

SC 199549

SCOTTISH WIDOWS PLC

DIRECTORS' REPORT
AND
FINANCIAL STATEMENTS

31 DECEMBER 2012

Member of Lloyds Banking Group plc

THURSDAY



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COMPANY INFORMATION**Board of Directors**

Lord Blackwell (Chairman)

Dr N M Bryson (Deputy Chairman)

M Christophers

M G Culmer

M A Fisher

J Goford

A M Parsons*

A M Peck

Drs C A C M Schrauwers

T E Strauss*

D J Walkden*

Company Secretary

C M Herd

Actuarial Function

C M Murison

Independent Auditors

PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Erskine House
68-73 Queen Street
Edinburgh
EH2 4NH

Registered Office

69 Morrison Street
Edinburgh
EH3 8YF

Company Registration Number

SC199549

* denotes Executive Director

DIRECTORS' REPORT

Principal activities

The Directors present the audited consolidated financial statements of Scottish Widows plc ("the Company") and its subsidiary undertakings (together referred to as "the Group"). The Company is a limited liability company domiciled and incorporated in the United Kingdom. Details of the most significant subsidiary undertakings are given in note 16.

The principal activity of the Group is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the United Kingdom. The Group also has branches operating within the EU, which write a relatively small amount of business, principally in Germany. The Group offers a wide range of life insurance products such as annuities, pensions, whole life, term life and investment type products through independent financial advisers, the Lloyds Banking Group ("LBG") network and direct sales. The Company also reinsures business with related undertakings and with insurance entities external to the Group. This includes the majority of the pensions linked business, which is reinsured to the Company's subsidiary, Scottish Widows Unit Funds Limited ("SWUF"); its annuity business, which is reinsured to the Company's subsidiary, Scottish Widows Annuities Limited ("SWA"); and new protection business, which is reinsured to the Company's subsidiary, Clerical Medical Investment Group Limited ("CMIG").

Strategic focus

Insurance is focused on helping our customers to protect themselves today whilst preparing for a secure financial future. Our objective is to be the best insurance and retirement savings business for customers; providing simple, trusted, value for money propositions accessible through multiple channels.

Progress against strategic initiatives

2012 has been characterised by huge changes in the Insurance industry which has been reflected in our Insurance business. Our strategy of **simplification** is in line with the direction of regulation, which has removed complex commission structures, gender discrimination and tax cross subsidies. By combining our UK Life Pensions and Investment ("LP&I UK") business, of which the Group is the core part, with our General Insurance business, we have a single leadership team, a simpler, flatter structure and a lower cost base. We have also transferred most of our operations to the LBG combined Group Operations functions, where we expect scale economies and depth of expertise to yield further cost savings and improvements to customer service. This simplified business model has already strengthened our position as a cost leader in the industry.

Our focus is on **investing** to build profit streams in areas where we have market scale and competitive advantage, leveraging LBG synergies. The Group's business is focused on retirement savings, both the provision of annuities and pensions sold externally through intermediary and direct channels under the iconic Scottish Widows brand. In 2012 we were the market leaders in corporate pensions. Whilst we also have a strong stream of ongoing profits from our legacy back book, including £24 billion invested in our With Profits funds, we are streamlining and **reshaping** the business including exiting the offshore bonds market.

We see strong potential in the bancassurance channel. Whilst we withdrew investment advisors following a review of the implications of Retail Distribution Review ("RDR"), we continue to maintain a strong advisor force within branches to service insurance needs of customers. We have expanded our life insurance proposition with a new earnings protection product with simple application and claims processes.

We are committed to **strengthening** our position in the growing retirement savings market. In corporate pensions, strong activity in the run up to RDR resulted in 23% growth, with auto-enrolment expected to drive further growth over the next 3 to 5 years. In partnership with the People's Pension, we launched AssistMe, a technology tool that supports our customers in meeting their auto-enrolment obligations, complementing our existing corporate platform MyMoneyWorks. In annuities, we are developing our propositions to compete more effectively in an increasingly open market. We launched our enhanced annuities pilot in the last quarter of the year and expect this to be fully rolled out by mid 2013. This is the first step in expanding our participation in the annuity market, supported by our investment strategy that saw us purchase over £1 billion of attractive, high yielding, long-dated assets to match long duration Insurance liabilities. Looking forwards we see enormous potential to serve the retirement needs of our retail bank customers, many of whom may no longer be able to get independent financial advice at retirement.

We continue to focus on retention of customers within our legacy LP&I books, including opportunities to migrate customers with maturing products into new investment propositions. Whilst we have invested in the systems and processes to help Independent Financial Advisers through RDR, we anticipate exits from the market and the direct channel will be increasingly important for the 'orphan' customers created.

We have developed a deep understanding of the protection and savings needs of our customers through our annual Protection, Pension and Savings reports. The Centre for the Modern Family, which aims to improve understanding of families' needs in the UK, was launched in December 2011 as part of our commitment to better understanding our customers' needs and Helping Britain Prosper. The benefits of this insight are reflected in the strength of our customer propositions which have won several industry awards including: 'Best Stakeholder Pension provider' for the third year running at the Moneywise 2012 Pension Awards, 'Best Group Pension Provider' in the Corporate Adviser awards and 'Best Personal Pensions Provider' in the Professional Adviser awards.

DIRECTORS' REPORT (continued)**Review of the Business***Single Integrated Insurance Business*

Our business model positions us to maximise the capital benefits from risk diversification available under the proposed Individual Capital Assessment Plus (ICA plus) regime and ultimately Solvency II.

In preparation for the introduction of the Solvency II regime the insurance entities within LBG's Insurance Division were restructured in 2011 to bring all relevant entities under Scottish Widows Group Limited ("SWG"). As a result SWG became the holding company for the entities within the single integrated insurance business and is the ultimate insurance undertaking for solvency purposes. All subsidiaries of SWG, including the Group, are now managed within an overall risk and capital management framework. The capital management framework will facilitate the monitoring and allocation of capital across the entities owned by SWG, including those within the Group. Further details on the approach to capital management are set out in note 40.

In future, when Solvency II is fully implemented, it is expected that the Insurance Division of LBG will be able to recognise the capital diversification benefits which will flow from the management of capital and risk within this overall structure. Although the implementation date for Solvency II within the European Union has been deferred, the structure will enable the business to operate effectively within the transitional arrangements that have been proposed.

Investment strategy

The Group continues to practise efficient balance sheet management with a focus on investment and liquidity management opportunities. This includes leveraging wider LBG skills and capabilities where it is appropriate to do so. Activity completed in 2012 and future planned activity to invest in higher yielding illiquid assets is expected to deliver significant increased investment return to the Group, without increasing credit risk beyond the Group's risk appetite. During 2012 excess liquidity was invested in less liquid credit assets purchased from, or issued by, parties within LBG including a £1.4bn collateralised loan, £0.7bn of asset backed securities and covered bonds, and £0.5bn of loans secured on real estate.

In addition, £0.6bn of US dollar denominated corporate bonds were purchased. All assets were acquired at their fair value. Further details on the credit risk and fair value measurement of these assets can be found in note 40.

Gender Neutral Pricing

The European Court of Justice made a ruling on 1 March 2011 that the current insurance industry practice of pricing products differently for men and women, to reflect differing risk, would not be allowed from 21 December 2012. To comply with the ruling the Group introduced gender neutral pricing, affecting all new annuity and protection policy quotes, on 12 November 2012. Any annuity and protection policies quoted before this date and in place before 21 December 2012 are unaffected.

Retail Distribution Review

The Retail Distribution Review ("RDR") is an FSA initiative designed to increase consumer confidence in the advice they are given on investments and pensions, and came into effect on 1 January 2013. Financial advisers will meet higher standards of qualifications and agree charges for investment advice directly with the customer, instead of being paid by commission from the charges on investment products bought from the Group.

There remains significant uncertainty regarding market and consumer behaviour and the resultant impact on new business and retention which will only become clearer following implementation. It is expected that, as a result of RDR, some independent financial advisers may choose to exit markets, therefore some customers may look to receive advice elsewhere. Accordingly, the Group is committed to providing a direct proposition to maintain a high quality of service to these customers, and has updated its range of products to deliver transparent and flexible charging solutions for advisers and their clients.

Auto-enrolment

Auto-enrolment in pension schemes came into effect from 1 October 2012 and will be rolled out to almost all UK employers over the next five years. The Group recognises this as a significant opportunity and in September 2012 unveiled the new AssistMe platform, which will help employers of all sizes meet their auto-enrolment obligations.

Taxation of life assurance companies

The Finance Act 2012 introduced a new UK tax regime for insurance companies which took effect from 1 January 2013. The new regime, together with current economic forecasts, has had a number of impacts on the deferred tax charge of the Company. This has resulted in an overall additional charge of £709m, comprising £529m charge due to the revaluation of policyholder tax assets, £237m charge due to the inclusion of certain investments to the charge to tax under the new regime, and £57m credit due to the revaluation of tax losses.

DIRECTORS' REPORT (continued)*German Insurance Business litigation*

CMIG has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. In the accounts for the year ended 31 December 2011 the Group recognised a provision of £175m with respect to this litigation. Following decisions in July 2012 from the Federal Court of Justice in Germany the Group has recognised a further provision of £150m with respect to this litigation, increasing the total provision to £325m.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions, and the implications with respect to the claims facing CMIG. As a result the ultimate financial effect, which could be significantly different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved.

Issue of subordinated debt

In June 2012 CMIG issued £250m subordinated debt to SWG. Further details of these financial instruments can be found in note 33.

Results and dividend

The result of the Group for the year ended 31 December 2012 is a profit before tax of £205m (2011: £391m). The result of the Group, excluding a charge for the amortisation of the acquired value of in-force intangible asset was £506m (2011: £566m). This charge relates principally to the acquisition of Clerical Medical Investment Group in July 2011.

The result reflects market conditions in the year, as well as the impact of items such as the taxation changes and German Insurance Business litigation mentioned above. The Directors consider the result for the year to be satisfactory in light of these factors.

During the year, no interim dividends (2011: £nil) were paid. The Directors recommend no payment of a dividend in respect of the year ended 31 December 2012.

Key performance indicators*New Business*

An analysis of the present value of new life business premiums for business is given below:

	2012 £ m	2011 £ m	Change %
Analysis by product			
Corporate pensions	5,427	4,423	23%
Individual pensions	1,580	1,480	7%
Retirement income	729	747	(2%)
Protection	554	729	(24%)
Investments	1,715	2,840	(40%)
Total	10,005	10,219⁽²⁾	(2%)
Analysis by channel			
Intermediary	7,053	6,415	10%
Bancassurance	2,325	3,216	(28%)
Direct	627	588	7%
Total	10,005	10,219⁽²⁾	(2%)
New Business Profit on an EEV⁽¹⁾ Basis	389	423⁽²⁾	(8%)
New Business Margin on an EEV⁽¹⁾ Basis	3.9%	4.1%	(0.2%)

Total sales (PVNBP) have decreased by 2% to £10,005m primarily reflecting lower investments and protection volumes partially offset by strong sales of corporate and individual pensions in LP&I UK. Sales of investment products and protection through the bancassurance channel have reduced due to subdued customer demand (reflecting the economic environment) and the withdrawal in the second half of 2012 from investment advice within the Retail business for customers with savings below £100,000.

DIRECTORS' REPORT (continued)

This lower bancassurance demand has similarly affected total new business profit on an EEV Basis decreasing by £34m. This has been partially offset by strong growth in the Intermediary channel, particularly in corporate pensions where sales were 23% higher than 2011 ahead of the introduction of RDR. This reflects the underlying strength of our proposition and the quality of service provided to customers. However, this change in business mix has resulted in a slight decrease in EEV new business margin which remains strong at 3.9%.

Initiatives such as MyMoneyWorks and our market leading auto enrolment engine, combined with a continuing focus on our strong relationships, ensure that we are well placed to take advantage of the changing market-place as a result of RDR. Individual pensions sales have increased by 3%, driven by sales of our flagship Retirement Account product.

The direct channel continues to perform well and is being developed for future growth. This channel will become even more important to our business with the introduction of RDR.

⁽¹⁾ The new business results of the life, pensions and investments business sold by the Insurance Division of LBG are also reported under the European Embedded Value basis. This basis complies with the principles adopted by the CFO Forum, except that it has been extended to cover Open Ended Investment Companies.

⁽²⁾ The above analysis includes sales for CMIG and its subsidiaries for the twelve months ended 31 December 2011, to enable comparison.

Funds under management

Funds under management relating to policyholder liabilities were £112.3bn (2011: £107.8bn), the movement reflecting net flows from policyholders and investment return for the period.

Capital Resources

The Directors believe that the Group and Company currently have adequate capital resources and will continue to do so in the foreseeable future. The regulatory surplus of the Group in excess of capital requirements is £3,904m (2011: £3,682m). The regulatory surplus attributable to the shareholder, excluding the regulatory surplus attributable to the with profits funds, is £3,737m (2011: £3,516m).

Further information on the capital position of the Company is given in note 40.

Other Sources

The Company also forms part of LBG's Insurance Division. The development, performance and position of the Insurance Division are presented within LBG's annual report, which does not form part of this report.

The Directors consider that the above are the key performance indicators which are appropriate to the principal activity of the Company. These, together with other metrics which cover customer, operational measures and capital, are included in the balanced scorecard which is used to measure all aspects of the performance of the business. In addition, the Directors are of the opinion that the information contained in the Company's Financial Services Authority ("FSA") returns on capital resources and requirements and regular actuarial reports, in conjunction with the information presented in the financial statements as a whole, provide the management information necessary for the Directors to understand the development, performance and position of the business of the Company. Along with fellow direct and indirect subsidiaries of the ultimate insurance parent undertaking, the Group is included in the calculation of the Scottish Widows Group capital surplus. This is calculated in accordance with the Insurance Groups Directive, and is reported in the LBG annual report.

Outlook

The Directors consider that the Group and Company's principal activities will continue unchanged in the foreseeable future.

Principal risks and uncertainties

The management of the business and the execution of the Company's and Group's strategy are subject to a number of risks. The financial risk management objectives and policies of the Company and Group and the exposure to market, insurance, credit, financial soundness, conduct, operational and political risk and uncertainties are set out in note 40.

In addition, the Company and Group are also exposed to financial and prudential regulatory reporting risk, in particular the risk of reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial reporting or over prudential regulatory reporting and financial reporting fraud. The financial and risk management objectives and policies of the Company and Group in respect of financial and prudential regulatory reporting risk are also set out in note 40.

DIRECTORS' REPORT (continued)

The Group, like other insurers, is subject to legal proceedings in the normal course of business. Whilst it is not practicable to forecast or determine the final results of all pending or threatened legal proceedings, management does not believe that such proceedings, including litigation, will have a material effect on the results and financial position of the Group except for the German insurance business litigation, for which a provision has been established, as discussed earlier in this report and set out in note 30.

Directors

The names of the current Directors are listed on page 3. Changes in directorships during the year and since the end of the year are as follows:

R J M Bulloch	(appointed 1 January, resigned 31 December 2012)
D J Walkden	(appointed 1 January 2012)
R Harris	(resigned 29 February 2012)
Lord A P Leitch	(resigned 29 February 2012)
Drs C A C M Schrauwers	(appointed 14 May 2012)
Lord Blackwell	(appointed 1 September 2012)
M A Fisher	(appointed 19 September 2012)
G N Stewart	(resigned 5 October 2012)
M G Culmer	(appointed 31 October 2012)
A M Parsons	(appointed 9 November 2012)

Particulars of the Directors' emoluments are set out in note 41.

All Directors have the benefit of a contract of indemnity, which is both a Qualifying Third Party Indemnity Provision and a Qualifying Pension Scheme Indemnity Provision. This was in force during the whole of the year. Directors no longer in office but who served on the Board at any time in the year had the benefit of this contract of indemnity during that period of service.

Disclosure of information to auditors

Each person who is a Director at the date of approval of this report confirms that, so far as the Director is aware, there is no relevant audit information of which the Company's auditors are unaware and each Director has taken all the steps that he ought to have taken as a Director in order to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information. This confirmation is given, and should be interpreted in accordance with, the provisions of the Companies Act 2006.

Employees

LBG is committed to providing employment practices and policies which recognise the diversity of the workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief. In the UK, LBG belongs to the major employer groups campaigning for equality for all staff, including Employers' Forum on Disability, Employers' Forum on Age and Stonewall. LBG is also represented on the Board of Race for Opportunity and the Equal Opportunities Commission. Involvement with these organisations enables LBG to identify and implement best practice for staff.

Employees are kept closely involved in major changes affecting them through such measures as team meetings, briefings, internal communications and opinion surveys. These meetings, briefings and internal communications also serve to achieve a common awareness of the financial and economic factors that affect the performance of the company. There are well established procedures, including regular meetings with recognised unions, to ensure that the views of employees are taken into account in reaching decisions. Schemes offering share options or the acquisition of shares are available for most staff, to encourage their financial involvement in LBG. Further details are set out in note 42.

Charitable and political contributions

During the year, the Group made contributions totalling £8,054 (2011: £8,023) for charitable purposes. These donations were made to a variety of children's and cancer charities. The Group made no political contributions (2011: £nil).

Policy and practice on payment of creditors

The Group follows the "Prompt Payment Code" published by the Department for Business Innovation and Skills ("BIS") regarding the making of payments to suppliers. A copy of the code and information about it may be obtained from the BIS website.

The Group's policy is to agree terms of payment with suppliers and these normally provide for settlement within 30 days after the date of the invoice, except where other arrangements have been negotiated. It is the policy of the Group to abide by agreed terms of payment, provided the supplier performs according to the terms of contract.

DIRECTORS' REPORT (continued)

The processing of invoices from suppliers and settlement of trade creditors is undertaken by Scottish Widows Services Limited ("SWS") within the Scottish Widows Group. As the Company owed no amounts to trade creditors at 31 December 2012 (2011: £nil), the number of days shown in this report, to comply with the provisions of the Companies Act 2006, is nil (2011: nil).

Statement of Directors' responsibilities

The Directors are responsible for preparing 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, the Directors have prepared the Group and Parent Company financial statements in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union. Under company law, the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and Company and of the profit or loss of the Group for that period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and accounting estimates that are reasonable and prudent;
- state whether applicable IFRSs as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis, unless it is inappropriate to presume that the Company will continue in business.

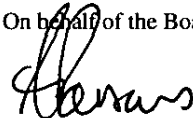
The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and the Group and enable them to ensure that the financial statements comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the Company's website www.scottishwidows.co.uk. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the Directors whose names are listed on page 3 confirms that, to the best of their knowledge:

- the Group and Company financial statements, which have been prepared in accordance with IFRSs as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and profit of the Group and Company; and
- the Directors' Report on pages 4 to 9 includes a fair review of the development and performance of the business and the position of the Group and Company, together with a description of the principal risks and uncertainties that it faces.

On behalf of the Board of Directors



A M Parsons
Director

21 March 2013

INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF SCOTTISH WIDOWS PLC

We have audited the Group and parent Company financial statements (the "financial statements") of Scottish Widows plc for the year ended 31 December 2012 which comprise the Consolidated Statement of Comprehensive Income, the Group and Company Balance Sheets, the Group and Company Statements of Cash Flows, the Group and Company Statements of Changes in Equity and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the parent Company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Respective responsibilities of directors and auditors

As explained more fully in the statement of Directors' responsibilities set out on page 9, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Directors' report and financial statements to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent Company's affairs as at 31 December 2012 and of the Group's profit and Group's and parent Company's cash flows for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

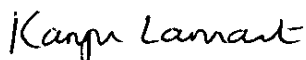
Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.



Karyn Lamont (Senior Statutory Auditor)
For and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Edinburgh, 21 March 2013

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2012

	Notes	2012 £ m	2011 £ m
		<u>Group</u>	<u>Group</u>
Revenue			
Gross earned premiums	3	6,705	5,413
Premiums ceded to reinsurers		(152)	(224)
Premiums net of reinsurance		6,553	5,189
Fee and commission income	4	404	378
Investment income	5	3,648	3,006
Net gains/(losses) on assets and liabilities at fair value through profit or loss	6	5,680	(2,276)
Other income	7	252	244
Total revenue		16,537	6,541
Expenses			
Gross claims and benefits paid		8,217	6,154
Claims recoveries from reinsurers		(146)	(74)
		8,071	6,080
Change in insurance contract and participating investment contract liabilities		3,639	(459)
Change in non-participating investment contract liabilities		(1,244)	(359)
Change in reinsurers' share of liabilities	19	2,956	68
Change in unallocated surplus	28	(48)	(366)
		5,303	(1,116)
Net loss/(profit) attributable to external interests in collective investment vehicles		1,046	(324)
Operating expenses	8	1,509	1,234
Expenses for asset management services received		234	139
Finance costs	11	169	137
		2,958	1,186
Total expenses		16,332	6,150
Profit before tax		205	391
Taxation charge	12	(573)	(109)
(Loss)/Profit for the year		(368)	282
Other comprehensive income			
Movement in net investment hedges, net of tax		1	(3)
Currency translation differences		(1)	3
		-	-
Total comprehensive (loss)/income for the year		(368)	282
Total comprehensive (loss)/income for the year attributable to :			
- equity holder of the Company		(368)	282
		(368)	282

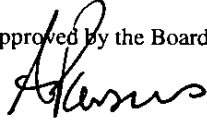
The notes set out on pages 15 to 94 are an integral part of these financial statements.

BALANCE SHEETS AS AT 31 DECEMBER 2012

	Notes	2012		2011	
		£ m	£ m	£ m	£ m
		<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
ASSETS					
Retirement benefit surplus	31	133	-	115	-
Intangible assets including insurance intangible assets	13	2,305	-	2,633	-
Deferred costs	14	1,197	403	1,072	450
Deferred tax assets	15	366	611	485	716
Investment in subsidiaries	16	-	11,942	-	8,046
Property and equipment	17	90	18	100	19
Investment properties	18	4,096	1,188	4,397	1,402
Assets arising from reinsurance contracts held	19	7,147	38,415	4,720	33,017
Current tax receivables	15	277	38	238	20
Prepayments and accrued income	20	155	28	281	30
Financial assets:					
Derivative financial instruments	21	1,335	331	1,390	225
Loans and receivables	22	20,687	2,536	19,077	1,180
Investments at fair value through profit or loss	23	91,828	11,281	89,925	16,680
Cash at bank	24	1,029	46	989	48
Total assets		130,645	66,837	125,422	61,833
EQUITY AND LIABILITIES					
Capital and reserves attributable to Group's equity shareholder					
Share capital	25	1,470	1,470	1,470	1,470
Other reserves	26	1,254	1,254	1,254	1,254
Retained earnings		3,197	1,334	3,565	1,646
Total equity		5,921	4,058	6,289	4,370
Liabilities					
Insurance contract and participating investment contract liabilities	27	73,511	43,886	69,718	38,896
Unallocated surplus	28	250	193	298	239
		73,761	44,079	70,016	39,135
Future profits on non-participating business in the With Profits Funds	29	(196)	(196)	(45)	(45)
Retirement benefit obligations	31	27	-	27	-
Deferred tax liabilities	15	1,307	548	968	187
Current tax payables	15	212	-	163	-
Provisions for other liabilities and charges	30	289	-	172	-
Accruals and deferred income	32	337	1,510	251	1,355
Financial liabilities:					
Subordinated debt	33	2,159	1,416	1,875	1,424
Non-participating investment contract liabilities	34	26,406	13,967	26,374	13,686
Derivative financial instruments	21	1,273	746	1,162	628
Other financial liabilities	35	1,908	705	2,235	1,089
External interests in collective investment vehicles		17,220	-	15,928	-
Borrowings	36	21	4	7	4
Total liabilities		124,724	62,779	119,133	57,463
Total liabilities and equity		130,645	66,837	125,422	61,833

The notes set out on pages 15 to 94 are an integral part of these financial statements.

Approved by the Board on 21 March 2013.


A M Parsons
Director

STATEMENTS OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2012

	Notes	2012		2011	
		£ m	£ m	£ m	£ m
		<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Cash flows from operating activities					
Profit before tax		205	181	391	257
Adjusted for:					
Depreciation of property and equipment	17	10	1	9	1
Amortisation of intangible assets	13	333	-	200	-
Finance costs	11	169	81	137	99
Dividends received					
Net decrease/(increase) in operating assets and liabilities	37	(1,813)	(139)	15,820	765
Taxation paid		(108)	(45)	(63)	8
Net cash flows from operating activities		(1,204)	79	16,494	1,130
Cash flows from investing activities					
Acquisition of subsidiary		-	-	(772)	(1,846)
Purchase of property and equipment	17	-	-	(6)	-
Additions to intangible assets	13	(5)	-	(63)	-
Net cash flows from investing activities		(5)	-	(841)	(1,846)
Cash flows from financing activities					
Proceeds from issue of share capital		-	-	821	821
Proceeds from issue of subordinated debt	33	250	-	-	-
Dividends paid	38	-	-	-	-
Finance costs paid		(169)	(81)	(137)	(99)
Net cash flows from financing activities		81	(81)	684	722
Net (decrease)/increase in cash and cash equivalents		(1,128)	(2)	16,337	6
Cash and cash equivalents at the beginning of the year		16,831	44	494	38
Net cash and cash equivalents at the end of the year	24	15,703	42	16,831	44

The notes set out on pages 15 to 94 are an integral part of these financial statements.

STATEMENTS OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2012

Group

	Issued share capital £ m	Retained earnings £ m	Other reserves £ m	Total attributable to owner of the parent £ m
Balance as at 1 January 2011	649	1,663	1,254	3,566
Increase in ordinary share capital	821	-	-	821
Comprehensive income				
Profit for the year	-	282	-	282
Other comprehensive income				
Movement in net investment hedges, net of tax	-	(3)	-	(3)
Currency translation	-	3	-	3
Other movements	-	1,620	-	1,620
Balance as at 31 December 2011	1,470	3,565	1,254	6,289
Comprehensive income				
Loss for the year	-	(368)	-	(368)
Other comprehensive income				
Movement in net investment hedges, net of tax	-	1	-	1
Currency translation	-	(1)	-	(1)
Balance as at 31 December 2012	1,470	3,197	1,254	5,921

Company

	Issued share capital £ m	Retained earnings £ m	Other reserves £ m	Total attributable to owner of the parent £ m
Balance at 1 January 2011	649	1,350	1,254	3,253
Increase in ordinary share capital	821	-	-	821
Comprehensive income				
Profit for the year	-	296	-	296
Balance as at 31 December 2011	1,470	1,646	1,254	4,370
Comprehensive income				
Loss for the year	-	(312)	-	(312)
Balance as at 31 December 2012	1,470	1,334	1,254	4,058

Not all of the above amounts can be distributed to the equity holder since the Company is required to meet regulatory capital requirements. Further details are given in note 40.

The notes set out on pages 15 to 94 are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies

The accounting policies adopted in the preparation of the financial statements, which have been consistently applied to all periods presented in these financial statements unless stated otherwise, are set out below.

(a) Basis of preparation

The financial statements of the Group and Company have been prepared:

- (1) in accordance with the International Accounting Standards ("IASs") and IFRSs issued by the International Accounting Standards Board and the Standards and Interpretations ("SICs") and International Financial Reporting Interpretations ("IFRICs") issued by its IFRS Interpretations Committee, as endorsed by the European Union;
- (2) in accordance with those parts of the Companies Act 2006 applicable to companies reporting under IFRSs;
- (3) in respect of the Group's and Company's With Profits Fund liabilities, in accordance with Financial Reporting Standard ("FRS") 27 "Life Assurance" issued by the United Kingdom Accounting Standards Board; and
- (4) under the historical cost convention, as modified by the revaluation of investment properties and certain financial assets and financial liabilities at fair value through profit or loss, as set out in the relevant accounting policies.

The Directors are satisfied that the Group and Company have adequate resources to continue in business for the foreseeable future. Accordingly, the financial statements of the Group and Company have been prepared on a going concern basis.

In accordance with IAS 1 "Presentation of Financial Statements", assets and liabilities in the balance sheet are presented in accordance with management's estimated order of liquidity. Analysis of the assets and liabilities of the Group and Company into amounts expected to be received or settled within 12 months after the reporting date (current) and more than 12 months after the reporting date (non-current) is presented in the notes.

The Group has taken advantage of the provisions of section 408 of the Companies Act 2006 and has not disclosed a statement of comprehensive income and related notes in respect of the Company.

Standards and interpretations effective in 2012

A number of standards, amendments to and interpretations of published standards which have the potential to impact on the Group's financial statements have been issued and are mandatory for accounting periods beginning on or after 1 January 2012. Their relevance to the Group's financial statements is assessed at note 45.

Details of standards and interpretations in issue but which have not been adopted early are set out at note 46.

(b) Basis of consolidation

The assets, liabilities and results of Group undertakings (including special purpose entities) are included in the financial statements on the basis of financial statements made up to the reporting date. Group undertakings include all entities over which the Group has the ability to control the financial and operating policies, which is generally where the Group has a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity.

Collective investment vehicles are consolidated where the Group, partly through its long term funds, has a controlling interest, which is generally where the Group manages the fund and also has a majority beneficial interest. Where collective investment vehicles are consolidated the interest of parties other than the Group are reported within liabilities as external interests in collective investment vehicles.

Group undertakings are fully consolidated from the date on which the ability to exercise control is transferred to the Group and cease to be consolidated from the date on which the ability to exercise control ceases.

Intragroup transactions, balances and gains and losses on transactions between Group companies have been eliminated.

All the financial statements included are uniformly prepared in conformity with IFRSs and the Group's accounting policies and have adopted consistent accounting policies as at 31 December 2012.

Non-controlling interests in the net assets of consolidated subsidiaries (other than non-controlling interests in collective investment vehicles, which are presented as liabilities) are identified separately from the Group's equity. A non-controlling interest in a subsidiary consists of the amount of that interest at the date of the original business combination and the non-controlling interest share of changes in equity since that date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

Losses applicable to the non-controlling interest share in the subsidiary's equity are allocated against the interests of the Group once all non-controlling interest in previous positive changes in equity has been extinguished, except to the extent that the non-controlling party has a binding obligation and is able to make additional investment to cover the losses.

(c) Product classification

The Group issues contracts that transfer insurance risk or financial risk or both.

Insurance contracts

Insurance contracts are those contracts which transfer significant insurance risk. Such contracts may also transfer financial risk. As a general guideline, the Group defines as significant insurance risk the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. Once a contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly over time.

Investment contracts

Any long term contracts not considered to be insurance contracts under IFRSs because they do not transfer significant insurance risk are classified as investment contracts. Such contracts are further analysed between those with and without a discretionary participation feature ("DPF"). Contracts containing a DPF are referred to as participating investment contracts and those without a DPF as non-participating investment contracts.

A DPF is a contractual right that gives investors the right to receive, as a supplement to guaranteed benefits, additional discretionary benefits or bonuses that are likely to be a significant portion of the total contractual benefits, through participation in the surplus arising from the assets held in the fund. The Group has the discretion within the constraints of the terms and conditions of the contract to allocate part of this surplus to the policyholders and part to the Group's shareholder. Participating investment contracts are accounted for in the same manner as insurance contracts in accordance with the requirements of IFRS 4 "Insurance Contracts".

Non-participating investment contracts are contracts that neither transfer significant insurance risk nor contain a DPF.

Hybrid contracts

For certain investment contracts within Scottish Widows heritage, the contract can be partly invested in units which contain a DPF and partly in units without. Where switching levels for similar contracts are deemed to be significant, new investment contracts which contain an option to switch into investment contracts with DPF have been classified as participating investment contracts. Where the switching levels are not deemed to be significant, a new contract is split, with units containing a DPF being allocated as a participating investment contract and the units without a DPF as a non-participating investment contract. Investment contracts which were in force when IFRS was implemented in 2005 were classified according to the switching levels observed at the time and retain their original classification.

For certain investment contracts within Clerical Medical heritage, the contract can be partly invested in units which contain a participating feature and partly without. Where the contract is split, part is allocated as a non-participating investment contract and part as a participating investment contract.

(d) Financial assets and financial liabilities

Management determines the classification of its financial assets and financial liabilities at initial recognition. Management's policies for the recognition of specific financial assets and financial liabilities, as identified on the balance sheet, are set out under the relevant accounting policies.

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all of the risks and rewards of ownership. Financial liabilities are derecognised only when the obligation specified in the contract is discharged, cancelled or expires.

All financial assets and financial liabilities are designated at fair value through profit or loss, with the exception of certain loans and receivables, subordinated liabilities, borrowings and other financial liabilities which are stated at amortised cost (as described in policies (q), (z), (ae) and (ac) respectively) and derivatives (policy p). The classification depends on the purpose for which the financial assets and financial liabilities were acquired.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

Certain financial assets and financial liabilities, whose default accounting treatment would be to record these balances at amortised cost, are instead designated at fair value through profit or loss as they are held to match insurance and investment contract liabilities linked to the changes in fair value of these assets and liabilities, thereby reducing measurement inconsistencies, and reflecting the fact that these are managed and their performance evaluated on a fair value basis. Information on these balances is provided internally on a fair value basis to the Group's key management. The Group's investment strategy is to invest in equity and debt securities, loans, investment property, derivatives and cash and to evaluate the Group's investments with reference to their fair values.

Fair value methodology

All financial instruments carried at fair value are categorised into a "fair value hierarchy" as follows:

(i) Level 1

Valued using quoted prices (unadjusted) in active markets for identical assets and liabilities to those being valued. An active market is one in which similar arm's length transactions in the instrument occur with both sufficient frequency and volume to provide pricing information on an ongoing basis. Examples include listed equities, listed debt securities, Open Ended Investment Companies ("OEICs") and unit trusts traded in active markets and exchange traded derivatives such as futures.

(ii) Level 2

Valued using inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices). If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

- Quoted prices for similar (but not identical) instruments in active markets;
- Quoted prices for identical or similar instruments in markets that are not active, where prices are not current, or price quotations vary substantially either over time or among market makers;
- Inputs other than quoted prices that are observable for the instrument (for example, interest rates and yield curves observable at commonly quoted intervals and default rates);
- Inputs that are derived principally from, or corroborated by, observable market data by correlation or other means.

Examples of these are securities measured using discounted cash flow models based on market observable swap yields, and listed debt or equity securities in a market that is inactive.

(iii) Level 3

Valued using inputs for the asset or liability that are not based on observable market data (unobservable inputs). Unobservable inputs may have been used to measure fair value where observable inputs are not available. This approach allows for situations in which there is little, if any, market activity for the asset or liability at the measurement date (or market information for the inputs to any valuation models). Unobservable inputs reflect the assumptions the Group considers that market participants would use in pricing the asset or liability, for example private equity investments held by the Group and Company.

Where estimates are used, these are based on a combination of independent third-party evidence and internally developed models, calibrated to market observable data where possible.

Further analysis of the Group's and Company's instruments held at fair value is set out at note 40.

The Group's management, through a fair value pricing committee, review information on the fair value of the Group's financial assets and financial liabilities and the sensitivities to these values on a regular basis.

No assets are classified as held-to-maturity or available-for-sale. Derivative assets (other than a derivative which is a designated and effective hedging instrument) are classified as held for trading. With the exception of derivative liabilities, no liabilities are classified as held for trading. Further information on derivatives is set out at policy (p).

Transaction costs incidental to the acquisition of a financial asset are expensed through the statement of comprehensive income, within net gains and losses on assets and liabilities at fair value through profit or loss.

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet only when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

(e) Revenue recognition

Premium income

Premiums received in respect of life insurance contracts and participating investment contracts are recognised as revenue when they become payable by the policyholder and are shown before deduction of commission. Premiums ceded to reinsurers are recognised when the related gross premiums are recognised. Gross and ceded premiums are recorded through the relevant lines in the statement of comprehensive income.

Fee and commission income

The Group receives ongoing investment management fees which are recognised as revenue as the services are provided.

The Group also receives initial investment management fees in the form of an adjustment, or charge, to the amount invested. These fees are in respect of services rendered in conjunction with the issue and management of investment contracts where the Group actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the contract. These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Group defers these fees and recognises them on a straight-line basis over the estimated lives of the contracts unless there is evidence to support an alternative recognition basis. Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned. The income is recognised through the statement of comprehensive income, within fee and commission income. The liability is recognised in the balance sheet within accruals and deferred income until recognition criteria are met.

Net gains and losses on assets and liabilities at fair value through profit or loss

Net gains and losses on assets and liabilities at fair value through profit or loss includes both realised and unrealised gains and losses. Movements are recognised in the statement of comprehensive income in the period in which they arise.

Investment income

Interest income for all interest-bearing financial instruments is recognised in the statement of comprehensive income as it accrues, within investment income.

Dividends receivable in respect of listed shares and collective investment vehicles are recognised on the date that these are quoted ex-dividend; other dividend income is recognised when received. All dividends received are recognised through the statement of comprehensive income, within investment income.

Rental income in respect of investment properties is recognised on a straight line basis over the term of the lease. The cost of incentives are recognised as a reduction of total income over the term of the lease on a straight line basis.

Other income

Other income recognised in the statement of comprehensive income comprises recharges of costs incurred in respect of several LBG subsidiaries which are not consolidated in these financial statements. Income is recognised as the related expenses are incurred.

(f) Expense recognition

Claims

Claims are recorded as an expense on the earlier of the maturity date or the date on which the claim is notified. Claims recoveries from reinsurers are recognised when the related claims are recognised. Claims and claims recoveries are recognised through the relevant lines in the statement of comprehensive income. Claims handling costs and interest on late claims are also included in claims.

Operating expenses

Commission paid in respect of the business written by the Group is recognised through the statement of comprehensive income, within operating expenses. Where certain criteria are met, commission and other acquisition costs may be deferred. The circumstances under which such costs are deferred are set out at policy (j).

Other operating expenses are recognised in the statement of comprehensive income as incurred, within operating expenses.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)**Expenses for asset management services received**

Expenses for asset management services received are recognised in the statement of comprehensive income as they accrue, within expenses for asset management services received.

Finance costs

Interest expense for all interest-bearing financial instruments is recognised in the statement of comprehensive income as it accrues, within finance costs.

(g) Leases

Assets leased to or from third parties, including properties leased to tenants, are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee; all other leases are classified as operating leases. Operating lease rental income and expenditure are recognised on a straight-line basis over the life of the leases through the statement of comprehensive income, within investment income and operating expenses respectively.

Properties leased out to tenants under operating leases are included in investment properties in the balance sheet.

(h) Share-based payments

LBG operates a number of equity-settled, share-based compensation plans in respect of services received from certain of the Group's employees. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments. This expense is determined by LBG by reference to the fair value of the number of equity instruments that are expected to vest, and the appropriate proportion is recharged to, and recognised as an expense by, the Group. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each reporting date, this estimate is reassessed and, if necessary, revised. Any revision of the original estimate is recognised in the statement of comprehensive income over the remaining vesting period, within operating expenses. Cancellations by employees of contributions to LBG's Save As You Earn plans are treated as non-vesting conditions and in accordance with IFRS 2 (Revised) the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental changes are charged to the income statement over any remaining vesting period.

(i) Intangible assets including insurance intangible assets**(i) Acquired value of in-force business**

Insurance and investment contracts acquired in business combinations are measured at fair value at the time of acquisition. This measurement includes the recognition of an acquired value of in-force ("acquired VIF") asset which reflects the present value of future cash flows expected from the business acquired. The asset is shown gross of attributable tax and a corresponding deferred tax liability has been established. Amortisation of the acquired VIF balance and related tax is carried out on a best estimate basis over the estimated life of the contracts. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the acquired VIF balance is tested for impairment at each reporting date. Such an asset is not recognised in respect of future profits on contracts written in the normal course of business.

(ii) Software development costs

Costs that are directly associated with the production of identifiable and unique software products controlled by the Group, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets, subject to de minimis limits. Direct costs include the software development team's employee costs and an appropriate portion of relevant overheads. All other costs associated with developing or maintaining computer software programmes are recognised through the statement of comprehensive income as an expense as incurred, within operating expenses.

Computer software development costs recognised as assets are amortised using the straight-line method over their expected useful lives, not exceeding a period of five years. Subsequent expenditure is only capitalised when it increases the expected future economic benefits of the specific asset to which it relates.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

The amortisation charge for the year in respect of software licences and software development costs is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the assets is tested for impairment at each reporting date. Further information on the Group's impairment policy is set out at policy (t).

(j) Deferred costs**(i) Deferred acquisition costs**

The costs of acquiring new insurance contracts and participating investment contracts (excluding those assessed on a realistic basis in accordance with FRS 27), which are incurred during a financial period but which relate to subsequent financial periods, are deferred to the extent that they are recoverable out of future revenue margins. The deferred acquisition cost asset is amortised over the lifetime of the related contracts based on the pattern of margins arising from these contracts unless there is evidence to support an alternative recognition basis. Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the asset is tested for impairment at each reporting date. Further information on the Group's impairment policy is set out at policy (t).

(ii) Deferred origination costs

Costs which are directly attributable and incremental to securing new non-participating investment contracts are capitalised. This asset is subsequently amortised over the estimated contractual lifetime of each policy on a straight-line basis unless there is evidence to support an alternative recognition basis. Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the asset is tested for impairment at each reporting date. Further information on the Group's impairment policy is set out at policy (t).

(k) Investment in subsidiaries

The Company owns a number of subsidiaries as set out in note 16. Certain subsidiaries do not form part of actively managed investment portfolios and the risks and rewards of owning those subsidiaries primarily rest with the shareholder of the Company, including such investments where ownership of the subsidiary is split between the Company's long-term fund and its shareholder fund. These subsidiaries are held initially at cost, being the fair value of the consideration given to acquire the holding, then subsequently at cost subject to impairment. Further information on the Group's impairment policy is set out at policy (t).

Certain subsidiaries, including holdings in collective investment vehicles, are held primarily as vehicles through which specific investments are held as part of the actively managed investment portfolios. These subsidiaries hold assets which are designated at fair value through profit or loss in accordance with IAS 39 "Financial Instruments: Recognition and Measurement" and primarily match policyholder liabilities. Accordingly, subsidiaries which are managed as part of policyholder investment funds are carried at fair value and changes in their fair value are reflected in the statement of comprehensive income, within net gains and losses on assets and liabilities at fair value through profit or loss.

(l) Property and equipment

All property (other than investment property) and equipment is stated at cost less accumulated depreciation and any impairment in value. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for its intended use. Subsequent costs are included in an asset's carrying value only when it is probable that future economic benefits related to the asset will flow to the Group and such costs can be measured reliably.

Depreciation of property and equipment is calculated on a straight-line basis to allocate the difference between the cost and the estimated residual value over the estimated useful lives of these assets. The depreciation charge is recognised through the statement of comprehensive income, within operating expenses.

The periods generally applicable are:

• Buildings	40 years
• Fixtures and fittings	15 years
• Furnishings	10 years
• Computer equipment	3 years
• Other equipment	5 years

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

Land is considered to have an indefinite useful life and is therefore not depreciated.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each reporting date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than the recoverable amount, it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

(m) Investment properties

Investment properties comprise freehold and long leasehold land and buildings, which are held either to earn rental income or for capital appreciation, or both, are initially measured at cost, being the fair value of the consideration given, including directly attributable transaction costs. Subsequently, on a periodic basis and at each reporting date, such properties are carried at fair value as assessed by qualified external appraisers who have recent experience in the relevant location and the category of properties being valued. Fair value is based on active market prices, adjusted, if necessary, for any difference in the nature, location or condition of the specific asset. If this information is not available, alternative valuation methods such as discounted cash flow analysis or recent prices in less active markets are used. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value.

Gains or losses arising from changes in the fair values of investment properties are recognised in the statement of comprehensive income in the period in which they arise, within net gains and losses on assets and liabilities at fair value through profit or loss.

(n) Reinsurance

The Group cedes reinsurance in the normal course of business. Where the reinsurance contract transfers significant insurance risk to the reinsurer, the assets arising from reinsurance contracts held are classified as insurance contracts. Where the reinsurance contract does not transfer significant insurance risk to the reinsurer for the assets arising from reinsurance contracts held are classified as a financial asset designated as fair value through profit or loss.

Assets arising from reinsurance contracts held – classified as insurance contracts

These assets are recognised within assets arising from reinsurance contracts held. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the underlying contracts and in accordance with the terms of each reinsurance contract. These balances are subject to an annual impairment review. Further information on the Group's impairment policy is set out at policy (t).

Premiums ceded and claims reimbursed are recognised when due and disclosed separately on the face of the statement of comprehensive income. Changes in these assets are recognised on the face of the statement of comprehensive income, through change in assets arising from reinsurance contracts held.

Assets arising from reinsurance contracts held – at fair value through profit or loss

Amounts due from reinsurers in respect of contracts that do not transfer significant insurance risk to the reinsurer are designated as fair value through profit or loss as this ensures consistency of valuation with the underlying liabilities. These contracts, whilst legally reinsurance contracts, do not meet the definition of a reinsurance contract under IFRSs. Where this is the case, the amounts recoverable have been recognised as a financial asset within assets arising from reinsurance contracts held. Changes in these assets are recognised on the face of the statement of comprehensive income, through change in assets arising from reinsurance contracts held. These balances are subject to an annual impairment review. Further information on the Group's impairment policy is set out at policy (t).

(o) Investment in joint ventures and associates

Joint ventures are entities where the Group has joint control with another party. Associates are entities where the Group has significant influence, but not control or joint control, over the financial and operating policies. Joint ventures and associates that are held within investment linked insurance funds of the Group are designated at fair value through profit or loss in accordance with IAS 39. Accordingly, the measurement requirements of IAS 31 "Interests in Joint Ventures" and IAS 28 "Interests in Associates" do not apply and these investments are recognised within investments at fair value through profit or loss. Changes in the fair value of the investments are recognised in the statement of comprehensive income, within net gains and losses on assets and liabilities at fair value through profit or loss.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

(p) Derivative financial instruments

Classification

Derivative financial instruments, including embedded derivatives, are held for trading, with the exception of derivatives which are designated as effective hedging instruments, which are held at fair value through profit or loss. Derivatives held for trading are used for the purposes of efficient portfolio management or to match contractual liabilities.

Recognition

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently re-measured at their fair value.

Measurement

The best evidence of the fair value of a derivative at initial recognition is the transaction price unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument.

Fair values are obtained from quoted market prices in active markets, including recent market transactions. For over-the-counter ("OTC") derivatives, the value is derived from a hierarchy of valuation sources, as follows:

- primary source – an independent valuation source
- secondary source – generally, this would be the counterparty valuation
- tertiary source – generally, this would be the fund manager valuation

Data from a primary source will initially be used in valuing derivatives. However, tolerance checks are also performed between valuations derived from different sources in order to validate the calculated valuations, detect any potential discrepancies and, if appropriate, select a secondary or tertiary price for use in the valuation instead. If, as a result of this process, the primary, secondary and tertiary values for an instrument are not within tolerance then the valuation is referred to the relevant authority within Insurance Finance to agree a final pricing decision.

For exchange traded contracts, the value is based on the quoted bid price at close of business where the contract is an asset held or liability to be issued. Where the contract is an asset to be acquired or liability held, the value is based on the quoted ask price at close of business.

Changes in the fair value of derivatives are recognised in the statement of comprehensive income, through net gains and losses on assets and liabilities at fair value through profit or loss.

Hedge accounting

In limited circumstances, derivatives are designated as fair value hedges. Hedge accounting allows one instrument, generally a derivative such as a swap, to be designated as a hedge of another instrument such as a loan.

Derivatives may only be designated as hedging instruments provided certain strict criteria are met. At the inception of a hedge, its terms must be clearly documented and there must be an expectation that the derivative will be highly effective in offsetting changes in the fair value of the hedged risk. The hedge documentation must also specify the methodology that will be used to measure effectiveness. Changes in the fair value of derivatives that are designated as fair value hedges are recorded in the statement of comprehensive income, through net gains and losses on assets and liabilities at fair value through profit or loss, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

The effectiveness of the hedging relationship must be tested throughout its life. A hedge is regarded as highly effective if the change in fair value of the hedge instrument and the hedge item are negatively correlated within a range of 80% to 125%, either for the period since effectiveness was last tested or for the period since inception. Where the hedge is highly effective, the net impact on the statement of comprehensive income is minimised. If, at a reporting date, it is concluded that the hedge is no longer highly effective in achieving its objective, the hedge relationship is terminated. Should this happen, changes in the fair value of the hedged item are no longer recognised in the statement of comprehensive income and the adjustment that has been made to the carrying amount of the hedged item is amortised to the statement of comprehensive income over the period to maturity of the hedged item.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the statement of comprehensive income, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the statement of comprehensive income. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the statement of comprehensive income using the effective interest method over the period to maturity.

Changes in the fair value of derivatives that qualify as a net investment hedge on foreign operations are taken to other comprehensive income when the hedge is deemed to be effective. The ineffective portion of any net investment hedge is recognised in the statement of comprehensive income immediately.

The fair values of derivative instruments used for hedging purposes are disclosed in note 21.

All derivatives are presented as assets when their fair value is positive and as liabilities when their fair value is negative.

(q) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and that are not designated as fair value through profit or loss at initial recognition.

Loans and receivables are initially recognised at fair value less directly attributable transaction costs and subsequently measured at amortised cost, subject to impairment. With the exception of certain long-term loans made to related parties, in practice the carrying value of these balances equates to the fair value due to the short-term nature of the amounts included within loans and receivables.

A charge for impairment in respect of loans and receivables would be made in the statement of comprehensive income when there is objective evidence that the Group will not be able to collect all amounts due according to their original terms. The impairment charge would be recognised through operating expenses in that part of the statement of comprehensive income. Receivables arising from insurance contracts are also classified in this category and are reviewed for impairment as part of the impairment review of loans and receivables. Such amounts are reflected through the statement of comprehensive income, within gross premiums written and claims recoveries from reinsurers. Further information on the Group's impairment policy is set out at policy (t).

(r) Investments at fair value through profit or loss

Investments at fair value through profit or loss comprise debt and equity securities and loans.

Classification

A financial asset is classified in this category at inception if acquired principally for the purpose of selling in the short-term, if it forms part of a portfolio of financial assets in which there is evidence of short-term profit-taking, or if designated as such.

Recognition

Purchases and sales of financial assets are recognised on the trade date, i.e. the date the Group commits to purchase the asset from, or deliver the asset to, the counterparty. Investments are initially recognised at cost, being the fair value of the consideration given, and are subsequently remeasured at fair value.

Measurement

The fair values of investments are based on current bid prices. If the market for a financial asset is not active, and also for unlisted securities, the Group establishes fair value by using valuation techniques. These include the use of similar arm's length transactions and reference to other instruments that are substantially the same, making maximum use of market inputs and relying as little as possible on entity-specific inputs.

For equity investments that are quoted and actively traded in organised financial markets, fair value is determined by reference to Stock Exchange quoted market bid prices at the final pricing point on the reporting date. Prices are provided by vendors such as Reuters or Bloomberg or by direct reference to the Stock Exchange.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

For quoted debt security investments, bid prices at the final pricing point on the reporting date are obtained from index providers who obtain prices from a number of leading brokers, investment banks and market makers. Where no independent price is available, a valuation technique is used to determine fair value. The technique uses a spread over a comparable term gilt as the best estimate of fair value. Spreads are calculated by reference to the wider market movement in credit spreads, the way in which the security is structured, other assets issued by the issuer or other assets with similar characteristics.

For corporate bonds, the Group's management perform a comparison of information received from the index provider used against other available price sources on a monthly basis to ensure that prices can be supported by market data.

The fair value of holdings in collective investment vehicles (including OEICs and Unit Trusts) is determined as the last published price applicable to the vehicle at the reporting date.

In addition to the measurement policies, investment asset prices are reviewed weekly to identify those assets where the price has not moved for at least six days. This review provides an initial indication that the market for each identified asset may be inactive. These assets are then reviewed by management who may identify an alternative price source for assets which in their view are still actively traded. On conclusion that a particular asset is illiquid, management will identify an alternative valuation technique by deciding whether an appropriate price can be obtained from a recognised independent broker. Where this is the case, the broker will be approved as a price source for the asset. A price will then be obtained from the broker on a monthly basis. A review of all illiquid assets and prices obtained or calculated is conducted by the Fair Value Pricing Committee on a monthly basis.

For equity investments such as private equity, fair value is determined by reference to the most recent valuation, adjusted for any cash movements or other relevant information since the last valuation point, which is likely to be up to one quarter prior to the reporting date.

In order to ensure that a fair value is recognised for unquoted or illiquid debt securities, the primary price source is an external broker valuation. If available, a further external broker valuation is sought as a secondary valuation source in order to validate the primary source. A formal review is then carried out which challenges the external valuation and includes consideration of the impact of any relevant movements in underlying variables such as:

- underlying movements in the relevant markets, for example credit spreads;
- how current transactions are being priced in the market;
- how the security is structured; and
- any supporting quantitative analysis as appropriate, for example with reference to Bloomberg or internal models.

Property investments through special purpose vehicles

The Group invests in a number of investment properties through holdings in special purpose vehicles ("SPVs"). Some of these SPVs are consolidated. Unconsolidated SPVs are initially recognised at cost, being the fair value of the consideration given. After initial recognition, such assets are accounted for and measured at fair value, which equates to the relevant proportion of the published net asset value of the company. This valuation is based on open market valuations of the properties held by the SPVs, as provided at the reporting date by independent valuers.

(s) Cash and cash equivalents

Cash and cash equivalents includes cash at bank, short-term highly liquid investments with original maturities of three months or less (excluding such investments as otherwise meet this definition but which are held for investment purposes rather than for the purposes of meeting short-term cash commitments) and bank overdrafts where a legal right of set off exists.

(t) Impairment**Financial assets**

The carrying value of all financial assets held at amortised cost is reviewed for impairment whenever events or circumstances indicate that the carrying amount may not be recoverable. The identification of impairment and the determination of recoverable amounts is an inherently uncertain process involving various assumptions and factors, including the financial condition of the counterparty, expected future cash flows, observable fair prices and expected net selling prices. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its estimated recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

Non-financial assets

Assets that have an indefinite useful life, for example land, are not subject to depreciation or amortisation and are tested annually for impairment. Assets that are subject to amortisation 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 estimated recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows.

If there is objective evidence that an impairment loss has occurred, the amount of the loss is charged to the relevant line in the statement of comprehensive income in the period in which it occurs. Non-financial assets other than goodwill that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date.

Impairment process

Objective evidence that an asset or group of assets is impaired includes observable data that comes to the attention of the Group and Company about the following events:

- (i) significant financial difficulty of the issuer or debtor;
- (ii) a breach of contract;
- (iii) the disappearance of an active market for that asset because of financial difficulties; or
- (iv) observable data indicating that there is a measurable decrease in the estimated future cash flow from a group of assets since the initial recognition of those assets, even where the decrease cannot yet be identified with the individual assets of the Group or Company, including:
 - adverse changes in the payment status of issuers or debtors; or
 - national or local economic conditions that correlate with defaults on the assets in the Group or Company.

The Group first assesses whether objective evidence of impairment exists individually for assets that are individually significant. If the Group determines that no objective evidence of impairment exists for an individually assessed asset, whether significant or not, it includes the asset in a group of assets with similar credit risk characteristics and collectively assesses them for impairment. Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the issuer's ability to pay all amounts due under the contractual terms of the debt instrument being evaluated. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

(u) Taxes

Tax on the profit or loss for the year is recognised in the statement of comprehensive income within taxation and comprises current and deferred tax.

Current tax

Current tax is the expected tax payable on the taxable income for the period, using tax rates and legislation enacted or substantively enacted at the reporting date, together with adjustments to estimates made in prior years.

Deferred income tax

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes at the reporting date. However, if the deferred income tax arises from initial recognition of an asset or liability in a transaction other than a business combination that, at the time of the transaction affects neither accounting nor taxable profit or loss, it is not accounted for. 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 and legislation enacted or substantively enacted at the reporting date.

Deferred income tax assets are only recognised to the extent that it is probable that future taxable profits will be available against which the temporary differences, carry-forward of unused tax assets and unused tax losses can be utilised.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

The carrying amount of deferred income tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the deferred income tax asset to be utilised. Deferred tax assets and liabilities held outwith the policyholder liabilities are undiscounted.

Allocation of tax charge between shareholder and policyholders

The tax expense in the statement of comprehensive income is analysed between policyholder and shareholder tax. This allocation is based on an assessment of the rates of tax which will be applied to the returns under current UK tax rules.

(v) Share capital

Shares are classified as equity when there is no obligation to transfer cash or other assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

Dividends payable

Dividends payable on ordinary shares are recognised in equity in the period in which they are approved.

(w) Insurance contracts and participating investment contracts

The Group issues life insurance contracts to protect customers from the consequences of events (such as death, critical illness or disability) that would affect the ability of the customer or their dependants to maintain their current level of income and also issues pension and annuity contracts. Guaranteed claims paid on occurrence of the specified insured event are either fixed or linked to the extent of the economic loss suffered by the policyholder.

Insurance contracts or participating investment contracts in the Group's With Profits Funds

Liabilities of the Group's With Profits Funds, including guarantees and options embedded within products written by the funds, are accounted for under the realistic method in accordance with the requirements of FRS 27. However, in contrast to the approach used for the FSA's realistic capital regime, projected transfers out of the funds into other funds of the Group are not treated as insurance liabilities, but are recorded in unallocated surplus. Changes in the value of these liabilities are recognised in the statement of comprehensive income, through change in insurance contract and participating investment contract liabilities.

Liabilities for non-participating insurance contracts in the Group's With Profits Funds are measured using the traditional regulatory assessment. In addition, the realistic value of future profits on those contracts is recognised as an offset to the corresponding liabilities in the balance sheet, as future profits on non-participating business in the With Profits Funds. The movement in this balance is recognised in the statement of comprehensive income, through change in insurance and participating investment contract liabilities.

Insurance contracts or participating investment contracts which are not unit-linked or in the Group's With Profits Funds

The liability is calculated by estimating the future cash flows over the duration of in-force policies and discounting them back to the valuation date, allowing for probabilities of occurrence. The liability will vary with movements in interest rates and with the cost of life assurance and annuity benefits where future mortality is uncertain. Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs. Changes in the value of these liabilities are recognised in the statement of comprehensive income, through change in insurance contract and participating investment contract liabilities.

Insurance contracts or participating investment contracts which are unit-linked

Allocated premiums in respect of unit-linked contracts that are either insurance contracts or participating investment contracts are recognised as liabilities. These liabilities are increased or reduced by the change in the unit prices and are reduced by policy administration fees, mortality and surrender charges and any withdrawals. Where the mortality charges deducted in each period from the policyholders as a group are not considered adequate to cover the expected total death benefit claims in excess of the contract account balances in each period, additional liabilities are established for these claims. Income consists of fees deducted for mortality, policy administration and surrender charges. Interest or changes in the unit prices credited to the account balances incurred in the period are charged as expenses in the statement of comprehensive income, through changes in insurance contract and participating investment contract liabilities. Benefit claims in excess of the account balances incurred in the period are charged as expenses in the statement of comprehensive income, through gross claims and benefits paid.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

Unallocated surplus

Any amounts in the With Profits Funds not yet determined as being due to policyholders or the equity holder and projected transfers out of the funds to other funds of the Group are recognised as an unallocated surplus which is shown separately from the other insurance liabilities.

Bonuses

Bonuses in a given year comprise:

- Unit price increases and new reversionary bonuses declared in respect of that year which are provided within the calculation of insurance and participating investment contract liabilities;
- Terminal and interim bonuses paid out to policyholders on maturity and included within gross claims and benefits paid.

(x) Retirement benefit obligations

Individuals employed by the Group may be members of the Scottish Widows Retirement Benefit Scheme ("SRBS") or of other pension schemes (LBG Pension Schemes Nos 1 and 2) administered by LBG (the "Lloyds Schemes"). All schemes are funded through payments to trustee-administered funds, determined by periodic actuarial calculations.

The Group contributes to both defined benefit and defined contribution elements of the pension schemes in question. A defined benefit plan is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and salary. A defined contribution plan is a pension plan under which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

Scottish Widows Retirement Benefit Scheme

A full actuarial valuation of this defined benefit scheme is carried out every three years with interim reviews in the intervening years; the valuation is updated to 31 December each year by a qualified actuary. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method adjusted for unrecognised actuarial gains and losses. The actuary is an employee of the Company.

The amount recognised in the balance sheet in respect of the defined benefit element of the pension scheme is the present value of the defined benefit obligation at the reporting date less the fair value of plan assets, together with adjustments for unrecognised actuarial gains or losses and past service costs, all as adjusted to exclude the portion of the pension scheme transactions and balances relating to employees of the Scottish Widows Investment Partnership Group Limited ("SWIP Group"), which are presented in the SWIP Group financial statements. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates equivalent to the market yields at the reporting date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid and that have terms to maturity that are approximate to the terms of the related pension asset/liability.

A surplus is only recognised to the extent that it is recoverable through a contractual right to make reduced contributions in the future or to receive a refund from the scheme.

The Group's statement of comprehensive income includes the current service cost of providing pension benefits, the expected return on the scheme's assets and the interest cost on the scheme's liabilities. The current service cost is recognised within operating expenses and the expected return and interest cost are recognised within other income.

Actuarial gains and losses arising from experience adjustments and changes in the actuarial assumptions are not recognised unless the cumulative unrecognised gain or loss at the end of the previous reporting period exceeds the greater of 10% of the scheme assets or liabilities (the "corridor approach"). In these circumstances, the excess is charged or credited to income over the employees' expected average remaining working lives.

Past service costs are recognised immediately through income, within operating expenses, unless the changes to the pension plan are conditional on the employees remaining in service for a specified period of time (the "vesting period"). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

The effect of material changes to the terms of the scheme which reduce benefits are recognised through the statement of total comprehensive income when the curtailments occur.

Scottish Widows plc share of LBG defined benefit pension scheme deficit

Some employees are members of certain LBG pension schemes. Accordingly, defined benefit pension scheme accounting, as set out above, has been applied to reflect the Group's share of those schemes' deficits.

Full actuarial valuations of these group-wide schemes are carried out every three years, with interim reviews in the intervening years which are updated by qualified independent actuaries. Scheme assets are included at their fair value. Scheme liabilities are measured on an actuarial basis using the projected unit credit method, adjusted for unrecognised actuarial gains and losses, and are discounted using rates equivalent to the market yields at the reporting date on high-quality corporate bonds that have terms to maturity approximating to the terms of the related pension liability.

The Group's share of the resulting net surplus or deficit, determined on the basis of the Group's cash contributions into the schemes for employee members (calculated in accordance with the rules of each scheme) is included in the consolidated balance sheet. The Group's statement of comprehensive income includes the Group's share of the current service cost of providing pension benefits, the expected return on the schemes' assets, net of expected administration costs, and the interest cost on the schemes' liabilities, which is again determined on the basis of the Group's cash contributions into the schemes for employee members. These amounts are recognised in the same way as the respective amounts in relation to the SRBS. The Group's share of actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions is not recognised unless the cumulative unrecognised gain or loss at the end of the previous reporting period exceeds the greater of 10% of each scheme's assets or liabilities. In these circumstances, the excess is charged or credited to the statement of comprehensive income over the employees' expected average remaining working lives. Past service costs are charged immediately to the statement of comprehensive income, within operating expenses, unless the changes are conditional on the employees remaining in service for a specified period of time. In this case, the past service costs are amortised on a straight-line basis over the vesting period. The effect of material changes to the terms of the scheme which reduce benefits are recognised through the statement of total comprehensive income when the curtailments occur.

Defined contribution schemes

Contributions made by the Group to defined contribution schemes are recognised in the statement of comprehensive income as an employee benefit expense when they are due, within operating expenses.

(y) Provisions for other liabilities and charges

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, when it is probable that the obligation will result in an outflow of resources to settle the obligation and when a reliable estimate of the amount of the obligation can be made. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessment of the time value of money and, where appropriate, the risks specific to the liability.

The Group recognises a provision for onerous contracts when the expected benefits to be derived from contracts are less than the unavoidable costs of meeting the obligations under the contracts.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless the likelihood of possible obligations arising is remote.

(z) Subordinated liabilities

Subordinated liabilities comprise dated and undated loan capital and are carried at amortised cost. The undated subordinated liabilities are adjusted for hedged interest rate risk. Changes in the resulting value of the undated subordinated debt are accounted for as set out at policy (p). Interest payable is recognised in the statement of comprehensive income, through finance costs.

The subordinated guaranteed bonds are classified as a liability on the basis of the existence of a capital disqualification event considered to be a genuine settlement provision in the context of current uncertainty surrounding the direction of future regulatory rule developments.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)**(aa) Non-participating investment contracts**

The Group's non-participating investment contracts are primarily unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the reporting date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable.

Interest or changes in the unit prices credited to the account balances incurred in the period are charged as expenses in the statement of comprehensive income, through changes in non-participating investment contract liabilities.

Deposits and withdrawals are not accounted for through the statement of comprehensive income but are accounted for directly in the balance sheet as adjustments to the non-participating investment contract liability.

(ab) Liability adequacy test

At each reporting date, liability adequacy tests are performed to ensure the adequacy of the insurance contracts and participating investment contract liabilities net of related deferred costs and acquired VIF. In performing these tests, current best estimates of future contractual cash flows, claims handling and policy administration expenses, as well as investment income from assets backing such liabilities, are used. Any deficiency is immediately charged to the statement of comprehensive income, initially by writing off the relevant assets and subsequently by establishing a provision for losses arising from the liability adequacy tests.

(ac) Other financial liabilities

Other financial liabilities are initially recognised at fair value less directly attributable transaction costs and subsequently measured at amortised cost. In practice, the carrying value of these balances equates to the fair value due to the short-term nature of the amounts included within other financial liabilities.

(ad) External interests in collective investment vehicles

External interests in collective investment vehicles which are accounted for by the Group as investments in subsidiaries as set out at policy (k) above are initially recognised, and subsequently stated, at fair value. The fair value of holdings in these funds is determined at the valuation point applicable to the collective investment vehicles at the reporting date as set out under policy (r) above. Changes in the fair value of this balance are recognised in the statement of comprehensive income, through net profit attributable to external interests in collective investment vehicles.

(ae) Borrowings

Borrowings are recognised initially at fair value, being the issue proceeds net of transaction costs incurred. Borrowings are subsequently stated at amortised cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the statement of comprehensive income through finance costs over the period of the borrowings using the effective interest rate applicable to the instrument. In practice, due to the nature of these balances, being bank overdrafts, the carrying value equates to the fair value of these liabilities as the borrowings are repayable on demand.

(af) Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The consolidated financial statements are presented in pounds sterling, (rounded to the nearest million ("£ m")), which is the company's presentation and functional currency.

Monetary items denominated in foreign currencies are translated into sterling at the exchange rates ruling at the reporting date. Non-monetary items denominated in foreign currencies that are measured at fair value are translated at the exchange rates ruling at the date when the current fair value is determined. Non-monetary items denominated in foreign currencies that are measured at historical cost are translated at the exchange rates ruling at the date of the transaction. Revenue transactions and those relating to the acquisition and realisation of investments have been translated at rates of exchange ruling at the time of the respective transactions. Any exchange differences are dealt with in that part of the statement of comprehensive income in which the underlying transaction is reported.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1. Accounting policies (continued)

The results and financial position of the Group's foreign operations that have a functional currency different from the presentational currency are translated into the presentation currency as follows. The assets and liabilities of foreign operations are translated into sterling at foreign exchange rates ruling at the balance sheet date. The income and expenses of foreign operations are translated into sterling at average exchange rates, unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions. Foreign exchange differences arising on the translation of foreign operations are recognised in other comprehensive income.

(ag) Collateral

The Group receives or pledges collateral in the form of cash or securities in respect of derivative transactions it undertakes. The Group also receives collateral in the form of securities in respect of stock lending agreements, repurchase agreements and certain loans made to related parties. Collateral received is recognised as an asset on the balance sheet when the risks and rewards of ownership are substantially transferred to the Group. A corresponding liability for repayment of collateral is recognised in financial liabilities. Collateral received that is not recognised on the balance sheet is legally segregated from the assets of the Group. Collateral pledged continues to be recognised as an asset on the balance sheet unless the risks and rewards have been substantially transferred to the counterparty.

(ah) Business combinations of entities under common control

Business combinations of entities under common control are outside the scope of IFRS 3 "Business Combinations" in accordance with paragraph 2(c). As a result there is currently no specific guidance in IFRS for the accounting treatment or disclosure of such transactions so management has applied IAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors" in developing an appropriate policy. The result of this is that the principles of predecessor accounting are applied to business combinations of entities under common control, meaning that the acquirer does not restate acquired assets or liabilities to fair value but instead incorporates predecessor carrying values. The difference between the consideration paid and the net assets acquired is taken to reserves, as shown in the Statement of Changes in Equity.

2. Critical accounting estimates and judgments in applying accounting policies

The Group's management makes estimates and judgments that affect the reported amount of assets and liabilities. Estimates and judgments are continually evaluated and based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

(a) Insurance contract and participating investment contract liabilities

The estimation of the ultimate liability arising from insurance contracts and participating investment contracts which are not unit-linked is the Group's most critical accounting estimate.

In accordance with FRS 27, the liabilities of the Group's With Profits Funds are calculated using stochastic simulation models which value liabilities on a basis consistent with tradable market option contracts (a "market-consistent" basis). The liabilities are sensitive to both investment market conditions and changes to a number of non-economic assumptions, such as the level of take-up of options inherent in the contracts, mortality rates and lapses prior to dates at which a guarantee would apply.

For insurance contracts outside the With Profits Funds, the liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses, credit default and mortality. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets. The most critical non-economic assumptions are mortality rates in respect of annuity business written and levels of future expenses. Such assumptions are based on recent actual experience, supplemented by industry information where appropriate. No critical accounting estimates apply for participating investment contracts as the contract liabilities arising outside of the With Profits Funds are almost entirely current unit values

At each reporting date, the estimates and assumptions referred to above are reassessed for adequacy and changes will be reflected in adjustments to the liability, through the statement of comprehensive income. Further information on these assumptions is given in note 39.

Sensitivities regarding changes to key assumptions in calculating insurance and participating investment contract liabilities are given in note 39.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

2. Critical accounting estimates and judgments in applying accounting policies (continued)

(b) Intangible assets including intangible insurance assets**Acquired value of in-force business**

Following the acquisition of Scottish Widows Unit Trust Managers Limited ("SWUTM") in 2006 and the acquisition of CMIG in 2011, the Group holds assets representing the acquired VIF of each transaction.

The asset arising on the acquisition of SWUTM was calculated by projecting the future surpluses and other cash flows attributable to the Group arising from business written, excluding the value of future investment risk margins, discounted at an appropriate rate. The key assumptions used in estimating future surpluses related to lapse rates and expenses. The assumptions were determined on a best-estimate basis and, as above, were based on recent actual experience and industry information where appropriate.

The asset arising on the acquisition of CMIG was calculated in the context of predecessor accounting, reflecting the carrying value applied by LBG as at the date of acquisition as described in accounting policy (ah).

Amortisation of these balances and the related deferred tax is carried out on a best estimate basis over the estimated life of the contracts. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of this asset is tested for impairment at each reporting date. Further information on this asset is given in note 13.

(c) Deferred costs

For insurance contracts and participating investment contracts (excluding those assessed on a realistic basis in accordance with FRS 27) acquisition costs which are incurred during a financial period but which relate to subsequent financial periods are deferred to the extent that they are recoverable out of future revenue margins. All other costs are recognised as expenses when incurred. The calculation of the deferred acquisition cost asset and its pattern of amortisation requires estimation of both the expected pattern of receipt of future revenue margins and the period that the business is expected to remain in force. Further information on this asset is given in note 14.

The recognition of costs and income in respect of non-participating investment contracts is governed by IAS 18 "Revenue". Under this standard, directly attributable and incremental costs to securing new business are capitalised and are then subsequently amortised over the period of the provision of the investment management services. Estimation is required of the period that the business is expected to remain in force and prudent assumptions are required for contracts which do not have a fixed maturity date.

(d) Accruals and deferred income

For non-participating investment contracts, the recognition of income is governed by IAS 18. Income received for services to be provided in future periods is deferred and recognised in the statement of comprehensive income as the service is provided. As above, estimation is required of the period that the business is expected to remain in force and prudent assumptions are required for contracts which do not have a fixed maturity date. Further information on this liability is given in note 32.

(e) Retirement benefit obligations

The majority of the Company's employees are members of the SRBS, although some employees are members of certain LBG Schemes. All schemes provide defined benefits and/or defined contribution benefits to the members of those schemes.

The risks associated with the LBG Schemes are shared among various entities under the common control of LBG. The appropriate share of the deficit associated with these schemes has been added to the retirement benefit obligations of SWS, which is included within these consolidated financial statements. Further information on these liabilities is given in note 31.

(f) Taxation

The Company recognises current and deferred tax assets in line with IAS 12 "Income Taxes". In recognising these assets, management takes into account the likely impact of tax issues that are subject to ongoing discussion with HM Revenue and Customs and other tax authorities. With regard to the Group's and Company's deferred tax assets, a significant feature is the management judgment applied in determining the timing, sensitivities and probability of them reversing. This judgment is based on tax forecasts reflecting new business assumptions, sensitivities and proposed management actions. Further information in relation to the Group's and Company's current and deferred tax assets is set out at notes 12 and 15.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

2. Critical accounting estimates and judgments in applying accounting policies (continued)

(g) Fair value of financial instruments

In accordance with IFRS 7, the Group categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques. These valuation techniques involve management judgement and estimates, the extent of which depends on the complexity of the instrument and the availability of market observable information. Further details of these valuations are described in note 40.

(h) Provisions for other liabilities and charges

As previously disclosed, CMIG has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. In its accounts for the year ended 31 December 2011 the Group recognised a provision of £175 million with respect to this litigation and following decisions in July 2012 from the FCJ the Group recognised a further provision of £150 million with respect to this litigation in its third quarter results, increasing the total provision to £325 million.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions, and the implications with respect to the claims facing CMIG. As a result the ultimate financial effect, which could be significantly different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved.

The Directors believe this provision represents an appropriate estimate of the financial impact based upon a series of assumptions, including the number of claims received from the respective populations of different classes of policies, the proportion upheld, and resulting legal and administration costs. Further information in relation to the provision is set out in note 30.

3. Segmental analysis

In the opinion of the Directors, the Group operates in a single business segment, being the provision of long-term insurance and investment contracts, and therefore there are no specific disclosure requirements under IFRS 8 "Operating Segments".

The table below provides a summary of the gross premiums written within the single business segment:

	2012 £ m	2011 £ m
Regular premiums	3,224	2,400
Single premiums	3,481	3,013
Total	6,705	5,413

4. Fee and commission income

	2012 £ m	2011 £ m
Fund management and policy administration fees	387	357
Change in deferred income	7	16
Fee income from reinsured business	10	5
Total	404	378

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

5. Investment income

	2012 £ m	2011 £ m
Net income on investments designated at fair value through profit or loss	3,315	2,671
Interest receivable on swap	20	21
Derivative fee income	(19)	(93)
Financial instruments at amortised cost		
Interest income on intercompany loans	3	27
Rental income on investment properties	252	245
Stocklending income	11	7
Fund manager rebates received	43	42
Foreign currency translation differences	16	75
Other	7	11
Total	3,648	3,006

6. Net gains/(losses) on assets and liabilities at fair value through profit or loss

	2012 £ m	2011 £ m
Derivative financial instruments at fair value through profit or loss	37	(619)
Investments designated at fair value through profit or loss	5,882	(1,347)
Investment properties at fair value through profit or loss	(121)	(67)
Foreign exchange	(77)	(244)
Fair value hedge adjustment in respect of swap	(50)	25
Fair value hedge adjustment for change in value of subordinated debt	9	(24)
Total	5,680	(2,276)

The fair value hedge adjustments in the above table reflect gains and losses arising in respect of undated subordinated debt issued by the Company which forms part of a hedge relationship. Further information in respect of this subordinated debt is set out at note 33.

7. Other income

Included within the Group is a service company which incurs costs on behalf of several subsidiary undertakings of LBG which are not consolidated into these financial statements. The costs recharged to those entities are recorded as other income.

8. Operating expenses

	2012 £ m	2011 £ m
Acquisition and origination costs in respect of insurance and investment contracts	236	243
Expenses for administration	915	686
	1,151	929
Provision in relation to German insurance business litigation	150	175
Amortisation of software development costs	32	25
Change in deferred costs	(125)	(70)
Amortisation of acquired VIF	301	175
Total	1,509	1,234

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

9. Staff costs and other employee related costs

	2012 £ m	2011 £ m
Wages and salaries	263	252
Share-based payments	5	2
Social security costs	24	20
Other pension costs – defined contribution plan	3	4
Other pension costs – defined benefit plan	18	18
Total	313	296

The average number of employees directly employed by the Insurance Division, analysed into business functions, is as follows:

	2012	2011
Client service	4,100	2,067
Marketing and sales	742	701
Other support services	1,312	853
Banking	179	211
Total	6,333	3,832

The increase in number of employees reflects structural changes within LBG, notably the inclusion of General Insurance employees in 2012. The costs of certain employees in the above table are recharged to companies outside the Group.

10. Auditors' remuneration

	2012		2011	
	£ m	£ m	£ m	£ m
	<i>Group</i>	<i>Company</i>	<i>Group</i>	<i>Company</i>
Audit fees				
Fees payable to the Company's auditor for the audit of the Company's annual financial statements	0.9	0.9	0.9	0.9
Fees payable to the Company's auditor and its associates for other services:				
The audit of the Company's subsidiaries	0.8	-	0.8	-
Audit-related assurance services	1.5	0.7	1.5	0.7
Tax related services	0.1	0.1	0.1	0.1
Other assurance services	-	-	0.4	0.4
Total	3.3	1.7	3.7	2.1

During the year, the Group incurred audit fees in respect of its pension schemes of £29,650 (2011: £28,050).

11. Finance costs

	2012 £ m	2011 £ m
Interest on borrowings	2	10
Interest on repos	3	13
Interest on swaps	6	5
Interest on subordinated debt	158	109
Total	169	137

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

12. Taxation

(a) Current year tax charge/(credit)

	2012 £ m	2011 £ m
Current tax:		
UK corporation tax	76	164
Overseas tax	13	2
Adjustment in respect of prior years	27	(27)
Total current tax	116	139
Deferred tax:		
Origination/(reversal) of temporary differences	488	(57)
Adjustment in respect of prior years	(31)	27
Total deferred tax	457	(30)
Total income tax charge	573	109

The policyholder tax benefit or expense is included in income tax charge/(credit). Policyholder tax is a charge of £744m (2011: charge of £234m), including a prior year tax credit of £0.5m (2011: charge of £51m).

(b) Reconciliation of tax charge/(credit)

	2012 £ m	2011 £ m
Profit before tax	205	391
Tax at 24.5% (2011: 26.5%)	50	104
Effects of:		
Income tax at other than standard rate	44	(33)
Disallowable Expenses	-	4
Non-deductible policyholder tax	562	190
Adjustment to tax charge in respect of prior years	(4)	(51)
Reclassification of pension losses	(239)	53
Overseas tax	10	14
Change in tax rate	(61)	(64)
Unallocated Surplus	(18)	(70)
Group relief received for less than full value	-	(34)
2013 tax regime transitional adjustments	237	-
Other	(8)	(4)
Total	573	109

The standard rate of Corporation Tax in the UK changed from 26% to 24% with effect from 1 April 2012. Accordingly, the Company's profits for this accounting period are taxed at an effective rate of 24.5%.

The Finance Act 2012 has reduced the rate of corporation tax from 24% to 23% with effect from 1 April 2013. The impact of this reduction in tax rate, which is applicable to the calculation of deferred tax assets and liabilities at the reporting date, is reflected in the above table.

The Finance Act 2012 introduced changes to the taxation of life assurance companies with effect from 1st January 2013. The impact of these changes on the calculation of deferred tax assets and liabilities at the reporting date is reflected in the above table under the heading '2013 tax regime transitional adjustments'.

13. Intangible assets including intangible insurance assets

		2012 £ m	2011 £ m
		<u>Group</u>	<u>Group</u>
Acquired VIF	(a)	2,182	2,483
Software development costs	(b)	123	150
Total		2,305	2,633

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

(a) Acquired VIF

	2012 £ m	2011 £ m
	<u>Group</u>	<u>Group</u>
<i>Cost</i>		
At 1 January	2,876	371
Additions	-	2,505
At 31 December	2,876	2,876
<i>Accumulated amortisation and impairment</i>		
At 1 January	393	218
Amortisation during the year	301	175
At 31 December	694	393
<i>Carrying amount</i>		
At 31 December	2,182	2,483

Following completion of the annual impairment review in respect of these assets for 2012, no impairment charge has been required.

Of the above total, £1,939m (2011: £2,183m) is expected to be recovered more than one year after the reporting date.

13. Intangible assets including intangible insurance assets (continued)

(b) Software development costs

	2012 £ m	2011 £ m
	<u>Group</u>	<u>Group</u>
<i>Cost</i>		
At 1 January	293	224
Adjustment on acquisition	-	6
Additions	5	63
At 31 December	298	293
<i>Accumulated amortisation</i>		
At 1 January	143	114
Adjustment on acquisition	-	4
Amortisation charge for the year	32	25
At 31 December	175	143
<i>Carrying amount</i>		
At 31 December	123	150

Of the above total, £98m (2011: £120m) is expected to be recovered more than one year after the reporting date.

14. Deferred costs

		2012 £ m	2012 £ m	2011 £ m	2011 £ m
		<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Deferred acquisition costs	(a)	967	225	804	246
Deferred origination costs	(b)	230	178	268	204
Total		1,197	403	1,072	450

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

(a) Deferred acquisition costs

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
At 1 January	804	246	694	240
Amounts incurred during the year	237	40	209	42
Amortisation during the year	(74)	(61)	(99)	(36)
At 31 December	967	225	804	246

Of the above total, £871m for Group and £181m for Company (2011: £712m for Group and £219m for Company) is expected to be recovered more than one year after the reporting date.

(b) Deferred origination costs

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
At 1 January	268	204	308	235
Amounts incurred during the year	42	5	24	7
Amortisation during the year	(80)	(31)	(64)	(38)
At 31 December	230	178	268	204

Of the above total, £199m for Group and £158m Company (2011: £235m for Group and £180m Company) are expected to be recovered more than one year after the reporting date.

15. Tax assets and liabilities

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Current tax receivables	277	38	238	20
Deferred tax assets	366	611	485	716
Total tax assets	643	649	723	736
Current tax payables	212	-	163	-
Deferred tax liabilities	1,307	548	968	187
Total tax liabilities	1,519	548	1,131	187

Of the deferred tax assets and liabilities included in the above table, £47m of the deferred tax liability is expected to be settled within one year of the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

15. Tax assets and liabilities (continued)

(a) Recognised deferred tax

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes relate to the same fiscal authority. The amounts are as follows:

	2012		2011	
	£ m	£ m	£ m	£ m
	<i>Group</i>	<i>Company</i>	<i>Group</i>	<i>Company</i>
Deferred tax assets comprise:				
Trading losses	278	265	188	188
Tax on deferred income	8	346	17	344
Expenses deductible in future periods	42	-	242	184
Other	38	-	38	-
Total deferred tax assets	366	611	485	716
Deferred tax liabilities comprise:				
Unrealised gains on investment assets	7	5	8	5
Deferred acquisition costs	276	93	254	112
2013 tax regime transitional adjustments	469	450	114	70
Pension and other post retirement benefit obligations	23	-	19	-
Accelerated capital allowances	5	-	6	-
Deferred tax on acquired VIF	502	-	532	-
Fair Value of subordinated debt	24	-	-	-
Other	1	-	35	-
Total deferred tax liabilities	1,307	548	968	187
Net deferred tax (liabilities)/assets	(941)	63	(483)	529

Of the deferred tax assets and liabilities balances shown in the above table, £422m for Group and £405m Company (2011: £263m for Group and £178m Company), relating to '2013 tax regime transitional adjustments', are expected to be settled more than one year after the reporting date.

The deferred tax balances include an asset of £265m (2011: £188m) in respect of tax losses incurred by the Group in respect of its pension business. These losses are fully recoverable against the future pension business profits in the VIF and thus can be recognised in full under IAS 12. During the year the Group decided to write off in full deferred tax balances from the asset previously held in respect of expenses incurred considered as deductible in future periods of £184m (2011: £nil). This decision was taken due to insufficient certainty that these expenses could be offset against future income and gains based on current projections.

The deferred tax liability shown above in respect of life business capital gains of £5m (2011: £5m) is the net position at a Company level. No further policyholder provisions are recognised in respect of capital losses relating to unit linked business. In addition, policyholder provisions of £24m (2011: £22m) are included within unallocated surplus in respect of with profit business.

The Finance Act 2012 has reduced the rate of corporation tax from 24% to 23% with effect from 1 April 2013. The impact of this reduction in tax rate, which is applicable to the calculation of deferred tax assets and liabilities at the reporting date, is reflected in the above table.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

15. Tax assets and liabilities (continued)

The tax charge/(credit) in the income statement relating to each of the above items is as follows:

	2012 £ m	2011 £ m
	<u>Group</u>	<u>Group</u>
Trading losses	(90)	(7)
Tax on deferred income	9	(3)
Expenses deductible in future periods	200	(4)
Pensions and post-retirement benefit obligations	4	8
Other deferred tax assets	-	(7)
Unrealised gains/losses on investment assets	(1)	53
Deferred acquisition costs	23	22
Other insurance related items	119	12
Accelerated capital allowances	(1)	(1)
Acquired VIF	(30)	(103)
Transitional adjustments on introduction of new life tax regime	237	-
Fair Value of subordinated debt	(11)	-
Other liabilities	(2)	-
Total deferred tax (credit)/charge	457	(30)

(b) Unrecognised deferred tax

Deferred income tax assets are recognised for tax loss carry forwards only to the extent that realisation of the related tax benefit is probable.

The Group has significant With Profits pension businesses. The business is subject to UK corporation tax on the basis of a notional return determined by UK taxation authorities. To the extent that the actual return from the business is less than the notional return, tax losses accumulate which may be carried forward and offset against excess returns in future years. The maximum potential value of these losses at 31 December 2012 was £938m (2011: £875m). No asset has been recognised in respect of these losses as there will be no excess returns in future years against which they can be offset.

Deferred tax assets have not been recognised in respect of unrelieved capital losses of £150m (2011: £254m), as there is insufficient certainty as to the availability of future profits.

Deferred tax assets have not been recognised in respect of excess expenses carried forward of £232m (2011: £63m), as there is insufficient certainty as to the availability of future profits.

16. Investment in subsidiaries

	2012 £ m	2011 £ m
	<u>Company</u>	<u>Company</u>
At 1 January	8,046	1,892
Additions	217	1,846
Revaluations	(32)	33
Movements in holdings in collective investment vehicles at fair value	3,711	4,275
At 31 December	11,942	8,046

Investments in subsidiaries held at cost are generally recoverable more than one year after the reporting date. Due to the nature of investments in collective investment vehicles (including OEICs), there is no fixed term associated with these investments.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

16. Investment in subsidiaries (continued)

The following are particulars of the Company's principal subsidiaries:

Name	Class of Share or Stock	Percentage held	Country of Registration or Incorporation	Nature of Business
Scottish Widows Annuities Limited	Ordinary	100	Scotland	Life Insurance
Pensions Management (S.W.F.) Limited ¹	Debenture	100	Scotland	Life Insurance
Scottish Widows Unit Funds Limited	Ordinary & Deferred	100	Scotland	Life Insurance
Scottish Widows Services Limited	Ordinary	100	Scotland	Management Services
Scottish Widows Unit Trust Managers Limited	Ordinary	100	England	OEIC Management
Clerical Medical Investment Group Limited	Ordinary	100	England	Life Insurance
Halifax Life Limited ²	Ordinary	100	England	Life Insurance
St Andrew's Life Assurance Plc ²	Ordinary	100	England	Life Insurance

Notes: ¹ limited by guarantee

² indirect holding

The above subsidiaries operate in the United Kingdom and have been included within the consolidated financial statements, along with controlled collective investment vehicles and other entities held as part of the actively managed investment portfolios.

During 2011, the Company acquired the entire share capital of CMIG and also entered into an agreement with Scottish Widows Financial Services Holdings Limited ("SWFSH") to sell CMIG to SWFSH at fair value (with a minimum value of zero) should there be an event that reduced CMIG's capital in excess of its regulatory requirement to nil. This agreement has £nil value as at 31 December 2012 (2011: £nil).

The Company also invests in a number of collective investment vehicles including OEICs which have been classified as investments in subsidiaries as described in the accounting policies.

The ability of regulated entities to pay cash dividends to the Company or repay loans or advances is restricted by regulatory solvency requirements as well as Companies Act distributable reserves requirements. The ability of non-regulated entities to pay cash dividends to the Company or repay loans or advances is restricted by Companies Act distributable reserves requirements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

17. Property and equipment

	Land and buildings £ m	Equipment £ m	Total £ m	Land and buildings £ m
	<u>Group</u>	<u>Group</u>	<u>Group</u>	<u>Company</u>
<i>Cost</i>				
At 1 January 2011	120	51	171	27
Additions	-	6	6	-
Disposals	-	(8)	(8)	-
At 31 December 2011	120	49	169	27
Disposals	-	(19)	(19)	-
At 31 December 2012	120	30	150	27
<i>Accumulated depreciation</i>				
At 1 January 2011	29	40	69	7
Depreciation charge for the year	3	6	9	1
Disposals	-	(9)	(9)	-
At 31 December 2011	32	37	69	8
Depreciation charge for the year	4	6	10	1
Disposals	-	(19)	(19)	-
At 31 December 2012	36	24	60	9
<i>Carrying amount</i>				
At 31 December 2011	88	12	100	19
At 31 December 2012	84	6	90	18

The valuation for the purposes of impairment testing was undertaken by Jones Lang LaSalle. The above assets are generally recoverable more than one year after the reporting date.

18. Investment properties

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
At 1 January	4,397	1,402	2,603	1,464
Adjustment on acquisition	-	-	2,002	-
Additions – new properties	249	24	219	41
Additions – subsequent expenditure on existing properties	50	14	36	14
Disposals	(425)	(246)	(396)	(96)
Foreign exchange valuation difference	(19)	-	(2)	-
Net loss from change in fair values	(156)	(6)	(65)	(21)
At 31 December	4,096	1,188	4,397	1,402

Investment property in the above table contains amounts of £4,096m (2011: £4,397m) which is held entirely within the long-term insurance funds of the Group. These balances are not therefore readily available for use by the Group.

Rental income arising from investment properties during the year amounted to £252m (2011: £245m), which is included in investment income. Direct operating expenses (included within operating expenses) arising in respect of such investment properties during the year amounted to £24m (2011: £22m).

Expenditure on investment properties which did not generate rental income was £1m (2011: £2m). The carrying value of investment properties under development is £88m (2011: £63m).

The investment properties are independently valued by Drivers Jonas, Jones Lang LaSalle, DTZ, CB Richard Ellis and Cushman & Wakefield on at least a quarterly basis for the purpose of determining the open market value of the properties.

Due to the nature of the above assets, there is no fixed term associated with these investments.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

19. Assets arising from reinsurance contracts held

The Company's assets arising from reinsurance contracts held can be analysed between those classified as insurance contracts and those classified as financial assets designated at fair value through profit or loss as follows:

<u>Group</u>	2012			2011		
	Classified as		Total	Classified as		Total
	Insurance contracts	Fair value through profit or loss		Insurance contracts	Fair value through profit or loss	
	£ m	£ m	£ m	£ m	£ m	£ m
At 1 January	782	3,938	4,720	496	2,328	2,824
Adjustment on acquisition	-	-	-	265	76	341
Movement recognised through the statement of comprehensive income	(278)	3,234	2,956	21	47	68
Movement recognised directly through the balance sheet	-	(529)	(529)	-	1,487	1,487
At 31 December	504	6,643	7,147	782	3,938	4,720
Amounts in respect of insurance and participating investment contract liabilities	504	6,255	6,759	782	3,873	4,655
Amounts in respect of non-participating investment contract liabilities	-	388	388	-	65	65
Total	504	6,643	7,147	782	3,938	4,720

<u>Company</u>	2012			2011		
	Classified as		Total	Classified as		Total
	Insurance contracts	Fair value through profit or loss		Insurance contracts	Fair value through profit or loss	
	£ m	£ m	£ m	£ m	£ m	£ m
Amounts backing insurance and participating investment contract liabilities	5,968	20,726	26,694	5,714	16,792	22,506
Amounts backing non-participating investment contract liabilities	-	11,721	11,721	-	10,511	10,511
Total	5,968	32,447	38,415	5,714	27,303	33,017

Assets arising from reinsurance contracts held include £5,324m Group and £37,735m Company (2011: £3,391m Group and £32,433m Company) that is expected to be settled more than one year after the reporting date.

20. Prepayments and accrued income

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Amounts relating to trading balances	155	28	281	30
Total	155	28	281	30

Of the above total, £155m for Group and £28m for Company (2011: £281m for Group and £30m for Company) is expected to be recovered less than one year after the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

21. Derivative financial instruments

In the normal course of business, the Group enters into swap contracts, option contracts, index futures contracts and forward foreign exchange contracts. All such contracts are undertaken either for efficient portfolio management purposes or for the purpose of matching contractual liabilities. In addition, the Company has entered into a swap for the specific purpose of hedging movements in the fair value of certain subordinated debt, as described in note 33.

Swap contracts include interest and inflation rate swaps. An interest or inflation rate swap is an agreement between two parties to exchange fixed and variable rate interest payments, based upon interest or inflation rates defined in the contract, without the exchange of the underlying principal amount.

Option contracts include index and single equity options. Such options represent a contract sold by one party to another party offering the right, but not the obligation, to buy or sell a financial asset at an agreed price on a specified future date or within a specified period of time.

Index futures contracts are used to hedge the investment portfolio against adverse movements in underlying markets or effecting policy switches between markets without the need to trade the underlying securities. Futures may also be used for the purposes of efficient portfolio management provided that their substance would otherwise be permitted as a series of direct transactions.

Forward foreign exchange contracts are an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate.

Details regarding derivative financial instruments are given in the following tables:

<u>Group</u>	Contract Amount £ m	2012 Fair value assets £ m	Fair value liabilities £ m	Contract Amount £ m	2011 Fair value assets £ m	Fair value liabilities £ m
Derivative financial instruments held for trading:						
Swap contracts	8,948	732	1,214	11,579	586	1,104
Option contracts	3,013	456	4	5,628	639	8
Index futures contracts	3,900	71	13	2,787	19	30
Forward foreign exchange contracts	6,220	30	42	4,702	50	19
Derivative financial instruments designated as fair value hedges	874	46	-	885	96	-
Derivative financial instruments designated as net investment hedges	284	-	-	49	-	1
Total	23,239	1,335	1,273	25,630	1,390	1,162

<u>Company</u>	Contract Amount £ m	2012 Fair value assets £ m	Fair value liabilities £ m	Contract Amount £ m	2011 Fair value assets £ m	Fair value liabilities £ m
Derivative financial instruments held for trading:						
Swap contracts	4,290	261	734	3,629	111	617
Option contracts	362	20	-	782	33	-
Index futures contracts	1,345	27	-	572	2	8
Forward foreign exchange contracts	3,082	7	12	1,238	14	3
Derivative financial instruments designated as fair value hedges	560	16	-	560	65	-
Total	9,639	331	746	6,781	225	628

Derivative financial instrument fair value assets include £865m for Group and £295m for Company (2011: £1,180m for Group and £140m for Company) that is expected to be recovered more than one year after the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

21. Derivative financial instruments (continued)

Derivative financial instrument fair value liabilities include £1,140m for Group and £671m for Company (2011: £1,052m for Group and £567m for Company) that is expected to be settled more than one year after the reporting date.

The fair value hedge included in the above tables represents interest rate swaps in respect of the interest payments relating to subordinated debt issued by the Group. This instrument forms part of a hedge relationship with the subordinated debt issued.

The net investment hedge included in the table above is held in respect of the European branch of the Group. The hedge has been put in place to offset the currency exposure relating to the branch with changes in the fair value of the derivative being taken directly to equity.

Details of collateral accepted and pledged in respect of derivative financial instruments are given in note 40.

22. Loans and receivables

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Insurance business:				
Amounts receivable in respect of direct insurance business	102	47	95	42
Amounts receivable under reinsurance contracts	18	8	28	24
Other loans and receivables:				
Investments held through liquidity funds	17,302	-	17,171	-
Accrued interest and rent	564	273	600	299
Other amounts due from related parties	1,770	1,759	263	304
Other	931	449	920	511
Total	20,687	2,536	19,077	1,180

Of the above total, £191m for Group and £1m for Company (2011: £106m for Group and £106m for Company) is expected to be recovered more than one year after the reporting date.

Amounts due from reinsurers represent reinsurance receivables where the Company has the right to cover losses on contracts provided to policyholders.

The carrying amount of loans to related parties is a reasonable approximation of fair value.

There is no significant concentration of credit risk with respect to loans and receivables. Further information in respect of credit risk, including collateral held against loans to related parties, is given in note 40.

23. Investments at fair value through profit or loss

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Shares and other variable yield securities	54,811	3,073	52,249	6,991
Debt and other fixed/variable income securities	36,921	7,347	37,580	8,942
Other investments	96	861	96	747
Total investments at fair value	91,828	11,281	89,925	16,680

Of the debt securities £25,436m for Group and £7,229m for Company (2011: £18,033m for Group and £8,691m for Company) is expected to be recovered more than one year after the reporting date. Due to the nature of equity securities and investments in pooled investment funds there is no fixed term associated with these securities.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

23. Investments at fair value through profit or loss (continued)

The following are particulars of the principal joint ventures that are measured at fair value through profit or loss:

	Average interest held %			
	2012		2011	
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
The Great Wigmore Partnership	50	50	50	50
Barbirolli Square Limited Partnership	50	-	50	-

The Great Wigmore Partnership is registered in the United Kingdom, in accordance with the Limited Partnerships Act 1907. The principal activity of the Partnership is investment in, and development of, freehold and leasehold property in the United Kingdom. The Partnership had no capital commitments at 31 December 2012 (2011: none).

Barbirolli Square Limited Partnership is registered in Scotland as a limited partnership under the Limited Partnerships Act 1907. The principal activity of the Partnership is that of property investment which the General Partner considers offers potential to deliver attractive returns within an acceptable risk profile. The Partnership had no capital commitments at 31 December 2012 (2011: none).

24. Cash and cash equivalents

Cash and cash equivalents for the purposes of the statement of cash flows include the following:

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Cash at bank	599	46	679	48
Short term deposits	430	-	310	-
Cash at bank	1,029	46	989	48
Investments held through liquidity funds (note 22)	17,302	-	17,171	-
Less: amounts with a maturity of over three months	(2,607)	-	(1,322)	-
	15,724	46	16,838	48
Less: bank overdrafts (note 36)	(21)	(4)	(7)	(4)
Total	15,703	42	16,831	44

Cash and cash equivalents in the above table contains amounts of £8,993m (2011: £8,565m) which are held entirely within the long-term insurance funds of the Group. These balances are not therefore readily available for use by the Group.

25. Share capital

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Allotted, called up and fully paid share capital:				
1,470,092,670 ordinary shares of £1 each	1,470	1,470	1,470	1,470
Total	1,470	1,470	1,470	1,470

26. Other reserves

The balance of other reserves was established on 3 March 2000 at the point when the Company acquired certain long term business assets and liabilities following the demutualisation of Scottish Widows Fund and Life Assurance Society ("SWFLAS"). The balance at 3 March 2000 represented the amount of surplus assets over liabilities allocated to the Non-Participating Fund and Shareholders Fund of the Company under the Scheme of Transfer ("the Scheme"). Since that date, the balance of other reserves has reduced as net transfers have been made to retained earnings.

Movements in the balance of other reserves are disclosed in the statement of changes in equity. The Non-Participating Fund made a contingent loan to the With Profits Fund on the demutualisation of SWFLAS. Under the terms of the Scheme, the With Profits Fund is entitled to receive the profits arising on the business allocated to the Non-Participating Fund at demutualisation but is then required to repay the contingent loan by a corresponding amount. There were no movements in other reserves during the year ended 31 December 2012 or 31 December 2011.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

27. Insurance and participating investment contract liabilities

An analysis of the change in insurance and participating investment contract liabilities and reinsurers' share of insurance and participating investment contract liabilities is as follows:

<i>Group</i>	2012			2011		
	£ m	£ m	£ m	£ m	£ m	£ m
	<i>Gross</i>	<i>Reinsurance</i>	<i>Net</i>	<i>Gross</i>	<i>Reinsurance</i>	<i>Net</i>
At 1 January	69,718	4,665	65,053	40,202	2,824	37,378
Adjustment on acquisition	-	-	-	30,053	265	29,788
New business	3,998	1,281	2,717	3,331	1,727	1,604
Changes in existing business	(549)	895	(1,444)	(4,922)	(511)	(4,411)
Assumption changes	344	(82)	426	1,054	360	694
At 31 December	73,511	6,759	66,752	69,718	4,665	65,053

<i>Company</i>	2012			2011		
	£ m	£ m	£ m	£ m	£ m	£ m
	<i>Gross</i>	<i>Reinsurance</i>	<i>Net</i>	<i>Gross</i>	<i>Reinsurance</i>	<i>Net</i>
At 1 January	38,896	22,506	16,390	38,066	20,741	17,325
Adjustment on acquisition	-	-	-	-	-	-
New business	3,581	1,169	2,412	3,051	2,715	336
Changes in existing business	1,421	2,962	(1,541)	(2,518)	(1,275)	(1,243)
Assumption changes	(12)	57	(69)	297	325	(28)
At 31 December	43,886	26,694	17,192	38,896	22,506	16,390

As the Group is wholly owned by an entity which prepares group financial statements, the Group has taken advantage of the provisions contained in FRS 27 and has not presented a capital position statement and supporting disclosures. Information in which the Group is included is given in the financial statements of LBG.

An analysis of the expected maturities of insurance and participating investment contract liabilities is given in note 40.

Recapture of reinsured business

The Company currently reinsures annuity business to SWA. It is proposed that this business is recaptured by the Company and all directly written annuity and protection business in SWA be reinsured to the Company, with effect from 1 January 2013. The Directors' of both companies will be asked to approve this proposal shortly after the approval of these financial statements. This transaction is expected to have no initial effect on the Company's profit, but all profits on this business from 1 January 2013 will arise in the Company instead of SWA.

28. Unallocated surplus

An analysis of the change in unallocated surplus is as follows:

	2012		2011	
	£ m	£ m	£ m	£ m
	<i>Group</i>	<i>Company</i>	<i>Group</i>	<i>Company</i>
At 1 January	298	239	325	325
Adjustment on acquisition	-	-	339	-
Change recognised through the statement of comprehensive income	(48)	(46)	(366)	(86)
At 31 December	250	193	298	239

Of the above total, £250m for Group and £193m for Company (2011: £298m for Group and £239m for Company) is expected to be settled more than one year after the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

29. Future profits on non-participating business in the With Profits Fund

An analysis of the change in future profits on non-participating business in the Scottish Widows With Profits Fund is as follows:

	2012		2011	
	£ m	£ m	£ m	£ m
	<i>Group</i>	<i>Company</i>	<i>Group</i>	<i>Company</i>
At 1 January	45	45	86	86
Change recognised through the statement of comprehensive income	151	151	(41)	(41)
At 31 December	196	196	45	45

Of the above total, £194m for Group and £194m for Company (2011: £45m for Group and £45m for Company) is expected to be recovered more than one year after the reporting date.

30. Provisions for other liabilities and charges

<i>Group</i>	2012			2011		
	German insurance business litigation	Other	Total	German insurance business litigation	Other	Total
	£ m	£ m	£ m	£ m	£ m	£ m
At 1 January	170	2	172	-	5	5
Adjustment on acquisition	-	-	-	-	3	3
Charge for the year	150	-	150	175	(6)	169
Exchange and other adjustments	1	-	1	-	-	-
Amount utilised in the period	(33)	(1)	(34)	(5)	-	(5)
At 31 December	288	1	289	170	2	172

Provision in relation to German insurance business litigation

CMIG has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. In the accounts for the year ended 31 December 2011 the Group recognised a provision of £175m with respect to this litigation. Following decisions in July 2012 from the Federal Court of Justice in Germany the Group has recognised a further provision of £150m with respect to this litigation, increasing the total provision to £325m.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions, and the implications with respect to the claims facing CMIG. As a result the ultimate financial effect, which could be significantly different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved.

The Directors believe this provision represents an appropriate estimate of the financial impact based upon a series of assumptions, including the number and proportions of claims received from the respective populations of different classes of policies, the proportion upheld, and resulting legal and administration costs.

Other

Other provisions include provisions held in respect of onerous leases on investment properties.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

31. Retirement benefit obligations

The Company's employees may be members of the SRBS, which provides mainly defined benefits, or members of LBG Schemes, which provide defined benefits and/or defined contribution benefits to the members of those schemes. As a result of harmonisation of defined contribution benefits across LBG most of the defined contribution members of the SRBS transferred to the Your Tomorrow section of the LBG Pension Scheme No 1. This was completed on 27 July 2012 with the transfer of assets representing past contributions to the scheme.

Scottish Widows Retirement Benefits Scheme

The latest full valuation of the SRBS was carried out as at 1 May 2012; this has been updated to 31 December 2012 by a qualified actuary employed by Scottish Widows. Employee contributions made during the year were £0.3m (2011: £1.5m). The principal assumptions used in determining the pension benefit obligations for the Group, as determined by the Trustees, are as follows:

	2012 %	2011 %
Rate of inflation – Retail Prices Index	2.90	3.00
Rate of Inflation – Consumer Price Index	2.00	2.00
Rate of salary increases	2.00	2.00
Rate of increase for pensions in payment	2.90	2.80
Discount rate	4.60	5.00
Expected rate of return on assets (average)	4.30	4.87
Deferred pensions revaluation	2.00	2.00

The sensitivity of the pension scheme deficit at the reporting date, before application of the "corridor", to changes in the key assumptions set out above is set out below. The table demonstrates the effect of a change in a key assumption whilst other assumptions remain unchanged. Numbers in brackets represent an increase in a deficit or a reduction in a surplus.

	2012 £000	2011 £000
0.2% (2011: 0.2%) increase in discount rate	38,700	16,400
0.2% (2011: 0.2%) decrease in discount rate	(41,100)	(15,400)
0.2% (2011: 0.2%) increase in inflation rate	(35,800)	(17,000)
0.2% (2011: 0.2%) decrease in inflation rate	34,000	15,500
1 year increase in mortality age rating	22,600	16,300
1 year decrease in mortality age rating	(22,200)	(17,200)

The above changes would be offset by an equal and opposite change in the amount of unrecognised actuarial gains and losses, with no net impact on the pension scheme surplus or deficit reported on the balance sheet.

The mortality assumptions used are illustrated by the following years of life expectancy in retirement:

	2012 Years	2011 Years
Life expectancy for member aged 60, on the valuation date		
Men	27	27
Women	30	28
Life expectancy for member aged 60, 15 years after the valuation date		
Men	29	29
Women	31	30

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

31. Retirement benefit obligations (continued)

The assets of the SRBS and the expected rates of return are summarised as follows:

	2012			2011		
	Fair value of assets	Proportion of total assets	Expected long-term rate of return	Fair value of assets	Proportion of total assets	Expected long-term rate of return
	£ m	%	%	£ m	%	%
Equities	303	34.3	6.8	285	35.3	8.3
Fixed Interest Gilts	29	3.3	2.3	5	0.6	3.0
Index linked gilts	224	25.4	2.8	254	31.5	2.8
Non-government bonds	121	13.7	3.1	106	13.0	4.9
Property	38	4.3	6.8	31	3.8	6.6
Swaps	6	0.6	-	(6)	(0.7)	-
Cash	162	18.4	2.4	133	16.5	2.6
Total fair value of scheme assets	883	100.0	4.3	808	100	4.9

The amounts recognised in the Group's balance sheet are as follows:

	2012 £ m	2011 £ m
Fair value of scheme assets	883	808
Present value of defined benefit obligations	(849)	(773)
Unrecognised losses	111	92
Unrecognised curtailment losses	(12)	(12)
Asset recognised in the balance sheet	133	115

The above amount is generally expected to be settled more than one year after the reporting date (2011: more than one year).

As referred to in the accounting policies, gains and losses are not recognised unless the cumulative gain or loss at the end of the previous reporting period exceeds the greater of 10% of the scheme assets or liabilities. At 31 December 2012, although this limit was exceeded, the movement will not impact the 2013 result due to changes in reporting standards (see note 46).

The amounts recognised in the statement of comprehensive income are as follows:

	2012 £ m	2011 £ m
Current service cost	19	18
Interest cost on benefit obligation	38	41
Expected return on scheme assets	(40)	(49)
Net expense recognised	17	10

Of the total net income for the year, a debit of £18m for SRBS and £nil for the LBG schemes (2011: credit of £46m for SRBS and £nil for the LBG schemes) has been included within operating expenses and a credit of £2m for SRBS and £nil for the LBG schemes (2011: credit of £4m for SRBS and £nil for the LBG schemes) has been included within other income.

The actual return on the assets of the scheme amounted to a gain of £73m (2011: gain of £27m).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

31. Retirement benefit obligations (continued)

Movements in the present value of defined benefit obligations for the SRBS are as follows:

	2012 £ m	2011 £ m
At 1 January	773	725
Current service cost	19	18
Interest cost on benefit obligations	38	41
Benefits paid	(28)	(20)
Scheme obligations transferred to Scottish Widows Investment Partnership Group Limited at 31 December	(1)	(2)
Actuarial losses	48	11
At 31 December	849	773

Movements in the fair value of the assets of the SRBS during the year are as follows:

	2012 £ m	2011 £ m
At 1 January	808	767
Expected return on scheme assets	40	49
Contributions received – employers	35	37
Scheme assets transferred to Scottish Widows Investment Partnership Group Limited at 31 December 2011	(1)	(2)
Benefits paid	(28)	(20)
Actuarial gains/(losses)	29	(23)
At 31 December	883	808

The estimated amount of contributions expected to be paid during the financial year ended 31 December 2013 is £37m (2012: £45m).

A summary of the financial position of the SRBS, excluding unrecognised gains and losses, and the five year history of experience adjustments is as follows:

	2012 £ m	2011 £ m	2010 £ m	2009 £ m	2008 £ m
Fair value of scheme assets	883	808	767	661	573
Present value of defined benefit obligations	(849)	(773)	(725)	(763)	(565)
(Deficit)/surplus in the scheme	34	35	42	(102)	8
Experience adjustments on scheme liabilities:					
Amount	(£3m)	£1m	£9m	£7m	(£5m)
Percentage of scheme liabilities	(0.3%)	0.1%	(1.1%)	1.0%	1%
Experience adjustments on scheme assets:					
Amount	£31m	£(24)m	£38m	£(51)m	(£124m)
Percentage of scheme assets	3.3%	2.9%	4.7%	8%	21%

The SRBS also includes a defined contribution section; most of the members have now transferred to the Your Tomorrow defined contribution section of the LBG Pension Scheme No. 1. During the year ended 31 December 2012, the charge to the Group's statement of comprehensive income in respect of this scheme was £2m (2011: £2m), representing the contributions payable by SWS in accordance with the scheme's rules. There were no outstanding or prepaid contributions at 31 December 2012.

The Company provides a guarantee to the trustees of SRBS to explicitly cover the minimum legal obligations imposed on the employers (SWS and SWIP) by Sections 75 of the Pension Act 1995. As a result, the Company will be liable to its proportionate share of the deficit in the SRBS at the relevant time (calculated as the cost of securing benefits with an insurer) in the event that: SRBS is wound up; the employers become insolvent; or an employer ceases to employ active members of SRBS at a time when another employer continues to do so.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

31. Retirement benefit obligations (continued)

The guarantee is considered to have an immaterial value on the basis that the likelihood of the events detailed arising are considered remote. Consequently, there are currently no indications that any amounts payable under this guarantee will materially affect the financial position of the Company.

Other schemes**Defined contribution schemes**

The Company's ultimate parent company operates a number of defined contribution schemes, principally the defined contribution sections of the LBG Schemes; new employees are offered membership of the Your Tomorrow defined contribution section of the LBG Pension Scheme No. 1.

During the year ended 31 December 2012, the charge to the statement of comprehensive income in respect of these schemes was nil (2011: nil), representing the contributions payable by the Company in accordance with each scheme's rules. There were no outstanding or prepaid contributions at 31 December 2012.

Defined benefit schemes

The Company's ultimate parent company has established a number of defined benefit pension schemes in the UK and overseas. A small number of the Company's employees are members of the defined benefit sections of the LBG Schemes. These are funded schemes providing retirement benefits calculated as a percentage of final salary depending on length of service; the minimum retirement age under the rules of the schemes is 50.

The latest full valuations of the two main schemes were carried out as at 30 June 2011; these have been updated to 31 December 2012 by qualified independent actuaries.

The amounts shown below relate to the Company's share of obligations arising from membership by the Company's employees of the defined benefit schemes operated by the Company's ultimate parent company.

The amounts recognised in the Group's balance sheet are as follows:

	2012 £ m	2011 £ m
Fair value of scheme assets	150	150
Present value of defined benefit obligations	(180)	(180)
Unrecognised losses	3	3
Liability recognised in the balance sheet	(27)	(27)

The above amount is generally expected to be settled more than one year after the reporting date (2011: more than one year).

The movements in the liability recognised in the balance sheet are as follows:

	2012 £ m	2011 £ m
At 1 January	26	26
Exchange and other	-	-
At 31 December	26	26

The following information relates to the LBG Schemes as at 31 December 2012

In accordance with IAS 19 "Employee Benefits", the remaining information below relates to the LBG Schemes operated by the Company's ultimate parent company.

The Company's ultimate parent company expects to pay contributions of approximately £645m in respect of the LBG Schemes in 2013.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

31. Retirement benefit obligations (continued)

Movements in the present value of defined benefit obligations during the year are as follows:

	2012 £ m	2011 £ m
At 1 January	17,332	16,627
Merger of No1 and AMC schemes	518	-
Current service costs	166	166
Interest cost on benefit obligations	876	897
Benefits paid	(662)	(604)
Actuarial gains	1,654	236
Past service cost	16	10
Curtailment	4	-
Exchange and other adjustments	(1)	-
At 31 December	19,903	17,332

Movements in the fair value of scheme assets during the year are as follows:

	2012 £ m	2011 £ m
At 1 January	17,254	16,290
Merger of No1 and AMC schemes	424	-
Expected return on scheme assets	897	1,009
Contributions received	273	413
Benefits paid	(662)	(604)
Actuarial gains	287	146
At 31 December	18,473	17,254

The actual return on the assets of the scheme amounted to a gain of £1,171m (2011: gain of £1,581m).

The principal actuarial and financial assumptions used in the valuations of all of the LBG's defined benefit pension schemes, including the No's 1 and 2 schemes, were as follows:

	2012 %	2011 %
Rate of inflation – Retail Prices Index	2.90	3.00
Rate of inflation – Consumer Price Index	2.00	2.00
Rate of salary increases	2.00	2.00
Rate of increase for pensions in payment and deferred pensions	2.70	2.80
Discount rate	4.60	5.00

The sensitivity of the LBG Scheme's deficit at the reporting date to changes in the key assumptions set out above is set out below. The table demonstrates the effect of change in key assumptions whilst other assumptions remain unchanged. Numbers in brackets represent an increase in a deficit or a reduction in a surplus.

	2012 £ m	2011 £ m
0.2% (2011: 0.2%) increase in discount rate	1,056	909
0.2% (2011: 0.2%) decrease in discount rate	(1,102)	(957)
0.2% (2011: 0.2%) increase in inflation rate	(884)	(798)
0.2% (2011: 0.2%) decrease in inflation rate	815	783
1 year increase in life expectancy	(697)	(655)
1 year decrease in life expectancy	686	667

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

31. Retirement benefit obligations (continued)

In addition, the mortality assumptions used for the LBG Schemes are illustrated by the following years of life expectancy in retirement:

	2012 Years	2011 Years
Life expectancy for member aged 60, on the valuation date		
Men	27	27
Women	30	28
Life expectancy for member aged 60, 15 years after the valuation date		
Men	29	29
Women	31	30

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with both current industry experience and the actual experience of the relevant schemes.

An analysis of the impact of a reasonable change in these assumptions is provided in the 2012 annual report and accounts of Lloyds Banking Group. Copies of the 2012 annual report and accounts of LBG may be obtained from the Group Secretary's Department, Lloyds Banking Group plc, 25 Gresham Street, London, EC2V 7HN.

The expected return on scheme assets for all of the LBG's schemes, including the No's 1 and 2 schemes, is based on the following assumptions:

	2012 %	2011 %
Equities	7.3	8.3
Fixed interest gilts	3.0	4.0
Index linked gilts	2.8	3.9
Non-government bonds	4.9	4.9
Property	6.6	7.3
Money market instruments and cash	2.6	3.9

The expected return on scheme assets in 2013 for all of the LBG's schemes, including the No's 1 and 2 schemes, uses the following assumptions:

	2013 %
Equities	6.8
Fixed interest gilts	2.3
Index linked gilts	2.8
Non-government bonds	3.1
Property	6.8
Money market instruments and cash	2.4

Composition of scheme assets:

	2012 £ m	2011 £ m
Equities	7,820	6,495
UK fixed interest gilts	287	391
UK index linked gilts	5,115	4,692
Sterling non-government bonds	2,964	2,882
Property	1,132	1,311
Derivative assets	429	642
Cash, and other assets and liabilities	725	841
At 31 December	18,472	17,254

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

31. Retirement benefit obligations (continued)

The assets of all the funded pension plans are held independently of the LBG's assets in separate trustee administered funds.

The expected return on plan assets is determined by considering the expected returns available on the assets underlying the current investment policy. Expected yields on fixed interest investments are based on gross redemption yields at the reporting date. Expected returns on equity and property investments reflect long-term real rates of return experienced in the respective markets.

Experience adjustments history relating to the LBG's schemes (since the adoption of IAS 19):

	2012 £ m	2011 £ m	2010 £ m	2009 £ m	2008 £ m
Present value of defined benefit obligation	19,903	17,332	16,290	14,662	12,433
Fair value of scheme assets	(18,473)	(17,254)	(16,627)	(16,962)	(14,089)
	1,430	78	(337)	(2,300)	(1,656)
Unrecognised actuarial (losses)/gains	(2,182)	(769)	679	2,146	217
(Asset)/liability in the LBG balance sheet	(752)	(691)	342	(154)	(1,439)
Experience losses on scheme liabilities	(371)	(132)	(466)	(3)	(29)
Experience gains/(losses) on scheme assets	287	146	1,052	440	(3,227)

The expense recognised in the statement of comprehensive income comprises:

	2012 £ m	2011 £ m
Current service cost	166	166
Interest cost on benefit obligation	876	897
Expected return on scheme assets	(897)	(1,009)
Past service cost	16	10
Total pension expense	161	64

32. Accruals and deferred income

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Accrued expenses	218	7	117	17
Deferred income	119	1,503	134	1,338
Total	337	1,510	251	1,355

Of the above total, £163m Group and £1,329m Company (2011: £89m Group and £1,165m Company) is expected to be settled more than one year after the reporting date.

33. Subordinated debt

The carrying value shown in the balance sheet is as follows:

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Subordinated debt	2,039	1,347	1,745	1,345
Issue costs	12	3	13	4
	2,051	1,350	1,758	1,349
Accrued interest on subordinated debt	25	7	26	7
Fair value hedge adjustment	83	59	91	68
Total	2,159	1,416	1,875	1,424

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

33. Subordinated debt (continued)

The fair value of the subordinated debt of the Company is as follows:

<i>Company</i>	2012		2011	
	£ m	£ m	£ m	£ m
	<i>Carrying value</i>	<i>Fair value</i>	<i>Carrying value</i>	<i>Fair value</i>
Undated subordinated liabilities	616	623	624	364
Dated subordinated liabilities	800	818	800	820
Total	1,416	1,441	1,424	1,184

Details of the subordinated liabilities of the Company are as follows:

1) £560m of step-up perpetual subordinated notes issued by the Company, in September 2005. Redemption of the notes is at the option of the Company, and is generally not allowable prior to the first call date on 24 September 2015. Interest is payable on an annual basis at a rate of 5.125% until the first call date, after which point interest is payable on a variable rate basis at three monthly intervals. Repayment of the notes is subordinate to the claims of the Company's senior creditors, including all policyholders.

The interest rate risk of the notes is managed using a derivative which is accounted for using hedge accounting, as set out in note 21.

2) £800m of floating rate subordinated notes, issued by the Company in June 2010. Redemption of the notes is due in 2040. However, the notes may be redeemed at an earlier date provided that certain conditions, including the provision of six months' written notice of the intention to redeem, are met. Interest is payable on a quarterly basis at a rate of 3 month LIBOR plus 5.1%. Repayment of the notes is subordinate to the claims of the Company's senior creditors, including all policyholders.

<i>Group</i>	2012		2011	
	£ m	£ m	£ m	£ m
	<i>Carrying value</i>	<i>Fair value</i>	<i>Carrying value</i>	<i>Fair value</i>
Undated subordinated liabilities	1,174	1,317	899	603
Dated subordinated liabilities	985	998	976	969
Total	2,159	2,315	1,875	1,572

Details of the subordinated liabilities of the Group's subsidiary CMIG are as follows:

1) £51m of 7.375% undated Subordinated Guaranteed Bonds held by Clerical Medical Finance plc, the redemption of which is at the option of Clerical Medical Finance plc and is generally not allowable prior to 5 November 2019. The interest rate charged to CMIG by Clerical Medical Finance plc is 7.61%.

2) €219m of 6.45% dated Subordinated Guaranteed Bonds held by Clerical Medical Finance plc maturing on 5 July 2023. Redemption of the bonds is at the option of Clerical Medical Finance plc and is generally not allowable prior to July 2013, after which time if the bond has not been redeemed floating rate interest is payable. The interest rate charged to CMIG by Clerical Medical Finance plc is 6.555%

3) €388m of 4.25% undated Subordinated Guaranteed Bonds held by Clerical Medical Finance plc. Redemption of the bonds is at the option of Clerical Medical Finance plc and is generally not allowable prior to 27 June 2015, after which time if the bond has not been redeemed floating rate interest is payable. The interest rate charged to CMIG by Clerical Medical Finance plc is 4.27%. An interest rate swap has been put in place in respect of the €388m tranche of the subordinated debt, which is accounted for using hedge accounting, as set out in note 1 (z).

4) £250m of floating rate subordinated notes held by Scottish Widows Group Limited, issued by CMIG in June 2012. Redemption of the notes is due in 2042. However, the notes may be redeemed at an earlier date provided that certain conditions, including the provision of six months' written notice of the intention to redeem, are met. Interest is payable on a quarterly basis at a rate of 3 month LIBOR plus 7.45%. Repayment of the notes is subordinate to the claims of CMIG's senior creditors, including all policyholders.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

33. Subordinated debt (continued)

The fair value of undated subordinated liabilities has been calculated using published bid prices at the reporting date. The fair value of dated subordinated liabilities has been assessed by management with reference to published prices.

34. Non-participating investment contract liabilities

An analysis of the change in net investment contract liabilities is as follows:

<i>Group</i>	Gross £ m	2012 Reinsurance £ m	Net £ m	Gross £ m	2011 Reinsurance £ m	Net £ m
At 1 January	26,374	65	26,309	16,226	-	16,226
Adjustment on acquisition	-	-	-	12,084	76	12,008
New business	257	199	58	392	3	389
Changes in existing business	(225)	124	(349)	(2,328)	(14)	(2,316)
At 31 December	26,406	388	26,018	26,374	65	26,307

<i>Company</i>	Gross £ m	2012 Reinsurance £ m	Net £ m	Gross £ m	2011 Reinsurance £ m	Net £ m
At 1 January	13,686	10,511	3,175	13,852	10,375	3,477
New business	175	162	13	246	221	25
Changes in existing business	106	1,048	(942)	(412)	(85)	(327)
At 31 December	13,967	11,721	2,246	13,686	10,511	3,175

An analysis of the contractual and expected maturities of non-participating investment contract liabilities is given in note 40.

35. Other financial liabilities

	2012		2011	
	£ m	£ m	£ m	£ m
	<i>Group</i>	<i>Company</i>	<i>Group</i>	<i>Company</i>
Insurance business:				
Amounts payable in respect of direct insurance business	453	242	425	216
Amounts payable on reinsurance contracts	35	-	17	-
Other liabilities:				
Due to related parties	591	315	707	566
Due to brokers	222	14	289	179
Repurchase creditor	-	-	287	-
Other	607	134	510	128
Total	1,908	705	2,235	1,089

Of the above total, £219m Group (2011: £274m Group) is expected to be settled more than one year after the reporting date. All of the Company balance is expected to be settled within one year of the reporting date (2011: all of the balance). Included within other liabilities, as required by IAS 32 "Financial Instruments: Presentation", is £100 of 6% cumulative preference shares issued by the Company during 2005.

36. Borrowings

	2012		2011	
	£ m	£ m	£ m	£ m
	<i>Group</i>	<i>Company</i>	<i>Group</i>	<i>Company</i>
Bank overdrafts	21	4	7	4
Total	21	4	7	4

The fair value of the balances set out above is not materially different to the carrying value due to the short-term nature of these balances.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

37. (Increase)/decrease in operating assets and liabilities

	2012		2011	
	£ m	£ m	£ m	£ m
	<i>Group</i>	<i>Company</i>	<i>Group</i>	<i>Company</i>
Increase in operating assets:				
Retirement benefit surplus	(18)	-	-	-
Deferred costs	(125)	47	(70)	25
Investment properties	301	214	208	62
Assets arising from reinsurance contracts held	(2,427)	(5,398)	(3,894)	(1,901)
Prepayments	126	(2)	10	1
Financial assets:				
Derivative financial instruments	55	(106)	(415)	(48)
Loans and receivables	(2,764)	(1,356)	2,100	569
Investments at fair value through income	(1,904)	1,507	14,319	2,563
Net (increase)/decrease in operating assets	(6,756)	(5,094)	12,258	1,271
Increase in operating liabilities:				
Insurance contract and participating investment contract liabilities	3,642	4,839	(497)	871
Unallocated surplus	(48)	(46)	(366)	(85)
Retirement benefit obligations	-	-	(26)	-
Provision for other liabilities and charges	118	-	164	-
Accruals and deferred income	86	156	(293)	128
Financial liabilities:				
Subordinated debt	34	(8)	12	14
Non-participating investment contract liabilities	32	281	(1,937)	(166)
Derivative financial instruments	111	117	534	295
Other financial liabilities	(324)	(384)	(2,130)	(1,563)
External interest in collective investment vehicles	1,292	-	8,101	-
Net increase/(decrease) in operating liabilities	4,943	4,955	3,562	(506)
Net (increase)/decrease in operating assets and liabilities	(1,813)	(139)	15,820	765

38. Dividends paid

	2012	2011
	£ m	£ m
Total dividends paid on equity shares	-	-

The dividend paid in the year amounted to nil pence per share (2011: nil pence per share).

39. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities

Policyholder liabilities can be analysed into With Profits Fund liabilities and non-participating fund liabilities. In accordance with FRS 27, the liabilities of the With Profits Funds are accounted for using the realistic capital regime of the FSA (realistic liabilities). All non-participating liabilities are accounted for using a traditional prospective actuarial discounted cash flow methodology.

(1) Processes used to determine key assumptions in respect of insurance and investment contracts**(a) Liabilities of the With Profits Funds calculated on a realistic basis**

The Group has With Profits Funds within the Company and its subsidiary CMIG containing both insurance and participating investment contracts. The main components of the realistic liabilities are:

- with profits benefit reserves, i.e. the total asset shares for with profits policies;
- the costs of options and guarantees;
- deductions levied against asset shares; and
- the impact of smoothing policy.

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market consistent basis. The calculation of realistic liabilities uses best estimate assumptions of e.g. mortality, persistency and expenses.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

39. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

The processes for determining the key assumptions are set out below, and remain unchanged from the prior year:

- Investment returns and discount rates

A stochastic economic scenario generator, which uses recognised asset models, provides future asset value and yield scenarios; these determine investment returns for each scenario. The economic scenario generator is calibrated to observable yield curves and option prices where possible. Nominal interest rates are modelled using a standard interest rate model, calibrated to risk-free yields. The risk-free yield is defined as the spot yield derived from the UK gilt yield curve. The liabilities are valued by discounting projected future cash flows using the risk free yield.

- Investment volatility

The volatility of future equity returns in excess of nominal interest rates has been calibrated to at-the-money-forward options of up to 10 years term on appropriate indices. The indices used are the FTSE-100, the EuroStoxx-50, and the S&P 500. For property, no observable prices exist and so volatility has been derived from analysis of historic data.

- Mortality

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are based on recent actual experience, industry tables and projection models, and mortality rates implied by indicative reinsurance terms.

- Persistency

Persistency is a function of both the rate of policy termination and the rate at which policyholders stop paying regular premiums. The assumed levels of these rates are based on a combination of historical experience and management's views on future experience taking into consideration potential changes that may result from guarantees and options becoming more valuable under adverse market conditions.

- Maintenance expenses

Allowance is made for the charges applied to the With Profits Funds and these are, for conventional with profits business, governed by the relevant Schemes of Transfer.

- Guaranteed annuity option take-up rates

The guaranteed annuity option take-up rates are set with regard to the Company's recent actual experience, increased to reflect future uncertainties where the exercise of options by policyholders might increase liabilities.

(b) Liabilities outwith the With Profit Funds

(i) Insurance contracts and participating investment contracts

The liabilities of the Group and Company are determined on the basis of recognised actuarial methods and consistently with the approach to be used for the FSA returns. The methods used involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting these cash flows back to the valuation date allowing for probabilities of occurrence.

The liabilities will vary with movements in interest rates (this applies in particular to the cost of guaranteed benefits payable in the future) and with movements in the cost of life assurance and annuity benefits for which future mortality is uncertain.

Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs. Generally, assumptions used to value the liabilities contain a margin for adverse deviation and are determined as required by FSA rules. This margin for adverse deviation is based on management's judgment and reflects management's views on the inherent level of uncertainty. The assumptions to which the liabilities are most sensitive are the interest rates used to discount the cash flows and the mortality assumptions, particularly those for annuitants.

The key assumptions used in the measurement of the non-participating fund liabilities are:

- **Interest rates**

The rates used are derived consistently with the approach to be used for the FSA returns. These limit the rates of interest that can be used by reference to a number of factors including the dividend and earnings yields on equities, rental income, and redemption yields on fixed interest assets at the valuation date. Margins for risk are allowed for in the assumed interest rates. These are derived from the limits used for FSA reporting, including reductions made to the available yields to allow for default risk based upon the credit rating of each stock, and an over-riding restriction which limits the yield from investments in property by reference to the yield from appropriate long-term gilts.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

39. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

- **Mortality and morbidity**

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and includes a margin for adverse deviation. The assumptions have additional margins over the With Profits Fund assumptions, as required by FSA regulations. Improvements in female annuitant mortality are assumed to follow the CMI 2011 projection for females from the Actuarial profession's mortality committee with a long term rate of improvement of 1.5% per annum. Similarly improvements in male annuitant mortality are assumed to follow the CMI 2011 projection for males from the Actuarial Profession's mortality committee with a long term rate of improvement of 1.5% per annum.

- **Maintenance expenses**

Allowance is explicitly made for future policy costs. Expense loadings are determined by reference to an internal analysis of current and expected future expense levels, plus a margin for adverse deviations. Explicit allowance is made for future expense inflation from the valuation date. No allowance is made for any expected reductions in expense levels that have not occurred at the valuation date.

- **Persistency rates**

Prudent lapse rate assumptions have been used for term assurance business and other business categories. Whether a lapse rate is prudent broadly depends on whether the policy liability is negative or positive at any point in its life, thus for each policy a high lapse rate is assumed at points where the projected liability is negative and a low lapse rate is assumed at points where the projected liability is positive.

(ii) **Non-participating investment contracts**

These contracts are unit-linked, and the liability is determined as the value of the units allocated to the contracts plus an allowance for other amounts not reflected in the unit value.

(2) Key assumptions**(a) With Profits Fund - Scottish Widows plc**

Assumptions are set for the realistic valuation of the Company's With Profits Fund. In addition, liabilities in respect of non-participating policies in the With Profits Fund were also accounted for on the regulatory assessment.

(i) Investment returns and discount rates

In the realistic valuation of liabilities in calibrating the economic scenario generator, the risk-free yield curve is defined as the yield curve for UK gilts.

The following interest rates are assumed in the regulatory valuation of non-participating policies in the With Profits Funds:

Class of business	Interest rate (net)	
	2012 %	2011 %
Annuities in Payment	2.50	3.50
Deferred Annuities	3.00	3.40

(ii) Investment volatility (realistic liabilities only)

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2012, the 10 year-equity-implied-at-the-money assumption was 26.3% (27.2% as at 31 December 2011). The assumption for property volatility was 15% (31 December 2011: 15%). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 18% as at 31 December 2012 (31 December 2011: 19%).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

39. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

(iii) Mortality assumptions

The mortality assumptions for the main classes of business are as follows:

		2012	2011
Assurances (excluding term assurances)			
Conventional With Profits	Males		
	Smoker	81% AMS00 ult	81% AMS00 ult
	Non-smoker	73% AMN00 ult	73% AMN00 ult
	Unknown	68% AMC00 ult	68% AMC00 ult
	Females		
	Smoker	61% AFS00 ult	61% AFS00 ult
	Non-smoker	80% AFN00 ult	80% AFN00 ult
	Unknown	65% AFC00 ult	65% AFC00 ult
Unitised Assurances	Males	48% AMC00 ult	52% AMC00 ult
	Females	62% AFC00 ult	62% AFC00 ult
Annuities			
Self-employed / Personal Pensions	Males	84% RMV 2000 ult CMI_2011_M_1.25%	84% RMV 2000 ult CMI_2011_M_1.25%
	Females	103% RFV 2000 ult CMI_2011_F_1.25%	103% RFV 2000 ult CMI_2011_F_1.25%
	Males	90-113% PCMA 2000 ult CMI_2011_M_1.25%	90-113% PCMA 2000 ult CMI_2011_M_1.25%
	Females	93-106% PCFA 2000 ult CMI_2011_F_1.25%	93-106% PCFA 2000 ult CMI_2011_F_1.25%
Other Annuities in payment	Males	82% AMC00 ult *	85% AMC00 ult *
	Females	74% AFC00 ult *	77% AFC00 ult *

With regard to the above and subsequent tables:

'CMI_2011_M_1.25%' denotes that future improvement factors, which are applied from 31 December 2002, are taken from CMI 2011 tables for males, with a long term improvement rate of 1.25% per annum. Similarly 'CMI_2011_F_1.25%' tables are used for females. CMI_2011 denotes that explicit provision for future mortality improvement is made by applying the 2011 version of Continuous Mortality Investigation mortality projection model released in September 2011.

* For deferred annuities an explicit provision for future improvement has been made by assuming mortality in deferment reduces at a rate of 3% pa from the valuation date through deferment.

(iv) Other assumptions

Deferred annuity contracts with a guaranteed-rate annuity option have been valued based upon an assumed rate of take-up of the guaranteed annuity option of 85% for the realistic assessment (85.0% assumed at 31 December 2011).

(b) With Profits Fund - Clerical Medical Investment Group Limited

Assumptions are given for the realistic valuation of CMIG's With Profits Fund. In addition, liabilities in respect of non-participating policies in the With Profits Fund were also accounted for on the traditional regulatory assessment.

(i) Investment returns and discount rates

In the realistic valuation of liabilities in calibrating the economic scenario generator, the risk-free yield curve is defined as the yield curve for UK gilts.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

39. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

(ii) Investment volatility (realistic liabilities only)

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2012, the 10 year-equity-implied-at-the-money assumption was set at 26.3% (27.2% as at 31 December 2011). The assumption for property volatility was 15% (31 December 2011: 15%). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 18% as at 31 December 2012 (31 December 2011: 19%).

(iii) Mortality assumptions

The mortality assumptions for the main classes of business are as follows:

		2012	2011
Assurances (excluding term assurances)			
Conventional With Profits	Males	45% AMC00 Ultimate	50% AMC00 Ultimate
	Females	60% AFC00 Ultimate	60% AFC00 Ultimate
Unitised Assurances	Males	85% AMC00 Ultimate	90% AMC00 Ultimate
	Females	90% AFC00 Ultimate	95% AFC00 Ultimate
Annuities			
Self-employed / Personal Pensions	Males	96% PCMA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)	96% PCMA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)
	Females	94% PCFA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)	94% PCFA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)
Other Annuities in payment	Males	96% PCMA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)	96% PCMA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)
	Females	94% PCFA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)	94% PCFA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)
Deferred Annuities	Males	96% PCMA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)	96% PCMA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)
	Females	94% PCFA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)	94% PCFA00 (CMI 2011 - 1.25%minimum improvement rate from 2003)

(iv) Other assumptions

Deferred annuity contracts with a guaranteed-rate annuity option have been valued based upon an assumed rate of take-up of the guaranteed annuity option of 85% for the realistic assessment (85.0% assumed at 31 December 2011).

(c) Non-participating funds

The principal assumptions underlying the calculation of the each of the Group's subsidiaries non-participating fund liabilities are given below.

(i) Investment returns and discount rates

Scottish Widows plc

Class of business	Interest rate (net)	
	2012 %	2011 %
Conventional Life business and non-unit reserves on linked life business	1.04	1.92
Annuities in payment reinsured to Scottish Widows Annuities Limited	2.86	3.37

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

39. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

Clerical Medical Investment Group Limited

Class of business	Interest rate (net)	
	2012 %	2011 %
Conventional Life business and non-unit reserves on linked business	0.51	0.57
Annuities in payment	2.23	2.54

Halifax Life Limited

Class of business	Interest rate (net)	
	2012 %	2011 %
Non-unit reserves on linked business	0.64	0.71
ELAS reassured annuities in payment	3.04	2.93
Annuities in payment	1.46	1.64

St Andrew's Life Assurance plc

Class of business	Interest rate (net)	
	2012 %	2011 %
Conventional Life business	0.51	0.57
Non-unit reserves on linked business	0.51	0.57

(ii) Mortality assumptions

Scottish Widows plc

The mortality assumptions for the main classes of business are as follows:

		2012	2011
Term Assurances	Males		
	Smoker	85-160% TMS00(5) select	95-160% TMS00(5) select
	Non smoker	85-180% TMN00(5) select	90-180% TMN00(5) select
	Unknown	85% TMN00(5) select to 150% TMC00(5) select	90% TMN00(5) select to 150% TMC00(5) select
	Females		
	Smoker	75-130% TFS00(5) select	90-130% TFS00(5) select
	Non smoker	80-190% TFN00(5) select	95-190% TFN00(5) select
	Unknown	80% TFN00(5) select to 150% TFC00(5) select	95% TFN00(5) select to 150% TFC00(5) select
Annuities			
	Purchased (whole life)		
	Males	94% IML 2000 ult CMI_2011_M_1.5%	94% IML 2000 ult CMI_2011_M_1.5%
	Females	84% IFL 2000 ult CMI_2011_F_1.5%	84% IFL 2000 ult CMI_2011_F_1.5%
Self-employed / personal Pensions	Males	76% RMV 2000 ult CMI_2011_M_1.5%	76% RMV 2000 ult CMI_2011_M_1.5%
	Females	93% RFV 2000 ult CMI_2011_F_1.5%	93% RFV 2000 ult CMI_2011_F_1.5%
Other Annuities in payment	Males	82 - 113% PCMA 2000 ult CMI_2011_M_1.5%	82 - 113% PCMA 2000 ult CMI_2011_M_1.5%
	Females	84 - 96% PCFA 2000 ult CMI_2011_F_1.5%	84 - 96% PCFA 2000 ult CMI_2011_F_1.5%
Deferred annuities	Males	70% AMC00 ult *	75% AMC00 ult *
	Females	65% AFC00 ult *	70% AFC00 ult *

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

39. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

* For deferred annuities, an explicit provision for future improvement has been made by assuming mortality in deferment reduces at a rate of 4% pa from the valuation date through deferment.

Clerical Medical Investment Group Limited

The mortality assumptions for the main classes of business are as follows:

		2012	2011
Term Assurances			
	Males	51.75% TMC00 Select	57.5% TMC00 Select
	Females	57.5% TFC00 Select	63.25% TFC00 Select
Annuities			
Purchased (whole life)	Males	86.4% PCMA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)	86.4% PCMA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)
	Females	84.6% PCFA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)	84.6% PCFA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)
Self-employed / personal Pensions	Males	86.4% PCMA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)	86.4% PCMA00 CMI_2011_M_1.5%
	Females	84.6% PCFA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)	84.6% PCFA00 CMI_2011_F_1.5%
Other Annuities in payment	Males	86.4% PCMA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)	86.4% PCMA00 CMI_2011_M_1.5%
	Females	84.6% PCFA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)	84.6% PCFA00 CMI_2011_F_1.5%
Deferred annuities	Males	86.4% PCMA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)	86.4% PCMA00 CMI_2011_M_1.5%
	Females	84.6% PCFA00 (CMI 2011 - 1.5% minimum improvement rate from 2003)	84.6% PCFA00 CMI_2011_F_1.5%

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

39. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

Halifax Life Limited

The mortality assumptions for the main classes of business are as follows:

		2012	2011
UL Individual Pensions Regular Premium	Males	83% AMC00 U	83% AMC00 U
	Females	72% AFC00 U	77% AFC00 U
UL Individual Pensions Single Premium	Males	83% AMC00 U	83% AMC00 U
	Females	72% AFC00 U	77% AFC00 U
UL Group Pension	Males	99% AMC00 U	94% AMC00 U
	Females	88% AFC00 U	88% AFC00 U
Pension Annuities	Males	86% PCMA00 (CMI_2011 1.5% from 2003)	86% PCMA00 (CMI_2011 1.5% from 2003)
	Females	85% PCFA00 (CMI_2011 1.5% from 2003)	85% PCFA00 (CMI_2011 1.5% from 2003)
Deferred Annuities	Males	86% PCMA00 (CMI_2011 1.5% from 2003)	86% PCMA00 (CMI_2011 1.5% from 2003)
	Females	85% PCFA00 (CMI_2011 1.5% from 2003)	85% PCFA00 (CMI_2011 1.5% from 2003)

St Andrew's Life Assurance plc

The mortality assumptions for the main classes of business are as follows:

		2012	2011
Term Assurances	Males		
	Smoker	103.5% TMS00U	97.75% TMS00U
	Non-Smoker	103.5% TMN00U	97.75% TMN00U
	Females		
	Smoker	115% TFS00U	97.75% TFS00U
	Non-Smoker	109.25% TFN00U	115% TFN00U
Investment Bonds	Males	77% AMC00U	77% AMC00U
	Females	93.5% AFC00U	93.5% AFC00U

(3) The effect of changes in key assumptions**(a) With Profits Funds**

There is no net impact on profit before tax of the changes in key assumptions within the With Profits Funds as any change in policyholder liabilities is offset by an equal and opposite movement in the unallocated surplus of the long-term business.

(b) Non-participating funds

Changes in certain key assumptions were made during the year with the following impacts on profit after tax:

Variable	Impact on profit after tax			
	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Mortality	(42)	(1)	190	13
Expenses	47	9	161	49
Lapses	(1)	(1)	-	-
Valuation Interest Rate	14	(41)	(146)	(2)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

39. Insurance and investment contract liabilities – assumptions, change in assumptions and sensitivities (continued)

(4) Sensitivity analysis (in respect of insurance and participating investment contracts only)**(a) With Profits Funds**

There is no net impact on profit before tax of the changes in key assumptions within the With Profits Funds as any change in policyholder liabilities is offset by an equal and opposite movement in the unallocated surplus of the long-term business.

(b) Non-participating funds

The following table demonstrates the effect of changes in key assumptions on profit after tax assuming that the other assumptions remain unchanged. In practice this is unlikely to occur, and changes in some assumptions may be correlated.

Variable	Change in variable	Impact on profit after tax			
		2012		2011	
		£ m	£ m	£ m	£ m
		<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Annuitant Mortality	5% reduction	(157)	(3)	(135)	(5)
Other Mortality	5% reduction	16	9	26	15
Lapses	10% reduction	(32)	(6)	(32)	(5)
Maintenance expenses	10% reduction	103	23	110	30
Interest rate – change in redemption yield ⁽¹⁾	0.25% reduction	(56)	(3)	(44)	(3)
Interest rates – change in valuation margin ⁽²⁾	0.25% reduction	(255)	n/a	(221)	n/a

(1) This interest rate sensitivity shows the impact of a 0.25% movement in gilt yields and all of the consequential impacts on key economic assumptions including the investment returns, the valuation rates of interest and values of assets backing the business in question. This excludes any impact on assets not backing the liabilities.

(2) This interest rate sensitivity shows, for pensions annuity business, the impact of a change to the valuation rate of interest without a corresponding change to asset yields; this would increase the margin available to cover default and other risks.

40. Risk management

The principal activity of the Group is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the United Kingdom. The Group offers a wide range of life insurance products such as annuities, pensions, whole life, term life and investment type products through independent financial advisers, the LBG network and direct sales. The Company also reinsures business with subsidiary undertakings and with insurance entities external to the Group. This includes the majority of the pensions linked business, which is reinsured to the Company's subsidiary, SWUF, the annuity business which is reinsured to the Company's subsidiary SWA, and protection business, which is reinsured to the Company's subsidiary, CMIG.

The Group assesses the relative costs and concentrations of each type of risk through the Individual Capital Assessment ("ICA") and Solvency II capital assessments and material issues are escalated to the Insurance Risk Committee and the Insurance Executive Committee.

This note summarises these risks and the way in which the Group manages them.

(a) Governance framework

The Group is part of LBG, which has established a risk management function with responsibility for implementing the LBG risk management framework within the Group.

Responsibility for the setting and management of risk appetite and risk policy resides with the Board of each Group company. The Board manages risks in line with LBG and Insurance risk policies. The Board has delegated operational implementation to the Insurance Executive Committee.

The approach to risk management aims to that there is effective independent checking or "oversight" of key decisions through the operation of a "three lines of defence" model. The first line of defence is line management, who have direct accountability for risk decisions. The Risk function provides oversight and challenge and forms the second line of defence.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

Internal Audit constitutes the third line of defence, whose objective is to provide the required independent assurance to the Audit Committee and the Board that risks within the Group are recognised, monitored and managed within acceptable parameters.

An enterprise-wide risk management framework for the identification, assessment, measurement and management of risk is in place. The framework is in line with LBG's risk management principles and covers the full spectrum of risks that the Group and Company are exposed to. Under this framework, risks are categorised according to an approved LBG risk language which has been adopted across the Group. This covers the principal risks faced by the Group, including the exposures to market, insurance, credit, financial soundness and operational risk. The performance of the Group, its continuing ability to write business and the strategic management of the business depend on its ability to manage these risks.

Policy owners, identified from appropriate areas across the business, are responsible for drafting the LBG and Insurance risk policies, for ensuring that they remain up-to-date and for facilitating any changes. These policies are subject to at least an annual review, or earlier if deemed necessary. Limits are prescribed within which those responsible for the day to day management of each Group company can take decisions. Line management are required to follow prescribed reporting procedures to the bodies responsible for monitoring compliance with policy and controlling the risks.

(b) Risk appetite

The Board has defined the methodology for the management of risk appetite and approved appropriate limits. Limits are defined for the Group as a whole and for the individual risk components. The limits are defined in terms of the amount of capital required to be held to cover certain specified stressed scenarios.

Exposure to each type of risk is monitored against the prescribed limits and the results reported to the Board. Where the exposure to any risk exceeds a trigger amount, the Insurance Executive Committee must approve an action plan to reduce the exposure or the Insurance Board must approve a revised limit.

(c) Financial risks

The Group writes a variety of insurance and investment contracts which are subject to a variety of financial risks, as set out below. Contracts can be either single or regular premium and conventional (non-profit), with profits or unit-linked in nature.

The Group is exposed to a range of financial risks through its financial assets, financial liabilities, reinsurance assets and insurance and investment contract liabilities. In particular, the key financial risk is that long-term investment proceeds are not sufficient to fund the obligations arising from its insurance and investment contracts. The most important components of financial risk are market, insurance, credit and financial soundness risk.

The market risks that the Group primarily faces due to the nature of its investments and liabilities are interest rate, equity, property and foreign exchange risk.

The Group manages these risks in a number of ways, including risk appetite assessment and monitoring of capital resource requirements. In addition, the Principles and Practices of Financial Management ("PPFM") set out the way in which the with profits business is managed. The Group also uses financial instruments (including derivatives) as part of its business activities and to reduce its own exposure to market risk and credit risk.

For with profits business, subject to minimum guarantees, policyholders' benefits are influenced by the smoothed investment returns on assets held in the With Profits Funds. The smoothing cushions policyholders from daily fluctuations in investment markets. This process is managed in accordance with the published PPFM's.

The Group bears financial risk in relation to the guaranteed benefits payable under these contracts. The amount of the guaranteed benefits increases as additional benefits are declared and allocated to policies.

For unit-linked business, policyholders' benefits are closely linked to the investment returns on the underlying funds. In the short term, profit and equity are therefore largely unaffected by investment returns on assets in internal unit-linked funds as any gains or losses will be largely offset by changes in the corresponding insurance and investment contract liabilities, provided that there is appropriate matching of assets and liabilities within these funds. However, any change in the market value of these funds will have an indirect impact on the Group and Company through the collection of annual management and other fund related charges. As markets rise or fall, the value of these charges rises or falls correspondingly.

For non-participating business, the principal market risk is interest rate risk, which arises because assets and liabilities may exhibit differing changes in market value as a result of changes in interest rates. Asset and liability matching is used to mitigate the impact of changes in interest rates where the difference is material.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The summary of significant accounting policies (note 1) describes how the classes of financial instruments are measured and how income and expenses, including fair value gains and losses, are recognised.

The timing of the unwind of the deferred tax assets and liabilities is dependent on the timing of the unwind of the temporary timing differences, arising between the tax bases of the assets and liabilities and their carrying amounts for financial reporting purposes, to which these balances relate.

The sensitivity analyses given throughout this note are based on a change in an assumption while holding all other assumptions constant. In practice, this is unlikely to occur as changes in some of the assumptions may be correlated, for example changes in interest rates and changes in market values. The sensitivity analysis presented also represents, in accordance with the requirements of IFRS 7, management's assessment of a reasonably possible alternative in respect of each sensitivity, rather than worst case scenario positions.

(1) Market risk

Market risk is the risk of reductions in earnings and/or value, through financial or reputational loss, from unfavourable market movements. This risk typically arises from fluctuations in market prices (equity and property risk), market interest rates (interest rate risk) and foreign exchange rates (foreign exchange risk), whether such changes are caused by factors specific to the individual instrument or its issuer or factors affecting all instruments traded in the market.

Investment holdings within the Group are diversified across markets and, within markets, across sectors. Holdings of individual assets are diversified to minimise specific risk and large individual exposures are monitored closely. For assets held outwith unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

Market risk policy is dependent on the nature of the funds in question, and can be broadly summarised as follows:

- Assets held in shareholder funds are invested in money market funds, gilts and investment grade bonds to match regulatory capital requirements. The balance of the shareholder fund assets is managed in line with the policies of LBG to optimise shareholder risk and return. This includes suitable use of derivatives to minimise shareholder risk.
- Unit-linked assets are invested in accordance with the nature of the fund mandates.
- Conventional non-profit liabilities are "close matched" as far as possible in relation to currency, nature and duration.
- With Profits funds are managed in line with the published PPFMs. Benchmarks and minimum and maximum holdings in asset classes are specified to allow limited investment management discretion whilst ensuring adequate diversification. Variable rate bonds and associated additional swap transactions provide significant protection to the With Profits Funds from the effects of interest rate falls in respect of the cost of guaranteed annuity rates.

An analysis of financial assets and financial liabilities at fair value through profit or loss according to their fair value hierarchy (as defined in note 1 (d)) is given below:

As at 31 December 2012

Group

	Level 1	Fair value hierarchy		Total
	£ m	Level 2 £ m	Level 3 £ m	£ m
Equity securities	53,885	28	898	54,811
Debt securities	14,183	21,542	707	36,432
Investments - loans	-	-	489	489
Other investments	-	96	-	96
Derivative financial assets	58	1,277	-	1,335
Total assets	68,126	22,943	2,094	93,163
Derivative financial liabilities	8	1,265	-	1,273
Non-participating investment contract liabilities	-	26,406	-	26,406
Total liabilities	8	27,671	-	27,679

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

Company

	Level 1	Fair value hierarchy		Total
	£ m	Level 2	Level 3	£ m
		£ m	£ m	
Equity securities	2,775	-	298	3,073
Debt securities	2,263	5,084	-	7,347
Other investments	-	861	-	861
Derivative financial assets	27	304	-	331
Investment in subsidiaries at fair value*	8,104	79	452	8,635
Total assets	13,169	6,328	750	20,247
Derivative financial liabilities	-	746	-	746
Non-participating investment contract liabilities	-	13,967	-	13,967
Total liabilities	-	14,713	-	14,713

As at 31 December 2011

Group

	Level 1	Fair value hierarchy		Total
	£ m	Level 2	Level 3	£ m
		£ m	£ m	
Equity securities	51,397	1	776	52,174
Debt securities	18,993	18,587	-	37,580
Other investments	-	96	-	96
Derivative financial assets	14	1,376	-	1,390
Total assets	70,404	20,060	776	91,240
Derivative financial liabilities	32	1,130	-	1,162
Non-participating investment contract liabilities	-	26,374	-	26,374
Total liabilities	32	27,504	-	27,536

Company

	Level 1	Fair value hierarchy		Total
	£ m	Level 2	Level 3	£ m
		£ m	£ m	
Equity securities	6,702	-	238	6,940
Debt securities	4,077	4,865	-	8,942
Other investments	-	747	-	747
Derivative financial assets	2	223	-	225
Investment in subsidiaries at fair value*	4,398	77	481	4,956
Total assets	15,179	5,912	719	21,810
Derivative financial liabilities	8	620	-	628
Non-participating investment contract liabilities	-	13,686	-	13,686
Total liabilities	8	14,306	-	14,314

*Investment in subsidiaries exclude those held at cost of £3,307m (2011: £3,090m).

Of the debt securities classified as Level 2 above, £4,883m of the Group assets and £1,146m of the Company assets (2011: £2,026m Group and £1,263m Company) have been valued using a modelled price or based on a price from a single broker. The models used to derive these prices use only observable data and are therefore level 2 rather than level 3. The remaining assets are priced using prices obtained via a price vendor. This vendor obtains prices from a number of different market makers in corporate bonds and calculates a consensus price to give the best reflection of the market price on that day. On the basis that this price may not be based on actual trades and as information regarding the volume of individual trades is not readily available, these assets have been classified as level 2 rather than level 1.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

The derivative securities classified as Level 2 above have been valued using a tri-party pricing model as determined by the Pricing Source Agreement between SWIP and State Street. Prices are sourced from external sources, counterparties, and the Investment Manager. Where the primary value is within tolerance of the secondary value, the primary value will be utilised.

If the primary and secondary values are out of tolerance, then the primary value will be validated against the tertiary value. If it is within tolerance the primary value will be applied. If primary and tertiary values are outwith tolerance, then the secondary value is validated against the tertiary value. If secondary and tertiary values are within tolerance, then the secondary value is applied. If they are out of tolerance then the investment manager is notified to allow them to make the final pricing decision.

Assets classified as level 3 comprise private equity investments, property investment vehicles and certain loans, asset backed securities and covered bonds.

Private equity investments are valued using the financial statements of the underlying companies prepared by the general partners, adjusted for known cash flows since valuation and subject to a fair value review to take account of other relevant information. Property investment vehicles are valued based on the net asset value of the relevant company which incorporates surveyors' valuations of property. Whilst such valuations are sensitive to estimates, it is believed that changing one or more of the assumptions to reasonably possible alternative assumptions would not change the fair value significantly.

Loans classified as level 3 are valued using a discounted cash flow model. The discount rate comprises market observable interest rates, a risk margin that reflects credit scores that are calibrated to observed ratings and credit spreads on bonds issued within the same sector, and an incremental liquidity premium that is estimated by reference to historical spreads at origination on similar loans where available and established measures of market liquidity. An expected value approach, based on historical data, is applied to options embedded in the loans. The effect of applying reasonably possible alternative assumptions to the value of these loans would be to decrease the fair value by £22m or increase it by £18m. The amount of change in the fair value of these loans that is attributable to changes in credit risk during the period is £nil (2011: £nil), and cumulatively £nil. The amount of change in the fair value that is attributable to credit risk is determined as the amount of change that is not attributable to changes in market conditions that give rise to market risk.

Asset backed securities and covered bonds classified as level 3 are not actively traded, and are valued using a discounted cash flow model. The valuation incorporates credit risk spreads, which are generally based on observable spreads on similar securities, plus a liquidity premium. Assumptions are made about the expected life of the securities, reflecting prepayment behaviour. The effect of applying reasonably possible alternative assumptions to the value of these asset backed securities and covered bonds would be to decrease the fair value by £4m or increase it by £4m.

The table below shows movements in the assets and liabilities measured at fair value based on valuation techniques for which any significant input is not based on observable market data (level 3 only).

Group

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
Balance at 1 January	777	-	541	-
Adjustment on acquisition	-	-	387	-
Net gains/(losses) recognised within net gains/(losses) on assets and liabilities at fair value through profit or loss in the statement of comprehensive income	136	-	(202)	-
Purchases	1,270	-	50	-
Disposals	(89)	-	-	-
Balance at 31 December	2,094	-	776	-
Total gains/(losses) for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	136	-	(202)	-

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

Company

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
Balance at 1 January	719	-	653	-
Total net (losses)/gains recognised within net gains/(losses) on assets and liabilities at fair value through profit or loss in the statement of comprehensive income	(10)	-	45	-
Purchases	41	-	21	-
Balance at 31 December	750	-	719	-
Total gains for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	(10)	-	45	-

Total gains or losses for the period included in the statement of comprehensive income, as well as total gains or losses relating to assets and liabilities held at the reporting date, are presented in the statement of comprehensive income, through net gains/losses on assets and liabilities at fair value through profit or loss.

(i) Equity risk

The exposure of the Group's insurance and investment contract business to equity risk relates to financial assets and financial liabilities whose values will fluctuate as a result of changes in market prices other than from interest and foreign exchange fluctuations. This is due to factors specific to individual instruments, their issuers or factors affecting all instruments traded in the market. Accordingly, the Group monitors exposure limits both to any one counterparty and any one market.

The sensitivity analysis below illustrates how the fair value of future cash flows in respect of equities and properties, net of offsetting movements in insurance and investment contract liabilities, will fluctuate because of changes in market prices at the reporting date.

	Impact on profit after tax and equity for the year	
	2012	2011
	£ m	£ m
6.6% (2011: 9.8%) increase in equity prices	3	1
6.6% (2011: 9.8%) decrease in equity prices	(3)	(1)
5.0% (2011: 2.9%) increase in property prices	-	-
5.0% (2011: 2.9%) decrease in property prices	-	-

(ii) Interest rate risk

Interest rate risk is the risk that the value of future cash flows of a financial instrument will fluctuate because of changes in interest rates and the shape of the yield curve. Interest rate risk in respect of the Group's insurance and investment contracts arises when there is a mismatch in duration or yield between liabilities and the assets backing those liabilities.

The Group's interest rate risk policy requires that the maturity profile of interest-bearing financial assets is appropriately matched to the guaranteed elements of the financial liabilities.

A fall in market interest rates will result in a lower yield on the assets supporting guaranteed investment returns payable to policyholders. This investment return guarantee risk is managed by matching assets to liabilities as closely as possible. An increase in market interest rates will result in a reduction in the value of assets subject to fixed rates of interest which may result in losses if, as a result of an increase in the level of surrenders, the corresponding fixed income securities have to be sold.

The effect of changes in interest rates in respect of financial assets which back insurance contract liabilities is given in note 39. The effect on the Group of changes in the value of investments held in respect of investment contract liabilities due to fluctuations in market interest rates is negligible as any changes will be offset by movements in the corresponding liability.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

The sensitivity analysis below illustrates how the fair value of future cash flows in respect of interest-bearing financial assets, net of offsetting movements in insurance and investment contract liabilities, will fluctuate because of changes in market interest rates at the reporting date.

	Impact on profit after tax and equity for the year	
	2012	2011
	£ m	£ m
25 basis points (2011: 25 basis points) increase in yield curves	40	31
25 basis points (2011: 25 basis points) decrease in yield curves	(54)	(33)

(iii) Foreign exchange risk

Foreign exchange risk relates to the effects of movements in exchange markets including changes in exchange rates.

US corporate bonds are held within the annuity portfolio, the cash flows which are hedged to ensure close matching of the annuity liabilities is maintained. Foreign exchange risk arises on these investments as there may be a mismatch in fair values of the bonds and derivatives resulting from movements in US dollar - sterling exchange rates.

With the exception of these holdings, the overall risk to the Group is minimal due to the following:

- The Group's principal transactions are carried out in pounds sterling;
- The Group's financial assets are primarily denominated in the same currencies as its insurance and investment contract liabilities; and
- Other than shareholder funds, all non-linked investments of the non-profit funds are in sterling or should be currency matched. The effect on the Group of changes in the value of investments held in respect of investment contract liabilities due to fluctuations in foreign exchange rates is negligible as any changes will be offset by movements in the corresponding liability.

The sensitivity analysis below illustrates how the fair value of US dollar assets and liabilities, net of offsetting movements in insurance and investment contract liabilities, will fluctuate because of changes in exchange rates at the reporting date.

	Impact on profit after tax and equity for the year	
	2012	2011
	£ m	£ m
10% (2011: nil) reduction in US dollar – sterling exchange rate	-	-

(2) Insurance risk

Insurance risk is the risk of reductions in earnings and/or value through financial or reputational loss due to fluctuations in the timing, frequency and severity of insured events and to fluctuations in the timing and amount of claim settlements. The principal risk the Group faces under insurance contracts is that the actual claims and benefit payments exceed the amounts expected at the time of determining the insurance liabilities.

The nature of the Group's business involves the accepting of insurance risks which primarily relate to mortality, morbidity, persistency and expenses. Each company within the Group which transacts new business underwrites policies to ensure an appropriate premium is charged for the risk or that the risk is declined.

The Group principally writes the following types of life insurance contracts:

- Life assurance – where the life of the policyholder is insured against death or permanent disability, usually for pre-determined amounts;
- Annuity products – where typically the policyholder is entitled to payments which cease upon death; and
- Morbidity products – where the policyholder is insured against the risk of contracting a defined illness

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

For contracts where death is the insured risk, the most significant factors that could increase the overall level of claims are epidemics or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected. The possibility of a pandemic, for example one arising from Swine Flu, is regarded as a potentially significant mortality risk.

For contracts where survival is the insured risk, the most significant factor is continued improvement in medical science and social conditions that would increase longevity.

For contracts with fixed and guaranteed benefits and fixed future premiums, there are no mitigating terms and conditions that significantly reduce the insurance risk accepted. For participating investment contracts, the participating nature of these contracts results in a significant portion of the insurance risk being shared with the policyholder.

Insurance risk is also affected by the policyholders' right to pay reduced or no future premiums, to terminate the contract completely or to exercise a guaranteed annuity option. As a result, the amount of insurance risk is also subject to policyholder behaviour. On the assumption that policyholders will make decisions that are in their best interests, overall insurance risk will generally be aggravated by policyholder behaviour. For example, it is likely that policyholders whose health has deteriorated significantly will be less inclined to terminate contracts insuring death benefits than those policyholders who remain in good health.

The Group has taken account of the expected impact of policyholder behaviour in setting the assumptions used to measure insurance and investment contract liabilities.

The principal methods available to the Group to control or mitigate longevity, mortality and morbidity risk are through the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed);
- Pricing-to-risk (new insurance proposals would usually be priced in accordance with the underwriting assessment);
- Claims management;
- Product design;
- Policy wording; and
- The use of reinsurance and other risk mitigation techniques.

Rates of mortality and morbidity are investigated annually based on the Group's recent experience and future mortality assumptions are set using the latest population data available. Where they exist, the reinsurance arrangements of each company in the Group are reviewed at least annually.

Persistency risk is the risk associated with the ability to retain long-term business and the ability to renew short-term business. The Group aims to reduce its exposure to persistency risk by undertaking various initiatives to promote customer loyalty. These initiatives are aimed both at the point of sale and through direct contact with existing policyholders, for example through annual statement information packs.

Further information on assumptions, changes in assumptions and sensitivities in respect of insurance and participating investment contracts is given in note 39.

(3) Credit risk

Credit risk is the risk of reductions in earnings and/or value, through financial or reputational loss, as a result of the failure of the party with whom the Group or Company has contracted to meet its obligations.

Investment counterparty default risk arises primarily from holding invested assets to meet liabilities, and reinsurer default credit risk primarily arises from exposure to reinsurers.

Credit risk in respect of unit-linked funds is borne by the policyholders and credit risk in respect of With Profits funds is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for those funds.

For non-linked funds investments, limits on the exposure to a single entity are specified and monitored. Bond exposures are managed through credit rating bands and maximum exposures to individual assets and sectors are set. Assets are restricted to securities in a specified list of countries, and limits applicable to property portfolios are set to prevent concentration of exposure to single tenants and single buildings.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

Shareholder funds are managed in line with the Insurance Credit Risk Policy and the wider LBG Credit Risk Policy and the principles are the same as those outlined above in respect of non-linked funds.

Reinsurance is primarily used to reduce insurance risk. However, it is also sought for other reasons such as improving profitability, reducing capital requirements and obtaining technical support. In addition, reinsurance is also used to offer Investment Fund Links which we are unable to provide through other means. The Group's reinsurance strategy is to reduce the volatility of profits through the use of reinsurance whilst managing the insurance and credit risk within the constraints of the risk appetite limits.

The Group has reinsurance on all significant lines of business where mortality or morbidity risk exceeds set retention limits. This does not, however, discharge the Group's liability as primary insurer. If a reinsurer fails to pay a claim for any reason, the Group remains liable for the payment to the policyholder. All new material reinsurance treaties are subject to Board approval and reinsurance arrangements are reviewed annually to ensure that the reinsurance strategy is being achieved.

Policies are treated as lapsed when payments from the policyholder have not been received for three consecutive months and the policyholder has not provided further information in respect of the non-payment of premiums.

Exposure to other trade debtors is assessed on a case by case basis, using a credit rating agency where appropriate.

The tables below analyse financial assets subject to credit risk using Standard & Poor's rating or equivalent.

As at 31 December 2012

Group

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower £ m	Not rated £ m
Assets arising from reinsurance contracts held	7,147	-	436	6,676	35	-
Debt securities	36,432	17,342	3,729	7,731	7,335*	295
Investments - loans	489	-	272	217	-	-
Other investments	96	-	-	96	-	-
Derivative financial instruments	1,335	-	-	1,002	327	6
Loans and receivables	20,687	17,311	35	2,029	102	1,210
Cash at bank	1,029	370	5	644	3	7
Total	67,215	35,023	4,477	18,395	7,802	1,518

*Of which £6,929m is BBB rated.

Amounts classified as "not rated" in the above tables are not rated by Standard and Poor's or an equivalent rating agency.

Included in the loans and receivables balance above is £1m (2011: £4m) in respect of assets that were past due but not impaired at the reporting date. There were no impaired assets at 31 December 2012 or 31 December 2011. No terms in respect of financial assets had been renegotiated at 31 December 2012 or 31 December 2011.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

As at 31 December 2011

Group

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower £ m	Not rated £ m
Assets arising from reinsurance contracts held	4,720	-	529	4,105	9	77
Debt securities	37,580	22,214	2,330	7,215	5,126*	695
Deposits with credit institutions	-	-	-	-	-	-
Derivative financial instruments	1,390	-	-	1,390	-	-
Loans and receivables	19,077	1,920	8,437	7,642	124	954
Cash at bank	989	12	94	883	-	-
Total	63,756	24,146	11,390	21,235	5,259	1,726

*Of which £4,109m is BBB rated.

Amounts which were past due but not impaired are analysed as follows:

As at 31 December 2012

Group

	Total £ m	Less than 1 month £ m	1 – 3 months £ m	3 – 12 months £ m	More than 12 months £ m
Loans and receivables	1	1	-	-	-
Total	1	1	-	-	-

As at 31 December 2011

Group

	Total £ m	Less than 1 month £ m	1 – 3 months £ m	3 – 12 months £ m	More than 12 months £ m
Loans and receivables	4	2	-	1	1
Total	4	2	-	1	1

As at 31 December 2012

Company

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower £ m	Not rated £ m
Assets arising from reinsurance contracts held	38,415	-	363	6,354	-	31,698
Debt securities	7,346	3,980	351	1,403	1,548*	64
Derivative financial instruments	331	-	-	161	170	-
Loans and receivables	2,536	34	5	1,711	37	749
Cash at bank	46	-	-	46	-	-
Total	48,674	4,014	719	9,675	1,755	32,511

*Of which £1,489m is BBB rated.

Amounts classified as "not rated" within loans and receivables and amounts due from reinsurers in respect of non-participating investment contracts include £1,770m (2011: £1,135m) due from other Group companies which are not rated by Standard & Poor's or an equivalent rating agency.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

As at 31 December 2011

Company

	Total £ m	AAA £ m	AA £ m	A £ m	BBB or lower £ m	Not rated £ m
Assets arising from reinsurance contracts held	33,017	-	404	4,002	-	28,611
Debt securities	8,942	5,932	342	1,566	1,069*	33
Derivative financial instruments	225	-	-	225	-	-
Loans and receivables	1,980	39	7	336	31	1,567
Cash at bank	48	-	-	48	-	-
Total	44,212	5,971	753	6,177	1,100	30,211

*Of which £1,046m is BBB rated.

Amounts classified as “not rated” in the above tables are not rated by Standard and Poor’s or an equivalent rating agency.

Included in the loans and receivables balance above is £1m (2011: £1m) in respect of assets that were past due but not impaired at the reporting date. There were no impaired assets at 31 December 2012 or 31 December 2011. No terms in respect of financial assets had been renegotiated at 31 December 2012 or 31 December 2011.

Amounts which were past due but not impaired are analysed as follows:

As at 31 December 2012

Company

	Total £ m	Less than 1 month £ m	1 – 3 months £ m	3 – 12 months £ m	More than 12 months £ m
Loans and receivables	1	1	-	-	-
Total	1	1	-	-	-

As at 31 December 2011

Company

	Total £ m	Less than 1 month £ m	1 – 3 months £ m	3 – 12 months £ m	More than 12 months £ m
Loans and receivables	1	1	-	-	-
Total	1	1	-	-	-

(i) Concentration risk

Credit concentration risk

Credit concentration risk relates to the inadequate diversification of credit risk.

The Group requires strict control on the use of derivatives by each fund as set out in the Insurance Derivatives Risk Policy (“DRP”).

Credit risk is managed through the setting and regular review of counterparty credit and concentration limits on asset types which are considered more likely to lead to a concentration of credit risk. For other asset types, such as UK government securities or investments in funds falling under the UCITS Directive, no limits are prescribed as the risk of credit concentration is deemed to be immaterial. This policy supports the approach mandated by the FSA for regulatory reporting.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

At 31 December 2012 and 31 December 2011, the Group did not have any significant concentration of credit risk with a single counterparty or group of counterparties where limits applied. With the exception of Government bonds and UCITS funds, the largest aggregated counterparty exposure is less than 0.1% (2011: less than 0.1% of the Group's total assets).

Liquidity concentration risk

Liquidity concentration risk arises where the Group is unable to meet its obligations as they fall due or do so only at an excessive cost, due to over-concentration of investments in particular financial assets or classes of financial asset.

As most of the Group's invested assets are diversified across a range of marketable equity and debt securities in line with the investment options offered to policyholders it is unlikely that a material concentration of liquidity concentration could arise.

This is supplemented by active liquidity management in the Group, to ensure that even under stress conditions the Group has sufficient liquidity as required to meet its obligations. This is delegated by the Board to and monitored through the Shareholder and With Profits Investment Management Committee ("SAWPIM"), Operational Banking Committee and Insurance Finance and Capital Committee ("IFCC").

(ii) Collateral management

Collateral in respect of derivatives

The Group requires strict control limits on net open derivative positions, namely the difference between purchase and sale contracts, by both amount and term. The amount subject to credit risk at any one time is limited to the current fair value of instruments that are favourable to the Group (that is, assets), which in relation to derivatives is only a fraction of the contract or notional values used to express the volume of instruments outstanding. For derivative asset positions, the value of collateral held is at least equal to the value of the asset held on the balance sheet.

The requirement for collateralisation of OTC derivatives, including the levels at which collateral is required and the types of asset that are deemed to be acceptable collateral, are set out in a Credit Support Annex ("CSA"). A CSA is a bilateral legal agreement which, once signed, forms part of the International Swaps and Derivatives Association ("ISDA") agreement between the Company and the counterparty.

A CSA must be completed for OTC derivatives as part of the contracts for such transactions. The CSA will require collateralisation where any net exposure to a counterparty exceeds the OTC counterparty limit, which must be established in accordance with the DRP. The aggregate uncollateralised exposure to any one counterparty must not exceed limits specified in the DRP. Where derivative counterparties are related, the aggregate net exposure is considered for the purposes of applying these limits.

The aggregate exposure to any one counterparty, net of any collateralisation, across all life companies, funds and transactions, should not exceed £10m.

Acceptable collateral is defined in each instance and must take into account the quality and appropriateness of the proposed collateral as well as being acceptable to the entity receiving the collateral. Collateral may include the following:

- Sovereign government debt of developed economies
- Supranational debt denominated in eligible currencies
- Corporate bonds denominated in eligible currencies
- Equities denominated in eligible currencies
- Cash (this is received and invested in the SWIP Global Liquidity Fund)

Assets with the following carrying amounts have been pledged in accordance with the terms of the relevant CSAs entered into in respect of various OTC derivative contracts:

	2012		2011	
	£ m	£ m	£ m	£ m
	<u>Group</u>	<u>Company</u>	<u>Group</u>	<u>Company</u>
Financial assets:				
Investments at fair value through profit or loss	205	110	577	497
Cash and cash equivalents	339	312	-	-
Total	544	422	577	497

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

The Company has the right to recall any collateral pledged provided that this is replaced with alternative acceptable assets. Collateral pledged continues to be recognised on the Company's balance sheet.

Collateral amounts held against derivatives are not recognised as assets. Assets with a fair value of £583m (2011: £1,235m) were accepted by the Group and £57m (2011: £497m) by the Company as collateral, of which £402m (2011: £165m) for the Group and £2m (2011: £35m) for the Company is permitted to be sold or repledged in the absence of default. The policy of the Group and Company is not to repledge assets, and no collateral was sold or repledged by the Group or Company during the year or in the prior year. The Group and Company have an obligation to return these assets to the pledgor.

All collateral held relates to fully performing assets.

Collateral in respect of loans to related parties

The Company has made loans to related parties against which collateral is held. The collateral includes asset backed securities and covered bonds cash lent.

Collateral amounts held are not recognised as assets. At 31 December 2012, collateral with a fair value of £nil (2011: £nil) was available to the Group and Company to sell or repledge in the absence of default by the counterparty. The policy of the Group and Company is not to repledge assets, and no collateral (2011: £nil) was sold or repledged during the year. The Group and Company have an obligation to return these assets to the pledgor.

Collateral in respect of stocklending

The Group enters into stocklending transactions. The Insurance Investment Strategy Committee (IISC) and its sub-committee Investment Management Operational Review Committee (IMOR) are responsible for setting the parameters of stocklending and therefore changes to those parameters. The accepted collateral can include cash, equities, certain bonds and money market instruments. On a daily basis, the fair value of collateral is compared to the fair value of stock on loan. The value of collateral must always exceed the value of stock on loan.

Stocklending is permitted in accordance with the Insurance Stocklending Policy. All stocklending takes place on an open/call basis, enabling the loan to be recalled at any time within the standard settlement terms of the market concerned.

The policy requires all lending to be undertaken via a fully indemnified programme (where the agent of the programme provides an indemnification against borrower and collateral default).

Additionally, IMOR will set limits on the maximum amount of any security that may be lent and the markets in which lending can take place.

The policy requires acceptable collateral to be pledged to at least the value of securities lent and sets specific parameters over what qualifies as acceptable collateral.

The aggregate value of securities on loan by the Group is £6,026m (2011: £7,364m) and by the Company is £1,863m (2011: £3,083m). Securities on loan are included in investments at fair value through profit or loss and no account is taken of collateral held. The aggregate fair value of collateral held is £6,364m (2011: £7,686m) for Group and £1,972m (2011: £3,231m) for Company. There were no collateral defaults in respect of stocklending during the year ended 31 December 2012 (2011: none) which required a call to be made on collateral.

Collateral pledged in respect of a repurchase agreement with HBOS Treasury continues to be recognised on the Company's balance sheet. The amount pledged was £78m (2011: £274m).

(4) Financial soundness risk

Financial soundness risk covers the risk of financial failure, reputational loss or loss of earnings and/or value arising from a lack of liquidity, funding or capital and/or the inappropriate recording, reporting or disclosure of financial, taxation and regulatory information.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

(i) Financial and prudential regulatory reporting, tax and disclosure risks

The Group and Company are exposed to the risk that policies and procedures are not sufficient to maintain adequate books and records to support statutory (including the requirement to prepare consolidated financial statements), regulatory and tax reporting and to prevent and detect financial reporting fraud.

The Group has developed procedures to ensure that compliance with both current and potential future requirements are understood and that policies are aligned to its risk appetite. The Group has established a system of internal controls the objective of which is to provide reasonable assurance that transactions are recorded and undertaken in accordance with delegated authorities that permit the preparation and disclosure of financial statements (including consolidated financial statements), regulatory reporting and tax returns in accordance with IFRSs, statutory and regulatory requirements.

The Group undertakes a programme of work designed to support an annual assessment of the effectiveness of internal controls over financial reporting, to identify tax liabilities and to assess emerging legislation and regulation.

(ii) Liquidity risk

Liquidity risk is the risk that the Group will encounter difficulty in raising funds to meet its financial commitments as they fall due, or can secure them only at an excessive cost. Liquidity risk may result from either the inability to sell financial assets quickly at their fair values; or from an insurance liability falling due for payment earlier than expected; or from the inability to generate cash inflows as anticipated.

Liquidity risk has been analysed as arising from payments to policyholders (including those where payment is at the discretion of the policyholder) and non policyholder related activity (such as investment purchases and the payment of shareholder expenses).

In order to quantify the liquidity risk exposure various stress tests are considered. At the start of 2012 liquidity risk was measured by comparing the projected outflow in the stress scenario for twelve months of surrenders and three months of maturities against the sum of liquid resources available. During 2012 a new liquidity risk appetite was introduced that required that in a one-in-ten year event the Company has sufficient liquid assets to cover three times net cash flows (to policyholders, shareholders and debt holders). A further revision was made to the liquidity risk appetite in December 2012. The new appetite considers two time periods; a three month stressed outflow is required to be covered by primary liquid assets; and a one year stressed outflow is required to be covered by primary and secondary liquid assets, after taking account of management actions. Primary liquid assets are gilts or cash, and secondary liquid assets are tradable non-primary assets. Stressed outflows are based on the most severe of several scenarios; Group firm-specific stress scenarios; FSA market-wide scenarios; and FSA market wide scenarios with Insurance-specific overlays. The risk appetite sets a coverage benchmark of over 150%.

Liquidity risk in respect of each of the major product areas is primarily mitigated as follows:

Annuity contracts:

Assets are held which are specifically chosen to correspond to the expectation of timing of annuity payments. Gilts, corporate bonds, loans and, where required, derivatives are selected to reflect the expected annuity payments as closely as possible and are regularly rebalanced to ensure that this remains the case in future.

With profits contracts

For with profits business, a portfolio of assets is held in line with investment mandates which will reflect policyholder expectations as set out in the published PPFMs.

Liquidity is maintained within the portfolio via the holding of cash balances and a substantial number of highly liquid assets, principally gilts and bonds. Management also have the ability to sell less liquid assets at a reduced price if necessary, with any loss passed on to policyholder in line with policyholders' reasonable expectations. Losses are managed and mitigated by anticipating policyholder behaviour and sales of underlying assets within funds.

Non-participating contracts

For unit-linked products, portfolios are invested in accordance with unit fund mandates. Deferral clauses are included in policyholder contracts to give time, when necessary, to realise linked assets without being a forced seller. As at 31 December 2012, there are no funds under management subject to deferral.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

For non-linked products other than annuity contracts, backing investments are mostly held in gilts with minimal liquidity risk. Investments are arranged to minimise the possibility of being a distressed seller whilst at the same time investing to meet policyholder obligations. This is achieved by anticipating policyholder behaviour and sales of underlying assets within funds.

Shareholder funds

For shareholder funds, liquidity risk is managed in line with the Insurance Liquidity Risk Policy and the wider LBG Funding and Liquidity Risk Policy.

The following tables indicate the timing of the contractual cash flows arising from the Group and Company's financial liabilities, as required by IFRS 7. The table is based on the undiscounted cash flows of financial liabilities based on the earliest date on which the Company is obliged to pay. The table includes both interest and principal cash flows.

Liquidity risk in respect of insurance and participating investment contract liabilities has been analysed based on the expected pattern of maturities as permitted by IFRS 4 rather than by contractual maturity. A maturity analysis of non-participating investment contracts based on expected contract maturities is also given as it is considered that this analysis provides additional useful information in respect of the liquidity risk relating to contracts written by the Group and Company.

As at 31 December 2012

Group

Liabilities	Carrying amount (discounted)	No stated maturity	Contractual cash flows (undiscounted)				
			Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m	£ m
Non-participating investment contract liabilities	26,406	-	26,406	-	-	-	-
External interests in collective investment vehicles	17,220	-	17,220	-	-	-	-
Derivative financial instruments	1,273	-	229	31	73	321	1,004
Subordinated debt	2,159	378	-	19	93	1,022	2,763
Borrowings	21	-	21	-	-	-	-
Other financial liabilities	1,908	28	1,847	-	33	-	-
Total	48,987	406	45,723	50	199	1,343	3,767

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

As at 31 December 2011

Group

Liabilities	Carrying amount (discounted)	No stated maturity	Contractual cash flows (undiscounted)				
			Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m	£ m
Non-participating investment contract liabilities	26,374	-	26,374	-	-	-	-
External interests in collective investment vehicles	15,928	5,411	10,516	-	-	-	-
Derivative financial instruments	1,162	-	23	490	42	213	1,400
Subordinated debt	1,875	396	-	19	70	930	2,178
Borrowings	7	-	7	-	-	-	-
Other financial liabilities	2,235	83	2,102	-	-	50	-
Total	47,581	5,890	39,022	509	112	1,193	3,578

The contractual cash flow analysis set out above has been based on the earliest possible contractual date, regardless of the surrender penalties that might apply and has not been adjusted to take account of such penalties.

An analysis of the contractual cash flows in respect of insurance and investment contract liabilities by expected contract maturity, on a discounted basis, is shown below:

As at 31 December 2012

Group

Maturity Analysis for insurance and investment contracts	Total	Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m
Insurance and participating investment contracts	73,511	838	1,193	5,132	14,919	51,429
Non-participating investment contracts	26,406	1,062	389	1,756	7,384	15,815

As at 31 December 2011

Group

Maturity Analysis for insurance and investment contract liabilities	Total	Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m
Insurance and participating investment contracts	69,894	600	1,397	4,509	17,337	46,051
Non-participating investment contracts	26,374	167	269	1,035	4,788	20,115

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

As at 31 December 2012

Company

Liabilities	Carrying amount (discounted)	No stated maturity	Contractual cash flows (undiscounted)				
			Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m	£ m
Borrowings	4	-	4	-	-	-	-
Non-participating investment contract liabilities	13,967	-	13,967	-	-	-	-
Derivative financial instruments	746	-	19	26	70	315	732
Subordinated debt	1,416	-	-	19	58	880	1,910
Other financial liabilities	705	-	705	-	-	-	-
Total	16,838	-	14,695	45	128	1,195	2,642

As at 31 December 2011

Company

Liabilities	Carrying amount (discounted)	No stated maturity	Contractual cash flows (undiscounted)				
			Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
	£ m	£ m	£ m	£ m	£ m	£ m	£ m
Non-participating investment contract liabilities	13,686	-	13,686	-	-	-	-
Derivative financial instruments	628	-	12	-	35	165	1,119
Subordinated debt	1,424	-	-	19	58	880	1,910
Borrowings	3	-	3	-	-	-	-
Other financial liabilities	1,089	-	1,089	-	-	-	-
Total	16,830	-	14,790	19	93	1,045	3,029

The contractual cash flow analysis set out above has been based on the earliest possible contractual date, regardless of the surrender penalties that might apply and has not been adjusted to take account of such penalties.

An analysis of insurance and investment contract liabilities by expected contract maturity, on a discounted basis, is shown below:

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

As at 31 December 2012

Company

Maturity Analysis for insurance and investment contract liabilities	Total £ m	Less than 1 month £ m	1-3 months £ m	3-12 months £ m	1-5 years £ m	More than 5 years £ m
Insurance and participating investment contracts	43,886	513	563	2,489	10,553	29,768
Non-participating investment contracts	13,967	155	177	814	3,662	9,159

As at 31 December 2011

Company

Maturity Analysis for insurance and investment contract liabilities	Total £ m	Less than 1 month £ m	1-3 months £ m	3-12 months £ m	1-5 years £ m	More than 5 years £ m
Insurance and participating investment contracts	38,896	285	651	2,301	8,416	27,243
Non-participating investment contracts	13,686	51	86	208	1,553	11,788

(iii) Capital risk

Capital risk is defined as the risk that:

- the Group, or one of its separately regulated subsidiaries, has insufficient capital to meet its regulatory capital requirements;
- the Group has insufficient capital to provide a stable resource to absorb all losses up to a confidence level defined in the risk appetite;
- the Group loses reputational status by having capital that is regarded as inappropriate, either in quantity, type or distribution; and/or
- the capital structure is inefficient.

The business of several of the companies within the Group is regulated by the FSA. The FSA specifies the minimum amount of capital that must be held by each of the regulated companies within the Group in addition to their insurance liabilities. Under the FSA rules, each insurance company within the Group must hold assets in excess of the higher of:

- the Pillar 1 amount, which is calculated by applying fixed percentages of mathematical reserves and capital at risk; and
- the Pillar 2 amount, which is derived from an economic capital assessment undertaken by each regulated company, which is reviewed by the FSA.

The minimum required capital must be maintained at all times throughout the year. These capital requirements and the capital available to meet them are regularly estimated in order to ensure that capital maintenance requirements are being met.

The Group's objectives when managing capital are:

- to have sufficient capital to safeguard the Group's ability to continue as a going concern so that it can continue to provide returns for the shareholder and benefits for other stakeholders;
- to comply with the insurance capital requirements set out by the FSA in the UK;
- when capital is needed, to require an adequate return to the shareholder by pricing insurance and investment contracts according to the level of risk associated with the business written; and
- to meet the requirements of the Schemes of Transfer.

The capital management strategy is such that the single integrated insurance business (comprising SWG and its subsidiaries, including the Group) will hold capital in line with the stated risk appetite for the business, which is to be able to withstand a one in ten year stress event without breaching the solvency capital requirements. At SWG level it is intended that all surplus capital above that required to absorb a one in ten year stress event will be distributed to LBG.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)

The Company's capital comprises all components of equity, movements in which are set out in the statement of changes in equity and includes subordinated debt (note 33).

The table below sets out the regulatory capital and the required capital held at 31 December in each year on a Pillar 1 basis. The current year information is taken from the final FSA return.

	2012			2011		
	With Profit £ m	Shareholder £ m	Total £ m	With Profit £ m	Shareholder £ m	Total £ m
Available Capital	3,553	5,002	8,555	3,261	4,698	7,959
Capital Requirements	(3,386)	(1,265)	(4,651)	(3,095)	(1,182)	(4,277)
Regulatory Surplus	167	3,737	3,904	166	3,516	3,682

All minimum regulatory requirements were met during the year.

(d) Operational risk

Operational risk covers the risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people related or external events.

There are a number of categories of operational risk:

Conduct risk

The risk of regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer outcomes. Associated risks include poor product design and development, customer advice, customer service and customer complaint handling.

Customer treatment and how LBG as a whole manages its customer relationships affects all aspects of the Group's operations and is closely aligned with achievement of LBG's strategic vision to be the best bank for customers. There remains a high level of scrutiny regarding the treatment of customers by financial institutions from regulatory bodies, the press and politicians.

People risk

The risk of reductions in earnings and/or value through financial or reputational loss arising from ineffectively leading colleagues responsibly and proficiently, managing people resource, supporting and developing colleague talent, or meeting regulatory obligations related to our people.

Financial crime and security risk

Financial crime risk covers the risk of reduction in earnings and/or value, through financial or reputational loss, associated with financial crime and failure to comply with related regulatory obligations, these losses may include censure, fines or the cost of litigation. This includes risks associated with fraud and bribery, and obligations related to money laundering, sanctions and counter terrorism.

Security risk relates to the risk of reductions in earnings and/or value, through financial or reputational loss, resulting from theft of or damage to the Group's assets, the loss, corruption, misuse or theft of the Group's information assets or threats or actual harm to the Group's people. This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events.

Organisational infrastructure and change risk

Organisational infrastructure risk covers the risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor internally facing business processes at a Group, divisional or company level. Organisational infrastructure in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise. Change risk comprises the risk of potential loss from change initiatives failing to deliver to requirements, budget or timescale, failing to implement change effectively or failing to realise desired benefits.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

40. Risk management (continued)**Political risks and uncertainties**

Political risk is the risk of reductions in earnings and/or value through financial loss from a changing political environment. In the absence of a definitive, agreed and fully-implemented solution to the Eurozone crisis there continues to be some risk that ongoing economic uncertainty in Europe and the availability of credit could cause a return to recession in the UK and Ireland.

A Scottish Independence referendum is due to be held in 2014. A LBG Scottish Constitutional Change Steering Group, with cross-Group representation, has been set up to assess any potential impact for the business.

Supplier management risk

The risk of reductions in earnings and/or value through financial or reputational loss from services with outsourced partners or third party suppliers.

IT Systems risk

The risk of reductions in earnings and/or value through financial or reputational loss resulting from the failure to develop, deliver or maintain effective IT solutions.

(e) Legal and regulatory risks

Legal and regulatory risk is the risk of reductions in earnings and/or value, through financial or reputational loss, from failing to comply with the applicable laws, regulations or codes.

A provision is held in respect of German litigation. This is discussed further in note 30.

The volume of actual and expected regulatory change remains high where work is ongoing to review, assess and embed new regulatory requirements into day-to-day operational and business practices across the Group.

Regulators are interested in protecting the rights of the policyholders and ensuring that the Group is satisfactorily managing affairs for the benefit of the policyholders. Regulators are also keen to ensure that the Group maintains appropriate solvency levels to meet unforeseen liabilities arising from reasonably foreseeable economic shocks or natural disasters. As such, the Group is subject to regulatory requirements which prescribe and impose certain restrictive provisions.

41. Related party transactions**(a) Ultimate parent and shareholding**

The Group's immediate parent undertaking is Scottish Widows Financial Services Holdings, a company registered in the United Kingdom. Scottish Widows Financial Services Holdings has taken advantage of the provisions of the Companies Act 2006 and has not produced consolidated financial statements.

The Company's ultimate parent company and ultimate controlling party is Lloyds Banking Group plc, which is also the parent undertaking of the largest group of undertakings for which group accounts are drawn up and of which the Company is a member. Lloyds TSB Bank plc is the parent undertaking of the smallest such group of undertakings for which group accounts are drawn up and of which the Company is a member. Copies of the Lloyds Banking Group plc financial statements in which the Company is consolidated can be obtained from the Group Secretary's Department, Lloyds Banking Group plc, 25 Gresham Street, London EC2V 7HN.

(b) Transactions and balances with related parties**Transactions between the Group and other LBG companies**

In accordance with IAS 24 "Related Party Disclosures", transactions and balances between Group companies have been eliminated on consolidation and have not been reported as part of the consolidated financial statements.

The Group has entered into the following transactions with other related parties during the year and holds the following balances with other related parties at the end of the year:

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

41. Related party transactions (continued)

Relationship	Transactions in the Year		Outstanding Balance at 31 December	
	2012 £ m	2011 £ m	2012 £ m	2011 £ m
Ultimate parent undertaking – LBG plc:				
Expense recharges and amounts payable	(111)	(328)	(161)	(50)
Invested assets	1,083	(8)	1,390	307
Stock lending	1,400	-	1,400	-
Other intercompany charges	-	18	4	2
Parent undertaking – Lloyds TSB Bank plc:				
Bank account balances	-	-	3	-
Commission and amounts payable	-	-	(5)	-
Parent undertaking – Scottish Widows Group Limited:				
Subordinated debt	(250)	-	(250)	-
Subordinated debt interest paid	(14)	-	(14)	-
Intercompany debtor	-	-	67	67

	Transactions in the Year		Outstanding Balance at 31 December	
	2012 £ m	2011 £ m	2012 £ m	2011 £ m
Other related parties:				
Bank account balances	211	(15)	552	341
Intercompany debtor balances	-	-	3	200
Investment assets purchased	-	-	-	2,038
Holdings in OEICs	-	-	45,527	27,585
Intercompany creditor balances	-	-	(14)	(18)
Dividend income and amounts receivable	-	14	-	-
Interest income	(3)	125	-	3
Expense recharges and amounts payable	74	82	(7)	(81)
Reinsurance premiums	26	(9)	-	26
Investment management fees	1	(87)	2	(15)
Commission	(72)	(22)	-	(2)
Subordinated debt	(35)	(23)	(1,358)	(1,383)
Loans receivable	-	-	115	-
Other interest paid	(11)	(24)	(11)	-

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

41. Related party transactions (continued)

Transactions between the Company and other LBG companies

The Company has entered into the following transactions with other related parties during the year and holds the following balances with other related parties at the end of the year:

Relationship	Transactions in the Year		Outstanding Balance at 31 December	
	2012 £ m	2011 £ m	2012 £ m	2011 £ m
Subsidiary undertaking:				
Investment assets	-	-	-	3,197
Holdings in OEICs	-	-	10,513	5,153
Intercompany debtor balances	-	-	35	50
Dividend income and amounts receivable	140	36	-	-
Contingent loan and interest receivable	10	8	868	744
Reinsurance claims and amounts payable	2,992	2,776	-	-
Investment management fee rebates	-	7	10	-
Loan notes and interest receivable	4	4	38	38
Customer remediation income and amounts receivable	1	-	72	69
Annual management charges received	12	28	13	30
Reinsurance commission	372	373	-	-
Reinsurance premiums	(3,471)	(3,383)	-	-
Reinsurance claims	42	30	-	-
Reinsurance expenses	-	-	-	-
Expense recharges and amounts payable	(199)	(202)	(21)	(53)
Annual management charges paid	(2)	(2)	-	-
Renewal commission and amounts receivable	33	16	1	2
Interest income	-	19	-	-

	Transactions in the Year		Outstanding Balance at 31 December	
	2012 £ m	2011 £ m	2012 £ m	2011 £ m
Other related parties:				
Bank account balances	-	-	167	132
Investment assets	-	-	74	1,208
Intercompany debtor balances	-	-	157	158
Intercompany creditor balances	-	-	(14)	(21)
Interest income	3	28	3	3
Stock lending	1,400	-	1,400	-
Dividend income and amounts receivable	3	3	-	-
Investment management fees	(16)	(16)	(1)	(1)
Commission	(20)	(5)	(6)	(25)
Subordinated debt	(48)	(23)	(800)	(800)
Other interest paid	-	(24)	(12)	(12)

The above balances are unsecured in nature and are expected to be settled in cash.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

41. Related party transactions (continued)

Transactions between the Group and key management

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Company which, for the Company, are the Executive Directors.

Transactions between the key management personnel of the Group and parties related to them as defined by IAS 24 are as follows:

Key management compensation:

	2012 £ m	2011 £ m	2012 £ m	2011 £ m
	<u>Group</u>	<u>Group</u>	<u>Company</u>	<u>Company</u>
Salaries and other short-term benefits	5.1	2.7	4.1	1.0
Post-employment benefits	0.2	0.1	0.2	-
Share-based payments	1.0	1.2	0.8	0.7
Total	6.3	4.0	5.1	1.7

Certain members of key management in the Group, including the highest paid director, provide services to other companies within LBG. In such cases, for the purposes of this note, figures have been included based on an apportionment to the Group of the total compensation earned.

Retirement benefits are accruing to three Directors and key management personnel (2011: none) under defined benefit pension schemes. Twelve Directors and key management personnel (2011: two) are paying into a defined contribution scheme.

The aggregate value of contributions paid to a pension scheme for qualifying services was £0.1m for the Group (2011: £0.1m) and £0.1m for the Company (2011: £0.1m).

During the year £nil (2011: £nil) was paid to Directors of the Group as compensation for loss of office.

The aggregate amount of money receivable by directors, and the net value of assets received/receivable by directors, under long term incentive schemes in respect of qualifying services was £1.5m (2011: £4.0m).

During the year, two directors exercised share options (2011: nil) and seven directors' qualifying services shares were received under long term incentive schemes (2011: six).

Detail regarding the highest paid Director is as follows:

	2012 £ m	2011 £ m	2012 £ m	2011 £ m
	<u>Group</u>	<u>Group</u>	<u>Company</u>	<u>Company</u>
Apportioned aggregate emoluments	0.8	0.3	0.7	0.1
Defined benefits pension scheme accrued benefit at 31 December (all amounts less than £1m)	-	-	-	-

The highest paid Director exercised share options during the year and was granted shares in respect of qualifying service during the year. This was also the case in the prior year.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

41. Related party transactions (continued)

Other transactions between key management and LBG companies:

Deposits

	2012 £000	2011 £000
Outstanding at 1 January	-	-
Placed during the year	-	-
Interest earned during the year	-	-
Withdrawn during the year	-	-
Outstanding at 31 December	-	-

Other

	2012 £000	2011 £000
Value of investments managed by LBG entities	3,313	2,991
Insurance premiums paid	-	-
Insurance claims received	264	274

Other transactions

HM Treasury

In January 2009, HM Treasury became a related party of the Company following its subscription for ordinary shares in LBG, the Company's ultimate parent company, issued under a placing and open offer. As at 31 December 2012, HM Treasury held a 39.2 % (2011: 40.2%) interest in LBG's ordinary share capital and, consequently, HM Treasury remained a related party of the Company throughout 2012.

There were no material transactions between the Group or Company and HM Treasury during the year (2011: none) that were not made in the ordinary course of business or that are unusual in their nature or conditions. In addition, the Group and Company have entered into transactions with HM Treasury on an arm's length basis including, but not exclusively in relation to, the payment of corporation tax and value added tax.

42. Share-based payments

During the year ended 31 December 2012 LBG operated a number of share-based payment schemes for which employees of the Group were eligible, all of which are equity settled. Details of all schemes operated by LBG are set out below; these are managed and operated on a LBG-wide basis.

The amount charged to the Group's income statement in respect of LBG share-based payment schemes, and which is included in staff costs (note 9), was £5m (2011: £2m).

During the year ended 31 December 2012 the Company's ultimate parent company operated the following share-based payment schemes, all of which are equity settled.

Executive share option schemes

The executive share option schemes were long-term incentive schemes available to certain senior executives of Lloyds Banking Group plc, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between March 2004 and August 2004, the aggregate value of the award based upon the market price at the date of grant could not exceed four times the executive's annual remuneration and, normally, the limit for the grant of options to an executive in any one year would be equal to 1.5 times annual salary with a maximum performance multiplier of 3.5.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

42. Share-based payments (continued)

Performance conditions for executive options*For options granted in 2004*

The performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 17 companies including Lloyds Banking Group plc.

The performance condition was measured over a three year period which commenced at the end of the financial year preceding the grant of the option and continued until the end of the third subsequent year. If the performance condition was not then met, it was measured at the end of the fourth financial year. If the condition was not then met, the options would lapse.

To meet the performance conditions, the Lloyds Banking Group plc's ranking against the comparator group was required to be at least ninth. The full grant of options only became exercisable if the Lloyds Banking Group plc was ranked first. A performance multiplier (of between nil and 100%) was applied below this level to calculate the number of shares in respect of which options granted to Executive Directors would become exercisable, and were calculated on a sliding scale. If Lloyds Banking Group plc was ranked below median the options would not be exercisable.

Options granted to senior executives other than Executive Directors were not so highly leveraged and, as a result, different performance multipliers were applied to their options. For the majority of executives, options were granted with the performance condition but with no performance multiplier.

For options granted in 2005

The same conditions applied as for grants made in 2004, except that:

- the performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 15 companies including Lloyds Banking Group plc;
- if the performance condition was not met at the end of the third subsequent year, the options would lapse; and
- the full grant of options became exercisable only if Lloyds Banking Group plc was ranked in the top four places of the comparator group. A sliding scale applied between fourth and eighth positions. If Lloyds Banking Group plc was ranked below the median (ninth or below) the options would lapse.

Save-As-You-Earn schemes

Eligible employees may enter into contracts through the Save-As-You-Earn schemes to save up to £250 per month and, at the expiry of a fixed term of three, five or seven years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Lloyds Banking Group plc at a discounted price of no less than 80% of the market price at the start of the invitation.

Other share option plansLloyds Banking Group Executive Share Plan 2003

The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and as such were not subject to any performance conditions. The Plan's usage has now been extended to not only compensate new recruits for any lost share awards but also to make grants to key individuals for retention purposes with, in some instances, the grant being made subject to individual performance conditions.

Lloyds Banking Group Share Buy Out Awards

As part of arrangements to facilitate the recruitment of certain Executives, options have been granted by individual deed and, where appropriate, in accordance with the Listing Rules of the UK Listing Authority.

The awards were granted in recognition that the Executives' outstanding awards over shares in their previous employing company lapsed on accepting employment with the Lloyds Banking Group.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

42. Share-based payments (continued)

Lloyds Banking Group Long-Term Incentive Plan

The Long-Term Incentive Plan (LTIP) introduced in 2006 is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of Lloyds Banking Group plc over a three year period. Awards are made within limits set by the rules of the Plan, with the limits determining the maximum number of shares that can be awarded equating to three times annual salary. In exceptional circumstances this may increase to four times annual salary.

The performance conditions for awards made in April, May and September 2009 are as follows:

(i) Earnings per share (EPS): relevant to 50% of the award. Performance will be measured based on EPS growth over a three-year period from the baseline EPS of 2008.

(ii) Economic Profit (EP): relevant to 50% of the award. Performance will be measured based on the extent to which cumulative EP targets are achieved over the three-year period.

An additional discretionary award was made in April, May and September 2009. The performance conditions for those awards are as follows:

(i) Synergy Savings: The release of 50% of the shares will be dependent on the achievement of target run-rate synergy savings in 2009 and 2010 as well as the achievement of sustainable synergy savings of at least £1.5 billion by the end of 2011. The award will be broken down into three equally weighted annual tranches. Performance will be assessed at the end of each year against annual performance targets based on a trajectory to meet the 2011 target. The extent to which targets have been achieved will determine the proportion of shares to be banked each year. Any release of shares will be subject to the Lloyds Banking Group plc Remuneration Committee judging the overall success of the delivery of the integration programme.

(ii) Integration Balanced Scorecard: The release of the remaining 50% of the shares will be dependent on the outcome of a Balanced Scorecard of non-financial measures of the success of the integration in each of 2009, 2010 and 2011. The Balanced Scorecard element will be broken down into three equally weighted tranches. The tranches will be crystallised and banked for each year of the performance cycle subject to separate annual performance targets across the four measurement categories of Building the Business, Customer, Risk and People and Organisation Development.

The performance conditions for awards made in March and August 2010 are as follows:

(i) EPS: relevant to 50% of the award. Performance will be measured based on EPS growth over a three-year period from the baseline EPS of 2009.

(ii) Economic Profit: relevant to 50% of the award. Performance will be measured based on the compound annual growth rate of adjusted EP over the three financial years starting on 1 January 2010 relative to an adjusted 2009 Economic Profit base.

The performance conditions for awards made in March and September 2011 are as follows:

(i) EPS: relevant to 50% of the award. The performance target is based on 2013 adjusted EPS outcome.

(ii) EP: relevant to 50% of the award. The performance target is based on 2013 adjusted EP outcome.

The performance conditions for awards made in March and September 2012 are as follows:

(i) EP: relevant to 30% of the award. The performance target is based on 2014 adjusted EP outcome.

(ii) Absolute Total Shareholder Return (ATSR): relevant to 30% of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2014.

(iii) Short-term funding as a percentage of total funding: relevant to 10% of the award. Performance will be measured relative to 2014 targets.

(iv) Non-core assets at the end of 2014: relevant to 10% of the award. Performance will be measured by reference to balance sheet non-core assets at 31 December 2014.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

42. Share-based payments (continued)

(v) Net simplification benefits: relevant to 10% of the award. Performance will be measured by reference to the run rate achieved by the end of 2014.

(vi) Customer satisfaction: relevant to 10% of the award. Performance will be measured by reference to the total number of FSA reportable complaints per 1,000 customers over the three year period to 31 December 2014.

Share incentive planFree shares

An award of shares may be made annually to employees based on a percentage of each employee's salary in the preceding year up to a maximum of £3,000. The percentage is normally announced concurrently with Lloyds Banking Group plc's annual results and the price of the shares awarded is announced at the time of award. The shares awarded are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves the Lloyds Banking Group plc within this three year period for other than a 'good' reason, all of the shares awarded will be forfeited.

The last award of free shares was made in 2008.

Matching shares

Lloyds Banking Group plc undertakes to match shares purchased by employees up to the value of £30 per month; these matching shares are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, 100% of the matching shares are forfeited. Similarly if the employees sell their purchased shares within three years, their matching shares are forfeited.

Other information

The charge made to the income statement represents the Company's share of the cost of the above schemes. This charge has been allocated to the Company based on the number of the Company's employees who participate in the above schemes. It is not practicable for the Company to provide information regarding the ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life information and the number of options outstanding that is specific to the Company's employees without incurring significant additional cost.

Full details of the ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life information and number of options outstanding for the above schemes overall can be found in the 2012 annual report and accounts of the Company's ultimate parent company. Copies of the ultimate parent company's 2012 annual report and accounts may be obtained from the Company Secretary's Department, Lloyds Banking Group plc, 25 Gresham Street, London, EC2V 7HN.

43. Operating leases

The total future minimum rental payments receivable under non-cancellable leases, including subleases, are as follows:

	2012 £ m	2011 £ m
Within one year	227	241
Between two and five years	790	874
Beyond five years	1,318	1,575
Total	2,335	2,690

The total of contingent rents recognised as income during the year was £nil (2011: £nil). The total of contingent rents recognised as operating expenses during the year was £nil (2011: £nil). Generally the Group's operating leases are for terms of 15 years or more.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

44. Capital commitments

The Group has given an undertaking to provide up to EUR 170m (£138m) (2011: EUR 170m (£148m)) of capital to the European Balanced Property Fund. At 31 December 2012, EUR 157m (£128m) had been drawn down (2011: EUR 141m (£123m)) and EUR 11m had been redeemed. The remainder of the funds committed can no longer be drawn down as the draw down period has closed.

The Group has contracted for, but not paid for, £9m (2011: nil) development expenses for investment property. Of this amount, the Company has contracted for, but not paid for, £2m (2011: £nil).

The Company invests in a number of private equity entities to which capital of EUR 371m (£301m) and £151m were committed at 31 December 2012 (2011: EUR 370m (£309m) and £155m). The total amount drawn down at 31 December 2012 was EUR 267m (£216m) and £109m (2011: EUR 257m (£214m) and £105m). The remainder of the funds committed can be drawn down as required by the Funds.

At a consolidated level, the Group invests in private equity entities to which capital of EUR 531m (£431m) and £151m were committed at 31 December 2012 (2011: EUR 527m (£441m) and £155m). The total amount drawn down at 31 December 2012 was EUR 383m (£310m) and £109m (2011: EUR 366m (£306m) and £105m). The remainder of the funds committed can be drawn down as required by the Funds.

45. Standards and interpretations effective in 2012

The Group has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2012. Neither of these standards or amendments has had a material impact on these financial statements.

(i) Disclosures – Transfers of Financial Assets. (Amendments to IFRS 7). Requires disclosure in respect of all transferred financial assets that are not derecognised in their entirety and transferred assets that are derecognised in their entirety but with which there is continuing involvement.

(ii) Deferred Tax – Recovery of Underlying Assets (Amendment to IAS 12). Introduces a rebuttable presumption that investment property measured at fair value is recovered entirely through sale and that deferred tax in respect of such investment property is recognised on that basis. The Group's existing practices are consistent with this Amendment.

Details of those IFRSs pronouncements which will be relevant to the Group but which were not effective at 31 December 2012 and which have not been applied in preparing these financial statements are given in note 46.

46. Future accounting developments

The following pronouncements may have a significant effect on the Group's financial statements but are not applicable for the year ending 31 December 2012 and have not been applied in preparing these financial statements. Except as disclosed below, the full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	IASB effective date
Amendments to IAS 1 "Presentation of Financial Statements" – 'Presentation of Items of Other Comprehensive Income'	Requires entities to group items presented in other comprehensive income on the basis of whether they are potentially reclassified to profit or loss subsequently.	Annual periods beginning on or after 1 July 2012.
Amendments to IFRS 7 "Financial Instruments: Disclosures" – 'Disclosures-Offsetting Financial Assets and Financial Liabilities'	Requires an entity to disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's balance sheet.	Annual periods beginning on or after 1 January 2013.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

46. Future accounting developments (continued)

Pronouncement	Nature of change	IASB effective date
IFRS 9 "Financial Instruments" ^{1,2}	Replace those parts of IAS 39: 'Financial Instruments: Recognition and Measurement' relating to the classification, measurement and derecognition of financial assets and liabilities. IFRS 9 requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instrument, and eliminates the available-for-sale financial asset and held-to-maturity investment categories in IAS 39. The requirements for financial liabilities and derecognition are broadly unchanged from IAS 39.	Annual periods beginning on or after 1 January 2015.
IFRS 10 "Consolidated Financial Statements"	Supersedes IAS 27 "Consolidated and Separate Financial Statements" and SIC-12 Consolidation "Special Purpose Entities" and establishes the principles for when the Group controls another entity and therefore is required to consolidate the other entity in the Group's financial statements. The effect of applying IFRS 10 as at 1 January 2013 will be to recognise at that date an increase in total assets and total liabilities of approximately £11.6bn.	Annual periods beginning on or after 1 January 2013
IFRS 12 "Disclosure of Interests in Other Entities"	Requires an entity to disclose information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.	Annual periods beginning on or after 1 January 2013
IFRS 13 "Fair Value Measurement"	Defines fair value, sets out a framework for measuring fair value and requires disclosures about fair value measurements. It applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements.	Annual periods beginning on or after 1 January 2013
IAS 19 "Employee Benefits"	Prescribes the accounting and disclosure by employers for employee benefits. Actuarial gains and losses (remeasurements) in respect of defined benefit pension schemes can no longer be deferred using the corridor approach and must be recognised immediately in other comprehensive income, and finance costs are now calculated on a net funding basis. The net effect of applying revised IAS 19 on 1 January 2013 is to recognise at that date within other comprehensive income previously unrecognised actuarial losses of approximately £98.6m and reduce retained profits by approximately £74.4m.	Annual periods beginning on or after 1 January 2013
Amendments to IAS 32 "Financial Instruments: Presentation" – 'Offsetting Financial Assets and Financial Liabilities'	Inserts application guidance to address inconsistencies identified in applying the offsetting criteria used in the standard. Some gross settlement systems may qualify for offsetting where they exhibit certain characteristics akin to net settlement.	Annual periods beginning on or after 1 January 2014

¹ At the date of this report, these pronouncements are awaiting EU endorsement.

² IFRS 9 is the initial stage of the project to replace IAS 39. Future stages are expected to result in amendments to IFRS 9 to deal with changes to the impairment of financial assets measured at amortised cost and hedge accounting, as well as a reconsideration of classification and measurement. Until all stage of the replacement project are complete, it is not possible to determine the overall impact on the financial statements of the replacement of IAS 39.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012**47. Post balance sheet events**

The proposed further reductions in the rate of corporation tax to 21% by 1 April 2014 is expected to be enacted during 2013. The effect of this further change upon the Group's deferred tax balances is estimated to be an £82m reduction in the net deferred tax liability for the Group and a £5.5m reduction in the net deferred tax asset for the Company. The proposed further reductions in the rate of corporation tax to 20 per cent by 1 April 2015 is expected to be enacted during 2014. The effect of this further change upon the Group's deferred tax balances is estimated to be an £41m reduction in the net deferred tax liability for the Group and a £2.8m reduction in the net deferred tax asset for the Company.

The Company currently reinsures annuity business to SWA. It is proposed that this business is recaptured by the Company and all directly written annuity and protection business in SWA be reinsured to the Company, with effect from 1 January 2013. The Directors' of both companies will be asked to approve this proposal shortly after the approval of these financial statements. This transaction is expected to have no initial effect on the Company's profit, but all profits on this business from 1 January 2013 will arise in the Company instead of SWA.