

# Full Year Results for Partnership Assurance Group plc (‘Partnership’)

For the year ended 31 December 2014

3 March 2015

**Highly profitable new business delivered through careful risk selection and prioritisation of margin over sales volumes in a disrupted market. Positive outlook for long-term growth via three-pronged strategy to leverage our unique Intellectual Property in the UK retail, Defined Benefit and US Care markets**

## Financial highlights

- Continued focus on writing profitable new business delivered total operating profits of £64 million comprising:
  - £39 million of new business operating profits, representing a new business margin of 4.9%. Our focus on carefully selecting risks based on our unique Intellectual Property (‘IP’), prioritising margin over sales volumes and implementing cost management actions helped offset the impact on profitability of lower new business sales
  - £9 million of in-force operating profits and £16 million return on surplus assets, representing a yield of 4% on a larger pool of surplus assets relative to comparable period

Total new business premiums of £791 million maintained at two thirds of FY13 levels including:

- £466 million of individually underwritten annuities
- A near threefold increase in medically underwritten Defined Benefit (‘DB’) bulk annuity sales to £247 million in 2014, including the largest individually underwritten DB deal in the UK to date
- 15% increase in care annuity sales to £76 million following an intensive adviser education campaign
- MCEV per share increased 14p/11% to 144p at 31 December 2014
- Proforma estimated economic capital surplus of £232 million, representing coverage of 159%, at 31 December 2014 after taking into account £100 million bond issued via private placing also announced today
- 2014 final dividend of 1p per share

## Operational highlights

- Strengthened Defined Benefit proposition delivered strong results in 2014 and now established as a key strategic area. All transactions to date have been medically underwritten, creating a sustainable competitive advantage. The recently announced £206m top-slicing transaction demonstrates Partnership’s ability to utilise its unique IP across the whole spectrum of pension scheme sizes within this expanding market
- Targeted FY15 run rate for operating expenses already achieved. Additional £5m reduction in FY15 cost base now targeted, bringing cost base target down to £75 million vs. £80 million target previously announced. Core technical expertise maintained to allow identified growth opportunities to be seized effectively
- Customer focussed proposition continues to be recognised with awards for ‘Best Retirement Provider’<sup>(2)</sup> and ‘Best Enhanced Annuity Provider’<sup>(3)</sup> for the fifth consecutive year
- Work ongoing to develop innovative new products and enhance our existing individual underwritten annuity proposition to meet customer needs post April 2015
- Good progress made on ongoing discussions with potential partners for launch of immediate needs care annuity in the US

## Capital structure and capital management

- Capital structure diversified and strengthened in Q1 2015 through £100 million bond issued via private placing to funds managed by Cinven Capital Management. Further details of the bond issue are set out in separate announcement also released today
- Partnership's Solvency II programme is progressing well and based on Partnership's interpretation of the current draft regulations, the Group is expected to remain well capitalised

## Current trading and outlook

- Structural growth drivers of at-retirement market remain intact and positive long-term outlook for individually underwritten annuity market supported by Financial Conduct Authority's ('FCA') Additional Protection for consumers and the Pension Wise guidance service
- In the near term, disruption to Partnership's core individually underwritten annuity market is expected to continue. Deferrals are likely to increase during Q1 2015 as the April 2015 implementation date for pension taxation changes approaches
- Given the typical two month lead time from quote to conversion, an increase in individual annuity sales is expected to be gradual and is unlikely to begin before H2 2015
- Based on the current pipeline, we anticipate DB transactions in 2015 of at least £200 million, but the timing of completions remains unpredictable and will be subject to changes in economic conditions. Updates will be provided throughout the year

### Steve Groves, Chief Executive Officer, commented:

"Partnership has now weathered most of the difficult period of market dislocation prior to the implementation of the Pensions Reforms next month. We have generated highly profitable new business through careful risk selection and a conscious decision to prioritise margin over sales volumes while continuing to deliver better outcomes for our customers in this disrupted market.

"Although our core individually underwritten annuity market has been impacted significantly, consumer and adviser research continues to show the importance of an income guaranteed for life. I strongly welcome the FCA's retirement income market reform proposals, which should enhance our market opportunity by providing further encouragement for all retirees to shop around.

"I am pleased to report that investment in our DB proposition is delivering results with £247 million of bulk annuity sales for 2014, a near threefold increase on the prior year and a strong high quality pipeline going into 2015. We have also made tangible progress during 2014 in the development of our US expansion plans, selecting a reinsurance-based market entry strategy and progressing discussions with a short list of potential partners regarding the launch of our care annuity in the US.

"As Partnership celebrates its 20th anniversary, I look forward with confidence to the future. I believe our clear strategy to diversify our business model, based on leveraging our unique proprietary Intellectual Property and doing our best for customers within the UK Retail, DB and US Care markets, positions us well to deliver profitable growth and long-term shareholder value."

## Summary of results

|                                    | 2014              | 2013  |
|------------------------------------|-------------------|-------|
| Total new business premiums (£m)   | 791               | 1,229 |
| New business operating profit (£m) | 39                | 86    |
| New business margin                | 4.9%              | 7.0%  |
| Total operating profit (£m)        | 64                | 131   |
| Economic capital ratio             | 159% <sup>1</sup> | 159%  |
| MCEV per share                     | 144p              | 130p  |
| Assets under management (£bn)      | 4.9               | 4.1   |

## New business sales by quarter (£m)<sup>(4)</sup>

| 3 months to:         | 31-Dec-14 | 30-Sep-14 | 30-Jun-14 | 31-Mar-14 | 31-Dec-13 |
|----------------------|-----------|-----------|-----------|-----------|-----------|
| Individual annuities | 62        | 69        | 135       | 200       | 226       |
| DB bulk annuities    | 210       | –         | 3         | 34        | 49        |
| Care                 | 19        | 20        | 16        | 20        | 21        |
| Protection           | 1         | 1         | 1         | 1         | 1         |
| Total new business   | 291       | 89        | 155       | 254       | 297       |

## New business sales (£m)<sup>(4)</sup>

| 12 months to:                       | 31-Dec-14 | 31-Dec-13 |
|-------------------------------------|-----------|-----------|
| Individually underwritten annuities | 466       | 1,076     |
| DB bulk annuities                   | 247       | 84        |
| Care                                | 76        | 66        |
| Protection                          | 3         | 3         |
| Total new business                  | 791       | 1,229     |

### Notes:

1. Proforma represents position adjusted to take into account £100 million bond issue
2. Annual Professional Adviser Awards
3. Moneyfacts Awards 2014
4. New business premiums are Single Premium Equivalent (SPE) sales completed in the period. Totals are subject to rounding.

## Enquiries

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|--|--|--|
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## Further information

A copy of this announcement is available on Partnership's website [www.partnership-group.com](http://www.partnership-group.com)

A presentation for analysts and investors will take place at 9am (UK time) today in the Bishopsgate room at the Andaz Hotel, Liverpool Street, EC2M 7QN.

Access to the webcast and a copy of the presentation will also be available via our website.

A replay of the presentation will be made available on the website.

Participants may also dial in as follows:

+44 (0)20 3059 8125

Please quote "Partnership" to access the call.

## Financial calendar

|                         |  |
|-------------------------|--|
| <b>07 May 2015</b>      | Ex-dividend date – Final dividend                            |
| <b>08 May 2015</b>      | Record date to be eligible for the final dividend            |
| <b>13 May 2015</b>      | 2015 Q1 interim management statement                         |
| <b>19 May 2015</b>      | Annual General Meeting                                       |
| <b>29 May 2015</b>      | Final dividend payment date for the year to 31 December 2014 |
| <b>11 August 2015</b>   | Interim results  |
| <b>05 November 2015</b> | 2015 Q3 interim management statement                         |

## Forward looking statements

This announcement in relation to Partnership Assurance Group Plc and its subsidiaries (the 'Group') contains, and we may make other statements (verbal or otherwise) containing, forward-looking statements about the Group's current plans, goals and expectations relating to future financial conditions, performance, results, strategy and/or objectives.

Statements containing the words: 'believes', 'intends', 'expects', 'plans', 'seeks', 'targets', 'continues' and 'anticipates' or other words of similar meaning are forward-looking (although their absence does not mean that a statement is not forward-looking). Forward-looking statements involve risk and uncertainty because they relate to future events and circumstances that are beyond the Group's control. For example, certain insurance risk disclosures are dependent on the Group's choices about assumptions and models, which by their nature are estimates. As such, actual future gains and losses could differ materially from those that we have estimated.

Other factors which could cause actual results to differ materially from those estimated by forward-looking statements include but are not limited to: domestic and global economic and business conditions; asset prices; market related risks such as fluctuations in interest rates and exchange rates, and the performance of financial markets generally; the policies and actions of governmental and/or regulatory authorities, including, for example, new government initiatives related to the provision of retirement benefits or the costs of social care and the effect of the European Union's "Solvency II" requirements on the Group's capital maintenance requirements; the impact of inflation and deflation; market competition; changes in assumptions in pricing and reserving for insurance business (particularly with regard to mortality and morbidity trends, gender pricing and lapse rates); risks associated with arrangements with third parties, including joint ventures and distribution partners; inability of reinsurers to meet obligations or unavailability of reinsurance coverage; the impact of changes in capital, solvency or accounting standards, and tax and other legislation and regulations in the jurisdictions in which the Group operates.

As a result, the Group's actual future financial condition, performance and results may differ materially from the plans, goals and expectations set out in the forward-looking statements within this announcement. The Group undertakes no obligation to update any of the forward-looking statements contained within this announcement or any other forward-looking statements it may make. Nothing in this announcement should be construed as a profit forecast.

# Chairman's statement

## A year of unprecedented change

**Our first full year as a listed company has been characterised by unprecedented changes in our core individually underwritten annuity market, brought about by the 2014 Budget announcement in March (“the Budget”).**

The Chancellor's proposal for increased freedoms for pension savings is the most fundamental reform in this area since the 1920's and was unforeseen by the insurance industry, financial advisers, customers and, indeed, shareholders. The effect of the announcement was considerable and instant, with both our sales and share price immediately impacted.

Since March, a period of disruption has followed, while legislation and regulations have been drafted and the details of the guidance guarantee, which will provide free impartial guidance for all retirees, have been developed. Implementation of these changes is set for April 2015, but it is likely that adviser recommendations and customer behaviour will take longer to stabilise.

However, it is clear that Partnership's underlying proposition, which is to remove the significant financial uncertainty our retirement and care customers face as a result of a highly variable future lifespan in retirement through a guaranteed income for life, remains as valid now as it was before the Budget. Indeed, recent independent research by the International Longevity Centre – UK shows that nearly 70% of customers with Defined Contribution savings would prefer their pensions to deliver a guaranteed income for life over anything else.

In February 2015, we celebrated our 20th anniversary, and the structural drivers and ageing demographics which supported our rapid growth in previous years remain intact. Our customers' need for financial security has not changed and the new regulations provide opportunities to utilise our unique intellectual property to develop more flexible products in the “new world”.

## New opportunities

At our investor day in November, we emphasised two further strands to the Group's strategy, which I believe will help the Company generate long-term shareholder value; our Defined Benefit proposition and the US care opportunity.

Our Defined Benefit proposition brings the benefits of medical underwriting to trustees who are seeking to de-risk their defined benefit pension scheme through a bulk annuity. The overall bulk annuity market is forecast to be above £20 billion per annum by 2020 (KPMG 2014 Bulk Annuity Market Insight Report) and Partnership is well positioned to secure an increasing proportion of this growing market through its extended and strengthened medically underwritten bulk annuity proposition. For example, our top-slicing proposition, which allows trustees to insure pensioners with the largest liabilities, who represent a disproportionate risk concentration for the scheme, means we can help to de-risk even the largest pension schemes. The £206m top-slicing transaction we announced in December is testament to the strength of our proposition and the traction gained with Employee Benefit Consultants during the year.

The market opportunity in the US for a care annuity sold at the point of need is potentially significant, which is evidenced by a sizeable market, supportive demographics, lack of alternatives for customers at the point of need and the validity of our dataset for use in the US. A care annuity, which guarantees an income for life to meet the costs of care funding, would allow us to provide peace of mind to US customers, who currently face significant financial uncertainty as a result of the cost of an extended stay in care. Our proposed market entry strategy through a reinsurance arrangement is, we believe, lower risk and will require less capital than other options. We will set out an implementation timetable for this attractive proposition when our partner selection discussions have concluded.

## Dividend

Recognising the on-going disruption in our core market and the need to balance investment in the business with our desire to also deliver shareholder returns in the form of a dividend, the Board has recommended a 2014 final dividend of 1 pence per share, bringing the total dividend for the full year to 1.5 pence per share. Given the on-going uncertainty in our core individual annuity market, and the varying stages of development of our Defined Benefit and US Care propositions, the Board will keep the dividend policy under review.

## Board and Governance

Your Board has also undergone change throughout the year. I would like to thank Marisa Cassoni, Maxim Crewe, Robin Phipps and David Young, who left the Board during the year, for their significant contributions during their tenures and the support they provided to me as Chairman. I would also like to welcome Paul Bishop, Clare Spottiswoode and Simon Waugh, who joined the Board during the year as non-executive Directors, bringing a breadth of experience and skills from a variety of sectors, which will be invaluable to the Company in its next phase of development.

## Our people and distributors

On behalf of the Board, I would like to take this opportunity to extend my thanks to my colleagues within Partnership; without their commitment and expertise, the Company would have fared less well through this challenging period. Finally, I would like to thank our suppliers and distributors for their support throughout the year, and particularly through the market disruption since the Budget.

## Looking ahead

It will be some time before the dust settles on the changes brought about by the Budget, but I look forward with confidence to a strong future for Partnership, where we continue to use our unique intellectual property to deliver better outcomes and peace of mind for our customers in both existing and new markets.

# Chief Executive Officer's statement

## Overview

The Budget's effect on our core business was significant and immediately impacted sales within our core individual annuity market, with advisers pausing to digest the changes and customers deferring their retirement income decision until post April 2015 when there is more clarity on products and the guidance guarantee.

The consequence of this for Partnership was a 57% reduction in sales of individual annuities in 2014 versus 2013. However, I am comforted by the fact that although the total market for individual annuities in the nine months post Budget fell by approximately £4.2 billion, sales of drawdown contracts in the same period increased by only £0.7 billion, indicating that, rather than investing in alternative products, a significant proportion of customers are simply leaving their pension savings untouched while uncertainty remains. I continue to expect a significant proportion of these deferred pension savings to return to the at-retirement market over time, and believe the higher annuity rates offered by Partnership mean we are well placed to secure a share of this market, whose structural growth continues to be underpinned by supportive demographics.

Our efforts to develop the market for individually underwritten bulk annuities are now delivering results, with £247m of Defined Benefit sales in 2014; a near threefold increase compared with £84m achieved in 2013. In December we announced the completion of the UK's largest individually underwritten bulk annuity transaction. Although quarterly performance has been, and will continue to be, variable, this £206m top-slicing transaction is a perfect example of how Partnership is able to bring the advantages of our unique intellectual property and underwriting expertise to trustees, corporates and pension scheme members across the entire spectrum of pension scheme sizes within the growing UK defined benefit market.

We achieved £76m of sales of our immediate needs care annuities, which compares favourably to sales of £66m in 2013, as the prior year's market disruption reversed and we undertook an intensive adviser education campaign. Finally, we secured £3m of protection sales, in line with 2013.

## Action taken on costs

After the Budget, we took immediate action to realign our cost base to the level required to support lower sales of individual annuities. The cost reductions were less extensive than implied by the size of annuity market reduction, but were targeted so that we could maintain our technical and product development expertise to allow new initiatives to be pursued and to be ready for the return to growth. We targeted a reduction of £21 million versus our planned £101 million 2015 cost base. I am pleased to report that we reduced our 2014 operating expenses to £78 million compared with £84m in 2013 and we are now targeting operating expenses of £75 million in 2015, representing a £26 million reduction against the planned 2015 cost base.

## Operating profits

We monitor a range of financial measures in managing the business, including operating profits, MCEV and capital. New business is assessed and priced taking into account these metrics. Despite the market disruption, we have remained true to our pricing discipline, seeking to ensure that new business covers its capital requirement.

However, as total new business sales fell by 36% in 2014 without an equivalent reduction in operating expenses, new business operating profits for the year totalled £39m, a 55% reduction compared with £86m achieved in 2013. This is reflected in our overall new business margin of 4.9% for 2014 versus 7.0% in 2013.

We believe that it is important, particularly in a period of market disruption like this, to deploy shareholder resources in a way which generates long-term value and have therefore concentrated our efforts on prioritising margin as much as possible, albeit on lower sales, rather than potentially eroding capital by chasing sales volumes.

We also continue to generate operating profits from our in-force business and the return on excess assets, which were £9m and £16m respectively in 2014. Operating profits for 2014 totalled £64m compared with £131m in 2013.

## Balance sheet

Despite the market conditions, the value of our assets under management increased by 20% to £4.9 billion in 2014.

At 31 December 2014, the surplus over our economic capital requirement was £132 million representing a coverage ratio of 134%. The reduction in the position since 2013 (surplus £173 million, coverage 159%) is largely due to the impact of long term risk-free rates falling to all time lows, which increased the capital requirement. The position has also been impacted by the temporary mismatch in the cost base relative to new business and the natural dilution of the position as business is written at a lower coverage ratio. The board continues to target a minimum coverage ratio of 125%.

At 31 December 2014, we were entirely equity funded. In January we began to explore opportunities to provide financial flexibility with a prudent level of leverage. On 3 March 2015 we announced a £100 million bond issue via private placing to Cinven, our majority shareholder. The Tier 2, Solvency II compliant 10 year bond has been issued by PAG plc with a coupon of 9.5%. After taking the bond into account, on a proforma basis at 31 December 2014, our gearing (Gearing calculated as debt/MCEV) remains low at 17%, versus a sector average of between 25 and 30%. Our economic capital surplus and coverage increased on a proforma basis to £232m/159% respectively, providing us with financial flexibility to invest in our new initiatives and helping to support a prudent transition to Solvency II.

Our MCEV increased by £56 million during the year to £576 million, representing MCEV per share of 144 pence. The increase in MCEV is due to an increase in the value of in-force business which came largely from new business written in the period. The net worth also increased due to retained profits after dividend payments.

We have maintained a conservative asset management portfolio, driven by our focus on closely matching our assets with the cash flows of our illiquid long dated liabilities. 73% of the portfolio comprises bonds with an average credit rating of A, with the majority of the remainder invested in equity release assets which diversify our risk profile. In December, we completed a bulk equity release deal, securing £61 million of assets with a higher risk adjusted return, which are a particularly good match for our illiquid liabilities. We will continue to explore bulk equity release opportunities where they are economically attractive.

## Solvency II

Our Solvency II programme is designed to ensure the Group meets the Solvency II requirements, when they go live on 1 January 2016.

Our programme is planned so as to deliver the standard formula approach to capital measurement. We will keep the option of developing an internal model under review, with a view to being ready to apply for an internal model for certain risks if and when it is considered appropriate.

Although how the regulation will be applied in practice is still uncertain, based on our current interpretation of the Solvency II regulations, the Group is expected to remain well capitalised. We are putting in place plans to mitigate risks in the regulation, such as the treatment of equity release assets in the matching adjustment calculation.

## People and values

Following the Budget, we took immediate action to manage our cost base in light of significantly reduced new business volumes, which resulted in our headcount being reduced by 129 roles to 427 at the end of year. Whilst this is regrettable, we believed it was necessary to manage our cost base to reflect the impact of the Budget on sales of individual annuities.

Despite this, the core strength which underpins our unique intellectual property is still the expertise of our people. It is challenging periods like this which bind an organisation more closely together and enable it to weather the storm, and then thrive. The tireless dedication of our people in 2014 has been outstanding and I would like to thank them for their continued support and the way in which they have exemplified our values of fairness, integrity, respect, service and trust.

## Strategy and outlook

Significant uncertainty surrounds future customer behaviour, product opportunities and the impact of the Pension Wise Service and the FCA's 'Additional Protection' in our core market. As we approach the April 2015 implementation date of the pension changes, we expect deferrals to increase and, in the short term, our sales of



individual annuities to therefore reduce from the £62m achieved in the fourth quarter. Given the time delay between quote and conversion, we believe that a significant recovery in sales is unlikely to begin before the second half of 2015. Longer term, we believe the value of a guaranteed income for life, whether in the form of an annuity or as part of a broader retirement account, will continue to form the cornerstone of individual retirement income planning.

As we head into 2015, the pipeline of medically underwritten bulk annuities in the market remains strong. We believe the strength and quality of our current pipeline and market activity is consistent with defined benefit sales of at least £200 million during 2015. However, timing remains unpredictable and so quarterly completions will continue to be variable and subject to changes in economic conditions.

We continue to progress our plans to launch an immediate needs care annuity in the US, and our advanced discussions with potential partners are on-going. We will provide further updates on our implementation timetable in due course, once the partner selection process has concluded.

At the heart of our strategy is our focus on delivering better outcomes for our customers by using our unique intellectual property, which allows us to better understand, and therefore more accurately price, longevity for customers with health conditions. As we look to the future for Partnership, I believe our three-pronged strategy based on doing the best for customers within the UK retail, Defined Benefit and US Care markets positions us well to deliver profitable growth and long-term shareholder value.

# How we are performing

## Performance review

Total new business premiums were £791m for the year ended 31 December 2014, maintained at two-thirds of 2013 levels, despite significant disruption following the Budget.

|                                 | 2014<br>£m | 2013<br>£m   |
|---------------------------------|------------|--------------|
| Individual retirement annuities | 466        | 1,076        |
| Defined Benefit annuities       | 247        | 84           |
| Care annuities                  | 76         | 66           |
| Protection                      | 3          | 3            |
| <b>New business premiums</b>    | <b>791</b> | <b>1,229</b> |

## Individual retirement annuities

The Budget had a significant impact on sales. Despite the uncertainty that the announcement caused, the majority of customers with annuities in our pipeline at the time of the Budget decided to continue with their purchase after discussion with their advisers. However, the Budget has resulted in lower quote volumes and conversion levels which has resulted in lower completions from the second quarter of the year.

In May, we launched a new flexible product the Enhanced Choice Annuity, in response to the requirement for increased flexibility for customers. Sales of this product have been below expectations, but the accelerated development and launch of this product demonstrated our innovation and speed of response.

There remains significant uncertainty over the near-term level of annuity sales as research indicates that people are currently deferring their retirement or their at-retirement decumulation decisions. This level of deferral is likely to increase as we approach April 2015 and the changes to the Pensions Taxation rules are implemented. We do not expect a recovery in sales to begin until the second half of 2015.

In the longer term, it is likely that the increased flexibility will lead to fewer people buying an annuity. However, consumer research indicates that a guaranteed income for life continues to be an attractive retirement option. It is also clear that longevity risk cannot be managed on an individual basis.

After April 2015, we see the potential for our addressable market to increase as more retirees are encouraged to shop-around through the Pension Wise service. We are pleased to note that the guidance process will be impartial and we will continue to work with government, regulatory and industry stakeholders as the new regime is developed.

The "Additional Protection", where the FCA is expected to require pension providers to ask customers about key aspects of their circumstances that relate to the choice they are making, is also expected to be helpful.

The long-term structural drivers behind the growth of the defined contribution pension market remain intact. The new regulations create the opportunity to develop new products where our unique intellectual property and versatile product development capability mean we are well positioned for success in the future.

## Defined Benefit annuities

Defined Benefit bulk annuity ("DB") sales were unaffected by the Budget.

We have continued to invest in the development of our defined benefit de-risking proposition with investments into our support infrastructure, pricing capability and our sales capability throughout the year to ensure that we are best-placed to succeed in this nascent and potentially material medically underwritten market.

This investment was rewarded with the completion of the UK's largest medically underwritten defined benefit de-risking transaction in December 2014. This £206m transaction confirms the potential of the market opportunity and our ability to compete within it.

Our focus is on increasing the proportion of deals that are medically underwritten. In 2014 we have extended and strengthened our distribution network and Employee Benefits Consultant (EBC) relationships and are encouraged by the increased acceptance of medically underwritten transactions amongst EBCs, Scheme Trustees and sponsoring companies.

We have a strong, high-quality pipeline moving into 2015.

### Care annuities

Sales of care annuities were increased by 15% to £76m (2013: £66m) following an intensive adviser education campaign.

After subdued trading in 2013, which reflected the outcome of the RDR on advisers selling Care Annuities and uncertainty surrounding Government Care policy, advisers appear to be returning to the market.

However, the conversion from quote to policy for Care Annuities can be lengthy and unpredictable and the impact on sales may take longer to be seen.

### Protection

Protection sales are unaffected by the Budget and remained flat at £3m (2013: £3m).

Partnership regards protection as an opportunity to leverage our proprietary Intellectual Property (IP) to be able to provide protection cover for people that other insurers cannot quote for.

Whilst a small component of our business in 2014, there are opportunities to grow in the future, as we increase the pool of potential customers we are able to protect.

### Financial headlines

Total operating profit in 2014 was £64m (2013: £131m), a decrease of 51%. Within this overall result, we have delivered new business operating profits of £39m (2013: £86m), achieving a new business operating margin of 4.9% (2013: 7.0%).

The fall in new business operating profit is largely due to the lower sales resulting from the 2014 Budget announcement. The overall impact of reduced volumes on new business operating profit and margin has been mitigated to an extent by our maintenance of pricing discipline, prioritisation of margin over volume and by expense reduction actions.

The cost management proposals announced in June together with the actions taken immediately post Budget are now expected to generate cost savings of £26m against the anticipated 2015 cost base of £101 million, resulting in us targeting underlying operating expenses of approximately £75 million in 2015.

Profits emerging from the in-force book in 2014 were £9m (2013: £34m). The 2013 result included the benefit from the release of expense reserves due to economies of scale realised on in-force business, in part due to the transfer of the administration of a significant acquired block of in-force annuities onto our in-house administration platform. The 2014 result is therefore more representative of the underlying level of in-force profits. The net impact of assumption changes made during 2014 was £(3) million.

We delivered an expected return on surplus assets of £16m (2013: £11m), reflecting the growth in surplus assets in the period and allocation into higher-yielding assets, including equity release.

The level of excess economic capital at 31 December 2014 was £132m (2013: £173m), giving a capital coverage ratio of 134% (2013: 159%), which is in excess of our targeted minimum of 125% under normal economic circumstances.

Taking into account the March 2015 bond issue, the economic capital surplus increased to £232m /159% on a proforma basis.

The close matching of assets and liabilities, efficient use of reinsurance, and monitoring of risk levels against our Board tolerances means the proforma economic capital position remains in excess of the Board's minimum targets for the stress and scenario tests we perform.

Assets under management have increased to £4.9bn (2013: £4.1bn), including accrued interest, but excluding £270m (2013: £272m) of assets that the Group manages on behalf of reinsurers under certain reinsurance arrangements. Our focus remains on seeking superior risk-adjusted yields and capital efficiency for the benefit of policyholders and shareholders.

Our investment portfolio is of high overall quality with (excluding equity release assets) in excess of 64% (2013: 66%) invested in bonds rated A or better and 99% (2013: 99%) rated BBB or better.

We continue to source equity release loans through a combination of newly originated loans and bulk purchases. Newly originated loans in 2014 totalled £171m (2013: £129m). In December 2014 we completed a bulk acquisition, acquiring loans with a value of £61 million (2013: £287million). The level of equity release mortgage assets as a proportion of total assets under management at 31 December 2014 increased to 25% (2013: 21%). This increased proportion is due in part to the reduction in risk-free rates during the year, as well as a slightly higher proportion of equity release assets allocated to back new annuity business.

In September 2014 we made our first investment into commercial real estate mortgages, which offer an attractive risk-adjusted return and are a good match for our annuity liabilities. At the end of 2014 we had £38m invested in high quality assets and are expecting to increase this investment over the course of 2015. We have in place a mandate with NM Rothschild & Sons Ltd and we are actively investigating other alternative assets that can provide superior risk-adjusted returns for the benefit of shareholders or to match insurance liabilities.

Total market consistent embedded value (MCEV) as at 31 December 2014 was £576m (2013: £520m). The majority of the increase in the year is due to the MCEV of new business which was £56 million (2013: £81 million) net of tax.

### Investing in our future

Despite the disruption to our business cause by the Budget changes, we have continued to innovate and invest for the benefit of our customers and shareholders.

In 2015 we will continue to invest and innovate and expect to incur approximately £12m on non-recurring cash items. This investment includes expenditure on Solvency II as well as circa £5m on development of our Retirement Account and US Care initiatives.

Our investments in both human capital and technology enable the continued improvement in Partnership's IP, underpinning our core competitive advantage in the individually underwritten annuity market.

# Financial review of segmental information

The consolidated segment information provides information about the performance of the Group analysed on the basis of segment information provided to the Board

Details of significant movements in the year are set out below:

## IFRS operating profit before tax

| For the year ended 31 December                      | 2014<br>£000's | 2013<br>£000's |
|---|----------------|----------------|
| New business operating profit                       | 38,962         | 85,678         |
| In-force operating profit                           | 8,477          | 34,278         |
| Long-term expected return on surplus assets         | 16,328         | 11,435         |
| <b>Operating profit</b>                             | <b>63,767</b>  | <b>131,391</b> |
| Investment variances                                | (23,491)       | 8,643          |
| Non-recurring expenditure                           | (16,348)       | (30,769)       |
| Other   | 139            | (1,201)        |
| Interest on borrowings                              | –              | (25,403)       |
| <b>Profit from continuing operations before tax</b> | <b>24,067</b>  | <b>82,661</b>  |

## Total operating profit

Total operating profit in the year to 31 December 2014 of £63.8m is down £67.6m from the £131.4m reported for 2013 as both in-force operating profit and new business profits have reduced as explained below.

## New business operating profit

New business operating profit has decreased by 54% from £85.7m in 2013 to £39.0m in 2014. This change is primarily as a result of the fall in sales volumes feeding through into a drop in gross margin offset, in part, by lower new business expenses.

## In-force operating profit

In-force operating profit was £8.5m for the year ended 31 December 2014 compared to £34.3m for 2013. Underlying profits emerging from the in-force book of £11.4m reflect the long-term assumptions set at the beginning of the period.

The underlying profits were offset by non-recurring assumption and other changes totalling £(2.8)m. The 2013 comparative included a £21m benefit from assumption and other changes which did not repeat in 2014.

## Long-term return on surplus assets

Long-term expected return on surplus assets for the year ended 31 December 2014 was up by £4.9m to £16.3m (2013: £11.4m) as surplus investments in high yielding loans secured by residential mortgages were designated as surplus assets.

## Investment variances

The negative investment variance in the period reflects a decrease in risk-free yields and a widening spread between risk-free yields and the yields achieved on the Group's corporate bonds in 2014.

## Non-recurring expenditure

Detail of non-recurring expenditure is included in note 1(a).

## Interest on borrowings

All external borrowings were repaid in 2013.

## IFRS Profit before tax

IFRS profit before tax amounted to £24.1m compared to £82.7m for 2013. The decrease is due to the effects of the fall in sales volumes and the benefit from assumption and other changes in 2013 which did not repeat in 2014.

## Capital management

The Economic Capital and Insurance Group's Directive (IGD) capital positions as at 31 December 2014 are calculated for the Group's ultimate Parent Company, PAG plc. Neither capital measure includes any deduction for the final dividend recommended but not paid.

|                         | Economic Capital <sup>1</sup>        |             |             | IGD                                  |             |             |
|-------------------------|--------------------------------------|-------------|-------------|--------------------------------------|-------------|-------------|
|                         | 2014<br>proforma <sup>2</sup><br>£'m | 2014<br>£'m | 2013<br>£'m | 2014<br>proforma <sup>2</sup><br>£'m | 2014<br>£'m | 2013<br>£'m |
| Total Capital Available | 625                                  | 525         | 467         | 568                                  | 468         | 469         |
| Capital Required        | 393                                  | 393         | 294         | 224                                  | 224         | 193         |
| Excess Surplus          | 232                                  | 132         | 173         | 344                                  | 242         | 276         |
| Coverage Ratio (%)      | 159%                                 | 134%        | 159%        | 254%                                 | 209%        | 243%        |

Excess Capital surplus on both an Economic Capital and IGD basis decreased in 2014. The key drivers for this reduction in surplus were the changes to economic factors, reduced sales volumes and dividends paid.

Note 11 provides a reconciliation between the Group's equity and the IGD measure of available capital.

As part of Partnership's risk management approach, the Group has entered into hedging arrangements to limit the financial impact of future reductions in risk free rates on the economic capital position.

### Scenario Testing

|                                       | Impact on surplus<br>£'m | Coverage ratio post stress    |      |
|---------------------------------------|--------------------------|-------------------------------|------|
|                                       |                          | 2014<br>proforma <sup>2</sup> | 2014 |
| Economic capital surplus              |                          | 232                           | 132  |
| Economic capital coverage             |                          | 159%                          | 134% |
| Interest +1%                          | 31                       | 176%                          | 147% |
| Interest -1%                          | (46)                     | 141%                          | 119% |
| Credit spread widening +100bps        | (8)                      | 159%                          | 133% |
| "Lehmans" crisis <sup>3</sup>         | (49)                     | 157%                          | 126% |
| Eurozone crisis <sup>3</sup>          | (31)                     | 158%                          | 129% |
| Property -10% price fall <sup>4</sup> | (44)                     | 147%                          | 122% |
| Longevity +5% deterioration           | (30)                     | 151%                          | 126% |

<sup>1</sup> Economic capital is Group's own internal risk based assessment of its capital requirement and does not imply capital as required by regulators.

<sup>2</sup> Proforma for £100m bond issue excluding costs of issue (expected to be <£1m) assuming bond issue proceeds held in cash

<sup>3</sup> Lehman and Eurozone crisis scenarios modelled by applying credit spreads of 5 December 2008 and 7 October 2011, respectively

<sup>4</sup> Property stress represents 10% decrease in carrying value, equivalent to a 35% fall from current market values.

# Directors' Responsibility Statement to Disclosure and Transparency Rule 4 (extracted from the 2014 Annual Report and Accounts)

The Annual Report and Accounts contains the following statements regarding responsibility for the financial statements and business review included in the Annual Report and accounts.

We confirm that to the best of our knowledge:

- The financial statements, prepared in accordance with the IFRS as adopted by the EU, give a true and fair view of the assets, liabilities, financial positions and profit or loss of the Company and the undertakings included in the consolidation taken as a whole;
- The Directors' report includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a descriptions of the principal risk and uncertainties that they face; and
- The Board confirms that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the performance, strategy and business model of the Company.

By order of the Board  
Steve Groves  
Chief Executive Officer

# Consolidated statement of comprehensive income

For the year ended 31 December 2014

|   | Note | 2014<br>£000's   | 2013<br>£000's   |
|---|------|------------------|------------------|
| Gross premiums written  | 1    | 760,638          | 1,159,562        |
| Outward reinsurance premiums  |      | (307,959)        | (733,849)        |
| Net premiums earned   |      | 452,679          | 425,713          |
| Net investment income   | 3    | 299,232          | 137,762          |
| Share of results of joint ventures and associates accounted for using the equity method |      | (179)            | (162)            |
| Profit on loss of control of subsidiary   |      | 158              | –                |
| Other income  |      | 207              | 219              |
| <b>Total income</b>   |      | <b>752,097</b>   | <b>563,532</b>   |
| Gross claims paid   |      | (390,570)        | (341,124)        |
| Reinsurers' share of claims paid  |      | 255,957          | 225,277          |
| Change in insurance liabilities:  |      |                  |                  |
| Gross amount  |      | (883,524)        | (624,290)        |
| Reinsurers' share   |      | 405,259          | 428,197          |
|   |      | (478,265)        | (196,093)        |
| Acquisition costs   |      | (4,997)          | (13,036)         |
| Investment expenses and charges   |      | (14,352)         | (13,270)         |
| Interest on external borrowings   |      | –                | (25,403)         |
| Other operating expenses  |      | (95,803)         | (117,223)        |
|   |      | (115,152)        | (168,931)        |
| <b>Total claims and expenses</b>  |      | <b>(728,030)</b> | <b>(480,871)</b> |
| <b>Profit from continuing operations before tax</b>                                     |      | <b>24,067</b>    | <b>82,661</b>    |
| Income tax charge from continuing operations  |      | (5,213)          | (23,240)         |
| <b>Profit for the year from continuing operations</b>                                   |      | <b>18,854</b>    | <b>59,421</b>    |
| <b>Profit/(loss) attributable to:</b>   |      |                  |                  |
| – Owners of the Parent  |      | 18,852           | 59,465           |
| – Non-controlling interest  |      | 2                | (44)             |
| <b>Profit for the period</b>  |      | <b>18,854</b>    | <b>59,421</b>    |
| <b>Basic earnings per ordinary share</b>  | 4    | <b>£0.05</b>     | £0.17            |
| <b>Diluted earnings per ordinary share</b>  | 4    | <b>£0.05</b>     | £0.17            |



# Consolidated statement of changes in equity

For the year ended 31 December 2014

|  | Attributable to Owners of the Parent |                         |                         |   |                             |  |                              |                 |   |                 |
|--|--------------------------------------|-------------------------|-------------------------|---|-----------------------------|--|------------------------------|-----------------|---|-----------------|
|  | Note                                 | Share Capital<br>£000's | Share Premium<br>£000's | Capital Redemption<br>Reserve<br>£000's | Merger<br>Reserve<br>£000's | Shares held by<br>Employee<br>Benefit<br>Trust<br>£000's | Retained<br>profit<br>£000's | Total<br>£000's | Non-<br>controlling<br>interest<br>£000's | Total<br>£000's |
| At 1 January 2013                            |                                      | 36                      | 182                     | 3,297                                   | –                           | (33)   | 78,901                       | 82,383          | (22)                                      | 82,361          |
| PAGH shares exchanged<br>for ordinary shares |                                      | 28,250                  | (182)                   | (3,297)                                 | (24,521)                    | (250)  | –                            | –               | –   | –               |
| Loan notes exchanged<br>for ordinary shares  |                                      | 8,462                   | 317,288                 | –                                       | –                           | –  | –                            | 325,750         | –   | 325,750         |
| Shares issued/bought for<br>cash             |                                      | 3,252                   | 121,993                 | –                                       | –                           | (46)   | 526                          | 125,725         | –   | 125,725         |
| Share issue costs                            |                                      | –                       | (4,032)                 | –                                       | –                           | –  | –                            | (4,032)         | –   | (4,032)         |
| Share-based payments                         |                                      | –                       | –                       | –                                       | –                           | 271  | 9,053                        | 9,324           | –   | 9,324           |
| Profit for the year                          |                                      | –                       | –                       | –                                       | –                           | –  | 59,465                       | 59,465          | (44)                                      | 59,421          |
| At 31 December 2013                          |                                      | 40,000                  | 435,249                 | –                                       | (24,521)                    | (58)   | 147,945                      | 598,615         | (66)                                      | 598,549         |
| At 1 January 2014                            |                                      | <b>40,000</b>           | <b>435,249</b>          | <b>–</b>                                | <b>(24,521)</b>             | <b>(58)</b>  | <b>147,945</b>               | <b>598,615</b>  | <b>(66)</b>                               | <b>598,549</b>  |
| Share-based payments                         |                                      | –                       | –                       | –                                       | –                           | (78)   | 1,301                        | 1,223           | –   | 1,223           |
| Disposal of subsidiary                       |                                      | –                       | –                       | –                                       | –                           | –  | –                            | –               | 64  | 64              |
| Dividends paid                               |                                      | –                       | –                       | –                                       | –                           | –  | (14,000)                     | (14,000)        | –   | (14,000)        |
| Profit for the year                          |                                      | –                       | –                       | –                                       | –                           | –  | 18,852                       | 18,852          | 2   | 18,854          |
| <b>At 31 December 2014</b>                   |                                      | <b>40,000</b>           | <b>435,249</b>          | <b>–</b>                                | <b>(24,521)</b>             | <b>(136)</b>   | <b>154,098</b>               | <b>604,690</b>  | <b>–</b>                                  | <b>604,690</b>  |

# Consolidated statement of financial position

As at 31 December 2014

|  | Note | 2014<br>£000's   | Restated<br>2013<br>£000's |
|--|------|------------------|----------------------------|
| <b>Assets</b>  |      |                  |                            |
| Property, plant and equipment                            |      | 12,557           | 15,459                     |
| Goodwill   |      | 126,207          | 126,207                    |
| Other intangible assets                                  | 5    | 15,219           | 16,401                     |
| Financial assets   | 6    | 4,910,904        | 4,010,269                  |
| Investment in joint ventures and associates              |      | 233              | 206                        |
| Reinsurance assets                                       | 7    | 3,246,008        | 2,840,749                  |
| Insurance and other receivables                          |      | 39,167           | 79,633                     |
| Prepayments and accrued income                           |      | 3,615            | 10,991                     |
| Deferred tax asset                                       |      | 519              | 424                        |
| Cash and cash equivalents                                |      | 87,251           | 112,741                    |
| <b>Total assets</b>                                      |      | <b>8,441,680</b> | <b>7,213,080</b>           |
| <b>Equity</b>  |      |                  |                            |
| Share capital  | 13   | 40,000           | 40,000                     |
| Share premium  | 13   | 435,249          | 435,249                    |
| Merger reserve   |      | (24,521)         | (24,521)                   |
| Shares held by Employee Benefit Trust                    | 13   | (136)            | (58)                       |
| Retained profit  |      | 154,098          | 147,945                    |
| <b>Total equity attributable to owners of the Parent</b> |      | <b>604,690</b>   | <b>598,615</b>             |
| Non-controlling interest                                 |      | –                | (66)                       |
| <b>Total equity</b>                                      |      | <b>604,690</b>   | <b>598,549</b>             |
| <b>Liabilities</b>                                       |      |                  |                            |
| Insurance liabilities                                    | 7    | 5,231,112        | 4,347,588                  |
| Insurance and other payables                             |      | 29,527           | 34,004                     |
| Financial liabilities                                    | 8    | 2,571,288        | 2,214,741                  |
| Current tax liabilities                                  |      | 3,735            | 18,198                     |
| Deferred tax liability                                   |      | 1,328            | –                          |
| <b>Total liabilities</b>                                 |      | <b>7,836,990</b> | <b>6,614,531</b>           |
| <b>Total equity and liabilities</b>                      |      | <b>8,441,680</b> | <b>7,213,080</b>           |

# Consolidated cash flow statement

For the year ended 31 December 2014

|   | Note | 2014<br>£000's  | 2013<br>£000's |
|---|------|-----------------|----------------|
| <b>Cash generated from/(used in) operations</b>           |      | <b>11,664</b>   | (56,851)       |
| Corporation tax paid                                      |      | (19,705)        | (17,000)       |
| <b>Net cash used in operating activities</b>              |      | <b>(8,041)</b>  | (73,851)       |
| Cash flows from investing activities:                     |      |                 |                |
| Purchase of property, plant and equipment                 |      | (1,308)         | (13,657)       |
| Purchase of other intangible assets                       | 5    | (2,093)         | (7,696)        |
| Investment in associate                                   |      | (48)            | –              |
| Disposal of subsidiary                                    |      | –               | –              |
| <b>Net cash used in investing activities</b>              |      | <b>(3,449)</b>  | (21,353)       |
| Cash flows from financing activities:                     |      |                 |                |
| Proceeds from issuance of share capital                   | 13   | –               | 121,693        |
| Repayment of loan notes                                   |      | –               | (7,656)        |
| Repayment of bank loan                                    |      | –               | (70,000)       |
| Dividends paid to shareholders                            |      | (14,000)        | –              |
| Interest payable on external borrowings                   |      | –               | (2,365)        |
| <b>Net cash (used in)/from financing activities</b>       |      | <b>(14,000)</b> | 41,672         |
| <b>Net decrease/increase in cash and cash equivalents</b> |      | <b>(25,490)</b> | (53,532)       |
| Cash and cash equivalents brought forward                 |      | 112,741         | 166,273        |
| <b>Cash and cash equivalents carried forward</b>          |      | <b>87,251</b>   | 112,741        |

Cash flows related to the sale and purchase of financial investments are included in operating cash flows as they are associated with the origination of insurance contracts and payment of insurance claims.

## 1 Segmental analysis

The operating segments reflect the level within the Group at which key strategic and resource allocation decisions are made and the way in which operating performance is reported internally to the chief operating decision makers in the Group, being the Group Board.

Information is provided to the Board which identifies operating profit segmented between: that achieved on new business written in the period; that which derives from in-force policies; and that relating to the long-term expected return on surplus assets. This split forms the reportable operating segments in accordance with IFRS 8 "Operating Segments".

New business revenue is reported as Single Premium Equivalent ("SPE"), being the actual single premium plus 10 times the annual regular premium for new contracts written during the year. These revenue measures are monitored by the Board separately for each core target market.

### a) Segmental analysis of profit

The table below shows operating profit for each year, together with a reconciliation to profit before tax:

| <b>For the year ended 31 December</b>               | <b>2014<br/>£000's</b> | <b>2013<br/>£000's</b> |
|---|------------------------|------------------------|
| New business operating profit                       | <b>38,962</b>          | 85,678                 |
| In-force operating profit                           | <b>8,477</b>           | 34,278                 |
| Long-term expected return on surplus assets         | <b>16,328</b>          | 11,435                 |
| <b>Operating profit</b>                             | <b>63,767</b>          | 131,391                |
| Investment variances                                | <b>(23,491)</b>        | 8,643                  |
| Non-recurring expenditure                           | <b>(16,348)</b>        | (30,769)               |
| Other   | <b>139</b>             | (1,201)                |
| Interest on borrowings                              | <b>–</b>               | (25,403)               |
| <b>Profit from continuing operations before tax</b> | <b>24,067</b>          | 82,661                 |

Investment variances reflect:

- the difference between actual performance on investment assets (e.g. cash, gilts, corporate bonds, loans secured by residential mortgages and loans secured by commercial mortgages) over the reporting period and the investment yield allowed for in the calculation of in-force liabilities at the start of the reporting period;
- the difference between the yield on investment assets allowed for in the calculation of new business profits and the actual investment performance including differences arising from investing at different yields and asset allocations than those expected when pricing new business;
- the difference between actual performance on investment assets and long-term assumed return on surplus assets; and
- the impact of changes in the best-estimate credit default allowance made against the Group's invested assets.

Non-recurring expenditure primarily relates to:

- £2.0m of Solvency II related costs (2013: £4.1m);
- £2.3m of costs incurred in developing scalable and flexible DB architecture (2013: £nil);
- £3.5m of implementation costs in respect of cost management actions, new initiatives, product development and other items (2013: £1.1m).

In addition, non-recurring non cash items were recognised, comprising £6.0m impairment of sales infrastructure in and a further £2.5m of IT development costs, which are being amortised over a 5 year period (2013: £nil).

2013 non-recurring expenditure also included £15.8m expenses in respect of the Group's restructure and IPO and £9.8m in respect of the Group's staff share option which vested as a result of the IPO.

Other gains/(losses) relate to the Group's interest in distribution subsidiaries and holding company expenses.

The profit measure used by the Board to monitor performance is operating profit before tax, analysed between new business operating profit, in-force operating profit and the long-term expected return on surplus assets.

- New business operating profit is profit generated from new business completed in the period, calculated using actuarial assumptions applicable at the time the new business was written, and utilising a discount rate based upon investment yields on investment assets (e.g. cash, gilts, corporate bonds, loans secured by residential mortgages and loans secured by commercial mortgages) used to generate the annuity quotation, net of expenses allocated against new business.
- In-force operating profit is generated from the actual experience measured against the assumed experience in the actuarial basis. The actuarial basis includes a number of assumptions, the most material of which are mortality levels, levels of default on investments, expense levels (to maintain the business in-force), levels of inflation, and lapse rates (for regular premium business). In-force operating profit also includes the effect recognised in the IFRS profit arising from changes to the reported value of insurance (and associated financial) liabilities resulting from changes to the actuarial assumptions, valuation methods, or underlying data, made subsequent to the point of sale.
- Return on surplus assets is the long-term, risk-adjusted, expected return on investments that are surplus to those investments that are used to back insurance liabilities. The long-term expected return is derived from applying an average expected yield appropriate to the category of surplus assets held, and is adjusted for the best-estimate expected level of defaults on those investments. The risk-adjusted annual yields applied to surplus assets during the period were:

|  | 2014  | 2013  |
|--|-------|-------|
| Cash                                   | 0.5%  | 0.5%  |
| Gilts                                  | 3.0%  | 3.0%  |
| Corporate bonds                        | 4.5%  | 4.5%  |
| Commodity Trade Finance loans          | 10.0% | 10.0% |
| Loans secured by residential mortgages | 6.0%  | n/a   |

#### b) Segmental analysis of new business revenue by target market

| For the year ended 31 December           | 2014<br>£000's | 2013<br>£000's   |
|--|----------------|------------------|
| Individual retirement annuities          | 465,840        | 1,076,693        |
| Defined benefit buy-in/buy-out annuities | 246,573        | 82,923           |
| Individual care annuities                | 75,741         | 65,854           |
| Individual protection policies           | 3,083          | 3,389            |
| <b>Total SPE</b>                         | <b>791,237</b> | <b>1,228,859</b> |

#### c) Reconciliation of new business revenue by target market to gross premiums written

Premiums are recognised in the accounting period in which an insurance contract commences, gross of any commission paid. Premiums which have been received and for which no contract is yet in-force are classified as payables arising from insurance contracts and are included within insurance and other payables in the consolidated statement of financial position. Where a contract has been issued but premiums have not yet been received, a debtor arising out of direct insurance operations is recognised for the expected premiums due. Reinsurance premiums and recoveries are accounted for in the accounting period in accordance with the contractual terms of the reinsurance treaties. Premiums exclude any taxes or duties based on premiums.

New business revenue by target market reconciles to gross premiums written as follows:

| For the year ended 31 December                      | 2014<br>£000's | 2013<br>£000's |
|---|----------------|----------------|
| Total single premium equivalent                     | 791,237        | 1,228,859      |
| Adjustment in respect of regular premium business   | 135            | (5)            |
| Change in premiums receivable – not included in SPE | (30,734)       | (69,335)       |
| Reinsurance premiums received                       | –              | 43             |

|                               |                |           |
|-------------------------------|----------------|-----------|
| <b>Gross premiums written</b> | <b>760,638</b> | 1,159,562 |
|-------------------------------|----------------|-----------|

Premiums are written at the point an insurance contract comes into force. For management purposes SPE is recorded when all funds have been received from the policyholder.

#### **d) Product revenue information**

The following table illustrates revenue by product as required by IFRS 8 "Operating Segments". All revenues from external customers are predominantly derived from business originated in the UK, and as such no geographical information is disclosed.

The Board considers the Group's external customers to be the individual policyholders. As such, the Group is not reliant on any individual customer.

An analysis of gross premiums written by product is set out below:

| <b>For the year ended 31 December 2014</b> | <b>2014<br/>£000's</b> | 2013<br>£000's |
|--|------------------------|----------------|
| Individual retirement annuities            | <b>435,106</b>         | 1,007,359      |
| Defined benefit buy-in/buy-out annuities   | <b>246,573</b>         | 82,923         |
| Individual care annuities                  | <b>75,864</b>          | 65,979         |
| Individual protection policies             | <b>3,095</b>           | 3,258          |
| Other                                      | –                      | 43             |
| <b>Total gross premiums written</b>        | <b>760,638</b>         | 1,159,562      |

## 2 Basis of preparation and new and revised standards

### Basis of preparation

Partnership Assurance Group (PAG) plc (the “Company”) was incorporated in the United Kingdom and registered in England and Wales on 26 February 2013 as a public company limited by shares. The Company’s registered office address is 5th Floor, 110 Bishopsgate, London, EC2N 4AY.

The results included in this announcement have been extracted from the audited consolidated annual financial statements of the Group made up to 31 December 2014. The consolidated financial statements have been prepared and approved by the Directors in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”) and endorsed by the European Union (“EU”), and those parts of the Companies Act 2006 applicable to companies reporting under IFRS.

The results of subsidiaries acquired or disposed of during the period are included from or up to the effective date of acquisition or disposal. Non-controlling interests in the net assets of consolidated subsidiaries are identified separately from the Group’s equity therein. The Group has control over an entity if all of the following conditions are met: (a) the Group has power over an entity; (b) the Group is exposed to, or has rights, to variable returns from its involvement with the entity; (c) the Group has the ability to use its power over the entity to affect its own returns.

The Group has adopted the following new standards and changes to existing standards which are relevant to the Group’s operations, and became effective for financial years beginning on or after 1 January 2014:

- IFRS 10 Consolidated financial statements
- IFRS 11 Joint Arrangements
- IFRS 12 Disclosures of interests in other entities
- IAS 32 Financial Instruments – Presentation
- IAS 36 Impairment of assets
- IAS 39 Financial Instruments: Recognition and measurement

None of these standards and changes had a material impact on the financial statements.

Other changes in accounting policy are:

- Segmental analysis – To reflect changes in the information provided to the Board, revenue attributable to Defined Benefit buy-in / buy out annuities is now presented separately from revenue attributable to Individual retirement annuities in the segmental analysis of revenue. Previously these categories were presented together in a Retirement Annuity segment. Comparative information has been re-analysed accordingly.

Restatement of 2013 Balance sheet

- Presentation of accrued income arising from financial investments- During the year the Group reviewed the presentation of accrued income arising from financial investments classified as fair value through profit and loss in the consolidated statement of financial position. It was concluded that presenting all components of the fair value of financial investments on the same line provides more clarity as to the Group’s exposure to these investments and therefore provides more relevant and no less reliable information. As a result of this change in policy an amount of £65.8m (2013: £59.1m) was reclassified from Prepayments and accrued income to Financial Assets. This change in policy has no effect on profit for the current or prior period or earnings per share.
- Payables and receivables arising from reinsurance contracts- During the year the Group reviewed the presentation of balances due to and from the Group under reinsurance contracts. It was concluded that presenting financial liabilities due to reinsurers where assets are legally and physically deposited back to the Group separately from other payables and receivables under reinsurance contracts better reflects the Group’s management of reinsurance balances and therefore provides more relevant and no less reliable information. As a result of this change in policy an amount of £21.5m (2013: £15.2m) was reclassified from financial liabilities to Insurance and other receivables. An amount of £3.2m (2013: £1.9m) was reclassified

from financial liabilities to Insurance and other payables. This change in policy has no effect on profit for the current or prior period or earning per share.

This announcement does not constitute statutory accounts as defined in Section 434 of the Companies Act 2006.

The auditors have reported on the consolidated financial statements. Their report was unqualified, did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying their report and did not contain a statement under section 498(2) or (3) of the Companies Act 2006.

The Directors have undertaken a going concern assessment in accordance with "Going Concern and Liquidity Risk: Guidance for UK directors of UK Companies 2009", as published by the Financial Reporting Council in October 2009.



### 3 Net investment income

Investment income comprises interest received on financial investments, realised investment gains and losses and movements in unrealised gains and losses. Expenses and charges are included on an accruals basis.

Realised gains and losses on investments are calculated as the difference between net sales proceeds less costs of sale and original cost. Unrealised gains and losses on investments represent the difference between the valuation at the balance sheet date and their purchase price or, if they have been previously valued, their valuation at the last balance sheet date. The movement in unrealised gains and losses recognised in the year also includes the reversal of unrealised gains and losses recognised in earlier accounting periods in respect of investment disposals in the current period.

| <b>For the year ended 31 December</b>           | <b>2014<br/>£000's</b> | <b>2013<br/>£000's</b> |
|---|------------------------|------------------------|
| Interest receivable from financial assets       | <b>152,519</b>         | 138,533                |
| Interest payable on financial liabilities       | <b>(81,065)</b>        | (71,596)               |
| Movement in fair value of financial assets      | <b>365,915</b>         | 26,616                 |
| Movement in fair value of financial liabilities | <b>(176,573)</b>       | 17,382                 |
| Realised gains on financial assets              | <b>95,158</b>          | 72,604                 |
| Realised losses on financial liabilities        | <b>(56,723)</b>        | (45,777)               |
| <b>Total net investment income</b>              | <b>299,232</b>         | 137,762                |

All financial assets and liabilities at 31 December 2014 are classified at fair value through profit and loss.

## 4 Earnings per share

Basic earnings per share is calculated using the earnings attributable to ordinary equity holders of the Parent, divided by the weighted average number of ordinary shares in issue during the period.

For diluted earnings per share, the weighted average number of ordinary shares in issue is adjusted to assume conversion of all potentially dilutive ordinary shares, including share options and awards.

Diluted earnings per share amounts are calculated by dividing the profit attributable to ordinary equity holders of the Parent by the weighted average number of ordinary shares outstanding during the year plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive ordinary shares into ordinary shares.

The calculation of the basic and diluted earnings per share from continuing operations is based on the following data:

| <b>For the year ended 31 December</b>                              | <b>2014<br/>£000's</b> | 2013<br>£000's |
|--|------------------------|----------------|
| Profit for the year  | <b>18,854</b>          | 59,421         |
| Less non-controlling interests                                     | <b>(2)</b>             | 44             |
| Profit attributable to equity holders of the Parent                | <b>18,852</b>          | 59,465         |
| Effect of dilutive potential ordinary shares:                      |                        |                |
| Share options  | –                      | –              |
| <b>Diluted profit attributable to equity holders of the Parent</b> | <b>18,852</b>          | 59,465         |

Prior to 12 June 2013 the top holding company in the Group was PAG Holdings Limited (PAGH). All of PAGH's A, B and C shares (see note 13) were exchanged for PAG plc shares on 12 June 2013. For the purpose of the earnings per share calculation, the weighted average number of share shown below has been calculated as if the exchange of these PAGH shares had occurred at the beginning of the comparative period.

| <b>For the year ended 31 December</b>            | <b>2014<br/>Number of<br/>shares</b> | 2013<br>Number of<br>shares |
|--|--------------------------------------|-----------------------------|
| Basic weighted average number of shares          | <b>399,870,568</b>                   | 346,138,910                 |
| Effect of dilutive potential ordinary shares:    |                                      |                             |
| Share options                                    | <b>2,780,521</b>                     | 1,276,243                   |
| <b>Diluted weighted average number of shares</b> | <b>402,651,089</b>                   | 347,415,153                 |

The options granted by the PAGH trust in respect of the ESOP scheme have a dilutive effect, up to the date of the IPO when these options vested.

The Group implemented a number of new employee share-based plans following admission on the London Stock Exchange. The Share Incentive Plan (SIP) has a dilutive effect.

It is our current intention that the Long Term Incentive Plan (LTIP) and the share element of the Deferred Share Bonus Plan (DSBP) be settled by fresh issues of shares as the awards vest. The weighted average number of shares calculation above has been derived on the assumption that the vesting of shares in respect of the LTIP and DSBP awards will be settled by a fresh issue of shares when the awards vest and hence will be dilutive.

## 5 Other intangible assets

Other intangible assets comprise intellectual property and software development costs.

The intellectual property asset comprises of specific mortality tables derived from data collected over an extended period and are deemed to have an indefinite life. Consequently no amortisation is charged against its carrying value.

Development costs that are directly attributable to the design and testing of identifiable software products, controlled by the Group, are recognised as intangible assets when it can be demonstrated that it is technically feasible to complete the product so that it is available for use and will generate probable future economic benefits. Software development costs have a finite useful life and are amortised using the straight-line method over three to five years.

### Impairment review of other intangible assets

The carrying amounts of intangible assets with finite expected useful economic lives are tested for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. A review for indicators of impairment is conducted annually. The carrying amounts of intangible assets with indefinite expected useful economic lives are tested for impairment at least annually, or when circumstances or events indicate there may be uncertainty over this value. An impairment loss is recognised in the consolidated statement of comprehensive Income for the amount by which the asset's carrying amount exceeds its recoverable amount.

The recoverable amount of an asset is the greater of its net selling price (fair value less selling costs) and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit, or company of units, to which the asset belongs.

|  | 2014<br>£000's | 2013<br>£000's |
|--|----------------|----------------|
| <b>Intellectual property cost and carrying amount:</b> |                |                |
| At 1 January   | 3,100          | 3,100          |
| <b>At 31 December</b>                                  | <b>3,100</b>   | <b>3,100</b>   |
| <b>Software development cost:</b>                      |                |                |
| At 1 January   | 17,805         | 11,750         |
| Additions at cost                                      | 2,093          | 7,696          |
| Assets written off                                     | –              | (1,641)        |
| <b>At 31 December</b>                                  | <b>19,898</b>  | <b>17,805</b>  |
| <b>Software development accumulated amortisation:</b>  |                |                |
| At 1 January   | 4,504          | 2,507          |
| Charge for the year                                    | 3,275          | 1,997          |
| <b>At 31 December</b>                                  | <b>7,779</b>   | <b>4,504</b>   |
| Total intangible assets at 1 January                   | 16,401         | 12,343         |
| <b>Total intangible assets at 31 December</b>          | <b>15,219</b>  | <b>16,401</b>  |

The value of intellectual property has been determined based upon an estimate of the costs to employ adequately skilled individuals over an appropriate period of time to develop intellectual property of a similar nature sufficient to enable the Group to replicate the estimated future cash flows and profits deriving from that intellectual property.

The intellectual property is continually updated through the collection of further data, updated analyses, and conversion into new and more detailed underwriting manuals and mortality tables. For this reason, the intangible asset is deemed to have an indefinite life, and consequently, no amortisation is provided against the value of the intangible asset. The carrying value of the intangible asset is tested for impairment at each reporting date, and is allocated to the "new business" cash-generating unit, the scope of which is identical to the "new business"

operating segment described in note 1. The method and assumptions used in this test are identical to those applied in the goodwill impairment test, as set out in note 12.

No impairment of intellectual property has been recognised in 2013 or 2014.

## 6 Financial assets

### Financial assets classification

The Group classifies its financial assets as financial investments, loans secured by residential mortgages, loans secured by commercial mortgages and derivative financial assets at fair value through profit and loss. The category of fair value through profit and loss has two sub-categories: those that meet the definition as being held for trading; and those that the Group chooses to designate as fair value. The fair value through profit and loss is selected as the Group's strategy is to manage its financial assets, as a portfolio, on a fair value basis.

### Financial investments

Purchases and sales of debt securities and other fixed income securities are recognised on the trade date, which is the date that the Group commits to purchase or sell the assets, at their fair values. Transaction costs are expensed as incurred. These investments are derecognised when the contractual rights to receive cash flows from the investments expire, or where the investments have been transferred, together with substantially all the risks and rewards of ownership.

Debt securities and other fixed income securities are subsequently carried at fair value with changes in fair value included in the consolidated statement of comprehensive Income in the period in which they arise.

The fair values of debt securities are based on quoted bid prices, or based on modelled prices (using observable market inputs) where quoted bid-prices are not available.

Commodity Trade Finance Investments, whether by way of a direct loan or an investment in a fund of such loans (CTF Investments), are carried at fair value on initial recognition and are recognised when the cash is advanced for the trade. CTF Investments are subsequently carried at fair value with changes in fair value included in the consolidated statement of comprehensive income in the period in which they arise. The fair value of these investments is not based on observable market data.

### Loans secured by residential mortgages

Loans secured by residential mortgages are recognised when the cash is advanced to borrowers at their fair values. These loans are derecognised when the contractual rights to receive cash flows from the investments expire, or where the investments have been transferred, together with substantially all the risks and rewards of ownership.

Loans secured by residential mortgages are subsequently carried at fair value with changes in fair value included in the consolidated statement of comprehensive income in the period in which they arise.

The fair value of loans secured by residential mortgages is initially deemed to be the transaction price and subsequently marked to model. The underlying model follows the methodology used to establish transaction prices. It uses longevity assumptions to derive expected cash flows and the Black-Scholes option pricing methodology to establish the value of the no negative equity guarantee that is embedded in the product. The discount rates that are applied to cash flows to produce fair value are based on long dated swaps adjusted so that they would produce transaction date prices on the date of transaction.

### Loans secured by commercial mortgages

Loans secured by commercial mortgages are recognised when the cash is advanced to borrowers at their fair values. These loans are derecognised when the contractual rights to receive cash flows from the investments expire, or where the investments have been transferred, together with substantially all the risks and rewards of ownership.

Loans secured by commercial mortgages are subsequently carried at fair value with changes in fair value included in the consolidated statement of comprehensive income in the period in which they arise.

The fair value of loans secured by commercial mortgages is initially deemed to be the transaction price and subsequently marked to model. The valuation model produces a series of projected future cash flows for each mortgage, based on a range of simulations of changes in property prices drawn from a distribution based on

historic observed changes. Potential changes in property tenancy are also modelled in a range of simulations. The discount rates that are applied to cash flows to produce the fair value are based on long dated swaps adjusted so that they would produce transaction date prices on the date of the transaction.

### Derivative financial instruments

The Group enters into a variety of derivative financial instruments to manage its exposure to interest rates, inflation, credit default and foreign exchange rate risk, including foreign exchange forward contracts, interest rate swaps, credit default swaps and inflations swaps.

Derivative contracts are traded either through an exchange or over-the-counter ("OTC"). OTC derivative contracts are individually negotiated between contracting parties and can include options, swaps, caps and floors.

Derivatives are initially recognised at fair value at the date that a derivative contract is entered into and are subsequently remeasured to fair value at each balance sheet date. The resulting gain or loss is recognised in the consolidated statement of comprehensive income. The fair values are obtained from quoted market prices or, if these are not available, by using standard valuation techniques based on discounted cash flow models or option pricing models. All derivatives are carried as assets when the fair value is positive and liabilities when the fair values are negative. Premiums paid for derivatives are recorded as an asset in the consolidated statement of financial position at the date of purchase representing their fair value at that date.

| <b>Financial assets<br/>Fair value at 31 December</b> | <b>2014<br/>£000's</b> | <b>Restated<sup>i</sup><br/>2013<br/>£000's</b> |
|---|------------------------|---|
| Financial investments                                 | <b>3,584,820</b>       | 3,133,790                                       |
| Loans secured by residential mortgages                | <b>1,212,324</b>       | 840,066   |
| Derivative assets                                     | <b>75,892</b>          | 36,413  |
| Loans secured by commercial mortgages                 | <b>37,868</b>          | –   |
| <b>Total financial assets</b>                         | <b>4,910,904</b>       | 4,010,269                                       |

i See note 2.

The methodology used to derive the fair values is set out in note 9.

| <b>Financial assets<br/>Cost at 31 December</b> | <b>2014<br/>£000's</b> | <b>2013<br/>£000's</b> |
|---|------------------------|------------------------|
| Financial investments                           | <b>3,298,543</b>       | 2,991,196              |
| Loans secured by residential mortgages at cost  | <b>950,909</b>         | 796,788                |
| Derivative assets                               | –                      | –                      |
| Loans secured by commercial mortgages at cost   | <b>37,481</b>          | –                      |
| <b>Total financial assets</b>                   | <b>4,286,933</b>       | 3,787,984              |

## 7 Insurance liabilities and reinsurance assets

### Insurance liabilities

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

The Group's long-term insurance contracts include annuities to fund retirement income, annuities to fund care fees (immediate needs and deferred), long-term care insurance and whole of life and term protection insurance. These contracts are expected to remain in force for an extended period of time, and insure events associated with human life.

One of the purposes of insurance is to enable policyholders to protect themselves against future uncertain events such as death or specific types of illness. Insurance companies accept the transfer of uncertainty from policyholders and seek to add value through the aggregation and management of these risks. As a consequence of this uncertainty, estimation techniques are employed by suitably qualified personnel in computing the levels of provisions held against such uncertainty.

The insurance liabilities, which are also referred to as the long-term business provision and policyholder reserves elsewhere in this report, are determined by the Partnership Board on the advice of the Group's Actuarial Function Holder on the modified statutory basis using recognised actuarial methods with due regard to the actuarial principles set out in the PRA's (formerly the FSA's) Insurance Prudential Sourcebook. In particular, a prospective gross premium valuation method has been adopted for major classes of business.

Although the process for the establishment of insurance liabilities follows specified rules and guidelines, the provisions that result from the process remain uncertain. As a consequence of this uncertainty, the eventual value of claims could vary from the amounts provided to cover future claims. The Group seeks to provide for appropriate levels of contract liabilities taking known facts and experiences into account but nevertheless such provisions remain uncertain.

The estimation process used in determining insurance liabilities involves projecting future annuity payments and the costs of maintaining the contracts. For non-annuity contracts, the long-term business provision is determined as the sum of the discounted value of future benefit payments and future administration expenses less the expected value of premiums payable under the contract. The key sensitivities are the assumed level of interest rates and the mortality experience.

At the balance sheet date, provision is made for all notified claims plus an estimate for those claims that have been incurred but not reported.

### Reinsurance assets

Long-term business is ceded to reinsurers under contracts to transfer part or all of one or more of the following risks: mortality, morbidity, investment, persistency and expenses. The benefits to which the Group are entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers (classified within "Insurance and other receivables") as well as longer-term receivables that are dependent on the expected benefits arising under the related reinsured contracts.

Amounts recoverable from reinsurers are estimated in a consistent manner with insurance liabilities, and are classified as "Reinsurance assets".

Some contracts, which provide for the transfer of significant risk, are also structured to provide financing. When, under such contracts, financing components are to be repaid in future accounting periods, the amount outstanding under the contract at the balance sheet date are classified as "Payables arising from reinsurance contracts" and included within insurance and other payables in the consolidated statement of financial position.

If the reinsurance asset were impaired, the Group would adjust the carrying amount accordingly and recognise that impairment loss in the consolidated statement of comprehensive income. A reinsurance asset is impaired if there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the

Group may not receive all amounts due to it under the terms of the contract, and the event has a reliably measurable impact on the amounts that the Group will receive from the reinsurer.

### Liability adequacy test

At the end of each reporting period, liability adequacy tests are performed to ensure the adequacy of the insurance liabilities. In performing these tests, current best estimates of future contractual cash flows and claims handling and administration expenses, as well as investment income from assets backing such liabilities, are used. Any deficiency is immediately charged to the consolidated statement of comprehensive income.

### Claims

Maturity claims and annuities are charged against revenue when due for payment. Death claims and all other claims are accounted for when notified. Claims reinsurance recoveries are accounted for in the same period as the related claim. Where reinsurance treaties are recaptured, amounts received to compensate for the transfer of risk from the reinsurer are accounted for when received or, if earlier, on the date the treaty ceases to be included within the calculation of the reinsurers' share of long-term business provision.

| <b>At 31 December</b>                             | <b>2014<br/>£000's</b> | <b>2013<br/>£000's</b> |
|---|------------------------|------------------------|
| Long-term business provision                      | <b>5,231,112</b>       | 4,347,588              |
| Reinsurers' share of long-term business provision | <b>(3,246,008)</b>     | (2,840,749)            |
| <b>Net provision</b>                              | <b>1,985,104</b>       | 1,506,839              |

### a) Principal assumptions

The principal assumptions underlying the calculation of the long-term business provision are as follows:

|   |      |  | <b>Valuation<br/>discount<br/>rates</b> |
|---|------|--|---|
| <b>Mortality tables</b>                 |      |  |   |
| Medically underwritten annuity products | 2014 | Modified E&W Population Mortality with CMI 2013m (1.25%) and CMI 2013f (1.00%) | 3.53%                                   |
|   | 2013 | Modified E&W Population Mortality with CMI 2012m (1.75%) and CMI 2012f (1.50%) | 4.31%                                   |
| Other annuity products                  | 2014 | Modified PCMA/PCFA00u bespoke  | 1.35%                                   |
|   | 2013 | Modified PCMA/PCFA00u bespoke  | 1.70%                                   |
| Term and whole of life products         | 2014 | 86.25% TM/TF00Select   | 1.00%                                   |
|   | 2013 | 86.25% TM/TF00Select   | 1.44%                                   |

Valuation discount rate assumptions are set with regards to yields on supporting assets. An allowance for risk is included by making an explicit deduction from the yields on debt and other fixed income securities based on historical default experience and expected experience of each asset class. The allowance for credit risk has been set at 42% (31 December 2013: 47%) of the spread on the yield of the corporate bonds over the yield on gilts.

The changes in the valuation discount rates at each period end reflect changes in yields on the supporting assets and changes made to the allowance for risk.

The mortality tables used have been adjusted to reflect additional mortality based on the proprietary data held by the Group developed from actual experience incurred. The valuation basis used to calculate the long-term business provisions includes an allowance for future expenses.

## b) Movements

Movements in the carrying amount of insurance liabilities and reinsurance assets are explained as follows:

| <b>For the year ended 31 December 2014</b>  | <b>Gross<br/>£000's</b> | <b>Reinsurance<br/>£000's</b> | <b>Net<br/>£000's</b> |
|---|-------------------------|-------------------------------|-----------------------|
| At 1 January 2014                           | 4,347,588               | (2,840,749)                   | 1,506,839             |
| Increase in liability from new business     | 692,005                 | (266,845)                     | 425,160               |
| Release of in-force liability               | (130,286)               | 87,709                        | (42,577)              |
| Release of liability due to recorded deaths | (67,743)                | 31,799                        | (35,944)              |
| Economic changes                            | 332,956                 | (211,434)                     | 121,522               |
| Non-economic changes                        | 912                     | –                             | 912                   |
| Other                                       | 55,680                  | (46,488)                      | 9,192                 |
| <b>At 31 December 2014</b>                  | <b>5,231,112</b>        | <b>(3,246,008)</b>            | <b>1,985,104</b>      |

| <b>For the year ended 31 December 2013</b>  | <b>Gross<br/>£000's</b> | <b>Reinsurance<br/>£000's</b> | <b>Net<br/>£000's</b> |
|---|-------------------------|-------------------------------|-----------------------|
| At 1 January 2013                           | 3,723,298               | (2,412,551)                   | 1,310,747             |
| Increase in liability from new business     | 1,038,011               | (678,827)                     | 359,184               |
| Release of in-force liability               | (111,110)               | 75,012                        | (36,098)              |
| Release of liability due to recorded deaths | (69,967)                | 31,040                        | (38,927)              |
| Economic changes                            | (209,299)               | 144,164                       | (65,135)              |
| Non-economic changes                        | (25,847)                | 1,609                         | (24,238)              |
| Other                                       | 2,502                   | (1,196)                       | 1,306                 |
| At 31 December 2013                         | 4,347,588               | (2,840,749)                   | 1,506,839             |

## c) Analysis of expected maturity

The following table analyses insurance liabilities and reinsurance assets by duration.

|  | Expected cash flows (undiscounted) |                                |                                |                                  | Carrying value<br>(discounted)<br>£000's |
|--|------------------------------------|--------------------------------|--------------------------------|----------------------------------|--|
|  | less than one<br>year<br>£000's    | one to five<br>years<br>£000's | five to ten<br>years<br>£000's | more than ten<br>years<br>£000's |  |
| <b>At 31 December 2014</b>                           |                                    |                                |                                |                                  |  |
| Long-term business provision                         | 411,885                            | 1,510,716                      | 1,624,201                      | 4,367,492                        | 5,231,112                                |
| Reinsurers' share of long-term<br>business provision | (258,539)                          | (966,479)                      | (1,053,161)                    | (2,699,933)                      | (3,246,008)                              |
| <b>Net</b>   | <b>153,346</b>                     | <b>544,237</b>                 | <b>571,040</b>                 | <b>1,667,559</b>                 | <b>1,985,104</b>                         |

|  | Expected cash flows (undiscounted) |                             |                             |                                  | Carrying value<br>(discounted)<br>£000's |
|--|------------------------------------|-----------------------------|-----------------------------|----------------------------------|--|
|  | less than one<br>year<br>£000's    | one to five years<br>£000's | five to ten years<br>£000's | more than ten<br>years<br>£000's |  |
| At 31 December 2013                                  |                                    |                             |                             |                                  |  |
| Long-term business provision                         | 373,419                            | 1,360,968                   | 1,450,164                   | 3,829,024                        | 4,347,588                                |
| Reinsurers' share of long-term<br>business provision | (241,692)                          | (903,711)                   | (985,311)                   | (2,544,018)                      | (2,840,749)                              |
| <b>Net</b>   | <b>131,727</b>                     | <b>457,257</b>              | <b>464,853</b>              | <b>1,285,006</b>                 | <b>1,506,839</b>                         |



#### d) Sensitivity analysis

Life insurance results are inherently uncertain due to actual experience being different to modelled assumptions. Sensitivity analysis is provided below to illustrate the impact of changes in key assumptions.

| Sensitivity factor                  | Description of sensitivity factor applied   |
|-------------------------------------|---|
| Interest rate and investment return | The impact of a change in the market interest rates by +/- 1% (e.g. if a current interest rate is 5%, the impact of an immediate change to 4% and 6% respectively). The test allows consistently for similar changes to investment returns and movements in the market backing fixed interest securities. |
| Credit spreads                      | The impact of credit spreads widening by 50bps with a corresponding pro-rated change to defaults.   |
| Expenses                            | The impact of an increase in maintenance expenses by 10%.   |
| Mortality rates                     | The impact of a decrease in mortality rates by 5%.  |
| Property values                     | The impact of an immediate decrease in the value of properties by 10%. The test allows for the impact on the annuity liabilities arising from any change in yield on the loans secured by residential mortgages and loans secured by commercial mortgages used to back the liabilities.                   |
| Voluntary redemptions               | The impact of an increase in voluntary redemption rates on loans secured by residential mortgages by 10%. The test allows for the impact on the annuity liabilities arising from any change in yield on the loans secured by residential mortgages that are used to back the liabilities.                 |

The table below demonstrates the effect of a change in a key assumption whilst other assumptions remain unchanged. In reality, such an occurrence is unlikely due to correlation between the assumptions and other factors. It should also be noted that these sensitivities are non-linear, and larger or smaller impacts should not be interpolated or extrapolated from these results. The sensitivity analyses do not take into consideration that the Group's assets and liabilities are actively managed and may vary at the time that any actual market movement occurs.

| Change in assumption:      | Increase/(decrease) in profit before tax |                |
|----------------------------|--|----------------|
|                            | 2014<br>£000's                           | 2013<br>£000's |
| Interest rates +1%         | 2,866                                    | 2,954          |
| Interest rates -1%         | (5,993)                                  | (3,308)        |
| Credit spreads +0.5%       | (11,621)                                 | (10,917)       |
| Expenses +10%              | (10,906)                                 | (9,962)        |
| Mortality -5%              | (32,027)                                 | (22,140)       |
| Property prices -10%       | (38,583)                                 | (25,313)       |
| Voluntary redemptions +10% | (6,412)                                  | (2,402)        |

## 8 Financial liabilities

As well as derivative financial liabilities, the Group carries financial liabilities where assets under specific reinsurance treaties are legally and physically deposited back to the Group by reinsurers. Financial liabilities are initially recognised at fair value on the same date that the value of underlying deposited assets is recognised and are subsequently remeasured at fair value at each balance sheet date. The resulting gain or loss is recognised in the consolidated statement of comprehensive income. The net gain or loss recognised incorporates any interest paid on the financial liability. Fair value is determined as the amount payable discounted from the first date that the amount is required to be paid.

A financial liability (including subordinated debt and external borrowings) is generally derecognised when the contract that gives rise to it, is settled, sold, cancelled or expires.

Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange of modification is treated as a derecognition of the original liability and the recognition of a new liability, such that the difference in the respective carrying amounts together with any costs or fees incurred are recognised in the consolidated statement of comprehensive income.

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into.

| <b>At 31 December</b>              | <b>2014<br/>£000's</b> | <b>Restated<sup>i</sup><br/>2013<br/>£000's</b> |
|------------------------------------|------------------------|---|
| Deposits from reinsurers           | <b>2,491,795</b>       | 2,182,350                                       |
| Derivative liabilities             | <b>79,493</b>          | 32,391  |
| <b>Total financial liabilities</b> | <b>2,571,288</b>       | 2,214,741                                       |

i See note 2.

Payables arising from reinsurance contracts at fair value through profit and loss are designated as such on initial recognition. Derivative liabilities are carried at fair value through profit and loss.

## 9 Financial instruments – fair value methodology

All financial instruments, with the exception of external borrowings, are classified at fair value through profit and loss. In accordance with IFRS 13 Fair Value Measurement, financial instruments at fair value have been classified into three categories:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices); or

Level 3: Inputs for the assets or liabilities that are not based on observable market data (that is, unobservable inputs).

An analysis of financial assets and liabilities held at fair value in accordance with the fair value hierarchy is set out below. All these financial assets and liabilities relate to recurring fair value measurements. There are no non-recurring fair value measurements as at 31 December 2014 and 31 December 2013.

| At 31 December 2014                                   | Level 1<br>£000's | Level 2<br>£000's | Level 3<br>£000's | Total<br>£000's  |
|---|-------------------|-------------------|-------------------|------------------|
| Financial investments (a)                             | 3,583,183         | –                 | 1,637             | 3,584,820        |
| Loans secured by residential mortgages (b)            | –                 | –                 | 1,212,324         | 1,212,324        |
| Derivative assets (c)                                 | –                 | 75,892            | –                 | 75,892           |
| Loans secured by commercial mortgages (d)             | –                 | –                 | 37,868            | 37,868           |
| <b>Total financial assets held at fair value</b>      | <b>3,583,183</b>  | <b>75,892</b>     | <b>1,251,829</b>  | <b>4,910,904</b> |
| Deposits from reinsurers (e)                          | –                 | –                 | 2,491,795         | 2,491,795        |
| Derivative liabilities (c)                            | –                 | 79,493            | –                 | 79,493           |
| <b>Total financial liabilities held at fair value</b> | <b>–</b>          | <b>79,493</b>     | <b>2,491,795</b>  | <b>2,571,288</b> |

| Restated <sup>i</sup><br>At 31 December 2013   | Level 1<br>£000's | Level 2<br>£000's | Level 3<br>£000's | Total<br>£000's |
|--|-------------------|-------------------|-------------------|-----------------|
| Financial investments (a)                      | 3,122,222         | –                 | 11,568            | 3,133,790       |
| Loans secured by residential mortgages (b)     | –                 | –                 | 840,066           | 840,066         |
| Derivative assets (c)                          | –                 | 36,413            | –                 | 36,413          |
| Total financial assets held at fair value      | 3,122,222         | 36,413            | 851,634           | 4,010,269       |
| Deposits from reinsurers (e)                   | –                 | –                 | 2,182,350         | 2,182,350       |
| Derivative liabilities (c)                     | –                 | 32,391            | –                 | 32,391          |
| Total financial liabilities held at fair value | –                 | 32,391            | 2,182,350         | 2,214,741       |

<sup>i</sup> See note 2.

The Group's policy is to recognise transfers into and transfers out of Levels 1, 2 and 3 as of the date at which the consolidated statement of financial position is prepared.

There have been no transfers between Levels 1, 2 and 3 in 2014.

The table below reconciles the opening and closing recorded amount of level 3 financial liabilities and financial assets which are stated at fair value.

|  | Deposits<br>from<br>reinsurers<br>£000's | Loans<br>secured<br>by<br>commercial<br>mortgages<br>£000's | CTF<br>Investments<br>£000's | Loans<br>secured<br>by<br>residential<br>mortgages<br>£000's |
|--|--|---|------------------------------|--|
| <b>For the year ended 31 December 2014</b>                             |  |   |                              |  |
| At 1 January 2014  | (2,182,350)                              | –   | 11,568                       | 840,066  |
| Loans (received)/advanced  | (307,959)                                | 37,481  | 6,321                        | 232,519  |
| Total (losses)/gains in consolidated statement of comprehensive income | (139,376)                                | 263   | (884)                        | 185,634  |
| Redemptions made/(received)  | 229,082                                  | –   | (16,386)                     | (51,273)   |
| (Interest payable accrued)/interest receivable accrued                 | (91,192)                                 | 125   | 1,018                        | 5,378  |
| <b>At 31 December 2014</b>   | <b>(2,491,795)</b>                       | <b>37,869</b>   | <b>1,637</b>                 | <b>1,212,324</b>   |

|  | Deposits<br>from<br>reinsurers<br>£000's | Loans<br>secured<br>by<br>commercial<br>mortgages<br>£000's | CTF<br>Investments<br>£000's | Loans<br>secured<br>by<br>residential<br>mortgages<br>£000's |
|--|--|---|------------------------------|--|
| Restated <sup>i</sup><br>For the year ended 31 December 2013           |  |   |                              |  |
| At 1 January 2013  | (1,728,998)                              | –   | –                            | 478,097  |
| Loans (received)/advanced  | (733,849)                                | –   | 23,990                       | 416,473  |
| Total (losses)/gains in consolidated statement of comprehensive income | (155,522)                                | –   | (3,135)                      | (25,695)   |
| Redemptions made/(received)  | 514,878                                  | –   | (11,306)                     | (34,187)   |
| (Interest payable accrued)/interest receivable accrued                 | (78,859)                                 | –   | 2,019                        | 5,378  |
| At 31 December 2013  | (2,182,350)                              | –   | 11,568                       | 840,066  |

<sup>i</sup> See note 2.

The gains and losses are included within net investment income in the consolidated statement of comprehensive income.

The unrealised gains/(losses) in respect of payables arising out of reinsurance contracts, commodity trade finance investments, loans secured by residential mortgages and loans secured by commercial mortgages for the period to 31 December 2014 are £139.4m (2013: £155.5m), £0.9m (2013: £(1.1)m), £191.0m (2013: £(20.3)m) and £0.2m (2013: £nil) respectively. These unrealised gains and losses are included within net investment income in the consolidated statement of comprehensive income.

### Level 3 sensitivity analysis

|  |                                       | Impact of alternative assumption |                                  |                                  |
|--|---------------------------------------|----------------------------------|----------------------------------|----------------------------------|
| At 31 December 2014                          | Significant assumption                | Current fair value<br>£000's     | Increase in fair value<br>£000's | Decrease in fair value<br>£000's |
| <b>Assets</b>                                |                                       |                                  |                                  |                                  |
| CTF Investments                              | Expected defaults                     | 1,637                            | 289                              | (353)                            |
| Loans secured by commercial mortgages        | Discount rate                         | 37,868                           | 2,744                            | (2,501)                          |
| Loans secured by residential mortgages       | Discount rate                         | 1,212,324                        | 156,367                          | (132,186)                        |
| <b>Liabilities</b>                           |                                       |                                  |                                  |                                  |
| Deposits from reinsurers                     | Discount rate                         | (2,491,795)                      | (220,538)                        | 192,268                          |
| <hr/>  |                                       |                                  |                                  |                                  |
| Restated <sup>i</sup><br>At 31 December 2013 | Significant assumption                | Current fair value<br>£000's     | Increase in fair value<br>£000's | Decrease in fair value<br>£000's |
| <b>Assets</b>                                |                                       |                                  |                                  |                                  |
| CTF Investments                              | Expected defaults                     | 11,568                           | 406                              | (584)                            |
| Loans secured by residential mortgages       | Value of no negative equity guarantee | 840,066                          | 100,863                          | (86,046)                         |
| <b>Liabilities</b>                           |                                       |                                  |                                  |                                  |
| Deposits from reinsurers                     | Discount rate                         | (2,182,350)                      | (182,645)                        | 161,733                          |

<sup>i</sup> See note 2.

The impact of reasonably possible alternative assumptions are estimated by modelling alternative scenarios for the key assumptions for each valuation model.

#### a) Financial investments

All financial investments are designated at fair value through profit and loss. All financial investments excluding commodity trade finance are listed.

In assessing the fair value of the debt securities and other fixed income securities, the Directors have relied upon values provided by an independent third party which specialises in providing such values to companies. The third party provides prices based upon quoted market prices, or where not available, modelled prices using observable market inputs. At 31 December 2014 and 31 December 2013, 100% of the values provided were based on quoted market prices that are observable for the asset or liability.

Due to the short-term nature of the commodity trade finance (CTF) loans, the fair value of these instruments is estimated as the principal amount borrowed plus accrued interest from the date of acquisition, adjusted for incurred and expected defaults. These CTF loans are considered to be Level 3 within the valuation category prescribed by IFRS 13 as the inputs to the fair value calculation are not based on observable market data, and includes the Group's own assumptions.

The change in the fair value of Level 3 financial instruments from period to period is analysed into loans advanced, loans repaid/redemptions, and interest accrued, with the remaining balance representing fair value measurement gains and losses recognised in the statement of comprehensive income.

**Interest rate:** The interest rate used in estimating the fair value of the CTF Funds as at 31 December 2014 was nil% p.a. (31 December 2013: 12%).

#### b) Loans secured by residential mortgages

The fair value recognised in the financial statements for loans secured by residential mortgages is determined using a marked to model valuation technique where a significant proportion of inputs are not based on observable market data and so these assets are considered to be Level 3 within the valuation category prescribed by IFRS 13.

The valuation model discounts the expected future cash flows using an interest rate swap curve with an additional spread or yield factor minus the cost of the no-negative equity guarantee. The no-negative equity guarantee

represents an embedded guarantee that the repayment of the loan cannot exceed the value of the property at the time of repayment.

Although such valuations are sensitive to various estimates, it is considered that only the discount rate and no-negative equity guarantee assumptions would have significant impact the fair value.

**Discount rate:** Loans secured by mortgages are valued using the swap rate appropriate to the term of each contract with adjustment to reflect the credit and liquidity risk associated with such long-dated contracts. The risk adjusted swap rate for the portfolio weighted by average value at 31 December 2014 was 5.05% (31 December 2013: 6.42%).

**No-negative equity guarantee:** The fair value of loans secured by residential mortgages takes into account an explicit provision in respect of the no-negative equity guarantee which is calculated using a variant of the Black-Scholes option pricing model. The key assumptions used to derive the value of the no-negative equity guarantee include property growth, volatility and over-valuation. The property growth and volatility assumed at 31 December 2014 were 5.5% (31 December 2013: 5.5%) and 13% (31 December 2013: 13%) respectively. The over-valuation assumption used as at 31 December 2014 was 27.4% (31 December 2013: 22%). The value of the no-negative equity guarantee as at 31 December 2014 was £112.5m (31 December 2013: £67.3m).

The valuation technique that the Group uses to assess the fair value of loans secured by mortgages is consistent with that used to derive the prices applied at the initial transaction. As such, there is no difference between the fair value of loans secured by equity release mortgages at initial recognition and the amount that would have been determined at that date using the valuation technique.

### **c) Derivative assets and liabilities**

The estimated fair value of derivative instruments reflects the estimated amount the Group would receive or pay in an arm's length transaction. All the derivatives held at 31 December 2014 and 31 December 2013 were purchased over-the-counter.

The Group's derivative assets and liabilities largely relate to forward currency positions, interest rate swaps and inflation swaps.

**Forward currency positions:** Forward currency exchange contracts are priced by independent third parties.

**Interest rate swaps:** The fair value of the interest rate swaps is derived using an interest rate swap pricing model, using a time series of historical LIBOR rates, an applicable zero coupon interest rate swap curve to derive future cash flows ("forward curve") and an applicable zero coupon interest rate swap curve to discount future cash flows ("discount curve") as inputs. The forward curve is used by the pricing model to determine the future LIBOR rates to be applied in the calculation of the floating leg cash flow(s). The discount curve is used to calculate the present value of the future cash flow(s) of both the fixed and floating legs of the swap and its composition is driven by the terms of the Credit Support Annex under which the swap is traded.

**Inflation swaps:** The fair value of the inflation swaps is derived using the inflation swap pricing model, using a time series of historical inflation index levels, a zero coupon swap inflation expectation curve, an inflation seasonality model and a zero coupon interest rate swap curve as inputs. The inflation swap pricing model generates a future cash flow for both the fixed and inflation legs of a swap for which a present value is determined using zero coupon interest rate swap curve.

The derivative assets and liabilities are presented on a gross basis in the consolidated statement of financial position. All over-the-counter derivative transactions are conducted under standardised ISDA (International Swaps and Derivatives Association Inc) master agreements and the Group has collateral agreements between the individual Group entities and relevant counterparties in place under each of these master agreements.

### **d) Loans secured by commercial mortgages**

The fair value recognised in the financial statements for loans secured by commercial mortgages is determined using a marked to model valuation technique where a significant proportion of inputs are not based on observable market data and so these assets are considered to be Level 3 within the valuation category prescribed by IFRS 13.

The valuation model produces a series of projected future cash flows for each mortgage, based on a range of simulations of changes in property prices drawn from a distribution based on historic observed changes. Potential changes in property tenancy (e.g. tenant default, exercise of break clause or non-renewal of lease) are also

modelled in a range of simulations. Risk adjusted cash flows are calculated as the average across the range of simulations.

The risk adjusted cash flows are discounted using a swap curve with an additional spread. The additional spread is the increase in swap discount rates required so that the initial discounted risk adjusted cash flows equal the initial purchase price. This uplift is reviewed if there is evidence that market has moved materially.

The discount rate and changes in property prices and tenancy are the most significant assumptions applied in calculating the fair value of the loans.

Discount rate: Loans secured by commercial mortgages are valued using the swap rate appropriate to the term of each contract with adjustment to reflect the credit and liquidity risk associated with such long-dated contracts. The risk adjusted swap rate for the portfolio weighted by average value at 31 December 2014 was 3.02%.

#### **e) Deposits from reinsurers**

The fair value recognised in the financial statements is determined using a marked to model valuation technique where not all inputs are based on observable market data and so these liabilities are considered to be Level 3 within the valuation category prescribed by IFRS 13.

The valuation model discounts the expected future cash flows using a discount rate derived from the assets hypothecated to back these liabilities at a product level.

As payables arising from reinsurance contracts do not have a single fixed maturity date it is not possible to determine an amount that would be contractually required to pay at maturity.

**Discount rate:** The key inputs to the derivation of the discount rate include market observable gross redemption yields, contractual investment expenses and an allowance for credit risk on a best estimate basis. The discount rates used as at 31 December 2014 for Individual retirement and Individual care annuities were 4.16% and 1.67% respectively (31 December 2013: 4.95% and 1.97% respectively).

## 10 Management of insurance and financial risk

The Group issues contracts that accept insurance risk in return for a premium. In addition the Group is exposed to financial risk through its financial assets, financial liabilities, reinsurance assets and policyholder liabilities. In particular, the key financial risk is that the proceeds from financial assets are not sufficient to fund the obligations arising from contracts with policyholders. The most important components of this financial risk are interest rate risk, credit risk, property risk and liquidity risk. The Group is not exposed to any equity price risk and to currency risk only to an immaterial extent.

### a) Insurance risk

#### *a1) Underwriting, pricing and reserving risk*

Underwriting and pricing risk is the risk that insurance contracts will be written that are not within the Board's risk appetite, or that the premium charged for that business is not adequate to cover the risks borne by the Group.

The accurate pricing of non-standard annuities is dependent on the Group's assessment of the impact on prospective customers' longevity of various medical and lifestyle factors and an estimate of future investment yields and credit default.

The actual timing of deaths and investment income experience may be inconsistent with the assumptions and pricing models used in underwriting and setting prices for its products.

Reserving risk is the risk that the reserves have been calculated incorrectly, or the assumptions used in the calculations are inappropriate.

As the Group's insurance business is targeted at people with conditions affecting their life expectancy, or people seeking to fund domiciliary or residential care, the underwriting risk is managed through the use of highly trained, and qualified underwriting staff, together with detailed underwriting manuals designed to cover a large range of medical conditions.

Partnership has developed its own proprietary underwriting manuals for retirement annuity business and those seeking care funding, based on industry standard mortality tables modified to take account of experience data recorded by Partnership.

The assumptions used in the reserving for future policyholder payments are set based on available market and experience data, on the advice of Partnership's Actuarial Function Holder. The assumptions are approved by the Board. The reserves are calculated using recognised actuarial methods with due regard to the actuarial principles set out in the PRA's sourcebooks, including appropriate levels of prudential margin against future adverse experience.

#### *a2) Specific insurance risk*

Insurance risk on the Group's annuity contracts arises through longevity risk and through the risk that operating factors, such as administration expenses, are worse than expected. Insurance risk on the Group's protection policies arises through higher than expected mortality levels. The Group's longevity and mortality experience is monitored on a regular basis and compared to the underlying assumptions used to reserve for future insurance payments. The exposure to longevity and mortality risk is reduced through the use of reinsurance.

Expense risk is managed through regular assessment and quarterly reforecasting of expenses incurred against budgets.

### b) Interest Rate Risk

Interest rate risk arises from open positions in fixed and variable rate stock issued by government and corporate bodies that are exposed to general and specific market movements. The Group is exposed to the market movements in interest rates to the extent that the asset value movement is different to the accompanying movement in the value of its insurance liabilities.

The difference between asset and liability movements can arise from both a change in the absolute level of interest rates, and from a change in the "spread" (that is the level of interest rates applying to an asset in excess of the risk-free interest rate).



The Group manages its interest rate risk within an asset liability management (ALM) framework that has been developed to achieve investment returns in excess of its obligations under insurance contracts. The principal technique of the ALM framework is to match assets to the liabilities arising from insurance contracts by reference to the type of benefits payable to policyholders.

The Group monitors interest rate risk by calculating the mean duration and cash flow profile of the investment portfolio and the liabilities. The mean duration is an indicator of the sensitivity of the assets and insurance liabilities to changes in current interest rates but is not sufficient in isolation. The mean duration of the liabilities is determined by means of projecting expected cash flows from the contracts using best estimates of mortality and voluntary terminations. No future discretionary supplemental benefits are assumed to accrue. The mean duration of the assets is calculated in a consistent manner. Any gap between the mean duration of the assets and the mean duration of the liabilities is minimised by means of buying and selling fixed interest securities of different durations or purchasing interest rate swap derivatives to alter the effective mean duration of the assets. Periodically the cash flow matching is reviewed and rebalanced.

At 31 December 2014, the mean duration of the assets including surplus assets was 8.3 years (2013: 7.5 years) measured with reference to a gross redemption yield and the mean duration of the liabilities (including both retirement and care liabilities) was at 9.6 years (2013: 8.9 years) measured with reference to the valuation interest rate.

The Group has reinsurance arrangements in place which provide for fixed payments to the reinsurer over future periods. In assessing the fair value of this liability, the Directors have used a discount rate derived from current market yields earned on assets held to fund the future cash outflows, adjusted for the risk of default on those assets. No further adjustment to the discount rate to reflect any risk of the Group defaulting on those payments to the reinsurer was deemed appropriate.

### **c) Credit risk**

Market credit risk is the risk that the Group invests in assets that may default.

If an asset fails to repay either interest or capital, or that payment is significantly delayed, the Group may make losses and be unable to meet liabilities as they fall due.

The Group's Investment Management Guidelines set out maximum exposure to bonds issued by a single, or related group of, counterparty(/ies) and to credit ratings. The allowance made for issuer default in the Group's valuation is regularly monitored and kept up to date.

At 31 December 2014, £19.0m of collateral (2013: £0.9m) had been pledged to the Group to mitigate the credit risk exposure associated with the derivative assets held at that time.

Counterparty credit risk arises if another party fails to honour its obligations to the Group including failure to honour these obligations in a timely manner.

The Group's primary counterparty credit risk exposure arises from the inability of the reinsurers to meet their claim payment obligations.

The Group has arrangements with its reinsurers whereby most reinsurance premiums are either deposited back to the Group or held by a third party in a trust arrangement.

In addition, the Group's reinsurance policy is to seek to choose companies with a minimum "A" credit rating.

The following table analyses the credit exposure of the Group by type of asset and includes the credit risk arising out of reinsurance exposures, based on the credit ratings of the reinsurer, as published by Standard & Poors, or an equivalent rating from another recognised rating agency.

| At 31 December 2014                    | Credit rating  |                  |                  |                  |                   | Total<br>£000's  |
|--|----------------|------------------|------------------|------------------|-------------------|------------------|
|  | AAA<br>£000's  | AA<br>£000's     | A<br>£000's      | BBB<br>£000's    | Unrated<br>£000's |                  |
| Financial investments                  | 815,605        | 234,771          | 1,251,104        | 1,280,870        | 2,470             | 3,584,820        |
| Derivative assets                      | –              | –                | –                | –                | 75,892            | 75,892           |
| Loans secured by residential mortgages | –              | –                | –                | –                | 1,212,324         | 1,212,324        |
| Loans secured by commercial mortgages  | –              | –                | –                | –                | 37,868            | 37,868           |
| Reinsurance assets                     | –              | 1,290,232        | 1,955,776        | –                | –                 | 3,246,008        |
| Insurance and other receivables        | –              | 17,761           | 4,761            | –                | 16,645            | 39,167           |
| <b>Total</b>                           | <b>815,605</b> | <b>1,542,764</b> | <b>3,211,641</b> | <b>1,280,870</b> | <b>1,345,199</b>  | <b>8,196,079</b> |

| Restated<br>At 31 December 2013        | Credit rating  |                  |                  |                  |                   | Total<br>£000's  |
|--|----------------|------------------|------------------|------------------|-------------------|------------------|
|  | AAA<br>£000's  | AA<br>£000's     | A<br>£000's      | BBB<br>£000's    | Unrated<br>£000's |                  |
| Financial investments                  | 611,062        | 260,620          | 1,193,352        | 1,057,189        | 11,568            | 3,133,790        |
| Derivative assets                      | –              | –                | –                | –                | 36,413            | 36,413           |
| Loans secured by residential mortgages | –              | –                | –                | –                | 840,066           | 840,066          |
| Reinsurance assets                     | –              | 1,240,280        | 1,600,469        | –                | –                 | 2,840,749        |
| Insurance and other receivables        | –              | 13,132           | 11,064           | –                | 55,437            | 79,633           |
| <b>Total</b>                           | <b>611,062</b> | <b>1,514,032</b> | <b>2,804,885</b> | <b>1,057,189</b> | <b>943,484</b>    | <b>6,930,651</b> |

i See note 2.

The following table presents an aging analysis of financial assets by payment due status:

No financial assets were past due at 31 December 2014.

| Restated<br>At 31 December 2013 | Not past due<br>£000's | Past due but not impaired      |                      |                      |                                 | Impaired<br>£000's | Total<br>£000's |
|---------------------------------|------------------------|--------------------------------|----------------------|----------------------|---------------------------------|--------------------|-----------------|
|                                 |                        | Less than 1<br>month<br>£000's | 1–3 months<br>£000's | 3–6 months<br>£000's | More than 6<br>months<br>£000's |                    |                 |
| CTF investments                 | 7,094                  | –                              | 742                  | 3,732                | –                               | –                  | 11,568          |
| Loans secured by<br>mortgages   | 840,066                | –                              | –                    | –                    | –                               | –                  | 840,066         |
| Other financial assets          | 6,079,017              | –                              | –                    | –                    | –                               | –                  | 6,079,017       |

i See note 2.

#### d) Liquidity risk

Liquidity risk arises where cash flows from investments and from new premiums prove insufficient to meet our obligations to policyholders and other third parties as they fall due.

The Group's ALM framework ensures that cash flows are sufficient to meet both long- and short-term liabilities.

The Group maintains a minimum level of cash and highly liquid assets such that, in the extreme scenario of new business cash flows being insufficient to meet current obligations, those obligations can continue to be met.

In accordance with PRA regulations, the Group's assets are reviewed to ensure they are of sufficient amount and of an appropriate currency and term to ensure that the cash inflows from those assets will meet the expected cash outflows from the Group's insurance and other financial liabilities.

In the following table expected cash outflows for:

- net insurance liabilities have been modelled with reference to underlying mortality and longevity assumptions;

- payables arising from reinsurance include interest and payments due under the terms of reinsurance treaties; and
- derivative liabilities have been modelled with reference to the yield curves that existed at the balance sheet date and assumed to be held to maturity.

The following table includes insurance and financial liabilities that are exposed to liquidity risk.

|                                   | Expected cash flows (undiscounted) |                          |                          |                            | Carrying value (discounted) £000's |
|-----------------------------------|------------------------------------|--------------------------|--------------------------|----------------------------|------------------------------------|
|                                   | less than one year £000's          | one to five years £000's | five to ten years £000's | more than ten years £000's |                                    |
| <b>At 31 December 2014</b>        |                                    |                          |                          |                            |                                    |
| Net insurance liabilities         | 153,346                            | 544,237                  | 571,040                  | 1,667,559                  | 1,985,104                          |
| Deposits received from reinsurers | 213,142                            | 793,042                  | 843,324                  | 2,005,880                  | 2,491,795                          |
| Derivative liabilities            | 13,523                             | 37,602                   | 10,603                   | 34,097                     | 79,493                             |
| <b>Total</b>                      | <b>380,011</b>                     | <b>1,374,881</b>         | <b>1,424,967</b>         | <b>3,707,536</b>           | <b>4,556,392</b>                   |

| Restated<br>At 31 December 2013   | Expected cash flows (undiscounted) |                          |                          |                            | Carrying value (discounted) £000's |
|-----------------------------------|------------------------------------|--------------------------|--------------------------|----------------------------|------------------------------------|
|                                   | less than one year £000's          | one to five years £000's | five to ten years £000's | more than ten years £000's |                                    |
| Net insurance liabilities         | 131,727                            | 457,257                  | 464,853                  | 1,285,066                  | 1,506,839                          |
| Deposits received from reinsurers | 1,831,083                          | 735,336                  | 792,792                  | 1,934,163                  | 2,182,350                          |
| Derivative liabilities            | 584                                | 10,252                   | 14,381                   | 15,596                     | 32,391                             |
| <b>Total</b>                      | <b>1,963,394</b>                   | <b>1,202,845</b>         | <b>1,272,026</b>         | <b>3,234,825</b>           | <b>3,721,580</b>                   |

The maximum exposure to credit risk is equal to the balance sheet value of debt instruments/derivatives.

#### e) Property risk

Property risk arises from the provision of a protected equity guarantee on the mortgages underlying the equity release assets purchased. The Group is exposed to the risk that property values do not rise sufficiently, or that the property is not maintained properly, to recover the full value of the loan made plus accrued interest.

The Group manages its purchase of loan assets to a level appropriate to its liability profile and ensures that the purchase prices of loan assets reflect a prudent assessment of future property price growth. Appropriate limits are applied to the "loan to value ratio" in order to limit the risk exposure to the Group. The Group seeks to avoid excess concentration of property holdings in any geographical area.

Property risk on commercial mortgages is the risk that property values decline or property tenancy changes such that the full value of the commercial mortgage loan is not recovered. The initial loan value is restricted to a maximum "loan to value" ratio that limits its exposure for the Group.

## 11 Available capital resources

Economic capital is the principal risk-based capital measure used by the Board. Economic capital is based on the Board's view of the available capital and required capital calibrated to a 1 in 200 stress.

The Group's capital consists of equity attributable to equity holders of the Parent Company. For the purposes of regulatory capital requirements, certain assets are restricted, or are inadmissible.

The Group manages its capital to ensure that all of entities within the Group will be able to continue to operate as going concerns, remaining compliant with all regulatory capital requirements to which each is subject.

Partnership Life Assurance Company Limited (PLACL), the principal operating and only insurance company in the Group, is required to comply with minimum capital requirements calculated at the level of its EEA parent and ultimate Parent Company level as required by the PRA as set out in the Insurance Groups Directive, as well as its own single entity level as required by the PRA. PAG plc is both the EEA parent and ultimate Parent Company of PLACL.

The table below provides a reconciliation between the available capital resources of the PAG plc Group, measured under IFRS, and the surplus over regulatory capital requirement as is required to be measured under the Insurance Groups Directive. Any changes or release of capital from long-term funds is subject to there being an established surplus shown by an actuarial investigation.

| <b>At 31 December</b>   | <b>2014</b>      | <b>2013</b>   |
|---|------------------|---------------|
|   | <b>£000's</b>    | <b>£000's</b> |
| <b>Total equity of PAG plc Group</b>  | <b>604,690</b>   | 598,549       |
| Minority Interest in equity for regulated business  | –                | (66)          |
| Adjustments in respect of regulatory capital basis:   |                  |               |
| Inadmissible intangible assets  | <b>(15,219)</b>  | (16,401)      |
| Inadmissible goodwill   | <b>(126,207)</b> | (126,207)     |
| Inadmissible deferred tax asset   | <b>(519)</b>     | (424)         |
| Equity and reserves related to non-regulated entities (excluded from regulatory capital calculation), adjusted for inadmissible assets already adjusted above | <b>3,042</b>     | 13,031        |
| <b>Total available capital resources (IGD basis)</b>  | <b>465,787</b>   | 468,482       |
| Group minimum capital requirement (IGD basis)   | <b>(224,127)</b> | (191,630)     |
| <b>Surplus over regulatory capital requirement</b>  | <b>241,660</b>   | 276,852       |

Movements in equity are shown in the consolidated statement of changes in equity.

Throughout the year, each regulated subsidiary has maintained capital resources in excess of the minimum required by the PRA regulations and the EU directives.

## 12 Goodwill

Goodwill represents the excess of cost of acquisition over the fair value of the separable net assets of businesses acquired. Goodwill is initially recognised as an asset at cost and is subsequently measured at cost less any accumulated impairment losses. Goodwill is allocated to each of the cash-generating units (“CGU”) that are expected to benefit from the combination. Goodwill is tested for impairment at least annually, or when circumstances or events indicate there may be uncertainty over this value. Impairment is determined by assessing the recoverable amount of each CGU to which the goodwill relates. When the recoverable amount of the CGU is less than its carrying amount, an impairment loss is recognised. Any impairment is recognised immediately in the consolidated statement of comprehensive income and is not subsequently reversed.

|                       | 2014<br>£000's | 2013<br>£000's |
|-----------------------|----------------|----------------|
| At 1 January          | 126,207        | 126,207        |
| <b>At 31 December</b> | <b>126,207</b> | 126,207        |

The goodwill arose on acquisition of the PLACL operations and the value represented the potential of this business to generate value from future sales. Therefore the goodwill is allocated to the new business cash-generating unit, the scope of which is identical to the “new business” operating segment described in note 1.

The carrying value of goodwill has been tested for impairment at the balance sheet date.

The impairment test compares the carrying value of the new business cash generating unit (including goodwill and intangible assets) to its recoverable amount. The recoverable amount of the CGU is the higher of fair value less costs to sell and value in use. The Group uses an estimate of value in use as the primary measure of the recoverable amount. The future cash flows from the CGU are estimated as the expected future profits for the CGU set out in the Group's business plan as determined by management for a period of five years from the balance sheet date. These plans reflect management's best estimate of future profits based on both historical experience and expected growth rates for the CGU. The underlying assumptions of these projections include market size and growth, market share, profit margins, customer numbers and mortality.

Expected future profits for the CGU are discounted using a risk adjusted discount rate. The risk adjusted discount rate is a combination of a risk-free rate and an allowance for risk estimated with reference to observable rates and factors applied to business of similar size and nature. A rate of 13.1% (2013: 10.0%) has been applied to discount cash flows to a present value.

No impairment has been recognised in 2014 or 2013.

## 13 Share Capital

The Group has issued ordinary shares which are classified as equity. Incremental external costs that are directly attributable to the issue of the ordinary shares are recognised in equity, net of tax.

| At 31 December 2014  | Number of shares   | Share capital<br>£000's | Share premium<br>£000's |
|--|--------------------|-------------------------|-------------------------|
| <b>The allotted and issued share capital of PAG plc:</b>     |                    |                         |                         |
| Shares subdivided into 500,000 ordinary shares of £0.10 each | 399,999,971        | 40,000                  | 435,249                 |
| <b>As at 31 December 2014, ordinary shares of £0.10 each</b> | <b>399,999,971</b> | <b>40,000</b>           | <b>435,249</b>          |

| At 31 December 2013   | Number of shares   | Share capital<br>£'000s | Share premium<br>£'000s |
|---|--------------------|-------------------------|-------------------------|
| <b>The allotted and issued share capital of PAG plc:</b>                                      |                    |                         |                         |
| On incorporation, ordinary shares of £1.00 each   | 50,000             | 50                      | –                       |
| On 12 June 2013:  | –                  | –                       | –                       |
| Shares subdivided into 500,000 ordinary shares of £0.10 each                                  | 450,000            | –                       | –                       |
| Exchange of the A and B loan notes  | 69,212,294         | 6,921                   | 259,547                 |
| Exchange of C loan notes  | 15,397,726         | 1,540                   | 57,742                  |
| Share for share exchange of A, B and C ordinary shares in PAGH for ordinary shares in PAG plc | 282,358,446        | 28,236                  | –                       |
| New issue of shares as part of Global Offer   | 32,467,532         | 3,247                   | 121,752                 |
| New ordinary shares issued to senior management   | 51,948             | 5                       | 195                     |
| New ordinary shares issued to EBT   | 12,025             | 1                       | 45                      |
| Share issue costs   | –                  | –                       | (4,032)                 |
| <b>As at 31 December 2013, ordinary shares of £0.10 each</b>                                  | <b>399,999,971</b> | <b>40,000</b>           | <b>435,249</b>          |

The ordinary share entitles the holder to dividends declared by the Board which are not cumulative. The ordinary share entitles the holder to one vote for every share held.

### Shares held by the employee trust

Where an employee trust acquires shares in the Company or obtains rights to purchase its shares, the consideration paid (including attributable transaction costs, net of tax) is shown as a deduction from the owners' equity. Gains and losses on sales of shares held by the employee trust are charged or credited to the own shares account in equity.

| At 31 December                | 2014<br>£000's | 2013<br>£000's |
|-------------------------------|----------------|----------------|
| <b>Employee benefit trust</b> | <b>(136)</b>   | <b>(58)</b>    |

## 14 Related party transactions

Balances and transactions between the Company and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note.

During the period, the Group entered into transactions, in the ordinary course of business, with other related parties. Transactions entered into and balances outstanding at the end of each reporting date are detailed below.

### a) Remuneration of key management personnel

Key management personnel consist of the Directors of the Company. The key management personnel changed during the year 2014 reflecting the Group reorganisation. The remuneration of the Directors, who are the key management personnel of the Group, is set out below:

| <b>At 31 December</b>        | <b>2014<br/>£000's</b> | <b>2013<br/>£000's</b> |
|------------------------------|------------------------|------------------------|
| Short-term employee benefits | <b>2,850</b>           | 2,060                  |
| Post-employment benefits     | <b>16</b>              | 55                     |
| <b>Total</b>                 | <b>2,866</b>           | 2,115                  |

### b) Directors' loans

A number of Directors who are defined as key management personnel of the Company held loans during the period. The loans owed to/by the Directors are detailed as follows:

| <b>At 31 December</b>          | <b>2014<br/>£000's</b> | <b>2013<br/>£000's</b> |
|--------------------------------|------------------------|------------------------|
| Amounts owed to Directors:     |                        |                        |
| Loan advances                  | <b>302</b>             | 289                    |
| <b>Loans owed by Directors</b> | <b>302</b>             | 289                    |

The B and Vendor loan notes were exchanged for ordinary shares in the Company as part of the IPO.

The loan advances to directors accrue interest fixed at 4% per annum and are repayable in whole or in part at any time.

The amounts accruing (to)/from the Directors in respect of these loan notes are detailed below:

| <b>At 31 December</b>                           | <b>2014<br/>£000's</b> | <b>2013<br/>£000's</b> |
|---|------------------------|------------------------|
| Interest accrued on B and Vendor loan notes     | –                      | (663)                  |
| Interest accrued on Directors' loan advances    | <b>12</b>              | 6                      |
| <b>Interest accrued due from/(to) Directors</b> | <b>12</b>              | (657)                  |

### c) Other related party transactions

During the year the Group entered into transactions with other entities controlled by Cinven Limited, associates and joint ventures as set out below. All transactions were on a commercial basis.

|   | <b>2014<br/>£000's</b> | <b>2013<br/>£000's</b> |
|---|------------------------|------------------------|
| Costs paid to entities related to the ultimate parent controlling party | <b>122</b>             | 558                    |
| Group's share of losses of joint venture investment                     | <b>6</b>               | –                      |
| Loans advanced to associate and fees on loans                           | <b>187</b>             | –                      |
| <b>Value of other related party transactions</b>                        | <b>315</b>             | 558                    |

Costs paid to entities related to the ultimate parent controlling party include management fees paid to Cinven Partnerships LLP for director services. The comparative cost in 2013 included expenses associated with the 2013 IPO. At 31 December 2014 there was no amount due or receivable from any entities related to the ultimate parent controlling party (2013: £nil).

The Group's share of losses of joint venture investment arose in Gateway prior to sale on 29 August 2014. At 31 December 2014 there was no amount due or receivable from Gateway (2013: £289,000).

Loans were advanced to the Group's associate, Eldercare, during the 2014. At 31 December 2014, Eldercare owed the Group £153,000. At 31 December 2013 Eldercare was not an associate of the Group.

**d) Ultimate controlling party**

As at 31 December 2014 a majority of the Company's ordinary shares are held by the partnerships comprising the Fourth Cinven Funds (the "Cinven Funds"), being funds managed and advised by Cinven Limited, a company incorporated in the United Kingdom. Accordingly, the Directors consider the Company's ultimate controlling party to be Cinven Limited, the manager and adviser to the Cinven Funds.



## 15 Events after the balance sheet date

### **Dividend**

Subsequent to 31 December 2014, the Directors proposed a final dividend for 2014 of 1.0 pence per ordinary share (2013: 3.0 pence), amounting to £4.0m (2013: £12m) in total. Subject to approval by shareholders at the AGM, the dividend will be paid on 29 May 2015 and will be accounted for as an appropriation of retained earnings in the year ending 31 December 2015.

### **Bond issue**

On 2 March 2015 the Group entered into an agreement to issue a £100m bond to funds managed by Cinven Capital Management ('Cinven'), its majority shareholder. The bond is repayable after a 10 year term with possible redemption, at option of the Group, at the fifth anniversary or on any interest payment date thereafter, in each case subject to PRA consent. The bond has an annual interest rate of 9.5% payable annually in arrears from the issue date. The bond is a Tier 2 qualifying regulatory capital instrument under existing solvency regulations and Solvency II compliant following implementation of the Solvency II regime on 1 January 2016. The bond is issued by Partnership Assurance Group plc with a guarantee provided by Partnership Life Assurance Company Limited.

## Group MCEV analysis of earnings (net of tax)

For the year ended 31 December 2014

|                                    | Note | Year ended 31 December 2014        |  |                               | Year ended<br>31 December<br>2013 |
|------------------------------------|------|------------------------------------|--|-------------------------------|-----------------------------------|
|                                    |      | Covered<br>business MCEV<br>£000's | Non-covered<br>business IFRS<br>£000's | Total<br>Group MCEV<br>£000's | Total<br>Group MCEV<br>£000's     |
| <b>Opening Group MCEV</b>          |      | <b>463,494</b>                     | <b>56,139</b>                          | <b>519,633</b>                | 9,890                             |
| Operating MCEV earnings            | 3    | <b>86,502</b>                      | –                                      | <b>86,502</b>                 | 107,236                           |
| Non-operating MCEV earnings        | 3    | <b>(15,464)</b>                    | <b>(1,607)</b>                         | <b>(17,071)</b>               | (54,225)                          |
| <b>Total MCEV earnings</b>         |      | <b>71,038</b>                      | <b>(1,607)</b>                         | <b>69,431</b>                 | 53,011                            |
| Other movements in IFRS net equity | 4    | –                                  | <b>1,222</b>                           | <b>1,222</b>                  | 456,732                           |
| Capital and dividend flows         | 3    | <b>23,000</b>                      | <b>(37,000)</b>                        | <b>(14,000)</b>               | –                                 |
| <b>Closing Group MCEV</b>          |      | <b>557,532</b>                     | <b>18,754</b>                          | <b>576,286</b>                | 519,633                           |

# Covered business analysis of movement in embedded Value (net of tax)

For the year ended 31 December 2014

|  |      | Year ended 31 December 2014 |                               |                |                | Year ended<br>31 December<br>2013 |
|--|------|-----------------------------|-------------------------------|----------------|----------------|-----------------------------------|
|  | Note | Free surplus<br>£000's      | Required<br>capital<br>£000's | VIF<br>£000's  | MCEV<br>£000's | MCEV<br>£000's                    |
| <b>Opening MCEV</b>  |      | <b>58,840</b>               | <b>354,330</b>                | <b>50,324</b>  | <b>463,494</b> | 383,600                           |
| New business value   | 3    | (41,879)                    | 72,299                        | 25,652         | 56,072         | 81,094                            |
| Expected existing business contribution<br>(reference rate & in excess of reference<br>rate) | 3    | –                           | –                             | 4,106          | 4,106          | 2,800                             |
| Transfers from VIF and required capital to<br>free surplus                                   | 3    | 27,044                      | (17,263)                      | (6,313)        | 3,469          | 5,226                             |
| Experience variances   | 3    | (770)                       | –                             | (317)          | (1,087)        | (301)                             |
| Assumption changes   |      | 4,171                       | (6,529)                       | 1,877          | (481)          | 9,799                             |
| Other operating variances  | 3    | 15,081                      | (8,196)                       | 17,537         | 24,423         | 8,618                             |
| <b>Operating MCEV earnings</b>   |      | <b>3,647</b>                | <b>40,311</b>                 | <b>42,542</b>  | <b>86,502</b>  | 107,236                           |
| Economic variances   | 3    | (41,297)                    | 22,856                        | 14,447         | (3,994)        | 1,734                             |
| Other non-operating variances  | 3    | (13,357)                    | 739                           | 1,147          | (11,471)       | (4,076)                           |
| <b>Total MCEV earnings</b>   |      | <b>(51,007)</b>             | <b>63,906</b>                 | <b>58,136</b>  | <b>71,037</b>  | 104,894                           |
| Capital and dividend flows   | 3    | 23,000                      | –                             | –              | 23,000         | (25,000)                          |
| <b>Closing MCEV</b>  |      | <b>30,833</b>               | <b>418,236</b>                | <b>108,460</b> | <b>557,531</b> | 463,494                           |

# Reconciliation of Group IFRS net assets to MCEV

As at 31 December 2014

|  | Year ended 31 December 2014                |  |                | Year ended 31 December 2013                |  |              |
|--|--|--|----------------|--|--|--------------|
|  | Covered business adjusted net worth £000's | Non-covered business adjusted net worth £000's | Group £000's   | Covered business adjusted net worth £000's | Non-covered business adjusted net worth £000's | Group £000's |
| <b>Group Net Assets as reported under IFRS</b> | <b>458,959</b>                             | <b>145,729</b>                                 | <b>604,688</b> | 415,501                                    | 183,114  | 598,615      |
| Goodwill                                       | (1,332)                                    | (124,875)                                      | (126,207)      | (1,332)                                    | (124,875)                                      | (126,207)    |
| Intangibles                                    | (1,000)                                    | (2,100)  | (3,100)        | (1,000)                                    | (2,100)  | (3,100)      |
| Adjustments to IFRS                            | (7,555)                                    | –  | (7,555)        | –  | –  | –            |
| <b>MCEV Net Worth</b>                          | <b>449,071</b>                             | <b>18,754</b>                                  | <b>475,381</b> | 413,169                                    | 56,139   | 469,308      |
| VIF  | 108,460                                    | –  | 108,460        | 50,325                                     | –  | 50,325       |
| <b>MCEV (net of taxation)</b>                  | <b>557,357</b>                             | <b>18,754</b>                                  | <b>576,286</b> | 463,494                                    | 56,139   | 519,633      |

# Notes to the MCEV financial statements

for the period ended 31 December 2014

## 1 Basis of preparation

The supplementary information which comprises the group MCEV analysis of earnings (net of tax), covered business analysis of movement in embedded value (net of tax), reconciliation of Group IFRS net assets to MCEV and the related notes 1 to 5 has been prepared on a Market Consistent Embedded Value (MCEV) basis and results for non-covered business on the International Financial Reporting Standards (IFRS) basis.

The MCEV methodology adopted is in accordance with the MCEV Principles published by the CFO Forum in October 2009.

### Covered business

The MCEV calculations cover all lines of insurance business within PLACL. No other Group companies contain any covered business and the value of these companies has been included in the Group MCEV at IFRS net asset value, less the value of goodwill and intangibles, to the extent that their recovery is supported by future profits.

### Group financing

The Group MCEV includes the value of external debt, at the outstanding face value, within the net worth of Group companies outside of PLACL. The Group has been debt free during 2014 and does not make use of any financial reinsurance.

### MCEV methodology

#### *Overview*

Under the MCEV methodology, profit is recognised as it is earned over the life of products defined within covered business. The total profit recognised over the lifetime of a policy is the same under MCEV and IFRS, but the timing of recognition is different.

#### *Embedded value*

The embedded value is the sum of the adjusted net worth of the Group companies plus the value of in-force on the covered business, this being the present value of profits that will emerge over time.

The embedded value is calculated net of the impacts of reinsurance and allows for taxation based on current legislation and known future changes.

#### *i) Net worth*

The net worth is the market value of the shareholders' funds and the shareholders' interest in the surplus held in the long-term business fund. This is the net assets on a regulatory basis for the life company and the IFRS net asset value for other Group companies, less the value of goodwill and intangibles, to the extent that their recovery is supported by future profits.

The net worth is equal to the sum of the required capital and free surplus in the Group.

#### *ii) Required capital*

Required capital is the market value of assets attributed to the covered business in excess of assets required to back liabilities for covered business, and for which distribution to shareholders is restricted. The level of required capital is set equal to the higher of:

- The level of capital at which the regulator is empowered to take action;
- The capital requirement under the Group's Economic Capital framework; and
- The target capital level

This methodology reflects the level of capital considered by the Directors to be appropriate to manage the business, and includes any additional shareholder funds not available for distribution. The same definition of required capital is used for both existing and new business.

The level of required capital is disclosed as the percentage of the EU minimum capital requirement (Capital Resources Requirement).

The free surplus is the market value of any assets allocated to, but not required to support, the in-force covered business at the valuation date.

### *iii) Value of in-force covered business (VIF)*

The value of in-force covered business consists of the following components:

- Present value of future profits;
- Time value of financial options and guarantees;
- Frictional costs of required capital; and
- Cost of residual non-hedgeable risk.

#### **a) Present value of future profits (PVFP)**

The PVFP is the present value of the distributable profits to shareholders arising from the in-force covered business projected on a best estimate basis. Distributable profits generally arise when they are released following actuarial valuations. These valuations are carried out in accordance with PRA statutory requirements designed to ensure and demonstrate solvency in long-term business funds. Future distributable profits will depend on experience in a number of areas such as investment return, mortality, lapse rates and administration costs. Releases to shareholders arising in future years from the in-force covered business and associated required capital can be projected using assumptions of future experience.

Future profits are projected using best estimate non-economic assumptions and market consistent economic assumptions. In principle, each cash flow is discounted at a rate that appropriately reflects the riskiness of that cash flow, so higher risk cash flows are discounted at higher rates. In practice, the PVFP is calculated using the 'certainty equivalent' approach, under which the reference rate is used for both the investment return and the discount rate. This approach ensures that asset cash flows are valued consistently with the market prices of assets without options and guarantees. Further information on the risk-free rates is in the following pages.

#### **b) Time value of financial options and guarantees (TVOG)**

The PVFP calculation is based on a single (base) economic scenario; however, a single scenario cannot appropriately allow for the effect of certain asset features. If an option or guarantee affects shareholder cash flows in the base scenario, the impact is included in the PVFP and is referred to as the intrinsic value of the option guarantee; however, future investment returns are uncertain and the actual impact on shareholder profits may be higher or lower. The covered business does not contain any significant policyholder options or guarantees and therefore the TVOG is zero.

The assets backing the covered business include mortgages secured against individual domestic property (loans secured by residential mortgages). The mortgages contain guarantees where if the value of the property is lower than the mortgage balance at the time of death or entry into a care home, then the lower of the property value and mortgage balance is repaid. The time value of this option and guarantee is allowed for in the asset valuation using closed form calculations.

#### **c) Frictional costs of required capital (FCoRC)**

The additional costs to a shareholder of holding the assets backing required capital within an insurance company rather than directly in the market are called frictional costs. They are explicitly deducted from the PVFP. The additional costs allowed for are the taxation costs and any additional investment expenses on the assets backing the required capital. The level of required capital has been set out in the net worth section.

Frictional costs are calculated by projecting forwards the future levels of required capital. The projection of the required capital has been based on an approximate method assuming that the required capital is a constant proportion of the Long Term Insurance Capital Requirement. Tax on investment return and investment expenses are payable on the assets backing required capital, up until the point that they are released to shareholders.

#### **d) Cost of residual non-hedgeable risks (CoRNHR)**

The cost of residual non-hedgeable risks (CoRNHR) covers risks not already allowed for in the time value of options and guarantees or the PVFP. The allowance includes the impact of both non-hedgeable financial and non-financial risks. The most significant risks not included in the PVFP are operational risks and equity release property risks.

Asymmetric risks allowed for in the PVFP are described earlier in the basis of preparation. No allowance has been made within the cost of non-hedgeable risk for symmetrical risks as these are diversifiable by investors. The CoRNHR includes an allowance for non-modelled non-hedgeable risks. For ease of comparison the CoRNHR is expressed as percentage cost of non-hedgeable capital.

#### **New business**

All annuity business is written on a single premium basis. Premium increments received following policy issue are excluded from the value of new business. Single and regular premium protection business is included in new business.

Point of sale economic and non-economic assumptions are used to value the new business. Any variances or changes in assumptions after the point of sale are recorded within the analysis of the MCEV earnings as operating experience variances or operating assumption changes.

#### **Participating business**

The Group does not contain any policies where the policyholders participate in the profits of the business.

## 2 Assumptions

### Reference rates

Reference rates are calculated by adding the liquidity premium of corporate bonds, loans secured by residential mortgages and loans secured by commercial mortgages liquidity premiums to the swap curve. The liquidity premium on corporate bond assets is calculated by deducting an allowance for credit default, individually assessed for each bond based on credit rating, and comparing the resulting risk adjusted internal rate of return on the portfolio to the swap curve.

Loans secured by residential mortgages are valued using a mark to model approach that allows for the cost of the no negative equity guarantee, where relevant, with the liquidity premium calculated on a consistent basis.

Loans secured by commercial mortgages are valued using a mark to model approach that allows for the risk from change in tenant behaviour and property value, where relevant, with the liquidity premium calculated on a consistent basis.

For protection business, cash flows are assumed to be liquid and as such are discounted with no allowance for a liquidity premium.

The liquidity premiums used for the annuity in-force business are as follows:

|                                     | Liquidity premium |
|-------------------------------------|-------------------|
| <b>Wednesday, December 31, 2014</b> | <b>211 bps</b>    |
| Tuesday, December 31, 2013          | 180 bps           |

The liquidity premium on new business is determined using an approach consistent with that for the in-force business. For new business, the liquidity premium in excess of swaps is derived on a daily basis using the prevailing market conditions.

The weighted average liquidity premiums used for the new business MCEV calculations are as follows:

|                                     | Liquidity premium |
|-------------------------------------|-------------------|
| <b>Wednesday, December 31, 2014</b> | <b>273 bps</b>    |
| Tuesday, December 31, 2013          | 216 bps           |

### Swap Rates

The swap curve is constructed from cash rates, future strips, and semi-annual swap rates sourced from a variety of counterparties and brokers with flat interpolation beyond 50 years.

The table below sets out the swap rates used for the MCEV valuations as at period end. These rates have been supplied by PLACL's investment manager.

|                                     | 6 months     | 1 year       | 2 years      | 5 years      | 10 years     | 15 years     | 20 years     |
|-------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| <b>Wednesday, December 31, 2014</b> | <b>0.74%</b> | <b>0.74%</b> | <b>0.93%</b> | <b>1.46%</b> | <b>1.87%</b> | <b>2.11%</b> | <b>2.24%</b> |
| Tuesday, December 31, 2013          | 0.71%        | 0.71%        | 1.03%        | 2.17%        | 3.10%        | 3.47%        | 3.57%        |

### Operating earnings

For operating earnings, PLACL uses the risk adjusted yield on the asset portfolio backing liabilities in order to determine the total existing business contribution. This represents management's long-term expectations of total return on the portfolio.

The expected return has been calculated by reference to the internal rate of return on the backing assets less an appropriate risk margin.

### Mortality rates



Assumed future mortality, morbidity and lapse rates have been derived from PLACL's historical experience data. The assumption is set as a best estimate of future experience. Improvements in annuitant longevity have been included in this best estimate.

## Expenses

Maintenance expenses are based on the costs allocated or recharged to the PLACL in-force business. No credit for future productivity gains or economies of scale has been included in the MCEV.

Non-recurring expenses, associated with the covered business, are charged to the non-operating earnings in the year incurred and are excluded from the per policy maintenance expense assumptions. These amounted to £16.4m for the year to 31 December 2014 (31 December 2013: £5.2m).

Best estimate expense inflation applied as at 31 December 2014 was 4.5% p.a. (31 December 2013: 4.8%).

## Taxation

The current and future tax rates are corporation tax rates as published by HM Treasury and take into account both taxes enacted by legislation and those disclosed in budget announcements. The effective tax rate in PLACL is lower than the corporation tax rate in 2014 due to a £1.9m research and development tax reclaim on prior years. All significant external debt, which had previously produced interest costs that were used to reduce the effective tax rate in PLACL, was repaid in 2013. The effective tax rate for 2014 was 13.4% (31 December 2013: 17.1%).

For the purposes of modelling tax on future profits, a calendar assumption is set using a pro rata method based on months at each effective rate. This is implemented as prescribed by HMRC.

The blended corporation tax rates used were as follows:

|       | Year ended<br>31<br>December<br>2014 | Year ended<br>31<br>December<br>2013 |
|-------|--------------------------------------|--------------------------------------|
| 2014  | 21.50%                               | 21.50%                               |
| 2015  | 20.25%                               | 20.25%                               |
| 2016+ | 20.00%                               | 20.00%                               |

## Volatilities and correlations

Residential property and commercial property volatilities are the only direct volatility inputs to the MCEV calculations. Residential property volatility is used in the evaluation of the "No Negative Equity Guarantee ("NNEG") on loans secured by residential mortgages. As at 31 December 2014 the assumption was set to 12% (31 December 2013: 12%). Commercial property volatility is used to model property prices of properties backing commercial mortgage loans. As at 31 December 2014 the assumption was set to 11%.

Correlations between the risks inherent in the business are used for the calculation of the CoRNHR total non-hedgeable risk capital. The correlations are consistent with the Group's Economic Capital assumptions which are based on historic correlations with adjustment for prudence as required.

## Non-hedgeable risk

For the balance sheet and operating profit, a charge of 0.9% (31 December 2013: 1.2%) has been applied to the non-hedgeable capital required for a 1-in-200 year basis over the remaining lifetime of in-force business. The charge includes an allowance for all material non-hedgeable risks identified which are not already included in the PVFP calculation.

The capital levels used are consistent with those used in the Economic Capital calculation for those risks covered. Diversification benefits are included between non-hedgeable risks of the covered business. No diversification credit has been taken with hedgeable risks in the covered or non-covered business. The capital has been projected as running off over the remaining lifetime of the covered business in line with the capital resources requirement.

## Frictional cost of required capital

The required capital has been set to be 190% of the capital resources requirement (31 December 2013: 185%). The required capital has been projected as running off over the remaining lifetime of the covered business in line with the capital resources requirement.

The total frictional cost allowance for investment expenses and tax on investment income earned on the required capital is 0.5% as at 31 December 2014 (31 December 2013: 1.1%).

### 3 Commentary on the analysis of movement in embedded value (net of tax)

#### **Covered business**

The key driver of the reduction in MCEV earnings in respect of new business written over the year was the lower business volumes in 2014 compared to 2013.

The total expected existing business contribution has increased in the period as a result of continued growth in the portfolio.

Experience variances in the period are negligible in aggregate.

Assumption changes includes the net impact of basis changes in 2014 including a complete review of our longevity basis. The overall impact of the basis review was small.

During the period the methodology for the calculation of frictional cost of capital has been reassessed to more accurately reflect the assets backing required capital, resulting in a one-off increase in MCEV of £10.1m that has been included in other operating variances.

Other operating variances include expected long-term return on excess assets of £12.8m (£9.5m at 31 December 2013).

An adjustment to the provision for tax in the calculation of required capital has contributed to the movement in the allocation of required capital and free surplus in other non-operating variances but does not result in an overall change to MCEV.

Economic variances on MCEV predominantly relate to a reduction in risk-free rates over the period. The reduction in net worth was partially offset by the increase in VIF due to economic variances.

Non-operating variance is predominantly related to exceptional expenses incurred over 2014.

£23.0m of capital was injected from non-covered business into covered business in 2014.

#### **Non-covered business**

The £37.0m dividend and capital flows are due to the payment of the 2013 final dividend (£12.0m) and the 2014 interim dividend (£2.0m) and the £23.0m capital injection into covered business.

Most of the £1.6m non-operating MCEV losses in the period have arisen due to an increased effective tax rate on non-covered business. The research and development claim on prior years, that prompted a credit to the covered business, produced a smaller deferred tax charge on non-covered business.

#### 4 Commentary on the movements in IFRS net equity (net of tax)

The other movements in IFRS net equity have arisen as the share-based payment reserve has been increased to reflect the charge arising from the Group's non-cash employee benefits.

## 5 Sensitivities

No future management actions are modelled following the change to the assumptions. The results are shown net of tax. The Required Capital has not been recalculated in each scenario and is modelled as a level percentage of the Capital Resources Requirement (CRR) (although the CRR will have increased or decreased as a result of any change in IFRS reserves and will impact on the FCoRC).

The sensitivity of the embedded value and the value of new business to changes in economic and non-economic assumptions is as follows:

| 31 December 2014 Sensitivity                          | In-force                 |                     | New Business             |                     |
|---|--------------------------|---------------------|--------------------------|---------------------|
|   | Impact on MCEV<br>£000's | Change in MCEV<br>% | Impact on MCEV<br>£000's | Change in MCEV<br>% |
| <b>Embedded Value (Base)</b>                          | <b>557,532</b>           |                     | <b>56,072</b>            |                     |
| Interest rate environment +100 bps                    | (5,714)                  | (1%)                | n/a                      | n/a                 |
| Interest rate environment<br>-100 bps                 | 828                      | 0%                  | n/a                      | n/a                 |
| Swaption implied volatilities + 25%                   | –                        | 0%                  | n/a                      | n/a                 |
| Property volatilities +25%                            | (23,055)                 | (4%)                | (1,166)                  | (2%)                |
| Property Values -10%                                  | (29,763)                 | (5%)                | n/a                      | n/a                 |
| Lapses -10% (including equity release)                | 4,771                    | 1%                  | n/a                      | n/a                 |
| Mortality -5% (annuities)                             | (21,603)                 | (4%)                | (1,825)                  | (3%)                |
| Expenses -10%   | 6,663                    | 1%                  | 180                      | 0%                  |
| Mortality improvements +0.25% (best<br>estimate only) | (11,254)                 | (2%)                | (1,747)                  | (3%)                |
| Decrease in liquidity premium 25 bps                  | (79,212)                 | (14%)               | (12,595)                 | (22%)               |
| Required capital set to be 100% of CRR                | 10,995                   | 2%                  | 2,927                    | 5%                  |

| 31 December 2013 Sensitivity                          | In-force                 |                     | New Business             |                     |
|---|--------------------------|---------------------|--------------------------|---------------------|
|   | Impact on MCEV<br>£000's | Change in MCEV<br>% | Impact on MCEV<br>£000's | Change in MCEV<br>% |
| <b>Embedded Value (Base)</b>                          | <b>463,494</b>           |                     | <b>81,094</b>            |                     |
| Interest rate environment +100 bps                    | 760                      | 0%                  | n/a                      | n/a                 |
| Interest rate environment<br>-100 bps                 | (4,802)                  | (1%)                | n/a                      | n/a                 |
| Swaption implied volatilities + 25%                   | n/a                      | n/a                 | n/a                      | n/a                 |
| Property volatilities +25%                            | (23,601)                 | (5%)                | (4,100)                  | (5%)                |
| Property Values -10%                                  | (17,364)                 | (4%)                | n/a                      | n/a                 |
| Lapses -10% (including equity release)                | 1,861                    | 0%                  | n/a                      | n/a                 |
| Mortality -5% (annuities)                             | (16,892)                 | (4%)                | (3,179)                  | (4%)                |
| Expenses -10%   | 5,842                    | 1%                  | 1,322                    | 2%                  |
| Mortality improvements +0.25%<br>(best estimate only) | (7,149)                  | (2%)                | (1,986)                  | (2%)                |
| Decrease in liquidity premium 25 bps                  | (60,529)                 | (13%)               | (17,363)                 | (22%)               |
| Required capital set to be 100% of CRR                | 16,813                   | 4%                  | 6,466                    | 8%                  |

### Notes to the sensitivities:

- Interest rate environment +/-100 bps – this sensitivity is modelled as a 100bp change to the yield on each asset. The sensitivity allows for the resulting change in asset value and the change in liability value that follows from the change in risk adjusted internal rate of return on the portfolio. In the -100bp sensitivity the reference rate has a floor of 0%.

- No sensitivity to swaption implied volatilities has been shown as swaption volatilities are not used in any part of the MCEV calculation for PLACL.
- 25% increase in property volatility – this sensitivity allows for the change in the value of loans secured by residential mortgages as a result of the change in the cost of the “No Negative Equity Guarantee”, and for the change in the value of loans secured by commercial mortgages. The sensitivity also allows for the corresponding change in liabilities as a result of the yield change.
- 10% fall in property values – this sensitivity allows for the change in asset value arising from an immediate fall of 10% in property prices. The property sensitivity represents a 10% decrease in carrying value, equivalent to a 35% fall from current market value. For loans secured by residential mortgages this increases the cost of the “No Negative Equity Guarantee”. For loans secured by commercial mortgages this increases the probability of default on the loan. The sensitivity also allows for the corresponding change in liabilities as a result of the yield change.
- 10% proportionate change in lapses (e.g. base lapse rate of 5% becomes 90% \* 5%) - equity release repayment rates are also adjusted, the IFRS reserves are changed in this scenario as a result of changing yields on loans secured by residential mortgages.
- 5% decrease in base mortality – this sensitivity is modelled for the annuity business only. Remaining products are not material. This is modelled as a change in the best estimate mortality level and the prudent margins remain unchanged.
- 10% decrease in maintenance expenses – modelled as a 10% change in the expense reserve. There is no change to expense inflation and no change to valuation interest rates.
- Mortality improvements +0.25% - this sensitivity is modelled as an additional 0.25% improvement in each future year within the best estimate basis. Prudent margins are unchanged.
- 25bps decrease in liquidity premiums – this sensitivity is modelled as a 25bp parallel shift in the reference rates used for annuity business.
- The required capital sensitivity is modelled by reducing capital from 190% to 100% of the capital resource requirement. This has no impact on net worth and increases the VIF as a result of lower frictional costs of capital.
- Interest rate and property value sensitivities are not modelled for new business as the group actively reviews its pricing, and in the event of a sudden movement in asset values the pricing of new business would be changed.