PENSION INSURANCE CORPORATION

REMOVING RISK FROM DEFINED BENEFIT PENSION FUNDS

Pension Insurance Corporation plc Annual Report and Financial Statements 2015

VALUING OUR CUSTOMERS

Specialist insurance to remove risk from defined benefit pension funds

Pension Insurance Corporation plc ("PIC") provides tailored pension insurance buyouts and buy-ins, or bulk annuities, to the trustees and sponsors of UK defined benefit pension funds

132,100
pensions insured

£16.6
billion in financial investments

2015 HIGHLIGHTS

Providing long-term financial security and stability for our customers and attractive returns for our shareholders

Continued strong performance in 2015

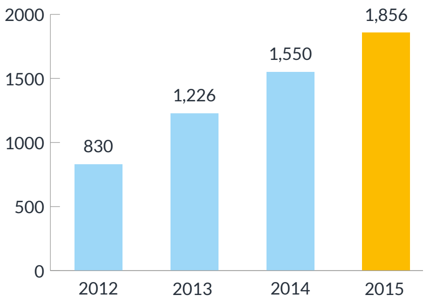
£1,856m
Embedded value

£3,755m
2015 Premiums

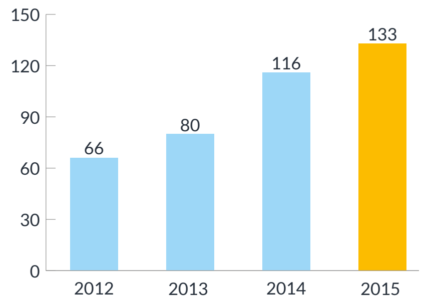
£133m
Underlying operating profit before tax

99.3%
Customer satisfaction ratio

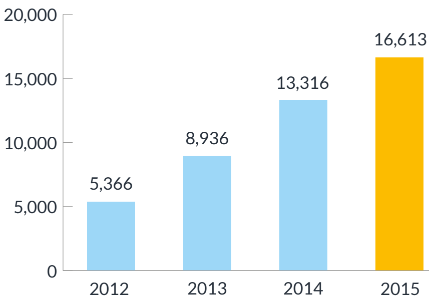
Embedded value
£m



Underlying operating profit
£m



Financial investments
£m



Other highlights

- All Solvency II applications approved, asset portfolio evolved to take advantage of market opportunities and align with Solvency II
- Pillar 1 Regulatory Ratio: 231%; Solvency II ratio of 151%
- Largest ever full buyout transacted
- Clients include Philips, NAPF/PLSA, Sanyo
- £3.8bn of longevity risk reinsured, including an unprecedented level of non-retired members
- Continued innovation in asset strategy with investments in Church of England retirement homes and Heathrow landing slots
- Accredited with the Institute of Customer Service's ServiceMark
- More than 2,000 attendees at our complimentary policyholder events, including sponsorship of the Ideal Home Show
- New Chief Executive Officer appointed
- Very high levels of customer satisfaction, with 99.3% of our policyholders satisfied or very satisfied with PIC's service

STRATEGIC REPORT
FOR THE YEAR ENDED 31 DECEMBER 2015

The Directors present the Strategic Report, Directors' Report and the audited financial statements for Pension Insurance Corporation plc ("PIC", or the "Company") registered number 05706720, for the year ended 31 December 2015.

Principal activity
The principal activity of PIC is providing insurance annuity products to UK defined benefit occupational pension funds and their members ("pension insurance").

Business Review
Background
The Company is authorised to write long-term insurance business by the Prudential Regulation Authority ("PRA") and is regulated by the PRA and the Financial Conduct Authority ("FCA"). Pension insurance products are used by pension funds to transfer risks and liabilities arising from the benefit promises made to pension fund members to an insurance company. Insurance is also used as a means by which the ultimate responsibility to pay the benefits promised is transferred to the insurance company through the issuance of an individual annuity insurance policy to the pension fund member.

The Company takes a lead role in developing and informing the pensions market through pension trustee training events. It publishes regular papers on the pensions market and information on how to address certain key issues for the commercial and the public sector, such as managing pension costs and risk inherent in pension schemes. It has an active thought leadership programme in dealing with Government, corporate sponsors and pension trustees and working with them on pension solutions in the public and private sectors.

The Company's ultimate parent company is Pension Insurance Corporation Group Limited ("PICG").

Strategy
The Company has continued with its strategy of seeking pension insurance business across all segments including the corporate and public sectors and insurer to insurer business. This strategy has been executed by selectively identifying opportunities which meet PIC's internal criteria for proceeding and tailoring an insurance transaction to be attractive to the trustees of the pension scheme and beneficial to members.

The escalating financial cost to pension schemes and their sponsors of pension provision, arising from volatility in asset performance, increases in life expectancy and the need to match assets more closely with liabilities (in order to comply with ever more stringent accounting and funding regime standards) have driven corporate sponsors to look at the benefit of transferring the risks associated with their defined benefit pension funds to the security of an insurance company regulated by the PRA and the FCA, such as PIC.

Accordingly, the size of PIC's potential market continues to broaden and deepen and is influenced by the affordability and benefits of the insurance offered. The Directors believe that, as the market continues to develop and pension insurance becomes more commonplace, these solutions will continue to be considered as affordable and necessary.

Key Performance Indicators
The Company has identified a number of financial and non-financial key performance indicators ("KPIs") and performance measures that it considers relevant at this point in its development. These indicators are shown below. As the business continues to develop, management will determine whether these indicators remain the most appropriate measures by which to manage the risk and profitability of the business.

Financial KPIs

	As at 31 December 2015	As at 31 December 2014
Measures of profit or loss		
Underlying operating profit before tax	**£133m**	£116m
Operating profit before tax	**£188m**	£154m
IFRS profit before tax	**£104m**	£170m
Measures of assets and liabilities		
Embedded value	**£1,856m**	£1,550m
Measures of income and expenditure		
New business (gross of reinsurance)		
Premiums written	**£3,755m**	£2,646m
Cost base		
Expenses as a % of closing financial investments under management	**0.42%**	0.45%
Non-financial KPIs		
Customer satisfaction ratio	**99.3%**	99.8%

Operating profit before tax has been defined to reflect the activities which are core to PIC's business, and to reflect the management choices and decisions around those activities. These encompass the writing and management of bulk annuity contracts, the management of risk through reinsurance, and the day-to-day investment and management of the insurance assets and liabilities.

Within this, management have defined a measure of "underlying operating profit before tax" which captures the returns made from the in-force book of insurance liabilities and expected long-term returns from surplus assets.

Non-operating profit includes the impacts of the external economic environment on the Company, as well as one-off expenses and the effects of actuarial assumption changes where PIC is required to recognise the overall impact of changes within one discrete accounting period.

The operating profit basis is more aligned to the way management view the business, and the decisions which management make around the Company's core activities.

The embedded value ("EV") result seeks to build on the IFRS results, and is prepared under the European Embedded Value ("EEV") principles issued in May 2004 by the European CFO Forum, as supplemented by the Additional Guidance on EEV Disclosures issued in October 2005.

The starting point is the IFRS balance sheet, but to this is added an estimate of the after-tax value that is expected to emerge in the future from the release of the margins built in to the actuarial valuation of the in-force business. It is essentially a discounted cash flow valuation of the business.

No allowance has been made for the possible impact of Solvency II in the calculation of the December 2015 embedded value. This approach is consistent with the additional guidance for EV reporting issued by the CFO Forum in October 2015.

Results for the year ended 31 December 2015

A summary of the IFRS-based measures of profit or loss, and an explanation of the results of the Company expressed on this basis, follows below:

	2015 £m	2014 £m
Return earned on insurance book	**87**	65
Expected return earned on surplus assets	**46**	51
Underlying operating profit before tax	**133**	116
New business and reinsurance	**59**	38
Other changes to in-force business	**(4)**	–
Operating profit before tax	**188**	154
Non-operating (loss)/profit before tax	**(84)**	16
IFRS profit before tax	**104**	170

Underlying operating profit before tax

Underlying operating profit before tax consists of the net returns the Company makes from its insurance liabilities and assets, and the return made from its surplus assets held above this level, estimated using a long-term assumption of the returns which these assets will generate.

Underlying operating profit before tax in 2015 was £133m (2014: £116m). The return earned from the insurance book (£87m) is higher than 2014, reflecting the growth in the overall asset base over the past 12 months. The expected return on surplus assets (£46m) is lower than 2014 reflecting the fall in long-term risk free rates over that time.

Operating profit before tax

In addition to the items which constitute underlying operating profit before tax, operating profit before tax considers the impacts of new business and reinsurance transactions undertaken in the year, as well as any other changes to in-force business.

During the year PIC completed a further 13 (2014: 19) new transactions with pension schemes, with a total premium value of £3.8bn (2014: £2.6bn). The Philips pension scheme, which was transacted in November 2015 for a premium of £2.4bn, was the largest buy-out deal in the bulk insurance sector and insured pension benefits of approximately 26,000 pension scheme members.

PIC concluded one quota share (2014: two) and three longevity swap (2014: two) reinsurance transactions during the year which covered longevity risk on c.£3.8bn (2014: £3.0bn) of insurance liabilities.

Taking into account the liabilities acquired in new business transactions, together with the costs incurred and the reinsured liabilities during the year, these items contributed £59m (2014: £38m) to operating profits.

Non-operating profit before tax

Included within this are the short-term fluctuations in return, the impact of changes in actuarial assumptions, non-recurring costs and interest payments made in servicing the Company's subordinated debt.

Non-operating profit before tax for the year was a loss of £84m (2014: £16m profit). A significant portion of this loss resulted from the one-off costs incurred to align the Company's investment portfolio with the new Solvency II requirements. There were also some smaller adverse variances from market movements in the year.

Other operational highlights

Previously PIC reinsured certain liabilities under a quota share agreement with Pension Security Insurance Corporation Limited ("PSIC"), a group reinsurance company. With effect from 1 March 2015, this reinsurance was recaptured by PIC, the effect being to recapture c. £385m of insurance liabilities and £358m of related assets. PIC realised a £15m loss on recapture, although it will benefit from future profits arising from the recaptured business.

By the end of 2015 PIC had total financial investments of £16.6bn, compared to £13.3bn at the end of 2014. The increase of £3.3bn over 2015 was principally due to the new business premiums received as well as the effect of reinsurance contracts and market movements during the year, less claim payments made to policyholders.

At 31 December 2015 73% of PIC's total longevity exposure on a regulatory solvency basis was reinsured to third party, investment grade reinsurer counterparties (2014: 66%).

The Company is now responsible for the pension payments of 132,100 individuals (2014: 103,600). Payment of annuities grew by 16% in 2015 to £484m (2014: £416m) mainly through new business written during the year. Total claim amounts paid were £581m (2014: £456m), an increase of 27% as the growth in annuities was exceeded by the growth in lump sum payments and transfers out compared to the previous year.

At the end of 2015 PIC had 81,000 current individual policies in issue, in respect of 64 pension schemes, up from 51,000 in respect of 45 schemes a year ago. The remaining schemes are either in the transition process, which includes the verification of scheme data and finalisation of liabilities prior to individual policies being issued by PIC, or are buy-ins under which PIC's contract is with the pension scheme and no individual policies are issued. The growth in the number of policies in issue is also affected by reductions due to leavers, transfers and deaths.

The Directors remain positive about both the Company's own financial position, and the growth potential of its market and the Company's ability to participate in that growth.

STRATEGIC REPORT
FOR THE YEAR ENDED 31 DECEMBER 2015 continued

Solvency
The Company has complied with the regulatory capital requirements under Pillar 1 as set out in the relevant PRA rules (see Note 18) throughout the year.

The Company's regulatory (Pillar 1) solvency ratio at 31 December 2015 was 231% (2014: 270%) and it had surplus assets which were £864m (2014: £865m) in excess of regulatory requirements.

Solvency II
The European Union ("EU") has developed a new solvency framework for insurance companies, referred to as Solvency II. The initial Solvency II Directive was formally approved by the Economic and Financial Affairs Council in November 2009 and has progressed through a series of formal consultations and updates to date.

The new approach is based on the concept of three pillars – minimum capital requirements, supervisory review of firms' assessments of risk and enhanced disclosure requirements – and was implemented on 1 January 2016. The Solvency II regime replaces the exising Solvency I regulatory regime with effect from that date.

The Company has transitioned from the Solvency I regime and is fully compliant with the new Solvency II regime as a result of the successful conclusion to a comprehensive implementation programme run under the direct oversight of the Board.

PIC has obtained approval from the PRA to use an Internal Model to calculate its Solvency Capital Requirement, to make use of the Matching Adjustment and Volatility Adjustment and to utilise Transitional Measures on its Technical Provisions under Solvency II.

At 31 December 2015, the Company's unaudited ratio on the Solvency II basis was 151%.

Material contracts
During the year Pension Services Corporation Limited ("PSC"), a UK limited company that is a fellow subsidiary of Pension Insurance Corporation Group Limited, continued to provide management, staff, IT and office services to the Company under a defined service agreement.

Principal risks and uncertainties
The principal risks affecting the Company's business and its strategy for managing those risks are set out in detail in Note 15 to the financial statements.

On behalf of the Board

Tracy Blackwell
Chief Executive
23 March 2016

14 Cornhill
London
EC3V 3ND

DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER 2015

Directors and their interests
The Directors who served during the year and up to the date of approval of these financial statements were:

Director	Position	Executive/ Non-Executive	Notes
Sir Mark Weinberg	Chairman	Non-Executive	
Tracy Blackwell	Chief Executive	Executive	Appointed on 1 July 2015
Rob Sewell		Executive	
Bill Winters		Non-Executive	Resigned on 1 October 2015
Chris McKechnie		Non-Executive	
Eloy Michotte		Non-Executive	
Harriet Maunsell		Non-Executive	
John Coomber		Non-Executive	Resigned as CEO on 30 June 2015, appointed as Non-Executive on 27 August 2015
Mark Stephen		Non-Executive	
Nicholas Lyons		Non-Executive	Appointed on 26 February 2016
Nicholas Parker		Non-Executive	Resigned on 31 October 2015
Roger Marshall		Non-Executive	Appointed on 1 September 2015
Steve Sarjant		Non-Executive	
Tim Hanford		Non-Executive	
Wilhelm Van Zyl		Non-Executive	Appointed on 1 May 2015

None of the Directors who held office at the end of the financial year had any disclosable interest in the shares of the Company.

Corporate Governance Statement
The Company has a listed security in issue and complies with the applicable sections DTR 7.1 and DTR 7.2 of the Financial Conduct Authority ("FCA") handbook.

The Company does not have a Premium Listing and is not required to comply with the UK Corporate Governance Code (formerly the Combined Code).

The Board and its Directors
The Company is led by a Board of Directors ("Board"). The appointment of the Directors is pursuant to the Articles of Association dated 9 June 2014. The Company arranges formal induction for all new Directors. An ongoing training programme is also in place. The Directors are covered by the Company's directors' and officers' indemnity insurance policy.

The Board acknowledges that it is collectively responsible for the success of the Company by providing leadership, setting the Company's strategic aims, ensuring that the necessary financial and human resources are in place and reviewing management performance. All Directors receive appropriate and timely information and briefing papers in advance of Board Meetings.

The Directors ensure that the Board is structured in such a way that each member of the Board is able to bring different experiences and skills to the operation of the Company and encourages and supports each Director to regularly update and refresh their skills and knowledge.

Internal control and risk management systems
The Board has overall responsibility for the system of internal control and risk management across the Company and for reviewing its effectiveness. The Board has delegated responsibility to the Audit Committee and the Risk Committee for monitoring this system and reporting on its effectiveness to the Board.

Review of internal controls
The internal control framework is designed to manage and reduce, rather than eliminate, the risk of failing to achieving business objectives. It can only provide the Board with reasonable, and not absolute, assurance against material misstatement or loss.

The key features of the Company's system of internal control include:

- An established management structure operating across PIC with clearly defined levels of responsibility and delegated authorities;
- A risk management and compliance system – the Board has established a process for identifying, evaluating and managing the risks faced by the Company;
- As part of the requirements of DTR 7.1.3 the Board, in line with the delegated authority to the Audit Committee, specifically monitors the financial reporting process and the statutory audit of the annual financial statements through reports provided by management and reporting received from the Audit Committee;

- Audit Committee oversight – the Audit Committee, which is composed of five non-executive directors including independent directors with relevant accounting and financial reporting experience, meets regularly with members of the executive management group and the internal and external auditors to review the annual and half-yearly financial information and internal control matters, and to satisfy themselves that the internal control systems are operating effectively. The Audit Committee also reviews any follow-up action to correct identified weaknesses. All Board members receive the minutes of all Audit Committee meetings;
- Internal audit assurance – the Company's internal audit function is managed by the head of Internal Audit using an outsourced model and has a direct reporting line to the Audit Committee. The internal audit programme is designed to review key areas of risk. The Audit Committee approves the internal audit plan annually and monitors progress against the plan including the results of individual audits;
- External audit assurance – the work of the external auditors provides further independent assurance on the internal control environment, as described in their reporting to the Audit Committee. Furthermore, the Audit Committee reviews and monitors the independence of the statutory auditor and considers the relationship with PIC as part of its assessment, including provision of non-audit services;
- Board Risk Committee oversight – working closely with the Audit Committee, the Committee provides oversight and advice to the Board with regard to the Company's current and likely risk exposures; risk tolerances and appetite; risk measurement; risk management performance; and its risk policies and procedures and risk controls;
- Procedures to ensure the employment, retention, training and development of suitably qualified staff to manage activities;
- The preparation and monitoring of budgets and long-term business plans – the Board, Audit Committee and Risk Committee and the executive management group review the Company's performance throughout the year. The reports ensure that variances are investigated and acted upon.

The Board has reviewed the effectiveness of the system of internal controls, including risk management, for the year to 31 December 2015 and up to the date of signing these financial statements and the annual report. It has not identified any weaknesses sufficient to cause material misstatement or loss which requires disclosure in the financial statements.

Issue of shares

The Company issued 65 million £1 ordinary shares at par on 23 March 2015. The issue was fully paid and wholly subscribed by Pension Holding Company (UK) 3 Limited, the immediate parent company, for consideration consisting of tradeable securities and managed funds with a market value of £65m. The shares were issued in connection with the recapture of the reinsurance treaty from PSIC. No shares were issued to investors in the ultimate group company, PICG (or its predecessor ultimate group company, Pension Corporation Group Limited).

Dividends

The Directors do not recommend a dividend for the year (2014: nil).

Political contributions

The Company made no political contributions during the year (2014: nil).

Qualifying third party indemnities

The Articles of Association of the Company provide for the Directors and officers of the Company to be indemnified in respect of liabilities incurred as a result of their office. The Company also provides certain forms of protection for its Directors and senior managers of companies within the PICG Group against personal financial exposure that they may incur in their capacity as such.

During the year and at the time the Directors' Report was approved under section 234 of the Companies Act 2006 this protection included qualifying third party indemnity provisions (as defined under section 234 of the Companies Act 2006) in force for the benefit of the Company's Directors.

Going concern

After making enquiries, including specific consideration of Solvency II, the Directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the financial statements.

Disclosure of information to auditors

The Directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware; and each Director has taken all the steps that he ought to have taken as a Director to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Auditor

In accordance with section 487 of the Companies Act 2006, the auditor will be deemed to be reappointed and KPMG LLP will therefore continue in office.

On behalf of the Board

Tracy Blackwell
Chief Executive
23 March 2016

14 Cornhill
London
EC3V 3ND

STATEMENT OF DIRECTORS' RESPONSIBILITIES

IN RESPECT OF THE STRATEGIC REPORT, DIRECTORS' REPORT AND THE FINANCIAL STATEMENTS

The Directors are responsible for preparing the Strategic Report, the Directors' Report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with International Financial Reporting Standards ("IFRS") as adopted by the EU and applicable law.

Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRS as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

INDEPENDENT AUDITOR'S REPORT
TO THE MEMBERS OF PENSION INSURANCE CORPORATION PLC

We have audited the financial statements of Pension Insurance Corporation plc for the year ended 31 December 2015 set out on pages 9 to 39. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards ("IFRS") as adopted by the EU.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. 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 7, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the 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.

Scope of the audit of the financial statements
A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

Opinion on financial statements
In our opinion the financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2015 and of its profit for the year then ended;
- have been properly prepared in accordance with IFRS as adopted by the EU; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006
In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception
We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Mostyn Wilson (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
23 March 2016

KPMG LLP
15 Canada Square,
London,
E14 5GL

STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 DECEMBER 2015

		Year ended 31 December 2015		Year ended 31 December 2014	
	Note	**£m**	**£m**	£m	£m
Revenue					
Gross premiums written		**3,755**		2,646	
Outward reinsurance premiums	10f	**157**		(176)	
Net premium revenue earned			**3,912**		2,470
Investment return	3		**(252)**		1,785
Total revenue (net of reinsurance premiums)			**3,660**		4,255
Expenses					
Claims paid – gross		**(581)**		(456)	
Reinsurers' share of claims paid		**16**		20	
			(565)		(436)
Increase in insurance liabilities – gross		**(2,656)**		(4,387)	
(Decrease)/increase in reinsurers' share of insurance liabilities	10f	**(247)**		808	
			(2,903)		(3,579)
Acquisition expenses	4	**(43)**		(35)	
Other operating expenses	5	**(25)**		(25)	
Finance costs	12	**(20)**		(10)	
			(88)		(70)
Total claims and expenses			**(3,556)**		(4,085)
Profit before taxation			**104**		170
Tax charge	8		**(21)**		(35)
Profit or loss and total comprehensive income for the year			**83**		135

The amounts shown above are in respect of continuing operations.

The accounting policies and notes on pages 13 to 39 form an integral part of these financial statements.

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 2015

31 December 2015	Share capital £m	Other reserves £m	Retained profit £m	Total £m
At beginning of year	**692**	**60**	**396**	**1,148**
Total comprehensive income				
Profit for the year	**–**	**–**	**83**	**83**
Transactions with owners				
Share capital issued	**65**	**–**	**–**	**65**
At end of year	**757**	**60**	**479**	**1,296**

31 December 2014	Share capital £m	Other reserves £m	Retained profit £m	Total £m
At beginning of year	625	60	261	946
Total comprehensive income				
Profit for the year	–	–	135	135
Transactions with owners				
Share capital issued for cash consideration	67	–	–	67
At end of year	692	60	396	1,148

The accounting policies and notes on pages 13 to 39 form an integral part of these financial statements.

STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 2015

		31 December 2015		31 December 2014	
	Note	£m	£m	£m	£m
Assets					
Investment properties	9		**96**		96
Reinsurers' share of insurance liabilities	10		**1,917**		2,164
Receivables and other financial assets	13		**182**		136
Prepayments			**74**		37
Financial investments	13		**16,613**		13,316
Derivative assets	14		**4,900**		2,761
Cash and cash equivalents	13		**12**		5
Total Assets			**23,794**		18,515
Equity					
Share capital	16	**757**		692	
Other reserves	17	**60**		60	
Retained profit	17	**479**		396	
Total Equity			**1,296**		1,148
Liabilities					
Gross insurance liabilities	10	**16,480**		13,824	
Deferred tax liability	11	**5**		6	
Derivative liabilities	14	**5,635**		3,093	
Borrowings	12	**295**		294	
Insurance and other payables	13	**53**		118	
Current taxation		**15**		17	
Accruals	13	**15**		15	
Total Liabilities			**22,498**		17,367
Total Equity and Liabilities			**23,794**		18,515

The accounting policies and notes on pages 13 to 39 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 23 March 2016 and were signed on its behalf by:

Rob Sewell
Director

Registration number: 05706720

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 31 DECEMBER 2015

	Note	Year ended 31 December 2015 £m	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m	Year ended 31 December 2014 £m
Cash flows from operating activities					
Profit for the year			**83**		135
Adjustments for non-cash movements					
Interest income recognised in profit or loss	3	**(368)**		(291)	
Other investment income recognised in profit or loss	3	**(79)**		(23)	
Interest expense recognised in profit or loss		**19**		10	
Amortisation of subordinated debt issue costs and discount		**1**		–	
Movement in fair value of investment properties	9	**–**		(3)	
Movement in tax provisions	8	**21**		35	
			(323)		(137)
Changes in operating assets and liabilities					
(Increase)/decrease in receivables and other financial assets		**(5)**		62	
Increase in financial investments including derivative assets		**(5,371)**		(6,374)	
Increase in prepayments		**(37)**		(9)	
Decrease/(increase) in reinsurers' share of insurance liabilities		**247**		(808)	
Increase in insurance liabilities		**2,656**		4,387	
Increase in financial liabilities including derivative liabilities		**2,542**		2,191	
(Decrease)/increase in insurance and other payables		**(65)**		71	
Decrease in accruals		**(1)**		(7)	
			(34)		(487)
Cash outflow from operating activities			**(357)**		(624)
Taxation paid			**(24)**		(31)
Net outflow from operating activities			**(381)**		(655)
Cash flows from investing activities					
Interest income received		**329**		276	
Other investment income received		**79**		23	
			408		299
Cash flows from financing activities					
Proceeds from issue of share capital	16	**–**		67	
Proceeds from issue of subordinated debt	12	**–**		297	
Interest paid on subordinated debt		**(20)**		–	
Issue costs	12	**–**		(3)	
			(20)		361
Net increase in cash and cash equivalents			**7**		5
Cash and cash equivalents at beginning of year			**5**		–
Cash and cash equivalents at end of year			**12**		5

The accounting policies and notes on pages 13 to 39 form an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015

1. ACCOUNTING POLICIES

(a) Basis of preparation

The financial statements have been prepared in accordance with the International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU") and those parts of the Companies Act 2006 applicable to companies reporting under IFRS. The financial statements also comply with the Statement of Recommended Practice on Accounting for Insurance Business (issued by the Association of British Insurers in December 2005, as amended in 2006) insofar as these requirements do not contradict IFRS requirements.

These financial statements have been presented in millions of pounds sterling (£m) unless otherwise stated.

The financial statements have been prepared on a going concern basis.

The Company has applied all IFRS and interpretations that are adopted by the EU and are effective for accounting periods beginning on or after 1 January 2015. There is no material effect on the results of the Company arising from implementation of these standards.

The Company has not adopted the following standards which are not yet mandatory:

IFRS 9 – Financial Instruments – not yet endorsed by the EU, effective for accounting periods beginning on or after 1 January 2018.

IFRS 15 – Revenue from Contracts with Customers – not yet endorsed by the EU, effective for accounting periods beginning on or after 1 January 2018.

The Company believes that it is not currently possible to evaluate the impact the adoption of the above Accounting Standards will have on the results of the Company.

(b) Recognition and derecognition of financial instruments

A financial instrument is recognised if the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognised if the Company's contractual rights to the cash flows from the financial assets expire, or if either the Company transfers the financial asset to another party without retaining control or substantially all risks and rewards of the asset are transferred to another party. Regular purchases and sales of financial assets are accounted for at the date of trading. Financial liabilities are derecognised when the Company's obligations specified in the contract expire or are discharged or cancelled.

(c) Contract classification

IFRS 4 "Insurance Contracts" requires policyholder contracts written by insurers to be classified as either insurance contracts or investment contracts depending on the level of insurance risk transferred.

Insurance contracts are defined as those contracts containing significant insurance risk if, and only if, an insured event could cause an insurer to make significant additional payments in any scenario, excluding scenarios that lack commercial substance, at the inception of the contract. Such contracts remain insurance contracts until all rights and obligations are extinguished or expire.

Policy contracts which do not transfer significant insurance risk to the insurer are classified as investment contracts. The Company has classified all its policyholder contracts as insurance contracts.

(d) Premiums

Premiums are received in consideration for completing an insurance policy with the trustees of the pension scheme. They are recognised and valued on the day risk is accepted. Retrospective adjustments to premiums may be required following work performed during the transition of a scheme prior to completion of a full buy-out and issuance of individual annuity policies to pension scheme members. Such adjustments are recognised and valued at the date they become payable or receivable by the Company.

Premiums reported exclude any taxes or duties based on premiums.

(e) Acquisition costs

Acquisition costs comprise all direct and indirect costs of obtaining and processing new business. Indirect costs consist primarily of management, staff and related overhead costs.

A deferred acquisition cost asset has not been established in the Statement of financial position. The majority of acquisition costs incurred are not directly related to individual sales and the amount of directly attributable acquisition costs, that would be deferrable, is not considered to be material.

(f) Claims

Claims and benefits payable consist of regular annuities paid to pension scheme members and beneficiaries, and surrenders which consist of full settlements of transfers out and partial settlement of tax-free cash components of pension benefits. Annuities are recognised when due for payment. Surrenders are accounted for when paid. Death claims are accounted for when notified, at which time the policy ceases to be included within the calculation of the insurance contract liabilities.

(g) Investment return

Interest income is calculated using the effective interest method.

Dividend income is recognised when the related investment goes "ex-dividend" and is grossed up where appropriate by the tax credit.

Realised gains or losses represent the difference between net sale proceeds and the purchase price or in the case of investments valued at amortised cost, the latest carrying value prior to the date of sale.

Unrealised gains and losses on investments measure the difference between the fair value of investments held at the end of each financial year and their purchase price. The net movement reflects both unrealised gains and losses recognised during the year adjusted for any prior period unrealised gains and losses which have been realised in the current accounting period.

(h) Investment expenses and charges

Investment expenses comprise:

- fees payable to investment managers for advisory services including performance-related fees; and
- transaction costs on financial assets at fair value through profit or loss.

Fees payable to investment managers are recognised on an accruals basis.

Performance fees are payable to certain investment managers who exceed certain targets measured over a number of financial years. The Company recognises the costs of such agreements during the life of each contract. No provision is made for fees on potential outperformance of targets in future years.

(i) Finance costs

Finance costs comprise the interest expense on borrowings, which is calculated using the effective interest method.

(j) Investment properties

Investments in freehold properties not for occupation by the Company are carried at fair value, with changes in fair value included in the Statement of comprehensive income.

Properties are valued annually by professional external valuers using the Royal Institution of Chartered Surveyors ("RICS") guidelines. The RICS guidelines apply separate assumptions to the value of the land, buildings and tenancy associated with each property.

The external valuers also consider changes in market conditions and the status of the tenants in determining whether a full physical inspection is required each year. Irrespective of such considerations, each property is fully inspected as part of the valuation process at least once every three years. The cost of additions and renovations is capitalised and considered when estimating fair value.

Fair value is based on active market prices, adjusted, if necessary, for any difference in the nature, location or condition of the specific property.

(k) Financial instruments

Derivative financial instruments are measured at fair value through profit or loss ("FVTPL") and classified as held for trading. All other financial assets and financial liabilities with the exception of short-term assets and liabilities and cash and cash equivalents are classified as fair value through profit or loss.

Financial investments are designated at FVTPL upon initial recognition where they are managed on a fair value basis in accordance with risk management and investment strategies, and information is provided internally to key management personnel on that basis. Financial instruments at FVTPL are initially recognised at fair value in the Statement of financial position with transaction costs and any subsequent change in fair value taken directly to the Statement of comprehensive income. All changes in fair value are recognised in the Statement of comprehensive income and are included within the "Investment return" category as explained in Note 1(g) above.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

1. ACCOUNTING POLICIES continued

The amount of each class of financial asset and liability that has been designated at fair value through profit or loss and the methodology for determining the fair value for financial assets and liabilities are set out in Note 13.

(l) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the Statement of financial position only when there is an unconditional and a legally enforceable right to offset the recognised amounts in all circumstances (including the default by, or insolvency or bankruptcy of the Company and all counterparties), and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously. Realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the settlements are executed at the same time, or within a single settlement process or cycle, resulting in no or insignificant credit and liquidity risk.

(m) Assets pledged as collateral

The Company receives and pledges collateral in the form of cash and non-cash assets in respect of certain derivative contracts in order to meet its contractual obligations. The amount of collateral required is determined by the valuation of each contract on a mark-to-market basis and the type of collateral to be deposited is specified within the agreement with each counterparty.

Collateral pledged in the form of cash and non-cash assets, which are not legally segregated from the Company, continues to be recognised in the Statement of financial position within the appropriate asset classification as the Company retains all rights relating to these assets. If the Company relinquishes the economic risks and rewards of ownership when pledging the assets, it derecognises the asset with a corresponding receivable recognised for its return.

Collateral received in the form of cash and non-cash assets are not recognised as an asset in the Statement of financial position unless the Company acquires the rights relating to the economic risks and rewards relating to these assets. Where such assets are recognised, the Company recognises a corresponding financial liability.

(n) Cash and cash equivalents

Cash and cash equivalents consist of cash balances, including any overdrawn balances, and deposits held at call with banks with less than 90 days maturity from date of acquisition.

(o) Foreign currencies

The functional currency of the Company is pounds sterling. The Company has chosen to present its financial statements in this currency.

Monetary assets and liabilities denominated in a foreign currency are translated into the functional currency at the foreign exchange rate ruling at the end of the financial year. Non-monetary assets and liabilities are translated into the functional currency using the historic rate. All revenue and expense items are reflected in the Statement of comprehensive income at the rate effective at the date the transaction took place.

(p) Taxation

Current taxation is provided on taxable profits at the corporation tax rate ruling in the year they are earned.

Deferred tax is provided on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes, and the amounts used for taxation purposes. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates ruling at the date the timing difference is expected to reverse.

A deferred tax asset is recognised only to the extent that it is probable that future profits will be available against which the asset can be utilised.

(q) Prepayments

Prepayments include annuity payments made to pension schemes in advance of the Statement of financial position date to ensure settlement of the following month's annuity payments to policyholders on a timely basis.

(r) Impairment of non-financial assets

Non-financial assets that are measured at amortised cost are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use.

(s) Borrowings
Borrowings are recognised initially at fair value which is the cash consideration received net of transaction costs incurred. Borrowings classified as liabilities are subsequently stated at amortised cost. The difference between the net proceeds and the redemption value is recognised in the Statement of comprehensive income over the borrowing period using the effective interest method.

(t) Insurance liabilities
Insurance liabilities are determined by the Company's internal actuarial department, using methods and assumptions approved by the Directors having regard to the advice of the Company's Actuarial Function Holder, and using recognised actuarial methods consistent with the actuarial principles laid down in Directive 2002/83/EC. The liabilities are calculated initially on a statutory solvency basis to comply with the reporting requirements under the Financial Services and Markets Act 2000. The liabilities are then adjusted to remove certain contingency and other reserves required under the regulations set out in INSPRU (the Prudential Sourcebook for Insurers issued by the Prudential Regulation Authority ("PRA")), which are not required to be recognised as insurance liabilities under IFRS 4.

Insurance liabilities comprise the present value of future obligations to current policyholders, increased to take due account of investment expenses and future administration costs associated with the maintenance of the in-force business. Estimates of future obligations to policyholders allow for the impact of mortality in line with the bases set out in Note 10. These bases have been derived having regard to recent UK general population mortality experience, the demographic profile of the Company's in-force business and the Company's own internal mortality experience, and include an appropriate allowance for improvements in longevity in the future.

The interest rate used for discounting future claims payments and the associated expenses is derived from the yield on the assets held to back those liabilities and includes an allowance for risks, including credit risk, associated with holding these assets. The calculation of the valuation rate of interest complies with the relevant PRA regulations (INSPRU 1.2.33R and INSPRU 3.1) adjusted for any modifications agreed with the PRA in respect of the Company's application of these regulations.

(u) Reinsurance
Amounts recoverable from or due to reinsurers are measured consistently with the amounts covered under each of the in-force reinsurance contracts and in accordance with the terms of each reinsurance contract.

Premiums payable under quota share reinsurance contracts are recognised at the inception of each reinsurance contract. In cases where the amount of premiums due to the reinsurer has not been finalised at the end of a reporting period, an estimate is made in accordance with the terms of each reinsurance contract. Subsequent adjustments to the premium payable are accounted for in the period in which the adjustment arises.

Premiums payable for reinsurance ceded are recognised in the period in which the benefit of the reinsurance treaty is recognised within insurance contract liabilities.

The benefits to which the Company is entitled under its reinsurance contracts are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers, together with longer-term receivables that are dependent on the expected claims and benefits arising under the related reinsured insurance contracts.

The Company has two types of quota share reinsurance arrangements. The first type is a quota share agreement covering all policyholder benefit payments for a proportion of the business reinsured. This proportion varies between 50% and 90% for certain discrete blocks of business. The second type is a tail-risk quota share arrangement with an external reinsurer under which 100% of all benefit payments after a fixed period (subject to certain treaty-specific limits) are covered in return for an initial single premium.

The Company has also entered into a number of longevity reinsurance contracts with reinsurers under which it has committed to pay the reinsurer a schedule of fixed payments ("the fixed line") in respect of expected claims relating to defined tranches of policyholder benefits and in return the reinsurer undertakes to reimburse the actual cost of claims on those tranches to the Company. Separately, there is also an insurance fee on each of these contracts for which the Company is liable. Settlement of the contract is on a net basis; however, the amounts receivable from or payable to reinsurers are not offset in the Statement of financial position and are included in the appropriate heading under either "receivables and other financial assets" or "insurance and other payables".

Fees paid in respect of certain longevity reinsurance contracts, which are contingent on Pillar 1 surplus, are recognised as incurred and are included under outward reinsurance premiums.

Reinsurance recoveries are accounted for in the same period as the related claim is incurred.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

1. ACCOUNTING POLICIES continued

The Company impairs its reinsurance assets if there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that not all amounts due to it under the terms of the contract will be received and the impact of the event on the amount to be received from the reinsurer can be reliably measured. An impairment loss is recognised for the amount by which the reinsurance asset's carrying amount exceeds its recoverable amount.

(v) Critical accounting policies, estimates and judgements

Included in the financial statements are certain critical accounting judgements as described below:

The Company is exposed to longevity risk, namely the risk that annuitant policyholders live longer than assumed. In order to calculate the associated amount of insurance liabilities and the reinsurers' share of these liabilities, the Company makes assumptions relating to the incidence of deaths for each year of the duration of the insurance contracts. These assumptions are reconsidered annually and are based on standard mortality tables which are adjusted to reflect the anticipated experience for each individual separately, and the provision of explicit allowances for future mortality improvements.

The Company has reinsured a significant proportion of its longevity risk through the use of reinsurance contracts. The anticipated effect of these contracts is reflected as an asset within the Statement of financial position.

The carrying value of insurance liabilities net of reinsurance at the end of the financial year is £14.6bn (2014: £11.7bn). The assumptions used to establish insurance contract liabilities and appropriate sensitivities relating to variations in these assumptions are disclosed in Note 10.

Financial instruments

Where an active market does not exist for a financial instrument, the Company uses financial modelling to ascertain fair value. The models consider the anticipated future cash flows expected to be derived from the assets or paid in respect of the liabilities and discount them to reflect the timing of payments and, for debt assets, the likelihood of default given the relative seniority of the holding in order of repayment. The relevant fair value disclosures are set out in Note 13.

2. OPERATING SEGMENTS

Management considers that the Company consists of one operating segment, which operates in one geographical location (the United Kingdom) and has one line of business: the provision of insurance annuity products to UK defined benefit occupational pension funds and their members.

A summary of the IFRS based measures of profit or loss used by the Executive Committee, the Company's Chief Operating Decision Maker, and a reconciliation of these measures to the equivalent measure under International Financial Reporting Standards, is as follows:

	2015 £m	2014 £m
Return earned on insurance book	**87**	65
Return earned on surplus assets	**46**	51
Underlying operating profit before tax	**133**	116
New business and reinsurance	**59**	38
Other changes to in-force business	**(4)**	–
Operating profit before tax	**188**	154
Non-operating (loss)/profit before tax	**(84)**	16
IFRS profit before tax	**104**	170

Underlying operating profit before tax

Underlying operating profit before tax consists of the net returns the Company makes from its insurance liabilities and assets, and the return made from its surplus assets held above this level, estimated using a long-term assumption of the returns which these assets will generate.

Operating profit before tax

In addition to the items which constitute underlying operating profit before tax, operating profit before tax considers the impacts of new business and reinsurance transactions undertaken in the year, as well as any other changes to in-force business.

During the year PIC completed a further 13 (2014: 19) new transactions with pension schemes with a total premium value of £3.8bn (2014: £2.6bn).

Non-operating profit before tax
Included within this is the overall impact of economic factors outside of management's normal expectations, as well as the impact of changes in actuarial assumptions, non-recurring costs and interest payments made in servicing the Company's subordinated debt.

Customers
The nature of the Company's business is that it conducts a relatively small number of individual transactions each year. These transactions are all one-off in nature, and the Company's business plans do not anticipate conducting a significant amount of repeat business with any particular customers. Revenue concentration items have therefore not been disclosed.

3. INVESTMENT RETURN

	Year ended 31 December 2015		Year ended 31 December 2014	
	£m	**£m**	£m	£m
Income from debt securities	**356**		283	
Interest income on cash deposits	**7**		4	
Income from mortgage backed securities	**5**		4	
Interest income		**368**		291
Rental income	**5**		5	
Income from other investments				
– Investment schemes	**4**		3	
– Other asset backed securities	**8**		11	
– Other investments	**62**		4	
		79		23
Total investment income		**447**		314
Realised gains on:				
– Investments designated as FVTPL on initial recognition	**391**		202	
– Investments classified as held for trading	**163**		32	
Realised losses on:				
– Investments designated as FVTPL on initial recognition	**(24)**		(1)	
– Investments classified as held for trading	**(85)**		(158)	
Net realised gains		**445**		75
Unrealised gains on:				
– Investments designated as FVTPL on initial recognition	**3**		1,467	
– Investments classified as held for trading	**12**		255	
Unrealised losses on:				
– Investments designated as FVTPL on initial recognition	**(688)**		(7)	
– Investments classified as held for trading	**(471)**		(319)	
Net unrealised (losses)/gains		**(1,144)**		1,396
Investment return		**(252)**		1,785

4. ACQUISITION EXPENSES

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
Acquisition expenses	**43**	35

Acquisition expenses include an element of the wages and salaries of staff involved in the activity of acquiring new contracts.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

5. OTHER OPERATING EXPENSES

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
Investment charges and related expenses	**9**	9
Other expenses	**16**	16
	25	25

Investment charges and related expenses include amounts due at the end of each financial year relating to investment performance fees payable on targets based over a number of financial years.

6. AUDITOR'S REMUNERATION

	Year ended 31 December 2015 £	Year ended 31 December 2014 £
Fees payable to the Company's auditor for the audit of the Company's annual accounts	**182,050**	175,935
Fees payable to the Company's auditor and its associates for other services:		
Audit-related assurance services	**196,266**	37,710
Other assurance services	**39,428**	–
Tax compliance services	**20,150**	71,887
All other services	**121,193**	409,094
Total fees paid to the auditor	**559,087**	694,626

7. DIRECTORS' REMUNERATION, EMPLOYEE COSTS AND HEADCOUNT

Pension Services Corporation Limited ("PSC") was the main provider of management, staff, IT and office services to the Company, under a defined service agreement, throughout the year.

The Company employs no staff directly as all staff were provided by PSC during the year.

The costs of Directors and employees of the Company for the year were as follows:

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
Wages and salaries	**19**	17
Social security costs	**2**	2
Other pension costs	**1**	–
	22	19

The Company has 14 Directors who served during the year (2014: 12). All of the Directors were employed by or contracted by the Company's service providers. The total remuneration received by the Directors for their services, was £3m (2014: £3m).

The amount of remuneration received by the highest paid Director was £1m (2014: £1m). These amounts relate solely to the services provided by the Directors to the Company and do not include any payments due for services provided with regard to other Group entities.

Three Directors had money paid to money purchase pension schemes or were provided a cash alternative where their lifetime limit had been reached (2014: two). No Directors, including the highest paid Director, were eligible for shares or share options in the Company under a long-term incentive scheme (2014: nil). No Directors exercised options in the Company during the year (2014: nil).

8. CORPORATION TAX

The Company's tax charge for the year is:

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
Current taxation		
Tax payable for the current year	**22**	36
Prior year under/(over) provision	**–**	–
Total current tax	**22**	36
Deferred taxation		
Recognition of deferred tax liability on temporary timing differences	**–**	–
Tax transitional adjustment	**(1)**	(1)
Effect of change in tax rates	**–**	–
Total deferred tax	**(1)**	(1)
Corporation tax charge	**21**	35

The current tax charge for the period is the same as (2014: lower) the standard rate of corporation tax in the United Kingdom of 20.25% (2014: 21.50%). The differences are explained below:

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
Reconciliation of total income to the applicable tax rate		
Profit before taxation	**104**	170
Corporation tax at 20.25% (2014: 21.50%)	**21**	36
Effects of:		
Expenses not deductible for tax purposes	**–**	–
Income not subject to corporation tax	**–**	(1)
Prior year under/(over) provision	**–**	–
Effect of change in tax rates	**–**	–
Corporation tax charge	**21**	35

Factors that may affect future tax charges

A new tax regime commenced in January 2013 which changed the calculation of taxable profits of insurance companies. The main change in the new regime was that the tax payable was based upon IFRS profits rather than those disclosed in the annual returns to the PRA. This resulted in higher taxable profits as certain reserves required to calculate solvency under the PRA rules were not permitted under IFRS.

The Company has incorporated the effects of the enacted legislation in calculating its deferred tax liability at 31 December 2015.

Following the change in the taxation regime for insurance companies, the benefit of the differences between IFRS retained earnings and taxable profits at 31 December 2012 will reverse over a period of ten years. Consequently the Company has recognised a deferred tax liability at 31 December 2015 of £5m (2014: £6m) in respect of these timing differences which total £28m (2014: £33m).

Reductions in the UK corporation tax rate from 23% to 21% (effective from 1 April 2014) and 20% (effective from 1 April 2015) were substantively enacted on 2 July 2013. Further reductions to 19% (effective from 1 April 2017) and to 18% (effective 1 April 2020) were substantively enacted on 26 October 2015. This will reduce the Company's future current tax charge accordingly. The deferred tax liability at 31 December 2015 has been calculated based on these rates.

The Company has no other timing differences or tax losses carried forward at 31 December 2015 which may give rise to reduced tax charges in future periods (2014: nil).

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

9. INVESTMENT PROPERTY

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
At beginning of year	**96**	93
Change in fair value during the year	**–**	3
At end of year	**96**	96

The Company holds 99.9% of the issued units in eight Guernsey registered property unit trusts ("GPUTs"). The GPUTs own the freehold of six properties and have a long leasehold interest in the remaining two properties. All eight properties are located in the United Kingdom.

During the year, the GPUTs have been restructured by changing a single unit into A and B units, representing income and capital streams.

Investment properties have been classified as Level 2 in the fair value hierarchy.

Rental income received in relation to these properties is shown within investment return in Note 3.

10. INSURANCE CONTRACTS AND RELATED INSURANCE LIABILITIES

In accordance with the accounting policy on product classification, all policyholder contracts have been classified as insurance contracts.

The Company's liabilities in relation to future policyholders' benefits are:

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
Future policyholders' benefits		
Gross	**16,480**	13,824
Reinsurance	**(1,917)**	(2,164)
Net	**14,563**	11,660

The gross insurance liabilities shown above are stated in accordance with the Company's accounting policies as set out in Note 1. The figures exclude reserves which are required for the calculation of regulatory solvency under the PRA rules but which do not meet the definition of a liability under IFRS and therefore are excluded from insurance liabilities under IFRS 4 and IAS 37 "Provisions, Contingent Assets and Contingent Liabilities".

The reinsured liabilities include liabilities ceded under longevity reinsurance contracts with external counterparties and immediate and deferred annuity payments ceded under external quota share arrangements. Previously PIC reinsured certain liabilities under a quota share agreement with Pension Security Insurance Corporation Limited ("PSIC"). On 27 February 2015 PIC issued a formal recapture notice to PSIC under the terms of its reinsurance treaty dated 6 June 2008. This served to recapture approximately £385m of insurance liabilities and £358m of related assets (as at 31 December 2014) with effect from 1 March 2015. PIC realised a £15m loss on recapture.

(a) Terms and conditions of insurance contracts

The Company's insurance liabilities represent contracts that provide immediate annuities for current pensioners and deferred annuities for members who have not yet reached pensionable age. Annuities in deferment and in payment can be level, subject to fixed increases or increases linked to inflation, or a mixture of the three, and in many cases are also subject to defined caps and floors on the increases that can be applied. The insurance liabilities also include member options, such as the option to commute part of the pension for a tax-free cash lump sum on vesting, and annuities payable to spouses or other dependants on the death of the main member.

The Company's insurance contracts are a mixture of "buy-in" policies, where the policyholder is the pension scheme and the insured liabilities cover defined benefits within the scheme, and "buyout" policies, where the policyholder is an individual.

Insurance liabilities are calculated as the present value of future annuity payments and expenses. The principal assumptions used in the calculation are set out below.

(b) Principal assumptions used in the preparation of insurance liabilities

Mortality assumptions

The base mortality assumptions as at 31 December 2015 inherent in the projected cash flows used in the valuation of insurance contract liabilities are set with reference to the S2 series of mortality tables published by the Continuous Mortality Investigation (a research body with strong links to the Institute and Faculty of Actuaries in the UK) ("CMI").

The assumption for future improvements to mortality is modelled using the CMI 2012 table for improvements to the end of 2015 followed by the CMI 2014 table thereafter (2014: CMI 2012 throughout).

Adjustments are applied to these according to a number of factors including, but not limited to, an individual's gender, age, pension amount, occupation and place of residence.

Valuation rate of interest ("VRI")

The Company has applied the requirements of INSPRU 1.2.33R in calculating the VRI. Within the calculation it has applied a direction made by the Financial Services Authority in May 2010, which was renewed by the PRA in April 2015 on the application of the Company, under section 148 of the Financial Services and Markets Act 2000. The effect of the direction is to modify the provisions of INSPRU 3.1.35R and IPRU(INS) Appendix 9.3 so that the Company can use a more appropriate rate of interest based on the yields on all of the assets backing its liabilities taken in combination.

The VRI is adjusted to reflect risks, including credit risk, associated with the assets held to match liabilities. The regulatory requirements set out in INSPRU 3.1 state that the VRI should be set at 97.5% of the risk-adjusted yield on the assets backing the liabilities, with a further reduction for reinvestment risk. The rate calculated in accordance with these rules as at 31 December 2015 for PIC was 2.95% for both index-linked liabilities and non-linked liabilities (2014: 2.81%).

Inflation

Assumptions for expected future Retail Price Index ("RPI") inflation are based on a curve derived from market prices of inflation-linked swap contracts. For Limited Price Index ("LPI") linked annuities, which are subject to maximum and minimum percentage annual increases, a mark-to-model approach is used to allow for the inherent optionality, as there is currently no deep and liquid market in appropriate swap contracts.

Other assumptions

The internal costs of maintaining the existing insurance contracts, project costs, the fees payable to third-party administrators engaged to manage payments due under the in-force policies, fees due to reinsurers and investment management expenses are factored into the calculation of liabilities by adding appropriate allowances, and include an estimate of the impact of future inflation where this is applicable. No allowances are included for expenses incurred by the Company in relation to the generation of new business.

(c) Movements

The following table analyses the movement between the insurance liabilities at the beginning and the end of the year into its major components. The main reason for the increase is the new business written in the year.

2015	Gross £m	Reinsurance £m	Net £m
At beginning of year	13,824	(2,164)	11,660
Increase in liability from new premiums	3,649	(208)	3,441
Reduction in liability from claims	(569)	7	(562)
Changes in economic assumptions	(373)	(17)	(390)
Changes in non-economic assumptions	(82)	52	(30)
PSIC reinsurance recapture	22	351	373
Other movements (including net investment return)	9	62	71
At end of year	16,480	(1,917)	14,563

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

10. INSURANCE CONTRACTS AND RELATED INSURANCE LIABILITIES continued

2014	Gross £m	Reinsurance £m	Net £m
At beginning of year	9,437	(1,356)	8,081
Increase in liability from new premiums	2,567	(188)	2,379
Reduction in liability from claims	(452)	15	(437)
Changes in economic assumptions	2,034	(545)	1,489
Changes in non-economic assumptions	126	(59)	67
Other movements (including net investment return)	112	(31)	81
At end of year	13,824	(2,164)	11,660

Changes in assumptions

The movements during the year relating to economic and non-economic assumptions, as shown in the above table, comprise the following items:

Economic assumptions

The primary economic assumption change during the year is in respect of increases in credit spreads over the year resulting in a decrease in liabilities (2014: increase in liabilities). The reduction in liabilities has been partly offset by a fall in long-term interest rates.

Non-economic assumptions

There have been a number of changes to the non-economic assumptions over the year, including expenses, investment management fees and mortality.

PSIC reinsurance recapture

During 2015, the Company recaptured an internal reinsurance treaty from PSIC. The movements shown above reflect the impact of this recapture.

(d) Analysis of expected maturity of gross and net insurance contract liabilities

The table below indicates the net insurance contract liabilities analysed by duration, showing the discounted values of the policy cash flows estimated to arise during each period.

	Within one year £m	**In 1-5 years £m**	**In 5-15 years £m**	**Over 15 years £m**	**Total £m**
Deferred annuities					
Gross	**40**	**298**	**1,200**	**3,925**	**5,463**
Reinsurance	**(4)**	**(27)**	**(81)**	**(1,133)**	**(1,245)**
As at 31 December 2015	**36**	**271**	**1,119**	**2,792**	**4,218**
Annuities in payment					
Gross	**576**	**2,154**	**4,195**	**4,092**	**11,017**
Reinsurance	**12**	**24**	**(85)**	**(623)**	**(672)**
As at 31 December 2015	**588**	**2,178**	**4,110**	**3,469**	**10,345**

	Within one year £m	In 1-5 years £m	In 5-15 years £m	Over 15 years £m	Total £m
Deferred annuities					
Gross	28	206	854	2,898	3,986
Reinsurance	(4)	(30)	(98)	(1,171)	(1,303)
As at 31 December 2014	24	176	756	1,727	2,683
Annuities in payment					
Gross	487	1,854	3,749	3,748	9,838
Reinsurance	(5)	(37)	(186)	(633)	(861)
As at 31 December 2014	482	1,817	3,563	3,115	8,977

(e) Sensitivity analysis

In accordance with IFRS 4 and IFRS 7 "Financial Instruments: Disclosures" the Directors have considered the effect on profit or loss and equity at 31 December 2015 resulting from changes in a number of key assumptions. The effect of each of the assumption changes is considered in isolation on the basis that all other key assumptions remain unaltered. The impact of this sensitivity analysis on profits is set out in the table below.

31 December 2015	Interest rates: Increase of 50bps £m	Interest rates: Fall of 50bps £m	Inflation rates: Increase of 50bps £m	Inflation rates: Fall of 50bps £m
Movement in assets	**(1,110)**	**1,257**	**844**	**(745)**
Movement in liabilities	**1,036**	**(1,176)**	**(755)**	**721**
Tax effect	**15**	**(16)**	**(18)**	**5**
Movement in profit and equity	**(59)**	**65**	**71**	**(19)**

	Base mortality (see below) £m	Mortality improvements (see below) £m	Renewal expenses (see below) £m	Credit spreads increase of 25bps £m
Movement in assets	**–**	**–**	**–**	**(248)**
Movement in liabilities	**(15)**	**(44)**	**(60)**	**229**
Tax effect	**3**	**9**	**12**	**4**
Movement in profit and equity	**(12)**	**(35)**	**(48)**	**(15)**

31 December 2014	Interest rates: Increase of 50bps £m	Interest rates: Fall of 50bps £m	Inflation rates: Increase of 50bps £m	Inflation rates: Fall of 50bps £m
Movement in assets	(796)	888	473	(424)
Movement in liabilities	790	(891)	(488)	463
Tax effect	1	1	3	(8)
Movement in profit and equity	(5)	(2)	(12)	31

	Base mortality (see below) £m	Mortality improvements (see below) £m	Renewal expenses (see below) £m	Credit spreads increase of 25bps £m
Movement in assets	–	–	–	(191)
Movement in liabilities	(15)	(37)	(48)	162
Tax effect	3	8	10	6
Movement in profit and equity	(12)	(29)	(38)	(23)

Parameters for longevity and renewal expense sensitivities

The base mortality sensitivity is based on a 1% decrease in the base mortality rates.

The mortality improvements sensitivity is based on a 0.1% increase in annual mortality improvement rates.

The expense sensitivity is based on an increase in annual maintenance expenses (including third party administration costs) of 15%.

The key assumptions, methodology and limitations of the sensitivity analysis are as follows:

- The effects of the specified changes in factors are determined based on the year-end financial instrument values. The level of movements in market factors on which the sensitivity analyses are based were determined based on economic forecasts and historical experience of variations in these factors. The sensitivity analysis is based on the risks to which the Company is exposed at the end of the reporting period, and reflects the changes in relevant risk variables that are reasonably possible at this date and over the next reporting period. The sensitivities used are based around the core assumptions in the financial statements rather than considering more extreme scenarios.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

10. INSURANCE CONTRACTS AND RELATED INSURANCE LIABILITIES continued

- Each entry in the sensitivity table demonstrates the effect of a change in a single key assumption while other assumptions remain unchanged. However, the occurrence of a change in a single market factor will often lead to changes in other market factors. In particular, the Company's use of derivatives is designed to ensure that its exposure to interest and inflation risks are hedged.
- There is no significant currency risk on the Company's business and the associated sensitivity analysis has therefore not been shown.

(f) Reinsurance results

The effect of reinsurance contracts entered into by the Company on profit before taxation is as follows:

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
Outward reinsurance premiums	**157**	(176)
Reinsurers' share of claims paid	**16**	20
Changes in reinsurers' share of insurance liabilities	**(247)**	808
Net effect of reinsurance contracts on profit before taxation	**(74)**	652

Outward reinsurance premiums include amounts payable in respect of quota share arrangements and insurance fees payable in respect of longevity reinsurance contracts. Outward reinsurance premiums also include the amounts received from PSIC on recapture of the reinsurance agreement in March 2015. The charge for the year comprises the following items:

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
Amounts payable in respect of insurance fees	**19**	14
Current year premiums payable in respect of quota share arrangements	**180**	162
Reinsurance recapture received	**(356)**	–
Outward reinsurance premiums	**(157)**	176

11. DEFERRED TAX

At 31 December 2015 the Company's deferred tax balances calculated in accordance with IAS 12 "Income Taxes" were as follows:

	Asset £m	Liability £m	Total £m
31 December 2015			
Tax transitional adjustment	**–**	**(5)**	**(5)**
31 December 2014			
Tax transitional adjustment	–	(6)	(6)

The movement in the deferred tax balance during the year was as follows:

	Year ended 31 December 2015 £m	Year ended 31 December 2014 £m
At beginning of year	**(6)**	(7)
Recognition of deferred tax liability on temporary timing differences	**–**	–
Effect of tax transitional adjustment	**1**	1
Effect of change in tax rates	**–**	–
At end of year	**(5)**	(6)

Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all available evidence, it can be regarded as more likely than not that sufficient future taxable profits will arise from which the underlying temporary differences can be deducted.

The tax transitional adjustment arose following the introduction of a new tax regime that commenced in January 2013 which changed the calculation of taxable profits of insurance companies (see Note 8). The Company has no timing differences or tax losses carried forward at 31 December 2015 (2014: nil) which may give rise to reduced tax charges in future periods.

12. BORROWINGS

On 3 July 2014, the Company issued £300m subordinated loan notes due 2024 with a fixed coupon of 6.5% paid annually in arrears. The notes were issued at 99.107% of par. The notes represent direct, unsecured and subordinated obligations of the Company, and are classified as qualifying dated Tier 2 securities for the purposes of the regulatory capital requirements. The notes are listed on the London Stock Exchange.

At 31 December 2015, the notes have a carrying value of £295m (2014: £294m), which is calculated on an amortised cost basis, and a fair value of £303m (2014: £312m), calculated by applying an adjustment to the quoted price to reflect market illiquidity. Consequently, the loan notes have been classified as Level 2 in the fair value hierarchy.

For the year ended 31 December 2015, an interest expense of £20m (2014: £10m), calculated using the amortised cost method, was recognised in the Statement of comprehensive income in respect of the notes.

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES

All of the Company's financial assets and liabilities have been designated as fair value through profit and loss or categorised as loans and receivables (and accounted for at amortised cost) as detailed below.

	31 December 2015		31 December 2014	
	Fair value through profit and loss £m	**Amortised cost £m**	Fair value through profit and loss £m	Amortised cost £m
Financial assets				
Financial investments				
Debt securities	**14,588**		11,155	
Mortgage backed and other asset backed securities	**296**		488	
Deposits with credit institutions	**513**		167	
Participation in investment schemes	**1,216**		1,364	
Collateralised loan obligations	**–**		142	
Total financial investments	**16,613**	**–**	13,316	–
Derivative assets	**4,900**		2,761	
Loans and receivables and other financial assets				
Debtors arising out of direct insurance operations		**33**		24
Other debtors		**–**		4
Accrued interest		**149**		108
Total receivables and other financial assets		**182**		136
Cash and cash equivalents		**12**		5
Total financial assets	**21,513**	**194**	16,077	141
Financial liabilities				
Derivative liabilities	**5,635**		3,093	
Creditors arising out of reinsurance operations		**26**		7
Other creditors		**27**		111
Insurance and other payables		**53**		118
Borrowings		**295**		294
Accruals		**15**		15
Total financial liabilities	**5,635**	**363**	3,093	427

Other creditors of £111m as at 31 December 2014 included the amounts totalling £90m relating to the undrawn amounts under the terms of debt securities with contractual drawdown features. In the current year, the presentation of both the asset, and the associated contractual payments, has been amended to show the net amounts, within financial investments. This presentational change has no impact on net assets, and has been made at 31 December 2015. Prior year amounts have not been restated.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES continued

Included within receivables and other financial assets are amounts totalling £1m (2014: £3m) due to be received in more than one year. All amounts relating to insurance and other payables and accruals are expected to be settled within one year.

Included within financial assets designated as fair value through profit or loss are amounts totalling £21,005m (2014: £15,994m) due to be received in more than one year.

Deposits with credit institutions

Deposits with credit institutions include £10m (2014: £10m) in two bank accounts which are designated fee collateral bank accounts. These accounts were established under deeds of charge dated 9 July 2012 and 11 December 2012 between PIC and Munchener Ruckversicherungsgesellschaft ("Munich Re") in respect of longevity reinsurance agreements. The amount deposited in each account represents a proportion of PIC's liability for the payment of fees due over the life of each agreement ("fee collateral amount") and is subject to annual review by each party.

The Company retains control of the cash deposited in these accounts; however, it must maintain a balance at least equal to the agreed fee collateral amount and Munich Re has a fixed first charge over the accounts which gives it the right to withdraw an amount equivalent to its outstanding fees due under the agreement on the occurrence of certain specified default events.

Assets pledged as collateral

As explained in Note 14, the Company uses derivative financial instruments as part of its risk management strategy. Most over the counter derivative transactions require collateral to be received or pledged by the Company to mitigate the counterparty credit risk. The Company has collateral agreements with each counterparty based on standard ISDA master netting agreements, which specify minimum thresholds, asset class and credit quality of collateral and the frequency of valuation. While each party to the contract has a legal right to the collateral received if the counterparty does not meet its obligations, there is no economic benefit from holding the assets as each party has the right to substitute the collateral delivered for another asset of the same value and quality at any time. Therefore, these agreements do not meet the criteria for offsetting under IAS 32.

The Company returns/receives the collateral received/pledged upon contract termination or settlement. The amount of collateral received/pledged fluctuates due to the changes in fair value of the derivative subject to the minimum thresholds.

At 31 December 2015 the Company has included £1,031m (2014: £574m) of financial assets which have been pledged as security under the terms of derivative contracts. The Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and consequently none of these assets have been derecognised in the financial statements.

At 31 December 2015, the amount of collateral received by the Company was £343m (2014: £245m). While the Company is permitted to sell or repledge collateral received, no collateral was sold or repledged in the absence of default during the year (2014: £nil).

In 2014 the Company concluded a pension insurance buy-in transaction to underwrite approximately £1.6bn of pension liabilities. Under the terms of the agreement, a security structure was put in place which required the Company to transfer legal title to certain assets back to the Trustee as collateral against default by the Company. Under the terms of the security, the Trustee is free to use the assets without constraint; however, it is obliged to deliver equivalent assets (defined as "an asset of the same type, nominal value, description and amount"), as well as the income earned and gains or losses incurred on these assets to the Company. The Company retains the right to replace any of the assets with assets of similar nature. Collateral is returned to the Company as it services the insured pension liabilities under the policy. This, in theory, exposes the Company to counterparty credit risk, which is, however, fully mitigated as the Company has the contractual right to offset its obligation to pay under the policy in the event of default by the Trustee.

The Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and accordingly continues to recognise the assets which it has pledged under title transfer security in its financial statements. At 31 December 2015, this totalled £1.6bn (31 December 2014: £1.7bn).

In 2015, the Company has included £24m of financial assets which have been pledged as collateral under the terms of certain reinsurance contracts. The Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and consequently none of these assets have been derecognised in the financial statements.

At 31 December 2015, the Company received £13m (2014: £9m) cash as collateral under the terms of certain reinsurance contracts.

Offsetting

The Company does not offset financial assets and liabilities in the Statement of financial position unless there is a legally enforceable right to offset and the Company has the intention to settle the asset and liability on a net basis, or to realise the asset and settle the liability simultaneously. Except for foreign exchange forward agreements, the Company has no financial assets and financial liabilities that have been offset in the Statement of financial position as at 31 December 2015 (2014: £nil).

The table below contains disclosures related to financial assets and financial liabilities that are subject to enforceable master netting arrangements or similar agreements as required by IFRS 7.

31 December 2015	Gross amounts of recognised financial assets £m	Amounts offset in accordance with IAS 32 £m	Net amounts as recognised in the Statement of financial position £m	Related amounts not offset in the Statement of financial position: Financial instruments received £m	Cash collateral received £m	Derivative liabilities £m	Net amount £m
Financial assets							
Derivatives	**5,681**	**(781)**	**4,900**	**(54)**	**(289)**	**(4,460)**	**97**

31 December 2015	Gross amounts of recognised financial liabilities £m	Amounts offset in accordance with IAS 32 £m	Net amounts as recognised in the Statement of financial position £m	Related amounts not offset in the Statement of financial position: Financial instruments pledged £m	Cash collateral pledged £m	Derivative assets £m	Net amount £m
Financial liabilities							
Derivatives	**6,416**	**(781)**	**5,635**	**(1,018)**	**(13)**	**(4,460)**	**144**

31 December 2014	Gross amounts of recognised financial assets £m	Amounts offset in accordance with IAS 32 £m	Net amounts as recognised in the Statement of financial position £m	Related amounts not offset in the Statement of financial position: Financial instruments received £m	Cash collateral received £m	Derivative liabilities £m	Net amount £m
Financial assets							
Derivatives	4,907	(2,146)	2,761	(43)	(202)	(2,419)	97

31 December 2014	Gross amounts of recognised financial liabilities £m	Amounts offset in accordance with IAS 32 £m	Net amounts as recognised in the Statement of financial position £m	Related amounts not offset in the Statement of financial position: Financial instruments pledged £m	Cash collateral pledged £m	Derivative assets £m	Net amount £m
Financial liabilities							
Derivatives	5,239	(2,146)	3,093	(574)	–	(2,419)	100

Measurement of financial assets and liabilities

The Company's financial assets and liabilities have been valued using the following methods in accordance with IAS 39 "Financial Instruments".

The fair values of investments quoted in an active market are based on their bid market prices. For unlisted securities and all other financial assets for which there is no active market, the Company establishes fair value using appropriate valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, counterparty and broker valuations and option pricing models. These assessments are based largely on observable market data.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES continued

The specific valuation techniques used for the main classifications of financial assets and liabilities are:

(a) Investments in shares, debt securities, unit trusts and participation in investment schemes

The fair value of shares and debt securities is determined by reference to their quoted bid price at the reporting date. For instruments quoted on a recognised stock exchange, these would generally be considered as Level 1 within the fair value hierarchy.

Fair values for unlisted shares and variable yield schemes are estimated using applicable valuation techniques such as price/earnings or price/cash flow ratios or other measures refined to reflect the specific circumstances of the issuer. Fair values for unlisted debt securities are estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. Where the inputs for these calculations are readily observable, these would generally be classified as Level 2 within the fair value hierarchy.

Some debt securities are valued as mark to model, where no observable market data exists. These include infrastructure and other loans in respect of capital projects. These investments have been included in Level 3 within the fair value hierarchy.

(b) Derivatives

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently remeasured at their fair value. The fair value of foreign exchange forward contracts, futures and swaps are based on market prices, where available. For swaps, market prices are calculated using discounted cash flow techniques based on adjusted market data such as composite curves derived from a number of market counterparties. Derivative contracts may not be readily tradeable and consequently they have been classified as Level 2 assets within the fair value hierarchy.

All derivatives are carried as assets when the fair value is positive and as liabilities when the fair value is negative. Net gains or losses arising from changes in the fair value of the derivative financial instruments are recognised immediately in the Statement of comprehensive income within the heading investment return.

(c) Mortgage backed and other asset backed securities

The fair value of mortgage backed and other asset backed securities is determined by reference to their listed market price. Due to the types of markets in which these instruments are traded, such instruments would usually be classified as Level 2 within the fair value hierarchy.

(d) Deposits with credit institutions

The fair value of deposits held with credit institutions represents their cash value in current terms. All deposits are redeemable within three months and consequently no discounting adjustment has been made at the year end. Deposits with credit institutions are classified as Level 1 within the fair value hierarchy.

Measurement of fair value

The following table analyses the Company's financial investments according to the basis of measurement required by IFRS 13 "Fair Value Measurement":

31 December 2015	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Debt securities	5,449	8,742	397	14,588
Mortgage backed and other asset backed securities	–	296	–	296
Deposits with credit institutions	513	–	–	513
Participation in investment schemes	851	365	–	1,216
Collateralised loan obligations	–	–	–	–
Financial investments	6,813	9,403	397	16,613
Derivative assets	–	4,900	–	4,900
Financial assets	6,813	14,303	397	21,513
Derivative liabilities	–	(5,635)	–	(5,635)

31 December 2014	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Debt securities	4,934	5,274	947	11,155
Mortgage backed and other asset backed securities	–	488	–	488
Deposits with credit institutions	167	–	–	167
Participation in investment schemes	1,027	337	–	1,364
Collateralised loan obligations	–	–	142	142
Financial investments	6,128	6,099	1,089	13,316
Derivative assets	–	2,761	–	2,761
Financial assets	6,128	8,860	1,089	16,077
Derivative liabilities	(2)	(3,091)	–	(3,093)

Level 1 assets are those assets for which the fair value has been measured using quoted prices, without adjustment, in an active market.

Level 2 assets are those assets for which the fair value has been measured using observable inputs other than quoted prices included in Level 1.

Assets classified as Level 3 are those assets for which no observable data exists in relation to a significant element of the fair value measurement.

Transfers between levels of the fair value hierarchy

For recurring fair value measurements, the Company's policy is to recognise transfers into and out of fair value hierarchy levels at the end of the year in which the event or change in circumstances that caused the transfer has occurred.

Transfers between Level 1 and Level 2

There have been no transfers during the year between Levels 1 and 2 (2014: £nil).

Transfers out of Level 3

During the year, £604m of debt securities were transferred out of Level 3 into Level 2 (2014: £nil).

Transfers out of Level 3 relate to debt securities which are valued using discounted cash flow models. Within the model, interest rate, inflation rate and credit risk assumptions are derived from market data with adjustments applied to ensure they are relevant to the debt securities held by the Company. Whilst these are not fully market observable, the impact of these adjustments on the value of the debt securities was not significant. As a result, these assets have been classified as Level 2 and transferred out of Level 3.

Movements relating to Level 3 assets during the reporting period are analysed as follows:

Year ended 31 December 2015	**CLOs £m**	**Debt securities £m**	**Total £m**
Opening balance	**142**	**947**	**1,089**
Unrealised gains or losses	**–**	**8**	**8**
Acquisitions in year	**–**	**75**	**75**
Transfers out of Level 3	**–**	**(604)**	**(604)**
Disposals in year	**(142)**	**(29)**	**(171)**
Closing balance	**–**	**397**	**397**

Year ended 31 December 2014	Swaps £m	CLOs £m	Debt securities £m	Total £m
Opening balance	24	167	616	807
Unrealised gains or losses	–	(11)	92	81
Acquisitions in year	–	24	246	270
Disposals in year	(24)	(38)	(7)	(69)
Closing balance	–	142	947	1,089

Swap assets are stated net of swap liabilities in the above table.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES continued

The investment return within the Statement of comprehensive income includes the following income and investment gains and losses relating to Level 3 assets:

Year ended 31 December 2015	CLOs £m	Debt securities £m	Total £m
Interest income	**–**	**–**	**–**
Income from debt securities	**–**	**27**	**27**
Income from other investments	**2**	**–**	**2**
Realised gains or losses	**(3)**	**7**	**4**
Unrealised gains or losses	**–**	**8**	**8**
Investment return on Level 3 assets	**(1)**	**42**	**41**

Year ended 31 December 2014	Swaps £m	CLOs £m	Debt securities £m	Total £m
Interest income	–	–	–	–
Income from debt securities	–	–	24	24
Income from other investments	–	5	–	5
Realised gains or losses	(23)	(1)	–	(24)
Unrealised gains or losses	–	(11)	92	81
Investment return on Level 3 assets	(23)	(7)	116	86

As discussed above, the valuations of financial assets classified as Level 3 are, under certain circumstances, measured using valuation techniques that incorporate assumptions based on unobservable inputs which cannot be evidenced by readily available market information.

The following table shows the effect on the fair value of Level 3 financial assets from changes in unobservable inputs to a reasonable alternative for the valuation assumptions.

2015	Main assumptions	Sensitivity	Current fair value £m	Increase in fair value £m	Decrease in fair value £m
Debt securities	**Interest rates**	**+/- 50bps Credit Spread**	**397**	**24**	**(22)**
			397	**24**	**(22)**

2014	Main assumptions	Sensitivity	Current fair value £m	Increase in fair value £m	Decrease in fair value £m
CLOs	Interest rates	+/- 100bps Interest Rate	142	2	(3)
Debt securities	Interest rates	+/- 50bps Credit Spread	947	61	(56)
			1,089	63	(59)

14. DERIVATIVE FINANCIAL INSTRUMENTS

The Company enters into a number of inflation rate and interest rate swap agreements during the ordinary course of business as part of its risk management strategy. Inflation swaps protect the Company against the adverse effects of inflation over a period of time, while the Company enters into interest rate swap transactions to assist in hedging contractual liabilities. Currency swaps and forward contracts are entered into to eliminate the majority of the currency risk on financial assets invested in non-sterling based debt securities where liabilities are denominated in sterling.

	31 December 2015		31 December 2014	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Interest rate swaps	4,377	(4,594)	2,429	(2,541)
Inflation swaps	493	(861)	314	(536)
Credit default swaps	6	–	–	(2)
Currency swaps	17	(167)	11	(2)
Foreign exchange forward contracts	7	(13)	7	(10)
Futures	–	–	–	(2)
Total derivative position	4,900	(5,635)	2,761	(3,093)

15. RISK MANAGEMENT

As a provider of insurance solutions to defined benefit pension schemes, the Company's business involves the acceptance and management of risk to achieve its strategic objectives.

The principal risk factors which affect the Company's operating results and financial condition include financial risks such as market risk, credit risk and liquidity risk, insurance risk, and other risks such as operational risk, regulatory risk and reputational risk.

Insurance risk is implicit in the Company's business and mainly arises from exposure to longevity in respect of annuity payments. Regulatory risk stems principally from the risk of changed solvency requirements such as those arising from the new Solvency II regulations. In 2015, the Company received approval from the regulator on all applications it sought under the new regime. These approvals include the use of its own Internal Model, the Matching Adjustment, the Volatility Adjustment and transitional measures. The main reputational risks relate to ensuring good conduct, the need to maintain a good reputation with trustees of pension schemes and their advisers in order to attract new business and with its own policyholders through treating them fairly. Maintaining a good internal culture is recognised as a key tool in mitigating these risks.

The Directors have overall responsibility for the management of the exposure to these risks. They are supported through formal committees of the Board including the Asset Liability Management Committee, Audit Committee, Origination Committee, Nomination and Remuneration Committee and Risk Committee. The membership of these committees is mainly comprised of Non-Executive Directors. Executive Directors and relevant senior management who attend meetings as requested. The Board retains direct responsibility for reputational risk. The Board has instigated a co-ordinated approach between Risk, Compliance, Actuarial and Internal Audit Functions to provide integrated assurance in the monitoring of the internal risk and control environment.

The management and control of the Company's risks is a significant focus area for the Board as an uncontrolled and unmanaged development in various risks may affect the Company's performance and capital adequacy. The Company adopts an integrated view to the management and qualitative assessment of risk under risk acceptance guidelines and policies set by the Board and aims to minimise its exposure to risks, such as interest rate risk and inflation risk, which carry little reward for the Company. Risks such as longevity risk are mitigated through reinsurance to the extent that it is economic to do so.

The Company uses derivatives for the purpose of efficient portfolio management or to reduce risk in aspects of the Company's investment activities such as the implementation of tactical asset allocation changes around the strategic benchmark, the hedging of cash flows, and the control of the risk profile of an identified strategy. The Company uses cross currency swaps, forward exchange contracts and futures for these purposes. It also uses interest and inflation rate swaps for the purpose of matching assets and liabilities, and credit default swaps to tactically control credit risk.

The Company monitors its exposure to risks through regular reviews of its portfolios of assets and liabilities and their underlying characteristics. Consequently, the Directors have chosen not to apply hedge accounting to the Company's derivatives.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

15. RISK MANAGEMENT continued

(a) Market risk

The Company is exposed to market risk as a consequence of fluctuations in values or returns on assets and liabilities which are influenced by one or more external factors. These include changes and volatility in interest rates, credit spreads, inflation expectations and currency exchange rates.

The Company manages market risk through an asset liability management ("ALM") framework that has been developed to closely match the investment portfolio duration and income to its obligations under insurance contracts.

Within the context of the ALM framework the Company uses derivative financial instruments to reduce market risk. Interest rate and inflation swaps are entered into to improve the matching of asset and liability cash flows, and ensure that risk driver sensitivities are aligned across the maturity spectrum. The quality of the interest rate and inflation matching strategies is carefully monitored by management, and is operated within tightly defined limits. Currency forwards and swaps are entered into to eliminate the majority of the currency risk on financial assets invested in non-sterling based debt securities where liabilities are denominated in sterling.

The Company is also exposed to risks of movements in the property market through its investment in the GPUTs. The short-term market risk is mitigated by the fact that all eight of its properties are occupied on leases extending to 1 April 2033. The Company performs regular reviews of both the movement in the property market specific to these properties and the financial status of the tenants.

Further asset exposures include investments in hedge funds, insurance linked funds and public finance initiative related debt, including Social Housing. Where appropriate, the management of these alternative exposures is delegated to specialist fund managers, in line with defined investment management mandates. In all cases the Company ensures regular oversight of the investment management activities, and maintains detailed risk models for all investment types, incorporating analysis of alternative investments in its risk and capital assessment.

(b) Credit risk

Credit risk is the risk of loss due to the default of another party in performing its financial obligations to the Company. The Company is primarily exposed to credit risk through its investment in debt securities and cash deposits within both the long-term business fund and shareholder fund.

Credit risk also arises in respect of derivative contracts to the extent that there is the potential for the counterparties to default on their obligations.

The Company manages exposure to credit risk by placing limits on exposures to individual counterparties as well as groups of counterparties. Counterparty risk on derivatives is controlled through establishment of collateral agreements and master netting agreements on interest rate and currency swaps. To further minimise credit risk, the financial condition of counterparties is monitored on a regular basis.

The following table sets out the credit risk exposure and ratings of financial assets which are susceptible to credit risk. The ratings used are Bloomberg Composite except in instances where such a rating does not exist, in which case an S&P, Moody's or Fitch rating has been used. The remaining unrated assets are not classified by Bloomberg Composite, S&P, Moody's or Fitch.

During the year, the Company modified its approach to reporting credit risk exposure to align with the Solvency II requirements by incorporating internally assessed credit ratings in some instances where external ratings are not available. Previously, the Company's exposure to credit risk was reported on a broadly similar basis but one which excluded the use of internal ratings.

31 December 2015	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Loans and debt securities							
Debt securities[1]	951	5,721	3,874	3,812	187	43	14,588
Mortgage backed and other asset backed securities[2]	27	93	101	46	29	–	296
	978	5,814	3,975	3,858	216	43	14,884
Other assets							
Derivative assets	–	–	–	–	–	4,900	4,900
Participation in investment schemes	851	–	–	–	–	365	1,216
Receivables and other financial assets	18	20	49	60	2	33	182
Deposits with credit institutions	–	–	513	–	–	–	513
Cash and cash equivalents	–	–	–	12	–	–	12
	869	20	562	72	2	5,298	6,823

1. Within Debt securities there are £57m AAA rated, £409m AA rated, £339m BBB rated and £44m BB rated securities, which have been rated using internally assessed credit ratings.
2. Within Mortgage backed and other asset backed securities there are £4m A rated securities, which have been rated using internally assessed credit ratings.

31 December 2014	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Loans and debt securities							
Debt securities	785	5,136	2,132	2,402	21	679	11,155
Mortgage backed and other asset backed securities	8	151	159	155	3	12	488
Collateralised loan obligations	3	24	30	60	10	15	142
	796	5,311	2,321	2,617	34	706	11,785
Other assets							
Derivative assets	–	–	–	–	–	2,761	2,761
Participation in investment schemes	1,027	–	–	–	–	337	1,364
Receivables and other financial assets	19	17	29	40	–	31	136
Deposits with credit institutions	–	–	167	–	–	–	167
	1,046	17	196	40	–	3,129	4,428

Although the instruments themselves are unrated, the ultimate issuing party for most derivative assets do have a credit rating. Applying the issuer rating to the assets held at 31 December 2015 produces the following split:

31 December 2015	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Derivative assets	**–**	**516**	**3,940**	**444**	**–**	**–**	**4,900**

31 December 2014	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Derivative assets	–	411	2,350	–	–	–	2,761

There have been no changes in credit rating since the Statement of financial position date.

These assets are included with regular stress testing undertaken by the Company which assesses the impact of a number of scenarios on the Company's solvency position.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

15. RISK MANAGEMENT continued

Reinsurance counterparties

The Company has reinsurance contracts in place with seven external reinsurers with an exposure of £1,910m at 31 December 2015 (2014: £1,782m). Measures are in place with respect to the reinsurance contracts to manage counterparty exposure, including collateral arrangements and other protections. The credit rating of each reinsurer is reported to management on a monthly basis. The credit rating of each reinsurer was A or higher at both 31 December 2015 and 31 December 2014.

Impaired assets

The Company did not have any impaired or past due date assets at 31 December 2015 (2014: nil).

(c) Liquidity risk

Liquidity risk is the risk that the Company may not have liquid assets available at the right times to be able to pay its liabilities, despite the fact that it meets its regulatory solvency requirements. This would typically arise if derivative contracts to manage inflation and interest rates required collateral to be posted, a large proportion of deferred policyholders opted to take transfer values, or if a large proportion of assets were invested in assets which are not easy or straightforward to liquidate.

In order to manage this, projected cash flows for all new policy liabilities taken on are determined as a part of the new business origination process to identify the expected profile of liability payments, including expected mortality experience. This is then used to identify appropriate assets, which provide matching cash flows at an acceptable price.

The Company's risk policies define a minimum proportion of its assets to be held in highly liquid cash and gilts, and stress testing is conducted to ensure that there are sufficient liquid assets at all times to meet potential demands from derivative movements under extreme scenarios.

The projected cash flows are updated regularly, and assumptions are updated at least annually, taking into account factors such as mortality experience and how this affects the required cash flows in the future.

The following table sets out the contractual maturity analysis of financial liabilities.

31 December 2015	Within one year £m	In 1-5 years £m	In 5-15 years £m	Over 15 years £m	Total £m
Creditors arising out of reinsurance operations	**26**	**–**	**–**	**–**	**26**
Other creditors	**27**	**–**	**–**	**–**	**27**
Accruals	**15**	**–**	**–**	**–**	**15**
Borrowings	**–**	**–**	**295**	**–**	**295**
Derivative liabilities	**28**	**176**	**821**	**4,610**	**5,635**
	96	**176**	**1,116**	**4,610**	**5,998**

31 December 2014	Within one year £m	In 1-5 years £m	In 5-15 years £m	Over 15 years £m	Total £m
Creditors arising out of reinsurance operations	7	–	–	–	7
Other creditors	111	–	–	–	111
Accruals	15	–	–	–	15
Borrowings	–	–	294	–	294
Derivative liabilities	18	43	377	2,655	3,093
	151	43	671	2,655	3,520

Amounts due to group undertakings are included within other creditors. At 31 December 2015 £26m was payable to PSC (2014: £17m). This amount is expected to be paid in the next financial year.

The amounts disclosed in more than one year columns in the above table are expected to be settled more than 12 months after the reporting date.

(d) Insurance risk

Longevity risk is the risk that mortality experience of the Company's policyholders is lighter than assumed, thus requiring pensions to be paid for a longer period than anticipated, resulting in a higher than expected cost to the Company.

In order to help minimise this risk and also uncertainty arising through future longevity experience, PIC adopts an active approach to reinsuring these risks where it is economic to do so. This reinsurance can be classified into two broad categories:

Longevity only reinsurance

This provides longevity cover in respect of certain policyholders. Under these contracts, the Company has committed to pay the reinsurer a fixed line of cash flows for specified sets of liabilities relating to members / former members of particular pension schemes. The reinsurer undertakes to reimburse the actual cost of claims to the Company. Separately, there is also an insurance fee for which the Company is liable. Settlement of the contract is on a net basis. These contracts also transfer the contingent longevity risk relating to any eligible dependents of relevant policyholders.

Longevity reinsurance via the transfer of assets

Under such contracts, in return for a premium, the reinsurer agrees to reimburse the actual cost of future claims to the Company in respect of an agreed set of policyholders. These contracts also transfer the contingent risks relating to eligible dependents of relevant policyholders.

The Company monitors the levels of its counterparty risk and actively seeks to reinsure with a range of providers to help mitigate its exposure to any one such entity.

One aspect of deriving overall best estimate longevity assumptions is to establish the “current” or “initial” rates of mortality. These assumptions are set by applying appropriate mortality factors to each individual member / policyholder. Individual variations are subject to a number of factors including, but not limited to, an individual's gender, age and pension amount.

The other aspect is the allowance for future improvements in mortality. The pattern in which mortality is expected to improve over time is an important but complex assumption for cash flow and liability calculations. This is regularly reviewed in the light of a number of factors including evolving methodologies for these projections together with views from industry and professional bodies on the factors driving mortality change.

Whilst longevity risk is the fundamental risk relating to its portfolio, the Company also considers the following risks:

Risk arising from a specific insurance contract

The Company considers, as part of its risk management process, the risk attached to each new contract accepted and the mitigation of such risk.

Exposure to changes in financial market conditions

The Company prepares information based upon a range of possible market conditions. The results of this exercise are then considered with regard to the effect on the current portfolio.

(e) Operational risk

Operational risk is the potential for loss resulting from inadequate or failed internal processes, people and systems, or from external events. The Company's internal control processes are supported by an operational risk committee, the maintenance of a central risk register and an independent internal audit review. The risk of internal fraud is managed through a number of processes including the screening of staff at recruitment, a continuous training programme, segregation of duties and whistle-blowing policies.

The Company has significant outsourcing arrangements in respect of pension administration and other functions. These arrangements are subject to agreements with formal service levels, operate within agreed authority limits and are subject to regular review by senior management.

Emergency and business continuity plans have also been established to counter adverse occurrences.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

16. SHARE CAPITAL

The authorised, issued and fully paid share capital of the Company is:

	2015 Number of shares	2015 £m	2014 Number of shares	2014 £m
Authorised, issued and fully paid				
At beginning of year	**692,210,351**	**692**	625,304,196	625
Shares issued at par	**64,600,000**	**65**	66,906,155	67
At end of year	**756,810,351**	**757**	692,210,351	692

On 23 March 2015, the Company issued 64,600,000 fully paid £1 ordinary shares at par for consideration consisting of tradeable securities and managed funds with a market value of £64,600,000.

17. RESERVES

	2015 Other reserves £m	2015 Retained profit £m	2014 Other reserves £m	2014 Retained profit £m
At beginning of year	**60**	**396**	60	261
Total comprehensive income	**–**	**83**	–	135
At end of year	**60**	**479**	60	396

Other reserves comprise £60m contributed in 2008 by Pension Holding Company (UK) 3 Limited, the immediate Parent Company.

18. CAPITAL RESOURCES

The Board's policy is to maintain a strong capital base to protect policyholders' and creditors' interests and ensure compliance with the relevant financial services regulations, whilst still creating shareholder value. The Company's capital resources comprise equity and debt capital. The details of the Company's equity capital resources are given in the Statement of changes in equity.

The Company's regulatory solvency ratio at 31 December 2015 was 231% (2014: 270%) and it had net assets on a regulatory basis which were £864m (2014: £865m) in excess of regulatory requirements. The Company has complied with the regulatory capital requirements under Pillar 1 as set out in the relevant PRA rules throughout the year.

The Company's objectives in managing its capital are:

- to match the profile of its assets and liabilities closely, taking account of the risks inherent in the business;
- to maintain financial strength sufficient to support new business growth in line with the Company's business plan;
- to satisfy the contractual entitlements of its policyholders and the requirements of its regulators;
- to ensure financial flexibility by maintaining strong liquidity and access to a range of capital markets;
- to allocate capital efficiently to support growth;
- to manage exposure to changes in interest and inflation rates by way of a comprehensive hedging programme; and
- to manage exposure to movements in exchange rates.

The Company currently has sufficient capital resources available to meet all its present capital requirements and does not utilise financial reinsurance or securitisation.

The Company is required to hold sufficient capital at all times to meet the PRA's capital requirements and it manages its capital so as to ensure compliance. The capital requirement is calculated on the regulatory basis, which is based on EU Directives. For all regulated insurance business, account is also taken of the Individual Capital Assessment which considers certain business risks not reflected in the regulatory basis.

The Company reviews its capital resources formally at least monthly and has complied with all externally and internally imposed capital requirements during the year. It remains the intention of management to ensure that there is adequate capital to exceed the Company's regulatory requirements. This is managed through the Company's internal policy of maintaining capital at a level which exceeds the higher of its internal capital requirement and the relevant regulatory capital requirement plus a specified margin.

The following table analyses the Company's capital resources between those held within the long-term insurance business fund ("LTIBF") and other capital resources. The total available capital resources indicates the capital that is available to meet the regulatory capital requirements of the business.

31 December 2015	UK Non-participating £m	Life Business Shareholders funds £m	Total Life Business £m
Capital resources held outside LTIBF	**–**	**1,463**	**1,463**
Capital resources held in LTIBF	**127**	**–**	**127**
Total shareholders' interests	**127**	**1,463**	**1,590**
Adjustments onto regulatory basis:			
Adjustments for regulatory solvency	**(69)**	**–**	**(69)**
	58	**1,463**	**1,521**
Other qualifying capital	**–**	**–**	**–**
Total available capital resources	**58**	**1,463**	**1,521**

31 December 2014	UK Non-participating £m	Life Business Shareholders funds £m	Total Life Business £m
Capital resources held outside LTIBF	–	917	917
Capital resources held in LTIBF	525	–	525
Total shareholders' interests	525	917	1,442
Adjustments onto regulatory basis:			
Adjustments for regulatory solvency	(67)	–	(67)
	458	917	1,375
Other qualifying capital	–	–	–
Total available capital resources	458	917	1,375

Solvency II

The European Union ("EU") has developed a new solvency framework for insurance companies, referred to as Solvency II. The initial Solvency II Directive was formally approved by the Economic and Financial Affairs Council in November 2009 and has progressed through a series of formal consultations and updates to date.

The new approach is based on the concept of three pillars – minimum capital requirements, supervisory review of firms' assessments of risk and enhanced disclosure requirements – and was implemented on 1 January 2016.

In the future, the Company's regulatory solvency will be expressed on the Solvency II basis, using the Company's specific internal model approved by the PRA.

19. RELATED PARTY TRANSACTIONS

As at 31 December 2015 the Directors regarded Pension Insurance Corporation Group Limited ("PICG"), a limited company incorporated in England and Wales, as the Company's ultimate parent and controlling party.

The group controlled by PICG includes seven other companies which the Directors consider to be related parties by virtue of their common control.

The compensation paid to key management personnel is disclosed in Note 7.

During the year, the Company concluded a £180m pension insurance buyout of a certain pension scheme, which became a related party to the Company through the family connections of one of the Company's executive team members. As a safeguard, a complete segregation was introduced so that this Executive had no involvement in the deal. The Company won the deal through a competitive tender process organised by the Trustees of the scheme, which represents an arm's length transaction. There are no outstanding balances due to or from the scheme as at 31 December 2015.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2015 continued

19. RELATED PARTY TRANSACTIONS continued

The Company had transactions with three of its fellow subsidiaries of PICG as follows:

(a) Transactions with Pension Security Insurance Corporation Limited ("PSIC")

The Company did not cede any insurance premiums to PSIC during the year (2014: nil). No commissions (2014: nil) and no recovery of claims (2014: £11m) were due under the terms of the reinsurance contract in place with PSIC.

On 27 February 2015 PIC issued a formal recapture notice to PSIC under the terms of its reinsurance treaty dated 6 June 2008. This served to recapture approximately £385m of insurance liabilities and £358m of related assets (as at 31 December 2014) with effect from 1 March 2015. PIC realised a £15m loss on recapture.

At 31 December 2015 there were no outstanding balance in claims due from PSIC (2014: £6m).

(b) Transactions with Pension Services Corporation Limited ("PSC")

PSC is the main provider of management, staff, IT, office services and contracted director services to the Company. Total charges for the period to 31 December 2015 were £60m (2014: £51m). At 31 December 2015 the amount due to PSC relating to the services provided was £26m (2014: £17m).

(c) Transactions with Pension Holding Company (UK) 3 Limited ("PHC3")

On 20 December 2013 the Company transferred all of its rights accruing under the terms of a loan to Co-Investment Limited to PHC3 in return for a loan note valued at £1 issued by that company. The fair value of this loan at the date of transfer was £nil. The loan note issued by PHC3 is repayable by the borrower at its discretion and attracts interest at a rate 2.5% above LIBOR calculated quarterly. The amount outstanding at 31 December 2015 and 31 December 2014 was £1.

On 14 May 2012 the Company acquired an £80,000 loan facility from Pension Insurance Corporation Holdings LLP ("PICH"). The facility was provided to PHC3 for the purpose of funding its investment in the GPUTs. The loan is repayable on demand from the Company or at the discretion of the borrower with an interest rate of 2% above LIBOR calculated quarterly. The amount outstanding at 31 December 2015 was £67,400 (2014: £71,083).

20. FINANCIAL COMMITMENTS AND CONTINGENCIES

Commitments

During the year the Company executed transactions to purchase partly funded securities. The Company expects to pay a further £74m within the next four years (2014: £90m), £31m of this being due within 12 months of the financial reporting date (2014: £13m).

	31 December 2015 £m	31 December 2014 £m
Within 1 year	**31**	13
In 1-5 years	**43**	77
Over 5 years	**–**	–
	74	90

Contingent liabilities

Certain of the Company's reinsurance agreements include fees that are contingent on PIC remaining solvent on the current statutory (i.e. Pillar 1) basis. Such fees do not meet the definition of a liability, therefore are not recognised on the statement of financial position. At 31 December 2015, the estimated value of the contingent fees payable was £48m (2014: £52m).

21. PARENT COMPANY AND ULTIMATE CONTROLLING PARTY

The Company is a wholly owned subsidiary of PHC3, which is incorporated in England and Wales.

The Directors regard PICG, a limited company incorporated in England and Wales, as the ultimate parent and controlling party. PICG is the largest and smallest group of which the Company is a member and for which Group financial statements are prepared. The consolidated financial statements of PICG are available to the public and may be obtained from 14 Cornhill, London EC3V 3ND.

PENSION INSURANCE
CORPORATION

Pension Insurance Corporation plc
Annual Report and Financial Satements 2015

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