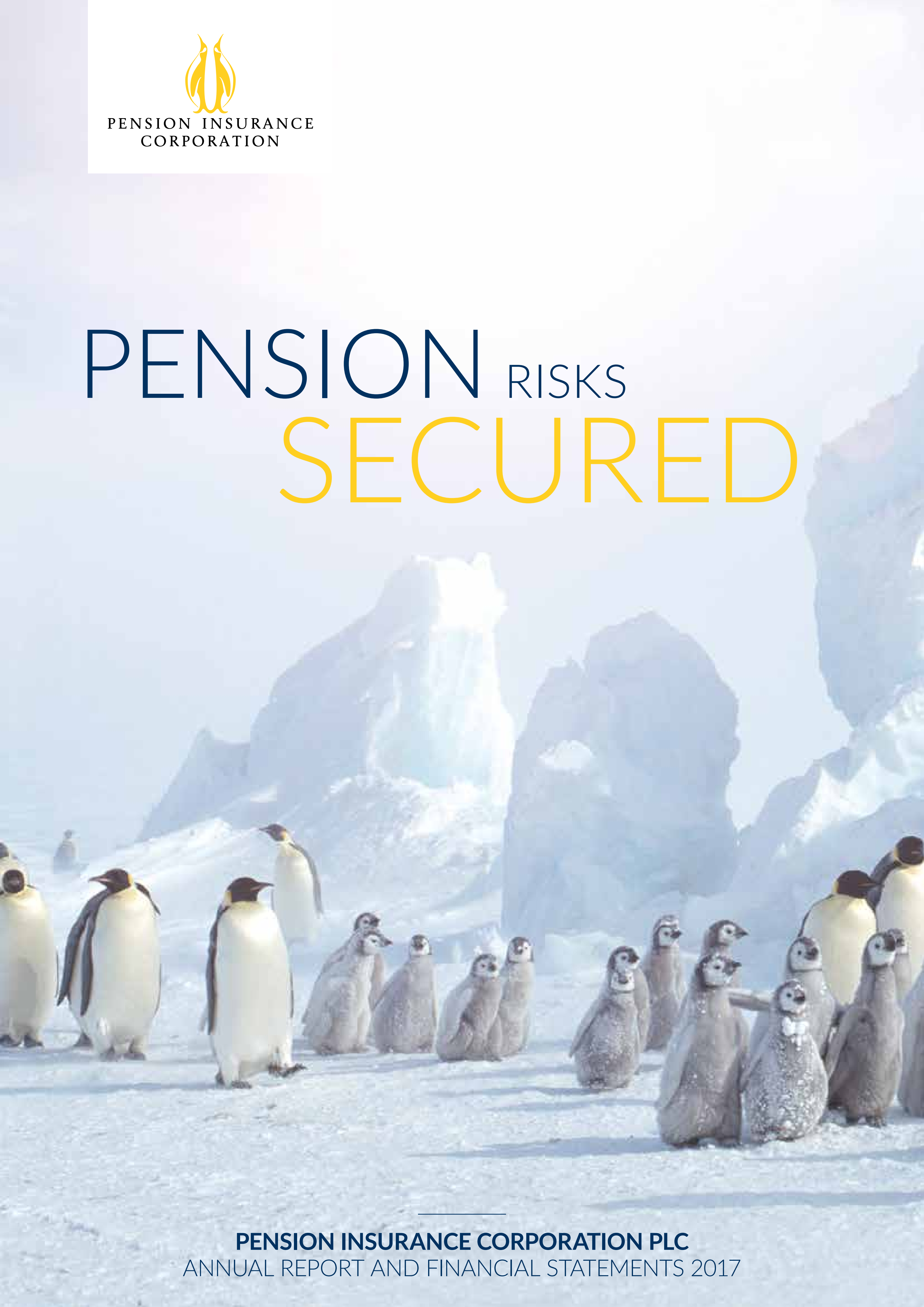
PENSION INSURANCE CORPORATION

# PENSION RISKS SECURED



## PENSION INSURANCE CORPORATION PLC
ANNUAL REPORT AND FINANCIAL STATEMENTS 2017

Pension Insurance Corporation plc (PIC) is a market-leading, specialist UK insurer of defined benefit pension funds.

**PIC'S PURPOSE**

Our purpose is to pay the pensions of our policyholders.

**WHO WE ARE**

We are recognised as a leader in the bulk annuity sector.

**We provide secure and stable retirement incomes for our policyholders through leading customer service, comprehensive risk management and excellence in asset and liability management.**

# AT A GLANCE

Paying the pensions of our policyholders, removing risk from defined benefit pensions, creating certainty for employers and trustees

**Our business**

### A specialist insurer, focused on securing the pensions of our growing policyholder base

- We secure the risks associated with defined benefit pension funds in the UK.
- We stand for customer service and integrity in our dealings with all our stakeholders.
- We are straightforward to deal with and do what we say we'll do.

### A leader in the established, expanding market for pension insurance

- We specialise in pension insurance buyouts and buy-ins (bulk annuities).
- We price and structure transactions that meet individual client needs.
- We have robust risk management.
- We are authorised by the Prudential Regulation Authority (PRA) and regulated by the PRA and Financial Conduct Authority (FCA).

### A focused business model

- We offer superior client service for policyholders, trustees and pension fund sponsors.
- We have no legacy business lines or product exposures.
- We deploy capital only if it meets internal economic criteria.
- We have an efficient operating model with economies of scale.
- We have fit-for-purpose IT and specialised processes.

# BUSINESS MODEL

## Resources

**Pension insurance buy-ins and buyouts**
Transfer assets and pension payment obligations to PIC from pension scheme trustees and corporate sponsors

**PIC's employees, Board and business partners**
Provide specialist expertise and resources

**PIC's shareholders and bondholders**
Provide capital resources

## What we do

**Governance and regulation**
Ensure that we do what we say and have oversight and control on our decisions and actions

**Invest our assets:** to deliver long-term cash flows that can pay our pension obligations

**Manage our liabilities:** to make them more certain and predictable

**Manage our risks:** to ensure that our capital resources are always sufficient to withstand market shocks and unfavourable developments

**Focus on customer care:** to ensure our policyholders receive the benefits they are promised with excellent service levels

**Our values and culture**
Ensure that we appropriately meet the needs and expectations of our stakeholders in our actions and behaviours

**Secure long-term pension benefits for our policyholders**

**Attractive risk adjusted returns for our capital providers (shareholders and bondholders)**

**Rewarding careers for our employees**

## Outcomes

# 1 STRATEGIC REPORT



# 58 CORPORATE GOVERNANCE



# 73 IFRS FINANCIAL STATEMENTS



# 2017 HIGHLIGHTS

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

## Premiums
£3,704M

| | |
|---|---|
| 2017 | £3,704m |
| 2016 | £2,598m |
| 2015 | £3,755m |
| 2014 | £2,646m |
| 2013 | £3,663m |

## Financial investments
£25.7BN

| | |
|---|---|
| 2017 | £25.7bn |
| 2016 | £22.6bn |
| 2015 | £16.6bn |
| 2014 | £13.3bn |
| 2013 | £8.9bn |

## IFRS Profit before tax
£391M

| | |
|---|---|
| 2017 | £391m |
| 2016 | £276m |
| 2015 | £104m |
| 2014 | £170m |
| 2013 | £114m |

## MCEV
£2,926M

| | |
|---|---|
| 2017 | £2,926m |
| 2016 | £2,579m |
| 2015 | £1,998m |

## Underlying operating profit
£195M

| | |
|---|---|
| 2017 | £195m |
| 2016 | £177m |
| 2015 | £133m |
| 2014 | £116m |
| 2013 | £80m |

## Assets held to meet solvency and risk margin
£4.3BN

| | |
|---|---|
| 2017 | £4.3bn |
| 2016 | £4.3bn |
| 2015 | £2.8bn |

## Solvency ratio
160%(1)

| | |
|---|---|
| 2017 | 160% |
| 2016 | 164% |
| 2015 | 151% |

## Customer satisfaction
98.3%

| | |
|---|---|
| 2017 | 98.3% |
| 2016 | 98.5% |
| 2015 | 99.3% |
| 2014 | 99.8% |
| 2013 | 99.3% |

(1) Estimated and unaudited

# WHAT WE DO

## Policyholders

"ACTIONS SPEAK LOUDER THAN WORDS AND PIC'S CUSTOMER SERVICE LEVELS HAVE GONE BEYOND MY EXPECTATIONS"

I have been a PIC policyholder for six years, when the Morris Ashby Pension Fund was bought out. PIC was very supportive and responsive during the transaction, and from the way they dealt with taking on the Morris Ashby Pension Fund, they do a good job of focusing on their core purpose of securing our pensions. This was pleasing as when I first heard that my benefits were moving from a pension scheme to an insurance company, there were some concerns. However, everything ran smoothly and as they say, actions speak louder than words and PIC's customer service levels have gone beyond my expectations.

I've been to some of the policyholder events that the company has put on and like having the chance to meet with old colleagues and members of the PIC team. The letters and documents are all easy to understand, and PIC has always been very helpful whether I am dealing with them by phone, online or through email.

**Ray Parker, former Morris Ashby Pension Fund member, now a proud PIC policyholder**

# Employees

## “I FEEL VALUED HERE”

I have worked at PIC for almost seven years, having previously worked as an actuarial analyst at a pensions consultancy. Working for a growing and successful company has allowed me to develop my knowledge and skills across a range of areas as the business is evolving. I get a lot of variety in my work and I can shape how we implement changes into our regular processes. Senior colleagues are very approachable and supportive and I get to work with and share ideas with colleagues from other teams, which I wouldn’t be able to do as easily in a larger firm. I feel valued here.

When I heard about the Actuarial Mentoring Programme (see page 31), I was really attracted to it. I wanted more direction on where my career as an actuary was heading and how I could progress. It’s great to have the support network available to female actuaries and I’m already finding it of great benefit. Looking forward, I am hopeful for a long career as an actuary and a bright career ahead of me at PIC.

**Rachel Ives, PIC actuary**

# CHAIRMAN'S STATEMENT

**Jon Aisbitt**
Chairman

**I am delighted to report that PIC had an outstanding year in 2017, with strong new business flows, increased profitability and high levels of customer and employee satisfaction. It was a year of strong, profitable growth in which we successfully completed several internal projects to further improve productivity, as well as the consistency and robustness of governance across the business.**

The macro context within which PIC operates was broadly stable during the year. On the regulatory front, Solvency II is well bedded in and the bulk annuity market has shown that it can function effectively within this regulatory environment. However, the regulatory regime is not perfect, and we continue to work with industry counterparts on further refining it. In terms of markets, there was nothing significant to note from PIC's perspective during the year, although as ever, we would very much welcome more opportunities to invest in secure, long-term assets, such as infrastructure.

Politically, the major area of uncertainty for most financial services companies, Brexit, is not as relevant for us as it is for many others, given our UK focus. Any market volatility arising from Brexit would affect us, but the operational impacts are minimal. As a major consolidator of pension scheme assets and liabilities, we responded to the Government's consultation on the possibility of pension scheme superfunds, emphasising the need for pension scheme consolidators to be properly regulated, capitalised and governed.

In aggregate, the bulk annuity market had a creditable year, with £11 billion of liabilities being insured, which is the fourth year in a row the market has exceeded £10 billion. What was particularly interesting about 2017 was that this level of market activity was achieved without any individual bulk annuity transaction exceeding £1 billion. The largest transaction of the year was the £725 million buy-in we completed for the Dock Workers Pension Fund.

The outlook for the sector remains positive, with trustees of pension schemes having increased the certainty of their funding positions by investing a greater proportion of their assets in fixed income than ever before. These are assets that could back a future pension insurance buyout or buy-in.

As Chairman, the two criteria that I see as key to judging our success in managing the business are: whether our policyholders have full confidence in the security of their pension benefits; and whether our shareholders and bondholders receive an attractive return on their investment over time, commensurate with the level of risk to which they are exposed. My belief

> "SOLVENCY II IS WELL BEDDED IN AND THE BULK ANNUITY MARKET HAS SHOWN THAT IT CAN FUNCTION HIGHLY EFFECTIVELY WITHIN THIS REGULATORY ENVIRONMENT"

is that as we focus on our purpose of paying the pensions of our policyholders in a secure and sustainable way, these two objectives are both compatible and desirable, with the interests of these stakeholders being fully aligned.

Consistent with our stated objectives, PIC has a conservative capital structure and a deep-rooted risk management culture. So, whilst we wrote £3.7 billion of new business in 2017 (2016: £2.6 billion), our second-best year, we maintained strict pricing discipline. Our focus on excellence in customer care has helped our reputation grow as our business has developed and this has in turn become increasingly important in winning new business.

As described in the Chief Financial Officer's review on page 40, the Company achieved strong results in the year.

During 2017, the Board focused on important issues including the on-going validation of the Company's regulatory capital model, share schemes for employees and governance arrangements such as the structure and membership of the Board and its committees, including diversity related matters. In terms of capabilities, an external review of the Board concluded that PIC's directors have a high level of industry experience, with strong expertise in the actuarial, finance and investment fields.

In Q1 2017 we welcomed CVC as a new, major shareholder and I am very pleased that we have a group of committed shareholders who have the means and desire to support the business in the long term.

Also during 2017, John Coomber stepped down from the Board, ending a long association with PIC, including a very successful period as CEO. PIC was fortunate to benefit from his many years of insurance experience, including as CEO of Swiss Re, and I want to thank him for his insights, guidance and dedication.

I very much look forward to chairing PIC's Board for a second year.

"OUR FOCUS ON EXCELLENCE IN CUSTOMER CARE HAS HELPED OUR REPUTATION GROW AS OUR BUSINESS HAS DEVELOPED"

# SECTOR REVIEW

A significant, growing market, driven by an increasing desire by pension fund trustees to reduce risk, combined with a healthy and competitive bulk annuity sector providing them with the opportunity to do so at an affordable price

## UK DEFINED BENEFIT PENSIONS: THE KEY NUMBERS

### Assets held within UK defined benefit pension schemes[(1)]

2016: £1.3 TRILLION

2017: £1.5 TRILLION

### Gilts and fixed income assets to securely match liabilities[(2)]

2016: £650 BILLION

2017: £840 BILLION

**A GROWING MARKET**

### Percentage of FTSE 100 companies over 80% funded on a buyout basis[(3)]

2016: 10%

2017: 20%

### Defined benefit pension liabilities insured through buyouts and buy-ins[(4)]

2016: £70 BILLION

2017: £81 BILLION

(1) PPF Purple Book 2017
(2) PPF Purple Book 2017
(3) LCP Pensions Derisking Report January 2018
(4) LCP and Willis Towers Watson (Data from 2017 includes transactions announced at time of going to press)

## Buy-in and buyout volumes
(£bn)

**£11BN**(1)

| | |
|---|---|
| 2017 | 11.0 |
| 2016 | 10.2 |
| 2015 | 12.3 |
| 2014 | 13.2 |
| 2013 | 7.5 |

**Since 2008, when PIC wrote its first transaction, the Company has maintained an average market share of 27% for buyouts and buy-ins**(2)

> “INSURER COMPETITION AND ASSET OPPORTUNITIES ARE DRIVING ATTRACTIVE PRICING”

**Hymans Robertson buy-in monitoring service, October 2017**

> “THE AVERAGE BUYOUT FUNDING LEVEL IS NOW AT ITS HIGHEST LEVEL SINCE BEFORE THE BANKING CRISIS IN 2008”

**LCP Derisking Report, January 2018**

(1) LCP and Willis Towers Watson buyout reports (Data from 2017 includes transactions announced at time of going to press)
(2) Source: Hymans Robertson and LCP reports. Only business with a UK pension scheme is included.

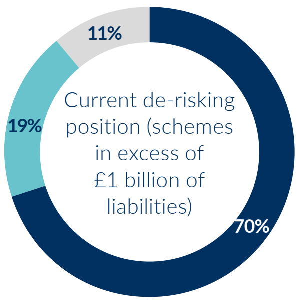
# SECTOR REVIEW

CONTINUED

Pension schemes are increasingly showing a desire to de-risk which, combined with more closely matching assets and liabilities and a healthy bulk annuity sector, has meant that full buyouts are a realistic prospect for more pension schemes. In the meantime, many trustee boards are conducting multiple buy-ins

## Intention

### Do schemes want to de-risk?




**Q. What is your scheme's current position with regard to de-risking?**

- Expect to reduce risk in the next 24 months
- Expect to make no changes in the next 24 months
- Intend to increase risk to target higher returns

Source: Professional Pensions/PIC research, 2017

## Opportunity

### A healthy bulk annuity sector

### Repeat buy-in strategy

Market data shows that the majority of transactions during 2016 and 2017 have been pensioner buy-ins.

**The advantages to this include:**

**Tailoring**
Opportunity to tailor the tranches, for example, according to the insurer's target market.

**Optimal pricing**
Prices vary according to the market and the liabilities being insured. Transacting in phases allows schemes to move at the right time for them.

**Efficiency**
Synergies with the overall investment strategy of the scheme can be realised through a phased approach.

**Simplifies decision-making**
Schemes can progressively remove risk, whilst achieving the scheme's long-term objectives.

**Successful schemes typically:**

- **Use specialist advisors**
- **Have realistic pricing expectations**
- **Have clear decision milestones and lines of authority**
- **Don't delay implementing the decision**

### Move to full buyout

**Improved investment returns, changes to interest rates and indications of a slow-down in longevity improvements are leading to improved funding levels for pension schemes, potentially fuelling an increase in demand for buyouts.**

# Means

## Are schemes in a position to consider securing their liabilities through a buy-in or buyout?

### Preparatory steps

Pension schemes are positioning themselves to take advantage of a competitive market and the ability to move quickly. Being prepared can increase the likelihood of securing a transaction and attractive pricing.

**Q. Which of the following risk reduction strategies has your scheme implemented?**

**51%**
Increasing proportion held in close matching assets

**33%**
Increasing interest rate and/or inflation hedging ratio

**13%**
Managing liabilities through Pension Increase Exchanges, ETVs etc

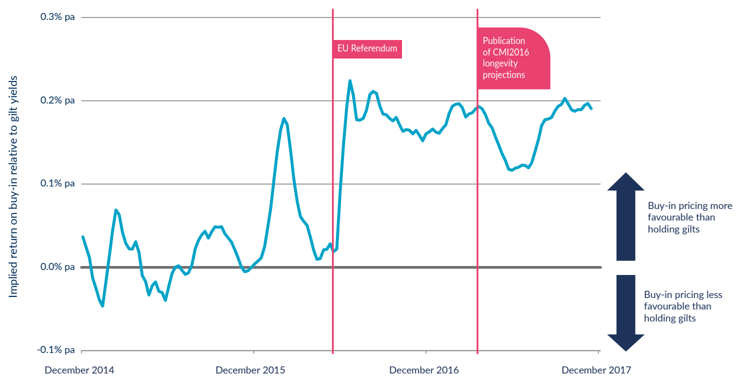
**21%**
Sponsor pledged assets

**17%**
Buy-ins/buyouts

### The cost of a buy-in versus gilts

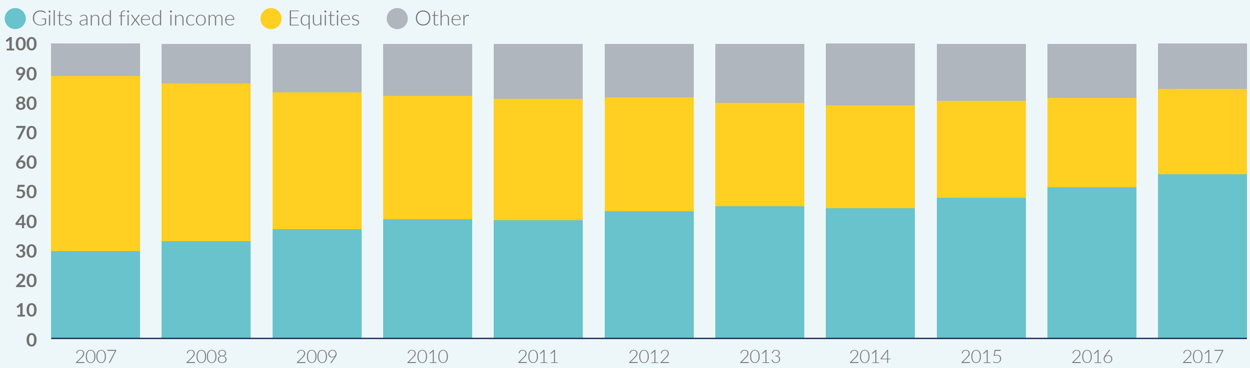
Gilts, assets which are used to closely match pension liabilities, can be used to purchase a pensioner buy-in for little or no incremental cost.

### Pensioner buy-in pricing relative to holding gilts




Source: LCP Pensions Derisking Report January 2018

### Asset allocation of defined benefit pension schemes (%)




Source: PPF Purple Book 2017

# WHAT WE DO

## New business

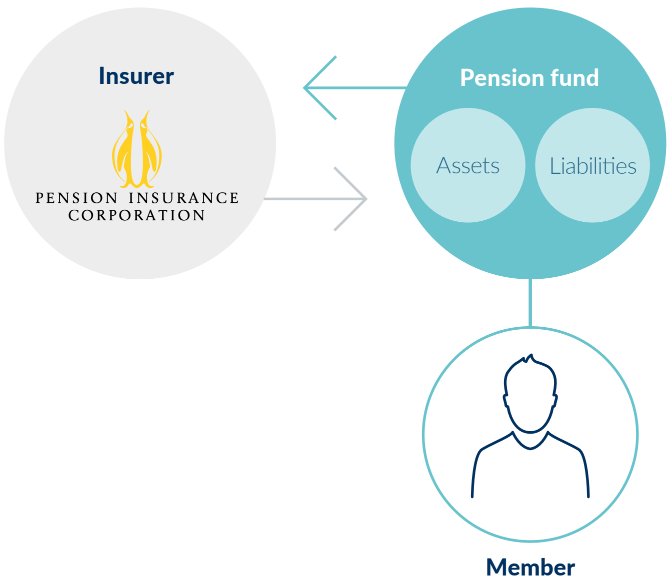
### What is a pension insurance buy-in?

> The pension fund purchases a bulk annuity insurance policy to cover its obligations to a subset of the fund members. The insurance policy is held as an asset of the pension plan.

> A buy-in is a perfectly matching investment for the insured liabilities.

> A buy-in removes the pension fund's longevity, market interest rate, inflation and other risks, as these are transferred to PIC.

> PIC has no direct relationship with pension fund members, who continue to be managed by the trustees.




## Examples of 2017 new schemes

### Pirelli pension schemes

- PIC concluded a c.£100 million full scheme buy-in with the Trustees of three defined benefit pension schemes sponsored by Pirelli UK Limited and Pirelli Tyres Limited.
- Each of the three schemes were completely de-risked providing greater security to members.

### WPP pension schemes

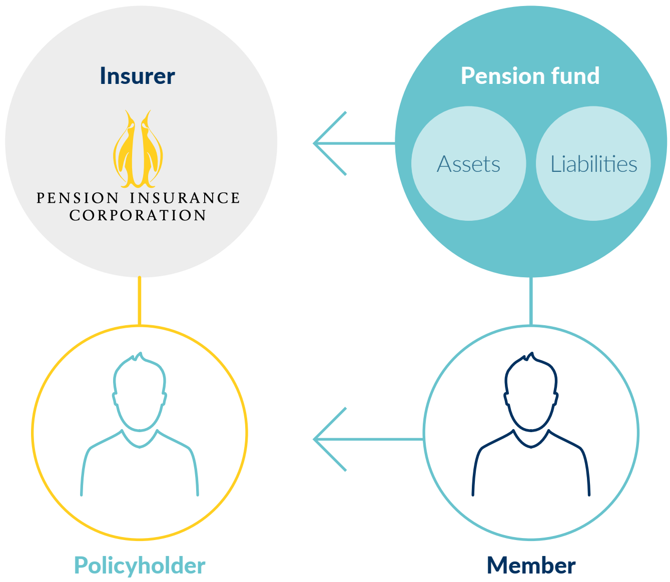
- PIC simultaneously insured £140 million of liabilities of five pension schemes sponsored by WPP, covering pensioner and deferred liabilities.
- WPP is a British multinational advertising and public relations company, listed on the LSE and is a constituent of the FTSE 100.

### Wolseley Group Pension Plan

- PIC concluded a £600 million pension insurance buy-in of the Wolseley Group Retirement Benefits Plan covering all of the pensioner liabilities.
- The Trustees de-risking strategy allowed them to take advantage of market conditions.

## What is a pension insurance buyout?

- A buyout removes pension assets and liabilities from a pension fund and employer's financial reports i.e. a full settlement of the pension fund and employer's obligations to the fund members.
- PIC issues individual annuity insurance policies to the members of the pension fund as a replacement for their claim on the pension fund.
- The pension fund is typically wound up and assets pass across to PIC.




## Our clients

We have successfully completed buy-in and buyout transactions for clients including:

AON
Cadbury
citi
Civil Aviation Authority
Department for Environment Food & Rural Affairs
EMI
HONDA The Power of Dreams
Institute and Faculty of Actuaries
London Stock Exchange
PENSIONS AND LIFETIME SAVINGS ASSOCIATION
TOTAL
WPP

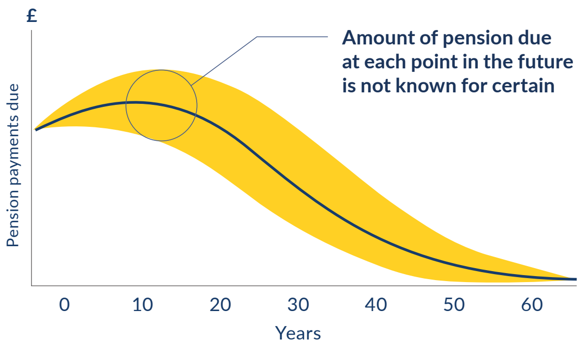
STRATEGIC REPORT

# OUR BUSINESS MODEL

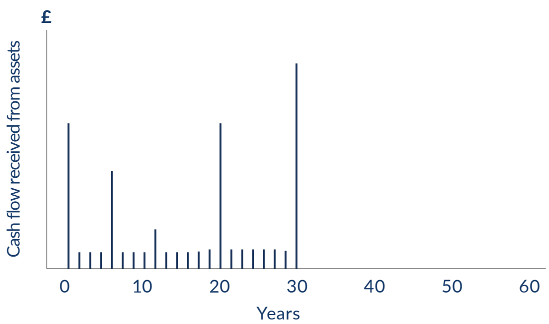
Three key steps in securing pensions and generating long-term shareholder returns

## 1 What we receive

**Pension liabilities** taken on are uncertain in both timing and amount (longevity and inflation uncertainty)




**Assets** are typically received in cash and gilts and are not cash flow matched to the liabilities




The profile of cash returns from the assets are typically very different to the profile of the cash payments due to pensioners (see chart above)

## 2 What we do

LIABILITIES ARE HEDGED FOR INTEREST RATE AND INFLATION EXPOSURE

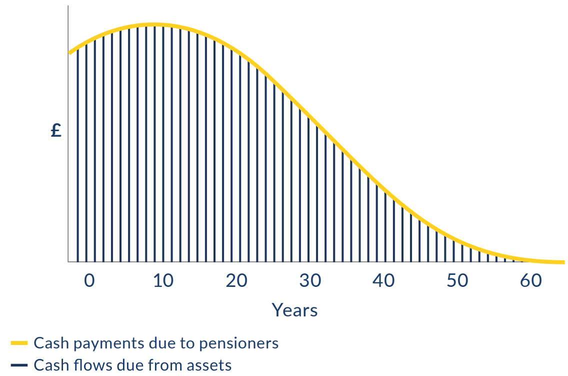
ASSETS RECEIVED ARE REINVESTED TO OPTIMISE RETURNS ON A CASH FLOW MATCHED AND RISK-ADJUSTED BASIS

LONGEVITY RISK IS REINSURED TO REMOVE RISK, CREATE CERTAIN LIABILITY CASH FLOWS AND OPTIMISE CAPITAL DEPLOYMENT

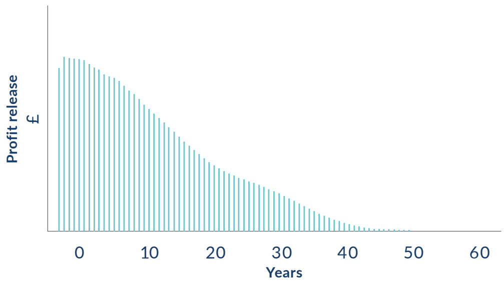
PIC CAPITAL RESOURCES COMMITTED

## 3 The outcome

**Best estimate liabilities** are made more certain and cash flow matched with high quality assets to provide secure long-term pensions for our policyholders




**Underlying profit profile** in premium is optimised and, together with the committed capital resources, is released over time, generating attractive risk-adjusted returns on capital employed




## Keys to success

PIC is a specialist insurer completely focused on the activities required to succeed in its chosen sector

**Success in the bulk annuity market requires expertise in**

- looking after policyholders
- structuring transactions
- investing assets
- hedging liabilities
- reinsuring longevity risk
- raising capital
- bringing all these skills together on a coordinated and efficient basis for transacting and transitioning new business.

**PIC's track record in all of these areas underpins its position as a leader in providing bulk annuities.**

STRATEGIC REPORT

# CHIEF EXECUTIVE OFFICER'S REPORT

**Tracy Blackwell**
Chief Executive Officer

**PIC had a very successful year in 2017 across a number of fronts including our focus on customer care, the amount of new business transacted, the record level of longevity risk reinsured, our overall financial results, and levels of support from our employees.**

Our key financial metrics demonstrate the strength of the business. We finished the year with total new business premiums of £3.7 billion, across 20 pension schemes, and took on responsibility for the pension payments of an additional 24,000 policyholders. Our IFRS profit before tax for the year of £391 million represents a 42% increase on the prior year.

PIC's underlying operating profit, which better reflects management's view of the profitability of the business and its activities (see page 41 for an explanation of this metric), grew to £195 million (2016: £177 million), an increase of 10% year-on-year. PIC's Market Consistent Embedded Value (MCEV) rose to £2,926 million (2016: £2,579 million), an increase of 13% in the year. Due to strong new business numbers, our investment portfolio is now £25.7 billion (2016: £22.6 billion), and PIC's solvency ratio at year-end was 160% (2016: 164%).

To fulfil our main purpose of providing financially secure pensions to our policyholders, as well as transacting new business and growing that pool of policyholders, there are several key areas in which we, as a specialist insurance company, need to excel. These include a very clear and strong focus on getting the best outcome for our customers, the ability to source the right sort of assets, the development of strong working relationships with reinsurers and the need to retain excellent staff.

Excellence in customer service is an area that is very close to my heart, as well as one of our key values. We were therefore proud to attain the Institute of Customer Service's (ICS) ServiceMark with Distinction – the only financial services company in the country to have done so. As the ICS noted, "Their dedication to, and passion for, great customer service marks PIC out as a standard bearer – one that others should follow." Our customers also continue to give us excellent feedback, with over 98% of policyholders expressing overall satisfaction with our service.

Over the past few years, PIC has built a team capable of sourcing, analysing and investing in secure, inflation-linked assets, on a private basis, to back very long-term liabilities. The rationale for this strategy is that compared to what is available in the public bond markets we are able to achieve better pricing for equivalent credit risk, obtain both higher and more reliable levels of security and source cash flows that more precisely match our long-term liabilities. The team invested more than £1 billion in 17 private debt transactions, in areas such as social housing, university accommodation and offshore wind power generation. Not only is this beneficial for those pensioners these assets are helping to secure, it is also beneficial for future generations who will benefit from our investment today in the country's infrastructure.

The main issue for us is that demand for these types of assets continues to outstrip supply. As well as developing the necessary levels of expertise, innovation and flexibility in-house to ensure we are a lender of choice for borrowers, we have consistently raised this issue with Government Ministers to encourage them to increase the supply of infrastructure assets in which we can invest. Separately, we were pleased to provide our first line of funding for equity release mortgages during the year. We see equity release mortgages as a product that fills an important need in our ageing society and we believe we can play an effective role in its development.

"OVER THE PAST FEW YEARS, PIC HAS BUILT A TEAM CAPABLE OF SOURCING, ANALYSING AND INVESTING IN SECURE, INFLATION-LINKED ASSETS, ON A PRIVATE BASIS, TO BACK VERY LONG-TERM LIABILITIES"

At PIC we have always sought to carefully manage our longevity risk, signing our first longevity reinsurance contract as long ago as 2008. However, our latest reinsurance transaction is particularly pleasing. In December, we were able to reinsure the entirety of our longevity exposure to the Dock Workers Pension Fund (which we fully insured in November 2017), with PartnerRe, a new counterparty for us. We also added SCOR as a new reinsurance counterparty in the year, as well as Challenger Life. We now have strong working relationships with ten major reinsurance companies, providing us with a deep pool of risk mitigation counterparties.

As I noted in my half year report, we welcomed CVC as the latest shareholder in PIC's ultimate parent company, Pension Insurance Corporation Group, following their purchase of shares from historical long-term shareholders. We have a supportive group of shareholders who are able and willing to enable us to meet any significant increase in demand from trustees.

The results of our latest employee survey have also been very pleasing. 97% of our employees believe PIC is customer focused (2016: 95%), 92% feel proud to work for PIC (2016: 90%), and 99% of employees believe PIC will be successful over the next few years (2016: 98%). I want to thank our employees for all their hard work in making 2017 so successful.

Finally, we are fast approaching the tenth anniversary of the collapse of Lehman Brothers and the depths of the financial crisis. It is my firm conviction that we in the finance industry have not done enough in those ten years to rebuild trust with society. I believe that financial services companies have a duty of responsibility that goes well beyond our shareholders and even our customers. I was delighted therefore to progress two initiatives that demonstrate PIC's commitment to playing our part in society: a project to encourage discussion and action based on "The Purpose of Finance", which has engendered interest from senior politicians and leaders in finance alike; and a pioneering mentoring scheme for female actuaries, "Project AMP", in conjunction with the Institute and Faculty of Actuaries, to help increase levels of female talent at the top of the profession over time.

As a business we are passionate about ensuring the best outcomes for our stakeholders including our customers (our policyholders, as well as pension scheme trustees and their sponsoring companies), our investors, and our employees. 2017 was a very successful year for us, and I believe that this focus will mean continued success.

# OUR STRATEGY

## Continued progress in meeting our key strategic objectives

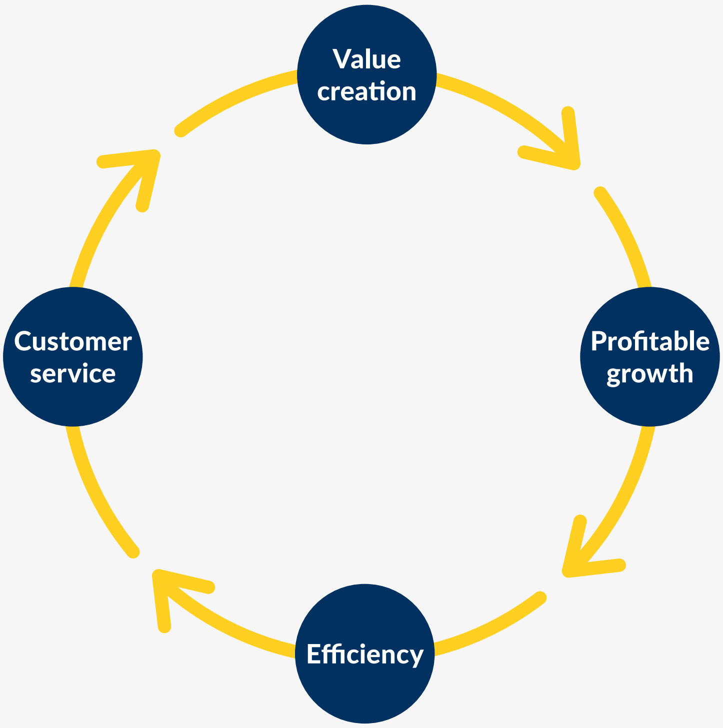
| Strategic objectives | 2017 progress | KPIs |
|---|---|---|
| **Growth and focus**<br>Grow the value of the business on a focused, secure and sustainable basis | > Maintained long-term market share of c.27%, with a focus on pricing discipline<br>> New business comprises an increased number of repeat transactions via buy-ins<br>> More than £1 billion invested directly with long-term borrowers to provide higher yielding, secure assets to back pension cash flows<br>> Reinsurance of £4 billion of longevity risk<br>> Solvency position of 160% | > More than 30% organic growth in PIC's embedded value since year-end 2015<br>> Investment portfolio has grown by 30% Compound Annual Growth Rate ("CAGR") since year-end 2013 |
| **Reputation**<br>Long-term value creation through market-leading customer service | > Awarded ServiceMark with Distinction by the Institute of Customer Service<br>> Senior management hosted almost 3,000 policyholders and guests at complimentary events<br>> Annual survey of employees completed to assess their understanding of, and grounding in, PIC's customer service culture and values | > 98% of policyholders are satisfied or highly satisfied with PIC's service levels<br>> 97% of employees believe PIC is customer focused (always seeking to understand and meet customer needs) (2016: 95%) |
| **Returns**<br>Deliver attractive risk adjusted total shareholder returns | > £3.7 billion of new business written in 2017 on terms consistent with PIC's long-term IRR targets<br>> IFRS profit before tax was £391 million (2016: £276 million), an increase of 42%<br>> PIC's underlying operating profit before tax was £195 million (2016: £177 million), an increase of 10% in 2017<br>> Market Consistent Embedded Value (MCEV) increased to £2,926 million (2016: £2,579 million), a rise of 13% during the year<br>> £4.3 billion of assets (2016: £4.3 billion), in excess of best estimate liabilities | > 25% CAGR in PIC's underlying operating profit over the past four years<br>> Over 30% organic growth in embedded value over the past two years<br>> 30% CAGR in financial investments over four years |
| **Cost efficient**<br>A scalable business model that optimises internal and external resources | > Expenses reflect investment in business infrastructure to capture future economies of scale<br>> Reduction in debt yield indicates lower future cost of capital<br>> Continued development of Board committees and structure to enhance decision making | > Improving efficiency as the business develops<br>> The yield on the two subordinated debt issues fell over the year |
| **Knowledge and conduct**<br>Ensure that our behaviours reflect our values | > Proposed and funded mentoring programme for junior female actuaries, in conjunction with the Institute and Faculty of Actuaries<br>> Published ground-breaking report on "The Purpose of Finance" to encourage financial services businesses to think about why they exist and how to rebuild trust with society | > Knowledge and conduct are not a formal KPI; however, they provide an important foundation stone on which business support is built<br>> 95% of employees said they had a good understanding of PIC's values (2016: 94%) |

# “PRUDENTIAL IS PROUD TO STRENGTHEN ITS GROWING PARTNERSHIP WITH PENSION INSURANCE CORPORATION”

**William McCloskey, Prudential Insurance Company of America’s head of transactions for international longevity reinsurance (£900 million longevity reinsurance transaction)**

# KEY PERFORMANCE INDICATORS

## Proven track record of growth across all metrics

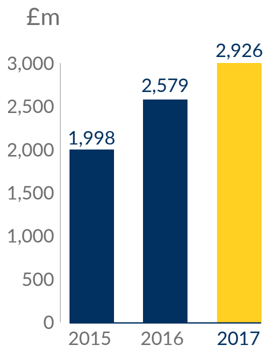



**PIC focuses on five Key Performance Indicators (KPIs) to measure its performance in four main areas[1]:**

Growth and overall value of the business,
total shareholder returns,
scale and efficiency,
and customer satisfaction.

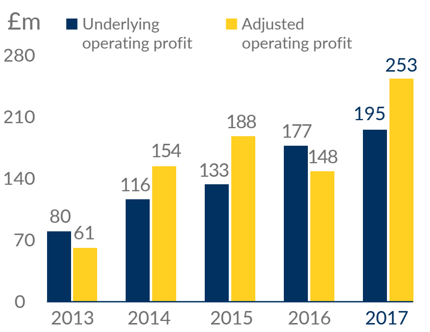
1 Full list of performance indicators are included on page 41

## MCEV




- From 1 January 2017, PIC has adopted the European Insurance CFO Forum Market Consistent Embedded Values Principles ("MCEV Principles")[2] for its embedded value measurement and reporting.
- Embedded value gives a snapshot of the value created to date and facilitates market comparisons.
- MCEV is the key financial metric the Board uses to evaluate the progress of the business.

## Profitability



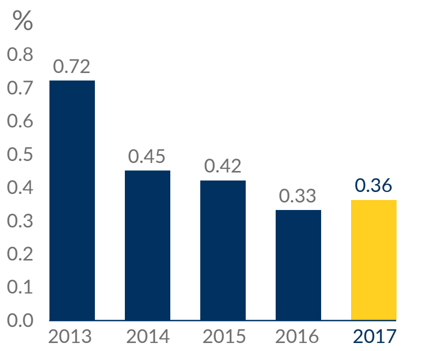

Underlying operating profit evidences the translation of embedded value into reported profits.

Underlying operating profit captures the returns made from the in-force book of insurance liabilities, and expected long-term returns from surplus assets.

Growth of underlying operating profit evidences the levels of growth we are achieving in building long-term profitability.

Adjusted operating profit includes the immediate short-term impact of new business and reinsurance.

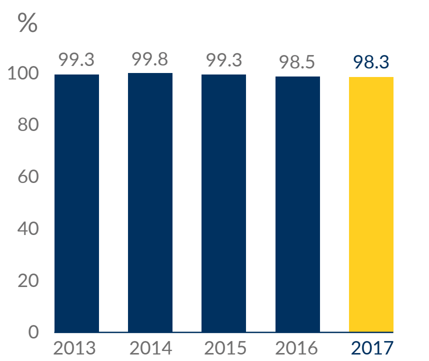
## Expense ratio




Expenses as a % of closing financial investments under management evidences how our cost base relates to our financial investments and hence our relative efficiency.

PIC is more financially efficient as we have gained scale and capability.

## Customer satisfaction

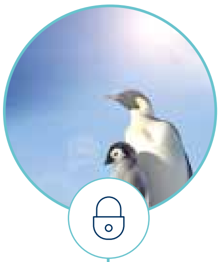



As well as the financial metrics, the business also uses customer satisfaction as a KPI with an emphasis on excellent customer service. This is done by measuring:

- % of customers surveyed who give PIC a satisfied or very satisfied rating, evidencing the quality of the service we have given.
- The average number of complaints per 1,000 policyholders over the past five years, which evidences how proactive our service is and the clarity and efficiency of our policyholder communications (see page 22).

# STAKEHOLDER ENGAGEMENT

## Our values



### Providing security

#### The resilience to withstand even the harshest of economic storms

We are committed to managing risk and providing long-term stability and financial security for our customers. We respect boundaries and regulate ourselves at a level in excess of regulations. Our strong, conservatively managed balance sheet ensures resilience against tough economic events.

### Valuing our customers

**Our customers are our priority and our purpose is to pay the pensions of our policyholders on a financially secure basis. We value all our customers (policyholders, trustees and sponsors) and work hard to provide exceptional service. We listen to and will be responsive to their requirements acknowledging the need for fair and sustainable commercial practices.**

### Being a team

#### Our nature? To nurture

We know the benefit of working together as a team. We respect, value and nurture our people both in terms of their development and engagement. And we're open to new ideas, perspectives and opinions.

### Doing the right thing

#### All-weather friends

Our policyholders are our partners for life, which is why our strong ethos around doing the right thing is so important to us. Our policyholders must be able to trust us. So, we live by a set of ethical principles and standards of behaviour and genuinely believe that fairness and honesty really count.

### Embracing new ideas

#### Adaptable enough to operate successfully in any environment

We pride ourselves on doing things differently, being adaptable enough to operate successfully in any environment and match any challenge. We go beyond existing ways of thinking to come up with innovative, personalised solutions.

### Striving to be the best

#### Leadership is second nature

We provide sector-leading expertise, operating at a level of excellence in everything we do. We listen carefully, are not afraid to learn and challenge ourselves and deliver a consistently high-quality offering.

“I BELIEVE THAT FINANCIAL SERVICES COMPANIES HAVE A DUTY OF RESPONSIBILITY THAT GOES BEYOND OUR SHAREHOLDERS AND EVEN OUR CUSTOMERS”

**Tracy Blackwell, PIC CEO**

# STAKEHOLDER ENGAGEMENT

CONTINUED

## Key statistics

### Number of pensioners insured


The number of pensioners insured grew by 12% in 2017 to 151,600 (2016: 134,900).

### Annuities paid


Payment of annuities grew by 21% in 2017 to £725 million (2016: £600 million).

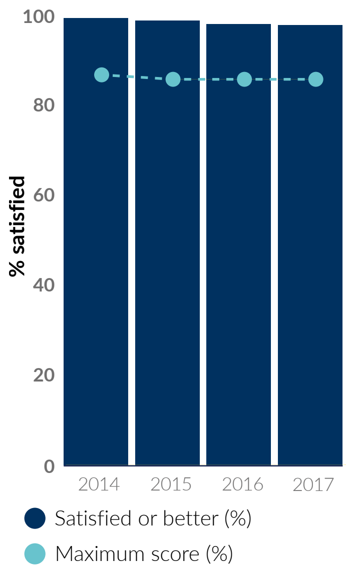
### Total claims paid


Total claim amounts paid were £1,003 million (2016: £797 million), an increase of 26% as the growth in annuities was supplemented by the increases in lump sum and other payments compared to the previous year.

### Individual policies in issue


At the end of 2017, PIC had 84,300 current individual policies in issue, in respect of 90 pension schemes, compared to 80,900 in respect of 74 schemes in 2016.

### Extremely high levels of member satisfaction:




We have extremely high levels of policyholder satisfaction and have maintained over 98% satisfaction in the last seven years.

# Policyholder satisfaction

**Policyholder satisfaction is measured in a number of ways and is a key part of PIC's ongoing commitment to market-leading customer service:**

- Member satisfaction levels are monitored via telephone and paper surveys.
- Close monitoring of complaint levels and analysis of complaint root cause.
- Stringent oversight of outsourced administrators, such as:
  - monthly file and call review;
  - regular site visits; and
  - weekly operational catch-ups and formal monthly service reviews.
- Face-to-face feedback at our six policyholder events.
- Institute of Customer Service ServiceMark survey.
- Complaints reviewed by senior management and the Board.
- 98.3% of policyholders expressed overall satisfaction with our service and 86% gave us the maximum score.
- Our complaints level has averaged only 1.4 complaints per thousand policyholders over the past 5 years.

A selection of pictures from PIC's Policyholder Days in 2017

PIC Board member Mark Stephen chats to policyholders

A policyholder completes her feedback form at one of PIC's events


Policyholders enjoying refreshments and socialising at the London Policyholder Day

Policyholders chat to one another at one of PIC's events

# STAKEHOLDER ENGAGEMENT

CONTINUED

## Customer service

"ATTAINING SERVICEMARK IN 2015 WAS A REAL ACHIEVEMENT AND I AM DELIGHTED THAT WE HAVE NOW BEEN ABLE TO AWARD PIC SERVICEMARK WITH DISTINCTION. THEIR DEDICATION TO, AND PASSION FOR, GREAT CUSTOMER SERVICE MARKS PIC OUT AS A STANDARD BEARER – ONE THAT OTHERS SHOULD FOLLOW… PIC CLEARLY UNDERSTANDS HOW A RELENTLESS DEMONSTRATION OF SERVICE EXCELLENCE MAKES A REAL DIFFERENCE"

**Jo Causon, CEO of the Institute for Customer Service, on PIC's attainment of ServiceMark with Distinction, 2017**

### Putting customers first through exceptional customer service for our trustees and policyholders

PIC was awarded ServiceMark with Distinction by the Institute for Customer Service (ICS) for "…dedication to, and passion for, great customer service". PIC is the only financial services company in the country to hold this award.

PIC has been developing and monitoring its customer service levels with the ICS for a number of years, and in 2015 was awarded the ICS's ServiceMark. In March 2017 PIC won the Quality Service Provider Award at the ICS's Customer Service Awards.

The ICS noted, as part of the award assessment process, that: "The commitment to the company's vision to be the best service provider and to do the right thing filters through from the top down… **the team at PIC works hard to build and maintain trust with their customers**… the 'no blame' culture was well documented and any complaints are viewed as learning opportunities… plenty of evidence was seen that **PIC look at the process from the customer's point of view…** staff are recruited in the first instance for the right attitude towards customers and colleagues… **PIC makes it easy for customers to deal with them**… they are keen to be seen as a champion for great service in the industry."

# Customer service – policyholders

PIC's CEO Tracy Blackwell and the Executive Management team take questions from the audience at the London Policyholder Day 2017

## Policyholder events

PIC has welcomed more than 15,000 policyholders to complimentary events around the country over the past few years. These include Christmas lunches, as well as full-day events where our policyholders have the opportunity to meet with and question senior management and other members of the PIC team. Speakers regularly include our Chairman, CEO, CFO or other members of PIC's Board and senior management who talk about the security of our policyholders' pension benefits; PIC's financial strength; and why providing high levels of customer service is so important to us. A talk by a famous face as our headline speaker rounds off the day, giving a positive message of staying active in later life. PIC's administration team is on hand so policyholders can discuss pension queries face-to-face, and we invite local charities and social groups to give free information and advice. This helps to ensure that our policyholders enjoy the day as a whole, giving them the chance to enjoy a day out as well as being educated and informed.

Whilst isolation and loneliness are much discussed issues affecting many of the older generation, we recognise the role that companies such as ours can play in helping to establish vital connections with friends, family and the occasional new face. Many of the attendees enjoy these events as they give an opportunity to reconnect with former colleagues and reminisce about days gone by.

We believe the opportunity for our employees to engage directly with our policyholders is essential in making sure they understand the centrality of our policyholders to our business.

## Case study

"IT'S NICE THAT PIC TREATS ME AS AN INDIVIDUAL"

PIC have been looking after my pension since October 2014, when they took on responsibility for the Leaf Pension Fund. PIC's purpose of securing pensions is at the heart of what the company is all about and they certainly do a good job of it. The transition to PIC was seamless and I was very impressed with how they kept us informed on all issues every step of the way. The service levels are different to other companies, they communicate well and letters and other documents are easy to follow and jargon free.

It's nice that PIC genuinely treats me as an individual. I have now attended three of the Christmas lunches, which I think is a really nice idea. It's good to meet other PIC policyholders and a number of the PIC team.

**Ian Gillard, former Leaf Pension Fund member, now a proud PIC policyholder**

# STAKEHOLDER ENGAGEMENT

CONTINUED

## Customer service – trustee engagement

**Former Registered Dock Workers Pension Fund: the largest bulk annuity market transaction of 2017**

In November 2017, PIC completed a £725 million full buy-in with the Trustee of the Former Registered Dock Workers Pension Fund (the "Fund"). Together with existing insurance policies, the transaction completely removed the risk in respect of the Fund's pension liabilities.

The transaction benefitted from significant preparatory work undertaken by the Fund, putting it in a position where the Trustee could move quickly to secure attractive pricing and obtain comprehensive risk cover.

Unusually the transaction was funded entirely from the Fund's assets without need for further contributions from the sponsoring employers. For details of the longevity reinsurance transaction see page 48.

"WE ARE DELIGHTED TO HAVE SECURED THE BENEFITS FOR ALL MEMBERS IN FULL WITH AN ESTABLISHED, UK REGULATED INSURANCE COMPANY. THE TRUSTEE IS GRATEFUL TO … PIC FOR DEALING WITH THE TRANSACTION SO EFFICIENTLY"

**Ian Forrest, Chairman of the Trustee of The Former Registered Dock Workers Pension Fund (£725 million full buy-in)**

“THE PLAN HAS BEEN DE-RISKING FOR A NUMBER OF YEARS, PRIMARILY BY MOVING OUR ASSET MIX TO FAVOUR INDEX-LINKED GILTS. WE ARE VERY PLEASED TO HAVE BEEN ABLE TO COMPLETE THIS LOGICAL NEXT STEP IN OUR LONG-TERM DE-RISKING PROGRAMME. PIC DEMONSTRATED SIGNIFICANT EXPERTISE WHILE HELPING US TO MANAGE A COMPLEX PROJECT AND ULTIMATELY DELIVER THE TRANSACTION WE REQUIRED”

**Carol Woodley, Chairman of Trustees, 3i Pension Scheme (£200 million buy-in)**

# STAKEHOLDER ENGAGEMENT

CONTINUED

## Employees

"EXTREMELY WELL-RUN ORGANISATION WITH AN INCREDIBLY BRIGHT FUTURE. THE CULTURE RUNS RIGHT THROUGH THE HEART OF THE BUSINESS AND EVERYONE WORKS TOGETHER AND IS PULLING IN THE SAME DIRECTION TO MEET OUR COMMON GOALS"

**PIC Employee Survey, December 2017**

"PIC IS A COMPANY WORTH ADMIRATION... IT IS NOT ONLY A LEADER IN ITS INDUSTRY, BUT A LEADER ON HOW TO ENGAGE AND ENABLE ITS EMPLOYEES TO BE THE BEST THEY CAN BE..."

**PIC Employee Survey, December 2017**

**The ability to fulfil our purpose – paying the pensions of our policyholders – is down to the skills, knowledge and experience of each of our employees. As a growing company, we are committed to ensuring that our culture is part of the recruitment process, where candidates are assessed against the behaviours we expect from our staff.**

We are proud to have a flat structure with short reporting lines. Our open plan office means senior management and employees sit together, resulting in increased accessibility and responsiveness. Together this encourages entrepreneurial and innovative behaviours, supported by a strong team ethic.

The views and opinions of our employees are important to us in helping to enhance our culture, and as part of our desire to be the best, we conduct an annual staff survey to gather views from all our staff. The results provide clear evidence that our culture and values really do make PIC an attractive place to work and help us to manage conduct risk. More than 93% of employees would recommend PIC as a place to work and our employee engagement scores put us in the top quartile of UK companies.

### SAYE

PIC operates an annual Save As You Earn Scheme, which gives staff members the opportunity to acquire PIC shares at a favourable price. This is not a common practice for a private company, but is designed to develop a pride of ownership, laying the foundations for a sustainable and successful company for many years to come. Since it launched in 2013, a majority of PIC staff have participated in the scheme each year with many subscribing every year, demonstrating their belief in the future prospects of the company and aligning their interests more closely with those of other stakeholders.

### Employee benefits

We believe in rewarding the hard work of our employees and for that reason we offer a wide range of benefits, which include:

- Generous pension contributions;
- Private medical cover;
- Season ticket loan;
- Company-sponsored events (including a discretionary weekend away for our staff and their families as a thank you for the support given over the year); and
- Travel insurance.

# What our employees said about our values

## EMPLOYEE FEEDBACK

**↑ 97% (2016: 95%)**
believe PIC is customer focused (always seeking to understand and meet customer needs)

### "Valuing our customers"
We pride ourselves on our customer focus and work hard to ensure that employees feel they can serve our customers' interests efficiently and effectively without undue red tape.

**↑ 92% (2016: 90%)**
feel proud to work for PIC

### "Doing the right thing"
The result clearly demonstrates that a good understanding of the values and a focus on purpose brings pride. Employees expressed very high levels of trust and confidence in the senior leadership team.

**↑ 93% (2016: 92%)**
would recommend PIC as a place to work

### "Being a team" and "Embracing new ideas"
Many employees commented on the recognition they received and the appreciation that managers and the leadership team showed to them for their contribution, reinforcing the team ethos and commitment to innovation that these values represent.

**↑ 99% (2016: 98%)**
believe that PIC will be successful over the next 2-3 years

### "Striving to be the best" and "Providing security"
Employees have a demonstrable understanding of PIC's purpose, strategy and focus on the customer. The vast majority of employees feel that PIC is effectively managed and well run.

**↑ 95% (2016: 94%)**
say they have a good understanding of PIC's values

### "Good understanding of PIC values"
Our values are integral to the way that we work. Every effort is made to hire those individuals who are alive to the importance of organisational purpose, culture and the values which flow from this.

# STAKEHOLDER ENGAGEMENT

CONTINUED

## Employees and their families

### Case study

"THE WHOLE WEEKEND WAS A NICE REWARD FOR STAFF"

My husband, Paul, has worked for PIC for almost two years. Initially, we were unsure about spending a weekend with Paul's colleagues but our concerns were quickly assuaged by the friendly and relaxed atmosphere that was obvious as soon as we arrived. It was lovely to meet the other families, and the location, entertainment and food were fantastic. It was also very nice to meet people from different areas of the company who have been at PIC for various amounts of time.

The whole weekend was a nice reward for staff, who could spend this quality time with their families and colleagues. It helped those of us external to PIC to put the sometimes long working hours into context. PIC is not just a faceless employer; it is now a company that we can relate to and one in which we have a better understanding of its goals and values. Everyone we met, including management, was approachable, friendly and down-to-earth.

Overall PIC comes across as being ambitious and driven, but at the same time balancing this with a sense of fun and a lack of arrogance despite its success to date.

**Malini McCauley, wife of PIC employee Paul McCauley**

### Away Weekend

PIC recognises how central our employees are to the success of the organisation and in 2017 we asked all staff and their families to join us for an Away Weekend in congenial surroundings, a perhaps unique staff benefit.

The Away Weekend was a thank you to staff for their hard work and also to their families for their support and understanding of any late nights worked. It was incredibly useful, and enjoyable, for everyone – from Board members to more junior members of the team – to get to know one another outside the office.

One of PIC's core values is "being a team", and this event reinforced that value, providing a motivating and energising experience for our employees.

# Industry diversity

### The Actuarial Mentoring Programme ("Project AMP")

In 2017, PIC, in collaboration with the Institute and Faculty of Actuaries (IFoA), launched a pioneering mentoring scheme for female actuaries called Project AMP. The programme was launched to help improve diversity at senior levels of the actuarial profession, after research found non-retiring female actuaries were leaving the profession 13 years earlier than their male counterparts.

In its first year, PIC, together with eight other organisations – the Prudential Regulation Authority, Aviva, Phoenix Group, Mercer, Lane Clark & Peacock, Barnett Waddingham, Xafinity and the Government's Actuary Department – signed up to the scheme, with 100 male and female mentors and mentees signed up to participate.

## Case study

"PIC REALLY IS LIKE ONE BIG TEAM"

My job at PIC principally consists of transferring PIC's longevity risk to the global reinsurance market. I wanted to complement my technical experience by volunteering for the IFoA, so when I found out PIC was sponsoring Project AMP, it seemed like the perfect opportunity. The scheme enables you to build relationships with peers across the industry and it is a great example of our company values in action. I am very pleased to be part of Project AMP and give something back to the actuarial profession.

One of the best things about working at PIC is that it is easy to see how your team contributes to the success of the company, which I find really motivating. PIC really is like one big team, with lots of different departments working together during a buy-in or buyout. PIC just wouldn't function without this collaboration.

**Rachel Jervis, PIC longevity risk manager and Project AMP Mentor**

PROJECT AMP

# ASSET AND LIABILITY MANAGEMENT

**Rob Groves**
Chief Investment Officer

**PIC's investment philosophy is designed to ensure that we can pay the pensions of our policyholders on a secure basis.**

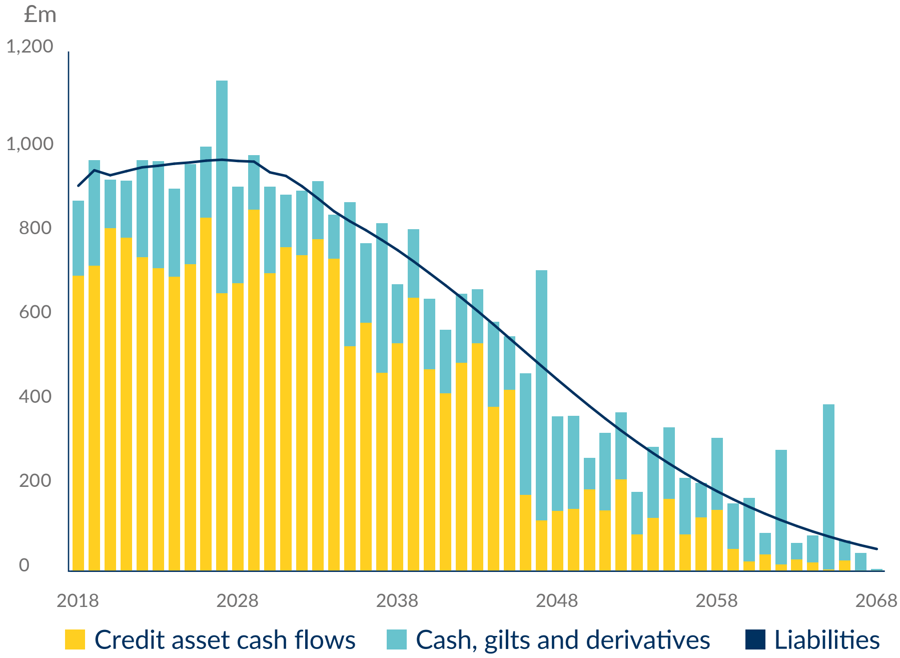
Whilst we have views on potential downside scenarios, including economic and political risks, we do not seek to directly predict the future, but rather we seek to build an investment portfolio that will perform well whatever happens in the future, i.e. is "weatherproofed". This means a high-quality, low-risk portfolio that protects against economic and market events. The majority of our portfolio is invested in cash flow matching, fixed income assets with a derivative overlay, to remove unwanted risks. Our principal unwanted risks are interest rates, inflation and currency.

We seek to take advantage of attractive investment opportunities but take a disciplined approach to our due diligence and only invest in assets we fully understand. Recent examples include debt investments in the universities, social housing and renewable energy sectors.

As the majority of our liabilities are non-callable and have a predictable cash flow profile, we are able, and have a requirement under Solvency II, to closely match our asset and liability cash flows by year. We also ensure we have appropriate liquidity in the portfolio in order to pay pensions and transfer values, post collateral for derivatives and reinsurance contracts and to pay the interest due on PIC's subordinated debt issuance.

Each annual liability cash flow is matched with assets such as corporate bonds, private debt, government bonds and derivatives. Each new business transaction is priced on a bespoke basis incorporating the team's forward-looking assessment of the attractiveness of the available asset universe. The assets are then adjusted for investment management fees, hedging costs and capital costs to create the most efficient cash flow matched portfolio.

**Asset risk: cashflow matching**



Just under 50% of our portfolio is managed externally, with mandates to invest in UK and US dollar (including Emerging Market) investment grade credit portfolios. Importantly, our managers are not benchmarked against their competitors or the market. Managers are measured by their ability to select bonds with lower probabilities of default and downgrade.

The other half of our portfolio is managed by a growing in-house team of specialists, focused on investing in assets that offer superior risk-adjusted returns through having features such as better security (for example, through physical assets, contractually agreed seniority and strong covenants), and crucially in a Solvency II world, have cash flows in years where there are few assets or there are liquidity constraints, to match our liability cash flows more precisely.

To date, we have a historic default experience of about 1bps per annum, against a Solvency II best estimate reserving assumption of 20bps per annum. We also hold a significant additional reserve for the cost of downgrades (the cost of maintaining the portfolio's overall rating following a downgrade in our portfolio). In total, the reserve held on our Solvency II balance sheet against the cost of defaults and downgrades exceeds £1.2 billion.

We currently have more than £8 billion of highly liquid assets (c.33% of our total assets) within the portfolio, consisting predominantly of gilts and cash. The size of our collateral requirement under extreme market moves (calibrated to be a 1 in 200 year stress scenario) is c.£4 billion. Thus we have over £4 billion of highly liquid assets in excess of what we would expect to need even in very extreme market conditions.

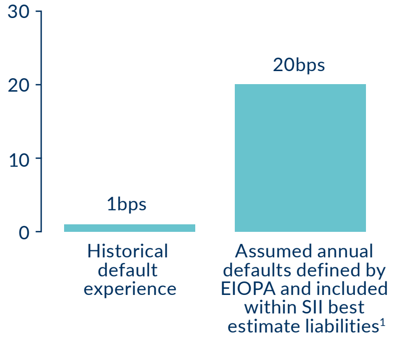
We invested over £1 billion directly in 2017 through 17 different transactions, which included £250 million of university related lending and over £320 million lent to UK housing associations, supporting the building or refurbishment of thousands of homes. Other innovative deals included a CPI-linked debt backed by renewable energy (offshore wind power generation). PIC also entered the equity release mortgage market in April 2017, providing a long-term funding commitment which allows our partner provider to expand its product range, with a focus on customer care that matches our own focus on policyholder care.

As a constant, PIC retains pricing and credit discipline when investing in private debt. The £1 billion we actually invested last year represents a conservative conversion rate when set against the c.£16 billion of potential investment opportunities that we looked at during the year. On average we reject 15 opportunities for every deal that we invest in.

All in all, 2017 was a very strong year for the investment team, as we compete against larger investors, or pension fund-backed investors who are subject to less regulatory oversight.

## Historical default experience

bps per annum




The actual default experience is an average of five years. We have not experienced any defaults since 2013.

[1] The European Insurance and Occupational Pensions Authority ("EIOPA") is a European Union financial regulatory institution that replaced the Committee of European Insurance and Occupational Pensions Supervisors. It is established under EU Regulation 1094/2010.

## Portfolio highlights

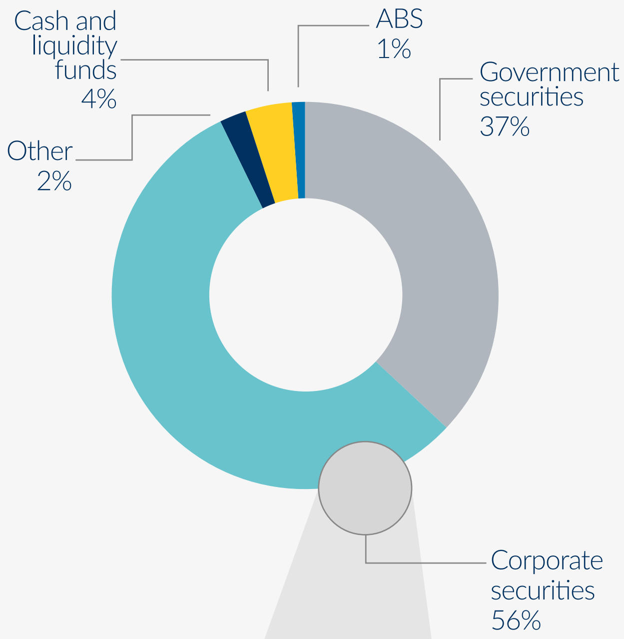
- 93% of financial investments in government and corporate securities.
- Corporate securities: 97% investment grade rated.
- No single counterparty (excluding UK government) represents more than 1.70% of total investment assets.
- 48% of financial investments managed by external asset managers.
- 52% of PIC's total investment assets managed directly, including UK gilts, supranational bonds and debt private placements.
- Investment strategy designed for long-dated assets to match long-dated liabilities.
- Discount rate applied to liabilities is set based on the asset portfolio yield net of adjustments for defaults and downgrades.

# ASSET AND LIABILITY MANAGEMENT

CONTINUED

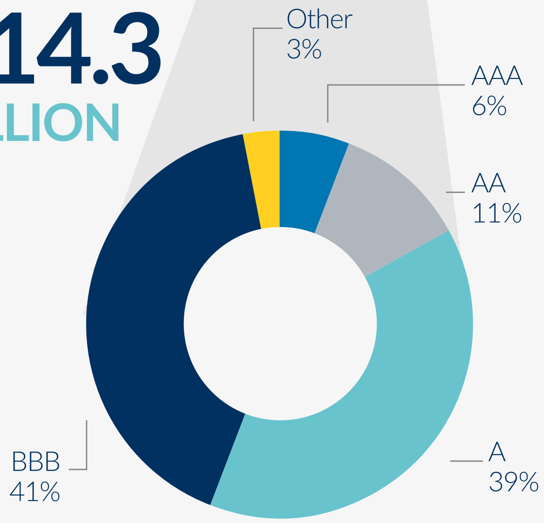
## Asset portfolio by asset class (31 December 2017)

**£25.7 BILLION**




## Corporate securities by rating

**£14.3 BILLION**




## Corporate securities by industry

| Industry sector | 31 December 2017 Market value (£m) | % |
|---|---|---|
| Financial | 4,096 | 28.6 |
| Utilities | 1,548 | 10.9 |
| Consumer, non-cyclical | 1,548 | 10.9 |
| Energy | 1,415 | 9.9 |
| Communications | 1,371 | 9.6 |
| PFI and direct investment loans (unlisted) | 1,463 | 10.2 |
| Consumer, cyclical | 940 | 6.6 |
| Technology | 733 | 5.1 |
| Industrial | 572 | 4.0 |
| Basic materials | 506 | 3.5 |
| Diversified | 101 | 0.7 |
| Quasi-Government | 6 | 0.0 |
| **Total** | **14,299** | **100.0** |

## Corporate securities by region

| Country | 31 December 2017 Market value (£m) | % |
|---|---|---|
| UK | 6,409 | 44.8 |
| US | 4,965 | 34.7 |
| Europe | 1,506 | 10.5 |
| Rest of the world | 1,419 | 10.0 |
| **Total** | **14,299** | **100.0** |

### Patient capital: backing our policyholders' pensions with investments that promote economic growth

As banks have withdrawn from long-term lending, life insurance companies with long-term liability cash flows, have taken their place and now play an increasingly important, and socially useful, role in the development of the UK's economy. In short, we are enhancing and improving the quality of life for future generations whilst securely backing the benefits of our pensioners.

By working directly with potential borrowers, typically on private debt issuance under £200 million, PIC is able to structure deals that are innovative, flexible and, importantly from our policyholders' perspective, very secure. In particular, these types of projects provide inflation-linked cash flows that can be shaped to mature in specific years, and provide us with security over the physical asset.

As natural consolidators of UK defined benefit pension fund assets and liabilities, the scale and investment in expertise of bulk annuity insurers allows us to do this type of investment more effectively than the majority of pension funds. Sectors that we have invested in include social housing (see case study overleaf), offshore wind power generation (see case study overleaf), biomass, student accommodation, healthcare, solar power generation and the rail network.

The internal investment process is tightly governed, with separate internal committees providing both detailed scrutiny on the credit quality of an asset, and giving final approval to ensure that the asset matches the company's risk appetite.

However, infrastructure development in the UK has focused on a small number of large-scale (and high-risk) trophy projects, as opposed to a larger number of smaller deals. The feeling among private investors remains that there is a lack of suitable projects. There is also a need for more ready-to-finance opportunities where there is no requirement for investors to involve themselves in the earlier, riskier stages of infrastructure development.

# ASSET AND LIABILITY MANAGEMENT

CONTINUED

## Case study
### Aldwyck Housing Group

In April 2017, PIC invested £40 million in secured debt issued by Aldwyck Housing Group, a housing association providing more than 11,000 homes and management services for around 25,000 people. The debt, which has a fixed rate, matures in 2033 matching PIC's pension liability cash flows. It will be used to refinance existing debt and build new homes.

PIC has invested more than £1 billion in social and affordable housing in the UK. The company anticipates investing considerably more in the sector over the coming years.

Ian McDermott, Group Chief Executive of Aldwyck Housing Group, said: "Aldwyck is delighted to have secured this £40 million private placement. We have a long and successful track record in development and over the next four years will be building over 800 much needed new homes to meet the needs of local communities. We are very pleased to work with PIC, who have a strong understanding of the needs of social housing providers and a demonstrable commitment to the sector."

**ALDWYCK HOUSING**
@aldwyckofficial • Apr 11 2017

BREAKING NEWS: Aldwyck and @PensionCorp complete £40 million investment deal. Read all about it here: aldwyck.co.uk/latest-news/al...

## Case study
## Walney Offshore Wind Farm

In November 2017 PIC invested £115 million in the Walney Extension Offshore Wind Farm Project. Situated off the coast of Cumbria, the offshore wind farm will have a total capacity of 659MW and power more than 500,000 UK homes. PIC has previously invested in renewable energy including solar power generation and biomass. The investment provides a very good match for PIC's pension liabilities.

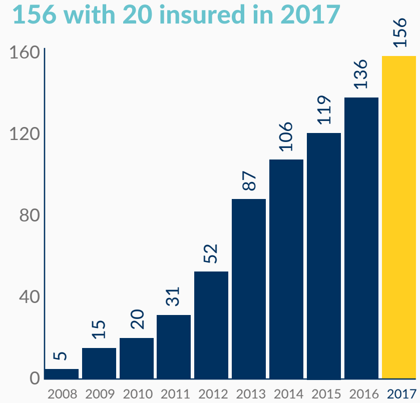
Key aspects of the transaction:

- CPI-linked, secured debt which matures in 2033 to match specific pensioner cash-flows.
- Backed by the Government's Contract for Difference (CfD), ensuring predictable, secure cash flows.
- Once built, the Walney Extension will be the world's largest offshore wind farm.

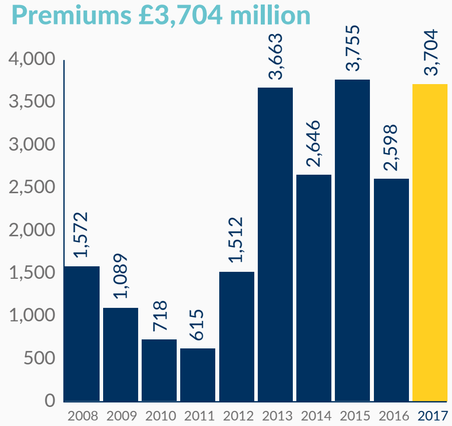
# FINANCIAL RESULTS SUMMARY

PIC's financial track record – continuous growth

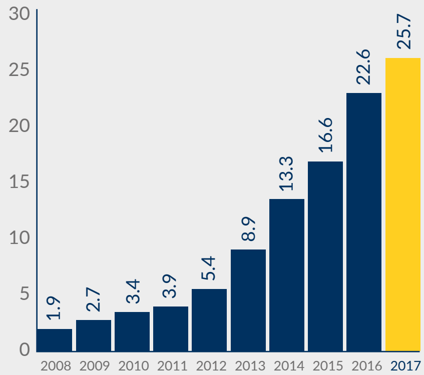
**Number of pension schemes insured (cumulative)**
**156 with 20 insured in 2017**




**New business premium (£m)**
**Premiums £3,704 million**

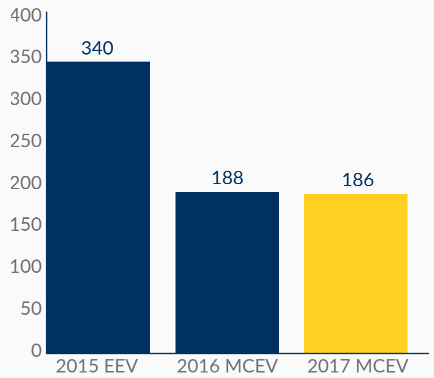



**Financial investments (£bn)**
**Financial assets £25.7 billion**

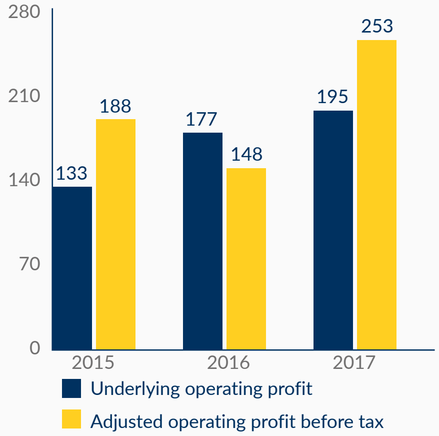


# PIC's financial track record – significant value generation

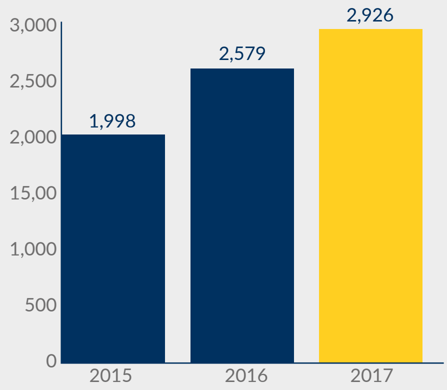
## New business value (post tax) (£m)
**£186 million**




## Profitability (£m)
**Underlying operating profit £195 million**




## Market Consistent Embedded Value (£m)
**£2,926 million**



# CHIEF FINANCIAL OFFICER'S REVIEW

**Rob Sewell**
Chief Financial Officer

**2017 was a successful year for PIC, with strong new business volumes, good profitability, growth in embedded value and very satisfactory solvency levels.**

PIC's profit before tax in 2017 was £391 million (2016: £276 million) and its underlying operating profit before tax was £195 million (2016: £177 million). The increase of 10% in underlying operating profit was driven by our ability to write business that delivers long-term profits and support this with high-quality, high-performance assets.

PIC's measure of underlying operating profit captures the long-term returns we make from the release of prudent margins in our in-force book of insurance assets and liabilities, and the investment returns on our surplus assets, based on our long-term return assumptions. Our IFRS approach means that these prudent margins are material, which serves to reduce the amount of profit recognised at the point of sale but increase the profits released over the remaining lifetime of the policy. This approach leads to long-term profit generation from the in-force book, which will continue to grow over time and aligns the timing of IFRS profit recognition with the actual run-off of the underlying insurance contracts.

Our overall profit in any one year is therefore less reliant on the new business written in the year and more reflective of the profits actually earned on our whole in-force business, as the anticipated profit loading in the premium represented by prudent margins is translated into actual earned profits. This long-term profit recognition approach is reflective of the long-term ownership culture of PIC's shareholders.

Adjusted operating profit adds the outcome of new business and reinsurance activities to the underlying operating profit and in 2017 we had a particularly strong reinsurance performance. Pre-tax profits were additionally aided by an assumption change in respect of our prudent margins, where around £170 million of additional prudent margins were released to profit during the year. However the balance sheet remains very conservative, with a further £1.7 billion of prudent margins yet to be released into profit in the coming years.

PIC has £4.3 billion of assets in excess of its best estimate of liabilities (2016: £4.3 billion).

During the year, PIC reinsured longevity exposure on £4 billion of reserves, a record amount and at year-end 73% of the Company's total longevity exposure had been reinsured (2016: 68%). In December, PIC completed a £725 million longevity swap reinsurance deal covering the Dock Workers Pension Fund with PartnerRe, another new reinsurance counterparty for PIC. This takes the total number of PIC's reinsurance counterparties to ten, all of which are investment grade. Three new relationships were developed during 2017.

Over the last few years we have seen a shortening of life expectancies versus our original assumptions. Whilst we are adopting the new improvement tables (CMI 2016) for our future longevity projections, we are not taking any benefit at the moment for the beneficial experience we have seen to date. We will do further work on this, with an expectation of further updating our longevity assumptions during the course of 2018.

PIC's solvency ratio at the end of 2017 remained strong, at 160% (2016: 164%). Despite the significant new business volumes written during the year, a combination of effective capital management, careful underwriting and reinsurance ensured that our solvency levels remain very secure.

Finally, it is worth noting that PIC's debt leverage remains very comfortable at 21% on an IFRS basis. This is reflective of our wider conservative approach to financial management for the business.

## 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.

| | **As at 31 December 2017** | As at 31 December 2016 |
|---|---|---|
| **Financial KPIs** | | |
| **Measures of profit or loss** | | |
| Underlying operating profit before tax | **£195m** | £177m |
| Adjusted operating profit before tax | **£253m** | £148m |
| IFRS profit before tax | **£391m** | £276m |
| **Measures of assets and liabilities** | | |
| IFRS net asset value ("NAV") | **£2,076m** | £1,760m |
| Market Consistent Embedded Value | **£2,926m** | £2,579m |
| **Measures of financial strength** | | |
| Solvency II regulatory solvency ratio | **160%** | 164% |
| **Measures of income and expenditure** | | |
| New business premiums written | **£3,704m** | £2,598m |
| **Cost base** | | |
| Operating expenses as a % of closing financial investments under management | **0.36%** | 0.33% |
| **Non-financial KPIs** | | |
| Customer satisfaction ratio | **98.3%** | 98.5% |

A summary of the alternative measures of profit or loss follows below:

- Profits generated from release of prudent margins for business written in previous years.
- Return on shareholder funds based on long-term investment return assumptions.
- Profit depends on characteristics of plans acquired.
- New business written to target IRRs.
- Prudent margins and capital released over life of contract.
- Creates VIF asset, resulting in increased EV.
- Emergence of future profits de-risked through hedges and reinsurance.
- Short-term fluctuations in investment return, model and assumption changes and non-recurring expenses.

| | **2017 £m** | 2016 £m |
|---|---|---|
| Return earned on insurance book | **143** | 122 |
| Expected return earned on surplus assets | **52** | 55 |
| **Underlying operating profit before tax** | **195** | 177 |
| New business and reinsurance | **70** | (26) |
| Other changes to in-force business | **(12)** | (3) |
| **Adjusted operating profit before tax** | **253** | 148 |
| Non-economic assumption changes | **170** | 21 |
| Finance costs | **(41)** | (22) |
| Other movements | **9** | 129 |
| **IFRS profit before tax** | **391** | 276 |

- Underlying operating profit reflects stable emergence of profits from in-force business (i.e. if no new business was written);
- Total adjusted operating profit includes impact from new business and reinsurance:
  - New business profits can be positive or negative at inception subject to characteristics of plans acquired;
  - Non-operating profit can be further impacted by short-term fluctuations in investment return, model and assumption changes and non-recurring expenses. The Company does not believe this measure is reflective of the long-term nature of PIC's business, and therefore does not use it as an alternative profit measure.

Adjusted 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.

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

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 Embedded Value ("EV") analysis was prepared under the European Insurance CFO Forum MCEV Principles issued in April 2016. 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.

# CHIEF FINANCIAL OFFICER'S REVIEW

CONTINUED

### Reconciliation of adjusted operating profit

| | 2017 £m | 2016 £m |
|---|---|---|
| Total IFRS revenue | **4,756** | 5,794 |
| Less IFRS net claims paid | **(909)** | (768) |
| Less IFRS net change in liabilities | **(3,324)** | (4,656) |
| | **523** | 370 |
| Less non-economic assumption changes included in non-operating profit | **(170)** | (21) |
| Less acquisition and other operating expenses | **(91)** | (72) |
| Less other movements included in non-operating profit | **(9)** | (129) |
| Adjusted operating profit before tax | **253** | 148 |
| Adjusted operating profit before tax consists of: | | |
| Underlying operating profit | **195** | 177 |
| New business and reinsurance | **70** | (26) |
| Other changes to in-force business | **(12)** | (3) |
| | **253** | 148 |

### 2017 financial performance

As explained above, management chooses to analyse its IFRS results on an adjusted operating profit basis, reflecting the activities of the Company rather than the statutory income and expense categories. The table on the preceding page takes all the items in the IFRS income statement and apportions them between the various categories.

### Underlying operating profit before tax

Underlying operating profit before tax in 2017 was £195 million (2016: £177 million). The return earned from the insurance book (£143 million) is higher than 2016, reflecting the growth in the in-force book over the past 12 months. The expected return on surplus assets (£52 million) is slightly lower than 2016, reflecting lower rates of expected returns compared to 2016.

### Adjusted operating profit before tax

During the year, PIC completed a further 20 (2016: 17) new transactions with pension schemes, with a total premium amount of £3.7 billion (2016: £2.6 billion).

PIC concluded seven longevity (2016: two) reinsurance transactions during the year, which covered longevity exposure on £4.0 billion (2016: £1.4 billion) of reserves, a record amount. At 31 December 2017, 73% of the Company's total longevity exposure had been reinsured (2016: 68%).

In December 2017, PIC completed a £725 million longevity swap reinsurance deal covering the Dock Workers Pension Fund with PartnerRe, another new reinsurance counterparty for PIC. This takes the total number of PIC's reinsurance counterparties to ten, all of which are investment grade. Three new relationships were developed during 2017.

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 a positive £70 million (2016: £26 million loss) to the adjusted operating profit.

Other changes to in-force business represents the impact of differences between actual and expected deaths and the impact of policyholders retiring earlier or later than expected and taking lump sum benefits.

### Non-operating profit before tax

Non-operating profit before tax for the year was £138 million (2016: £128 million profit).

During the year, as a part of its annual examination of the IFRS reserving basis, the Company updated its actuarial assumptions in respect of the prudent margins held within the IFRS insurance liabilities, principally around future improvements in mortality rates and credit defaults. This, together with positive impacts from updates to policy data, offset by an increase in reserves due to updated long-term expense assumptions, contributed £170 million to the profits.

The Company has two series of subordinated debt instruments in issue, on which it incurs an annual interest expense of £41 million per year. This amount is also included within non-operating profit before tax.

Other movements, including short-term market movements and project costs, have had a net positive impact on the Company in 2017 of £9 million compared to £129 million gain in 2016. The net gain in 2017 consisted of £7 million gain due to market fluctuations and £2 million net gain from other minor items. The net gain in 2016 was mainly due to the impact of significant fluctuations in interest and inflation rates in particular. The Company's preferred hedging benchmark in 2016 was focused on the regulatory balance sheet which resulted in the IFRS balance sheet being not fully hedged. The fluctuations in market rates in 2016 resulted in £151 million of gains, offset by some smaller losses elsewhere, leading to the overall £129 million gain.

## Statement of comprehensive income highlights

| | 2017 £m | 2016 £m |
|---|---|---|
| Gross premiums written | **3,704** | 2,598 |
| Net premiums revenue earned | **3,663** | 2,574 |
| Investment return (including commissions earned) | **1,093** | 3,220 |
| **Total revenue** | **4,756** | 5,794 |
| Claims paid | **(909)** | (768) |
| Change in insurance liabilities | **(3,324)** | (4,656) |
| Operating expenses | **(91)** | (72) |
| Finance costs | **(41)** | (22) |
| **Total claims and expenses** | **(4,365)** | (5,518) |
| **Profit before tax** | **391** | 276 |

### Premiums
Gross premiums written has increased significantly from £2,598 million in 2016 to £3,704 million in 2017 as a result of 20 new business transactions during the year.

Net premiums earned represent the gross premiums written less the premiums ceded to reinsurers. Net premiums written has increased at a lower rate than gross premiums due to seven new reinsurance transactions concluded in 2017.

### Investment return
Investment return comprises interest received on fixed income securities, the realised and unrealised gains or losses on financial investments.

Interest received increased from £561 million in 2016 to £631 million in 2017, reflecting the growth in the investment portfolio.

The net movement in the fair value of assets, including realised gains, was a gain of £526 million compared to a gain of £2,613 million in 2016. This comprises realised gains of £310 million (2016: £374 million) and unrealised gains of £216 million (2016: £2,239 million). The significant reduction in the unrealised gains was due to the increase in interest rates during the year.

### Claims paid
Claims paid represents the total payments made to policyholders during the year and was £1.0 billion in 2017.

Net claims paid are gross claims paid less the amounts recovered from reinsurers. Net claims paid increased from £768 million in 2016 to £909 million in 2017, reflecting the increase in the insurance book during the year.

### Change in insurance liabilities
Change in insurance liabilities represents the change in the gross insurance liabilities less the reinsurance assets. The increase in liabilities was due to the new business written in 2017, claims paid and the impact of market fluctuations.

### Operating expenses
The increase in operating expenses from £72 million in 2016 to £92 million in 2017 was in line with the growth of the business.

### Finance costs
Finance costs represent the interest payable on borrowings. The £41 million expense in 2017 includes the full year interest payable on the two subordinated debt securities issued by the Company.

## Balance sheet review

| | 2017 £m | 2016 £m |
|---|---|---|
| Reinsurance assets | **2,450** | 2,522 |
| Financial investments | **25,671** | 22,594 |
| Derivative assets | **8,775** | 9,320 |
| Gross insurance liabilities | **(24,993)** | (21,741) |
| Derivative liabilities | **(9,663)** | (10,654) |

By the end of 2017, PIC had total financial investments of £25.7 billion, compared with £22.6 billion at the end of 2016. The increase of £3.1 billion over 2017 was principally due to the effect of the new business premiums received offset by the impact of market movements, reinsurance contracts during the year and claim payments made to policyholders.

The increase in insurance liabilities since December 2016 reflects the addition of new business written during 2017, less claims paid and changes in actuarial assumptions, as well as the impact of movements in macroeconomic factors such as interest rates and inflation during the year.

Gross derivative assets and derivative liabilities have both reduced since 31 December 2016, as the Company sought to close out certain swap contracts during the year. IFRS NAV increased from £1,760 million in 2016 to £2,076 million in 2017 reflecting the profits generated during the year.

### MCEV results
At 31 December 2017, the Company's MCEV was £2,926 million (2016: £2,579 million). The increase in MCEV since December 2016 of £347 million reflects the beneficial impacts of new business written during the year, the in-force business contribution, the positive impacts of investment market movements and changes to the Company's internal model during 2017, offset by increases in the cost of capital and fair value of the subordinated loan notes.

### Other operational highlights
Operating expenses as a % of closing financial investments under management, which is a measure of how the cost base of the Company compares to the size of the asset base which it manages, has risen slightly during 2017 from 0.33% to 0.36%. This largely reflects additional acquisition expenses incurred in 2017, reflecting the increase in new business volume in 2017 compared to the prior year.

Customer focus is a central element of the activities and culture of the Company, and the customer satisfaction ratio of 98.3%, compared to 98.6% in the prior year continues to reflect PIC's industry-leading customer service capabilities as well as the continued focus on putting our policyholders at the centre of everything we do.

# CHIEF FINANCIAL OFFICER'S REVIEW

CONTINUED

## Regulatory solvency

PIC is required to comply with the Solvency II regulatory framework which has been in place since 1 January 2016. Solvency II is based on the concept of three pillars – minimum capital requirements, supervisory review of firms' assessments of risk and enhanced disclosure requirements.

Solvency II requires firms to either follow a prescribed approach to calculating required regulatory capital (the standard formula approach), or to apply to the PRA to use an "internal model", developed by the Company but subject to comprehensive review and approval by the regulator.

PIC has received PRA approval to apply an internal model, which is a better reflection of the risk profile of the Company's business than the Standard Formula.

PIC also applies the Matching Adjustment, Volatility Adjustment and Transitional Measures, which are all related to how elements of the Solvency II balance sheet are calculated. These were also subject to applications made by the Company and subject to approval by the PRA.

During 2017, PIC developed and implemented a major change to its internal model, which enabled the Company to update the capital it is required to hold against inflation and longevity risks. This change was approved by the PRA.

The Company has complied with the Solvency Capital Requirements under Solvency II as set out in the relevant PRA rules (see Note 18 to the financial statements) throughout the year. At 31 December 2017, the Company's solvency ratio on the Solvency II basis was 160% (2016: 164%) and it had surplus funds which were £1,246 million (2016: £1,222 million) in excess of Solvency Capital Requirements (SCR).

PIC has been granted a regulatory waiver, such that it is required to submit only one regulatory Solvency & Financial Condition Report ("SFCR") by 15 June 2018, covering both PIC and the consolidated Pension Insurance Corporation Group (the "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.

Solvency II results presented below are estimated and have not been audited at the date of publishing this report.

| | **2017 £m** | 2016 £m |
|---|---|---|
| Net assets held in excess of best estimate liabilities (BEL) | **4,279** | 4,256 |
| Risk margin net of transitionals | **(951)** | (1,122) |
| Own funds | **3,328** | 3,134 |
| Solvency II capital requirements | **(2,082)** | (1,912) |
| Solvency II surplus | **1,246** | 1,222 |
| Solvency ratio | **160%** | 164% |

### Key solvency sensitivities

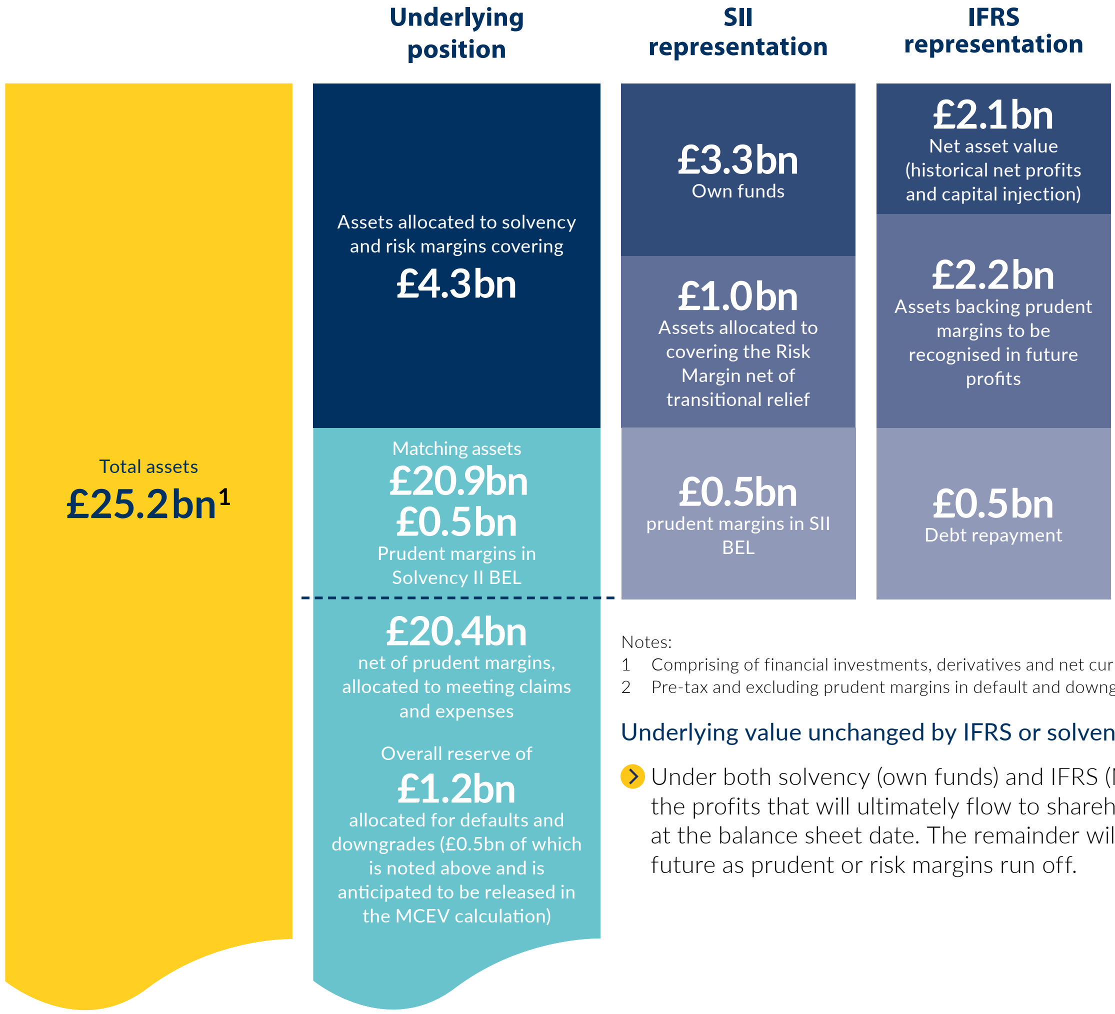
- **PIC uses various management tools to mitigate the impact of market fluctuations and manage its capital position:**
  - Pricing applied to new business and control of new business volumes.
  - New business is only transacted provided it meets the Company's return on capital targets.
- **Hedging strategy structured to protect regulatory solvency balance sheet:**
  - Interest rate, inflation and FX risks are hedged to manage solvency balance sheet.
  - Longevity risk is managed through reinsurance where majority of risk is transferred.

| PIC sensitivity of solvency ratio to changes in assumptions | **2017** | 2016 |
|---|---|---|
| As at 31 December | **160%** | 164% |
| 25 bps increase in interest rates[1] | **6.0%** | 5.7% |
| 25 bps reduction in interest rates[1] | **(6.5)%** | (5.9)% |
| £100 million credit default (no recovery) | **(4.8)%** | (5.7)% |
| 5% reduction in base mortality[2] | **(9.3)%** | (8.0)% |

Notes:
1 This allows for a transitional measure for technical provisions recalculation.
2 Equivalent to a 0.4 year increase in life expectancy from 21.7 years to 22.1 years for a typical male aged 65.

# Regulatory solvency

## Solvency II and IFRS balance sheets




Notes:
1 Comprising of financial investments, derivatives and net current assets.
2 Pre-tax and excluding prudent margins in default and downgrade reserve.

### Underlying value unchanged by IFRS or solvency representation:

- Under both solvency (own funds) and IFRS (NAV), only a portion of the profits that will ultimately flow to shareholders are recognised at the balance sheet date. The remainder will be recognised in the future as prudent or risk margins run off.

### Solvency II to MCEV reconciliation

With effect from 1 January 2017 the Company has adopted the 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.

| 31 December 2017 (£m) | Solvency II balance sheet | Allow for sub-debt | Recognise the FCoC | Release (RM, DTL minus transitionals) recognise CRNHR | Release MA margins | Tax on future profits | MCEV (£m) |
|---|---|---|---|---|---|---|---|
| Assets | 25,155 | | | | | | |
| Best estimate liabilities (net of reinsurance) | (20,876) | | | | | | |
| Risk margin (RM), Deferred tax liability (DTL) net of transitional measures | (951) | | | | | | |
| SII Own Funds | 3,328 | | | | | | 3,328 |
| Present value of future profits | | | | 951 | 512 | (355) | 1,108 |
| Cost of residual non-hedgeable risks (CRNHR) | | | | (675) | | | (675) |
| Frictional cost of required capital (FCoC) | | | (161) | | | | (161) |
| Subordinated debt | | (674) | | | | | (674) |
| **MCEV** | | | | | | | **2,926** |

# RISK MANAGEMENT

## Chief Risk Officer Review

**Giles Fairhead**
Chief Risk Officer

Since my appointment as Chief Risk Officer at the beginning of 2017, we have invested considerable time and resource ensuring that managing risk remains at the core of everything we do at PIC. It is very important that we maintain an appropriately skilled risk team, independent of those people at the "coal face", who can effectively challenge decisions and actions. This helps ensure that we protect our policyholders and strike an appropriate balance between risk and return. Given our recent growth, and aspirations for the future, the risk team has seen significant reorganisation and increase in headcount during 2017. This increase in resource and change in structure will ensure that we are very well placed for continued growth and have the appropriate skills and expertise to manage risk effectively in these uncertain times.

Given the increased level of uncertainty within the macro-economic, political, regulatory and social environments in which we operate, a key area is our ability to carry out stress and scenario testing. This gives us the capability to better consider the "what if" scenarios and then assess their impact on the business. We have also focused on enhancing our capabilities in relation to financial risk, with a particular focus on credit and counterparty risk management. Given the continued low interest rate environment, sourcing high-quality, long-term assets remains difficult. PIC looks to a broad range of sources (corporate credit in the UK and US, government debt, infrastructure and property to name but a few) to find these assets which help ensure we maintain a well-diversified, high-quality portfolio. In this context, we have increased the skills and expertise in my team to ensure that we can continue to effectively assess, and when required challenge, these investment decisions.

PIC operates a three lines of defence model (see page 50), with risk management being implemented by the first line and then oversight and challenge provided by the second line (risk and compliance) and third line (audit). This means that the risk team involves itself in all significant decisions across the business to ensure they are made in line with the Board's risk preferences and appetites. We also operate a process of independent monitoring across the business to ensure that on an ongoing basis the business operates within the Board defined thresholds.

One of our key monitoring tools is our full internal model which we use to quantify the risks in the business and thus the amount of capital we should hold as a mitigant for these risks. This model was approved by the PRA at the beginning of 2016 and because it is calibrated to the specific risks that PIC has as a business it allows us to better understand and mitigate our risks. At the end of 2017 our model calculated that we needed to hold £2.1 billion of risk based capital, and as an additional buffer we held £1.2 billion in excess of this on our Solvency II Balance Sheet.

We carried out considerable development of our internal model in 2017. Bringing together people from across the business we have set up a new team in the finance function

> "WE HAVE INVESTED CONSIDERABLE TIME AND RESOURCE ENSURING THAT MANAGING RISK REMAINS AT THE CORE OF EVERYTHING WE DO HERE AT PIC"

**Giles Fairhead, Chief Risk Officer**

to manage and develop our thinking in relation to risk based capital. We have also carried out our first major change of the model. Major changes to our internal model must be approved by the PRA and I am delighted that we managed to achieve regulatory approval for our change at the end of 2017. This has allowed us to update our model to ensure that the risk based capital we hold for inflation and longevity risk remains appropriate. This change, and the formation of a new team focused on the management of our regulatory capital, means that the model is now well embedded into our business as usual environment.

Whilst our business is not directly affected by Brexit, the macro environment will remain uncertain throughout 2018, which could affect us. Our "horizon scanning" allows us to consider fully the potential scenarios that these uncertain times might bring. We can then use our stress and scenario capabilities to assess their potential impact on the business which in turn allows us to consider what, if any, action we need to take. We are also looking to enhance our monitoring of the business to ensure that the management information we receive continues to be well aligned to our key risks and covers all areas of the business. This will have a particular emphasis on more recent emerging risks such as cyber and data security.

**Case study**

"PARTNER RE IS DELIGHTED TO PROVIDE A REINSURANCE SOLUTION THAT WILL HELP PIC TO MANAGE THEIR CAPITAL MORE EFFICIENTLY...WE LOOK FORWARD TO SUPPORTING THE PIC TEAM ON FUTURE TRANSACTIONS."

**Kevin O'Regan, Head of Longevity and Portfolio Reinsurance at PartnerRe**

**Former Registered Dock Workers Pension Fund longevity risk reinsurance**

At the end of 2017, PIC and PartnerRe entered into a £725 million longevity reinsurance transaction. This was the first time the two companies had entered into a reinsurance deal.

The deal followed a full market tender process and covered the longevity risk acquired when PIC insured the Former Registered Dock Workers Pension Fund in a full buy-in. As a result of this agreement, PIC's total number of highly rated reinsurance counterparties increased to ten, with three of the new relationships developed in 2017.

## Longevity

### Longevity Risk Management at PIC

The cornerstone of PIC's longevity risk management is the use of reinsurance. PIC has always been active in reinsuring its longevity risk exposure, completing its first transaction in 2008. The Company has now reinsured 73% of total longevity exposure on our regulatory solvency basis across ten highly rated counterparties. The introduction of the Solvency II regulatory regime (on 1 January 2016) increased the importance of the role of longevity reinsurance in the business models of many UK annuity investors. Longevity reinsurance reduces the uncertainty around mortality rates for firms, allowing them to reduce the capital they hold as a buffer against this risk, in the form of the solvency capital requirement ("SCR") and the risk margin ("RM").

Assumptions about future rates of mortality are typically made by considering the expected mortality rates over the coming year ("base mortality"), and the expected changes in these rates over time, known as "improvements" or "trends". In March 2017, the Continuous Mortality Investigation released a revised model for projecting future mortality improvement rates (CMI 2016). This model reflects the heavy mortality experience seen in the England and Wales population since 2011 and, all else being equal, acts to reduce projected life expectancies. PIC has made a partial allowance for CMI 2016 in its mortality improvement rate assumption, recognising the uncertainty as to whether observed heavy mortality experience will continue. A further review is expected during H1 2018.

PIC also takes a number of internal steps to manage its longevity exposure:

- Reviews mortality experience and assumptions regularly, i.e. have the assumptions made in the past proved accurate when compared to the actual patterns of deaths;
- Regular benchmarking of its assumptions using industry surveys and other sources;
- PIC's Board Risk Committee must approve any proposed reinsurance counterparty; and
- The Committee may also choose to put limits on exposures to single counterparties, for example by approving them only for a single deal or up to a certain amount of liabilities.

PIC added three new major reinsurance counterparties during 2017, taking the total number to ten.

The reinsurers with which PIC currently has longevity swap reinsurance contracts are Hannover Rück SE, Munich Reinsurance Company, Pacific Life Re Limited, Prudential Insurance Company of America, Canada Life Assurance Company, PartnerRe, SCOR, Challenger Life and RGA Global Reinsurance Company Limited.

In addition, PIC has entered into a number of tail-risk quota share arrangements with Berkshire Hathaway Life Insurance Company of Nebraska, a US-regulated insurer. All transactions have appropriate collateral arrangements in place to manage PIC's credit exposures.

STRATEGIC REPORT

# SOLVENCY AND RISKS

## Risk management framework

### Risk management

The overall strength of our insurance company is determined by our solvency position, our approach to managing risks and our ability to manage the assets and liabilities through the lifetime of each insurance policy. The key aspects of our financial covenant are:

- A strong solvency ratio;
- Reserving assumptions which are suitably prudent;
- Capital focused solely on securing and managing pension liabilities, free from distraction from other lines of insurance;
- A disciplined risk management approach, where we focus our risk taking on those areas where we excel (investment risk) and seek to minimise unrewarded risks, for example interest rates and inflation, which are hedged and transferred;
- An active approach to reinsurance of longevity risk, where in 2017 we have reinsured 73% of our longevity exposure, taking advantage of the reinsurers' ability to diversify the longevity risk with their substantial mortality risks;
- A secure and prudent investment approach, where the majority of our liabilities are matched by income streams from long-dated and secure assets;
- Active and proficient investor in the UK's infrastructure, including schools, hospitals, social housing and universities; and
- Proven track record of successfully managing investments through volatile economic conditions.

### The role of risk management at PIC

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

Our risk management approach is designed to support our business ambitions and has the following core objectives:

- To define the risks that we are able and willing to accept that can give us sustainable returns, and to set out risks we believe are unrewarded and require closely managing;
- To optimise the capital that we hold so that we can deliver our strategy;
- To provide a framework within which authority for taking risks can be appropriately delegated and controlled throughout the organisation. This enables the Board to draw assurance that the risks to which we are exposed are being appropriately identified, managed and where necessary minimised;
- To ensure we remain forward thinking in assessing what could happen to the business and what actions could be taken to manage or mitigate the risks; and
- Effective risk management is integral to our success and is embedded through the organisation.

# SOLVENCY AND RISKS

CONTINUED

## 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 the 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.

### First line

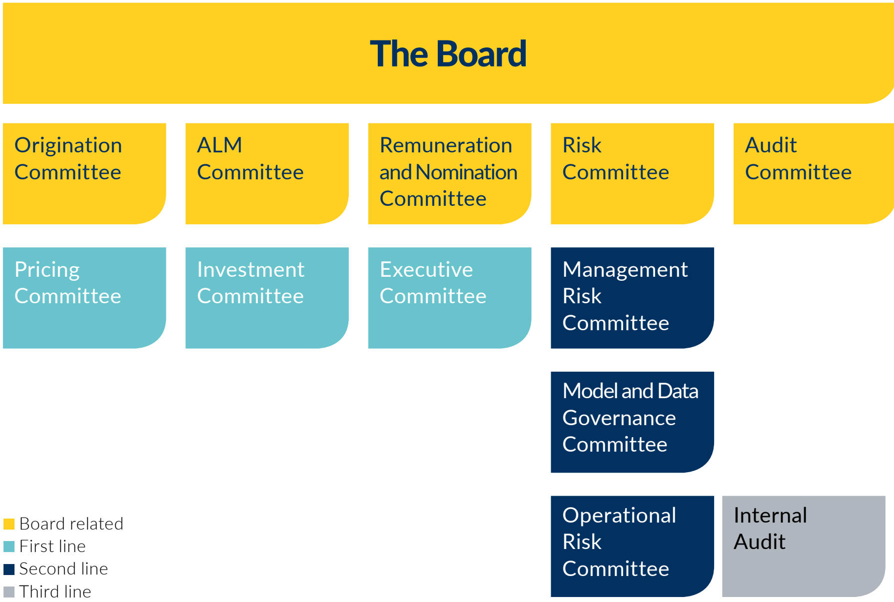
- Operational line management responsible for delivering actual performance aligned with the plan.
- Responsible for day-to-day management of risk.
- Must comply with all Group strategies, policies and risk appetite.

### Second line

- Independent of first line.
- Includes Risk function, Actuarial function and Compliance function.
- Responsible for providing the framework within which the strategy is delivered.
- Provides information, oversight, support and challenge to decision making.
- Advises Board on forward-looking assessment of threats and opportunities.

### Third line

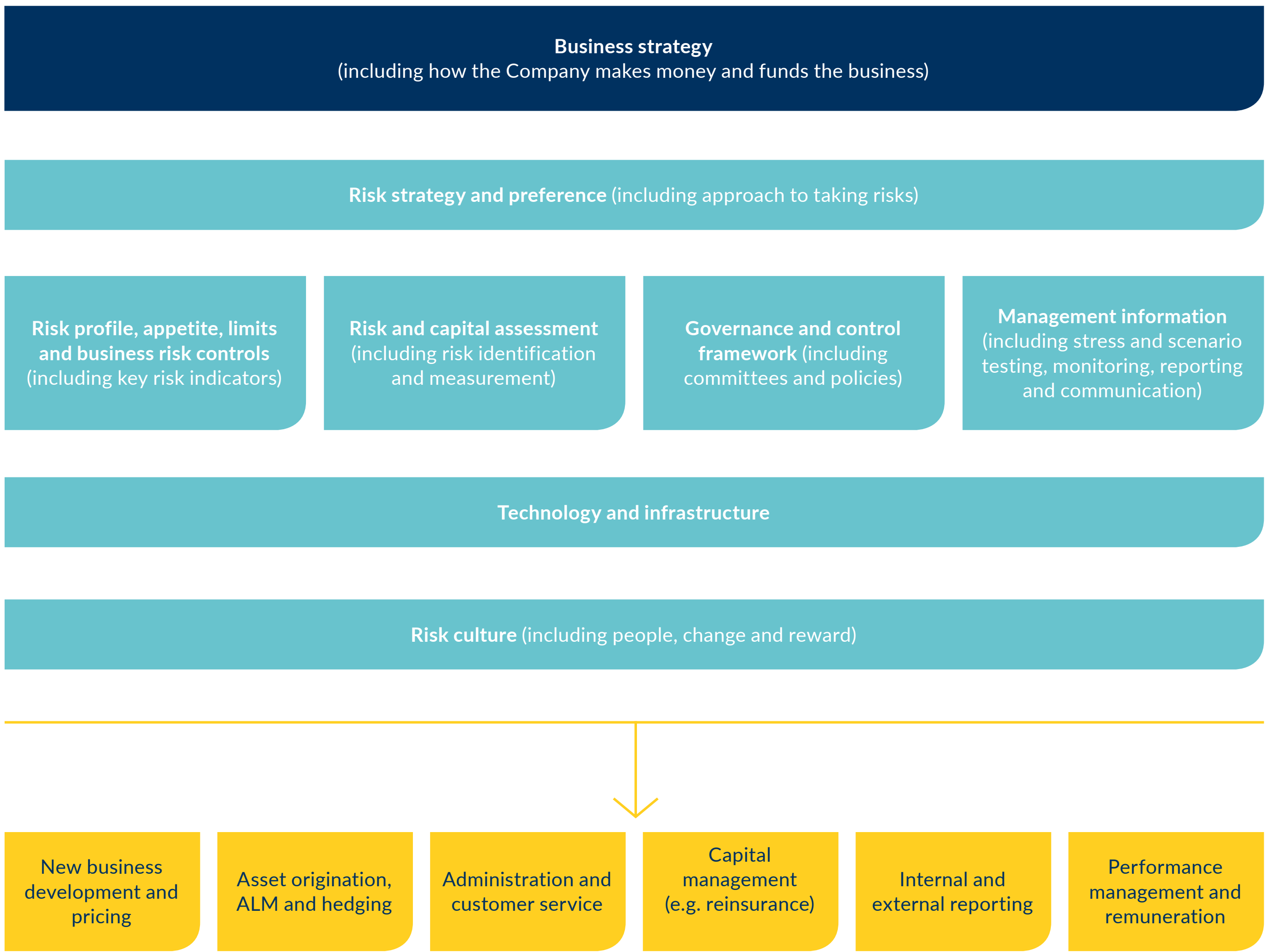
- Provides independent assurance on the overall systems of internal control.




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

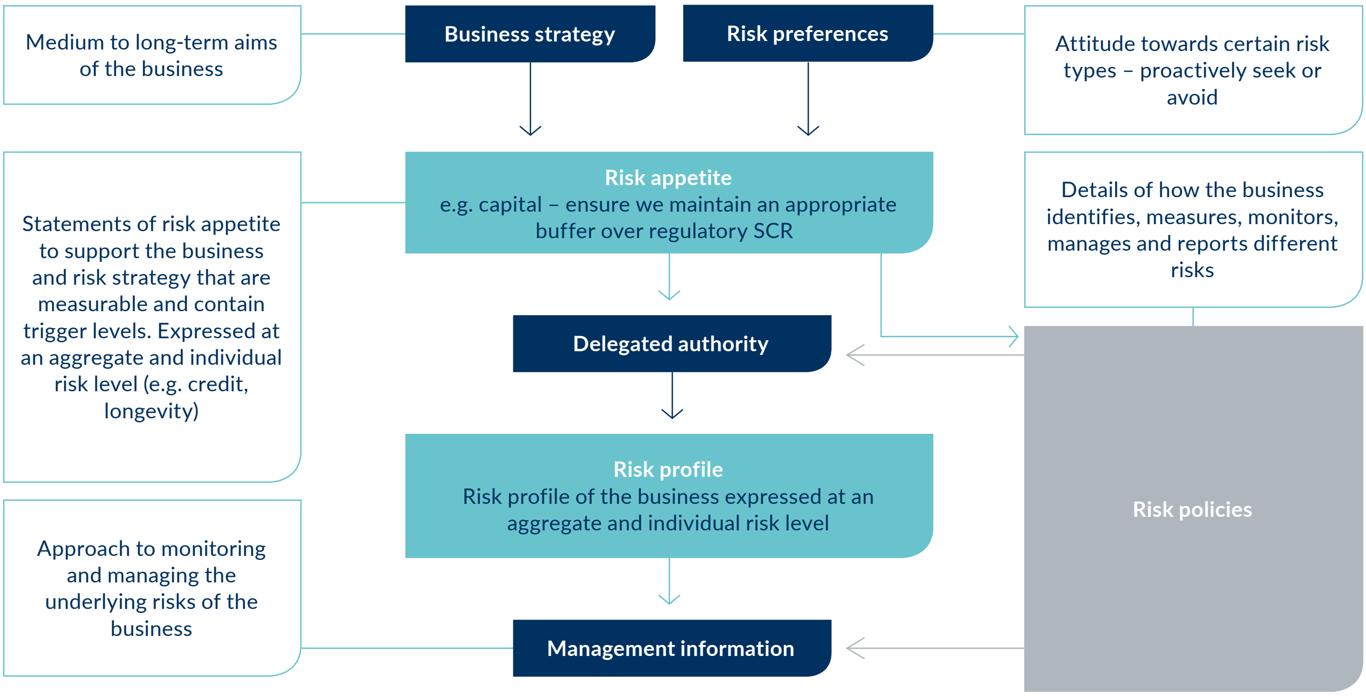
# Risk management framework

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.



## 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 appetite 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:

- 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; and
- beneficial to enhancing diversification benefits (i.e. reducing the aggregated risk capital requirement) when viewed holistically across the business.

### Minimises risks that are:

- necessary to incur as a by-product of exposure to the risks the Company actively seeks;
- necessary to incur as a by-product 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").

### Avoids or transfers risks which are:

- 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.

# SOLVENCY AND RISKS

CONTINUED

## Risk strategy and preferences

### 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 (ORSA).

### 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 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.

STRATEGIC REPORT
# PRINCIPAL RISKS

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 risk – Political and/or regulatory intervention. | While DB pensions remained on the political and regulatory agenda during 2017, including a Government consultation on the future of defined benefit pension schemes, published in early 2017, the greater focus has been on the implications of the UK's decision to leave the EU. The findings of the Treasury Select Committee review of the Solvency II regulations in the context of the decision to leave the EU recommended that the PRA move quickly in adapting Solvency II to more closely fit the UK's insurance landscape. This was viewed as positive for the UK bulk annuity market and was seen as a step forward towards increasing cooperation in the UK insurance industry. | PIC maintains an open dialogue with regulators and policymakers, and closely monitors regulatory and legislative developments. Regular horizon scanning helps identify key risks to best position PIC's strategy. |
| Market risk – Impact of market and/or economic volatility on PIC's capital position. | The UK financial markets experienced significantly less volatility during 2017 than was seen in the previous 12 months (although spikes were seen around the results of the UK general election). The expectation is of continued uncertainty and volatility as markets react to developments such as the UK's future relationship with the EU, changing political trends across the world and threats to global trade/a rise of protectionism. | PIC closely manages its balance sheet, such that the Company actively hedges its balance sheet against adverse movements in financial markets. However, the residual Risk Margin results in a capital requirement that remains sensitive to interest and inflation rates.<br>PIC monitors areas of potential pricing bubbles that may see market corrections in order to limit exposures where appropriate.<br>Regular stress and scenario analysis is carried out to assess the impact of different possibilities.<br>The business holds a significant amount of risk based capital to protect against market movements. |

# PRINCIPAL RISKS

CONTINUED

| Risks and uncertainties | Trend and outlook | Mitigation |
|---|---|---|
| Economic risk – Prolonged low interest rates may affect PIC's capital position and cause difficulties in sourcing appropriate long-dated assets. | The costs associated with maintaining the Risk Margin in a prolonged low interest rate environment may impact PIC's profitability.<br><br>While the Bank of England made its first increase to the UK base rate in over a decade in November 2017, in response to a reduction in the level of economic slack and increasing inflation, the expectation is of a continuing low rate environment in the short-to-medium term. | Hedging helps protect PIC's capital position against adverse movements in interest rates. However, Risk Margin volatility in a lower interest rate environment may impact PIC's solvency. |
| Default risk – On credit/debt assets in the portfolio. | While PIC has historically experienced low levels of default in the portfolio (see page 33 for historical experience), this risk continues to be significant given the growth of our balance sheet and the increased volatility of financial markets. | PIC selects and monitors its investment holdings very closely, either directly or through high-quality external managers.<br><br>£1.2 billion provision held for defaults and downgrades in the Solvency II balance sheet in addition to the risk-based capital requirements. |
| Counterparty and outsourcer risk – The possibility of failure by our reinsurance and swap counterparties and outsourcers who are contracted to honour their obligations in a timely manner. | The impact of Solvency II and the increased volatility in the financial markets has increased the importance of third party risk transfers, for example longevity risk. | PIC transacts with highly rated reinsurance counterparties, and also includes collateral provisions to improve overall security, for example interest rate swaps, which are fully collateralised on a daily basis.<br><br>PIC carries out continuous monitoring of our counterparties to ensure issues can be identified earlier, allowing actions to be taken to reduce the risk.<br><br>The Board provides an oversight of oursourcer risk |
| Longevity risk – PIC's insured policyholders may live 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.<br><br>The UK has experienced another year of heavier-than-expected pensioner mortality, which has been attributed to a number of factors including increased deaths from dementia and influenza, and the increased strain on the NHS and social care budgets impacting the level of care provided to the ageing population. Offsetting this are continued improvements in awareness of the impact of lifestyle on health, and technology increasingly providing new opportunities for individuals to track and monitor their own health, and even to carry out screening tests for diseases using their mobile phones. | PIC regularly reviews its longevity experience to ensure assumptions remain appropriate, and continually seeks to enhance its understanding of the evolution of annuitant mortality.<br><br>PIC holds a significant amount of risk-based capital to protect the business against potential increases in longevity. This is calculated using our PRA approved internal model.<br><br>PIC aims to reinsure more than 60% of its longevity risk exposure. As at 31 December 2017, PIC had reinsured 73% of its total longevity exposure. |

| Risks and uncertainties | Trend and outlook | Mitigation |
|---|---|---|
| New business risk – Business is written for a price which fails to generate an appropriate risk-adjusted return in line with our strategic objectives. This may lead to reduced profits, or even financial loss. | PIC's specialisation and historical experience in the bulk annuity sector gives the Board and management comfort that this risk can be managed within risk tolerances. | • PIC ensures that any new business meets risk appetite criteria, and that all assumptions that go into the new business quotation process are subject to rigorous governance and control.<br>• The business plan is fully stress tested to ensure decision makers are clear of the consequences of this risk. |
| Cyber risk – The financial services sector is increasingly becoming a target for cyber crime. This might include the risks that third parties may seek to disrupt PIC's operations, steal personal data or perpetrate acts of fraud. | The drivers of this risk continue to evolve rapidly as technology is changing the way firms do business and society operates.<br><br>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. | • 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.<br>• PIC works with its business partners to maintain controls and regular monitoring to proactively address emerging threats.<br>• The IT environment is regularly tested internally and externally to maintain up-to-date awareness of latest threats and how these may impact PIC.<br>• PIC is on target to deliver its obligations under General Data Protection Regulation, which is intended to provide enhanced protection for policyholder data. |

On behalf of the Board

**Jon Aisbitt**
Chairman

14 Cornhill
London
EC3V 3ND

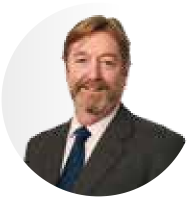
6 March 2018

# Corporate Governance



CORPORATE GOVERNANCE

# CHAIRMAN'S INTRODUCTION TO CORPORATE GOVERNANCE



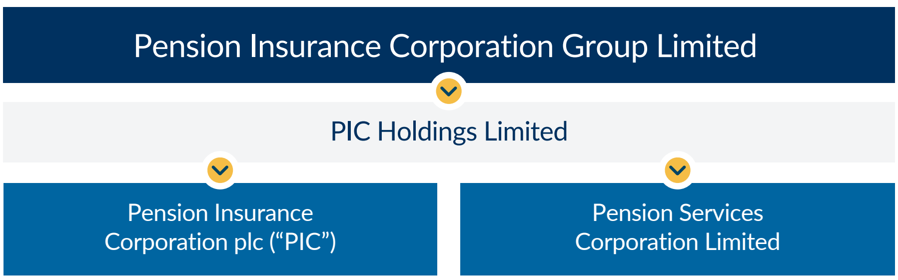
PIC continues to be managed by a Board of Directors consisting of 13 members (2016: 13), a majority of whom are independent. The Group structure, as the diagram below shows, remains straightforward, with PIC's ultimate parent company, Pension Insurance Corporation Group ("PICG"), being incorporated in the UK. PIC is the main operating company of PICG. Pension Services Corporation Limited provides services for the Group and employs all staff.

In last year's Governance section of this report, I set out two main areas of focus for Board development during the year. The first was continued integration of the Board and its Committees to allow a more streamlined decision-making process. I am very pleased therefore that in my first full year as Chairman, we have made considerable progress in refining and improving the Board Committee structure.

We have now shaped the membership of the Committees to best reflect the skills of our Directors. At the same time, we have enhanced the interfaces between the Committees such that the deliberations of one Committee are now routinely shared with other, related Committees. Having Board members play an active role on related Committees in this way has proved a remarkably efficient way of sharing information, made best use of the wide talent base of the Board, and has also ensured that decisions are not taken in isolation by individual Committees. In addition, we regularly seek input from employees, using their deep sector expertise to develop our thinking.

The second action point was to develop the diversity of the Board, in particular the number of female Board members. On this, and despite welcoming Amanda Bowe to the Board early in the year, I regret that we have been less successful, although not through lack of effort. We will refocus on this in 2018.

In 2018, the Board will continue to consider the potential for expanding the scope of opportunities for investing our assets and how this could support the Company's new business pipeline, as well as enhancing the security and value of our in-force business. We will also concentrate on implementing the Board Diversity Policy, adopted in 2017.



# 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 on pages 64 to 67. 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 62.

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, and 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 also has a Senior Independent Director, Nick Lyons, who acts as a sounding board for the Chairman and a trusted intermediary for the other Directors.

The Board meets formally on a regular basis and attends 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. At each meeting, the Board receives updates from the Chief Executive Officer and Chief Financial Officer on the execution against strategy and performance against plan. The Board also reviews regular executive reports from different business areas, including matters relating to new business pipeline and associated investments, policyholders and our obligation to treat them fairly. The Chief Risk Officer attends each meeting and also provides regular updates. The Chairmen of the Board Committees, (Risk, Audit, Asset Liability Management, Origination and Nomination and Remuneration), also report to the Board on the work carried out during the year on matters within the authority delegated to those Committees. 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 of 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 2017, an external evaluation of Board effectiveness was carried out which focused on the composition, skills and size of the Board. It also addressed how the role of the Board is understood and how meetings are chaired and conducted, whether information provided is of good quality and whether the Board focuses on the right matters with an appropriate balance between strategy, risk, operations, performance, people and regulatory matters. The review further explored the relationship between executive and non-executive directors, and how well they challenged and helped each other to be effective in their roles and relationships between the Board and its Committees. It also considered the Board's relationships with stakeholders. The Board continued to have a majority of independent directors throughout 2017. The strengths and areas for development for the Board are listed overleaf.

### Board strengths

- PIC benefits from a group of diligent and committed Directors with a high level of industry experience and in which actuarial, finance and investment expertise remains strong.
- The Board continued to have a good connection to the business and maintained a culture of challenging the management team in a constructive way. Whilst operating in a collaborative way, independent views continued to be encouraged and heard by the Board.
- The Board and Committees' structure and composition were reviewed and updated so that each Director is able to use their experiences and skills to best effect in active engagement with the business and to ensure good communication between Committees.
- During the year the Board considered succession plans for Board members and adopted the Board Diversity Policy to maintain continuity on the Board and further build diversity of skills and knowledge.
- The Board continued to update and refresh their skills and knowledge. A series of targeted teach-in sessions was held during 2017 for the Board and Committee members which included security awareness, credit sensitivities/hedging, IFRS 17, Diversified Capital Fund and EMIR and central clearing.

### Areas for Board development

- Further development of understanding of new asset classes and how these could support the Company's new business pipeline.
- The Board is committed to diversity through its Board Diversity Policy adopted in 2017 and now needs to concentrate on implementation of that policy.

### Board focus 2017

In 2017, the Board met five times and attended to matters by written resolutions. Some of the key matters considered at its meeting are listed below:

- Q1 2017 – changes in shareholder base at PIC Group level and bringing onboard CVC as a significant investor in the PIC Group; 2016 Annual Report and Financial Statements, consolidated validation of the Company's internal model, remuneration matters including share schemes and governance arrangements including structure and membership of Board committees; 2016 Own Risk and Solvency Assessment report.
- Q2 2017 – business improvement projects, contingency planning for Brexit, own risk assessment and stress and scenario testing, Solvency and Financial Condition Report, Regular Supervisory Report, Anti-Slavery and Human Trafficking Policy and its implementation, framework for 2018 five-year plan, Board effectiveness review by external independent party and recovery and resolution plans, oversight of operational matters, in particular, performance of significant outsourcers, consideration of new assets strategy and mid-year review of the integrated assurance report.
- Q3 2017 – general strategy, draft 2018 five-year business plan, review of the Company's values and standards and overall culture, continued oversight of significant outsourcers, IT strategy, reinsurance strategy, hedging programme, internal model changes, risk appetite and tolerances framework, Board succession planning and Board Diversity Policy.
- Q4 2017 – 2018 five-year business plan and its key risks, budget, compensation, strategic projects, stress and scenario testing results, integrated assurance report and plan and actuarial function holder report.

# CORPORATE GOVERNANCE OVERVIEW
CONTINUED

### Board attendance

| | 21/03/2017 | 22/05/2017 | 19/07/2017 | 25/09/2017 | 07/12/2017 | |
|---|---|---|---|---|---|---|
| Jon Aisbitt | ● | ● | ● | ● | ● | 5/5 |
| Tracy Blackwell | ● | ● | ● | ● | ● | 5/5 |
| Amanda Bowe[1] | ● | ● | ● | ● | ● | 5/5 |
| John Coomber[2] | ● | ● | ○ | ○ | ○ | 2/2 |
| Tim Hanford | ● | ● | apologies | ● | ● | 4/5 |
| Arno Kitts | ● | ● | ● | ● | ● | 5/5 |
| Nick Lyons | ● | ● | ● | ● | ● | 5/5 |
| Roger Marshall | ● | ● | ● | ● | ● | 5/5 |
| Eloy Michotte | ● | ● | ● | ● | ● | 5/5 |
| Peter Rutland[3] | ○ | ● | ● | ● | ● | 4/4 |
| Steve Sarjant | ● | ● | apologies | ● | ● | 4/5 |
| Rob Sewell | ● | ● | ● | ● | ● | 5/5 |
| Mark Stephen | apologies | ● | ● | ● | ● | 4/5 |
| Wilhelm Van Zyl | ● | ● | ● | ● | ● | 5/5 |

○ Not on the Board ● On the Board

1 Amanda Bowe was appointed with effect from 1 January 2017
2 John Coomber resigned with effect from 22 May 2017 close of business
3 Peter Rutland was appointed with effect from 5 May 2017

### 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.

# PIC'S BOARD OF DIRECTORS

## Nomination and Remuneration Committee

- Reviews the structure, size, succession plans and composition (including the skills, knowledge, experience and diversity) of the Board and makes recommendations with regard to any changes.
- 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.
- Reviews PIC's Talent Management programme and overall remuneration arrangements and approves share incentive plans.
- Met six times in 2017 and its primary focus was on compliance with Solvency II remuneration requirements, Material Risk Taker identification, culture, diversity and succession planning.

## Asset Liability Management Committee

- Oversees the management of all aspects of investment policy and strategy for the Company and provides oversight of the operation of the Company's investment portfolios within the established strategy and risk frameworks.
- Focuses on asset strategies to support new business pricing and reviews the Company's hedging strategy.
- Met five times in 2017 and its primary focus was on an ongoing oversight of the Company's portfolio and performance, reviewing the Investment Policy and operational framework, consideration of new asset class proposals, backbook optimisation, debt origination strategy, and liquidity management framework in the context of EMIR central clearing.

## Origination Committee

- Oversees the management of all aspects of the Company's new business and reinsurance origination within established strategy and risk frameworks, including conduct risk.
- Also oversees all aspects of interaction with policyholders including administration, tracing and complaints; and recommends to the Board any actions needed to ensure policyholders are treated fairly.
- Met eight times in 2017 and attended to various matters via written resolutions. Its primary focus was on the oversight of new business and reinsurance, the review and approval of pricing for large deals and approval of new counterparties. The Committee also oversaw the administration and transition of pension schemes to the PIC portfolio in 2017, and attended to customer related matters.

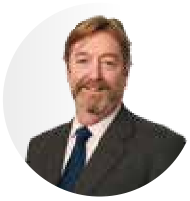
## Audit Committee

- Assists the Board with the discharge of its responsibilities with regard to internal and external audits, financial reporting, systems of internal controls and risk management.
- Other areas of consideration include data governance, oversight of business continuity planning and disaster recovery, oversight of the relationship with external auditors and making recommendations to the Board in relation to appointment of external auditors.
- Met seven times in 2017 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 also reviewed the Annual Solvency and Financial Condition Report, considered recalculation of transitional measures for technical provisions, oversaw various business improvement projects and reviewed the Half Year 2017 Investor Report. The Committee's considerations were supported by the integrated assurance reporting from the assurance functions. Throughout the year the Committee also received regular updates on compliance, anti-bribery and corruption as well as anti-money laundering and interactions with the regulator.

## Risk Committee

- Assists the Board in its oversight of the Company's current and likely risk exposures, tolerances and appetite, risk measurement and risk management performance.
- Has oversight of the Company's risk policies and procedures and risk controls.
- Is responsible for oversight of the internal model and for reporting to the Board on any areas needing improvement.
- Met eight times in 2017 and its primary focus was on assisting the Board with monitoring and reviewing the Company's risk appetite and tolerances, reviewing PIC's approach to hedging, considering different aspects of the ORSA processes, reviewing the Company's risk framework and risk policies, and the recovery and resolution plan. The Committee provided ongoing monitoring of the Company's Internal Model and made recommendations to the Board with regard to its calibration and in respect of the Internal Model major change application. Furthermore, the Committee considered the CRO's report to the Nomination and Remuneration Committee to ensure that risk management was properly incorporated in the incentive structure for the executives.

# BOARD OF DIRECTORS



## Jon Aisbitt

Chairman of the Board, Co-Chair of the Origination Committee and Chairman of the Nomination Committee

## Tracy Blackwell

Chief Executive Officer and Co-Chair of the Origination Committee

## Amanda Bowe

Independent Non-Executive Director

| | Jon Aisbitt | Tracy Blackwell | Amanda Bowe |
|---|---|---|---|
| **DATE OF APPOINTMENT** | Jon was appointed to the Board as independent Non-Executive Chairman in October 2016. | Tracy was appointed to the Board as an executive director in July 2011 and appointed as Chief Executive Officer in July 2015. | Amanda was appointed to the Board as an independent Non-Executive Director in January 2017. |
| **BACKGROUND AND CAREER** | Jon was Chairman of Man Group plc until he stepped down in May 2016. Prior to joining Man Group plc, Jon held senior roles at Goldman Sachs. He was previously Deputy Chairman of Ocean Rig plc and Honorary Treasurer of the NSPCC. He is a Fellow of the Institute of Chartered Accountants of England and Wales. | Tracy joined PIC at its founding in 2006 as Chief Investment Officer. Prior to PIC, she held senior roles in Goldman Sachs, including as Head of Risk Management, EMEA at Goldman Sachs Asset Management, working with pension fund and insurance company clients on investment, risk and strategic issues. | Amanda was the Group Regulatory Risk Director for Aegon UK where she provided advice, guidance and assurance on customer, conduct and prudential regulatory matters and managed the relationship with the PRA and FCA. Before joining Aegon, Amanda spent over 20 years with the Financial Services Authority where she undertook a variety of supervisory roles. Amanda is a member of the Chartered Institute of Securities and Investments, London. |
| **AREAS OF EXPERTISE** | Jon has over 20 years' experience in international corporate finance. He has significant technical knowledge of capital markets and the complex regulatory backdrop in which they operate. He has significant change management experience. | Tracy has more than 25 years' experience of investment markets, including matching pension assets to liabilities and risk hedging strategies. She has a strong knowledge and understanding of the regulatory landscape. | Amanda has considerable expertise as a financial services regulator, focused in particular on the pensions, savings and investment sectors. She also has experience of managing the risks associated with financial crime and data protection |
| **CURRENT EXTERNAL ROLES** | Jon is a director of New Forests Company Holdings Limited (African sustainable forestry and timber processing) and a Non-Executive Director of Pro Bono Bio plc (biotechnology). | Tracy is a Non-Executive Director of United Trust Bank. She is also the Honorary Treasurer of the Elton John AIDS Foundation. | Amanda is an Independent Board Director of Standard Life Assurance and Chair of the Standard Life Risk and Capital Committee. She is also an independent Board Director of Standard Life Savings, Elevate Portfolio Services, Equatex AG and Post Office Management Services, where she also chairs the Audit and Risk Committee. |
| **COMMITTEE MEMBERSHIP** | Jon is Chairman of the Nomination Committee and a member of the Remuneration Committee. He is Co-Chair of the Origination Committee. He attends Audit and Risk Committee meetings by invitation. | Tracy is Co-Chair of the Origination Committee. She attends Audit, Risk Committee, and Remuneration and Nomination Committee meetings by invitation. | Amanda is a member of the Audit Committee. |

## Tim Hanford

Non-Executive Director

Tim was appointed to the Board as a Non-Executive Director in January 2009.

Tim is Managing Director for Europe of J.C. Flowers & Co. Tim has previously held senior roles at FPK Capital and at Dresdner Bank. Tim has been an independent director of Schroders. Tim has an M.S. in Management from Stanford University Graduate School of Business where he was a Sloan Fellow.

Tim has over 25 years' experience in banking and investment, including credit strategies, risk management, mergers and acquisitions.

Tim serves on the Boards of OneSavings Bank plc, Castle Trust and Cabot Credit Management and is the Managing Director in charge of JCF Europe.

Tim is a Non-Executive Director and member of the Asset and Liability Management and Nomination and Remuneration Committees.

## Arno Kitts

Independent Non-Executive Director and Chairman of Asset and Liability Management Committee

Arno was appointed to the Board as an independent Non-Executive Director in July 2016.

Arno has held senior roles at BlackRock, Henderson Global Investors and JPMorgan Asset Management and JPMorgan Life. He served as a Director of Alphagen Capella Fund and the Pensions and Lifetime Savings Association (PLSA). Arno was a Member of the Council and Finance & Investment Board of the Actuarial Profession. He is a Fellow of the Institute of Actuaries and holds a PhD from Southampton University.

Arno was responsible for distribution and institutional business with clients worldwide, encompassing sales and marketing, product development and client consultant relationship management and service. He has been involved in investment management since 1989.

Arno is a director of Perspective Capital Management Limited. He is the Governor of the Pensions Policy Institute and a Director of Wake Trade Technologies.

Arno is an independent Non-Executive Director and Chairman of the Asset and Liability Management Committee and a member of the Risk Committee.

## Nick Lyons

Senior Independent Director and Chairman of the Remuneration Committee

Nick was appointed to the Board as Senior Independent Director in February 2016.

Nick headed the European Financial Institutions Group at Lehman Brothers Europe until 2003. Previous roles include executive positions at JP Morgan and Salomon Brothers. Nick served as Non-Executive Chairman of Miller Insurance Services LLP, as well as a director of Catlin Group, Friends Life Group plc, Price Forbes and Quayle Munro plc.

Nick has considerable expertise and experience in the financial services and insurance industries. Nick also has extensive experience in serving as an independent Non-Executive Director.

Nick serves on the Boards of Directors of Clipstone Logistics Reit plc and Temple Bar Investment Trust plc. Nick is also the Chairman of Longbow Capital LLP and Alderman for the City of London Corporation.

Nick is the Senior Independent Director, Chairman of the Remuneration Committee and a member of the Risk Committee.

## Roger Marshall

Independent Non-Executive Director and Chairman of the Audit Committee

Roger was appointed to the Board as an independent Non-Executive Director in September 2015.

Roger held senior roles at PricewaterhouseCoopers, including the Chairmanship of PwC's Global Audit Policy Board and its global Corporate Reporting Task Force. Roger is a Fellow of the Institute of Chartered Accountants in England and Wales.

Roger has gained substantial financial services expertise through his career at PwC and subsequent non-executive roles.

Roger is a member of the FRC Board, the FRC Codes and Standards Committee and the FRC Corporate Reporting Council. Roger also serves on the Boards of the European Financial Reporting Advisory Group and Old Mutual plc.

Roger is an independent Non-Executive Director, Chairman of the Audit Committee and a member of the Risk Committee.

# BOARD OF DIRECTORS

CONTINUED

| | **Eloy Michotte**<br>Non-Executive Director | **Steve Sarjant**<br>Independent Non-Executive Director and Chairman of the Risk Committee | **Rob Sewell**<br>Chief Financial Officer |
|---|---|---|---|
| **DATE OF APPOINTMENT** | Eloy was appointed to the Board as a Non-Executive Director in October 2012. | Steve was appointed to the Board as an independent Non-Executive Director in November 2014. | Rob was appointed to the Board as an Executive Director in July 2008. |
| **BACKGROUND AND CAREER** | Eloy has held senior roles at Compagnie Financière Richemont S.A., Reinet Investments Manager S.A. and Reinet Fund Manager S.A.. He has previously worked for Ford, McKinsey & Co and Bankers Trust Company prior to joining Richemont at the time of its formation in 1988. He graduated in engineering and applied mathematics from the University of Louvain in Belgium and holds an MBA from the University of Chicago. | Steve spent 20 years at Towers Watson (previously Watson Wyatt) where he was a Managing Director in its Risk and Financial Services segment and Global Leader, Mergers and Acquisitions. Prior to this Steve held roles at Criterion Assurance Group and National Provident Institution in a variety of roles. Steve has a BSc in Mathematics from the University of Bristol. He is a Fellow of the Institute and Faculty of Actuaries. | In a professional career of over 30 years, Rob's previous roles have included being UK CFO for Legal & General Group plc, and CEO of National Westminster Life Assurance. He is a Fellow of the Institue of Chartered Accountants in England and Wales. |
| **AREAS OF EXPERTISE** | Eloy has extensive experience in international business and finance, including mergers and acquisitions. | Steve has over 30 years' experience in the financial services industry. | Rob has extensive managerial, financial and accounting experience in the insurance and regulatory markets. |
| **CURRENT EXTERNAL ROLES** | Eloy serves on the Boards of a number of companies in which Reinet Investments S.C.A. and Richemont hold interests. | Steve is a Non-Executive Director and Chairman of the Actuarial Committee for Vitality Health and Vitality Life, and an Independent Member of the With Profits Committee of Liverpool Victoria Friendly Society. | Rob serves as a Non-Executive Director of HCT Group. |
| **COMMITTEE MEMBERSHIP** | Eloy is a Non-Executive Director and member of the Origination, Asset and Liability Management, Nomination and Remuneration Committees. | Steve is an independent Non-Executive Director, Chair of the Risk Committee and member of the Origination Committee. | Rob is an Executive member of the Board and a member of the Origination Committee. He attends Audit, ALM and Risk Committee meetings by invitation. |

## Mark Stephen

Independent Non-Executive Director

Mark was appointed to the Board as an independent Non-Executive Director in November 2014.

Mark was previously a partner at PricewaterhouseCoopers LLP. He is a member of the Institute of Chartered Accountants in England and Wales.

Mark has over 30 years' experience of advising and working with insurance company Boards on many aspects of business, including how they adapt to the changing regulatory and business landscape.

Mark serves as a Director of TransRe London Limited.

Mark is an independent Non-Executive Director and member of the Asset and Liability Management and Audit Committees.

## Wilhelm Van Zyl

Non-Executive Director

Wilhelm was appointed to the Board as a Non-Executive Director in May 2015.

Wilhelm is the Chief Executive of Reinet Investments Manager S.A. and Reinet Fund Manager S.A.. Prior to this Wilhelm held senior roles in a long career at Metropolitan Holdings and MMI Holdings. Wilhelm holds a BCom degree from the University of Stellenbosch and is a Fellow of the Institute and Faculty of Actuaries (UK) and Fellow of the Actuarial Society of South Africa.

Wilhelm has a strong background in the international financial services sector, including investment strategy.

Wilhelm is the Chief Executive of Reinet Investments Manager S.A. and Reinet Fund Manager S.A.. He serves on the Boards of a number of companies in which Reinet holds interests.

Wilhelm is a Non-Executive Director and member of the Risk and Audit Committees.

## Peter Rutland

Non-Executive Director

Peter was appointed to the Board as a Non-Executive Director in May 2017.

Peter is Co-Head of CVC's Financial Services Group and is based in London. He also serves on the Board of Domestic & General Group, Newday and dxc.technology. Prior to joining CVC, he worked for Advent International since 2002. Prior to working at Advent, Peter worked for Goldman Sachs in the Investment Banking Division. Peter holds an MA Degree from the University of Cambridge and an MBA from INSEAD.

Peter has 16 years' experience in the banking, investment and insurance industries as well as experience as a Director of both private and listed companies.

Peter is a Director of Newday Group UK Limited, DXC. Technology Company and Domestic & General Group. He is a partner and global co-head of financial services at CVC Capital Partners Limited and serves on the Boards of a number of companies in which CVC holds interests.

Peter is a Non-Executive Director and member of the Origination and Asset and Liability Management Committees.

# CORPORATE GOVERNANCE
# DIRECTORS' REPORT

## for the year ended 31 December 2017

**Directors' interests**
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 on pages 59 to 67.

**Dividends**
The Directors do not recommend a dividend for the year (2016: nil).

**Political contributions**
The Company made no political contributions during the year (2016: nil).

**Qualifying third party indemnities**
The Articles of Association of the Company provide for the Directors and officers of the Company to be indemnified in respect of liabilities incurred as a result of their office. The Company also provides certain forms of protection for its Directors and senior managers of companies within the PIC 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.

**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.<br><br>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.<br><br>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.<br><br>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 the 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 46 to 57) | 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.<br><br>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.<br><br>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 2017 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

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.

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

### 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
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
1. The assessment process
The aim of the long-term viability statement is for the Directors to assess the prospects of the Company and establish whether it can be reasonably expected that the Company will continue in operation and meet its liabilities as they fall due over the period of their assessment. This process is primarily carried out by strategic and financial planning. PIC's strategy (see page 16), and year-on-year activities combined with a focus on material factors which may impact the Company in the foreseeable future are central to the long-term viability assessment. PIC's business plan is prepared annually and 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 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. This includes 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.

2. The assessment period
The Directors have assessed the viability of the Company by reference to the five-year planning period to December 2022 which has been chosen as appropriate because it reflects PIC's business model and the dynamics of the Bulk Annuity Market as covered by PIC's five-year business plan.

3. Assessment of viability
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 from December 2017 to December 2022. The Directors considered the draft business plan at the Board meeting held on 25 September 2017 and at an additional strategy session in October 2017. The Directors also considered the Company's principal risks and how these are managed, as detailed on pages 55 to 57. The final business plan was reviewed and approved at the Board meeting held on 7 December 2017 and was supported by the assessment of key risks to the successful execution of the business plan. The risk assessment included stress and scenario testing of key assumptions and horizon scanning to consider the key risks to the business and the potential impact of these on the business plan objectives.

Some of the key scenarios included:

- Macro-economic events calibrated at increasing levels of severity;
- Changes to the Company's projected business volumes and mix;
- Changes to key assumptions around life expectancy; and
- Challenges in sourcing reinsurance and assets to support new business on a timely and cost-effective basis.

The scenarios listed above are theoretical and chosen at the level of severity which creates outcomes that have the ability to threaten the viability of the Company. In addition, scenarios have been considered covering the potential impact of specific events expected to occur within the current business plan period such as Brexit. The risk section (pages 46 to 57) of the Strategic Report describes various mitigants and management actions available to manage and minimise the impact of risk events to the Company's business model. Additionally, the Directors have made certain assumptions around additional funding in order to maintain the growth forecast in the business plan.

4. Viability statement
Based on the results of the assessment of the Company's prospects and viability, 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

14 Cornhill
London
EC3V 3ND

6 March 2018

# 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.

# Financial Statements



# INDEPENDENT AUDITOR'S REPORT

## TO THE MEMBERS OF PENSION INSURANCE CORPORATION PLC

### 1 Our opinion is unmodified

We have audited the financial statements of Pension Insurance Corporation PLC ("the Company") for the year ended 31st December 2017 which comprise the Statement of comprehensive income, Statement of financial position, Statement of cash flows, Statement of changes in equity, and the related notes, including the accounting policies in Note 1.

In our opinion:

- the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 2017 and of its profit for the year then ended;
- the Company financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU); and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

### Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities are described below. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion. Our audit opinion is consistent with our report to the audit committee.

We were appointed as auditor by the shareholders during 2006. The period of total uninterrupted engagement is for the 11 financial years ended 31 December 2017. We have fulfilled our ethical responsibilities under, and we remain independent of the Company in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to listed public interest entities. No non-audit services prohibited by that standard were provided.

### 2 Key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgement, were of most significance in the audit of the financial statements and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. We summarise below the key audit matters (unchanged from 2016), in decreasing order of audit significance, in arriving at our audit opinion above, together with our key audit procedures to address those matters and, as required for public interest entities, our results from those procedures. These matters were addressed, and our results are based on procedures undertaken, in the context of, and solely for the purpose of, our audit of the financial statements as a whole, and in forming our opinion thereon, and consequently are incidental to that opinion, and we do not provide a separate opinion on these matters.

**Valuation of insurance contract liabilities (2017: £24,993 million, 2016: £21,741 million)**
The risk compared to the prior year is unchanged.

*Refer to page 86 (accounting policy) and pages 92 to 97 (financial disclosures)*

| The risk | Our response |
|---|---|
| The Company has significant insurance contract liabilities representing 71 per cent of the Company's total liabilities.<br><br>**Subjective valuation**<br>This is an area that involves significant judgement over uncertain future outcomes, mainly the ultimate total settlement value of these liabilities. | We used our own actuarial specialists to assist us in performing our procedures in this area.<br><br>Our procedures included:<br><br>**Controls design and re-performance;**<br>Testing of the design, implementation and operating effectiveness of key controls over the reserving process to determine the valuation of the liabilities including management's review and approval of the methods and assumptions adopted over the calculation of insurance contract liabilities and appropriate change management controls over the actuarial models. |

**Valuation of insurance contract liabilities (2017: £24,993 million, 2016: £21,741 million)**
The risk compared to the prior year is unchanged.

*Refer to page 86 (accounting policy) and pages 92 to 97 (financial disclosures)*

| The risk | Our response |
|---|---|
| **Operating and economic assumptions and sector experience**<br>Management is required to use judgement in the selection of key assumptions covering both operating assumptions and economic assumptions.<br><br>The key operating assumptions include baseline mortality and future longevity improvement rates and maintenance expenses.<br><br>Mortality and longevity improvement rates require a high degree of judgement due to the number of factors which may influence future mortality experience. These judgements are set based on Company's own experience, management's and industry expected levels of future rate of mortality improvement and other external factors arising from developments in the annuity market.<br><br>Maintenance Expenses assumptions require significant judgement to set the unit cost based on the expected future costs for administering the underlying policies.<br><br>The most material economic assumption is the valuation rate of interest ('VRI') i.e. the discount rate applied to the insurance liabilities. Inflation rates are also a key economic assumption for calculating the increase in benefit and expenses reserves for insurance contracts.<br><br>**Completeness and accuracy of data**<br>Management uses the actuarial models to calculate annuity liabilities. There is a risk that the modelling does not appropriately reflect the model specifications and / or the product features due to incorrect or incomplete data input into the model and / or unauthorised or erroneous changes to the models.<br><br>**Disclosures**<br>There is a risk that the Company's disclosures in relation to the assumptions used in the calculation of policyholder liabilities are not compliant with the relevant accounting requirements. | **Methodology choice**<br>We have assessed the methodology for selecting assumptions and calculating the liabilities. This included:<br>• Evaluating the analysis of the movements in insurance contract liabilities during the year, including consideration of whether the movements were in line with the methodology and assumptions adopted;<br>• Applying our understanding of developments in the business and the impact of changes in methodology on this; and<br>• Comparing changes in methodology to our expectations derived from market experience.<br><br>**Historical comparisons:**<br>• Evaluating the evidence used to prepare the Company's mortality experience investigation by reference to actual mortality experience of the policyholders in order to assess whether this supported the yearend assumptions adopted.<br><br>**Benchmarking assumptions and sector experience:**<br>• Comparing mortality assumptions to industry data on current mortality and expectations of future mortality improvements. Further assessing appropriateness of management's choice of the Continuous Mortality Investigation used.<br>• Assessing whether the expense assumptions reflect the expected future costs of administering the underlying policies by analysing 2018 expense budget and the likely impact of planned management actions on future costs.<br>• Evaluating the methodology used to calculate VRI by reference to the industry practice.<br>• Utilised the results of KPMG benchmarking of assumptions and actuarial market practice to inform our challenge of management's assumptions in some of the areas noted above.<br><br>**Independent reperformance:**<br>• Using our own valuation models to perform independent calculations to verify results for new business reserves.<br><br>**Disclosures**<br>• Considering whether the Company's disclosures in relation to the assumptions used in the calculation of insurance contract liabilities are compliant with the relevant accounting requirements and appropriately represent the sensitivities of these assumptions to alternative scenarios and inputs.<br><br>**Our results**<br>We found the valuation and presentation of insurance contract liabilities to be acceptable. |

# INDEPENDENT AUDITOR'S REPORT

## TO THE MEMBERS OF PENSION INSURANCE CORPORATION PLC

CONTINUED

**Valuation of investments (2017: £24,882 million, 2016: £21,357 million).**
The risk compared to the prior year is unchanged.

*The risk compared to the prior year is unchanged Refer to page 85 to 86 (accounting policy) and pages 92 and 98 to 104 (financial disclosures)*

| The risk | Our response |
|---|---|
| Investment portfolio represents 90 per cent of the total assets.<br><br>The portfolio of quoted investments makes up 27.8 per cent of the total assets (by value). We do not consider these investments to be at a high risk of significant misstatement, or to be subject to a significant level of judgement because they comprise liquid, quoted investments. However, due to their materiality in the context of the financial statements as a whole, they are considered to be one of the areas which had the greatest effect on our overall audit strategy and allocation of resources in planning and completing our audit.<br><br>**Subjective valuation**<br>The areas that involved significant audit effort and judgement in 2017 were the valuation of harder to value investments within the financial investments portfolio representing 38.8 per cent of the total assets. These included unlisted debt securities, participation in investment schemes, asset backed securities, derivatives, investment property and equity release mortgage. For these application of expert judgement in the valuations needs to be adopted.<br><br>The valuation of the portfolio involves judgement depending on the observability of the inputs into the valuation and further judgement in determining the appropriate valuation methodology for harder to value investments where external pricing sources are either not readily available or are unreliable.<br><br>Disclosures<br>There is a risk that the Company's disclosures in relation to the valuation of investments are not compliant with the relevant accounting requirements and do not appropriately present the sensitivity of the valuation of the particular assets based on alternative assumptions. | We used our own valuation specialists and pricing services in order to assist us in performing our procedures in this area.<br><br>Our procedures included:<br><br>Controls design and re-performance:<br>• Testing of the design and implementation of key controls over the valuation process for the investments, including review and approval of the methodology, estimates and assumptions used for the valuation and key authorisation and data input controls.<br><br>Methodology choice:<br>• We assessed the appropriateness of the pricing methodologies with reference to relevant accounting standards and PIC's own valuation guidelines as well as industry practice for harder to value investments.<br><br>Benchmarking of assumptions and sector experience:<br>• Assessing pricing model methodologies and management chosen inputs and assumptions into the discounted cash flow models against industry practice, valuation guidelines and Company's historical experience.<br><br>Independent reperformance:<br>• Performing our own independent price checks from our own pricing services for liquid and illiquid positions where observable inputs could be identified.<br><br>Disclosures<br>• We also assessed whether the disclosures in relation to the valuation of investments are compliant with the relevant accounting requirements and appropriately present the sensitivities in the valuations based on alternative outcomes.<br><br>**Our result**<br>We found valuation and presentation of investments to be acceptable. |

### 3 Our application of materiality and an overview of the scope of our audit

Materiality for the financial statements was set at £20 million (2016: £20 million), determined with reference to a benchmark of Net Assets, consistent with 2016, of which it represents approximately 1.0 per cent (2016: 1.1 per cent) of the Company Net Assets. We consider Company's net assets to be the most appropriate benchmark as it represents the residual interest that can be ascribed to shareholders after assets and corresponding liabilities have been accounted for. We compared our materiality against other relevant benchmarks, such as total assets, total revenue and profit before tax to ensure the materiality selected was appropriate for our audit.

We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £1 million (2016: £1 million), in addition to other identified misstatements that warranted reporting on qualitative grounds.

### 4 We have nothing to report on going concern

We are required to report to you if we have concluded that the use of the going concern basis of accounting is inappropriate or there is an undisclosed material uncertainty that may cast significant doubt over the use of that basis for a period of at least twelve months from the date of approval of the financial statements. We have nothing to report in these respects.

### 5 We have nothing to report on the other information in the Annual Report

The directors are responsible for the other information presented in the Annual Report together with the financial statements. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except as explicitly stated below, any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work we have not identified material misstatements in the other information.

#### Strategic report and directors' report

Based solely on our work on the other information:

- we have not identified material misstatements in the strategic report and the directors' report;
- in our opinion the information given in those reports for the financial year is consistent with the financial statements; and
- in our opinion those reports have been prepared in accordance with the Companies Act 2006.

### 6 We have nothing to report on the other matters on which we are required to report by exception

Under the Companies Act 2006, we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent Company 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.

We have nothing to report in these respects.

### 7 Respective responsibilities

#### Directors' responsibilities

As explained more fully in their statement set out on page 72, the directors are responsible for: the preparation of the financial statements including being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and using the going concern basis of accounting unless they either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

#### Auditor's responsibilities

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud, other irregularities, or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud, other irregularities or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. The risk of not detecting a material misstatement resulting from fraud or other irregularities is higher than for one resulting from error, as they may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control and may involve any area of law and regulation not just those directly affecting the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities.

*Irregularities – ability to detect*

Our audit aimed to detect non-compliance with relevant laws and regulations (irregularities) that could have a material effect on the financial statements. In planning and performing our audit, we considered the impact of laws and regulations in the specific areas of the Companies Act 2006 and the Prudential Regulation Authority regulatory regime. We identified these areas through discussion with the directors and other management (as required by auditing standards), from our sector experience and from inspection of the Company's regulatory and legal correspondence. In addition we had regard to laws and regulations in other areas including financial reporting, and company and taxation legislation.

We considered the extent of compliance with those laws and regulations that directly affect the financial statements, being the Companies Act 2006, as part of our procedures on the related financial statement items. For the remaining laws and regulations, we made enquiries of the directors and other management (as required by auditing standards) and inspected correspondence with regulatory authorities, as well as legal correspondence.

We communicated the identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit.

As with any audit, there remained a higher risk of non-detection of irregularities, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls.

## 8 The purpose of our audit work and to whom we owe our responsibilities

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.

**Philip Smart (Senior Statutory Auditor)**
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
15 Canada Square
Canary Wharf
London
E14 5GL

6 March 2018

FINANCIAL STATEMENTS

# STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 DECEMBER 2017

| | Note | 2017 £m | 2016 £m |
|---|---|---|---|
| **Revenue** | | | |
| Gross premiums written | | **3,704** | 2,598 |
| Outward reinsurance premiums | 10f | **(41)** | (24) |
| **Net premium revenue earned** | | **3,663** | 2,574 |
| Investment return | 3 | **1,092** | 3,219 |
| Commissions earned | | **1** | 1 |
| **Total revenue (net of reinsurance premiums)** | | **4,756** | 5,794 |
| **Expenses** | | | |
| Claims paid – gross | | **(1,003)** | (797) |
| Reinsurers' share of claims paid | 10f | **94** | 29 |
| | | **(909)** | (768) |
| Increase in insurance liabilities – gross | | **(3,252)** | (5,261) |
| (Decrease)/increase in reinsurers' share of insurance liabilities | 10f | **(72)** | 605 |
| | | **(3,324)** | (4,656) |
| Acquisition expenses | 4 | **(51)** | (42) |
| Other operating expenses | 5 | **(40)** | (30) |
| Finance costs | 12 | **(41)** | (22) |
| | | **(132)** | (94) |
| **Total claims and expenses** | | **(4,365)** | (5,518) |
| **Profit before taxation** | | **391** | 276 |
| Tax charge | 8 | **(75)** | (55) |
| **Profit or loss and total comprehensive income for the year** | | **316** | 221 |

The amounts shown above are in respect of continuing operations.

The accounting policies and notes on pages 83 to 111 form an integral part of these financial statements.

# STATEMENT OF CHANGES IN EQUITY

## FOR THE YEAR ENDED 31 DECEMBER 2017

| 31 December 2017 | Share capital £m | Other reserves £m | Retained profit £m | Total £m |
|---|---|---|---|---|
| **At beginning of year** | **1,000** | **60** | **700** | **1,760** |
| *Total comprehensive income* | | | | |
| Profit for the year | **–** | **–** | **316** | **316** |
| **At end of year** | **1,000** | **60** | **1,016** | **2,076** |

| 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 for cash consideration | 243 | – | – | 243 |
| At end of year | 1,000 | 60 | 700 | 1,760 |

The accounting policies and notes on pages 83 to 111 form an integral part of these financial statements.

FINANCIAL STATEMENTS

# STATEMENT OF FINANCIAL POSITION

AS AT 31 DECEMBER 2017

| | Note | 2017 £m | 2016 £m |
|---|---|---|---|
| **Assets** | | | |
| Investment properties | 9 | **99** | 97 |
| Reinsurers' share of insurance liabilities | 10 | **2,450** | 2,522 |
| Receivables and other financial assets | 13 | **316** | 216 |
| Prepayments | | **43** | 34 |
| Financial investments | 13 | **25,671** | 22,594 |
| Derivative assets | 14 | **8,775** | 9,320 |
| Cash and cash equivalents | 13 | **33** | 6 |
| **Total assets** | | **37,387** | 34,789 |
| **Equity** | | | |
| Share capital | 16 | **1,000** | 1,000 |
| Other reserves | 17 | **60** | 60 |
| Retained profit | 17 | **1,016** | 700 |
| **Total equity** | | **2,076** | 1,760 |
| **Liabilities** | | | |
| Gross insurance liabilities | 10 | **24,993** | 21,741 |
| Borrowings | 12 | **543** | 542 |
| Deferred tax liability | 11 | **4** | 4 |
| Derivative liabilities | 14 | **9,663** | 10,654 |
| Insurance and other payables | 13 | **48** | 38 |
| Current taxation | | **44** | 32 |
| Accruals | 13 | **16** | 18 |
| **Total liabilities** | | **35,311** | 33,029 |
| **Total equity and liabilities** | | **37,387** | 34,789 |

The accounting policies and notes on pages 83 to 111 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 6 March 2018 and were signed on its behalf by:

**Rob Sewell**
Director

Registration number: 05706720

# STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 31 DECEMBER 2017

| | Note | 2017 £m | 2016 £m |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Profit for the year | | **316** | 221 |
| **Adjustments for non-cash movements** | | | |
| Interest income recognised in profit or loss | 3 | **(631)** | (561) |
| Other investment income recognised in profit or loss | 3 | **65** | (45) |
| Interest expense recognised in profit or loss | | **40** | 21 |
| Amortisation of subordinated debt issue costs and discount | | **1** | 1 |
| Movement in fair value of investment properties | 9 | **(2)** | (1) |
| Movement in tax provisions | 8 | **75** | 55 |
| | | **(136)** | (309) |
| **Changes in operating assets and liabilities** | | | |
| Increase in receivables and other financial assets | | **(90)** | (7) |
| Increase in financial investments including derivative assets | | **(2,532)** | (10,401) |
| (Increase)/decrease in prepayments | | **(9)** | 40 |
| Decrease/(increase) in reinsurers' share of insurance liabilities | | **72** | (605) |
| Increase in insurance liabilities | | **3,252** | 5,261 |
| (Decrease)/increase in financial liabilities including derivative liabilities | | **(991)** | 5,018 |
| Increase/(decrease) in insurance and other payables | | **10** | (15) |
| (Decrease)/increase in accruals | | **(2)** | 1 |
| | | **(290)** | (708) |
| **Cash outflow from operating activities** | | **(426)** | (1,017) |
| **Taxation paid** | | **(63)** | (39) |
| **Net outflow from operating activities** | | **(489)** | (1,056) |
| **Cash flows from investing activities** | | | |
| Interest income received | | **621** | 535 |
| Other investment income (paid)/received | | **(65)** | 45 |
| | | **556** | 580 |
| **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 | | **(40)** | (20) |
| Issue costs | 12 | **–** | (3) |
| | | **(40)** | 470 |
| **Net increase/(decrease) in cash and cash equivalents** | | **27** | (6) |
| Cash and cash equivalents at beginning of year | | **6** | 12 |
| **Cash and cash equivalents at end of year** | | **33** | 6 |

The accounting policies and notes on pages 83 to 111 form an integral part of these financial statements.

FINANCIAL STATEMENTS

# NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

## 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 2017. 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 – endorsed by the EU on 22 November 2016, 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.

The Company plans to take advantage of the option in IFRS 17 – Insurance Contracts, which allows certain insurers to align the implementation of IFRS 9 with IFRS 17, deferring the effective date until accounting periods beginning on or after 1 January 2021.

*IFRS 15 – Revenue from Contracts with Customers – endorsed by the EU on 22 September 2016, effective for accounting periods beginning on or after 1 January 2018.*

The Company's principal sources of revenue arise from insurance contracts and investments, which are both 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.

*IFRS 17 – Insurance Contracts – not yet endorsed by the EU, effective for accounting periods beginning on or after 1 January 2021.*

The Company intends to adopt IFRS 17 for its financial year beginning on 1 January 2021. The adoption of the standard is expected to have a significant impact on PIC's financial statements as it transforms the way the Company measures, presents and discloses the insurance and reinsurance assets and liabilities in the Statement of comprehensive income, Statement of financial position and the notes to the financial statements.

Under IFRS 17, new business profits at inception are recognised as Contractual Service Margin ("CSM"), which is released to the Statement of comprehensive income over time. In addition to the CSM, an explicit margin called the Risk adjustment ("RA") is required to be held for non-financial risks. More quantitative and qualitative information will be disclosed, including the reconciliations of CSM, RA and present value of future cash flows.

The Statement of comprehensive income will no longer include premium and claim volumes, and instead will focus on new measures, such as insurance contract revenue and insurance service expense.

IFRS 17 is expected to introduce significant operational changes. A new CSM model will be developed together with significant updates to the current systems and processes to account for new requirements for collection, aggregation and analysis of data.

The Company has created an IFRS 17 implementation project team, whose primary task is to understand the requirements of IFRS 17, and develop and implement models and capabilities to meet those requirements over the next three years. The Company is in the process of undertaking an initial impact assessment; however, given the complexity of the requirements, it believes that it is not currently possible to quantify the impact the adoption of the standard will have on the results of the Company.

## 1. Accounting policies continued

### (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.

### (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 on initial recognition.

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.

# NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

## 1. Accounting policies continued

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. The liabilities are calculated using assumptions equivalent to those used for reporting under Solvency II but with the addition of prudential margins. The liabilities are then adjusted to remove certain items which are not required to be recognised as insurance liabilities under IFRS4.

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.

### (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:

*Insurance liabilities*

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 include provision of explicit allowances for future mortality improvements.

# NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

## 1. Accounting policies continued

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 £22.5 billion (2016: £19.2 billion). The assumptions used to establish insurance contract liabilities and appropriate sensitivities relating to variations in these assumptions are disclosed in Note 10.

*Financial instruments*

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

## 2. Operating segments

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

A summary of the alternative 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:

| | 2017 £m | 2016 £m |
|---|---|---|
| Return earned on insurance book | **143** | 122 |
| Return earned on surplus assets | **52** | 55 |
| Underlying operating profit before tax | **195** | 177 |
| New business and reinsurance | **70** | (26) |
| Other changes to in-force business | **(12)** | (3) |
| Adjusted operating profit before tax | **253** | 148 |
| Non-operating profit before tax | **138** | 128 |
| IFRS profit before tax | **391** | 276 |

### 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.

### Adjusted operating profit before tax

In addition to the items that constitute underlying operating profit before tax, adjusted 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 20 (2016: 17) new transactions with pension schemes with a total premium value of £3.7 billion (2016: £2.6 billion).

### 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

| | 2017 £m | 2016 £m |
|---|---|---|
| Income from debt securities | **615** | 546 |
| Interest income on cash deposits | **15** | 12 |
| Income from mortgage backed securities ("MBS") | **1** | 3 |
| Interest income | **631** | 561 |
| Rental income | **5** | 5 |
| Income from other investments | | |
| – Investment schemes | **3** | 4 |
| – Other asset backed securities ("ABS") | **8** | 10 |
| – Net (loss)/income on other investments | **(81)** | 26 |
| | **(65)** | 45 |
| Total investment income | **566** | 606 |
| Realised gains on: | | |
| – Investments designated as FVTPL on initial recognition | **320** | 310 |
| – Investments classified as held for trading | **11** | 106 |
| Realised losses on: | | |
| – Investments designated as FVTPL on initial recognition | **(4)** | (1) |
| – Investments classified as held for trading | **(17)** | (41) |
| Net realised gains | **310** | 374 |
| Unrealised gains on: | | |
| – Investments designated as FVTPL on initial recognition | **177** | 2,999 |
| – Investments classified as held for trading | **723** | 13 |
| Unrealised losses on: | | |
| – Investments designated as FVTPL on initial recognition | **(407)** | (17) |
| – Investments classified as held for trading | **(277)** | (756) |
| Net unrealised gains | **216** | 2,239 |
| Investment return | **1,092** | 3,219 |

## 4. Acquisition expenses

| | 2017 £m | 2016 £m |
|---|---|---|
| Acquisition expenses | **51** | 42 |

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

## 5. Other operating expenses

| | 2017 £m | 2016 £m |
|---|---|---|
| Investment charges and related expenses | **16** | 9 |
| Other expenses | **24** | 21 |
| | **40** | 30 |

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.

# NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

## 6. Auditor's remuneration

| | 2017 £ | 2016 £ |
|---|---|---|
| Fees payable to the Company's auditor for the audit of the Company's annual accounts | **187,256** | 199,282 |
| Fees payable to the Company's auditor and its associates for other services: | | |
| Audit-related assurance services | **142,446** | 167,674 |
| Other assurance services | **–** | 40,000 |
| Tax compliance services | **–** | 22,000 |
| All other services | **71,593** | 137,808 |
| Total fees paid to the auditor | **401,295** | 566,764 |

## 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:

| | 2017 £m | 2016 £m |
|---|---|---|
| Wages and salaries | **24** | 21 |
| Social security costs | **4** | 3 |
| Other pension costs | **1** | 1 |
| | **29** | 25 |

The Company has 14 Directors who served during the year (2016: 15). All Directors were employed by or contracted by the Company's service provider. The total remuneration received by the Directors for their services, was £3 million (2016: £3 million). Certain Directors also receive remuneration from Pension Insurance Corporation Group Limited, the ultimate parent company.

The amount of remuneration received by the highest paid Director was £1 million (2016: £1 million). 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 (2016: two). No Directors, including the highest paid Director, were eligible for shares or share options in the Company under a long-term incentive scheme (2016: nil). No Directors exercised options in the Company during the year (2016: nil).

## 8. Corporation tax

The Company's tax charge for the year is:

| | 2017 £m | 2016 £m |
|---|---|---|
| **Current taxation** | | |
| Tax payable for the current year | **75** | 56 |
| Prior year under/(over) provision | **–** | – |
| **Total current tax** | **75** | 56 |
| **Deferred taxation** | | |
| Recognition of deferred tax liability on temporary timing differences | **–** | – |
| Tax transitional adjustment | **–** | (1) |
| Effect of change in tax rates | **–** | – |
| **Total deferred tax** | **–** | (1) |
| **Corporation tax charge** | **75** | 55 |

The effective current tax charge for the period is the same as (2016: the same as) the standard rate of corporation tax in the UK of 19.25% (2016: 20%). The differences are explained below:

| | 2017 £m | 2016 £m |
|---|---|---|
| *Reconciliation of total income to the applicable tax rate* | | |
| Profit before taxation | **391** | 276 |
| Corporation tax at 19.25% (*2016: 20%*) | **75** | 55 |
| *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** | **75** | 55 |

### 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.

## 8. Corporation tax continued

The Company has incorporated the effects of the enacted legislation in calculating its deferred tax liability at 31 December 2017.

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 2017 of £4 million (2016: £4 million) in respect of these timing differences which total £20 million (2016: £24 million).

UK corporation tax rates are 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 2017 has been calculated based on these rates.

The Company has no other timing differences or tax losses carried forward at 31 December 2017 which may give rise to reduced tax charges in future periods (2016: nil).

## 9. Investment property

| | **2017 £m** | 2016 £m |
|---|---|---|
| At beginning of year | **97** | 96 |
| Change in fair value during the year | **2** | 1 |
| At end of year | **99** | 97 |

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:

| | **2017 £m** | 2016 £m |
|---|---|---|
| Future policyholders' benefits | | |
| Gross | **24,993** | 21,741 |
| Reinsurance | **(2,450)** | (2,522) |
| Net | **22,543** | 19,219 |

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 2017 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 2016 table.

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 the risk-adjusted yield on assets backing liabilities (2016: 97.5% of the risk adjusted yield on assets). Risk adjustments are applied for credit risk associated with the assets held to match liabilities. The rate calculated in accordance with these rules as at 31 December 2017 for PIC was 2.06% for both index-linked liabilities and non-linked liabilities (2016: 2.11%).

*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, 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.

### 10. **Insurance contracts and related insurance liabilities** continued

#### (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.

| | **Gross £m** | **Reinsurance £m** | **Net £m** |
|---|---|---|---|
| 2017 | | | |
| At beginning of year | **21,741** | **(2,522)** | **19,219** |
| Increase in liability from new premiums | **3,985** | **(9)** | **3,976** |
| Impact of reinsurance entered into in the year | **–** | **(164)** | **(164)** |
| Reduction in liability from claims | **(921)** | **6** | **(915)** |
| Changes in economic assumptions | **643** | **(68)** | **575** |
| Changes in non-economic assumptions | **(390)** | **220** | **(170)** |
| Other movements (including net investment return) | **(65)** | **87** | **22** |
| At end of year | **24,993** | **(2,450)** | **22,543** |

| | Gross £m | Reinsurance £m | Net £m |
|---|---|---|---|
| 2016 | | | |
| At beginning of year | 16,480 | (1,917) | 14,563 |
| Increase in liability from new premiums | 2,596 | – | 2,596 |
| Impact of reinsurance entered into in the year | – | (41) | (41) |
| 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 | 22 | 115 |
| At end of year | 21,741 | (2,522) | 19,219 |

***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*

Assumptions follow the movement in long-term interest rates, inflation expectations and credit spreads.

The main driver of the movements is narrowing credit spreads over 2017, resulting in an increase in the value of liabilities (2016: increase in liabilities). Foreign currency movements also resulted in a small increase in liabilities.

*Non-economic assumptions*

There have been a number of changes to the non-economic assumptions over the year.

The assumption for future improvements to mortality was updated to reflect the CMI 2016 table published in March 2017, which caused a release of reserves. In addition the IFRS discount rate margin, which was previously linked to the Solvency I Pilllar 1 regulations, has been revised, removing the 2.5% margin that was previously included.

These impacts have been partially offset by an update to expense and investment management fee assumptions.

### (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 1 year £m | In 1–5 years £m | In 5–15 years £m | Over 15 years £m | Total £m |
|---|---|---|---|---|---|
| *Deferred annuities* | | | | | |
| Gross | **35** | **341** | **1,353** | **4,658** | **6,387** |
| Reinsurance | **(3)** | **(28)** | **(104)** | **(1,352)** | **(1,487)** |
| As at 31 December 2017 | **32** | **313** | **1,249** | **3,306** | **4,900** |
| *Annuities in payment* | | | | | |
| Gross | **646** | **3,326** | **7,041** | **7,593** | **18,606** |
| Reinsurance | **17** | **61** | **(86)** | **(955)** | **(963)** |
| As at 31 December 2017 | **663** | **3,387** | **6,955** | **6,638** | **17,643** |

| | Within 1 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 |

### (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 2017 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 2017 | Increase of 25bps £m | Fall of 25bps £m | Increase of 50bps £m | Fall of 50bps £m |
| Movement in assets | **(775)** | **817** | **1,108** | **(989)** |
| Movement in liabilities | **791** | **(843)** | **(1,127)** | **1,070** |
| Tax effect | **(3)** | **5** | **4** | **(16)** |
| Movement in profit and equity | **13** | **(21)** | **(15)** | **65** |

| | Base mortality (see below) £m | Mortality improve-ments (see below) £m | Renewal expenses (see below) £m | Exchange rates (see below) £m | Credit spreads increase of 25bps £m |
|---|---|---|---|---|---|
| Movement in assets | **–** | **–** | **–** | **15** | **(442)** |
| Movement in liabilities | **(25)** | **(65)** | **(106)** | **(12)** | **325** |
| Tax effect | **5** | **12** | **20** | **(1)** | **23** |
| Movement in profit and equity | **(20)** | **(53)** | **(86)** | **2** | **(94)** |

## 10. Insurance contracts and related insurance liabilities continued

| 31 December 2016 | Interest rates: Increase of 25bps £m | Interest rates: Fall of 25bps £m | Inflation rates: Increase of 50bps £m | Inflation rates: 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 improve-ments (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 |

***Parameters for exchange rate, 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 22.9 years to 23.0 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 22.9 years to 23.0 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 is carefully managed.

### (f) Reinsurance results

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

| | **2017 £m** | 2016 £m |
|---|---|---|
| Outward reinsurance premiums | **(41)** | (24) |
| Reinsurers' share of claims paid | **94** | 29 |
| Changes in reinsurers' share of insurance liabilities | **(72)** | 605 |
| Net effect of reinsurance contracts on profit before taxation | **(19)** | 610 |

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:

| | **2017 £m** | 2016 £m |
|---|---|---|
| Amounts payable in respect of insurance fees | **41** | 24 |
| Current year premiums payable in respect of quota share arrangements | **–** | – |
| Outward reinsurance premiums | **41** | 24 |

## 11. Deferred tax

At 31 December 2017, 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 2017** | | | |
| Tax transitional adjustment | **–** | **(4)** | **(4)** |
| 31 December 2016 | | | |
| Tax transitional adjustment | – | (4) | (4) |

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

| | **2017 £m** | 2016 £m |
|---|---|---|
| At beginning of year | **(4)** | (5) |
| Recognition of deferred tax liability on temporary timing differences | **–** | – |
| Effect of tax transitional adjustment | **–** | 1 |
| Effect of change in tax rates | **–** | – |
| At end of year | **(4)** | (4) |

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 2017 (2016: nil) which may give rise to reduced tax charges in future periods.

## 12. Borrowings

On 3 July 2014, the Company issued £300 million subordinated loan notes due to be repaid in 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 £250 million subordinated loan notes due to be repaid in 2026 with a fixed coupon of 8.0% paid annually in arrears. These notes were issued at 98.916% of par.

# NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

### 12. Borrowings continued

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.

| Loan notes | 2017 Carrying value £m | 2017 Fair value £m | 2016 Carrying value £m | 2016 Fair value £m |
|---|---|---|---|---|
| £300 million notes maturing 2024 | **296** | **354** | 295 | 302 |
| £250 million notes maturing 2026 | **247** | **320** | 247 | 259 |
| Total | **543** | **674** | 542 | 561 |

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 2017, an interest expense of £41 million (2016: £22 million), 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.

| Financial assets | 2017 Fair value through profit and loss £m | 2017 Amortised cost £m | 2016 Fair value through profit and loss £m | 2016 Amortised cost £m |
|---|---|---|---|---|
| *Financial investments* | | | | |
| Debt securities | **23,723** | | 20,524 | |
| MBS and ABS | **240** | | 327 | |
| Equity release mortgages | **107** | | – | |
| Deposits with credit institutions | **577** | | 536 | |
| Participation in investment schemes | **1,024** | | 1,207 | |
| Total financial investments | **25,671** | **–** | 22,594 | – |
| Derivative assets | **8,775** | | 9,320 | |
| *Loans and receivables and other financial assets* | | | | |
| Debtors arising out of direct insurance operations | | **120** | | 4 |
| Other debtors | | **11** | | 36 |
| Accrued interest | | **185** | | 176 |
| Total receivables and other financial assets | | **316** | | 216 |
| Cash and cash equivalents | | **33** | | 6 |
| Total financial assets | **34,446** | **349** | 31,914 | 222 |
| **Financial liabilities** | | | | |
| Derivative liabilities | **9,663** | | 10,654 | |
| Creditors arising out of reinsurance operations | | **9** | | 8 |
| Other creditors | | **39** | | 30 |
| Insurance and other payables | | **48** | | 38 |
| Borrowings | | **543** | | 542 |
| Accruals | | **16** | | 18 |
| Total financial liabilities | **9,663** | **607** | 10,654 | 598 |

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 £32,636 million (2016: £30,203 million) due to be received in more than one year.

### Deposits with credit institutions

Deposits with credit institutions include £18 million (2016: £16 million) 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.

At 31 December 2017, the Company has included £1,688 million (2016: £1,759 million) 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 2017, the amount of collateral received by the Company was £662 million (2016: £483 million). 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 (2016: £nil).

In 2014, the Company concluded a pension insurance buy-in transaction to underwrite approximately £1.6 billion 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 2017, this totalled £1.8 billion (31 December 2016: £1.8 billion).

In 2017, the Company has included £116 million of financial assets which have been pledged as collateral under the terms of certain reinsurance contracts (2016: £51 million). 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 2017, the Company received £7 million (2016: £8 million) cash as collateral under the terms of certain reinsurance contracts.

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

### 13. Financial assets and financial liabilities continued

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 a potential counterparty default. In sale and repurchase agreements the Company receives cash for a specified period in return for providing collateral in the form of UK gilts or other sovereign bonds. 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 all cases, the Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and consequently none of these assets have been derecognised in the financial statements. At 31 December 2017, the Company had £1,209 million (2016: £851 million) assets related to securities lending and reverse sale and repurchase agreements, and held £1,209 million (2016: £851 million) 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 2017 (2016: £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 2017** | **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 | **9,784** | **(1,009)** | **8,775** | **(57)** | **(605)** | **(7,846)** | **267** |
| Debt securities | **838** | **–** | **838** | **(838)** | **–** | **–** | **–** |
| Deposits with credit institutions | **371** | **–** | **371** | **(371)** | **–** | **–** | **–** |
| **Financial liabilities** | | | | | | | |
| Derivatives | **(10,672)** | **1,009** | **(9,663)** | **1,688** | **–** | **7,846** | **(129)** |

| | | | | 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) |

### 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.

PIC makes use of derivatives to convert investment returns on overseas assets denominated in currencies other than sterling to fixed rate Sterling returns. This is necessary in order to ensure that the cash flows from these assets provide a close match to the cash flows from the Company's insurance liabilities. PIC also uses derivatives to hedge its solvency position against changes in interest rates and inflation.

#### (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.

#### (e) Equity release mortgages

The fair value of equity release mortgage ("ERM") assets are estimated using applicable valuation techniques. These investments have been included in Level 3 within the fair value hierarchy as significant inputs are not market observable.

# NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

## 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 2017** | **Level 1 £m** | **Level 2 £m** | **Level 3 £m** | **Total £m** |
|---|---|---|---|---|
| Debt securities | **9,266** | **13,296** | **1,161** | **23,723** |
| MBS and ABS | **–** | **196** | **44** | **240** |
| Equity release mortgages | **–** | **–** | **107** | **107** |
| Deposits with credit institutions | **577** | **–** | **–** | **577** |
| Participation in investment schemes | **538** | **486** | **–** | **1,024** |
| Financial investments | **10,381** | **13,978** | **1,312** | **25,671** |
| Derivative assets | **–** | **8,775** | **–** | **8,775** |
| Financial assets | **10,381** | **22,753** | **1,312** | **34,446** |
| Derivative liabilities | **–** | **(9,663)** | **–** | **(9,663)** |

| 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) |

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 (2016: £nil).

### Transfers out of Level 3

During the year, £144 million of debt securities were transferred from Level 2 to Level 3 (2016: £163 million) and no debt securities were transferred out of Level 3 to Level 2 (2016: £168 million).

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 2017 | ERM £m | MBS and ABS £m | Debt securities £m | Total £m |
|---|---|---|---|---|
| **Opening balance** | **–** | **59** | **620** | **679** |
| Unrealised gains or losses | **3** | **(1)** | **18** | **20** |
| Acquisitions in year | **104** | **–** | **381** | **485** |
| Transfers in to Level 3 | **–** | **–** | **144** | **144** |
| Transfers out of Level 3 | **–** | **–** | **–** | **–** |
| Disposals in year | **–** | **(14)** | **(2)** | **(16)** |
| **Closing balance** | **107** | **44** | **1,161** | **1,312** |

| Year ended 31 December 2016 | MBS and ABS £m | Debt securities £m | Total £m |
|---|---|---|---|
| Opening balance | – | 397 | 397 |
| Unrealised gains or losses | 4 | 99 | 103 |
| Acquisitions in year | 55 | 135 | 190 |
| Transfers in to Level 3 | – | 163 | 163 |
| Transfers out of Level 3 | – | (168) | (168) |
| Disposals in year | – | (6) | (6) |
| Closing balance | 59 | 620 | 679 |

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 2017 | ERM £m | MBS and ABS £m | Debt securities £m | Total £m |
|---|---|---|---|---|
| Interest income | **–** | **–** | **–** | **–** |
| Income from securities | **–** | **4** | **14** | **18** |
| Realised gains or losses | **–** | **1** | **–** | **1** |
| Unrealised gains or losses | **3** | **(1)** | **18** | **20** |
| **Investment return on Level 3 assets** | **3** | **4** | **32** | **39** |

| Year ended 31 December 2016 | MBS and 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 |

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.

### 13. Financial assets and financial liabilities continued

The following table shows the effect on the fair value of Level 3 financial assets from changes in unobservable input assumptions.

| 2017 | Main assumptions | Sensitivity | Current fair value £m | Increase in fair value £m | Decrease in fair value £m |
|---|---|---|---|---|---|
| Debt securities | Discount rates | +/– 50bps credit spread | **1,161** | **130** | **(113)** |
| MBS and ABS | Expected loss ("EL") | +/– 30% change in EL | **44** | **1** | **(1)** |
| ERM | Mortality | +/-5% change in mortality assumption | **107** | **–** | **–** |
| | Property price | +/-20% change in property prices | | **2** | **(3)** |
| | Property growth | +/- 1% change in property growth assumption | | **2** | **(3)** |
| | Voluntary Redemptions | +/-10% change in voluntary redemption assumption | | **–** | **–** |
| | | | **1,312** | **135** | **(120)** |

| 2016 | Main assumptions | Sensitivity | Current fair value £m | Increase in fair value £m | Decrease in fair value £m |
|---|---|---|---|---|---|
| Debt securities | Discount rates | +/– 50bps credit spread | 620 | 69 | (64) |
| MBS and ABS | Expected loss ("EL") | +/– 30% change in EL | 59 | 1 | (1) |
| | | | 679 | 70 | (65) |

### 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.

| | **2017** | | 2016 | |
|---|---|---|---|---|
| | **Assets £m** | **Liabilities £m** | Assets £m | Liabilities £m |
| Interest rate swaps | **7,884** | **(8,147)** | 8,615 | (8,750) |
| Inflation swaps | **638** | **(1,117)** | 641 | (1,001) |
| Credit default swaps | **19** | **(32)** | 24 | (6) |
| Currency swaps | **223** | **(360)** | 30 | (882) |
| Foreign exchange forward contracts | **11** | **(7)** | 10 | (15) |
| Total derivative position | **8,775** | **(9,663)** | 9,320 | (10,654) |

### 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.

# NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

## 15. Risk management continued

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.

| 31 December 2017 | AAA £m | AA £m | A £m | BBB £m | BB £m | Unrated £m | Total £m |
|---|---|---|---|---|---|---|---|
| **Loans and debt securities** | | | | | | | |
| Debt securities[1] | **1,191** | **10,092** | **5,832** | **6,216** | **203** | **189** | **23,723** |
| MBS and ABS[2] | **12** | **23** | **130** | **30** | **–** | **45** | **240** |
| ERM | **–** | **–** | **–** | **–** | **–** | **107** | **107** |
| | **1,203** | **10,115** | **5,962** | **6,246** | **203** | **341** | **24,070** |
| **Other assets** | | | | | | | |
| Derivative assets | **–** | **–** | **–** | **–** | **–** | **8,775** | **8,775** |
| Participation in investment schemes | **538** | **–** | **–** | **–** | **–** | **486** | **1,024** |
| Receivables and other financial assets | **15** | **30** | **59** | **80** | **1** | **131** | **316** |
| Deposits with credit institutions | **–** | **–** | **577** | **–** | **–** | **–** | **577** |
| Cash and cash equivalents | **–** | **–** | **–** | **33** | **–** | **–** | **33** |
| | **553** | **30** | **636** | **113** | **1** | **9,392** | **10,725** |

1. Within Debt securities there are £59 million AAA rated, £381 million AA rated, £768 million A rated, £641 million BBB rated and £59 million BB rated securities, which have been rated using internally assessed credit ratings.
2. Within MBS and ABS there are £4 million A rated securities and £1 million BBB rated securities which have been rated using internally assessed credit ratings.

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

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 with highly rated instruments, so as to mitigate any credit or counterparty risk. Applying the issuer rating to the assets held at 31 December 2017 produces the following split:

| 31 December 2017 | AAA £m | AA £m | A £m | BBB £m | BB £m | Unrated £m | Total £m |
|---|---|---|---|---|---|---|---|
| Derivative assets | **–** | **943** | **6,173** | **1,659** | **–** | **–** | **8,775** |

| 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 |

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 ten external reinsurers with an exposure of £2,450 million at 31 December 2017 (2016: £2,522 million). 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 2017 and 31 December 2016.

*Impaired assets*

The Company did not have any impaired or past due date assets at 31 December 2017 (2016: 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 2017 | Within 1 year £m | In 1–5 years £m | In 5–15 years £m | Over 15 years £m | Total £m |
|---|---|---|---|---|---|
| Creditors arising out of reinsurance operations | **9** | **–** | **–** | **–** | **9** |
| Other creditors | **39** | **–** | **–** | **–** | **39** |
| Accruals | **16** | **–** | **–** | **–** | **16** |
| Borrowings | **–** | **–** | **543** | **–** | **543** |
| Derivative liabilities | **49** | **371** | **1,062** | **8,181** | **9,663** |
| | **113** | **371** | **1,605** | **8,181** | **10,270** |

| 31 December 2016 | Within 1 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 |

Amounts due to group undertakings are included within Other creditors. At 31 December 2017, £27 million was payable to PSC (2016: £19 million). 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.

## 15. Risk management continued

### (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, occupation and place of residence.

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:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | **Number of shares** | **£m** | Number of shares | £m |
| Authorised, issued and fully paid | | | | |
| At beginning of year | **999,810,351** | **1,000** | 756,810,351 | 757 |
| Shares issued at par | **–** | **–** | 243,000,000 | 243 |
| At end of year | **999,810,351** | **1,000** | 999,810,351 | 1,000 |

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.

## 17. Reserves

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | **Other reserves £m** | **Retained profit £m** | Other reserves £m | Retained profit £m |
| At beginning of year | **60** | **700** | 60 | 479 |
| Total comprehensive income | **–** | **316** | – | 221 |
| At end of year | **60** | **1,016** | 60 | 700 |

Other reserves comprise £60 million 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.

The Company is required to measure and manage its capital in accordance with the requirements of the EU Solvency II Framework Directive ("Solvency II"), 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.

# NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

### 18. Capital resources continued

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 73% of longevity exposure has been transferred as at 31 December 2017, based on regulatory liabilities.

### 19. Related party transactions

As at 31 December 2017, 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. Seven of the key management personnel of the Company, including the Directors, were participants in these schemes and received a total of 1,961,561 ordinary shares of PICG upon vesting in line with the scheme rules.

The Company had transactions with three 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 2017 were £76 million (2016: £63 million). At 31 December 2017, the amount due to PSC relating to the services provided was £27 million (2016: £19 million).

#### (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 2017 and 31 December 2016 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 2017 was £78,032 (2016: £78,032). The accrued interest on this loan amounted to £7,896 (2016: £7,184) at 31 December 2017.

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 2017, the outstanding payable balance was £26,316 (2016: £21,589).

#### (c) Transactions with Pension Insurance Corporation Group Limited ("PICG")

During the year the Company received tax losses surrendered from PICG as part of group relief. The amount outstanding at 31 December 2017 was £217,902.

### 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 £351 million within the next five years (2016: £261 million), £92 million of this being due within 12 months of the financial reporting date (2016: £64 million).

| | **2017 £m** | 2016 Restated £m |
|---|---|---|
| Within 1 year | **92** | 64 |
| In 1–5 years | **259** | 197 |
| Over 5 years | **–** | – |
| | **351** | 261 |

#### 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 2017, the estimated value of the contingent fees payable was £10 million (2016: £10 million).

### 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
14 CORNHILL, LONDON EC3V 3ND

**www.pensioncorporation.com**