PENSION INSURANCE
CORPORATION

REMOVING RISK FROM PENSION SCHEMES

PENSION INSURANCE CORPORATION PLC
ANNUAL REPORT AND FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2016

VALUING OUR CUSTOMERS

Pension Insurance Corporation plc is a specialist insurer, providing long-term security for our policyholders' pensions, based on superior customer service, robust risk management, and expertise in asset and liability management.

Pension Insurance Corporation plc is 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). Its registered office is at 14 Cornhill, London EC3V 3ND.

2016 HIGHLIGHTS

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

European embedded value (£m)

£2,567m

2016	2,567
2015	1,856
2014	1,550
2013	1,226
2012	830

2016 premiums (£m)

£2,598m

2016	2,598
2015	3,755
2014	2,646
2013	3,663
2012	1,512

Underlying operating profit before tax (£m)

£177m

2016	177
2015	133
2014	116
2013	80
2012	66

Financial investments (£bn)

£22.6bn

2016	22.6
2015	16.6
2014	13.3
2013	8.9
2012	5.4

Customer satisfaction (%)

98.5%

2016	98.5
2015	99.3
2014	99.8
2013	99.3
2012	98.7

2016 MCEV (£m)

£2,579m

With effect from 1 January 2017, the Company has adopted the European Insurance CFO Forum Market Consistent Embedded Values Principles[1] ("MCEV Principles") for its Embedded Value measurement and reporting. The Company intends to follow the MCEV methodology going forward, and will no longer prepare financial information under the EEV principles.

Other 2016 highlights

- The first sizeable pension insurance transaction under Solvency II
- Continued investment in infrastructure: Thames Tideway, social housing and student accommodation
- 2016 solvency ratio of **164%**
- 2016 clients included Aon, Smiths Industries, ICI and GKN
- **£1 billion** Innovative £1 billion longevity reinsurance transaction
- **£250 million** of new equity capital raised by the Group
- Continued popularity of our unique policyholder events, with more than 3,000 attendees during the year
- Excellent levels of customer satisfaction
- **£250 million** of new debt issued
- New Chairman appointed

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CHAIRMAN'S STATEMENT

Jon Aisbitt, *Chairman*

2016 was indisputably a year of change and unpredictability. Brexit, Trump, a – perhaps radical – change of leadership in the UK, combined with market volatility and continued political uncertainty, impacted the financial position of many financial institutions, including those of our clients, corporate pension funds. Headlines about the travails of the BHS and British Steel pension schemes led to a parliamentary inquiry with recommendations the Government is still considering. In the pension insurance market, the introduction of the new Solvency II regulatory regime has dominated the year.

From a personal perspective, I was delighted to take up the role of Chairman of Pension Insurance Corporation in October. As I said at the time, the three things which I always look for when investing in a company are the potential for growth, evidence of a talented and committed management team and a clear sense of purpose. When conducting my background research on the Company, I became convinced that PIC has all three. Since taking up the role, I have found that my confidence was fully justified in the talent and commitment of the whole team: Board, management and employees. There is a clear sense of purpose in the Company and much work has been done to ensure that our values remain a constant as the business develops in a changing world. PIC's reputation for customer care derives from this sense of purpose.

We are pleased to have been able to deliver strong underlying operating profit before tax of £177m, with Embedded Value (EV) growing over the year to £2,567m at 31 December 2016. Over the four years since end 2012, PIC's EV has grown by more than 200%, which is underpinned by an underlying organic annual growth rate of over 20% p.a. Through managed, disciplined growth, the business has delivered tangible shareholder value. But shareholders invest in a business for its future, not its past. A key factor which makes PIC an attractive investment is the future growth prospects of the Company, which are considerable. PIC has built up a substantial store of assets in the business which can ultimately be paid back to shareholders. The growth opportunity for the pension insurance market will allow the Company to invest current and emerging surplus capital at attractive risk-adjusted returns and thus enable PIC to grow this underlying shareholder value in the future.

It is therefore vital that the Board continues to exercise the right controls and oversight over the business, both to protect our policyholders and to grow the business on a secure and sustainable basis. As outlined in the Risk Management and Governance sections of this document, PIC has a robust corporate governance framework in place. At PIC, the Board Committees are directly linked into our core business: investment and risk management are what we do.

Through the year, the Board and its committees have focused on a number of key areas. Detailed consideration has been given to stress and scenario testing of the business and its ability to withstand external shocks and adverse events. The Board reviewed pricing methodology under the new Solvency II regime and later in the year spent some considerable time evaluating the impact of the EU referendum result on PIC and the investment portfolio. The Board approved a debt issuance, through which the Group raised £250m of additional regulatory capital in November. This took the total amount of new capital raised in the year to £500m, with existing shareholder Reinet investing a further £140m alongside £110m from new investor Legend Holdings into the ultimate parent company. A final key area for the Board was reviewing the Company's values, standards and approach to policyholder care.

It is clear to me that the experience and quality of our people are core strengths of the business. The Board and management have a clear vision and strategy and it is for these reasons that I relish the challenges and opportunities that the years ahead will bring.

CHIEF EXECUTIVE OFFICER'S REPORT

Tracy Blackwell, *Chief Executive Officer*

Business development

I noted in our half year results summary that the first six months of 2016 were eventful. I think we can safely extend that description to the second half of the year. With insurers bedding down the transition to Solvency II, political risk translating into significant market volatility, and defined benefit pension funds continuing to wrestle with large and volatile deficits, there was no shortage of challenges throughout the year.

As a specialist insurer, our purpose is straightforward to define: it is to pay the pensions of our policyholders, both now and for the full term of their policies with us. Our expertise and specialisation have allowed us to develop a deep understanding of the factors that could prevent us fulfilling this purpose, as well as a robust, sophisticated approach to managing risk. So we positioned ourselves very well to meet the types of challenges we faced in 2016 and to take the opportunities that arose to build the business. I am therefore delighted, but not at all surprised, that the Company continued to perform very well through the year.

We insured £2.6bn of pension liabilities during the year on terms consistent with our long-term IRR targets, and maintained our long-term market share of about 26%. Our solvency ratio increased to 164% at the year end, due to capital raised during 2016, but also the effectiveness of our hedging strategies. PIC is very much in a growth phase, building an asset pool which will throw off increasingly large cash flows for very many years. As a result of this, our underlying operating profit was £177m, up from £133m last year, reflecting our continued growth and store of long-term future profits.

Our investment strategy means we have an asset portfolio that is flexible and resilient. In spite of significant volatility, it performed extremely well, due to the very close matching of our asset and liability cash flows. We continue to invest in infrastructure, including in social housing and student accommodation, through bilateral deals that are structured to be beneficial for both parties.

Bulk annuity market

The market for pension insurance during the year was £10.2bn which is smaller than was seen in 2015, when the market size was £12.3bn. The first half of the year was relatively quiet and this, in our view, reflected in part the introduction of the Solvency II regulatory regime as well as volatile market conditions. In the second half of the year, after the Brexit vote, we saw a significant increase in new business volumes, writing 15 transactions compared with 2 in the first half of the year.

We also saw a notable increase in the very largest pension schemes looking to de-risk through insuring slices of their pension scheme liabilities, and thereby to fully insure their pension schemes over a number of years. The growth in this large market segment, in addition to the strong volumes seen in the second half of the year, point to a strong pipeline of potential business for the foreseeable future.

We were therefore delighted to be able to raise £500m of new capital in the year to allow us to meet this projected increased demand. We raised £250m of equity capital in June. In November, we took advantage of a window of opportunity in the markets and issued a second tranche of debt, raising a further £250m.

Stakeholder views

We conducted research into the views of two crucial groups of stakeholders in 2016. In the first, the Institute of Customer Service surveyed our existing trustee clients. It was very pleasing to see that every single one of the trustees who responded would recommend PIC to another trustee.

The second survey was of our employees, 95% of whom believe PIC is customer-focused and 90% of whom feel proud to work for PIC.

I don't believe that we achieved these results by accident. Our success flows directly from a strong sense of purpose and a culture and set of values on which the whole team is focused. This is something that we will be building on in the coming years.

Finally, we were delighted to welcome Jon Aisbitt, our new Chairman, in October. He replaced Sir Mark Weinberg, a legend in the insurance industry, who retired from PIC at the age of 85. Jon really has hit the ground running and I very much look forward to working with him.

Alongside our exceptional customer service track record, the Company has an enviable financial track record, demonstrating consistent growth and significant value generation over many years. Our results are a credit to the whole team and I am confident that we are ideally placed to continue building the business on a focused, secure and sustainable basis.

STRATEGIC REPORT

FOR THE YEAR ENDED 31 DECEMBER 2016

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 2016.

Principal activity

The principal activity of PIC is providing insurance annuity products to UK defined benefit occupational pension funds and their members (commonly referred to as "pension insurance" or "bulk annuities").

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 to an insurance company the risks and liabilities arising from the benefit promises made to pension fund members. 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's ultimate parent company is Pension Insurance Corporation Group Limited ("PICG").

Strategy

PIC's continued strategy is to use its capital resources and expertise to provide long-term security for its policyholders and to generate target returns for its shareholders by writing pension insurance for UK defined benefit pension funds.

PIC aims to deliver these objectives through:

- a strong and sustainable pipeline of new business: PIC provides tailored products to meet the specific requirements of each of its clients, dealing with complexity through innovation and flexibility, and offering price certainty where this is a requirement;
- risk-adjusted asset performance: PIC aims to source and acquire long-dated assets which provide investment returns over and above those needed to meet the liabilities assumed, whilst optimising the impact of those assets on capital requirements and reserve calculations;
- hedging out unwanted risks: PIC seeks to pass on inflation, interest rate and currency risk through hedging strategies, and to manage its longevity risk through the use of reinsurance;
- a focus on administration efficiency and customer service levels: PIC aims to provide policyholders with a high-quality service, adhering to the requirements and principles of the FCA's "Treating Customers Fairly" principles, whilst building on its reputation in this key area; and
- a focused use of skills and resources: PIC aims to be efficient in deploying resources to manage and operate its business, and uses services from outsourcing partners where it is efficient and cost effective to do so.

The escalating financial costs 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 pension fund trustees and 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 of the insurance offering. 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 metrics by which to measure the risk and profitability of the business.

Financial KPIs

	As at 31 December 2016	As at 31 December 2015
Measures of profit or loss		
Underlying operating profit before tax	**£177m**	£133m
Operating profit before tax	**£148m**	£188m
IFRS profit before tax	**£276m**	£104m
Measures of assets and liabilities		
Embedded value*	**£2,567m**	£1,856m
Measures of financial strength		
Solvency II regulatory solvency ratio	**164%**	151%**
Measures of income and expenditure		
New business (gross of reinsurance)		
Premiums written	**£2,598m**	£3,755m
Cost base		
Operating expenses as a % of closing financial investments under management	**0.33%**	0.42%
Non-financial KPIs		
Customer satisfaction ratio	**98.5%**	99.3%

* From 1 January 2017, the embedded value methodology will be updated to take into account the Solvency II regulatory capital regime as explained below.

** Pro-forma. The Solvency II regime came into force on 1 January 2016.

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 pension insurance 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") analysis was 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.

With effect from 1 January 2017, the Company has adopted the European Insurance CFO Forum Market Consistent Embedded Value Principles[1] ("MCEV Principles") issued in April 2016 for its EV measurement and reporting. The Company has also updated its EV approach to reflect the Solvency II regulatory framework. The starting point is the Solvency II 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 into the actuarial valuation of the in-force business. Further adjustments to the regulatory balance sheet are made in respect of the subordinated loan notes, frictional cost of capital and cost of residual non-hedgeable risks so as to arrive at a more appropriate quantification of the Company's value.

The Company intends to follow the MCEV methodology going forward, and will no longer prepare financial information under the EEV principles.

Based on this new methodology, at 31 December 2016 the embedded value on MCEV basis was £2,579m.

Results for the year ended 31 December 2016

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:

	2016 £m	2015 £m
Return earned on insurance book	**122**	87
Expected return earned on surplus assets	**55**	46
Underlying operating profit before tax	**177**	133
New business and reinsurance	**(26)**	59
Other changes to in-force business	**(3)**	(4)
Operating profit before tax	**148**	188
Non-operating profit/(loss) before tax	**128**	(84)
IFRS profit before tax	**276**	104

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 2016 was £177m (2015: £133m). The return earned from the insurance book (£122m) is higher than 2015, reflecting the growth in the value of financial investments over the past 12 months. The expected return on surplus assets (£55m) is higher than 2015, reflecting the increase in the amount of surplus assets during the year.

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 that are within management discretion.

During the year, PIC completed a further 17 (2015: 13) new transactions with pension schemes, with a total premium amount of £2.6bn (2015: £3.8bn).

PIC concluded two longevity swap (2015: three) reinsurance transactions during the year which covered longevity risk on c.£1.4bn (2015: £3.8bn) of insurance liabilities.

Taking into account the requirement to set up technical provisions in respect of liabilities acquired in new business transactions, together with the costs incurred, but offset by the impact of reinsurance completed during the year, these items contributed negative £26m (2015: £59m profit) to operating profits.

Non-operating profit before tax

Non-operating profit before tax for the year was £128m (2015: £84m loss). Non-operating profit encompasses the impacts of the wider economic environment on the Company, as well as interest expense on subordinated loan notes, 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 Company's preferred hedging benchmark for interest rates and inflation rates is the regulatory Solvency II balance sheet. This does however create basis risk for the IFRS results. Significant interest and inflation rate volatilities seen during the year as well as narrowing credit spreads over the period resulted in a £153m IFRS profit. Such profits are not expected to arise to the same extent going forward as the hedging benchmarks across IFRS and Solvency II basis become more closely aligned. This gain was offset by a £22m interest expense and a net £3m loss from other minor items.

Balance sheet review

Balance sheet extract	**2016 £m**	2015 £m
Reinsurance assets	**2,522**	1,917
Financial investments	**22,594**	16,613
Derivative assets	**9,320**	4,900
Gross insurance liabilities	**(21,741)**	(16,480)
Derivative liabilities	**(10,654)**	(5,635)

By the end of 2016, PIC had total financial investments of £22.6bn, compared with £16.6bn at the end of 2015. The increase of £6.0bn over 2016 was principally due to the effect of the new business premiums received and proceeds from new equity and debt capital as well as market movements and reinsurance contracts during the year, less claim payments made to policyholders.

The increase in insurance liabilities since December 2015 reflect the new business written during 2016, and the impact of market movements (particularly falls in long-term interest rates) on PIC's assets and associated insurance liabilities during the year.

Derivative assets and derivative liabilities have grown significantly since 31 December 2015. This largely reflects the market movements referenced above, as well as changes made to the Company's interest and inflation hedging approach to reflect the adoption of Solvency II at the start of 2016. The net derivative position has increased from £(0.7)bn to £(1.3)bn due mainly to currency movements following the Brexit referendum.

Embedded value

The increase in EV since December 2015 of £711m reflects the beneficial impacts of new business written during the year, the in-force business contribution, the addition of new share capital, and the positive impacts of investment market movements, offset by increases in the cost of capital.

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Other operational highlights

At 31 December 2016, 68% of PIC's total longevity exposure on a regulatory solvency basis was reinsured to third party, investment grade reinsurer counterparties (2015: 71% on a comparable basis).

The Company is now responsible for the pension payments of 134,900 individuals (2015: 132,100). Payment of annuities grew by 24% in 2016 to £600m (2015: £484m) mainly through new business written during the year and previous year. Total claim amounts paid were £797m (2015: £581m), an increase of 37%, as the growth in annuity payments was supplemented by a growth in lump sum payments and transfers out compared with the prior year.

At the end of 2016, PIC had 80,900 current individual policies in issue, in respect of 74 pension schemes, compared with 81,000 in respect of 64 schemes in 2015. The number of individual policies in issue reduced by 4,000 as a result of a winding up lump sum exercise carried out during the year, whilst a number of individual policies were written as schemes converted to full buyout. The remaining policies are either in the transition process, which includes the verification of policy 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 trustees and no individual policies are issued. The number of policies in issue will also be 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.

Regulatory solvency

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.

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 PIC's case the PRA.

In December 2015, the PRA confirmed its approval of PIC's internal model, which is a better reflection of the risk profile of the Company's business than the standard formula. 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.

The Company has complied with the solvency capital requirements under Solvency II as set out in the relevant PRA rules (see Note 18) throughout the year. At 31 December 2016, the Company's solvency ratio on the Solvency II basis was 164% (2015: 151%) and it had surplus funds which were £1,222m (2015: £796m) in excess of solvency capital requirements.

PIC has been granted a regulatory waiver, such that it is required to submit only one regulatory Solvency & Financial Condition Report ("SFCR") by 1 July 2017, covering both PIC and the PICG Group. This is in place of submitting separate reports for each of PIC and the Group. Once submitted the document will be available on the Company's website.

Material contracts

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

Risk management

PIC has a key focus on effective risk management, facilitated through a strong risk-aware culture throughout the organisation.
This is designed to:

- protect the Company's obligations to policyholders and to continue to treat them fairly; and
- seek to grow shareholder value through making informed risk-return based business decisions resulting from a balanced awareness of the prevalent opportunities and threats. Critically, the Company will only seek to take on risks which it has the capability to understand and manage.

The key features of the risk management system are explained in more detail below.

Governance and control framework

PIC operates a three lines of defence model as part of its Risk Governance Framework. Under this model, the "First Line" is the business operating areas, which have prime day-to-day responsibility for management of risks within the agreed risk management framework; the "Second Line" consists of independent risk and compliance functions and risk management committees, with responsibility for setting and monitoring the risk framework within which the First Line operates, and the actuarial function; and the "Third Line" is Internal Audit, External Audit and the Audit Committee which have responsibility for assessing operation of the risk and control environment.

Risk governance framework

The role of the Board and its Committees is explained more fully in the Corporate Governance Overview.

First Line			Second Line	Third Line
THE BOARD				
Origination Committee	ALM Committee	Rem/Nom Committee	Board Risk Committee	Audit Committee
	ALM Operating Committee	Executive Committee	Management Risk Committee	
Discretions Committee	Investment Committee	Capital Resources Committee	Model and Data Governance Committee	
Information Security Council	Policy Data Forum		Operational Risk Committee	
BUSINESS AREAS			Risk Function	Internal Audit
			Head of Actuarial Function	External Audit
			Compliance Function	

BUSINESS AREAS
Origination
Asset Liability Management (ALM)
Administration and investment operations
Finance, finance actuarial & longevity risk managament
Human resources & IT
Corporate communications
Legal
Strategy and business development

Line 1
- Operational line management responsible for delivering actual performance aligned with the plan
- Responsible for day-to-day management of risk
- Must comply with all group strategies, policies and risk appetite

Line 2
- Independent of First Line
- Responsible for providing the framework within which the strategy is delivered
- Provided information, oversight, support and challenge to decision making
- Advises Board on forward looking assessment of threats and opportunities

Line 3
- Provides independent assurance on the overall systems of internal control

PIC's risk management framework has the objective of linking its business strategy objectives and its approach to risk management through the key business processes of the Company.

BUSINESS STRATEGY
(including how the Company makes money and funds the business)

Risk strategy and preferences (including approach to taking risks)

Risk profile, appetite, limits and business risk controls (including key risk indicators)	Risk and capital assessment (including risk identification and measurement)	Governance and control framework (including committees and policies)	Management information (including stress and scenario testing, monitoring, reporting and communication)

Technology and infrastructure

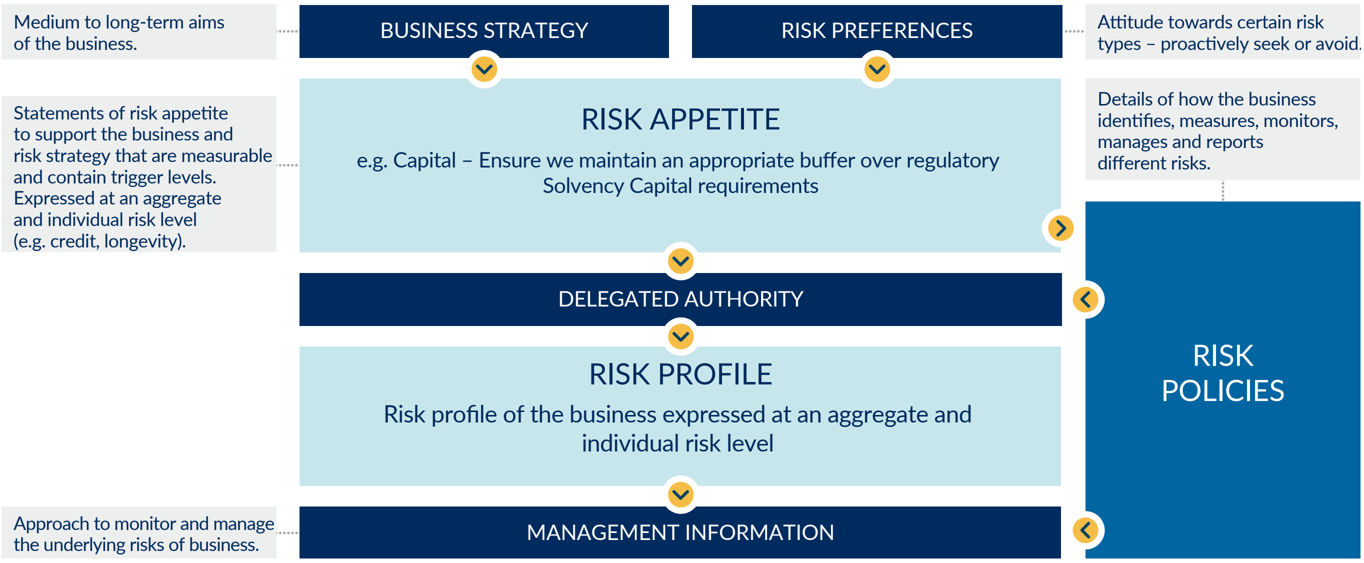
Risk culture (including people, change and reward)

New business development and pricing	Asset origination, ALM and hedging	Administration and customer service	Capital management (e.g. reinsurance)	Internal and external reporting	Performance management and remuneration

RISK MANAGEMENT CONTINUED

Risk appetite framework

The risk appetite framework considers the material risks to the business, its strategy and to PIC's reputation with trustees, policyholders and investors. It also includes risk tolerances and limits, and outlines the roles and responsibilities of those who implement and monitor the Company's risk appetite.



Risk strategy and preferences

PIC's risk preferences define the Board's preference towards taking different types of risks that the Company may be exposed to in pursuit of its strategic objectives. Risks are categorised as those the Company actively seeks, those the Company seeks to minimise and those the Company seeks to avoid or transfer. The Board's preferences for taking risk are reflected in the development of the risk appetite statements and associated limits.

Actively seeks risks that are:	Minimise risks that are:	Avoid or transfer risks which:
• aligned with business strategy, and expectations given to policyholders and other stakeholder groups; • within the expertise, experience and capacity of its staff to understand, price, monitor and manage; • within the capabilities and capacity of its systems to price, monitor and manage; • expected to contribute to risk-adjusted return on capital that PIC needs to hold against the risk; • beneficial to enhancing diversification benefits (i.e. reducing the aggregated risk capital requirement) when viewed holistically across the business; and • transferable and scalable (ability to dial up and down exposures without deteriorating the risk-adjusted return on capital).	• necessary to incur as a byproduct of exposure to the risks the Company actively seeks; • necessary to incur as a byproduct of avoiding risks it actively wishes not to be exposed to; and • necessary to incur as part of being authorised to conduct insurance business in a competitive market place (i.e. incurred as part of "being in business").	• give rise to undue concentration of risk within PIC's portfolio; • jeopardise the Company's ability to meet obligations to policyholders, staff and other stakeholders; • are terminal to the strategy of the Company should they arise; • are not within the experience, expertise and capacity of its staff to price, understand, monitor and manage; and • are not within the capabilities and capacity of its systems to price, monitor and manage.

Risk appetite

PIC has a risk appetite which is closely aligned with its business strategy. This is defined for the medium term (typically three to five years) and reviewed annually.

The Company has developed risk appetite metrics, which are designed to align with supporting the safe delivery of the business strategy objectives. A target, threshold and limit are set for each of the risk appetite metrics. As one of the risk appetite metrics passes through a threshold or limit, it necessitates escalation and possible management action.

Risk assessment and measurement

PIC's risk management system outlines how risks are identified, assessed, controlled and managed. Risk assessment is a continuous process incorporating regular monitoring, stress and scenario testing and deep dive reviews.

Quantifiable and material risks over the coming year which are mitigated through holding capital are measured using PIC's internal model which is used to determine the solvency capital requirements (SCR) for the business. Presently, the categories approved by the Board and used in the internal model are:

- Market risk
- Counterparty risk
- Insurance risk
- Expense risk
- Operational risk

Those quantifiable and material risks for which capital is not held as part of their risk mitigation treatment or which are expected to occur at a future date over the planning horizon, in excess of the 12-month horizon of the SCR calculation, are not included within PIC's internal model, and are instead measured by considering their impact as part of the stress and scenario testing programme; and also discussed in risk and solvency reports, such as the Own Risk and Solvency Assessment.

Management information

A consolidated pack of management information is regularly presented to Executives and the Risk Committee of the Board detailing the position of the business against the risk appetite metrics and expected evolution of these positions.

Own Risk and Solvency Assessment

The annual Own Risk and Solvency Assessment (ORSA) report provides an ongoing assessment of the risks to PIC's business plan and solvency over the five-year business planning horizon.

The ORSA report summarises the output of a process which addresses the following questions:

1. What are the Company's current risks (risk profile)?
2. What is the Company's assessment of the capital it currently needs to hold to cover these risks (economic capital)?
3. What risks does the Company want to be exposed to (the target position)?
4. If the Company is exposed to these risks, what capital will it need to hold?
5. How is the Company going to get from current position to target position (the business plan)?
6. What could go wrong over this time horizon?

The ORSA process comprises a set of static and dynamic documents that are compiled and maintained over the year.

The ORSA documents are reviewed and approved throughout the year by the Board. These are summarised in the annual ORSA report.

Principal risks and uncertainties

The principal risks affecting the Company's business and its strategy for managing those risks are set out below. More details are also included in Note 15 to the financial statements.

Risks and uncertainties	Trend and outlook	Mitigation
Political intervention or changes in regulation and legislation may have a detrimental impact on PIC's strategy.	Retirement solutions including pension provisions remain high on the political and regulatory agenda. The current Government increasingly focused on allowing individuals to access their pension savings through increased pensions freedoms. The impact on PIC's strategy has been limited as actions to date have not directly affected the bulk annuity market. More recent developments such as the potential provision of a secondary annuity market have been dropped in light of fears of consumer protection and poor value for money with the Treasury highlighting that most pensioners should be better off keeping their annuity. While Solvency II was implemented in 2016, challenges remain in ensuring the regulatory regime is proportionate and cost effective for the insurance sector. Most recently, the DWP issued a Green Paper on Security and Sustainability in Defined Benefit Pension Schemes. As a successful consolidator of pension schemes' assets and liabilities, PIC welcomed the paper and will provide a full and considered response.	PIC maintains an open dialogue with regulators and closely monitors regulatory and legislative developments. Regular horizon scanning helps identify key risks to best position PIC's strategy. PIC will contribute to the debate arising from the DWP Green Paper on defined benefit pension schemes.

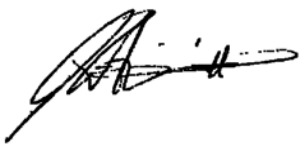
RISK MANAGEMENT CONTINUED

Principal risks and uncertainties continued

Risks and uncertainties	Trend and outlook	Mitigation
Movements in financial markets and conditions in the broader economy may lead to an adverse impact on PIC's capital position.	Ongoing uncertainty and increased volatility in the UK and global financial markets are expected to continue, reflecting the increasing uncertainty of the UK's relationship with the EU, the ongoing strength of the UK's economy together with uncertainty around global trade and a rise of increasingly protectionist politics. While the impact of the UK's decision to leave the EU is not expected to significantly impact PIC's business model, this will be closely monitored going forward.	Management closely monitor the performance of PIC's balance sheet in response to economic conditions and where appropriate takes preventative action. In particular, PIC actively hedges its balance sheet against adverse movements in financial markets. While the models used for assessing and managing the risks on PIC's balance sheet are subject to a rigorous governance and control environment, PIC remains exposed to residual model risk should experience diverge.
Prolonged low interest rates may result in a drag on PIC's capital position and cause difficulties sourcing appropriate long-dated assets.	The introduction of Solvency II has led to insurers having to hold a risk margin on their balance sheets in respect of the potential cost of capital required for transferring the insurance liabilities to a third party at any point over the policy lifetime. Prolonged low interest rates increase the present value of this component of the balance sheet. The impact of low interest rates disproportionately impacts the annuity market due to the very long-term nature of the business and this drives the relative size of the risk margin on the balance sheet.	While PIC's hedging programme helps protect the capital position against adverse movements in interest rates, the costs associated with maintaining this under a prolonged low interest rate environment may impact on PIC's profitability.
In dealing with issuers of debt, PIC is exposed to the risk of financial loss through defaults.	While PIC has historically experienced low levels of default in the portfolio, this risk continues to be significant given the growth of PIC's balance sheet and the increased volatility of financial markets.	PIC selects and monitors its investment holdings very closely. Where external managers are used, only selected, high quality and expert managers are used to place our investments. Changes to PIC's investments are subject to a rigorous governance and control environment. This includes ongoing monitoring of holdings to ensure credit quality is appropriate, and that timely action can be taken to manage exposures. PIC maintains in-house expertise for evaluating, rating and managing bilateral debt to ensure it is able to source appropriate transactions.
In managing risk exposures, PIC enters into contracts with third parties such as reinsurance and swap counterparties. These third parties may fail to honour their obligations in a timely manner.	The move to Solvency II and the increased volatility in the financial markets has increased the importance of third party risk transfers.	PIC only transacts with highly rated reinsurance counterparties, and also includes collateral provisions where necessary to ensure that any monies due under the contracts are suitably secure. All of PIC's swaps are placed with bank counterparties. All swaps that are entered into are fully collateralised on a daily basis to ensure that any potential losses are minimised.
PIC's insured policyholders may live for longer than was originally assumed when pricing new business.	PIC is exposed to factors that may lead to increases in life expectancy, such as improvements in medical science beyond those anticipated.	PIC regularly reviews its longevity experience to ensure assumptions remain appropriate, and continually seeks to enhance its understanding of the evolution of annuitant mortality. PIC uses reinsurance, where it is economic to do so, to pass a proportion of risk on to established, highly rated reinsurance companies. Reinsurance pricing also acts to validate the assumptions that have been made at the point of pricing.

Risks and uncertainties	Trend and outlook	Mitigation
There is a risk that 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 in line with our strategic objectives. Generally, this would result in reduced profits, but in extreme circumstances this could lead to losses.	While the bulk annuity market continues to grow and attract new entrants, PIC's historical experience in the sector and pricing discipline and governance gives management comfort that the risk can continue to be managed within risk tolerances.	PIC has clear and detailed processes in place to ensure that any new business sought is within its risk appetite, and that all assumptions that go into the new business quotation process are appropriately checked. This process is subject to a rigorous governance and control environment. PIC also has a post-completion reconciliation process to ensure that the terms on which any new business proposal was entered into were those anticipated.
The financial services sector is increasingly becoming a target for cyber-crime with the increased use of technology by industry participants. Inherently, PIC is exposed to the risk that third parties may seek to disrupt its operations, steal personal data or perpetrate acts of fraud. A significant cyber event could result in reputational damage and financial loss.	The drivers of this risk continue to evolve rapidly as technology is changing the way firms do business and society operates. The financial services sector has seen a significant increase in the number of attempts by third parties to seek and exploit vulnerabilities in IT systems. The threats include network intrusions to steal data, electronic diversion of funds and blocking of responses to false electronic postings to exploit stock price movements.	PIC maintains a robust IT environment to ensure protection of its data and security of its systems and those of outsourced or third parties that we work with. PIC works with its business partners to maintain controls and proactively address emerging threats. As this is a "man-made" risk, there will always be a residual risk. The IT environment is regularly tested internally and externally for resilience purposes. This also contributes to the overall awareness of the latest threats and how these may impact PIC.

On behalf of the Board



Jon Aisbitt
Chairman

21 March 2017

14 Cornhill
London
EC3V 3ND

CORPORATE GOVERNANCE OVERVIEW

STRUCTURE OF THE BOARD AND BOARD COMMITTEES

The role of the Board

The Company is led by a Board of Directors (the "Board"). The appointment of the Directors is pursuant to the Articles of Association last updated on 9 June 2014. The Board comprises an independent non-executive Chairman, the Chief Executive Officer, the Chief Financial Officer and ten Non-Executive Directors. Biographical details of all Directors are included in the Annual Review. The Directors are covered by the Company's Directors' and Officers' indemnity insurance policy.

The Directors who served during the year are listed on page 14.

The Board's primary focus is on promoting the sustainable long-term success of the Company and providing leadership within a framework of prudent and effective controls which enable risks to be assessed and managed. The Board influences the Company by promoting high standards of conduct and an ethical culture across the organisation. The Board believes that good governance means strong values and doing what is right for employees, policyholders, shareholders and other stakeholders. The Board acknowledges its collective responsibility for setting the Company's strategic aims, ensuring that the necessary financial and human resources are in place and reviewing management performance. The principal responsibilities of the Board are included in its terms of reference which also list matters specifically reserved for decision by the Board.

How the Board operates

The Board is led by the Chairman, Jon Aisbitt, who was appointed on 14 October 2016, replacing Sir Mark Weinberg who had served as the Chairman of the Board since 2012. The day-to-day management of the Company is led by the Chief Executive Officer, Tracy Blackwell. The responsibilities of the Chairman and the Chief Executive Officer are clearly defined and agreed by the Board. As Chairman, Jon focuses on the leadership of the Board, ensuring its effectiveness and promoting a culture of openness and constructive debate among the Directors. He also advocates effective, fair and transparent communication with stakeholders including policyholders, employees and shareholders. As Chief Executive Officer, Tracy leads the executives in the day-to-day management of the business and effective implementation of Board decisions.

The Board meets formally on a regular basis. In 2016, it held six meetings and attended to various matters by way of written resolutions. The Chairman and the Company Secretary ensure that, prior to each meeting, the Directors receive accurate, clear and timely information which aids the decision making process. The Board materials are distributed through a secure board portal. The Board's work is not limited to scheduled formal Board meetings. There is an ongoing dialogue between the Executive and Non-Executive Directors outside the formal meetings.

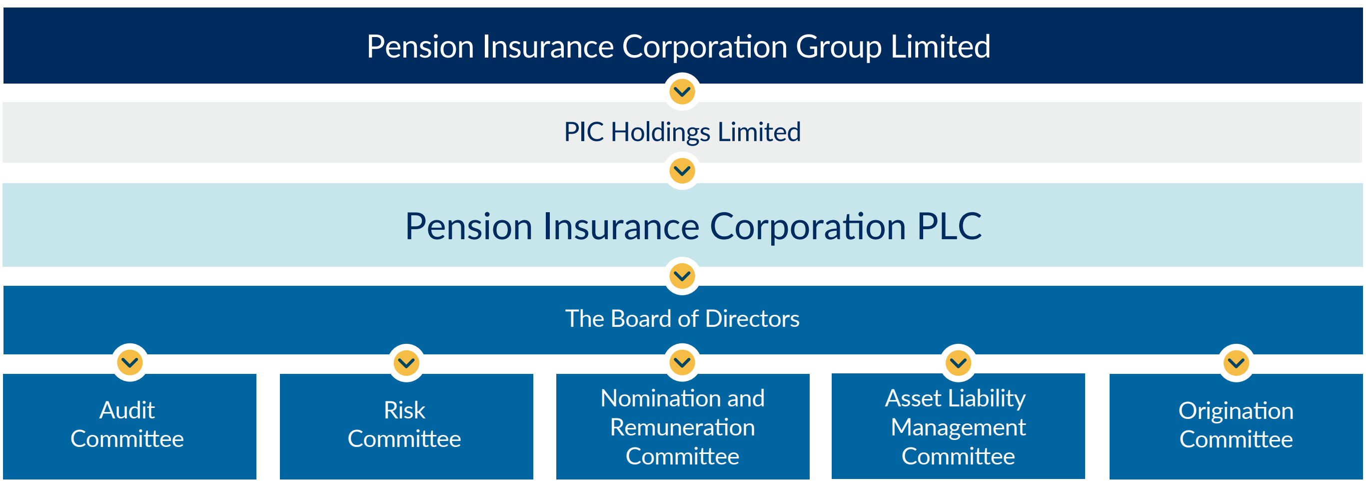
Board effectiveness

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. The Board encourages and supports each Director to regularly update and refresh their skills and knowledge. The Company arranges a formal induction for all new Directors and there is a Board training programme in place. The Board is aware of the other commitments of the Directors and considers that these do not conflict with the commitment to the Company.

The Board evaluates its effectiveness each year and identifies any areas for development. Every three years the evaluation process is facilitated by an external consulting firm. In 2016, an external evaluation of the Board's composition was carried out which focused on the skills and expertise of each of the Non-Executive Directors and the degree to which they could be regarded as independent. The review was completed with a view to assisting the Board to be compliant with the recommendations of the UK Corporate Governance Code. The Board achieved a majority of independent Directors in 2016.

Governance framework

The Board delegates specific responsibilities to five Board Committees which assist the Board in its oversight and control of the business. The Committees include Audit, Risk, Nomination and Remuneration, Asset Liability Management and Origination. Members of the Committees are appointed by the Board on recommendation of the Nomination and Remuneration Committee in consultation with the Committees' chairmen. There are a number of executive and operating committees which assist executives with business management and oversight.



Nomination and Remuneration Committee

The Nomination and Remuneration Committee comprises four Non-Executive Directors. Nick Lyons chairs remuneration matters and Jon Aisbitt chairs nomination matters. The Committee meets at least five times a year or as required by business needs. The Committee's role is to regularly review the structure, size and composition (including the skills, knowledge, experience and diversity) of the Board and make recommendations to the Board with regard to any changes. It determines and agrees with the Board the framework or broad policy for the remuneration and recruitment of the Company's Chairman, Non-Executive Directors, Chief Executive, the Executive Directors and other members of the executive management.

The Committee met eight times in 2016 and its primary focus was on the external review of the Board composition and succession plans which led to a search for a new Chairman, recruitment of three Non-Executive Directors and a Chief Risk Officer. The Committee reviewed the Talent Management programme, overall remuneration arrangements and approved share incentive plans. The Committee also reviewed and approved the PIC Remuneration Policy Statement.

Asset Liability Management Committee

The Asset Liability Management Committee comprises four Non-Executive Directors. Arno Kitts was appointed Chairman of the Committee on 1 July 2016 and took over from Chris McKechnie who stepped down from the Board on 25 May 2016. The Committee meets at least five times a year or as required by business needs. The key role of the Committee is to oversee the management of all aspects of investment policy and strategy for the Company and provide oversight of the operation of the Company's investment portfolios within the established strategy and risk framework.

In 2016, the Committee met six times and its primary focus was on reviewing new asset strategies to support new business pricing in a more competitive environment, reviewing the approach to hedging and an ongoing oversight of the Company's portfolio and performance.

Origination Committee

The Origination Committee comprises two Executive Directors and four Non-Executive Directors. It is co-chaired by Tracy Blackwell and Jon Aisbitt who was appointed co-Chairman of the Committee on 14 October 2016 and took over from Sir Mark Weinberg. The Committee meets at least six times a year or as required by business needs. The key role of the Committee is to oversee the management of all aspects of Company's new business and reinsurance origination within the established strategy and risk framework, including conduct risk. The Committee also oversees all aspects of interaction with policyholders including administration, complaints and Treating Customers Fairly.

In 2016, the Committee met 15 times and its primary focus was on the oversight of new business and reinsurance and the review and approval of pricing for large deals and pricing under the Solvency II regime. The Committee also oversaw the administration and transition of pension schemes to the PIC portfolio in 2016.

Audit Committee

The Audit Committee comprises five Non-Executive Directors and is chaired by Roger Marshall. The Committee meets at least five times a year at appropriate times in the reporting and audit cycle or as required by business needs. The key role of the Audit Committee is to assist the Board with the discharge of its responsibilities with regard to internal and external audits, financial reporting, systems of internal controls and risk management.

In 2016, the Committee met eight times and its primary focus was on reviewing the annual financial statements including review of significant judgements, the Company's going concern assumptions, and considering and approving the Internal Audit plan. The Committee reviewed the external audit arrangements and following a tender process it recommended to the Board to reappoint KPMG as external auditors of the Company.

Risk Committee

The Risk Committee comprises four Non-Executive Directors and is chaired by Steve Sarjant. The Committee meets at least five times a year or as required by business needs. The key role of the Risk Committee is to assist the Board in its oversight of the Company's current and likely risk exposures, tolerances and appetite, risk measurement and risk management performance. The Committee also provides an oversight of the Company's risk policies and procedures and risk controls. Furthermore, the Risk Committee is responsible for an oversight of the internal model and for reporting to the Board on any areas needing improvement.

In 2016, the Committee met seven times and its primary focus was on assisting the Board with monitoring and reviewing the Company's risk appetite and tolerances, bedding down of the Solvency II regime, reviewing a new approach to hedging, considering different aspects of the ORSA, reviewing the Company's risk framework and risk policies, and a review of business continuity plan and disaster recovery. The Committee provided ongoing monitoring of the Company's internal model and made recommendations to the Board with regard to its calibration.

DIRECTORS' REPORT

FOR THE YEAR ENDED 31 DECEMBER 2016

Directors and their interests

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

Members of the Board		Audit Committee	Risk Committee	Nomination and Remuneration Committee	Asset Liability Management Committee	Origination Committee
Jon Aisbitt[1]	Chairman	–	–	Chairman	–	Co-Chairman
Tracy Blackwell	Chief Executive	Standing attendee	Standing attendee	Standing attendee	Standing attendee	Co-Chairman
Amanda Bowe[2]	Non-executive	–	–	–	–	–
John Coomber	Non-executive	Member	–	–	–	Member
Tim Hanford	Non-executive	–	–	Member	Member	–
Arno Kitts[3]	Non-executive	–	–	–	Chairman	–
Nick Lyons[4]	Non-executive	–	–	Chairman	–	–
Roger Marshall	Non-executive	Chairman	Member	–	–	–
Harriet Maunsell[5]	Non-executive	–	–	Chairman	–	Member
Eloy Michotte	Non-executive	–	–	Member	Member	Member
Steve Sarjant	Non-executive	Member	Chairman	–	–	Member
Rob Sewell	Executive	Standing attendee	Standing attendee	–	Standing attendee	Member
Mark Stephen	Non-executive	Member	Member	–	Member	–
Wilhelm Van Zyl	Non-executive	Member	Member	–	–	–

1 Independent non-executive Chairman of the Board appointed on 14/10/2016, replacing Sir Mark Weinberg who stepped down on the same day. Chairman of nomination matters on the Nomination and Remuneration Committee.
2 Appointed to the Board on 1/01/2017.
3 Appointed to the Board on 1/07/2016, replacing Chris McKechnie who stepped down on 25/05/2016.
4 Appointed to the Board on 26/02/2016, Senior Independent Director and Chairman of remuneration matters on the Nomination and Remuneration Committee.
5 Resigned on 31/12/2016.

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 listed securities in issue and complies with the applicable sections DTR7.1 and DTR7.2 of the FCA handbook. The Company does not have a Premium Listing and therefore has not adopted the UK Corporate Governance Code. However, the Board and the executive management are committed to the principles and high standards of the Corporate Governance Code as they believe these underpin the success of the Company and are for the benefit of its shareholders and stakeholders including policyholders. Additional information on the Company's governing body and its committees is included in the Corporate Governance Overview on pages 12 and 13.

Issue of shares and debt

The Company issued 150 million £1 ordinary shares at par on 13 July 2016 and a further 93 million £1 ordinary shares at par on 27 September 2016. Both share issues were fully paid and wholly subscribed by PIC Holdings Limited, the immediate parent company, for cash consideration. This followed the issue by PICG (PIC's ultimate holding company) of 250 million £1 ordinary shares in June 2016 to investors in PICG.

On 23 November 2016, PIC successfully issued £250m subordinated loan notes due 2026 with a fixed coupon of 8.0% paid annually in arrears. These notes were issued at 98.916% of par and classified as Tier 2 capital.

Dividends

The Directors do not recommend a dividend for the year (2015: nil).

Political contributions

The Company made no political contributions during the year (2015: nil).

Internal controls and risk management system

The Board has overall responsibility for the system of risk management and internal controls, and for reviewing its effectiveness. The Company has a risk management and internal controls system in place which is designed to manage and reduce rather than eliminate the risk of failing to achieve business objectives. It can only provide the Board with reasonable, and not absolute, assurance against material misstatement or loss.

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. Each year, the Board approves an Integrated Assurance Plan which is intended to provide the Board with assurance that the internal control and risk management system works effectively. The plan, which is effected by the Internal Audit, Compliance and Risk functions within the Company, is overseen by the Risk and Audit Committees as part of their delegated authority from the Board. The overlap in membership of those two Committees ensures that all areas of the system are adequately covered.

The key features of the Company's internal controls framework

Financial reporting	Responsibility
Delegated authority	An established management structure operates across PIC with clearly defined levels of responsibility and delegated authorities.
Financial reporting	The Company has a robust system for reporting of the financial results to the Board. During the year, monthly and quarterly financial results are produced which include comparison to forecast and prior year. The Board, Audit Committee, Risk Committee and the executive management group review the Company's performance throughout the year and monitor the operation of budgets and long-term business plans. The reports ensure that variances are investigated and acted upon.
Internal controls, processes and procedures	The Company has formal written procedures and controls in operation which are designed to facilitate effective and efficient business operation, robust financial reporting and compliance with laws and regulations. Procedures, processes and controls are updated regularly to ensure they are effective and in compliance with best practice. As part of the requirements of DTR 7.1.3 of the FCA handbook, 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 reporting provided by management and reporting received from the Audit Committee. The Audit Committee meets regularly with members of the executive management group and internal and external auditors to review the annual 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 actions to correct identified weaknesses. All Board members receive minutes of the Audit Committee meetings.
Internal audit assurance	The Audit Committee oversees the Company's Internal Audit function which is managed by Head of Internal Audit using a co-sourced model and has a direct reporting line to the Audit Committee. The Audit Committee approves an annual internal audit plan which is designed to review key areas of risk. Regular updates on progress of the internal audit plan are provided to the Audit Committee by the Head of Internal Audit who is a standing attendee at the Audit Committee's meetings. Progress reports include results of individual audits. The Head of Internal Audit provides an annual report and opinion on internal controls, governance and culture.
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.
Risk management framework (more information is included on pages 6 to 11)	The Board has established a risk management and compliance system which includes a process for identifying, evaluating and managing the risks faced by the Company. The Risk Committee works closely with the Audit Committee and 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. All Board members receive minutes of the Risk Committee meetings. Procedures are in place to ensure the employment, retention, training and development of suitably qualified staff to manage activities.

The Board has reviewed the effectiveness of the system of internal controls, including risk management, for the year ended 31 December 2016 and up to the date of signing of 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.

DIRECTORS' REPORT

FOR THE YEAR ENDED 31 DECEMBER 2016
CONTINUED

Financial instruments
The information relating to the Company's financial instruments is included in Note 13 to the financial statements.

Future developments
The information that fulfils the reporting requirements relating to the likely future developments in the business of the Company is included in the Strategic Report which is separate to this Directors' Report.

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 regulatory solvency, 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 ought to have been taken as a Director to be aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Auditor
During the year, in light of the recent changes to auditor independence requirements resulting from the new EU Audit Regulation and Directive, the Audit Committee undertook a tender for the external audit for the year ending 31 December 2017 (KPMG LLP having been the Company's auditor since 2006). The result of the tender was that, on the recommendation of the Audit Committee, the Board of Directors chose to retain KPMG LLP as auditors.

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.

Long-term viability statement
The Directors have assessed the prospects of the Company by reference to the five-year planning period to December 2021. The Company prepares a business plan annually and this covers a five-year period on a rolling basis. The plan covers projected performance and related profitability, cash and value generation and the capital position of the Company over the five-year period. The plan is designed within the Company's risk appetite framework which forms an integral part of the business planning process.

The plan is tested against the risk appetite set for the Company by the Board and a number of stress scenarios which consider the Company's resilience and capacity to respond to relevant stresses and shock events which may potentially impact the Company. The Company also evaluates various management actions designed to maintain and restore key capital and solvency metrics to within the Company's approved risk appetite over the planning period.

The Directors have carried out an assessment by reference to the Company's current position and strategy, the Board's risk appetite and the Company's financial forecasts. The Directors also considered the Company's principal risks and how these are managed, as detailed on pages 9 to 11. Based on this assessment the Directors confirm that they have a reasonable expectation that the Company will continue to operate and meet its liabilities as they fall due in the five-year assessment period.

On behalf of the Board

Jon Aisbitt
Chairman

21 March 2017

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 2016 set out on pages 19 to 45. 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 17, 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 2016 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.

Based solely on the work required to be undertaken in the course of the audit of the financial statements and from reading the Strategic Report and the Directors' Report:

- we have not identified material misstatements in those reports; and
- in our opinion, those reports have been prepared in accordance with the Companies Act 2006.

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.

MWilson

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

21 March 2017

KPMG LLP
15 Canada Square
London
E14 5GL

STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 DECEMBER 2016

	Note	**Year ended 31 December 2016** £m	**Year ended 31 December 2016** £m	Year ended 31 December 2015 £m	Year ended 31 December 2015 £m
Revenue					
Gross premiums written		**2,598**		3,755	
Outward reinsurance premiums	10f	**(24)**		157	
Net premium revenue earned			**2,574**		3,912
Investment return	3		**3,219**		(252)
Commissions earned			**1**		–
Total revenue (net of reinsurance premiums)			**5,794**		3,660
Expenses					
Claims paid – gross		**(797)**		(581)	
Reinsurers' share of claims paid		**29**		16	
			(768)		(565)
Increase in insurance liabilities – gross		**(5,261)**		(2,656)	
Increase/(decrease) in reinsurers' share of insurance liabilities	10f	**605**		(247)	
			(4,656)		(2,903)
Acquisition expenses	4	**(42)**		(43)	
Other operating expenses	5	**(30)**		(25)	
Finance costs	12	**(22)**		(20)	
			(94)		(88)
Total claims and expenses			**(5,518)**		(3,556)
Profit before taxation			**276**		104
Tax charge	8		**(55)**		(21)
Profit or loss and total comprehensive income for the year			**221**		83

The amounts shown above are in respect of continuing operations.

The accounting policies and notes on pages 23 to 45 form an integral part of these financial statements.

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 2016

31 December 2016	Share capital £m	Other reserves £m	Retained profit £m	Total £m
At beginning of year	**757**	**60**	**479**	**1,296**
Total comprehensive income				
Profit for the year	**–**	**–**	**221**	**221**
Transactions with owners				
Share capital issued	**243**	**–**	**–**	**243**
At end of year	**1,000**	**60**	**700**	**1,760**

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 for cash consideration	65	–	–	65
At end of year	757	60	479	1,296

The accounting policies and notes on pages 23 to 45 form an integral part of these financial statements.

STATEMENT OF FINANCIAL POSITION

AS AT 31 DECEMBER 2016

		31 December 2016		31 December 2015	
	Note	**£m**	**£m**	£m	£m
Assets					
Investment properties	9		**97**		96
Reinsurers' share of insurance liabilities	10		**2,522**		1,917
Receivables and other financial assets	13		**216**		182
Prepayments			**34**		74
Financial investments	13		**22,594**		16,613
Derivative assets	14		**9,320**		4,900
Cash and cash equivalents	13		**6**		12
Total Assets			**34,789**		23,794
Equity					
Share capital	16	**1,000**		757	
Other reserves	17	**60**		60	
Retained profit	17	**700**		479	
Total Equity			**1,760**		1,296
Liabilities					
Gross insurance liabilities	10	**21,741**		16,480	
Deferred tax liability	11	**4**		5	
Derivative liabilities	14	**10,654**		5,635	
Borrowings	12	**542**		295	
Insurance and other payables	13	**38**		53	
Current taxation		**32**		15	
Accruals	13	**18**		15	
Total Liabilities			**33,029**		22,498
Total Equity and Liabilities			**34,789**		23,794

The accounting policies and notes on pages 23 to 45 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 21 March 2017 and were signed on its behalf by:

Rob Sewell
Director

Registration number: 05706720

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 31 DECEMBER 2016

	Note	Year ended 31 December 2016 £m	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m	Year ended 31 December 2015 £m
Cash flows from operating activities					
Profit for the year			**221**		83
Adjustments for non-cash movements					
Interest income recognised in profit or loss	3	**(561)**		(368)	
Other investment income recognised in profit or loss	3	**(45)**		(79)	
Interest expense recognised in profit or loss		**21**		19	
Amortisation of subordinated debt issue costs and discount		**1**		1	
Movement in fair value of investment properties	9	**(1)**		–	
Movement in tax provisions	8	**55**		21	
			(309)		(323)
Changes in operating assets and liabilities					
Increase in receivables and other financial assets		**(7)**		(5)	
Increase in financial investments including derivative assets		**(10,401)**		(5,371)	
Decrease/(increase) in prepayments		**40**		(37)	
(Increase)/decrease in reinsurers' share of insurance liabilities		**(605)**		247	
Increase in insurance liabilities		**5,261**		2,656	
Increase in financial liabilities including derivative liabilities		**5,018**		2,542	
Decrease in insurance and other payables		**(15)**		(65)	
Increase/(decrease) in accruals		**1**		(1)	
			(708)		(34)
Cash outflow from operating activities			**(1,017)**		(357)
Taxation paid			**(39)**		(24)
Net outflow from operating activities			**(1,056)**		(381)
Cash flows from investing activities					
Interest income received		**535**		329	
Other investment income received		**45**		79	
			580		408
Cash flows from financing activities					
Proceeds from issue of share capital	16	**243**		–	
Proceeds from issue of subordinated debt	12	**250**		–	
Interest paid on subordinated debt		**(20)**		(20)	
Issue costs	12	**(3)**		–	
			470		(20)
Net (decrease)/increase in cash and cash equivalents			**(6)**		7
Cash and cash equivalents at beginning of year			**12**		5
Cash and cash equivalents at end of year			**6**		12

The accounting policies and notes on pages 23 to 45 form an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2016

1. ACCOUNTING POLICIES

(a) Basis of preparation

The financial statements have been prepared in accordance with 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.

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 2016. 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.

The financial instruments held by the Company are classified as fair value through profit and loss, therefore the adoption of the standard will not have material impact on the results of the Company.

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's principal source of revenue arises from insurance contracts, which are outside the scope of IFRS 15. Consequently, the adoption of the standard is not expected to have a material impact on the results of the Company.

IFRS 16 – Leases – not yet endorsed by the EU, effective for accounting periods beginning on or after 1 January 2019.

The Company does not have any lease contracts that are material to the financial statements.

(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. Any adjustments to premiums following work performed during the transition of a scheme 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.

1. ACCOUNTING POLICIES CONTINUED

(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.

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.

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 is 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, and using recognised actuarial methods consistent with the actuarial principles laid down in the previous regulatory regime, Solvency I. The liabilities are calculated initially to comply with the reporting requirements under the Financial Services and Markets Act 2000. The liabilities are then adjusted to remove certain contingencies and other reserves required under the previous solvency regime, 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.

1. ACCOUNTING POLICIES CONTINUED

(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 with an external reinsurer 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 external 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. The amounts receivable from or payable to reinsurers are recognised as Reinsurers' share of insurance liabilities in the Statement of financial position.

Fees paid in respect of certain longevity reinsurance contracts which are contingent on surplus levels under the historical solvency regime 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.

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 £19.2bn (2015: £14.6bn). 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 consider 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 Company's Executive Committee, and a reconciliation of these measures to the equivalent measure under IFRS, is as follows:

	2016 £m	2015 £m
Return earned on insurance book	**122**	87
Return earned on surplus assets	**55**	46
Underlying operating profit before tax	**177**	133
New business and reinsurance	**(26)**	59
Other changes to in-force business	**(3)**	(4)
Operating profit before tax	**148**	188
Non-operating profit/(loss) before tax	**128**	(84)
IFRS profit before tax	**276**	104

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 that 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 17 (2015: 13) new transactions with pension schemes with a total premium value of £2.6bn (2015: £3.8bn).

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 2016		Year ended 31 December 2015	
	£m	£m	£m	£m
Income from debt securities	**546**		356	
Interest income on cash deposits	**12**		7	
Income from mortgage backed securities ("MBS")	**3**		5	
Interest income		**561**		368
Rental income	**5**		5	
Income from other investments				
– Investment schemes	**4**		4	
– Other asset backed securities ("ABS")	**10**		8	
– Other investments	**26**		62	
		45		79
Total investment income		**606**		447
Realised gains on:				
– Investments designated as FVTPL on initial recognition	**310**		391	
– Investments classified as held for trading	**106**		163	
Realised losses on:				
– Investments designated as FVTPL on initial recognition	**(1)**		(24)	
– Investments classified as held for trading	**(41)**		(85)	
Net realised gains		**374**		445
Unrealised gains on:				
– Investments designated as FVTPL on initial recognition	**2,999**		3	
– Investments classified as held for trading	**13**		12	
Unrealised losses on:				
– Investments designated as FVTPL on initial recognition	**(17)**		(688)	
– Investments classified as held for trading	**(756)**		(471)	
Net unrealised gains/(losses)		**2,239**		(1,144)
Investment return		**3,219**		(252)

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2016
CONTINUED

4. ACQUISITION EXPENSES

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Acquisition expenses	**42**	43

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

5. OTHER OPERATING EXPENSES

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Investment charges and related expenses	**9**	9
Other expenses	**21**	16
	30	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 2016 £	Year ended 31 December 2015 £
Fees payable to the Company's auditor for the audit of the Company's annual accounts	**199,282**	182,050
Fees payable to the Company's auditor and its associates for other services:		
Audit-related assurance services	**167,674**	196,266
Other assurance services	**40,000**	39,428
Tax compliance services	**22,000**	20,150
All other services	**137,808**	121,193
Total fees paid to the auditor	**566,764**	559,087

7. DIRECTORS' REMUNERATION, EMPLOYEE COSTS AND HEADCOUNT

Pension Services Corporation Limited ("PSC") was the 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 2016 £m	Year ended 31 December 2015 £m
Wages and salaries	**21**	19
Social security costs	**3**	2
Other pension costs	**1**	1
	25	22

The Company has 15 Directors who served during the year (2015: 14). All Directors were employed by or contracted by the Company's service provider. The total remuneration received by the Directors for their services, was £3m (2015: £3m).

The amount of remuneration received by the highest paid Director was £1m (2015: £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.

Two Directors had money paid to money purchase pension schemes or were provided a cash alternative where their lifetime limit had been reached (2015: three). No Directors, including the highest paid Director, were eligible for shares or share options in the Company under a long-term incentive scheme (2015: nil). No Directors exercised options in the Company during the year (2015: nil).

8. CORPORATION TAX

The Company's tax charge for the year is:

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Current taxation		
Tax payable for the current year	**56**	22
Prior year under/(over) provision	**–**	–
Total current tax	**56**	22
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	**55**	21

The effective current tax charge for the period is the same as (2015: the same as) the standard rate of corporation tax in the UK of 20% (2015: 20.25%). The differences are explained below:

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Reconciliation of total income to the applicable tax rate		
Profit before taxation	**276**	104
Corporation tax at 20% (2015: 20.25%)	**55**	21
Effects of:		
Expenses not deductible for tax purposes	**–**	–
Income not subject to corporation tax	**–**	–
Prior year under/(over) provision	**–**	–
Effect of change in tax rates	**–**	–
Corporation tax charge	**55**	21

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 2016.

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 2016 of £4m (2015: £5m) in respect of these timing differences which total £24m (2015: £28m).

UK corporation tax rates are 20% from 1 April 2015 (enacted 17 July 2013), 19% from 1 April 2017 (enacted 18 November 2015) and 17% from 1 April 2020 (enacted 15 September 2016). These rates will reduce the Company's future current tax charge accordingly. The deferred tax liability at 31 December 2016 has been calculated based on these rates.

The Company has no other timing differences or tax losses carried forward at 31 December 2016 which may give rise to reduced tax charges in future periods (2015: nil).

9. INVESTMENT PROPERTY

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
At beginning of year	**96**	96
Change in fair value during the year	**1**	–
At end of year	**97**	96

The Company classifies its investment in eight Guernsey registered property unit trusts ("GPUTs") as investment properties. The Company holds 99.9% of the issued units in the 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 UK.

In 2015, the GPUTs were 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 2016 £m	Year ended 31 December 2015 £m
Future policyholders' benefits		
Gross	**21,741**	16,480
Reinsurance	**(2,522)**	(1,917)
Net	**19,219**	14,563

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.

(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 2016 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 (this is consistent with the assumption used in 2015).

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 VRI is set at 97.5% of the risk-adjusted yield on assets backing liabilities, as required by the previous solvency regime. Risk adjustments are for credit risk associated with the assets held to match liabilities. The rate calculated in accordance with these rules as at 31 December 2016 for PIC was 2.11% for both index-linked liabilities and non-linked liabilities (2015: 2.95%).

Inflation

Assumptions for expected future Retail Price Index inflation and Consumer Price Index inflation are based on a curve derived from market prices of inflation-linked swap contracts. For Limited Price Index 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 reasons for the increase are the new business written in the year and changes in underlying economic assumptions.

2016	Gross £m	Reinsurance £m	Net £m
At beginning of year	**16,480**	**(1,917)**	**14,563**
Increase in liability from new premiums	**2,596**	–	**2,596**
Reduction in liability from claims	**(732)**	**6**	**(726)**
Changes in economic assumptions	**3,348**	**(615)**	**2,733**
Changes in non-economic assumptions	**(44)**	**23**	**(21)**
Other movements (including net investment return)	**93**	**(19)**	**74**
At end of year	**21,741**	**(2,522)**	**19,219**

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

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 a fall in long-term interest rates resulting in an increase in liabilities (2015: decrease in liabilities).

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.

10. INSURANCE CONTRACTS AND RELATED INSURANCE LIABILITIES CONTINUED

(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	**37**	**336**	**1,367**	**4,918**	**6,658**
Reinsurance	**(4)**	**(27)**	**(92)**	**(1,468)**	**(1,591)**
As at 31 December 2016	**33**	**309**	**1,275**	**3,450**	**5,067**
Annuities in payment					
Gross	**687**	**2,659**	**5,610**	**6,127**	**15,083**
Reinsurance	**14**	**31**	**(106)**	**(870)**	**(931)**
As at 31 December 2016	**701**	**2,690**	**5,504**	**5,257**	**14,152**

	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

(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 2016 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.

	Interest rates		**Inflation rates**	
31 December 2016	**Increase of 25bps £m**	**Fall of 25bps £m**	**Increase of 50bps £m**	**Fall of 50bps £m**
Movement in assets	**(704)**	**748**	**1,051**	**(929)**
Movement in liabilities	**738**	**(787)**	**(1,026)**	**981**
Tax effect	**(7)**	**8**	**(5)**	**(10)**
Movement in profit and equity	**27**	**(31)**	**20**	**42**

	Base mortality (see below) £m	**Mortality improvements (see below) £m**	**Renewal expenses (see below) £m**	**Exchange rates (see below) £m**	**Credit spreads increase of 25bps £m**
Movement in assets	**–**	**–**	**–**	**11**	**(346)**
Movement in liabilities	**(26)**	**(70)**	**(69)**	**(13)**	**363**
Tax effect	**5**	**14**	**14**	**–**	**(3)**
Movement in profit and equity	**(21)**	**(56)**	**(55)**	**(2)**	**14**

31 December 2015	Interest rates Increase of 25bps £m	Fall of 25bps £m	Inflation rates Increase of 50bps £m	Fall of 50bps £m
Movement in assets	(555)	629	844	(745)
Movement in liabilities	518	(588)	(755)	721
Tax effect	7	(8)	(18)	5
Movement in profit and equity	(30)	33	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)

Parameters for longevity and renewal expense sensitivities

The exchange rate sensitivity is based on weakening of USD and euro against sterling by 1%.

The base mortality sensitivity is based on a 1% decrease in the base mortality rates. This is equivalent to a 0.1 year increase in life expectancy from 23.5 years to 23.6 years for a typical male aged 65.

The mortality improvements sensitivity is based on a 0.1% increase in annual mortality improvement rates. This is equivalent to a 0.1 year increase in life expectancy from 23.5 years to 23.6 years for a typical male aged 65.

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 on the core assumptions in the financial statements rather than considering more extreme scenarios.
- 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 2016 £m	Year ended 31 December 2015 £m
Outward reinsurance premiums	**(24)**	157
Reinsurers' share of claims paid	**29**	16
Changes in reinsurers' share of insurance liabilities	**605**	(247)
Net effect of reinsurance contracts on profit before taxation	**610**	(74)

Outward reinsurance premiums include amounts payable in respect of quota share arrangements and insurance fees payable in respect of longevity reinsurance contracts. The charge for the year comprises the following items:

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Amounts payable in respect of insurance fees	**24**	19
Current year premiums payable in respect of quota share arrangements	**–**	180
Reinsurance recapture received	**–**	(356)
Outward reinsurance premiums	**24**	(157)

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2016
CONTINUED

11. DEFERRED TAX

At 31 December 2016, 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 2016			
Tax transitional adjustment	**–**	**(4)**	**(4)**
31 December 2015			
Tax transitional adjustment	–	(5)	(5)

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

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
At beginning of year	**(5)**	(6)
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	**(4)**	(5)

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 2016 (2015: 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.

On 23 November 2016, PIC issued a further £250m subordinated loan notes due 2026 with a fixed coupon of 8.0% paid annually in arrears. These notes were issued at 98.916% of par.

Both notes represent direct, unsecured and subordinated obligations of the Company, and are classified as qualifying dated Tier 2 securities for the purposes of regulatory capital requirements. The notes are listed on the London Stock Exchange.

	31 December 2016		31 December 2015	
Loan notes	**Carrying value £m**	**Fair value £m**	Carrying value £m	Fair value £m
£300m notes maturing 2024	**294**	**302**	295	303
£250m notes maturing 2026	**248**	**259**	–	–
Total	**542**	**561**	295	303

The fair value has been 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 2016, an interest expense of £22m (2015: £20m), 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 2016		31 December 2015	
	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	**20,524**		14,588	
MBS and ABS	**327**		296	
Deposits with credit institutions	**536**		513	
Participation in investment schemes	**1,207**		1,216	
Total financial investments	**22,594**	**–**	16,613	–
Derivative assets	**9,320**		4,900	
Loans and receivables and other financial assets				
Debtors arising out of direct insurance operations		**4**		33
Other debtors		**36**		–
Accrued interest		**176**		149
Total receivables and other financial assets		**216**		182
Cash and cash equivalents		**6**		12
Total financial assets	**31,914**	**222**	21,513	194
Financial liabilities				
Derivative liabilities	**10,654**		5,635	
Creditors arising out of reinsurance operations		**8**		26
Other creditors		**30**		27
Insurance and other payables		**38**		53
Borrowings		**542**		295
Accruals		**18**		15
Total financial liabilities	**10,654**	**598**	5,635	363

All amounts relating to receivables and other financial assets are expected to be received within 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 £30,203m (2015: £21,005m) due to be received in more than one year.

Deposits with credit institutions

Deposits with credit institutions include £16m (2015: £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 Münchener Rückversicherungs gesellschaft ("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.

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES CONTINUED

At 31 December 2016, the Company has included £1,759m (2015: £1,031m) 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 has been derecognised in the financial statements.

At 31 December 2016, the amount of collateral received by the Company was £483m (2015: £343m). 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 (2015: £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 2016, this totalled £1.8bn (31 December 2015: £1.6bn).

In 2016, the Company has included £51m of financial assets which have been pledged as collateral under the terms of certain reinsurance contracts (2015: £24m). The Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and consequently none of these assets has been derecognised in the financial statements.

At 31 December 2016, the Company received £8m (2015: £13m) cash as collateral under the terms of certain reinsurance contracts.

The Company enters into a number of securities lending, and reverse sale and repurchase arrangements.

In securities lending arrangements, the Company lends an agreed debt security to a counterparty and receives collateral in the form of eligible, investment grade debt securities as a security against potential counterparty default. In reverse sale and repurchase arrangements, the Company provides cash for a specified period and receives collateral in the form of UK gilts or other sovereign bonds.

In both cases, the Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and consequently none of these assets has been derecognised in the financial statements. At 31 December 2016, the Company had £851m (2015: £nil) assets related to securities lending and reverse sale and repurchase agreements, and held £851m (2015: £nil) in gilts and eligible securities as collateral in respect of these arrangements.

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 2016 (2015: £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.

				Related amounts not offset in the Statement of financial position			
31 December 2016	Gross amounts of recognised financial assets/ (liabilities) £m	Amounts offset in accordance with IAS 32 £m	Net amounts as recognised in the Statement of financial position £m	Financial instruments (received)/ pledged £m	Cash collateral (received)/ pledged £m	Derivative (liabilities)/ assets £m	Net amount £m
Financial assets							
Derivatives	**10,733**	**(1,413)**	**9,320**	**(30)**	**(453)**	**(8,558)**	**279**
Debt securities	**571**	**–**	**571**	**(571)**	**–**	**–**	**–**
Deposits with credit institutions	**280**	**–**	**280**	**(280)**	**–**	**–**	**–**
Financial liabilities							
Derivatives	**(12,067)**	**1,413**	**(10,654)**	**1,759**	**–**	**8,558**	**(337)**

31 December 2015	Gross amounts of recognised financial assets/ (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 (received)/ pledged £m	Cash collateral (received)/ pledged £m	Derivative (liabilities)/ assets £m	Net amount £m
Financial assets							
Derivatives	5,681	(781)	4,900	(54)	(289)	(4,460)	97
Financial liabilities							
Derivatives	(6,416)	781	(5,635)	1,018	13	4,460	(144)

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.

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 is 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) MBS and ABS

The fair value of MBS and ABS 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.

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES CONTINUED

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 2016	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Debt securities	**7,857**	**12,047**	**620**	**20,524**
MBS and ABS	**–**	**268**	**59**	**327**
Deposits with credit institutions	**536**	**–**	**–**	**536**
Participation in investment schemes	**888**	**319**	**–**	**1,207**
Financial investments	**9,281**	**12,634**	**679**	**22,594**
Derivative assets	**–**	**9,320**	**–**	**9,320**
Financial assets	**9,281**	**21,954**	**679**	**31,914**
Derivative liabilities	**–**	**(10,654)**	**–**	**(10,654)**

31 December 2015	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Debt securities	5,449	8,742	397	14,588
MBS and ABS	–	296	–	296
Deposits with credit institutions	513	–	–	513
Participation in investment schemes	851	365	–	1,216
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)

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 (2015: £nil).

Transfers out of Level 3

During the year, £163m of debt securities were transferred from Level 2 to Level 3 (2015: £nil) and £168m of debt securities were transferred out of Level 3 to Level 2 (2015: £604m).

Transfers into and 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. Where the impact of the adjustments on the value of the debt securities become significant, these securities would be classified as Level 3 and transferred from Level 2 to Level 3 at the end of the year. Conversely, where the impact becomes less significant, the securities would be classified as Level 2 and transferred out of Level 3 to Level 2.

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

Year ended 31 December 2016	Other ABS £m	Debt securities £m	Total £m
Opening balance	**–**	**397**	**397**
Unrealised gains or losses	**4**	**99**	**103**
Acquisitions in year	**63**	**127**	**190**
Transfers in to Level 3	**–**	**163**	**163**
Transfers out of Level 3	**–**	**(168)**	**(168)**
Disposals in year	**–**	**(6)**	**(6)**
Closing balance	**67**	**612**	**679**

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

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 2016	**Other ABS £m**	**Debt securities £m**	**Total £m**
Interest income	**–**	**–**	**–**
Income from securities	**3**	**9**	**12**
Realised gains or losses	**–**	**–**	**–**
Unrealised gains or losses	**4**	**99**	**103**
Investment return on Level 3 assets	**7**	**108**	**115**

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

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 input assumptions.

2016	Main assumptions	Sensitivity	**Current fair value £m**	**Increase in fair value £m**	**Decrease in fair value £m**
Debt securities	Interest rates	+/- 50bps credit spread	**612**	**69**	**(64)**
Other ABS	Expected loss ("EL")	+/- 30% change in EL	**67**	**1**	**(1)**
			679	**70**	**(65)**

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)

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 2016		31 December 2015	
	Assets £m	**Liabilities £m**	Assets £m	Liabilities £m
Interest rate swaps	**8,615**	**(8,750)**	4,377	(4,594)
Inflation swaps	**641**	**(1,001)**	493	(861)
Credit default swaps	**24**	**(6)**	6	–
Currency swaps	**30**	**(882)**	17	(167)
Foreign exchange forward contracts	**10**	**(15)**	7	(13)
Total derivative position	**9,320**	**(10,654)**	4,900	(5,635)

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 changes to the regulatory environment in which PIC operates. 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 attend meetings as requested. The Board retains direct responsibility for reputational risk. The Board has instigated a coordinated 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.

(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.

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 have been sourced from S&P, Moody's or Fitch. The remaining unrated assets are not classified by S&P, Moody's or Fitch.

In 2015, 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.

31 December 2016	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Loans and debt securities							
Debt securities[1]	**923**	**8,601**	**5,462**	**5,176**	**264**	**98**	**20,524**
MBS and ABS[2]	**20**	**74**	**98**	**46**	**30**	**59**	**327**
	943	**8,675**	**5,560**	**5,222**	**294**	**157**	**20,851**
Other assets							
Derivative assets	**–**	**–**	**–**	**–**	**–**	**9,320**	**9,320**
Participation in investment schemes	**888**	**–**	**–**	**–**	**–**	**319**	**1,207**
Receivables and other financial assets	**13**	**28**	**60**	**72**	**2**	**41**	**216**
Deposits with credit institutions	**–**	**–**	**536**	**–**	**–**	**–**	**536**
Cash and cash equivalents	**–**	**–**	**–**	**6**	**–**	**–**	**6**
	901	**28**	**596**	**78**	**2**	**9,680**	**11,285**

1. Within Debt securities there are £210m AAA rated, £614m AA rated, £312m BBB rated and £68m BB rated securities, which have been rated using internally assessed credit ratings.
2. Within MBS and ABS there are £4m A rated securities, which have been rated using internally assessed credit 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
MBS and ABS[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 MBS and ABS there are £4m A rated securities, which have been rated using internally assessed credit ratings.

15. RISK MANAGEMENT CONTINUED

Although the instruments themselves are unrated, the ultimate issuing parties for most derivative assets do have a credit rating. Additionally, the derivatives are fully collateralised so as to mitigate any credit or counterparty risk. Applying the issuer rating to the assets held at 31 December 2016 produces the following split:

31 December 2016	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Derivative assets	**–**	**910**	**6,726**	**1,684**	**–**	**–**	**9,320**

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

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.

Reinsurance counterparties

The Company has reinsurance contracts in place with eight external reinsurers with an exposure of £2,523m at 31 December 2016 (2015: £1,910m). 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 2016 and 31 December 2015.

Impaired assets

The Company did not have any impaired or past due date assets at 31 December 2016 (2015: 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 2016	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	**8**	**–**	**–**	**–**	**8**
Other creditors	**30**	**–**	**–**	**–**	**30**
Accruals	**18**	**–**	**–**	**–**	**18**
Borrowings	**–**	**–**	**542**	**–**	**542**
Derivative liabilities	**86**	**420**	**1,508**	**8,640**	**10,654**
	142	**420**	**2,050**	**8,640**	**11,252**

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

Amounts due to group undertakings are included within Other creditors. At 31 December 2016, £19m was payable to PSC (2015: £26m). 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 the 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 dependants 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 dependants 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 insurance liability 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 insurance liability 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 whistleblowing 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.

16. SHARE CAPITAL

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

	2016		2015	
	Number of shares	**£m**	Number of shares	£m
Authorised, issued and fully paid				
At beginning of year	**756,810,351**	**757**	692,210,351	692
Shares issued at par	**243,000,000**	**243**	64,600,000	65
At end of year	**999,810,351**	**1,000**	756,810,351	757

The Company issued 150 million £1 ordinary shares at par on 13 July 2016 and a further 93 million £1 ordinary shares at par on 27 September 2016 for cash consideration.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2016

CONTINUED

17. RESERVES

	2016		2015	
	Other reserves £m	**Retained profit £m**	Other reserves £m	Retained profit £m
At beginning of year	**60**	**479**	60	396
Total comprehensive income	**–**	**221**	–	83
At end of year	**60**	**700**	60	479

Other reserves comprise £60m contributed in 2008 by PIC Holdings 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.

Up to 31 December 2015, PIC was required to hold sufficient capital to meet the capital requirements calculated on the Pillar 1 statutory basis under the previous regulatory regime. The 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 progressed through a series of formal consultations and updates prior to implementation on 1 January 2016.

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.

From 1 January 2016, the Company was required to measure and manage its capital on Solvency II basis and to comply with the requirements of the Solvency II Framework Directive, as adopted by the PRA. There are certain valuation differences between the IFRS balance sheet and the Solvency II balance sheet, for example between IFRS insurance liabilities and Solvency II technical provisions. Also, under Solvency II the Company is able to treat the subordinated debt referred to in Note 12 as regulatory capital. The Company has complied with the capital requirements under Solvency II 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.

Under Solvency II, PIC uses an internal model to set its statutory solvency capital requirements. This evaluates market risk, insurance risk, operational risk, expense risk and counterparty risk. In addition, PIC produces an own risk and solvency assessment report annually, which provides an analysis of the risks facing the Company and its capital resources.

PIC manages its business according to the risk strategy, appetite and tolerances set out in its risk policies. Specifically, PIC's "risk appetite" policy defines a target level of capital that it wishes to maintain, which PIC regularly monitors and reports. Capital volatility is managed through risk management techniques, including the use of inflation rate, interest rate and currency hedging instruments to reduce exposure to potential adverse market movements. PIC is also able to manage its capital position through the level of new business it writes and its broader investment and reinsurance strategies.

PIC focuses on hedging its Solvency II balance sheet through hedging its best estimate liabilities and solvency capital requirements to interest rates and inflation rates. This provides a proxy to IFRS and embedded value sensitivities, although some basis risk remains. PIC aims to remove all foreign exchange risk through cross-currency hedging. Longevity risk is managed through reinsurance, where 68% of risk has been transferred as at 31 December 2016, based on regulatory liabilities.

19. RELATED PARTY TRANSACTIONS

As at 31 December 2016, 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 four 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, certain share based payment schemes operated by PICG in respect of employees of Pension Services Corporation Limited have vested. Nine of the key management personnel of the Company, including the Directors, were participants in these schemes and received a total of 24,104,452 ordinary shares of PICG upon vesting in line with the scheme rules.

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

(a) 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 2016 were £63m (2015: £60m). At 31 December 2016, the amount due to PSC relating to the services provided was £19m (2015: £26m).

(b) Transactions with PIC Holdings Limited ("PICH")

On 20 December 2013, the Company transferred all of its rights accruing under the terms of a loan to Co-Investment Limited to PICH 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 PICH 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 2016 and 31 December 2015 was £1.

On 14 May 2012, the Company acquired an £80,000 loan facility from Pension Insurance Corporation Holdings LLP. The facility was provided to PICH 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 2016 was £78,032 (2015: £78,032). The accrued interest on this loan amounted to £7,184 (2015: £5,510) at 31 December 2016.

As disclosed in Note 9, the Company holds 99.9% of the issued units in eight GPUTs. The remaining 0.1% are held by PICH. The Company receives 100% of the rental income and consequently recognises an intercompany payable to PICH for its share of the income, which is set off against the loan facility. At 31 December 2016, the outstanding payable balance was £21,589 (2015: £16,141).

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 £261m within the next 5 years (2015: £74m), £64m of this being due within 12 months of the financial reporting date (2015: £31m).

	31 December 2016 £m	31 December 2015 £m
Within 1 year	**64**	31
In 1–5 years	**197**	43
Over 5 years	**–**	–
	261	74

Contingent liabilities

The Company has certain reinsurance agreements, which include fees that are contingent on occurrence of specific events. Such fees do not meet the definition of a liability, therefore are not recognised on the Statement of financial position. At 31 December 2016, the estimated value of the contingent fees payable was £10m (2015: £48m).

21. PARENT COMPANY AND ULTIMATE CONTROLLING PARTY

The Company is a wholly owned subsidiary of PICH, 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 the Company's registered address at 14 Cornhill, London EC3V 3ND.

PENSION INSURANCE CORPORATION
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www.pensioncorporation.com