Pension Insurance Corporation plc

Full Year 2015 Report

Removing risk from pension funds

PENSION INSURANCE CORPORATION

31 December 2015

Contents

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Pension Insurance Corporation plc is a public limited company registered in England and Wales under company number 05706720. It is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority (FRN 454345). Pension Services Corporation Limited is a limited company registered in England and Wales under company number 8019046 and provides services to PIC. Registered offices of both companies are at 14 Cornhill, London EC3V 3ND.

Summary of Full Year 2015 Results

IFRS Underlying Operating Profit (£m)
Up 15%

FY 2015:	**133**
FY 2014:	116

IFRS Operating Profit (£m)
Up 22%

FY 2015:	**188**
FY 2014:	154

IFRS Pre-tax Profit (£m)
Down 39%

FY 2015:	**104**
FY 2014:	170

New Business Premium (£m)
Up 42%

FY 2015:	**3,755**
FY 2014:	2,646

Assets Under Management (£m)
Up 22%

FY 2015:	**16,122**
FY 2014:	13,189

Pillar 1 Solvency Ratio

FY 2015:	**231%**
FY 2014:	270%

£m	2008	2009	2010	2011	2012	2013	2014	**2015**
New business premiums	1,572	1,089	718	615	1,512	3,663	2,646	**3,755**
Profit before tax	(60)	18	90	12	184	114	170	**104**
Period end Pillar 1 solvency ratio	232%	189%	209%	190%	251%	249%	270%	**231%**
Period end embedded value	n/a[1]	n/a[1]	n/a[1]	619	830	1,226	1,550	**1,856**

1 Embedded value for 2008-2010 was not prepared on a PIC stand-alone basis.

Financial Commentary

The financial model

PIC's strategy is to manage the assets associated with defined benefit pension scheme liabilities and to make a consistent margin on these assets over the very long term. The liabilities that we take on are in respect of the obligations to pay the pensions of members or former members of pension schemes. As these obligations are highly predictable and the majority are non-callable, we are able to invest in assets with a very long-term investment horizon.

PIC is authorised to write long-term insurance business by the Prudential Regulation Authority ("PRA") and regulated by the PRA and the Financial Conduct Authority ("FCA"). We operate in a highly regulated environment where our UK prudential regulator, the PRA, requires us to invest our assets and measure our liabilities in accordance with strict and detailed rules and guidance. The PRA also requires us to hold capital over and above the assets required to pay out policyholder benefits, as an additional safeguard for policyholders. The published statutory measure of our regulatory capital strength as at 31 December 2015 is referred to as the Pillar 1 basis, but we are also required to calculate our capital strength on a private basis referred to as Pillar 2, which is agreed with the PRA having regard to our particular circumstances. From 1 January 2016 a new regulatory framework, Solvency II, has been introduced in the UK and replaces the former Pillar 1 and Pillar 2 approach. Further details of this new solvency regime are provided below.

Our main income derives from new business premiums and investment returns. Our principal outgoings are pension related payments to policyholders, investment management expenses and general management expenses, against which we maintain actuarially calculated reserves and provisions.

As a long-term business we complement our IFRS disclosures with additional information on an "embedded value" basis, which captures the inherent future value of the emerging margins in our business that are not recognised in our IFRS reporting. Ultimately our embedded value will be realised as profit in our IFRS accounts.

Presentation of financial results

The 2015 and 2014 full year IFRS basis results have been derived from the 2015 and 2014 statutory accounts respectively. The auditors have reported on the 2015 and 2014 statutory accounts. The auditors' reports were (i) unqualified, (ii) did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying their report and (iii) did not contain a statement under section 498(2) or (3) of the Companies Act 2006.

The 2015 and 2014 year end embedded value results have been derived from the 2015 and 2014 year end PIC embedded value reports, which included an unqualified audit report from the auditors.

Because of the nature of our business, we present our results on a number of different bases, all of which provide different insights into the Company. The following paragraphs provide a summary of the different methods and insights offered by each basis.

Solvency capital ratio

The Solvency Capital Ratio sets out the ratio of available assets to the minimum capital that the PRA requires regulated companies to hold. This is typically expressed as a percentage of the required capital. At the end of December 2015, the ratio for PIC was 231%, calculated on a Pillar 1 basis.

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 prior to its implementation.

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, PIC's regulatory solvency will be expressed on the Solvency II basis.

PIC is not required to report formally on its Solvency II basis results until 31 December 2016. The Company has, however, successfully transitioned to the Solvency II regime and is fully compliant with the new requirements. This follows a comprehensive implementation programme run under the direct oversight of the Board.

Under the new solvency regime, firms can either follow a prescribed approach to calculating this required regulatory capital (the standard formula approach), or they can apply to the supervisory regulatory body to use an "internal model", developed by the company but subject to comprehensive review and approval by the regulatory body, in our case the PRA.

PIC is delighted that the PRA confirmed its approval of PIC's internal model, which we believe better reflects the risk profile of the Company's business. The PRA also approved other Solvency II related applications made by the Company in respect of the Matching Adjustment, Volatility Adjustment and Transitional Measures, which are all related to how the company calculates its pension liabilities under Solvency II.

At 31 December 2015 the Company's solvency ratio on the Solvency II basis was 151% and is comparable with the ratio as measured under the former Pillar 2 regime.

Financial Commentary (continued)

IFRS
The full year IFRS results are prepared on the same basis as those required for annual statutory reporting purposes. For the Company, these results are closely aligned with the methodology used to prepare the Pillar 1 capital basis. This means that they are prepared on a "prudent" basis, recognising liabilities in full using best-estimate assumptions to which margins for prudence are added, with no credit taken for future earnings or for the release of the prudent margins.

The discount rate used to value the future liabilities is derived from the yield on the asset portfolio that we hold, but with appropriate adjustments to ensure that the discount rate itself is on a prudent basis.

Because of this prudent approach, the impact of new business on the accounts is typically fairly small, and can be negative. The value arising from new business written emerges over many years, and the IFRS accounts will only reflect this emerging value over the lifetime of the new business.

IFRS based measures of profit or loss ("Operating and non-operating profit")
Operating profit 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. This encompasses 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, we have defined a measure of "underlying operating profit", which captures the returns we make from our in-force book of insurance assets and liabilities and return from our surplus assets based on our long-term return assumptions.

Non-operating profit encompasses the impacts of the wider 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 each discrete accounting period.

The operating profit basis is more aligned to the way management view the business, and the decisions which management makes around the Company's core activities. Accordingly, commentary is presented on an operating profit basis, rather than on the statutory income statement basis.

Embedded value
The embedded value ("EV") result builds on the IFRS results. 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 prudent margins built in to the actuarial valuation of the in-force business. It is essentially a discounted cash flow valuation of the business. The embedded value result is prepared in accordance with principles laid down in 2004 by the CFO Forum, a representative body of the European insurance industry. These principles act as an industry standard on the preparation of embedded values.

The embedded value consists of three main elements:

- The "net worth" is essentially the IFRS net assets, but with some adjustments to reflect fair value movements in the Company's debt as well as differences between IFRS and Pillar 1 solvency reporting.
- The "value of in-force business" ("VIF") is designed to capture the present value of the after-tax return for shareholders that will be generated by policies currently on our books. It represents a combination of the release of the prudent margins we are required to hold for regulatory purposes and the investment return on the assets that back the reserves held over and above that assumed in the actuarial valuation.
- The "cost of capital" is the frictional cost applied to the regulatory capital that is required to be held in the business to meet our regulatory obligations.

The CFO Forum has recently stated that it remains acceptable for 2015 year end for companies to continue to prepare their embedded values based on the Pillar 1 capital rules, and that any impacts from the introduction of Solvency II can be considered only for the 2016 year end. As such, the Company has continued to use its current Pillar 1 based approach for the 2015 year end.

IFRS Results

Income Statement – Statutory Basis

£m	Year ended 31 December 2015	Year ended 31 December 2014
New business premiums	**3,755**	2,646
Reinsurance premiums	**(199)**	(176)
Reinsurance recapture received	**356**	–
Net premiums	**3,912**	2,470
Investment income	**447**	314
Realised and unrealised investment movements	**(699)**	1,471
Total revenue	**3,660**	4,255
Net claims payments	**(565)**	(436)
Acquisition and management expenses	**(68)**	(60)
Debt interest	**(20)**	(10)
Change in insurance liabilities	**(2,903)**	(3,579)
Total claims and expenses	**(3,556)**	(4,085)
Net profit before taxation	**104**	170
Tax on net profit	**(21)**	(35)
Net profit after taxation	**83**	135

Income Statement – Operating Profit Basis

£m	Year ended 31 December 2015	Year ended 31 December 2014
Return earned on insurance book	**87**	65
Return earned on surplus assets	**46**	51
Underlying operating profit	**133**	116
New business and reinsurance	**59**	38
Other changes to in-force business	**(4)**	–
Operating profit before tax	**188**	154
Short-term fluctuations in return	**(94)**	118
Model and assumption changes	**52**	(85)
Non-recurring costs	**(22)**	(7)
Debt interest	**(20)**	(10)
Total non-operating (loss)/profit	**(84)**	16
Net profit before taxation	**104**	170
Tax on net profit	**(21)**	(35)
Net profit after taxation	**83**	135

Commentary

Definitions of terms used in operating profit presentation

Underlying operating profit is defined as the net spread earned on the assets backing the Company's insurance liabilities and the expected release of the prudent margins used in calculating the reserves held for these liabilities, plus the expected return earned in the period on surplus assets based on a long-term expectation of the returns that are achievable.

Operating profit, in addition to these items, also contains the IFRS impacts of the new business and reinsurance contracts which have been written during the period.

Other items are treated as non-operating profits or losses, and are presented "below the line". Items shown as non-operating profits or losses comprise:

- items arising from market events / movements;
- items of a one-off or exceptional nature which are not expected to recur; or
- items where, due to the nature of insurance accounting, the Company is obliged to capitalise a multi-year effect and show it within a single accounting period.

Examples of the items treated as non-operating include:

- short-term variations from the long-term investment assumptions used above;
- one-off costs, such as project or restructuring costs;
- financing costs, such as the interest payable on the subordinated debt issued by PIC; and
- changes in long-term insurance assumptions, where multiple years' worth of income or expense must be recognised in a single accounting period.

Overall

PIC's IFRS underlying operating profit before tax was £133m in 2015, ahead of 2014 (£116m), and operating profit before tax was £188m (2014: £154m).

IFRS profit before tax for 2015 was £104m, down on the same period last year (£170m).

IFRS Results (continued)

Further commentary and explanations of the classifications used are given below.

Operating profit items

Return earned on insurance book

The return earned on the insurance book represents the spread earned on the assets which are held to back the insurance liabilities. During 2015 this was £87m, compared to £65m in 2014. During 2015, the return which PIC has been able to generate on its insurance book has increased due to a slight improvement in the asset spreads on its portfolio and an increase in the size of the overall asset base. This reflects the significant new business written by PIC over the last 12 months, and the rise in insurance liabilities from £11,660m at 31 December 2014 to £14,563m at 31 December 2015.

Return earned on surplus assets

The return earned on surplus assets is calculated using an expectation of the long-term rate which the surplus assets will earn, but which will vary according to the mix of surplus assets held at the start of each quarter. This means that any short-term variations, up or down, in market movements outside the long-term expectation are smoothed out. The variations are still recorded and accounted for, but are recognised outside of operating profit and instead are included in non-operating profit.

During 2015, the expected return earned on surplus assets was £46m, marginally lower than £51m in 2014. While the surplus assets in PIC have increased significantly over that time, from £1,376m at end of December 2014 to £1,521m at the end of December 2015, the impact of this increase was offset by a decrease in the overall rate that the portfolio of assets was expected to earn, reflecting falls in long-term interest rate expectations, particularly in the second half of 2014, which have then impacted on the full year 2015 outturn.

New business and reinsurance

PIC completed 13 new business transactions in 2015, five of which were concluded in Q4 for a total premium of £2.8bn. The buy-out of 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.

During Q4 2015, PIC also completed two reinsurance deals, including the reinsurance of the Philips deal with Hannover Re, which was finalised on the same day that the new business deal was concluded. Earlier in 2015, PIC entered into two reinsurance agreements with Prudential Insurance Company of America, covering the longevity risk on approximately £1.7bn of liabilities across 75 schemes. The total amount of liabilities reinsured amount to c. 73% of PIC's total longevity exposure at 31 December 2015.

The reinsurance treaty with Pension Security Insurance Corporation Limited ("PSIC"), a Group reinsurance company, was recaptured in March 2015. The impact of this is included in the non-recurring costs section below.

New business and reinsurance activity, together with the premium related adjustments, contributed £59m to the operating profit in 2015 compared to £38m in 2014.

Other changes to in-force business

This primarily represents the variance between actual and expected claims and demographic experience, and is an adverse £4m in 2015 (2014: £nil).

Items in non-operating profit

Short-term fluctuations in return

This item mainly relates to the differences between the 'expected' returns that are included within operating profit and the actual amounts that are recorded for that period.

During 2015, short-term fluctuations in return came to £(94)m, compared to £118m in the prior year.

During 2015, market conditions were volatile with significant fluctuations in credit spreads, interest and inflation rates. After falling in the first quarter, credit spreads have widened throughout the rest of the year, and this has had an adverse impact on the non-operating profits for the year.

Apart from a dip in Q3 2015, interest rates have gradually increased during the year. Falling interest rates generally result in higher asset values and insurance liabilities. Inflation rates continued to increase throughout 2015. Increases in inflation rates will generally result in higher asset values and insurance liabilities. The net impact of the interest and inflation rate changes was adverse on the results of PIC. PIC uses interest and inflation rate hedges to protect against the adverse impact of interest and inflation rates on regulatory capital levels. However, as regulatory capital differs from IFRS liabilities, there will be a degree of volatility in IFRS earnings as inflation and interest rates change.

As well as the movements referred to above, PIC undertook a significant amount of asset purchases and sales in H2 2015 to ensure that its asset portfolio was best placed for the new Solvency II rules, particularly the Matching Adjustment, which came into force on 1 January 2016. This resulted in a higher than normal level of transaction costs.

Model and assumption changes

Modelling and assumption changes represent the one-time impacts of updates to the actuarial modelling of liabilities and the impact of any changes made to the underlying valuation assumptions. Of the £52m profit in 2015, £10m resulted from improvements to the model and £42m from assumption changes, principal among which were a reduction in the assumed level of future investment management fees following a review of external fund manager mandates, and a change to the assumed level of future mortality improvements reflecting more recent figures published by the Continuous Mortality Investigation Bureau.

Non-recurring costs

Non-recurring costs are those costs which are generally one-off and which have been incurred for specific, limited purposes. Generally these are costs for ongoing discrete projects which have a defined lifespan. Such costs amounted to £7m in 2015.

The recapture of the PSIC reinsurance arrangement resulted in a premium received from PSIC of £356m and a loss on recapture of £15m, although the impact on the EV was a positive £12m (pre-cost of capital).

Debt interest

PIC bears an interest cost of approximately £5m per quarter (pre-tax) on its listed debt security.

Tax

The taxation charge for the year ended 31 December 2015 is in line with the effective rate of tax of 20.25% which PIC expected to apply to overall FY 2015 profits.

Balance Sheet

£m	31 December 2015	31 December 2014
Assets		
Receivables and other financial assets	**107**	64
Financial investments	**16,122**	13,189
Cash and cash equivalents	**12**	5
Total assets	**16,241**	13,258
Liabilities		
Insurance liabilities	**(14,563)**	(11,660)
Borrowings	**(295)**	(294)
Deferred tax liability	**(5)**	(6)
Current tax liability	**(15)**	(15)
Insurance and other payables	**(67)**	(135)
Total liabilities	**(14,945)**	(12,110)
Net assets	**1,296**	1,148
Equity		
Share capital	**757**	692
Reserves	**539**	456
Total equity	**1,296**	1,148

Commentary

Net assets increased by £148m in 2015, reflecting additional £65m share capital from PIC's ultimate parent company in March 2015, and the profits made by PIC during the year. The additional share capital was received in connection with the recapture of the reinsurance from PSIC. At a group level there was no increase in share capital.

The increases in both financial investments and insurance liabilities since December 2014 reflect the new business written during 2015, and the recapture of the reinsurance arrangement with PSIC in March 2015, as well as the impact of market movements on PIC's assets and associated insurance liabilities during the period.

Embedded Value

Embedded value balance sheet

£m	31 December 2015	31 December 2014
Net assets	**1,296**	1,148
Effect of movement from IFRS to EV valuation basis	**(69)**	(83)
Net worth	**1,227**	1,065
Value of in-force business (after tax)	**965**	748
Embedded value before cost of capital	**2,192**	1,813
Cost of capital at 3.20% p.a.	**(336)**	(263)
Embedded value post cost of capital	**1,856**	1,550

Commentary

The increase in EV since December 2014 of £306m reflects the beneficial impacts of new business written during the year, the in-force business contribution, the addition of £65m of new share capital into PIC in March 2015 and the positive impact of PSIC recapture on the embedded value, offset by the adverse impacts of investment market movements and the increase in the cost of capital.

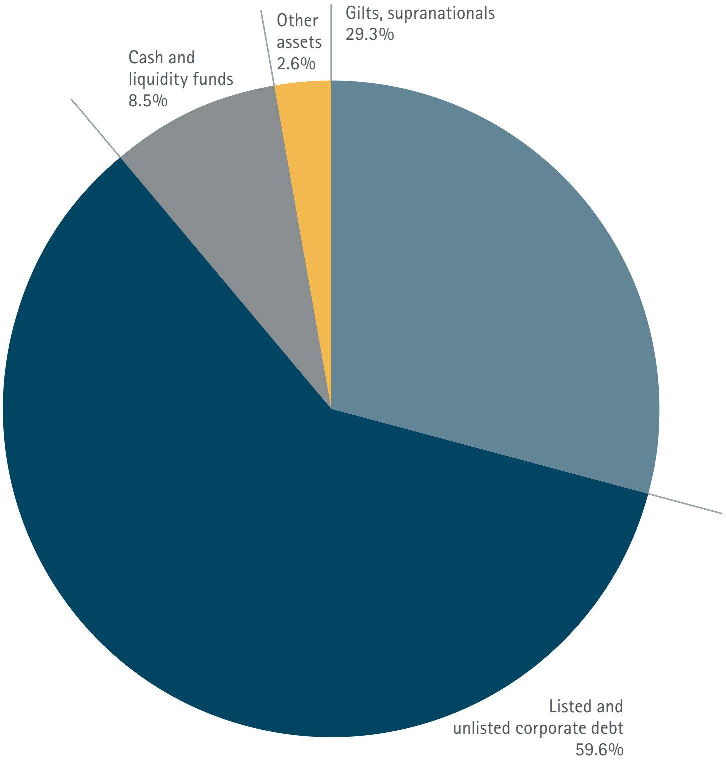
Financial Investments

Asset position as of 31 December 2015

PIC Assets (£m)	31 December 2015 MV (£m)	31 December 2015	31 December 2014 MV (£m)	31 December 2014
Gilts, supranationals	**4,721**	**29.3%**	4,574	34.7%
Listed and unlisted corporate debt[1]	**9,611**	**59.6%**	6,843	51.9%
Cash and liquidity funds[2]	**1,372**	**8.5%**	1,235	9.3%
Other assets[3]	**418**	**2.6%**	537	4.1%
Total Investments	**16,122**	**100.0%**	13,189	100.0%

1 Listed and unlisted corporate debt includes corporate bonds, asset backed securities, PFI, bilateral loans and bonds.
2 Cash and liquidity funds includes cash at bank, bank deposits and holdings in liquidity funds.
3 Other assets includes property, collateralised loan obligations, as well as smaller holdings of other asset classes.

Breakdown of aggregate assets 31 December 2015



Commentary

The overall level of financial investments increased by 22% during 2015, driven principally by new business, assets acquired as a result of the recapture of the PSIC reinsurance agreement, new capital and the impact of investment market movements.

The proportion of the portfolio invested in corporate bonds has increased by 7.7% to 59.6% since 2014 year end, whilst the holdings in other asset classes have reduced as a percentage of the overall book during the same period. This was mainly due to PIC transitioning its asset portfolio in consideration of the new Solvency II requirements, which became effective from 1 January 2016.

No defaults have been recorded in 2015 (2014 full year: £nil).

Capital and Reserves

Solvency
Pillar 1 basis

£m	31 December 2015	31 December 2014
Shareholder fund assets	**1,463**	917
Long-term fund assets	**14,691**	12,184
Reserves and provisions	**(14,633)**	(11,726)
Available capital resources	**1,521**	1,375
Statutory capital requirements	**(657)**	(510)
Pillar 1 excess assets	**864**	865
Pillar 1 solvency ratio	**231%**	270%

Solvency II
Solvency II basis

£m	31 December 2015
Available assets	**2,370**
Solvency capital requirements	**(1,574)**
Solvency II excess assets	**796**
Solvency ratio	**151%**

Commentary

Under the Pillar 1 regulatory rules for insurance companies, the capital position is measured by looking at the Available Capital Resources versus the Capital Requirements set out by the PRA.

PIC has consistently maintained a Pillar 1 solvency ratio (the ratio of Available Capital Resources to Capital Requirements) of around 200% or more since inception. Whilst this level is not a target, it nevertheless indicates the financial strength that allows the Company to continue to write new business.

At 31 December 2015 the Pillar 1 solvency ratio was 231%, which is lower than the 270% ratio reported at the end of 2014, reflecting the capital strain from the new business deals concluded during the year.

The figures provided for Solvency II basis represent the Company's opening balance sheet under the new solvency regime. As can be seen, the available assets are significantly higher than the available capital resources under Solvency I. This reflects the inclusion of prudent margins in the Solvency I basis, which are not included in Solvency II. However, Solvency II requires capital to be held based on the risk profile of the business and this is significantly higher than the formulaic approach under Solvency I. The net result is that the disclosed solvency ratio is significantly lower than reported under Solvency I, whereas the excess assets are only slightly less.

Risk Management

Key risks faced by PIC and how these risks are managed

Effective risk management is integral to the success of our business. Our risk management framework seeks to support our overall business strategy, enabling us to manage and mitigate those risks that we believe are unrewarded, and to optimise the capital that we hold to support our business strategy. The following sections are intended to set out the nature of the key risks that we face, and how we manage and mitigate them. A comprehensive governance framework, overseen by the Board of Directors, together with the Board sub-committees, is in place to ensure that risks to our business are appropriately identified, understood, monitored and managed.

Insurance risk

Insurance risk is principally longevity risk, i.e. the risk that our insured policyholders live longer than we had assumed in our pricing and reserving. It also covers the risk that our management expenses are greater than we have assumed for pricing and reserving purposes.

Once insurance risk is on our books, we use reinsurance, where it is economic to do so, to pass a proportion on to established reinsurance companies. This process ensures that the risks on our balance sheet are managed appropriately, and acts to validate the assumptions we have made at the point of pricing. Reinsurance counterparties are regularly monitored to ensure they continue to meet our criteria for counterparties.

In respect of expense risk we have a comprehensive expense planning, approval and monitoring framework in place to ensure that expenses are appropriately managed.

Market risk

Predominantly, market risk for PIC arises in three ways:

i. Investment performance. The accounting basis for the vast majority of our assets is fair value. Therefore we are at risk of volatility in investment performance, as prices of our assets rise or fall. The basis of our liability discounting is such that a portion of any rise or fall in investment values due to credit spreads (as opposed to interest rate changes, which are commented on in (ii) below) is factored into the discount rate applied to our liabilities, so that the overall financial impact of such spread changes is dampened. Whilst we have a predominantly buy and hold investment strategy, we closely monitor the performance and credit quality of our financial investments and, where appropriate, take preventative action to mitigate the impact of downgrades and defaults.

ii. Interest rates and inflation. Interest rate and inflation movements have the potential to impact the value of our financial investments. We hedge interest rate and inflation exposures on both our assets and liabilities so as to minimise the impact of movements on our financial strength. This hedging is predominantly done through the use of swaps with highly rated counterparties. We hedge our liabilities plus regulatory required capital and, in consequence, the EV has some exposure to these risk factors

iii. Currency. A portion of our investment portfolio is held in non-sterling denominated assets. We mitigate the exposure by using currency swaps to convert any non-sterling exposure back to sterling, with limits on the amount of exposure to foreign currencies that we are willing to accept.

Counterparty credit risk

Predominantly, credit risk for PIC arises in three ways:

i. Financial investment default. Our holdings of predominantly fixed income securities are used to fund our highly predictable policyholder obligations. Defaults of any of our fixed income securities put at risk our ability to fund our policyholder obligations. To ensure that any risk of default is managed effectively we monitor our investment holdings very closely. Where we use external managers we are careful to ensure that only high quality and expert managers are used to place our investments. Our holdings are subject to ongoing monitoring to ensure credit quality is appropriate, and timely action can be taken to manage exposures.

ii. Swap counterparty default. All of our swaps are placed with bank counterparties. All swaps that we enter into are fully collateralised on a daily basis to ensure that any potential losses are minimised.

iii. Reinsurer counterparty default. We make use of extensive reinsurance of our longevity risk and use established reinsurance counterparties. If one of these reinsurers were to default on its obligations then this would require us to increase our longevity related reserves or increase the capital we hold in respect of longevity risk. We monitor the rating of our reinsurance counterparties, and also use collateral provisions where appropriate to minimise our potential loss should a reinsurer default.

Liquidity risk

Liquidity risk is the risk that PIC 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 transactions are determined as 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.

PIC'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.

Origination risk

Origination risk is the risk that all of the various risks associated with accepting new business are not adequately identified, and that business is written for a price which fails to generate an appropriate risk-adjusted return. Generally, this would result in reduced profits for the Company, but in extreme circumstances this could lead to PIC being loss-making.

There is a clear and detailed process in place to ensure that any new business sought is within the risk appetite of the business, and that all assumptions that go into the new business quotation process are appropriately checked. There is also a post-completion reconciliation process to ensure that the terms on which any new business proposal was entered into were those anticipated.

Regulatory and conduct risk

Regulatory risk stems principally from the risk of changed solvency requirements including, but not only, uncertainties over the impact of the Solvency II regulations.

In 2015, the Company received approval from the regulator on all applications it sought under the new solvency regime. These approvals include the use of its own Internal Model, the Matching Adjustment, the Volatility Adjustment and transitional measures. PIC continues to maintain an open dialogue with regulators.

Conduct risk is the risk that our behaviours lead to outcomes that are not in the interests of our policyholders. We have a strong ethical culture in place led by the Board to ensure that we minimise any conduct risk together with a values and behaviours based performance appraisal system. We monitor conduct risk through measuring customer outcomes and complaints, and reviewing breaches to note the cause and in particular what, if any, behaviour has led to the breach and take action as appropriate.

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 systems are supported by an operational risk committee, the maintenance of a central operational risk register and an independent internal audit function.

PIC has significant outsourcing arrangements for pension payrolls and other functions. These arrangements are subject to agreements with formal service levels, require the outsourcers to have appropriate business continuity arrangements, operate within agreed authority limits and are subject to regular review by senior management.

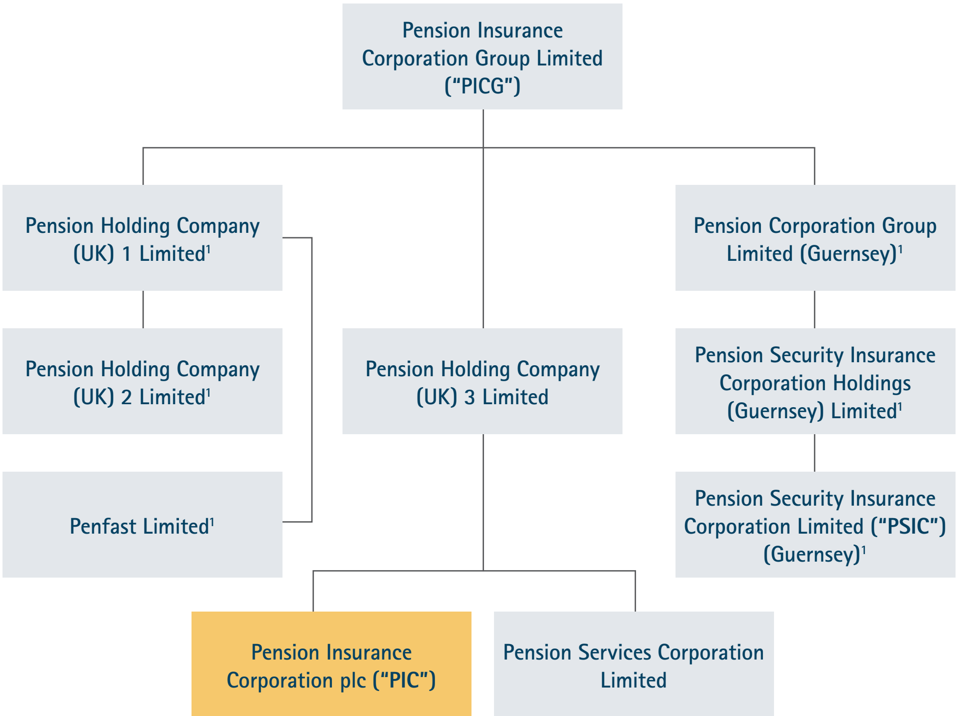
Reputation risk

The main reputation risks relate to the need for PIC to maintain a good reputation with trustees of pension schemes and their advisers in order to attract new business, with its own policyholders through treating them fairly, with its regulators and with other key stakeholders.

Maintenance of good professional relationships with the trustees of pension schemes we insure and their advisers is key, and our service level commitments are underpinned by using best-in-class administrators and monitoring their performance. Staff are given regular training to ensure we continue to treat customers fairly.

Appendix:

Summary Structure of PICG



1 Being wound up as part of the Group reorganisation.

PICG structure chart

During Q4 2015, a Group Reorganisation was carried out, which resulted in PICG replacing Pension Corporation Group Limited ("PCG") as the top group company. The rationale for this reorganisation was to eliminate a potential risk of becoming subject to supervision by regulators in both the United Kingdom and Guernsey as a consequence of the Solvency II regulations that became effective from 1 January 2016. The reorganisation took place on 8 December 2015, when PICG acquired PCG and its subsidiary undertakings including the main trading entity, Pension Insurance Corporation plc ("PIC") a public limited company registered in England. On the same date, further distributions and capital reductions were made at book value within the PHC1 sub-group with no gains or losses arising, and resulting in the new group structure depicted above.

PIC is the main operating subsidiary in the Group. PSIC was a Guernsey authorised insurer which provided a small amount of internal reinsurance to PIC (approximately 2.7% of its gross insurance liabilities at the end of 2014). In March 2015, PIC recaptured the PSIC reinsurance treaty, and as a result PSIC has returned its Guernsey insurance authorisation and no longer contains any insurance business.

Pension Services Corporation Limited is the PIC Group's services company, employing all employees. PIC is dependent upon Pension Services Corporation Limited for the provision of services from its employees, directors and consultants.

For further information in connection with this Full Year 2015 Report, please contact:

Tracey Campbell
Investor Relations
campbell@pensioncorporation.com

Rob Sewell
Chief Financial Officer
sewell@pensioncorporation.com

PENSION INSURANCE CORPORATION