitions) plus an agreed internal rate of return The total value of the pool available for distribution to participants is 2% of the increase in realised value (the Company will also bear employers' NICs in addition to the 2%) since the Company's first acquisition in November 2009 An internal rate of return of 12% p.a. over the measurement period must be achieved before any realised value is delivered to participants. Once the internal rate of return is achieved, awards are made on the basis of the total increase in realised value Awards to new joiners will be pro-rated where they have joined part-way through the UK Life Project (subject, in some cases, to an underpin that pro-rating will not reduce the units by more than 50%)
New hires and promotions	To secure the appointment and promotion of high-calibre executives	For appointments involving external candidates additional cash and/or share based incentives may be offered. For internal appointments, any variable pay element awarded in respect of the prior role may either continue on its original terms or be adjusted to reflect the new appointment as appropriate

Operation in 2012 and proposed changes from 2013
Paid monthly in cash Salary reviews take place annually in April. From April 2013, the following salaries for executive directors are proposed: Andy Briggs, Group CEO £675,000 (2012: £600,000) Tim Tookey, CFO £650,000 (2012: £650,000)
Executive directors on legacy contracts participated in the FLG pension plan ("FPP") on the standard employee terms with any excess over the pensionable salary cap paid as an additional allowance equivalent to 20% of the difference between actual salary and the pensionable salary cap Andy Briggs and Tim Tookey do not participate in the FPP and instead receive a pension allowance of 20% of base salary (which is not taken into account for bonus or insured benefits purposes)
Car allowance, chauffeur expenses (for Group CEO only), income protection, life assurance and medical insurance
Measured annually, with criteria built around a balanced scorecard Paid in one tranche (less the deferred share award) in March following the year end Performance assessed against a number of financial and strategic corporate targets as well as individual performance 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 Bonus payments are subject to claw-back in certain circumstances and, for 2013 bonuses, the claw-back has been extended to include the ability to claw-back (or to reduce unvested share incentive awards) where circumstances have created a sufficiently significant impact on the reputation of the Group to justify, in the view of the Committee, the operation of claw-back
Initial awards were made in March 2010, with further awards made subsequently The Company is seeking shareholder consent at the 2013 AGM to make amendments to the LTIP, by introducing a market value based calculation, to enable measurement of performance in the absence of an exit event. One-third of participants' units (before the application of pro-rating) will be measured against the LTIP's existing internal rate of return performance threshold on each of 30 June 2014, 2015 and 2016 under the new mechanism. The total number of units which may be delivered under the plan will be further reduced after the impact of pro-rating, to 75% of the initial pool (1.5% of the increase in value). The original 12% per annum internal rate of return hurdle rate will continue as before
Where it is necessary to make a recruitment related award to an external candidate, the Company will not pay more than the Committee considers necessary. All such awards for external appointments will take account of the nature, time-horizons and performance requirements of any remuneration relinquished by the individual when leaving a previous employer, and will be appropriately discounted to ensure that the Company does not, in the opinion of the Committee, overpay

Directors' share interests for the year ended 31 December 2012

The directors' beneficial interests in the Company's shares are set out below.

	Number of ordinary shares held at 1 January 2012 (or date of taking up office, if later)	Number of ordinary shares held at 31 December 2012 (or date of leaving office, if earlier)	% of issued share capital at 31 December 2012
Company directors			
Jacques Aigrain	80,066	84,880	0.006
Gerardo Arostegui	90,000	90,000	0.006
Michael Biggs	113,513	113,513	0.008
Mel Carvill	62,400	62,400	0.004
Fergus Dunlop	–	–	–
Phil Hodkinson	–	–	–
Denise Mileham	18,595	18,595	0.001
Peter Niven	–	–	–
Gerhard Roggemann[1]	18,000	18,000	0.001
Tim Wade	40,000	40,000	0.003
FLG directors[2]			
David Allvey	–	–	–
Evelyn Bourke[3]	170,848	171,397	0.012
Andy Briggs[4]	113,721	227,493	0.016
Clive Cowdery[5]	240,000	8,487,184	0.598
Peter Gibbs	–	–	–
David Hynam[6]	270	270	0.000
Nick Lyons	–	–	–
Andy Parsons[7]	743	743	0.000
Mary Phibbs	–	–	–
Robin Phipps	2,100	2,100	0.000
Belinda Richards	–	–	–
Karl Sternberg	–	–	–
John Tiner	2,829	2,829	0.000
Tim Tookey[8]	–	67,735	0.005
Sir Malcolm Williamson	51,078	55,975	0.005

Notes
1. Gerhard Roggemann also served as a director of FLG during 2012.
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 99. Since the end of 2012, Andy Briggs has acquired a further 144 shares under the SIP.
3. Evelyn Bourke left FLG's board on her resignation from FLG on 21 September 2012.
4. As part of his terms of joining, Andy Briggs received the second of three share transfers on 1 June 2012. 236,920 shares in the Company were allocated but, with his agreement, 123,199 shares were withheld to meet the Income Tax and National Insurance contributions liabilities so the net number of shares transferred was 113,721 shares in the Company.
5. Clive Cowdery became the sole shareholder of Resolution Capital Limited ("RCAP") on12 December 2012. RCAP holds 8,247,184 shares in the Company and Mr Cowdery is the indirect owner of these shares.
6. David Hynam resigned as a director of FLG on 17 December 2012 (but remains an employee of FLG).
7. Andy Parsons resigned as a director of FLG on 30 March 2012, and left FLG on 10 June 2012.
8. As part of his terms of joining, as reported on page 97, Tim Tookey received the first of three share transfers on 28 March 2012. 141,116 shares in the Company were allocated but, with his agreement, 73,381 shares were withheld to meet the Income Tax and National Insurance contributions liability so the net number of shares transferred was 67,735 shares in the Company. On 5 March 2013, being the first anniversary of his joining, Tim Tookey became entitled to receive a further 96,037 shares in the Company. These shares, net of Income Tax and National Insurance contribution liabilities will be transferred to him when the Company is not in a close period.

Share ownership guidelines

As part of the review of remuneration, at the recommendation of FLG's reward team and the RAG, the Committee approved the introduction of share ownership guidelines for executive directors ("Guidelines") to further strengthen the alignment between the interests of executive directors and those of shareholders. Andy Briggs, Group Chief Executive Officer will be required to acquire and maintain an interest in the Company's shares over time equivalent to 300% of base salary, and Tim Tookey, Chief Financial Officer, will be required to acquire and maintain an interest equivalent to 250% of base salary, and all shares that vest (after deductions for the settlement of tax liabilities) from participation in share plans must be retained until the thresholds have been achieved, and subsequently maintained.

As shown in the table on page 96 as at 31 December 2012, Andy Briggs held 227,493 shares, which represented 93.8% of his base salary and Tim Tookey held 67,735 shares, which represented 25.8% of his base salary.

Share awards

FLG executive director		Date of award[1]	Opening balance 1 January 2012 or date of taking up office, if later	Shares awarded during year	Shares lapsed during the year	Vested during the year	Closing balance 31 December 2012 or at date of leaving office if earlier	Vesting date
Evelyn Bourke[1]	DSAP	31 Mar 2011	4,579	–	(4,579)	–	–	
	DSAP	3 April 2012	–	42,040	(42,040)	–	–	
	Total		4,579	42,040	(46,619)	–	–	
Andy Briggs[2]	Recruitment	1 June 2011	473,840	–	–	(236,920)[6]	236,920	1 June 2013
	DSAP	3 April 2012[5]		44,628	(42,040)	–	44,628	31 Dec 2014
	Total		473,840	44,628	(46,619)	(236,920)	281,548	
Andy Parsons[3]	DSAP	3 April 2012	–	24,542	–	(24,542)	–	
	Total		–	24,542	–	(24,542)	–	
David Hynam	DSAP	31 Mar 2011	27,299	–	–	–	27,299	31 Dec 2013
	DSAP	3 April 2012	–	68,005	–	–	68,005	31 Dec 2014
	Total		27,299	68,005	–	–	95,304	
Tim Tookey[4]	Recruitment	5 Mar 2012	–	568,501	–	(141,116)[7]	96,037	5 Mar 2013
	Recruitment	5 Mar 2012	–	–	–	–	331,348	5 Mar 2014
	Total		–	568,501	–	(141,116)	427,385	

Notes

Under the Deferred Share Award Plan ("DSAP") one-third of the annual bonus for any year is delivered as a conditional award over shares in the Company ("shares"), which vests after three years from the end of the preceding financial year end. If a DSAP participant resigns before the vesting date of the award, the shares subject to it will be forfeited, unless the Committee decides otherwise.

1. Evelyn Bourke's awards lapsed on her resignation from FLG.
2. As reported in 2011, Andy Briggs received this award as part of the terms of his joining, to compensate him for awards foregone on leaving his previous employer. The awards are subject to claw-back if he resigns or is summarily dismissed before 31 May 2014.
3. Andy Parsons' award vested on 10 June 2012, on the early termination of his interim appointment following Tim Tookey joining as CFO. Shares were transferred on 12 June 2012 and the market value of a share on that day was 195.3 pence.
4. As reported in 2011, Tim Tookey received this award as part of his joining FLG, to compensate him for awards foregone on leaving his previous employer. The awards are subject to claw-back if he resigns or is summarily dismissed before 5 March 2015.
5. The market value of a share on 3 April 2012, the date on which awards were made under the DSAP, was 259.0 pence.
6. The market value of a share on 1 June 2012, the date on which the second tranche of Andy Briggs' recruitment award vested was 192.4 pence.
7. The market value of a share on 28 March 2012 the date on which the first tranche of Tim Tookey's recruitment award vested was 263.2 pence.

FLG Long-term incentive plan ("LTIP")

The LTIP was established early in 2010, the key features of which are set out in the table on pages 94 and 95. The LTIP creates a profit pool which is divided into a maximum of 10,000 units (of which 64% 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 below and 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. Under the terms of the LTIP:

- no award will vest until the threshold under the LTIP rules is achieved;
- in the event of an exit of the Company or FLG before 30 June 2014, current pro-rating provisions will apply and, in the event of such an exit between then and 30 June 2016, any unvested tranches will be subject to measurement and pro-rating on the date of the event with payment deferred to September 2015 or 2016 as explained in the Notice of AGM; and
- if a participant leaves the Group as a result of the disposal of a single business, the normal rules will continue to apply but his or her award will not be pro-rated to reflect such early disposal.

FLG executive director	Total units at 1 January 2012	Units awarded during the year	Units lapsed or released during the year	Total units at 31 December 2012 or date of leaving office if earlier
Evelyn Bourke[1]	700	–	(700)	–
Andy Briggs	1,100	400	–	1,500
David Hynam	500	–	–	500
Andy Parsons[2]	150	–	(150)	–
Tim Tookey	–	1,200	–	1,200

Notes
1. Evelyn Bourke's award lapsed on her leaving FLG on 21 September 2012.
2. Andy Parsons' award was pro-rated to his leaving date of 10 June 2012, at which time his award was bought out at a cost of £75,000 and his participation in the LTIP ceased.

LTIP proposals

As explained in the Remuneration Committee Chairman's statement, during the year, in light of the changes announced in August 2012, the Committee undertook a comprehensive review of remuneration arrangements. It is proposed that the current LTIP, in which the executive directors and senior management of FLG participate, is to be amended, subject to the approval of shareholders at the 2013 AGM.

As the rules are currently structured, an award would only be made under the LTIP if the realised value from FLG exceeded the net capital contributed into FLG (primarily to fund acquisitions) plus a 12% per annum internal rate of return. This essentially incentivises participants to effect a sale of FLG businesses to trigger a pay-out during the lifetime of the LTIP. As the Group's strategy no longer involves targeting a specific exit event, but instead is focused on ensuring that FLG is a successful and sustainable life insurance group with a clear and strong cash profile focused on maximising shareholder value, it is considered appropriate to address this misalignment with Group strategy by replacing the implicit need in the LTIP rules for an exit, with a market value based calculation to measure performance, without impacting the level of stretch in the performance targets.

The proposed amendments provide that:

- one-third of the units awarded to each individual (before the impact of pro-rating) will be measured against the existing performance threshold test as at each of 30 June 2014, 30 June 2015 and 30 June 2016;
- given the absence of a planned exit by the Company, the share price of the Company at the relevant time will be used to determine the value realised from FLG, with an adjustment for any net assets of the Company which do not form part of FLG (such as cash held by the Company itself). Accordingly, the relevant units will vest if the aggregate of actual distributions from FLG to the Company plus the deemed value exceeds the aggregate amount of the contributions made to FLG plus the 12% cumulative return; and which, as at 31 December 2012, would have required a Company share price of 337 pence per share;
- an average share price over the 40 business days following the measurement date will be used to determine the deemed value;
- as performance is proposed to be measured on three separate dates, any resulting entitlement for the units to which each test applies will be settled in full following each calculation;

- if there is a change of control of the Company prior to 30 June 2016, the offer price will be used to determine the value realised from FLG and any unvested tranches of the units awarded to each individual will be subject to measurement and pro-rating on the date of the change of control, with payment deferred to September 2015 or September 2016;
- the current pro-rating provisions will apply and will be calculated to each measurement date. The effect of pro-rating will be to reduce Andy Briggs' 1,500 units to 1,075.20 and Tim Tookey's 1,200 units to 694.40;
- to ensure that measurement of Group performance does not give rise to unintended consequences, recognising that the targets were designed with a subsidiary structure in mind, the Committee will be given discretion to adjust the formula to ensure that the LTIP operates as originally intended; and
- to ensure compliance with the share ownership guidelines summarised on page 97, the rules will be amended to permit awards to be satisfied in shares of the Company.

In summary, therefore, the commercial impact of these modifications is essentially to introduce an alternative market value based approach in measuring performance under the LTIP (in three tranches) in the absence of an exit, but to have no impact on the level of stretch in the targets.

No further LTIP awards will be made to Andy Briggs or Tim Tookey. Additional awards will be made during 2013 to senior management, but no further awards under the LTIP will be made beyond 2013. As explained earlier, the available pool for awards under the LTIP, assuming full vesting, and after allowing for pro-rating will be reduced from the current 2% of the growth in value of FLG over the period to 1.5% (in both cases plus employers' NI).

Deferred Share Award Plan ("DSAP") proposals

As set out on page 104, under the Deferred Share Award Plan ("DSAP") one-third of the annual bonus for any year is delivered to participants as a conditional award of shares in the Company, which vests after three years. It is proposed to amend the rules of the DSAP to permit executive directors to participate, to permit awards to be satisfied by newly issued shares, as well as to include wider claw-back provisions, and consistent with market practice, dividend roll up for consistency or accrual. Under the rules, which will be presented for approval by shareholders at the 2013 AGM, the Committee will have discretion to reduce the award on vesting (to nil, if appropriate) and/or "claw-back" amounts already vested, within three years of the vesting of an award. The vesting period will be lengthened to the three years from the actual date of grant.

If approved at the AGM, the first awards made under the amended plan will be granted in 2013 in respect of bonuses awarded for 2012.

Save As You Earn scheme ("SAYE") proposals

SAYE rules will be presented for approval by shareholders at the 2013 AGM, to enable the Company to operate a HMRC approved SAYE scheme for all UK tax resident employees, including executive directors.

Share incentive plan ("SIP")

During 2012, the Group continued to operate a HMRC approved SIP which is open to all UK tax resident 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 legislation permits such additional awards.

FLG executive director	SIP participation in 2012
Evelyn Bourke	£125 per month until Sep 2012
Andy Briggs	£125 per month from Dec 2012
David Hynam	n/a
Andy Parsons	n/a
Tim Tookey	n/a

Non-executive directors' terms of appointment and fees

In respect of the period up to 27 March 2013, the non-executive directors of the Company who served during the year all had letters of appointment which included a six month notice provision. FLG non-executive directors were all subject to one month's notice.

Non-executive directors do not have any entitlement to pensions, annual bonuses, share options or long-term incentives.

Fees for the year ended 31 December 2012

The Company's non-executive directors receive a fee in respect of the services they provide to the Company. These fees are determined by the Chairman, in consultation with the Chief Executive of ROL. 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 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.

Company Board 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

Company directors	Fees 2012 £'000	Fees 2011 £'000
Jacques Aigrain	93	93
Gerardo Arostegui	93	93
Michael Biggs	360	360
Mel Carvill	103	103
Fergus Dunlop	93	93
Phil Hodkinson	128	128
Denise Mileham	103	103
Peter Niven	93	93
Gerhard Roggemann	98	98
Tim Wade	118	118
Total	**1,282**	**1,282**

FLG's non-executive directors' fees have been set at a lower level than for the Company's non-executive directors, reflecting the status of FLG as a subsidiary. 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

FLG directors	Fees 2012 £'000	Fees 2011 £'000
David Allvey	120	120
Peter Gibbs[1]	95	35
Nick Lyons	115	115
Mary Phibbs[2]	75	32
Robin Phipps[3]	130	130
Belinda Richards	75	75
Gerhard Roggemann	60	60
Derek Ross	130	130
Karl Sternberg	90	90
Sir Malcolm Williamson	300	300
Total	**1,190**	**1,087**

Neither Clive Cowdery nor John Tiner received any fees in respect of their non-executive directorship of FLG during the year ended 31 December 2012.

Notes
1. Peter Gibbs was appointed on15 July 2011 and his fees were pro-rated accordingly for 2011. Peter received £20,000 in respect of his chairmanship of Friends Life Investments Limited from 1 May 2012. The fee for this role is £30,000 per annum.
2. Mary Phibbs was appointed on 27 July 2011 and her fees were pro-rated accordingly for 2011.
3. Includes a fee of £30,000 received as Chairman of the FLG With-Profits Committee.

Non-executive directors' appointment terms and fees from 1 April 2013

All non-executive directors who will be on the Board on 28 March 2013 have entered into new letters of appointment, which provide for one month's notice.

Non-executive directors who are retiring from the Company's Board and/or FLG's board on 28 March 2013 will be paid fees in lieu of notice, according to their notice periods (six months for the Company's directors and one month for FLG directors) which is a contractual entitlement of those directors and not an ex-gratia payment. Mike Biggs will not receive any fees in lieu of notice once he steps down from the Board at the conclusion of the Company's AGM on 16 May 2013.

The proposed fees for the non-executive directors from 1 April 2013 are set out below, and are based on 2012 fee levels, except that, an adjustment has been made to reflect the fact that a separate Risk and Compliance Committee will be constituted from 28 March 2013. All the directors on the Board will also sit on FLG's board, and no separate fees will be payable in respect of these appointments.

Director	Base fee	SID fee	Audit Committee	Investment Oversight Committee	Nomination Committee	Remuneration Committee	Risk and Compliance Committee	Total
David Allvey	67,500	–	25,000	–	10,000	15,000	40,000	157,500
Michael Biggs	360,000	–	–	–	–	–	–	360,000
Mel Carvill	67,500	–	–	–	10,000	–	25,000	102,500
Clive Cowdery	67,500	–	–	–	–	–	–	67,500
Peter Gibbs[1]	67,500	–	–	15,000	–	–	–	82,500
Phil Hodkinson	67,500	25,000	25,000	–	10,000	15,000	–	142,500
Nick Lyons	67,500	–	–	15,000	–	30,000	25,000	137,500
Robin Phipps[2]	67,500	–	–	–	–	–	25,000	92,500
Belinda Richards	67,500	–	–	–	10,000	–	25,000	102,500
Karl Sternberg	67,500	–	25,000	30,000	–	–	–	122,500
John Tiner	67,500	–	–	–	–	–	–	67,500
Tim Wade	67,500	–	40,000	–	–	–	25,000	132,500
Sir Malcolm Williamson[3]	300,000		–	–	–	–	–	300,000
Total	1,402,500	25,000	115,000	60,000	40,000	60,000	165,000	1,867,500

Notes

1. Peter Gibbs will receive an additional £30,000 per annum in respect of his Chairmanship of Friends Life Investments Limited.
2. Robin Phipps will receive an additional £30,000 per annum in respect of his Chairmanship of the FLG With-Profits Committee.
3. Sir Malcolm Williamson's fee will increase to £360,000 per annum when he succeeds Mike Biggs as Chairman at the conclusion of the Company's 2013 AGM.

Committee	Member's fee (£ p.a.)	Chairman's fee (£ p.a.)
Audit Committee	25,000	40,000
Investment Oversight Committee	15,000	30,000
Nomination Committee	10,000	n/a
Remuneration Committee	15,000	30,000
Risk and Compliance Committee	25,000	40,000

Executive directors' service agreements

The service contract for executive directors of FLG 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 was, and David Hynam is, employed on legacy contracts, which provide for 12 months' notice by the employer and six months' notice by the employee. 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 remained on his legacy contract, which provided for six months' notice by either party. It included express permission for the employer to terminate without notice and compensation in defined misconduct cases. There were no payment in lieu of notice provisions so general principles would apply although the contract specified 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.

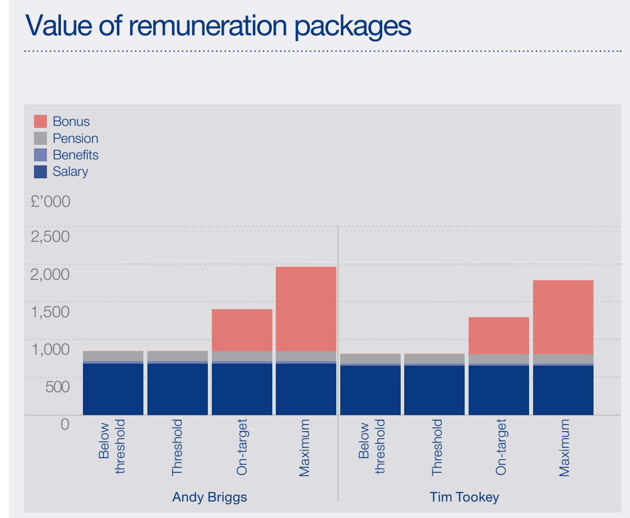
FLG executive director		Date of contract	Notice period due from FLG	Notice period due from director
Evelyn Bourke	Chief Executive Officer, Heritage (to 21 Sep 2012)	1 May 2009	12 months	6 months
Andy Briggs	Group Chief Executive Officer	27 Sep 2011	12 months	12 months
David Hynam	Chief Operating Officer (to 17 Dec 2012)	15 Sep 2010	12 months	6 months
Andy Parsons	Interim Executive Director, Finance (to 30 Mar 2012)	7 Sep 2010	6 months	6 months
Tim Tookey	Chief Financial Officer (from 5 Mar 2012)	27 April 2012	12 months	12 months

Executive directors' emoluments for the year ended 31 December 2012

FLG executive director	Base Salary £'000	Benefits in Kind £'000	Pension £'000	Total Annual Bonus £'000	Other £'000	Total 2012 £'000	Total 2011 £'000
Evelyn Bourke[1]	328	10	46	–	–	384	861
Andy Briggs[2]	600	36	120	478	125	1,359	1,032
David Hynam[3]	400	13	53	295	–	761	1,006
Andy Parsons[4]	75	4	9	75	316	479	732
Tim Tookey[5]	537	15	107	371	411	1,441	–

Notes
1. Evelyn Bourke ceased to be a director when she resigned from FLG on 21 September 2012 and did not receive any termination payment.
2. As agreed and disclosed on his appointment, Andy Briggs received a cash payment of £124,500 on 1 June 2012 and 236,920 shares in the Company, as disclosed in the table on page 96. The cash amount paid on joining is included in the emoluments table.
3. David Hynam ceased to be a director of FLG on 17 December 2012 (but remains an FLG employee).
4. Andy Parsons ceased to be a director on 30 March 2012 and left FLG on 10 June 2012 and received £316,000, comprising salary, benefits and pension allowance from 31 March to 10 June 2012 and was inclusive of redundancy and severance payments amounting to £175,000.
5. As disclosed in last year's report, on his appointment, Tim Tookey received a cash payment of £411,213 and 141,116 shares in the Company on 28 March 2012, as disclosed in the table on page 96. The cash amount paid on joining is included in the emoluments table.
6. The above table includes the full bonus earned in respect of the 2012 financial year, including any element which will be allocated as a conditional share award under the DSAP in 2013. The table on page 97 shows the number of shares allocated as a conditional share award in 2012 in respect of the bonus earned for the 2011 financial year.

Potential total reward



Note: the above table shows the annualised potential rewards available to the executive directors, based on remuneration from 1 April 2013, ignoring share price appreciation and roll-up of dividends on deferred bonus elements. On-target bonus represents 50% of maximum bonus opportunity. No LTIP element is shown as the Company will not commence annual LTIP grants before 2014 (under a new LTIP which it is intended will be presented to shareholders at the 2014 AGM).

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 2012. Fees of €45,000 were paid to and retained by Evelyn Bourke in respect of her directorship of IFG Group plc for the year ended 31 December 2012.

Executive directors' appointment terms and salaries from 1 April 2013

The Group Chief Executive Officer Designate, Andy Briggs, and the Chief Financial Officer Designate, Tim Tookey, will be appointed to the Company's Board with effect from 28 March 2013.

In the context of the Company's governance restructure, the Committee has reviewed the remuneration of Andy Briggs and Tim Tookey. While it has been decided not to increase Tim Tookey's remuneration, the Committee recommends that Andy Briggs' salary be increased to £675,000 per annum, based on the forthcoming increase in his responsibilities as Group Chief Executive Officer. The review covered total executive remuneration and it is proposed that whilst Andy Briggs' salary be increased, his bonus opportunity should decrease from 175% to 165%. The proposed salary increase and bonus reduction will be effective from 1 April 2013.

Executive directors' 2012 bonus

80% of the 2012 bonus entitlement has been assessed according to corporate performance targets, which are designed to support the Group's strategic objectives (of which 60% comprise financial targets). 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 Company's financial targets and their relative weightings are shown in the table below.

Measure	Weighting
Cash	20%
IRR	15%
MCEV operating profit before tax	15%
Expense management	10%
Total	60%

The Chief Risk Officer has been involved in considering the bonus outcomes for all financial metrics and the risk and control metrics respectively. In accordance with best practice, the Chief Risk Officer's own annual bonus arrangements exclude the measurement of any financial performance.

The table below shows the degree of achievement of the 2012 bonus targets for each executive director's 2012 bonus plus the actual bonus paid as a percentage of salary. In agreeing the final bonus outcomes for the FLG executive directors, the Committee exercised discretion to adjust elements earned under the formulaic bonus plan by Andy Briggs and David Hynam, taking into account the additional one-off costs communicated in November 2012. The table below includes the percentage reductions applied by the Committee.

Two-thirds of the 2012 bonus will be paid in cash. The remaining third will be payable in deferred shares under the DSAP, following approval of amended DSAP rules at the 2013 AGM. The amendments include wider claw-back provisions, and the Committee will have discretion to reduce the award on vesting (to nil, if appropriate) and/or "claw-back" amounts already vested, within three years of the vesting of an award.

2012 bonus element	Evelyn Bourke	Andy Briggs	David Hynam	Andy Parsons	Tim Tookey
Financials (as % of max, 60% weighting)	–	43.7%	46.0%	n/a	39.4%
Non-financials (as % of max, 20% weighting)	–	51.7%	65.4%	n/a	30.9%
Individual (as a % of max, 20% weighting)	–	70%	44.7%	n/a	82.1%
Total pre-adjustment	**–**	**50.7%**	**49.7%**	**50.0%**	**46.3%**
Committee adjustment	–	(10.1%)	(25.7%)	n/a	–
Total post-adjustment	–	45.5%	36.9%	60.0%	46.3%
2012 Maximum Bonus (as a % of salary)	–	175%	200%	120%	150%
2012 Actual Bonus (as a % of salary)	–	79.7%	73.8%	60.0%	69.5%

Notes
1. Percentages have been rounded up to one decimal place so do not add up.
2. The adjustments to Andy Briggs' and David Hynam's bonus criteria relate to the exercise of discretion by the Committee to reflect the additional one-off costs communicated in November 2012.
3. Tim Tookey's bonus has been pro-rated for the time employed.
4. This payment was made on Andy Parsons' leaving date based on an On Target performance assessment made at the time.

Executive directors' 2013 bonus

The performance criteria for the 2013 annual bonus will be based on a balanced scorecard approach as set out in the table below:

Type	Measure	2013 weighting
Financial	Cash (Sustainable Free Surplus)	20%
	IRR	15%
	MCEV operating profit before tax	15%
	Expense management	10%
Customer	Customer Index	8%
Colleague	Colleague Engagement	6%
Risk & Control	Risk Index	6%
Individual	Individual Key Performance Indicators	20%

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 2012. The FTSE 100 has been chosen as being the most relevant comparator index.

On behalf of the Board

Gerhard Roggemann
Chairman of the Remuneration Committee
25 March 2013

Corporate responsibility

Overview

The Board has reaffirmed its commitment to complying with industry best practice in corporate responsibility. The Corporate Social Responsibility Committee ("CSR Committee"), chaired by Phil Hodkinson, has responsibility for ensuring that this commitment is met.

During 2012, the CSR Committee, which also comprised the ROL Head of Secretariat and senior members of FLG's HR and corporate affairs teams, met five times. Its main activities included considering CSR strategy and overseeing the Group's overall CSR programme, including diversity initiatives, implementation of the Living Wage, forthcoming changes to external reporting in light of regulatory developments, and reviewing the Group Corporate Social Responsibility Policy (CSR Policy").

The CSR 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 Company's corporate responsibility programme are set out below.

Reflecting the Company's desire to meet best practice, Phil Hodkinson continues to represent the Company on the board of the leading business-led charity, Business in the Community ("BitC").

Corporate social responsibility strategy

During 2011, the Company commissioned Forum for the Future ("Forum") to outline the environmental, social and governance trends 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.

As reported last year, the 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 CSR Committee incorporated the outcome of this materiality analysis into the Company's strategic corporate responsibility framework, and during the year, the analysis was revisited, given the change in the Company's strategic direction. It was concluded that the Company's strategic CSR objectives remained the same.

The Committee regularly reviews FLG's CSR agenda and strategy, via members of its HR and corporate affairs teams. FLG's annual CSR programme was approved by the Group Executive Committee ("GEC") in August 2012. The governance of the programme has been strengthened by the creation of two new committees whose joint objective is to embed CSR into FLG's culture. FLG has partnered with BitC to identify opportunities for improvement, including clearer leadership of FLG's CSR programme.

Corporate responsibility within the business

Customers

Maintaining the highest quality of service to customers is an ongoing priority. FLG is guided by the Principles of Treating Customers Fairly ("TCF"), a regulatory initiative, which is implemented under the auspices of the FLG Customer Committee. Across FLG, each business unit has defined relevant key performance indicators specific to their function, within a TCF framework. Individual performance measures and responsibilities for senior management in the Group include a variety of customer-related indicators.

In FLG's Protection business, to continue to add value to Group Critical Illness scheme members, a number of enhancements to the list and extent of diseases covered beyond standard ABI definitions were added during the year, and improvements were made to product terms and conditions.

Mental health is a major cause of claims against Income Protection policies. Consequently, FLG has continued its relationship with the mental health charity Mind, encouraging greater employer understanding and support for affected employees. This partnership culminated in FLG's sponsorship of the 2012 Mind Media Awards.

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.

Since the Company last reported on the Board's commitment to the Living Wage for all UK employees and contract workers, Living Wage has been incorporated into the Group's pay policy and review process. In March 2013, FLG was accredited with the Living Wage Foundation as a Living Wage employer.

For the purpose of measuring employee engagement, regular employee surveys are carried out to ensure that concerns can be communicated and addressed. However, ongoing organisational restructuring involving redundancies has had a negative effect on employee engagement and affected employee survey scores, compared to 2011.

From November 2011 to November 2012, employee engagement in FLG rose from 52% to 56% but remained 17% below the Financial Services Sector Index (73%). There was a 5% drop in the FLG scores from April to November, largely driven by organisational restructuring. Employee engagement continues to be a key focus area for FLG's GEC, and action plans to address the low scores were finalised in February 2013.

Diversity

FLG's GEC regularly monitors diversity statistics covering age, gender, disability, and monitors salary split by gender across the organisation, and the analysis of diversity statistics in developing recruitment, performance measurement and working practices.

FLG is actively seeking to build in-house diversity expertise through external networking and its continuing partnership with BitC.

At present, there are no specific programmes or initiatives in place to increase gender diversity in FLG's senior management population, which has been identified as a key reason why the proportion of women in senior management is low compared with the gender split across the organisation. FLG's GEC are reviewing this, and during the year FLG introduced a revised talent review and succession planning process to encourage employees to reach their full potential, to retain talent, and to provide greater visibility of career pathways. The revised process will form part of FLG's development of its diversity agenda, which will focus on gender diversity and encouraging female talent progression.

Currently, only 11% of FLG's GEC population is female. The gender split across all job grades in the Group remained at around 50%.

The Company's Board, which during the year discussed and considered ways of increasing gender diversity, fully supports FLG's initiatives to increase the pool of female senior management, and thus in time, to increase the percentage of women on the Board and on the GEC.

For further details on Board diversity, see page 67 of the Directors' report.

Environment

During the year, 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 24,395 tonnes CO_2 (2011:27,100 tonnes CO_2) which equates to an intensity of 0.21 tonnes per m^2 or 6.48 tonnes per employee (2011:0.18 tonnes per m^2 or 4.72 tonnes per employee). Besides energy consumption, the Company seeks to manage waste and water. In 2012, 2,257 tonnes or 63% of waste was recycled (2011:56%), the remaining 1,313 tonnes going to landfill (2011:2,160 tonnes). Total water consumption was 78,428 m^3 (2011:89,900 m^3), which equates to an intensity measure of 20,800 litres of water per employee (2011:15,600 litres).

FLG has implemented a number of local employee initiatives to reduce environmental impact of the organisation through its continued collaboration with Global Action Plan, the environmental behaviour change charity.

Community

The total community investment in 2012 was £1,214,000 (2011: £1,487,000), measured according to London Benchmarking Group guidelines. Employees volunteered 6,700 hours in company time and raised a further £30,000 (2011: 6,000 hours and £40,000) for the Company's charitable partner Macmillan Cancer Support, to which FLG provided additional funding of £44,000 during the year.

2012 saw the highest level of employee volunteering to date, with nearly 900 employees taking part in team events during the Friends Life Challenge Fortnight.

During the year, the Company supported BitC's "Seeing is Believing" programme. The programme seeks to close the gap between the boardroom and the community, to help business leaders see first-hand what a difference a responsible business can make. The programme highlights success stories of community investment projects to future business leaders, in order to grow the network of companies in the UK engaged in the corporate responsibility agenda.

The Company has made a three-year commitment to support Seeing is Believing, and in the current year will fund impact assessments and research, and alumni events. The development of the Seeing is Believing alumni network and the impact of the programme as a whole will support BitC's campaign to develop more responsible business leadership and provide opportunities to engage the next generation of responsible leaders.

Responsible investment

The Group has £114 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 contained in 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 whilst ESG processes and controls of all other fund managers form part of FLG's ongoing oversight and governance.

Participation in industry initiatives, public policy and regulation

For a number of years the industry and government have been collaborating to resolve the long-standing issues of increased longevity, the lack of a savings culture, increasing levels of household debt in the UK amidst a continuing fragile economic environment. 2012 was the year that a number of the regulatory solutions came to fruition; Retail Distribution Review and auto-enrolment. Additionally, gender neutral pricing came into force in December.

FLG was instrumental during the development of the auto-enrolment system in lobbying HMRC to amend their salary sacrifice guidance in relation to auto-enrolment so that any employee opting out of auto-enrolment would not be penalised by losing previous contributions. Had HRMC not amended the rules, it risked jeopardising the integrity of the system by calling into question the Tax and National Insurance associated with the salary sacrifice mechanism, as well as employers' ability to effectively market the facility, diminishing the overall value of the solution to the lack of pension provision. During the year, the Group worked with government, responding directly to official inquiries and indirectly through various industry bodies, notably the ABI.

2013 will see the introduction of the new regulatory body, the Financial Conduct Authority, whose supervisory role will ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants.

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, each life company in 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, provides an independent opinion on whether the PPFM is being adhered to and more generally on whether the life company boards have exercised their discretion on with-profits policies fairly.

Furthermore, during a restructure of with-profits funds, whenever policies and backing assets are transferred between life companies, an independent report must be obtained to assess the impact of the transfer, in order to obtain Court approval.

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 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.

The Company has now confirmed its intention to move from an externally advised, project-based structure to a more conventional, simplified corporate structure, more appropriate for a company no longer seeking acquisitions or a specific exit event. As a result, and subject to shareholder approval, the directors expect to conduct the affairs of the Company in such a way that it will become UK tax resident in due course.

Despite the generally low tax rate currently applicable to Guernsey companies, the Company 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.

FLG, which produces 99% of total Group profits, continues to pay tax on profits in full in the UK and elsewhere in the EU. According to the Company's analysis, being based in the UK rather than in Guernsey would not have materially affected the amount of tax being paid in the UK in respect of 2012.

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.

During the year, the Committee supported Floral Guernsey, an all-island community enterprise that seeks to create pride in Guernsey's floral heritage, and increase the island's profile among its target tourist audience through horticultural initiatives such as competitions and educational events.

The Company has agreed to make an annual donation of £35,000 to Floral Guernsey until 2014.

In addition, the Company continued its support of 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 UK's largest children's charity. Young People Guernsey aims to provide young people with early support and advice on a number of issues, to help young teenagers reach their maximum potential, through a locally delivered, professional, sustainable resource.

The Company has agreed to make an annual donation of £15,000 to Young People Guernsey until 2014.

The activities described in this report do not include the work of the Resolution Foundation, which operates independently of the Group.

Measurement

The Company maintained its membership of FTSE4Good, achieving an overall rating of 92% (2011: 94%). The Company also participated in the Dow Jones Sustainability Index and scored 10 percentage points above the industry average, though still 13 percentage points away from qualifying for the Index.

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.

More information is available on the Company's website: www.resolution.gg

IFRS financial statements

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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 2012 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 August 2012 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 68, 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 2012 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 2012.

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 report 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 68, in relation to going concern, which the Company has requested that we review.

John Headley
for and on behalf of Ernst & Young LLP
London
25 March 2013

Consolidated income statement

For the year ended 31 December 2012

	Notes	2012 £m	2011[ii] £m
Revenue			
Gross earned premiums	3	**1,906**	2,128
Premiums ceded to reinsurers	3	**(602)**	(599)
Net earned premiums	3	**1,304**	1,529
Fee and commission income and income from service activities		**749**	771
Investment return	4	**9,077**	1,804
Total revenue		**11,130**	4,104
Other income	3	**–**	134
Claims, benefits and expenses			
Gross claims and benefits paid	5	**(4,175)**	(3,859)
Amounts receivable from reinsurers	5	**680**	643
Net claims and benefits paid	5	**(3,495)**	(3,216)
Change in insurance contracts liabilities		**8**	216
Change in investment contracts liabilities	29	**(5,052)**	495
Transfer (to)/from unallocated surplus		**(4)**	484
Movement in net asset value attributable to unit holders	32	**(118)**	48
Movement in policyholder liabilities		**(5,166)**	1,243
Acquisition expenses	6	**(614)**	(591)
Administrative and other expenses	7	**(1,629)**	(1,776)
Finance costs	10	**(157)**	(165)
Total claims, benefits and expenses		**(11,061)**	(4,505)
Share of loss of associates and joint venture	18	**(3)**	(1)
Profit/(loss) before tax from continuing operations		**66**	(268)
Policyholder tax	11	**(258)**	(220)
Loss before shareholder tax from continuing operations		**(192)**	(488)
Total tax (charge)/credit	11	**(107)**	237
Policyholder tax	11	**258**	220
Shareholder tax	11	**151**	457
Loss for the year		**(41)**	(31)
Attributable to:			
Equity holders of the parent[i]		**(72)**	(62)
Non-controlling interests		**31**	31
Loss for the year		**(41)**	(31)

Earnings per share from continuing operations		2012 pence	2011 pence
Basic earnings per share	13	**(5.17)**	(4.35)
Diluted earnings per share	13	**(5.17)**	(4.35)

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

The notes on pages 117 to 221 form an integral part of these financial statements.

Consolidated statement of comprehensive income

For the year ended 31 December 2012

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

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

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

Consolidated statement of IFRS based operating profit

For the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Profit/(loss) before tax from continuing operations	3	**66**	(268)
Policyholder tax	11	**(258)**	(220)
Loss before shareholder tax excluding returns generated within policyholder funds		**(192)**	(488)
Non-recurring items	3	**258**	180
Amortisation and impairment of acquired present value of in-force business	14	**417**	675
Amortisation and impairment of other acquired intangible assets	14	**97**	84
Interest payable on STICS	3	**(31)**	(31)
Short-term fluctuations in investment return		**(275)**	261
IFRS based operating profit before tax		**274**	681
Tax on operating profit		**2**	38
IFRS based operating profit after tax attributable to equity holders of the parent(i)		**276**	719

Earnings per share		2012 Pence	2011 Pence
Operating earnings per share	13	**19.84**	50.43

(i) IFRS based operating profit excludes: (a) investment variances from expected investment return for non-linked business which is calculated using a longer term rate of return; (b) returns attributable to non-controlling interests in policyholder funds; (c) significant non-recurring items; and (d) amortisation and impairment of present value of acquired in-force business and other intangible assets and is stated after policyholder tax and the deduction of interest payable on STICS. 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 2012

As at 31 December	Notes	2012 £m	2011 £m
Assets			
Pension scheme surplus	8	**33**	20
Intangible assets	14	**4,321**	4,847
Property and equipment	15	**53**	58
Investment properties	16	**2,735**	3,015
Investment in associates and joint venture	18	**4**	37
Financial assets	19	**105,990**	103,636
Deferred acquisition costs	20	**838**	643
Reinsurance assets	21	**3,153**	3,213
Current tax assets		**8**	6
Insurance and other receivables	23	**1,125**	1,140
Cash and cash equivalents	24	**9,449**	8,791
Net assets of operations classified as held for sale	18	**30**	–
Total assets		**127,739**	125,406
Liabilities			
Insurance contracts	26	**37,232**	37,264
Unallocated surplus		**656**	652
Financial liabilities:			
– investment contracts	29	**78,184**	75,191
– loans and borrowings	30	**1,099**	1,195
– amounts due to reinsurers	31	**1,767**	1,800
Net asset value attributable to unit-holders	32	**754**	1,173
Provisions	33	**278**	228
Deferred tax liabilities	22	**893**	872
Current tax liabilities		**21**	20
Insurance payables, other payables and deferred income	34	**1,157**	1,016
Total liabilities		**122,041**	119,411
Equity attributable to equity holders of the parent			
– Share capital	35	**4,225**	4,128
– Other reserves	36	**1,152**	1,544
		5,377	5,672
Attributable to non-controlling interests	37	**321**	323
Total equity		**5,698**	5,995
Total equity and liabilities		**127,739**	125,406

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

Fergus Dunlop
Director

Consolidated statement of changes in equity

For the year end 31 December 2012

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

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

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

Consolidated statement of cash flows

For the year ended 31 December 2012

For the year ended 31 December	Notes	2012 £m	2011 £m
Operating activities			
Loss for the year		**(41)**	(31)
Adjusted for:			
– other income		**–**	(116)
– net realised and unrealised (gains)/losses on assets at fair value		**(5,630)**	1,595
– finance costs		**157**	165
– amortisation and impairment of intangible assets		**514**	759
– depreciation of property and equipment		**5**	4
– movement in deferred acquisition costs		**(195)**	(285)
– total tax charge/(credit)		**107**	(237)
– purchase of shares and other variable yield securities		**(22,536)**	(22,585)
– sale of shares and other variable yield securities		**23,045**	22,705
– purchase of loans, debt securities and other fixed income securities		**(23,841)**	(33,973)
– sale of loans, debt securities and other fixed income securities		**26,166**	34,380
– purchase of investment properties		**(51)**	(43)
– sale of investment properties		**228**	305
– decrease in insurance contract liabilities		**(32)**	(101)
– increase/(decrease) in investment contract liabilities		**3,532**	(2,057)
– increase/(decrease) in unallocated surplus		**4**	(484)
– increase/(decrease) in provisions		**50**	(1)
– net movement in receivables and payables		**(214)**	(51)
Pre-tax cash inflow/(outflow) from operating activities		**1,268**	(51)
Tax paid		**(70)**	(25)
Net cash inflow/(outflow) from operating activities		**1,198**	(76)
Investing activities			
Acquisition of subsidiaries, net of cash acquired		**–**	12
Disposal of held for sale assets, net of cash transferred		**–**	285
Investment in associate		**–**	(6)
Additions to internally generated intangible assets		**(4)**	(4)
Net additions of property and equipment		**(2)**	(17)
Net cash (outflow)/inflow from investing activities		**(6)**	270
Financing activities			
Shares purchased in settlement of incentive schemes		**(4)**	–
Proceeds from issue of non-controlling interests		**–**	1
Share repurchase		**–**	(250)
Proceeds from increase in long-term debt		**349**	496
Repayment of long-term debt		**(423)**	(477)
Finance costs		**(170)**	(131)
STICS interest		**(31)**	(31)
Net movement in other borrowings, net of expenses		**(20)**	(36)
Dividends paid to equity holders of the parent		**(193)**	(226)
Net cash outflow from financing activities		**(492)**	(654)
Increase/(decrease) in cash and cash equivalents		**700**	(460)
Balance at beginning of year	24	**8,791**	9,288
Exchange adjustments on the translation of foreign operations		**(42)**	(37)
Balance at end of year		**9,449**	8,791

Notes to the consolidated accounts

For the year ended 31 December 2012

1. Accounting policies

1.1 Basis of preparation

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

The 2011 comparatives include the results of:

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

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

The presentation currency of the Group is Sterling. Unless otherwise stated the amounts shown in the consolidated financial statements are in millions of pounds Sterling (£ million).

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 amendment effective from 1 January 2012. It does not have a material impact on the Group:

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

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

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

New standards:

- IFRS 9: *Financial instruments*: *classification and measurement*. This IFRS reflects the first phase of the IASB's work on the replacement of IAS 39: *Financial Instruments: Recognition and Measurement*, and relates to the classification and measurement of financial assets as defined in IAS 39. The adoption of IFRS 9 will have a material impact on the classification and measurement of the Group's financial assets;
- IFRS 10: *Consolidated financial statements*. This IFRS provides a single consolidation model that identifies control as the basis for consolidation for all types of entities. It replaces the requirements in IAS 27: *Consolidated and Separate Financial Statements* and SIC 12: *Consolidation – Special Purpose Entities*. IFRS 10 is effective for annual periods beginning on or after 1 January 2013. This standard has been endorsed by the EU for annual periods beginning on or after 1 January 2014, at the latest;
- IFRS 11: *Joint Arrangements*. This IFRS establishes principles for the financial reporting by parties to a joint arrangement. It supersedes the requirements in IAS 31: *Interests in Joint Ventures* and SIC 13: *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*. IFRS 11 is effective for annual periods beginning on or after 1 January 2013. This standard has been endorsed by the EU for annual periods beginning on or after 1 January 2014, at the latest;
- IFRS 12: *Disclosure of Interests in Other Entities*. This IFRS combines, enhances and replaces disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities. IFRS 12 is effective for annual periods beginning on or after 1 January 2013. This standard has been endorsed by the EU for annual periods beginning on or after 1 January 2014, at the latest; and
- IFRS 13: *Fair Value Measurement*. This IFRS defines fair value and sets out in a single IFRS a framework for measuring fair value and requires disclosures about fair value measurements. IFRS 13 is effective for annual periods beginning on or after 1 January 2013 and has been endorsed by the EU.

1. Accounting policies continued

Amendments to existing standards:

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

The financial statements comply with the Statement of Recommended Practice issued by the Association of British Insurers in December 2005 (as amended in December 2006) insofar as these requirements do not contradict the requirements of IFRS.

The Group presents its consolidated statement of financial position in order of liquidity. Where applicable, for each asset and liability line item that combines amounts expected to be recovered or settled both within and beyond 12 months after the balance sheet date, disclosure of the amount due beyond 12 months is made in the respective note.

Financial assets and financial liabilities are not offset, unless there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liability simultaneously. Income and expenses are not offset in the income statement unless required or permitted by an accounting standard or interpretation, as specifically disclosed in the accounting policies of the Group.

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,* 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, as there is a contractual obligation to deliver cash, and presented 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.

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 Segmental 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 consolidated statement of comprehensive income.

b) Overseas subsidiaries and associates
The assets and liabilities of overseas subsidiaries and associates, including goodwill and intangible assets attributable to the acquisition of the overseas subsidiary or associate, and fair value adjustments arising on consolidation, are translated to Sterling (the presentational currency of the Group) at foreign exchange rates ruling at the 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.

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, with the carrying value being reviewed for impairment at least annually and whenever events or changes in circumstances indicate that the carrying value may be impaired.

For the purpose of impairment testing, goodwill is allocated to the related CGUs. Where the recoverable amount of the CGU is less than its carrying amount, including the related goodwill, an impairment loss is recognised in the income statement. 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 segmental 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 years 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 the statement of other comprehensive income. Revaluation losses, and their reversal, are recognised in the income statement.

Equipment is recognised at cost less accumulated depreciation and impairment losses.

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 comprise land and/or buildings that are not occupied by the Group and are held either to earn rental income or for capital appreciation, or for both.

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 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

The benefits to which the Group is entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers, as well as longer term receivables that are dependent on the expected claims and benefits arising under the related reinsured insurance contracts. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured insurance contracts and in accordance with the terms of each reinsurance contract. Reinsurance liabilities are primarily premiums payable for reinsurance contracts and are recognised when due.

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. Deferred taxation is not recognised on the initial recognition of goodwill or an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss.

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, the liabilities to policyholders include both declared and constructive obligations for future bonuses not yet declared (excluding the shareholders' share of future bonuses) and include the cost of options and guarantees measured on a market consistent basis. The basis of calculation does not recognise deferred acquisition costs, but allows for future profits of non-profit and unit-linked business written in the with-profits fund to be recognised.

The calculation of liabilities to policyholders for non-profit contracts includes explicit allowance for future expenses and allows for lapses where appropriate.

The value of unit-linked insurance contract liabilities includes provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to policyholders.

As an insurance special purpose vehicle, Friends Annuities Limited ("FAL") is not required to value liabilities on an FSA basis. However, insurance contract liabilities are valued using a methodology similar to that used for other UK non-profit contracts. 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 the statement of other comprehensive income. Adjustments are made to the insurance contract provisions to reflect the movements that would have arisen if the unrealised gains and losses had been recognised in the income statement. The corresponding change in the value of these insurance contract liabilities is recognised in the consolidated statement of comprehensive income.

The Group carries out an annual liability adequacy test on its insurance contract liabilities less related deferred acquisition costs and other related intangible assets to ensure that the carrying amount of its liabilities is sufficient in light of estimated future cash flows. Where a shortfall is identified, an additional provision is made.

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 these 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.

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.

1.2.26 Employee benefits

a) Pension obligations

(i) Defined benefit schemes
Pension schemes are in operation for employees of certain subsidiary undertakings. The proportion of employees accruing benefits under a funded defined benefit type scheme reduced during 2012 and this scheme was closed to active membership as at 31 December 2012. 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 consolidated statement of comprehensive income.

1. Accounting policies continued

(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 Group offers share-based payment plans to certain key employees. The expense charged to the income statement is based upon the fair value of the options granted, the vesting period and the vesting conditions. Fair values are determined using stochastic and scenario-based modelling techniques where appropriate.

For equity-settled schemes, the fair value is determined at grant date and expensed on a straight-line basis over the vesting period in the income statement. A corresponding amount is credited to equity. At each balance sheet date the Group revises its estimates of the number of shares that are expected to be issued and recognises the impact of the revision of original estimates, if any, in the income statement, with a corresponding adjustment to equity over the remaining vesting period. Where a leaver is entitled to their scheme benefits, this is treated as an acceleration of vesting and hence a shortening of the period over which the expense is charged.

For cash-settled schemes, the fair value is expensed on a straight-line basis over the vesting period in the income statement and the cumulative provision for obligations under cash-settled schemes is recognised as a liability in the statement of financial position. The fair value is re-measured at each reporting date, with any changes in fair value recognised in the income statement for the period.

Details of the schemes operated by the Group are disclosed in note 9.

2. Use of judgements, estimates and assumptions

The Group makes judgements in the application of critical accounting policies that affect the reported amounts of assets and liabilities. The Group also makes key assumptions about the future and other sources of uncertainty. These are continually evaluated and based on historical experience and other factors, including expectations of future events that are considered to be reasonable under the circumstances.

a) Product classification

IFRS 4: *Insurance contracts* requires judgement in classifying contracts as either “insurance contracts” or “investment contracts” based on the significance of insurance risk present in the contract with consequential impacts on the accounting policies applied to the valuation of policyholder liabilities, deferral of acquisition costs and pattern of revenue recognition.

b) Liabilities arising from insurance contracts and investment contracts with DPF

Determination of the ultimate liabilities of insurance contracts or investment contracts with DPF arising is a critical accounting estimate. There are several sources of uncertainty that need to be considered in determining the key assumptions made in estimating the liabilities that the Group will ultimately pay on claims made and on maturity of the policies.

The most significant assumptions are:

- mortality, morbidity, persistency and expense assumptions;
- for with-profits policies, the stochastic models used to value liabilities are sensitive to risk-free rates, assumed asset volatilities and the assumed correlation between asset volatilities. Risk-free rates are set in accordance with current market gilt rates;
- for OLAB policies with return of premium guarantees, the stochastic models used to value the cost of the guarantee are sensitive to risk-free rates, assumed asset volatilities and the assumed correlation between asset volatilities. Risk-free rates are set in accordance with current market swap rates. The cost also depends on assumptions such as the level of policy discontinuance;
- valuation interest rate for annuities in payment – fixed-interest assets, predominantly corporate bonds, are held to match the expected 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;

2. Use of judgements, estimates and assumptions continued

- other valuation interest rates have been calculated by reference to changes in consistent economic indices. The impact of all interest rate changes on liabilities is included within the impact of economic basis changes in note 26(a). The impact of these liability changes on surplus is generally to offset some or all of the corresponding impact on the value of fixed-interest assets backing the liabilities;
- for guaranteed annuity options (one of the principal guarantees written by the Group) the cost depends on assumptions such as the level of policy discontinuance and the tax-free cash take-up rate; and
- changes in assumptions behind the valuation techniques for assets that are not quoted in active markets could have a significant impact on the value of assets that are backing insurance and investment contract liabilities, and therefore could have a subsequent impact on the valuation of the liability itself.

Details of insurance and investment contract liabilities are given in notes 25, 26 and 29.

c) AVIF and other intangible assets

The determination of the present value of future profits on a portfolio of long-term insurance and investment contracts, acquired through the purchase of a subsidiary, and recognised as an intangible asset, is subject to judgement and estimation. The Group's policy is to calculate AVIF balances arising on acquisition by reference to a market consistent embedded value methodology. Information relating to the methods used to value other intangible assets is set out in note 14.

d) Fair value determination of financial instruments at fair value through profit 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.

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.

Exchange-traded derivatives are valued using active market prices. The values of over-the counter derivative financial instruments are estimates 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 on the basis of open market values as at each year end.

An analysis of financial assets by category is disclosed in note 19.

2. Use of judgements, estimates and assumptions continued

e) Staff pension schemes assumptions

In assessing the pension benefit obligation, assumptions are made as to the life expectancy of all current, deferred and retired members, rates of increases of salaries and pensions, interest and inflation rates. Material assumptions used and sensitivities are explained in detail in note 8. Estimates are made for the recoverability of any surplus through a potential refund should the scheme be wound up when in surplus.

f) Deferred tax assets and liabilities and unit linked tax loss provisions

In assessing deferred tax assets, an estimate of probable future taxable profits is made, against which the temporary differences, being the carry forward of excess tax expenses, and tax losses are utilised. These involve management's best estimate based on past profit experience, adjusted for possible future deviations that management considers might occur. Details of deferred tax assets and liabilities are analysed in note 22.

The principal deferred tax liabilities relate to deferred tax on purchased value of in-force business which are subsequently being amortised in line with the run-off of the underlying assets. The deferred tax assets and liabilities were calculated using detailed actuarial forecast cash flows.

In assessing investment and insurance contract liabilities in respect of unit linked tax loss provisions, the most significant assumptions are in relation to estimates of future fund growth rates; these are aligned with the Group's MCEV reporting assumptions, as provided in the MCEV supplementary information within the Report and Accounts. The provision is highly sensitive to small changes in growth rates, leading to potential volatility in the results of the Group, reflected through "short term fluctuations in investment return" outside of IFRS based operating profit.

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.

h) Longer term shareholder investment return – IFRS based operating profit

In assessing the longer term investment return used in arriving at IFRS based operating profit before tax, assumptions are made as to the appropriate gilt and cash returns to apply, adjusted where appropriate to reflect the additional risks associated with other types of investment class.

Material assumptions used and sensitivities are detailed in note 4.

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 and net income for the year ended 31 December 2012 includes a full year of all acquired subsidiaries. The segmental information relating to revenue and net income for the year ended 31 December 2011 includes BHA from 31 January 2011, FLWL from the date of acquisition on 7 November 2011 and the business of the GOF and TIP portfolios up to the date of their disposal on 1 November 2011.

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

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

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

b) Operating segment information

(i) IFRS based operating profit

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

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

3. Segmental information continued

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

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

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

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

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

(iii) Includes shareholder investment return short-term fluctuations (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. In 2012, this includes £99 million benefit from the release of unit-linked tax loss provisions as a result of updated fund growth estimates.

(iv) UK and Heritage non-recurring items for the year ended 31 December 2011 include £68 million (£67 million net of stamp duty expenses) in respect of the gain on acquisition of BHA and £48 million (£46 million net of stamp duty expenses) in respect of the gain on acquisition of WLUK. Further details are set out in note 39. This is offset by £(293) million of non-recurring costs comprising £(133) million of separation and integration costs in respect of the acquired businesses, £(55) million in respect of Solvency II and other finance system developments, £(84) million of reserve impacts in respect of the outsourcing arrangement with Diligenta and £(21) million of other costs.

3. Segmental information continued

(iii) Revenue and expenses

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

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

3. Segmental information continued

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

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

3. Segmental information continued

(iv) Products and services

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

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

3. Segmental information continued

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

Products and services are presented consistently with the disclosure of business segments, with each segment being broken down into the business units and products of which they comprise.

(v) Assets and liabilities

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

3. Segmental information continued

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

(i) Eliminations mainly comprise intercompany loans.

c) Geographical segmental information

In presenting geographical segment information, revenue is based on the geographical location of customers. The Group has defined two geographical areas: UK and the rest of the world.

For the year ended 31 December 2012	**UK £m**	**Rest of the world £m**	**Total £m**
Gross earned premiums	**1,785**	**121**	**1,906**
Fee and commission income	**587**	**162**	**749**
Revenue from external customers	**2,372**	**283**	**2,655**
Investment return			**9,077**
Premiums ceded to reinsurers			**(602)**
Total revenue			**11,130**

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

4. Investment return

a) Analysis of investment return

For the year ended 31 December	2012 £m	2011 £m
Interest income:		
– assets at fair value through profit or loss	**1,565**	1,733
– loans and receivables	**24**	27
Expected return on pension scheme assets, net of interest cost	**3**	6
Curtailment gain on defined benefit pension scheme	**32**	–
Dividend income	**1,636**	1,443
Rental income	**185**	190
Movement in fair value:		
– investment properties	**(103)**	45
– financial assets or financial liabilities at fair value through profit or loss:		
– financial derivative instruments	**57**	173
– financial assets designated on initial recognition	**5,676**	(1,813)
Retranslation of foreign currency loans and borrowings	**2**	–
Total investment return	**9,077**	1,804

b) Longer term investment return – IFRS based operating profit

The longer term investment return used in arriving at IFRS based operating profit before tax is calculated in respect of equity and fixed interest investments of shareholder funds and surplus assets held within long-term funds, by applying the longer term rate of return for each investment category to the quarterly weighted average of the corresponding assets, after adjusting for the effect of any short-term market movements. The longer term rates of return are based on assumed gilt and cash returns, adjusted where appropriate to reflect the additional risks associated with the type of investment. The directors have determined the assumptions to be applied as follows:

For the year ended 31 December	2012 %	2011 %
Equities	**5.40**	6.70
Government fixed interest	**2.40**	3.70
Other fixed interest	**4.22**	5.00
Cash (life and pensions business)	**2.40**	3.70
Cash (corporate)	**1.35**	1.14

The rate applied to cash held in the life and pensions businesses and government fixed interest investments reflects the annualised swap curve spot rate, based on the term of the gilt portfolio (typically around 10 years). The expected rate of return applied to equities and other fixed interest investments incorporates an additional risk premium. The rate applied to the cash held at corporate level is the one year spot rate reflecting the typically short-term nature of those cash balances.

The longer term investment return also includes the expected return on the Group's external debt, including the STICS, calculated using the coupon on these instruments and their market value at the start of the year.

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

For the year ended 31 December	2012 £m	2011 £m
Longer term investment return:	**(23)**	(26)
– After the impact of a 1% increase in the longer term rates of investment return	**(4)**	(1)
– After the impact of a 1% decrease in the longer term rates of investment return	**(41)**	(50)

4. Investment return continued

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

	2012 £m	2011 £m
Actual investment return attributable to shareholders	(44)	(72)
Longer term shareholder investment return	23	26
Deficit of actual shareholder return over longer term return	**(21)**	(46)

Short-term fluctuations in investment return reported in IFRS based operating profit of £275 million comprises £(21) million deficit of actual shareholder return over longer term return, as shown above, together with £197 million variance arising from investment variances and economic assumption changes on assets backing long-term business, and £99 million benefit from the release of unit-linked tax loss provisions.

5. Net claims and benefits paid

For the year ended 31 December 2012	Gross claims and benefits paid £m	Amounts receivable from reinsurers £m	Total net claims and benefits paid £m
UK and Heritage			
Corporate benefits	151	(13)	138
Protection	116	(68)	48
Retirement income	48	–	48
Heritage:			
– With-profits	1,844	(5)	1,839
– Pensions	195	(124)	71
– Investments	1,038	(22)	1,016
– Protection	172	(89)	83
– Annuities	591	(357)	234
FPI			
– Investment	16	(1)	15
– Protection	4	(1)	3
Total	4,175	(680)	3,495

5. Net claims and benefits paid continued

For the year ended 31 December 2011	Gross claims and benefits paid £m	Amounts receivable from reinsurers £m	Total net claims and benefits paid £m
UK and Heritage			
Corporate benefits	138	(3)	135
Protection	85	(51)	34
Retirement income	170	(109)	61
Heritage			
– With-profits	1,684	(108)	1,792
– Pensions	485	(249)	236
– Investments	764	(29)	735
– Protection	224	(79)	145
– Annuities	302	(231)	71
FPI			
– Investment	6	–	6
– Protection	1	–	1
Total	3,859	(643)	3,216

Net claims and benefits are presented consistently with the disclosure of business segments, with each segment being broken down into the business units and products of which they are comprised.

6. Acquisition expenses

For the year ended 31 December	2012 £m	2011 £m
Commission	**323**	383
Other acquisition expenses	**486**	493
Deferral	**(274)**	(369)
Amortisation and impairment of deferred acquisition costs[i]	**79**	84
Net acquisition expenses	**614**	591

(i) For the year ended 31 December 2012, this includes an impairment charge of £8 million in respect of the FPI segment's Overseas Life Assurance Business ("OLAB") operations.

7. Administrative and other expenses

a) Analysis of administrative and other expenses

For the year ended 31 December	2012 £m	2011 £m
Amortisation and impairment of intangible assets	**514**	759
Employee remuneration	**171**	189
Auditor's remuneration (7b)	**6**	11
Investment expenses and charges	**248**	246
Investment property expenses	**8**	9
IT costs	**36**	45
Operating lease rentals, land and buildings	**21**	22
Renewal commission	**62**	56
Non-recurring costs (7c)	**333**	212
Other administrative expenses	**230**	227
Total administrative and other expenses	**1,629**	1,776

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	2012 £m	2011 £m
Audit of the financial statements	**0.2**	0.2
Audit of subsidiaries	**4.0**	4.9
Total audit	**4.2**	5.1
Audit related assurance services	**1.1**	1.3
Other assurance services	**0.6**	0.5
All taxation advisory services	**0.1**	0.1
Corporate finance services (excluding amounts included above in tax and advisory and other assurance services)	**–**	3.0
Audit of Market Consistent Embedded Value ("MCEV") supplementary information	**0.5**	0.5
Other non audit services	**–**	0.1
Total non audit services	**2.3**	5.5
Total fees	**6.5**	10.6

In addition, £45,850 (2011: £45,000) was payable in respect of the audit of the Group pension schemes.

c) Non-recurring costs

Non-recurring costs for the year include charges related to separation and integration activities in respect of the acquired businesses, expenditure on enhancing systems and reporting processes including Solvency II, costs in respect of the transition and service improvement elements of the outsourcing arrangement with Diligenta, costs related to the capital optimisation programme, and costs taken on by the Group in relation to the termination of arrangements between the Company and ROL and the adoption of unified membership of the boards of the Company and FLG.

8. Staff pension schemes

a) Introduction

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

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

b) FPPS defined benefit scheme overview

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

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

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

Under IFRIC 14, deficit reduction contributions are considered to be a minimum funding requirement and, to the extent that the contributions payable will not be available after they are paid into the scheme, a liability is recognised when the obligation arises. An additional liability of £29 million has been recognised at 31 December 2012 (2011: £32 million), reflecting the 35% tax that would arise on any notional refund in respect of the resultant IAS 19 surplus of £82 million (£20 million deficit reduction contributions plus the current surplus of £62 million). A deferred tax asset of £5 million (2011: £10 million) has also been recognised to reflect tax relief at a rate of 23% (2011: 25%) that is expected to be available on the deficit reduction contributions, in future periods.

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

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

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

8. Staff pension schemes continued

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

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

Movement in IAS 19 pension surplus

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

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

Analysis of net pension surplus and related deferred tax asset

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

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

8. Staff pension schemes continued

Amounts recognised in the consolidated statement of comprehensive income

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

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

c) FPPS additional disclosures

i) Principal assumptions used by the Scheme Actuary in calculating the scheme liabilities

For the year ended 31 December	2012 %	2011 %
Rate of increase in salaries(i)	**3.00**	3.00
Rate of increase in pensions in payment	**Relevant RPI inflation swap curve**	Relevant RPI inflation swap curve
Discount rate for deferred members (and active members in 2011)	**4.75**	5.03
Discount rate for pensioners	**4.20**	4.76

(i) Fixed rate of salary increases assumed for two years of 3% (2011: salary increases of 3% assumed for three years) then salary increases at National Average Earnings (assumed retail price index ("RPI") + 1%) plus an allowance for salary scale increases. With the closure of the scheme as at 31 December 2012, all active members become deferred members and the impact of the 2012 salary assumptions are reflected in the curtailment gains noted.

The inflation rate assumptions for revaluation of deferred pensions in excess of Guaranteed Minimum Pensions ("GMPs") have been based on the consumer price index as the statutory inflation index. The scheme applies the revaluation factors published by the Government with the factors based on the higher compound cap of 5% per annum applied in respect of benefits accrued up to 31 December 2010 and on the lower compound cap of 2.5% per annum applied for benefits between 1 January 2011 and 31 December 2012 (when the scheme closed to active membership).

ii) Mortality assumptions

Mortality assumptions are a proportion of the "SAPS-All" series mortality tables published by the Continuous Mortality Investigations ("CMI"), with proportions varying by sex and by status determined from an analysis of the members' postcodes and annual pension amounts:

Proportion of "SAPS-All" likelihood of death in any year:	2012 %	2011 %
Male pensioner	**83**	83
Female pensioner	**98**	98
Male non-pensioner	**90**	90
Female non-pensioner	**100**	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 provide the following average life expectancies of future pensioners currently aged 46 retiring at the age of 60, and current pensioners aged 70.

8. Staff pension schemes continued

For the year ended 31 December	2012 years	2011 years
Expected age at death of future male pensioner	**90**	90
Expected age at death of future female pensioner	**92**	92
Expected age at death of current male pensioner	**89**	89
Expected age at death of current female pensioner	**90**	90

The present value of providing an annuity of £1 per annum for members aged 60, based on the above assumptions, is as follows:

Cost of annuities	2012 £	2011 £
Male annuity	**25.69**	25.36
Female annuity	**24.75**	24.72

These rates assume a monthly payments model with a discount rate of 4.75% (2011: 5.03%). The rates also assume two-thirds of the members' benefit will be paid to the spouse or civil partner on the death of the member. A guarantee is provided for pensioners who die within five years of retiring. Pensions in payment in excess of the GMPs accrued up to 31 December 2010 will increase in line with the RPI with a minimum of zero and a maximum of 5% and accrued from 1 January 2011 to 31 December 2012 (when the scheme closed to active membership) will increase in line with the RPI with a minimum of zero and a maximum 2.5%.

Cost of annuities	2012 % of total membership	2011 % of total membership
Active members	**–**	10
Deferred members	**72**	63
Pensioners	**28**	27
	100	100

The sensitivities regarding the principal assumptions used to measure the scheme liabilities are set out below:

Assumption	Increase/decrease in assumption	Increase/decrease in scheme liabilities
Inflation	0.5%	7.5%
Salaries	0.5%	0.0%
Pensions	0.5%	7.2%
Discount rate	0.5%	10.9%
Rate of mortality	1 year	2.5%

iii) Changes in the present value of obligations of defined benefit scheme

For the year ended 31 December	2012 £m	2011 £m
Present value of obligations at 1 January	**1,242**	1,047
Current service cost	**7**	7
Interest cost	**60**	57
Contributions by plan participants	**–**	1
Actuarial losses	**46**	168
Benefits paid	**(41)**	(38)
Curtailment	**(32)**	–
Present value of obligations at 31 December	**1,282**	1,242

8. Staff pension schemes continued

iv) Analysis of defined benefit obligations

The profile of the obligations is analysed as follows:

As at 31 December	2012 £m	2011 £m
Active members	–	228
Deferred members	716	495
Pensioners	566	519
Wholly or partly funded plans	1,282	1,242

v) Changes in present value of defined benefit plan assets

For the year ended 31 December	2012 £m	2011 £m
Fair value of plan assets at 1 January	1,294	1,113
Expected return on plan assets	63	63
Actuarial gains	1	122
Employer contributions	27	33
Contributions by plan participants	–	1
Benefits paid	(41)	(38)
Fair value of plan assets at 31 December	1,344	1,294

At 31 December 2012, there are no investments in internal linked funds (2011: £nil).

vi) Assets in the defined benefit scheme and the expected rate of return

	Expected rate of return 2012 %	Value 2012 £m	Expected rate of return 2011 %	Value 2011 £m
Equities	5	201	5	180
Liability-driven investment (“LDI”) pools	5	385	5	398
Fixed interest (LDI in specie)	5	170	5	173
Insured assets	4	559	5	513
Cash	1	29	2	30
Total market value of assets		1,344		1,294
Present value of scheme liabilities		(1,282)		(1,242)
Surplus in the scheme		62		52

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

	2008 £m	2009 £m	2010 £m	2011 £m	**2012 £m**
Present value of defined benefit obligation	(912)	(953)	(1,047)	(1,242)	**(1,282)**
Fair value of plan assets	1,025	1,012	1,113	1,294	**1,344**
Surplus	113	59	66	52	**62**
Difference between the expected and actual return on scheme assets					
– Amounts	(17)	(66)	36	122	**1**
– Percentage of closing scheme assets	(2%)	(7%)	3%	9%	**0%**
Experience gains and losses on scheme liabilities					
– Amounts	(17)	(5)	3	11	**3**
– Percentage of the present value of the scheme liabilities	(2%)	(1%)	0%	1%	**0%**
Total amount recognised in the statement of comprehensive income					
– Amounts	85	(77)	(46)	(34)	**(42)**
– Percentage of the present value of the scheme liabilities	9%	(8%)	(4%)	(3%)	**(3%)**

The table above is provided for information purposes as the FPPS has been in existence for longer than the 38 months since the Group acquired Friends Provident on 4 November 2009.

viii) Future funding

As stated in section (b), an updated triennial valuation as at 30 September 2011 was performed and an agreement entered into in January 2013 to pay across additional deficit funding contributions totalling £195 million from January 2013 to July 2021, plus a £20 million contribution already paid following the triennial date. From 1 July 2007 the scheme has been closed to new members and was closed to active membership effective from 31 December 2012.

Existing member contributions were 7% in 2012 for benefits with a pension age of 60, and 2% for benefits with a pension age of 65. The Group paid contributions of 15% in 2012 plus a shortfall contribution paid in January 2013, agreed with the Trustee, of £4 million for the cost of accrual between 1 October 2011 and 31 December 2012.

A Statement of Funding Principles was agreed by the Group and the Trustee in January 2013. That statement provides the principles around assumption setting, in particular, choosing the discount rate, future price inflation, future pension increases, rates of mortality, pension commencement age, and typical partner or dependant information and assumes:

- the discounted value of the annuity contract with Aviva Annuity UK Limited ("Aviva") will exactly match the discounted liabilities for pensioners insured under the contract. The pensions in payment up to 30 June 2012 have now been reassured by the Trustees to Aviva under a buy-in annuity contract where the premium progressively transfers from the Trustee to Aviva over the duration of the contract; and
- the discounted value of non-insured liabilities will be measured using an interest rate swap curve plus a margin of 0.75%, reflecting an expected return on the scheme's other investments equivalent to swap yields, and the strategic allocation of 25% of the scheme's non-annuity investments in equities.

In addition the Trustee has the following objectives for investments, as set out in the Statement of Investment Principles:

- to achieve and maintain a minimum funding level of 100% on a long-term ongoing basis; and
- to agree the cost of providing the benefits and consult the Employer on any material changes that may be required to the agreed funding arrangements in light of experience.

8. Staff pension schemes continued

Amounts paid to FPPS in the past three years and expected future payments over the next two years are as follows:

	£m
FPPS (DB) contributions paid	
2010	41
2011	33
2012	27
FPPS contributions expected to be paid	
2013	28
2014	23

ix) Risk management

The scheme's assets, which are administered by four external investment managers, are held under the control of the Trustee and used to secure benefits for the members of the scheme and their dependants in accordance with the Trust Deed and Rules. The Trustee board consists of a chairman who is appointed by the employer and six additional directors of which three are employer-appointed directors and three are members nominated trustee directors.

The Trustee has established a separate Risk and Investment Subcommittee ("RISC") which is responsible for assisting the Trustee in investment policy and monitoring the scheme's investments. The RISC 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 LDI strategy in 2003 to reduce exposure to interest rate and inflation risk. This strategy was extended in 2008 to reduce exposure to a wider range of risks in respect of pensions in payment through investing in an insured bulk annuity buy-in contract that covers pensions in payment up to 30 June 2012. 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 means that the scheme can review the liabilities periodically to ensure the interest rate and inflation sensitivities are appropriately 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 currently 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 2012, 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 in a bulk annuity contract with Aviva as a buy-in investment in 2008 with further tranches of investment in each of the years 2009, 2010, 2011 and 2012. The contract between the Trustee and Aviva now reassures benefits for pensioners in payment up to 30 June 2012 and includes a facility for the Trustee to invest further tranches of benefits in 2013.

The contract is an investment of the Trustee and includes additional security to that of a standard bulk annuity contract with an insurance company. The ownership of the scheme's assets are being drip fed to Aviva over the duration of the contract. This additional protection has been negotiated by the Trustee to mitigate the risk of any decline in the financial strength of Aviva as the counterparty under the contract. This was a general requirement of the tender process for any counterparty to be selected. These assets have been set up under a ring-fenced Trustee Investment Plan that is managed by Aviva and with the title to those assets secured in the Trustee's name through a safekeeping custody account set up with Citibank. These ring-fenced assets would only be accessed by the Trustee in the event of Aviva failing to meet its obligations under this long-term contract.

Currency risk
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

Contributions to the defined contribution schemes were as follows:

For the year ended 31 December	2012 £m	2011 £m
AXA UK Life Businesses and BHA	**8.4**	10.2
Friends Provident	**3.8**	3.3
FPI	**1.0**	0.9
Sesame Bankhall Group	**0.8**	0.8

The defined contribution scheme for former Friends Provident employees who have joined since July 2007 and the defined contribution scheme for former AXA and BHA employees and new joiners to Friends Life in the UK, 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. The range of amounts the Group contributed in 2012 depended on the contribution structure for each section. Typically the Group contributed in a range between 7.3% and 13.2% depending on the employees' contributions and whether they are paid via salary sacrifice.

On 28 September 2012, the Group confirmed that the Group Personal Pension Plan was to be closed to future contributions from 31 December 2012. UK employees were offered membership to the FRA from 1 January 2013. The Group contributes in a range between 6.3% and 13.2% depending on the employees' contributions and whether they pay via salary sacrifice.

9. Share-based payments

Lombard International Assurance SA

Description of the schemes

i) Equity based scheme

Lombard senior management have been incentivised through a scheme that entitles them to share in the growth in value in Lombard. The scheme is an equity-settled share-based payment scheme. Subject to achievement of performance conditions, the scheme entitles participants to shares in Resolution Limited. The scheme lasts for six years, with 25% of the value accruing on the third, fourth, fifth and sixth anniversary of the scheme, with an effective start date of 1 January 2009. Scheme participants purchase shares in Lombard when they join the scheme. As at 31 December 2012, participants owned 0.8 million shares in Lombard (2011: 1.6 million). A total of 0.5 million Lombard shares (2011: nil) were repurchased by the Group in June 2012 as part of the 2012 scheme payout and 0.3 million Lombard shares were returned by scheme leavers.

The scheme's fair value on the commencement date was the best estimate of the cost of the scheme, based on probability weighted performance scenarios to estimate the number of awards expected to vest. This initially resulted in a fair value of £10 million to be expensed over the six-year term of the scheme.

During 2010, the terms of the scheme were modified resulting in the fair value of the scheme increasing from £10 million to £22 million. This increased the total expense by £12 million spread over the years 2010 to 2015.

In 2012, being the third anniversary of commencement of the scheme, an independent assessment was carried out to determine whether performance conditions had been met to require a payout under the terms of the scheme. The assessment concluded that performance conditions had been met and accordingly Lombard senior management received shares in Resolution Limited equating to a total market value of £5 million. No new Resolution Limited shares were issued in connection with this payout under the scheme.

A charge of £4 million has been recognised in the consolidated income statement in respect of this scheme in 2012 (2011: £6 million) with a corresponding increase to equity.

ii) Cash based schemes

Lombard middle management are incentivised through a scheme that entitles them to cash payments, based on a valuation of the Lombard business as at 31 December each maturity year. The first allocations were granted to participants in April 2010 and the first pay-outs, subject to the scheme performance conditions being met, will occur in 2013. A second allocation was made in 2011, and a third in 2012.

In order to estimate the required liability, as each tranche of the scheme has a duration of three years, stochastic modelling techniques (based on option pricing methodology) are used to calculate both the intrinsic value and the time value of the liability under the scheme.

A charge of £1 million has been recognised in the consolidated income statement (2011: £1 million) and a corresponding liability is included in the consolidated statement of financial position. The total liability as at 31 December 2012 is £2 million (2011: £1 million).

A cash settled retention bonus plan was put in place alongside, but separate to, the equity based scheme, enabling participants to receive a return of their initial investment if certain performance conditions are met.

A charge of £4 million has been recognised in the consolidated income statement (2011: £nil) and a corresponding liability is included in the consolidated statement of financial position. A total of £2 million was paid out to the scheme participants in the year with a resultant total liability as at 31 December 2012 of £2 million (2011: £nil).

9. Share-based payments continued

Friends Life group

Description of the schemes

i) Long Term Incentive Plan ("LTIP")
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 from the Friends Life group (for example through payment of dividends to the Resolution holding companies) and the aggregate cost of the acquired Friends Life companies.

The scheme is a cash-settled share-based payment scheme and the fair value of the awards in issue, being the relevant percentage of the value expected to emerge from the Friends Life group, is measured at each reporting date, with any changes in fair value being recognised in the consolidated income statement for the period.

The value expected to emerge 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 3,700 and 1,100 were forfeited (2011: 2,975 and 1,150 respectively). At 31 December 2012 there were 7,925 (2011: 5,325) awards in issue and a credit of £2 million (2011: £2 million charge) has been recognised in the consolidated income statement with a corresponding reduction in the liability recognised in the consolidated statement of financial position. The total liability as at 31 December 2012 is £5 million (2011: £7 million).

This year, at the 2013 annual general meeting ("AGM"), a resolution will be submitted for shareholder approval in respect of amendments to the Friends Life group LTIP. The changes are proposed in order to continue to properly incentivise the Group's senior executives in the wake of the change in the Company's strategy, as announced in August 2012. The LTIP was primarily designed to mature on an exit by the Company's from the Friends Life business, provided that a 12% internal rate of return had been achieved. As the Company strategy is no longer focused on an exit event, it is proposed to amend the LTIP terms so that the implicit need for an exit event is replaced with a market value based calculation to measure performance, without altering the required internal rate of return.

ii) Deferred Share Award Plan ("DSAP")
Certain key management have one-third of any annual bonus deferred into shares in Resolution Limited for a period of three years. The awards are accounted for as equity-settled schemes. The fair value of these schemes is calculated at each award date based upon the number of shares awarded and the expense charge is recognised over the course of the vesting period.

A charge of £1 million (2011: £nil) has been recognised in the consolidated income statement in respect of these schemes and a corresponding increase in equity is included in the consolidated statement of financial position.

iii) Share awards
Certain directors are entitled to cash and shares in Resolution Limited to compensate them for awards they forfeited from their previous employer as a result of joining FLG. The share element of these awards are treated as equity-settled schemes. The fair value of these schemes is estimated at the grant date and is recognised over the course of the vesting periods.

A charge of £1 million (2011: £nil) has been recognised in the consolidated income statement in respect of these schemes and a corresponding increase in equity of £1 million is included in the consolidated statement of financial position.

Sesame Bankhall Group

Description of the scheme
Key management of 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 2012, the scheme participants have purchased 0.5 million shares (2011: 0.5 million).

The fair value of the obligation 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.

9. Share-based payments continued

A charge of £6 million (2011: £3 million) has been recognised in the consolidated income statement in respect of this scheme and a corresponding liability is included in the consolidated statement of financial position. The liability at 31 December 2012 is £9 million (2011: £3 million).

10. Finance costs

For the year ended 31 December	2012 £m	2011 £m
Subordinated loan interest	62	46
Deferred consideration notes interest	23	30
Interest paid to reinsurers	58	60
Interest on acquisition finance facility	–	10
Interest paid to credit institutions	14	19
Total finance costs	**157**	**165**

Interest expense is calculated using the effective interest rate method.

Interest paid to reinsurers represents payments in relation to a reinsurance treaty as detailed in note 31.

11. Taxation

(a) Tax recognised in the consolidated income statement

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

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

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

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

11. Taxation continued

b) Factors affecting tax charge for year

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

12. Appropriations of profit

a) Dividends paid on ordinary shares

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

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

b) Step-up tier one Insurance Capital Securities interest

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

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

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

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

13. Earnings per share

a) Basic and operating earnings per share from continuing operations

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

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

b) Diluted basic earnings per share from continuing operations

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

c) Weighted average number of ordinary shares

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

13. Earnings per share continued

c) Weighted average number of ordinary shares continued

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

14. Intangible assets

Movements in intangible assets are as follows:

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

14. Intangible assets continued

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

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

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

Intangible assets relating to customer relationships and distribution channels have been valued using an income approach method, specifically the Multi-period Excess Earnings Method ("MEEM"). The principle behind the MEEM is that the value of an intangible asset is equal to the present value of the after tax cash flows attributable only to that intangible asset. Other intangibles include in-house developed IT systems and databases which have been valued using a replacement cost approach which assesses the cost of reproducing the equivalent technology in its current form.

For each type of asset, the useful economic life was determined, being the period over which the asset is expected to contribute directly or indirectly to future cash flows. The value of the assets will be amortised over the respective useful economic lives 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 2011, a rebranding exercise was carried out to change all inherited brands to "Friends Life".

On acquisition of a portfolio of insurance contracts and/or investment contracts, either directly or through the acquisition of a subsidiary undertaking, the net present value of the Group's interest in the expected pre-tax cash flows of the in-force business is capitalised in the consolidated statement of financial position as AVIF. AVIF is shown gross of policyholder and shareholder tax of £849 million (2011: £995 million), with the offsetting balance included in deferred taxation. The AVIF is based on the value of in-force business calculated on a market consistent embedded value basis.

14. Intangible assets continued

a) AVIF

AVIF is allocated to CGUs, which represent the lowest level within the Group at which AVIF is monitored for internal management purposes. An analysis of AVIF by operating segments used for segmental reporting (see note 3) is set out below:

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

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

b) Other intangibles

Other intangibles are made up of the following:

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

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

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 consolidated income statement.

AVIF is tested for impairment by comparing the carrying amount with its recoverable amount. The calculation of the recoverable amount is consistent with the measurement methodology for AVIF at initial recognition and is based on the current MCEV VIF balance for pre-acquisition business only, adjusted for differences between the IFRS and MCEV measurement basis for other net assets. The assumptions underpinning the Group's MCEV basis of reporting are provided in the MCEV supplementary information.

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

Impairment of FPI intangible assets

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

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

15. Property and equipment

For the year ended 31 December 2012	Owner occupied properties £m	Computer equipment £m	Fixtures, fittings and office equipment £m	Total £m
Cost				
At 1 January 2012	43	8	15	66
Additions	–	1	2	3
Disposals	(1)	–	–	(1)
Revaluation	(2)	–	–	(2)
At 31 December 2012	40	9	17	66
Depreciation				
At 1 January 2012	–	4	4	8
Depreciation charge	–	2	3	5
At 31 December 2012	–	6	7	13
Carrying amounts at 31 December 2012	40	3	10	53

15. Property and equipment continued

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

If owner-occupied properties were measured on a cost basis, the carrying amount would be £49 million (2011: £50 million).

16. Investment properties

For the year ended 31 December	2012 £m	2011 £m
At 1 January	**3,015**	3,189
Purchases	**51**	43
Acquisitions through business combinations	**–**	43
Disposals	**(228)**	(305)
Fair value adjustments	**(103)**	45
At 31 December	**2,735**	3,015

Of the total, £1,284 million (2011: £1,327 million) is held in with-profits funds and £1,451 million (2011: £1,688 million) in unit-linked funds.

17. Principal Group undertakings

Principal subsidiary undertakings of the Group as at 31 December 2012 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.

On 28 December 2012 all of the business of Friends Life Assurance Society Limited ("FLAS") and the majority of the business of Friends Life Company Limited ("FLC") were transferred into FLL, their immediate parent company, under the provisions of Part VII of the Financial Services and Markets Act 2000. The purpose of this internal group reorganisation was to achieve greater alignment of the business structure with the preferred trading strategy, dividing the UK segment into the closed book Heritage and open book UK businesses. The reorganisation also provides the Group with a more robust solvency capital position and will result in the emergence of cost synergies due to a reduction in the number of legal operating entities. As the Part VII transfers are between companies which are 100% owned by the Group, there is no material impact on the consolidated financial statements.

Subsidiary undertaking	Activity	% held
Corporate		
Resolution Holdco No.1 LP[(i) (ii)]	Holding company	99.99
Resolution Holdings (Guernsey) Limited[(iii)]	Holding company	100
Friends Life Group plc	Holding company	100
Friends Life FPG Limited	Holding company	100
Friends Life FPL Limited	Holding company	100
Life and Pensions		
Friends Annuities Limited	Insurance	100
Friends Life Assurance Society Limited	Insurance	100
Friends Life Company Limited	Insurance	100
Friends Life Limited	Insurance	100
Friends Life and Pensions Limited	Insurance	100
Friends Provident International Limited[(iv)]	Insurance	100
Friends Life WL Limited (formerly Winterthur Life UK Limited)	Insurance	100
Lombard International Assurance SA[(v)]	Insurance	99.62
Friends Life Management Services Limited	Management services	100
Friends Life Services Limited	Management services	100
Other		
Friends Life Investments Limited	Investment management	100
Sesame Bankhall Group Limited	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 the Isle of Man.
(v) Incorporated in Luxembourg. The Group's holding in 2011 was 99.23%.

18. Investment in joint venture and associates held for sale

a) Joint venture

As at 31 December	2012 £m	2011 £m
Carrying amount of investment	4	5

This investment is in Tenet Group Limited, which operates in the retail financial services distribution sector. It comprises two appointed representative networks and a provider of support services to directly authorised advisers. It also operates a funds management business and a captive insurance vehicle providing professional indemnity insurance to one of its networks. The Group's interest in the ordinary share capital of Tenet Group Limited is 23.67% (2011: 23.67%). The Group's share of total assets, liabilities, revenue and profits is as follows:

As at 31 December	2012 £m	2011 £m
Current assets	10	9
Current liabilities	(3)	(2)
Non-current liabilities	(3)	(2)
Net assets	4	5
Revenue	23	20
Loss before tax	(1)	–

b) Associates held for sale

As at 31 December	2012 £m	2011 £m
Carrying amount of investments in associates	–	32
Net assets of operations classified as held for sale	30	–

Investments in associated undertakings include the Group's investment in AmLife Insurance Berhad, a Malaysia based life assurance business. The Group's interest in the ordinary share capital of AmLife Insurance Berhad 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.

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

At 31 December 2012, the investment in AmLife is reported within net assets of operations classified as held for sale.

The Group's share of the total assets, liabilities, revenues and profits of associates are shown below. Revenue and loss before tax for 2012 are reflective of the results of AmLife up until designation as held for sale on 3 October 2012:

For the year ended 31 December	2012 £m	2011 £m
Revenue	19	27
Loss before tax	(2)	(1)

18. Investment in joint venture and associates held for sale continued

	2011 £m
Current assets	32
Non-current assets	39
Total assets	71
Current liabilities	(17)
Non-current liabilities	(22)
Total liabilities	(39)
Net assets[(i)]	32
Retained earnings	31
Foreign translation reserve	1
Total equity	32

(i) The net asset value of AmLife was presented within "Investments in associates and joint venture" in 2011 and "Net assets of operations held for sale" in 2012. In accordance with IFRS 5: *Non-current assets held for sale and discontinued operations*, no disclosure of assets and liabilities is required for 2012.

19. Financial assets

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

As at 31 December	2012 £m	2011 £m
Fair value through profit or loss (note 19(a))		
Designated on initial recognition	**105,172**	102,756
Held for trading	**812**	875
Loans at amortised cost (note 19(f))	**6**	5
Total financial assets	**105,990**	103,636

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

19. Financial assets continued

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

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

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

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

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

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

For unit-linked funds, the policyholders bear the investment risk and any change in asset values is matched by a broadly equivalent change in the liability.

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

Asset-backed securities (excluding those held by the linked funds) amount to £3,940 million (2011: £3,060 million) and 96% (2011: 94%) of these are at investment grade as set out in note 28.

19. Financial assets continued

b) Determination of fair value hierarchy

In accordance with the requirements of IFRS 7: *Financial Instruments: Disclosures*, financial assets at fair value have been classified into three categories as set out below. Financial assets at fair value include shares and other variable yield securities, government securities, corporate bonds (including asset-backed securities), derivative financial instruments and deposits with credit institutions.

Level 1 – quoted prices (unadjusted) in active markets for identical assets. An active market is one in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. Examples include listed equities and bonds in active markets and quoted unit trusts/OEICs.

Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset, either directly (i.e. as prices) or indirectly (i.e. derived from prices). This category generally includes assets that are priced based on models using market observable inputs. Examples include certificates of deposit and derivatives.

Level 3 – inputs that are not based on observable market data. Assets with single price feeds and/or limited trading activity are included in this category. Examples include unlisted equities and private equity investments.

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

The fair values of these assets are generally provided by external parties. During the year, the Group has performed independent reviews of pricing models to ensure that appropriate methodologies have been applied. The approach taken for each class of specific unlisted investment is set out below:

The valuation of the holdings in private equity limited partnerships and companies is based on the most recent underlying valuations available at the reporting date as adjusted for contributions, distributions and known diminutions in value of individual underlying investments in the period since valuations were performed. The valuation technique is not supported by observable market values. Valuations of private equity holdings are prepared in accordance with International Private Equity and Venture Capital Board ("IPEV") guidelines.

The fair value of the investments in property limited partnerships is taken as the Group's appropriate share of the net asset value of the partnerships. The net asset value is based on the latest external market valuation of the underlying property investments, which is updated at least every six months. The valuation would be adjusted in the event of a significant market movement in the period between the last market valuation and the reporting date.

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

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

19. Financial assets continued

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

The Group has financial liabilities which contain discretionary participation features of £9,543 million (2011: £9,426 million) that form part of its with-profits funds. Products giving rise to these liabilities are mainly investment or pension contracts with a unitised with-profits element. The Group is unable to measure the fair value of these financial liabilities reliably due to the lack of a robust basis to measure the supplemental discretionary returns arising on with-profits contracts and because there is not an active market for such instruments. These liabilities have therefore been excluded from the fair value hierarchy analysis below.

An analysis of financial assets and liabilities held at fair value in accordance with the fair value hierarchy is set out below. The table shows both the total financial assets and liabilities and the total excluding unit-linked assets and liabilities, as shareholders have no direct exposure to profits or losses on unit-linked assets (other than through investment management and annual management fees).

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

19. Financial assets continued

As at 31 December 2011	Including unit-linked				Excluding unit-linked			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
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

c) Transfers between level 1 and level 2

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

d) Financial instruments

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

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

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

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

19. Financial assets continued

e) Level 3 sensitivity analysis

As at 31 December	2012 Carrying amount £m	2012 Effect of reasonably possible alternative assumptions £m	2011 Carrying amount £m	2011 Effect of reasonably possible alternative assumptions £m
Unit-linked investments	**2,139**	**–**	2,835	–
Shares and other variable yield securities	**1,228**	**246**	1,124	224
Government bonds	**5**	**1**	5	1
Corporate bonds (including ABS)	**596**	**60**	510	51
Total Level 3 financial assets	**3,968**	**307**	4,474	276

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

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

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

f) Loans

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

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

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

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

20. Deferred acquisition costs

For the year ended 31 December 2012	Insurance contracts £m	Investment contracts £m	Total £m
At 1 January	90	553	643
Incurred and deferred in the period	47	227	274
Amortisation and impairment(i)	(16)	(63)	(79)
At 31 December	121	717	838

(i) Includes an impairment charge of £8 million in respect of the FPI segment's OLAB operations.

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

Included in the carrying values above, £733 million (2011: £570 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	2012 £m	2011 £m
At 1 January	**3,213**	2,637
Acquired through business combinations	**–**	485
Premiums	**602**	599
Claims	**(680)**	(643)
Other movements	**18**	135
At 31 December	**3,153**	3,213

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

Included in the carrying values above, £2,849 million (2011: £2,991 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 insurance contracts 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:

	2012			2011		
As at 31 December	Assets £m	Liabilities £m	Net £m	Assets £m	Liabilities £m	Net £m
Property and equipment	**31**	**–**	**31**	32	–	32
AVIF	**–**	**(849)**	**(849)**	–	(995)	(995)
Other intangible assets	**–**	**(60)**	**(60)**	–	(82)	(82)
Unrealised gains on investments	**–**	**(279)**	**(279)**	–	(215)	(215)
Employee benefits	**5**	**–**	**5**	10	–	10
Deferred acquisition costs	**–**	**(42)**	**(42)**	–	(25)	(25)
Tax value of recognised tax losses	**339**	**–**	**339**	467	–	467
Short-term temporary differences	**–**	**(38)**	**(38)**	–	(64)	(64)
Deferred tax assets/(liabilities)	**375**	**(1,268)**	**(893)**	509	(1,381)	(872)
Offset of deferred tax (liabilities)/assets	**(375)**	**375**	**–**	(509)	509	–
Net deferred tax liabilities	**–**	**(893)**	**(893)**	–	(872)	(872)

At 31 December 2012, all of the deferred tax assets above (2011: £509 million) can be offset against deferred tax liabilities and are presented net in the consolidated statement of financial position.

22. Deferred tax assets and liabilities continued

b) Movement in deferred tax assets and liabilities

For the year ended 31 December 2012	At 1 January 2012 £m	Recognised in income £m	Recognised in other comprehensive income £m	Foreign exchange £m	Acquired in year £m	At 31 December 2012 £m
Property and equipment	32	(1)	–	–	–	31
AVIF(i)	(995)	142	4	–	–	(849)
Other intangible assets	(82)	22	–	–	–	(60)
Unrealised losses on investments	(215)	(64)	–	–	–	(279)
Employee benefits	10	(12)	7	–	–	5
Deferred acquisition costs	(25)	(17)	–	–	–	(42)
Tax value of recognised tax losses	467	(128)	–	–	–	339
Short-term temporary differences	(64)	26	–	–	–	(38)
Net deferred tax (liabilities)/assets	**(872)**	**(32)**	**11**	**–**	**–**	**(893)**

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	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 (losses)/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)

(i) The £4 million (2011: £12 million) recognised in other comprehensive income represents exchange movements relating to deferred tax on AVIF.

c) Unrecognised deferred tax assets and liabilities

Deferred tax assets of £87 million (2011: £57 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.

d) Impact of new life tax regime

Legislation in respect of the new life tax regime was included in Finance Act 2012, which received Royal Assent on 17 July 2012. The new life tax regime took effect from 1 January 2013 and therefore impacts deferred tax but not current tax in the 2012 accounts, with no material impact on the Group's IFRS results. There remains an element of risk and uncertainty because the legislation is new, and therefore may be subject to change either by legislative update or by developments in interpretation.

23. Insurance and other receivables

As at 31 December	2012 £m	2011 £m
Receivables arising out of direct insurance operations:		
– policyholders	**81**	80
– agents, brokers and intermediaries	**33**	31
Investment income receivables	**108**	167
Investments sold for subsequent settlement	**195**	41
Prepayments and accrued income	**528**	551
Other receivables	**180**	270
Total insurance and other receivables	**1,125**	1,140

Of the carrying value above, £78 million (2011: £59 million) is 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	2012 £m	2011 £m
Bank and cash balances	**4,944**	3,583
Short-term deposits	**4,505**	5,208
Total cash and cash equivalents	**9,449**	8,791

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

As at 31 December	2012 £m	2011 £m
OEICs	**153**	211
Long-term funds	**7,047**	7,130
Total cash and cash equivalents not available for use by shareholders	**7,200**	7,341

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 Friends Life FP With Profits Fund ("FP WPF"), Friends Life FLC Old With Profits Fund ("FLC Old WPF"), Friends Life FLC New With Profits Fund ("FLC New WPF"), Friends Life FLAS With Profits Fund ("FLAS WPF"), Friends Life WL With Profits Fund ("WL WPF") and OLAB 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	2012 £m	2011 £m
At 1 January	**37,264**	35,081
Acquired through business combinations	**–**	2,284
Increase in liability from premiums	**1,556**	1,887
Release of liability due to recorded claims	**(3,829)**	(3,747)
Unwinding of discount	**343**	517
Change in assumptions:		
– Economic	**558**	1,076
– Non-economic	**(25)**	(667)
Other movements including net investment return	**1,365**	833
At 31 December	**37,232**	37,264

Included in the carrying amount above is £32,266 million (2011: £32,790 million) which is expected to be settled more than 12 months after the balance sheet date.

During the year, the insurance business of FLAS, the majority of the insurance business of FLC and the ownership of FAL were transferred to FLL under the provisions of Part VII of the Financial Services and Markets Act 2000.

A liability adequacy test was carried out at portfolio level and resulted in no additional provision in 2012 (2011: £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) Options and guarantees

Options and guarantees are features of life assurance and pensions contracts that confer potentially valuable benefits to policyholders. They are not unique to with-profits funds and can arise in non-participating funds. They can expose an insurance company to two types of risk: insurance (such as mortality/morbidity) and financial (such as market prices/interest rates). The value of an option or guarantee comprises two elements: the intrinsic value and the time value. The intrinsic value is the amount that would be payable if the option or guarantee was exercised immediately. The time value is the additional value that reflects the possibility of the intrinsic value increasing in the future, before the expiry of the option or guarantee. Under 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 basis that takes into account both the time value and the intrinsic value of the options and guarantees.

All material options and guarantees are valued stochastically and included in the liabilities. There are two main types of guarantees and options within the with-profits funds: maturity guarantees and guaranteed annuity options and one for OLAB: return of premium guarantee. Maturity guarantees are in respect of conventional with-profits business and unitised with-profits business and represent the sum assured and reversionary bonuses declared to date. For certain with-profits pension policies there are options guaranteeing the rates at which annuities can be purchased. OLAB return of premium guarantees relate to a guarantee to repay all premiums paid to maturity. The cost of the maturity guarantees, guaranteed annuity options and return of premium guarantees have been calculated as:

		31 December 2012 £m	31 December 2011 £m
Maturity guarantees	FP WPF	**362**	439
	FLC New WPF	**332**	331
	FLC Old WPF	**84**	92
	FLAS WPF	**264**	391
	WL WPF	**103**	137
Guaranteed annuity options	FP WPF	**583**	609
	FLC New WPF	**210**	266
	FLC Old WPF	**71**	86
	FLAS WPF	**116**	166
	WL WPF	**8**	12
Return of premium guarantee	OLAB	**72**	39

d) Year end assumptions

i) Economic assumptions

Details regarding the economic assumptions used in the stochastic model for the valuation of with-profits policyholder liabilities are set out below.

The cost of with-profits guarantees is most sensitive to the assumed volatility of future returns on asset shares, the level of future interest rates and the rates of discontinuance on these policies. The guarantee cost in respect of guaranteed annuity options is most sensitive to the level of future interest rates, future mortality rates, assumed rates of discontinuance and early retirements, and the assumptions relating to the exercise of the tax free cash option on these policies. The cost of OLAB return of premium guarantees is most sensitive to the assumed volatility of future investment returns on unit funds, the level of future interest rates and the rates of discontinuance on these policies. Further details on these assumptions are provided below.

The cost of the with-profit guarantees and OLAB return of premium guarantee 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 with-profits guarantees model is calibrated using the gilt risk-free curve assuming interest rates of between 0.2% and 3.6% per annum and implied volatilities in the market as shown in the following disclosures. The OLAB return of premium guarantee model is calibrated using the Euro swap curve assuming interest rates of between 0.3% and 2.4% per annum and implied volatilities as shown in the following disclosures.

26. Insurance contracts continued

Swaption implied volatilities – FP WPF and Friends Life FPLAL With-Profits Fund ("FPLAL WPF")

	31 December 2012 swap term			
Option term	10 years	15 years	20 years	25 years
UK Sterling				
10 years	18%	17%	16%	15%
15 years	18%	17%	16%	16%
20 years	16%	16%	15%	15%
25 years	16%	16%	16%	15%

	31 December 2011 swap term			
Option 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%

Swaption implied volatilities – FLC New WPF, FLC Old WPF and FLAS WPF

	31 December 2012 swap term			
Option term	10 years	15 years	20 years	25 years
UK Sterling				
10 years	**18%**	**17%**	**16%**	**15%**
15 years	**18%**	**17%**	**16%**	**16%**
20 years	**16%**	**16%**	**15%**	**15%**
25 years	**16%**	**16%**	**16%**	**15%**

	31 December 2011 swap term			
Option 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%

Swaption implied volatilities – WL WPF

	31 December 2012 swap term			
Option term	10 years	15 years	20 years	25 years
UK Sterling				
10 years	**18%**	**17%**	**16%**	**15%**
15 years	**18%**	**17%**	**16%**	**16%**
20 years	**16%**	**16%**	**15%**	**15%**
25 years	**16%**	**16%**	**16%**	**15%**

26. Insurance contracts continued

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%

Swaption implied volatilities – OLAB

Option term	31 December 2012 swap term			
	10 years	15 years	20 years	25 years
Euro				
10 years	24%	24%	23%	20%
15 years	27%	26%	24%	20%
20 years	26%	24%	21%	17%
25 years	23%	20%	18%	15%

For equity capital return and property total return, implied volatilities are shown in the table below:

FP WPF and FPLAL WPF

Option term	31 December 2012		31 December 2011	
	Equities	Property	Equities	Property
5 years	24%	15%	27%	15%
10 years	26%	15%	27%	15%
15 years	27%	15%	27%	15%

FLC WPF

Option term	31 December 2012		31 December 2011	
	Equities	Property	Equities	Property
5 years	24%	15%	28%	15%
10 years	26%	15%	28%	15%
15 years	27%	15%	29%	15%

FLAS WPF

Option term	31 December 2012		31 December 2011	
	Equities	Property	Equities	Property
5 years	24%	15%	29%	15%
10 years	26%	15%	29%	15%
15 years	27%	15%	31%	15%

WL WPF

Option term	31 December 2012		31 December 2011	
	Equities	Property	Equities	Property
5 years	24%	15%	30%	15%
10 years	26%	15%	30%	15%
15 years	27%	15%	30%	15%

26. Insurance contracts continued

OLAB

	31 December 2012	
Option term	Equities	Property
5 years	25%	n/a
10 years	25%	n/a
15 years	25%	n/a

The cost of with-profits guarantees also depends on management actions that would be taken under various scenarios. For WL WPF and FP WPF, the regular bonus rate is set each year such that, by maturity, guaranteed benefits are targeted as a predefined proportion of asset share, leaving the remaining portion of the asset share to be paid as a final bonus. This management action is in line with the companies' Principles and Practices of Financial Management ("PPFM").

For FLAS WPF, FLC Old WPF and FLC New WPF, the regular bonus rates are derived from the gross redemption yields on gilts with deductions for guaranteed interest rates, tax, expenses, shareholder transfers and a contingency margin. The remaining portion of the asset share is paid as a final bonus. This management action is in line with the Company's PPFM.

The guarantee cost in respect of guaranteed annuity options is assessed using a market consistent stochastic model and values both the current level of the guaranteed annuity rate benefit (allowing for future improvements in annuitant mortality) and the time value due to uncertainty in future interest rates. The guarantee cost in each scenario is the value of the excess annuity benefit provided by the options, relative to an annuity purchased in the open market. In estimating the future open market annuity rate, the model allows for stochastic variation in interest rates and for future mortality improvements. The stochastic interest rate assumption reflects that implied by current market interest rate derivative prices. Future annuitant mortality within the FLL with-profits balance sheet has been derived from the premium basis at which annuities can be purchased from FLPL, which allows for future mortality improvements.

The guarantee cost in respect of premium guarantees is assessed using a market consistent stochastic model and values both the current level of the guarantee and the time value due to uncertainty in future unit growth. The guarantee cost in each scenario is the value of the excess benefit provided by the guarantee relative to the projected unit fund at maturity, including future contractual premiums. In estimating the projected fund at maturity, the model allows for stochastic variation in equity and cash values.

ii) Non-economic assumptions

The provision for insurance contracts and investment contracts with DPF liabilities is sensitive to the principal assumptions in respect of mortality, morbidity and maintenance expenses (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 the insurance business of FLAS and FLC that was transferred to FLL under the provisions of Part VII of the Financial Services and Markets Act 2000 ("ex-FLAS" and "ex-FLC" respectively) and FLWL the provision for future expenses covers the expected level of servicing fees payable to Friends Life Services Limited ("FLSL") under the management services agreement, fees payable to investment managers and further amounts in respect of other expenses.

Experience investigations for mortality, morbidity, persistency, guaranteed annuity option take-up rates and maintenance expenses are performed at least annually for major product classes. Where industry analysis indicates that changes in expected future mortality, morbidity or other assumptions 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 New WPF, FLC Old WPF and FLAS WPF, the benefit from a prudent view of expected future mortality improvements is taken on non-profit protection business in the realistic balance sheet. Improving mortality has been assumed when valuing annuities 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 and OLAB return of premium cost also depend upon other factors such as policy discontinuance and for guaranteed annuity options the take up rate for the options. The factors are based on recent experience adjusted to reflect industry benchmarks and to anticipate trends in policyholder behaviour. A summary of the key assumptions is as follows:

Policy discontinuances: lapse, early retirement and paid-up rates vary by policy type and period and have been based on recent experience.

26. Insurance contracts continued

Policy lapses and paid up rates are generally in the ranges shown below:

FP WPF

	2012 % pa	2011 % pa
Pensions – lapses	**1 to 9**	1 to 8
Life – lapses	**3 to 15**	3 to 15
Mortgage endowments – lapses	**3 to 4**	5 to 10
With-profits bonds – lapses	**9**	11.5
Pensions – paid-up	**4 to 17**	4 to 17
Life – paid-up	**0.5 to 2**	0.5 to 2

FLC New WPF

	2012 % pa	2011 % pa
Pensions – lapses	**4 to 11.5**	4 to 11.5
Life – lapses	**3 to 8**	5.5 to 6
Mortgage endowments – lapses	**1 to 6.5**	3.5 to 6.5
With-profits bonds – lapses	**7.5 to 8.5**	7.5 to 8.5
Pensions – paid-up	**4.5 to 12**	4.5 to 12
Life – paid-up	**0.5 to 2**	0.5 to 1

FLC Old WPF

	2012 % pa	2011 % pa
Pensions – lapses	**4 to 11.5**	4 to 11.5
Life – lapses	**3 to 8**	5.5 to 6
Mortgage endowments – lapses	**1 to 6.5**	3.5 to 6.5
With-profits bonds – lapses	**7.5 to 8.5**	7.5 to 8.5
Pensions – paid-up	**4.5 to 12**	4.5 to 12
Life – paid-up	**0.5 to 2**	0.5 to 1

FLAS WPF

	2012 % pa	2011 % pa
Pensions – lapses	**6 to 10**	5.5 to 10
Life – lapses	**4.5 to 12**	5.5 to 10
Mortgage endowments – lapses	**1 to 6.5**	2.5 to 3.5
With-profits bonds – lapses	**7.5 to 8.5**	7.5 to 8.5
Pensions – paid-up	**5 to 12**	5 to 12
Life – paid-up	**1 to 2**	1 to 2

26. Insurance contracts continued

WL WPF

	2012 % pa	2011 % pa
Pensions – lapses	**3 to 8**	2 to 3
Life – lapses	**3 to 8**	3 to 8
Mortgage endowments – lapses	**2 to 8**	2 to 8
With-profits bonds – lapses	**5 to 9**	5 to 9

FPLAL WPF

	2012 % pa	2011 % pa
Whole of Life – lapses	**3.5**	3.5
Whole of Life – paid up	**5.0**	5.0

OLAB

	2012 % pa	2011 % pa
Whole of Life – lapses	**2.5 to 10**	4 to 10
Whole of Life – paid up	**0 to 9**	5 to 10

Early retirement rates vary by age band and policy type and are set based on recent experience.

Tax free cash option: where a guaranteed annuity option is more valuable than the cash equivalent it is assumed that 5% to 30% (2011: 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.

26. Insurance contracts continued

e) Valuation interest rates

As explained above, with-profits business within FLL and FLWL is valued in accordance with the FSA's realistic reporting regime.

Valuation interest rates for other than conventional with-profits business are shown in the table below.

	Company	Class of Business	2012 %	2011 %
Life	FLL	Endowment and Whole Life in non-profit funds	**1.80**	1.90
		Protection	**1.80**	1.90
		Endowment and Whole Life in with-profits funds	**2.30**	2.30
	ex-FLC	Over 50 Plan in non-profit funds	**1.45**	1.80
		Over 50 Plan in with-profits funds	**1.40**	1.80
		Additional life reserves	**1.45**	1.90
		Other conventional life in non-profit funds	**1.45**	1.90
		Other conventional life in with-profits funds	**1.40**	1.85
		Life annuities from FLAS	**1.80**	2.40
		Unit-linked life	**1.45**	1.90
	ex-FLAS	Conventional life	**1.95**	2.35
		Unit-linked life	**1.95**	2.35
	FLWL	With-profits fund immediate annuities	**1.60**	1.70
		Life (other)	**2.15**	2.30
		Non-profit fund life	**1.35**	2.10
Income Protection	FLL	Income Protection	**1.70**	1.90
	ex-FLC	Permanent Health Insurance	**1.80**	2.40
Pensions	FLL	Annuities in payment	**3.25 to 3.27**	3.57–4.09
		Protection	**2.20**	2.40
		Individual and Group pensions in non-profit funds	**2.20**	2.40
		Individual and Group pensions in with-profits funds	**2.80**	2.90
	ex-FLC	Unit-linked pensions	**1.80**	2.40
		Conventional pensions in non-profit funds	**1.80**	2.40
		Conventional pensions in with-profits funds	**1.80**	2.30
		Additional pensions reserves	**1.80**	2.40
	ex-FLAS	Conventional pensions	**2.70**	3.05
		Unit-linked pensions	**2.45**	2.95
	FAL	Ex-FLC annuities reinsured December 2007	**2.90**	3.60
		Ex-FLAS annuities reinsured July 2009	**2.95**	3.40
		Ex-FLC index-linked annuities reinsured December 2007	**(0.60)**	(0.25)
		Ex-FLAS index-linked annuities reinsured July 2009	**(0.85)**	(0.40)
	FLWL	With-profits fund pensions (immediate annuities)	**2.00**	2.10
		Non-profit fund pensions (immediate annuities)	**3.05**	3.20
		Non-profit fund pensions (other)	**1.70**	2.90
		With-profits fund with-profits business deferred	**1.80**	2.05
		With-profits fund with-profits business other	**2.65**	2.90

26. Insurance contracts continued

Within FLL certain products can have positive or negative reserves. The interest rate used for these products depends on which is more onerous.

	31 December 2012		31 December 2011	
	Positive reserves %	Negative reserves %	Positive reserves %	Negative reserves %
FLL	**1.30**	**3.30**	1.40	3.40
ex-FLC non-CIC	**0.95**	**1.95**	1.40	1.90
ex-FLC CIC	**1.30**	**2.30**	2.40	2.90

26. Insurance contracts continued

f) Mortality, morbidity and lapse rates

Insurance contract liabilities allow for mortality and morbidity risk by making assumptions about the proportion of policyholders who die or become sick. Allowance for future mortality has been made using the following percentages of the standard published tables below:

		31 December 2012	31 December 2011
Term assurances – FLL	Smoker male	**83% TMS00(5)**	83% TMS00(5)
	Smoker female	**77% TFS00(5)**	77% TFS00(5)
	Non-smoker male	**88% TMN00(5)**	99% TMN00(5)
	Non-smoker female	**72% TFN00(5)**	72% TFN00(5)
Term assurances – ex-FLC/ex-FLAS	Smoker male	**90% TMS00(5)**	90% TMS00(5)
	Smoker female	**84% TFS00(5)**	84% TFS00(5)
	Non-smoker male	**96% TMN00(5)**	108% TMN00(5)
	Non-smoker female	**78% TFN00(5)**	78% TFN00(5)
Term assurance – FLWL	Smoker male	**126% TM92ult[i]**	150% TM92
	Smoker female	**108% TF92ult[i]**	165% TF92
	Non-smoker male	**66% TM92ult[i]**	80% TM92
	Non-smoker female	**66% TF92ult[i]**	90% TF92
Critical illness	FLL	**CIBT02[ii]**	CIBT02[ii]
Critical illness	ex-FLC/ex-FLAS	**CIBT02[iii]**	CIBT02[iii]
Other life assurances	FLL	**120% AM/FC00ult**	120% AM/FC00ult
Other life assurances	ex-FLC/ex-FLAS male	**140% AMC00**	140% AMC00
	ex-FLC/ex-FLAS female	**125% AFC00**	125% AFC00
Unitised policies	Life – FLL	**130% AM/FC00ult**	130% AM/FC00ult
	Other – FLL	**110% AM/FC00ult**	110% AM/FC00ult
Unitised policies	Life/Other – ex-FLC/ex-FLAS male	**102.5% AMC00ult**	105% AMC00ult
	Life/Other – ex-FLC/ex-FLAS female	**100% AFC00ult**	120% AFC00ult
Pensions	FLL/FLPL male	**65% AMC00ult**	65% AM/FC00ult
	FLL/FLPL female	**55% AMFC00ult**	55% AM/FC00ult
	ex-FLC/ex-FLAS male	**90.91% A67/70ult–1**	90.91% A67/70ult–1
	ex-FLC/ex-FLAS female	**90.91% AF80ult–1**	90.91% AF80ult–1
Individual income protection	FLL	**60% AM/F80ult[iv]**	60% AM/F80ult[iv]
	ex-FLC/ex-FLAS	**100% AM/AF92[v]**	100% AM/AF92[v]
Annuities in payment	FLL/FLPL individual annuities	**PCMA/PCFA00[vi]**	PCMA/PCFA00[vi]
	FLL/FLPL group annuities	**PCMA/PCFA00[vi]**	PCMA/PCFA00[vii]
	ex-FLC/ FAL pension annuities male	**92% PCMA00[vii]**	92% PCMA00[vii]
	ex-FLC/FAL pension annuities female	**87.4% PCFA00[vii]**	87.4% PCFA00[vii]
	ex-FLAS pension annuities male	**89.7% PCMA00[vii]**	89.7% PCMA00[vii]
	ex-FLAS pension annuities female	**92% PCFA00[vii]**	92% PCFA00[vii]
Immediate annuities – FLWL	Male	**98.9% PCMA00[vii]**	98.9% PCMA00[vii]
	Female	**98.9% PCFA00[vii]**	98.9% PCFA00[vii]

26. Insurance contracts continued

(i) Aids loading at 1/3 of the R6A standard requirement applied to reserving basis.
(ii) The percentages of the table used differ by sex and smoker status. CIBT02 has been adjusted to allow for a select period as follows: Year 1: 80% of CIBT02; Year 2: 95% of CIBT02; Year 3+: I00% of CIBT02 Future deterioration in morbidity is allowed for by assuming claim rates increase by1.25% per annum and 1.5% per annum for males and females respectively.
(iii) The percentages of the table used differ by sex, smoker status and sales group. Future deterioration in morbidity is allowed for by assuming claim rates increase by:
a) 0.75% per annum and 1.50% per annum for males and females respectively for standalone critical illness
b) 0.50% per annum and 1.00% per annum for males and females respectively for accelerated critical illness
(iv) Individual income protection sickness and recovery rates are based on percentages of CMI 12 (male and female) published tables. Rates differentiate by smoker status, deferred period and occupational class.
(v) 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.
(vi) Age related percentages of the mortality tables are used.
(vii) Future improvements in mortality are based on the CMI's core model CMI-2011 with a long-term rate of 2%.

For protection business, lapse rates are based on recent experience with a prudent margin.

In determining liabilities for with-profits business, it is assumed that a proportion of policies is discontinued (surrendered, lapsed or converted paid-up) in each future year. The relevant rates vary by product and duration.

g) Apportionment of surplus between shareholders and with-profits policyholders

Shareholders are entitled to 100% of surplus emerging from companies within the Group, with the exception of surplus emerging in the with-profits funds.

The Group has six with-profits funds of which only FP WPF is open to new business and five (FLC New WPF, FLC Old WPF, WL WPF, FPLAL WPF and FLAS WPF) are closed to new business.

Shareholders are entitled to one-ninth of the cost of bonuses added to policies, except for:

- within the FP WPF, surplus arising on pre-demutualisation non-profit and unitised business (excluding the investment element) arises within the with-profits fund but assets of the with-profit fund equal to 60% of the surplus arising are transferred to shareholders;
- within the FP WPF, post demutualisation policyholders are only entitled to surplus from the return on their investments; other sources of surplus are wholly-owned by shareholders including policies written by FPLA and FLP, where the investment element is reinsured to the FP WPF;
- within the FPLAL WPF, policyholders are entitled to all the surplus of that fund. In addition, FLL has a closed unitised with-profits fund. Shareholders are entitled to all profits from the unitised with-profits fund other than investment profits, which are wholly-owned by with-profits policyholders. The investment element of the contract is wholly reinsured to the FP WPF;
- certain unitised with-profits policies in FLWL are written in the non-profit fund and reassured to the with-profits fund; and
- certain policies in FLC New WPF and FLC Old WPF with guaranteed bonus rates, where the shareholders do not receive one-ninth of guaranteed bonuses.

The effect of the fund structure is that investment risk, in respect of assets backing with-profits policies is largely borne by policyholders; shareholders bear 10% of the investment risk from conventional with-profits policies, other than within the new FPLAL WPF.

Expense risk is borne by shareholders, other than within the new FPLAL WPF. Increases to expenses that can be charged to the FLWL with-profits fund are capped in line with RPI.

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 capital resources requirement ("CRR") as required by local solvency rules and CRR as required by the local capital management policy;
- to hold capital resources for FLG that meet a minimum of 150% (2011: 150%) of the Group CRR (excluding the with-profit insurance capital component ("WPICC");
- to maintain financial strength within the Group and regulated entities sufficient to support new business growth targets, and to satisfy the requirements of the policyholders, regulators and stakeholders including rating agencies;
- to retain financial flexibility by maintaining strong liquidity to cover expected and unexpected events, which includes access to an undrawn facility with a consortium of banks;
- to manage the with-profits business of the Group in accordance with agreed risk appetites and all statutory requirements; and
- to ensure that transfers from long-term business funds and dividends from entities that support the cash generation requirements of the Group are balanced with the need to maintain appropriate capital within the Group and regulated entities.

The operations of the Group are subject to regulatory requirements within the countries where it operates. Such regulations specify that a minimum amount of required capital must be maintained at all times throughout the financial year.

Under 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 life operations 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 the long-term business in FLAS was transferred to FLL and its with-profits fund renamed as "Friends Life FLAS With Profits fund" ("FLAS WPF");
- the majority of the long-term business of FLC was transferred to FLL and its with-profits funds renamed as "Friends Life FLC New With Profits fund" ("FLC New WPF") and "Friends Life FLC Old With Profits Fund" ("FLC Old WPF");
- all of the shares in FAL were transferred from the FLC shareholder fund to the FLL shareholder fund; and
- the "New FPLAL Closed Fund" with-profits fund was renamed as "Friends Life FPLAL With Profits Fund" ("FP WPF").

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.

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 policyholder liabilities on an IFRS basis.

27. Capital continued

As at 31 December 2012	Total UK with-profits funds £m	UK shareholder and non-profit funds £m	Overseas life operations £m	Total life operations £m	Other operations and consolidation adjustments £m	Total £m
Shareholders' equity						
Outside long-term fund	–	46	110	156	3,451	3,607
Inside long-term fund	–	1,717	53	1,770	–	1,770
	–	1,763	163	1,926	3,451	5,377
Other qualifying capital						
Preference shares	–	300	–	300	(300)	–
Innovative tier one capital (STICS)	–	511	–	511	(23)	488
Subordinated debt	–	854	1	855	162	1,017
Unallocated surplus	656	–	–	656	–	656
	656	3,428	164	4,248	3,290	7,538
Regulatory adjustments						
Assets	(33)	(1,468)	(15)	(1,516)	(3,547)	(5,063)
Liabilities	4,200	119	43	4,362	862	5,224
Available capital resources	4,823	2,079	192	7,094	605	7,699
Capital requirement						
UK realistic basis	4,386	–	–	4,386	–	4,386
Other regulatory bases	–	687	88	775	24	799
	4,386	687	88	5,161	24	5,185
Local basis capital resources over capital requirement						2,514
IGCA valuation adjustments						
Restricted assets(i) and shareholders capital support of the with-profits funds						(495)
Other						1
FLG IGCA surplus						2,020
Analysis of policyholders' liabilities						
With-profits	18,703	–	146	18,849	–	18,849
Unit-linked	242	50,373	25,327	75,942	–	75,942
Non-participating and other non-unit reserves	7,984	11,427	1,214	20,625	–	20,625
Total policyholder liabilities	26,929	61,800	26,687	115,416	–	115,416

(i) 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 2012	FP WPF £m	WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
Other qualifying capital							
Unallocated surplus	243	3	162	52	186	10	656
Regulatory adjustments							
Assets	(14)	–	–	–	(1)	(18)	(33)
Liabilities	1,484	29	1,217	400	973	97	4,200
Available capital resources	1,713	32	1,379	452	1,158	89	4,823
Capital requirement							
UK realistic basis	1,507	32	1,309	411	1,033	94	4,386
Local basis capital resources over capital resources requirement							437
Analysis of policyholders' liabilities							
With-profits	8,202	155	4,840	1,344	3,641	521	18,703
Unit-linked	33	–	–	–	42	167	242
Non-participating and other non-unit reserves	2,399	96	973	134	4,291	91	7,984
Total	10,634	251	5,813	1,478	7,974	779	26,929

27. Capital continued

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						
Preference shares	–	300	–	300	(300)	–
Innovative tier one capital (STICS)	–	511	–	511	(23)	488
Subordinated debt[i]	–	700	2	702	162	864
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 and other non-unit reserves	6,854	10,974	(24)	17,804	–	17,804
Total policyholder liabilities	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	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
Other qualifying capital							
Unallocated surplus	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 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 and other non-unit reserves	2,371	91	826	129	3,421	16	6,854
Total	10,924	275	5,698	1,374	8,100	914	27,285

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

- FP WPF: shareholders are entitled to one-ninth of the amount distributed to conventional with-profits policyholders in the form of bonuses. In addition, shareholders are entitled to 60% of the surplus arising in respect of the pre-demutualisation non-profit and unitised business written in the fund (excluding the investment element); the remaining 40% belongs to with-profits policyholders. Also, post-demutualisation policyholders are only entitled to surplus from the return on their investments; other sources of surplus are wholly owned by shareholders.
- FPLAL WPF: the surplus in the closed with-profits fund may only be distributed to policyholders.
- FLC New WPF, FLC Old WPF and FLAS WPF: shareholders are entitled to one ninth of the amount distributed to policyholders in the form of bonuses, with the following exception: certain policies in FLC with-profits funds with guaranteed bonus rates, where the shareholders do not receive one ninth of guaranteed bonuses.
- WL WPF: shareholders are entitled to one-ninth of the amount distributed to policyholders in the form of bonuses, with the following exception: where elements of the FLWL with-profits policies were written in the non-profit fund, the shareholder receives the management charges in the non-profit fund for these.

27. Capital continued

Non-participating business

For non-participating business, surplus can generally be distributed to shareholders subject to meeting regulatory requirements of the COP 2012 scheme in relation to support arrangements for the with-profits funds in FLL as set out in the disclosures on intra-group capital arrangements in section d.

c) Movement in available capital

At 31 December 2012, total available capital resources in the life operations have increased during the year by £255 million to £7,094 million (2011: £697 million decrease to £6,839 million), as shown below.

For the year ended 31 December 2012	UK Total with-profits funds £m	UK shareholders' and non-profit funds £m	Overseas life operations £m	Total life operations £m
At 1 January 2012	4,230	2,432	177	6,839
Value of new business	–	(75)	(113)	(188)
Expected existing business contribution	54	444	126	624
Experience variances and development costs	34	(55)	(33)	(54)
Operating assumption changes	7	7	(74)	(60)
Other operating items	(8)	50	(1)	41
Economic variance and other non-operating items	506	(79)	(15)	412
Other capital and dividend flows	–	(645)	128	(517)
Foreign exchange variances	–	–	(3)	(3)
At 31 December 2012	4,823	2,079	192	7,094

Analysis of with-profits funds

For the year ended 31 December 2012	FL WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
At 1 January 2012	1,526	27	1,123	322	1,149	83	4,230
Expected existing business contribution	(71)	1	131	61	(68)	–	54
Experience variances and development costs	33	–	2	1	–	(2)	34
Operating assumption changes	1	–	6	1	(1)	–	7
Other capital and dividend flows	(8)	–	–	–	–	–	(8)
Economic variance and other non-operating items	229	5	120	66	77	9	506
At 31 December 2012	1,710	33	1,382	451	1,157	90	4,823

27. Capital continued

For the year ended 31 December 2011	Total UK 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	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
At 1 January 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

d) Intra-group capital arrangements

There is a financing arrangement in the form of reinsurance of certain business written by FLAS which was transferred into FLC from Sun Life Pensions Management Limited ("SLPM") through a Part VII Scheme in 2007. Following the COP 2012 Part VII transfer this financing arrangement exists between the FLAS WPF and the FLL non-profit fund both of which are separate funds in FLL. The net amount of financing outstanding at 31 December 2012 was £26 million (2011: £44 million).

FLL has guaranteed the £210 million (2011: £210 million) STICS issued in 2003 and the £268 million (2011: £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 repaid £500 million of the £700 million internal fixed rate unsecured loan notes. On 14 November 2012 FLG repaid the outstanding £200 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. The £500 million external LT2 debt is guaranteed on a subordinated basis by FLL.

On 8 November 2012, the Group issued a US$575 million Upper Tier 2 ("UT2") reset perpetual subordinated debt instrument with a coupon of 7.875%, which is irrevocably guaranteed on a subordinated basis by FLL. A derivative instrument was entered into on 8 November 2012 to mitigate the risks associated with fluctuations in exchange rates on the issue of this debt.

Following the Part VII transfer of business from FLC to FLL, the requirement to retain the FLC reattributed inherited estate ("RIE") to support the FLC Old WPF and FLC New WPF and other previously existing with-profits fund support arrangements have been incorporated into one FLL scheme such that, as at 31 December 2012, the FLL shareholder fund and non-profit fund are required to retain £1.4 billion of capital support assets (of which £0.9 billion is in respect of the former FLC with-profits funds). Of this, £0.8 billion (£406 million in respect of former FLC with-profit funds) needs to be held in the form of tangible assets which could be transferred to the various FLL with-profits funds on a temporary basis if necessary. As at 31 December 2012 £59 million (2011: £54 million) of these support assets have been temporarily transferred to the FLL with-profits fund in the form of a contingent loan.

In the case of a temporary transfer to the with-profits funds, assets and related investment income would remain attributable to the shareholders as they would be returned when they are no longer required to support the capital requirements of the with-profits funds, under the tests set out in the COP 2012 scheme. In the case of the FLC with-profits funds if all or part of the assets transferred were unlikely to be returned in the foreseeable future (taking into consideration the duration of the in force with-profits policies), then the relevant part of the transfer would be designated permanent resulting in an income statement charge to the shareholders. Under the rules of the COP 2012 scheme a test must be performed once in every 12 month period and may result in a transfer being made to the with-profits funds. As at 31 December 2012 the transfer to the with-profits funds was nil (2011: nil).

FLWL 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-profits 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-profits fund. Any unused SSF will be gradually released to the shareholders, as the mathematical reserves of the protected Colonial policies run off. Following the annual inherited estate test at 31 December 2012, the SSF had net assets of £18 million (2011: £20 milllion).

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

Risks to which the Group is exposed

The Group, in the course of doing business, is exposed to the following categories of risk:

- financial risks: these are risks relating to the financial management of the business, the economy and other external events which result in the Group being unable to meet its financial obligations, and include market, credit, liquidity and insurance risks;
- strategic risks: these are risks related to the Group's business strategy and decision making, and include risks associated with mergers and acquisitions activity and the composition of the Group's capital structure;
- operational risks: these are risks of losses arising from inadequate or failed internal processes, personnel or systems, or from external events. Operational risks include regulatory, financial crime, people, legal, outsourcing, information technology and business protection risks; and
- Group risks: these are risks of losses or reputational damage due to the activities of a Group member, including any business unit or subsidiary.

This note presents information about the Group's exposure to financial risks and the Group's 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 2012 and 2011, split by UK and Heritage (including the Corporate business where relevant) and International (comprising of FPI and 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.

Sensitivities shown in a single direction have broadly symmetrical impacts.

28. Risk management objectives and policies for mitigating risks continued

2012 Sensitivities	Change in MCEV (net of tax)			Change in VNB (gross of tax)		
	UK & Heritage £m	Int'l[v] £m	Total £m	UK & Heritage £m	Int'l[v] £m	Total £m
Base MCEV and VNB (per note 11 of the supplementary information)	3,696	1,227	4,923	144	50	194
Market and credit risk						
100bps increase in reference rates	(53)	(3)	(56)	(6)	(2)	(8)
100bps reduction in reference rates	37	15	52	5	2	7
Removal of illiquidity premium for immediate annuities	(544)	–	(544)	(31)	–	(31)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield[i]	(181)	(60)	(241)	n/a	n/a	n/a
25% increase in equity and property volatility at the valuation date	(32)	–	(32)	n/a	n/a	n/a
25% increase in swaption implied volatility at the valuation date	(4)	–	(4)	n/a	n/a	n/a
100bps increase in corporate bond spreads[ii]	(203)	(11)	(214)	(14)	–	(14)
100bps decrease in corporate bond spreads[ii]	261	11	272	13	–	13
10% adverse movement in Sterling/overseas exchange rate[iii]	(30)	(92)	(122)	n/a	n/a	n/a
10% fall in value in unit-linked funds	(207)	(96)	(303)	n/a	n/a	n/a
100bps increase in expense inflation	(65)	(39)	(104)	(7)	(5)	(12)
100bps decrease in expense inflation	57	32	89	6	4	10
Insurance and other risk						
Reduction to EU minimum capital or equivalent[iv]	40	–	40	2	–	2
10% proportionate reduction in maintenance expenses	109	50	159	8	8	16
10% proportionate reduction in lapse rates	83	49	132	13	5	18
10% reduction in paid-up rates	13	12	25	5	1	6
5% reduction in mortality and morbidity (excluding annuities):						
Before reinsurance	79	12	91	10	4	14
After reinsurance	38	8	46	5	1	6
5% reduction in annuitant mortality/morbidity:						
Before reinsurance	(132)	–	(132)	(4)	–	(4)
After reinsurance	(67)	–	(67)	(4)	–	(4)
Effect of end of period assumptions on VNB	n/a	n/a	n/a	4	(1)	3

(i) The movement in UK embedded value from a reduction in market values comprises a £nil million (2011: £nil million) change in the value of shareholders' net worth and a £181 million (2011: £188 million) reduction in the value of in-force covered business.
(ii) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40 bps (2011: 35bps) for in-force business and 40 bps (2011: 35bps) for the value of new business.
(iii) Currency risk is expressed in terms of total overseas exposure; the Group's principal currency exposures other than Sterling are the Euro and US Dollar.
(iv) Required capital is set at the greater of regulatory capital and requirements arising from internal capital management policies. In aggregate, the required capital is higher than the regulatory requirement by £886 million (2011: £902 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.
(v) The base MCEV for International includes £43 million in respect of AmLife and the base VNB for International includes £3 million in respect of AmLife, however the International sensitivities exclude AmLife due to its sale on 4 January 2013 and its immaterial impact.

28. Risk management objectives and policies for mitigating risks continued

2011 Sensitivities	Change in MCEV (net of tax) UK & Heritage £m	Int'l £m	Total £m	Change in VNB (gross of tax) UK & Heritage £m	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 reduction 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	(256)	(18)	(274)	(7)	–	(7)
100bps decrease in corporate bond spreads	238	19	257	1	–	1
10% adverse movement in Sterling/overseas exchange rate	(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% proportionate reduction in maintenance expenses	147	44	191	10	7	17
10% proportionate reduction in lapse rates	90	45	135	11	8	19
10% 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	n/a	n/a	n/a	8	6	14

(i) The movement in UK embedded value from a reduction in market values comprises a £nil million (2011: £nil million) change in the value of shareholders' net worth and a £181 million (2011: £188 million) reduction in the value of in-force covered business.
(ii) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40 bps (2011: 35bps) for in-force business and 40 bps (2011: 35bps) for the value of new business.
(iii) Currency risk is expressed in terms of total overseas exposure; the Group's principal currency exposures other than Sterling are the Euro and US Dollar.
(iv) Required capital is set at the greater of regulatory capital and requirements arising from internal capital management policies. In aggregate, the required capital is higher than the regulatory requirement by £886 million (2011: £902 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.
(v) The base MCEV for International includes £43 million in respect of AmLife and the base VNB for International includes £3 million in respect of AmLife, however the International sensitivities exclude AmLife due to its sale on 4 January 2013 and its immaterial impact.

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, interest rate risk, volatility risk and foreign exchange risk.

Market risk arises on guarantees and options offered on some of the Group's products. As described within the section on policyholder liabilities (see note 25 and 26), the Group is exposed to guarantees on bonus additions that become more valuable as investment values fall and where the cost of hedging increases. In addition, the Group is exposed to guaranteed cash and annuity options on certain pension policies that become more valuable as interest rates fall and where the cost of hedging increases.

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 Group Actuarial Director, 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 gilts and corporate bond exposures, cash exposures, derivative exposures, equity and other exposures, and also limits in relation to interest rate risk, inflation risk, foreign exchange risk, implied equity and interest rate volatility. The relevant limits are also reflected in investment guideline documents which are maintained for each fund.

To support the setting of investment limits, the Asset and Liability Management ("ALM") function 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 during the year was a sub-committee of the FLG board, but from 28 March 2013 will become a Committee of the Board, oversees investment policy and strategy, which the Group controls primarily through the use of investment fund mandates. Day-to-day implementation of investment policy and strategy is managed predominantly by:

- F&C in respect of the FP WPF as well as unit-linked business sold by FLL and FLPL;
- AXA Investment Management UK Limited ("AXA IM") in respect of all FLWL business, the FLC WPFs and FLAS WPF, and unit-linked business sold by FLC; and
- FLI in respect of shareholder, non-profit, and shareholder annuity portfolios.

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.

28. Risk management objectives and policies for mitigating risks continued

FLI, F&C and AXA IM managed funds may hold derivatives to facilitate efficient portfolio management where their use is provided for in the relevant fund mandates. The types of derivatives held vary between investment mandates but may include both rates and equity derivatives. Currency forwards and other derivatives may also be held to manage currency risk, but only if permitted by individual fund mandates. The Group may seek to reduce investment risk by holding derivatives (without disproportionately increasing other types of risk).

Unit-linked funds may use derivatives for the purposes of efficient portfolio management and risk reduction in accordance with 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 income protection policies.

In order to manage the exposure arising from guarantees and options, the Group has purchased a number of derivatives, including interest rate swaps, equity put options, currency forwards, inflation swaps, interest rate swaptions and equity futures to manage exposures to movements in equity prices or interest rates. Hedge accounting has not been applied to these derivatives, as movements in the fair value of these instruments will be offset by the movement in the valuation of the liability. As noted, the majority of these guarantees arise within the Group's with-profits funds and so any net fair value movement will be reflected in the unallocated surplus rather than within shareholders' funds. In addition, derivatives are used to manage guarantees in respect of non-profit business.

The following provides additional information on the exposure to equity and property risk, foreign exchange risk, interest rate risk and volatility risk:

i) Equity and property risk

Equity and property risk are accepted in accordance with agreed risk appetite in order to achieve the desired level of return from policyholder assets.

Asset allocation within the with-profits funds is actively managed. At 31 December 2012 the proportion of equities and property backing asset shares in the FP WPF was reduced from 50% to 45%, and for the FLC WPFs the ratio was reduced from 65% to 60%. These actions reflect the perceived risk appetite of the with-profits funds 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 WPF is managed on a basis which targets a stable proportion over time. This is also true in FLWL for policies with equity participation, although as policies get close to maturity their allocation is moved towards short-term fixed interest investments, and thus the overall equity and property proportion is likely to fall over time. For the FLC WPFs, asset allocation varies for different policies depending on how close they are to maturity, and thus the overall equity and property proportion within the fund is expected to gradually reduce over time.

For with-profits and unit-linked policies, the policyholders bear the majority of the investment risk and any change in asset values is matched by a broadly equivalent change in the realistic liability. 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 2012 there has been no material exposure to equity risk within any of the shareholders' funds.

ii) Foreign exchange risk

The Group is exposed to foreign exchange risk through its investment in foreign operations, fee income derived from financial instruments denominated in currencies other than its measurement currency (pounds Sterling), revenues receivable and payables due in foreign currency. Consequently, the Group is exposed to the risk that the exchange rate of its measurement currency relative to other currencies may change in a manner that has an adverse effect on the value of the Group's financial assets and liabilities. Derivative instruments are used to manage potential foreign exchange volatility in relation to foreign currency loans and borrowings, all other exchange rate risk is accepted as being within the Group's agreed risk appetite given the relative materiality of the exposure.

28. Risk management objectives and policies for mitigating risks continued

The net exposure to foreign exchange risk through investment in overseas equities is currently small, and exposure through debt securities is limited due to the restrictions through limits placed by investment mandates. For unit-linked contracts and with-profits policies (to the extent that currency risk on overseas equities held by the with-profits funds are only partially hedged), currency risk is borne by the policyholder. As noted above, the shareholder is subject to currency risk only to the extent that income from policyholder funds is based on the value of the financial assets held in those funds. The liability for non-linked insurance contracts in currencies other than Sterling is immaterial.

iii) Interest rate risk

The Group is exposed to fair value interest rate risk where changes to interest rates result in changes to fair values rather than cash flows, for example fixed interest rate loans and assets. Conversely, floating rate loans expose the Group to cash flow interest rate risk. The Group makes use of derivatives to manage interest rate risk. In the case of swaps the Group holds both:

- receiver interest rate swaps (where fixed payments are received in return for floating payments being paid) – increases to interest rates increase cash flows payable and reduce fair value; and
- payer interest rate swaps (where floating payments are received in return for fixed payments being paid) – reductions to interest rates reduce cash flows receivable and reduce fair value.

However both types of swaps are held in order to reduce the net asset/liability rate risk which would otherwise arise.

Bond-related performance benchmarks within fund mandates are generally set so that asset profiles broadly match liability profiles and hence the interest rate risk is minimised. However in FAL and in FLWL with-profits funds and, in FLL, the FP, FLC, FLAS with-profit funds assets have been invested deliberately in bonds with a shorter duration than the companies' liabilities. Interest rate swaps have then been put in place to reduce the reinvestment risk which would otherwise arise.

Day-to-day investment decisions around the management of interest rate risk and its impact on the value of FLG's investments are largely undertaken on behalf of FLG by the relevant investment manager, within the boundaries set by fund mandates. In its decision-making on gilt and corporate bond investments, the investment manager will assess the extent of interest rate risk allowed by the fund as set out in the fund objectives and relative to the defined performance benchmarks.

FLG's ALM function is responsible for monitoring and managing net asset/liability interest rate risk across all of the FLG businesses. From time to time the ALM function may propose changes to the fund mandates to reflect changes in interest rate risk appetite.

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;

28. Risk management objectives and policies for mitigating risks continued

- loan risk – financial loss arising from a debtor's inability to repay all, or part, of its loan obligations or the deterioration of the debtor's financial position;
- country risk – financial loss arising from economic agents in a sovereign foreign country, including its government, being unable or unwilling to fulfil their international obligations due to a shortage of foreign exchange or another common reason such as currency inconvertibility; and
- settlement risk – financial loss arising from the failure or substantial delay of an expected settlement in a transfer system to take place, due to a party other than the Group defaulting/not delivering on its settlement obligations.

i) Investment Credit risk

The Group's Life and Pensions business will take on investment credit risk when it is deemed financially beneficial to do so in support of its financial objectives.

The Group is exposed to investment credit risk on its investment portfolio (in line with the Group's risk 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, AXA IM and FLI. In their decision making, F&C, AXA IM or FLI (as appropriate), will assess the extent of investment credit risk allowed by each fund as set out in the fund mandates and relative to defined performance benchmarks.

The majority of the Group's corporate bond portfolio has a high credit rating (see subsequent tables in this note).

ii) Derivative counterparty risk

Derivatives purchased over the counter have the potential to expose the Group to substantial credit risk but this risk is significantly reduced through collateral arrangements with counterparties. 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.

iii) Reinsurance counterparty risk

The Group is exposed to reinsurance counterparty risk of three different types:

- as a result of debts arising from claims made but not yet paid by the reinsurer;
- from reinsurance premium payments made to the reinsurer in advance; and
- as a result of reserves held by the reinsurer which would have to be met by the Group in the event of default.

In addition, there is potential for the Group's credit risk exposure to increase significantly under adverse insurance risk events, e.g. if one of the insurance companies within the Group received a large number of claims for which it needed to recover amounts from its reinsurers. In order to mitigate reinsurance counterparty risk, the Group gives consideration to the credit quality of a reinsurer before incepting a reinsurance treaty. To facilitate this process, a list of acceptable reinsurers is maintained.

iv) Deposit risk

The Group is exposed to credit risk on the balances deposited with banks in the form of cash, certificates of deposit and money market instruments. Money market instruments issued by parties other than banks such as commercial paper are also covered under this heading. The primary risk is borrower quality; this is mitigated by limiting holdings in any one issuer.

In certain, limited circumstances, Lombard is exposed to deposit risk:

- of custodian banks relating to unit-linked policyholder cash positions; and
- for cash amounts held on behalf of unit-linked policyholders for premium proceeds with respect to policies not yet issued, and withdrawal/surrenders/death claim proceeds not yet paid to beneficiaries.

28. Risk management objectives and policies for mitigating risks continued

v) Loan risk

Companies in the Group are exposed to loan risk in several different areas, the most material of which are:

- loans to Independent Financial Advisors ("IFAs") as part of strategic investments;
- other strategic loans;
- loans to appointed representatives;
- loans to brokers;
- agency debt (including debt arising as a result of clawback of commission);
- policyholder debt; and
- rental income due.

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

vi) Company risk

The Group is exposed to country risk in a number of key areas, the most significant of which is bonds issued by foreign governments in non-domestic currency. The mandates that govern all F&C, AXA IM and FLI managed funds restrict the purchase of foreign government bonds to only those that exceed a minimum level of creditworthiness.

The management of country risk on the creditworthiness of the investments is largely undertaken on behalf of the Group by F&C, AXA IM and FLI. Counterparties are assessed on an individual basis, including the counterparty's sensitivity to a sovereign debt crisis in its country of domicile.

viii) Settlement risk

Settlement risk is a form of credit risk that arises at the settlement of a transaction, as a result of a counterparty failing to perform its obligations. The Group is exposed to settlement risk in the following key areas:

- bank transfers, including foreign exchange transactions;
- the purchase or sale of investments;
- the purchase or sale of property;
- the purchase, sale or expiry of exchange-traded derivatives or the transfer of periodic payments under these contracts; and
- the settlement of derivative contracts.

Objectives in managing credit risk

To mitigate credit risk:

- investment mandates for many funds will have a prescribed minimum credit rating of bonds that may be held and will generally prohibit investment in bonds of below specified minimum ratings, subject to some discretion where assets are downgraded. Investing in a diverse portfolio reduces the impact from individual companies defaulting;
- counterparty limits are set for investments, cash deposits, foreign exchange trade exposure and stock lending;
- all over the counter derivative transactions are covered by collateral, with minor exceptions;
- the Group regularly reviews the financial security of its reinsurers; and
- in some cases, derivatives are held to protect against the risk of credit default or internal hedge solutions have been implemented.

The exposure to individual counterparties is limited to specific percentages of total non-linked assets in the long-term fund, based on regulatory categorisation of counterparties.

Concentrations of credit risk might exist where the Group has significant exposure to a group of counterparties with similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic and other conditions.

Lombard deposits cash amounts with custodian banks. The deposit risk is managed by diversification across a number of custodian banks, holdings via diversified monetary collective funds, longer term balances being held in highly rated and/or state-backed custodian banks and via, in some cases, clients' acceptance of the risk in general policy conditions.

28. Risk management objectives and policies for mitigating risks continued

An indication of the Group's exposure to credit risk is the quality of the investments and counterparties with which it transacts. The Group is most exposed to credit risk on debt and other fixed-income securities, derivative financial instruments, deposits with credit institutions, reinsurance arrangements and cash equivalents. Debt and other fixed-income securities mainly comprise government bonds and corporate bonds. The Group monitors the quality of its corporate bonds and sovereign debt 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 consolidated statement of financial position represents the maximum credit exposure.

As at 31 December 2012	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Not rated £m	Total £m	Collateral held £m
Corporate bonds	1,037	3,043	5,035	2.945	417	44	44	12,565	–
Asset-backed securities	1,493	1,007	873	423	67	58	19	3,940	–
Derivative financial instruments	–	6	760	–	–	–	24	790	564
Reinsurance assets	–	3,021	131	–	–	–	1	3,153	–
Cash and cash equivalents	2,579	270	1,644	–	25	–	86	4,604	–
Insurance and other receivables	–	–	–	–	–	–	402	402	–
Total	5,109	7,347	8,443	3,368	509	102	576	25,454	564
%	20%	29%	33%	13%	2%	1%	2%	100%	

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	–
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%	–

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.

28. Risk management objectives and policies for mitigating risks continued

The direct exposure of the Group to government and corporate debt of Ireland, Portugal, Italy and Spain (being countries where the risk of credit default is perceived as higher) in shareholder and annuity funds at 31 December 2012 and 2011 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.

	2012			2011		
As at 31 December	Govt. debt £m	Corporate debt £m	Total[i] £m	Govt. debt £m	Corporate debt £m	Total[i] £m
Ireland	–	38	38	–	39	39
Portugal	–	5	5	–	10	10
Italy	7	145	152	6	154	160
Spain	–	146	146	–	167	167
Total	7	334	341	6	370	376

(i) Includes shareholder exposure to the 60:40 with-profits fund.

	Ireland £m	Portugal £m	Italy £m	Spain £m	Total £m
Corporate exposure:					
Domestic banks	–	–	18	15	33
Domestic non-bank financials	13	–	16	–	29
Non-domestic banks	–	–	–	67	67
Domestic non-financials	24	5	111	62	202
Non-domestic non-financials	1	–	–	2	3
Total 31 December 2012	38	5	145	146	334
Total 31 December 2011	39	10	154	167	370

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.

	2012		2011	
As at 31 December	Insurance receivables	Loans	Insurance receivables	Loans
Financial assets that are neither past due nor impaired	94.78%	100%	91.55%	100%
Financial assets that are past due:				
0 – 3 months past due	0.78%		4.44%	
3 – 6 months past due	1.55%		0.22%	
6 – 12 months past due	0.67%		3.14%	
Impaired financial assets for which provision is made	2.22%		0.65%	
Total before provision for impairment (£m)	902	6	923	5

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 2012, the fair value of such collateral held was £564 million (2011: £643 million). No collateral has been sold or repledged (2011: £nil).

Reinsurance assets include an amount of £1,767 million (2011: £1,800 million) which relates to a reinsurance agreement with Swiss Reinsurance Company Ltd ("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 2012, the value of such collateral was £1,783 million (2011: £1,807 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;
- the ability to deal with the liquidity implications of strategic initiatives, such as merger and acquisition activity;
- the capacity to provide financial support across the Group; and
- the ability to fund its day-to-day cash flow requirements.

The overall objective of shareholder liquidity risk management is to ensure that there is sufficient liquidity over short (up to one year) and medium time horizons to meet the cash flow needs of the business.

28. Risk management objectives and policies for mitigating risks continued

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.

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.

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

28. Risk management objectives and policies for mitigating risks continued

The following table details the undiscounted contractual net cash flows in respect of financial and insurance liabilities. Where contracts have a surrender value (i.e. the policy is theoretically payable on demand), the current surrender value is disclosed within the "within one year or payable on demand" column.

		Contractual undiscounted cash flows		
Year ended 31 December 2012	Carrying value £m	Within 1 year or payable on demand £m	1–5 years £m	More than 5 years £m
Non-derivative financial liabilities				
Insurance contracts	37,232	20,564	3,535	15,895
Investment contracts	78,184	78,184	–	–
Loans and borrowings:				
– Principal	1,099	59	17	1,015
– Interest	–	50	200	145
Due to reinsurers	1,767	116	451	1,752
Net asset value attributable to unit-holders	754	754	–	–
Insurance payables and other payables	871	865	–	6
Derivative financial liabilities				
Interest rate swaps	158	4	103	51
Inflation rate swaps	1	–	1	–
Futures backing equities	6	6	–	–
Credit default swaps	4	–	2	1
Cross-currency swaps	56	7	4	45
Futures – fixed-interest	1	1	–	–
Forward currency contracts	4	4	–	–

28. Risk management objectives and policies for mitigating risks continued

Year ended 31 December 2011	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	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	–	–

Amounts expected to be settled from the unallocated surplus are excluded from the analysis above as there is no contractual obligation to settle the liability. Of the carrying amount in the consolidated statement of financial position in respect of the unallocated surplus, £577 million (2011: £586 million) is expected to be settled more than 12 months after the balance sheet date.

e) Insurance risk

Insurance risk includes the following areas:

- mortality risk – risk of loss arising due to policyholder death experience being different from expectations; or for annuities, risk of annuitants living longer than expected (called annuity longevity risk);
- morbidity risk – risk of loss arising due to policyholder health experience being different from expectations;
- persistency risk – risk of loss arising from lapse experience being different from expectations;
- expense risk – risk of loss due to expense experience being different from expectations; and
- option risk – risk of loss arising from experience of take up of options and guarantees being different from expectations.

The Group's Life and Pensions business actively pursues mortality risk, longevity risk and morbidity risk in those areas where it believes it has a competitive advantage in managing these risks to generate shareholder value (without compromising the interests of policyholders, and the need to treat customers fairly). Persistency risk, 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, in particular quota share reinsurance may be used to limit overall exposure to mortality, morbidity and longevity risks. 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.

Changes in legislation that impact pricing

On 1 March 2011 the European Court of Justice ("ECJ") ruled that it is unlawful for insurers to use gender in risk pricing. The resulting amendment to the UK Equality Act came into force on 21 December 2012.

There will now be a potential for an increased financial risk in relation to the future business which may have a gender mix which is detrimental to profit i.e. adverse relative to the assumption within pricing.

For protection business there are also transition risks relating to lapse and re-entry, where the change results in lower premiums.

There is an additional risk in relation to amendments to in-force business where the changes to legislation are not so clear and there is some risk that the Group could be challenged on its approach.

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 in with-profits funds 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 £1,767 million at 31 December 2012 (2011: £1,800 million).

28. Risk management objectives and policies for mitigating risks continued

Longevity risk within FAL and the FLAS WPF was reduced during 2009 and 2010 by reinsurance of the annuity business with external parties. The agreement reinsures 95% of the longevity risk in respect of £3 billion of annuity liabilities in the FP WPF and a further £2 billion of annuity liabilities in the FLAS WPF of FLL.

ii) Persistency and option risk

Persistency experience varies over time as well as from one type of contract to another. Factors that will cause lapse rates to vary over time include changes in investment performance of the assets underlying the contract where appropriate, regulatory changes that make alternative products more attractive (or incentivise advisors to be more or less active in recommending policyholders to switch provider), customer perceptions of the insurance industry in general and the Group in particular, and the general economic environment.

The valuation of the Group's guarantees and options is described in note 26. As stated in that note, the cost of guaranteed annuity options is dependent on decisions made by policyholders such as policy discontinuance and tax-free cash take-up. These assumptions are set by reference to recent experience.

iii) Expense risk

Although under IFRS 4 expense risk is not a component of insurance risk, it is an important policy cash flow risk in the context of insurance and investment contracts.

The whole of the impact of changes in expense levels is borne by shareholders with the following exceptions:

- the charges made to the FP WPF for managing policies are due to be reviewed in 2014 to reflect market rates at that time. Pre-demutualisation with-profits policyholders will bear the impact of any resulting changes to charges;
- FPLAL WPF closed fund with-profits policyholders bear the full expense risk for the fund; and
- FLC WPFs, FLAS WPF and WL WPF have a fee agreement with FLSL, under which increased expenses may be passed on to the funds provided independent review of the proposed expenses shows they are in line with market rates.

Contractual terms for unit-linked and unitised with-profits products include provision for increases in charges. Certain expenses (such as fees and commissions) are fixed at the time a contract is written.

FLG follows a heavily outsourced operating model which assists in the management of expense risk by ensuring the cost base allows for variable costs built into contractual assumptions. During 2012 Friends Life commenced a major deal to outsource further parts of its operations to Diligenta. 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	2012 £m	2011 £m
At 1 January	**75,191**	72,411
Acquired through business combinations	**–**	5,195
Premiums	**7,724**	6,775
Claims	**(8,224)**	(7,323)
Investment return, annual management charges and other expenses	**4,032**	(1,509)
Foreign exchange adjustments	**(539)**	(358)
At 31 December	**78,184**	75,191
Analysed as follows:		
Unit-linked contracts	**67,428**	65,259
Policies with DPF	**9,543**	9,457
Other non-unit reserves	**1,213**	475
Total investments contract liabilities	**78,184**	75,191

None of the movement in liabilities is attributable to changes in credit risk of the liabilities. Investment return of £5,052 million (2011: £(495) million) is included within the income statement arising from movements in investment contract liabilities.

Included in the carrying amount above, £68,587 million (2011: £69,455 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 %	2012 £m	2011 £m
Subordinated liabilities:			
Lombard undated subordinated loans	Various	**1**	2
Friends Life Group plc £162 million LT2 subordinated debt due 2021	12.00	**181**	183
Friends Life Group plc £500 million LT2 subordinated debt due 2022	8.25	**496**	496
Friends Life Group plc $575 million UT2 reset perpetual subordinated debt	7.875	**346**	–
Deferred consideration notes:			
Series A deferred consideration notes	6.00	**–**	232
Series B deferred consideration notes	7.25–6.50	**–**	191
Reinsurance:			
Lombard financial reinsurance treaties	Various	**4**	8
International financial reinsurance treaties	Various	**57**	64
Other:			
Amounts owed to credit institutions (overdrafts)		**14**	19
Total loans and borrowings		**1,099**	1,195

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

Subordinated liabilities

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

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

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

Deferred consideration notes

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

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

30. Loans and borrowings continued

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

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

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

Financial reinsurance

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

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

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

Other

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

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

30. Loans and borrowings continued

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

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

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

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

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 £1,767 million (2011: £1,800 million) is £1,648 million (2011: £1,682 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	2012 £m	2011 £m
At 1 January	**1,173**	1,173
Acquired through business combinations	–	(28)
Share of total return in the year	118	(48)
Share of distributions in the year	(22)	(27)
Amount paid on issue of shares	409	546
Disposals	(515)	(52)
Amount received on cancellation of shares	(409)	(391)
At 31 December	**754**	1,173

The carrying value of net asset value attributable to unit-holders approximates fair value.

33. Provisions

For the year ended 31 December	2012 £m	2011 £m
At 1 January	**228**	221
Acquired through business combinations	**–**	8
Charged in the period	**138**	78
Released in the period	**(32)**	(32)
Utilised in the period	**(56)**	(47)
At 31 December	**278**	228

Included in the carrying amount above, £147 million (2011: £150 million) is expected to be settled more than 12 months after the balance sheet date.

a) Review of mortgage endowment and pension sales

Provision continues to be held 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. An accounting provision of £18 million (2011: £11 million) and an actuarial reserve of £4 million (2011: £5 million) were held in respect of estimated further complaints.

b) Separation and integration costs

As part of the respective purchase agreements, the Group continues to incur various costs to separate the businesses purchased from AXA UK plc, Bupa Investments Limited and its parent, Bupa Finance plc, and to integrate the businesses within the Group. At the year end, the Group has provided £1 million (2011: £4 million) for separation costs where the Group has an onerous commitment to separation activities and the separation plans are sufficiently progressed. In addition, £9 million (2011: £13 million) has been provided against reorganisation activities where the FLG board has approved the plans.

c) ROL separation costs

Provision of £14 million has been made for ROL transition costs (2011: £nil): £10 million mainly in relation to the costs of transferring an operating agreement, under which the Company outsources most of its operating functions, from ROL to the Group and the recognition of an onerous lease provision in respect of the ROL offices to be taken over by the Group. A further £4 million has been provided for restructuring activities where separation plans are sufficiently progressed. An additional £2 million of ROL transition costs are accrued within insurance payables, other payables and deferred income.

d) Other

Other provisions include lapse provisions within Sesame Bankhall of £19 million (2011: £21 million), provisions for vacant property of £11 million (2011: £19 million), provision recognised for anticipated costs associated with the migration of hosting from AXA systems onto the Group's network of £25 million (2011: £nil), a provision recognised in respect of committed costs linked to the Diligenta outsourcing agreement of £32 million (2011: £nil), which the Group entered into during 2012. Also included is £149 million (2011: £145 million) inclusive of potential costs that may be incurred by the acquired AXA UK Life Businesses. These include provisions for policyholder compensation arising 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. This also includes a provision related to certain aspects of the administration by the acquired AXA UK Life Businesses of defined benefit pension schemes. Where provisions are held for the longer term, discounting is applied at a rate of 3% per annum, a net £nil (2011: £nil) is included within the charge for the year in respect of the unwind of discount and £nil (2011: £5 million) relating to a change in the discount rate applied.

34. Insurance payables, other payables and deferred income

As at 31 December	2012 £m	2011 £m
Creditors arising out of direct insurance operations	**73**	70
Creditors arising out of reinsurance operations	**84**	55
Accruals and deferred income	**186**	225
Investments purchased for subsequent settlement	**210**	20
Deferred front-end fees	**53**	38
Derivative contracts	**230**	287
Other payables	**321**	321
Total insurance payables, other payables and deferred income	**1,157**	1,016

Included in the carrying amount above, £278 million (2011: £260 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.

Issued and fully paid	2012 Number of shares (million)	2012 £m	2011 Number of shares (million)	2011 £m
Shares of no par value fully paid	**1,418.1**	**4,225**	1,376.2	4,135
Own shares held by the Group	**–**	**–**	(2.7)	(7)
Total at 31 December	**1,418.1**	**4,225**	1,373.5	4,128

35. Share capital continued

Changes to share capital during the year

Issued and fully paid	31 December 2012 Number of shares (million)	Share capital £m
Opening share capital	**1,376.2**	**4,135**
Own shares held by the Group	(2.7)	(7)
Adjusted opening share capital	**1,373.5**	**4,128**
Shares issued in respect of scrip dividend (final 2011)	15.5	35
Shares issued in respect of scrip dividend (interim 2012)	26.4	55
Reduction in own shares held by the Group	2.7	7
Closing share capital	**1,418.1**	**4,225**

Issued and fully paid	31 December 2011 Number of shares (million)	Share capital £m
Opening share capital	1,452.6	4,337
Own shares held by the Group	(8.6)	(20)
Adjusted opening share capital	1,444.0	4,317
Shares issued 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

All ordinary shares in issue in the Company rank pari passu and carry the same voting rights and rights to receive dividends and other distributions declared or paid by the Company.

36. Other reserves

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

For the year ended 31 December 2012	Capital reserve £m	Retained earnings £m	Foreign currency translation reserve £m	Total £m
1 January 2012	1	1,567	(24)	1,544
Loss for the period	–	(72)	–	(72)
Actuarial loss on defined benefit scheme (net of tax)	–	(35)	–	(35)
Tax relief on STICS interest	–	7	–	7
Foreign exchange adjustments (net of tax) and other items	–	–	(12)	(12)
Share-based payments	–	3	–	3
Dividends	–	(283)	–	(283)
At 31 December 2012	1	1,187	(36)	1,152

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

37. Non-controlling interests

As at 31 December	2012 £m	2011 £m
2003 STICS	135	135
2005 STICS	183	183
Other	3	5
Total non-controlling interests	**321**	323

The STICS are carried at their fair value at the date of acquisition.

37. Non-controlling interests continued

a) Step-up tier one 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 IFRS based operating profit for the Group. No ordinary dividend can be paid if the STICS dividend is not paid. The STICS are presented in the financial statements as a non-controlling interest.

A summary of the principal terms of the STICS is set out in the following paragraphs.

2003 STICS

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 2012 is £3 million (31 December 2011: £5 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 and interpretation of tax law. While there can be no assurances, at this time the directors believe, based on the information currently available to them, that it is not probable that the ultimate outcome of any of these matters will have a material adverse effect on the financial condition of the Group.

b) Commitments

Operating leases where the Group is lessee

The Group leases a number of properties under operating leases with the most material running to 2026. Lease terms include annual escalation clauses to reflect current market conditions.

The future minimum rentals payable under all non-cancellable leases are as follows:

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

Restatement of prior period figures

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

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

Other commitments

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

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

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

39. Business combinations

There have been no acquisitions or disposals in 2012. Business combinations in 2011 are set out in the note below. These acquisitions were consistent with the strategy of the Group's ultimate parent, Resolution Limited, to generate value by consolidating UK life and asset management businesses.

Acquisitions and disposals made in 2011 are discussed below:

a) Acquisition of Bupa Health Assurance Limited in the prior year

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.

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 for 2011 included £1 million within administrative and other expenses in relation to stamp duty payable on the shares acquired.

b) Acquisition of Winterthur Life UK Limited ("WLUK") in the prior year

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 for 2011 included £2 million within administrative and other expenses in relation to stamp duty payable on the shares acquired.

39. Business combinations continued

c) Disposal of GOF and TIP portfolios

The assets and liabilities related to the Guaranteed Over Fifties ("GOF") and Trustee Investment Plan ("TIP") portfolios of business were disposed of 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 was recognised as income in the consolidated income statement for the year ended 31 December 2011. 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	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 2011 income statement of the held for sale business:

	2011 £m
Gross earned premiums	71
Gross claims and benefits paid	(15)
Change in insurance contracts liabilities	2
Administrative and other expenses	(51)
Profit before tax	7

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 for key management in place at 31 December 2012:

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

40. Related parties continued

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

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

The compensation paid to ROL is disclosed in note 40 (b) below.

b) Other related parties

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

- the Company continued to outsource the majority of its operating functions to ROL. The Company paid ROL an annual operating fee based on 0.5% of the non-cash value of the Company (subject to (i) a minimum payment of £10 million and (ii) a maximum reduction in any year of up to £2 million if ROL manages, advises or provides similar services to any new projects outside the UK Life Project). In addition, the Company paid ROL amounts for additional accounting services and certain company secretarial services. The total amount charged under the Operating Agreement for the twelve months ended 31 December 2012 was £18 million (2011: £20 million), of which £2 million (2011: £2 million) was incurred by the Company and £16 million (2011 £18 million) was incurred by Resolution Holdco No. 1 LP (a direct wholly owned subsidiary of the Company). An accrual of £0.1 million (2011: £0.2 million) in respect of ROL fees payable has been recognised in the Company's statement of financial position as at 31 December 2012; and
- subject to certain conditions, the Company may advance funds up to an aggregate of £20 million to ROL for development work on new projects outside the UK Life Project. The amounts advanced by the Company are reimbursable by ROL, together with an appropriate investment return (which, subject to the Company's agreement may be paid in cash or take the form of another benefit to the Company or its shareholders) if ROL successfully launches a new project. Any amounts that are reimbursed by ROL replenish the aggregate amount of funding that may be advanced to ROL to fund development work on new projects. The total amount of funding advanced under the Operating Agreement to ROL for development work on new projects is £1 million (2011: £1 million). On 10 December 2012, the Company announced that ROL had agreed not to request any further funding of new projects.

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

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

40. Related parties continued

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

As shown in note 17, the Company has a 99.99% interest in, and is the general partner in, Resolution Holdco No.1 LP, a Guernsey limited partnership. RCAP Guernsey LP, a member of the Resolution Group, is a limited partner in Resolution Holdco No.1 LP. The Company entered into the limited partnership for the purpose of making acquisitions and rewarding the Resolution Group for value created in the limited partnership from those acquisitions. This arrangement is not time limited.

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

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

41. Post balance sheet events

Disposal of AmLife

On 4 January 2013 the Company disposed of its entire holding of 30% of the ordinary share capital of both AmLife Insurance Berhad and AmFamily Takaful Burhad (collectively "AmLife") to AmBank Group of Malaysia for RM 245 million (£50 million) resulting in a profit on disposal of £20 million. Prior to sale, AmLife was held within the FPI operating segment (see note 18).

FPPS defined benefit scheme deficit reduction funding

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

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

Arrangements with ROL

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

Dividend Reinvestment Plan ("DRIP")

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

Changes in the rate of corporation tax

The Chancellor delivered his Budget on 20 March 2013. The impact of the further 1% rate reduction in corporation tax (which is in addition to the 1% reduction announced in the Autumn Statement on 5 December 2012) has been assessed in note 11. The Group is reviewing the detail of the other announcements and the preliminary view is that they are not expected to have a significant impact.

MCEV financial statements

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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

25 March 2013

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 2012, 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 230 to 233.

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 230 to 233 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 2012 are prepared, in all material respects, in accordance with the CFO Forum Principles and the basis of preparation set out on pages 230 to 233.

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 August 2012 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 2012. 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

25 March 2013

Consolidated income statement – MCEV basis

For the year ended 31 December 2012

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

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

The notes on pages 230 to 264 form an integral part of these financial statements.

Earnings per share – MCEV basis

For the year ended 31 December 2012

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

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

(i) amortisation and impairment of non-covered business acquired intangible assets;

(ii) the effect of economic variances (including the impact of economic assumption changes); and

(iii) significant non-recurring items and non-operating items.

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

Consolidated statement of comprehensive income – MCEV basis

For the year ended 31 December 2012

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

(i) Total comprehensive income/(loss) for the year is attributable to equity holders of the parent.

Consolidated statement of changes in equity – MCEV basis

For the year ended 31 December 2012

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

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

Consolidated statement of financial position – MCEV basis

As at 31 December 2012

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

Group MCEV analysis of earnings

For the year ended 31 December 2012

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

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

Notes to the MCEV results

For the year ended 31 December 2012

1. Basis of preparation

Introduction

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

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

The 2011 comparatives include the following:

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

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

Segmental analysis and definitions

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

MCEV methodology

Overview

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

Covered business

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

The external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 are formally allocated to covered business on the basis that all obligations to make payments in respect of this debt are guaranteed by FLL. The external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 are included within the MCEV at market value, based on listed ask prices.

Non-covered business

The Group's non-covered business includes the IFA distribution businesses, the management services businesses, Friends Life Investments ("FLI") and the net pension asset of FPPS on an IAS 19 basis. FLG corporate net assets, certain holding company costs, RSL corporate net assets, the deferred consideration notes issued by Resolution Limited, (until the date of their repayment on 20 November 2012), the acquisition finance facility (until the date of its repayment in April 2011) and the internal LT2 subordinated debt 2020 issued by FLG to Resolution holding companies (until the date of its repayment in November 2012) are all non-covered business.

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

(i) Copyright© Stichting CFO Forum Foundation 2008.

1. Basis of preparation continued

Segmental reporting under MCEV

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

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

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

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

New business

New business within the life and pensions covered business includes:

- premiums from the sale of new policies;
- payments on recurring single premium policies, including Department for Work and Pensions rebate premiums, except existing stakeholder-style pensions business where, if a regular pattern in the receipt of premiums for individuals has been established, the regular payment is treated as a renewal of an existing policy and not new business;
- non-contractual increments on existing policies;
- new entrants to existing schemes in the corporate benefits business; and
- immediate pension annuity contracts arising from internal vestings.

The MCEV new business definition is consistent with the quarterly new business disclosures.

Calculation of embedded value

The reported Group MCEV provides an estimate of the total consolidated MCEV of the Group and comprises the MCEV in respect of the life and pensions covered business, together with the IFRS net assets in respect of the non-covered business, excluding intangible assets relating to future new business.

The MCEV provides an estimate of the value of shareholders' interest in the covered business, excluding any value that may be generated from future new business. The MCEV comprises the sum of the shareholders' net worth of the life and pensions covered business and the value of in-force covered business. The shareholders' net worth of the life and pensions covered business includes the listed debt of the external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 at market value, based on listed ask prices.

The MCEV is calculated on a post-tax basis. Where gross results are presented, these have been calculated by grossing up the post-tax results for covered business at the appropriate rate of corporation tax for each segment. For non-covered business the gross results are presented gross of any IFRS tax attributed.

a) Shareholders' net worth

The shareholders' net worth of the life and pensions covered business consists of free surplus and required capital.

Free surplus is the market value of any assets allocated, but not required, to support the in-force covered business at the valuation date. Required capital is the market value of assets, attributed to the covered business over and above that required to back liabilities for covered business, whose distribution to shareholders is restricted. The Group's required capital is set at the greater of local regulatory capital requirements and those requirements arising from internal capital management policies, which include economic risk capital objectives. The economic risk capital is determined from internal models, based on the Group's risk appetite. The level of required capital is shown in note 10.

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

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

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

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

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

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

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

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

Only modest amounts of new with-profits business are written and the guarantee levels offered are lower, hence there is no material impact in respect of the TVOG on the value of new business.

Frictional costs of required capital

The value of in-force covered business includes a deduction for the additional costs to an investor of holding the assets backing required capital through investment in a life company, rather than investing in the asset directly. These additional frictional costs comprise taxation and investment expenses on the assets backing the required capital.

The frictional costs of required capital are calculated as the difference between the market value of assets backing required capital and the present value of future releases of that capital allowing for future investment return (net of frictional costs) on that capital. The calculation allows for the run-off of the required capital over time using projections of the run-off of the underlying risks and regulatory requirements.

Details of the level of required capital are set out in note 10.

1. Basis of preparation continued

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

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

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

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

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

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

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

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

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

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

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

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

Exchange rates
The results and cash flows of overseas subsidiaries and joint ventures have been translated at the average exchange rates for the period and the assets and liabilities have been translated at the period end rates. Translation differences are shown as foreign exchange adjustments in the consolidated statement of comprehensive income. Exchange rate driven movements in MCEV earnings are reported within economic variances.

Details of the exchange rates used are shown in note 10.

2. Analysis of MCEV earnings

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

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

The analysis is shown separately for free surplus, required capital and the value of the in-force covered business. All figures are shown net of tax.

Net of tax **For the year ended 31 December 2012**	FLG						RSL	
	Covered business							
	Free surplus £m	Required capital £m	VIF £m	MCEV £m	Non-covered business £m	Total £m	Non-covered business £m	Total £m
Opening Group MCEV	821	747	3,844	5,412	537	5,949	(153)	5,796
Value of new business	(285)	97	340	152	–	152	–	152
Expected existing business contribution:								
– expected existing business contribution: reference rate	26	(10)	57	73	–	73	–	73
– expected existing business contribution: in excess of reference rate	9	(47)	215	177	–	177	–	177
Transfers from VIF and required capital to free surplus	560	(18)	(542)	–	–	–	–	–
Operating experience variances and development costs	(69)	(12)	(3)	(84)	–	(84)	–	(84)
Operating assumption changes	(67)	–	54	(13)	–	(13)	–	(13)
Other operating items	86	(37)	(29)	20	(35)	(15)	(28)	(43)
Operating Group MCEV earnings	260	(27)	92	325	(35)	290	(28)	262
Economic variances	119	(200)	197	116	1	117	–	117
Other non-operating items	(107)	(120)	120	(107)	(2)	(109)	(2)	(111)
Total Group MCEV earnings	272	(347)	409	334	(36)	298	(30)	268
Other movements in IFRS net equity	–	–	–	–	(35)	(35)	7	(28)
Closing adjustments:								
– capital and dividend flows	(452)	(356)	1	(807)	309	(498)	309	(189)
– foreign exchange variances	–	(4)	(12)	(16)	–	(16)	–	(16)
Closing Group MCEV	641	40	4,242	4,923	775	5,698	133	5,831

2. Analysis of MCEV earnings continued

Net of tax For the year ended 31 December 2011	FLG						RSL	
	Covered business							
	Free surplus £m	Required capital £m	VIF £m	MCEV £m	Non-covered business £m	Total £m	Non-covered business £m	Total £m
Opening Group MCEV	977	1,291	4,202	6,470	44	6,514	1	6,515
Opening adjustments:								
– acquired value of BHA	3	91	132	226	–	226	–	226
– cost of acquisition of BHA(i)	(168)	–	–	(168)	–	(168)	–	(168)
– acquired value of WLUK	(42)	102	211	271	–	271	–	271
– cost of acquisition of WLUK(i)	–	–	–	–	(248)	(248)	–	(248)
Adjusted opening Group MCEV	770	1,484	4,545	6,799	(204)	6,595	1	6,596
Value of new business	(325)	80	364	119	–	119	–	119
Expected existing business contribution:								
– expected existing business contribution: reference rate	22	(8)	55	69	–	69	–	69
– expected existing business contribution: in excess of reference rate	(46)	32	217	203	–	203	–	203
Transfers from VIF and required capital to free surplus	686	(81)	(605)	–	–	–	–	–
Operating experience variances and development costs	(51)	(4)	7	(48)	–	(48)	–	(48)
Operating assumption changes	204	(16)	(86)	102	–	102	–	102
Other operating items	242	(64)	(180)	(2)	(35)	(37)	(41)	(78)
Operating Group MCEV earnings	732	(61)	(228)	443	(35)	408	(41)	367
Economic variances	(353)	200	(300)	(453)	–	(453)	–	(453)
Other non-operating items	109	(352)	35	(208)	(1)	(209)	–	(209)
Total Group MCEV earnings	488	(213)	(493)	(218)	(36)	(254)	(41)	(295)
Other movements in IFRS net equity	–	–	–	–	(32)	(32)	13	(19)
Closing adjustments:								
– capital and dividend flows	(682)	(521)	(1)	(1,204)	859	(345)	(126)	(471)
– foreign exchange variances	(1)	(3)	(11)	(15)	–	(15)	–	(15)
– transfer of GOF and TIP businesses to AXA UK plc	246	–	(196)	50	(50)	–	–	–
Closing Group MCEV	821	747	3,844	5,412	537	5,949	(153)	5,796

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

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 Friends Life group.

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

Gross of tax For the year ended 31 December 2012	FLG						RSL	
	Covered business							
	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Non-covered business £m	Total £m	RSL (ex. FLG)(i) Non-covered business £m	Total £m
Value of new business	144	5	45	–	–	194	–	194
Expected existing business contribution	342	23	35	(75)	–	325	–	325
Operating experience variances	(21)	(12)	(23)	–	–	(56)	–	(56)
Operating assumption changes	62	(107)	36	–	–	(9)	–	(9)
Other operating variances	19	(5)	13	–	–	27	–	27
Development costs	(42)	(6)	(2)	–	–	(50)	–	(50)
Life and pensions covered business operating profit/(loss) before tax	504	(102)	104	(75)	–	431	–	431
Other income and charges	–	–	–	–	(21)	(21)	–	(21)
Life and pensions operating profit/(loss) before tax	504	(102)	104	(75)	(21)	410	–	410
Corporate income and charges	–	–	–	–	–	–	(28)	(28)
Operating profit/(loss) before tax	504	(102)	104	(75)	(21)	410	(28)	382
Economic variances	459	(19)	17	(304)	1	154	–	154
Other non-operating items	(139)	1	(4)	–	2	(140)	(2)	(142)
Profit/(loss) before tax	824	(120)	117	(379)	(18)	424	(30)	394
Attributed tax on operating profits	(123)	23	(24)	18	(14)	(120)	–	(120)
Attributed tax on other activities	(77)	2	(3)	76	(4)	(6)	–	(6)
Profit/(loss) after tax	624	(95)	90	(285)	(36)	298	(30)	268

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

3. Segmental analysis of MCEV earnings continued

Gross of tax For the year ended 31 December 2011	FLG						RSL	
	Covered business							
	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Non-covered business £m	Total £m	RSL (ex. FLG)[i] Non-covered business £m	Total £m
Value of new business	59	40	52	–	–	151	–	151
Expected existing business contribution	330	27	49	(46)	–	360	–	360
Operating experience variances	(9)	(7)	(12)	–	–	(28)	–	(28)
Operating assumption changes	147	(3)	(4)	–	–	140	–	140
Other operating variances	9	(20)	(2)	19	–	6	–	6
Development costs	(28)	(7)	(1)	–	–	(36)	–	(36)
Life and pensions covered business operating profit/(loss) before tax	508	30	82	(27)	–	593	–	593
Other income and charges	–	–	–	–	(35)	(35)	–	(35)
Life and pensions operating profit/(loss) before tax	508	30	82	(27)	(35)	558	–	558
Corporate income and charges	–	–	–	–	–	–	(41)	(41)
Operating profit/(loss) before tax	508	30	82	(27)	(35)	558	(41)	517
Economic variances	(519)	(58)	(120)	97	–	(600)	–	(600)
Other non-operating items	(329)	–	5	41	(2)	(285)	–	(285)
(Loss)/Profit before tax	(340)	(28)	(33)	111	(37)	(327)	(41)	(368)
Attributed tax on operating profits	(137)	–	(20)	7	–	(150)	–	(150)
Attributed tax on other activities	227	4	27	(36)	1	223	–	223
(Loss)/Profit after tax	(250)	(24)	(26)	82	(36)	(254)	(41)	(295)

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

UK and Heritage covered business

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

VNB

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

Expected existing business contribution

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

- the expected earnings over the period assuming the opening assets earn the beginning of period reference rate; and
- the additional expected earnings (in excess of the beginning of period reference rate) consistent with management's long-term expectation for the business.

The reference rate is based on the one-year swap return plus, for UK immediate annuity business only, an illiquidity premium equivalent to 90bps (2011: 75bps) at the beginning of the year.

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

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

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

Operating experience variances

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

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

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

Operating assumption changes

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

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

3. Segmental analysis of MCEV earnings continued

Other operating variances

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

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

Development costs

The total development costs of £(42) million (2011: £(28) million) relate to the costs that are expected to enhance current propositions and generate future profits which are not captured in the MCEV. These costs relate principally to:

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

FPI covered business

The life and pensions covered business operating loss before tax for the FPI segment was £(102) million in 2012 (2011: £30 million).

VNB

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

Expected existing business contribution

The expected contribution of £23 million (2011: £27 million) comprises £21 million (2011: £24 million) which reflects the expected return on the opening value of in-force of £502 million at 1 January 2012 (2011: £473 million at 1 January 2011) and £2 million (2011: £3 million) from the expected return on shareholders' net assets. The decrease in the expected return on the value of in-force primarily reflects the lower expected rates of return on equity and property assets.

Operating experience variances

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

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

Operating assumption changes

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

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

3. Segmental analysis of MCEV earnings continued

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

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

Lombard covered business

The life and pensions covered business operating profit before tax for the Lombard segment was £104 million (2011: £82 million).

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

Expected existing business contribution
The expected contribution of £35 million (2011: £49 million) reflects the expected return on the opening value of in-force of £457 million at 1 January 2012 (2011: £497 million at 1 January 2011).

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

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

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

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

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

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

3. Segmental analysis of MCEV earnings continued

FLG corporate covered business

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

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

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

Non-covered business

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

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

Economic variances

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

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

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

Other non-operating items

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

- £(132) million of non-recurring project costs within the covered business in respect of separation and integration of UK and Heritage businesses;
- £(42) million of non-recurring project costs within the covered business in respect of Solvency II costs and financial reporting improvements, partially offset by the release of a £34 million Solvency II provision;
- £(40) million from the initial costs associated with the outsourcing agreement with Diligenta; partially offset by the utilisation of the provision established against these costs (discussed in note 10) and curtailment gains on the defined benefits pension scheme from staff transfers;
- £(17) million of cost related to the capital optimisation programme;
- £(16) million of cost from the simplification of governance structure and transition from ROL to FLG;
- £(15) million charge from the impairment of non-covered business acquired intangible assets
- £22 million curtailment gains on the defined benefit scheme arising on the closure of the scheme to future accruals;
- £106 million from tax related non-operating items including a £70 million benefit on the UK value of in-force business of changing the ultimate corporation tax rate effective from April 2014 from 23% to 21%, following the Chancellor's Autumn Statement in December 2012 and the benefits from the NLTR; and
- £(8) million of other non-recurring items.

4. Earnings per share

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

Basic and operating earnings per share

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

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

Diluted earnings per share from continuing operations

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

Weighted average number of ordinary shares

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

4. Earnings per share continued

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

5. Reconciliation of equity attributable to ordinary shareholders

Ordinary shareholders' equity on the MCEV basis reconciles to equity attributable to ordinary shareholders on the IFRS basis as follows:

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

6. New business

The following tables set out the analysis of new business in terms of volumes and profitability.

New business volumes have been shown using two measures:

- Present Value of New Business Premiums ("PVNBP"). PVNBP is equal to the total single premium sales received in the period plus the discounted value of regular premiums expected to be received over the lifetime of new contracts, and is expressed at point of sale;
- Annual Premium Equivalent ("APE"). APE is calculated as the new regular premium per annum plus 10% of single premiums.

The MCEV new business definition is consistent with the quarterly new business disclosures.

The premium volumes and projection assumptions used to calculate the present value of regular premiums within PVNBP are the same as those used to calculate the value of new business.

The value of new business is calculated using economic assumptions at the beginning of the period for all products except immediate annuities. For annuity business, as the contribution is sensitive to the interest rate at outset, the appropriate rate for each month's new business is used.

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

The value of new business is shown after the effects of the frictional costs of holding required capital and share-based payments, and after the effect of the costs of residual non-hedgeable risks on the same basis as for the in-force covered business.

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

New business value

	New business premiums							
Year ended 31 December 2012	Single £m	Regular £m	APE £m	Average annual premium multiplier(i)	PVNBP £m	Post-tax VNB £m	Pre-tax VNB £m	New business margin %
UK Corporate Benefits	844	451	535	4.1	2,714	16	21	0.8
UK Protection	–	90	90	6.6	590	47	62	10.5
UK Retirement Income(ii)	436	–	44	–	436	44	59	13.5
UK Heritage	550	47	102	4.9	780	2	2	0.3
UK and Heritage total	1,830	588	771	4.6	4,520	109	144	3.2
FPI	633	139	202	4.9	1,315	8	5	0.4
Lombard	2,376	–	238	–	2,376	35	45	1.9
International total	3,009	139	440	4.9	3,691	43	50	1.4
Total	4,839	727	1,211	4.6	8,211	152	194	2.4

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

6. New business continued

New business value

Year ended 31 December 2011	New business premiums Single £m	Regular £m	APE £m	Average annual premium multiplier[i]	PVNBP £m	Post-tax VNB £m	Pre-tax VNB £m	New business margin %
UK Corporate Benefits	574	382	440	4.0	2,103	11	15	0.7
UK Protection	–	92	92	6.1	563	12	16	2.8
UK Retirement Income[ii]	321	–	32	–	321	23	32	10.0
Heritage	763	81	157	5.2	1,182	(3)	(4)	(0.3)
UK and Heritage total	1,658	555	721	4.5	4,169	43	59	1.4
FPI	648	187	252	5.1	1,603	36	40	2.5
Lombard	2,372	–	237	–	2,372	40	52	2.2
International total	3,020	187	489	5.1	3,975	76	92	2.3
Total	4,678	742	1,210	4.7	8,144	119	151	1.9

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

UK and Heritage

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

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

FPI

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

Lombard

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

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

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

New business key performance metrics

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

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

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

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

7. Segmental analysis of Group MCEV

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

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

(ii) For the purposes of this table "Gross" refers to the MCEV gross of the clean market value of the external STICS, the external UT2 subordinated debt with associated currency swap, the external LT2 subordinated debt 2021 and the external LT2 subordinated debt 2022. The accrued interest and tax adjustment on market valuation is included in the gross MCEV of FLG Corporate.

(iii) The FLG corporate external debt comprises: the external LT2 subordinated debt 2021; the external LT2 subordinated debt 2022; and the external UT2 subordinated debt with associated currency swap.

(iv) Resolution holding companies.

7. Segmental analysis of Group MCEV continued

i) Net worth

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

ii) PVFP

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

iii) TVOG

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

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

iv) Frictional costs of holding required capital

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

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

v) CNHR

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

8. Segmental analysis of Group MCEV earnings

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

All figures are shown net of attributed tax.

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

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

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

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

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

8. Segmental analysis of Group MCEV earnings continued

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

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

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

At 31 December 2012	Total £m	Years 1–5 £m	6–10 £m	11–15 £m	16–20 £m	21–25 £m	26–30 £m	31–35 £m	36–40 £m	41+ £m
UK and Heritage										
UK Corporate Benefits	629	243	170	112	62	29	10	3	–	–
UK Protection	223	84	49	37	27	15	7	3	1	–
UK Retirement Income	73	5	6	9	12	15	12	8	4	2
Heritage	2,267	989	521	321	192	109	62	35	20	18
UK and Heritage total	3,192	1,321	746	479	293	168	91	49	25	20
International										
FPI[(i)]	515	273	124	68	31	12	4	2	1	–
Lombard	535	201	124	84	52	32	20	11	7	4
International total	1,050	474	248	152	83	44	24	13	8	4
Total VIF	4,242	1,795	994	631	376	212	115	62	33	24

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

10. MCEV assumptions

10.1 Economic assumptions – deterministic calculations

Economic assumptions are derived actively, based on market yields on risk-free fixed interest assets at the end of each reporting period.

Reference rates – risk-free

The risk-free reference rate is determined with reference to the swap yield curve appropriate to the currency of the cash flows. For some business types, where the impact on VIF is small, a long-term risk-free reference rate has been used.

For annuity business the swap yield curve is extrapolated where necessary, assuming the last observable forward rate is constant thereafter, to provide rates appropriate to the duration of the liabilities.

No adjustment has been made to the reference rate for current sovereign debt market conditions because the exposure of the Friends Life group to such debt is minimal.

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

Reference rate – Illiquidity premium adjustment

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

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

The illiquidity premium has been evaluated by considering a number of different sources of information and methodologies. Two of the main approaches commonly used to determine the illiquidity premium within the life insurance industry are:

- a “negative basis trade”, which attributes a component of the difference between the spread on a corporate bond and a credit default swap (for the same issuing entity, maturity, seniority and currency) as being the illiquidity premium; and
- structural models – such as that used by the Bank of England in their analysis of corporate bond spreads – that use option pricing techniques to decompose the spread into its constituent parts including default risk, credit risk premium and a residual illiquidity premium.

Both of these methods have been used to help inform the extent of the illiquidity premium within the asset portfolios backing immediate and some deferred annuity business.

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

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

10. MCEV assumptions continued

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

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

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

Expected asset returns in excess of reference rates

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

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

For cash and government bonds, no excess over the one-year risk-free reference rate has been assumed for UK and Heritage and FPI, Lombard assumes the long-term rate is achieved. For corporate bonds, the return is based on the excess of actual corporate bond spreads on the reporting date, less an allowance for defaults, over the one-year risk-free reference rate for UK and Heritage and FPI. For Lombard the corporate bond return is derived using the long-term rate plus a risk premium of 1% (2011: 1%).

For annuity business the excess return reflects the excess of the bond portfolio over the reference rate including the illiquidity premium adjustment.

Expense inflation

Maintenance expenses for UK and Heritage and FPI are assumed to increase in the future at a rate of 1% (2011: 1%) per annum in excess of the assumed long-term rate of inflation. Long-term inflation assumptions are set relative to gilt curves at appropriate durations.

Maintenance expenses for Lombard are assumed to increase in the future at a rate of 0.75% (2011: 0.75%) per annum in excess of the assumed long-term rate of inflation. This is derived from an inflation swap curve based on a Eurozone price index taking into account the run-off profile of the business.

	Expense inflation	
	2012 %	2011 %
UK and Heritage	**3.70**	3.70
FPI	**3.70**	3.70
Lombard	**3.00**	2.95

10. MCEV assumptions continued

Exchange rates

The results and cash flows of all businesses, except Lombard and AmLife, are calculated in Sterling. The results and cash flows for Lombard are calculated in Euros and those of AmLife in Malaysian Ringgits, and converted to Sterling at the following rates:

	Exchange rates	
	2012	2011
Closing exchange rate		
– Euro	**0.811**	0.835
– Malaysian Ringgit	**0.201**	0.203
Average exchange rate		
– Euro	**0.813**	0.869
– Malaysian Ringgit	**0.204**	0.204

Other economic assumptions

Bonus rates on participating business have been set at levels consistent with the economic assumptions.

The MCEV allows for distribution of profit between the policyholders and shareholders within the following with-profits funds at the current rate of one-ninth of the cost of bonus:

- Friends Life FP With-Profits Fund (“FLFP WPF”)
- Friends Life FLAS With-Profits Fund (“FLFLAS WPF”)
- Friends Life FLC Old With-Profits Fund (“FLFLC OWPF”)
- Friends Life FLC New With-Profits Fund (“FLFLC NWPF”)
- Friends Life FLWL With-Profits Fund (“FLFLWL WPF”)

In addition it is assumed that the shareholder interest in the non-profit business of the FLFP WPF continues at the current rate of 60% of future profits.

Following the Part VII transfer of business from FLC to FLL, the requirement to retain the FLC reattributed inherited estate (“RIE”) to support FLFLC OWPF and FLFLC NWPF along with other previously existing with-profit fund support arrangements have been incorporated into one FLL Scheme effective from 28 December 2012.

The FLL Scheme rules require that a test be undertaken every five years to determine the level of shareholder capital support required for FLFLC OWPF and FLFLC NWPF. The test also determines whether it is possible to distribute any of the inherited estate retained in the FLFLC OWPF in the form of Special Bonuses (and associated transfer to the shareholders' fund). The latest five-yearly test was undertaken as at 31 December 2010.

The remaining RIE in the FLL NPF is predominantly in the form of the VIF of non-profit business written within the fund. To the extent that this VIF emerges into cash during the period 28 December 2012 to the next five-year test date at 31 December 2015, the cash may be available to be transferred to the FLL shareholders' fund subject to passing the relevant financial strength tests. The MCEV allows for best estimate projections of the amounts to be transferred in future.

10. MCEV assumptions continued

10.2 Economic assumptions – stochastic calculations

Model

The time value of financial options and guarantees and the OLAB return of premium guarantee are determined using a Barrie & Hibbert economic scenario generator and are calculated using 2,000 simulations. The with-profits model is consistent with the model used for the Realistic Balance Sheet and is calibrated to market conditions at the valuation date using the gilt risk-free curve and implied volatilities in the market. The OLAB return of premium guarantee model is calibrated to market conditions at the valuation date using a Euro swap curve and implied volatilities in the market. Correlations between the asset classes are derived from historic data.

Swaption implied volatilities – with-profits time value of financial options and guarantees

Option term	2012 swap term 10 yrs %	2012 swap term 15 yrs %	2012 swap term 20 yrs %	2012 swap term 25 yrs %	2011 swap term 10 yrs %	2011 swap term 15 yrs %	2011 swap term 20 yrs %	2011 swap term 25 yrs %
UK Sterling								
10 years	**18**	**17**	**16**	**15**	18	18	18	18
15 years	**18**	**17**	**16**	**16**	15	16	16	16
20 years	**16**	**16**	**15**	**15**	14	14	14	14
25 years	**16**	**16**	**16**	**15**	13	13	13	13

Swaption implied volatilities – OLAB return of premium guarantee

Option term	2012 swap term 10 yrs %	2012 swap term 15 yrs %	2012 swap term 20 yrs %	2012 swap term 25 yrs %
Euro				
10 years	**24**	**24**	**23**	**20**
15 years	**27**	**26**	**24**	**20**
20 years	**26**	**24**	**21**	**17**
25 years	**23**	**20**	**18**	**15**

Equity and property implied volatilities – with-profits time value of financial options and guarantees

Equity volatility is calibrated to market implied volatility and is a reasonable fit to the implied volatility of the FTSE 100 put options held by the with-profits funds. Property holdings are modelled assuming an initial volatility of 15% (2011: 15%) and a running yield of 4.3% (2011: 4.3%). Sample implied volatilities are shown in the table below.

Option term	2012 Equity %	2012 Property %	2011 Equity %	2011 Property %
5 years	**24**	**15**	27	15
10 years	**26**	**15**	27	15
15 years	**27**	**15**	27	15

10. MCEV assumptions continued

Equity implied volatilities – OLAB return of premium guarantee

Equity volatility is calibrated to put options on the EUROSTOXX50 index as an objective measure of market implied volatility. Sample implied "at-the-money" volatilities are shown in the table below.

Option term	2012 Equity %
5 years	**25**
10 years	**25**
15 years	**25**

10.3 Other assumptions

Required capital

Required capital under MCEV amounted to £40 million (2011: £747 million). The reduction in required capital has mainly resulted from the issuance of the new UT2 subordinated debt and the increase in the market value of other external debt over the year.

The projected required capital is derived from the Group's capital management policy which is to hold, within life company subsidiaries, the greater of 150% Pillar 1 CRR excluding WPICC and 125% of ICA plus ICG. In addition the Group's capital management policy is to hold 150% (2011: 150%) of Group CRR excluding WPICC, and any cost of holding this additional capital is shown within the FLG corporate covered business segment.

Taxation

The opening and closing embedded values in respect of covered business are determined on an after tax basis. The tax assumptions used are based upon the best estimate of the actual tax expected to arise. The attributable tax charge and profit before tax are derived by grossing up the profit after tax at the appropriate tax rates for each of the UK, Isle of Man, Luxembourg and Malaysia. Deferred tax is provided on the mark-to-market revaluation of the external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 allocated to the life and pensions covered business within FLG corporate. For UK and OLAB business the appropriate tax rate has been calculated as the average rate of corporation tax applicable over the period, and hence the rate applicable for 2012 reflects the reduction in corporation tax that took effect from April 2012.

For non-covered business, attributed tax is consistent with the IFRS financial statements.

	Tax rates	
	2012 **%**	2011 %
UK and Heritage	**24.5**	26.5
FPI		
– OLAB (UK)	**24.5**	26.5
– FPIL (Isle of Man)	**0.0**	0.0
– AmLife (Malaysia)	**25.0**	25.0
Lombard	**22.5**	23.5

The PVFP for UK and Heritage and OLAB businesses includes an allowance for the annual reductions in corporation tax announced in the Emergency Budget in June 2010 and the further reductions of 1% announced in each of the Budgets in April 2011 and April 2012 and the Autumn Statement in December 2012. The MCEV allows for anticipated future annual reductions in corporation tax from 24% to 21% (2011: 26% to 23%) over the period to 2014 and for an ultimate rate of 21% (2011: 23%) from April 2014.

Legislation in respect of the new life tax regime was included in Finance Act 2012, which received Royal Assent on 17 July 2012. The new life tax regime took effect from 1 January 2013 and a best estimate of its effect is therefore included in MCEV, being a forward looking measure. There remains an element of risk and uncertainty in estimating its effects given that the legislation is newly introduced and some regulations and guidance remain outstanding and are expected to be issued during 2013; therefore the outcomes may be subject to change as a result of either legislative update or by development in interpretation.

10. MCEV assumptions continued

The tax assumptions used within the MCEV do not take account of the additional 1% reduction in corporation tax, effective from 1 April 2015, announced on 20 March 2013. As a result of this change, the corporation tax rate is expected to be 22% from 1 April 2013, 21% from 1 April 2014 and 20% from 1 April 2015. The impact of this change is estimated to be an increase in the MCEV of £20m at 31 December 2012.

VAT in the UK of 20.0% (2011: 20.0%) less expected recoveries has been included on relevant investment management expenses and, where applicable, on outsourced administration contracts.

Demographic assumptions

Other assumptions (for example mortality, morbidity and persistency) are a reflection of the best estimate of the likely behaviours, outcomes or circumstances in the future. Typically the estimates are made on an annual basis following experience investigations based on the data available at the time both from the book of business and externally sourced information. The aim is to set assumptions at a level that reflects recent experience, unless there are reliable indicators that suggest their adoption would result in a significant variance compared to these assumptions in the future. In some instances, there may be little or no direct experience to use in setting assumptions and the future outcome is therefore uncertain.

The RDR came into effect from 1 January 2013 and an £88 million provision (gross of tax) was recognised as at 31 December 2011, to cover negative variances expected on initial commission business pre-RDR in 2012 where long-term assumptions were expected to be temporarily inadequate. Following the release of £55 million against adverse experience in 2012, this provision has been reduced to £33 million (gross of tax) as at 31 December 2012.

Future improvements in annuitant mortality have been assumed to be in accordance with the projections published by the Continuous Mortality Investigation ("CMI") in 2011, with a long-term rate of 1.25% (2011: 1.25%).

Expense assumptions

The management expenses (including those relating to holding companies) attributable to the covered businesses have been analysed between expenses relating to the acquisition of new business, maintenance of in-force business (including investment management expenses) and development expenses.

Future maintenance expense assumptions reflect the expected ongoing expense levels required to manage the in-force business.

Productivity gains have generally only been included to the extent they have been achieved by the end of the reporting period.

In June 2009 FLSL entered into a 15-year agreement with Capita Life & Pensions Regulated Services Limited ("Capita") to outsource the administration of mature traditional life and pensions policies. This agreement includes the rationalisation of IT systems and significant longer term cost reductions. The maintenance expense assumptions for the relevant business allow for the agreed service fees with Capita. In addition allowance is made for the initial significant development expenditure and anticipated longer term savings as a result of a reduction in IT costs, which result in an overall expense overrun in FLSL.

Strategic development plans for the Lombard business have resulted in projected short-term expense overruns which have been allowed for by reducing the PVFP by £2 million for a projected overrun to 2013.

In November 2011 Friends Life announced a 15-year agreement with Diligenta to outsource IT and in-house customer service functions – along with HR, Finance and Business Risk services that support these functions. This agreement resulted in significant longer term cost reductions and an overall increase to MCEV of £76 million in 2011. In addition, allowance was made in 2011 for the initial significant development expenditure of £(124) million, considered to be non-recurring and shown within other non-operating items in the 2011 results. During 2012, initial development costs of £(72) million, net of a curtailment gain on the pension scheme, have been incurred in relation to the Diligenta arrangement which have been partially offset by a £32 million utilisation of the £124 million provision set up in 2011. The net cost of £(40) million is shown in the consolidated income statement within other non-operating items.

Other one-off costs shown within non-recurring items can be categorised as:

- Solvency II and Finance Transformation project costs;
- Separation and Integration costs;
- Capital restructuring costs; or
- Corporate acquisitions/disposal costs.

Any other one-off costs that do not fall into these categories are treated as operating exceptional costs within operating experience variances.

The MCEV includes provision for certain development costs to the extent that these are known with sufficient certainty and in line with current plans.

10. MCEV assumptions continued

Development costs of £50 million (2011: £36 million) have been excluded from the calculation of unit costs and have been recognised in operating profits. Development costs relate to investment in activities expected to create value in the future, but where that expected value cannot be anticipated within the current year's financial results until the value is realised.

Development costs

	FLG 2012 £m	FLG 2011 £m
UK and Heritage	**42**	28
FPI	**6**	7
Lombard	**2**	1
Total	**50**	36

Non-hedgeable risks

A charge equivalent to 1.5% (2011: 2%) has been applied to the projected risk-based group required capital for all non-hedgeable risks over the remaining lifetime of in-force business.

In line with management's view of the business, allowance has been made for diversification benefits within the non-hedgeable risks of the covered business.

Other assumptions

The external STICS, external UT2 subordinated debt with associated currency swap, external LT2 subordinated debt 2021 and external LT2 subordinated debt 2022 are included within the MCEV at market value, based on listed ask price.

At 31 December 2012	Principal £m	Clean market value of debt £m	Accrued interest £m	Tax adjustment on market valuation £m	Value of debt included in FLG corporate(i) £m
STICS 2003	**210**	**193**	**2**	**4**	**199**
STICS 2005	**268**	**250**	**8**	**1**	**259**
LT2 subordinated debt 2021	**162**	**215**	**12**	**(16)**	**211**
LT2 subordinated debt 2022	**500**	**554**	**29**	**(21)**	**562**
UT2 subordinated debt (ii)	**356**	**378**	**4**	**(8)**	**374**
Currency swap	**–**	**6**	**–**	**–**	**6**
Total	**1,496**	**1,596**	**55**	**(40)**	**1,611**

At 31 December 2011	Principal £m	Clean market value of debt £m	Accrued interest £m	Tax adjustment on market valuation £m	Value of debt included in FLG corporate(i) £m
STICS 2003	210	142	2	17	161
STICS 2005	268	185	8	19	212
LT2 subordinated debt 2021	162	182	12	(9)	185
LT2 subordinated debt 2022	500	450	29	4	483
Total	1,140	959	51	31	1,041

(i) The value of debt included in the FLG corporate category is the market value of debt, including accrued interest, and the deferred tax (asset)/liability on the market value adjustment.
(ii) The UT2 subordinated debt was issued in US dollars with principal of $575 million, equivalent to £356 million at the date of issue in November 2012.

10. MCEV assumptions continued

The deferred consideration notes, issued in September 2010 in connection with the acquisition of the AXA UK Life Businesses, were repaid on 20 November 2012 (2011: £423 million).

11. Sensitivity analysis

The following tables show the sensitivity of the embedded value and the value of new business to changes in assumptions. The sensitivities below apply to covered business only and include the impact on both shareholder net worth and VIF.

For each sensitivity, the other future experience assumptions remain unchanged, except where changes in economic assumptions directly affect them. The assumptions underlying the statutory reserving calculations remain unchanged in all sensitivities. There are no additional management actions or changes in policyholder behaviour assumed within any of the sensitivities.

Sensitivities shown in a single direction have broadly symmetrical impacts.

At 31 December 2012	FLG covered business				
Change in MCEV (net of tax)	UK & Heritage £m	FPI[vi] £m	Lombard £m	FLG corporate £m	Total £m
Base MCEV	5,307	612	615	(1,611)	4,923
Market risk					
100bps increase in reference rates	(160)	(3)	–	107	(56)
100bps decrease in reference rates	156	19	(4)	(119)	52
Removal of illiquidity premium for immediate annuities	(544)	–	–	–	(544)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield[i]	(181)	(23)	(37)	–	(241)
25% increase in equity/property volatility at the valuation date	(32)	–	–	–	(32)
25% increase in swaption implied volatility at the valuation date	(4)	–	–	–	(4)
100bps increase in corporate bond spreads[ii]	(310)	–	(11)	107	(214)
100bps decrease in corporate bond spreads[ii]	380	–	11	(119)	272
10% adverse movement in Sterling/overseas exchange rate[iii]	(30)	(39)	(53)	–	(122)
10% fall in value of unit-linked funds	(207)	(27)	(69)	–	(303)
100bps increase in expense inflation	(65)	(24)	(15)	–	(104)
100bps decrease in expense inflation	57	20	12	–	89
Insurance and other risk					
Reduction to EU minimum capital or equivalent[iv]	40	–	–	–	40
10% decrease in maintenance expenses	109	31	19	–	159
10% proportionate decrease in lapse rates	83	12	37	–	132
10% proportionate decrease in PUP rates	13	12	–	–	25
5% decrease in mortality/morbidity – life assurance					
– Before reinsurance[v]	79	9	3	–	91
– After reinsurance	38	6	2	–	46
5% decrease in mortality/morbidity – annuity business					
– Before reinsurance[v]	(132)	–	–	–	(132)
– After reinsurance	(67)	–	–	–	(67)

11. Sensitivity analysis continued

At 31 December 2011	FLG covered business				
Change in MCEV (net of tax)	UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Total £m
Base MCEV	5,341	571	541	(1,041)	5,412
Market risk					
100bps increase in reference rates	(130)	(5)	3	47	(85)
100bps decrease in reference rates	121	16	(8)	(51)	78
Removal of illiquidity premium for immediate annuities	(607)	–	–	–	(607)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield(i)	(188)	(23)	(32)	–	(243)
25% increase in equity/property volatility at the valuation date	(32)	–	–	–	(32)
25% increase in swaption implied volatility at the valuation date	(4)	–	–	–	(4)
100bps increase in corporate bond spreads(ii)	(303)	(4)	(14)	47	(274)
100bps decrease in corporate bond spreads(ii)	289	5	14	(51)	257
10% adverse movement in Sterling/overseas exchange rate(iii)	(43)	(46)	(69)	–	(158)
10% fall in value of unit-linked funds	(220)	(26)	(67)	–	(313)
Insurance and other risk					
Reduction to EU minimum capital or equivalent(iv)	41	–	–	–	41
10% decrease in maintenance expenses	147	21	23	–	191
10% proportionate decrease in lapse rates	90	12	33	–	135
10% proportionate decrease in PUP rates	13	7	–	–	20
5% decrease in mortality/morbidity – life assurance					
– Before reinsurance	287	4	2	–	293
– After reinsurance	52	3	2	–	57
5% decrease in mortality/morbidity – annuity business					
– Before reinsurance	(27)	–	–	–	(27)
– After reinsurance	(68)	–	–	–	(68)

(i) The movement in UK and Heritage embedded value from a reduction in market values comprises a £nil million (2011: £nil million) fall in the value of shareholders' net worth and a £181 million (2011: £188 million) reduction in the value of in-force covered business.
(ii) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40bps (2011: 35bps) for in-force business and 40bps (2011: 35bps) for the value of new business.
(iii) Currency risk is expressed in terms of total overseas exposure; the Group's principal currency exposures other than Sterling are the Euro and US Dollar.
(iv) Required capital is set at the greater of regulatory capital and requirements arising from internal capital management policies. In aggregate, the required capital is higher than the regulatory requirement by £886 million (2011: £902 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.
(v) As part of the modelling development in 2012 the methodology for the "Before reinsurance" sensitivities has been harmonised within the UK and Heritage segment, resulting in reduced sensitivity to changes in mortality and morbidity compared to prior years.
(vi) The base MCEV for FPI includes £43 million in respect of AmLife, however the FPI sensitivities exclude AmLife due to its sale on 4 January 2013 and its immaterial impact.

11. Sensitivity analysis continued

At 31 December 2012	FLG covered business			
Change in value of new business (gross of tax)	UK & Heritage £m	FPI[iii] £m	Lombard £m	Total £m
Base value of new business	144	5	45	194
Market risk				
100bps increase in reference rates	(6)	(2)	–	(8)
100bps decrease in reference rates	5	2	–	7
Removal of illiquidity premium for immediate annuities	(31)	–	–	(31)
100bps increase in corporate bond spreads[i]	(14)	–	–	(14)
100bps decrease in corporate bond spreads[i]	13	–	–	13
100bps increase in expense inflation	(7)	(5)	–	(12)
100bps decrease in expense inflation	6	4	–	10
Insurance and other risk				
Reduction to EU minimum capital or equivalent	2	–	–	2
10% decrease in maintenance expenses	8	6	2	16
10% proportionate decrease in lapse rates	13	–	5	18
10% proportionate decrease in PUP rates	5	1	–	6
5% decrease in mortality/morbidity – life assurance				
– Before reinsurance[ii]	10	3	1	14
– After reinsurance	5	1	–	6
5% decrease in mortality/morbidity – annuity business				
– Before reinsurance[ii]	(4)	–	–	(4)
– After reinsurance	(4)	–	–	(4)
Impact of end of period assumptions on VNB	4	(1)	–	3

(i) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40bps (2011: 35bps) for in-force business and 40bps (2011: 35bps) for the value of new business.
(ii) As part of the modelling development in 2012 the methodology for the "Before reinsurance" sensitivities has been harmonised within the UK and Heritage segment.
(iii) The base value of new business for FPI includes £3 million in respect of AmLife.

11. Sensitivity analysis continued

At 31 December 2011	FLG covered business			
Change in value of new business (gross of tax)	UK & Heritage £m	FPI £m	Lombard £m	Total £m
Base value of new business	59	40	52	151
Market risk				
100bp increase in reference rates	(8)	(3)	–	(11)
100bp decrease in reference rates	8	3	(1)	10
Removal of illiquidity premium for immediate annuities	(27)	–	–	(27)
100bps increase in corporate bond spreads	(7)	–	–	(7)
100bps decrease in corporate bond spreads	1	–	–	1
Insurance and other risk				
Reduction to EU minimum capital or equivalent	2	–	–	2
10% decrease in maintenance expenses	10	5	2	17
10% proportionate decrease in lapse rates	11	3	5	19
10% proportionate decrease in PUP rates	4	2	–	6
5% decrease in mortality/morbidity – life assurance				
– Before reinsurance	13	1	–	14
– After reinsurance	4	–	–	4
5% decrease in mortality/morbidity – annuity business				
– Before reinsurance	(3)	–	–	(3)
– After reinsurance	(3)	–	–	(3)
Impact of end of period assumptions on VNB	8	7	(1)	14

12. Comparison of MCEV and IFRS classification and segments

The covered business segments within MCEV are consistent with the IFRS business segments.

The split of the MCEV by IFRS business segment for FLG is shown in the tables below:

FLG At 31 December 2012	MCEV classification UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Non-covered business £m	Total MCEV by IFRS segments £m
IFRS segment						
UK and Heritage	5,307	–	–	–	38	5,345
FPI	–	612	–	–	1	613
Lombard	–	–	615	–	5	620
FLG corporate	–	–	–	(1,611)	731	(880)
Total MCEV (by MCEV segments)	**5,307**	**612**	**615**	**(1,611)**	**775**	**5,698**

FLG At 31 December 2011	MCEV classification UK & Heritage £m	FPI £m	Lombard £m	FLG corporate £m	Non-covered business £m	Total MCEV by IFRS segments £m
IFRS segment						
UK and Heritage	5,341	–	–	–	63	5,404
FPI	–	571	–	–	(2)	569
Lombard	–	–	541	–	3	544
FLG corporate	–	–	–	(1,041)	473	(568)
Total MCEV (by MCEV segments)	5,341	571	541	(1,041)	537	5,949

13. FLG annualised return on embedded value

	2012		2011	
	£m	% p.a.	£m	% p.a.
Value of new business	194	2.8	151	2.0
Expected existing business contribution(i)	400	5.7	406	5.3
Operating experience variances	(56)	(0.8)	(28)	(0.4)
Operating assumption changes	(9)	(0.1)	140	1.8
Other operating variances	27	0.4	6	0.1
Development costs	(50)	(0.7)	(36)	(0.4)
Other income and charges(i)	(5)	(0.1)	(2)	–
MCEV operating profit before tax and financing	501	7.2	637	8.4
Impact of financing	(91)	–	(79)	0.5
Attributed tax charge on MCEV operating profit	(120)	(2.1)	(150)	(2.4)
MCEV operating profit after tax	290	5.1	408	6.5
Economic variances	154	2.7	(600)	(9.5)
Other non-operating items	(140)	(2.5)	(285)	(4.5)
Attributed tax on other activities	(6)	(0.1)	223	3.5
MCEV profit/(loss) after tax	298	5.2	(254)	(4.0)
Actuarial losses on defined benefit pension schemes	(35)	(0.5)	(32)	(0.6)
Foreign exchange adjustments	(16)	(0.3)	(15)	(0.2)
Total return on MCEV over the year	247	4.4	(301)	(4.8)

(i) Impact of financing comprises the expected impact of financing of covered debt of £75 million for 2012 (2011: £46 million), and £16 million impact of financing of non-covered debt of £200 million until it was repaid in November 2012 (2011: £33 million). These amounts have been deducted from the expected existing business contribution and other income and charges respectively.

The table above provides an analysis of the return on FLG embedded value. The starting embedded value for 2012 is £5,949 million, net of the market-consistent value of debt instruments of £1,159 million. The 2012 embedded value has been adjusted to allow for the timing of dividend payments, the full repayment of the internal LT2 subordinated debt 2020 issued to Resolution holding companies by FLG and the new external UT2 subordinated debt and associated currency swap issued during the period.

The starting embedded value for 2011 was £6,514 million, net of the market-consistent value of debt instruments of £1,296 million. The 2011 embedded value was adjusted to allow for the timing of dividend payments, the acquisition of BHA, the acquisition of WLUK and the transfer of the GOF/TIP business to AXA UK, the partial repayment of the internal LT2 subordinated debt 2020 issued to Resolution holding companies by FLG, and the new external LT2 subordinated debt 2022 issued during the period.

The MCEV operating return before tax and financing is based on the gross MCEV (ie 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.

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Definitions

AmFamily means AmFamily Takaful Berhad

AmLife means, collectively, AmFamily and AmLife Insurance Berhad

Annual Premium Equivalent ("APE") represents annualised new regular premiums plus 10% of single premiums.

Annualised operating return on embedded value is calculated as the MCEV operating profit after tax over the period divided by the net Group MCEV at the start of the period adjusted to allow for the timing of dividend payments and any acquisitions or disposals through the period. Where the period is not a full year, the calculated rate is then annualised.

Asset quality is the percentage of corporate bonds and asset-backed securities in the shareholder and non-profit funds at investment grade compared to the total of such assets in these funds.

Available shareholder cash ("ASC") represents cash available to cover corporate costs, to service debt issued by Resolution holding companies and, subject to shareholder approval, to pay dividends or return to shareholders. ASC reflects the deduction of working capital from free surplus.

AXA UK Life Businesses means the traditional and protection businesses, a majority of the corporate benefits business and a minority of the wealth management business carried on by AXA UK which were acquired by the Group in September 2010 and which includes FLWL from November 2011.

Board means the Resolution Limited Board.

Cash payback on new business is the time at which the value of the expected cash flows, after tax, is sufficient to have recouped the capital invested to support the writing of the business. The cash flows are calculated on the same assumptions and expense basis as those used for the value of new business.

Company means Resolution Limited.

Distributable Cash Target ("DCT") is the increase in FLG ASC after interest and before dividends to Resolution holding companies and is the amount that could be paid to Resolution holding companies without reducing the MCEV of FLG, excluding investment variances and non-recurring items.

Dividend coverage ratio is the expected total cost of dividends to shareholders in respect of the year compared to the dividends from life companies up streamed in respect of the year.

Equity Backing Ratio ("EBR") is the proportion of equities and property backing asset shares.

Free surplus at the end of the year represents the excess of net worth (equivalent to shareholder resources) over required capital and inadmissible items on an MCEV basis for covered businesses plus IFRS net assets, less required capital and inadmissible assets on an IGCA basis for non-covered businesses and holding companies. Free surplus comprises ASC plus working capital.

Free surplus generated comprises the movement in free surplus over the period adjusted for capital, foreign exchange and other reserve movements.

Friends Life or Friends Life group means Friends Life Group plc (and its subsidiaries and subsidiary undertakings from time to time including Friends Provident from November 2009, the AXA UK Life Business from September 2010, BHA from January 2011 and FLWL from November 2011).

Friends Life holding companies means Friends Life Group plc, Friends Life FPG Limited and Friends Life FPL Limited.

Group means Resolution Limited and its subsidiaries and subsidiary undertakings from time to time. For the avoidance of doubt, neither the Group nor the Company form part of the Resolution Group.

Group embedded value on an MCEV basis ("Group MCEV") is the equity attributable to equity holders of the parent as shown in the consolidated statement of financial position - MCEV basis.

Heritage division means Friends Life's UK business comprising products that are no longer actively marketed to new customers and legacy products that have previously been closed to new business.

IFRS based operating profit/(loss) is the profit (or loss) based on longer-term investment return excluding: (i) all investment return variances from expected investment return which is calculated on a long-term rate of return, (ii) policyholder tax, (iii) returns attributable to minority interests in policyholder funds (iv), significant non-recurring items, (v) amortisation and impairment of acquired intangible assets and present value of acquired in-force business; and is stated after deducting interest payable on STICS.

IFRS profit/(loss) after tax is the profit (or loss) after tax as shown in the consolidated income statement.

IGCA surplus is the Insurance Groups Capital Adequacy surplus capital as defined by the FSA in the Insurance Groups Directive. It is calculated as the surplus of the available capital resources over the capital resources requirement. It excludes the surplus capital held within the long-term funds.

Internal rate of return ("IRR") on new business is equivalent to the discount rate at which the present value of the after tax cash flows expected to be earned over the lifetime of the business written is equal to the capital invested to support the writing of the business. With the exception of investment return, all assumptions and expenses are consistent with those used for calculating VNB. IRR assumes best estimate investment returns after an allowance for default risk, whereas VNB assumes (market consistent) risk-free rates. IRR also takes into account the funding and release of regulatory capital requirements.

MCEV operating profit/(loss) is the MCEV profit (or loss) based on expected investment return and excludes: (i) amortisation and impairment of non-covered business acquired intangible assets, (ii) effect of economic variances (including the impact of economic assumption changes) and (iii) significant non-recurring items.

MCEV profit/(loss) after tax is the MCEV profit (or loss) after tax as shown in the consolidated income statement - MCEV basis.

New business margins are defined as the pre-tax VNB generated by each product type, divided by the PVNBP for that product.

New Life Tax Regime ("NLTR") refers to legislation enacted in the Finance Act 2012 and supporting regulations. NLTR applies to life insurance companies with effect from 1 January 2013 and has not altered the "I minus E" basis of taxation.

Northern Trust means Northern Trust International Fund Administration.

Pillar 1 surplus is the excess of capital resources over capital resource requirements calculated in accordance with regulatory requirements.

Pillar 2 surplus is the excess of capital resources over the capital calculated on an economic basis required to ensure that the regulated entities can meet their liabilities, with a high likelihood, as they fall due. The result is reviewed and may be modified by the FSA. Pillar 2 requirements are not generally disclosed.

Present value of new business premiums ("PVNBP") represents new single premiums plus the expected present value of new business regular premiums expressed at the point of sale.

Required capital of the Group is based on the most onerous capital management policy for the Group, currently IGCA.

Resolution holding companies means the Company, Resolution Holdco No. 1 LP and Resolution Holdings (Guernsey) Limited.

Resolution Operations LLP ("ROL") is a privately owned advisory and operating firm which, as part of the Resolution Group, has provided services to Resolution Limited within the framework of an operating agreement. Under a Business Sale Agreement with ROL, ROL will, on 27 March 2013, transfer to the Company business activities that relate to the services provided to the Company and the ROL employees who provide these services. At the same time, ROL will cease to provide services to the Company.

Shareholder resources are a measure of the tangible assets available to the life and pensions business and attributable to shareholders. The movement in shareholder resources provides a view of the sustainability of the business model. Shareholder resources are based on shareholders' invested net assets included within the embedded value, but adjusted to include securitisation and financial reinsurance balances and to exclude intangible assets relating to the value of future new business.

Sustainable Free Surplus ("SFS") is a component of free surplus generated comprising the expected return from in-force business, before financing costs, less amounts invested in new business. It does not include economic impacts or other one-off items.

The Resolution Group means Resolution Operations LLP, Resolution Financial Markets LLP, RCAP Guernsey LP, Resolution Capital Limited and their respective subsidiaries and subsidiary undertakings from time to time. For the avoidance of doubt, neither the Group nor the Company are part of the Resolution Group.

Value of new business ("VNB") relates to new business written in the reporting period and reflects the present value of future cash flows on that block of business. It is calculated using economic assumptions at the beginning of the period except for immediate annuities for which the assumptions used are appropriate for each month's new business on account of their interest rate sensitivity. It is also calculated using year end operating assumptions consistent with those used to determine the year end MCEV embedded value. VNB is shown after the effects of the frictional costs of holding required capital and share-based payments, and after the effect of the costs of residual non-hedgeable risks.

Working capital, as a component of the Group's cash and capital management framework, represents free surplus assets set aside to cover known future requirements and amounts necessary to maintain sufficient flexibility to facilitate compliance with the Group capital policy, additional regulatory requirements and any other assets restricted in their availability to shareholders.

Abbreviations

ABI	Association of British Insurers
ABS	Asset-Backed Securities
AGM	Annual General Meeting
ALM	Asset and Liability Management
AMC	Annual Management Charge
APE	Annual Premium Equivalent
ASC	Available Shareholder Cash
AVIF	Acquired Value of In-Force
AXA IM	AXA Investment Management
BHA	Friends Life BHA Limited (formerly known as Bupa Health Assurance Limited)
BRCC	FLG Board Risk and Compliance Committee
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CGU	Cash Generating Unit
CMI	Continuous Mortality Investigations
CMIR	Continuous Mortality Investigations Report
CMPs	Capital Management Policies
CNHR	Cost of Non-Hedgeable Risk
COP	Capital Optimisation Programme
CRO	Chief Risk Officer
CRR	Capital Resource Requirements
DAC	Deferred Acquisition Costs
DCN	Deferred Consideration Notes
DCT	Distributable Cash Target
DFF	Deferred Front End Fees
DPF	Discretionary Participation Features
DRIP	Dividend Reinvestment Plan
EBC	Employee Benefit Consultant
EBR	Equity Backing Ratio
ECJ	European Court of Justice
EEA	European Economic Area
ERC	Executive Risk Committee
EU	European Union
FAL	Friends Annuities Limited (formerly known as AXA Annuity Company Limited)
FASLH	Friends ASLH Limited (formerly known as AXA Sun Life Holding Limited)
FLAS	Friends Life Assurance Society Limited (formerly known as Sun Life Assurance Society plc)
FLC	Friends Life Company Limited (formerly known as AXA Sun Life plc)
FLDL	Friends Life Distribution Limited
FLG	Friends Life Group plc (formerly known as Friends Provident Holdings (UK) plc). In respect of MCEV disclosures, FLG denotes Friends Life Group plc and its subsidiary undertakings in the period post-acquisition
FLG AC	FLG Audit Committee
FLI	Friends Life Investments
FLL	Friends Life Limited (formerly known as Friends Provident Life and Pensions Limited)

FLPL	Friends Life and Pensions Limited
FLSL	Friends Life Services Limited (formerly known as AXA Sun Life Services plc)
FLWL	Friends Life WL Limited (formerly known as Winterthur Life UK Limited or WLUK)
fpb	Financial Business Partners AG
FPI	A segment within the International division comprising FPIL, OLAB and AmLife
FPIL	Friends Provident International Limited
FPL	Friends Life FPL Limited
FPLAL	Friends Provident Life Assurance Limited
FPMS	Friends Provident Management Services Limited
FPPS	Friends Provident Pension Scheme
FRA	Flexible Retirement Account
FRS	Financial Reporting Standards
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
FTE	Full Time Employees
FUM	Funds Under Management
GMP	Guaranteed Minimum Pension
GOF	Guaranteed Over Fifties
HNWI	Higher Net Worth Individuals
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICA	Individual Capital Assessment
ICG	Individual Capital Guidance
IFA	Independent Financial Adviser
IFRIC	IFRS Interpretation Committee
IFRS	International Financial Reporting Standards
IGCA	Insurance Groups Capital Adequacy
IPEV	International Private Equity and Venture Capital board
IRR	Internal Rate of Return
LDI	Liability Driven Investment
LTIP	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
NLTR	New Life Tax Regime
NPF	Non-Profit Fund
OCI	Other Comprehensive Income
OEIC	Open Ended Investment Company
OLAB	Overseas Life Assurance Business
OMO	Open Market Option

PBSE	Post-Balance Sheet Event
PIIGS	Portugal, Ireland, Italy, Greece and Spain
PPFM	Principles and Practices of Financial Management
PUP	Paid Up Policies
PVFP	Present Value of Future Profits
PVNBP	Present Value of New Business Premiums
RCM	Risk Capital Margin
RDR	Retail Distribution Review
RHG	Resolution Holdings (Guernsey) Limited
RICS	Royal Institution of Chartered Surveyors
RIE	Re-attributed Inherited Estate
RISC	Risk and Investment Sub-committee
ROEV	Return on Embedded Value
ROL	Resolution Operations LLP
RPI	Retail Prices Index
RSL	Resolution Limited. In respect of MCEV disclosures, RSL denotes Resolution Limited and its subsidiary undertakings
SBG	Sesame Bankhall Group
SFS	Sustainable Free Surplus
SID	Senior Independent Director
SSF	Segregated Sub Fund
STICS	Step-up Tier one Insurance Capital Securities
TIP	Trustee Investment Plan
TVOG	Time Value of financial Options and Guarantees
USGAAP	Generally Accepted Accounting Principles (United States)
UT2	Upper Tier 2
VIF	Value of In-Force
VNB	Value of New Business
WLUK	Friends Life WL Limited (formerly Winterthur Life UK Limited)
WPF	With-Profits Fund
WPICC	With Profits Insurance Capital Component

Shareholder information

Annual General Meeting

The AGM will be held in the Mountbatten Room at The Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE, United Kingdom at 11.00 am on 16 May 2013.

Shareholders will receive a separate circular containing a notice of the meeting and detailing the resolutions being proposed.

Registrar

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.

Dividend reinvestment plan

The Company will introduce a dividend reinvestment plan ("DRIP") in time for the 2012 final dividend, to replace the existing scrip dividend scheme. The latest date for receipt of DRIP elections will be 26 April 2013. Full details of the DRIP, 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 page.

Alternatively, shareholders 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 2012 was 247.5 pence and the range during the year was 190.3 pence to 284.0 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 the Company is available in the financial press and on the Company's website www.resolution.gg

Analysis of registered shareholder accounts 31 December 2012

Size of shareholding	Number of shares	% of total number of shares
1–1,000	3,914,239	0.2760
1,001–5,000	6,893,248	0.4861
5,001–10,000	2,610,369	0.1841
10,001–100,000	15,398,494	1.0858
100,001–500,000	51,286,079	3.6165
500,001–1,000,000	51,525,610	3.6334
1,000,001–10,000,000	444,093,675	31.3159
10,000,001–1,000,000,000	842,387,314	59.4022
Total	**1,418,109,028**	**100**

Financial calendar

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

2012 final dividend

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

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