PENSION INSURANCE CORPORATION

REMOVING RISK FROM PENSION FUNDS

PENSION INSURANCE CORPORATION PLC

HALF YEAR REPORT – 30 JUNE 2016

CONTENTS

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PIC 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 HALF YEAR 2016 RESULTS

IFRS underlying operating profit (£m)

Change from HY 2015 of +25%

£79m

IFRS operating profit (£m)

Change from HY 2015 of -31%

£81m

IFRS pre-tax profit (£m)

Change from HY 2015 of +181%

£152m

New business premium (£m)

Change from HY 2015 of +31%

£918m

Assets under management (£m)

Change from FY 2015 of +16%

£18.4bn

Solvency II solvency ratio

146%

£m	2008	2009	2010	2011	2012	2013	2014	2015	**HY 2016**
New business premiums	1,572	1,089	718	615	1,512	3,663	2,646	3,755	**918**
Profit before tax	(60)	18	90	12	184	114	170	104	**151**
Period end Pillar 1 solvency ratio	232%	189%	209%	190%	251%	249%	270%	231%	**n/a**
Solvency II solvency ratio	n/a	n/a	n/a	n/a	n/a	n/a	n/a	151%	**146%**
Period end embedded value	n/a[1]	n/a[1]	n/a[1]	619	830	1,226	1,550	1,856	**2,254**

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

CHIEF EXECUTIVE OFFICER'S REVIEW

Tracy Blackwell, Chief Executive Officer

AN EVENTFUL SIX MONTHS

It has been, to say the least, a very eventful first six months of 2016. I am pleased to report that PIC has had a successful first half, in terms of new business levels, solvency and financial performance. This was achieved notwithstanding the challenges posed by the introduction of a new solvency regime and the impact on the financial markets of the UK's referendum result to leave the European Union.

The foundations for our strong first half performance were laid last year, following our successful preparations for the implementation of Solvency II. We were delighted to be one of only 19 UK insurers to have had its Internal Model approved by the Prudential Regulation Authority ("PRA") in advance of implementation. We also obtained approvals for our other Solvency II related applications.

This has meant that we have been able to continue to manage our solvency in a way that fully reflects the risks within our business and so allows us to best manage those risks.

We were delighted that PIC's ultimate parent company, Pension Insurance Corporation Group Limited ("PICG"), was able to successfully raise £250 million of capital in June. Our largest existing shareholder, Reinet, contributed a further £140m and Legend, a new investor, subscribed for £110m of shares. Legend is best known for owning the Lenovo computer brand, but what really attracted us to them is their focus on building long-term successful businesses with a very strong emphasis on the customer; attributes with which we can readily identify.

CHIEF EXECUTIVE OFFICER'S REVIEW
CONTINUED

"I AM CONFIDENT THAT PIC IS WELL PLACED TO CAPITALISE ON THE UNDOUBTED OPPORTUNITIES THAT WILL ARISE."

Tracy Blackwell
Chief Executive Officer

We wrote £918m of new business in the period, compared to £702m in H1 2015. The majority of this new business came from one scheme, the Aon Retirement Plan. This transaction was particularly pleasing as PIC had previously concluded two buy-in transactions with a separate Aon-sponsored pension scheme.

The UK referendum result in support of leaving the EU caused significant upheaval in the financial markets and in particular caused sharp falls in interest rates. Through effective risk management in the period, whether with reinsurance or hedging, PIC's solvency at the end of June 2016 was 146% (31 December 2015: 151%).

Our reported figures for the first half validate the confidence placed in the business by our shareholders. PIC's embedded value has grown by £398m, or 21%. It now stands at £2.3bn. At the same time, PIC's IFRS underlying operating profit was £79m, an increase of 25% on the same figure at this point in 2015.

Maintaining strong relationships with reinsurers is a key part of capital management. We were therefore pleased to complete our third longevity reinsurance transaction with the Prudential Insurance Company of America ("PICA"), covering the lives of 2,900 pensioners we insured primarily as part of the Aon transaction.

During a period of uncertainty and volatility in the markets, we have continued to evolve our asset portfolio to take advantage of opportunities and to source investments that help pricing for new business.

We made further investments into infrastructure, including £100m in debt secured on the Thames Tideway Tunnel, a 25km tunnel underneath the River Thames in London. The benefits of investing in this type of asset are that they are very secure and the cash flows and maturity profile can be sculpted to match our liabilities, including very long maturities of almost 50 years. It is rare to be able to invest in debt with a maturity that long, as the opportunities in the bond markets at that duration are somewhat scarce. Sourcing investments that match our cash flows this well feeds through to the pricing we are able to offer to trustees and helps us win new business.

Finally, we continue to maintain a real focus on policyholder care. As part of this we are looking forward to welcoming almost 3,000 policyholders and guests to our events up and down the country over the next few months. I am sure that this focus helps us to maintain excellent customer satisfaction rates, with 99% of our policyholders expressing overall satisfaction with our service.

So whilst it has been a period of uncertainty, I am confident that PIC is well placed to capitalise on the undoubted opportunities that will arise in the rest of the year.

Tracy Blackwell
Chief Executive Officer

BUSINESS REVIEW
FOR THE PERIOD TO 30 JUNE 2016

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 is 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. From 1 January 2016 a new regulatory framework, Solvency II, has been introduced in the UK and replaces the former Solvency I regime. 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 IFRS basis results for the 2016 and 2015 half years are unaudited and they have not been reviewed in accordance with International Standard on Review Engagements 2410. The 2015 full year IFRS basis results have been derived from the 2015 statutory accounts. The auditors have reported on the 2015 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 embedded value results for the 2016 and 2015 half years are unaudited. The 2015 year end embedded value results have been derived from the 2015 year end PIC embedded value report, which included an unqualified audit report from the auditors in respect of compliance with the Embedded Value principles set out by the European CFO Forum.

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 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.

After many years of design, consultation, refinement and preparation across Europe, the Solvency II regulatory framework was implemented on 1 January 2016. It is based on the concept of three pillars – minimum capital requirements, supervisory review of firms' assessments of risk and enhanced disclosure requirements.

PIC is not required to report publicly with Solvency II results until May 2017, when the 2016 results will be available. 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 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.

BUSINESS REVIEW
FOR THE PERIOD TO 30 JUNE 2016
CONTINUED

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 elements of the Solvency II balance sheet are calculated.

At 30 June 2016, the Company's solvency ratio on the Solvency II basis was 146% (FY 2015: 151%).

IFRS
The half year IFRS results are prepared on the same basis as those required for annual statutory reporting purposes. The results 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 EV result is prepared in accordance with principles laid down in 2004 by the European CFO Forum, a representative body of the European insurance industry. These principles act as an industry standard on the preparation of embedded values.

In May 2016, the CFO Forum released amended principles governing the calculation of embedded values, reflecting the adoption of the Solvency II regulatory regime across the EU from the start of 2016. Management will consider the implications of these for the full year 2016 financial results, but in the meantime, the EV at 30 June 2016 has been prepared on the same basis as for the year ended 31 December 2015.

The EV 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 the old Solvency I Pillar 1 solvency reporting regime.
- 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 deemed to be required under the principles to be held in the business to meet our regulatory obligations.

IFRS RESULTS

Income statement – statutory basis

Statement of comprehensive income (£m)	**Half year ended 30 June 2016**	Half year ended 30 June 2015	Year ended 31 December 2015
Revenue			
Gross premiums written	**918**	702	3,755
Outward reinsurance premiums	**(12)**	(9)	(199)
Reinsurance recapture received	**–**	356	356
Net premium revenue earned	**906**	1,049	3,912
Investment return	**1,983**	(116)	(252)
Total revenue (net of reinsurance premiums)	**2,889**	933	3,660
Expenses			
Claims paid – gross	**(414)**	(277)	(581)
Reinsurers' share of claims paid	**12**	9	16
	(402)	(268)	(565)
Increase in insurance liabilities – gross	**(2,874)**	(230)	(2,656)
Change in reinsurers' share of insurance liabilities	**584**	(341)	(247)
	(2,290)	(571)	(2,903)
Acquisition expenses	**(20)**	(18)	(43)
Other operating expenses	**(15)**	(12)	(25)
Finance costs	**(10)**	(10)	(20)
	(45)	(40)	(88)
Total claims and expenses	**(2,737)**	(879)	(3,556)
Profit before taxation	**152**	54	104
Income tax charge	**(31)**	(11)	(21)
Profit for the period	**121**	43	83

Income statement – operating profit basis

£m	**Half year ended 30 June 2016**	Half year ended 30 June 2015	Year ended 31 December 2015
Return earned on insurance book	**54**	40	87
Return earned on surplus assets	**25**	23	46
Underlying operating profit	**79**	63	133
New business and reinsurance	**10**	59	59
Other changes to in-force business	**(8)**	(4)	(4)
Operating profit before tax	**81**	118	188
Short-term fluctuations in return	**121**	(30)	(94)
Model and assumption changes	**(36)**	(4)	52
Non-recurring costs	**(4)**	(20)	(22)
Debt interest	**(10)**	(10)	(20)
Total non-operating (loss)/profit	**71**	(64)	(84)
Net profit before taxation	**152**	54	104
Tax on net profit	**(31)**	(11)	(21)
Net profit after taxation	**121**	43	83

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.

IFRS RESULTS
CONTINUED

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 £79m for the first half of 2016, ahead of the same period of 2015 (£63m), and operating profit before tax was £81m (2015: £118m).

IFRS profit before tax for the first half of 2016 was £152m, significantly up on the same period last year (£54m).

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 net spread earned on the assets which are held to back the insurance liabilities. During the first half of 2016 this was £54m, compared to £40m for the same period in 2015. During 2016, 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 the assets hypothecated to the liabilities 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 gross insurance liabilities from £14,054m at 30 June 2015 to £19,354m at 30 June 2016.

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 the period to 30 June 2016, the expected return earned on surplus assets was £25m, marginally higher than £23m for the same period in 2015. While there was an increase in surplus assets, from £1,476m at the end of June 2015 to £1,717m at the end of June 2016, the impact of this was partially offset by a slight drop in the overall rate that the portfolio of assets was expected to earn in the period.

New business and reinsurance

PIC completed two new business transactions in the first half of 2016 (H1 2015: six), including the Aon buy-in deal in March, which insured approximately £0.9bn of insurance liabilities. The longevity risk arising from this deal was subsequently reinsured with Prudential Insurance Company of America.

The total amount of PIC's overall liabilities reinsured (on a Solvency II basis) amounted to c.75% of PIC's total longevity liabilities at 30 June 2016.

New business and reinsurance activity, together with the premium related adjustments, contributed £10m to the operating profit in the period to 30 June 2016 compared to £59m in the same period of 2015. This fall was mainly due to larger volumes of reinsurance deals concluded in the same period of last year, which generated higher profits compared to the current half year.

Other changes to in-force business

This primarily represents the variance between actual and expected claims and demographic experience, and is an £8m loss in the first half of 2016, compared to a £4m loss in the same period of 2015.

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 the first half of 2016, short-term fluctuations in return came to £121m, compared to £(30)m in the same period of the prior year.

The Company's preferred hedging benchmark for interest rates and inflation rates is the regulatory balance sheet. This does however create basis risk for the IFRS and EV balance sheets. The introduction of Solvency II, coupled with the significant interest rate volatility seen in the period has led to large IFRS profits. Such profits are not expected to arise to the same extent going forward as the hedging benchmarks across IFRS, EV and Solvency II basis have been better aligned.

IFRS RESULTS
CONTINUED

The Company's IFRS results are impacted by credit spread movements on those of its assets which are not risk-free; however, the extent of this is dampened by the discount rate which is applied to the liabilities, which is based in part on the spread of the asset portfolio. Overall, the impact of the credit related movements was positive to the Company's results.

Model and assumption changes
Modelling and assumption changes represent the one-time impact of updates to the actuarial modelling of liabilities and the impact of any changes made to the underlying valuation assumptions. A significant portion of the £36m adverse movement in the first half of 2016 resulted from the renegotiation of an existing reinsurance contract, where the impact of the renegotiation was to change the accounting treatment for IFRS purposes, recognising the present value of all expected future fees payable (whereas the previous treatment required fees to be recognised only when paid).

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 discrete projects which have a defined lifespan. Such costs amounted to £4m in the first half of 2016.

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 half year ended 30 June 2016 is in line with the effective rate of tax of 20% which PIC expects to apply to overall FY 2016 profits.

IFRS RESULTS
CONTINUED

Balance sheet

	30 June 2016 £m	30 June 2015 £m	31 December 2015 £m
Assets			
Investment properties	**96**	96	96
Reinsurers' share of insurance liabilities	**2,501**	1,823	1,917
Receivables and other financial assets	**171**	207	182
Prepayments	**32**	55	63
Financial investments	**19,859**	13,952	16,613
Derivative assets	**11,534**	2,678	4,900
Cash and cash equivalents	**10**	–	23
Total assets	**34,203**	18,811	23,794
Equity			
Share capital	**757**	757	757
Other reserves	**60**	60	60
Retained profit	**600**	438	479
Total equity	**1,417**	1,255	1,296
Liabilities			
Gross insurance liabilities	**19,354**	14,054	16,480
Borrowings	**295**	294	295
Deferred tax liability	**5**	6	5
Derivative liabilities	**13,027**	3,015	5,635
Insurance and other payables	**46**	153	53
Current taxation	**31**	11	15
Accruals	**28**	23	15
Total liabilities	**32,786**	17,556	22,498
Total equity and liabilities	**34,203**	18,811	23,794

Commentary

Net assets increased by £121m in the first half of 2016, reflecting the profits made by PIC during the period.

The increases in both financial investments and insurance liabilities since December 2015 reflect the new business written during the first half of 2016, and the impact of market movements on PIC's assets and associated insurance liabilities during the half year.

Derivative assets and derivative liabilities have grown significantly since end December. This largely reflects changes to our interest and inflation hedging approach due to Solvency II. The net derivative position has increased from £(0.7)bn to £(1.5)bn due mainly to currency movements following the Brexit referendum.

In June, PIC's parent company, Pension Insurance Corporation Group Limited, raised a further £250m of equity share capital, before expenses. This is not reflected in PIC's balance sheet at 30 June 2016, as the proceeds remain at holding company level at that date.

EMBEDDED VALUE

Embedded value balance sheet

£m	30 June 2016	30 June 2015	31 December 2015
Net assets	**1,417**	1,255	1,296
Effect of movement from IFRS to EV valuation basis	**(58)**	(80)	(69)
Net worth	**1,359**	1,175	1,227
Value of in-force business (after tax)	**1,293**	777	965
EV before cost of capital	**2,652**	1,952	2,192
Cost of capital at 3.20% p.a.	**(398)**	(279)	(336)
EV post cost of capital	**2,254**	1,673	1,856

Commentary

The increase in EV since December 2015 of £398m reflects the beneficial impacts of new business written during the year, the in-force business contribution, and the positive impacts of investment market movements, offset by the increase in the cost of capital.

Analysis of movement in embedded value

£m	6 months to 30 June 2016	6 months to 30 June 2015	Year ended 31 December 2015
New business contribution	**51**	65	340
In-force business contribution	**36**	42	3
Operating return (including new business)	**87**	107	343
Investment variances	**372**	(61)	(108)
Other economic variances	**(12)**	20	63
Non-operating return	**360**	(41)	(45)
Change in EV (before cost of capital)	**447**	66	298
Change in cost of capital	**(62)**	(17)	(74)
Capital injection less costs	**–**	65	65
Movement in fair value of subordinated debt	**13**	9	17
EV at start of period	**1,856**	1,550	1,550
EV at end of period	**2,254**	1,673	1,856

Commentary

The movement in the EV over the year is split into a number of categories:

New business contribution

The new business contribution of £51m represents the increase in EV from the two new business transactions written in the period.

EMBEDDED VALUE
CONTINUED

In-force business contribution

The in-force business contribution represents the net contribution arising from business already on the books. There are certain items, such as the expected return on net assets and unwinding of the discount rate margin on the VIF, which will emerge in a reasonably predictable way each month. In addition, there are periodic adjustments to the actuarial modelling and assumptions used in the calculation of the current reserves and future expected profits, such as the impact of changes to the assumed future longevity and expense assumptions, and the impact of variances between actual and expected experience over the year.

The in-force business contribution for the half year was £36m, compared to £42m for the same period of 2015. Within this, the expected return and discount rate margin unwind together contributed slightly over £7m per month. The reinsurance deal completed in the period together with the actual versus expected claims experience had an adverse impact on the EV of approximately £8m.

Non-operating return (investment variances and other economic variances)

Investment variances, in particular changes in interest rates, inflation and credit spreads, gave rise to a £372m profit on an EV basis in the first half of 2016. PIC's interest and inflation rate hedging strategy is focused on minimising interest rate and inflation risk on its Solvency II capital rather than on its EV. As such, the VIF is exposed to interest and inflation rate volatility, leading to a degree of variability in non-operating returns from period to period.

The impact of other general economic movements was a negative £12m in the first half of 2016. This loss was mainly due to the interest expense incurred on PIC's subordinated debt.

Change in cost of capital

The assumed cost of capital is 3.20% p.a., the same rate as at 31 December 2015. This reflects a deduction to account for the perceived opportunity cost of having to hold capital which is not immediately available for distribution to shareholders.

Change in fair value of subordinated debt

Under EV principles, PIC's subordinated debt is included at its fair value (based on the market value). During the period this decreased by £13m, providing an increase in the EV.

FINANCIAL INVESTMENTS

Summary

PIC Assets (£m)	ASSET POSITION AS OF 30 JUNE 2016					
	30 June 2016 Market Value (£m)	**30 June 2016**	30 June 2015 Market Value (£m)	30 June 2015	31 December 2015 Market Value (£m)	31 December 2015
Debt securities – government	**6,257**	**31.5%**	5,455	39.1%	5,449	32.8%
Debt securities – corporate	**11,577**	**58.3%**	6,618	47.4%	9,139	55.0%
Participation in investment schemes	**1,060**	**5.3%**	1,027	7.4%	1,216	7.3%
Mortgage and other asset backed securities	**313**	**1.6%**	436	3.1%	296	1.8%
Deposits with credit institutions	**652**	**3.3%**	294	2.1%	513	3.1%
Collateralised loan obligations	**–**	**–**	122	0.9%	–	–
Financial investments excluding derivatives	**19,859**	**100.0%**	13,952	100.0%	16,613	100.0%
Derivatives (net)	**(1,493)**		(337)		(735)	
Total investments	**18,366**		13,615		15,878	

Commentary

The overall level of financial investments increased by £2,488m, or 16% during 2016, driven principally by the assets acquired on new business, and the impact of investment market movements, offset by claims and reinsurance paid in the period.

The proportion of the portfolio invested in corporate bonds has increased by 3.3% to 58.3% since 2015 year end, whilst the holdings in other asset classes have reduced as a percentage of the overall book during the same period.

Impact on the financial results of the business following the outcome of the vote on the referendum to leave the EU

Following the results of the referendum on 23 June 2016 in which the UK electorate voted to leave the EU, there has been a significant amount of volatility in financial markets.

The Company has carefully considered whether the volatility which has arisen could cause any issues in relation to the valuation of its assets and liabilities. The vast majority of the assets which PIC holds – such as gilts and corporate bonds – are traded on regulated stock exchanges, and (as required by IFRS) the valuations recorded at any moment in time reflect the price quoted to sell the assets. These prices remained a reliable indicator of fair value as at 30 June 2016.

For a small number of assets (such as bilateral private placement deals), PIC uses model valuations as quoted prices are not readily available. Where available, these models use market observable inputs to derive the asset valuations used in the financial records. Management has not observed any indicators of material impairment in respect of these assets as at 30 June 2016.

Despite the volatility around 30 June 2016, management considers that these valuation methodologies remain appropriate for PIC to use to value its assets and liabilities. Should volatile conditions persist, management will continue to assess whether market quotes provide a sufficiently reliable basis for valuation purposes, or whether model-based valuations need to be reconsidered.

No defaults have been recorded in the first six months of 2016 (2015 full year: £nil).

FINANCIAL INVESTMENTS

CONTINUED

Credit rating of investment portfolio

The credit rating of PIC's assets at 30 June 2016 was as follows:

30 June 2016	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Loans and debt securities							
Debt securities – government	253	5,910	10	84	–	–	6,257
Debt securities – corporate	689	997	4,896	4,735	227	33	11,577
Mortgage backed and other asset backed securities	34	104	107	38	30	–	313
	976	7,011	5,013	4,857	257	33	18,147
Other assets							
Net derivative assets/(liabilities)	–	(179)	(962)	(352)	–	–	(1,493)
Participation in investment schemes	706	–	–	–	–	354	1,060
Deposits with credit institutions	–	–	652	–	–	–	652
	706	(179)	(310)	(352)	–	354	219

31 December 2015	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Loans and debt securities							
Debt securities – government	319	5,063	1	66	–	–	5,449
Debt securities – corporate	632	658	3,873	3,746	187	43	9,139
Mortgage backed and other asset backed securities	27	93	101	46	29	–	296
	978	5,814	3,975	3,858	216	43	14,884
Other assets							
Net derivative assets/(liabilities)	–	(115)	(445)	(175)	–	–	(735)
Participation in investment schemes	851	–	–	–	–	365	1,216
Deposits with credit institutions	–	–	513	–	–	–	513
	851	(115)	68	(175)	–	365	994

The primary ratings used are Bloomberg Composite: where this is not available, Standard & Poor's, Moody's or Fitch has been used where these agencies provide a rating. The remaining unrated assets are not classified by any of the three rating agencies.

FINANCIAL INVESTMENTS

CONTINUED

Measurement of fair value

The following table provides a view of the Company's financial investments according to how readily observable the market price is for the assets in question (known commonly as 'Level 1, Level 2, or Level 3', as defined in the accounting standard IFRS 13):

30 June 2016	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Debt securities – government	6,231	26	–	6,257
Debt securities – corporate	–	11,139	438	11,577
Mortgage backed and other asset backed securities	–	313	–	313
Deposits with credit institutions	652	–	–	652
Participation in investment schemes	706	354	–	1,060
Financial investments excluding derivatives	**7,589**	**11,832**	**438**	**19,859**
Net derivative assets/(liabilities)	**–**	**(1,493)**	**–**	**(1,493)**
Financial investments	**7,589**	**10,339**	**438**	**18,366**

31 December 2015	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Debt securities – government	5,449	–	–	5,449
Debt securities – corporate	–	8,742	397	9,139
Mortgage backed and other asset backed securities	–	296	–	296
Deposits with credit institutions	513	–	–	513
Participation in investment schemes	851	365	–	1,216
Financial investments excluding derivatives	6,813	9,403	397	16,613
Net derivative assets/(liabilities)	–	(735)	–	(735)
Financial investments	6,813	8,668	397	15,878

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.

There were no assets held at 30 June 2016 that were reclassified during the period (FY 2015: £604m transferred from Level 3 to Level 2). All other movements relate to acquisitions and disposals, realised and unrealised gains.

REGULATORY CAPITAL AND SOLVENCY

Surplus capital and solvency

£m	30 June 2016	31 December 2015
Own funds	**2,663**	2,370
Solvency capital requirement	**(1,825)**	(1,574)
Solvency II surplus funds	**838**	796
Solvency ratio[1]	**146%**	151%

1 Assumes an update to the transitional calculations at 30 June 2016

Commentary

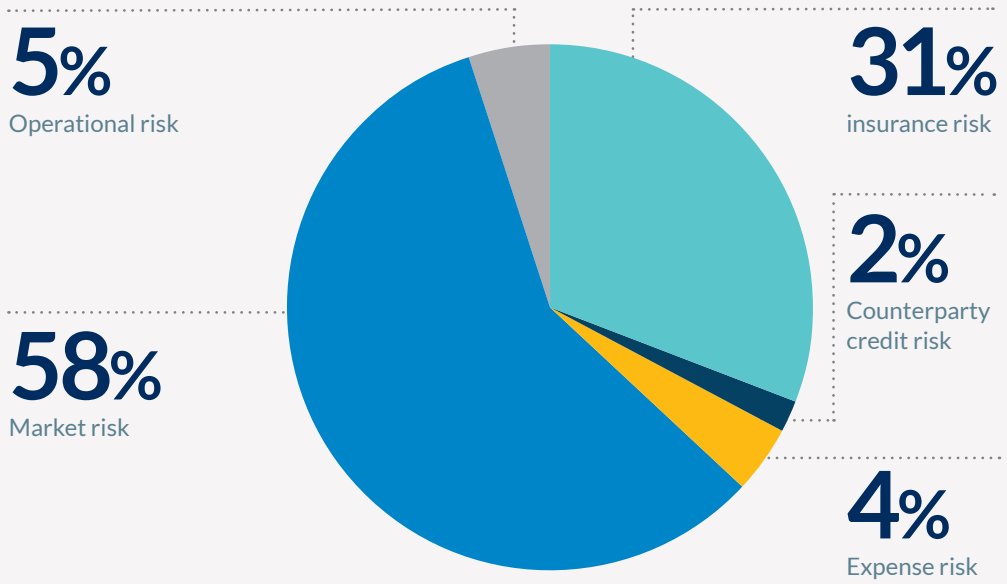
The figures provided for Solvency II basis represent the Company's balance sheet under the new solvency regime. This excludes any resources held at other companies in the Group.

PIC's solvency ratio dropped slightly during the period to 146%. New business written during the period reduced the solvency ratio, although this was offset by the impacts of reinsurance and market movements.

Analysis of solvency capital requirement by risk component

The chart below show's PIC's solvency capital requirement (before diversification between risk catergories and other benefits) split by main risk categories as at 30 June 2016. This reflects PIC's internal model which was approved by the PRA in December 2015.

Solvency capital requirement by risk component



REGULATORY CAPITAL AND SOLVENCY

CONTINUED

Sensitivity of reported metrics to economic changes

The table below sets out estimates of the sensitivity of the Company's results and metrics to changes in underlying economic conditions. All impacts are as at 30 June 2016.

	Regulatory solvency: impact on	
	Own funds (£m)[1]	Solvency ratio (%)[1]
As at 30 June 2016	2,663	146%
Interest rates		
Impact of 50bps fall in ten-year interest rates	110	–6.9%
Impact of 50bps rise in ten-year interest rates	(82)	6.9%
Credit spreads		
Impact of 25bps fall in credit spreads	(58)	–7.6%
Impact of 25bps rise in credit spreads	51	7.7%

1 Assumes recalculation of transitional deduction measures on technical provisions as appropriate, with interest rate sensitivities allowing for hedge rebalancing.

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. These risks are considered within the Company's approved full Internal Model for calculation of regulatory capital. Risks are also considered over the business planning horizon and stress testing and reverse testing as part of the Own Risk and Solvency Assessment ("ORSA") process which ensures that the Company has sufficient capital to meet its business plan objectives.

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 improves capital efficiency; it also acts to validate the assumptions made at the point of pricing. Reinsurance counterparties are continuously monitored to ensure they 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.

RISK MANAGEMENT
CONTINUED

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 when required.

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. 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 consistent with those anticipated.

Regulatory and conduct risk
Regulatory risk stems principally from the risk of changes in regulation or the interpretation of regulation. This could include changes to the way pension schemes are regulated as this could affect the attractiveness of the products we offer as well as changes to the rules or the way the relevant UK regulators (the PRA and the FCA) may interpret current legislation. The introduction of the Solvency II regulations means that IFRS surplus and regulatory surplus may differ due to the operation of the matching adjustment, transitional arrangements and the application of the Risk Margin. IFRS 4 Phase II is currently being developed and may increase or decrease the difference between accounting profits and changes in regulatory surplus.

Conduct risk stems from the way the Company conducts itself, particularly with its customers and with other stakeholders. 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. PIC maintains an open dialogue with regulators.

RISK MANAGEMENT
CONTINUED

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 internal audit function which is independent of management.

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.

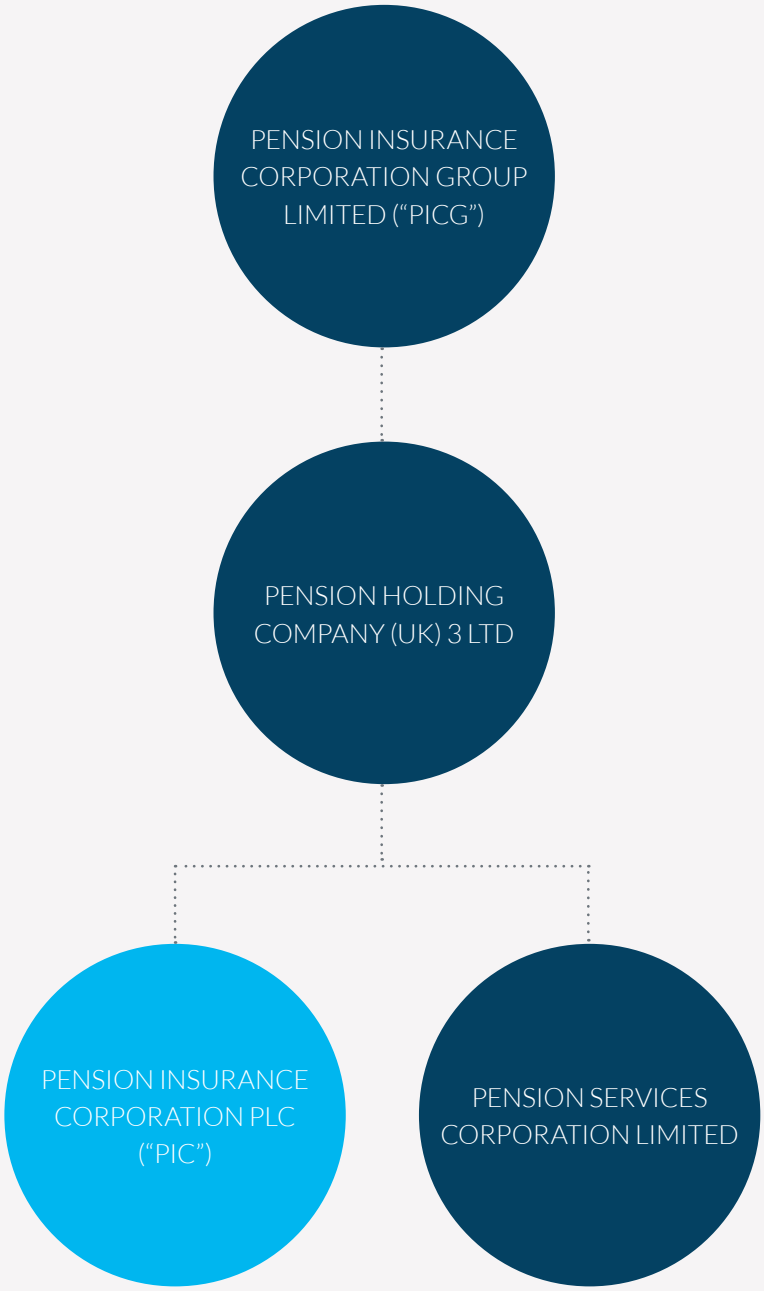
APPENDIX 1:
SUMMARY STRUCTURE OF PICG

Following the Group restructuring which took place in late 2015, the now-dormant companies in the Group structure which no longer serve a corporate purpose are being liquidated. The simplified Group structure of the Pension Insurance Corporation Group is shown to the right.

PICG structure chart

PIC is the main operating subsidiary in the Group. 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.

PICG structure chart



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