Registered Number: 00093792

ROYAL & SUN ALLIANCE INSURANCE PLC

Annual Report and Accounts

for the year ended 31 December 2012

Royal & Sun Alliance Insurance plc

Contents

Company information

Directors

A P Brown

M Harris

R D Houghton

S P G Lee

D A Weymouth

Secretary

Roysun Limited

Registered office

St Mark's Court
Chart Way
Horsham
West Sussex
RH12 1XL

Auditor

Deloitte LLP
Chartered Accountants and Statutory Auditor
London

The directors present their annual report on the affairs of the Company and the audited financial statements for the year ended 31 December 2012

RSA Insurance Group plc (the Group), of which the Company is an important part is managed along divisional lines The Company transacts the majority of the UK business, as described in the Annual Report & Accounts of the Group The directors of the Company have considered whether the Group approach to strategy, risk management, performance review and custody of assets fully meets the needs of the Company as a separate regulated entity They have concluded that it does

Business review, principal activities and future outlook

The principal activity of the Company, its subsidiaries and overseas branches is the transaction of insurance and related financial services in the United Kingdom and overseas The principal subsidiaries and associated undertakings are listed in note 34 to the financial statements

As part of the Group's response to the anticipated implementation of the Solvency II Directive and to deliver significant operational efficiencies, the Company undertook an insurance business transfer under Part VII of the Financial Services and Markets Act 2000 whereby some or all of the business of certain Group companies transferred to the Company with effect from 1 January 2012 A small part of the Company's business was transferred to The Marine Insurance Company Limited, an RSA Group company, under a similar insurance business transfer scheme and the legacy general insurance business of PA (GI) Limited ("PAGI") (a former Group company that is currently a member of the Phoenix Group of companies) was also transferred to the Company and The Marine Insurance Company Limited under two separate insurance business transfer schemes Further detail is included in note 6 to the financial statements

The results for the Company show a profit on ordinary activities before tax of £406m *(2011 £425m)* for the year, due principally to £606m *(2011 £629m)* of dividend income from subsidiary undertakings and gross premiums written of £4,293m *(2011 £3,576m)* Gross premiums written are higher in 2012 principally due to the above mentioned insurance business transfer effective from 1 January 2012 The shareholders' funds of the Company were £4,575m as at 31 December 2012 *(31 December 2011 £4,312m)*

In the United Kingdom, which is the Company's major market, the Company is a leading Commercial insurer and a top five Personal lines insurer through direct and affinity channels In Commercial the Company offers a full suite of products across Property, Liability Motor and Marine and distributes predominantly through insurance brokers In Personal the Company provides Household, Motor and Pet insurance through insurance brokers and affinity partners as well as MORE TH>N and eChoice, its direct businesses

In Personal business, premiums are down compared to 2011, whilst the underwriting result has improved Following poor weather in the first half of the year, the Personal Household underwriting result was down The focus on profit over volume in Personal Motor delivered an improved underwriting result, however softening prices throughout the year continue to make this a challenging market Pet insurance also delivered a stronger underwriting result

The Company is actively dealing with the challenges in the UK Commercial Market, by remaining selective regarding the brokers it wants to work with and driving rate increases across the business Commercial Property performed well with both premiums and underwriting result benefitting from sustained rating activity Liability suffered from a number of large losses and an increase in the frequency of "slip and trip" claims The Company is addressing this trend through underwriting and rating action Included in the Commercial Motor result is a large Commercial Motor contract which represents the majority of Commercial Motor premiums and underwriting result The Company is working on the details of new arrangements for this contract to be effective from October 2013, however, Commercial Motor will continue to be negatively affected by the contract's old tranches for the next few years The Company is confident that it is making progress in the Commercial Motor market Excluding this large contract, Commercial Motor premiums were down in 2012 During the year, the Company exited a number of Commercial Motor markets including Risk Managed Motor and Motor Trade Marine premiums were up against 2011 but the underwriting result suffered from large losses including the Costa Concordia and Superstorm Sandy

The Company's focus will continue to be on underwriting profit over volume The Company will continue with its intensive approach to portfolio management and expects only modest growth in premiums

Dividends

Interim dividends of £nil *(2011 £500m)* were declared during the year The directors do not recommend payment of a final ordinary dividend *(2011 £nil)*

Principal risks and uncertainties

The Company's principal risks and uncertainties are integrated within and managed together with the principal risks of the Group The principal risks and uncertainties of the Group, which include those of the UK business, and hence the Company, are set out in the estimation techniques, risks, uncertainties and contingencies on pages 88 to 91, and in the risk review on pages 26 to 29 of the Annual Report & Accounts of the Group which do not form part of this report

A discussion of the management of financial risk is set out below

Financial risk management

The Company is exposed to financial risk through its financial assets, financial liabilities, reinsurance assets and insurance liabilities In particular the key financial risk is that the proceeds from the realisation of its financial assets are not sufficient to fund the obligations arising from its insurance contracts

The Company manages its financial assets within a framework that has been developed to seek to ensure the ability to meet its obligations under insurance contracts A key principle behind this process is to hold assets that provide a broad match against the liabilities arising from insurance contracts

There is a potential risk within the investment portfolio arising from an inappropriate matching of cash and fixed interest assets against liabilities by duration However the relatively short duration of a general insurance portfolio together with the Company's strategy of broadly matching assets and liabilities by duration provides mitigation against these risks The Company reviews the duration of its liabilities and asset portfolios to ensure that they remain broadly matched Investment directives limit permissible duration ranges within the individual portfolios These directives also include objectives for liquidity, asset sector concentration and credit quality The Company is not party to any arrangements for which hedge accounting is used

Credit risk

The primary sources of credit risk within the Company are investment and treasury activities and reinsurance counterparty risk Within the investment management and treasury activities, a range of bank counterparty concentration and credit quality limits together with other controls are in place to ensure that exposure is managed New reinsurance cover is placed with reinsurers that are authorised as Approved Reinsurance Counterparties recommended by the Group Reinsurance Credit Committee

Market risk

Market risk arises within the Company's investment portfolios A Group committee oversees the Company's investment strategy and sets appropriate risk limits to ensure that no significant concentrations to individual companies or sectors arise

Liquidity risk

Liquidity risk is considered to be a low risk category Liquidity is managed such that the Company maintains a minimum level of cash or cash equivalents or highly liquid assets that can be liquidated within a maximum stated period of time Contingency funding plans are prepared and monitored to ensure that these minimum levels are met even in stress conditions

Key performance indicators

The directors of the Group manage the Group's operations on a divisional basis as described in the Annual Report & Accounts of the Group For this reason the Company's directors believe that analysis using key performance indicators (KPIs) for the UK business in aggregate is relevant to the Company

A key measure used by the Company in managing the business is the technical result This measure is calculated by aggregating earned premiums less claims incurred less expenses

Further information on financial KPIs is detailed in the Annual Report & Accounts of the Group (which do not form part of this report) within the Group Chief Executive's review on pages 10 to 13 and the regional business reviews on pages 18 to 25 The Annual Report & Accounts of the Group also includes non-financial KPIs which are detailed in the regional business reviews on pages 18 to 25, the corporate responsibility report on pages 30 to 33 and the Directors' and corporate governance report on pages 40 to 54

Employment policy

The Company's approach and employment policy reflects its belief that motivated and skilled employees are critical to the Company's success

The Company is committed to the promotion of equal opportunities for all employees and creating a working environment that fosters diversity and inclusion The Company seeks to ensure that recruitment, talent selection and development, reward, performance management and internal promotion are all carried out solely on the grounds of ability, and are entirely free from any form of discrimination To do this all reasonable adjustments are made, where it is appropriate to do so, to the Company's policies, practices, processes and terms and conditions of employment The Company is also committed wherever possible, to employing people who are disabled or become disabled during their career with the Company Diversity and inclusion are encouraged and supported and in 2012 a Global Forum was established, sponsored by Group and Regional CEOs, to ensure further focus and progress in this area

The Company is committed to fostering a constructive relationship with recognised independent trade unions, ensuring a regular and open dialogue on business issues and early consultation on changes affecting the workforce In the UK, Unite is formally recognised through a partnership agreement which covers collective consultation and bargaining on behalf of non management employees The Management Association (TMA) represents managerial employees under a separate consultative agreement

The Company is committed to having an engaged and motivated workforce, believing that is has a direct impact on customers' experience and overall long-term success Every September, the Group runs a global employee survey of employees using the Gallup Q12 questions, which measures the key drivers of engagement The survey is completed by circa three million people globally and is open to all employees The Group has amongst the highest participation of any client Gallup works with and in 2012 saw the highest participation ever, with 94% of employees completing the survey

Since 2008, significant progress has been made on improving employee engagement In 2012, a Grand Mean score of 4 29 (out of a maximum score of 5) was achieved, which places the Group in Gallup's top decile for companies with over 1,000 employees The Group also won a range of awards in 2012 for its engagement programme including the Gallup Global Workplace Award, presented to the world s most engaged and productive organisations, 6th in the Sunday Times Best Big Companies to Work For and Overall Winner and Employee Engagement category winner at the prestigious 2012 CIPD People Management Awards

The Group has a long-standing philosophy of encouraging employee share ownership, operating two HMRC-recognised share schemes Sharebuild and Sharesave Currently, a total of 6,543 employees from across the Group participate in Sharesave, contributing an average of £73 94 per month for the three year savings plan and an average of £61 17 for the five year savings plan Sharebuild is offered to UK employees only and currently 34% of those eligible to join the plan participate in it, contributing an average of £73 97 per month

The Company also encourages employees and their families to acquire products at a discounted rate The Staff Saver Scheme in the UK currently has approximately 11,500 Staff Saver policies in force Furthermore, the UK operates a flexible benefits scheme which provides employees with additional opportunities to tailor their benefits package to meet individual circumstances Over 50% of employees elected to participate in the scheme in 2012

Employees are kept well informed of the overall performance and objectives of the Group Communications are regularly provided through face to face meetings and presentations, by email, intranet articles and staff publications Key messages from the biannual Group Leaders Conferences are disseminated to teams by the Group CEO via WebEx and through local management

The Company actively encourages employees to become involved in supporting their local communities

Supplier payment policy

It is the Company's policy to agree appropriate terms and conditions in advance with its suppliers and to make payment in accordance with those terms and conditions, provided that the supplier has complied with them In most cases, agreements for the supply of goods or services are made under standard terms of contract that lay down payment terms In the United Kingdom these are available on request from UK Strategic Sourcing, Leadenhall Court, 1 Leadenhall Street, London EC3V 1PP

The Company's outstanding indebtedness to trade creditors on 31 December 2012 amounted to £20m *(2011 £31m)*, corresponding to 15 *(2011 23)* days' payment when averaged over the year

Directors

The names of the current directors are listed on page 1 Mr M G Culmer served as a director until his resignation on 14 May 2012 and Mr R J Clayton, Ms D P Cockrem, Mr I A Craston and Mr W R B McDonnell served as directors until their resignations on 13 February 2013 Mr R D Houghton and Mr D A Weymouth were appointed directors on 14 September 2012 and 13 February 2013 respectively The other directors served throughout the year None of the directors had any interests in the shares of the Company

Auditor

Each of the persons who is a director at the date of approval of this report confirms that

- so far as the director is aware, there is no relevant audit information of which the Company's auditor is unaware, and

- the director has taken all steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information, and to establish that the Company's auditor is aware of that information

This confirmation is given and should be interpreted in accordance with the provisions of s418 of the Companies Act 2006

At the 2013 Annual General Meeting the directors intend to recommend to shareholders that they appoint KPMG LLP as external auditor to the Company for 2013 This follows the impending appointment of the Group and Company's current external auditor, Deloitte LLP, to undertake additional consultancy work for the Group in Scandinavia which the directors, and they, felt could impair the perception of their independence

Going concern

In considering the appropriateness of the going concern basis, the Board has reviewed the Company's ongoing financial commitments for the next twelve months and beyond The Board's review included consideration of the Company's underwriting plans, strong regulatory capital surplus, diverse insurance risk profile, considerable undrawn financing facilities and highly liquid investment portfolio As a result of this review the directors have satisfied themselves that it is appropriate to prepare these financial statements on a going concern basis

By order of the Board

J M Mills
For and on behalf of
Roysun Limited
Secretary
19 February 2013

Directors' responsibilities statement

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations

Company law requires the directors to prepare financial statements for each financial year Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law) Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period In preparing these financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgements and accounting estimates that are reasonable and prudent,
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements, and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006 They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities

Independent auditor's report to the members of Royal & Sun Alliance Insurance plc

We have audited the financial statements of Royal & Sun Alliance Insurance plc for the year ended 31 December 2012 which comprise the Profit and Loss account, the Statement of Total Recognised Gains and Losses, the Balance Sheet, the Reconciliation of Movement in Shareholders' Funds and the related notes 1 to 34 The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice), having regard to the statutory requirement for insurance companies to maintain equalisation provisions The nature of equalisation provisions, the amounts set aside at 31 December 2012, and the effect of the movement in those provisions during the year on shareholders' funds, the balance on the general business technical account and profit before tax, are disclosed in note 23

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

Respective responsibilities of directors and the auditor

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

Scope of the audit of the financial statements

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

Opinion on financial statements

In our opinion the financial statements

- give a true and fair view of the state of the Company's affairs as at 31 December 2012 and of its profit for the year then ended,
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, and
- have been prepared in accordance with the requirements of the Companies Act 2006

Opinion on other matters prescribed by the Companies Act 2006

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

Matters on which we are required to report by exception

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

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

Alexander Arterton BSc ACA (Senior Statutory Auditor),
For and on behalf of Deloitte LLP,
Chartered Accountants and Statutory Auditor,
London, UK
19 February 2013

Profit & loss account
for the year ended 31 December 2012

Technical account – General business

	Notes	2012 £m	2011 £m
Gross premiums written	6	**4,293**	3,576
Outward reinsurance premiums		**(622)**	(511)
Premiums written, net of reinsurance		**3,671**	3,065
Change in the gross provision for unearned premiums		**(225)**	(112)
Change in the provision for unearned premiums, reinsurers' share		**15**	11
Earned premiums, net of reinsurance		**3,461**	2,964
Claims paid			
Gross amount		**(2,295)**	(2,506)
Reinsurers share		**305**	456
		(1,990)	(2,050)
Change in the provision for claims			
Gross amount		**(288)**	209
Reinsurers' share		**(51)**	(151)
		(339)	58
Claims incurred, net of reinsurance		**(2,329)**	(1,992)
Acquisition costs		**(1,038)**	(840)
Change in deferred acquisition costs		**23**	17
Administrative expenses		**(289)**	(283)
Reinsurance commissions and profit participation		**36**	31
Net operating expenses		**(1,268)**	(1,075)
Amortisation of renewal rights	15	**(1)**	(2)
Balance on the technical account before change in equalisation provision		**(137)**	(105)
Change in the equalisation provision	23	**(30)**	(17)
Balance on the Technical Account for General Business		**(167)**	(122)

All amounts relate to continuing operations

The notes on pages 12 to 49 form an integral part of these accounts

Profit & loss account (continued)
for the year ended 31 December 2012

Non-technical account

	Notes	2012 £m	2011 £m
Balance on the Technical Account for General Business		**(167)**	(122)
Investment income	12	**790**	801
Gains on the realisation of investments	12	**47**	125
		837	926
Unrealised gains/(losses) on trading investments / investment property	12	**46**	(71)
Revaluation of subsidiary undertakings	17	**(187)**	(165)
Investment expenses, charges and interest	12	**(122)**	(135)
Other charges		**(1)**	(8)
Operating profit		**406**	425
Profit on ordinary activities before tax		**406**	425
Taxation on profit on ordinary activities	13	**7**	25
Profit for the financial year attributable to shareholders		**413**	450

Current year discontinued and acquired operations do not form a material part of the figures above

Statement of total recognised gains and losses for the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Profit for the financial year		**413**	450
Foreign exchange (losses)/gains		**(6)**	3
Tax credit/(charge) on foreign exchange losses		**1**	(2)
Movement in valuation of participating interests	18	**2**	(5)
Pension fund actuarial losses	10	**(160)**	(48)
UK deferred tax credit attributable to actuarial losses	10	**35**	10
Total recognised gains and losses relating to the year		**285**	408

Reconciliation of movement in shareholders' funds

	Notes	Share Capital £m	Share Premium £m	Profit and loss account £m	2012 £m	2011 £m
Shareholders' funds at 1 January		1,128	2,646	538	**4,312**	4,426
Shareholders' recognised gains		-	-	285	**285**	408
Interest on subordinated debt net of tax	21	-	-	(22)	**(22)**	(22)
Dividends	14	-	-	-	**-**	(500)
Shareholders' funds at 31 December		1,128	2,646	801	**4,575**	4,312

The notes on pages 12 to 49 form an integral part of these accounts

Registered Number: 00093792

Royal & Sun Alliance Insurance plc

Balance sheet
as at 31 December 2012

ASSETS	Notes	2012 £m	2011 £m
Intangible assets	15	**26**	17
Investments			
Land and buildings	16	**317**	342
Investments in group undertakings and participating interests			
Investment in subsidiary undertakings	17	**10,676**	10,733
Interests in associated undertakings	18	**14**	11
		10,690	10,744
Other financial investments			
Shares and other variable yield securities and units in unit trusts		**402**	689
Debt securities and other fixed income securities		**3,375**	2,940
Loans and deposits with credit institutions		**76**	39
	16	**3,853**	3,668
Deposits with ceding undertakings		**2**	1
Total investments		**14,862**	14,755
Reinsurers' share of technical provisions			
Provision for unearned premiums		**164**	151
Claims outstanding		**810**	867
		974	1,018
Debtors			
Debtors arising out of direct insurance operations - policyholders		**349**	258
Debtors arising out of direct insurance operations - intermediaries		**1,310**	1,280
Debtors arising out of reinsurance operations		**546**	86
Amounts owed by group undertakings		**1,467**	1,328
Deferred taxation	25	**186**	166
Other debtors, including taxation	13	**230**	207
		4,088	3,325
Other assets			
Tangible assets	19	**141**	164
Cash at bank and in hand		**222**	173
		363	337
Prepayments and accrued income			
Accrued interest and rent		**55**	49
Deferred acquisition costs		**430**	408
Other prepayments and accrued income		**80**	134
		565	591
		20,878	20,043
Pension fund asset	10	**29**	21
Total assets		**20,907**	20,064

The notes on page 12 to 49 form an integral part of these accounts

Registered Number: 00093792

Royal & Sun Alliance Insurance plc

Balance sheet (continued)

as at 31 December 2012

LIABILITIES	Notes	2012 £m	2011 £m
Capital and reserves			
Called up share capital	20	**1,128**	1,128
Share premium account		**2,646**	2,646
Profit and loss account		**801**	538
Shareholders' funds		**4,575**	4,312
Other capital instruments			
Subordinated loan note equity instruments	21	**372**	372
Funds attributable to equity holders		**4,947**	4,684
Subordinated liabilities	21	**492**	492
Technical provisions			
Provision for unearned premiums		**2,286**	2,070
Claims outstanding	22	**4,804**	4,542
Equalisation provision	23	**316**	286
		7,406	6,898
Provisions for other risks	24	**95**	93
Deposits received from reinsurers		**3**	7
Creditors			
Creditors arising out of direct insurance operations		**123**	122
Creditors arising out of reinsurance operations		**154**	156
Amounts owed to credit institutions	26	**348**	388
Amounts owed to group undertakings		**6,896**	6,846
Other creditors including taxation and social security	27	**129**	144
		7,650	7,656
Accruals and deferred income		**171**	147
		20,764	19,977
Pension fund liability	10	**143**	87
Total liabilities		**20,907**	20,064

The notes on pages 12 to 49 form an integral part of these accounts

The financial statements were approved by the Board of Directors on 19 February 2013 and are signed on its behalf by

Simon Lee.

S P G Lee

Director

R D Houghton

Director

1. Accounting Policies

Basis of preparation

The financial statements are prepared in accordance with applicable UK accounting standards and in compliance the Companies Act 2006, including schedule 3 of the accounting regulations issued under the Act and the Statement of Recommended Practice (SORP) on Accounting for Insurance Business issued by the Association of British Insurers in December 2005 (as amended in December 2006), having regard to the statutory requirement for insurance companies to maintain equalisation provisions As noted in the investment accounting policy the true and fair override has been adopted in respect of the valuation of the Company's investment properties and no depreciation is provided The Company has taken advantage of the exemption under Section 400 of the Companies Act 2006 from the requirement to prepare consolidated financial statements as it is a wholly-owned subsidiary of RSA Insurance Group plc, which prepares group accounts The financial statements have been prepared under the current value rules, as permitted by Schedule 3 of the Companies Act 2006, on the going concern basis

In considering the appropriateness of the going concern basis the Board has reviewed the Company's ongoing financial commitments for the next twelve months and beyond The Board's review included consideration of the Company's underwriting plans, strong regulatory capital surplus, diverse insurance risk profile, considerable undrawn financing facilities and highly liquid investment portfolio As a result of this review the directors have satisfied themselves that it is appropriate to prepare these financial statements on a going concern basis

a) Insurance Contracts – product classification

Insurance contracts are those contracts that transfer significant insurance risk at the inception of the contract Insurance risk is transferred when the Company agrees to compensate a policyholder if a specified uncertain future event (other than a change in a financial variable) adversely affects the policyholder Any contracts not meeting the definition of an insurance contract are classified as investment contracts or derivative contracts, as appropriate

b) General insurance business

i. Underwriting result

The underwriting result, being the balance on the technical account before change in equalisation provisions, is accounted for on an annual basis whereby the incurred cost of claims, commission and related expenses are charged against the earned proportion of premiums, net of reinsurance Premiums written are accounted for in the year in which the contract is entered into and include estimates where the amounts are not determined at the balance sheet date Premiums written exclude taxes and duties levied on premiums and directly related expenses, e g commissions Premiums are earned as revenue over the period of the contract and are calculated principally on a daily pro-rata basis Commission and other acquisition costs incurred in writing the business are deferred and amortised over the period in which the related premiums are earned

Claims paid represents all payments made during the period whether arising from events during that or earlier periods

The balance on the General Business Technical Account is arrived at after taking account of changes in the equalisation provision

ii. Technical provisions

The provision for unearned premiums represents the proportion of premiums written relating to periods of insurance coverage subsequent to the balance sheet date after deduction of related acquisition costs

Acquisition costs comprise the direct and indirect costs of obtaining and processing new insurance business Deferred acquisition costs are amortised on the same basis as the related premiums earned

The provision for claims outstanding, whether reported or not, comprises the estimated cost of claims incurred but not settled at the balance sheet date It includes related expenses and a deduction for the expected value of salvage and other recoveries The provision is determined using the best information available of claims settlement patterns, forecast inflation and settlement of claims The provision for claims outstanding relating to long term permanent disability claims is also determined using recognised actuarial methods

1. Accounting Policies (continued)

ii. Technical provisions (continued)

Provisions for claims outstanding, and related reinsurance recoveries are discounted where there is a particularly long period from incident to claims settlement and where there exists a suitable claims payment pattern from which to calculate the discount In defining those claims with a long period from incident to claims settlement, those categories of claims where the average period of settlement is six years or more from the balance sheet date, has been used as a guide The discount rate used is based upon an investment return expected to be earned by assets, which are appropriate in magnitude and nature to cover the provisions for claims outstanding being discounted during the period necessary for the payment of such claims

Differences between the estimated cost and subsequent settlement of claims are dealt with in the technical account for the year in which the claims are settled or in which the provisions for claims outstanding are re-estimated

At each balance sheet date an assessment is made of whether the provisions for unearned premiums are adequate A separate provision is made, based on information available at the balance sheet date, for any estimated future underwriting losses relating to unexpired risks The provision is calculated after taking into account future investment income that is expected to be earned from the assets backing the provisions for unearned premiums (net of deferred acquisition costs) The unexpired risk provision is assessed in aggregate for business classes which, in the opinion of the directors, are managed together

Equalisation provisions are established in accordance with the Financial Services Authority s rules for insurers in the UK These provisions, notwithstanding that they do not represent liabilities at the balance sheet date as they are over and above the anticipated ultimate cost of outstanding claims, are required by Schedule 3 to the Companies Act 2006 to be included within technical provisions in the balance sheet and any change in the provisions during the year is required to be shown in the General Business Technical Account

iii Reinsurance ceded

Premiums payable in respect of reinsurance ceded are recognised in the period in which the reinsurance contract is entered into and include estimates where the amounts are not determined at the balance sheet date Premiums are expensed over the period of the reinsurance contract, calculated principally on a daily pro-rata basis

A reinsurance asset (reinsurers' share of insurance contract liabilities) is recognised to reflect the amount estimated to be recoverable under the reinsurance contracts in respect of the provisions for outstanding claims reported under insurance contract liabilities The amount recoverable from reinsurers is initially valued on the same basis as the underlying provisions for outstanding claims The amount recoverable is reduced when there is an event arising after the initial recognition that provides objective evidence that the Company may not receive all amounts due under the reinsurance contract and the event has a reliably measurable impact on the expected amount that will be recovered from the reinsurer

The reinsurers share of each unexpired risk provision is recognised on the same basis

Annuities purchased by the Company to make payments under structured settlement arrangements are accounted for as reinsurance ceded if the Company remains liable for the settlement in the event of default by the annuity provider Any gain or loss arising on the purchase of an annuity is recognised in the technical account at the date of purchase

c) Translation of foreign currencies

Monetary assets and liabilities denominated in foreign currencies are translated into sterling at rates ruling at the balance sheet date Differences arising on retranslation are included within the profit and loss account Transactions denominated in foreign currencies are translated into sterling using the cumulative average rate for the financial year The resulting exchange differences are included within the profit and loss account Non monetary items are translated at the rate of exchange at the date of the transaction, and are not subsequently retranslated

The results of overseas operations are translated at the average rates for the period and their balance sheets at the rates ruling at the balance sheet date The resulting exchange differences are taken to reserves

d) Investment return

Investment return is recognised in the Non-Technical Account and comprises all investment income, realised investment gains and losses and movements in unrealised gains and losses, net of investment expenses Dividends on equity investments are recognised on the date at which the investment is priced 'ex dividend' Interest income is recognised using the effective interest rate method

1. Accounting Policies (continued)

d) Investment return (continued)

Realised gains and losses on investments are calculated as the difference between net sales proceeds and purchase price

Movements in unrealised gains and losses on investments represent the difference between their carrying value at the balance sheet date and their purchase price or their carrying value at the last balance sheet date, together with the reversal of unrealised gains and losses recognised in earlier accounting periods in respect of investment disposals in the current period

e) Pension costs

Retirement Benefits

A defined contribution scheme is a pension scheme under which the Company pays fixed contributions into a separate entity A defined benefit scheme is a pension scheme that defines an amount of pension benefit that an employee will receive on retirement, usually dependent on one or more factors such as age, years of service and level of salary

Contributions to defined contribution pension schemes are charged in the period in which the employment services qualifying for the benefit are provided Differences between contributions payable in the year and contributions actually paid are shown as either prepayments or accruals in the balance sheet

The amounts charged (or credited where relevant) in the Profit and Loss Account relating to post retirement benefits in respect of defined benefit schemes are as follows

- the current service cost,
- the past service costs for additional benefits granted in the current or earlier periods,
- the interest cost for the period,
- the impact of any curtailments or settlements during the period, and
- the expected return on scheme assets (where relevant)

The current service cost in respect of defined benefit schemes comprises the present value of the additional benefits attributable to employees' services provided during the period

The present value of defined benefit obligations and the present values of additional benefits accruing during the period are calculated, using the Projected Unit Method

Past service costs arise where additional benefits are granted The cost of providing additional benefits is recognised on a straight line basis over the remaining period of service until such benefits vest The cost of providing additional benefits that vest on their introduction are recognised immediately

The calculation of the present value of accrued benefits includes an actuarial assumption of future interest rates, which is used to discount the expected ultimate cost of providing the benefits The discount rate is determined at each Balance Sheet date by reference to current market yields on high quality corporate bonds identified to match the currency and estimated term of the obligations The interest cost for the period is calculated by multiplying the discount rate determined at the start of the period by the defined benefit obligations during the period

The change in the present value of the defined benefit obligation and the changes in the fair value of scheme assets resulting from any curtailments and settlements of scheme liabilities during the period are recognised in the Profit and Loss Account Additionally, any previously unrecognised past service costs related to these liabilities are recognised in the gains or losses on settlement and curtailment

The expected return on scheme assets for the period is calculated, based upon the average rate of return (including both income and changes in fair value), net of scheme expenses, expected over the remaining life of the related obligation on the actual assets held by the scheme

Actuarial gains and losses arise from changes to actuarial assumptions when revaluing future benefits, and from actual experience in respect of scheme liabilities and investment performance of scheme assets being different from previous assumptions Actuarial gains and losses are recognised in the Statement of Total Recognised Gains and Losses

1. Accounting Policies (continued)

e) Pension costs (continued)

The value recognised in the Balance Sheet for each individual post retirement scheme, is calculated as follows

- the fair value at the Balance Sheet date of the scheme assets out of which the obligations are to be settled directly,
- minus the present value of defined benefit obligation of the scheme at the balance sheet date,
- minus any past service cost not yet recognised, and
- plus or minus the deferred tax liability or asset respectively relating to the defined benefit asset or liability

Termination benefits

Termination benefits are payable when employment is terminated before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits The Company recognises termination benefits when it is demonstrably committed to either terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal, or providing termination benefits as a result of an offer made to encourage voluntary redundancy Benefits falling due more than twelve months after the Balance Sheet date are discounted to present value

f) Share based payment

The value of the employee share options and other equity settled share based payments is calculated at fair value at the grant date using appropriate and recognised option pricing models The value of liabilities in respect of cash settled share based payment transactions are based upon the fair value of the awards at the balance sheet date

Vesting conditions, other than those based upon market conditions, are not taken into account when estimating the fair value of such awards but are taken into account by adjusting the number of equity instruments included in the ultimate measurement of the transaction amount The value of the awards is recognised as an expense on a systematic basis over the period during which the employment services are provided

g) Taxation

Current tax, based on profits and income for the year, including UK corporation tax and foreign tax, is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date

Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transactions or events that result in an obligation to pay more tax in the future or a right to pay less tax in the future have occurred at the balance sheet date Timing differences are differences between the Company's taxable profits and its results as stated in the financial statements that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognised in the financial statements

A net deferred tax asset is regarded as recoverable and therefore recognised only to the extent that, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted A deferred tax asset is recognised for relief for trading losses or other losses only to the extent that the directors anticipate that suitable profits will absorb such losses in the future

Deferred tax is not recognised when fixed assets are revalued unless by the balance sheet date there is a binding agreement to sell the revalued assets and the gain or loss expected to arise on sale has been recognised in the financial statements Neither is deferred tax recognised when fixed assets are sold and it is more likely than not that the taxable gain will be rolled over, being charged to tax only if and when the replacement assets are sold

Deferred tax is recognised in respect of the retained earnings of overseas subsidiaries and associates only to the extent that, at the balance sheet date, dividends have been accrued as receivable or a binding agreement to distribute past earnings in future has been entered into by the subsidiary or associate

Deferred tax is measured at the tax rates that are expected to apply in the periods in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date Deferred tax is measured on a non-discounted basis

1. Accounting Policies (continued)

h) Operating leases

Payments made under operating leases are charged on a straight-line basis over the term of the lease

i) Goodwill and other intangible assets

Goodwill, being the difference between the cost of an unincorporated business acquisition and the Company's interest in the net fair value of the identifiable assets and liabilities acquired, is initially capitalised in the balance sheet at cost and is subsequently recognised at cost less accumulated amortisation and any impairment losses The cost of the acquisition is the amount of cash paid and the fair value of other purchase consideration given together with directly related expenses Goodwill is regarded as having a limited useful life that does not exceed twenty years and is amortised on a straight-line basis over its useful life

Goodwill is subject to an impairment review at the end of the first full financial year following the initial recognition of the goodwill and, in other periods, if events or changes in circumstances indicate that its carrying value may not be recoverable in full Where the review reveals that the carrying amount is more than the recoverable amount, an impairment is recognised

Other intangible assets comprise renewal rights These assets are carried at cost less accumulated amortisation Amortisation on renewal rights is calculated using the straight line method to allocate the cost over the estimated useful life, which is normally estimated to be between 3 and 12 years

j) Investment property

Investment properties are shown at market value and are valued annually by independent professionally qualified valuers at open market value Unrealised gains and losses are recognised in the Non-Technical Account

The Companies Act requires properties to be depreciated over their expected useful economic lives The directors consider that depreciation of investment properties would not give a true and fair view In accordance with Statement of Standard Accounting Practice 19 'Accounting for Investment Properties', no depreciation is provided on these properties on the basis that depreciation is already reflected in the annual valuations The amounts attributed to this factor by the valuers cannot reasonably be separately identified or quantified

It is the Company's practice to maintain properties occupied by the Company in a continual state of sound repair Accordingly the directors consider that the economic lives of these properties and their residual values, based on prices prevailing at the time of acquisition or subsequent valuation, are such that any depreciation is insignificant and is thus not provided

k) Investments in subsidiaries

Investments in subsidiaries are valued at net asset value Reductions in the carrying value of investments in subsidiaries below historic cost and reversals of such reductions are taken to the profit and loss account Other differences between net asset values and book values of investments in subsidiaries are taken to the revaluation reserve

l) Interests in associates

Associates are entities over which the Company has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights Investments in associates are accounted as investments in participating interests and are carried in the balance sheet at a directors' valuation (based upon the Company's share of the net current assets of the associate) Changes in the valuation of associates are recognised in the Statement of Total Recognised Gains and Losses Dividends from associates are accounted for as income in the period in which the Company becomes entitled to receive the dividend

m) Financial assets.

A financial asset is initially recognised, on the date the Company commits to purchase the asset, at fair value plus transaction costs that are directly attributable to its acquisition A financial asset is derecognised when the rights to receive cashflows from the investment have expired or have been transferred and the Company has also transferred substantially the risks and rewards of ownership of the asset

1. Accounting Policies (continued)

m) Financial assets (continued)

Where the following conditions are satisfied, financial assets (other than derivatives and originated loans and receivables) are designated upon initial recognition as at fair value through profit or loss The conditions are that the performance of the assets is evaluated on a total return basis (including the changes in fair values) in accordance with a documented investment strategy and information is provided internally to the Company's key management personnel on this basis

On subsequent measurement, investments are measured at fair value with changes in fair value recognised in the Non-Technical Account Originated loans and receivables are measured at amortised cost

n) Estimation of the fair value of financial assets and liabilities other than investments in subsidiaries

The methods and assumptions used by the Company in estimating the fair value of financial assets and liabilities are

- for fixed maturity securities, fair values are generally based upon quoted market prices Where market prices are not readily available, fair values are estimated using either values obtained from quoted market prices of comparable securities or estimated by discounting expected future cash flows using a current market rate applicable to the yield, credit quality and maturity of the investment,
- for equity securities fair values are based upon quoted market prices,
- if the market for a financial asset is not active, the Company establishes fair value by using valuation techniques These include the use of recent arm s length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis and option pricing models,
- for mortgage loans on real estate and collateral loans, fair values are estimated using discounted cash flow calculations based upon prevailing market rates,
- for cash, short- term investments, commercial paper, other assets, liabilities and accruals carrying amounts approximate to fair value
- for notes bonds and loans payable, fair values are determined by reference to quoted market prices or estimated using discounted cash flow calculations based upon prevailing market rates Loan capital is carried at amortised cost and when this is different from fair value this is shown in the relevant note Fair value in this case is based on discounted future cash flows For borrowings that carry a variable rate of interest (other than loan capital), carrying values approximate to fair values, and
- for derivatives, fair values are generally based upon quoted market prices

o) Derivatives

Derivatives are recognised in the Balance sheet on a trade date basis and are carried at fair value Derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative All gains and losses arising are taken to the Non-technical account The Company does not hold or issue derivative financial instruments for speculative purposes

p) Tangible assets

Tangible assets comprise equipment and computer software These assets are stated in the balance sheet at cost less accumulated depreciation and any impairment losses Depreciation is calculated to write off the cost less the estimated residual value of the tangible fixed assets on a straight line basis over their expected useful lives as follows equipment 3 to 10 years and computer software 3 to 5 years

q) Subordinated loans

Subordinated loans are classified according to their contractual terms

Subordinated loans are classified as a separate class of capital when the terms of the loan contain no obligation on the Company to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the Company and contain no provision to settle the loan through the issue of equity instruments of the Company Interest paid on such subordinated loans is not recognised in the profit and loss account and is deducted from the profit and loss reserve when paid

Subordinated loans are classified as liabilities when the conditions above are not met Interest costs on such subordinated loans are calculated using the effective interest method and are recognised in the Non-technical account

2. Estimation Techniques, Risks, Uncertainties and Contingencies

Introduction

One of the purposes of insurance is to enable policyholders to protect themselves against uncertain future events Insurance companies accept the transfer of uncertainty from policyholders and seek to add value through the aggregation and management of these risks

The uncertainty inherent in insurance is inevitably reflected in the financial statements of insurance companies The uncertainty in the financial statements principally arises in respect of the insurance contract liabilities of the company

The insurance contract liabilities of an insurance company include the provision for unearned premiums and unexpired risks and the provision for outstanding claims Unearned premiums and unexpired risks represent the amount of income set aside by the company to cover the cost of claims that may arise during the unexpired period of risk of insurance policies in force at the end of the reporting period Outstanding claims represent the company's estimate of the cost of settlement of claims that have occurred by the end of the reporting period but have not yet been finally settled

In addition to the inherent uncertainty of having to make provision for future events, there is also considerable uncertainty as regards the eventual outcome of the claims that have occurred by the end of the reporting period but remain unsettled This includes claims that may have occurred but have not yet been notified to the company and those that are not yet apparent to the insured

As a consequence of this uncertainty, the insurance company needs to apply sophisticated estimation techniques to determine the appropriate provisions

Estimation techniques

Claims and unexpired risks provisions are determined based upon previous claims experience, knowledge of events and the terms and conditions of the relevant policies and on interpretation of circumstances Particularly relevant is experience with similar cases and historical claims payment trends The approach also includes the consideration of the development of loss payment trends, the potential longer term significance of large events, the levels of unpaid claims, legislative changes, judicial decisions and economic, political and regulatory conditions

Where possible the Company adopts multiple techniques to estimate the required level of provisions This assists in giving greater understanding of the trends inherent in the data being projected The Company's estimates of losses and loss expenses are reached after a review of several commonly accepted actuarial projection methodologies and a number of different bases to determine these provisions These include methods based upon the following

- the development of previously settled claims, where payments to date are extrapolated for each prior year,
- estimates based upon a projection of claims numbers and average cost,
- notified claims development, where notified claims to date for each year are extrapolated based upon observed development of earlier years, and
- expected loss ratios

In addition, the Company uses other methods such as the Bornhuetter-Ferguson method, which combines features of the above methods The Company also uses bespoke methods for specialist classes of business In selecting its best estimate, the Company considers the appropriateness of the methods and bases to the individual circumstances of the provision class and underwriting year The process is designed to select the most appropriate best estimate

Large claims impacting each relevant business class are generally assessed separately, being measured either at the face value of the loss adjusters' estimates or projected separately in order to allow for the future development of large claims

Provisions are calculated gross of any reinsurance recoveries A separate estimate is made of the amounts that will be recoverable from reinsurers based upon the gross provisions and having due regard to collectability

The claims provisions are subject to close scrutiny both within the Company's business units and at Group Corporate Centre In addition, for major classes where the risks and uncertainties inherent in the provisions are greatest, regular and ad hoc detailed reviews are undertaken by advisers who are able to draw upon their specialist expertise and a broader knowledge of current industry trends in claims development As an example, the Company's exposure to asbestos and environmental pollution is examined on this basis The results of these reviews are considered when establishing the appropriate levels of provisions for outstanding claims and unexpired periods of risk

2. Estimation Techniques, Risks, Uncertainties and Contingencies (continued)

Estimation techniques (continued)

It should be emphasised that the estimation techniques for the determination of insurance contract liabilities involve obtaining corroborative evidence from as wide a range of sources as possible and combining these to form the overall estimate This technique means that the estimate is inevitably deterministic rather than stochastic

The pension assets and pension and post retirement liabilities are calculated in accordance with Financial Reporting Standard 17 (FRS 17) The assets, liabilities and profit & loss account charge, calculated in accordance with FRS 17, are sensitive to the assumptions made from time to time, including inflation, interest rate, investment return and mortality FRS 17 compares, at a given date, the current market value of a pension fund's assets with its long term liabilities which are calculated using a discount rate in line with yields on 'AA' rated bonds of suitable duration and currency As such, the financial position of a pension fund on this basis is highly sensitive to changes in bond rates and will also be impacted by changes in equity markets

Uncertainties and contingencies

The uncertainty arising under insurance contracts may be characterised under a number of specific headings, such as

- uncertainty as to whether an event has occurred which would give rise to a policyholder suffering an insured loss,
- uncertainty as to the extent of policy coverage and limits applicable,
- uncertainty as to the amount of insured loss suffered by a policyholder as a result of the event occurring, and
- uncertainty over the timing of a settlement to a policyholder for a loss suffered

The degree of uncertainty will vary by policy class according to the characteristics of the insured risks and the cost of a claim will be determined by the actual loss suffered by the policyholder

There may be significant reporting lags between the occurrence of the insured event and the time it is actually reported to the Company Following the identification and notification of an insured loss, there may still be uncertainty as to the magnitude and timing of the settlement of the claim There are many factors that will determine the level of uncertainty such as inflation, inconsistent judicial interpretations and court judgments that broaden policy coverage beyond the intent of the original insurance, legislative changes and claims handling procedures

The establishment of insurance contract liabilities is an inherently uncertain process and, as a consequence of this uncertainty, the eventual cost of settlement of outstanding claims and unexpired risks can vary substantially from the initial estimates, particularly for the Company's long tail lines of business The Company seeks to provide appropriate levels of claims provision and provision for unexpired risks taking the known facts and experience into account

The Company has exposures to risks in each class of business within each operating segment that may develop and that could have a material impact upon the Company's financial position The geographic and insurance risk diversity within the Company's portfolio of issued insurance policies mean it is not possible to predict whether material development will occur and, if it does occur, the location and the timing of such an occurrence The estimation of insurance contract liabilities involves the use of judgments and assumptions that are specific to the insurance risks within each territory and the particular type of insurance risk covered The diversity of the insurance risks results in it not being possible to identify individual judgments and assumptions that are more likely than others to have a material impact on the future development of the insurance contract liabilities

The sections below identify a number of specific risks relating to asbestos and environmental claims There may be other classes of risk which could develop in the future and that could have a material impact on the Company's financial position

The Company evaluates the concentration of exposures to individual and cumulative insurance risk and establishes its reinsurance policy to reduce such exposure to levels acceptable to the Company

Asbestos and environmental claims

The estimation of the provisions for the ultimate cost of claims for asbestos and environmental pollution is subject to a range of uncertainties that is generally greater than those encountered for other classes of insurance business As a result it is not possible to determine the future development of asbestos and environmental claims with the same degree of reliability as with other types of claims, particularly in periods when theories of law are in flux Consequently, traditional techniques for estimating claims provisions cannot wholly be relied upon and the Company employs specialised techniques to determine provisions using the extensive knowledge of both internal asbestos and environmental pollution experts and external legal and professional advisors

2. Estimation Techniques, Risks, Uncertainties and Contingencies (continued)

Asbestos and environmental claims (continued)

Factors contributing to this higher degree of uncertainty include

- the long delay in reporting claims from the date of exposure (for example cases of mesothelioma can have a latent period of up to 40 years) This makes estimating the ultimate number of claims the Company will receive particularly difficult,
- issues of allocation of responsibility among potentially responsible parties and insurers,
- emerging court decisions and the possibility of retrospective legislative changes increasing or decreasing insurer liability,
- the tendency for social trends and factors to influence court awards,
- developments pertaining to the Company's ability to recover reinsurance for claims of this nature, and
- for US liabilities from the Company's London market business, developments in the tactics of US plaintiff lawyers and court decisions and awards

Potential change in discount rate for lump sum damages awards

Legislative changes may affect the Company s liability in respect of unsettled claims in the use of predetermined factors used by courts to calculate compensation claims For example, in the UK, standard formulae are used as an actuarial measure by the courts to assess lump sum damages awards for future losses (typically loss of earnings arising from personal injuries and fatal accidents) The calibration of these standard formulae can be updated by the UK Government and the Lord Chancellor may review the methodology to be applied in determining the discount rate to calculate the appropriate settlements, or the discount rate itself, in due course A reduction in the prescribed discount rate would increase the value of future claims settlements

Acquisitions and disposals

The Company makes acquisitions and disposals of businesses as part of its normal operations All acquisitions are made after due diligence, which will include, amongst other matters, assessment of the adequacy of claims reserves, assessment of the recoverability of reinsurance balances, inquiries with regard to outstanding litigation and inquiries of local regulators and taxation authorities Consideration is also given to potential costs, risks and issues in relation to the integration of any proposed acquisitions with existing RSA operations The Company will seek to receive the benefit of appropriate contractual representations and warranties in connection with any acquisition and, where necessary, additional indemnifications in relation to specific risks although there can be no guarantee that these processes and any such protection will be adequate in all circumstances The Company may also provide relevant representations, warranties and indemnities to counterparties on any disposal While such representations, warranties and indemnities are essential components of many contractual relationships, they do not represent the underlying purpose for the transaction

These clauses are customary in such contracts and may from time to time lead to the Company receiving claims from counterparties

Contracts with third parties

The Company enters into joint ventures, outsourcing contracts and distribution arrangements with third parties in the normal course of its business and is reliant upon those third parties being willing and able to perform their obligations in accordance with the terms and conditions of the contracts

Litigation, disputes and investigations

The Company, in common with the insurance industry in general, is subject to litigation, mediation and arbitration, and regulatory, governmental and other sectoral inquiries and investigations in the normal course of its business The directors do not believe that any current mediation, arbitration, regulatory, governmental or sectoral inquiries and investigations and pending or threatened litigation or dispute will have a material adverse effect on the Company's financial position, although there can be no assurance that losses or financial penalties resulting from any current mediation, arbitration, regulatory, governmental or sectoral inquiries and investigations and pending or threatened litigation or dispute will not materially affect the Company's financial position or cash flows for any period

2. Estimation Techniques, Risks, Uncertainties and Contingencies (continued)

Reinsurance

The Company is exposed to disputes on, and defects in, contracts with its reinsurers and the possibility of default by its reinsurers The Company is also exposed to the credit risk assumed in fronting arrangements and to potential reinsurance capacity constraints In selecting the reinsurers with whom the Company conducts business, its strategy is to seek reinsurers with the best combination of financial strength, price and capacity The Group Corporate Centre publishes internally a list of authorised reinsurers who pass the Group's selection process and which its operations may use for new transactions

The Company monitors the financial strength of its reinsurers, including those to whom risks are no longer ceded Allowance is made in the financial position for non recoverability due to reinsurer default by providing, in line with Group standards, having regard to companies on the Group's 'Watch List' The 'Watch List' is the list of companies whom the Group's directors believe will not be able to pay amounts due in full

Investment risk

The Company is exposed to market risk and credit risk on its invested assets Market risk includes the risk of potential losses from adverse movements in market rates and prices including interest rates, equity prices, property prices and foreign exchange rates The Company's exposure to market risks is controlled by the setting of investment limits in line with the Group's risk appetite From time to time the Company also makes use of derivative financial instruments to reduce exposure to adverse fluctuations in foreign exchange rates and equity markets The Company has strict controls over the use of derivative instruments

Credit risk includes the non performance of contractual payment obligations on invested assets and adverse changes in the credit worthiness of invested assets including exposures to issuers or counterparties for bonds, equities, deposits and derivatives Limits are set at both a portfolio and counterparty level based on likelihood of default to manage the Group's overall credit profile and specific concentrations within risk appetite The Company's insurance investment portfolios are concentrated in listed securities with very low levels of exposure to assets without quoted market prices The Company uses model based analysis to verify asset values when market values are not readily available

The current economic crisis adds further uncertainty and volatility to underlying levels of market and credit risk in the Eurozone The Company has, however, very limited direct exposure via its investment portfolio to the Eurozone and to the peripheral Eurozone countries in particular As with all other invested assets, limits are set in line with the Group's risk appetite The Company continues to monitor the situation closely and take action to manage its exposure as required

Rating environment

The ability of the Company to write certain types of insurance business is dependent on the maintenance of the appropriate credit ratings from the rating agencies The RSA Insurance Group has the objective of maintaining single 'A' ratings At the present time the ratings are 'A+' (negative outlook) from S&P and 'A2' (stable outlook) from Moody's Any worsening in the ratings could have an adverse impact on the ability of the RSA Insurance Group and the Company to write certain types of general insurance business

In assessing credit risk in relation to reinsurance and investments, the RSA Insurance Group takes into account a variety of factors, including credit rating If any such rating changes, or is otherwise reassessed, this has potential implications for the related exposures

Foreign exchange risk

The Company publishes financial statements in Pounds Sterling Therefore, fluctuations in exchange rates used to translate other currencies, particularly other European currencies and the Canadian dollar, into Pounds Sterling will impact the reported financial position, results of operations and cash flows from period to period These fluctuations in exchange rates will also impact the Pound Sterling value of and the return on the Company's investments

Income and expenses for each profit & loss account item are translated at average exchange rates Assets and liabilities, as reported in the balance sheet, are translated at closing exchange rates at the end of the reporting period

2. Estimation Techniques, Risks, Uncertainties and Contingencies (continued)

Regulatory environment

The legal, regulatory and accounting environment is subject to significant change in many of the jurisdictions in which the Company operates, including developments in response to changes in the economic and political environment and the recent financial crisis The Company continues to monitor the developments and react accordingly

The new solvency framework for insurers being developed by the EU, referred to as 'Solvency II', is intended in the medium term to achieve greater harmonisation of approach across EU member states to assessing capital resources and requirements There remains continued uncertainty as delays in agreeing the rules have caused the planned implementation date of 2014 to be delayed The Company is actively participating in shaping the outcome through its involvement with European and UK regulators and industry bodies, whilst appropriately progressing its implementation plans and the directors are confident that the Company will continue to meet all future regulatory capital requirements

3. Risk Management

Introduction

RSA Insurance Group plc (the Group), of which the Company is an important part, is managed along divisional lines The Company transacts the majority of the Group's UK business The directors of the Company have considered whether the Group approach to strategy, risk management, performance review and custody of assets fully meets the needs of the Company as a separate regulated entity They have concluded that it does The following discussion sets out the approach of the Group, and hence of the Company, to risk management

Risk Management

As an insurance company, the Company is fundamentally concerned with the management of risks This note summarises the key risks to the Group, and hence the Company, and the steps taken to manage them

The Group's Board of Directors defines the risk appetite of the organisation The Group employs a comprehensive Risk Management System to identify, measure, manage, monitor and report the risks arising as a result of operating the business The Risk Management System includes a comprehensive suite of risk policies, procedures, measurement, reporting and monitoring techniques and a series of stress tests and scenario analyses to ensure that the Group's risk exposures are managed appropriately

The Group is exposed to financial risk through its financial assets, financial liabilities (borrowings), reinsurance assets and insurance contract liabilities In particular the key financial risk is that the proceeds from the realisation of its financial assets are not sufficient to fund the obligations arising from its insurance contracts

The Group manages its financial assets within a framework that has been developed to seek to ensure the ability to meet its obligations under insurance contracts A key principle behind this process is to hold assets of sufficient credit quality and currency that provide a broad match against the liabilities arising from insurance contracts

The components of insurance, reinsurance, operational, credit, market and liquidity risk management are addressed below

Insurance risk

The Company's insurance activities are primarily concerned with the pricing, acceptance and management of risks from its customers In accepting risks the Company is committing to the payment of claims and therefore these risks must be understood and controlled Disciplined underwriting, encompassing risk assessment, risk management, pricing and exposure control is critical to the Company's success

3. Risk Management (continued)

Underwriting and claims risks

The Company manages these risks through its underwriting strategy, adequate reinsurance arrangements and proactive claims handling The underwriting strategy aims to ensure that the underwritten risks are well diversified in terms of type and amount of risk, industry and geography

Pricing for the Company's products is generally based upon historical claims frequencies and claims severity averages, adjusted for inflation and modelled catastrophes trended forward to recognise anticipated changes in claims patterns While claims remain the Company's principal cost, the Company also makes allowance in the pricing procedures for acquisition expenses, administration expenses, investment income, the cost of reinsurance and for a profit loading that adequately covers the cost of the capital the Company exposes to risk

Underwriting limits are in place to enforce appropriate risk selection criteria For example, the Company has the right not to renew individual policies it can impose deductibles and it has the right to reject the payment of a fraudulent claim In certain territories, legislation imposes a minimum amount for which employers can be liable for claims for compensation from employees injured at work These liabilities are usually insured under an employers' liability (or similar) insurance policy All policies issued by the Company comply with minimum statutory requirements

All of the Company's underwriters have specific licences that set clear parameters for the business they can underwrite, based on the experience of the individual underwriter Additionally, the Group has a centrally managed forum looking at Group underwriting issues, reviewing and agreeing underwriting direction and setting policy and directives where appropriate The Group has a quarterly portfolio management process across all its business units, which provides a consistent assessment of each portfolio performance against a set of key performance indicators Under the portfolio management system, key risk indicators are tracked to monitor emerging trends, opportunities and risks and, on an annual basis, a review forum of business and underwriting leaders undertake a detailed review of each portfolio utilising data from the quarterly reviews

The Company has developed enhanced methods of recording exposures and concentrations of risk This means that there is greater control of exposures in high risk areas and enables a prompt response to claims from policyholders should there be a catastrophic event such as an earthquake

Reinsurance arrangements in place include proportional, excess of loss, stop loss and catastrophe coverage The effect of such reinsurance arrangements is that the Group should not suffer total net insurance losses beyond the Group's risk appetite in any one year

Reserves – an overview

The Company establishes loss reserves to account for the anticipated ultimate costs of all losses and related loss adjustment expenses (LAE) on losses that have already occurred The Company establishes reserves for reported losses and LAE, as well as for incurred but not yet reported (IBNR) losses and unallocated loss adjustment expenses (ULAE) Loss reserve estimates are based on known facts and on interpretation of circumstances including the Company's experience with similar cases and historical claims payment trends The Company also considers the development of loss payment trends, levels of unpaid claims, judicial decisions and economic conditions

The Company uses a variety of statistical techniques and a number of different bases to set reserves, depending on the business unit and line of business in question The Company's reserving managers consider claims developments separately for each line of business and subdivide certain lines of business by major claim types or sub classifications of business Large claims impacting each relevant account are also generally assessed separately, either being reserved at the face value of the loss adjusters estimates or projected separately in order to allow for the future development of large claims

The Group has a Group Reserving Committee consisting of the Group Chief Executive Officer, Chief Financial Officer, Group Underwriting and Claims Director, Group Chief Actuary and Group Chief Risk Officer A similar committee has been established in each of the Group's major operating segments The Group Reserving Committee monitors the decisions and judgements made by the business units as to the level of reserves recommended and makes the final decision on the reserves to be included within the financial statements ('Management Best Estimate') In making its judgement, the Group Reserving Committee's aim is that, over the longer term, reserves should be more likely to run off favourably than adversely However, there can be no assurance that reserves will not develop adversely and exceed the Management Best Estimate In making its judgement of the Management Best Estimate of reserves to include in the financial statements, the Group Reserving Committee adopts the following approach

3. Risk Management (continued)

Reserves – an overview (continued)

- The Company's actuaries provide an indication of ultimate losses together with an assessment of risks and possible favourable or adverse developments that may not have been fully reflected in calculating these indications At the end of 2012 these risks and developments include the possibility of future legislative change having retrospective effect on open claims, changes in claims settlement procedures potentially leading to future claims payment patterns differing from historical experience, the possibility of new types of claim, such as disease claims, emerging from business written several years ago, general uncertainty in the claims environment, the emergence of latent exposures such as asbestos, the outcome of litigation on claims received, failure to recover reinsurance and unanticipated changes in claims inflation

- Consideration is also made of the views of internal peer reviewers of the reserves and of other parties including actuaries, legal counsel, risk directors, underwriters and claims managers

- Consideration is made of how previous actuarial indications have developed

In forming its collective judgement, the Committee considers this information as a whole

Emerging and legal risks

These are risks that have been identified as potentially affecting the Group but are not able to be quantified Existing or potential future risk exposures are identified and investigated in a structured way, using internal and external resources, and actions to mitigate, contain or remove these risks are taken

In the ordinary course of its insurance activities, the Company is routinely involved in legal or arbitration proceedings with respect to liabilities, which are the subject of policy claims However, as insurance industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge These issues can have a negative effect on the Company's financial results by either extending coverage beyond its underwriting intent or by increasing the number and size of claims

In addition, to the extent that legal decisions in any of the jurisdictions in which the Group operates worldwide may increase court awards, and that the impact may be applied prospectively or retrospectively, claims reserves may prove insufficient to cover actual losses, LAE or future policy benefits In such an event, or where it has been previously estimated that no liability would apply, the Company would add to its reserves and incur a charge to earnings Such insufficiencies could have a material adverse effect on the Company's future financial position, financial results and cash flows

Reinsurance risk

The Company is exposed to both multiple insured losses and losses arising out of a single occurrence, for example a natural peril event such as a hurricane, flood or an earthquake

The ability of the business units in each territory to assess the aggregation risk of a single event impacting on thousands of policyholders is vital The Group employs proprietary exposure measurement systems to assess these risks In some markets, particularly in the UK, the Group has in addition developed its own expertise in catastrophe modelling that is used in conjunction with outside consultants The accurate estimation of the potential expected maximum loss for a catastrophe is critical and is the primary factor considered in designing the Group's catastrophe reinsurance programme

The expertise within the Group on catastrophe modelling is shared through the Worldwide Reinsurance Practice Group, which also provides an overview of the Groupwide catastrophe exposures and reinsurance adequacy A reinsurance programme is considered to be 'adequate' only if it covers possible events that could happen in at least 199 out of 200 years This is referred to as the '1 in 200 year expected maximum loss'

The Group uses financial analysis models to assess the risk and reward effects of different reinsurance structures and prices A strategic review was undertaken during 2012, the result of which is to improve the financial performance of the Group through rebalancing retention levels whilst continuing to protect capital and manage volatility

3. Risk Management (continued)

Reinsurance risk (continued)

All of the Group's operations are required to purchase reinsurance within agreed local reinsurance appetite parameters The Group Corporate Centre authorises the operations' proposed treaty purchases to check that they at least meet the Group's appetite, for example the '1 in 200 year' standard for catastrophe risk Group Corporate Centre also checks to see that total Group exposures are within the limits set out above and also are consistent with the required risk based capital In addition local facultative arrangements may be purchased where deemed appropriate

The Group remains primarily liable as the direct insurer on all risks reinsured, although the reinsurer is liable to the Group to the extent of the insurance risk ceded

Operational risk

Operational risk is the risk of direct or indirect losses resulting from human factors, external events and inadequate or failed internal processes and systems Operational risks are inherent in the Group's operations and are typical of any large enterprise Major sources of operational risk include operational process reliability, information security, outsourcing of operations, dependence on key suppliers, implementation of strategic and operational change, integration of acquisitions, fraud, human error, customer service quality, inadequacy of business continuity arrangements, recruitment, training and retention of staff, and social and environmental impacts

The Company manages operational risk using a range of techniques and tools to identify, monitor and mitigate its operational risk in accordance with Group's risk appetite These tools include Risk and Control Self Assessments, Key Risk Indicators (e g fraud and service indicators), Scenario Analyses and Loss Reporting In addition the Group has developed a number of contingency plans including Incident Management and Business Continuity Plans Quantitative analysis of operational risk exposures material to the Company is used to inform decisions on the overall amount of capital held and the adequacy of contingency arrangements

Credit risk

Credit risk is the risk of loss of value of the financial assets due to counterparties failing to meet all or part of their obligations The Board Risk Committee (BRC) is responsible for ensuring that the Board approved Group credit risk appetite is not exceeded This is done through the setting and imposition of Group policies, procedures and limits In defining its appetite for credit risk the Group looks at exposures at both an aggregate and business unit level distinguishing between credit risks incurred as a result of offsetting insurance risks or operating in the insurance market (e g reinsurance credit risks and risks to receiving premiums due from policyholders and intermediaries) and credit risks incurred for the purposes of generating a return (e g invested assets credit risk)

Limits are set at both a portfolio and counterparty level based on likelihood of default, derived from the rating of the counterparty, to ensure that the Group's overall credit profile and specific concentrations are managed and controlled within risk appetite Financial assets are graded according to company standards AAA is the highest possible rating Investment grade financial assets are classified within the range of AAA to BBB ratings For invested assets, restrictions are placed on each of the Group's investment managers as to the level of exposure to various rating categories including unrated securities

3. Risk Management (continued)

Credit risk (continued)

The following table provides information regarding the aggregated credit risk exposure for financial assets of the Company as at 31 December 2012

	Credit rating relating to financial assets that are neither past due nor impaired						Total of financial assets that are neither past due nor impaired
	AAA	AA	A	BBB	<BBB	Not rated	
	£m	£m	£m	£m	£m	£m	£m
Debt securities	**1,345**	**521**	**1,246**	**209**	**39**	**15**	**3,375**
Other financial assets	**1**	**-**	**-**	**-**	**-**	**14**	**15**
Short term investments	**-**	**36**	**24**	**-**	**-**	**3**	**63**
Reinsurance assets	**97**	**236**	**404**	**149**	**36**	**48**	**970**
Insurance and reinsurance debtors (1)	**49**	**10**	**1,094**	**85**	**102**	**824**	**2,164**
Derivative assets	**-**	**5**	**39**	**-**	**-**	**-**	**44**
Cash at bank and in hand	**1**	**176**	**41**	**-**	**3**	**1**	**222**

As at 31 December 2011

	Credit rating relating to financial assets that are neither past due nor impaired						Total of financial assets that are neither past due nor impaired
	AAA	AA	A	BBB	<BBB	Not rated	
	£m	£m	£m	£m	£m	£m	£m
Debt securities	1,357	471	962	102	35	13	2 940
Other financial assets	-	-	1	1	-	4	6
Short term investments	-	7	25	-	-	2	34
Reinsurance assets	72	184	533	145	53	22	1 009
Insurance and reinsurance debtors (1)	41	6	13	31	-	1,506	1,597
Derivative assets	-	-	62	-	-	-	62
Cash at bank and in hand	43	107	16	3	-	4	173

Notes

1 The insurance and reinsurance debtors classified as not rated comprise personal policyholders and small corporate customers that do not have individual credit ratings The overall risk to the Company is deemed to be low as the cover could be cancelled if payments were not received on time

With the exception of AAA rated Government securities, the largest aggregate credit exposure does not exceed **3%** of the Company's total financial assets

The Company is exposed to credit and concentrations of risk with individual reinsurers, due to the nature of the reinsurance market and the restricted range of reinsurers that have acceptable credit ratings The reinsurance strategy is to purchase reinsurance in the most effective manner from reinsurers who meet its security standards Reinsurance counterparties are subject to a rigorous internal assessment process on an ongoing basis to ensure that their creditworthiness continues to be satisfactory and the potential impact from reinsurer default is measured regularly and managed accordingly The Group Reinsurance Credit Committee oversees the management of these risks Group standards are set such that reinsurers that have a financial strength rating of less than 'A–' with Standard & Poor's, or a comparable rating, are removed from the Group's authorised list of approved reinsurers unless the Group's internal review discovers exceptional circumstances in favour of the reinsurer Collateral is taken to mitigate exposures, where appropriate, to acceptable levels or the size or credit quality of the exposure

3. Risk Management (continued)

Credit risk (continued)

The Group regularly monitors its aggregate Exposures by reinsurer group against predetermined reinsurer group limits, in accordance with the methodology agreed by the BRC The Company's largest reinsurance exposures to active reinsurance groups are HDI-Gerling, Munich Re and Swiss Re At 31 December 2012 the reinsurance asset recoverable from these groups does not exceed **5%** of the Company's total financial assets Stress tests are performed by reinsurer counterparty and the limits are set such that in a catastrophic event, the exposure to a single reinsurer is estimated not to exceed **3%** of the Company's total financial assets The Company and certain of its subsidiaries are members of government mandated pools in various parts of the world As of 31 December 2012, the largest pool (by premium volume) is Pool Re operated by the UK Government to provide terrorism cover

There are no material financial assets that would have been past due or impaired had the terms not been renegotiated

The following table provides information regarding the carrying value of financial assets that have been impaired and the ageing of financial assets that are past due but not impaired as at 31 December 2012

	Neither past due nor impaired	**Financial assets that are past due but not impaired**				**Financial assets that have been impaired**	**Carrying value in the balance sheet**	**Impairment losses charged to the P&L**
		0-3 months	**3-6 months**	**6 - 12 months**	**Greater than 12 months**			
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Debt securities	**3,375**	-	-	-	-	-	**3,375**	-
Other financial assets	**15**	-	-	-	-	-	**15**	-
Short term investments	**63**	-	-	-	-	-	**63**	-
Reinsurance assets	**970**	-	-	-	-	**4**	**974**	-
Insurance and reinsurance debtors	**2,164**	**19**	**12**	**2**	**7**	**1**	**2,205**	**(5)**
Derivative assets	**44**	-	-	-	-	-	**44**	-
Cash at bank and in hand	**222**	-	-	-	-	-	**222**	-

As at 31 December 2011

	Neither past due nor impaired	Financial assets that are past due but not impaired				Financial assets that have been impaired	Carrying value in the balance sheet	Impairment losses charged to the P&L
		0-3 months	3-6 months	6 - 12 months	Greater than 12 months			
	£m	£m	£m	£m	£m	£m	£m	£m
Debt securities	2 940	-	-	-	-	-	2,940	-
Other financial assets	6	-	-	-	-	-	6	-
Short term investments	34	-	-	-	-	-	34	-
Reinsurance assets	1 009	-	-	-	-	9	1,018	(1)
Insurance and reinsurance debtors	1 597	12	6	3	3	3	1,624	(3)
Derivative assets	62	-	-	-	-	-	62	-
Cash at bank and in hand	173	-	-	-	-	-	173	-

Local operations are responsible for assessing and monitoring the creditworthiness of their counterparties (e g brokers and policyholders) Local credit committees are responsible for ensuring these exposures are within the risk appetite of the local operations Exposure monitoring and reporting is embedded throughout the organisation with aggregate credit positions reported and monitored at Group level

The Company's investments comprise a broad range of financial investments issued principally in the UK

At 31 December 2012, the Company had pledged **£901m** (*2011 £901m*) of financial assets as collateral for liabilities or contingent liabilities and had accepted **£453m** (*2011 £479m*) collateral that could be sold or pledged The nature of the assets pledged as collateral comprises government securities of **£855m** *(2011 £855m)*, cash and cash equivalents of **£13m** *(2011 £12m)* and debt securities **£33m** *(2011 £34m)* The terms and conditions of the collateral pledged are market standard in relation to letter of credit facilities

3. Risk Management (continued)

Credit risk (continued)

The Company is permitted to sell or repledge collateral held in the event of default by the owner, the fair value of which has been noted above at **£453m** The terms and conditions of the collateral held are market standard The assets held as collateral are readily convertible into cash

At 31 December 2012, the Company had entered into short term sale and repurchase agreements for UK government securities The Company continues to recognise the debt securities on the balance sheet as the Group remains exposed to the risks and rewards of ownership The carrying value of these debt securities recognised on the balance sheet is **£295m** *(2011 £297m)* and the carrying value of the associated liabilities is **£295m** *(2011 £297m)*

Certain of the Company's equities and debt securities that are held at fair value are unlisted (2012 **£639m**, *2011 £744m*) These primarily comprise cash instruments which are highly liquid and redeemable at short notice at carrying value The amount also includes a number of other unlisted investments which are valued either by reference to industry pricing sources or model based calculations

Market risk

The Group is exposed to the risk of potential losses from adverse movements in market prices including those of interest rates, equities, property, exchange rates and derivatives The Group's exposure to these risks is governed by market risk policy Exposures are controlled by the setting of investment limits and managing asset-liability matching in line with the Group's risk appetite

The Group Investment Committee (GIC), on behalf of the Group Board, is responsible for reviewing and approving the investment strategy for the Group's investment portfolios It provides approval for all major changes of the Group's investment strategy and, in particular, approves any substantive changes to the balance of the Group's funds between the major asset classes Importantly the GIC also approves the terms of reference of the Group's main operational investment committee, the Group Asset Management Committee (GAMC) The BRC issues GAMC with investment risk limits

Interest rate risk

The fair value of the Company s portfolio of fixed income securities is inversely correlated to changes in the market interest rates Thus if interest rates fall, the fair value of the portfolio would tend to rise and vice versa as set out in the sensitivity analysis on page 30

Equity price risk

The Company's portfolio of equity securities is subject to equity risk arising from changes in market price Thus if the value of equities rise so will the fair value of its portfolio and vice versa as set out in the sensitivity analysis on page 30

The Group sets appropriate risk limits to ensure that no significant concentrations to individual companies arise The Group takes a long term view in selecting shares and looks to build value over a sustained period of time rather than churning the portfolio looking for short term gains from its equity holdings

The Company makes use of derivative products as appropriate to manage equity exposure and to protect the portfolio from losses outside of its risk appetite

Property price risk

The Company's portfolio of properties is subject to property price risk arising from changes in the market value of properties Thus if the value of property falls so will the fair value of the portfolio as set out in the sensitivity analysis on page 30

A number of the Company's property holdings are Group occupied The Company s investment in investment property is recorded as such and these investments are held as part of an efficient portfolio management strategy

3. Risk Management (continued)

Currency risk

The Company incurs exposure to foreign currency exchange risk in two ways

- Operational currency risk – by underwriting liabilities in currencies other than the currency of the primary environment in which the business units operate (non functional currencies)

- Structural currency risk – by investing in overseas subsidiaries and operating an international insurance group

Operational currency risk is managed within the Company's individual operations by broadly matching assets and liabilities by currency

Structural currency risk is managed at a Group level through currency forward and foreign exchange option contracts within the limits that have been set In managing structural currency risk, the needs of the Group's subsidiaries to maintain net assets in local currencies to satisfy local regulatory solvency and internal risk based capital requirements are taken into account These assets should prove adequate to support local insurance activities irrespective of exchange rate movements

Derivatives

The Company may use derivative financial instruments for the purpose of reducing its exposure to adverse fluctuations in interest rates, foreign exchange rates, equity prices and long term inflation The Company does not use derivatives to leverage its exposure to markets and does not hold or issue financial instruments for speculative purposes Forward contracts and foreign exchange options are used to reduce the risk of adverse currency movements on certain forecast future cash transactions and for structural hedging The policy on use of derivatives is approved by the BRC

	Remaining life			Fair value		Notional principal amounts	
	Less than one year £m	One to five years £m	More than five years £m	2012 £m	2011 £m	2012 £m	2011 £m
Cross currency							
Asset	**14**	-	-	**14**	18	1,323	1,465
Liability	**13**	-	-	**13**	15	1,411	1,366
Inflation							
Asset	-	-	**21**	**21**	10	**See below**	See below
Liability	-	-	**24**	**24**	13	**See below**	See below
Equity/index							
Asset	**9**	-	-	**9**	34	**See below**	See below
Liability	**12**	-	-	**12**	27	**See below**	See below

At 31 December 2012 there were derivative contracts in place to protect the value of the UK, Canadian and European equity portfolios of the Group These provided limited protection against declines in market levels whilst also capping participation in any appreciation of the market In total, this strategy covers an underlying equity value up to approximately **£348m** *(2011 approximately £477m)* If UK, Canadian, European and US equity markets decreased by 15%, the impact of these derivatives as at 31 December 2012, would be to decrease the impact of the decline by **£26m** *(2011 £30m)*

During 2011 the Company entered into a series of swap contracts which collectively provide limited cover against a sharp increase in long term inflation In total the swap contracts provide inflation cover over a nominal value of **£180m** *(2011 £180m)* and are split over different contract terms

At 31 December 2012 the Company holds currency forward contracts and foreign exchange options that are designated as hedging instruments to reduce structural foreign exchange risk The external currency forward contracts have been mirrored by internal currency forward contracts in order to pass the benefit of the contracts to a subsidiary parent company of most of the overseas subsidiaries

3. Risk Management (continued)

Sensitivity analysis

The Group uses a number of sensitivity or stress test-based risk management tools to understand the impact of the above risks on earnings and capital in both normal and stressed conditions These stress tests combine deterministic shocks, analysis of historical scenarios and stochastic modelling using the internal capital model to inform the Group's decision making and planning process and also for identification and management of risks within the business units

The following table provides an indication for the Company of some of the single factor changes adopted within the Group

Impact on fair value of investments (note 1 and note 4)

	Increase/(decrease)	
	2012	2011
	£m	£m
Interest rate markets (note 2)		
Impact on fixed interest securities of increase in interest rates of 100bps	**(152)**	(100)
Decrease of equity markets (note 3)		
Direct impact on equities of a 15% fall in equity markets	**(38)**	(103)
Mitigating impact arising from derivatives held	**28**	30
Property markets (note 3)		
Decrease of property markets of 15%	**(46)**	(51)

Notes

1 This analysis assumes that there is no correlation between equity price interest rate and property market rate risks It also assumes that all other assets and liabilities remain unchanged and that no management action is taken This analysis does not represent management s view of future market change but reflects management's view of key sensitivities

2 The sensitivity of the fixed interest securities of the Company has been modelled by reference to a reasonable approximation of the average interest rate sensitivity of the investments held within each of the portfolios

3 The effect of movements in equity and property markets is reflected as a one time decrease of worldwide equity and property markets on 1 January 2013 and 1 January 2012 which results in a 15% decline in the value of the Group's assets in these investment categories

4 This analysis has not considered the impact of the above market changes on the valuation of the Company's insurance contract liabilities or retirement benefit obligations

5 This analysis is presented gross of the corresponding tax credits/(charges)

Liquidity risk

Liquidity risk is the risk that cash may not be available to pay obligations when due at a reasonable cost The Company has no appetite for liquidity risk and is committed to meeting all liabilities as they fall due The investment risk limits set by the BRC ensure that a large part of the Company's portfolio is kept in highly liquid marketable securities sufficient to meet its liabilities as they fall due based on actuarial assessment and allowing for contingencies The limits are monitored at a Group level as part of the Group Risk exposure monitoring,and BRC reporting process

In addition the Company has committed credit facilities available as set out in note 21

3. Risk Management (continued)

Maturity periods or contractual repricing

The following table summarises the contractual repricing or maturity dates (whichever is earlier) for financial liabilities that are subject to fixed and variable interest rates Insurance contract liabilities are also presented and are analysed by remaining duration

	Less than one year	One to two years	Two to three years	Three to four years	Four to five years	Five to ten years	Total	Balance sheet carrying value
	£m	£m	£m	£m	£m	£m	£m	£m
2012								
Financial liabilities								
Subordinated liabilities	-	-	-	-	-	492	492	492
Amounts owed to Group undertakings	6,896	-	-	-	-	-	6,896	6,896
Amounts owed to credit institutions	348	-	-	-	-	-	348	348
Derivative trading liabilities	49	-	-	-	-	-	49	49
Direct insurance creditors	119	4	-	-	-	-	123	123
Reinsurance creditors	139	9	2	4	-	-	154	154
Total	7,551	13	2	4	-	492	8,062	8,062
Interest on subordinated liabilities	46	46	46	46	46	92	322	-

	Less than one year	One to two years	Two to three years	Three to four years	Four to five years	Five to ten years	Total	Balance sheet carrying value
	£m	£m	£m	£m	£m	£m	£m	£m
2011								
Financial liabilities								
Subordinated liabilities	-	-	-	-	-	492	492	492
Amounts owed to Group undertakings	6,846	-	-	-	-	-	6,846	6,846
Amounts owed to credit institutions	388	-	-	-	-	-	388	388
Derivative trading liabilities	55	-	-	-	-	-	55	55
Direct insurance creditors	122	-	-	-	-	-	122	122
Reinsurance creditors	150	4	2	-	-	-	156	156
Total	7,561	4	2	-	-	492	8,059	8,059
Interest on subordinated liabilities	46	46	46	46	46	138	368	-

Capital management

Royal & Sun Alliance Insurance plc is the major UK insurer within the group of companies (the 'Group') controlled by RSA Insurance Group plc and is regulated by the Financial Services Authority ('FSA')

The maintenance of a strong capital position of both the Group and the Company (which owns all the regulated companies within the Group and transacts the majority of the UK business) is critical for the Company's ability to conduct business

The Group and the Company maintain sufficient capital, which comprises shareholders' equity and subordinated loan capital, to meet their plans and objectives This represents sufficient surpluses for both regulatory and economic capital, as well as sufficient capital to support the Group's and the Company's aim of maintaining single 'A' ratings

To provide protection against material events or shocks, the Company would normally expect to hold sufficient capital to maintain significant economic and regulatory surpluses The maintenance of a capital position in excess of regulatory requirements is an absolute requirement for all of the Group's regulated entities There is no tolerance for breaching capital requirements for any regulated entity

3. Risk Management (continued)

Capital management (continued)

The Group's regulated entities are required to hold appropriate levels of capital in order to satisfy applicable local regulations In certain instances this could restrict the subsidiaries' ability to transfer funds to the UK parent where retained earnings form part of the local required regulatory capital Additionally, regulation in certain countries in which the Group's subsidiaries operate may also impose other limitations such as foreign exchange control restrictions

Economic capital

Economic capital is the Group's preferred measure of capital sufficiency It is the Group's own assessment of the amount of capital it needs to hold to meet its obligations given the Group's risk appetite Assets and liabilities are valued on an economic basis providing the most realistic representation of the Group's financial position

The economic capital analysis compares the economic value of the Group's assets with the total resources required in a range of adverse scenarios, calibrated to a defined risk tolerance consistent with the Group's 'A' rating which is in line with target The economic capital surplus is the amount by which the economic assets exceed the total resources required The total resources required is the amount of assets the Group needs today to meet its liabilities under the defined risk tolerance The Group defines the economic capital required as the difference between the total resource requirement and the accounting value of liabilities At 31 December 2012, the Group's surplus economic capital is approximately **£0.7bn** *(2011 £0 8bn)* Additionally, the Company provides an economic capital assessment for the Royal & Sun Alliance Insurance plc group of UK insurance companies

The reduction in the year is mainly the result of falling yield curves in the territories in which the Group operates and the impact of increased acquisitions during the year

The economic capital model is used to support, inform and improve the Group's decision making across the Group It is used to determine the Group's optimum capital structure, its investment strategy its reinsurance programme and to determine the pricing and target returns for each portfolio The economic capital model is also used for the Group's and Company's internal capital assessment ('ICA') The only adjustment made is to use the FSA's required calibration

Regulatory solvency position

The Group and Company remain fully compliant with both the FSA's risk based ICA methodology and Solvency I

As at 31 December 2012 the Group and Company have a Solvency I surplus of approximately **£1.2bn** *(2011 £1 3bn)* and **£1.2bn** *(2011 £1 3bn)* respectively The coverage ratio for the Company stood at approximately 1 7 times at 31 December 2012 *(2011 1 8 times)*

The Group and Company received their latest Individual Capital Guidance (based on their ICA submission) from the FSA in late 2011 and at the request of the FSA remains confidential The ICA is a forward looking, economic assessment of the capital requirements of the Group and Company based on the assessment of the risks to which it is exposed The models used to determine the ICA have been integrated into the Group's business processes and are used to enhance the management of the Group

4. Reorganisation costs and other items

The Technical account includes

	2012 **£m**	2011 £m
Reorganisation costs	**13**	-
Operating lease rentals – equipment	**1**	1

Reorganisation costs comprised employee redundancy costs, vacant lease accruals and other restructuring expenses

5. Exchange rates

The rates of exchange used in these accounts in respect of the major overseas currencies are

	2012 Cumulative Average	**2012 End of Period**	2011 Cumulative Average	2011 End of Period
Euro	**1.23**	**1.23**	1 15	1 20
US Dollar	**1.59**	**1.63**	1 60	1 55
Hong Kong Dollar	**12.30**	**12.60**	12 49	12 07
Singapore Dollar	**1.98**	**1.99**	2 01	2 01

6. Segmental information

(a) by class of business

2012	**Accident & Health**	**Motor**	**Fire & Property**	**Marine Aviation & Transport**	**Third Party Liability**	**Assistance**	**Other**	**Re-insurance**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Gross premiums written	**44**	**1,022**	**1,565**	**371**	**467**	**27**	**285**	**512**	**4,293**
Gross premiums earned	**44**	**984**	**1,516**	**364**	**480**	**28**	**268**	**384**	**4,068**
Gross claims incurred	**(13)**	**(882)**	**(672)**	**(283)**	**(318)**	**(9)**	**(160)**	**(246)**	**(2,583)**
Gross operating expenses	**(15)**	**(197)**	**(633)**	**(135)**	**(191)**	**(11)**	**(78)**	**(133)**	**(1,393)**
Gross technical result	**16**	**(95)**	**211**	**(54)**	**(29)**	**8**	**30**	**5**	**92**
Reinsurance balance	**(4)**	**(10)**	**(205)**	**30**	**(43)**	**-**	**1**	**(28)**	**(259)**
Net technical result	**12**	**(105)**	**6**	**(24)**	**(72)**	**8**	**31**	**(23)**	**(167)**

2011	Accident & Health	Motor	Fire & Property	Marine Aviation & Transport	Third Party Liability	Assistance	Other	Re-insurance	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Gross premiums written	38	989	1,504	342	435	27	119	122	3,576
Gross premiums earned	37	944	1,470	338	453	28	79	115	3,464
Gross claims incurred	(17)	(923)	(736)	(204)	(266)	(9)	(112)	(30)	(2,297)
Gross operating expenses	(15)	(165)	(581)	(115)	(181)	(11)	(26)	(29)	(1,123)
Gross technical result	5	(144)	153	19	6	8	(59)	56	44
Reinsurance balance	(3)	11	(159)	1	(31)	-	62	(47)	(166)
Net technical result	2	(133)	(6)	20	(25)	8	3	9	(122)

All of the business above relates to general insurance which is considered to be the only business segment

(b) by geographical segment

	2012 £m	2011 £m
Gross premiums written for direct business by origin		
UK	**3,291**	3,256
Other EEA	**320**	44
Other	**170**	154
	3,781	3,454

Gross premiums are disclosed by origin There is no material difference between the amounts shown and those by reference to destination (i e location of risk)

Total commissions for direct insurance business accounted for by the Company during the year amounted to **£729m** *(2011 £578m)*

6. Segmental information (continued)

On 1 January 2012, the RSA Group rationalised its UK insurance operation by the legal transfer of insurance liabilities and the assets backing the insurance liabilities of a number of its UK subsidiaries and a former subsidiary to another authorised UK insurer within the Group The transferee companies with no remaining insurance liabilities were subsequently de-authorised as UK insurers

For the Company, the impact on the technical provisions was the assumption of gross technical provisions of £278m (£161m net of reinsurance) at 1 January 2012

In addition, the Company transferred technical provisions relating to its marine business to a subsidiary The impact on the technical provisions was the transfer of gross technical provisions of £185m (£70m net of reinsurance) at 1 January 2012

The Company also entered into contracts to reinsure the insurance liabilities at 1 January 2012 of two if its remaining UK subsidiary insurance companies From 1 January 2012, the Company reinsured 100% of the new business written by these two companies under a quota share arrangement

The overall impact of the insurance business transfer and the reinsurance contracts was to increase gross premiums written in 2012 by £618m

7. Auditor's remuneration

Fees payable to Deloitte LLP for the audit of the Company's annual accounts was **£40,000** *(2011 £40,000)* Details of non-audit fees payable to Deloitte LLP are disclosed in the RSA Insurance Group plc 2012 Annual Report & Accounts

8. Directors' emoluments

	2012 £000	2011 £000
The aggregate emoluments of the directors', including amounts received from subsidiaries, were as follows		
Salaries and bonuses	**3,896**	5,692
Allowances, benefits and other awards	**662**	1,325
	4,558	7,017

The criteria for making bonus awards is based on targeted levels of business sector profit and specific business objectives Details of director's interests in RSA Insurance Group plc, including share options granted to directors under the executive and Sharesave employee share option schemes, are included in the directors' report of RSA Insurance Group plc As at 31 December 2012, there was an interest free loan of £5,000 outstanding to A P Brown under the standard terms of the Group's UK Car Ownership Scheme, which is open to all UK managers within a qualifying salary band

	2012 £000	2011 £000
The emoluments of the highest paid director (S P G Lee / A K Haste) were		
Salary, bonus, allowances, benefits and other awards	**1,516**	2,770

At 31 December 2012 the highest paid director had accrued annual pension of **£nil** *(2011 £16,123)* This figure is based on the amount of annual pension which would be payable on his attaining normal pension age if he had left the Company's service on 31 December 2012

Retirement benefits accrued under defined benefit schemes for I A Craston who served during the year Contributions of **£108,856** *(2011 £185,815)* were made to Group defined contribution schemes during the year in respect of the other directors

9. Employees and staff costs

	2012 £m	2011 £m
Wages and salaries	**347**	348
Social security costs	**38**	38
Other pension costs	**16**	16
	401	402

Other pension costs include only those items included within operating costs Items reported elsewhere have been excluded

The average monthly number of persons (including executive directors) employed by the Company during the year was	2012	2011
UK	**8,317**	8,530
Other EEA	**244**	5
Other	**280**	255
	8,841	8,790

10. Retirement benefits

The Company operates defined contribution pension schemes and funded and unfunded defined benefit pension schemes The assets of the funded schemes are held mainly in separate trustee administered funds

In April 2002, the defined benefit schemes were effectively closed to new entrants following the introduction of a new, primarily defined contribution, scheme (the 2002 scheme) However, due to a small defined benefit underpin the 2002 Scheme is still disclosed as a defined benefit scheme

In 2005, following discussions with the Trustees and consultation with the members, the defined benefit schemes were altered from providing benefits on a final salary basis to benefits on a revalued average salary basis with effect from 1 January 2006 Under the new benefit formula, the accrued benefits of current active members are based on salaries at the date of change and will increase in line with inflation each year (limited to 5% in any year) up to their retirement date Benefits earned in each year from 1 January 2006 are based on salaries in that year and are revalued up to retirement

In addition to these changes, the 2002 scheme (which was the scheme to which new UK employees had been admitted following the closure of the defined benefit schemes to new members) has been closed to further accrual from 1 January 2006 It has been replaced by a stakeholder arrangement and members of the 2002 Scheme and future new employees in the UK accrue future benefits on a defined contribution basis under the stakeholder scheme In 2012 contributions of **£18m** *(2011 £17m)* were made to defined contribution schemes in the United Kingdom

During 2009 the Company entered into arrangements that insured 55% of the retirement obligations relating to pensions in payment in the two main UK schemes The arrangements comprise assets and interest rate swaps combined with an insurance contract that provide for the full payment of the pensions in return for the actual investment return on a segregated portfolio of assets held by the pension funds at the inception of the arrangement The pension schemes continue to benefit from the assets held in the portfolio and retain the obligation to meet the insured pension obligations The assets and pension obligations are therefore not derecognised in the financial statements and an asset (representing the recovery of the insured pension obligations) and a liability (to pay the investment return on the portfolio of assets to the insurer) are recognised

During 2010 changes were made to the benefit structure of the three main UK schemes Changes affected future accrual from 1 March 2010 onwards Accrual rates were reduced, the retirement age was increased, revaluation was subject to a cap of 2 5%, a cap was applied to the salary used for the defined benefit schemes and the schemes contracted back into the State scheme Employees were entitled to join the stakeholder scheme for earnings above the cap

10 Retirement benefits (continued)

For the two main UK defined benefit schemes, the level of contributions in 2012 were **£94m** *(2011 £73m)* of which **£70m** *(2011 £51m)* were additional contributions in line with the plan to reduce their funding deficits Expected contributions to the two schemes for the year ending 31 December 2013 are approximately £44m, including £30m of additional contributions to reduce the deficit Further additional contributions may become due once the results of the March 2012 funding valuations are known (results expected in 2013)

The components of the defined benefit pension cost that are included within profit before tax in the financial statements are as follows

	2012 £m	2011 £m
Current service cost	**19**	17
Past service cost	**1**	1
Total charge included in profit before tax	**20**	18
Expected return on assets	**(288)**	(289)
Interest cost on pension scheme liabilities	**266**	272
Total financing credit included in profit before tax	**(22)**	(17)

The schemes are effectively closed to new entrants The current service cost, under the projected unit method, measured as a percentage of active members' salaries, is likely to rise as the members' age profile increases

Amounts recognised within the Statement of total recognised gains and losses

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Actual return on assets in excess/(deficit) of expected return on assets	**226**	386	244	(413)	(352)
Experience (losses)/gains on liabilities	**(28)**	(70)	(43)	116	(99)
Change in actuarial assumptions underlying the present value of scheme liabilities	**(358)**	(364)	(82)	(644)	741
Actuarial (loss)/gain	**(160)**	(48)	119	(941)	290
Deferred taxation	**35**	10	(35)	263	(84)
Recognised in the Statement of total recognised gains and losses	**(125)**	(38)	84	(678)	206

Movement in deficit during the year	**2012 £m**	2011 £m
Deficit at 1 January	**(89)**	(119)
Total operating charge	**(20)**	(18)
Employer contribution	**98**	79
Total financing credit	**22**	17
Actuarial (loss)/gain	**(160)**	(48)
Deficit at 31 December	**(149)**	(89)

The value of the defined benefit liability that is included at 31 December in the financial statements is as follows

	2012 £m	2011 £m	2010 £m
Equities	**1,471**	1,336	1,351
Bonds	**4,705**	3,848	3,680
Other	**85**	570	274
Present value of funded obligations fully covered by insurance arrangement	**1,544**	1,510	1,431
Value of obligations under insurance arrangement	**(1,969)**	(1,809)	(1,809)
Fair value of assets held by pension schemes	**5,836**	5 455	4,927
Present value of pension liabilities	**(5,985)**	(5,544)	(5,046)
Net deficit	**(149)**	(89)	(119)
Related deferred tax asset	**35**	23	32
Pension fund asset	**29**	21	7
Pension fund liability	**(143)**	(87)	(94)
Net pension liability	**(114)**	(66)	(87)

10. Retirement benefits (continued)

Included in the profit and loss account reserve is a pension and post retirement reserve on a FRS 17 basis at 31 December 2012 of **£(831)m** *(2011 £(706)m)*

The following is a reconciliation of the Company's retirement benefit obligations

	2012 £m	2011 £m
Retirement benefit obligations at 1 January	**5,544**	5,046
Current service costs	**19**	17
Past service costs	**1**	1
Interest costs	**266**	272
Actuarial loss on obligations	**386**	434
Benefits paid	**(231)**	(226)
Retirement benefit obligations at 31 December	**5,985**	5,544

The following is a reconciliation of the Company's pension schemes assets

	2012 £m	2011 £m
Pension schemes' assets at 1 January	**5,455**	4,927
Return on schemes' assets	**514**	675
Contributions by the employer	**98**	79
Benefits paid	**(231)**	(226)
Pension schemes' assets at 31 December	**5,836**	5,455

Additional information for the current annual period and previous four annual periods

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
At 31 December					
Present value of defined benefit obligations	**5,985**	5,544	5,046	4,835	4,276
Fair value of plan assets	**5,836**	5,455	4,927	4,523	4,831
(Deficit)/surplus	**(149)**	(89)	(119)	(312)	555
Experience adjustments on plan liabilities	**(28)**	(70)	(43)	116	(99)
Experience adjustments on plan assets	**226**	386	244	(413)	(352)

The principal actuarial assumptions used were as follows

	2012 %	2011 %
Assumptions used in calculation of retirement benefit obligation		
Interest rate used to discount liabilities	4 3	4 9
Annual rate of general inflation	2 5	2 8
Annual rate of increase in salaries	2 6	3 6
Annual rate of increase in pensions	2 5	2 7
Assumptions used in calculation of profit & loss account credit/charge in year		
Discount rate	4 9	5 5
Expected return on		
Equities	8 0	8 0
Bonds	4 3	5 3
Other	4 9	5 4

Mortality rate

The mortality assumptions are set following investigations of the main schemes' recent experience by the schemes' actuaries for the funding valuations At the funding valuation in March 2009, the mortality assumptions adopted for the main UK schemes used the SAPS Light Normal base table with percentage adjustments to reflect the schemes' recent experience compared with that expected under these tables The next funding valuation has an effective date of March 2012, with results expected in 2013

10. Retirement benefits (continued)

Mortality rate (continued)

Reductions in future mortality rates are allowed for using 80% (males) and 60% (females) of the long cohort improvements The weighted average assumptions imply that a current pensioner aged 60 has an expected future lifetime of **27.6** *(2011 27 5)* years (males) and **28.2** *(2011 28 1)* years (females) and a future pensioner aged 60 in 15 years time has a future expected lifetime from age 60 of **28 3** *(2011 28 3)* years (males) and **28.7** *(2011 28 7)* years (females)

Commutation

Each of the UK defined benefit pension schemes has changed its rules to allow for increased commutation following 'A day' in April 2006 In 2011 and 2012, the Group followed the funding valuation assumptions, and an allowance was made for future commutation using the current commutation factors

Sensitivity analysis

The discount rate, the assumed inflation rate and the mortality assumptions all have a significant effect on the FRS 17 accounting valuation A 0 1% increase in the discount rate would reduce the defined benefit obligations in the UK not covered by the insurance arrangement by **£63m** *(2011 £55m)* A 0 1% increase in the inflation rate assumption would increase the defined benefit obligations in the UK not covered by the insurance arrangement by **£46m** *(2011 £51m)* An increase of one year in life expectancy would increase the defined benefit obligations in the UK not covered by the insurance arrangement by approximately **£97m** *(2011 £84m)*

11 Share based payment

The RSA Insurance Group (the Group) has four types of share based payment plans in which employees of the Company participate and which are settled in the form of ordinary shares the Long Term Incentive Plan (LTIP) the Sharesave Plan (SAYE), the Sharebuild Plan and the Executive Share Option Scheme (ESOS) Dilution levels for all schemes are held strictly within Association of British Insurers limits Further information on the LTIP scheme is included below and information on the other share schemes can be found in the remuneration report in the Annual Report and Accounts of the Group

The total employment cost recorded in the profit and loss account for all plans is **£4m** in 2012 *(2011 £6m)*

Analysis of share scheme costs (per profit and loss account)

	2012	2011
	£m	£m
LTIP	**-**	3
SAYE	**2**	2
Sharebuild	**2**	1
Total	**4**	6

The value of the awards granted during 2012 is **£8m** *(2011 £19m)* of which **£2m** *(2011 £4m)* is charged to the profit and loss account The balance of the value of the awards will be charged to the profit and loss account during the remaining vesting periods

Analysis of new awards costs

	2012		2011	
	Charge for year	**Total value**	Charge for year	Total value
	£m	**£m**	£m	£m
LTIP	**2**	**6**	4	16
SAYE	**-**	**-**	-	1
Sharebuild	**-**	**2**	-	2
Total	**2**	**8**	4	19

Long Term Incentive Plan

The Long Term Incentive Plan (LTIP) for Executive Directors and other selected executives was adopted following approval obtained at the Group's 2006 AGM Awards have been made each year since 2006 following shareholder approval

11. Share based payment (continued)

Long Term Incentive Plan (continued)

The structure of the plan allows for a number of different types of awards to be made Voluntary Deferred Shares are purchased by participants from net bonus payable (limited to a maximum value of 33% of net bonus), in addition, for senior executives, the Remuneration Committee may defer a portion of an individual's gross bonus (limited to 33% of that bonus) into an award over shares referred to for the purpose of the plan as Compulsory Deferred Shares Voluntary Deferred Shares are held in trust for three years Compulsory Deferred Shares awards are normally forfeited on an employee leaving the Group No further performance conditions apply The Remuneration Committee may make a conditional award of shares on a 'matched' basis to Voluntary and Compulsory Deferred Shares ('Matching Shares') up to a maximum of 2 1 and these are normally forfeited on an employee leaving the Group

Additionally, the Remuneration Committee may make conditional awards of Performance Shares to senior executives and conditional awards of Restricted Shares to other executives and senior managers

Awards of Performance Shares and Matching Shares related to Compulsory Deferred Shares are subject to a performance condition consisting of a combination of a return on equity target and a total shareholder return target (with performance measured by comparison against other European insurance companies) over a single three year performance period Matching Shares related to Voluntary Deferred Shares are subject only to the return on equity performance condition Restricted Shares are not subject to performance conditions All awards vest on the third anniversary of the date of grant to the extent that the performance conditions have been met Performance Shares and Restricted Shares are normally forfeited on an employee leaving the Group

Further information on the LTIP can be found in the remuneration report in the Annual Report and Accounts of the Group Further disclosures in respect of the SAYE and Sharebuild schemes have not been made on the grounds that the schemes are immaterial to the Group

12. Investment income, expenses and charges

	Investment income		Net realised gains/(losses)		Net unrealised gains/(losses)		Total investment return	
	2012	2011	**2012**	2011	**2012**	2011	**2012**	2011
	£m	£m	**£m**	£m	**£m**	£m	**£m**	£m
Investment income								
Investment property	**23**	15	**-**	3	**(25)**	(4)	**(2)**	14
Equity securities	**31**	37	**37**	98	**(3)**	(136)	**65**	(1)
Debt securities	**121**	101	**4**	-	**82**	56	**207**	157
Other investments								
Loans to subsidiaries	**3**	5	**-**	-	**-**	-	**3**	5
Other	**2**	11	**-**	-	**-**	-	**2**	11
Deposits, cash at bank and in hand	**3**	3	**-**	-	**-**	-	**3**	3
Derivatives	**1**	-	**6**	24	**(8)**	13	**(1)**	37
	184	172	**47**	125	**46**	(71)	**277**	226
Dividends from subsidiary undertakings	**606**	629	**-**	-	**-**	-	**606**	629
	790	801	**47**	125	**46**	(71)	**883**	855
Revaluation of subsidiary undertakings	**-**	-	**-**	-	**(187)**	(165)	**(187)**	(165)
Investment expenses, charges and interest								
Interest on bank loans and overdrafts							**(3)**	(4)
Interest on other loans							**(110)**	(111)
Investment management expenses							**(7)**	(9)
Unwind of discount							**(2)**	(11)
							(122)	(135)
Net investment return							**574**	555

13. Taxation

The credit for taxation in the profit and loss account comprises

	2012 £m	2011 £m
Current tax		
UK Corporation tax	**(6)**	11
Overseas taxation	**7**	-
Adjustments in respect of prior periods	**(11)**	30
Total current tax	**(10)**	41
Deferred tax		
Timing differences – origination and reversal	**(14)**	(39)
Adjustments in respect of prior periods	**3**	(37)
Adjustment for change in tax rates	**14**	10
Total deferred tax	**3**	(66)
Tax credit	**(7)**	(25)

UK corporation tax for the current year is based on a rate of **24.5%** *(2011 26 5%)*

Factors affecting the current tax (credit)/charge

The current tax (credit)/charge for the year is less than **24.5%** *(2011 less than 26 5%)* due to the items set out in the reconciliation below

	2012 £m	2011 £m
Profit on ordinary activities before tax	**406**	425
Tax at 24 5% *(2011 at 26 5%)*	**99**	113
Factors affecting (credit)/charge		
Expenses not deductible for tax purposes	**44**	44
Tax exempt income and investment gains/losses	**(155)**	(175)
Fiscal adjustments	**(19)**	(21)
Adjustment to tax charge in respect of previous periods	**(11)**	30
Group relief surrendered without payment	**9**	10
Unrelieved foreign tax credits	**8**	-
Other timing differences	**15**	40
Current tax (credit)/charge for the year	**(10)**	**41**

Other debtors includes **£34m** *(2011 £15m)* in respect of corporation tax receivable

14. Dividends

	2012 £m	2011 £m
Paid **Nil** *(2011 11 09p)* interim dividend per ordinary share	**-**	500

15. Intangible assets

	Goodwill on acquisition 2012 £m	Renewal rights 2012 £m	Total 2012 £m
Cost			
At 1 January	**21**	**15**	**36**
Additions	**7**	**3**	**10**
At 31 December	**28**	**18**	**46**
Amortisation			
At 1 January	**(10)**	**(9)**	**(19)**
Charge for the year	**-**	**(1)**	**(1)**
At 31 December	**(10)**	**(10)**	**(20)**
Net book value			
At 31 December 2012	**18**	**8**	**26**
At 31 December 2011	11	6	17

16 Investments

	2012 £m	2011 £m
Land and buildings		
Freehold	**278**	301
Long leasehold	**37**	39
Short leasehold	**2**	2
Total land and buildings	**317**	342
Of which Group occupied	**11**	12

Movement in the carrying value of land and buildings is detailed below

Land and buildings at 1 January	**342**	355
Sales	**-**	(9)
Purchases	**-**	-
Fair value losses	**(25)**	(4)
Land and buildings at 31 December	**317**	342

The historical cost of property at 31 December is **£363m** *(2011 £363m)*

	2012 £m	2011 £m
Other financial investments		
Shares and other variable yield securities and units in unit trusts	**402**	689
Debt securities and other fixed income securities		
British government securities	**1,183**	1,169
Other government securities	**168**	176
Corporate bonds	**2,024**	1,595
At fair value through profit or loss (designated as such upon initial recognition)	**3,777**	3,629
Loans and deposits with credit institutions		
Other loans	**13**	4
Deposits with credit institutions	**63**	35
Loans and receivables	**76**	39
Total other financial investments	**3,853**	3,668

16. Investments (continued)

	2012 £m	2011 £m
Listed investments		
Included in total investments are the following		
Shares and other variable yield securities and units in unit trusts	**311**	522
Debt securities and other fixed income securities	**2,828**	2,363
	3,139	2,885

Included within shares and other variable yield securities and units in unit trusts above are ordinary shares in RSA Insurance Group plc, the Company's ultimate parent, held by the Royal & Sun Alliance ESOP Trust and Royal & Sun Alliance ESOP Trust No 2, which have a carrying value of **£1m** (2011 £2m)

The historical cost of total investments is **£4,006m** *(2011 £3,838m)*

The property valuations have been prepared on the basis of open market value at the balance sheet date in accordance with The Royal Institute of Chartered Surveyors' Appraisal and Valuation Manual by Messrs Jones Lang LaSalle, external qualified valuation surveyors

Fair value measurements recognised in the balance sheet

The following table provides an analysis of financial instruments that are measured subsequent to initial recognition at fair value grouped into Levels 1 to 3 based on the degree to which the fair value is observable

	Fair value hierarchy			
	Level 1 2012 £m	**Level 2 2012 £m**	**Level 3 2012 £m**	**Total 2012 £m**
Financial assets at fair value through the profit and loss account				
Equity securities	**364**	-	**38**	**402**
Debt securities	**3,280**	**93**	**2**	**3,375**
Derivative assets	**44**	-	-	**44**
Derivative liabilities	**(50)**	-	-	**(50)**
Total	**3,638**	**93**	**40**	**3,771**

	Fair value hierarchy			
	Level 1 2011 £m	Level 2 2011 £m	Level 3 2011 £m	Total 2011 £m
Financial assets at fair value through the profit and loss account				
Equity securities	664	-	25	689
Debt securities	2,849	88	3	2,940
Derivative assets	62	-	-	62
Derivative liabilities	(53)	(2)	-	(55)
Total	3,522	86	28	3,636

None of the Company's insurance liabilities are measured at fair value There were no transfers between Level 1 and Level 2 during the year

16. Investments (continued)

A reconciliation of Level 3 fair value measurements of financial assets is shown in the table below There are no financial liabilities measured at fair value using Level 3 fair value measurements

	Equity securities £m	Debt securities £m	Total £m
Balance at 1 January 2011	17	2	19
Total gains or losses recognised in the profit and loss account	3	-	3
Purchases	6	1	7
Disposals	(1)	-	(1)
Balance at 31 December 2011	25	3	28
Total gains or losses recognised in the profit and loss account	**6**	**(1)**	**5**
Purchases	**7**	**-**	**7**
Balance at 31 December 2012	**38**	**2**	**40**

There were no transfers into or out of Level 3 during the period Of the total gains or losses for the period (shown in the reconciliation above) included in the profit and loss account, **£5m** *(2011 £nil)* relates to assets held at the end of the reporting period

17. Investment in subsidiary undertakings

The Company's principal subsidiaries at 31 December 2012 are set out in note 34 The companies are principally all engaged in the transaction of insurance or related business The countries shown are those of incorporation and principal operation The figure for shares in subsidiaries in the balance sheet comprises

	2012 £m	2011 £m
Net asset value.		
At 1 January	**10,733**	10,368
Acquisitions	**130**	530
Revaluation	**(187)**	(165)
At 31 December	**10,676**	10,733

The historical cost of investments in subsidiaries is **£11,523m** *(2011 £11,393m)*

Acquisitions of £130m in 2012 include the internal acquisition of 15% of the issued share capital of The Marine Insurance Company Limited from another company in the Group, Royal & Sun Alliance Insurance (Global) Limited, for consideration of £14m and capital injections of £94m, £18m and £4m into RSA Finance, Intouch Insurance Group BV and Sun Alliance Insurance (China) Limited respectively

18. Interests in associated undertakings

The Company has a 26 0% holding of ordinary shares in Royal Sundaram Alliance Insurance Limited, which operates and is incorporated in India During the year, Royal Sundaram Alliance Insurance Limited undertook a fund raising exercise in which the Company participated fully at a cost of £2 3m, maintaining its 26 0% holding

	2012 £m	2011 £m
Net asset value:		
At 1 January	**11**	15
Foreign exchange losses	**(1)**	(1)
Acquisitions	**2**	2
Revaluations	**2**	(5)
At 31 December	**14**	11

The historical cost of interests in associated undertakings is **£17m** *(2011 £15m)*

19. Tangible assets

	Equipment 2012 £m	Computer software 2012 £m	Total 2012 £m
Cost			
At 1 January	**100**	**208**	**308**
Additions	**10**	**-**	**10**
Disposals	(45)	**-**	(45)
At 31 December	**65**	**208**	**273**
Depreciation			
At 1 January	**(67)**	**(77)**	**(144)**
Charge for the year	**(7)**	**(25)**	**(32)**
Disposals	**44**	**-**	**44**
At 31 December	**(30)**	**(102)**	**(132)**
Net book value			
At 31 December 2012	**35**	**106**	**141**
At 31 December 2011	33	131	164

20 Share capital

	2012 £m	2011 £m
Allotted, issued and fully paid up·		
4,511,091,326 *(2011 4,511,091,326)* ordinary class A shares of 25p each	**1,128**	1 128
1 *(2011 1)* ordinary class B share of US$1	-	-

21. Subordinated loan notes

	2012 £m	2011 £m
Subordinated loan note equity instruments	**372**	372
Subordinated liabilities	**492**	492

Subordinated loan note equity instruments

On 1 December 2004, the Company obtained a subordinated loan from RSA Insurance Group plc, its ultimate parent company, of £294m, derived from the issue of £450m of subordinated guaranteed perpetual notes on 23 July 2004 The notes have an annual coupon of 8 50% The claims of the ultimate parent company on the loan are subordinated to the same extent as the claims of the holders of the notes The loan has no specified maturity

On 5 June 2006, the Company obtained a subordinated loan from RSA Insurance Group plc, its ultimate parent company, of £78m, derived from the issue of £375m of step up perpetual guaranteed subordinated capital securities on 12 May 2006 The notes have an annual coupon of 6 701% The claims of the ultimate parent company on the loan are subordinated to the same extent as the claims of the holders of the capital securities The loan has no specified maturity

Interest of **£22m** *(2011 £22m)* net of tax was paid during the year on the subordinated loan note equity instruments and has been recognised in the Reconciliation of movement in shareholders' funds on page 9

21. Subordinated loan notes (continued)

Subordinated liabilities

On 30 June 2009, The Company obtained a subordinated loan from RSA Insurance Group plc, its ultimate parent company, of £492m derived from the issue of £500m of subordinated guaranteed step-up notes on 20 May 2009 The notes have an annual coupon of 9 375% The claims of the ultimate parent company on the loan are subordinated to the same extent as the claims of the holders of the notes The loan has a maturity date of 20 May 2039 At 31 December 2012 the fair value of the subordinated liabilities is **£572m** *(2011 £572m)*

22 Claims outstanding

Claims outstanding include claims on certain classes of business which have been discounted The total value of outstanding claims provisions less related reinsurance recoveries before discounting amounted to **£4,693m** *(2011 £4,336m)* The total value of gross outstanding claims provisions before discounting amounted to **£5,731m** *(2011 £5,431m)*

Claims are discounted as follows

		Discount rate		Average period to settlement in years	
		2012 %	2011 %	**2012**	2011
UK	Asbestos & Environmental	**5.00**	5 00	**12**	13

In 2003 the Company wrote an Adverse Development Cover (ADC) contract with its former US subsidiary The liabilities arising under the ADC contract comprise an insurance component and a deposit component The liability arising under the insurance component represents the timing risk on the settlement of those liabilities The financial liability arising under the deposit component is offset by the value of funds held in a trust fund whose trust deed only permits the trust fund assets to be used to settle amounts due under the ADC The deposit component of the liability was fully paid during 2012 The value of the funds held in trust at 31 December 2011 was £0 1bn and the value of the liability of the deposit component was £0 1bn

The investment return corresponding to the unwind of the discount on the assets supporting the liabilities was **£2m** *(2011 £11m)*
In determining the average period to ultimate claims settlement, estimates have been made based on the underlying claims settlement patterns

In addition in the UK certain long tail liabilities are settled by an annuity This is contained within the discounted value of UK and Scandinavian annuities which is shown separately in note 20 of the Annual Report & Accounts of the Group

Prior year claims development

The movement in net incurred claims arising from the difference between the net claims provision at the beginning of the year and subsequent payments and the claims provision at the end of the year, was a surplus of **£64m** *(2011 £37m)* The positive run-off reflects the Company's approach to setting reserves at a level which is more likely than not to run off favourably over the longer term

23. Equalisation provisions

	2012 **£m**	2011 £m
Provision as at 1 January	**286**	269
Released to the Technical account - General business and in the profit on ordinary activities before tax	**30**	17
Provision as at 31 December	**316**	286

As explained in note 1b)ii the effect of this provision is to decrease shareholders' funds by **£316m** *(2011 £286m)* The increase in the provision during the year had the effect of decreasing the balance on the technical account for general business and the profit on ordinary activities before taxation by **£30m** *(2011 £17m)*

24. Provisions for other risks

	2012 £m	2011 £m
At 1 January	**93**	88
Charged/transferred to Profit and Loss Account	**55**	41
Utilised	**(43)**	(32)
Released	**(10)**	(4)
At 31 December	**95**	93

Provisions include provisions of **£39m** *(2011 £53m)* held relating to vacant property leases, dilapidations and refurbishments, the costs relating to which will be borne across the period over which the leases expire, which is up to 20 years Provisions also include Motor Insurance Bureau provision of **£18m** *(2011 £21m)*, reorganisation provisions of **£10m** *(2011 £nil)* and a Fire Brigade levy provision of **£7m** *(2011 £4m)*

25. Deferred tax

Deferred tax for the current year is based on a rate of **23%** *(2011 25%)*

	2012 £m	2011 £m
Unrealised investment gains	**5**	5
Accelerated capital allowances	**67**	58
Other timing differences	**114**	103
Deferred tax asset	**186**	166

	2012 £m	2011 £m
Deferred tax asset at 1 January	**166**	82
Credit for the year – Profit and loss account	**34**	95
Charge for the year – Statement of total recognised gains and losses	**-**	(1)
Adjustment for change in tax rate – Profit and loss account	**(14)**	(10)
Deferred tax asset at 31 December	**186**	166

At the balance sheet date, the Company had unused tax losses of **£1,570m** *(2011 £1,542m)* and unused tax credits of **£2.6m** *(2011 £2m)* available for offset against future profits A deferred tax asset of **£90m** *(2011 £91m)* has been recognised in respect of losses and **£2m** *(2011 £2m)* has been recognised in respect of tax credits included within other temporary differences at 31 December 2012 No deferred tax asset has been recognised in respect of the tax losses of **£1,177m** *(2011 £1,176m)* due to the unpredictability of future profit streams The losses may be carried forward indefinitely

Deferred tax assets of **£219m** *(2011 £188m)*, which are in excess of profits arising from the reversal of existing taxable temporary differences and that relate to tax jurisdictions in which the Company has suffered a loss in either the current or preceding period, have been recognised on the basis that future taxable profits will be available against which these can be utilised The evidence for the future taxable profits is a forecast consistent with the three year operational plans prepared by the relevant businesses, which are subject to internal review and challenge Where relevant, the forecast includes extrapolations of the operational plans using assumptions consistent with those used in the plans

26. Borrowings

	2012 £m	2011 £m
Amounts owed to credit institutions	**348**	388

Borrowings comprise secured loans from credit institutions and bank overdrafts which are repayable on demand At 31 December 2012 and 2011 the Company had in place a one billion US Dollar Euro commercial paper programme There were no amounts outstanding at 31 December 2012 *(2011 £nil)*

27. Other creditors

Other creditors including taxation and social security includes **£nil** *(2011 £nil)* in respect of corporation tax payable

28. Operating lease rentals

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

	Land & Buildings		Other	
	2012	2011	**2012**	2011
	£m	£m	**£m**	£m
Operating leases which expire				
Within one year	**1**	9	-	-
Within two and five years	**21**	20	-	-
After five years	**3**	7	-	-
	25	36	-	-

All material leases of land and buildings are subject to rent review periods of between three and five years

29. Capital commitments

The estimated amount of capital commitments contracted but not provided for in these financial statements is **£50m** *(2011 £96m)*

30. Contingent liabilities

Royal & Sun Alliance Insurance plc has guaranteed on behalf of RSA Insurance Group plc the following

- the US $24m 8 95% subordinated guaranteed bonds due 15 October 2029,
- the issue of £450m 8 50% subordinated guaranteed perpetual notes There is an option to call the notes on 8 December 2014 and every five years thereafter,
- the issue of £375m step up perpetual guaranteed subordinated capital securities There is an option to repay the bonds on specific dates starting 12 July 2017,
- the issue of £500m 9 375% subordinated guaranteed step-up notes There is an option to repay the notes on specific dates from 20 May 2019, and
- a £455m committed credit facility of which £nil has been drawn

31. Cash flow statement

The Company is a wholly-owned subsidiary of RSA Insurance Group plc and the cash flows of the Company are included in the consolidated cash flow statement of RSA Insurance Group plc The Company has thus taken advantage of the exemption permitted by FRS 1 (revised 1996) 'Cash flow Statements' and has elected not to prepare its own cash flow statement

32. Related party transactions

Advantage has been taken of the exemption provided in FRS 8 'Related Party Disclosures' from disclosing details of transactions with RSA Insurance Group plc and its subsidiaries and associated undertakings

33. Parent companies

The Company's immediate parent company is Royal Insurance Holdings plc, which is registered in England and Wales

The Company s ultimate parent company and controlling party is RSA Insurance Group plc, which is registered in England and Wales and is the parent company of the smallest and largest group to consolidate these financial statements A copy of that company's accounts can be obtained from 9th Floor, One Plantation Place, 30 Fenchurch Street, London, EC3M 3BD or www rsagroup com

34. Principal subsidiary companies

		Principal activity
United Kingdom	British Aviation Insurance Company Limited (57 1%)	General insurance
	The Globe Insurance Company Limited[4]	Holding company
	The Marine Insurance Company Limited	General insurance
	Royal International Insurance Holdings Limited*[5]	Holding company
	Royal & Sun Alliance Reinsurance Limited*	General insurance
	Sun Insurance Office Limited[6]	General insurance
Argentina	Royal & Sun Alliance Seguros (Argentina) SA	General insurance
	El Comercio Compañía de Seguros (96 7%)	General insurance
	Aseguradora de Créditos y Garantías (99 9%)	General insurance
Bahrain	Royal & Sun Alliance Insurance (Middle East) Limited E C (50 0%)	General insurance
Brazil	Royal & Sun Alliance Seguros (Brasil) SA	General insurance
Canada	Roins Financial Services Limited	Holding company
	Quebec Assurance Company	General insurance
	The Johnson Corporation	Holding company
	Royal & Sun Alliance Insurance Company of Canada [7]	General insurance
	Western Assurance Company	General insurance
	Canadian Northern Shield Insurance Company	General insurance
	L'Union Canadienne Compagnie D'Assurances	General insurance
Chile	RSA Seguros (Chile) SA (99 4%)	General insurance
China	Sun Alliance Insurance (China) Limited	General insurance
Colombia	Royal & Sun Alliance Seguros (Colombia) SA (86 7%)	General insurance
Denmark	Codan A/S	Holding company
	Codan Forsikring A/S	General insurance
Guernsey	Insurance Corporation of the Channel Islands Limited	General insurance
Isle of Man	Tower Insurance Company Limited	General insurance
Mexico	Royal & SunAlliance Seguros (Mexico) SA de C V	General insurance
Netherlands	RSA Overseas (Netherlands) BV	Holding company
	RSA Overseas Holdings BV	Holding company
	Intouch Insurance Group BV*	Holding company
Netherlands Antilles	Royal & Sun Alliance Insurance (Antilles) NV (51 0%)	General insurance
Poland	Link4 Towarzystwo Ubezpieczen SA	General insurance
Republic of Ireland	RSA Insurance Ireland Limited*	General insurance
Sweden	Trygg-Hansa Forsakrings AB	General insurance
Uruguay	Royal & Sun Alliance Seguros (Uruguay) SA	General insurance

34. Principal subsidiary companies (continued)

Notes

1 UK companies are incorporated in Great Britain and are registered in England & Wales,
*100% direct subsidiary of Royal & Sun Alliance Insurance plc

2 Except where indicated all holdings are of equity shares and represent 100% of the nominal issued capital

3 Some subsidiaries have been omitted from this statement to avoid providing particulars of excessive length

4 The general insurance business of The Globe Insurance Company Limited was legally transferred to Royal & Sun Alliance Insurance plc and The Marine Insurance Company Limited on 1 January 2012

5 The general insurance business of Royal International Insurance Holdings Limited was legally transferred to Royal & Sun Alliance Insurance plc and The Marine Insurance Company Limited on 1 January 2012 Following this transfer, the principal activity of Royal International Insurance Holdings Limited is as a holding company

6 On 1 January 2012, general insurance business from The Sea Insurance Company Limited and National Vulcan Engineering Insurance Group Limited legally transferred to Sun Insurance Office Limited

7 GCAN Insurance Company was amalgamated into Royal & Sun Alliance Insurance Company of Canada on 1 January 2012