PENSION INSURANCE CORPORATION

VALUING
OUR CUSTOMERS

PENSION INSURANCE CORPORATION PLC
ANNUAL REPORT AND ACCOUNTS 2018

The purpose of Pension Insurance Corporation plc ("PIC") is to pay the pensions of its current and future policyholders. PIC is a specialist insurer which provides secure and stable retirement incomes through financial strength, leading customer service, comprehensive risk management and excellence in asset and liability management. Delivering on this purpose provides attractive returns for shareholders and fulfilling careers for employees.

PIC has insured 192,100 pension scheme members and has £31.4 billion in financial investments, accumulated through the provision of 186 tailored pension insurance buyouts and buy-ins to the trustees and sponsors of UK defined benefit pension schemes.

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PIC IS A COMPANY TOTALLY FOCUSED ON THE BUSINESS OF PAYING PENSIONS TO ITS POLICYHOLDERS. IT IS ALSO ONE OF THE BEST FOR CUSTOMER SERVICE. FOR ME, THE EXPERIENCE TO DATE HAS BEEN FAULTLESS.

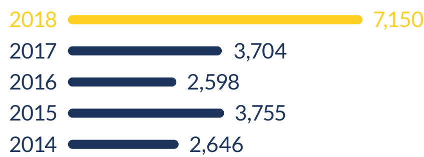
Ray Dawson, former member of the Honda pension fund and proud PIC policyholder

A RECORD YEAR

HIGHLIGHTS

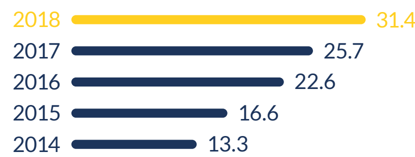
New premiums

£7,150m 2017: £3,704m



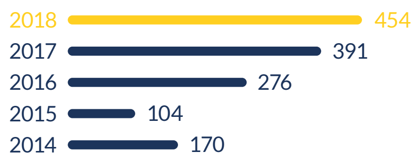
Financial investments

£31.4bn 2017: £25.7bn



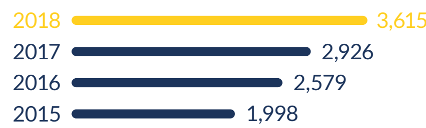
Profit before tax

£454m 2017: £391m



Embedded value

£3,615m 2017: £2,926m



PIC solvency ratio[1]

167% 2017: 160%

Customer satisfaction

97.3% 2017: 98.3%

1 Unaudited.

SOME OF OUR CLIENTS

FitchRatings
A+

Fitch Ratings has assigned Pension Insurance Corporation plc (PIC) an 'A+' (Strong) Insurer Financial Strength (IFS) rating.

Pension Insurance Corporation plc is registered in England and Wales under company number 05706720. It is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority (FRN 454345). Its registered office is at 14 Cornhill, London EC3V 3ND.

STRATEGIC REPORT
FOR THE YEAR ENDED 31 DECEMBER 2018

The Directors present the Strategic Report, Directors' Report and the audited financial statements for Pension Insurance Corporation plc ("PIC", or the "Company"), registered number 05706720, for the year ended 31 December 2018.

PRINCIPAL ACTIVITY
The principal activity of the Company is the provision of pension buy-in and buyout contracts to corporate pension schemes ("pension insurance" or "bulk annuities").

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

The Company takes a leading role in developing and informing the pensions market through pension trustee training events. It publishes regular papers on the pensions market and information on how to address certain key issues for the commercial and the public sector, such as managing pension costs and risk inherent in pension schemes. It has an active thought leadership programme in dealing with government, corporate sponsors and pension trustees and working with them on pension solutions in the public and private sectors.

The Company's ultimate parent company is Pension Insurance Corporation Group Limited ("PICG").

Strategy
The Company'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 policies for UK defined benefit pension funds.

The Company aims to deliver these objectives through:

- **a strong and sustainable pipeline of new business:** the Company 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 Company 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 Company 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 Company aims to provide policyholders with a high-quality service, adhering to the requirements and objectives 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 Company 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 a regulated insurance company such as PIC.

Accordingly, the size of the potential market in which PIC operates 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 Company has identified a number of financial and non-financial key performance indicators ("KPIs") and performance measures that it considers relevant at this point in its development. These indicators are shown below. As the business continues to develop, management will determine whether these indicators remain the most appropriate metrics by which to measure the risk and profitability of the business.

	Profit before tax £m	Embedded value £m	Solvency ratio %	Customer satisfaction %
2018	454	3,615	167	97.3
2017	391	2,926	160	98.3
2016	276	2,579	164	98.5
2015	104	1,998	–	99.3
2014	170	1,550	–	99.8

Embedded value

Since 1 January 2017, PIC has adopted the European Insurance CFO Forum Market Consistent Embedded Values Principles[1] ("MCEV Principles") for its embedded value measurement and reporting. The 2014 figure presented above is on a European Embedded Value rather than an MCEV basis. Embedded value gives a snapshot of the value created to date and facilitates market comparisons. MCEV is a key financial metric the Board uses to evaluate the progress of the business.

Solvency ratio

The solvency ratio demonstrates the proportion of surplus funds in excess of Regulatory Capital Requirements. A robust solvency ratio reflects the prudent management of interest, inflation and longevity risks, underpinned by capital optimisation, including hybrid debt issuance. Solvency II came into effect on 1 January 2016, therefore no comparatives are presented for 2014 and 2015.

Customer satisfaction

As well as the financial metrics, the business also uses customer satisfaction as a KPI, reflecting our emphasis on excellent customer service. This is done by measuring % of customers surveyed who give PIC a "satisfied" or "very satisfied" rating, evidencing the quality of the service we have given.

TRADING DURING THE YEAR

Overview

2018 was a successful year for PIC, with significant new business volumes written at good margins, good profitability, significant growth in embedded value and strong solvency levels.

PIC wrote new business premiums of £7.1 billion in 2018 compared to £3.7 billion in 2017. This level of new business activity was supported by PIC's own internal capital resources and a successful £350 million debt raise in September 2018.

Assumption and methodology changes

PIC focuses on long-term profitability, which is achieved by setting prudent actuarial assumptions in respect of the in-force book liabilities and new business liabilities acquired during the year. These assumptions are carefully managed and regularly reviewed throughout the year to ensure that they reflect the characteristics of our book and are consistent with wider market practice. As part of 2018 review, PIC implemented two major assumptions changes, in respect of our mortality assumptions and the provision for defaults allowed for in our liability discount rate.

Over the last few years we have seen a shortening of life expectancies versus our original assumptions. A new longevity improvement model (CMI 2016, issued by the Continuous Mortality Investigation) was adopted in 2017 for future longevity improvement projections. In 2018, following the annual review of our longevity experience, the CMI 2016 model was also applied to our base longevity assumptions (the current mortality rates excluding any future changes), which positively impacted the profits in the year by approximately £144 million.

We also took the opportunity during the year to review how we calculate the proportion of the credit spread on our assets which represents default risk. This is an important assumption, which feeds into the discount rate applied to our liabilities. Two changes to the methodology were made. The first was to move from a method that takes a variable percentage of spread as the default allowance to a method which is based on long-term rates of defaults as provided by Moody's Investor Services. To ensure that there is a suitable level of prudence, we have taken a multiple of three times the long-term rates of defaults as our assumption. Setting the level of prudence at this level though represents a reduction in the prudence compared to that which would have been in place under the old methodology. This reduction led to a decrease in the value of our liabilities and an increase in pre-tax profits of £320 million.

Another consequence of our updated calculation approach is that the default assumption is now sensitive to credit upgrades and downgrades rather than changes in credit spreads. We feel this better reflects the underlying credit performance and risks and is more in line with that adopted in our solvency calculations.

1 Copyright © Stichting CFO Forum Foundation 2008

STRATEGIC REPORT (continued)
FOR THE YEAR ENDED 31 DECEMBER 2018

Prudent margins
There are significant prudent margins within the actuarial assumptions used for the IFRS accounting basis. These prudent margins take three forms. The first are those in respect of key underlying assumptions, such as longevity and expenses. The second prudent margin is within the discount rate applied to the liabilities. The third prudent margin is within our best estimate liabilities ("BEL") where the Fundamental Spread (a default assumption specified by our regulator) contains known prudent margins. Notwithstanding the change to the discount rate methodology that released £320 million, at end 2018 total prudent margins amounted to £2.5 billion, compared to £1.9 billion at end 2017.

Under our expected outcome, these prudent margins will be released over the long-term and recognised as profits. They are essentially a store of future value that will emerge should our wider best estimate assumptions turn out to be correct. The impact of the above changes and the record high new business written in the period, combined with the reinsurance activities we have carried out, increased the Company's profit before tax in 2018 to £454 million from £391 million in 2017, an increase of 16%.

Reinsurance
During the year, the Company reinsured a record amount of longevity exposure, covering £5.6 billion of reserves, and at year end 74% of the Company's total longevity exposure had been reinsured (2017: 73%). In November 2018, the Company completed a £0.5 billion longevity swap reinsurance deal with SwissRe, a new reinsurance counterparty for PIC. This takes the total number of the Company's reinsurance counterparties to 11, all of which are investment grade.

Financial investments
The Company's financial investments increased by £5.7 billion to £31.4 billion (2017: £25.7 billion). The assets in which the Company invests are carefully chosen in order to match the cash flow profile of the policyholder obligations that they are designed to pay. Our investment strategy is to select assets that generate cash flows that match our future claims payments in both timing and amount. This means that the values of our assets and our liabilities should move broadly in tandem as factors such as interest rates and inflation rates change. Whilst our overall investment return (which comprises both investment income received and changes in market value of assets) in 2018 was negative, this was offset by reductions in our corresponding liability valuations.

Capital and solvency
PIC successfully issued a £350 million 12 year subordinated debt instrument during the year. This issuance led to the debt leverage ratio increasing to 27.0% on an IFRS basis (2017: 20.9%). The leverage ratio remains below the Company's risk appetite and is expected to reduce as the Company generates profits in future years.

PIC's solvency ratio at the end of 2018 remained strong at 167% (2017: 160%). Despite the significant new business volumes written during the year, a combination of effective capital management, debt issuance, careful underwriting and reinsurance ensured that our solvency levels remain very sound.

2018 FINANCIAL PERFORMANCE

Statement of comprehensive income highlights

	2018 £m	2017 £m
Gross premiums written	7,150	3,704
Net premiums revenue earned	7,121	3,663
Investment return (including commissions earned)	(977)	1,093
Total revenue	6,144	4,756
Claims paid	(1,174)	(909)
Change in insurance liabilities	(4,323)	(3,324)
Operating expenses	(147)	(91)
Finance costs	(46)	(41)
Total claims and expenses	(5,690)	(4,365)
Profit before tax	454	391

Premiums

Gross premiums written have increased significantly from £3,704 million in 2017 to £7,150 million in 2018 as a result of 30 new business transactions completed during the year (2017: 20).

Net premiums earned represent the gross premiums written less the premiums ceded to reinsurers. These grew at broadly the same rate as gross premiums, following the seven (2017: seven) new reinsurance transactions concluded in 2018.

Investment return

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

Interest received increased from £631 million in 2017 to £729 million in 2018 reflecting the growth in the investment portfolio.

The net movement in the fair value of assets, including realised and unrealised items, was a loss of £1,672 million compared to a gain of £526 million in 2017. This comprises realised gains of £163 million (2017: £310 million) and unrealised losses of £1,835 million (2017: £216 million gain). The significant increase in the unrealised losses was mainly due to the negative impact of market movements.

Claims paid

Claims paid represents the total payments made to policyholders during the year. This was £1,248 million in 2018 (2017: £1,003 million).

Net claims paid are gross claims paid less the amounts recovered from reinsurers. Net claims paid increased from £909 million in 2017 to £1,174 million in 2018, reflecting the increase in the size of the insurance book during the year.

Change in insurance liabilities

Change in insurance liabilities represents the change in the value of gross insurance liabilities less the reinsurance assets.

The change in liabilities was due to the record levels of new business written in 2018, claims paid to policyholders and the impact of market fluctuations, offset by a decrease in liabilities due to the same factors as impacted the value of our financial investments. The assumption changes in respect of moving fully to the CMI 2016 longevity improvements model and the updated prudence level in our liability discount rate further reduced the insurance liabilities by £464 million.

Operating expenses

Operating expenses increased by £56 million during the year. 2018 includes amounts relating to Group share based payment costs which were previously incurred in PICG. This has resulted in a one-off charge in PIC of £25 million and a one-off credit in PICG of the same amount. The rest of the increase was in line with the growth of the business.

Finance costs

Finance costs represent the interest payable on borrowings. The £46 million expense in 2018 represents the interest payable on the three subordinated debt securities issued.

STRATEGIC REPORT (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

Balance sheet review

Balance sheet extract	2018 £m	2017 £m
Reinsurance assets	1,854	2,450
Financial investments	31,371	25,671
Derivative assets	9,757	8,775
Gross insurance liabilities	(28,720)	(24,993)
Derivative liabilities	(11,303)	(9,663)

By the end of 2018, PIC had total financial investments of £31.4 billion, compared with £25.7 billion at the end of 2017. The increase of £5.7 billion over 2018 was principally due to the effect of the new business premiums received and the proceeds from new subordinated debt issue, offset by the impact of market movements and claim payments made to policyholders. The majority of the market movements had a relatively small net impact on our balance sheet because of the close matching of our assets and liabilities.

Reinsurance assets have reduced significantly during the year due to the impact of the update to the base mortality assumptions to reflect experience, which resulted in lower expected recoveries from our longevity swaps.

The increase in insurance liabilities since December 2017 reflects the addition of new business written during 2018, offset by the claims paid and the impact of changes in actuarial assumptions, as well as the impact of movements in macroeconomic factors such as interest rates and inflation during the year.

Gross derivative assets and derivative liabilities have both increased since 31 December 2017, as the Company implements hedges on the assets and liabilities associated with new business written in the year and rebalances hedges on existing liabilities.

MCEV results

The Company prepares an embedded value ("EV") analysis under the European Insurance CFO Forum MCEV Principles issued in April 2016. The starting point is the Solvency II balance sheet. To this is added an estimate of the after-tax value that is expected to emerge in the future from the release of the prudent margins built into the actuarial valuation of the in-force business. Further adjustments to the regulatory balance sheet are made in respect of the subordinated loan notes, frictional cost of capital and cost of residual non-hedgeable risks so as to arrive at a more appropriate quantification of the Company's value.

At 31 December 2018, the Company's MCEV was £3,615 million (2017: £2,926 million). This increase primarily reflects the record levels of new business in the year.

Other operational highlights

Operating expenses as a % of closing financial investments under management, which is a measure of how the cost base compares to the size of the asset base which it manages, fell slightly during 2018 from 0.36% to 0.35%. This largely reflects additional acquisition expenses incurred in 2018, relating to the increase in new business volume in 2018 compared to the prior year and an increased financial investment portfolio.

Customer focus is a central element of the activities and culture of the Company, and the customer satisfaction ratio of 97.3%, whilst representing a small decrease compared to 98.3% in the prior year, continues to reflect the Company's industry-leading customer service capabilities as well as the continued focus the Company has on its policyholders.

REGULATORY SOLVENCY

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

Solvency II requires firms to follow either 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 firm but subject to comprehensive review and approval by the regulator.

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

The Company has complied with the Solvency Capital Requirements under Solvency II as set out in the relevant PRA rules throughout the year (see Note 18 to the financial statements). At 31 December 2018, PIC's unaudited solvency ratio on the Solvency II basis was 167% (2017: 160%) and it had surplus funds which were £1,574 million (2017: £1,246 million) in excess of Solvency Capital Requirements.

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

	2018 £m (Unaudited)	2017 £m
Net assets held in excess of best estimate liabilities ("BEL")	5,122	4,279
Risk margin net of transitionals	(1,205)	(951)
Own funds	3,917	3,328
Solvency II capital requirements	(2,343)	(2,082)
Solvency II surplus	1,574	1,246
Solvency ratio	167%	160%

KEY SOLVENCY SENSITIVITIES

PIC uses various management tools to mitigate the impact of market fluctuations and manage its capital position:

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

PIC sensitivity of solvency ratio to changes in assumptions	2018 %	2017 %
As at 31 December	167	160
25 bps increase in interest rates[1]	6.1	6.0
25 bps reduction in interest rates[1]	(6.9)	(6.5)
£100 million credit default (no recovery)	(4.3)	(4.8)
5% reduction in base mortality[2]	(8.3)	(9.3)

1 This allows for a recalculation of the transitional measure for technical provisions.

2 Equivalent to a 0.4 year increase in life expectancy from 22.7 years to 23.1 years for a typical male aged 65.

STRATEGIC REPORT (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

PRINCIPAL RISKS AND UNCERTAINTIES

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

RISKS AND UNCERTAINTIES	TREND AND OUTLOOK	MITIGATION
Political risk – political and/or regulatory intervention.	Whilst defined benefit pensions remained on the political and regulatory agenda during 2018, the greater focus has continued to be on the implications of the UK's decision to leave the EU. Consultations also continue around the UK Government's plans for defined benefit pension scheme consolidation, with further clarity expected during 2019.	PIC maintains an open dialogue with regulators and policymakers and closely monitors regulatory and legislative developments. Regular horizon scanning helps identify key risks and allows PIC to optimise its strategy. A key consideration of the 2018 ORSA process has been around the risks associated with the UK leaving the EU and the potential impact that this may have on PIC's business model and its policyholders. This has included scenario assessments to assess whether appropriate controls are in place to ensure that PIC's contractual relationships with various stakeholders continue to operate as intended post Brexit, including the ability to pay policyholders, relationships with banking and reinsurance counterparties and the impact of legislation around data security. Scenarios have also been tested considering potential macro-economic impacts to ensure that adequate controls are in place to mitigate the potential balance sheet impacts of market movements on PIC's solvency and liquidity position in a worst-case Brexit scenario.
Market risk – impact of market and/or economic volatility on PIC's capital position.	Uncertainty around the near-term UK economic growth outlook remains heightened – despite improving economic data – as Brexit continues to crowd the macro outlook. At a global level, risks include geopolitical risks from protectionist measures, a slight weakening of global trade, Emerging Market weakness, higher oil prices and potential for a late-cycle correction from an abrupt tightening of monetary conditions.	Close management of PIC's balance sheet, such that the Company actively hedges its balance sheet against adverse movements in financial markets. PIC monitors areas of potential pricing bubbles that may see market corrections in order to limit exposures where appropriate. Regular stress and scenario analysis is carried out to assess the impact of different possibilities. The business holds a significant amount of risk-based capital to protect against market movements.
Default risk – on credit/debt assets in the portfolio.	While PIC has historically experienced low levels of default in the portfolio, this risk continues to be significant given the growth of our balance sheet and the increased volatility of financial markets.	PIC selects and monitors its investment holdings very closely, either directly or through high quality external managers. Provisions are held for defaults and downgrades in addition to the risk based capital requirements.
Counterparty risk – the possibility of failure by our reinsurance and swap counterparties who are contracted to honour their obligations in a timely manner.	The impact of Solvency II and the increased volatility in the financial markets has increased the importance of third party risk transfers, for example longevity risk.	PIC only transacts with highly rated reinsurance counterparties, and includes collateral provisions to improve overall security. Interest rate swaps are fully collateralised on a daily basis. PIC carries out continuous monitoring of our counterparties to ensure that issues can be identified promptly, allowing appropriate actions to be taken to reduce the risk.

RISKS AND UNCERTAINTIES	TREND AND OUTLOOK	MITIGATION
Longevity risk – PIC's insured policyholders may live longer than was originally assumed when pricing new business.	PIC is exposed to factors that may lead to increases in life expectancy, such as improvements in medical science beyond those anticipated. The UK has experienced another year of heavier than expected pensioner mortality, with the slowdown in mortality improvements considered to reflect a change in trend as opposed to a one-off event. The drivers of the slowdown are believed to be a combination of the increased strain on the NHS and social care budgets, and a change in morbidity prevalences including influenza and dementia, offset by changes in lifestyle and health monitoring as technology continues to provide new opportunities.	PIC regularly reviews its longevity experience to ensure its assumptions remain appropriate, and continually seeks to enhance its understanding of the evolution of annuitant mortality. PIC holds a significant amount of risk-based capital to protect the business against potential increases in longevity. This is calculated using our approved internal model. PIC aims to reinsure more than 60% of its longevity risk exposure. As at 31 December 2018, PIC had reinsured 74% of its total longevity exposure.
Cyber risk – the financial services sector is increasingly becoming a target for cyber crime. This might include the risks that third parties seek to disrupt PIC's operations, steal personal data or perpetrate acts of fraud.	The drivers of this risk continue to evolve rapidly as technology is changing the way firms do business and society operates. The financial services sector has seen a significant increase in the number of attempts by third parties to seek and exploit vulnerabilities in IT systems.	PIC maintains a robust IT environment to ensure protection of its data and security of its systems and those of outsourced or third parties that we work with. PIC works with its business partners to maintain controls and carries out regular monitoring to proactively address emerging threats. The IT environment is regularly tested internally and externally to maintain awareness of the latest threats and how these might impact PIC.
Conduct risk – the risk that PIC policyholders receive a poor outcome.	PIC now has 192,100 policyholders whose pensions we administer. We also have a significant number of vulnerable customers. PIC has historically achieved excellent levels of customer service. The challenge is to maintain standards of service and ensure good outcomes for policyholders across the customer lifecycle despite increased numbers of policyholders.	PIC continues to embed its conduct and TCF frameworks. This includes a focus on defining and evidencing good customer outcomes and identifying and supporting vulnerable customers.

On behalf of the Board

Jon Aisbitt
Chairman

14 Cornhill
London
EC3V 3ND

6 March 2019

DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER 2018

BOARD OF DIRECTORS
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	
Amanda Bowe		Non-Executive	Resigned on 6 December 2018
Tim Hanford		Non-Executive	Resigned on 18 October 2018
Stuart King		Non-Executive	Appointed on 1 January 2019
Arno Kitts		Non-Executive	
Nick Lyons		Non-Executive	Resigned on 31 July 2018
Roger Marshall		Non-Executive	
Eloy Michotte		Non-Executive	
Jérôme Mourgue D'Algue		Non-Executive	Appointed on 20 November 2018
Peter Rutland		Non-Executive	
Steve Sarjant		Non-Executive	
Rob Sewell		Executive	
Mark Stephen		Non-Executive	
Wilhelm Van Zyl		Non-Executive	

DIRECTORS' INTERESTS
None of the Directors who held office at the end of the financial year had any disclosable interest in the shares of the Company.

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

ISSUE OF SHARES AND DEBT
On 18 September 2018, PIC successfully issued £350 million subordinated loan notes due 2030 with a fixed coupon of 5.625% paid annually in arrears. These notes were issued at 99.693% of par and classified as Tier 2 regulatory capital.

There were no shares issued during the year.

POLITICAL CONTRIBUTIONS
The Company made no political contributions during the year (2017: nil).

DIVIDENDS
The Directors recommended and approved an interim dividend payment of £10 million for the year ended 31 December 2018 (2017: £nil). This was paid to shareholders on 24 October 2018. The Directors do not recommend any further dividends for the year (2017: £nil).

QUALIFYING THIRD PARTY INDEMNITIES
The Articles of Association of the Company provide for the Directors and officers of the Company to be indemnified in respect of liabilities incurred as a result of their office. The Company also provides certain forms of protection for its Directors and senior managers of companies within the PIC Group against personal financial exposure that they may incur in their capacity as such.

During the year and at the time the Directors' Report was approved under section 234 of the Companies Act 2006, this protection included qualifying third party indemnity provisions (as defined under section 234 of the Companies Act 2006) in force for the benefit of the Company's Directors.

GOING CONCERN

After making enquiries, including specific consideration of regulatory solvency, the Directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the financial statements.

INTERNAL CONTROLS AND RISK MANAGEMENT SYSTEM

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

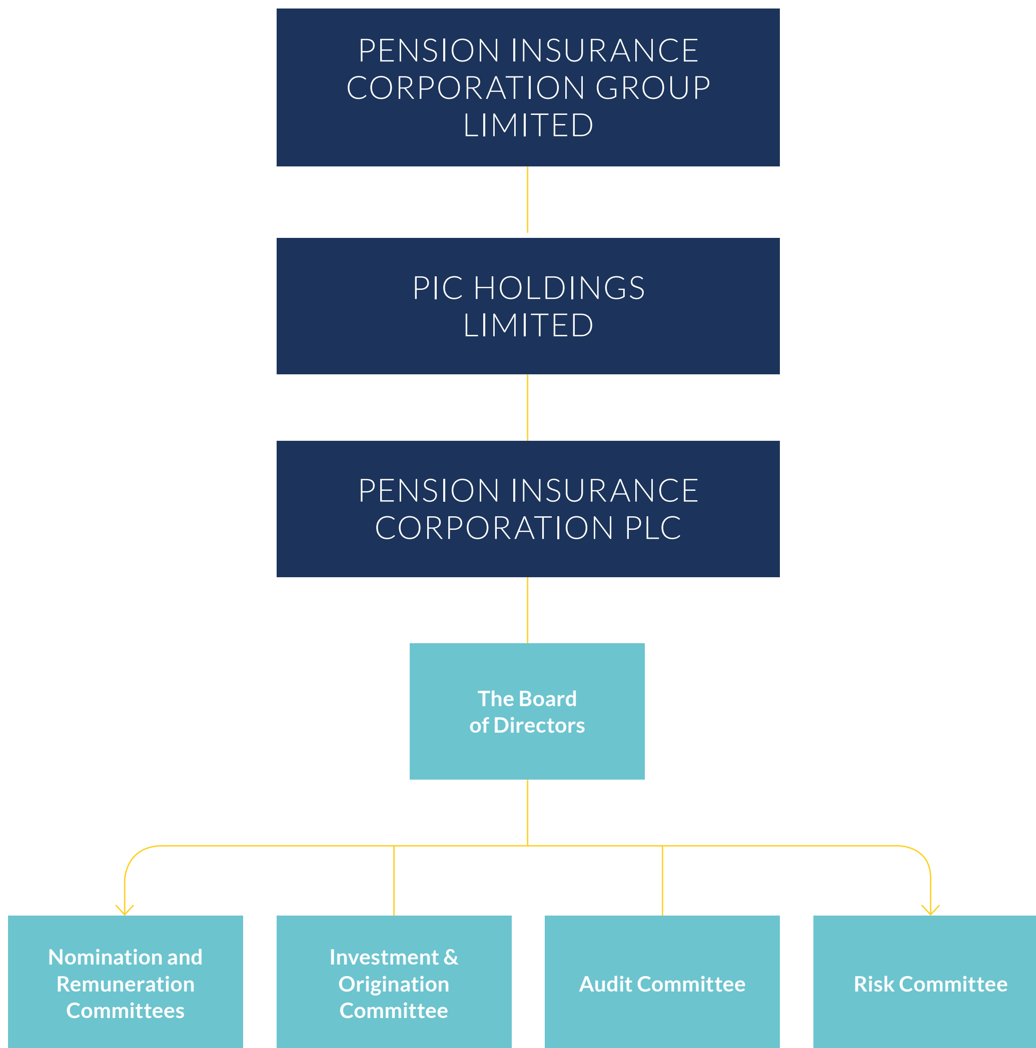
The Board has delegated responsibility to the Audit Committee and the Risk Committee for monitoring this system and reporting on its effectiveness to the Board. Each year, the Board approves an Integrated Assurance Plan which is intended to provide the Board with assurance that the internal control and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

DIRECTORS' REPORT (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

GOVERNANCE FRAMEWORK

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



PIC'S BOARD OF DIRECTORS

Nomination and Remuneration Committees

Role of the Committees

> Oversight of the structure, size and composition (including the skills, knowledge, experience and diversity) of the Board and to make recommendations with regard to any changes.

> Determine and agree with the Board the framework or broad policy for the remuneration and recruitment of the Company's chairman, Non-Executive Directors, Chief Executive Officer, the Executive Directors and such other members of the executive management as it is designated.

> Review and approve the Fit and Proper Persons Policy to ensure senior management, material risk takers and key function holders are, in a fair and responsible manner, rewarded for their individual contributions to the success, including the management of risk, of the Company.

> Oversee the implementation, and monitor the remuneration and risk management implications, of the Company's Remuneration Policy for all Solvency II identified staff.

> Oversee operational controls related to staff incentives and remuneration and approve the remuneration and share incentives of all Senior Management and Material Risk Takers.

> Review the design of all share incentive plans for approval by the Board and shareholders, taking advice from the Board Risk Committee and CRO on risk management.

> Met five times in 2018 and its main focus was on recruitment of new Non-Executive Directors, review and recommendation to the Board on the Board Diversity Policy, reviewing the structure and composition of the Board Committees and approval of the Remuneration Policy.

Investment & Origination Committee

Role of the Committee

> Oversee the management of all aspects of investment policy and strategy.

> Provide oversight of the operation of the Company's investment portfolios.

> Oversee all aspects of the Company's new business and reinsurance origination.

> Recommend to the Board investment arrangements and pricing for significant transactions for approval.

> The membership of the committee was formed from the memberships of the ALM and Origination Committees. As a combined Committee, it has met twice in 2018, in October and November. The ALM Committee met six times during the year and the Origination Committee met three times.

> The standing items for the Committee include review of performance of the Company's investment portfolio, a review of hedging and an update on the management of the surplus assets of the Company. The Committee will also receive regular updates from the Capital Resources, Investment and Pricing committees.

Audit Committee

Role of the Committee

> Appoint and oversee the external auditor and annual audit.

> Oversee the internal audit function.

> Review systems of internal controls and governance.

> Review the Company's external reporting, including annual report and solvency reporting.

> Met eight times in 2018 and its primary focus was on reviewing the annual financial statements, the Company's going concern assumptions, and considering and approving the Internal Audit plan. The Committee also reviewed the Annual Solvency and Financial Condition Report, oversaw various business projects and reviewed the Half Year 2018 Investor Report. The Committee's considerations were supported by the integrated assurance reporting from the assurance functions.

DIRECTORS' REPORT (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

Risk Committee

Role of the Committee:

> Provide oversight and advice to the Board on the Company's current and likely risk exposures; risk appetite; risk management; and risk controls.

> Oversee the Internal Model and recommend improvements to the Board.

> Ensure the effectiveness of the Risk function and the performance of the Chief Risk Officer.

> Provide challenge to embed and maintain a supportive risk culture throughout the Company.

> Review and oversee interactions between the Company and its regulators.

> Met six times in 2018 and its primary focus was on assisting the Board with monitoring and reviewing the Company's risk appetite and tolerances, reviewing PIC's approach to hedging, considering different aspects of the ORSA processes, reviewing the Company's risk framework and risk policies, and the recovery and resolution plan.

> The Committee provided ongoing monitoring of the Company's Internal Model and made recommendations to the Board with regard to its calibration. Furthermore, the Committee considered the CRO's report to the Nomination and Remuneration Committees to ensure that risk management was properly incorporated in the incentive structure for the executives.

Key features of the Company's internal controls framework

Financial reporting	Responsibility
Delegated authority	An established management structure operates across PIC with clearly defined levels of responsibility and delegated authorities.
Financial reporting	The Company has a robust system for reporting of the financial results to the Board. During the year, monthly and quarterly financial results are produced which include comparison to forecast and prior year. The Board, Audit Committee, Risk Committee and the executive management group review the Company's performance throughout the year and monitor the operation of budgets and long-term business plans. The reports ensure that variances are investigated and acted upon.
Internal controls, processes and procedures	The Company has in place formal written procedures and controls which are designed to facilitate effective and efficient business operation, robust financial reporting and compliance with laws and regulations. Procedures, processes and controls are updated regularly to ensure that they are effective and in compliance with best practice. As part of the requirements of DTR 7.1.3 of the FCA handbook, the Board, in line with the delegated authority to the Audit Committee, specifically monitors the financial reporting process and the statutory audit of the annual financial statements through reporting provided by management and reporting received from the Audit Committee. The Audit Committee meets regularly with members of the executive management group and internal and external auditors to review the annual financial information and internal control matters, and to satisfy themselves that the internal control systems are operating effectively. The Audit Committee also reviews any follow-up actions to correct identified weaknesses. All Board members receive minutes of the Audit Committee meetings.
Internal audit assurance	The Audit Committee oversees the Company's Internal Audit function which is managed by the Head of Internal Audit using a co-sourced model and has a direct reporting line to the Audit Committee. The Audit Committee approves an annual internal audit plan which is designed to review key areas of risk. Regular updates on progress of the internal audit plan are provided to the Audit Committee by the Head of Internal Audit who is a standing attendee at the Audit Committee's meetings. Progress reports include results of individual audits. The Head of Internal Audit provides an annual report and opinion on internal controls, governance and culture.
External audit assurance	The work of the external auditors provides further independent assurance on the internal control environment, as described in their reporting to the Audit Committee. Furthermore, the Audit Committee reviews and monitors the independence of the statutory auditor and considers the relationship with PIC as part of its assessment, including provision of non-audit services.
Risk management framework	The Board has established a risk management and compliance system which includes a process for identifying, evaluating and managing the risks faced by the Company. The Risk Committee works closely with the Audit Committee and provides oversight and advice to the Board with regard to the Company's current and likely risk exposures, risk tolerances and appetite, risk measurement, risk management performance and its risk policies and procedures and risk controls. All Board members receive minutes of the Risk Committee meetings. Procedures are in place to ensure that the employment, retention, training and development of suitably qualified staff to manage activities.

The Board has reviewed the effectiveness of the system of internal controls, including risk management, for the year ended 31 December 2018 and up to the date of signing of these financial statements and the annual report. It has not identified any weaknesses sufficient to cause material misstatement or loss which requires disclosure in the financial statements.

FINANCIAL INSTRUMENTS

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

FUTURE DEVELOPMENTS

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

MATERIAL CONTRACTS

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

DISCLOSURE OF INFORMATION TO 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 Company's auditor is unaware; and each Director has taken all the steps that ought to have been taken as a Director to be aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

AUDITOR

In accordance with section 489 of the Companies Act 2006, the auditor was appointed at the Annual General Meeting (the "AGM") of the Company held on 21 May 2018. The Board proposes reappointment of KPMG LLP and subject to approval by shareholders at the AGM, KPMG LLP will continue in office.

LONG-TERM VIABILITY STATEMENT

1. The assessment process

The long-term viability process is primarily carried out by strategic and financial planning. PIC's strategy, and year-on-year activities combined with a focus on material factors which may impact the Company in the foreseeable future are central to assessment that the Company can be reasonably expected to continue in operation and meet its liabilities as they fall due. PIC's business plan is prepared annually and covers a five-year period on a rolling basis. The plan covers projected performance and related profitability, cash and value generation and the capital position of the Company over the period. The plan is designed within the Company's risk appetite framework which forms an integral part of the business planning process. The plan is tested against the risk appetite set for the Company by the Board. This includes a number of stress scenarios which consider the Company's resilience and capacity to respond to relevant stresses and shock events which may potentially impact the Company. The Company also evaluates various management actions designed to maintain and restore key capital and solvency metrics to within the Company's approved risk appetite over the planning period.

2. The assessment period

The Directors have assessed the viability of the Company by reference to the five-year planning period to December 2023 which has been chosen as appropriate because it reflects PIC's business model and the dynamics of the Bulk Annuity Market as covered by PIC's five-year business plan.

DIRECTORS' REPORT (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

3. Assessment of viability

The Directors have carried out an assessment by reference to the Company's current position and strategy, the Board's risk appetite and the Company's financial forecasts from December 2018 to December 2023. The Directors considered the draft business plan at the Board meeting held on 26 September 2018. The Directors also considered the Company's principal risks and how these are managed. The final business plan was reviewed and approved at the Board meeting held on 6 December 2018 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.

The key areas considered in the risk assessment included:

> Risks from PIC's existing assets and liabilities – including macro-economic events such as a potential turn in the credit cycle or a "Hard Brexit" and adverse movements in longevity trends.

> Risks to PIC's operational resilience – including operational scenarios associated with cyber exposures.

> Risks to new business generation – including analysis of scenarios associated with asset quality and increased volumes of new business generation. In addition, reverse stress and scenario testing has been performed considering theoretical scenarios chosen at the level of severity which creates outcomes that could threaten the viability of the Company. The risk section of the Strategic Report describes various mitigating and management actions available to manage and minimise the impact of risk events to the Company's business model. Additionally, the Directors have made certain assumptions around additional funding to maintain the growth forecast in the business plan.

4. Viability statement

Based on the results of the assessment of the Company's prospects and viability, the Directors confirm that they have a reasonable expectation that the Company will continue to operate and meet its liabilities as they fall due in the five-year assessment period.

On behalf of the Board

Jon Aisbitt
Chairman

14 Cornhill
London
EC3V 3ND

6 March 2019

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

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

Company law requires the Directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with International Financial Reporting Standards 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 Company and of its profit or loss for that period. In preparing the 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 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 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 Company's transactions and disclose with reasonable accuracy at any time the financial position of the 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 Company and to prevent and detect fraud and other irregularities.

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

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF PENSION INSURANCE CORPORATION PLC

1 Our opinion is unmodified

We have audited the financial statements of Pension Insurance Corporation plc ("the Company") for the year ended 31 December 2018 which comprise the Statement of Comprehensive Income, Statement of Financial Position, Statement of Cash Flows, Statement of changes in Equity, and the related notes, including the accounting policies in Note 1.

In our opinion the financial statements:

> give a true and fair view of the state of the Company's affairs as at 31 December 2018 and of its profit for the year then ended;

> have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union; and

> have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for opinion

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

We were first appointed as auditor by the shareholders during 2006. The period of total uninterrupted engagement is for the 12 financial years ended 31 December 2018. We have fulfilled our ethical responsibilities under, and we remain independent of the Company in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to public interest entities. No non-audit services prohibited by that standard were provided.

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

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

THE IMPACT OF UNCERTAINTIES DUE TO THE UK EXITING THE EUROPEAN UNION ON OUR AUDIT

Refer to page 8 (principal risks), page 15 (viability statement) and page 29 (accounting policy)

THE RISK

Unprecedented levels of uncertainty
All audits assess and challenge the reasonableness of estimates, in particular as described in Valuation of Insurance Liabilities and Valuation of Investments below, and related disclosures and the appropriateness of the going concern basis of preparation of the financial statements. All of these depend on assessments of the future economic environment and the company's future prospects and performance.

Brexit is one of the most significant economic events for the UK and at the date of this report its effects are subject to unprecedented levels of uncertainty of outcomes, with the full range of possible effects unknown.

OUR RESPONSE

We developed a standardised firm-wide approach to the consideration of the uncertainties arising from Brexit in planning and performing our audits. Our procedures included:

Our Brexit knowledge
We considered the directors' assessment of Brexit-related sources of risk for the Company's business and financial resources compared with our own understanding of the risks. We considered the directors' plans to take action to mitigate the risks.

Sensitivity analysis
When addressing Valuation of Insurance Liabilities and Investments and other areas that depend on forecasts, we compared the directors' analysis to our assessment of the full range of reasonably possible scenarios resulting from Brexit uncertainty and, where forecast cash flows are required to be discounted, considered adjustments to discount rates for the level of remaining uncertainty.

Assessing transparency
As well as assessing individual disclosures as part of our procedures on Valuation of Insurance Liabilities and Investments we considered all of the Brexit related disclosures together, including those in the strategic report, comparing the overall picture against our understanding of the risks.

Our results
As reported under Valuation of Insurance Liabilities and Investments, we found the resulting estimates and related disclosures and disclosures in relation to going concern to be acceptable. However, no audit should be expected to predict the unknowable factors or all possible future implications for a company and this is particularly the case in relation to Brexit.

INDEPENDENT AUDITOR'S REPORT (continued)

TO THE MEMBERS OF PENSION INSURANCE CORPORATION PLC

VALUATION OF INSURANCE CONTRACT LIABILITIES (2018: £28,720 MILLION (2017: £24,993 MILLION))

The risk compared to the prior year is unchanged.

Refer to page 33 (accounting policy) and pages 38 to 43 (financial disclosures)

THE RISK

The Company has significant insurance contract liabilities representing 96.6% of the Company's total liabilities.

Subjective valuation
This is an area that involves significant judgement over uncertain future outcomes, mainly the ultimate total settlement value of these liabilities.

Operating and economic assumptions and sector experience
Management is required to use judgement in the selection of key assumptions covering both operating assumptions and economic assumptions.

The key operating assumptions include baseline mortality and future longevity improvement rates and maintenance expenses.

These mortality and longevity improvement rates require a high degree of judgement due to the number of factors which may influence future mortality experience. These judgements are set based on the Company's own experience, management's and industry expected levels of future rate of mortality improvement as well as other external factors arising from developments in the annuity market.

Maintenance Expenses assumptions require significant judgement to set the unit cost based on the expected future costs for administering the underlying policies.

The most material economic assumption is the valuation rate of interest ('VRI') i.e. the discount rate applied to the insurance liabilities.

Completeness and accuracy of data
Management uses the actuarial models to calculate annuity liabilities. There is a risk that the modelling does not appropriately reflect the model specifications and/or the product features due to incorrect or incomplete data input into the model and/or unauthorised or erroneous changes to the models.

Disclosures
There is a risk that the Company's disclosures in relation to the assumptions used in the calculation of policyholder liabilities are not compliant with the relevant accounting requirements.

OUR RESPONSE

We used our own actuarial specialists to assist us in performing our procedures in this area.

Our procedures included:

Controls design and re-performance
Testing of the design, implementation and operating effectiveness of key controls over the reserving process to determine the valuation of the liabilities including management's review and approval of the methods and assumptions adopted over the calculation of insurance contract liabilities and appropriate change management controls over the actuarial models. Further, we also tested the controls around the completeness and accuracy of data that is used for the determination of the valuation of liabilities.

Methodology choice
We have assessed the methodology for selecting assumptions and calculating the liabilities. This included:

> Evaluating the analysis of the movements in insurance contract liabilities during the year, including consideration of whether the movements were in line with the methodology and assumptions adopted/updated during the year;

> Applying our understanding of developments in the business and the impact of changes in methodology on this; and

> Comparing changes in methodology to our expectations derived from market experience.

Historical comparisons
> Evaluating the evidence used to prepare the Company's mortality experience investigation by reference to actual mortality experience of the policyholders in order to assess whether this supported the year end assumptions adopted.

Benchmarking assumptions and sector experience
> Comparing mortality assumptions to industry data on current mortality and expectations of future mortality improvements. Further assessing appropriateness of management's choice of the Continuous Mortality Investigation used.

> Assessing whether the expense assumptions reflect the expected future costs of administering the underlying policies by analysing 2019 expense budget and the likely impact of planned management actions on future costs.

> Evaluating the methodology used to calculate VRI by reference to the industry practice.

> Utilising the results of KPMG benchmarking of assumptions and actuarial market practice to inform our challenge of management's assumptions in some of the areas noted above.

Independent reperformance
> Using our own valuation models to perform independent calculations to verify results for new business reserves.

Completeness and accuracy of data
> Ensuring that the data input used in the actuarial models to calculate the annuity liabilities is complete and accurate.

VALUATION OF INSURANCE CONTRACT LIABILITIES (2018: £28,720 MILLION (2017: £24,993 MILLION))
(continued)

THE RISK

OUR RESPONSE

Assessing transparency
> Considering whether the Company's disclosures in relation to the assumptions used in the calculation of insurance contract liabilities are compliant with the relevant accounting requirements and appropriately represent the sensitivities of these assumptions to alternative scenarios and inputs.

Our results
We found the valuation and presentation of insurance contract liabilities to be acceptable (2017: acceptable).

VALUATION OF INVESTMENTS (2018: £29,921 MILLION, 2017: £24,882 MILLION).
The risk compared to the prior year is unchanged.

Refer to page 31 (accounting policy) and pages 45 to 57 (financial disclosures)

THE RISK

Investment portfolio represents 93% of the total assets.

Key audit matter
The portfolio of investments other than those requiring subjective valuation makes up 78.9% of the assets (by value). We do not consider these investments to be at a high risk of significant misstatement, or to be subject to a significant level of judgement because they comprise liquid, quoted investments. However, due to their materiality in the context of the financial statements as a whole, they are considered to be one of the areas which had the greatest effect on our overall audit strategy and allocation of resources in planning and completing our audit.

Subjective valuation
The areas that involved significant audit effort and judgement in 2018 were the valuation of harder to value investments within the financial investments portfolio representing 14.1% of the total assets. These included unquoted debt securities, alternate investment schemes, investment property and equity release mortgage. For these application of expert judgement in the valuations needs to be adopted.

The valuation of the portfolio involves judgement depending on the observability of the inputs into the valuation and further judgement in determining the appropriate valuation methodology for harder to value investments where external pricing sources are either not readily available or are unreliable.

Disclosures
There is a risk that the Company's disclosures in relation to the valuation of investments are not compliant with the relevant accounting requirements and do not appropriately present the sensitivity of the valuation of the particular assets based on alternative assumptions.

OUR RESPONSE

We used our own valuation specialists and pricing services in order to assist us in performing our procedures in this area.

Our procedures included:

Controls design and re-performance
> Testing of the design and implementation of key controls over the valuation process for the investments, including review and approval of the methodology, estimates and assumptions used for the valuation and key authorisation and data input controls.

Methodology choice
> Assessing the appropriateness of the pricing methodologies with reference to relevant accounting standards and the Company's own valuation guidelines as well as industry practice for harder to value investments.

Benchmarking of assumptions and sector experience
> Assessing pricing model methodologies and management chosen inputs and assumptions into the discounted cash flow models against industry practice, valuation guidelines and Company's historical experience.

Independent reperformance
> Performing our own independent price checks from our own pricing services for liquid and illiquid positions where observable inputs could be identified.

Assessing transparency
> Assessing whether the disclosures in relation to the valuation of investments are compliant with the relevant accounting requirements and appropriately present the sensitivities in the valuations based on alternative outcomes.

Our result
We found valuation and presentation of investments to be acceptable (2017: acceptable).

INDEPENDENT AUDITOR'S REPORT (continued)

TO THE MEMBERS OF PENSION INSURANCE CORPORATION PLC

3 Our application of materiality and an overview of the scope of our audit
Materiality for the financial statements was set at £27 million (2017: £20 million), determined with reference to a benchmark of Net Assets, consistent with 2017, of which it represents approximately 1.1% (2017: 1%) of the Company Net Assets. We consider the Company's net assets to be the most appropriate benchmark as it represents the residual interest that can be ascribed to shareholders after assets and corresponding liabilities have been accounted for. We compared our materiality against other relevant benchmarks, such as total assets, total revenue and profit before tax to ensure the materiality selected was appropriate for our audit.

We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £1.1 million (2017: £1 million), in addition to other identified misstatements that warranted reporting on qualitative grounds.

4 We have nothing to report on going concern
The Directors have prepared the financial statements on the going concern basis as they do not intend to liquidate the Company or to cease its operations, and as they have concluded that the Company's financial position means that this is realistic. They have also concluded that there are no material uncertainties that could have cast significant doubt over its ability to continue as a going concern for at least a year from the date of approval of the financial statements ("the going concern period").

Our responsibility is to conclude on the appropriateness of the Directors' conclusions and, had there been a material uncertainty related to going concern, to make reference to that in this audit report. However, as we cannot predict all future events or conditions and as subsequent events may result in outcomes that are inconsistent with judgements that were reasonable at the time they were made, the absence of reference to a material uncertainty in this auditor's report is not a guarantee that the Company will continue in operation.

In our evaluation of the Directors' conclusions, we considered the inherent risks to the Company's business model and analysed how those risks might affect the Company's financial resources or ability to continue operations over the going concern period. The risks that we considered most likely to adversely affect the Company's available financial resources over this period were:

- a significant deterioration in longevity experience, potentially caused by market wide event(s); and
- a deterioration in the valuation of the Company's investments.

As these were risks that could potentially cast significant doubt on the Company's ability to continue as a going concern, we considered sensitivities over the level of available financial resources indicated by the Company's financial forecasts. Taking account of reasonably possible (but not unrealistic) adverse effects that could arise from these risks individually and collectively and evaluated the achievability of the actions the Directors consider they would take to improve the position should the risks materialise. We also considered less predictable but realistic second order impacts, such as the impact of Brexit and the impact on the economic environment, which could result in a rapid reduction of available financial resources.

Based on this work, 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 a year from the date of approval of the financial statements.

We have nothing to report in these respects, and we did not identify going concern as a key audit matter.

5 We have nothing to report on the strategic report and the 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 those reports;
- in our opinion the information given in the strategic report and the directors' report for the financial year is consistent with the financial statements; and
- in our opinion those reports have been prepared in accordance with the Companies Act 2006.

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

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

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

> the financial statements are not in agreement with the accounting records and returns; or

> certain disclosures of directors' remuneration specified by law are not made; or

> we have not received all the information and explanations we require for our audit.

We have nothing to report in these respects.

7 Respective responsibilities

Directors' responsibilities

As explained more fully in their statement set out on page 17, the Directors are responsible for: the preparation of the financial statements including being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and using the going concern basis of accounting unless they either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or other irregularities (see below), or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud, other irregularities or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

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

Irregularities – ability to detect

We identified areas of laws and regulations that could reasonably be expected to have a material effect on the financial statements from our general commercial and sector experience, and through discussion with the directors and other management (as required by auditing standards), and from inspection of the Company's regulatory and legal correspondence and discussed with the directors and other management the policies and procedures regarding compliance with laws and regulations. We communicated identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit.

The potential effect of these laws and regulations on the financial statements varies considerably.

Firstly, the company is subject to laws and regulations that directly affect the financial statements, including financial reporting legislation (including related companies legislation), distributable profits legislation and taxation legislation. We assessed the extent of compliance with these laws and regulations as part of our procedures on the related financial statement items.

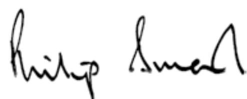
Secondly, the company is subject to many other laws and regulations where the consequences of non-compliance could have a material effect on amounts or disclosures in the financial statements, for instance through the imposition of fines or litigation or the loss of the Company's license to operate. We identified the following areas as those most likely to have such an effect: regulatory capital and liquidity and certain aspects of company legislation recognising the financial and regulated nature of the company's activities and its legal form. Auditing standards limit the required audit procedures to identify non-compliance with these laws and regulations to enquiry of the directors and inspection of regulatory and legal correspondence, if any. These limited procedures did not identify actual or suspected non-compliance.

Owing to the inherent limitations of an audit, there is an unavoidable risk that we may not have detected some material misstatements in the financial statements, even though we have properly planned and performed our audit in accordance with auditing standards. For example, the further removed non-compliance with laws and regulations (irregularities) is from the events and transactions reflected in the financial statements, the less likely the inherently limited procedures required by auditing standards would identify it. In addition, as with any audit, there remained a higher risk of non-detection of irregularities, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls. We are not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

INDEPENDENT AUDITOR'S REPORT (continued)

TO THE MEMBERS OF PENSION INSURANCE CORPORATION PLC

8 The purpose of our audit work and to whom we owe our responsibilities
This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.



Philip Smart (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants

15 Canada Square
Canary Wharf
London
E14 5GL

6 March 2019

STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 DECEMBER 2018

	Note	2018 £m	2017 £m
Revenue			
Gross premiums written		7,150	3,704
Outward reinsurance premiums	10f	(29)	(41)
Net premium revenue earned		7,121	3,663
Investment return	3	(978)	1,092
Commissions earned		1	1
Total revenue (net of reinsurance premiums)		6,144	4,756
Expenses			
Claims paid – gross		(1,248)	(1,003)
Reinsurers' share of claims paid	10f	74	94
		(1,174)	(909)
(Increase) in insurance liabilities – gross		(3,727)	(3,252)
(Decrease) in reinsurers' share of insurance liabilities	10f	(596)	(72)
		(4,323)	(3,324)
Acquisition expenses	4	(52)	(51)
Other operating expenses	5	(95)	(40)
Finance costs	12	(46)	(41)
		(193)	(132)
Total claims and expenses		(5,690)	(4,365)
Profit before taxation		454	391
Tax charge	8	(86)	(75)
Profit and total comprehensive income for the year		368	316

The amounts shown above are in respect of continuing operations.

The accounting policies and notes on pages 29 to 60 form an integral part of these financial statements.

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 2018

31 December 2018	Share capital £m	Other reserves £m	Retained profit £m	Total £m
At beginning of year	1,000	60	1,016	2,076
Total comprehensive income				
Profit for the year	–	–	368	368
Transactions with owners				
Dividends paid	–	–	(10)	(10)
At end of year	1,000	60	1,374	2,434

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

The accounting policies and notes on pages 29 to 60 form an integral part of these financial statements.

STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 2018

	Note	2018 £m	2017 £m
Assets			
Investment properties	9	96	99
Reinsurers' share of insurance liabilities	10	1,854	2,450
Receivables and other financial assets	13	276	316
Prepayments		58	43
Financial investments	13	31,371	25,671
Derivative assets	14	9,757	8,775
Cash and cash equivalents	13	67	33
Total Assets		43,479	37,387
Equity			
Share capital	16	1,000	1,000
Other reserves	17	60	60
Retained profit	17	1,374	1,016
Total Equity		2,434	2,076
Liabilities			
Gross insurance liabilities	10	28,720	24,993
Borrowings	12	891	543
Deferred tax liability	11	3	4
Derivative liabilities	14	11,303	9,663
Insurance and other payables	13	72	48
Current taxation		37	44
Accruals	13	19	16
Total Liabilities		41,045	35,311
Total Equity and Liabilities		43,479	37,387

The accounting policies and notes on pages 29 to 60 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 6 March 2019 and were signed on its behalf by:

Rob Sewell
Director

Registration number: 05706720

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 31 DECEMBER 2018

	Note	2018 £m	2017 £m
Cash flows from operating activities			
Profit for the year		368	316
Adjustments for non-cash movements			
Interest income recognised in profit or loss	3	(729)	(631)
Other investment income recognised in profit or loss	3	35	65
Interest expense recognised in profit or loss		45	40
Amortisation of subordinated debt issue costs and discount		1	1
Movement in fair value of investment properties	9	3	(2)
Movement in tax provisions	8	86	75
		(191)	(136)
Changes in operating assets and liabilities			
Increase/(decrease) in receivables and other financial assets		75	(90)
Increase in financial investments including derivative assets		(6,682)	(2,532)
(Increase) in prepayments		(15)	(9)
Decrease in reinsurers' share of insurance liabilities		596	72
Increase in insurance liabilities		3,727	3,252
Increase/(decrease) in financial liabilities including derivative liabilities		1,640	(991)
Increase in insurance and other payables		24	10
Increase/(decrease) in accruals		2	(2)
		(633)	(290)
Cash flows used in operating activities		(824)	(426)
Interest income received		691	621
Interest paid		(35)	(65)
Taxation paid		(94)	(63)
Net (outflow)/inflow from operating activities		(262)	67
Cash flows from financing activities			
Proceeds from issue of subordinated debt	12	350	–
Interest paid on subordinated debt		(41)	(40)
Issue costs	12	(3)	–
Dividends paid		(10)	–
		296	(40)
Net increase in cash and cash equivalents		34	27
Cash and cash equivalents at beginning of year		33	6
Cash and cash equivalents at end of year		67	33

The accounting policies and notes on pages 29 to 60 form an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018

1. ACCOUNTING POLICIES
(a) Basis of preparation
The financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU") and those parts of the Companies Act 2006 applicable to companies reporting under IFRS.

These financial statements have been presented in millions of pounds sterling (£m) unless otherwise stated.

The financial statements have been prepared on a going concern basis.

The Company has applied all IFRS and interpretations that are adopted by the EU and are effective for accounting periods beginning on or after 1 January 2018. There is no material effect on the results of the Company arising from implementation of these standards.

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

IFRS 9 – Financial Instruments – endorsed by the EU on 22 November 2016, effective for accounting periods beginning on or after 1 January 2018.
The financial instruments held by the Company are classified as fair value through profit and loss, therefore the adoption of the standard will not have a material impact on the results of the Company.

Although this standard is now effective the IASB published Amendments to IFRS 4 "applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts", which includes an optional temporary exemption from applying IFRS 9 until IFRS 17 is adopted. This exception is available to insurance entities whose activities are "predominantly connected with insurance" by meeting certain eligibility criteria. As at 31 December 2018 the Company met the eligibility criteria and will defer the adoption of IFRS 9 to 1 January 2022.

IFRS 16 – Leases – effective for accounting periods beginning on or after 1 January 2019.
The Company does not have any lease contracts that are material to the financial statements.

IFRS 17 – Insurance Contracts – not yet endorsed by the EU, effective for accounting periods beginning on or after 1 January 2022.
The Company intends to adopt IFRS 17 for its financial year beginning on 1 January 2022. The adoption of the standard is expected to have a significant impact on PIC's financial statements as it transforms the way the Company measures, presents and discloses the insurance and reinsurance assets and liabilities in the Statement of comprehensive income, Statement of financial position and the notes to the financial statements.

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

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

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

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

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

1. ACCOUNTING POLICIES (continued)

(b) Recognition and derecognition of financial instruments

A financial instrument is recognised if the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognised if the Company's contractual rights to the cash flows from the financial assets expire, or if either the Company transfers the financial asset to another party without retaining control or substantially all risks and rewards of the asset are transferred to another party. Regular purchases and sales of financial assets are accounted for at the date of trading. Financial liabilities are derecognised when the Company's obligations specified in the contract expire or are discharged or cancelled.

(c) Contract classification

IFRS 4 "Insurance Contracts" requires policyholder contracts written by insurers to be classified as either insurance contracts or investment contracts depending on the level of insurance risk transferred.

Insurance contracts are defined as those contracts containing significant insurance risk if, and only if, an insured event could cause an insurer to make significant additional payments in any scenario, excluding scenarios that lack commercial substance, at the inception of the contract. Such contracts remain insurance contracts until all rights and obligations are extinguished or expire.

Policy contracts which do not transfer significant insurance risk to the insurer are classified as investment contracts. The Company has classified all its policyholder contracts as insurance contracts.

(d) Premiums

Premiums are received in consideration for completing an insurance policy with the trustees of the pension scheme. They are recognised and valued on the day risk is accepted. Any adjustments to premiums following work performed during the transition of a scheme are recognised and valued at the date they become payable or receivable by the Company. Premiums reported exclude any taxes or duties based on premiums.

(e) Acquisition costs

Acquisition costs comprise all direct and indirect costs of obtaining and processing new business. Indirect costs consist primarily of management, staff and related overhead costs.

A deferred acquisition cost asset has not been established in the Statement of financial position. The majority of acquisition costs incurred are not directly related to individual sales and the amount of directly attributable acquisition costs that would be deferrable is not considered to be material.

(f) Claims

Claims and benefits payable consist of regular annuities paid to pension scheme members and beneficiaries, and surrenders which consist of full settlements of transfers out and partial settlement of tax-free cash components of pension benefits. Annuities are recognised when due for payment. Surrenders are accounted for when paid. Death claims are accounted for when notified, at which time the policy ceases to be included within the calculation of the insurance contract liabilities.

(g) Investment return

Interest income is calculated using the effective interest method.

Dividend income is recognised when the related investment goes "ex-dividend" and is grossed up where appropriate by the tax credit.

Realised gains or losses represent the difference between net sale proceeds and the purchase price or, in the case of investments valued at amortised cost, the latest carrying value prior to the date of sale.

Unrealised gains and losses on investments measure the difference between the fair value of investments held at the end of each financial year and their purchase price. The net movement reflects both unrealised gains and losses recognised during the year adjusted for any prior period unrealised gains and losses which have been realised in the current accounting period.

(h) Investment expenses and charges
Investment expenses comprise:

- fees payable to investment managers for advisory services including performance-related fees; and
- transaction costs on financial assets at fair value through profit or loss.

Fees payable to investment managers are recognised on an accruals basis.

Performance fees are payable to certain investment managers who exceed certain targets measured over a number of financial years. The Company recognises the costs of such agreements during the life of each contract. No provision is made for fees on potential outperformance of targets in future years.

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

(j) Investment properties
Investments in freehold properties not for occupation by the Company are carried at fair value, with changes in fair value included in the Statement of comprehensive income.

Properties are valued annually by professional external valuers using the Royal Institution of Chartered Surveyors ("RICS") guidelines. The RICS guidelines apply separate assumptions to the value of the land, buildings and tenancy associated with each property.

The external valuers also consider changes in market conditions and the status of the tenants in determining whether a full physical inspection is required each year. Irrespective of such considerations, each property is fully inspected as part of the valuation process at least once every three years. The cost of additions and renovations is capitalised.

Fair value is based on active market prices, adjusted, if necessary, for any difference in the nature, location or condition of the specific property.

(k) Financial instruments
Derivative financial instruments are measured at fair value through profit or loss ("FVTPL") and classified as held for trading. All other financial assets and financial liabilities with the exception of short-term assets and liabilities and cash and cash equivalents are classified as fair value through profit or loss on initial recognition.

Financial investments are designated at FVTPL upon initial recognition where they are managed on a fair value basis in accordance with risk management and investment strategies, and information is provided internally to key management personnel on that basis. Financial instruments at FVTPL are initially recognised at fair value in the Statement of financial position with transaction costs and any subsequent change in fair value taken directly to the Statement of comprehensive income. All changes in fair value are recognised in the Statement of comprehensive income and are included within the "Investment return" category as explained in Note 1(g) above.

The amount of each class of financial asset and liability that has been designated at fair value through profit or loss and the methodology for determining the fair value for financial assets and liabilities are set out in Note 13.

(l) Offsetting financial instruments
Financial assets and liabilities are offset and the net amount reported in the Statement of financial position only when there is an unconditional and a legally enforceable right to offset the recognised amounts in all circumstances (including the default by, or insolvency or bankruptcy of the Company and all counterparties), and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously. Realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the settlements are executed at the same time, or within a single settlement process or cycle, resulting in no or insignificant credit and liquidity risk.

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

1. ACCOUNTING POLICIES (continued)

(m) Assets pledged as collateral

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

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

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

(n) Cash and cash equivalents

Cash and cash equivalents consist of cash balances, including any overdrawn balances, and deposits held at call with banks with less than 90 days maturity from date of acquisition.

(o) Foreign currencies

The functional currency of the Company is pounds sterling. The Company has chosen to present its financial statements in this currency.

Monetary assets and liabilities denominated in a foreign currency are translated into the functional currency at the foreign exchange rate ruling at the end of the financial year. Non-monetary assets and liabilities are translated into the functional currency using the historic rate. All revenue and expense items are reflected in the Statement of comprehensive income at the rate effective at the date the transaction took place.

(p) Taxation

Current taxation is provided on taxable profits at the corporation tax rate ruling in the year they are earned.

Deferred tax is provided on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes, and the amounts used for taxation purposes. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates ruling at the date the timing difference is expected to reverse.

A deferred tax asset is recognised only to the extent that it is probable that future profits will be available against which the asset can be utilised.

(q) Prepayments

Prepayments include annuity payments made to pension schemes in advance of the Statement of financial position date to ensure settlement of the following month's annuity payments to policyholders on a timely basis.

(r) Impairment of non-financial assets

Non-financial assets that are measured at amortised cost are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use.

(s) Borrowings

Borrowings are recognised initially at fair value which is the cash consideration received net of transaction costs incurred. Borrowings classified as liabilities are subsequently stated at amortised cost. The difference between the net proceeds and the redemption value is recognised in the Statement of comprehensive income over the borrowing period using the effective interest method.

(t) Insurance liabilities
Insurance liabilities are determined by the Company's internal actuarial department, using methods and assumptions approved by the Directors, and using recognised actuarial methods. The liabilities are calculated using assumptions equivalent to those used for reporting under Solvency II but with the addition of prudential margins. The liabilities are then adjusted to remove certain items which are not required to be recognised as insurance liabilities under IFRS4.

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

The interest rate used for discounting future claims payments and the associated expenses is derived from the yield on the assets held to back those liabilities and includes an allowance for risks, including credit risk, associated with holding these assets.

(u) Reinsurance
Amounts recoverable from or due to reinsurers are measured consistently with the amounts covered under each of the in-force reinsurance contracts and in accordance with the terms of each reinsurance contract.

Premiums payable under quota share reinsurance contracts are recognised at the inception of each reinsurance contract. In cases where the amount of premiums due to the reinsurer has not been finalised at the end of a reporting period, an estimate is made in accordance with the terms of each reinsurance contract. Subsequent adjustments to the premium payable are accounted for in the period in which the adjustment arises.

Premiums payable for reinsurance ceded are recognised in the period in which the benefit of the reinsurance treaty is recognised within insurance contract liabilities.

The benefits to which the Company is entitled under its reinsurance contracts are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers, together with longer-term receivables that are dependent on the expected claims and benefits arising under the related reinsured insurance contracts.

The Company has two types of quota share reinsurance arrangements. The first type is a quota share agreement with an external reinsurer covering all policyholder benefit payments for a proportion of the business reinsured. This proportion varies between 50% and 90% for certain discrete blocks of business. The second type is a tail-risk quota share arrangement with an external reinsurer under which 100% of all benefit payments after a fixed period (subject to certain treaty-specific limits) are covered in return for an initial single premium.

The Company has also entered into a number of longevity reinsurance contracts with external reinsurers under which it has committed to pay the reinsurer a schedule of fixed payments ("the fixed line") in respect of expected claims relating to defined tranches of policyholder benefits and in return the reinsurer undertakes to reimburse the actual cost of claims on those tranches to the Company. Separately, there is also an insurance fee on each of these contracts for which the Company is liable. Settlement of the contract is on a net basis. The amounts receivable from or payable to reinsurers are recognised as Reinsurers' share of insurance liabilities in the Statement of financial position.

Fees paid in respect of certain longevity reinsurance contracts which are contingent on surplus levels under the historical solvency regime are recognised as incurred and are included under outward reinsurance premiums.

Reinsurance recoveries are accounted for in the same period as the related claim is incurred.

The Company impairs its reinsurance assets if there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that not all amounts due to it under the terms of the contract will be received and the impact of the event on the amount to be received from the reinsurer can be reliably measured. An impairment loss is recognised for the amount by which the reinsurance asset's carrying amount exceeds its recoverable amount.

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

1. ACCOUNTING POLICIES (continued)

(v) Critical accounting policies, estimates and judgements

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

Contract classification

IFRS 4 "Insurance Contracts" requires policyholder contracts written by insurers to be classified as either insurance contracts or investment contracts depending on the level of insurance risk transferred.

Insurance contracts are defined as those contracts containing significant insurance risk if, and only if, an insured event could cause an insurer to make significant additional payments in any scenario, excluding scenarios that lack commercial substance, at the inception of the contract. Such contracts remain insurance contracts until all rights and obligations are extinguished or expire.

Policy contracts which do not transfer significant insurance risk to the insurer are classified as investment contracts. The Company has classified all its policyholder contracts as insurance contracts.

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

Insurance liabilities

Insurance liabilities are valued using projected cash flows of future retirement income and the cost of administrating payments to policyholders. The key assumptions relate to future mortality, discount rates and inflation.

The carrying value of insurance liabilities net of reinsurance at the end of the financial year is £26.9 billion (2017: £22.5 billion). The assumptions used to establish insurance contract liabilities and appropriate sensitivities relating to variations in these assumptions are disclosed in Note 10.

Financial instruments

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

2. OPERATING SEGMENTS

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

Customers

The nature of the Company's business is that it conducts a relatively small number of individual transactions each year. These transactions are all one-off in nature, and the Company's business plans do not anticipate conducting a significant amount of repeat business with any particular customers. Revenue concentration items have therefore not been disclosed.

3. INVESTMENT RETURN

	2018 £m	2017 £m
Income from debt securities	708	615
Interest income on cash deposits	19	15
Income from mortgage backed securities ("MBS")	2	1
Interest income	729	631
Rental income	6	5
Income from other investments		
> Investment schemes	3	3
> Other asset backed securities ("ABS")	10	8
> Net (loss)/income on other investments	(54)	(81)
	(35)	(65)
Total investment income	694	566
Realised gains on:		
> Investments designated as FVTPL on initial recognition	256	320
> Investments classified as held for trading	28	11
Realised losses on:		
> Investments designated as FVTPL on initial recognition	(1)	(4)
> Investments classified as held for trading	(120)	(17)
Net realised gains	163	310
Unrealised gains on:		
> Investments designated as FVTPL on initial recognition	53	177
> Investments classified as held for trading	166	723
Unrealised losses on:		
> Investments designated as FVTPL on initial recognition	(1,230)	(407)
> Investments classified as held for trading	(824)	(277)
Net unrealised (losses)/gains	(1,835)	216
Investment return	(978)	1,092

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

4. ACQUISITION EXPENSES

	2018 £m	2017 £m
Acquisition expenses	52	51

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

5. OTHER OPERATING EXPENSES

	2018 £m	2017 £m
Investment charges and related expenses	26	16
Other expenses	69	24
	95	40

Included within the other expenses are the amounts relating to Group share based payment costs which were previously incurred in PICG. This has resulted in a one-off charge in PIC of £25 million and a one-off credit in PICG of the same amount. The rest of the increase was in line with the growth of the business.

Investment charges and related expenses include amounts due at the end of each financial year relating to investment performance fees payable on targets based over a number of financial years.

6. AUDITOR'S REMUNERATION

	2018 £	2017 £
Fees payable to the Company's auditor for the audit of the Company's annual accounts	216,001	187,256
Fees payable to the Company's auditor and its associates for other services:		
Audit-related assurance services	145,296	142,446
All other services	57,000	71,593
Total fees paid to the auditor	418,297	401,295

7. DIRECTORS' REMUNERATION, EMPLOYEE COSTS AND HEADCOUNT

Pension Services Corporation Limited ("PSC") was the provider of management, staff, IT and office services to the Company, under a defined service agreement, throughout the year.

The Company employs no staff directly as all staff were provided by PSC during the year.

The recharged costs of Directors and employees of the Company for the year were as follows:

	2018 £m	2017 £m
Wages and salaries	28	24
Social security costs	5	4
Other pension costs	1	1
	34	29

The Company has 14 Directors who served during the year (2017: 14). All Directors were employed by or contracted by the Company's service provider. The total remuneration received by the Directors for their services, was £3 million (2017: £3 million). Certain Directors also receive remuneration from Pension Insurance Corporation Group Limited, the ultimate parent company.

The amount of remuneration received by the highest paid Director was £1 million (2017: £1 million). These amounts relate solely to the services provided by the Directors to the Company and do not include any payments due for services provided with regard to other Group entities.

Two Directors had money paid to money purchase pension schemes or were provided a cash alternative where their lifetime limit had been reached (2017: two). No Directors, including the highest paid Director, were eligible for shares or share options in the Company under a long-term incentive scheme (2017: nil). No Directors exercised options in the Company during the year (2017: nil).

8. CORPORATION TAX

The Company's tax charge for the year is:

	2018 £m	2017 £m
Current taxation		
Tax payable for the current year	87	75
Prior year under/(over) provision	–	–
Total current tax	87	75
Deferred taxation		
Recognition of deferred tax liability on temporary timing differences	–	–
Tax transitional adjustment	(1)	–
Effect of change in tax rates	–	–
Total deferred tax	(1)	–
Corporation tax charge	86	75

The effective current tax charge for the period is the same as (2017: the same as) the standard rate of corporation tax in the UK of 19% (2017: 19.25%). The differences are explained below:

	2018 £m	2017 £m
Reconciliation of total income to the applicable tax rate		
Profit before taxation	454	391
Corporation tax at 19% (2017: 19.25%)	86	75
Effects of:		
Expenses not deductible for tax purposes	–	–
Income not subject to corporation tax	–	–
Prior year under/(over) provision	–	–
Effect of change in tax rates	–	–
Corporation tax charge	86	75

Factors that may affect future tax charges

Following the January 2013 change in the taxation regime for insurance companies, the benefit of the differences between IFRS retained earnings and taxable profits at 31 December 2012 will reverse over a period of ten years. Consequently, the Company has recognised a deferred tax liability at 31 December 2018 of £3 million (2017: £4 million) in respect of these timing differences which total £16 million (2017: £20 million).

UK corporation tax rates are 19% from 1 April 2017 (enacted 18 November 2015) and 17% from 1 April 2020 (enacted 15 September 2016). These rates will reduce the Company's future current tax charge accordingly. The deferred tax liability at 31 December 2018 has been calculated based on these rates.

The Company has no other timing differences or tax losses carried forward at 31 December 2018 which may give rise to reduced tax charges in future periods (2017: nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

9. INVESTMENT PROPERTY

	2018 £m	2017 £m
At beginning of year	99	97
Total (losses)/gains through profit and loss	(3)	2
At end of year	96	99

The Company classifies its investment in eight Guernsey registered property unit trusts ("GPUTs") as investment properties. The Company holds 99.9% of the issued units in the GPUTs. The GPUTs own the freehold of six properties and have a long leasehold interest in the remaining two properties. All eight properties are located in the UK.

In 2015, the GPUTs were restructured by changing a single unit into A and B units, representing income and capital streams.

Rental income received in relation to these properties of £6 million (2017: £5 million) is shown within investment return in Note 3. There were no additions or disposals made during the year (2017: nil).

Investment properties have been classified as Level 3 in the fair value hierarchy, due to the unobservable inputs used in the valuation model.

The market value of the investment properties is determined based on a valuation approach, which applies investment yield to the rental income. The investment yield is derived from available transactional evidence of similar rental units, considering the property specific factors such as its location, the unexpired term, current rent, size of the unit and other factors.

The sensitivity of the property values to +/-10% change in investment yield is +/-£2 million (2017: +/-£2 million).

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 gross insurance liabilities shown overleaf are stated in accordance with the Company's accounting policies as set out in Note 1. The figures exclude reserves which are required for the calculation of regulatory solvency (under the PRA rules) but which do not meet the definition of a liability under IFRS and therefore are excluded from insurance liabilities under IFRS 4 and IAS 37 "Provisions, Contingent Assets and Contingent Liabilities".

The Company's liabilities in relation to future policyholders' benefits are:

	2018 £m	2017 £m
Future policyholders' benefits		
Gross	28,720	24,993
Reinsurance	(1,854)	(2,450)
Net	26,866	22,543

The reinsured liabilities include liabilities ceded under longevity reinsurance contracts with external counterparties and immediate and deferred annuity payments ceded under external quota share arrangements.

(a) Terms and conditions of insurance contracts
The Company's insurance liabilities represent contracts that provide immediate annuities for current pensioners and deferred annuities for members who have not yet reached pensionable age. Annuities in deferment and in payment can be level, subject to fixed increases or increases linked to inflation, or a mixture of the three, and in many cases are also subject to defined caps and floors on the increases that can be applied. The insurance liabilities also include member options, such as the option to commute part of the pension for a tax-free cash lump sum on vesting, and annuities payable to spouses or other dependants on the death of the main member.

The Company's insurance contracts are a mixture of "buy-in" policies, where the policyholder is the pension scheme and the insured liabilities cover defined benefits within the scheme, and "buyout" policies, where the policyholder is an individual.

Insurance liabilities are calculated as the present value of future annuity payments and expenses. The principal assumptions used in the calculation are set out below.

(b) Principal assumptions used in the preparation of insurance liabilities
Mortality assumptions
The base mortality assumptions as at 31 December 2018 inherent in the projected cash flows used in the valuation of insurance contract liabilities are set with reference to the S2 series of mortality tables published by the Continuous Mortality Investigation ("CMI", a research body with strong links to the Institute and Faculty of Actuaries in the UK).

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.

In 2018, as a result of our annual investigation of the base mortality assumptions against our observed experience, we updated the base mortality assumptions from those used in the 2017 valuation. This update involved the adoption of the CMI 2016 model for mortality improvements from 2007 (the effective date of the S2 series mortality tables) to 2017 (2017: based on a combination of the CMI 2012 and CMI 2014 improvements models from 2007 to 2017) and updating the proportion of the S2 table to 99% (2017: 100%). These two changes caused a net weakening of our mortality assumptions and released £144 million of reserves. (No updates were made to the base mortality assumptions in 2017.)

The assumption for future improvements to mortality is modelled using the CMI 2016 model. This was an update in 2017 (where previously we had used the CMI 2014 improvements model) and led to a release of £113 million of reserves in 2017. No updates were made to the assumption for future improvements in 2018.

Valuation rate of interest ("VRI")
The VRI is set at 100% of the risk adjusted yield on assets backing liabilities. Risk adjustments are applied for credit risk associated with the assets held to match liabilities.

In 2018, the methodology to determine the risk adjustments was refined. This involved the release of some prudent margins and closer alignment to our Solvency II balance sheet, although with significant prudence built in. We updated our level of prudence so that, on an equivalent basis, at end 2017 we moved from assuming that 52% of spread related to defaults, to assuming that 44% of the spread related to defaults. This released £320 million of reserves. In addition, the calculation methodology was updated to be based on a fixed basis points default allowance by asset, based on historic levels of default and downgrade with prudent margins, rather than the "percentage of spread" approach used previously. This change has meant that the deduction related to defaults is now principally driven by ratings changes in our investment portfolio, rather than the spread on those assets. This methodology change makes the reported IFRS profits much less sensitive to changes in credit spreads going forwards.

The VRI calculated in accordance with these rules as at 31 December 2018 for PIC was 2.69% for both index-linked liabilities and non-linked liabilities (2017: 2.06%).

Inflation
Assumptions for expected future Retail Price Index inflation and Consumer Price Index inflation are based on a curve derived from market prices of inflation-linked swap contracts. For Limited Price Index linked annuities, which are subject to maximum and minimum percentage annual increases, a mark-to-model approach is used to allow for the inherent optionality, as there is currently no deep and liquid market in appropriate swap contracts.

Other assumptions
The internal costs of maintaining the existing insurance contracts, the fees payable to third-party administrators engaged to manage payments due under the in-force policies, fees due to reinsurers and investment management expenses are factored into the calculation of liabilities by adding appropriate allowances, and include an estimate of the impact of future inflation where this is applicable. No allowances are included for expenses incurred by the Company in relation to the generation of new business.

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

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.

2018	Gross £m	Reinsurance £m	Net £m
At beginning of year	24,993	(2,450)	22,543
Increase in liability from new premiums	7,511	2	7,513
Impact of reinsurance entered into in the year	–	(215)	(215)
Reduction in liability from claims	(1,179)	6	(1,173)
Impact of investment volatility	(1,874)	318	(1,556)
Changes in valuation assumptions	(857)	457	(400)
Other movements (including net investment return)	126	28	154
At end of year	28,720	(1,854)	26,866

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)
Impact of investment volatility	643	(68)	575
Changes in valuation assumptions	(390)	220	(170)
Other movements (including net investment return)	(65)	87	22
At end of year	24,993	(2,450)	22,543

Changes in assumptions

The movement during the year relating to economic and non-economic assumptions, as shown in the table above, comprise the following items:

Impact of investment volatility

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

The main driver of the movements is a change in the asset mix and duration of our credit risky asset portfolio, resulting in a reduction in the value of liabilities (2017: narrowing of credit spreads caused an increase in liabilities). In addition, foreign currency movements, interest rate movements and inflation movements also resulted in an increase in liabilities.

Changes in valuation assumptions

The movements during the year relating to valuation assumptions comprise the following items:

The assumption for base mortality was updated to reflect our most recent experience analysis, which caused a release of reserves.

The approach to determine the probability of default within the IFRS discount rate, has been revised to be based on a fixed basis point deduction, rather than a percentage of spread approach. This has also caused a release of reserves.

(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	52	457	1,548	4,328	6,385
Reinsurance	(3)	(24)	(107)	(976)	(1,110)
As at 31 December 2018	49	433	1,441	3,352	5,275
Annuities in payment					
Gross	1,131	4,274	8,713	8,217	22,335
Reinsurance	30	87	(59)	(802)	(744)
As at 31 December 2018	1,161	4,361	8,654	7,415	21,591

	Within one year £m	In 1-5 years £m	In 5-15 years £m	Over 15 years £m	Total £m
Deferred annuities					
Gross	48	353	1,368	4,618	6,387
Reinsurance	(5)	(29)	(108)	(1,345)	(1,487)
As at 31 December 2017	43	324	1,260	3,273	4,900
Annuities in payment					
Gross	858	3,310	6,993	7,445	18,606
Reinsurance	22	57	(97)	(945)	(963)
As at 31 December 2017	880	3,367	6,896	6,500	17,643

(e) Sensitivity analysis

In accordance with IFRS 4 and IFRS 7 "Financial Instruments: Disclosures", the Directors have considered the effect on profit or loss and equity at 31 December 2018 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 2018	Increase of 25bps £m	Fall of 25bps £m	Increase of 50bps £m	Fall of 50bps £m
Movement in assets	(873)	924	1,337	(1,190)
Movement in liabilities	831	(887)	(1,236)	1,169
Tax effect	8	(7)	(19)	4
Movement in profit and equity	(34)	30	82	(17)

	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	–	–	–	23	(524)
Movement in liabilities	(26)	(63)	(120)	(19)	536
Tax effect	5	12	23	(1)	(2)
Movement in profit and equity	(21)	(51)	(97)	3	10

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

10. INSURANCE CONTRACTS AND RELATED INSURANCE LIABILITIES (continued)

	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)

The sensitivity of the IFRS profits to changes in credit spreads has reduced significantly at the end of 2018 compared to the prior year. This is as a result of the methodology change made with regards to the allowance for credit defaults within the IFRS insurance liabilities (see note 10(b) for further details). The change in credit default methodology removed a large element of the credit spread sensitivity, with the assumption now being more dependent on upgrades/downgrades in credit ratings of assets in the underlying investment portfolio.

Parameters for exchange rate, longevity and renewal expense sensitivities

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

The base mortality sensitivity is based on a 1% decrease in the base mortality rates. This is equivalent to a 0.1 year increase in life expectancy from 22.7 years to 22.8 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 22.7 years to 22.8 years for a typical male aged 65.

The expense sensitivity is based on an increase in annual maintenance expenses (including third party administration costs) of 15%.

The key assumptions, methodology and limitations of the sensitivity analysis are as follows:

- The effects of the specified changes in factors are determined based on the year-end financial instrument values. The level of movements in market factors on which the sensitivity analyses are based were determined based on economic forecasts and historical experience of variations in these factors. The sensitivity analysis is based on the risks to which the Company is exposed at the end of the reporting period, and reflects the changes in relevant risk variables that are reasonably possible at this date and over the next reporting period. The sensitivities used are based on the core assumptions in the financial statements rather than considering more extreme scenarios.
- Each entry in the sensitivity table demonstrates the effect of a change in a single key assumption while other assumptions remain unchanged. However, the occurrence of a change in a single market factor will often lead to changes in other market factors. In particular, the Company's use of derivatives is designed to ensure that its exposure to interest and inflation risks is carefully managed.

(f) Reinsurance results
The effect of reinsurance contracts entered into by the Company on profit before taxation is as follows:

	2018 £m	2017 £m
Outward reinsurance premiums	(29)	(41)
Reinsurers' share of claims paid	74	94
Changes in reinsurers' share of insurance liabilities	(596)	(72)
Net effect of reinsurance contracts on profit before taxation	(551)	(19)

Reinsurance assets have reduced significantly during the year due to the impact of the annual update to the base mortality assumptions to reflect experience, which resulted in lower expected recoveries from our longevity swaps.

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:

	2018 £m	2017 £m
Amounts payable in respect of insurance fees	29	41
Current year premiums payable in respect of quota share arrangements	–	–
Outward reinsurance premiums	29	41

11. DEFERRED TAX

At 31 December 2018, the Company's deferred tax balances calculated in accordance with IAS 12 "*Income Taxes*" were as follows:

	Asset £m	Liability £m	Total £m
31 December 2018			
Tax transitional adjustment	–	(3)	(3)
31 December 2017			
Tax transitional adjustment	–	(4)	(4)

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

	2018 £m	2017 £m
At beginning of year	(4)	(4)
Effect of tax transitional adjustment	1	–
At end of year	(3)	(4)

Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all available evidence, it can be regarded as more likely than not that sufficient future taxable profits will arise from which the underlying temporary differences can be deducted.

The tax transitional adjustment arose following the introduction of a new tax regime that commenced in January 2013 which changed the calculation of taxable profits of insurance companies (see Note 8). The Company has no timing differences or tax losses carried forward at 31 December 2018 (2017: nil) which may give rise to reduced tax charges in future periods.

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

12. BORROWINGS

On 3 July 2014, the Company issued £300 million subordinated loan notes due to be repaid in 2024 with a fixed coupon of 6.5% paid annually in arrears. The notes were issued at 99.107% of par.

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

On 21 September 2018, PIC issued a further £350 million subordinated loan notes due 2030 with a fixed coupon of 5.625% paid annually in arrears. These notes were issued at 99.693% of par.

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

	2018		2017	
Loan notes	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
£300 million notes maturing 2024	297	332	296	354
£250 million notes maturing 2026	247	289	247	320
£350 million notes maturing 2030	347	341	–	–
Total	891	962	543	674

The fair value has been calculated by applying an adjustment to the quoted price to reflect market illiquidity. Consequently, the loan notes have been classified as Level 2 in the fair value hierarchy.

For the year ended 31 December 2018, an interest expense of £46 million (2017: £41 million), calculated using the amortised cost method, was recognised in the Statement of comprehensive income in respect of the notes.

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES

All of the Company's financial assets and liabilities have been designated as fair value through profit and loss or categorised as loans and receivables (and accounted for at amortised cost) as detailed below.

	2018		2017	
Financial assets	Fair value through profit and loss £m	Amortised cost £m	Fair value through profit and loss £m	Amortised cost £m
Financial investments				
Debt securities	28,288		23,723	
MBS and ABS	356		240	
Equity release mortgages	294		107	
Deposits with credit institutions	1,095		577	
Participation in investment schemes	1,338		1,024	
Total financial investments	31,371	–	25,671	–
Derivative assets	9,757		8,775	
Loans and receivables and other financial assets				
Debtors arising out of direct insurance operations		52		120
Other debtors		1		11
Accrued interest		223		185
Total receivables and other financial assets	–	276	–	316
Cash and cash equivalents	–	67	–	33
Total financial assets	41,128	343	34,446	349
Financial liabilities				
Derivative liabilities	11,303		9,663	
Creditors arising out of reinsurance operations		11		9
Other creditors		61		39
Insurance and other payables	–	72	–	48
Borrowings	–	891	–	543
Accruals	–	19	–	16
Total financial liabilities	11,303	982	9,663	607

All amounts relating to receivables and other financial assets are expected to be received within one year.

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

Included within financial assets designated as fair value through profit or loss are amounts totalling £38,741 million (2017: £32,636 million) due to be received in more than one year.

Deposits with credit institutions

Deposits with credit institutions include £18 million (2017: £18 million) in two bank accounts which are designated fee collateral bank accounts. These accounts were established under deeds of charge dated 9 July 2012 and 11 December 2012 between PIC and Münchener Rückversicherungs gesellschaft ("Munich Re") in respect of longevity reinsurance agreements. The amount deposited in each account represents a proportion of PIC's liability for the payment of fees due over the life of each agreement ("fee collateral amount") and is subject to annual review by each party.

The Company retains control of the cash deposited in these accounts; however, it must maintain a balance at least equal to the agreed fee collateral amount and Munich Re has a fixed first charge over the accounts which gives it the right to withdraw an amount equivalent to its outstanding fees due under the agreement on the occurrence of certain specified default events.

NOTES TO THE FINANCIAL STATEMENTS (continued)
FOR THE YEAR ENDED 31 DECEMBER 2018

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (continued)

Assets pledged as collateral

As explained in Note 14, the Company uses derivative financial instruments as part of its risk management strategy. Most over the counter derivative transactions require collateral to be received or pledged by the Company to mitigate the counterparty credit risk. The Company has collateral agreements with each counterparty based on standard ISDA master netting agreements, which specify minimum thresholds, asset class and credit quality of collateral and the frequency of valuation. While each party to the contract has a legal right to the collateral received if the counterparty does not meet its obligations, there is no economic benefit from holding the assets as each party has the right to substitute the collateral delivered for another asset of the same value and quality at any time. Therefore, these agreements do not meet the criteria for offsetting under IAS 32.

The Company returns/receives the collateral received/pledged upon contract termination or settlement. The amount of collateral received/pledged fluctuates due to the changes in fair value of the derivative subject to the minimum thresholds.

At 31 December 2018, the Company has included £2,338 million (2017: £1,688 million) of financial assets which have been pledged as security under the terms of derivative contracts. The Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and consequently none of these assets has been derecognised in the financial statements.

At 31 December 2018, the amount of collateral received by the Company was £591 million (2017: £662 million). While the Company is permitted to sell or repledge collateral received, no collateral was sold or repledged in the absence of default during the year (2017: £nil).

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

Under the terms of the security, the Trustee is free to use the assets without constraint; however, it is obliged to deliver equivalent assets (defined as "an asset of the same type, nominal value, description and amount"), as well as the income earned and gains or losses incurred on these assets to the Company. The Company retains the right to replace any of the assets with assets of similar nature. Collateral is returned to the Company as it services the insured pension liabilities under the policy. This, in theory, exposes the Company to counterparty credit risk, which is, however, fully mitigated as the Company has the contractual right to offset its obligation to pay under the policy in the event of default by the Trustee. The Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and accordingly continues to recognise the assets which it has pledged under title transfer security in its financial statements. At 31 December 2018, this totalled £1.7 billion (2017: £1.8 billion).

In 2018, the Company has included £150 million of financial assets which have been pledged as collateral under the terms of certain reinsurance contracts (2017: £116 million). The Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and consequently none of these assets has been derecognised in the financial statements.

At 31 December 2018, the Company held £1 million (2017: £7 million pledged) cash as collateral under the terms of certain reinsurance contracts.

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

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

In all cases, the Company retains substantially all the risks and rewards of ownership in respect of the transferred assets and consequently none of these assets have been derecognised in the financial statements. At 31 December 2018, the Company had £1,399 million (2017: £1,209 million) assets related to securities lending and reverse sale and repurchase agreements, and held £1,399 million (2017: £1,209 million) in gilts and eligible securities as collateral in respect of these arrangements.

Offsetting
The Company does not offset financial assets and liabilities in the Statement of financial position unless there is a legally enforceable right to offset and the Company has the intention to settle the asset and liability on a net basis, or to realise the asset and settle the liability simultaneously. Except for foreign exchange forward agreements, the Company has no financial assets and financial liabilities that have been offset in the Statement of financial position as at 31 December 2018 (2017: £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 2018	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	12,639	(2,882)	9,757	–	(591)	(8,910)	256
Debt securities	651	–	651	(651)	–	–	–
Deposits with credit institutions	748	–	748	(748)	–	–	–
Financial liabilities							
Derivatives	(14,185)	2,882	(11,303)	2,338	–	8,910	(55)

				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)

Measurement of financial assets and liabilities
The Company's financial assets and liabilities have been valued using the following methods in accordance with IAS 39 "*Financial Instruments*".

The fair values of investments quoted in an active market are based on their bid market prices. For unlisted securities and all other financial assets for which there is no active market, the Company establishes fair value using appropriate valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, counterparty and broker valuations and option pricing models. These assessments are based largely on observable market data.

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (continued)

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, which are valued on a discounted cash flow method with the primary assumption being the discount rate used. The biggest non observable data used is additional spreads. These investments have been included in Level 3 within the fair value hierarchy.

(b) Derivatives

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently remeasured at their fair value. The fair value of foreign exchange forward contracts, futures and swaps is based on market prices, where available. For swaps, market prices are calculated using discounted cash flow techniques based on adjusted market data such as composite curves derived from a number of market counterparties. Derivative contracts may not be readily tradeable and consequently they have been classified as Level 2 assets within the fair value hierarchy.

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

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

(c) MBS and ABS

The fair value of 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.

Included within MBS and ABS investments are credit linked notes, which are classified as Level 3 within the fair value hierarchy. The fair value of these notes is determined using a discounted cash flow model taking into account the cash flows, the capital structure and risk profile of each note and available market data such as recently traded prices for comparable notes.

(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

Equity release mortgages ("ERM") are loans secured against property that are repayable on death or entry into long-term care of the borrower. The fair value of ERM assets is determined using an internal valuation model which calculates the discounted value of future cash flows expected to arise from each loan. In addition to market observable inputs (such as interest and inflation rates), key inputs to the model also include assumptions relating to property growth, property volatility, equivalent spread, mortality, morbidity and early repayment rates, which are not market observable.

The valuation allows for the 'no negative equity guarantee', which restricts the amount recoverable by the Company on repayment of the mortgage to the net sale proceeds of the property. The value of this guarantee is calculated using option pricing models. Due to the impact of the unobservable inputs, the ERMs are classified as Level 3 assets within the fair value hierarchy.

Principal assumptions underlying the calculation of ERM assets include:

Equivalent spread

The loan-by-loan equivalent spread is solved at the point of each loan's inception to equate the present value of the expected cash flows to its face value. Subsequently each loan's equivalent spread is updated in line with changes in the spread of a reference corporate bond index.

Future property prices

The property values at the reporting date are estimated using the most recent property valuation adjusted using a property index. The projected property values reflect future property growth in line with the retail price index plus 50 bps and property volatility of 15%.

Early repayment rates

The Company has assumed early repayment rates of between 0.5% and 9% p.a. depending on the projection term and the loan's term since inception.

Mortality

The mortality assumptions are derived using the CMI 2016 mortality improvements and a multiple of the PXA08 mortality tables which varies by property postcode.

Dilapidation and sales costs

The valuation model allows for dilapidation and sales costs, both of which are set as a fixed percentage of the value of the property at the point of sale.

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (continued)

Measurement of fair value

The following table analyses the Company's financial investments according to the basis of measurement required by IFRS 13 "Fair Value Measurement":

31 December 2018	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Debt securities	11,648	14,680	1,960	28,288
MBS and ABS	–	332	24	356
Equity release mortgages	–	–	294	294
Deposits with credit institutions	1,095	–	–	1,095
Participation in investment schemes	538	651	149	1,338
Financial investments	13,281	15,663	2,427	31,371
Derivative assets	–	9,757	–	9,757
Financial assets	13,281	25,420	2,427	41,128
Derivative liabilities	–	(11,303)	–	(11,303)

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

Level 1 assets are those assets for which the fair value has been measured using quoted prices, without adjustment, in an active market.

Level 2 assets are those assets for which the fair value has been measured using observable inputs other than quoted prices included in Level 1.

Assets classified as Level 3 are those assets for which no observable data exists in relation to a significant element of the fair value measurement.

Transfers between levels of the fair value hierarchy

For recurring fair value measurements, the Company's policy is to recognise transfers into and out of fair value hierarchy levels at the end of the year in which the event or change in circumstances that caused the transfer has occurred.

Transfers between Level 1 and Level 2

There have been no transfers during the year between Levels 1 and 2 (2017: £nil).

Transfers into or out of Level 3

During the year, £313 million of debt securities were transferred from Level 2 to Level 3 (2017: £144 million) and £66 million of debt securities were transferred out of Level 3 to Level 2 (2017: £nil).

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 that they are relevant to the debt securities held by the Company. Where the impact of the adjustments on the value of the debt securities become significant, these securities would be classified as Level 3 and transferred from Level 2 to Level 3 at the end of the year. Conversely, where the impact becomes less significant, the securities would be classified as Level 2 and transferred out of Level 3 to Level 2.

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

Year ended 31 December 2018	Participation in investment schemes £m	ERM £m	MBS and ABS £m	Debt securities £m	Total £m
Opening balance	–	107	44	1,161	1,312
Unrealised gains or losses	–	–	8	(103)	(95)
Acquisitions in year	–	187	–	814	1,001
Transfers in to Level 3	149	–	–	164	313
Transfers out of Level 3	–	–	–	(66)	(66)
Disposals in year	–	–	(28)	(10)	(38)
Closing balance	149	294	24	1,960	2,427

Year ended 31 December 2017	Participation in investment schemes £m	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

The investment return within the Statement of comprehensive income includes the following income and investment gains and losses relating to Level 3 assets:

Year ended 31 December 2018	Participation in investment schemes £m	ERM £m	MBS and ABS £m	Debt securities £m	Total £m
Income from securities	–	–	2	22	24
Realised gains or losses	–	–	–	1	1
Unrealised gains or losses	–	–	8	(103)	(95)
Investment return on Level 3 assets	–	–	10	(80)	(70)

Year ended 31 December 2017	Participation in investment schemes £m	ERM £m	MBS and ABS £m	Debt securities £m	Total £m
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

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.

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (continued)

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

2018	Main Assumptions	Sensitivity	Current fair value £m	Increase in fair value £m	Decrease in fair value £m
Debt securities	Discount rates	+/- 50bps credit spread	1,960	260	(228)
MBS and ABS	Expected loss ("EL")	+/- 30% change in EL	24	–	–
ERM	Mortality	+/-5% change in mortality assumption	294	–	(1)
	Property price	+/-20% change in property prices		5	(9)
	Property growth	+/- 1% change in property growth assumption		5	(8)
	Voluntary Redemptions	+/-10% change in voluntary redemption assumption		1	(1)
Participation in investment schemes	Expected loss ("EL")	+/-£10 million change in EL	149	10	(10)
			2,427	281	(257)

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)

14. DERIVATIVE FINANCIAL INSTRUMENTS

The Company enters into a number of inflation rate and interest rate swap agreements during the ordinary course of business as part of its risk management strategy. Inflation swaps protect the Company against the adverse effects of inflation over a period of time, while the Company enters into interest rate swap transactions to assist in hedging contractual liabilities. Currency swaps and forward contracts are entered into to eliminate the majority of the currency risk on financial assets invested in non-sterling based debt securities where liabilities are denominated in sterling.

	2018		2017	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Interest rate swaps	8,856	(9,117)	7,884	(8,147)
Inflation swaps	715	(1,107)	638	(1,117)
Credit default swaps	118	(100)	19	(32)
Currency swaps	48	(950)	223	(360)
Foreign exchange forward contracts	14	(14)	11	(7)
Total return swap	6	(15)	–	–
Total derivative position	9,757	(11,303)	8,775	(9,663)

15. RISK MANAGEMENT

As a provider of insurance solutions to defined benefit pension schemes, the Company's business involves the acceptance and management of risk to achieve its strategic objectives.

The principal risk factors which affect the Company's operating results and financial condition include financial risks such as market risk, credit risk and liquidity risk, insurance risk, and other risks such as operational risk, regulatory risk and reputational risk.

Insurance risk is implicit in the Company's business and mainly arises from exposure to longevity in respect of annuity payments. Regulatory risk stems principally from the risk of changes to the regulatory environment in which PIC operates. The main reputational risks relate to ensuring good conduct, the need to maintain a good reputation with trustees of pension schemes and their advisers in order to attract new business, and with its own policyholders through treating them fairly. Maintaining a good internal culture is recognised as a key tool in mitigating these risks.

The Directors have overall responsibility for the management of the exposure to these risks. They are supported through formal committees of the Board including the Investment & Origination Committee, Audit Committee, Nomination and Remuneration Committees, and Risk Committee. The membership of these committees mainly comprise Non-Executive Directors. Executive Directors and relevant senior management attend meetings as requested. The Board retains direct responsibility for reputational risk. The Board has instigated a coordinated approach between Risk, Compliance, Actuarial and Internal Audit functions to provide integrated assurance in the monitoring of the internal risk and control environment.

The management and control of the Company's risks is a significant focus area for the Board as an uncontrolled and unmanaged development in various risks may affect the Company's performance and capital adequacy. The Company adopts an integrated view to the management and qualitative assessment of risk under risk acceptance guidelines and policies set by the Board and aims to minimise its exposure to risks such as interest rate risk and inflation risk, which carry little reward for the Company. Risks such as longevity risk are mitigated through reinsurance to the extent that it is economic to do so.

The Company uses derivatives for the purpose of efficient portfolio management or to reduce risk in aspects of the Company's investment activities such as the implementation of tactical asset allocation changes around the strategic benchmark, the hedging of cash flows, and the control of the risk profile of an identified strategy. The Company uses cross currency swaps, forward exchange contracts and futures for these purposes. It also uses interest and inflation rate swaps for the purpose of matching assets and liabilities, and credit default swaps to tactically control credit risk.

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

15. RISK MANAGEMENT (continued)

(a) Market risk

The Company is exposed to market risk as a consequence of fluctuations in values or returns on assets and liabilities which are influenced by one or more external factors. These include changes and volatility in interest rates, credit spreads, inflation expectations and currency exchange rates.

The Company manages market risk through an asset liability management ("ALM") framework that has been developed to closely match the investment portfolio duration and income to its obligations under insurance contracts.

Within the context of the ALM framework, the Company uses derivative financial instruments to reduce market risk. Interest rate and inflation swaps are entered into to improve the matching of asset and liability cash flows, and ensure that risk driver sensitivities are aligned across the maturity spectrum. The quality of the interest rate and inflation matching strategies is carefully monitored by management, and is operated within tightly defined limits. Currency forwards and swaps are entered into to eliminate the majority of the currency risk on financial assets invested in non-sterling based debt securities where liabilities are denominated in sterling.

The Company is also exposed to risks of movements in the property market through its investment in the GPUTs. The short-term market risk is mitigated by the fact that all eight of its properties are occupied on leases extending to 1 April 2033. The Company performs regular reviews of both the movement in the property market specific to these properties and the financial status of the tenants.

Further asset exposures include investments in hedge funds, insurance linked funds and public finance initiative related debt, including social housing. Where appropriate, the management of these alternative exposures is delegated to specialist fund managers, in line with defined investment management mandates. In all cases the Company ensures regular oversight of the investment management activities, and maintains detailed risk models for all investment types, incorporating analysis of alternative investments in its risk and capital assessment.

(b) Credit risk

Credit risk is the risk of loss due to the default of another party in performing its financial obligations to the Company. The Company is primarily exposed to credit risk through its investment in debt securities and cash deposits.

Credit risk also arises in respect of derivative contracts to the extent that there is the potential for the counterparties to default on their obligations.

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

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

31 December 2018	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Loans and debt securities							
Debt securities[1]	1,407	12,035	6,934	7,508	244	160	28,288
MBS and ABS[2]	–	17	290	21	–	28	356
ERM	–	–	–	–	–	294	294
	1,407	12,052	7,224	7,529	244	482	28,938
Other assets							
Derivative assets	–	–	–	–	–	9,757	9,757
Participation in investment schemes	538	–	–	–	–	800	1,338
Receivables and other financial assets	18	34	66	103	2	53	276
Deposits with credit institutions	–	290	805	–	–	–	1,095
Cash and cash equivalents	–	–	–	67	–	–	67
	556	324	871	170	2	10,610	12,533

1. Within Debt securities there are £69 million AAA rated, £848million AA rated, £1,288 million A rated, £747 million BBB rated and £121 million BB rated securities, which have been rated using internally assessed credit ratings.
2. Within MBS and ABS there are £4 million A rated securities which have been rated using internally assessed credit ratings.

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

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

Although the instruments themselves are unrated, the ultimate issuing parties for most derivative assets do have a credit rating. Additionally, the derivatives are fully collateralised with highly rated instruments, so as to mitigate any credit or counterparty risk. Applying the issuer rating to the assets held at 31 December 2018 produces the following split:

31 December 2018	AAA £m	AA £m	A £m	BBB £m	BB £m	Unrated £m	Total £m
Derivative assets	–	2,823	4,786	2,148	–	–	9,757

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

These assets are included with regular stress testing undertaken by the Company which assesses the impact of a number of scenarios on the Company's solvency position.

Reinsurance counterparties

The Company has reinsurance contracts in place with 11 external reinsurers with an exposure of £1,854 million at 31 December 2018 (2017: £2,450 million). Measures are in place with respect to the reinsurance contracts to manage counterparty exposure, including collateral arrangements and other protections. The credit rating of each reinsurer is reported to management on a monthly basis. The credit rating of each reinsurer was A or higher at both 31 December 2018 and 31 December 2017.

Impaired assets

The Company did not have any impaired or past due date assets at 31 December 2018 (2017: nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

15. RISK MANAGEMENT (continued)

(c) Liquidity risk

Liquidity risk is the risk that the Company may not have liquid assets available at the right times to be able to pay its liabilities, despite the fact that it meets its regulatory solvency requirements. This would typically arise if derivative contracts to manage inflation and interest rates required collateral to be posted, a large proportion of deferred policyholders opted to take transfer values, or if a large proportion of assets were invested in assets which are not easy or straightforward to liquidate.

In order to manage this, projected cash flows for all new policy liabilities taken on are determined as a part of the new business origination process to identify the expected profile of liability payments, including expected mortality experience. This is then used to identify appropriate assets, which provide matching cash flows at an acceptable price.

The Company's risk policies define a minimum proportion of its assets to be held in highly liquid cash and gilts, and stress testing is conducted to ensure that there are sufficient liquid assets at all times to meet potential demands from derivative movements under extreme scenarios.

The projected cash flows are updated regularly, and assumptions are updated at least annually, taking into account factors such as mortality experience and how this affects the required cash flows in the future.

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

31 December 2018	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	11	–	–	–	11
Other creditors	61	–	–	–	61
Accruals	19	–	–	–	19
Borrowings	–	–	891	–	891
Derivative liabilities	94	450	1,182	9,577	11,303
	185	450	2,073	9,577	12,285

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	39	–	–	–	39
Accruals	16	–	–	–	16
Borrowings	–	–	543	–	543
Derivative liabilities	49	371	1,062	8,181	9,663
	113	371	1,605	8,181	10,270

Amounts due to Group undertakings are included within Other creditors. At 31 December 2018, £61 million was payable to PSC (2017: £27 million). This amount is expected to be paid in the next financial year.

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

(d) Insurance risk

Longevity risk is the most significant component of insurance risk. It is the risk that the mortality experience of the Company's policyholders is lighter than assumed, thus requiring pensions to be paid for a longer period than anticipated, resulting in a higher than expected cost to the Company.

In order to help minimise this risk and also uncertainty arising through future longevity experience, PIC adopts an active approach to reinsuring these risks where it is economic to do so. This reinsurance can be classified into two broad categories:

Longevity only reinsurance

This provides longevity cover in respect of certain policyholders. Under these contracts, the Company has committed to pay the reinsurer a fixed line of cash flows for specified sets of liabilities relating to members/former members of particular pension schemes. The reinsurer undertakes to reimburse the actual cost of claims to the Company. Separately, there is also an insurance fee for which the Company is liable. Settlement of the contract is on a net basis. These contracts also transfer the contingent longevity risk relating to any eligible dependants of relevant policyholders.

Longevity reinsurance via the transfer of assets

Under such contracts, in return for a premium, the reinsurer agrees to reimburse the actual cost of future claims to the Company in respect of an agreed set of policyholders. These contracts also transfer the contingent risks relating to eligible dependants of relevant policyholders.

The Company monitors the levels of its counterparty risk and actively seeks to reinsure with a range of providers to help mitigate its exposure to any one such entity.

One aspect of deriving overall best estimate longevity assumptions is to establish the "current" or "initial" rates of mortality. These assumptions are set by applying appropriate mortality factors to each individual member/policyholder. Individual variations are subject to a number of factors including, but not limited to, an individual's gender, age, pension amount, occupation and place of residence.

The other aspect is the allowance for future improvements in mortality. The pattern in which mortality is expected to improve over time is an important but complex assumption for cash flow and liability calculations. This is regularly reviewed in the light of a number of factors including evolving methodologies for these projections together with views from industry and professional bodies on the factors driving mortality change.

Whilst longevity risk is the fundamental risk relating to its insurance liability portfolio, the Company also considers the following risks:

Risk arising from a specific insurance contract

The Company considers, as part of its risk management process, the risk attached to each new contract accepted and the mitigation of such risk.

Exposure to changes in financial market conditions

The Company prepares information based upon a range of possible market conditions. The results of this exercise are then considered with regard to the effect on the current insurance liability portfolio.

A key consideration of the 2018 ORSA process has been around the risks associated with the UK leaving the EU and the potential impact that this may have on PIC's business model and its policyholders. This has included scenario assessments to assess whether appropriate controls are in place to ensure that PIC's contractual relationships with various stakeholders continue to operate as intended post Brexit – including the ability to pay policyholders, relationships with banking and reinsurance counterparties and legislation around data security. Scenarios have also been performed considering potential macro-economic impacts to ensure that adequate controls are in place to mitigate the potential balance sheet impacts of market movements in a worst-case Brexit scenario on PIC's solvency and liquidity position.

(e) Operational risk

Operational risk is the potential for loss resulting from inadequate or failed internal processes, people and systems, or from external events. The Company's internal control processes are supported by an operational risk committee, the maintenance of a central risk register and an independent internal audit review. The risk of internal fraud is managed through a number of processes including the screening of staff at recruitment, a continuous training programme, segregation of duties and whistleblowing policies.

The Company has significant outsourcing arrangements in respect of pension administration and other functions. These arrangements are subject to agreements with formal service levels, operate within agreed authority limits and are subject to regular review by senior management.

Emergency and business continuity plans have also been established to counter adverse occurrences.

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

16. SHARE CAPITAL

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

	2018		2017	
	Number of shares	£m	Number of shares	£m
Authorised, issued and fully paid				
At beginning of year	999,810,351	1,000	999,810,351	1,000
Shares issued at par	–	–	–	–
At end of year	999,810,351	1,000	999,810,351	1,000

17. RESERVES

	2018		2017	
	Other reserves £m	Retained profit £m	Other reserves £m	Retained profit £m
At beginning of the year	60	1,016	60	700
Total comprehensive income	–	368	–	316
Dividends paid	–	(10)	–	–
At end of year	60	1,374	60	1,016

Other reserves comprise £60 million contributed in 2008 by PIC Holdings Limited, the immediate parent company.

18. CAPITAL RESOURCES

The Board's policy is to maintain a strong capital base to protect policyholders' and creditors' interests and ensure compliance with the relevant financial services regulations, whilst still creating shareholder value. The Company's capital resources comprise equity and debt capital. The details of the Company's equity capital resources are given in the Statement of changes in equity.

The Company is required to measure and manage its capital in accordance with the requirements of the EU Solvency II Framework Directive ("Solvency II"), as adopted by the PRA. There are certain valuation differences between the IFRS balance sheet and the Solvency II balance sheet, for example between IFRS insurance liabilities and Solvency II technical provisions. Also, under Solvency II the Company is able to treat the subordinated debt referred to in Note 12 as regulatory capital. The Company has complied with the capital requirements under Solvency II throughout the year.

The Company's objectives in managing its capital are:

- to match the profile of its assets and liabilities closely, taking account of the risks inherent in the business;
- to maintain financial strength sufficient to support new business growth in line with the Company's business plan;
- to satisfy the contractual entitlements of its policyholders and the requirements of its regulators;
- to ensure financial flexibility by maintaining strong liquidity and access to a range of capital markets;
- to allocate capital efficiently to support growth;
- to manage exposure to changes in interest and inflation rates by way of a comprehensive hedging programme; and
- to manage exposure to movements in exchange rates.

The Company currently has sufficient capital resources available to meet all its present capital requirements and does not utilise financial reinsurance or securitisation.

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

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

PIC focuses on hedging its Solvency II balance sheet through hedging its best estimate liabilities and solvency capital requirements to interest rates and inflation rates. This provides a proxy to IFRS and embedded value sensitivities, although some basis risk remains. PIC aims to remove all foreign exchange risk through cross-currency hedging. Longevity risk is managed through reinsurance, where 74% of longevity exposure has been transferred as at 31 December 2018, based on regulatory liabilities.

19. RELATED PARTY TRANSACTIONS

As at 31 December 2018, the Directors regarded Pension Insurance Corporation Group Limited ("PICG"), a limited company incorporated in England and Wales, as the Company's ultimate parent and controlling party.

The group controlled by PICG includes three other companies which the Directors consider to be related parties by virtue of their common control.

The compensation paid to key management personnel is disclosed in Note 7.

During the year, certain share based payment schemes operated by PICG in respect of employees of Pension Services Corporation Limited have vested. Seven of the key management personnel of the Company, including the Directors, were participants in these schemes and received a total of 1,512,256 ordinary shares of PICG upon exercising in line with the scheme rules.

The Company had transactions with three of its fellow group companies as follows:

a) Transactions with Pension Services Corporation Limited ("PSC")
PSC is the main provider of management, staff, IT, office services and contracted director services to the Company. Total charges for the period to 31 December 2018 were £104 million (2017: £76 million). At 31 December 2018, the amount due to PSC relating to the services provided was £61 million (2017: £27 million).

b) Transactions with PIC Holdings Limited ("PICH")
On 14 May 2012, the Company acquired an £80,000 loan facility from PICH. The facility was provided to PICH for the purpose of funding its investment in the GPUTs. The loan is repayable on demand from the Company or at the discretion of the borrower with an interest rate of 2% above LIBOR calculated quarterly. The amount outstanding at 31 December 2018 was £78,032 (2017: £78,032). The accrued interest on this loan amounted to £9,450 (2017: £7,896) at 31 December 2017.

As disclosed in Note 9, the Company holds 99.9% of the issued units in eight GPUTs. The remaining 0.1% are held by PICH. The Company receives 100% of the rental income and consequently recognises an intercompany payable to PICH for its share of the income, which is set off against the loan facility. At 31 December 2018, the outstanding payable balance was £31,973 (2017: £26,316).

c) Transactions with Pension Insurance Corporation Group Limited ("PICG")
During 2017 and 2018 the Company received tax losses surrendered from PICG as part of group relief. The amount outstanding at 31 December 2018 was £215,080 (2017: £217,902).

NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE YEAR ENDED 31 DECEMBER 2018

20. FINANCIAL COMMITMENTS AND CONTINGENCIES

Commitments

During the year the Company executed transactions to purchase partly funded securities. The Company expects to pay a further £855 million within the next five years (2017: £351 million), £122 million of this being due within 12 months of the financial reporting date (2017: £92 million).

	2018 £m	2017 £m
Within 1 year	122	92
In 1–5 years	733	259
Over 5 years	–	–
	855	351

Contingent liabilities

The Company has certain reinsurance agreements, which include fees that are contingent on occurrence of specific events. Such fees do not meet the definition of a liability, therefore are not recognised on the Statement of financial position. At 31 December 2018, the estimated value of the contingent fees payable was £9 million (2017: £10 million).

21. PARENT COMPANY AND ULTIMATE CONTROLLING PARTY

The Company is a wholly owned subsidiary of PICH, which is incorporated in England and Wales.

The Directors regard PICG, a limited company incorporated in England and Wales, as the ultimate parent and controlling party. PICG is the largest and smallest group of which the Company is a member and for which Group financial statements are prepared. The consolidated financial statements of PICG are available to the public and may be obtained from the Company's registered address at 14 Cornhill, London EC3V 3ND.

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