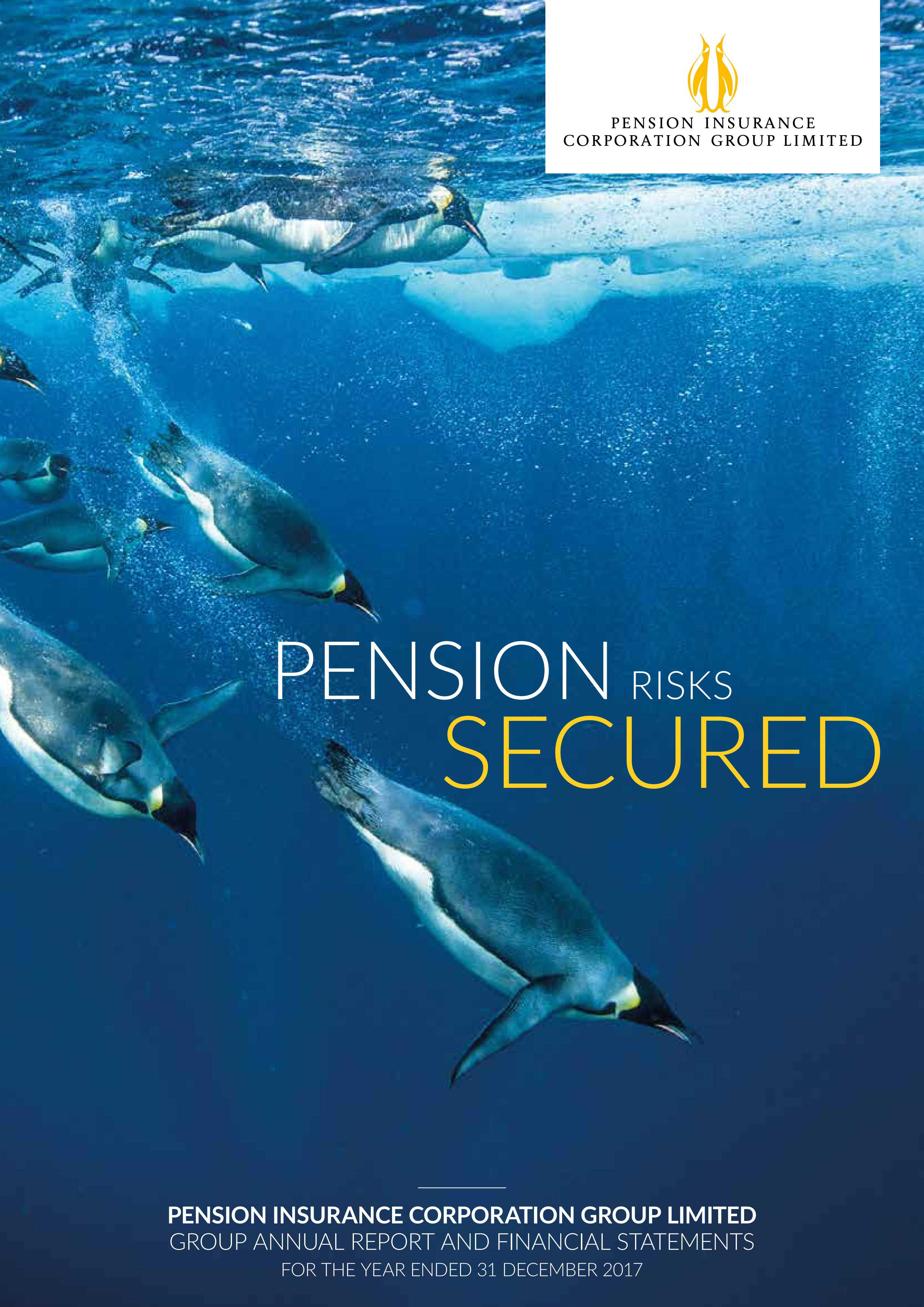

PENSION INSURANCE CORPORATION GROUP LIMITED

PENSION RISKS SECURED

PENSION INSURANCE CORPORATION GROUP LIMITED

GROUP ANNUAL REPORT AND FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

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

2017 HIGHLIGHTS

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

CONTENTS

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	£13.8bn
2013	£9.3bn

IFRS profit before tax

£383M

2017	£383m
2016	£266m
2015	£136m
2014	£163m
2013	£115m

MCEV

£2,932M

2017	£2,932m
2016	£2,600m

Solvency ratio (PIC)

160%

Estimated and unaudited

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%

Industry recognition

PENSIONS Age AWARDS 2018 WINNER RISK MANAGEMENT PROVIDER OF THE YEAR

The Institute of Customer Service UK Customer Satisfaction Awards 2018 WINNER

Pensions and Investment Awards 2018 Winner: DERISKING PROVIDER

ServiceMark The Institute of Customer Service

European Pensions AWARDS 2016 WINNER Insurance Company of the Year

STRATEGIC REPORT
FOR THE YEAR ENDED 31 DECEMBER 2017

Jon Aisbitt
Chairman

The Directors present the Strategic Report, Directors' Report and the audited financial statements for Pension Insurance Corporation Group Limited, registered number 09740110, (the "Company" or "PICG") and its subsidiaries (the "Group") for the year ended 31 December 2017.

Principal activity

The principal activity of the Company is to act as a holding entity for the Group. The principal activity of the Group is providing insurance annuity products to UK defined benefit occupational pension funds and their members (commonly referred to as "pension insurance" or "bulk annuities").

The main trading entity in the Group is Pension Insurance Corporation plc ("PIC"), a limited company incorporated in England.

PIC is authorised to write long-term insurance business by the Prudential Regulation Authority (the "PRA"), and regulated by the PRA and the Financial Conduct Authority (the "FCA"). Its principal product is the provision of pension insurance and annuities to individuals, corporate pension schemes and other insurance companies through innovative and bespoke risk management solutions ("pension insurance").

Business review

Pension insurance products are used by pension funds to transfer to an insurance company the risks and liabilities arising from the benefit promises made to pension fund members. Insurance is also used as a means by which the ultimate responsibility to pay the benefits promised is transferred to the insurance company through the issuance of an individual annuity insurance policy to the pension fund member.

Strategy

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

The Group aims to deliver these objectives through:

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

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

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

Key performance indicators

The Group has identified a number of key performance indicators 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.

	2017	2016
Measures of profit or loss		
IFRS profit before tax	**£383m**	£266m
Measures of assets & liabilities		
Market consistent embedded value	**£2,932m**	£2,600m
IFRS net asset value ("NAV")	**£2,083m**	£1,779m
Measures of income & 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%

With effect from 1 January 2017, the Group has adopted the European Insurance CFO Forum Market Consistent Embedded Value Principles[1] (the "MCEV Principles") issued in April 2016 for its embedded value measurement and reporting. The Group has also updated its embedded value approach to reflect the Solvency II regulatory framework. The starting point is the Solvency II balance sheet, but to this is added an estimate of the after-tax value that is expected to emerge in the future from the release of the prudent margins built in to 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 Group's value.

Trading during the year

The Group made a pre-tax profit in the year ended 31 December 2017 of £383m (2016: £266m). The main contributory factors to the Group's profitability were the returns from new business written in the year and the in-force book, longevity reinsurance treaties entered into during the year, the net positive impacts from updates to the actuarial assumptions in respect of the prudent margins held within the IFRS insurance liabilities, principally around future improvements in mortality rates, credit defaults and future expense assumptions, and the net impact of investment market conditions on asset and insurance liability valuations.

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

By the end of 2017, the Group had total financial investments of £25.7bn, compared to £22.6bn at the end of 2016. The increase of £3.1bn was principally due to the effect of the new business premiums received as well as market movements and reinsurance contracts during the year, less claim payments made to policyholders.

PIC concluded seven longevity swap reinsurance transactions during the year which covered longevity risk on c.£4bn (2016: £1.4bn) of insurance liabilities. At 31 December 2017, 73% of the Group's total longevity related reserves on a regulatory solvency basis was reinsured to third party, investment grade reinsurer counterparties (2016: 68%).

The Group's IFRS NAV increased from £1,779m in 2016 to £2,083m in 2017 mainly due to the profits generated during the year.

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STRATEGIC REPORT
FOR THE YEAR ENDED 31 DECEMBER 2017
CONTINUED

The Group is now responsible for the pension payments of 151,600 individuals (2016: 134,900). Payment of annuities grew by 21% in 2017 to £725m (2016: £600m) mainly through new business written during the year and previous year. Total claim amounts paid were £1,003m (2016: £797m), an increase of 26%, as the growth in annuity payments was supplemented by a growth in lump sum payments and transfers out compared to the prior year.

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

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

Regulatory solvency
Through its regulated subsidiary, PIC, the Group 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 Group but subject to comprehensive review and approval by the regulator.

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

The Group 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 Group and subject to approval by the PRA.

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

The Group has complied with the solvency capital requirements under Solvency II as set out in the relevant PRA rules (see Note 20) throughout the year. At 31 December 2017, the Group's solvency ratio on the Solvency II basis was 160%[2] (2016: 164%) and it had surplus funds which were £1,246m (2016: £1,222m) in excess of solvency capital requirements.

The Group has been granted a regulatory waiver, such that it is required to submit only one regulatory Solvency and Financial Condition Report ("SFCR") by 15 June 2018, covering both PIC and the consolidated Pension Insurance Corporation Group. This is in place of submitting separate reports for each of PIC and the Group. Once submitted the document will be available on PIC's website.

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

On behalf of the Board

Jon Aisbitt
Chairman
6 March 2018

2 Estimated and unaudited

DIRECTORS' REPORT

FOR THE YEAR ENDED 31 DECEMBER 2017

Directors and their interests

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

Director	Position	Executive/Non-Executive	Notes
Jon Aisbitt	Chairman	Non-Executive	
Tracy Blackwell	Chief Executive	Executive	
Michael Eves		Non-Executive	
Edward Giera		Non-Executive	
Tim Hanford		Non-Executive	
Arno Kitts		Non-Executive	
Jing Li		Non-Executive	
Nick Lyons		Non-Executive	
Josua Malherbe		Non-Executive	
Roger Marshall		Non-Executive	Appointed 1 April 2017
Eloy Michotte		Non-Executive	Resigned 11 October 2017
Peter Rutland		Non-Executive	Appointed 5 May 2017
Mark Stephen		Non-Executive	
Wilhelm Van Zyl		Non-Executive	Appointed 12 October 2017

One Director who held office during the financial year is a beneficiary of the Company's share-based award schemes, details of which are given in Note 7 to the financial statements. This Director received 227,828 ordinary shares of the Company upon vesting of certain schemes during the year (2016: Three Directors received a total of 5,711,190 ordinary shares).

Additionally, as a result of the liquidity event offered in accordance with the Articles of Association of the Company, four Directors purchased 675,000 ordinary shares in the Company in October 2017.

Share capital

Issue of shares

The Company issued 688,166 ordinary shares with a nominal value of £0.00161678179673884 on 4 July 2017. The share issue was fully paid and wholly subscribed for cash consideration. The issue of shares resulted in new share capital of £1,113.

C shares

On 29 June 2017, the Company issued 2,000 C shares with a nominal value of £0.00161678179673884. The share issue was fully paid and wholly subscribed for cash consideration. The issue of shares resulted in new share capital of £3.23 and a share premium of £1,629,997.

Own shares

At 31 December 2017, 4,985,393 ordinary shares of PICG were held in an Employee Benefit Trust (2016: 1,078,748), in accordance with the accounting policy in Note 1 (j).

Political contributions

Neither the Company nor the Group made any political contributions during the year (2016: £nil).

Financial instruments

The information relating to the Group'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 Group is included in the Strategic Report which is separate to this Directors' Report.

Qualifying third party indemnities
The Articles of Association of the Company provide for the Directors and officers of the Company to be indemnified in respect of liabilities incurred as a result of their office. The Company also provides certain forms of protection for its Directors and senior managers of companies within the 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 and the Group as a whole have adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the financial statements.

Disclosure of information to auditor
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 Group's auditor is unaware; and each Director of the Company and its subsidiary companies 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 Group's auditors is 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 Group and establish whether it can be reasonably expected that the Group 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.

The Group's strategy (see page 2), and year-on-year activities combined with a focus on material factors which may impact the Group in the foreseeable future are central to the long-term viability assessment. The Group'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 Group over the period. The plan is designed within the Group'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 Group by the PIC Board on the delegated authority from the PICG Board. This includes a number of stress scenarios which consider the Group's resilience and capacity to respond to relevant stresses and shock events which may potentially impact the Group. The Group also evaluates various management actions designed to maintain and restore key capital and solvency metrics to within the Group's approved risk appetite over the planning period.

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

3. Assessment of viability
The Directors have carried out an assessment by reference to the Group's current position and strategy, the Board's risk appetite and the Group's financial forecasts from December 2017 to December 2022. The Directors held a strategy session in October 2017 at which they also considered the Group's principal risks and how these are managed. 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.

DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER 2017
CONTINUED

Some of the key scenarios included:

- Macro-economic events calibrated at increasing levels of severity.
- Changes to the Group's projected business volumes and mix.
- Changes to key assumptions around life expectancy.
- 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 Group. 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. There are various mitigants and management actions available to manage and minimise the impact of risk events to the Group's business model. Additionally, the Directors have made certain assumptions around additional funding in order to maintain growth forecast in the business plan.

4. Viability statement
Based on the results of the assessment of the Group's prospects and viability, the Directors confirm that they have a reasonable expectation that the Group 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
6 March 2018

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

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

Company law requires the Directors to prepare Group and Parent Company financial statements for each financial year. Under that law they have elected to prepare both the Group and the Parent Company financial statements in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs 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 Group and Parent Company and of their profit or loss for that period. In preparing each of the Group and Parent Company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable, relevant and reliable;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- assess the Group and Parent Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and
- use the going concern basis of accounting unless they either intend to liquidate the Group or the Parent Company or to cease operations, or have no realistic alternative but to do so.

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

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

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF PENSION INSURANCE CORPORATION GROUP LIMITED

We have audited the financial statements of Pension Insurance Corporation Group Limited ("the company") for the year ended 31 December 2017 which comprise the consolidated Statement of Comprehensive Income, Statement of Financial Position, Statement of Changes in Equity, Statement of Cash Flows, 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 Group's and of the Parent Company's affairs as at 31 December 2017 and of the Group's profit for the year then ended;
- the Group 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);
- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; 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 have fulfilled our ethical responsibilities under, and are independent of the Group in accordance with, UK ethical requirements including the FRC Ethical Standard. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion.

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.

Strategic Report and Directors' Report

The Directors are responsible for the Strategic Report and the Directors' Report. Our opinion on the financial statements does not cover those reports and we do not express an audit opinion thereon.

Our responsibility is to read the Strategic Report and the Directors' Report 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 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.

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.

Directors' responsibilities

As explained more fully in their statement set out on page 8, the Directors are responsible for: the preparation of the financial statements and for 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 Group and Parent 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 Group or the Parent Company or to cease operations, or have no realistic alternative but to do so.

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF PENSION INSURANCE CORPORATION GROUP LIMITED

CONTINUED

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 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 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.

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

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

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

STATEMENT OF COMPREHENSIVE INCOME FOR THE GROUP

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	2	**1,092**	3,219
Commission 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	3	**(51)**	(42)
Other operating expenses	4	**(48)**	(40)
Finance costs	12	**(41)**	(22)
		(140)	(104)
Total claims and expenses		**(4,373)**	(5,528)
Profit before taxation		**383**	266
Tax charge	8	**(73)**	(54)
Profit and total comprehensive income for the year		**310**	212

The amounts shown above are in respect of continuing operations.

The accounting policies and notes on pages 18 to 49 form an integral part of these financial statements.

STATEMENT OF CHANGES IN EQUITY FOR THE GROUP

FOR THE YEAR ENDED 31 DECEMBER 2017

31 December 2017	Note	**Share capital £m**	**Share premium £m**	**Treasury shares £m**	**Retained profit £m**	**Capital reduction reserve £m**	**Merger reserve £m**	**Share-based payment reserve £m**	**Total £m**
At beginning of year		**2**	**118**	**(1)**	**565**	**1,055**	**34**	**6**	**1,779**
Total comprehensive income									
Profit for the year		**–**	**–**	**–**	**310**	**–**	**–**	**–**	**310**
Transactions with owners									
Ordinary shares issued for cash consideration	18, 19	**–**	**2**	**–**	**–**	**–**	**–**	**–**	**2**
Vesting of the share-based payment schemes	7, 18	**–**	**–**	**1**	**3**	**–**	**–**	**(4)**	**–**
Employee related share-based payments	7	**–**	**–**	**(12)**	**(4)**	**–**	**–**	**6**	**(10)**
Tax relating to share-based payments		**–**	**–**	**–**	**–**	**–**	**–**	**2**	**2**
At end of year		**2**	**120**	**(12)**	**874**	**1,055**	**34**	**10**	**2,083**

31 December 2016	Note	Share capital £m	Share premium £m	Treasury shares £m	Retained profit £m	Capital reduction reserve £m	Merger reserve £m	Share-based payment reserve £m	Total £m
At beginning of year		925	–	–	342	–	34	11	1,312
Total comprehensive income									
Profit for the year		–	–	–	212	–	–	–	212
Transactions with owners									
Ordinary shares issued for cash consideration	18, 19	129	121	–	–	–	–	–	250
Share issue costs recognised in equity	19	–	(3)	–	–	–	–	–	(3)
Vesting of the share-based payment schemes	7, 18	3	–	(1)	11	–	–	(13)	–
Ordinary share reduction	18, 19	(1,055)	–	–	–	1,055	–	–	–
Employee related share-based payments	7	–	–	–	–	–	–	8	8
At end of year		2	118	(1)	565	1,055	34	6	1,779

The accounting policies and notes on pages 18 to 49 form an integral part of these financial statements.

STATEMENT OF CHANGES IN EQUITY FOR THE COMPANY

FOR THE YEAR ENDED 31 DECEMBER 2017

31 December 2017	Note	**Share capital £m**	**Share premium £m**	**Treasury shares £m**	**Retained profit £m**	**Capital reduction reserve £m**	**Merger reserve £m**	**Share-based payment reserve £m**	**Total £m**
At beginning of year		**2**	**118**	**–**	**7**	**1,055**	**34**	**6**	**1,222**
Total comprehensive income									
Loss for the year		**–**	**–**	**–**	**(9)**	**–**	**–**	**–**	**(9)**
Transactions with owners									
Ordinary shares issued for cash consideration	18	**–**	**2**	**–**	**–**	**–**	**–**	**–**	**2**
Share issue costs recognised in equity	19	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Vesting of the share-based payment schemes	7, 18	**–**	**–**	**–**	**4**	**–**	**–**	**(4)**	**–**
Employee related share-based payments	7	**–**	**–**	**(12)**	**(4)**	**–**	**–**	**6**	**(10)**
At end of year		**2**	**120**	**(12)**	**(2)**	**1,055**	**34**	**8**	**1,205**

31 December 2016	Note	Share capital £m	Share premium £m	Retained profit £m	Capital reduction reserve £m	Merger reserve £m	Share-based payment reserve £m	Total £m
At beginning of year		925	–	6	–	34	11	976
Total comprehensive income								
Loss for the year		–	–	(12)	–	–	–	(12)
Transactions with owners								
Ordinary shares issued for cash consideration	18	129	121	–	–	–	–	250
Share issue costs recognised in equity	19	–	(3)	–	–	–	–	(3)
Vesting of the share-based payment schemes	7, 18	3	–	13	–	–	(13)	3
Ordinary share reduction	18, 19	(1,055)	–	–	1,055	–	–	–
Employee related share-based payments	7	–	–	–	–	–	8	8
At end of year		2	118	7	1,055	34	6	1,222

The accounting policies and notes on pages 18 to 49 form an integral part of these financial statements.

STATEMENT OF FINANCIAL POSITION FOR THE GROUP

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	**320**	218
Deferred tax asset	11	**3**	–
Prepayments		**45**	36
Financial investments	13	**25,671**	22,594
Derivative assets	14	**8,775**	9,320
Cash and cash equivalents	13	**43**	34
Total assets		**37,406**	34,821
Equity			
Share capital	18	**2**	2
Share premium	19	**120**	118
Treasury shares	19	**(12)**	(1)
Merger reserve	19	**34**	34
Capital reduction reserve	19	**1,055**	1,055
Share-based payment reserve	19	**10**	6
Retained (loss)/profit	19	**874**	565
Total equity		**2,083**	1,779
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	**21**	20
Current taxation		**43**	31
Accruals	13	**56**	50
Total liabilities		**35,323**	33,042
Total equity and liabilities		**37,406**	34,821

The accounting policies and notes on pages 18 to 49 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:

Tracy Blackwell
Director

Registered number: 09740110

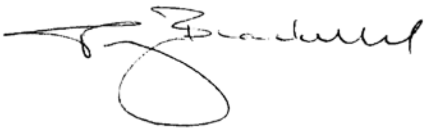
STATEMENT OF FINANCIAL POSITION FOR THE COMPANY

AS AT 31 DECEMBER 2017

	Note	2017 £m	2016 £m
Assets			
Investments in subsidiaries	17	**1,203**	1,204
Receivables and other financial assets		**2**	–
Cash and cash equivalents	13	**6**	20
Total assets		**1,211**	1,224
Equity			
Share capital	18	**2**	2
Share premium	19	**120**	118
Treasury shares	19	**(12)**	–
Merger reserve	19	**34**	34
Capital reduction reserve	19	**1,055**	1,055
Share-based payment reserve	19	**8**	6
Retained profit	19	**(2)**	7
Total equity		**1,205**	1,222
Liabilities			
Insurance and other payables	13	**6**	2
Total liabilities		**6**	2
Total equity and liabilities		**1,211**	1,224

The accounting policies and notes on pages 18 to 49 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:



Tracy Blackwell
Director

Registered number: 09740110

GROUP 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		**310**	212
Adjustments for non-cash movements			
Interest income recognised in profit or loss	2	**(631)**	(561)
Other investment (loss)/income recognised in profit or loss		**65**	(45)
Interest expense recognised in profit or loss		**40**	21
Amortisation of subordinated debt issue costs and discount		**1**	1
Movement in tax provisions	8	**73**	54
Movement in fair value of investment properties	9	**(2)**	(1)
Equity settled share-based payments	7	**6**	8
		(448)	(523)
Changes in operating assets and liabilities			
Increase in receivables and other financial assets		**(92)**	(8)
Increase in financial investments including derivative assets		**(2,532)**	(10,401)
Decrease/(increase) in prepayments		**(9)**	39
Decrease/(increase) in reinsurers' share of insurance liabilities	10	**72**	(605)
Increase in insurance liabilities	10	**3,252**	5,261
(Decrease)/increase in financial liabilities including derivative liabilities		**(991)**	5,018
Increase/(decrease) in insurance and other payables		**1**	(8)
Increase in accruals		**6**	1
		(293)	(703)
Cash outflow from operating activities		**(431)**	(1,014)
Taxation paid		**(62)**	(39)
Net outflow from operating activities		**(493)**	(1,053)
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	18	**2**	250
Proceeds from issue of subordinated debt	12	**–**	250
Purchase of treasury shares		**(16)**	(1)
Interest paid on subordinated debt		**(40)**	(20)
Equity and debt issue costs	12, 18	**–**	(6)
		(54)	473
Net increase in cash and cash equivalents		**9**	–
Cash and cash equivalents at beginning of year		**34**	34
Cash and cash equivalents at end of year		**43**	34

The accounting policies and notes on pages 18 to 49 form an integral part of these financial statements.

COMPANY STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 31 DECEMBER 2017

	Note	2017 £m	2016 £m
Cash flows from operating activities			
Loss for the year		**(9)**	(12)
Adjustments for non-cash movements:			
Impairment of investment		**1**	3
Equity settled share-based payments	7	**6**	8
		7	11
Changes in operating assets and liabilities			
(Increase)/decrease in debtors		**(2)**	13
Increase in insurance and other payables		**4**	2
		9	26
Cash (outflow)/inflow from operating activities		**–**	14
Investing activities			
Investment in subsidiary undertaking		**–**	(244)
Cash (outflow)/inflow from investing activities		**–**	(244)
Financing activities			
Proceeds of issue of share capital	18	**2**	250
Issue costs	18	**–**	(3)
Purchase of treasury shares		**(16)**	–
Cash inflow from financing activities		**(14)**	247
Net increase in cash and cash equivalents		**(14)**	17
Cash and cash equivalents at beginning of year		**20**	3
Cash and cash equivalents at end of year		**6**	20

The accounting policies and notes on pages 18 to 49 form an integral part of these 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.

In publishing its own financial statements here together with the Group financial statements, the Company has taken advantage of the exemption in section 408(3) of the Companies Act 2006 not to present its individual income statement and related notes that form a part of these financial statements.

The Group 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 Group arising from implementation of these standards.

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

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

The financial instruments held by the Group 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 Group 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 – not yet endorsed by the EU, effective for accounting periods beginning on or after 1 January 2018.

The Group'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 Group.

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

As disclosed in Note 21, the Group has operating lease liabilities amounting to £18m. On adoption of the standard, these lease liabilities are expected to be recognised on the Statement of financial position as an asset with a corresponding liability of equal value.

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

The Group 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 the financial statements as it transforms the way the Group 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 Group has created an IFRS 17 implementation project team, whose primary task is to understand the requirements of IFRS 17, develop and implement models and capabilities to meet those requirements over the next three years. The Group 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 Group.

(b) Recognition and derecognition of financial instruments

A financial instrument is recognised if the Group becomes a party to the contractual provisions of the instrument. Financial assets are derecognised if the Group's contractual rights to the cash flows from the financial assets expire, or if either the Group 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 date of trading. Financial liabilities are derecognised when the Group'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 Group 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 Group.

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 sales proceeds and 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.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

1. Accounting policies continued

(h) Finance costs

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

(i) 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 Group 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.

(j) Employee benefits

Defined contribution plans

Pension Services Corporation Limited ("PSC") operates a defined contribution pension plan into which PSC contributes 8% if the employee makes a minimum contribution of 2% of qualifying salary. Obligations for contributions to defined contribution plans are recognised as an employee benefit expense in the Statement of comprehensive income in the period during which the related services are rendered by employees.

Equity settled share-based payment transactions

The fair value on the grant date of equity settled share-based payment awards granted to Directors and employees is recognised as an employee expense, with a corresponding increase in equity, over the period that the employees become unconditionally entitled to the awards. The amount recognised as an expense is adjusted to reflect the number of awards for which the related service and performance conditions are expected to be met, such that the amount recognised as an expense is based on the number of awards that meet the relevant service conditions and performance conditions at vesting date.

Any ordinary shares required to fulfil entitlements under the share-based payment awards are provided by the Pension Corporation Group Employee Benefit Trust ("EBT"). The EBT is treated as a branch. Any shares purchased by the EBT to fund these awards and held at a period end date are accounted for as treasury shares within the Company and Group shareholders' equity.

When the awards vest and new shares are issued, the proceeds received, net of transaction costs, are credited to share capital (par value) and the balance, if any, to share premium. Where the shares are already held by the EBT, the net proceeds are credited against the cost of these shares, with the difference between cost and proceeds being taken to retained earnings. In both cases, the relevant amount in the share-based payments reserve is then credited to retained earnings.

(k) Investment properties

Investments in freehold properties not for occupation by the Group 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.

(l) 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.

(m) 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 Group 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.

(n) Assets pledged as collateral

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

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

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

(o) 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.

(p) Foreign currencies

The functional currency of the Group is pounds sterling. The Company and the Group have chosen to present their 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.

1. Accounting policies continued

(q) 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.

(r) 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.

(s) 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.

(t) 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.

(u) Insurance liabilities

Insurance liabilities are determined by the Group'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 IFRS 4.

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

(v) 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 Group 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 Group 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 Group 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 Group. Separately, there is also an insurance fee on each of these contracts for which the Group 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 Group impairs its reinsurance assets if there is an 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.

(w) Critical accounting policies, estimates and judgements

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

Insurance liabilities

The Group 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 Group 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.

The Group 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 £22.5bn (2016: £19.2bn). 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 Group 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.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

2. 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		
– Investments designated as FVTPL on initial recognition	**320**	310
– Investments classified as held for trading	**11**	106
Realised losses on investments		
– 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		
– Investments designated as FVTPL on initial recognition	**177**	2,999
– Investments classified as held for trading	**723**	13
Unrealised losses on investments		
– Investments designated as FVTPL on initial recognition	**(407)**	(17)
– Investments classified as held for trading	**(277)**	(756)
Net unrealised gains/(losses)	**216**	2,239
Investment return	**1,092**	3,219

3. Acquisition expenses

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

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

4. Other operating expenses

	2017 £m	2016 £m
Investment charges and related expenses	**16**	9
Equity settled share-based payments	**6**	8
Other expenses	**26**	23
	48	40

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.

5. Auditor's remuneration

	2017 £	2016 £
Fees payable to the Company's auditor for the audit of the Company's annual accounts	**20,636**	20,379
Fees payable to the Company's auditor and its associates for other services:		
Audit of accounts of subsidiaries	**245,295**	256,050
Audit-related assurance services	**146,818**	167,674
Other assurance services	**–**	40,000
Tax compliance services	**–**	22,000
All other services	**88,938**	194,429
Total fees paid to the auditor	**501,687**	700,532

6. Directors remuneration, employee costs and headcount

The cost of Directors and employees of the Group for the year were as follows:

	2017 £m	2016 £m
Wages and salaries	**24**	22
Social security costs	**4**	3
Other pension costs	**1**	1
	29	26

The fourteen Directors who served in the Company during the year received total remuneration of £1m (2016: £1m) for their services to the Company.

The amount of remuneration received by the highest paid Director was £1m (2016: £1m). This includes £1m (2016: £1m) in respect of services provided to other Group companies. In addition, the highest paid Director was awarded 227,828 ordinary shares on maturity of certain share incentive scheme during 2017 along with 556 C shares awarded under the Share Growth Plan.

No Directors had money paid to money purchase pension schemes on behalf of the Company during the year (2016: £nil).

One Director of the Company was awarded share options during their tenure (2016: one). One Director of the Company received a total of 227,828 ordinary shares of the Company upon vesting of the Share Plans during the year (2016: three Directors received a total of 5,368,690 ordinary shares).

The average number of persons employed by the Group (including Directors) during the year, analysed by category, was as follows:

	2017 No.	2016 No.
Employees	**157**	145
Directors	**12**	11

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

7. Share-based payment arrangements

The Company operates three types of share-based incentive schemes for employees. All three meet the definition of equity settled share-based payments under IFRS 2 "Share-Based Payment".

All schemes contain clawback provisions which allow the PIC Nominations and Remuneration Committee to reduce or extinguish awards in certain specified circumstances.

Analysis of expense recognised in the Statement of comprehensive income

	2017 £m	2016 £m
Equity settled share based payment transactions		
Share Growth Plan 2016	**–**	–
Share Growth Plan 2012	**–**	6
Performance Share Plan	**6**	2
Save As You Earn Share Plan	**–**	–
Total expense recognised for equity settled share based payments	**6**	8

Share Growth Plan

The commercial objective of this plan is to deliver to participants (Directors and senior management of Group companies) a proportion of growth in value of the Company above the value of the Company on implementation of the Plan ("Initial Company Value"):

- 4.25% of the growth in the value of the Company between Hurdle 1 (10% p.a.) and Hurdle 2 (12% p.a.);
- 5.525% of the growth in the value of the Company between Hurdle 2 and Hurdle 3 (15% p.a.);
- 0.85% of the growth in the value of the Company above Hurdle 4.

The Growth Shares (issued as C shares) will ordinarily vest four years from acquisition date, 1 January 2017 ("the Vesting Date"), subject to certain provisions. On the Vesting Date, the value of the Growth Shares will be determined and the Growth Shares will be converted into ordinary shares of equal value.

Participants will only be able to sell their ordinary shares received on conversion on the Vesting Date, in years 4, 5 and 6 in equal amounts, i.e. these shareholders will be able to sell a third each year after the growth plan vests.

If there is an exit event prior to the Vesting Date, the value of the Growth Shares will be determined on exit and the Growth shares will vest as follows:

- on a sale or winding up of the Company, Growth Shares would vest in full;
- on a listing, the Growth Shares would convert into ordinary shares of an equal value. One third of the resulting ordinary shares would vest upon listing; one third would vest on the earlier of the 4th anniversary of the grant date and 12 months following the listing; and one-third would vest on the earlier of the 4th anniversary of the grant date and 24 months following the listing.

The fair value of the Growth Plan was calculated to be £1.6m, which was fully paid by the participants. As a result, no expense has been recognised in the statement of comprehensive income in respect of this plan.

Performance Share Plan ("PSP")

This plan is designed to incentivise key individuals to grow the business and build a sustained and successful future for the Group by rewarding and retaining them through a long-term incentive arrangement. Initial awards under the plan were made by the Company on 30 January 2013 and again on 12 February 2014, 25 February 2015, 26 February 2016 and 20 February 2017. Awards may be made on an annual basis in future at the Company's discretion.

The awards under the PSP are in the form of a nil cost option over a number of the Company's ordinary shares.

	Awarded	Lapsed/forfeited	Exercised	Remaining
2013 awards	3,705,000	124,444	3,438,889	141,667
2014 awards	2,493,831	25,755	2,297,723	170,353
2015 awards	2,973,153	220,315	–	2,752,838
2016 awards	2,770,458	199,673	–	2,570,785
2017 awards	2,492,636	39,131	–	2,453,505
	14,435,078	**609,318**	**5,736,612**	**8,089,148**

Save As You Earn Share Plan ("SAYE")

The SAYE plan is designed to incentivise all employees to grow the business and participate in the rewards this offers. There are two types of SAYE schemes: approved and unapproved under HMRC tax beneficial regulations.

Initial awards under the plan were made by the Company on 9 April 2013 and again on 11 April 2014, 13 April 2015 and 16 May 2016. These were unapproved under HMRC tax beneficial regulations.

On 11 May 2017, awards were made by the Company, which were approved under HMRC tax and beneficial regulations. Awards may be made on an annual basis in future at the Company's discretion.

The SAYE plan is a savings plan that allows all staff to save a fixed amount each month over a three-year period. At the start of the savings period staff are also granted an option over a number of ordinary shares in the Company at a discount of up to 20% of the market value of the Company's shares at the date of grant. The minimum and maximum amounts for a savings contract are £20 and £500 (or 10% of gross salary if lower) per month respectively. These limits apply per plan and are an annual amount.

	Awarded	Lapsed/forfeited	Exercised	Remaining
2013 awards	780,300	103,950	665,950	10,400
2014 awards	502,255	103,561	363,469	35,225
2015 awards	336,455	36,843	–	299,612
2016 awards	439,738	58,175	–	381,563
2017 award	571,094	13,965	–	557,129
	2,629,842	**316,494**	**1,029,419**	**1,283,929**

8. Corporation tax

Group

The Group's tax charge for the year is:

	2017 £m	2016 £m
Current taxation		
Corporation tax payable for the current year	**74**	55
Prior year under/(over) provision	**–**	–
Total current tax	**74**	55
Deferred taxation		
Recognition of deferred tax asset on temporary timing differences	**(1)**	–
Tax transitional adjustment	**–**	(1)
Effect of change in tax rates	**–**	–
Total deferred tax	**(1)**	(1)
Tax charge	**73**	54

The effective current tax charge for the period is lower (2016: higher) than the standard rate of corporation tax in the United Kingdom 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	**383**	266
Corporation tax at 19.25% (2016: 20%)	**74**	53
Effects of:		
Expenses not deductible for tax purposes	**–**	2
Allowable charge against tax	**(2)**	(1)
Deferred taxation movement	**1**	–
Tax charge	**73**	54

8. Corporation tax continued

Factors that may affect future tax charges

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

The Group 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 Group has recognised a deferred tax liability at 31 December 2017 of £4m (2016: £4m) in respect of these timing differences which total £20m (2016: £24m).

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 Group's future current tax charge accordingly. The deferred tax liability at 31 December 2017 has been calculated based on these rates.

Company

The Company is subject to the standard company tax rate in the United Kingdom; however, it has not generated any taxable profits during the year. The recorded losses for the year have arisen from the share-based payment charges for the year and an impairment of the investment in subsidiary undertakings.

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 Group classifies its investment in eight Guernsey registered property unit trusts ("GPUTs") as investment properties. The Group holds 100% 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 United Kingdom.

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 2.

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 Group'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 Group'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 Group'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 Group'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 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 was 2.06% for both index-linked liabilities and non-linked liabilities (2016: 2.11% combined rate).

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 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.

2017	Gross £m	Reinsurance £m	Net £m
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**

2016	Gross £m	Reinsurance £m	Net £m
At beginning of year	16,480	(1,917)	14,563
Increase in liability from new premiums	2,596	–	2,596
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 I 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 one 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 one year £m	In 1–5 years £m	In 5–15 years £m	Over 15 years £m	Total £m
Deferred annuities					
Gross	37	336	1,367	4,918	6,658
Reinsurance	(4)	(27)	(92)	(1,468)	(1,591)
As at 31 December 2016	33	309	1,275	3,450	5,067
Annuities in payment					
Gross	687	2,659	5,610	6,127	15,083
Reinsurance	14	31	(106)	(870)	(931)
As at 31 December 2016	701	2,690	5,504	5,257	14,152

(e) Sensitivity analysis

In accordance with IFRS 4 and IFRS 7 "Financial Instruments: Disclosures" the Directors have considered the effect on profits 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 improvements (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 improvements (see below) £m	Renewal expenses (see below) £m	Exchange rates (see below) £m	Credit spreads increase of 25bps £m
Movement in assets	–	–	–	11	(346)
Movement in liabilities	(26)	(70)	(69)	(13)	363
Tax effect	5	14	14	–	(3)
Movement in profit and equity	(21)	(56)	(55)	(2)	14

Parameters for exchange rate, longevity and renewal expense sensitivities
The exchange rate sensitivity is based on weakening of US dollar 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 Group is exposed at the end of the reporting period, and reflects the changes in relevant risk variables that are reasonably possible at this date and over the next reporting period. The sensitivities used are based around the core assumptions in the financial statements rather than considering more extreme scenarios.
- 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 Group'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 Group 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 Group's deferred tax balances calculated in accordance with IAS 12 "Income Taxes" were as follows:

	Asset £m	Liability £m	Total £m
31 December 2017			
Additional reserves	**3**	**(4)**	**(1)**
31 December 2016			
Additional reserves	–	(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 asset on temporary timing differences	**3**	–
Effect of transitional tax arrangements	**–**	1
At end of year	**(1)**	(4)

Of the £3m movement in deferred tax, £2m was recognised through equity and £1m in the statement of comprehensive income.

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.

At 31 December 2016, an unrecognised deferred tax asset of £3m existed within the Group, representing an estimate of the potential future tax deduction available on vesting of existing share incentive schemes. During 2017, this asset has been recognised.

The Group has no other 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 Group's main subsidiary entity, PIC, issued £300m subordinated loan notes due 2024 with a fixed coupon of 6.5% paid annually in arrears. The notes were issued at 99.107% of par. On 23 November 2016, PIC issued a further tranche of £250m subordinated loan notes due 2026 with a fixed coupon of 8.0% paid annually in arrears. These notes were issued at 98.916% of par.

Both notes represent direct, unsecured and subordinated obligations of PIC, 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.

12. Borrowings continued

Loan notes	2017 Carrying value £m	2017 Fair value £m	2016 Carrying value £m	2016 Fair value £m
£300m notes maturing 2024	**296**	**354**	295	302
£250m 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. 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 £41m (2016: £22m), which was 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 Group'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.

Group

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	**–**	**15**	–	38
Accrued interest	**–**	**185**	–	176
Total receivables and other financial assets	**–**	**320**	–	218
Cash and cash equivalents	**–**	**43**	–	34
Total financial assets	**34,446**	**363**	31,914	252
Financial liabilities				
Derivative liabilities	**9,663**	**–**	10,654	–
Creditors arising out of reinsurance operations	**–**	**9**	–	8
Other creditors	**–**	**12**	–	12
Insurance and other payables	**–**	**21**	–	20
Borrowings	**–**	**543**	–	542
Accruals	**–**	**56**	–	50
Total financial liabilities	**9,663**	**620**	10,654	612

Amounts due to be received in more than one year in the above table are as follows:

	2017 £m	2016 £m
Financial assets designated as fair value through profit or loss	**32,636**	30,203
Debtors arising out of direct insurance operations	**–**	–

All amounts relating to insurance and other payables and accruals are expected to be settled within one year.

Deposits with credit institutions

Deposits with credit institutions include £18m (2016: £16m) in two bank accounts operated by PIC 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 Rückversicherungsgesellschaft ("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.

PIC 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 Group 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 Group or its counterparty to mitigate the counterparty credit risk. The Group 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 Group 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 Group has included £1,688m (2016: £1,759m) of financial assets which have been pledged as security under the terms of derivative contracts. The Group 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 amount of collateral received by the Group was £662m (2016: £483m). While the Group is permitted to sell or repledge collateral received, no collateral was actually sold or repledged in the absence of default during the year (2016: £nil).

In 2014, PIC concluded a pension insurance buy-in transaction to underwrite approximately £1.6bn of pension liabilities. Under the terms of the agreement, a security structure was put in place which required PIC to transfer legal title to certain assets back to the Trustee as collateral against PIC default.

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 PIC. PIC retains the right to replace any of the assets with assets of similar nature.

Collateral is returned to PIC as it services the insured pension liabilities under the policy. This, in theory, exposes PIC to counterparty credit risk, which is, however, fully mitigated as PIC has contractual right to offset its obligation to pay under the policy in the event of default by the Trustee. PIC retains substantially all the risks and rewards of ownership in respect of the transferred assets and accordingly PIC continues to recognise the assets which it has pledged under title transfer security in its financial statements. At 31 December 2017, this totalled £1.8bn (2016: £1.8bn).

13. Financial assets and financial liabilities continued

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

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

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

In all cases the Group 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 Group had £1,209m (2016: £851m) assets related to securities lending and reverse sale and repurchase agreements, and held £1,209m (2016: £851m) in gilts and eligible securities as collateral in respect of these arrangements.

Offsetting

The Group does not offset financial assets and liabilities in the Statement of financial position unless there is a legally enforceable right to offset and the Group 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 Group 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)

Company

All of the Company's financial assets and liabilities are valued at amortised cost as detailed below:

	2017 Amortised cost £m	2016 Amortised cost £m
Financial assets		
Cash and cash equivalents	**6**	20
Receivables and other financial assets	**2**	–
Total financial assets	**8**	20
Financial liabilities		
Insurance and other payables	**6**	2
Total financial liabilities	**6**	2

Included within receivables and other assets are amounts totalling £2m (2016: £nil) due to be received in more than one year. All amounts relating to insurance and other payables and accruals are expected to be settled within one year.

Measurement of financial assets and liabilities

The Group'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 Group 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 are based on market prices, where available. For swaps, market prices are calculated using discounted cash flow techniques based on adjusted market data such as composite curves derived from a number of market counterparties. Derivative contracts may not be readily tradeable and consequently they have been classified as Level 2 assets within the fair value hierarchy.

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

The Group 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.

13. Financial assets and financial liabilities continued

(c) MBS and ABS

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

(d) Deposits with credit institutions

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

(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.

Measurement of fair value

The following table analyses the Group'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 mortgage	**–**	**–**	**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 Group'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 into and out of Level 3

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

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 Group. 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:

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:

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

13. Financial assets and financial liabilities continued

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

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

31 December 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)**

31 December 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 Group 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 Group against the adverse effects of inflation over a period of time while the Group enters into interest rate swap transactions to assist in hedging contractual liabilities. Currency swaps and forward contracts are entered into to eliminate the majority of the currency risk on financial assets invested in non-sterling based debt securities where liabilities are denominated in sterling.

	31 December 2017		31 December 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 Group's business involves the acceptance and management of risk to achieve its strategic objectives.

The principal risk factors which affect the Group'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 Group'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 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 the formal committees of the PIC 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 PIC 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 Group's risks is a significant focus area for the Board as an uncontrolled and unmanaged development in various risks may affect the Group's performance and capital adequacy. The Group 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 Group. Risks such as longevity risk are mitigated through reinsurance to the extent that it is economic to do so.

The Group uses derivatives for the purpose of efficient portfolio management or to reduce risk in aspects of the Group'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 Group 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.

(a) Market risk

The Group 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 Group's derivatives.

The Group 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 Group 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 Group 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 Group 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 Group 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 Group 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 Group. The Group 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.

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15. Risk management continued

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

The following table sets out the credit risk exposure and ratings of financial assets which are susceptible to credit risk. The ratings used have been sourced from S&P, Moody's or Fitch. The remaining unrated assets are not classified by S&P, Moody's or Fitch.

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**
Equity release mortgages	**–**	**–**	**–**	**–**	**–**	**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**	**135**	**320**
Deposits with credit institutions	**–**	**–**	**577**	**–**	**–**	**–**	**577**
Cash and cash equivalents	**–**	**–**	**–**	**43**	**–**	**–**	**43**
	553	**30**	**636**	**123**	**1**	**9,396**	**10,739**

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

2 Within MBS and ABS there are £4m A rated securities and £1m 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	43	218
Deposits with credit institutions	–	–	536	–	–	–	536
Cash and cash equivalents	–	–	–	34	–	–	34
	901	28	596	106	2	9,682	11,315

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

2 Within MBS and ABS there are £4m A rated securities, which have been rated using internally assessed credit ratings.

Although the instruments themselves are unrated, the ultimate issuing party 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 Group which assesses the impact of a number of scenarios on the Group's solvency position.

Reinsurance counterparties

The Group has reinsurance contracts in place with ten external reinsurers with an exposure of £2,450m at 31 December 2017 (2016: £2,522m). 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 Group 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 Group 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 Group'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.

15. Risk management continued

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

31 December 2017	Within one year £m	In 1–5 years £m	In 5–15 years £m	Over 15 years £m	Total £m
Creditors arising out of reinsurance operations	**9**	**–**	**–**	**–**	**9**
Other creditors	**12**	**–**	**–**	**–**	**12**
Accruals	**56**	**–**	**–**	**–**	**56**
Borrowings	**–**	**–**	**543**	**–**	**543**
Derivative liabilities	**49**	**371**	**1,062**	**8,181**	**9,663**
	126	**371**	**1,605**	**8,181**	**10,283**

31 December 2016	Within one year £m	In 1–5 years £m	In 5–15 years £m	Over 15 years £m	Total £m
Creditors arising out of reinsurance operations	8	–	–	–	8
Other creditors	12	–	–	–	12
Accruals	50	–	–	–	50
Borrowings	–	–	542	–	542
Derivative liabilities	86	420	1,508	8,640	10,654
	156	420	2,050	8,640	11,266

All amounts due to other creditors are expected to be paid in the next financial year.

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

(d) Insurance risk

Longevity risk is the risk that mortality experience of the Group'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 Group.

In order to help minimise this risk and also uncertainty arising through future longevity experience, the Group 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 Group 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 Group. Separately, there is also an insurance fee for which the Group 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 Group in respect of an agreed set of policyholders. These contracts also transfer the contingent risks relating to eligible dependants of relevant policyholders.

The Group monitors the levels of its counterparty risk and actively seeks to reinsure with a wide 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, 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 Group also considers the following risks:

Risk arising from a specific insurance contract
The Group 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 Group 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 Group'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, regular compliance training, segregation of duties and whistleblowing policies.

The Group 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. Related party transactions
Group
At its discretion and as approved by the Remuneration Committee, the Group may settle personal tax liabilities on behalf of certain employees, including the Directors and key management personnel, who exercises their options upon vesting of Performance Share Plan. The settlement is made on the condition that the employees would repay this amount to the Group within 90 days after the end of the relevant tax year. At 31 December 2017, the Group recognised a loan asset of £1,892,652 (2016: £2,122,538) in respect of this transaction; of this amount £1,209,077 (2016: £1,112,396) was due from the Directors and key management personnel. The loan does not bear any interest, and except for the repayment period, does not have any other condition attached to it.

The Group had no other transactions with related parties during the period other than awards made under the Share Growth Plan which are detailed in Note 7.

Company
The Company had no transactions with related parties during the period other than awards made under the Share Growth Plan which are detailed in Note 7.

17. Investments in subsidiaries
The Company's investments in subsidiary undertakings is as follows:

	2017 £m	2016 £m
Cost		
At start of year	**1,204**	960
Acquired during the period	**–**	244
Reclassification of the EBT from a subsidiary to a branch	**(1)**	–
At end of the year	**1,203**	1,204
Net book value		
31 December	**1,203**	1,204

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17. Investments in subsidiaries continued

Following the Group reorganisation in December 2015, PICG acquired all of the subsidiaries of Pension Corporation Group Limited ("PCG"), the previous ultimate parent undertaking of the Group, including the EBT. The transfer of the EBT took place in 2017 and as a result it has been reclassified as a branch of PICG.

PICG owns 100% of the ordinary share capital of all the following companies. All subsidiaries have been consolidated in the accounts.

Subsidiary undertakings	Principal Activity	Country of incorporation	Notes
PIC Holdings Limited[1]	Holding Company	England	Trading company
Pension Insurance Corporation plc	Bulk Annuity Insurance	England	Trading company
Pension Services Corporation Limited	Service Company	England	Trading company
Pension Corporation Group Limited[1]	Holding Company	Guernsey	In liquidation

1 Denotes investment held directly by the Company at 31 December 2017.

On 12 January 2018, Pension Corporation Group Limited completed a solvent voluntary liquidation process.

18. Share capital

	2017		2016	
	Number of shares	**£m**	Number of shares	£m
Ordinary shares				
Authorised, issued and fully paid				
At beginning of year	**1,084,405,273**	**2**	925,000,000	925
Shares issued at premium	**–**	**–**	129,000,000	129
Shares issued to satisfy share-based payment awards	**688,166**	**–**	2,788,683	3
Share reduction	**–**	**–**	–	(1,055)
B share conversion to ordinary shares	**–**	**–**	27,616,590	–
At end of year	**1,085,093,439**	**2**	1,084,405,273	2
B Shares				
At beginning of year				
Ordinary B shares of £0.10 each	**–**	**–**	446,500	–
Conversion of B shares to 1 B share of £44,650	**–**	**–**	(446,499)	–
Conversion of 1 B share to ordinary shares	**–**	**–**	(1)	–
At end of year	**–**	**–**	–	–
C Shares				
At beginning of year	**–**	**–**	–	–
C shares of £0.00161678179673884 each issued	**2,000**	**–**	–	–
At end of year	**2,000**	**–**	–	–

Certain share-based payment schemes operated by the Company have vested during the year. The Company issued 688,166 ordinary shares with nominal value of £0.00161678179673884 at par on 4 July 2017 to satisfy the vesting of these awards.

The rights attaching to each class of shares existing at 31 December 2017 are as follows:

Ordinary shares

Voting rights are only conferred on the holders of ordinary shares, except when a resolution relates to a change of rights or privileges of convertible deferred shares or the winding up of the Company.

Ordinary shares are the only class entitled to dividends or distributions of income unless otherwise determined by the Board.

Ordinary B shares

As noted above, all ordinary B shares were converted to ordinary shares in 2016. No B shares are in existence at 31 December 2017.

C shares

2,000 C shares were issued at a subscription price of £815 per share and a nominal value of £0.00161678179673884 per share on 29 June 2017 to satisfy the requirements of the 2017 Share Growth Plan awarded to certain members of the Company's Executive Management team.

C shares are fully paid up and subscribed by the share plan participants.

C shares can be converted into ordinary shares on 1 January 2021, under the terms set out in the Company's Articles.

On winding up of the Company the holders of C shares have the right to receive in priority to the holders of ordinary shares an amount equal to the lower of the C Share Value on the date the Royal Court makes a compulsory winding up order in respect of the Company and the C Share original cost.

The Board in its absolute discretion may recommend a dividend in respect of C shares.

19. Reserves

Group

31 December 2017	**Share premium £m**	**Treasury shares £m**	**Retained profit £m**	**Capital reduction reserves £m**	**Merger reserve £m**	**Share-based payment reserve £m**
At beginning of year	**118**	**(1)**	**565**	**1,055**	**34**	**6**
Total comprehensive income	**–**	**–**	**310**	**–**	**–**	**–**
Ordinary shares issued for cash consideration	**2**	**–**	**–**	**–**	**–**	**–**
Vesting of the share-based payment schemes	**–**	**1**	**3**	**–**	**–**	**(4)**
Employee related share-based payments	**–**	**(12)**	**(4)**	**–**	**–**	**6**
Tax relating to share-based payments	**–**	**–**	**–**	**–**	**–**	**2**
At end of year	**120**	**(12)**	**874**	**1,055**	**34**	**10**

31 December 2016	Share premium £m	Treasury shares £m	Retained profit £m	Capital reduction reserves £m	Merger reserve £m	Share-based payment reserve £m
At beginning of year	–	–	342	–	34	11
Total comprehensive income	–	–	212	–	–	–
Ordinary shares issued for cash consideration	121	–	–	–	–	–
Share issue costs recognised in equity	(3)	–	–	–	–	–
Vesting of the share-based payment schemes	–	(1)	11	–	–	(13)
Ordinary share reduction	–	–	–	1,055	–	–
Employee related share-based payments	–	–	–	–	–	8
At end of year	118	(1)	565	1,055	34	6

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2017

CONTINUED

19. Reserves continued

Company

31 December 2017	Share premium £m	Treasury shares £m	Retained profit £m	Capital reduction reserves £m	Merger reserve £m	Share-based payment reserve £m
At beginning of year	118	–	7	1,055	34	6
Total comprehensive income	–	–	(9)	–	–	–
Ordinary shares issued for cash consideration	2	–	–	–	–	–
Vesting of the share-based payment schemes	–	–	4	–	–	(4)
Employee related share-based payments	–	(12)	(4)	–	–	6
At end of year	120	(12)	(2)	1,055	34	8

31 December 2016	Share premium £m	Retained profit £m	Capital reduction reserves £m	Merger reserve £m	Share-based payment reserve £m
At beginning of year	–	6	–	34	11
Total comprehensive income	–	(12)	–	–	–
Ordinary shares issued for cash consideration	121	–	–	–	–
Share issue costs recognised in equity	(3)	–	–	–	–
Vesting of the share-based payment schemes	–	13	–	–	(13)
Ordinary share reduction	–	–	1,055	–	–
Employee related share-based payments	–	–	–	–	8
At end of year	118	7	1,055	34	6

During the year, 2,000 C shares were issued at a subscription price of £815 per share and a nominal value of £0.00161678179673884 per share, giving rise to a £2m increase in share premium.

A Capital Reduction reserve was established on 21 October 2016, when the Company reduced the nominal value of its ordinary shares from £1 to £0.00161678179673884 in accordance with the relevant Special Resolution.

During 2016, the Company advanced £1m to the EBT to enable the settlement of share-based payment awards. These were accounted for as Treasury shares in the Group financial statements, and as an investment in subsidiary undertaking in the Company financial statements.

The Group carried out a group reorganisation in December 2015, which led to a recognition of a merger reserve of £34m in respect of the amount by which the book value of the PCG Group exceeded the nominal value of shares issued by PICG to acquire the PCG Group.

Share-based payment reserve is recognised in respect of the equity settled share-based payment awards in accordance with the accounting policy in Note 1 (j). The relevant disclosures in respect of the share-based payment schemes are provided in Note 7.

Treasury shares relate to the shares purchased by the EBT in respect of the Company's share-based payment awards.

20. 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 Group's capital resources comprise equity and debt capital. The details of the Group's capital resources are given in the Statement of changes in equity.

The Group 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 Group is able to treat the subordinated debt referred to in Note 12 as regulatory capital. The Group has complied with the capital requirements under Solvency II throughout the year.

The Group'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 Group'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 Group 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 requirement. This evaluates market risk, insurance risk, operational risk, expense risk and counterparty risk. In addition, PIC produces an own risk and solvency assessment report annually, which provides an analysis of the risks facing the Company and its capital resources.

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

PIC focuses on hedging its Solvency II balance sheet through hedging its best estimate liabilities and solvency capital requirement 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 exposure has been transferred as at 31 December 2017, based on regulatory liabilities.

21. Financial commitments and contingencies

Operating lease commitment

Operating lease rental commitments arise where a Group company is the lessee in respect of non-cancellable operating lease agreements. Payments made under operating leases (net of any incentives received from the lessor) are charged to the profit and loss on a straight-line basis over the period of the lease.

The future aggregate minimum lease payments under non-cancellable operating leases are as follows:

	2017 £m	2016 £m
Within 1 year	**3**	1
In 1-5 years	**11**	11
Over 5 years	**4**	7
	18	18

Other commitments

During the year the Group executed transactions to purchase partly funded securities. The Group expects to pay a further £351m within the next five years (2016: £261m), £92m of this being due within 12 months of the financial reporting date (2016: £64m).

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

Contingent liabilities

The Group 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 £10m (2016: £10m).

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