

# Full Year Results for Partnership Assurance Group plc

For the year ended 31 December 2015

11 March 2016

## Financial highlights

- Total operating profits of £40 million (2014: £64 million) comprising:
  - £11 million of new business operating profits, representing a new business margin of 1.7%, achieved by maintaining our gross margin through our pricing discipline and reducing operating expenses. The margin improved from (1)% in H1 to 3.3% in H2 demonstrating the operational leverage of the business
  - £15 million of in-force operating profits and £14 million return on surplus assets
- Total new business premiums of £631 million (2014: £791 million) comprising:
  - £280 million (2014: 466 million) of individually underwritten annuities, with H2 sales increasing by 19% relative to H1, following implementation of the Pension Freedoms in April 2015
  - Defined Benefit ('DB') medically underwritten bulk annuity sales of £277 million following a strong performance in December ahead of the implementation of Solvency II, across 15 transactions demonstrating increasing breadth and traction of the DB business, which represents almost 45% of 2015 new business premiums
  - £68 million of Care annuities and £5 million of Protection
- Operating expenses reduced to £69 million through careful cost management, 8% better than target of £75 million
- MCEV of 144p per share at 31 December 2015
- Strong economic capital surplus of £444 million, representing coverage of 224% at 31 December 2015 reflecting liabilities on a best estimate basis
- Solvency II surplus of £178 million, representing coverage of 144% at 31 December 2015, which remains resilient in stress scenarios
- IFRS loss before tax of £16 million, primarily due to one-off costs, in particular Solvency II
- The merger with Just Retirement Group plc ('JR') to form JRP Group plc ('JRP') is expected to complete in early April. On this basis, Partnership shareholders in JRP at the record date of 6 May 2016 would be entitled to the JR interim dividend of 1.1p share declared today, subject to the agreed merger ratio of 0.834 JR shares being issued for every one Partnership share. The declaration of this dividend would not result in any adjustment to the agreed merger ratio

## Operational highlights

- Regulatory approvals have been received for the merger with Just Retirement, and, subject to shareholder approval, the transaction is expected to become effective in early April.
- Enhanced Retirement Account ("ERA") launched in October 2015. The ERA is a simple low cost convenient tax efficient proposition which allows customers to receive a guaranteed income and retain the flexibility of drawdown within one SIPP wrapper on an award-winning third party platform. Customer feedback has been overwhelmingly positive and demonstrates Partnership's ability to innovate and respond to evolving customer needs
- Agreement with partner Genworth reached to launch a Care annuity in the US, which was launched in February 2016
- Partnership's customer focussed proposition continues to be recognised with awards for 'Best Annuity Service' at the Moneyfacts Awards, 'Best Retirement Provider' and Five star service rating for the sixth consecutive year, at the Professional Adviser Awards and achieved an 'Outstanding Achievement Award' at the FT Adviser Online Service Awards 2015.
- Partnership's Defined Benefit proposition recognised with industry award for "Buyout Firm of the Year" at the European Pensions Awards in June 2015.
- Implementation of Solvency II programme on a standard formula basis, effective 1 January 2016, with approval from PRA to use transitional measures and matching adjustment

## David Richardson, CFO of Partnership and Deputy CEO Designate of JRP Group, commented:

“2015 was the year when we delivered on our strategy to diversify the business. Defined Benefit sales increased by 12% in the year and represented almost 45% of our total sales. Defined Benefit is a market with long term growth potential and where we have a sustainable competitive advantage. In addition, sales of Individual Annuities grew by almost 20% in the second half of the year, following implementation of the Pension Freedoms in April. And finally, we announced the launch of our Care annuity in the US with Genworth. We have a conservative, well matched asset portfolio and a resilient capital position. I look forward to bringing together the strengths of Partnership and Just Retirement as we merge to become JRP Group.”

## Chris Gibson-Smith, Chairman of Partnership and Chairman Designate of JRP Group, commented:

“I am pleased to report that we have secured regulatory approvals for Partnership’s merger with Just Retirement, and, subject to shareholder approval, the transaction is expected to become effective in early April. The merger strengthens our position as a consumer champion and as a challenger to the traditional insurers in the Defined Benefit and retirement income markets. As JRP Group, we have a clear strategy to use our unrivalled intellectual property, underwriting expertise and asset/liability matching capability to deliver better customer outcomes, across our increasingly diversified suite of products in the UK, US and South Africa. JRP Group has an exciting future ahead of it, and, as Chairman Designate, I am delighted to be leading the business into its next chapter.”

## Summary of results

	2015	2014
Total new business premiums (£m)	631	791
New business operating profit (£m)	11	39
New business margin	1.7%	4.9%
Total operating profit (£m)	40	64
IFRS profit/(loss) before tax (£m)	(16)	24
Economic capital ratio	224%	159% <sup>2</sup>
Solvency II ratio	144%	n/a
MCEV per share	144p	144p
Assets under management (£bn)	5.3	4.9

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

3 months to:	31-Dec-15	30-Sep-15	30-Jun-15	31-Mar-15	31-Dec-14
Individual annuities	84	68	74	54	62
DB bulk annuities	186	24	44	24	210
Care	19	16	13	20	19
Protection	2	1	1	1	1
Total new business	290	109	132	99	291

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

12 months to:	31-Dec-15	31-Dec-14
Individually underwritten annuities	280	466
DB bulk annuities	277	247
Care	68	76
Protection	5	3
Total new business	631	791

## Notes:

1. New business premiums are Single Premium Equivalent (SPE) sales completed in the period. Totals are subject to rounding.
2. Proforma economic capital position, taking into account £100m bond issue in Q1 2015.

## Enquiries

<b>Investors:</b>	<b>Media:</b>	
Katherine Jones Director of Investor Relations +44 (0) 207 444 8040 <a href="mailto:katherine.jones@partnership.co.uk">katherine.jones@partnership.co.uk</a>	Jim Boyd Director of Corporate Affairs +44 (0) 207 618 2744 <a href="mailto:pressoffice@partnership.co.uk">pressoffice@partnership.co.uk</a>	Citigate Dewe Rogerson Grant Ringshaw +44 (0) 207 638 9571

## 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 9.00am (UK time) today at Nomura, 1 Angel Lane, London EC4R 3AB. Partnership will host the meeting jointly with Just Retirement, whose interim results for the 6 months ending 31 December 2015 were also released today.

Participants may also dial in as follows:

UK freecall: 0808 238 0673

United States freecall: 1866 655 1591

Standard international dial-in: +44 (0) 1452 541003

Conference ID: 52567060

A copy of the presentation and transcript of the conference call will also be made available via our website [www.partnership-group.com](http://www.partnership-group.com)

## 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.

# 2015 in review

This year saw continued success in growing the Defined Benefit annuity business, and a return to growth in retail annuities in the second half of 2015, after the introduction of the Pension Freedoms.

## Performance review

Total new business premiums were £631m for the year ended 31 December 2015, some 20% below the 2014 result. Towards the end of the year, we saw an increase in market activity, and sales beginning to grow again, after the expected lull around the date the Pension Freedoms were introduced.

	2015 £m	2014 £m
Individual retirement annuities	280	466
Defined Benefit annuities	277	247
Care annuities	69	76
Protection	5	3
<b>New business premiums</b>	<b>631</b>	<b>791</b>

## INDIVIDUAL RETIREMENT ANNUITIES

The sales result for the year continues to be affected by lower annuity market activity and sales when compared to the pre-2014 Budget (Pension Freedoms announcement) position. The comparative result for 2014 included pre-Budget sales results and the completion of the majority of our pipeline cases at the time of the Budget announcement.

The second half of 2015 achieved sales of £152m, up from £128m in the first half, which represents a second half increase of almost 20%.

The period after the introduction of the Pension Freedoms changes in April 2015 has seen an increase in market activity: we have seen an increase in the level of new quotations and a more marked increase in re-quote activity, which indicates that previously deferred cases may be coming back to the annuity market.

Towards the end of the year there was a further increase in activity as customers and advisers sought to secure annuities ahead of price changes driven by the new Solvency II capital requirements.

Overall in 2016, we do not expect individual annuity sales to be higher than the rate seen in the second half of 2015.

As the Pension Freedoms came into force the media commentary has focussed more on people's retirement income needs and the risks that the new freedoms posed to the security of pension income. It is clear that a guaranteed income for life to cover regular expenditure is a consumer priority and that the purchase of an annuity to satisfy this need continues to be an attractive retirement option. It is also clear that longevity risk cannot be managed on an individual basis.

In the longer term, we continue to see the potential for our addressable share of the market increasing as more retirees are encouraged to shop around through the impartial guidance process.

The Government review of the financial advice market announced earlier in 2015 is a welcome step in identifying how more consumers could benefit from proper advice when making a decision on their retirement income.

The Partnership Enhanced Retirement Account (ERA) was launched in October 2015 and has been well received by IFAs and customers. The ERA is a simple, low-cost, tax-efficient proposition which allows customers to receive a guaranteed income and retain the flexibility of drawdown within one SIPP wrapper on an award-winning third party platform. The ERA contains a flexible investment element offering a choice of investment funds and a cash account as well as a guaranteed element - an annuity - and demonstrates our ability to innovate in the new retirement market.

Whilst in the second half of 2015 there were signs that the annuity market was returning to growth, there remains uncertainty over the near-term level of annuity sales. There does appear to be a trend emerging for people to defer their retirement or their at-retirement decumulation decisions.

Consumer research indicates that a guaranteed income for life continues to be an attractive retirement option and as people are making retirement income decisions later in life, the potential attractiveness of an underwritten annuity may increase.

The long-term structural drivers behind the growth of the defined contribution pension market remain intact. The Pension Freedoms 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

We have continued to invest in the development of our defined benefit de-risking proposition in 2015 with ongoing investment into our support infrastructure, pricing capability and our sales capability.

This investment was rewarded with the completion of 15 (2014:6) transactions resulting in sales of £277m (2014: £247m).

Our focus is on increasing the proportion of deals that are medically underwritten. We expect that the percentage of bulk annuity deals under £100m in 2015 which were medically underwritten will have grown again, in comparison with the 10% achieved in 2014, demonstrating the continuing penetration of medical underwriting for bulk annuities.

In 2015 we have continued to strengthen our relationships with Employee Benefits Consultants (EBC) and are encouraged by the increased acceptance of medically underwritten transactions amongst EBCs, scheme trustees and sponsoring companies.

The future prospects for this growing market are strong. Whilst the timing of deals will remain uncertain, we have a strong, high-quality pipeline moving into 2016.

## CARE ANNUITIES

Sales of care annuities decreased by 9% to £69m (2014: £76m).

2015 trading was lower than recent trends in the middle of the year as we made some operational improvements. The end to the year was stronger, with second half sales meeting our expectations.

This market offers significant potential future opportunity, but continuing uncertainty surrounding the Government's care policy is acting as an inhibitor to growth.

## PROTECTION

Protection sales increased to £5m (2014: £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 2015, there are opportunities to grow in the future, as we increase the pool of potential customers we are able to protect through our new real time underwriting tool due to be launched in the first half of 2016.

## FINANCIAL HEADLINES

Total operating profit in 2015 was £40m (2014: £64m), a decrease of 38%. Within this overall result, we have delivered new business operating profits of £11m (2014: £39m), achieving a new business operating margin of 1.7% (2014: 4.9%).

The fall in new business operating profit is largely due to the lower retail annuity sales. 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, where margins, pre expenses, have been managed in line with our expectations, prioritising margin over volume and by expense reduction actions.

Following the successful delivery of the cost management actions announced in June 2014, we have continued to bear down on our operating expenses. We achieved an underlying level of operating expenses in 2015 of £69m, exceeding the target we set for the year of approximately £75m.

Profits emerging from the in-force book in 2015 were £15m (2014: £9m). Within this result, we have achieved a mortality profit which was partially offset by a small increase in reserves resulting from basis reviews. Within the in-force result, the overall impact of assumption changes and experience variances made during 2015 was £(4)m (2014: £(3)m).

We delivered an expected return on surplus assets of £14m (2014: £16m), reflecting a lower longer-term assumed rate of return in 2015, due to prevailing market conditions when the assumption was set, together with lower overall surplus assets.

The level of excess economic capital at 31 December 2015 was £444m (2014: £232m), giving a capital coverage ratio of 224% (2014 proforma: 159%), which is in excess of our targeted minimum of 125% under normal economic circumstances. The significant increase in the coverage ratio since FY14 was due to the equity capital raised during the year and the refinements to our economic capital basis that removed the peg to the ICAS regime. The changes included the removal of excessive prudence in the previous basis.

The 2014 economic capital comparative is a proforma result taking into account the March 2015 bond issue. 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 £5.3bn (2014: £4.9bn), including accrued interest, but excluding £233m (2014: £270m) 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 bond portfolio is of high overall quality with in excess of 59% (2014: 64%) invested in bonds rated A or better and 99% (2014: 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 2015 totalled £180m (2014: £171m). In December 2015 we completed two bulk acquisitions, acquiring loans with a value of £39m (2014: £61m). The level of equity release mortgage assets as a proportion of total assets under management at 31 December 2015 increased to 27% (2014: 25%). This increased proportion is due in part to a higher proportion of equity release assets allocated to back new Defined Benefit annuity business.

In 2015, we have continued to grow our 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 2015 we had £66m (2014: £38m) invested in high-quality assets and are expecting to further increase this investment over the course of 2016. 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 2015 was £633m (2014: £576m). The increase in the year includes the impact of new business in the period, the £53m net proceeds of the equity raise in September 2015, partially offset by dividend payments and merger-related costs.

## Solvency II

In 2015, we obtained PRA approval for use of the Matching Adjustment to value our liabilities and for the use of Transitional Measures.

Our Group Solvency II capital position, produced on a standard formula basis at 31 December 2015 was:

£m	
Capital Resources (Own Funds)	585
Capital Required (SCR)	407
Capital Surplus	178
Capital Coverage	144%

### Breakdown of SII Capital Resources

£m	
Tier 1	479
Tier 2	101
Tier 3	5
<b>Total</b>	<b>585</b>

### SII Sensitivities

£m		
<b>SII Capital Surplus</b>	<b>144%</b>	<b>178</b>
Change in SII Capital Surplus		
+100bps rise in interest rates	39%	109
-100bps fall in interest rates <sup>1</sup>	(14)%	(37)
+100bps credit spread widening	14%	32
+5% longevity shock	(10)%	(40)
-20% property value	(1)%	(2)

<sup>1</sup> Assumes transitionals are recalculated.

### *Reconciliation of IFRS net equity to SII capital resources ("Own Funds")*

<b>£m</b>	
<b>IFRS net equity</b>	<b>641</b>
Asset valuation differences	(132)
Liability valuation differences	(25)
Sub-debt contribution to capital resources	101
<b>SII capital resources ("Own Funds")</b>	<b>585</b>

### *Reconciliation of Economic Capital Surplus to Solvency II Surplus*

<b>£m</b>	
<b>EC surplus</b>	<b>444</b>
Own fund's differences	(218)
Required capital differences	(48)
<b>Solvency II surplus</b>	<b>178</b>

## **Investing in our Future**

Despite the disruption to our business caused by the Pension Freedoms, we have continued to innovate and invest for the benefit of our customers and shareholders.

In 2015 we incurred approximately £13.5m (2014: £7.8m) of non-recurring cash items. This investment includes expenditure on Solvency II, development of our Enhanced Retirement Account and US Care initiatives. The US Care business was launched in early 2016.

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

# Financial review of segmental information

The Consolidated Segmental 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	2015 £000's	2014 £000's
New business operating profit	10,755	38,962
In-force operating profit	14,601	8,477
Long-term expected return on surplus assets	14,451	16,328
<b>Operating profit</b>	<b>39,807</b>	<b>63,767</b>
Investment variances	(25,642)	(23,491)
Non-recurring items	(23,420)	(16,348)
Other	154	139
Interest on borrowings	(7,347)	–
<b>(Loss)/profit from continuing operations before tax</b>	<b>(16,448)</b>	<b>24,067</b>

## Total operating profit

Total operating profit in the year to 31 December 2015 of £39.8m is down £24.0m from the £63.8m reported for 2014 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 74% from £39.0m in 2014 to £10.8m in 2015. 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 £14.6m for the year ended 31 December 2015 compared with £8.5m for 2014.

In-force operating profit includes planned margin for longevity investment returns and expenses, together with experience variances and assumption changes in the period. In 2015, we made an overall longevity profit after allowing for basis changes.

The underlying profits were offset by non-recurring assumption and other variances totalling £(4.3)m (2014: £(2.8)m).

## Long-term return on surplus assets

Long-term expected return on surplus assets for the year ended 31 December 2015 was down by £1.8m to £14.5m (2014: £16.3m) due in part to a lower proportion of equity release (ER) assets in surplus.

## Investment variances

The negative investment variance in the period includes the net impact of differences between the assumed rates of investment return at the start of the period and those actually achieved. This includes, as the largest component, variances realised on re-balancing the portfolio ahead of the introduction of Solvency II to meet cash flow matching requirements.

## Non-recurring Items

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

## Interest on borrowings

The Group issued a £100m Solvency II tier 2 qualifying debt instrument at par in March 2015 with a maturity date of March 2025 and a coupon of 9.5%. Prior to this point the Company was debt free.



## IFRS loss before tax

IFRS loss before tax amounted to £16.4m compared with £24.1m profit for 2014. The decrease is due to the effects of the fall in sales volumes and higher non-recurring items.

## Capital management

The economic capital (EC) and Insurance Group's Directive (IGD) capital positions as at 31 December 2015 are calculated for the Group's ultimate Parent Company, PAG plc.

	Economic capital <sup>1</sup>		IGD	
	2015 £m	2014 proforma <sup>2</sup> £m	2015 £m	2014 proforma <sup>2</sup> £m
Total capital available	<b>803</b>	625	<b>604</b>	568
Capital required	<b>359</b>	393	<b>233</b>	224
Excess surplus	<b>444</b>	232	<b>371</b>	344
Coverage ratio (%)	<b>224%</b>	159%	<b>260%</b>	254%

Excess capital surplus on both an EC and IGD basis increased in 2015. The key driver of the increase was the capital raise (note 13) which took place during the year, together with a revision to the EC basis releasing excess prudence from the previous basis which was pegged to the ICAS regime. Note 12 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.

	Impact on surplus	Coverage ratio post stress	
	£m	2015	2014 proforma(2)
Economic capital surplus		<b>£444m</b>	£232m
Economic capital coverage		<b>224%</b>	159%
Interest +1%	<b>16</b>	<b>248%</b>	176%
Interest -1%	<b>15</b>	<b>212%</b>	141%
Credit spread widening +100bps	<b>(15)</b>	<b>231%</b>	159%
Property -10% price fall(4)	<b>(45)</b>	<b>209%</b>	147%
Longevity +5% deterioration	<b>(32)</b>	<b>215%</b>	151%

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

(2) 2014 proforma before final dividend and including £100m bond agreed on 2 March 2015.

(3) Property stress represents 10% decrease in carrying value, equivalent to a 35% fall from current market values.

# Directors' responsibility statement

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 IFRS as adopted by the EU, give a true and fair view of the assets, liabilities, financial position 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 description of the principal risks 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.

Neither the Company nor the Directors accept any liability to any person in relation to the Annual Report except to the extent that such liability could arise under English law. Accordingly, any liability to a person who has demonstrated reliance on any untrue or misleading statement or omission shall be determined in accordance with section 90A and schedule 10A of the Financial Services and Markets Act 2000.

# Consolidated Statement of Comprehensive Income

For the year ended 31 December 2015

	Note	2015 £000's	2014 £000's
Gross premiums written	1	651,447	760,638
Outward reinsurance premiums		(217,586)	(307,959)
Net premiums earned		433,861	452,679
Net investment income	3	51,271	299,232
Share of results of joint ventures and associates accounted for using the equity method		21	(179)
Profit on loss of control of subsidiary		–	158
Other income		194	207
<b>Total income</b>		<b>485,347</b>	<b>752,097</b>
Gross claims paid		(413,144)	(390,570)
Reinsurers' share of claims paid		263,480	255,957
Change in insurance liabilities:		(149,664)	(134,613)
Gross amount		(193,731)	(883,524)
Reinsurers' share		(41,953)	405,259
		(235,684)	(478,265)
Acquisition costs		(3,089)	(4,997)
Investment expenses and charges		(14,764)	(14,352)
Interest on external borrowings		(7,347)	–
Other operating expenses		(91,247)	(95,803)
		(116,447)	(115,152)
<b>Total claims and expenses</b>		<b>(501,795)</b>	<b>(728,030)</b>
<b>(Loss)/profit from continuing operations before tax</b>		<b>(16,448)</b>	<b>24,067</b>
Income tax credit/(expense) from continuing operations		2,348	(5,213)
<b>(Loss)/profit for the period</b>		<b>(14,100)</b>	<b>18,854</b>
<b>(Loss)/profit attributable to:</b>			
– Owners of the Parent		(14,100)	18,852
– Non-controlling interest		–	2
<b>(Loss)/profit for the period</b>		<b>(14,100)</b>	<b>18,854</b>
<b>Basic earnings per ordinary share</b>	4	<b>£(0.03)</b>	£0.05
<b>Diluted earnings per ordinary share</b>	4	<b>£(0.03)</b>	£0.05

# Consolidated Statement of Changes in Equity

For the year ended 31 December 2015

Attributable to owners of the Parent									
Note	Share capital £000's	Share premium £000's	Merger relief reserve £000's	Merger reserve £000's	Shares held by Employee Benefit Trust £000's	Retained profit £000's	Total £000's	Non- controlling interest £000's	Total £000's
At 1 January 2014	40,000	435,249	–	(24,521)	(58)	147,945	598,615	(66)	598,549
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
At 31 December 2014	40,000	435,249	–	(24,521)	(136)	154,098	604,690	–	604,690
At 1 January 2015	<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>
Shares issued/bought for cash	13	<b>4,013</b>	<b>–</b>	<b>49,085</b>	<b>–</b>	<b>–</b>	<b>53,098</b>	<b>–</b>	<b>53,098</b>
Share based payments	–	–	–	–	(56)	3,186	3,130	–	3,130
Dividends paid	–	–	–	–	–	(6,000)	(6,000)	–	(6,000)
Loss for the year	–	–	–	–	–	(14,100)	(14,100)	–	(14,100)
<b>At 31 December 2015</b>	<b>44,013</b>	<b>435,249</b>	<b>49,085</b>	<b>(24,521)</b>	<b>(192)</b>	<b>137,184</b>	<b>640,818</b>	<b>–</b>	<b>640,818</b>

# Consolidated statement of financial position

As at 31 December 2015

	Note	2015 £000's	2014 £000's
<b>Assets</b>			
Property, plant and equipment		9,297	12,557
Goodwill	5	126,207	126,207
Other intangible assets	6	12,220	15,219
Financial assets	7	4,886,583	4,910,904
Investment in joint ventures and associates		254	233
Reinsurance assets	8	3,204,055	3,246,008
Insurance and other receivables		90,382	39,167
Prepayments and accrued income		3,480	3,615
Deferred tax asset		938	519
Cash and cash equivalents		453,033	87,251
<b>Total assets</b>		<b>8,786,449</b>	<b>8,441,680</b>
<b>Equity</b>			
Share capital	13	44,013	40,000
Share premium	13	435,249	435,249
Merger relief reserves	13	49,085	–
Merger reserve	13	(24,521)	(24,521)
Shares held by Employee Benefit Trust	13	(192)	(136)
Retained profit		137,184	154,098
<b>Total equity</b>		<b>640,818</b>	<b>604,690</b>
<b>Liabilities</b>			
Insurance liabilities	8	5,424,843	5,231,112
Insurance and other payables		47,372	29,527
Financial liabilities	9	2,561,290	2,571,288
Current tax liabilities		3,957	3,735
External borrowings		107,257	–
Deferred tax liability		912	1,328
<b>Total liabilities</b>		<b>8,145,631</b>	<b>7,836,990</b>
<b>Total equity and liabilities</b>		<b>8,786,449</b>	<b>8,441,680</b>

# Consolidated cash flow statement

For the year ended 31 December 2015

	Note	2015 £000's	2014 £000's
<b>Cash generated from operations</b>		<b>224,569</b>	11,664
Corporation tax paid		<b>(5,315)</b>	(19,705)
<b>Net cash from/(used in) operating activities</b>		<b>219,254</b>	(8,041)
Cash flows from investing activities:			
Purchase of property, plant and equipment		<b>(285)</b>	(1,308)
Purchase of other intangible assets		<b>(195)</b>	(2,093)
Investment in associate		–	(48)
<b>Net cash used in investing activities</b>		<b>(480)</b>	(3,449)
Cash flows from financing activities:			
Proceeds from issuance of share capital	13	<b>53,098</b>	–
Dividends paid to shareholders		<b>(6,000)</b>	(14,000)
Proceeds from external borrowings		<b>99,910</b>	–
<b>Net cash from/(used in) financing activities</b>		<b>147,008</b>	(14,000)
<b>Net increase/(decrease) in cash and cash equivalents</b>		<b>365,782</b>	(25,490)
Cash and cash equivalents brought forward		<b>87,251</b>	112,741
<b>Cash and cash equivalents carried forward</b>		<b>453,033</b>	87,251

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 the 2015 loss and 2014 profit before tax:

For the year ended 31 December	2015 £000's	2014 £000's
New business operating profit	10,755	38,962
In-force operating profit	14,601	8,477
Long-term expected return on surplus assets	14,451	16,328
<b>Operating profit</b>	<b>39,807</b>	<b>63,767</b>
Investment variances	(25,642)	(23,491)
Non-recurring items	(23,420)	(16,348)
Other gains	154	139
Interest on borrowings	(7,347)	–
<b>(Loss)/profit from continuing operations before tax</b>	<b>(16,448)</b>	<b>24,067</b>

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 items primarily relates to:

- £5.8m of deal costs relating to the proposed merger with Just Retirement plc and costs relating to the capital raise in March 2015 (2014: £nil);
- £3.5m of Solvency II related charges (2014: £2.0m), plus a £3.5m of negative profit impact (2014: £nil) relating to an addendum to a closed reinsurance treaty in relation to Solvency II;
- £4.8m of implementation costs in respect of product development and new initiatives (2014: £0.8m and a further £2.7m on other projects that did not repeat in 2015); and
- £1.7m of costs incurred in developing scalable and flexible DB architecture (2014: £2.3m).

In addition, non-recurring amortisation and impairment totalled £3.8m in 2015 (2014: £8.5m).

Other gains 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:

For the year ended 31 December	2015	2014
Cash	0.5%	0.5%
Gilts	3.0%	3.0%
Corporate bonds	4.0%	4.5%
Commodity trade finance loans	N/A	10.0%
Loans secured by residential mortgages	6.0%	6.0%

No significant amount of commodity trade finance loans was held at any point during 2015, and so no yield on these investments was used in the derivation of long-term expected return.

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

For the year ended 31 December	2015 £000's	2014 £000's
Individual retirement annuities	280,235	465,840
Defined benefit buy-in/buy-out annuities	277,185	246,573
Individual care annuities	68,408	75,741
Individual protection policies	4,952	3,083
<b>Total SPE</b>	<b>630,780</b>	<b>791,237</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	2015 £000's	2014 £000's
Total SPE	630,780	791,237
Adjustment in respect of regular premium business	(4,393)	135
Change in premiums receivable – not included in SPE	25,060	(30,734)
<b>Gross premiums written</b>	<b>651,447</b>	<b>760,638</b>

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:

For the year ended 31 December	2015 £000's	2014 £000's
Individual retirement annuities	305,525	435,106
Defined benefit buy-in/buy-out annuities	274,155	246,573
Individual care annuities	68,522	75,864
Individual protection policies	3,245	3,095
<b>Total gross premiums written</b>	<b>651,447</b>	<b>760,638</b>

## 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 2015. 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 2015:

- An amendment to IAS 19 Employee benefits clarifying the requirements on attributing to periods of service contributions from employees or third parties that are linked to service. The amendment has no impact on the financial statements in the current or prior periods, and
- Minor amendments to various standards arising from the Annual Improvements 2010 - 2012 and 2011 – 2013 cycles, these changes have no impact on the financial statements in the current or prior periods.

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

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>2015 £000's</b>	2014 £000's
Net interest income on financial assets and financial liabilities	<b>63,837</b>	71,454
(Losses)/gains on financial assets and financial liabilities	<b>(7,782)</b>	231,327
Losses on derivative instruments (designated as held for trading)	<b>(4,784)</b>	(3,549)
<b>Total net investment income</b>	<b>51,271</b>	299,232

All financial assets and liabilities with the exception of external borrowings 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 or loss 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>2015 £000's</b>	2014 £000's
(Loss)/profit for the year	<b>(14,100)</b>	18,854
Less non-controlling interests	-	(2)
(Loss)/profit attributable to equity holders of the parent	<b>(14,100)</b>	18,852
Effect of dilutive potential ordinary shares:		
Share options	-	-
<b>Diluted profit attributable to equity holders of the parent</b>	<b>(14,100)</b>	18,852

<b>For the year ended 31 December</b>	<b>2015 Number of shares</b>	2014 Number of shares
Basic weighted average number of shares	<b>410,194,086</b>	399,870,568
Share options	<b>16,777,936</b>	2,780,521
<b>Diluted weighted average number of shares</b>	<b>426,972,022</b>	402,651,089

The Group has a number of other employee share-based plans. Each of these plans 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 (DBSP) 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.

On 29 September 2015, an additional 39,995,997 shares were issued raising capital of £53,284,942 and a further 136,154 shares were issued during December 2015 to settle LTIP and DBSP awards (see note 13).

## 5 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 (CGUs) 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.

	2015 £000's	2014 £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 CGU, 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. Value in use has been determined as the present value of expected future cash flows associated with new business. The cash flows used in this calculation are consistent with those monitored by management.

Expected future new business cash flows are based on financial plans approved by management, covering a period of five years from the balance sheet date. A rate of 15.1% (2014: 13.1%) has been applied to discount cash flows to a present value.

No impairment has been recognised in 2015 or 2014.

## 6 Other intangible assets

Other intangible assets comprise intellectual property and software development costs.

The intellectual property asset comprises specific mortality tables derived from data collected over an extended period and is 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 CGU, or company of units, to which the asset belongs.

	2015 £000's	2014 £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>	3,100
<b>Software development cost:</b>		
At 1 January	19,898	17,805
Additions at cost	195	2,093
<b>At 31 December</b>	<b>20,093</b>	19,898
<b>Software development accumulated amortisation:</b>		
At 1 January	7,779	4,504
Charge for the year	3,194	3,275
<b>At 31 December</b>	<b>10,973</b>	7,779
Total intangible assets at 1 January	15,219	16,401
<b>Total intangible assets at 31 December</b>	<b>12,220</b>	15,219

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" CGU, 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 5.

No impairment of intellectual property has been recognised in 2014 or 2015.

## 7 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 the fair values 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 historical 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 values 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 currency contracts, interest rate swaps, credit default swaps, inflation swaps, fixed coupon cross currency swaps, interest rate futures and swaptions.

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</b>	<b>2015</b>	<b>2014</b>
<b>Fair value at 31 December</b>	<b>£000's</b>	<b>£000's</b>
Financial investments	<b>3,371,950</b>	3,584,820
Loans secured by residential mortgages	<b>1,434,788</b>	1,212,324
Derivative assets	<b>14,228</b>	75,892
Loans secured by commercial mortgages	<b>65,617</b>	37,868
<b>Total financial assets</b>	<b>4,886,583</b>	4,910,904

The methodology used to derive the fair values is set out in note 10.

<b>Financial assets</b>	<b>2015</b>	<b>2014</b>
<b>Cost at 31 December</b>	<b>£000's</b>	<b>£000's</b>
Financial investments	<b>3,314,066</b>	3,298,543
Loans secured by residential mortgages	<b>1,139,627</b>	950,909
Derivative assets	<b>4,246</b>	–
Loans secured by commercial mortgages	<b>65,399</b>	37,481
<b>Total financial assets</b>	<b>4,523,338</b>	4,286,933

## 8 Insurance liabilities and reinsurance assets

### Insurance liabilities

Insurance contracts are defined as those containing significant insurance risk if, and only if, and insured event would cause and 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 Chief Actuary on the modified statutory basis using recognised actuarial methods with due regard to the actuarial principles set out in the PRA'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. The principal assumptions underlying the calculation of insurance liabilities are set out in note 8.

### 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.

At 31 December	2015 £000's	2014 £000's
Long-term business provision	5,424,843	5,231,112
Reinsurers' share of long-term business provision	(3,204,055)	(3,246,008)
<b>Net provision</b>	<b>2,220,788</b>	<b>1,985,104</b>

### a) Principal assumptions

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

	Mortality tables	Valuation discount rates
Medically underwritten annuity products	2015 Modified E&W Population Mortality with improvements based on CMI_2014_M (1.75%) and CMI_2014_F (1.50%)	3.88%
	2014 Modified E&W Population Mortality with improvements based on CMI_2013_M (1.75%) and CMI_2013_F (1.50%)	3.53%
Other annuity products	2015 Modified PCMA/PCFAOO bespoke improvements	1.68%
	2014 Modified PCMA/PCFA00 bespoke improvements	1.35%
Term and whole of life products	2015 86.25% TM/TF00Select	1.15%
	2014 86.25% TM/TF00Select	1.00%

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 43% (31 December 2014: 42%) 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:

For the year ended 31 December 2015	Gross £000's	Reinsurance £000's	Net £000's
At 1 January 2015	5,231,112	(3,246,008)	1,985,104
Increase in liability from new business	613,687	(149,631)	464,056
Release of in-force liability	(166,449)	107,560	(58,889)
Release of liability due to recorded deaths	(80,311)	39,467	(40,844)
Economic changes	(195,491)	113,394	(82,097)
Non-economic changes	521	-	521
Other	21,774	(68,837)	(47,063)
<b>At 31 December 2015</b>	<b>5,424,843</b>	<b>(3,204,055)</b>	<b>2,220,788</b>

For the year ended 31 December 2014	Gross £000's	Reinsurance £000's	Net £000's
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
At 31 December 2014	5,231,112	(3,246,008)	1,985,104

### c) Analysis of expected maturity

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

At 31 December 2015	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	
Long-term business provision	432,711	1,592,748	1,715,036	4,603,886	5,424,843
Reinsurers' share of long-term business provision	(266,774)	(993,084)	(1,071,279)	(2,612,022)	(3,204,055)
<b>Net</b>	<b>165,937</b>	<b>599,664</b>	<b>643,757</b>	<b>1,991,864</b>	<b>2,220,788</b>

At 31 December 2014	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	
Long-term business provision	411,885	1,510,716	1,624,201	4,367,492	5,231,112
Reinsurers' share of long-term 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>

### 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 & 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.

	Increase/(decrease) in profit before tax	
	2015 £000's	2014 £000's
<b>Change in assumption:</b>		
Interest rates +1%	<b>(6,805)</b>	2,866
Interest rates -1%	<b>35,537</b>	(5,993)
Credit spreads +0.5%	<b>(22,267)</b>	(11,621)
Expenses +10%	<b>(10,126)</b>	(10,906)
Mortality -5%	<b>(34,314)</b>	(32,027)
Property prices -10%	<b>(42,252)</b>	(38,583)
Voluntary redemptions +10%	<b>(5,861)</b>	(6,412)

## 9 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.

	2015 £000's	2014 £000's
<b>At 31 December</b>		
Deposits from reinsurers	<b>2,506,378</b>	2,491,795
Derivative liabilities	<b>54,912</b>	79,493
<b>Total financial liabilities</b>	<b>2,561,290</b>	2,571,288

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.

## 10 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 2015 and 31 December 2014.

At 31 December 2015	Level 1 £000's	Level 2 £000's	Level 3 £000's	Total £000's
Financial investments (a)	3,371,858	–	92	3,371,950
Loans secured by residential mortgages (b)	–	–	1,434,788	1,434,788
Derivative assets (c)	–	14,228	–	14,228
Loans secured by commercial mortgages (d)	–	–	65,617	65,617
<b>Total financial assets held at fair value</b>	<b>3,371,858</b>	<b>14,228</b>	<b>1,500,497</b>	<b>4,886,583</b>
Deposits from reinsurers (e)	–	–	2,506,378	2,506,378
Derivative liabilities (c)	–	54,912	–	54,912
<b>Total financial liabilities held at fair value</b>	<b>–</b>	<b>54,912</b>	<b>2,506,378</b>	<b>2,561,290</b>

At 31 December 2014	Level 1 £000's	Level 2 £000's	Level 3 £000's	Total £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
Total financial assets held at fair value	3,583,183	75,892	1,251,829	4,910,904
Deposits from reinsurers (e)	–	–	2,491,795	2,491,795
Derivative liabilities (c)	–	79,493	–	79,493
Total financial liabilities held at fair value	–	79,493	2,491,795	2,571,288

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 2015.

For the year ended 31 December 2015	Deposits from reinsurers £000's	Loans secured by commercial mortgages £000's	CTF Investments £000's	Loans secured by residential mortgages £000's
At 1 January 2015	(2,491,795)	37,868	1,637	1,212,324
Loans (received)/advanced	(217,586)	31,415	–	219,160
Total (losses)/gains in consolidated statement of comprehensive income	(70,189)	(1,356)	79	(215)
Redemptions made/(received)	366,377	(3,905)	(1,624)	(57,567)
(Interest payable accrued)/interest receivable accrued	(93,185)	1,595	–	61,086
<b>At 31 December 2015</b>	<b>(2,506,378)</b>	<b>65,617</b>	<b>92</b>	<b>1,434,788</b>

For the year ended 31 December 2014	Deposits from reinsurers £000's	Loans secured by commercial mortgages £000's	CTF Investments £000's	Loans secured by residential mortgages £000's
At 1 January 2014	(2,182,350)	–	11,568	840,066
Loans (received)/advanced	(307,959)	37,480	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
At 31 December 2014	(2,491,795)	37,868	1,637	1,212,324

The gains and losses are included within net investment income in the Consolidated Statement of Comprehensive Income.

The unrealised gains/(losses) in respect of deposits from reinsurers, loans secured by commercial mortgages, commodity trade finance investments and loans secured by residential mortgages for the period to 31 December

2015 are £(70.2)m (2014: £(139.4)m), £(1.4)m (2014: £0.3m), £0.1m (2014: £(0.9)m) and £(0.2)m (2014: £185.6m) respectively. These unrealised gains and losses are included within net investment income in the Consolidated Statement of Comprehensive Income.

### Level 3 sensitivity analysis

At 31 December 2015	Significant assumption	Impact of alternative assumption		
		Current fair value £000's	Increase in fair value £000's	Decrease in fair value £000's
<b>Assets</b>				
Loans secured by commercial mortgages	Discount rate	65,617	3,881	(3,582)
Loans secured by residential mortgages	Discount rate	1,434,788	182,255	(153,479)
<b>Liabilities</b>				
Deposits from reinsurers	Discount rate	(2,506,378)	(223,056)	190,339

At 31 December 2014	Significant assumption	Impact of alternative assumption		
		Current fair value £000's	Increase in fair value £000's	Decrease in fair value £000's
<b>Assets</b>				
CTF Investments	Expected defaults	1,637	289	(353)
Loans secured by commercial mortgages	Discount rate	37,869	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

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 (CTF) 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 2015 and 31 December 2014, 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 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 2015 was nil% p.a. (31 December 2014: nil%).

#### 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 on the fair value.

**Discount rate:** Loans secured by residential 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 2015 was 5.10% (31 December 2014: 5.05%).

**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 2015 were 5.5% (31 December 2014: 5.5%) and 13% (31 December 2014: 13%) respectively. The over-valuation assumption used as at 31 December 2015 was 28% (31 December 2014: 27.4%). The value of the no negative equity guarantee as at 31 December 2015 was £128.7m (31 December 2014: £112.5m).

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 2015 and 31 December 2014 were purchased over-the-counter.

The Group's derivative assets and liabilities include forward currency positions, interest rate swaps, inflation swaps, credit default swaps, fixed coupon cross currency swaps, interest rate futures and swaptions.

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

**Interest rate swaps:** The fair value of the interest rate swaps is derived from an interest rate swap pricing model. Inputs to the model are the characteristics of the swap and market rates such as SONIA, LIBOR, FRA rates and interest rate swap rates. The choice of which rates to use and how to combine them is dependent on the characteristics of the swap, and on the Credit Support Annex under which the swap is transacted. This data is used to calculate zero coupon interest rate swap curves. From this, forward curves are created to generate the future floating leg cash flows of the swap. The curves are also used to discount all fixed and derived future cash flows to create the fair value of the fixed and floating legs of the swaps.

**Inflation swaps:** The fair value of the inflation swaps is derived from an inflation swap pricing model. This uses a time series of historic inflation index levels, to create an inflation seasonality model, market zero coupon inflation swap rates, to create an inflation expectation curve, and a zero coupon interest rate swap curve, (see for Interest rate swap). The inflation swap pricing model generates the future cash flows for the inflation legs of the swap and then discounts both fixed and floating legs to create the fair value of the fixed and floating legs of the swap.

**Credit default swaps (CDS):** The fair value of credit default swaps is derived using a CDS pricing model. Inputs to the model are the characteristics of the CDS and market rates such as EONIA, LIBOR, FRA rates, interest rate swap rates and CDS spreads. The choice of which rates to use and how to combine them is dependent of the characteristics of the CDS, and on the Credit Support Annex under which the CDS is transacted. This data is used to calculate the probability of default and zero coupon interest rate swap curves. From these expected future cash flows are calculated and then discounted to create the fair value of the CDS.

**Fixed coupon cross currency swaps:** The fair value of fixed coupon cross currency swaps is derived using a cross currency swap pricing model. Inputs to the model are the characteristics of the swap and market rates such as SONIA, Fed Funds, LIBOR, FRA's, interest rate swap rates, basis swap rates and FX rates. The choice of which rates to use and how to combine them is dependent on the characteristics of the swap, and on the Credit Support Annex under which the swap is transacted. The model calculates zero coupon interest rate and cross currency swap curves for each currency. These curves and FX rates are then used to discount all cash flows to create the fair value of the swap.

**Interest rate futures:** The fair value of the futures is taken from the closing price from the relevant exchange.

**Swaptions:** The fair value of the swaptions is derived from a swaption pricing model. Inputs to the model are the characteristics of the swaption and market rates such as SONIA, LIBOR, FRA rates, interest rate swap rates and volatility and volatility skews. The choice of which rates to use and how to combine them is dependent on the type of swaption, and on the Credit Support Annex under which the swaption is transacted. The model calculated the fair value of the swaption using a sophisticated option pricing algorithm.

#### *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 the 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.

#### *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 2015 for Individual retirement and Individual care annuities were 4.43% and 1.67% respectively (31 December 2014: 4.16% and 1.67% respectively).

## 11 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 Chief Actuary. 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 2015, the mean duration of the assets including surplus assets was 8.7 years (2014: 8.3 years) measured with reference to a gross redemption yield and the mean duration of the liabilities (including both retirement and care liabilities) was at 9.8 years (2014: 9.6 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 2015, £6.7m of collateral (2014: £19.0m) 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 & Poor's, or an equivalent rating from another recognised rating agency. These principles continue to be the basis for IFRS reporting, though the new Solvency II regime works on a different basis for setting margins.

At 31 December 2015	Credit rating					Total £000's
	AAA £000's	AA £000's	A £000's	BBB £000's	Unrated £000's	
Financial investments	684,384	344,871	955,680	1,353,382	33,633	3,371,950
Derivative assets	–	–	–	–	14,228	14,228
Loans secured by residential mortgages	–	–	–	–	1,434,788	1,434,788
Loans secured by commercial mortgages	–	–	–	–	65,617	65,617
Reinsurance assets	–	1,242,972	1,961,083	–	–	3,204,055
Insurance and other receivables	–	6,072	3,808	–	80,502	90,382
<b>Total</b>	<b>684,384</b>	<b>1,593,915</b>	<b>2,920,571</b>	<b>1,353,382</b>	<b>1,628,768</b>	<b>8,181,020</b>

At 31 December 2014	Credit rating					Total £000's
	AAA £000's	AA £000's	A £000's	BBB £000's	Unrated £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>

No financial assets were past due at 31 December 2015 and 31 December 2014.

#### 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 Asset Liability Matching '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;
- 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; and
- External borrowings includes subordinated debt and the interest payments due under the terms of that loan agreement.

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 2015</b>					
Net insurance liabilities	165,937	599,664	643,757	1,991,864	2,220,788
Deposits from reinsurers	223,309	825,619	863,813	1,983,497	2,506,378
Derivative liabilities	4,220	30,957	26,813	64,432	54,912
External borrowings	9,500	38,000	147,500	–	107,257
<b>Total</b>	<b>402,966</b>	<b>1,494,240</b>	<b>1,681,883</b>	<b>4,039,793</b>	<b>4,889,335</b>

	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 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>

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" that limits its exposure for the Group.

## 12 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 the equity attributable to the 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 the 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.

Up until 31 December 2015 "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. From 1 January 2016 the minimum capital requirement that apply at the "PLACL" and "PAG plc" level have become those set out in the Solvency II regulation.

The table below provides a reconciliation between the available capital resources of the PAG plc Group, measured under IFRS, and the surplus over the 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.



At 31 December	2015 £000's	2014 £000's
<b>Total equity of PAG plc Group</b>	<b>640,818</b>	604,690
Adjustments in respect of regulatory capital basis:		
Tier 2 debt	<b>107,257</b>	–
Inadmissible intangible assets	<b>(12,220)</b>	(15,219)
Inadmissible goodwill	<b>(126,207)</b>	(126,207)
Inadmissible deferred tax asset	<b>(938)</b>	(519)
Equity and reserves related to non-regulated entities (excluded from regulatory capital calculation), adjusted for inadmissible assets already adjusted above	<b>(4,985)</b>	3,042
<b>Total available capital resources (IGD basis)</b>	<b>603,725</b>	465,787
Group minimum capital requirement (IGD basis)	<b>(232,578)</b>	(224,127)
<b>Surplus over regulatory capital requirement</b>	<b>371,147</b>	241,660

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.

### 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 2015	Number of shares	Share capital £000's	Share premium £000's
<b>The allotted and issued share capital of PAG plc:</b>			
Shares subdivided into 500,000 ordinary shares of £0.10 each	<b>399,999,971</b>	<b>40,000</b>	<b>435,249</b>
Shares issued for cash	<b>40,132,151</b>	<b>4,013</b>	–
<b>As at 31 December 2015, ordinary shares of £0.10 each</b>	<b>440,132,122</b>	<b>44,013</b>	<b>435,249</b>

At 31 December 2014	Number of shares	Share capital £000's	Share premium £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>	399,999,971	40,000	435,249

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.

On 29 September 2015, an additional 39,995,997 shares were issued raising capital of £53,284,942 and a further 136,154 shares were issued during December 2015 to settle LTIP and DBSP awards.

#### Merger Reserve

The Merger Reserve arose on 12 June 2013 as a result of the transfer of ordinary shares in PAG Holdings Limited to the Company in exchange for the allotment and issue of ordinary shares in the Company. This resulted in the creation of the Merger Reserve as a result of the Group electing to account for the acquisition of its 100% shareholding in PAGH as a Group reconstruction.

#### Merger Relief Reserve

The Merger Relief Reserve arose on 29 September 2015, as a result of the shares issued on that date. The shares were used to acquire all the outstanding ordinary shares of a limited company thereby qualifying for Merger Relief under section 612 of the Companies Act 2006. That limited company was wound up immediately after the transaction.

## 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	2015 £000's	2014 £000's
Employee benefit trust	(192)	(136)

## 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 remuneration of the Directors, who are the key management personnel of the Group, is set out below:

At 31 December	2015 £000's	2014 £000's
Short-term employee benefits	3,193	2,850
Post-employment benefits	–	16
<b>Total</b>	<b>3,193</b>	<b>2,866</b>

### 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:

At 31 December	2015 £000's	2014 £000's
Amounts owed to Directors:		
Loan advances	313	302
<b>Loans owed by Directors</b>	<b>313</b>	<b>302</b>

The loan advances to Directors accrue interest fixed at 4% p.a. and are repayable in whole or in part at any time.

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

At 31 December	2015 £000's	2014 £000's
Interest accrued on Directors' loan advances	12	12
<b>Interest accrued due from Directors</b>	<b>12</b>	<b>12</b>

### 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.

	2015 £000's	2014 £000's
Costs paid to entities related to the ultimate parent controlling party	65	122
Group's share of losses of joint venture investment	–	6
Loans advanced to associate and fees on loans	3	187
<b>Value of other related party transactions</b>	<b>68</b>	<b>315</b>

At 31 December 2015 there was no amount due or receivable from any entities related to the ultimate parent controlling party (2014: £nil).

Loans are regularly advanced to the Group's associate, Eldercare to provide short-term prefunding for policy holder annuity purchases. At 31 December 2015, Eldercare owed the Group £184,000 (2014: £185,000).

**d) Ultimate controlling party**

Prior to 29 September 2015 the majority of the Company's ordinary shares were 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 UK. After this point the Company did not have an ultimate controlling party.

# Group MCEV analysis of earnings (net of tax)

For the year ended 31 December 2015

	Note	Year ended 31 December 2015			Year ended 31 December 2014
		Covered business MCEV £000's	Non-covered business IFRS £000's	Total Group MCEV £000's	Total Group MCEV £000's
<b>Opening Group MCEV</b>		<b>557,532</b>	<b>18,754</b>	<b>576,286</b>	519,633
Operating MCEV earnings	3	<b>46,067</b>	–	<b>46,067</b>	86,502
Non-operating MCEV earnings	3	<b>(33,812)</b>	<b>(5,461)</b>	<b>(39,273)</b>	(17,071)
<b>Total MCEV earnings</b>		<b>12,255</b>	<b>(5,461)</b>	<b>6,794</b>	69,431
Other movements in IFRS net equity	4	–	<b>56,229</b>	<b>56,229</b>	1,222
Closing adjustments	3	–	<b>(6,000)</b>	<b>(6,000)</b>	(14,000)
<b>Closing Group MCEV</b>		<b>569,787</b>	<b>63,522</b>	<b>633,309</b>	576,286

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

For the year ended 31 December 2015

		Year ended 31 December 2015			Year ended 31 December 2014	
	Note	Free surplus £000's	Required capital £000's	VIF £000's	MCEV £000's	MCEV £000's
<b>Opening MCEV</b>		<b>30,834</b>	<b>418,238</b>	<b>108,460</b>	<b>557,532</b>	463,494
New business value	3	<b>(44,558)</b>	<b>52,485</b>	<b>21,691</b>	<b>29,888</b>	56,072
Expected existing business contribution (reference rate and in excess of reference rate)	3	–	–	<b>4,909</b>	<b>4,909</b>	4,106
Transfers from VIF and required capital to free surplus	3	<b>23,525</b>	<b>(10,667)</b>	<b>(10,003)</b>	<b>2,855</b>	3,469
Experience variances	3	<b>1,753</b>	<b>467</b>	<b>(609)</b>	<b>1,611</b>	(1,087)
Assumption changes		<b>40,460</b>	<b>(46,961)</b>	<b>2,754</b>	<b>(3,747)</b>	(481)
Other operating variances	3	<b>5,997</b>	<b>8,472</b>	<b>(3,917)</b>	<b>10,552</b>	24,423
<b>Operating MCEV earnings</b>		<b>27,177</b>	<b>3,796</b>	<b>15,094</b>	<b>46,067</b>	86,502
Economic variances	3	<b>(15,427)</b>	<b>(937)</b>	<b>(11,402)</b>	<b>(27,766)</b>	(3,994)
Other non-operating variances	3	<b>(26,581)</b>	<b>6,885</b>	<b>13,650</b>	<b>(6,046)</b>	(11,470)
<b>Total MCEV earnings</b>		<b>(14,831)</b>	<b>9,744</b>	<b>17,342</b>	<b>12,255</b>	71,038
Closing adjustments	3	–	–	–	–	23,000
<b>Closing MCEV</b>		<b>16,003</b>	<b>427,982</b>	<b>125,803</b>	<b>569,787</b>	557,532

# Reconciliation of Group IFRS net assets to MCEV

As at 31 December 2015

	Year ended 31 December 2015			Year ended 31 December 2014		
	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>450,321</b>	<b>190,497</b>	<b>640,818</b>	458,961	145,729	604,690
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	(4,005)	–	(4,005)	(7,557)	–	(7,557)
<b>MCEV Net Worth</b>	<b>443,984</b>	<b>63,522</b>	<b>507,506</b>	449,072	18,754	467,826
VIF	125,803	–	125,803	108,460	–	108,460
<b>MCEV (net of taxation)</b>	<b>569,787</b>	<b>63,522</b>	<b>633,309</b>	557,532	18,754	576,286

# Notes to the MCEV financial statements

for the period ended 31 December 2015

## 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 subordinated debt, at the fair value, within covered business.

### 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 (Equity release 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 is 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 using corporate bond, equity release and commercial mortgage liquidity premiums added 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.

The equity release assets 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.

The commercial mortgage assets are valued using a mark to model approach that allows for the risk of changes 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>31 December, 2015</b>	<b>230bps</b>
31 December, 2014	211bps

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>31 December, 2015</b>	<b>262bps</b>
31 December, 2014	273bps

### 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>31 December, 2015</b>	<b>0.84%</b>	<b>0.84%</b>	<b>1.10%</b>	<b>1.60%</b>	<b>2.04%</b>	<b>2.22%</b>	<b>2.25%</b>
31 December, 2014	0.74%	0.74%	0.93%	1.46%	1.87%	2.11%	2.24%

### 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 £23.4m for the year to 31 December 2015 (31 December 2014: £16.3m).

Best-estimate expense inflation applied as at 31 December 2015 was 4.5% p.a. (31 December 2014: 4.5%).

### Taxation

The current and future tax rates used are the 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 marginally greater than the corporation tax rate in 2015 because a tax reclaim of £0.3m in respect of research and development credits on prior years has increased the tax credit available on the loss. The effective tax rate for 2015 was 24.2% (31 December 2014: 13.4%).

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 31 December 2015	Year ended 31 December 2014
2014	21.50%	21.50%
2015	20.25%	20.25%
2016	20.00%	20.00%
2017	19.25%	20.00%
2018	19.00%	20.00%
2019	19.00%	20.00%
2020	18.25%	20.00%
2021	18.00%	20.00%

### Volatilities and correlations

Residential property and commercial property volatility 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 Equity release assets. As at 31 December 2015 the assumption was set to 12% (31 December 2014: 12%). Commercial property volatility is used to model property prices of properties backing commercial mortgage loans. As at 31 December 2015 the assumption was set to 11% (31 December 2014: 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 2014: 0.9%) 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 184% of the capital resources requirement (31 December 2014: 190%). 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 2015 (31 December 2014: 0.5%).

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

### Covered business

The lower new business volumes in 2015 compared to 2014 resulted in a reduction in MCEV earnings from the value of new business written. The total expected existing business contribution, transfers from VIF and required capital to free surplus have increased marginally in the period as a result of the growth in the portfolio.

Experience variances in the period are positive in aggregate as a result of heavier than expected mortality experience. The assumption changes adopted in the year reduced MCEV by £3.7m. The increase in free surplus and reduction in required capital from assumption changes reflect the release of some prudence within the economic capital balance sheet.

Other operating variances also include expected long-term return on excess assets (after tax) of £11.6m (£12.8m at 31 December 2014).

The £(27.8)m economic variance on MCEV includes the impact of a provision against the current and potential maximum future cost of our interest rate hedging strategy and the impact of trading activity in Q4 2015 to get the portfolio aligned for Solvency II which was partially offset by the lower valuation of the subordinated debt. Subordinated debt is valued at fair value for MCEV but carried at amortised cost for IFRS.

Non-operating variance free surplus predominantly consists of non-recurring expenses further detail of which is provided in note 1 to the Consolidated Financial Statements presented with this supplementary information. The increase in VIF from non-operating variances arises since future interest payments due on the subordinated debt reduce future profits. Therefore, future profit with value equivalent to the value of the future interest payments will be tax exempt.

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

The principal changes in the value of non-covered business are a capital raise in September 2015 of £53m, offset by dividends paid of £6.0m (includes the 2014 final dividend and the 2015 interim dividend).

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

The other movements in IFRS new equity have arisen as a result of the equity capital raise in September 2015 and a net increase to the share based payment reserve which increased as the Group's non-cash employee benefits were charged and reduced when awards crystallised in the year.

## 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:

	In-force		New business	
	Impact on MCEV £000's	Change in MCEV %	Impact on MCEV £000's	Change in MCEV %
<b>31 December 2015 Sensitivity</b>				
<b>Embedded Value (Base)</b>	<b>569,787</b>		<b>29,888</b>	
Interest rate environment +100bps	(29,375)	(5%)	n/a	n/a
Interest rate environment -100bps	59,998	11%	n/a	n/a
Swaption implied volatilities +25%	–	0%	n/a	n/a
Property volatilities +25%	(42,212)	(7%)	(3,993)	(13%)
Property Values -10%	(31,707)	(6%)	n/a	n/a
Lapses -10% (including equity release)	4,956	1%	n/a	n/a
Mortality -5% (annuities)	(23,010)	(4%)	(3,812)	(13%)
Expenses -10%	6,367	1%	141	0%
Mortality improvements +0.25% (best-estimate only)	(13,709)	(2%)	(2,507)	(8%)
Decrease in liquidity premium 25bps	(80,951)	(14%)	(9,387)	(31%)
Required capital set to be 100% of CRR	10,428	2%	1,269	4%

	In-force		New business	
	Impact on MCEV £000's	Change in MCEV %	Impact on MCEV £000's	Change in MCEV %
<b>31 December 2014 Sensitivity</b>				
<b>Embedded Value (Base)</b>	<b>557,532</b>		<b>56,072</b>	
Interest rate environment +100 bps	(25,447)	(5%)	n/a	n/a
Interest rate environment -100 bps	26,177	5%	n/a	n/a
Swaption implied volatilities +25%	–	0%	n/a	n/a
Property volatilities +25%	(39,445)	(7%)	(5,339)	(10%)
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-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%

### Notes to the sensitivities:

- Interest rate environment +/-100bps – 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 equity release asset value as a result of the change in the cost of the “no negative equity guarantee” (NNEG), and for the change in commercial mortgage asset value. 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 equity release assets this increases the cost of the “NNEG”. For 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 equity release 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 184% 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.