

# ABBHEY LIFE ASSURANCE COMPANY LIMITED

Company Registration Number: 710383

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STRATEGIC REPORT, DIRECTORS' REPORT AND  
FINANCIAL STATEMENTS  
for the year ended 31 December 2017



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## **Strategic report**

The Directors present the Strategic report, their Report and the financial statements of Abbey Life Assurance Company Limited ("the Company") for the year ended 31 December 2017.

The financial statements of the Company for the year ended 31 December 2017 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRS") and applied in accordance with the Companies Act 2006.

### **Business review**

#### ***Principal activities***

The principal activity of the Company is the transaction of life assurance and pension business which is largely in run off.

All business is written in the UK.

#### ***Strategy***

The strategy of the Phoenix Group, of which the Company is a member, is to manage closed life funds in an efficient and secure manner protecting and enhancing policyholders' interests whilst maximising value for shareholders.

#### ***Financial performance***

The results of the Company for the year are shown in the Statement of comprehensive income on page 25. The profit before owner's tax was £245m (2016: £42m).

The Company has chosen to report a non-GAAP measure of performance, being operating profit. Operating profit is considered to provide a comparable measure of the underlying performance of the business as it excludes the impact of short-term economic volatility and other one-off items. This measure incorporates an expected return, including a longer term return on financial investments backing shareholder and policyholder funds over the period, with consistent allowance for the corresponding expected movements in liabilities.

The operating profit was £154m. Operating profit includes expected returns of £81m, changes in demographic assumptions of £53m, £16m in respect of the change in estimates used in the valuation of insurance contracts and other impacts of £4m.

The Company's solvency position is an important measure of financial strength. The estimated 31 December 2017 Solvency II Own funds and excess of own funds over solvency capital requirement (unaudited) were £492m (2016: £998m) and £401m respectively (2016: £522m).

#### ***Corporate activity***

On 30 December 2016, the Company was acquired by Phoenix Life Holdings Limited ("PLHL"), a member of the Phoenix Group ("The Group"), from Deutsche Bank AG Group ("DB").

During 2016, the FCA published two thematic reviews into the fair treatment of long-standing customers and into the practices of non-advised annuity sales which have an impact on the Company. Provisions of £39m (additional £34m in the current year) have been recognised in respect of obligations identified as a result of past practices adopted by the Company in the areas covered by the two reviews.

As part of the acquisition, DB provided PLHL with a deed of indemnity in respect of expenses that may arise as a result of the FCA's thematic reviews. To ensure the Company benefitted from the deed of indemnity, PLHL provided the Company with a capital contribution of £23m.

In June 2017 a longevity swap provided by the Company was recaptured by the trustee of the scheme, resulting in a profit of £7m.

The obligations of the Company to the Abbey Life Staff Pension Scheme were transferred to Pearl Life Holdings Limited ("PeLHL") on 30 June 2017 for consideration of £114m. At transfer the Company de-recognised a deficit of £90m and recognised a loss of £24m within Administrative expenses.

On 8 November 2017 the Company paid a dividend of £162m, settled in cash.

On 12 December 2017 the Company issued a loan of £150m to PLHL. The loan plus accrued interest was settled by way of an in-specie dividend of £150m on 29 December 2017.

On 29 December 2017, substantially all of the risks and rewards of the existing and new business of the Company (that were not subject to existing reinsurance arrangements and with the exception of the with-profit and unit-linked funds) were reinsured to Phoenix Life Limited ("PLL"), a fellow member of the Phoenix Group, under two reinsurance agreements. The first reinsurance treaty relates to annuity policies within the Matching Adjustment portfolio and the second reinsurance treaty relates to all other business in-scope of the reinsurance transaction. Certain external reinsurance treaties and a deed of covenant were also novated as part of the transaction. On inception of the agreements, the Company reinsured £2,581m of technical provisions for a consideration of £2,478m, and subsequently recognised income and expenses of £67m and £(70)m respectively that had been previously deferred, as all related risks and benefits transferred to PLL. As a result, the Company made a one-off profit on inception of the reinsurance of £100m.

On 29 December 2017 the Company paid a further dividend of £155m, settled in cash.

#### ***Business transacted***

The Company has written a wide range of life and pensions business, predominantly on individual risks. The Company also provides de-risking products for corporate clients.

During the year, the Company has maintained two with-profits ("WP") funds, which operate on a 90:10 basis. The Company also maintains a portfolio of non-profit business, for which the profits accrue to the Shareholder. This portfolio of non-profit business had gross policyholder liabilities of £9,664m (2016: £10,085m) at the period end.

The WP funds transact conventional and unitised with-profits business. The shareholder non-profit portfolio comprises term assurance and permanent health insurance ("PHI") business as well as immediate and deferred annuities, together with some unit-linked business.

Reinsurance arrangements are in place with companies external to the Phoenix Group to cover certain blocks of immediate and deferred annuities and some permanent health, critical illness and term assurance risks and longevity.

Policy administration is outsourced to Capita Life and Pensions Regulated Services Limited ("Capita").

Asset management and investment administration is primarily outsourced to Aberdeen Asset Management plc and Deutsche Asset Management (UK) Ltd.

Custody services are primarily outsourced to State Street Bank and Trust Company.

The gross premium income of the Company for the year was £69m (2016: £88m).

The total value of assets was £10,800m (2016: £11,797m).

The gross liabilities under insurance and investment contracts at 31 December 2017 were £9,697m (2016: £10,247m).

#### ***Principal risks and uncertainties***

The Company is exposed to a number of financial risks arising from its underlying assets and liabilities, in particular from movements in financial markets, including changes in interest rates, widening of credit spreads, the risk of corporate defaults and also insurance risk.

Life assurance, permanent health and critical illness contracts are affected by mortality and morbidity risks whilst pension business is adversely affected by improving annuitant longevity. Persistency and expense inflation risks apply to most products. The funds also carry investment risk on holdings of fixed and variable rate income securities backing surplus assets in the funds and from investment performance associated with products carrying fund based charges. A significant proportion of the non-profit business is unit-linked with the investment performance risk being carried by policyholders. The reinsurance with PLL, effective 29 December 2017, transfers the majority of the risks of the business, including financial and reinsurance risks to PLL. The Company continues to manage financial assets outside of the with-profits and unit-linked funds, and is therefore exposed to financial risks associated with these assets.

The Company undertakes regular monitoring activities in relation to market risk exposure, including limits in each asset class, cash flow forecasting and stress and scenario testing.

Assets held to meet obligations to policyholders include debt securities. The Company is exposed to deterioration in the actual or perceived creditworthiness or default of issuers of relevant debt securities. It is also exposed to trading counterparties failing to meet all or part of their obligations, such as reinsurers failing to meet obligations assumed under reinsurance arrangements. An increase in credit spreads on debt securities, particularly if it is accompanied by a higher level of actual or expected issuer defaults, could have a material adverse impact on the Company's financial condition.

The Company regularly monitors its counterparty exposure and has specific limits relating to counterparty credit ratings. Where possible, exposures are diversified through the use of a range of counterparty providers. All material reinsurance and derivative positions are appropriately collateralised and guaranteed.

The Company has exposure to liquidity risk as a result of failure to meet its short and medium term cash flow requirements, to meet its obligations on policy liabilities. The Company's policy is to maintain sufficient liquid assets of suitable credit quality at all times and, where appropriate, to have access to borrowings so as to be able to meet all foreseeable current liabilities as they fall due in a cost-effective manner. Forecasts are prepared regularly to predict the required liquidity levels over both the short and medium term allowing management to respond appropriately to changes in circumstances.

The Company monitors insurance risk through the use of internal risk measurement models, experience analyses, sensitivity analysis and stress testing. Mortality, longevity and morbidity risks are mitigated by the use of reinsurance, although this exposes the Company to counterparty risk regarding the failure of the reinsurance party. Where significant, and in relation to external reinsurers, this counterparty exposure is mitigated by the Company holding collateral pledged by the reinsurer.

The Company closely manages the risk of failure to maintain sufficient capital to provide appropriate security for policyholders and meet all regulatory capital requirements mandated by the Solvency II Directive and the Prudential Regulation Authority ("PRA"). The Capital Management Framework is detailed in note 35.

One area of uncertainty is the outcome of the following Financial Conduct Authority ("FCA") thematic reviews:

- (i) Thematic Review of the Fair Treatment of Long Standing Customers in Life Assurance ("Legacy Review")
- (ii) Thematic Review of Annuities Sales Practices and Retirement Income Study ("Annuities Sales Practices")

The result of the Legacy Review was reported on 3 March 2016. The FCA announced that it will commence investigations into the Company and five other firms in relation to disclosure of customer exit and paid-up charges (Legacy Review).

As detailed in note 20, a £5m provision has been created to cover the potential cost of addressing the Legacy Review and a £34m provision has been created to cover the potential cost of addressing Annuity Sales Practices.

Following the reinsurance with PLL, the Company retains the risk of regulatory costs. However, regulatory costs arising from the Legacy Review and Annuities Sales Practices Review are covered by a capital contribution, which passes down the value of the deed of indemnity that PLHL has with DB.

#### *Operational risks*

In addition, the Company faces operational risks, including the performance of its third party arrangements, in particular its outsourced policy administration arrangements which, as noted above have been outsourced to Capita. Pearl Group Management Services ("PGMS") provide pass through management services in the form of staff and other services.

Following the acquisition of the Company by the Phoenix Group on 30 December 2016, the majority of the Company's business risks were reinsured to PLL in December 2017, and activity is underway to operationally integrate the two businesses.

#### *Regulatory and legislative landscape*

Changes in the regulatory and legislative landscape impact the way the Company has engaged with its customers. The conduct-focused regulator has had a greater focus on customer outcomes. This may continue to challenge the existing approach and/or may result in remediation exercises where the Company cannot demonstrate that it met the expected customer outcomes in the eyes of the regulator. The Company puts considerable effort into managing relationships with its regulators such that it is able to maintain a forward view regarding potential changes in the regulatory landscape. The Company assesses the risks of regulatory change and the impact on its operations and lobbies where appropriate.

The Company is making the necessary preparations for the introduction of the EU General Data Protection Regulation which comes into force in May 2018.

As progress is made towards the UK's exit from the EU, the Company is continuing to monitor developments to ensure that it can continue to service existing non-UK policyholders.

The Company continues to review data and consider proposals to ensure that product charges for customers remain appropriate.

Further information on financial risks is provided in the notes to the financial statements.

**Key Performance Indicators ("KPIs")**

The Company's performance is measured and monitored by the Board with particular regard paid to the following KPIs:

*Customers*

The Directors review various metrics in respect of Treating Customers Fairly ("TCF"), customer communication and complaints on a monthly basis. TCF is monitored through various TCF committees and any exceptions are reported to the Board as appropriate.

There is also a With-Profits Committee, comprising mostly of independent members, to opine on issues of fairness to policyholders including ensuring policyholder monies are managed in accordance with the Company's Principles and Practices of Financial Management ("PPFM").

*Capital resources*

The Company has monitored its regulatory capital adequacy under the Solvency II regime. Under this regime, the Company is required to retain sufficient capital (termed "Own Funds") at all times to meet the Solvency Capital Requirement ("SCR") as determined by the Company's standard formula valuation process.

As at 31 December 2017 the Company's estimated Solvency II Own Funds and excess of own funds over solvency capital requirement (unaudited) were £492m (2016: £998m) and £401m (2016: £522m) respectively.

*Operating profit*

Operating profit is considered a more representative measure of performance than IFRS profit after tax, as it provides long-term performance information unaffected by short-term economic volatility. For the year ended 31 December 2017, the Company reported an operating profit of £154m. No comparative is included as in 2016 the Company did not report an operating profit.

*Profits after taxation*

For the year ended 31 December 2017, the Company reported a profit after taxation of £180m (2016: £32m).

*Distributable reserves*

As at 31 December 2017, the Company had distributable reserves amounting to £209m (2016: £511m).

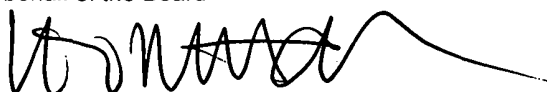
*Cash flows*

Policyholder and shareholder liquidity and cash flows are monitored closely by the business to ensure that all liabilities can be met as they fall due.

*Investment performance*

The performance of the Company's invested assets is reviewed against fund specific, pre-defined benchmarks by the Board, the Investment Committee and the Investment Management Committee ("IMC"), which is an internal management committee.

On behalf of the Board



L Nuttall  
For and on behalf of Pearl Group Secretariat Services Limited  
Company Secretary

8 March 2018

## Directors' report

Abbey Life Assurance Company Limited ("the Company") is incorporated in England and Wales. Its registration number is 710383 and its registered office is 1 Wythall Green Way, Wythall, Birmingham B47 6WG.

### Corporate governance

The Company, as part of a group wide framework, has established a governance framework for monitoring and overseeing strategy, operation of its business and compliance with applicable regulatory conduct standards that includes:

- a clear organisational structure with documented delegations of authority;
- matters reserved for the Board and written terms of reference for each of its committees;
- an Audit Committee, the members of which are all non-executive Directors, whose role is to monitor the overall integrity of the financial reporting by the Company and its subsidiaries, to review the overall effectiveness of the internal control and risk management systems of the Company and its subsidiaries, to monitor the overall effectiveness of the Internal Audit function of the Company and its subsidiaries and to oversee the relationship with the external auditors of the Company and its subsidiaries;
- a Risk Committee, whose membership is comprised of all the non-executive Directors of the Company, whose role is to advise the Board on risk appetite and tolerance in setting the future strategy, taking account of the Board's overall degree of risk aversion, the current financial situation of the Company and, drawing on assessment by the Audit Committee, the Company's capacity to manage and control risks within the agreed strategy; and
- the operation of a three lines of defence model with the Risk function providing risk oversight independent of management and the Internal Audit function providing independent verification of the adequacy and effectiveness of the internal controls and risk management processes in operation.

The Board is comprised of 5 non-executive Directors and 4 executive Directors.

### Financial instruments

Details of the Company's financial risk management objectives and policies in respect of its use of financial instruments are included in note 36 to the financial statements.

### Future developments

The Company's long term life assurance business is in gradual run off. The majority of the Company's risks were reinsured to PLL on 29 December 2017.

### Going concern

The Strategic report and Directors' report summarises the Company's activities, its financial performance and financial position together with any factors likely to affect its future development. In addition, it discusses the principal risks and uncertainties it faces. Notes 35 and 36 to the financial statements summarise the Company's risk and capital management objectives and policies together with its financial risks.

The Board has followed the UK Financial Reporting Council's "Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks (April 2016)" when performing their going concern assessment. To this end, the Board has undertaken a review of solvency, liquidity and cash flow projections under normal and stressed conditions.

As a result of this review, the Directors believe the Company has adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the financial statements.

**Directors**

The names of those individuals who served as Directors of the Company during the year and who held office at the date of signature of this report are as follows:

|                   |                          |
|-------------------|--------------------------|
| D R Cheeseman     |                          |
| S A Clarke        |                          |
| J R Lister        |                          |
| M J Merrick       | Resigned 31 March 2017   |
| D S Miller        |                          |
| A Moss            |                          |
| N H Poyntz-Wright |                          |
| A W Snow          |                          |
| M N Urmston       | (Chairman)               |
| D N Woollett      | Appointed 4 January 2017 |

**Secretary**

Pearl Group Secretariat Services Limited acted as Secretary throughout the year.

**Disclosure of indemnity**

Qualifying third party indemnity arrangements (as defined in section 234 of the Companies Act 2006) were in force for the benefit of the Directors of the Company during the year and remain in place at the date of approval of this report.

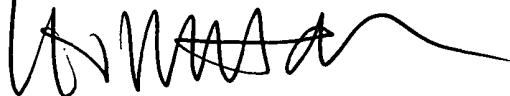
**Disclosure of information to auditor**

So far as each of the Directors is aware, there is no relevant audit information (as defined in the Companies Act 2006) of which the Company's auditor is unaware, and each of the Directors has taken all the steps that they ought to have taken as a Director to make themselves aware of any relevant audit information (as defined) 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 section 418(2) of the Companies Act 2006.

**Re-appointment of auditor**

With effect from 24 May 2017 KPMG resigned as an auditor of the Company and EY was appointed on 28 June 2017. In accordance with section 487 of the Companies Act 2006, the Company's auditor, Ernst & Young LLP, will be deemed to have been re-appointed at the end of the period of 28 days following circulation of copies of these financial statements as no notice has been received from members pursuant to section 488 of the Companies Act 2006 prior to the end of the accounting reference period to which these financial statements relate.

On behalf of the Board



L Nuttall  
For and on behalf of Pearl Group Secretariat Services Limited  
Company Secretary

8 March 2018



**Statement of Directors' responsibilities**

The Directors are responsible for preparing the Strategic report, the Directors' report and the Company's financial statements ("the financial statements") in accordance with applicable United Kingdom law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under the law the Directors have elected to prepare those statements in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union. Under company law, the Directors must not approve the financial statements unless they are satisfied that they present fairly the financial performance, financial position and cash flows of the Company for the accounting period. A fair presentation of the financial statements in accordance with IFRS requires the Directors to:

- select suitable accounting policies in accordance with IAS 8: *Accounting Policies, Changes in Accounting Estimates and Errors* and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Company's financial position and financial performance;
- state that the Company has complied with applicable IFRS, 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 taking reasonable steps for the prevention and detection of fraud and other irregularities.

**Independent auditor's report to the members of Abbey Life Assurance Company Limited**

**Opinion**

We have audited the financial statements of Abbey Life Assurance Company Limited for the year ended 31 December 2017 which comprise the Statement of comprehensive income, the Statement of financial position, the Statement of cash flows, the Statement of changes in equity and the related notes 1 to 39, including a summary of significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

In our opinion, the financial statements:

- give a true and fair view of the Company's affairs as at 31 December 2017 and of its profit for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

**Basis for opinion**

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report below. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Use of our report**

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.

**Conclusions relating to going concern**

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the Company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

## Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team. These matters were addressed in the context of our audit of the financial statements as a whole, and in our opinion thereon, and we do not provide a separate opinion on these matters.

Valuation of insurance contract liabilities £3.50 billion, 2016 £4.06 billion

*Refer to the Critical accounting estimates (page 17); Accounting policies (e) and note 16 of the financial statements (page 37).*

We considered the valuation of insurance contract liabilities to be a significant risk for the Company. Specifically we considered the actuarial assumptions and modelling that are applied, as these involve complex and significant judgements about future events, both internal and external to the business for which small changes can result in a material impact to the resultant valuation. Additionally, the valuation process is conditional upon the accuracy and completeness of the data. We have split the risks relating to the valuation of insurance contract liabilities into the following component parts:

- Actuarial assumptions
- Actuarial modelling
- Data

| Risk  | Our response to the risk   | Key observations communicated to the Audit Committee  |
|---|--|---|
| <p><b>Actuarial assumptions</b></p> <p>Economic assumptions are set by management taking into account market conditions as at the valuation date. Non-economic assumptions such as future expenses, longevity and mortality are set based on past experience, market experience, market practice, regulations and expectations about future trends.</p> <p>The assumptions that we consider to have the most significant impact are the base and trend longevity and persistency assumptions.</p> <p>These assumptions are used as inputs into a valuation model which uses standard actuarial methodologies.</p> | <p>To obtain sufficient audit evidence to conclude on the appropriateness of actuarial assumptions, we:</p> <ul style="list-style-type: none"> <li>• tested the design and operating effectiveness of key controls over management's process for setting and updating actuarial assumptions</li> <li>• compared the methodology and assumptions used with those we would expect based on our knowledge of the Company, industry standards and regulatory and financial reporting requirements</li> <li>• assessed the results of management's experience analysis, which supports the adopted assumptions and methodology, and checked that the assumptions used are consistent with this experience analysis</li> <li>• evaluated the choice of the industry standard Continuous Mortality Investigation ('CMI') model and the parameters used to ensure that it was appropriate given the demographics of policyholders</li> <li>• benchmarked the demographic assumptions against those of other industry participants</li> </ul> | <p>We determined that the actuarial assumptions used by management are reasonable based on the analysis of the experience to date, industry practice and the financial and regulatory requirements.</p> |

ABBEEY LIFE ASSURANCE COMPANY LIMITED

| Risk  | Our response to the risk  | Key observations communicated to the Audit Committee  |
|---|---|---|
|   | <ul style="list-style-type: none"> <li>reviewed that disclosures have been made in the financial statements regarding the sensitivity of the valuation of insurance contract liabilities to changes in the key actuarial assumptions.</li> </ul>  |   |
| <p><b>Actuarial modelling</b></p> <p>We consider the integrity and appropriateness of models to be critical to the overall valuation of insurance contract liabilities.</p> <p>Over £3.4 billion of the £3.50 billion of insurance contract liabilities are modelled using the actuarial modelling systems with the residual balance modelled outside these systems to cater for ancillary business. The key risk is therefore associated with the modelling systems but risks also exist in the calculation of amounts outside these systems</p> | <p>To obtain sufficient audit evidence to conclude on actuarial models, including those models outside the core system, we:</p> <ul style="list-style-type: none"> <li>tested the design, implementation and operating effectiveness of key controls over management's process for model changes during the year</li> <li>assessed the results of the management analysis of movements in insurance contract liabilities in order to confirm the completeness of model changes</li> <li>tested the design, implementation and operating effectiveness of key controls over management's process for modelling insurance contract liabilities outside the actuarial modelling systems</li> </ul> | <p>We determined that the models used are appropriate and that controls over managements processes for modelling insurance contract liabilities outside of the actuarial modelling system were operating effectively.</p> |
| <p><b>Data</b></p> <p>The policyholder data is a key input into the valuation process. The valuation of insurance contract liabilities is therefore conditional upon the accuracy and completeness of the data used.</p>  | <p>To obtain sufficient audit evidence to assess the integrity of actuarial data we:</p> <ul style="list-style-type: none"> <li>confirmed that the actuarial model data extracts provided by the OSPs were those used as an input to the actuarial model</li> <li>tested the design and operating effectiveness of key controls over management's data collection, extraction and validation process</li> <li>assessed the integrity of policy level data, performing corroborative testing on analysis of movement in Insurance Contract liabilities over the period</li> </ul>  | <p>We determined based on our audit work that the policyholder data used for the actuarial model inputs are materially complete and accurate.</p>   |

|   |   |  |
|---|---|--|
| <p>Change in IFRS reserving basis</p> <p><i>Refer to note 36 of the financial statements (page 55)</i></p> <p>Following the acquisition by the Phoenix Group, the Company has made certain changes to the assumptions and estimates used in the valuation of insurance contracts in the financial statements.</p> <ul style="list-style-type: none"> <li>• Change the risk free reference curve from gilts to swaps</li> <li>• Adjust the approach to allow for investment margins on non-profit business from the Valuation Rate of Interest to matching adjustment.</li> <li>• Change the approach to reserving for prudence in demographic assumptions from provisions for adverse deviation implicit in individual assumptions to an explicit margin.</li> </ul> <p>These changes have been made to align the IFRS basis more closely with the requirements of Solvency II and in line with the methodology of the wider Group.</p> | <p>To obtain sufficient audit evidence to conclude on the change in IFRS reserving basis, we:</p> <ul style="list-style-type: none"> <li>• reviewed the quantum impact of the change in reserving basis; and</li> <li>• reviewed the accounting treatment of the change in reserving basis against the applicable accounting framework</li> </ul>   | <p>We determined based on our audit work that the changes to the key assumptions and estimates used in the valuation of insurance contracts are reasonable and the accounting treatment of the revised IFRS reserving basis is in line with the applicable accounting framework.</p> |
| <p>Valuation of the longevity contracts (net asset position £85 million; 2016: £47 million)</p> <p><i>Refer to the Critical accounting estimates (page 17); Accounting policies (o) and note 29 of the financial statements (page 45)</i></p> <p>We considered the valuation of the longevity contracts to be a significant risk for the Company as the key assumptions applied by management involve complex and significant judgements. Furthermore, during the current financial year the Company management revised the IFRS valuation methodology of the longevity contracts and reassessed the related inputs and assumptions.</p> <p>Consequently, our risk focus is on the judgement and key assumptions applied by management to value the assets and liabilities of the longevity contracts and the impact of the revised IFRS valuation methodology.</p>   | <p>To obtain sufficient audit evidence to conclude on the valuation of longevity contracts, we:</p> <ul style="list-style-type: none"> <li>• tested the design and operating effectiveness of key controls over management's process in respect of the valuation of longevity contracts</li> <li>• evaluated the revised methodology, inputs and assumptions used to confirm that key valuation inputs were consistent with industry norms and our understanding of the longevity contract types</li> <li>• reviewed the accounting treatment of each individual longevity contract against the applicable accounting framework</li> <li>• reviewed the calculation of the longevity contracts valuation and assessed their reasonableness</li> <li>• reviewed that disclosures have been made in the financial statements regarding the sensitivity of the valuation of longevity contracts to changes in the key assumptions</li> </ul> | <p>We determined based on our audit work that the methodology and key assumptions used by management are reasonable and fair valuation of the longevity contracts is in line with the applicable accounting framework.</p>   |

|   |   |   |
|---|---|---|
| <p>Valuation of remediation of conduct risk (£39 million; 2016: £5 million)</p> <p><i>Refer to the Critical accounting estimates (page 17); Accounting policies (s) and note 20 of the financial statements (page 39)</i></p> <p>We consider valuation and recognition of provisions in relation to the conduct risk remediation to be a significant risk for the Company. This is due to the judgement involved in the redress methodology and the key assumptions used by management in the provisions assessment.</p>                            | <p>To obtain sufficient audit evidence to conclude on the provision for remediation of conduct risk, we:</p> <ul style="list-style-type: none"> <li>Assessed the valuation and recognition of accounting provisions in line with IAS 37 requirements</li> <li>Assessed the reasonableness of the key management assumptions and the applied methodology</li> <li>Assessed the completeness of the provisions held in response to the FCA reviews</li> </ul>   | <p>We determined based on our audit work that the key assumptions used by management are reasonable and valuation of the provision for remediation of conduct risk is in line with the applicable accounting framework.</p> |
| <p>Reinsurance to Phoenix Life Limited (PLL)</p> <p><i>Refer to the Accounting policies (p) and note 4 of the financial statements (page 33)</i></p> <p>To further the integration of ALAC into the Phoenix Group, management implemented two reinsurance treaties effective as at 29 December 2017.</p> <p>Given the quantum and one-off nature of the reinsurance arrangement, together with the judgement involved in determining the appropriate accounting treatment, we consider this transaction to be a key audit matter for our audit.</p> | <p>To obtain sufficient audit evidence to conclude on the accounting treatment of the reinsurance transactions we have;</p> <ul style="list-style-type: none"> <li>discussed with management the accounting treatment, including application of IFRS;</li> <li>obtained the reinsurance treaties and reviewed the commercial terms to establish whether these are reflective of the accounting treatment proposed by management;</li> <li>reviewed the quantum impact of the treaties on the related financial statement balances; and</li> <li>reviewed the financial statements to ensure the presentation and disclosure of the transaction is appropriate and in line with the requirements of IFRS.</li> </ul> | <p>Based on procedures performed we are satisfied that the reinsurance arrangement has been appropriately accounted for under IFRS 4, and the presentation and disclosure in the financial statements is reasonable</p>     |

## **An overview of the scope of our audit**

### **Tailoring the scope**

Our assessment of audit risk, our evaluation of materiality and our allocation of performance materiality determine our audit scope for the Company. This enables us to form an opinion on the financial statements. We take into account size, risk profile, the organisation of the Company and effectiveness of controls, including controls and changes in the business environment when assessing the level of work to be performed. All audit work was performed directly by the audit engagement team.

### **Our application of materiality**

We apply the concept of materiality in planning and performing the audit, in evaluating the effect of identified misstatements on the audit and in forming our audit opinion.

#### **Materiality**

*The magnitude of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users of the financial statements. Materiality provides a basis for determining the nature and extent of our audit procedures.*

We determined materiality for the Company to be £11 million, which is 2% of the Company net assets. Whilst profit before tax or operating profit are common bases used across the life insurance industry, we believe that the use of net assets as the basis for assessing materiality is more appropriate given that the Company is a closed life assurance consolidator and as such net assets provides a more stable, long-term measure of value. We note also that net assets more closely correlates with key Company performance metrics such as Solvency II capital requirements and Own Funds. However, as these measures are non-GAAP measures, we consider net assets to be most appropriate.

During the course of our audit, we reassessed initial materiality and concluded that the basis for materiality assessed at the planning stages of our audit remained appropriate.

#### **Performance materiality**

*The application of materiality at the individual account or balance level. It is set at an amount to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.*

On the basis of our risk assessments, together with our assessment of the Company's overall control environment, our judgement was that performance materiality was 50% of our planning materiality, namely £5.5 million. We have set performance materiality at this percentage due to the first year of audit of the Company.

#### **Reporting threshold**

*An amount below which identified misstatements are considered as being clearly trivial.*

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of £0.6 million, which is set at 5% of planning materiality, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in light of other relevant qualitative considerations in forming our opinion.

### **Other information**

The other information comprises the information included in the annual report set out on pages 2 to 8, other than the financial statements and our auditor's report thereon. The directors are responsible for the other information.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in this report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of the other information, we are required to report that fact.

We have nothing to report in this regard.

#### **Opinions on other matters prescribed by the Companies Act 2006**

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and directors' report have been prepared in accordance with applicable legal requirements.

#### **Matters on which we are required to report by exception**

In the light of the knowledge and understanding of the Company and its environment obtained in the course of the audit, we have not identified material misstatements in the strategic report or directors' report.

We have nothing to report in respect of the following matters in relation to which 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.

#### **Responsibilities of directors**

As explained more fully in the statement of directors' responsibilities set out on page 8, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

#### **Auditor's responsibilities for the audit of the financial statements**

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

#### ***Explanation as to what extent the audit was considered capable of detecting irregularities, including fraud***

The objectives of our audit:

- in respect to fraud, are to identify and assess the risks of material misstatement of the financial statements due to fraud; to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and to respond appropriately to fraud or suspected fraud identified during the audit. However, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management; and
- in respect to irregularities, considered to be non-compliance with laws and regulations, are to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements ('direct laws and regulations'), and perform other audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements. We are not responsible for preventing non-compliance with laws and regulations and our audit procedures cannot be expected to detect non-compliance with all laws and regulations.



Our approach was as follows:

- We obtained a general understanding of the legal and regulatory frameworks that are applicable to the Company and determined that the direct laws and regulations related to elements of company law and tax legislation, and the financial reporting framework. Our considerations of other laws and regulations that may have a material effect on the financial statements included permissions and supervisory requirements of the Prudential Regulation Authority ('PRA') and the Financial Conduct Authority ('FCA').
- We obtained a general understanding of how the Company is complying with those frameworks by making enquiries of management, internal audit, and those responsible for legal and compliance matters. We also reviewed correspondence between the Company and UK regulatory bodies; reviewed minutes of the Board and its Committees; and gained an understanding of the Company's approach to governance, demonstrated by the Board's approval of the Company's governance framework and the Board's review of the Company's risk management framework ('RMF') and internal control processes.
- For direct laws and regulations, we considered the extent of compliance with laws and regulations, we considered the extent of compliance with those laws and regulations as part of our procedures on the related financial statement items.
- For both direct and other laws and regulations our procedures involved: making enquiry of those charged with governance and senior management for their awareness of any non-compliance of laws or regulations, inquiring about the policies that have been established to prevent non-compliance with laws and regulations by officers and employees, inquiring about the Company's methods of enforcing and monitoring compliance with such policies, inspecting significant correspondence with the FCA and PRA.
- The Company operates in the insurance industry which is a highly regulated environment. As such the Senior Statutory Auditor considered the experience and expertise of the engagement team to ensure that the team had the appropriate competence and capabilities, which included the use of specialists where appropriate.
- We assessed the susceptibility of the Company's financial statements to material misstatement, including how fraud might occur by considering the controls that the Company has established to address risks identified by the entity, or that otherwise seek to prevent, deter or detect fraud. We also considered areas of significant judgement, including complex transactions, performance targets and economic or external pressures and the impact these have on the control environment. Where this risk was considered to be higher, we performed audit procedures to address each identified fraud risk. These procedures included testing manual journals and were designed to provide reasonable assurance that the financial statements were free from fraud or error.

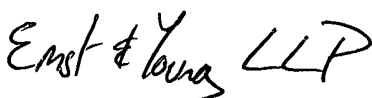
A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at <https://www.frc.org.uk/auditorsresponsibilities>. This description forms part of our auditor's report.

#### **Other matters we are required to address**

- We were appointed by the Company on 28 June 2017 to audit the financial statements for the year ending 31 December 2017 and subsequent financial periods.

We have not been auditors of the Company in the previous years.

- The non-audit services prohibited by the FRC's Ethical Standard were not provided to the Company and we remain independent of the Company in conducting the audit.
- The audit opinion is consistent with the additional report to the audit committee.



*Stuart Wilson (Senior statutory auditor)  
for and on behalf of Ernst & Young LLP, Statutory Auditor  
London  
13 March 2018*

## Accounting policies

### (a) Basis of preparation

The financial statements have been prepared on a historical cost basis except for investment property, investments in subsidiaries held for investment purposes and those financial assets and financial liabilities that have been measured at fair value.

Assets and liabilities are offset and the net amount reported in the statement of financial position only when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liability simultaneously. Income and expenses are not offset in the Statement of comprehensive income unless required or permitted by an international financial reporting standard or interpretation, as specifically disclosed in the accounting policies of the Company.

The financial statements are presented in sterling (£) rounded to the nearest £m except where otherwise stated.

The Company presents its statement of financial position broadly in order of liquidity. An analysis regarding recovery or settlement more than twelve months after the period end is presented in the notes.

The financial statements are separate financial statements and the exemption in section 401 of the Companies Act 2006 has been used not to present consolidated financial statements. The results of the Company are consolidated into the accounts of the Company's ultimate parent Phoenix Group Holdings, a company incorporated in the Cayman Islands and resident in the United Kingdom. The registered address of Phoenix Group Holdings is PO Box 309, Ugland House, Grand Cayman KY1-1104, Cayman Islands.

### Statement of compliance

The financial statements of the Company have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRS") as they apply to the financial statements of the Company for the year ended 31 December 2017, and applied in accordance with the Companies Act 2006.

### (b) Critical accounting estimates and judgements

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. Disclosures of judgements made by management in applying the Company's accounting policies include those that have the most significant effect on the amounts that are recognised in the Company's financial statements. Disclosures of estimates and associated assumptions include those that have a significant risk of resulting in a material change to the carrying value of assets and liabilities within the next year. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

Critical accounting estimates are those which involve the most complex or subjective judgements or assessments. The areas of the Company's business that typically require such estimates are operating profit, insurance and investment contract liabilities, determination of the fair value of financial assets and liabilities, income taxes, pension scheme assets and liabilities and the recognition of provisions.

### Insurance and investment contract liabilities

Insurance and investment contract liability accounting is discussed in more detail in accounting policies (e) and (f) with further detail of the key assumptions made in determining insurance and investment contract liabilities included in note 36. Economic assumptions are set taking into account market conditions as at the valuation date. Non-economic assumptions, such as future expenses, longevity and mortality are set based on past experience, market practice, regulations and expectations about future trends.

The valuation of insurance contract liabilities is sensitive to the assumptions which have been applied in their calculation. Details of sensitivities arising from significant non-economic assumptions are detailed in note 36.

### Fair value of financial assets and liabilities

The fair values of financial assets and liabilities are classified and accounted for as set out in accounting policies (o) and (g) respectively. Where possible, financial assets and liabilities are valued on the basis of listed market prices by reference to quoted market bid prices for assets and offer prices for liabilities. These are categorised as Level 1 financial instruments and do not involve estimates. If prices are not readily determinable, fair value is determined using valuation techniques including pricing models, discounted cash flow techniques or broker quotes. Financial instruments valued where valuation techniques are based on observable market data at the period end are categorised as Level 2 financial instruments. Financial instruments valued where valuation techniques are based on non-observable inputs are categorised as Level 3 financial instruments. Level 2 and Level 3 financial instruments therefore involve the use of estimates and note 29 provides further disclosures on fair value hierarchy and assumptions used to determine fair values.

In relation to the Level 3 financial instruments, sensitivity analysis is performed in respect of the key assumptions used in the valuation of these financial instruments. The details of this sensitivity analysis are included in note 29.

The longevity contracts which are classified as loans, debts or derivatives as appropriate are valued by models on actuarial bases. These are unobservable inputs and are classified as Level 3 financial instruments. The accounting policy for longevity contracts is set out in accounting policies (d) and (o).

**Income taxes**

Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all the available evidence, it can be regarded as more likely than not that there will be suitable taxable profits against which the losses can be relieved. Forecasts of future profitability are made which by their nature involve management's judgement. The UK taxation regime applies separate rules to trading and capital profits and losses. The distinction between temporary differences that arise from items of either a capital or trading nature may affect the recognition of deferred tax assets.

The accounting policy for income taxes (both current and deferred taxes) is discussed in more detail in accounting policy (k). Further details of incomes taxes are included in note 12.

**Pension scheme assets and liabilities**

The valuation of pension scheme assets and liabilities was determined using actuarial valuations that include a number of assumptions, including discount rate, inflation and longevity. As defined benefit pension schemes are long-term in nature, such assumptions are subject to significant uncertainty. Further details of pension scheme assets and liabilities are included in note 24. The accounting policy for pension scheme assets and liabilities is set out in accounting policy (w).

**Provisions**

Provision accounting is disclosed in more detail in accounting policy (s) with further details of provisions raised included in note 20.

**(c) Foreign currency transactions**

Assets and liabilities denominated in foreign currencies are translated into sterling at the closing rate at the period end. Income and expenses denominated in foreign currencies are translated at the prevailing rate at the date of the transaction. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of assets and liabilities denominated in foreign currencies are recognised within fair value gains and losses as income or an expense in the Statement of comprehensive income.

**(d) Classification of contracts**

Contracts are classified as insurance contracts where the Company accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if a specified uncertain event adversely affects the policyholder.

Contracts under which the transfer of insurance risk to the Company from the policyholder is not significant are classified as investment contracts.

The longevity contracts which are classified as loans, debts or derivatives as appropriate are valued by models on actuarial bases. These are unobservable inputs and are classified as Level 3 financial instruments.

**(e) Insurance contracts**

**Insurance liabilities**

Insurance contract liabilities for non-participating business, other than unit-linked insurance contracts, are calculated on the basis of current data and assumptions, using a gross premium method where the liability includes allowance for prudent lapses. Negative policy values are allowed for on individual policies:

- where there are no guaranteed surrender values; or
- in the periods where guaranteed surrender values do not apply even though guaranteed surrender values are applicable after a specified period of time.

For unit-linked insurance contract liabilities the provision is based on the fund value, together with an allowance for any excess of future expenses over charges, where appropriate.

For participating business, the liabilities under insurance contracts are calculated in accordance with the following methodology:

- liabilities to policyholders arising from the with-profits business are stated at the amount of the realistic value of the liabilities, adjusted to exclude the owners' share of projected future bonuses;
- acquisition costs are not deferred; and
- reinsurance recoveries are measured on a basis that is consistent with the valuation of the liability to policyholders to which the reinsurance applies.

The realistic liability for any contract is equal to the sum of the with-profit bonus reserve and the cost of future policy-related liabilities.

The with-profit bonus reserve for an individual contract is determined by either a retrospective calculation of 'accumulated asset share' approach or by way of a prospective 'bonus reserve valuation' method.

In calculating the realistic liabilities, account is taken of the future management actions consistent with those set out in the Principles and Practices of Financial Management ("PPFM").  
The principal assumptions are given in note 36.

#### **Embedded derivatives**

Embedded derivatives, including options to surrender insurance contracts, that meet the definition of insurance contracts or are closely related to the host insurance contract, are not separately measured. All other embedded derivatives are separated from the host contract and measured at fair value through profit or loss.

#### **Liability adequacy**

At each reporting date, liability adequacy tests are performed to assess whether the insurance contract liabilities are adequate. Current best estimates of future cash flows are compared to the carrying value of the liabilities. Any deficiency is charged as an expense to the Statement of comprehensive income.

The Company's accounting policies for insurance contracts meet the minimum specified requirements for liability adequacy testing under IFRS 4 *Insurance Contracts*, as they allow for current estimates of all contractual cash flows and of related cash flows such as claims handling costs. Cash flows resulting from embedded options and guarantees are also allowed for, with any deficiency being recognised as income or an expense in the Statement of comprehensive income.

#### **Unallocated surplus**

The unallocated surplus comprises the excess of the assets over the policyholder liabilities of the with-profits business. For the Company's with-profits funds, the amount included in the Statement of financial position line item 'Unallocated surplus' represents amounts which have yet to be allocated to owners since the unallocated surplus attributable to policyholders has been included within liabilities under insurance contracts. The with-profits funds are closed to new business and as permitted by IFRS 4, the whole of the unallocated surplus has been classified as a separate liability.

If the realistic value of liabilities to policyholders exceeds the value of the assets in any with-profits ("WP") fund, the unallocated surplus is valued at £nil.

#### **(f) Investment contracts**

Receipts and payments on investment contracts are accounted for using deposit accounting, under which the amounts collected and paid out are recognised in the Statement of financial position as an adjustment to the liability to the policyholder.

The valuation of liabilities on unit-linked contracts is based on the fair value of the related assets and liabilities. The financial liability is measured based on the carrying value of the assets and liabilities that are held to back the contract. The liability is the sum of the unit-linked liabilities plus an additional amount to cover the present value of the excess of future policy costs over future charges.

Investment income attributable to, and the movements in the fair value of, investment contracts are included in the 'Change in investment contract liabilities' as income or an expense in the Statement of comprehensive income.

#### **(g) Financial liabilities**

On initial recognition, financial liabilities are recognised when due and measured at the fair value of the consideration received less directly attributable transaction costs (with the exception of liabilities at fair value through profit or loss for which all transaction costs are expensed). Subsequent to initial recognition, financial liabilities (except for liabilities under investment contracts and other liabilities designated at amortised cost using the effective interest method) are measured at fair value through profit or loss.

Financial liabilities are designated upon initial recognition at fair value through profit or loss when doing so results in more meaningful information because either:

- it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the Company's key management personnel.

#### **(h) Borrowings**

The longevity contracts which are classified as loans, debts or derivatives as appropriate are valued by models on actuarial bases. These are unobservable inputs and are classified as Level 3 financial instruments.

**(k) Income tax**

Income tax comprises current and deferred tax. Income tax is recognised as income or an expense in the Statement of comprehensive income except to the extent that it relates to items recognised as other comprehensive income in the Statement of comprehensive income, in which case it is recognised as other comprehensive income in that statement.

Current tax is the expected tax payable on the taxable income for the year, using tax rates and laws enacted or substantively enacted at the date of the Statement of financial position together with adjustments to tax payable in respect of previous years.

Deferred tax is provided for on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates and laws enacted or substantively enacted at the period end.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

The tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on owners' returns. This allocation is calculated based on an assessment of the effective rate of tax that is applicable to owners for the year. Deferred tax assets and liabilities taxed at policyholder rates are not offset against deferred tax assets or liabilities taxed at shareholder rates due to restrictions in place in life tax legislation.

**(l) Investment property**

Investment property is stated at fair value. Fair value is the price that would be received to sell a property in an orderly transaction between market participants at the measurement date. Gains and losses arising from the change in fair value are recognised as income or an expense in the Statement of comprehensive income.

**(m) Investments in associates and joint ventures**

Investments in associates and joint ventures that are held for investment purposes are accounted for under IAS 39 *Financial Instruments: Recognition and Measurement* as permitted by IAS 28 *Investments in Associates and Joint Ventures*. These are measured at fair value through profit or loss.

**(n) Investment in subsidiaries**

Investments in shares in subsidiaries held for strategic purposes are carried in the Statement of financial position at cost less impairment. At each reporting date for subsidiaries held at cost less impairment, the Company assesses whether there are any indications of impairment or reversal of impairment. When such indications exist, an impairment test is carried out by comparing the carrying value of the investment against the estimate of the recoverable amount, which represents the higher of value in use or fair value less costs of disposal.

Investments in shares in subsidiaries held for investment purposes are carried at fair value through profit or loss. Investments in subsidiaries include Open-ended Investments Companies ('OEICs'), which the Company is considered to control.

**(o) Financial assets**

Purchases and sales of financial assets are recognised on the trade date, which is the date that the Company commits to purchase or sell the asset.

Loans and deposits are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. These investments are initially recognised at cost, being the fair value of the consideration paid for the acquisition of the investment. All transaction costs directly attributable to the acquisition are also included in the cost of the investment. Subsequent to initial recognition, these investments are carried at amortised cost, using the effective interest method.

Reinsurance and retrocession contracts not considered to be insurance contracts under IFRSs are classed as loans or debts held at fair value where that is appropriate. Such loans or debts are initially recognised and measured at fair value and are subsequently measured at fair value (after reflecting such factors as valuation adjustments for liquidity and credit) using forecast cash flows to avoid accounting mismatches.

Derivative financial instruments are classified as held for trading. They are recognised initially at fair value and subsequently are re-measured to fair value. Exchange-traded derivatives are valued at the published bid price, or, if these are not available, by using valuation techniques such as discounted cash flow models or option pricing models. The gain or loss on re-measurement to fair value is recognised as income or an expense in the Statement of comprehensive income.

Equities, fixed and variable rate income securities and collective investment schemes are designated at fair value through profit or loss and accordingly are stated in the Statement of financial position at fair value. They are designated at fair value through profit or loss because they are managed and evaluated on a fair value basis in accordance with the Company's stated risk management policies.

#### ***Impairment of financial assets***

The Company assesses at each period end whether a financial asset, or group of financial assets, held at amortised cost is impaired. The Company first assesses whether objective evidence of impairment exists for financial assets. If it is determined that no objective evidence of impairment exists for an individually assessed financial asset, the asset is included in a group of financial assets with similar credit risk characteristics and that group of financial assets is collectively assessed for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in the collective assessment of impairment.

#### ***Fair value estimation***

The fair value of financial instruments traded in active markets such as publicly traded securities and derivatives are based on quoted market prices at the period end. The quoted market price used for financial assets is the current bid price on the trade date. The fair value of investments that are not traded in an active market is determined using valuation techniques such as broker quotes, pricing models or discounted cash flow techniques. Where pricing models are used, inputs are based on market related data at the period end. Where discounted cash flow techniques are used, estimated future cash flows are based on contractual cash flows using current market conditions and market calibrated discount rates and interest rate assumptions for similar instruments.

For units in unit trusts and shares in open-ended investment companies, fair value is determined by reference to published bid-values. The fair value of receivables and floating rate and overnight deposits with credit institutions is their carrying value. The fair value of fixed interest-bearing deposits is estimated using discounted cash flow techniques.

#### ***Collateral***

The Company receives and pledges collateral in the form of cash or non-cash assets in respect of stock lending transactions, derivative contracts and reinsurance arrangements in order to reduce the credit risk of these transactions. The amount and type of collateral required where the Company receives collateral depends on an assessment of the credit risk of the counterparty.

Collateral received in the form of cash, where the Company has contractual rights to receive the cash flows generated, is recognised as an asset in the Statement of financial position with a corresponding liability for its repayment. Non-cash collateral received is not recognised in the Statement of financial position, unless the counterparty defaults on its obligations under the relevant agreement.

Cash and non-cash collateral pledged where the Company retains the contractual rights to receive the cash flows generated is not derecognised from the Statement of financial position, unless the Company defaults on its obligations under the relevant agreement. Cash and non-cash collateral pledged, where the counterparty has contractual rights to receive the cash flows generated, is derecognised from the Statement of financial position and a corresponding receivable is recognised for its return.

#### **(p) Reinsurance**

##### ***Reinsurance Ceded***

The Company cedes insurance risk in the normal course of business. Reinsurance assets represent balances due from reinsurance companies. Reinsurers' share of insurance contract liabilities are dependent on expected claims and benefits arising under the related reinsured policies.

Reinsurance assets are reviewed for impairment at each reporting date or more frequently when an indication of impairment arises during the reporting year. Impairment occurs when there is objective evidence as a result of an event that occurred after initial recognition of the reinsurance asset that the Company may not receive all outstanding amounts due under the terms of the contract and the event has a reliably measurable impact on the amounts that the Company will receive from the reinsurer. The impairment charge is recorded as an expense in the Statement of comprehensive income. The reinsurers' share of investment contract liabilities is measured on a basis that is consistent with the valuation of the underlying assets in which the policyholders funds have been invested.

Gains or losses on purchasing reinsurance are recognised as income or an expense in the Statement of comprehensive income at the date of purchase and are not amortised. They are the difference between the premiums ceded to reinsurers and the related change in the reinsurers' share of insurance contract liabilities. Reinsurance and retrocession contracts not considered to be insurance contracts under IFRSs are classed as derivatives, loans or borrowings, where that is appropriate.

**Reinsurance accepted**

The Company accepts insurance risk under reinsurance contracts. Amounts paid to cedants at the inception of reinsurance contracts in respect of future profits on certain blocks of business are recognised as a reinsurance asset. Changes in the value of the reinsurance assets created from the acceptance of reinsurance are recognised as an expense in the Statement of comprehensive income, consistent with the expected emergence of the economic benefits from the underlying blocks of business.

At each reporting date, the Company assesses whether there are any indications of impairment. When indications of impairment exist, an impairment test is carried out by comparing the carrying value of the asset with the estimate of the recoverable amount. When the recoverable amount is less than the carrying value, an impairment charge is recognised as an expense in the Statement of comprehensive income. Reinsurance assets are also considered in the liability adequacy test for each reporting period.

**(q) Deferred acquisition costs**

From 29 December 2017, the Company reinsured all new business to Phoenix Life Limited ("PLL"), a fellow group subsidiary, and from that date no longer deferred the costs associated with acquiring new business.

Prior to the reinsurance with PLL, acquisition costs, comprising all direct and indirect costs arising from the conclusion of non-profit insurance and investment contracts were deferred as an explicit acquisition cost asset. This asset was amortised over the period in which the costs were expected to be recoverable out of margins from matching revenues from related policies and in accordance with the pattern of such margins. Deferred acquisition cost amortisation has been expensed within acquisition costs in the Statement of comprehensive income. At the end of each accounting period, deferred acquisition costs were reviewed for recoverability, by category, against future margins from the related policies in force at the period end.

**(r) Cash and cash equivalents**

Cash and cash equivalents comprise cash balances and short-term deposits with an original maturity term of three months or less at the date of placement. Bank overdrafts that are repayable on demand and form an integral part of the Company's cash management are deducted from cash and cash equivalents for the purpose of the Statement of cash flows.

**(s) Provisions and contingent liabilities**

A provision is recognised when the Company has a present legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability. Where the Company has a present legal or constructive obligation but it is not probable that there will be an outflow of resources to settle the obligation or the amount cannot be reliably estimated, this is disclosed as a contingent liability.

A provision is recognised for onerous contracts in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs reflect the least net cost of exiting the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

Where it is expected that part of the expenditure required to settle a provision will be reimbursed by a third party the reimbursement is recognised when, and only when, it is virtually certain that the reimbursement will be received. This reimbursement shall be recognised as a separate asset within other receivables and will not exceed the amount of the provision

**(t) Dividends**

Final dividends on ordinary shares are recognised as a liability and deducted from equity when they are approved by the Company's owners. Interim dividends are deducted from equity when they are paid.

Dividends for the year that are approved after the reporting period are dealt with as an event after the reporting period.

**(u) Income recognition**

**Gross premiums**

In respect of insurance contracts, premiums are accounted for on a receivable basis and exclude any taxes or duties based on premiums. Funds at retirement under individual pension contracts converted to annuities with the Company are, for accounting purposes, included in both claims incurred and premiums within gross premiums written. Risk margins under longevity insurance and reinsurance contracts are reported as premiums. Reinsurance premiums ceded are disclosed separately.

**Reinsurance premiums**

Outward reinsurance premiums are accounted for on a payable basis.

Reinsurance premiums include amounts receivable as refunds of premiums in cases where the Company cancels arrangements for the reinsurance of risk to another insurer.

**Fee and commission income**

Fee and commission income relates to the following:

- investment contract income – investment contract policyholders are charged for policy administration services, investment management services, surrenders and other contract fees. These fees are recognised as revenue over the period in which the related services are performed. If the fees are for services provided in future periods, then they are deferred and recognised over those periods. 'Front end' fees are charged on some non-participating investment contracts. Where the non-participating investment contract is measured at fair value, such fees which relate to the provision of investment management services are deferred and recognised as the services are provided; and
- release of deferred income reserve.

**Net investment income**

Net investment income comprises interest, dividends, rents receivable, fair value gains and losses on financial assets and investment property and impairment reversals and losses on loans and deposits and investments in subsidiaries.

Interest income is recognised as income in the Statement of comprehensive income as it accrues using the effective interest method. Dividend income is recognised as income in the Statement of comprehensive income on the date the right to receive payments is established, which in the case of listed securities is the ex-dividend date.

Rental income from investment property is recognised as income in the Statement of comprehensive income on a straight-line basis over the term of the lease. Lease incentives granted are recognised as an integral part of the total rental income.

Fair value gains and losses on financial assets designated at fair value through profit or loss are recognised as income or expense in the Statement of comprehensive income. Realised gains and losses are the difference between the net sale proceeds and the original cost. Unrealised gains and losses are the difference between the valuation at the period end and their valuation at the previous period end or purchase price, if acquired during the year.

**(v) Benefits, claims and expenses recognition**

**Gross benefits and claims**

Claims on insurance contracts reflect the cost of all claims arising during the period, including policyholder bonuses allocated in anticipation of a bonus declaration. Claims payable on maturity are recognised when the claim becomes due for payment and claims payable on death are recognised on notification. Claims are recorded as an expense when they are notified in the case of deaths and surrenders, or become due in the case of maturities and annuities. The net amounts due in respect of variances between the expected and actual benefit values under longevity insurance and reinsurance contracts are reported as claims. Reinsurance claims reimbursed are disclosed separately. Where claims are payable and the contract remains in force, the claim instalment is accounted for when due for payment. Claims payable include the costs of settlement.

**Reinsurance claims**

Reinsurance claims are recognised when the related gross insurance claim is recognised according to the terms of the relevant contract.

**Finance costs**

Interest payable is recognised as an expense in the Statement of comprehensive income as it accrues and is calculated by using the effective interest method.

**(w) Pension and other post-retirement benefit obligations**

The majority of the Company's employees are members of the Abbey Life Staff Pension Scheme, a defined benefit scheme which was funded by the Company until 30 June 2017 and which is closed to new entrants. On 30 June 2017 the scheme was transferred to Pearl Life Holdings Limited ("PeLHL"), who now fund the scheme. The scheme is funded through payments to trustee-administered funds, which are legally separate from the Company and PeLHL, determined by periodic actuarial calculations.

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 compensation.



The asset or liability recognised in the Statement of financial position, in respect of the defined benefit element of the pension scheme, is the difference between the present value of the defined benefit obligation at the balance sheet date and the fair value of scheme assets, together with adjustments for past service costs. The defined benefit obligation is calculated annually by a qualified independent actuary using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high-quality corporate bonds that are denominated in the currency in which the benefits will be paid and that have terms to maturity that approximate to the terms of the related pension liability.

An asset or surplus is recognised only if the employer has an unconditional right to realise it at a future date. Actuarial gains and losses arising from experience adjustments and changes in the actuarial assumptions are presented in other comprehensive income for the year, together with the associated tax effects.

Other changes to past service liabilities are recognised immediately in income, unless the changes to the pension scheme are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

Certain employees are members of a defined contribution pension scheme. In 2016 all costs were charged to the Company's Statement of comprehensive income as the employee provided their service.

**(x) Share capital and capital contributions**

***Ordinary share capital***

The Company has issued ordinary shares which are classified as equity. Details of the relating entitlements are disclosed within note 13.

***Capital contributions***

Capital contributions received by the Company and which contain no agreement for their repayment are recognised directly in the Statement of changes in equity as a distributable reserve.

**(y) Segmental reporting**

The Company has one reportable segment.

**(z) Events after the reporting period**

The financial statements are adjusted to reflect significant events that have a material effect on the financial results and that have occurred between the period end and the date when the financial statements are authorised for issue, provided they give evidence of conditions that existed at the period end. Events that are indicative of conditions that arise after the period end that do not result in an adjustment to the financial statements are disclosed.

ABBEY LIFE ASSURANCE COMPANY LIMITED

**Statement of comprehensive income**  
for the year ended 31 December 2017

|   | Notes | 2017<br>£m     | 2016<br>£m<br>restated * |
|---|-------|----------------|--------------------------|
| Gross premiums written  | 3     | 69             | 88                       |
| Less: premiums ceded to reinsurers                                    | 4     | (2,492)        | (17)                     |
| <b>Net premiums written</b>   |       | <b>(2,423)</b> | <b>71</b>                |
| Fees and commissions  | 5     | 130            | 68                       |
| Net investment income   | 6     | 900            | 1,496                    |
| <b>Total revenue, net of reinsurance payable</b>                      |       | <b>(1,393)</b> | <b>1,635</b>             |
| <b>Net income</b>   |       | <b>(1,393)</b> | <b>1,635</b>             |
| Policyholder claims   |       | (322)          | (317)                    |
| Less: reinsurance recoveries  |       | 6              | 4                        |
| Change in insurance contract liabilities                              |       | 561            | (215)                    |
| Change in reinsurers' share of insurance contract liabilities         |       | 2,192          | (7)                      |
| <b>Net policyholder claims and benefits incurred</b>                  |       | <b>2,437</b>   | <b>(535)</b>             |
| Change in investment contract liabilities                             |       | (644)          | (968)                    |
| Acquisition costs   | 7     | (74)           | (11)                     |
| Administrative expenses   | 8     | (85)           | (50)                     |
| <b>Total operating expenses</b>                                       |       | <b>1,634</b>   | <b>(1,564)</b>           |
| <b>Profit before finance costs and tax</b>                            |       | <b>241</b>     | <b>71</b>                |
| Finance costs   | 11    | (2)            | (4)                      |
| <b>Profit for the year before tax</b>                                 |       | <b>239</b>     | <b>67</b>                |
| Tax credit/(charge) attributable to policyholders' returns            | 12    | 6              | (25)                     |
| <b>Profit before tax attributable to owners</b>                       |       | <b>245</b>     | <b>42</b>                |
| Tax charge  | 12    | (59)           | (35)                     |
| Less: tax attributable to policyholders' returns                      |       | (6)            | 25                       |
| Tax charge attributable to owners                                     |       | (65)           | (10)                     |
| <b>Profit for the year attributable to owners</b>                     |       | <b>180</b>     | <b>32</b>                |
| <b>Other comprehensive income</b>                                     |       |                |                          |
| Items that will not be reclassified to profit or loss:                |       |                |                          |
| Pension benefit plan actuarial (losses)/gains                         | 24    | (2)            | (34)                     |
| Taxation on items of other comprehensive income                       |       | -              | 5                        |
| <b>Other comprehensive income after tax</b>                           |       | <b>(2)</b>     | <b>(29)</b>              |
| <b>Total comprehensive income for the year attributable to owners</b> |       | <b>178</b>     | <b>3</b>                 |

\* Note

For details of the restatements see note 2

ABBAY LIFE ASSURANCE COMPANY LIMITED

**Statement of financial position – equity and liabilities**  
as at 31 December 2017

|   | Notes | As at 31<br>December<br>2017<br>£m | As at 31<br>December<br>2016<br>£m<br>restated * |
|---|-------|------------------------------------|--|
| <b>EQUITY AND LIABILITIES</b>                         |       |                                    |  |
| <b>Equity attributable to owners of the parent</b>    |       |                                    |  |
| Share capital   | 13    | 31                                 | 31   |
| Share premium   |       | 254                                | 254  |
| Capital contribution reserve                          | 14    | 29                                 | 6  |
| Pension benefits actuarial losses reserve             | 24    | -                                  | (102)  |
| Retained earnings                                     |       | 215                                | 606  |
| <b>Total equity</b>                                   |       | <b>529</b>                         | <b>795</b>                                       |
| <b>Liabilities</b>                                    |       |                                    |  |
| <b>Insurance contract liabilities</b>                 |       |                                    |  |
| Liabilities under insurance contracts                 | 16    | 3,495                              | 4,056  |
| Unallocated surplus                                   | 17    | 6                                  | 6  |
|   |       | <b>3,501</b>                       | <b>4,062</b>                                     |
| <b>Financial liabilities</b>                          |       |                                    |  |
| Investment contracts                                  |       | 6,202                              | 6,191  |
| Borrowings  | 18    | 51                                 | 87   |
| Derivatives   | 19    | 132                                | 305  |
|   | 29    | <b>6,385</b>                       | <b>6,583</b>                                     |
| Provisions  | 20    | 39                                 | 5  |
| Deferred tax  | 21    | 39                                 | 48   |
| Reinsurance payables                                  |       | 1                                  | 2  |
| Payables related to direct insurance contracts        | 22    | 118                                | 103  |
| Current tax   | 21    | -                                  | 8  |
| Accruals and deferred income                          | 23    | 9                                  | 80   |
| Pension and other post-retirement benefit obligations | 24    | -                                  | 87   |
| Other payables  | 25    | 179                                | 24   |
| <b>Total liabilities</b>                              |       | <b>10,271</b>                      | <b>11,002</b>                                    |
| <b>Total equity and liabilities</b>                   |       | <b>10,800</b>                      | <b>11,797</b>                                    |

\* Note

For details of the restatements see note 2

**Statement of financial position - assets**  
as at 31 December 2017

|   | Notes | As at 31<br>December<br>2017<br>£m | As at 31<br>December<br>2016<br>£m<br>restated * |
|---|-------|------------------------------------|--|
| <b>ASSETS</b>                                       |       |                                    |  |
| Investment in subsidiaries                          | 26    | 1,069                              | 1,083  |
| Investment property                                 | 27    | 7                                  | 7  |
| Financial assets                                    |       |                                    |  |
| Loans and deposits                                  | 28    | 113                                | 380  |
| Derivatives   | 19    | 152                                | 110  |
| Equities  |       | 4,134                              | 4,116  |
| Fixed and variable rate income securities           |       | 331                                | 2,870  |
| Collective investment schemes                       |       | 2,543                              | 2,902  |
|   | 29    | 7,273                              | 10,378   |
| Deferred tax assets                                 | 21    | 14                                 | 29   |
| Insurance assets                                    |       |                                    |  |
| Reinsurers' share of insurance contract liabilities | 16    | 2,292                              | 100  |
| Reinsurance receivables                             |       | 2                                  | 3  |
| Insurance contract receivables                      |       | 1                                  | 1  |
|   |       | 2,295                              | 104  |
| Current tax   | 21    | 3                                  | -  |
| Deferred acquisition costs                          |       | -                                  | 74   |
| Prepayments and accrued income                      | 31    | 14                                 | 52   |
| Other receivables                                   | 32    | 97                                 | 37   |
| Cash and cash equivalents                           | 33    | 28                                 | 33   |
| <b>Total assets</b>                                 |       | <b>10,800</b>                      | <b>11,797</b>                                    |

\* Note

For details of the restatements see note 2

On behalf of the Board



D Cheeseman  
Director

8 March 2018

ABBHEY LIFE ASSURANCE COMPANY LIMITED

**Statement of cash flows**  
for the year ended 31 December 2017

|   | Notes | 2017<br>£m   | 2016<br>£m<br>restated |
|---|-------|--------------|------------------------|
| <b>Cash flows from operating activities</b>                             |       |              |                        |
| Cash generated from operations  | 34    | 501          | 51                     |
| Taxation paid   |       | (22)         | (34)                   |
| <b>Net cash flows from operating activities</b>                         |       | <u>479</u>   | <u>17</u>              |
| <b>Cash flows from investing activities</b>                             |       |              |                        |
| <b>Cash flows from financing activities</b>                             |       |              |                        |
| Ordinary share dividends paid   | 15    | (317)        | -                      |
| Proceeds of capital contribution  | 14    | 23           | -                      |
| Loan issued to parent   |       | (150)        | -                      |
| Repayment of borrowings   | 18    | (40)         | (27)                   |
| Interest paid on borrowings   |       | -            | -                      |
| <b>Net cash flows from financing activities</b>                         |       | <u>(484)</u> | <u>(27)</u>            |
| <b>Net increase in cash and cash equivalents</b>                        |       | (5)          | (10)                   |
| Cash and cash equivalents at the beginning of the year                  |       | 33           | 43                     |
| <b>Cash and cash equivalents at the end of the year</b>                 | 33    | <u>28</u>    | <u>33</u>              |
| <b>Supplementary disclosures on cash flow from operating activities</b> |       |              |                        |
| Interest received   |       | <u>140</u>   | <u>150</u>             |
| Dividends received  |       | <u>151</u>   | <u>153</u>             |

ABBEEY LIFE ASSURANCE COMPANY LIMITED

**Statement of changes in equity**  
for the year ended 31 December 2017

|  | Share capital<br>(note 13)<br>£m | Share<br>premium<br>£m | Capital<br>contribution<br>reserve<br>(note 14)<br>£m | Pension<br>benefits<br>actuarial<br>(losses)<br>reserve<br>£m | Retained<br>earnings<br>£m | Total<br>£m |
|--|----------------------------------|------------------------|---|---|----------------------------|-------------|
| At 1 January 2017  | 31                               | 254                    | 6   | (102)   | 606                        | 795         |
| Profit for the year  | -                                | -                      | -   | -   | 180                        | 180         |
| Other comprehensive<br>income for the year                                   | -                                | -                      | -   | (2)   | -                          | (2)         |
| Total comprehensive<br>income for the year                                   | -                                | -                      | -   | (2)   | 180                        | 178         |
| Capital contribution<br>received (note 14)                                   | -                                | -                      | 23  | -   | -                          | 23          |
| Transfer of Pension<br>benefits reserve to<br>Retained earnings (note<br>24) | -                                | -                      | -   | 104   | (104)                      | -           |
| Dividends paid on<br>ordinary shares (note 15)                               | -                                | -                      | -   | -   | (467)                      | (467)       |
| At 31 December 2017  | 31                               | 254                    | 29  | -   | 215                        | 529         |

Of the above, £209m (2016: £511m) is considered distributable.

|  | Share capital<br>(note 13)<br>£m | Share<br>premium<br>£m | Capital<br>contribution<br>reserve<br>(note 14)<br>£m | Pension<br>benefits<br>actuarial<br>(losses)<br>reserve<br>£m | Retained<br>earnings<br>£m | Total<br>£m |
|--|----------------------------------|------------------------|---|---|----------------------------|-------------|
| At 1 January 2016                              | 31                               | 254                    | 6   | (73)  | 574                        | 792         |
| Profit for the year                            | -                                | -                      | -   | -   | 32                         | 32          |
| Other comprehensive<br>income for the year     | -                                | -                      | -   | (29)  | -                          | (29)        |
| Total comprehensive<br>income for the year     | -                                | -                      | -   | (29)  | 32                         | 3           |
| Dividends paid on<br>ordinary shares (note 15) | -                                | -                      | -   | -   | -                          | -           |
| At 31 December 2016                            | 31                               | 254                    | 6   | (102)   | 606                        | 795         |

## Notes to the financial statements

### 1. Financial information

The financial statements for the year ended 31 December 2017, set out on pages 17 to 67, were authorised by the Board of Directors for issue on 8 March 2018.

In preparing the financial statements the Company has adopted the following standards, interpretations and amendments which have been issued by the International Accounting Standards Board ("IASB") and have been adopted for use by the EU. None of the following have a material effect on the results of the Company.

#### Amendments to IAS 7 Disclosure Initiative

The Company has applied these amendments for the first time in the current year. The amendments require an entity to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both cash and non-cash changes.

The Company's liabilities arising from financing activities consist of borrowings. A reconciliation between the opening and closing balances of these items is provided in note 18. Consistent with the transition provisions of the amendments, the Company has not disclosed comparative information for the prior period. Apart from the additional disclosure in note 18 the application of these amendments has had no impact on the Company's financial statements.

#### Amendments to IAS 12 Recognition of Deferred Tax Assets for Unrealised Losses

The Company has applied these amendments for the first time in the current year. The amendments clarify how an entity should evaluate whether there will be sufficient future taxable profits against which it can utilise a deductible temporary difference.

The application of these amendments has had no impact on the Company's financial statements as the Company's existing approach to assessing the sufficiency of future taxable profits is consistent with that required under the amended standard.

#### Annual Improvements to IFRSs 2014-2016 Cycle

The Company has applied the amendments to IFRS 12 included in the Annual Improvements to IFRSs 2014-2016 Cycle for the first time in the current year. The other amendments included in this package are not yet mandatorily effective and have not been early adopted by the Company.

IFRS 12 states that an entity need not provide summarised financial information for interests in subsidiaries, associates or joint ventures that are classified (or included in a disposal group that is classified) as held for sale. The amendments clarify that this is the only concession from the disclosure requirements of IFRS 12 for such interests.

The application of these amendments has had no effect on the Company's financial statements as none of the Company's interests in these entities have been classified, or included in a disposal group that is classified, as held for sale in either the current or prior period.

The IASB has issued the following new or amended standards and interpretations which apply from the dates shown. The Company has decided not to early adopt any of these standards, interpretations or amendments where this is permitted.

#### IFRS 9 Financial Instruments (2018 – Deferred to 2021)

Under IFRS 9, all financial assets will be measured either at amortised cost or fair value and the basis of classification will depend on the business model and the contractual cash flow characteristics of the financial assets. In relation to the impairment of financial assets, IFRS 9 requires the use of an expected credit loss model, as opposed to the incurred credit loss model required under IAS 39. The expected credit loss model will require the Company to account for expected credit losses and changes in those expected credit losses at each reporting date to reflect changes in credit risk since initial recognition.

The Company has taken advantage of the temporary exemption granted to insurers in IFRS 4 Insurance Contracts from applying IFRS 9 until 1 January 2021 as a result of meeting the exemption criteria as at 31 December 2015. As at this date the Company's activities were considered to be predominantly connected with insurance as the percentage of the total carrying amount of its liabilities connected with insurance relative to the total carrying amount of all its liabilities was greater than 90%. There have been no changes to the activities of the Company that require this assessment to be re-performed. IFRS 9 will instead be implemented at the same time as the new insurance contracts standard (IFRS 17 Insurance Contracts). The Company expects to continue to value the majority of its financial assets as at fair value through profit or loss on initial recognition, so as to eliminate or reduce any potential accounting mismatch. As a result, no material financial impacts are anticipated. When applying the exemption, IFRS 4 requires that a number of disclosures be made in 2018 to provide information to allow comparison with entities adopting the standard in 2018.

#### **IFRS 15 Revenue from contracts with Customers (2018)**

IFRS 15 establishes a single comprehensive framework for determining whether, how and when revenue is recognised. The standard does not apply to insurance contracts or financial instruments within the scope of IAS 39 Financial Instruments: Recognition and Measurement. Accordingly a detailed impact assessment has been performed to consider the impact of IFRS 15 in relation to revenue streams from the Company's investment contracts and the provision of investment management services. As a result of the outcome of the assessment, the Company does not consider that the application of IFRS 15 will have an impact on the financial position and/or financial performance of the Company. IFRS 15 introduces additional disclosure requirements which will be reflected in the 2018 financial statements.

#### **Transfers of Investment Property (Amendments to IAS 40) (2018)**

The amendments clarify that a transfer to, or from, investment property necessitates an assessment of whether a property meets, or has ceased to meet, the definition of investment property, supported by observable evidence that a change in use has occurred. The amendments further clarify that situations other than the ones listed in IAS 40 may evidence a change in use, and that a change in use is possible for properties under construction (i.e. a change in use is not limited to completed properties). The Company anticipates that the application of these amendments may have an impact on the Company's financial statements in future periods should there be a change in use of any of its properties.

#### **Annual Improvements to IFRSs 2014-2016 Cycle (2018)**

The Annual Improvements include amendments to IFRS 1 and IAS 28 which are not yet mandatorily effective for the Company. The package also includes amendments to IFRS 12 which is mandatorily effective for the Company in the current year. The Company does not anticipate that the application of the amendments in the future will have any impact on the Company's financial statements as the Company is neither a first-time adopter of IFRS nor a venture capital organisation. Furthermore, the Company does not have any associate or joint venture that is an investment entity.

#### **IFRIC 23 Uncertainty over Income Tax Treatments (2019)**

This interpretation clarifies the accounting for income tax treatments that have yet to be accepted by tax authorities, whilst also aiming to enhance transparency.

#### **IFRS 17 Insurance contracts (2021)**

IFRS 17 is expected to significantly change the way the Company measures and reports its insurance contracts. The new standard uses three measurement approaches and the principles underlying these measurement approaches will significantly change the way the Company measures its insurance contracts and investment contracts with DPF. These changes will impact profit emergence patterns and add complexity to valuation processes, data requirements and assumption setting. As a consequence, during 2017 the Company commenced a project to perform an initial impact assessment of the standard on the Company and to produce a detailed implementation plan. Implementation activities will continue in 2018/19.

Where not specifically stated, the impact on the Company of adopting the above standards, amendments and interpretations is subject to evaluation.

## **2. Presentation of financial statements**

Following the acquisition of the Company by the Phoenix Group on 30 December 2016, the format of the 2017 accounts has been amended. The majority of changes relate to aligning to the Phoenix Group accounts format, although there are some presentational adjustments. Affected statements and notes are identified by the use of "Restated".

The impact on both total comprehensive income for the year attributable to owners and net assets is £nil.

The following table shows the key movements:



ABBHEY LIFE ASSURANCE COMPANY LIMITED

|   | 2016<br>As reported<br>£m | 2016<br>Restated<br>£m | 2016<br>Difference<br>£m |
|---|---------------------------|------------------------|--------------------------|
| <b>Statement of comprehensive income</b>  |                           |                        |                          |
| Fees and commissions  | 19                        | 68                     |                          |
| Net investment income   | 313                       | 1,496                  |                          |
| Net realised gains on financial assets  | 331                       | -                      |                          |
| Net fair value gains on assets/liabilities at fair value through profit or loss | 854                       | -                      |                          |
|   | 1,517                     | 1,564                  | (47)                     |
| Change in investment contract liabilities                                       | (919)                     | (968)                  |                          |
| Net operating expenses  | (46)                      | -                      |                          |
| Expenses for asset management services  | (14)                      | -                      |                          |
| Acquisition costs   | -                         | (11)                   |                          |
| Administrative expenses   | -                         | (50)                   |                          |
|   | (979)                     | (1,029)                | 50                       |
| Finance costs   | (6)                       | (4)                    | (2)                      |
| Taxation  | (36)                      | (35)                   | (1)                      |
| <b>Balance Sheet</b>  |                           |                        |                          |
| <b>Liabilities</b>  |                           |                        |                          |
| Other financial liabilities   | (200)                     | -                      |                          |
| Borrowings  | -                         | (87)                   |                          |
| Reinsurance payables  | -                         | (2)                    |                          |
| Payables related to direct insurance contracts                                  | -                         | (103)                  |                          |
| Other payables  | -                         | (24)                   |                          |
|   | (200)                     | (216)                  | 16                       |
| Accruals and deferred income  | (95)                      | (80)                   | (15)                     |
| <b>Assets</b>   |                           |                        |                          |
| Investment in associates  | 495                       | -                      |                          |
| Loans and receivables   | 454                       | -                      |                          |
| Loans and deposits  | -                         | 380                    |                          |
| Collective investment schemes   | 2,407                     | 2,902                  |                          |
| Reinsurance receivables   | -                         | 3                      |                          |
| Insurance contract receivables  | -                         | 1                      |                          |
| Prepayments and accrued income  | -                         | 52                     |                          |
| Other receivables   | -                         | 37                     |                          |
|   | 3,356                     | 3,375                  | (19)                     |
| Cash and cash equivalents   | 51                        | 33                     | 18                       |

Key presentational updates to note include the following:

Statement of comprehensive income:

To align with the Phoenix Group accounts format fees and commissions has been increased by £49m with a corresponding entry in change in investment contract liabilities.

Overseas withholding tax and corporation tax have been reclassified from net investment income to tax (£1m).

Commission received has been reclassified from administrative expenses to net investment income (£1m).

Customer compensation has been reclassified from finance costs to administrative expenses (£1m).

Balance sheet:

The Company has retrospectively applied accounting policy (m) to the prior period to align to the Phoenix Group policy, enhancing the relevance of the disclosure for users. This results in the reclassification of £495m of investments from investment in associates to collective investment schemes in the prior period. There is no impact of this change on the statement of comprehensive income.

Cash held with brokers has been reclassified from cash and cash equivalents to other receivables (£18m) as by nature it represents a receivable and not a cash balance. A change to the cash flow statement was required following this reclassification.

Other payables balances that had been allocated to accruals have been reclassified from accruals and deferred income to other payables (£15m).

**3. Gross premiums written**

Gross premiums written comprise:

|  | 2017 | 2016 |
|--|------|------|
|  | £m   | £m   |
| Gross premiums written under on-going arrangements | 69   | 88   |

**4. Premiums ceded to reinsurers**

On 29 December 2017, substantially all of the risks and rewards of the existing and new business of the Company (that were not subject to existing reinsurance arrangements and with the exception of the with-profit funds) were reinsured to PLL, a fellow member of the Phoenix Group, under two reinsurance agreements. The first treaty relates to policies within the Matching Adjustment portfolio and the second treaty relates to all other business in scope of the reinsurance transaction. The Company paid a reinsurance premium to PLL of £2,478m, and recognised reinsurers' share of insurance liabilities of £2,581m.

The Company subsequently recognised income and expenses of £67m and £(70)m respectively that had been previously deferred, as all related future benefits transferred to PLL.

As a result the Company made a one-off profit on inception of the reinsurance of £100m before tax.

Certain external reinsurance treaties and a deed of covenant were also novated as part of the transaction.

Premiums ceded to reinsurers comprise:

|  | 2017           | 2016        |
|--|----------------|-------------|
|  | £m             | £m          |
| Reinsurance premium paid to PLL                                    | (2,478)        | -           |
| Reinsurance premiums ceded under on-going reinsurance arrangements | (14)           | (17)        |
|  | <u>(2,492)</u> | <u>(17)</u> |

**5. Fees and commissions**

|                             | 2017       | 2016      |
|-----------------------------|------------|-----------|
|                             | £m         | £m        |
|                             |            | restated  |
| Investment contract income  | 59         | 56        |
| Movement in deferred income | 4          | 12        |
| Release of deferred income  | 67         | -         |
|                             | <u>130</u> | <u>68</u> |

The cost of the service obligation attached to the existing deferred income has been settled within the premium and transferred to PLL via the reinsurance agreements. Therefore, the deferred income has been released to the Statement of comprehensive income.

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**6. Net investment income**

|  | 2017<br>£m | 2016<br>£m<br>restated |
|--|------------|------------------------|
| Investment income  |            |                        |
| Interest income on loans and deposits  | 2          | 4                      |
| Interest income on financial assets designated at fair value through profit or loss on initial recognition | 138        | 146                    |
| Dividend income  | 151        | 153                    |
| Rental income  | -          | 1                      |
|  | <u>291</u> | <u>304</u>             |
| Fair value gains/(losses)  |            |                        |
| Financial assets and liabilities at fair value through profit or loss                                      |            |                        |
| Held for trading – derivatives   | 249        | 10                     |
| Designated upon initial recognition  | 246        | 1,024                  |
| Investment in subsidiaries (note 26)   | 114        | 158                    |
|  | <u>609</u> | <u>1,192</u>           |
| Net investment income  | <u>900</u> | <u>1,496</u>           |

**7. Acquisition costs**

|  | 2017<br>£m | 2016<br>£m |
|--|------------|------------|
| Acquisition costs paid                 | -          | 1          |
| Movement in deferred acquisition costs | 4          | 10         |
| Release of deferred acquisition costs  | 70         | -          |
|  | <u>74</u>  | <u>11</u>  |

The existing deferred acquisition costs will not be supportable by the future profits of the business, as these have been fully reinsured. Therefore, the deferred acquisition costs have been released into the Statement of comprehensive income.

**8. Administrative expenses**

|  | 2017<br>£m | 2016<br>£m<br>restated |
|--|------------|------------------------|
| Employee costs                                       | 4          | 7                      |
| Outsourcing expenses                                 | 45         | 24                     |
| Investment management expenses and transaction costs | 12         | 14                     |
| Transfer of staff pension scheme (note 24)           | 24         | -                      |
| Other  | -          | 5                      |
|  | <u>85</u>  | <u>50</u>              |

Employee costs comprise:

|   | 2017<br>£m | 2016<br>£m |
|---|------------|------------|
| Wages and salaries (including termination benefits) | 3          | 3          |
| Social security contributions                       | -          | 1          |
| Other pension costs (note 24)                       | 1          | 3          |
|   | <u>4</u>   | <u>7</u>   |

|                                    | 2017      | 2016      |
|------------------------------------|-----------|-----------|
| Average number of persons employed | <u>33</u> | <u>44</u> |

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**9. Directors' remuneration**

|   | 2017<br>£000   | 2016<br>£000   |
|---|----------------|----------------|
| Remuneration (executive and non-executive Directors' remuneration excluding pension contributions, awards under share option schemes and other long-term incentive schemes) | 446            | 1,242          |
| Share option schemes and other long-term benefits   | 153            | 102            |
| Contributions to money purchase pension schemes   | 17             | -              |
|   | 2017<br>Number | 2016<br>Number |
| Number of Directors accruing retirement benefits under:   |                |                |
| - a money purchase pension scheme   | 1              | 1              |
| Number of Directors who had exercised share options during the year   | 3              | -              |
|   | 2017<br>£000   | 2016<br>£000   |
| Highest paid Director's remuneration (apportionment)  | 219            | 712            |

The Executive Directors are employed by either PGMS or Pearl Group Services Limited ("PGS"). The Non-Executive Directors are not employed but provide their services via a letter of appointment. For the purposes of this note an apportionment of the total remuneration paid to the Directors of the Company by the Phoenix Group has been made based on an estimate of the services rendered to the Company.

**10. Auditor's remuneration**

The remuneration of the auditor of the Company, Ernst & Young LLP, including their associates, was £658,000 (2016: £351,800 to KPMG LLP). No services were provided to associated pension schemes. An additional £30,000 was paid to KPMG LLP in 2017 for services in respect of the 2016 year.

The following table shows fees paid to Ernst & Young LLP in 2017 and to KPMG LLP in 2016.

|   | 2017<br>£000 | 2016<br>£000 |
|---|--------------|--------------|
| Audit of the Company's financial statements | 658          | 352          |
| Audit related assurance services            | -            | 375          |
|   | 658          | 727          |

**11. Finance costs**

|                             | 2017<br>£m | 2016<br>£m |
|-----------------------------|------------|------------|
| Interest expense            |            |            |
| On borrowings at fair value | 2          | 4          |
| Attributable to:            |            |            |
| - shareholders              | 2          | 4          |

**12. Tax charge/(credit)**

**Current year tax charge**

|  | 2017<br>£m | 2016<br>£m |
|--|------------|------------|
| Current tax:   |            |            |
| UK Corporation tax   | 47         | 17         |
| Overseas tax   | 5          | 4          |
| Adjustment in respect of prior years                         | 1          | (1)        |
| Total current tax  | 53         | 20         |
| Deferred tax:  |            |            |
| Origination and reversal of temporary differences            | 6          | 15         |
| Total deferred tax   | 6          | 15         |
| Total tax charge for the year                                | 59         | 35         |
| Attributable to:   |            |            |
| - tax (credit)/charge attributable to policyholders' returns | (6)        | 25         |
| - tax charge attributable to owners                          | 65         | 10         |
| Total tax charge for the year                                | 59         | 35         |

The Company, as a proxy for policyholders in the UK, is required to pay taxes on investment income and gains each year. Accordingly, the tax benefit or expense attributable to UK life assurance policyholder earnings is included in income tax expense. The tax benefit attributable to policyholder earnings was £6m (2016: £25m expense).

**Reconciliation of tax charge/(credit)**

|  | 2017<br>£m | 2016<br>£m |
|--|------------|------------|
| Profit for the year before tax                             | 239        | 67         |
| Tax credit/(charge) attributable to policyholders' returns | 6          | (25)       |
| Profit before tax attributable to owners                   | 245        | 42         |
| Tax at standard UK rate of 19.25% (2016: 20%)              | 47         | 8          |
| Non-taxable income   | (5)        | (1)        |
| Non-taxable realised losses                                | 4          | -          |
| Adjustment to owner's tax charge in respect of prior years | -          | (1)        |
| Employer pension scheme deficit write-off                  | 15         | -          |
| Overseas tax   | 4          | 4          |
| Tax charge attributable to owners                          | 65         | 10         |
| Tax (credit)/charge attributable to policyholders' returns | (6)        | 25         |
| Total tax charge for the year                              | 59         | 35         |

**13. Share capital**

|  | 2017<br>£m | 2016<br>£m |
|--|------------|------------|
| Issued and fully paid  |            |            |
| 30,500,000 (2016: 30,500,000) "A" ordinary shares of £1 each | 31         | 31         |

The Company's Articles of Association contain a restriction on the number of shares that may be allotted.

The holders of the ordinary shares are entitled to one vote per share on matters to be voted on by owners and to receive such dividends, if any, as may be declared by the Board of Directors in its discretion out of legally available profits.

**14. Capital contribution reserve**

|                       | 2017<br>£m | 2016<br>£m |
|-----------------------|------------|------------|
| At 1 January          | 6          | 6          |
| Contribution received | 23         | -          |
| At 31 December        | 29         | 6          |

As part of the acquisition of the Company by Phoenix Life Holdings Limited ("PLHL") from Deutsche Bank AG Group ("DB") on 30 December 2016, DB provided PLHL with a deed of indemnity in respect of expenses that may arise as a result of the FCA's Long Standing Customer Enforcement Investigation and Annuity Sales Thematic review. To ensure the Company benefitted from the deed of indemnity, PLHL provided the Company with a capital contribution in the form of a Deed of covenant with a value of £23m. The capital contribution has been treated as capital as there is no agreement for repayment. The reserve is considered distributable.

**15. Dividends on ordinary shares**

|   | 2017<br>£m | 2016<br>£m |
|---|------------|------------|
| Cash dividends on ordinary shares:                    |            |            |
| Interim dividend for 2017 at 531p per share           | 162        | -          |
| Second interim dividend for 2017 at 508p per share    | 155        | -          |
| Interim in-specie dividend for 2017 at 492p per share | 150        | -          |
| Total dividends paid in the year                      | 467        | -          |

**16. Liabilities under insurance contracts**

|                          | Gross<br>liabilities<br>2017<br>£m | Re-<br>insurers'<br>share<br>2017<br>£m | Gross<br>liabilities<br>2016<br>£m | Re-<br>insurers'<br>share<br>2016<br>£m |
|--------------------------|------------------------------------|---|------------------------------------|---|
| Life assurance business: |                                    |   |                                    |   |
| Insurance contracts      | 3,495                              | 2,292                                   | 4,056                              | 100                                     |

Amounts due for settlement after 12 months

|                              | Gross<br>liabilities<br>2017<br>£m | Re-<br>insurers'<br>share<br>2017<br>£m | Gross<br>liabilities<br>2016<br>£m | Re-<br>insurers'<br>share<br>2016<br>£m |
|------------------------------|------------------------------------|---|------------------------------------|---|
| At 1 January                 | 4,056                              | 100                                     | 3,841                              | 108                                     |
| Premiums                     | 69                                 | 2,492                                   | 88                                 | 17                                      |
| Claims                       | (322)                              | (6)                                     | (317)                              | (4)                                     |
| Other changes in liabilities | (308)                              | (294)                                   | 444                                | (21)                                    |
| At 31 December               | 3,495                              | 2,292                                   | 4,056                              | 100                                     |

Other changes in liabilities principally comprise changes in economic and non-economic assumptions and experience.

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On 29 December 2017, the Company entered into two reinsurance agreements with PLL, a fellow Group Company. At the date of the transaction, the Company paid a reinsurance premium of £2,478m, which is included in the table above.

Following the implementation of the Solvency II regulatory regime effective from 1 January 2016, the Company made certain changes to the assumptions and estimates used in the 2017 valuation of insurance contracts. Further details are provided in note 36.

**17. Unallocated surplus**

|                | 2017<br>£m | 2016<br>£m |
|----------------|------------|------------|
| At 1 January   | 6          | 6          |
| At 31 December | 6          | 6          |

**18. Borrowings**

|   | 2017<br>£m | 2016<br>£m |
|---|------------|------------|
| <b>Carrying value</b>                                       |            |            |
| Financial liabilities at fair value through profit or loss: |            |            |
| Retrocession contracts                                      | 51         | 87         |
| Amount due for settlement after 12 months                   | 12         | 56         |

In 2012 the Company entered into retrocession contracts (classified as fair value debt) with Axia Insurance Ltd.

**Reconciliation of liabilities arising from financing**

The table below details changes in the Company's liabilities arising from financing activities, including both cash and non-cash changes. Liabilities arising from financing activities are those for which cash flows were, or future cash flows will be, classified in the Company's statement of cash flows as cash flows from financing activities.

|                        | At 1 Jan<br>2017<br>£m | Financing<br>cash flows<br>£m | Changes in<br>fair value<br>£m | At 31 Dec<br>2017<br>£m |
|------------------------|------------------------|-------------------------------|--------------------------------|-------------------------|
| Retrocession contracts | 87                     | (40)                          | 4                              | 51                      |

**19. Derivatives**

In the normal course of business, the Company enters into certain derivative contracts. All such contracts are undertaken either for efficient portfolio management purposes or for risk reduction. In particular, interest rate swap contracts are held chiefly for the purpose of matching guaranteed annuity option liabilities and retrocession contracts classified as derivatives offset risks in loans where cashflows are subject to variation due to mortality changes. Longevity swap contracts relate to the Corporate pension de-risking business. No derivatives held by the Company have been designated within hedge accounting relationships, as defined in IAS 39.

The fair values of derivative financial instruments are as follows:

|   | 2017<br>Assets<br>£m | 2017<br>Liabilities<br>£m | 2016<br>Assets<br>£m | 2016<br>Liabilities<br>£m |
|---|----------------------|---------------------------|----------------------|---------------------------|
| Forward currency                        | 2                    | (3)                       | 1                    | (4)                       |
| Stock index futures                     | 4                    | (9)                       | -                    | -                         |
| Interest rate and credit swap contracts | -                    | (21)                      | 52                   | (4)                       |
| Fixed income futures                    | 3                    | -                         | 6                    | (3)                       |
| Retrocession contracts                  | -                    | (21)                      | -                    | (254)                     |
| Longevity swap contracts                | 143                  | (78)                      | 51                   | (40)                      |
|   | 152                  | (132)                     | 110                  | (305)                     |

The amount recoverable after one year is £133m (2016: £110m). The amount payable after one year is £104m (2016: £305m).

The Company pledges and receives collateral in respect of its derivative positions. Further information is provided in note 29.

**20. Provisions**

|                       | Endowment<br>sales provision | Legacy Review | Annuity Sales<br>Practices | Total |
|-----------------------|------------------------------|---------------|----------------------------|-------|
|                       | £m                           | £m            | £m                         | £m    |
| At 1 January 2017     | -                            | 5             | -                          | 5     |
| Additions in the year | -                            | -             | 34                         | 34    |
| At 31 December 2017   | -                            | 5             | 34                         | 39    |

On 14 October 2016, the FCA published its thematic review of non-advised annuity sales. In its findings, the FCA identified concerns in a small number of firms relating to significant communications that took place orally, usually on the telephone. The FCA also identified other areas of possible concern, including in relation to the recording and maintenance of records of calls. The FCA encouraged all firms to consider its feedback and take appropriate action to address the points raised.

On 3 March 2016, the FCA published a thematic review report on the fair treatment of long-standing customers in the life insurance sector. Following completion of the review, the Company was subject to additional investigations. Specifically, the FCA is exploring whether remedial and/or disciplinary action is necessary or appropriate in respect of exit or paid-up charges being applied. Additionally, the Company is being investigated for potential contravention of regulatory requirements across a number of other areas assessed in the thematic review. The FCA has confirmed that these investigations have been commenced in order to enable the FCA to establish the reasons for the practices within firms and determine whether customers have suffered detriment as a result. No conclusion has been reached as to whether there have been any breaches of regulatory requirements. The commencement of investigations itself therefore cannot be taken to indicate that disciplinary action against the Company will result nor does it indicate that a penalty will inevitably be imposed or that redress will be payable.

The Company has recognised a provision of £39m as at 31 December 2017 (2016: £5m) in relation to its best estimate of its obligations arising as a result of past practices in the areas covered by the two thematic reviews. Any resultant outflow of economic benefits is subject to uncertainty given the absence of final findings from the FCA review procedures, which would determine the extent to which the FCA may require the Company to carry out remediation activities or impose financial penalties.

The endowment sales provision is in respect of compensation due to customers where past sales practices regarding mortgage endowment and other long term savings products were found to be deficient. The provision is for less than £1m.

**21. Tax assets and liabilities**

|  | 2017<br>£m  | 2016<br>£m  |
|--|-------------|-------------|
| <b>Current Tax</b>                     |             |             |
| Current tax recoverable                | 3           | -           |
| Current tax payable                    | -           | (8)         |
|  | <u>3</u>    | <u>(8)</u>  |
| <b>Deferred Tax</b>                    |             |             |
| The balances at 31 December comprises: |             |             |
| Deferred tax assets                    | 14          | 29          |
| Deferred tax liabilities               | (39)        | (48)        |
| <b>Net deferred tax liabilities</b>    | <u>(25)</u> | <u>(19)</u> |



**Movement in deferred tax assets and liabilities**

Year ended 31 December 2017

|   | At 1 January<br>£m | Recognised in the<br>Statement of<br>comprehensive<br>income<br>£m | At 31<br>December<br>£m |
|---|--------------------|--|-------------------------|
| Expenses and deferred acquisition costs | -                  | 12   | 12                      |
| Pension scheme deficit                  | 15                 | (15)   | -                       |
| Spread pension scheme payments          | 2                  | (1)  | 1                       |
| Movement in deferred income reserve     | 12                 | (12)   | -                       |
| Movement in deferred acquisition costs  | (12)               | 12   | -                       |
| Unrealised gain on investments          | (36)               | (2)  | (38)                    |
|   | (19)               | (6)  | (25)                    |

Year ended 31 December 2016

|  | At 1 January<br>£m | Recognised in the<br>Statement of<br>comprehensive<br>income<br>£m | At 31<br>December<br>£m |
|--|--------------------|--|-------------------------|
| Pension scheme deficit                 | 12                 | 3  | 15                      |
| Spread pension scheme payments         | -                  | 2  | 2                       |
| Movement in deferred income reserve    | 16                 | (4)  | 12                      |
| Movement in deferred acquisition costs | (16)               | 4  | (12)                    |
| Unrealised gain on investments         | (20)               | (16)   | (36)                    |
|  | (8)                | (11)   | (19)                    |

The Finance Act 2014 set the rate of corporation tax at 20% from 1 April 2015. The Finance (No. 2) Act 2015 announced a reduction in the rate from 20% to 19% from 1 April 2017, with a further reduction from 19% to 18% from 1 April 2020. The Finance Act 2016 which was substantively enacted on 15 September 2016 announced a further reduction in the rate from 18% to 17% from 1 April 2020. Consequently, a blended rate of tax has been used for the purposes of providing for deferred tax in these financial statements, where appropriate.

The Finance Act 2012 introduced new rules for the taxation of insurance companies, with effect from 1 January 2013. The deferred tax on the non-profit surplus has reversed and was replaced with IFRS transitional adjustments. The deferred tax on the transitional adjustments is being amortised over a 10 year period on a straight line basis commencing in 2013 and ending in 2022 as the IFRS tax transitional adjustment is brought into account in the current tax computations.

Deferred tax assets are recognised for tax losses carried forward only to the extent that realisation of the related tax benefit is probable.

**22. Payables related to direct insurance contracts**

|  | 2017<br>£m | 2016<br>£m<br>restated |
|--|------------|------------------------|
| Payables related to direct insurance contracts | 118        | 103                    |
| Amount due for settlement after 12 months      | -          | -                      |

Payables related to direct insurance contracts includes balances for outstanding claims.

**23. Accruals and deferred income**

|   | 2017<br>£m | 2016<br>£m<br>restated |
|---|------------|------------------------|
| Accruals                                  | 9          | 9                      |
| Deferred income                           | -          | 71                     |
|   | <u>9</u>   | <u>80</u>              |
| Amount due for settlement after 12 months | -          | -                      |

**24. Pension and other post-retirement benefit obligations**

The Abbey Life Staff Pension Scheme ("the Scheme") is a registered occupational pension scheme, set up under Trust. The Scheme is administered by Abbey Life Trust Securities Limited (The Trustee), a corporate trustee. There are six Trustee Directors, two of whom are nominated by the Scheme Members and four of whom are appointed by the Employer. The Trustee is responsible for administering the Scheme in accordance with the Trust Deed and Rules and pensions law and regulations.

The obligations of the Company to the Abbey Life Staff Pension Scheme were transferred to PeLHL on 30 June 2017 for consideration of £114m. At transfer, the Company derecognised a deficit of £90m and recognised a loss of £24m within Administrative expenses (note 8) based on the 30 June 2017 valuation results. At the same time the Pension benefits actuarial losses reserve of £(104)m was transferred to retained earnings.

The 30 June 2017 IAS 19 results have been calculated by Aon Hewitt Limited. The results have been calculated using full membership data as at 30 June 2017 collected by the Scheme Actuary for the funding valuation as at the same date.

|   | June<br>2017<br>% | December<br>2016<br>% |
|---|-------------------|-----------------------|
| Rate of inflation                                   | 3.2               | 3.2                   |
| Rate of salary increase                             | 4.2               | 4.2                   |
| Rate of increase for pensions                       |                   |                       |
| in payment  | 3.0               | 3.1                   |
| in deferment  | 2.2               | 2.2                   |
| Discount rate                                       | 2.6               | 2.7                   |
| Continuation of benefits to lump sums on retirement | 15.0              | 15.0                  |

The expected rate of return on assets is based on the weighted average return by asset class.

The assumption made regarding commutation of benefits is in line with the results now available of the full valuation of the Scheme, based on experience.

The rate of increase for pensions in deferment is linked to the Consumer Prices Index ("CPI") subject to caps set out in the Scheme documentation.

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

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|   | June<br>2017<br>Years | December<br>2016<br>Years |
|---|-----------------------|---------------------------|
| Life expectancy for member aged 65, on the valuation date             |                       |                           |
| - Men   | 24.2                  | 23.7                      |
| - Women   | 25.4                  | 25.3                      |
| Life expectancy for member aged 65, 20 years after the valuation date |                       |                           |
| - Men   | 25.8                  | 25.0                      |
| - Women   | 27.2                  | 27.2                      |

The combined assets of the Scheme and the expected rates of return as at 31 December 2016 are summarised as follows:

|  | Fair value of<br>assets<br>£m | Proportion of<br>total assets<br>% |
|--|-------------------------------|------------------------------------|
| 2016                                     |                               |                                    |
| Equities - UK                            | 25                            | 10.4                               |
| Fixed interest government bonds          | 115                           | 48.8                               |
| Corporate bonds                          | 123                           | 51.9                               |
| Derivatives                              | (35)                          | (15.0)                             |
| Cash and cash equivalents                | 9                             | 3.9                                |
| <b>Total fair value of Scheme assets</b> | <b>237</b>                    | <b>100.0</b>                       |

The deficit in the Scheme arises, and is recognised in the balance sheet, as follows:

|   | 2017<br>£m | 2016<br>£m  |
|---|------------|-------------|
| Present value of defined benefit obligation     | (322)      | (324)       |
| Fair value of scheme assets                     | 232        | 237         |
| Transfer of defined benefit obligation to PeLHL | 90         | -           |
| Liability recognised in the balance sheet       | <b>-</b>   | <b>(87)</b> |

The Trust Deed under which the Scheme is established provides for the gradual settlement of the plan liabilities over time until all members have left the Scheme.

The amounts recognised in profit or loss within the statement of comprehensive income are as follows:

|   | 2017<br>£m | 2016<br>£m |
|---|------------|------------|
| Interest cost on benefit obligation     | 4          | 11         |
| Interest (Income) on assets             | (3)        | (8)        |
| Loss on transfer of the Scheme to PeLHL | 24         | -          |
| Net expense recognised within expenses  | <b>25</b>  | <b>3</b>   |

The amounts recognised in other comprehensive income are as follows:

|                  | 2017<br>£m | 2016<br>£m |
|------------------|------------|------------|
| Actuarial losses | (2)        | (34)       |

The total over the period 2010 to 2017 is a loss of £97m.

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

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|   | 2017<br>£m | 2016<br>£m |
|---|------------|------------|
| At 1 January                                    | 324        | 274        |
| Current service costs                           | -          | 1          |
| Interest cost on benefit obligation             | 4          | 11         |
| Benefits paid                                   | (12)       | (15)       |
| Actuarial losses                                | 5          | 53         |
| Transfer of defined benefit obligation to PeLHL | (321)      | -          |
| At 31 December                                  | -          | 324        |

Of the total actuarial losses/(gains) above, the amount relating to experience adjustments is:

|   | 2017<br>£m | 2016<br>£m |
|---|------------|------------|
| At 1 January                                    | 237        | 206        |
| Expected return on Scheme assets                | 3          | 8          |
| Contributions received                          | 2          | 18         |
| Benefits paid                                   | (12)       | (15)       |
| Actuarial gains                                 | 2          | 19         |
| Transfer of defined benefit obligation to PeLHL | (232)      | -          |
| At 31 December                                  | -          | 237        |

All contributions received were made by the Company.

The actual return on Scheme assets amounted to a gain of £5m (2016: gain of £27m).

Actuarial gains above relate to investment experience adjustments:

|  | 2017<br>£m | 2016<br>£m |
|--|------------|------------|
| Movement in year                                   | 3          | 19         |
| Percentage of closing Scheme assets at 31 December | N/A        | (8.1)%     |

Certain employees are members of a defined contribution pension scheme. The cost to the Company in both 2017 and 2016 was less than £1m.

**25. Other payables**

|   | 2017<br>£m | 2016<br>£m<br>restated |
|---|------------|------------------------|
| Investment broker balances                | -          | 3                      |
| Deposit back arrangement with PLL *       | 126        | -                      |
| Corporation tax group relief              | 42         | -                      |
| Other payables                            | 11         | 21                     |
|   | 179        | 24                     |
| Amount due for settlement after 12 months | -          | -                      |

\* As part of the reinsurance ceded to PLL, effective 29 December 2017, the Company accepted an investment in the unit-linked funds from the reinsurer through a deposit back arrangement. The deposit back is repayable on demand.

## 26. Investment in subsidiaries

The Company invests in OEIC funds managed by Aberdeen Asset Management plc which have been classified as investments in subsidiaries as described in the accounting policy note (n). The value of subsidiaries shown on the balance sheet relates to the composition and value of this classification. Details of the holdings are set out below.

Investments in subsidiaries held at fair value

|                  | 2017<br>£m | 2016<br>£m<br>restated |
|------------------|------------|------------------------|
| At 1 January     | 1,083      | 1,040                  |
| Additions        | 9          | 26                     |
| Disposals        | (137)      | (141)                  |
| Fair value gains | 114        | 158                    |
| At 31 December   | 1,069      | 1,083                  |

The subsidiaries of the Company are as follows:

|                                | Measurement<br>basis | Country of<br>incorporation<br>and principal<br>place of<br>operation | Class of shares held<br>(wholly-owned unless<br>otherwise indicated) |
|--------------------------------|----------------------|---|--|
| Aberdeen Financial Equity Fund | Fair value           | England   | 84.63% interest  |
| Aberdeen Capital Trust         | Fair value           | England   | 99.77% interest  |

The registered office of each of these subsidiaries is Bow Bells House, 1 Bread Street, London EC4M 9HH.

On 30 June 2017 the Company transferred ownership of the following subsidiary to PeLHL for consideration of £1,000 for £nil gain or loss:

|                                     | Measurement<br>basis | Country of<br>incorporation<br>and principal<br>place of<br>operation | Class of shares held<br>(wholly-owned unless<br>otherwise indicated) |
|-------------------------------------|----------------------|---|--|
| Abbey Life Trust Securities Limited | Cost                 | UK  | Ordinary shares of £1  |

## 27. Investment property

|                  | 2017<br>£m | 2016<br>£m |
|------------------|------------|------------|
| At 1 January     | 7          | 7          |
| Fair value gains | -          | -          |
| At 31 December   | 7          | 7          |

Unrealised gains in the period on assets held at the end of the year

|   |   |
|---|---|
| - | - |
|---|---|

Commercial investment property is measured at fair value by independent property valuers having appropriate recognised professional qualifications and recent experience in the location and category of the property being valued. The valuations are carried out in accordance with the Royal Institute of Chartered Surveyors ("RICS") guidelines with expected income and capitalisation rate as the key non-observable inputs.

The fair value measurement of the investment properties has been categorised as a level 3 fair value based on the inputs to the valuation techniques used. The fair value has been determined by a combination of rateable value, planning issues and investment considerations:

The estimated fair value of the commercial property would increase (decrease) if:

- The expected income were to be higher (lower)
- The capitalisation rate were to be lower (higher)

Direct operating expenses in respect of the investment property that generated rental income during the year amounted to £342,000 (2016: £2,700,000).

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Future minimum lease rental receivables in respect of non-cancellable operating leases on the investment property was as follows:

|  | 2017 | 2016 |
|--|------|------|
|  | £m   | £m   |
| Later than one year and no later than five years | 2    | 2    |
| Later than five years                            | 1    | 1    |

**28. Loans and deposits**

|                                      | 2017       | 2016       |
|--------------------------------------|------------|------------|
|                                      | £m         | £m         |
| Loans and deposits at amortised cost | -          | 1          |
| Loan at fair value                   | 113        | 379        |
| At 31 December                       | <u>113</u> | <u>380</u> |

Certain retrocession contracts not qualifying for insurance accounting are classified as loans held at fair value to avoid accounting mismatches

The fair value of other loans and receivables which are not held at fair value is not materially different to their amortised cost.

**29. Financial instruments**

The table below sets out a comparison of the carrying amounts and fair values of financial instruments as at 31 December 2017:

|   | <u>Carrying value</u> |                                     |              |
|---|-----------------------|-------------------------------------|--------------|
|   | Total                 | Amounts recoverable after 12 months | Fair value   |
|   | £m                    | £m                                  | £m           |
| <b>Financial assets at 31 December 2017</b>           |                       |                                     |              |
| Financial assets at fair value through profit or loss |                       |                                     |              |
| Loans and deposits                                    | 113                   | 113                                 | 113          |
| Held for trading - derivatives                        | 152                   | 133                                 | 152          |
| Designated upon initial recognition                   |                       |                                     |              |
| Equities  | 4,134                 | -                                   | 4,134        |
| Fixed and variable rate income securities             | 331                   | 319                                 | 331          |
| Collective investment schemes                         | 2,543                 | -                                   | 2,543        |
|   | <u>7,273</u>          | <u>565</u>                          | <u>7,273</u> |

|  | <u>Carrying value</u> |  |              |
|--|-----------------------|--|--------------|
|  | Total                 | Amounts due for settlement after 12 months | Fair value   |
|  | £m                    | £m   | £m           |
| <b>Financial liabilities at 31 December 2017</b>           |                       |  |              |
| Financial liabilities at fair value through profit or loss |                       |  |              |
| Held for trading - derivatives                             | 132                   | 104  | 132          |
| Designated upon initial recognition                        |                       |  |              |
| Investment contracts                                       | 6,202                 | -  | 6,202        |
| Borrowings   | 51                    | 12   | 51           |
|  | <u>6,385</u>          | <u>116</u>                                 | <u>6,385</u> |

Equities and collective investment schemes have no expected settlement date.

|   | <u>Carrying value</u> |  |               |
|---|-----------------------|--|---------------|
|   | Total                 | Amounts<br>recoverable<br>after 12<br>months | Fair<br>value |
|   | £m                    | £m   | £m            |
| <b>Financial assets at 31 December 2016</b>           |                       |  |               |
| Loans and deposits at amortised cost                  | 1                     | -  | 1             |
| Financial assets at fair value through profit or loss |                       |  |               |
| Loans and deposits                                    | 379                   | -  | 379           |
| Held for trading - derivatives                        | 110                   | 110  | 110           |
| Designated upon initial recognition                   |                       |  |               |
| Equities  | 4,116                 | -  | 4,116         |
| Fixed and variable rate income securities             | 2,870                 | 2,766  | 2,870         |
| Collective investment schemes                         | 2,902                 | -  | 2,902         |
|   | <u>10,378</u>         | <u>2,876</u>                                 | <u>10,378</u> |

|  | <u>Carrying value</u> |  |               |
|--|-----------------------|--|---------------|
|  | Total                 | Amounts<br>due for<br>settlement<br>after 12<br>months | Fair<br>value |
|  | £m                    | £m   | £m            |
| <b>Financial liabilities at 31 December 2016</b>           |                       |  |               |
| Financial liabilities at fair value through profit or loss |                       |  |               |
| Held for trading - derivatives                             | 305                   | 305  | 305           |
| Designated upon initial recognition                        |                       |  |               |
| Investment contracts                                       | 6,191                 | -  | 6,191         |
| Borrowings   | 87                    | 56   | 87            |
|  | <u>6,583</u>          | <u>361</u>   | <u>6,583</u>  |

#### Determination of fair value and fair value hierarchy of financial instruments

Level 1 financial instruments. The fair value of financial instruments traded in active markets (such as exchange traded securities and derivatives) is based on quoted market prices at the period end provided by recognised pricing services. Market depth and bid ask spreads are used to corroborate whether an active market exists for an instrument. Greater depth and narrower bid-ask spread indicates higher liquidity in the instrument and are classed as Level 1 inputs. For collective investment schemes, fair value is by reference to published bid prices.

Level 2 financial instruments. The fair values of financial instruments traded in active markets with less depth or wider bid-ask spreads which do not meet the classification as Level 1 inputs are classified as Level 2. The fair values of financial instruments not traded in active markets are determined using broker quotes or valuation techniques with observable market inputs. Financial instruments valued using broker quotes are classified as Level 2, only where there is a sufficient range of available quotes. The fair value of unquoted equities, over the counter derivatives, loans and deposits and collective investment schemes where published bid prices are not available are estimated using pricing models or discounted cash flow techniques. Where pricing models are used, inputs are based on market related data at the period end. Where discounted cash flows are used, estimated future cash flows are based on management's best estimates and the discount rate used is a market related rate for a similar instrument.

Level 3 financial instruments. The Company's financial instruments determined by valuation techniques using non market observable inputs are based on a combination of independent third party evidence and internally developed models. Securities that are valued using broker quotes which could not be corroborated across a sufficient range of quotes are considered as Level 3. For a small number of investment vehicles and debt securities, standard valuation models are used, as due to their nature and complexity they have no external market. Inputs into such models are based on market observable data where applicable. The fair value of loans and some borrowings with no external market is determined by internally developed discounted cash flow models using a risk adjusted discount rate corroborated with external market data where possible.

Following the purchase of the Company by PLHL from Deutsche Bank AG Group ("DB"), there was a change in the accounting estimates placed on a number of longevity contracts. The change aligned the view of risks under

the relevant contracts, and hence the calculation of fair value, to the Phoenix Group risk framework and resulted in a change in value of £35m

The DB methodology was to calculate a best estimate view of the underlying longevity contracts and include a number of additional reserves. These were fed in to a Lee Carter model from which the 50th percentile output was taken with allowances made for inflation and discounting factors to arrive at a fair value. The Phoenix Group approach is also to calculate a best estimate view of the underlying longevity contracts with an adjustment to reflect a swaps plus 10bps discount curve, a proportion of longevity misestimation risk capital and a proportion of longevity trend risk capital.

For financial instruments that are recognised at fair value on a recurring basis, the Company determines whether transfers have occurred between levels in the hierarchy by re-assessing categorisation (based on the lowest level input that is significant to the fair value measurement as a whole) at the middle and end of each reporting period. Transfers identified are deemed to have taken place at the start of the reporting period.

#### Fair value hierarchy of financial instruments

The tables below separately identify financial instruments carried at fair value from those measured on another basis but for which fair value is disclosed.

At 31 December 2017

|   | Level 1<br>£m | Level 2<br>£m | Level 3<br>£m | Total fair<br>value<br>£m |
|---|---------------|---------------|---------------|---------------------------|
| <b>Investment in Subsidiaries measured at fair value</b>                                  | 1,069         | -             | -             | 1,069                     |
| <b>Financial assets measured at fair value</b>  |               |               |               |                           |
| Derivatives   | 7             | 2             | 143           | 152                       |
| Financial assets designated at fair value through profit or loss upon initial recognition |               |               |               |                           |
| Loans and deposits  | -             | -             | 113           | 113                       |
| Equities  | 4,134         | -             | -             | 4,134                     |
| Fixed and variable rate income securities   | 294           | 12            | 25            | 331                       |
| Collective investment schemes   | 2,348         | 195           | -             | 2,543                     |
| <b>Total financial assets measured at fair value</b>                                      | 6,783         | 209           | 281           | 7,273                     |
| <b>Total financial assets</b>   | 6,783         | 209           | 281           | 7,273                     |

Fair value hierarchy information for non-financial assets measured at fair value is included in note 27 for investment properties.



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|  | Level 1<br>£m | Level 2<br>£m | Level 3<br>£m | Total fair<br>value<br>£m |
|--|---------------|---------------|---------------|---------------------------|
| <b>Financial liabilities measured at fair value</b>  |               |               |               |                           |
| Derivatives  | 9             | 25            | 98            | 132                       |
| Financial liabilities designated at fair value through profit or loss upon initial recognition |               |               |               |                           |
| Investment contract liabilities  | -             | 6,202         | -             | 6,202                     |
| Borrowings   | -             | -             | 51            | 51                        |
| <b>Total financial liabilities measured at fair value</b>                                      | <b>9</b>      | <b>6,227</b>  | <b>149</b>    | <b>6,385</b>              |
| <b>Total financial liabilities</b>   | <b>9</b>      | <b>6,227</b>  | <b>149</b>    | <b>6,385</b>              |

| At 31 December 2016                                      | Level 1<br>£m | Level 2<br>£m | Level 3<br>£m | Total fair<br>value<br>£m |
|--|---------------|---------------|---------------|---------------------------|
| <b>Investment in Subsidiaries measured at fair value</b> | -             | 1,083         | -             | 1,083                     |

**Financial assets measured at fair value**

|   |              |              |            |               |
|---|--------------|--------------|------------|---------------|
| Derivatives   | -            | 58           | 52         | 110           |
| Financial assets designated at fair value through profit or loss upon initial recognition |              |              |            |               |
| Loans and deposits  | -            | -            | 379        | 379           |
| Equities  | 4,116        | -            | -          | 4,116         |
| Fixed and variable rate income securities   | 1,121        | 1,735        | 14         | 2,870         |
| Collective investment schemes   | 79           | 2,823        | -          | 2,902         |
| <b>Total financial assets measured at fair value</b>                                      | <b>5,316</b> | <b>4,616</b> | <b>445</b> | <b>10,377</b> |

**Financial assets for which fair values are disclosed**

|                                      |              |              |            |               |
|--------------------------------------|--------------|--------------|------------|---------------|
| Loans and deposits at amortised cost | -            | 1            | -          | 1             |
| <b>Total financial assets</b>        | <b>5,316</b> | <b>4,617</b> | <b>445</b> | <b>10,378</b> |

|  | Level 1<br>£m | Level 2<br>£m | Level 3<br>£m | Total fair<br>value<br>£m |
|--|---------------|---------------|---------------|---------------------------|
| <b>Financial liabilities measured at fair value</b>  |               |               |               |                           |
| Derivatives  | -             | 33            | 272           | 305                       |
| Financial liabilities designated at fair value through profit or loss upon initial recognition |               |               |               |                           |
| Investment contract liabilities  | -             | 6,191         | -             | 6,191                     |
| Borrowings   | -             | -             | 87            | 87                        |
| <b>Total financial liabilities measured at fair value</b>                                      | <b>-</b>      | <b>6,224</b>  | <b>359</b>    | <b>6,583</b>              |
| <b>Total financial liabilities</b>   | <b>-</b>      | <b>6,224</b>  | <b>359</b>    | <b>6,583</b>              |

### Level 3 financial instrument sensitivities

Included within derivative assets are longevity contracts with a value of £143m. These investments are valued using discounted cash flows from an actuarial projection to arrive at a present value. The valuations are sensitive to movement in yields. An increase of 1% would decrease the value by £16m, and a decrease of 1% would increase the value by £20m.

Included within derivative liabilities are longevity contracts with a value of £77m. These investments are valued using discounted cash flows from an actuarial projection to arrive at a present value. The valuations are sensitive to movement in yields. An increase of 1% would increase the value by £3m, and a decrease of 1% would decrease the value by £3m.

Also included within derivative liabilities are retrocession contracts with a value of £21m. These investments are valued using a discounted cash flow model using Euro cashflows converted to sterling at valuation date. The valuations are sensitive to movement in yields. An increase or decrease of 1% would have no significant impact on the value.

Included within loans and deposits are reinsurance contracts on certain term assurance policies with a value of £113m. These investments are valued using a discounted cash flow model using Euro cashflows converted to sterling at valuation date. The valuation is sensitive to movement in yields. An increase of 1% would decrease the value by £2m, and a decrease of 1% would increase the value by £1m.

Borrowings measured at fair value and categorised as Level 3 financial liabilities comprise retrocession contracts in relation to the reinsurance contracts on certain term assurance policies. These investments are valued using a discounted cash flow model using Euro cashflows converted to sterling at valuation date. The valuation is sensitive to movement in yields. An increase of 1% would increase the liability by £2m, and a decrease of 1% would decrease the liability by £2m.

### Significant transfers of financial instruments between level 1 and level 2

|   | From<br>level 1<br>to level 2<br>£m | From<br>level 2<br>to level 1<br>£m |
|---|-------------------------------------|-------------------------------------|
| At 31 December 2017   |                                     |                                     |
| <b>Investment in subsidiaries measured at fair value</b>                                  | -                                   | 1,083                               |
| <b>Financial assets at fair value</b>   |                                     |                                     |
| Derivatives   | -                                   | 6                                   |
| Financial assets designated at fair value through profit or loss upon initial recognition |                                     |                                     |
| Collective investment schemes   | -                                   | 2,604                               |
| <b>Financial liabilities at fair value</b>  |                                     |                                     |
| Derivatives   | -                                   | 3                                   |

All the Company's Level 1 and Level 2 assets have been valued using standard market pricing sources.

The application of the Phoenix Group's fair value hierarchy classification methodology to the company has resulted in an overall net movement of financial assets from level 2 to level 1 in the period.

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**Movement in level 3 financial instruments measured at fair value**

|  | At 1 January<br>2017 | Total gains/<br>(losses) in<br>Statement of<br>comprehensive<br>income | Sales       | Transfers from<br>level 1 and<br>level 2 | At 31<br>December<br>2017 | Unrealised<br>gains/ (losses)<br>in the period on<br>assets held at<br>end of year |
|--|----------------------|--|-------------|--|---------------------------|--|
|  | £m                   | £m   | £m          | £m                                       | £m                        | £m   |
| Derivatives  | 52                   | 91   | -           | -  | 143                       | 91   |
| Financial assets designated at fair value<br>through profit or loss upon initial recognition |                      |  |             |  |                           |  |
| Loans and deposits   | 379                  | (259)  | (7)         | -  | 113                       | (259)  |
| Fixed and variable rate income securities  | 14                   | -  | (6)         | 17                                       | 25                        | -  |
|  | <u>445</u>           | <u>(168)</u>   | <u>(13)</u> | <u>17</u>                                | <u>281</u>                | <u>(168)</u>   |

|   | At 1 January<br>2017 | Total losses in<br>Statement of<br>comprehensive<br>income | Settlements | Transfers (to)/<br>from level 1<br>and level 2 | At 31<br>December<br>2017 | Unrealised<br>losses in the<br>period on<br>liabilities held at<br>end of year |
|---|----------------------|--|-------------|--|---------------------------|--|
|   | £m                   | £m   | £m          | £m   | £m                        | £m   |
| Derivatives   | 272                  | (174)  | -           | -  | 98                        | (174)  |
| Financial liabilities designated at fair value<br>through profit or loss upon initial recognition |                      |  |             |  |                           |  |
| Borrowings  | 87                   | 4  | (40)        | -  | 51                        | 4  |
|   | <u>359</u>           | <u>(170)</u>   | <u>(40)</u> | <u>-</u>                                       | <u>149</u>                | <u>(170)</u>   |

|  | At 1 January<br>2016 | Total gains/<br>(losses) in<br>Statement of<br>comprehensive<br>income | Sales       | At 31 December<br>2016 | Unrealised gains/<br>(losses) in the<br>period on assets<br>held at end of year |
|--|----------------------|--|-------------|------------------------|---|
|  | £m                   | £m   | £m          | £m                     | £m  |
| Derivatives  | 38                   | 14   | -           | 52                     | 14  |
| Financial assets designated at fair value through<br>profit or loss upon initial recognition |                      |  |             |                        |   |
| Loans and deposits   | 369                  | 54   | (44)        | 379                    | 54  |
| Fixed and variable rate income securities  | 16                   | (2)  | -           | 14                     | (2)   |
| Collective investment schemes  | <u>423</u>           | <u>66</u>  | <u>(44)</u> | <u>445</u>             | <u>66</u>   |

|   | At 1 January<br>2016 | Total losses in<br>Statement of<br>comprehensive<br>income | Settlements | At 31 December<br>2016 | Unrealised losses<br>in the period on<br>liabilities held at<br>end of year |
|---|----------------------|--|-------------|------------------------|---|
|   | £m                   | £m   | £m          | £m                     | £m  |
| Derivatives   | 224                  | 48   | -           | 272                    | 48  |
| Financial liabilities designated at fair value<br>through profit or loss upon initial recognition |                      |  |             |                        |   |
| Borrowings  | 114                  | (18)   | (9)         | 87                     | (18)  |
|   | <u>338</u>           | <u>30</u>  | <u>(9)</u>  | <u>359</u>             | <u>30</u>   |

Gains and losses on Level 3 financial instruments are included as income or an expense in net investment income in the Statement of comprehensive income. There were no gains or losses recognised in other comprehensive income.

**Financial instrument collateral arrangements**  
**Offsetting financial assets and financial liabilities**

The Company has no financial assets and financial liabilities that have been offset in the Statement of financial position as at 31 December 2017 (2016: none).

The table below contains disclosures related to financial assets and financial liabilities recognised in the Statement of financial position that are subject to enforceable master netting arrangements or similar agreements. Such agreements do not meet the criteria for offsetting in the Statement of financial position as the Company has no current legally enforceable right to offset recognised financial instruments. Furthermore, certain related assets received as collateral under the netting arrangements will not be recognised in the Statement of financial position as the Company does not have permission to sell or re-pledge, except in the case of default. Details of the Company's collateral arrangements in respect of these recognised assets and liabilities are provided below.

**At 31 December 2017**

**Financial assets**

**Related amounts not offset**

|                             | Gross and net<br>amounts of<br>recognised<br>financial assets<br>£m | Financial<br>instruments<br>received as<br>collateral<br>£m | Cash received<br>as collateral<br>£m | Derivative<br>liabilities<br>£m | Net amount<br>£m |
|-----------------------------|---|---|--------------------------------------|---------------------------------|------------------|
| OTC Derivatives             | 145   | 460   | -                                    | -                               | (315)            |
| Exchange traded derivatives | 7   | -   | -                                    | 7                               | -                |
| <b>Total</b>                | <b>152</b>  | <b>460</b>  | <b>-</b>                             | <b>7</b>                        | <b>(315)</b>     |

**Financial liabilities**

**Related amounts not offset**

|                             | Gross and net<br>amounts of<br>recognised<br>financial<br>liabilities<br>£m | Financial<br>instruments<br>pledged as<br>collateral<br>£m | Cash pledged<br>as collateral<br>£m | Derivative<br>assets<br>£m | Net amount<br>£m |
|-----------------------------|---|--|-------------------------------------|----------------------------|------------------|
| OTC Derivatives             | 123   | 139  | -                                   | -                          | (16)             |
| Exchange traded derivatives | 9   | -  | 2                                   | 7                          | 0                |
| <b>Total</b>                | <b>132</b>  | <b>139</b>   | <b>2</b>                            | <b>7</b>                   | <b>(16)</b>      |

At 31 December 2016

**Financial assets**

Related amounts not offset

|                 | Gross and net<br>amounts of<br>recognised<br>financial assets<br>£m | Financial<br>instruments<br>received as<br>collateral<br>£m | Cash received<br>as collateral<br>£m | Derivative<br>liabilities<br>£m | Net amount<br>£m |
|-----------------|---|---|--------------------------------------|---------------------------------|------------------|
| OTC Derivatives | 110   | 484   | -                                    | -                               | (374)            |
| Total           | 110   | 484   | -                                    | -                               | (374)            |

**Financial liabilities**

Related amounts not offset

|                 | Gross and net<br>amounts of<br>recognised<br>financial<br>liabilities<br>£m | Financial<br>instruments<br>pledged as<br>collateral<br>£m | Cash pledged<br>as collateral<br>£m | Derivative<br>assets<br>£m | Net amount<br>£m |
|-----------------|---|--|-------------------------------------|----------------------------|------------------|
| OTC Derivatives | 305   | 177  | -                                   | -                          | 128              |
| Total           | 305   | 177  | -                                   | -                          | 128              |

**Derivative and reinsurance collateral arrangements**

Assets accepted

It is the Company's practice to obtain collateral to mitigate the counterparty risk related to over-the-counter ("OTC") derivatives and certain reinsurance transactions, usually in the form of cash or marketable financial instruments.

Where the Company receives collateral in the form of marketable financial instruments which it is not permitted to sell or re-pledge except in the case of default, it is not recognised in the Statement of financial position. The fair value of financial assets accepted as collateral for OTC derivatives and reinsurance transactions but not recognised in the Statement of financial position amounts to £461m and £nil respectively (2016: £484m and £nil).

The maximum exposure to credit risk in respect of OTC derivative assets is £145m (2016: £110m) of which credit risk of £142m (2016: £484m) is mitigated by use of collateral arrangements (which are settled net after taking account of any OTC derivative liabilities owed to the counterparty).

The maximum exposure to credit risk in respect of reinsurance assets is £2,292m (2016: £100m) and £nil (2016: £nil) of this is mitigated by use of collateral arrangements. £2,247m of the exposure to credit risk in respect of reinsurance assets is internal to the Group.

Assets pledged

The Company pledges collateral in respect of its OTC derivative liabilities.

Where the Company pledges collateral in the form of cash or marketable financial instruments and retains all the risks and rewards of the transferred assets, it continues to be recognised in the Statement of financial position. The value of assets pledged at 31 December 2017 in respect of OTC derivative liabilities amounted to £139m (2016: £177m).

**30. Structured Entities**

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only, and the relevant activities are directed by means of contractual arrangements. A structured entity often has some or all of the following features or attributes: (a) restricted activities; (b) a narrow and well-defined objective, such as to provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors; (c) insufficient equity to permit the structured entity to finance its activities without subordinated financial support; and (d) financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches).

The Company has determined that all of its investments in collective investment schemes are structured entities. In addition, a number of debt security structures have been identified as structured entities. The Company has assessed that it has interests in structured entities as shown below:

- Unit trusts
- OEICs
- SICAVs
- Liquidity funds
- Asset-backed securities
- Other debt structures

The Company's holdings in the above investments are subject to the terms and conditions of the respective fund's prospectus and are susceptible to market price risk arising from uncertainties about future values. The Company holds redeemable shares and units in each of the funds. The funds are managed by asset managers who apply various investment strategies to accomplish their respective investment objectives. All of the funds are managed by asset managers who are compensated by the respective funds for their services. Such compensation generally consists of an asset-based fee and a performance-based incentive fee and is reflected in the valuation of each fund.

#### Interests in structured entities

The Company does not provide financial or other support in relation to structured entities.

The Company's interests in structured entities are held at fair value through profit or loss. Any change in fair value is included in the Statement of comprehensive income in 'net investment income'.

A summary of the Company's interests in structured entities is included below. These are analysed by the nature of the investment and financial asset categorisation. The structured entities are presented within financial assets in the Statement of financial position except where the Company considers it has control and therefore has classified them as investments in subsidiaries (£1,069m (2016: £1,083m)).

|  | Carrying<br>value of<br>financial<br>assets<br>2017<br>£m | Carrying<br>value of<br>financial<br>assets<br>2016<br>£m |
|--|---|---|
| Collective investment schemes                                      |   |   |
| Equities   | 1,350   | 1,432   |
| Bonds  | 610   | 860   |
| Property   | 200   | 242   |
| Short term liquidity   | 1,447   | 1,437   |
| Diversified  | 5   | 14  |
| Total collective investment schemes and Investment in Subsidiaries | 3,612   | 3,985   |
| Fixed and variable rate income securities                          |   |   |
| Asset backed securities  | 19  | 277   |
|  | <u>3,631</u>  | <u>4,262</u>  |

Collective investment schemes have been analysed by reference to the predominant asset class the structure is investing in. Where there is no predominant class, investments are allocated to the classification 'Diversified'.

The Company's maximum exposure to loss to the interests presented above is the carrying amount of the Company's investments. Once the Company has disposed of its shares or units in a fund, it ceases to be exposed to any risk from that fund.

**31. Prepayments and accrued income**

|                | 2017<br>£m | 2016<br>£m |
|----------------|------------|------------|
| Prepayments    | 2          | 3          |
| Accrued Income | 12         | 49         |
|                | <u>14</u>  | <u>52</u>  |

Amount recoverable after 12 months

|   |   |
|---|---|
| - | - |
|---|---|

**32. Other receivables**

|                            | 2017<br>£m | 2016<br>£m |
|----------------------------|------------|------------|
| Investment broker balances | 40         | 18         |
| Other receivables          | 57         | 19         |
|                            | <u>97</u>  | <u>37</u>  |

Amount recoverable after 12 months

|   |   |
|---|---|
| - | - |
|---|---|

**33. Cash and cash equivalents**

|                        | 2017<br>£m | 2016<br>£m<br>restated |
|------------------------|------------|------------------------|
| Bank and cash balances | <u>28</u>  | <u>33</u>              |

**34. Cash flows**

***Cash flows from operating activities***

|  | 2017<br>£m | 2016<br>£m<br>restated |
|--|------------|------------------------|
| Profit for the year before tax                                   | 239        | 67                     |
| Non-cash movements in profit for the year before tax             |            |                        |
| Fair value (gains)/losses on:                                    |            |                        |
| Investment in subsidiaries                                       | (114)      | (158)                  |
| Financial assets   | (495)      | (1,034)                |
| Deferred Acquisition Costs                                       | 74         | 10                     |
| Changes in operating assets and liabilities                      |            |                        |
| Change in investment assets                                      | 3,240      | 445                    |
| Increase in other provisions                                     | 34         | 5                      |
| Pension benefits losses through other comprehensive income       | (2)        | (34)                   |
| Change in net derivative assets/(liabilities)                    | 34         | 14                     |
| Change in reinsurance assets                                     | (2,191)    | 8                      |
| Change in insurance contract and investment contract liabilities | (550)      | 638                    |
| Change in other assets   | 271        | 81                     |
| Change in other liabilities                                      | (39)       | 8                      |
| Cash generated from operations                                   | <u>501</u> | <u>51</u>              |

### 35. Capital management

#### Capital Management Framework

The Company's Capital Management Framework is designed to achieve the following objectives:

- provide appropriate security for policyholders and meet all regulatory capital requirements whilst not retaining unnecessary excess capital;
- ensure sufficient liquidity to meet obligations to policyholders and other creditors; and
- meet the dividend expectations of owners.

The Company has met all of these objectives throughout the financial year. The framework comprises a suite of capital management policies that govern the allocation of capital throughout the Company to achieve the framework objectives under a range of stress conditions. The policy suite is defined with reference to policyholder security, creditor obligations, owner dividend policy and regulatory capital requirements.

#### Own Funds and SCR

Following the implementation of the Solvency II Directive effective from 1 January 2016, the Company's capital is managed on a Solvency II basis.

A Solvency II capital assessment involves valuation in line with Solvency II principles of the Company's Own Funds and a risk-based assessment of the Company's Solvency Capital Requirement ("SCR"). Solvency II surplus is the excess of Eligible Own Funds over the SCR.

Basic Own Funds represent the excess of assets over liabilities from the Solvency II balance sheet adjusted to add back any relevant subordinated liabilities that meet the criteria to be treated as capital items. The Basic Own Funds are classified into three Tiers based on permanency and loss absorbency (Tier 1 being the highest quality and Tier 3 the lowest). Limits are imposed on the amount of each tier that can be held to cover the SCR.

Surplus funds in the with-profit funds are restricted and can only be included in Eligible Own Funds up to the value of the SCR they are used to support.

The Company's SCR is calibrated to ensure that the Company's liabilities could be met in one year's time with a 99.5% confidence level, or in other words to be able to withstand a one in 200 year event. The SCR has been calculated on a Standard Formula basis for 31 December 2017. The Company received the PRA's approval to calculate the SCR using an Internal Model in March 2018 which is expected to reduce the SCR and increase the Solvency II surplus position.

The estimated Solvency II surplus position (unaudited) at 31 December 2017 is presented in the Strategic report on page 2.

#### Capital Policy

The capital policy is set by the Board and ensures there is sufficient capital to cover the SCR under stress conditions. It is monitored weekly by management and is reported each month at an executive and Board level.

The policy also ensures sufficient liquidity to meet creditor and dividend obligations. Volatility in the latter is monitored at the executive and Board level through stress and scenario testing. Where cash flow volatility is judged to be in excess of the Board's risk appetite, de-risking activities are undertaken.

### 36. Risk management

The Company is exposed to a number of risks in its business including those arising from underlying assets and liabilities. The Company complies with the Group approach to risk management, which is described in the Phoenix Group Holdings annual report and accounts.

#### Risk and capital management objectives

The risk management objectives and policies of the Company are based on the requirement to protect the Company's regulatory capital position, thereby safeguarding policyholders' guaranteed benefits whilst also ensuring the Company can meet various cash flow requirements. Subject to this, the Company seeks to use available capital to achieve increased investment returns, balancing risk and reward, to generate additional value for policyholders and owners.

In pursuing these objectives, the Company deploys financial assets and incurs insurance contract liabilities and financial liabilities. Financial assets principally comprise investments in equity securities, fixed and variable rate income securities, collective investment schemes, derivatives, reinsurance, trade and other receivables, and banking deposits. Financial liabilities comprise investment contracts, borrowings for financing purposes, derivative liabilities and other payables.



### Financial risk and the asset liability management framework

The use of financial instruments naturally exposes the Company to the risks associated with them, mainly, market risk, credit risk and financial soundness risk.

Responsibility for agreeing the financial risk profile rests with the Board, as advised by investment managers, internal committees and the actuarial function. In setting the risk profile, the Board will receive advice from the appointed investment managers, the with-profit actuary and the actuarial function holder as to the potential implications of that risk profile on the probability of both realistic insolvency and of failing to meet the regulatory minimum capital requirement. The actuarial function holder will also advise the extent to which the investment risk assumed is consistent with the Company's commitment to treat customers fairly.

Derivatives are used in many of the Company's funds, within policy guidelines agreed by the Board and overseen by the Investment Committee, supported by the Management Oversight Committee. Derivatives are primarily used for risk hedging purposes or for efficient portfolio management.

More details on the Company's exposure to financial risk is provided below.

The Company is also exposed to insurance risk. Life insurance risk arises through exposure to mortality, longevity and to other variances between assumed and actual experience. These variances can also arise on persistency levels and management and administrative expenses. More details on the Company's exposure to insurance risk is provided below.

The Company's overall exposure to investment risk is monitored by appropriate committees, which agree policies for managing each type of risk on an ongoing basis, in line with the investment strategy developed to achieve investment returns in excess of amounts due in respect of insurance contracts. The effectiveness of the Company's Asset Liability Management ("ALM") framework relies on the matching of assets and liabilities arising from insurance and investment contracts, taking into account the types of benefits payable to policyholders under each type of contract. Separate portfolios of assets are maintained for with-profits business, non-linked non-participating business and unit-linked business.

On 29 December 2017, substantially all of the risks and rewards of the existing and new business of the Company (that were not subject to existing reinsurance arrangements and with the exception of the with-profit and unit-linked funds) were reinsured to PLL, a fellow member of the Phoenix Group, under two reinsurance agreements. The first reinsurance treaty relates to annuity policies within the Matching Adjustment portfolio and the second reinsurance treaty relates to all other business in-scope of the reinsurance transaction. Certain external reinsurance treaties and a deed of covenant were also novated as part of the transaction. The Company has retained risks associated with the with-profits and unit-linked funds. Therefore, in practice the risks associated with the insurance business borne by the owners are fully mitigated, except where highlighted in the analysis below.

### Financial risk analysis

Transactions in financial instruments result in the Company assuming financial risks. This includes credit risk, market risk and liquidity risk. Each of these are described below, together with a summary of how the Company manages them.

#### Credit risk

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. These obligations can relate to both recognised and unrecognised assets and liabilities.

There are two principal sources of credit risk for the Company:

- Credit risk which results from direct investment activities, including investments in fixed and variable rate income securities, derivatives, collective investment schemes, and the placing of cash deposits; and
- Credit risk which results indirectly from activities undertaken in the normal course of business. Such activities include premium payments, outsourcing contracts, and reinsurance.

The amount disclosed in the Statement of financial position in respect of all financial assets, together with rights secured under unrecognised collateral arrangements, and excluding those that back unit-linked liabilities, represents the Company's maximum exposure to credit risk.

Credit risk is managed by the monitoring of aggregate Company exposures to individual counterparties and by appropriate credit risk diversification. The Company manages the level of credit risk it accepts through the use of credit risk tolerances. In certain cases, protection against exposure to particular credit risk types may be achieved through use of derivatives.

#### Quality of credit assets

An indication of the Company's exposure to credit risk is the quality of the investments and counterparties with which it transacts. The following table provides information regarding the aggregate credit exposure with external credit ratings:

ABBEEY LIFE ASSURANCE COMPANY LIMITED

2017

|  | AAA<br>£m | AA<br>£m | A<br>£m | BBB<br>£m | BB<br>£m | B and<br>below<br>£m | Non<br>rated<br>£m | Unit-<br>linked<br>£m | Total<br>£m |
|--|-----------|----------|---------|-----------|----------|----------------------|--------------------|-----------------------|-------------|
| Loans and deposits                                   | -         | -        | 113     | -         | -        | -                    | -                  | -                     | 113         |
| Derivatives  | -         | -        | -       | -         | -        | -                    | 143                | 9                     | 152         |
| Fixed and variable rate income securities            | 14        | 19       | 44      | 36        | 1        | -                    | 4                  | 213                   | 331         |
| Reinsurers' share of investment contract liabilities | -         | -        | -       | -         | -        | -                    | -                  | -                     | -           |
| Reinsurers' share of insurance contract liabilities  | -         | 45       | 2,247   | -         | -        | -                    | -                  | -                     | 2,292       |
| Cash and cash equivalents                            | -         | 14       | (6)     | -         | -        | -                    | -                  | 20                    | 28          |

2016

|   | AAA<br>£m | AA<br>£m | A<br>£m | BBB<br>£m | BB<br>£m | B and<br>below<br>£m | Non<br>rated<br>£m | Unit-<br>linked<br>£m | Total<br>£m |
|---|-----------|----------|---------|-----------|----------|----------------------|--------------------|-----------------------|-------------|
| Loans and deposits                                  | -         | -        | -       | 380       | -        | -                    | -                  | -                     | 380         |
| Derivatives   | -         | -        | -       | 51        | -        | -                    | 52                 | 7                     | 110         |
| Fixed and variable rate income securities           | 135       | 1,001    | 733     | 669       | 101      | 12                   | 5                  | 214                   | 2,870       |
| Reinsurers' share of insurance contract liabilities | -         | 100      | -       | -         | -        | -                    | -                  | -                     | 100         |
| Cash and cash equivalents                           | -         | -        | -       | 20        | -        | -                    | -                  | 13                    | 33          |

Non-equity based derivatives are included in the credit risk table above and are subject to appropriate collateral arrangements.

Credit ratings have not been disclosed in the above tables for holdings in collective investment schemes. The credit quality of the underlying debt securities within these vehicles is managed by the safeguards built into the investment mandates for these vehicles.

The Company maintains accurate and consistent risk ratings across its asset portfolio. This enables management to focus on the applicable risks and to compare credit exposures across all lines of business, geographical regions and products. The rating system is supported by a variety of financial analytics combined with market information to provide the main inputs for the measurement of counterparty risk. All risk ratings are tailored to the various categories of assets and are assessed and updated regularly. Significant exposures and breaches are reported to the Board and to the Investment Committee.

A variety of methods are used to validate the appropriateness of credit assessment from external institutions and fund managers.

A further indicator of the quality of the Company's financial assets is the extent to which they are neither past due nor impaired. The Company had no material assets which were impaired or past due (2016: £nil).

Concentration of credit risk

Concentration of credit risk might exist where the Company has significant exposure to an individual counterparty or a group of counterparties with similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic and other conditions. The Company's counterparty risk is monitored by the counterparty limits contained within the investment guidelines and investment management agreements, overlaid by regulatory requirements and the monitoring of aggregate counterparty exposures across the Company. Counterparty risk in respect of OTC derivative counterparties is monitored using a Value-at-Risk ("Var") exposure metric.

The Company is also exposed to concentration risk with outsourced service providers. This is due to the nature of the outsourced services market. The Company operates a Credit Risk policy to manage outsourcer service counterparty exposures and the impact from default is reviewed regularly by executive committees and also measured through stress and scenario testing.

#### Reinsurance

The Company is exposed to credit risk as a result of insurance risk transfer contracts with reinsurers. This also gives rise to concentration 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 Company manages its exposure to reinsurance credit risk through the operation of a Reinsurance Policy, collateralization where appropriate, and regular monitoring of exposures at the Finance and Actuarial Technical Committee.

#### Collateral

The credit risk exposure of the Company is mitigated, in certain circumstances, by entering into collateral agreements. The amount and type of collateral required depends on an assessment of the credit risk of the counterparty. Guidelines are implemented regarding the acceptability of types of collateral and the valuation parameters. Collateral is mainly obtained in respect of certain reinsurance arrangements and to provide security against the maturity proceeds of derivative financial instruments. Management monitors the market value of the collateral received, requests additional collateral when needed and performs an impairment valuation when impairment indicators exist and the asset is not fully secured.

Further details on collateral held are given in note 29 above.

#### Market risk

Market risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises interest rate risk, currency risk and other price risk.

The Company is mainly exposed to market risk as a result of:

- the mismatch between liability profiles and the related asset investment portfolios;
- the investment of surplus assets including owners' reserves yet to be distributed, surplus assets within the long-term funds and assets held to meet regulatory capital and solvency requirements; and
- the income flow of management charges from the invested assets of the business.

The Company manages the levels of market risk that it accepts through the operation of a Market Risk Policy and an approach to investment management that determines:

- the constituents of market risk for the Company;
- the basis used to fair value financial assets and liabilities;
- the asset allocation and portfolio limit structure;
- diversification from benchmarks by type of instrument and geographical area;
- the net exposure limits by each counterparty or group of counterparties, geographical and industry segments;
- control over hedging activities;
- reporting of market risk exposures and activities; and
- monitoring of compliance with market risk policy and review of market risk policy for pertinence to the changing environment.

All operations comply with regulatory requirements relating to the taking of market risk.

#### Interest rate risk

Interest rate risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate relative to the respective liability due to the impact of changes in market interest rates on the value of interest-bearing assets and on the value of future guarantees provided under certain contracts of insurance.

Interest rate risk is managed by matching assets and liabilities where practicable and by entering into derivative arrangements for hedging purposes where appropriate. This is particularly the case for the non-profit funds.

The sensitivity analysis for interest rate risk indicates how changes in the fair value of future cash flows of a financial instrument arising from changes in market interest rates at the reporting date result in a change in profit after tax and in equity. It takes into account the effect of such changes in market interest rates on all assets and liabilities that contribute to the Company's reported profit after tax and to equity.

In the non-profit fund, policy liabilities' sensitivity to interest rates are matched with fixed and variable rate income securities, which limits the sensitivity to changes in interest rates.

Under the Solvency II regime, management has reviewed the matching position of assets and liabilities resulting in changes to the hedging positions for certain asset portfolios. As a result, an increase of 1% in interest rates, with all other variables held constant, would now result in a decrease in profit after tax in respect of a full financial year and a decrease in equity of £6m (2016: increase £16m). A decrease of 1% in interest rates, with all other variables held constant, would result in an increase in profit after tax in respect of a full financial year and in equity of £7m (2016: decrease £12m).

### **Equity, property and inflation risk**

The Company has exposure to financial assets and liabilities whose values will fluctuate as a result of changes in market prices other than from interest rate and currency fluctuations. This is due to factors specific to individual instruments, their issuers or factors affecting all instruments traded in the market. Accordingly, the Company limits its exposure to any one counterparty in its investment portfolios and to any one foreign market.

The portfolio of marketable equity securities and property investments which is carried in the Statement of financial position at fair value has exposure to price risk. The Company's objective in holding these assets is to earn higher long-term returns by investing in a diverse portfolio of high quality equities and properties. Portfolio characteristics are analysed regularly and price risks are actively managed in line with investment mandates. The Company's holdings are diversified across industries, and concentrations in any one company or industry are limited.

Equity and property price risk is primarily borne in respect of assets held in unit-linked funds. This risk is borne by policyholders and asset movements directly impact unit prices and hence policy values. The Company as a whole is exposed to price risk fluctuations impacting the income flow of management charges from the invested assets of all funds.

Equity and property price risk is managed through the agreement and monitoring of financial risk profiles that are appropriate for maintaining adequate regulatory capital and treating customers fairly. This is largely achieved through asset class diversification.

The impact of non-government fixed and variable rate income securities and, inter alia, the change in credit spreads during the year are fully reflected in the values shown in these financial statements. Credit spreads are the excess of corporate bond yields over gilt yields to reflect the higher level of risk. Similarly, the value of derivatives that the Company holds takes into account fully the changes in swap spreads.

The sensitivity analysis for equity and property price risk illustrates how a change in the fair value of equities and properties affects the Company result. It takes into account the effect of such changes in equity and property prices on all assets and liabilities that contribute to the Company's reported profit after tax and to equity.

A 10% decrease in equity/property prices, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full financial year and in equity of £1m (2016: £nil).

A 10% increase in equity/property prices, with all other variables held constant, would result in an increase in the profit after tax in respect of a full financial year and in equity of £1m (2016: £nil).

There is also an exposure to spread changes affecting the prices of corporate bonds and derivatives. This exposure applies to unit-linked funds, and in owners' funds.

A 100 basis point widening of credit spreads, with all other variables held constant, would result in a decrease in the profit after tax in respect of a full financial year and in equity of £5m (2016: £nil).

A 100 basis point narrowing of credit spreads, with all other variables held constant, would result in an increase in the profit after tax in respect of a full financial year and in equity of £5m (2016: decrease £1m).

### **Financial Soundness Risk**

Financial soundness risk is a broad risk category encompassing capital management risk, tax risk and liquidity and funding risk.

Capital management risk is defined as the failure of the Company to maintain sufficient capital to provide appropriate security for policyholders and meet all regulatory capital requirements whilst not retaining unnecessary capital. The Company has exposure to capital management risk through the regulatory capital requirements mandated by the PRA.

Tax risk is defined as the risk of financial or reputational loss arising from a lack of liquidity, funding or capital due to an unforeseen tax cost, or by the inappropriate reporting and disclosure of information in relation to taxation. The Company has exposure to tax risk through the annual statutory and regulatory reporting and through the processing of policyholder tax requirements. Tax risk is managed by maintaining an appropriately-staffed tax team who have the qualifications and experience to make judgements on tax issues, augmented by advice from external specialists where required. The Company has a formal tax risk policy, which sets out its risk appetite in relation to specific aspects of tax risk, and which details the controls the Company has in place to manage those risks. These controls are subject to a regular review process. The Finance Bill published in September 2017 confirmed mitigation against the proposed reform of the rules relating to the loss absorbing capacity of deferred tax. Surplus assets have been retained within the Company to mitigate any potential adverse impact of the change.

Liquidity and funding risk is defined as the failure of the Company to maintain adequate levels of financial resources to enable it to meet its obligations as they fall due. The Company has exposure to liquidity risk as a result of any failure to meet its short-term cash flow requirements, to meet its obligations to policy liabilities. The Board has defined a number of governance objectives and principles and the liquidity risk framework is designed to ensure that:

- liquidity risk is managed in a manner consistent with the Boards' strategic objectives, risk appetite and Principles and Practices of Financial Management ("PPFM");
- cash flows are appropriately managed and the reputation of the Company and the Phoenix Group are safeguarded; and
- appropriate information on liquidity risk is available to those making decisions.

The Company's policy is to maintain sufficient liquid assets of suitable credit quality at all times and, where appropriate, to have access to borrowings so as to be able to meet all foreseeable current liabilities as they fall due in a cost-effective manner. Forecasts are prepared regularly to predict required liquidity levels over both the short and medium term allowing management to respond appropriately to changes in circumstances.

The following table provides a maturity analysis showing the remaining contractual maturities of the Company's undiscounted financial liabilities and associated interest. The contractual maturities of liabilities under insurance contracts are included based on the estimated timing of the amounts recognised in the Statement of financial position in accordance with the requirements of IFRS 4:

2017

|  | 1 year or<br>less or on<br>demand<br>£m | 1-5 years<br>£m | Greater<br>than 5<br>years<br>£m | No fixed<br>term<br>£m | Total<br>£m |
|--|---|-----------------|----------------------------------|------------------------|-------------|
| Liabilities under insurance contracts            | 468                                     | 920             | 2,107                            | -                      | 3,495       |
| Investment contracts                             | 6,202                                   | -               | -                                | -                      | 6,202       |
| Borrowings                                       | -                                       | -               | -                                | 51                     | 51          |
| Derivatives                                      | 27                                      | 39              | 66                               | -                      | 132         |
| Obligations for repayment of collateral received | -                                       | -               | -                                | -                      | -           |
| Reinsurance payables                             | 1                                       | -               | -                                | -                      | 1           |
| Payables related to direct insurance contracts   | 118                                     | -               | -                                | -                      | 118         |
| Accruals and deferred income                     | 9                                       | -               | -                                | -                      | 9           |
| Other payables                                   | 179                                     | -               | -                                | -                      | 179         |

2016

|  | 1 year or<br>less or on<br>demand<br>£m | 1-5 years<br>£m | Greater<br>than 5<br>years<br>£m | No fixed<br>term<br>£m | Total<br>£m |
|--|---|-----------------|----------------------------------|------------------------|-------------|
| Liabilities under insurance contracts            | 141                                     | 177             | 3,738                            | -                      | 4,056       |
| Investment contracts                             | 6,191                                   | -               | -                                | -                      | 6,191       |
| Borrowings                                       | -                                       | -               | -                                | 87                     | 87          |
| Derivatives                                      | -                                       | -               | 50                               | 255                    | 305         |
| Obligations for repayment of collateral received | -                                       | -               | -                                | -                      | -           |
| Reinsurance payables                             | 2                                       | -               | -                                | -                      | 2           |
| Payables related to direct insurance contracts   | 103                                     | -               | -                                | -                      | 103         |
| Accruals and deferred income                     | 9                                       | -               | -                                | 71                     | 80          |
| Other payables                                   | 24                                      | -               | -                                | -                      | 24          |

Investment contract policyholders have the option to terminate or transfer their contracts at any time and to receive the surrender or transfer value of their policies. Although these liabilities are payable on demand, and are therefore included in the contractual maturity analysis as due within one year, the Company does not expect all these amounts to be paid out within one year of the reporting date.

A significant proportion of the Company's financial assets are held in gilts, cash, supranationals and investment grade securities which the Company considers sufficient to meet the liabilities as they fall due.

**Unit-linked contracts**

For unit-linked contracts the Company matches all the liabilities with assets in the portfolio on which the unit prices are based and any residual risks are covered by the reinsurance agreement with PLL. There is therefore no interest, price, currency or credit risk for the Company on these contracts.

In extreme circumstances, the Company could be exposed to liquidity risk in its unit-linked funds. This could occur where a high volume of surrenders coincides with a tightening of liquidity in a unit-linked fund to the point where assets of that fund have to be sold to meet those withdrawals. Where the fund affected consists of property, it can take several months to complete a sale and this would impede the proper operation of the fund. In these situations, the Company considers its risk to be low since there are steps that can be taken first within the funds themselves both to ensure the fair treatment of all investors in those funds and to protect the Company's own risk exposure.

**Insurance risk**

Insurance risk refers to the risk that the frequency or severity of insured events may be worse than expected and includes expense risk. The Company's liabilities under insurance contracts are detailed in note 16 and include the following sources of insurance risk:

- Mortality – Higher than expected death claims on assurance products;
- Longevity – Lower than expected number of deaths experienced on annuity products or greater than expected improvements in life expectancy on immediate and deferred annuity products;
- Expenses – Policies cost more to administer than expected;
- Lapses – An adverse movement in either surrender rates or persistency rates on policies with guaranteed benefits leading to losses. This includes the risk of greater than expected policyholder option exercise rates giving rise to increased claims costs.

Following the reinsurance of the majority of the business to PLL from 29 December 2017, ALAC is no longer exposed to significant insurance risk. This is reflected in the sensitivities shown below, which record £nil impact for 2017.

#### Objectives and policies for mitigating insurance risk

The Company uses several methods to assess and monitor insurance risk exposures both for individual types of risks insured and overall risks. These methods include internal risk measurement models, experience analyses, external data comparisons, sensitivity analyses, scenario analyses and stress testing. In addition to this, mortality, longevity and morbidity risks are mitigated by the use of reinsurance.

The profitability of the run-off of the Company's closed long-term insurance businesses depends to a significant extent on the values of claims paid in the future relative to the assets accumulated to the date of claim. Typically, over the lifetime of a contract, premiums and investment returns exceed claim costs in the early years and it is necessary to set aside these amounts to meet future obligations. The amount of such future obligations is assessed on actuarial principles by reference to assumptions about the development of financial and insurance risks.

It is therefore necessary for the Board to make decisions, based on actuarial advice, which ensure an appropriate accumulation of assets relative to liabilities. These decisions include investment policy, bonus policy and, where discretion exists, the level of payments on early termination.

#### Sensitivities

Insurance liabilities are sensitive to changes in risk variables, such as prevailing market interest rates, currency rates and equity prices, since these variations alter the value of the financial assets held to meet obligations arising from insurance contracts and changes in investment conditions also have an impact on the value of insurance liabilities themselves. Additionally, insurance liabilities are sensitive to the assumptions which have been applied in their calculation. Sometimes allowance must also be made for the effect on future assumptions of management or policyholder actions in certain economic scenarios. Subsequent to the reinsurance with PLL, effective 29 December 2017, the profit after tax and equity of the Company is no longer sensitive to mortality, longevity and lapse risk. The material non-economic sensitivity prior to the reinsurance was annuitant longevity. At 31 December 2016 an increase of 5% in annuitant longevity, with all other variables held constant, would have resulted in a decrease in the profit after tax in respect of a full year and an decrease in equity of £9m.

#### Assumptions

##### Valuation of non-participating insurance contracts

The non-participating insurance contract liabilities are determined using a gross premium valuation method.

##### Process used to determine assumptions

Following the acquisition by the Phoenix Group, the Company has made certain changes to the assumptions and estimates used in the valuation of insurance contracts in the financial statements, as follows:

- In determining the discount rate to be applied when calculating participating and non-participating insurance contract liabilities, the Company has amended the risk-free reference curve from a gilt yield curve plus a liquidity premium of 10bps to the swap curve plus 10bps.
- For non-participating insurance contract liabilities, the Company has previously used a valuation rate of interest and adjusted the liability discount rate by reference to the yield on the assets backing the liabilities to account for credit, default and reinvestment risk. The Company now makes an explicit adjustment to the risk-free rate to adjust for illiquidity in respect of assets backing illiquid liabilities. The new approach does not take any additional credit for investment margins compared to the previous methodology.
- For non-participating insurance contract liabilities, the Company previously derived demographic assumptions by adding an implicit prudent margin to best estimate assumptions. The Company has amended its approach in this regard and now sets assumptions at management's best estimates and recognises an explicit margin for demographic risks. For participating business, the assumptions about future demographic trends continue to represent 'best estimates'.

The assumption changes have been made to align the IFRS basis more closely with the requirements of Solvency II and in line with the methodology of the wider Group. As the Company manages its capital in accordance with Solvency II, the changes outlined above will mean the IFRS results will more closely reflect the way the business is managed and the Company's risk hedging strategies. The impact of the changes has resulted in a decrease in insurance contract liabilities and therefore a benefit to IFRS profit before tax of £16m.

During the year a number of changes were made to assumptions to reflect changes in expected experience or to harmonise the approach across the Phoenix Group. The impact of material changes during the year were as follows:

|                                   | Increase/<br>(Decrease)<br>in insurance<br>liabilities<br>2017<br>£m | Increase/<br>(Decrease)<br>in insurance<br>liabilities<br>2016<br>£m |
|-----------------------------------|--|--|
| Change in mortality assumptions   | (10)   | -  |
| Change in longevity assumptions   | (29)   | -  |
| Change in persistency assumptions | 14   | -  |
| Change in expenses assumptions    | (27)   | 18   |

#### Expense inflation

Expenses are assumed to increase at the rate of increase in the Retail Price Index ("RPI") or Retail Price Index excluding mortgage payments ("RPIX") plus a 1% margin.

#### Mortality and longevity rates

Mortality rates are based on published tables, adjusted appropriately to take account of changes in the underlying population mortality since the table was published, company experience and forecast changes in future mortality. Where appropriate, a margin is added to assurance mortality rates to allow for adverse future deviations. Annuity mortality rates are adjusted to make allowance for future improvements in pensioner longevity.

The mortality assumptions were varying proportions of the following published tables:

|  | Published Table<br>2017  | Published Table<br>2016       |
|--|--------------------------|-------------------------------|
| Annuities in payment (UK – level)        | 120% RMV00<br>125% RFV00 | 117.5% RMV00<br>127.55% RFV00 |
| Annuities in payment (UK – index linked) | 120% RMV00<br>125% RFV00 | 117.5% RMV00<br>127.5% RFV00  |
| Deferred annuities (UK, in deferment)    | A67/70                   | A67/70                        |
| Whole of life and endowments             | A67/70<br>A67/70 – 3 yrs | A67/70<br>A67/70 – 3 yrs      |
| Term assurances                          | TM80<br>AF80             | TM80<br>AF80                  |

#### Lapse rates

The assumed rates for surrender and voluntary premium discontinuance in the participating business depend primarily on the length of time a policy has been in force.

#### Policyholder options and guarantees

Some of the Company's products give potentially valuable guarantees, or give options to change policy benefits which can be exercised at the policyholders' discretion. These products are described below.

There are guaranteed surrender values on a small number of older contracts.

Some pension contracts include guaranteed annuity options (see deferred annuities below for details).

#### Discretionary participating bonus rate

The regular bonus rates assumed in each scenario are determined in accordance with the Company's PPFM. Final bonuses are assumed at a level such that maturity payments will equal asset shares subject to smoothing rules set out in the PPFM.

In common with other life companies in the UK which have written pension transfer and opt-out business, the Company has set up provisions for redress relating to personal pension policies. These provisions, which have been calculated from data derived from detailed file reviews of specific cases, are included in liabilities arising under insurance contracts.

#### Managing product risk

The following sections give an assessment of the risks associated with the Company's main life assurance products and the ways in which the Company manages those risks. The following tables provide a product analysis of the liabilities under insurance contracts and reinsurers' share of insurance contract liabilities within the Statement of financial position:



ABBAY LIFE ASSURANCE COMPANY LIMITED

| 2017                                 | Gross                     | Reinsurance               |
|--------------------------------------|---------------------------|---------------------------|
|                                      | Insurance contracts<br>£m | Insurance contracts<br>£m |
| With-profits funds:                  |                           |                           |
| Pensions:                            |                           |                           |
| Deferred annuities – with guarantees | -                         | -                         |
| Total pensions                       | -                         | -                         |
| Life:                                |                           |                           |
| Unitised with-profits                | -                         | -                         |
| Life with-profits                    | 32                        | 3                         |
| Total life                           | 32                        | 3                         |
| Non-profit funds:                    |                           |                           |
| Immediate annuities                  | 2,313                     | 2,346                     |
| Protection                           | 47                        | 43                        |
| Unit-linked                          | 1,409                     | 313                       |
| Other                                | (306)                     | (413)                     |
|                                      | <u>3,495</u>              | <u>2,292</u>              |
| 2016                                 | Gross                     | Reinsurance               |
|                                      | Insurance contracts<br>£m | Insurance contracts<br>£m |
| With-profits funds:                  |                           |                           |
| Pensions:                            |                           |                           |
| Deferred annuities – with guarantees | 1                         | -                         |
| Total pensions                       | 1                         | -                         |
| Life:                                |                           |                           |
| Life with-profits                    | 34                        | 2                         |
| Total life                           | 34                        | 2                         |
| Non-profit funds:                    |                           |                           |
| Deferred annuities – with guarantees | 469                       | -                         |
| Immediate annuities                  | 2,450                     | (24)                      |
| Protection                           | 37                        | 8                         |
| Unit-linked                          | 1,056                     |                           |
| Other                                | 9                         | 114                       |
|                                      | <u>4,056</u>              | <u>100</u>                |

**With-profits funds**

The Company operates two with-profits funds in which the with-profits policyholders benefit from a discretionary annual bonus (guaranteed once added in most cases) and a discretionary final bonus

The process for exercising discretion in the management of the with-profits funds is set out in the PPFM for each with-profits fund and is overseen by With-Profits Committees. Advice is also taken from the with-profits actuary of each with-profits fund. Compliance with the PPFM is reviewed annually and reported to the PRA and policyholders.

The bonuses are designed to distribute to policyholders a fair share of the return on the assets in the with-profits funds together with other elements of the experience of the fund. The owners of the Company are entitled to receive one-ninth of the cost of bonuses declared.

**Deferred annuities**

Deferred annuity policies are written to provide either a cash benefit at retirement, which the policyholder can use to buy an annuity on the terms then applicable, or an annuity payable from retirement. The policies contain an element of guarantee expressed in the form that the contract is written in i.e. to provide cash or an annuity. Deferred annuity policies written to provide a cash benefit may also contain an option to convert the cash benefit to an annuity benefit on guaranteed terms; these are known as GAR policies. Deferred annuity policies written to provide an annuity benefit may also contain an option to convert the annuity benefit into cash benefits on guaranteed terms; these are known as Guaranteed Cash Option ("GCO") policies.

During the last decade, interest rates and inflation have fallen and life expectancy has increased more rapidly than originally anticipated. Deferred annuity policies which are written to provide annuity benefits are managed in a similar manner to immediate annuities and are exposed to the same risks.

The guaranteed terms on GAR policies are more favourable than the annuity rates currently available in the market available for cash benefits. The guaranteed terms on GCO policies are currently not valuable.

The option provisions on GAR policies are particularly sensitive to downward movements in interest rates, increasing life expectancy and the proportion of customers exercising their option. Adverse movements in these factors could lead to a requirement to increase reserves which could adversely impact profit and potentially require additional capital.

The Company seeks to manage this risk in accordance with both the terms of the issued policies and the interests of customers, and has obtained external advice supporting the manner in which it operates the long-term funds in this respect.

#### Immediate annuities

This type of annuity is purchased with a single premium at the outset, and is paid to the policyholder for the remainder of their lifetime. Payments may also continue for the benefit of a surviving spouse or partner after the annuitant's death. Annuities may be level, or escalate at a fixed rate, or may escalate in line with a price index and may be payable for a minimum period irrespective of whether the policyholder remains alive.

The main risks associated with this product are longevity and investment risks. Longevity risk arises where the annuities are paid for the lifetime of the policyholder, and is managed through the initial pricing of the annuity and through reinsurance (appropriately collateralised) or transfer of existing liabilities. Annuities may also be a partial 'natural hedge' against losses incurred in protection business in the event of increased mortality (and vice versa) although the extent to which this occurs will depend on the similarity of the demographic profile of each book of business.

The pricing assumption for mortality risk is based on both historic internal information and externally generated information on mortality experience, including allowances for future mortality improvements. Pricing will also include a contingency margin for adverse deviations in assumptions.

Investment risk depends on the extent to which the annuity payments under the contracts have been matched by suitable assets which is managed under the ALM framework. Asset/liability modelling is used to monitor this position on a regular basis.

#### Protection

These contracts are typically secured by the payment of a regular premium payable for a period of years providing benefits payable on certain events occurring within the period. The benefits may be a single lump sum or a series of payments and may be payable on death, serious illness or sickness.

The main risk associated with this product is the claims experience and this risk is managed through the initial pricing of the policy (based on actuarial principles), the use of reinsurance and a clear process for administering claims.

#### Other risks

##### Customer risk

Customer risk is the risk of reductions in expected earnings and/or value to the Company or customers, through financial, reputational or operational losses as a result of:

- Failure to have in place an appropriate culture, structures, governance and frameworks across the Group to drive ethical and responsible behaviours, attitudes and decision making focussed on customer interests and outcomes.
- Failure to understand our customers' experience, behaviours and needs and act in their interests ensuring they are treated fairly, in line with our strategic objectives, and supported in making good financial decisions.
- Inappropriate conduct or poor customer treatment or experience (including poor advice) as a result of, but not limited to:
  - failure to execute / deliver on time;
  - not treating customers fairly in line with their reasonable expectations;
  - failure to identify and take appropriate steps to protect customers who are potentially vulnerable;
  - inability to satisfy agreed levels of service (including the handling of customer complaints). This also includes acting outside of customer instructions, and failing to observe customer confidentiality;
  - failure to provide customers with the information they need to make informed decisions about their policy in a way which is clear, accurate and unbiased;
  - failure to ensure that products offered to our customers by our affinity partners are subject to robust due diligence;

- failure to ensure that our products remain appropriate and deliver promised outcomes throughout the lifetime of the customer relationship;
- failure to understand and deliver all product promises to customers through our outsource service providers in a manner consistent with the Phoenix culture and current legislative and regulatory requirements.

Typical impacts for this type of loss event will include compensatory / ex gratia payments, or penalty payments resultant from breaching customer instructions for investments and increased resource requirements in order to provide rectification.

During 2015 and 2016, the following Financial Conduct Authority ("FCA") thematic reviews took place and resulted in findings in respect of the Company:

- (i) Thematic Review of the Fair Treatment of Long Standing Customers in Life Assurance ("Legacy Review")
- (ii) Thematic Review of Annuities Sales Practices and Retirement Income Study ("Annuities Sales Practices")

The result of the Legacy Review was reported on 3 March 2016. The FCA announced that it will commence investigations into the Company and five other firms in relation to disclosure of customer exit and paid-up charges (Legacy Review).

As detailed in note 20, a £5m provision has been recognised to cover the potential cost of addressing the paid up charges review resulting from the Legacy Review and a £34m provision has been recognised to cover the potential cost of addressing Annuity Sales Practices.

Following the reinsurance with PLL, the Company has retained the risk related to regulator imposed fines. Such costs associated with the Legacy Review and Annuities Sales Practices Review are indemnified by PLHL by way of a contingent subscription agreement.

The Company's overall aim, in line with our Customer Strategy, is to deliver a service to our customers which meet their needs, offering enhancements in agreed key areas and ensuring that we treat all customers fairly. This aim takes account of proportionality, such that actions taken should not have a disproportionate impact on other stakeholders.

#### Operational risk

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

### 37. Related party transactions

The Company enters into transactions with related parties in its normal course of business. These are at arms length on normal commercial terms.

PGMS provide pass through management services to the Company, in the form of staff and other services. The charge made to the Company for the year ended 31 December 2017 amounted to £38m (2016: £nil) and at the end of the year £4m (2016: £nil) was payable.

#### Transactions with Pearl Life Holdings Limited ("PeLHL")

The obligations of the Company to the Abbey Life Staff Pension Scheme were transferred to PeLHL on 30 June 2017 for consideration of £114m. At transfer the Company de-recognised a deficit of £90m and recognised a loss of £24m within Administrative expenses.

#### Transactions with Phoenix Life Holdings Limited ("PLHL")

As part of the acquisition of the Company, Deutsche Bank AG Group provided PLHL with a deed of indemnity in respect of expenses that may arise as a result of the FCA's Long Standing Customer Enforcement Investigation and Annuity Sales Thematic review. To ensure the Company benefitted from the deed of indemnity, PLHL provided the Company with a capital contribution of £23m in the year.

On 8 November 2017 the Company paid a dividend of £162m, settled in cash.

On 12 December 2017 the Company issued a loan of £150m to PLHL. The loan and all accrued interest was settled by an in-specie dividend of £150m on 29 December 2017.

On 29 December 2017 the Company paid a further dividend of £155m, settled in cash.

**Transactions with Phoenix Life Limited ("PLL")**

On 29 December 2017, substantially all of the risks and rewards of the existing and new business of the Company (that were not subject to existing reinsurance arrangements and with the exception of the with-profit funds) were reinsured to PLL, a fellow member of the Phoenix Group, under two reinsurance agreements. On inception of the agreements, the Company reinsured £2,581m of technical provisions for a consideration of £2,478m.

**Reinsurance transactions**

|  | 2017<br>£m | 2016<br>£m |
|--|------------|------------|
| Reinsurance ceded to fellow subsidiaries:      |            |            |
| Reinsurance premium paid to PLL                | 2,478      | -          |
| Reinsurers' share of insurance contract assets | 2,247      | -          |

**Amounts due to related parties**

|  | 2017<br>£m | 2016<br>£m |
|--|------------|------------|
| Other amounts due to fellow subsidiaries | 130        | -          |

**Amounts due from related parties**

|  | 2017<br>£m | 2016<br>£m |
|--|------------|------------|
| Other amounts due from fellow subsidiaries | 54         | -          |

**Key management compensation**

The compensation payable to employees classified as key management, which comprises the Directors, is disclosed in note 9. During the year to 31 December 2017, key management and other family members had no other transactions with the Company (2016: one Director paid premiums into critical illness policies and life protection policies issued by the Company with a total value of £1,066).

**Parent and ultimate parent entity**

Information on the Company's parent and ultimate parent is given in note 39.

**38. Contingent liabilities**

During 2016, the FCA published a thematic review into the fair treatment of long-standing customers. A provision has been recognised in respect of obligations identified by the Company in the areas covered by the review. As part of the review, other potential exposures were identified where it is not yet possible to conclude that the Company has a present obligation that will require an outflow of economic benefits. The determination of any additional liability arising remains dependent on the occurrence of uncertain future events, including finalisation of the FCA's enforcement investigation that commenced in response to the findings of the review into the fair treatment of long-standing customers. Further detailed information on these exposures is included in note 20.

The risks relating to the findings of the review, excluding potential fines imposed by the regulator, are in scope of the reinsurance with PLL effective 29 December 2017.

In addition in the normal course of business, the Company is exposed to certain legal issues, which involve litigation and arbitration. At year end, the Company has a number of contingent liabilities, none of which are considered by the Directors to be material.

**39. Other information**

The Company is a private limited company registered in England. Its registration number is 710383 and its registered office is 1 Wythall Green Way, Wythall, Birmingham B47 6WG. Its principal place of business is the United Kingdom.

The Company's immediate parent is Phoenix Life Holdings Limited and its ultimate parent is Phoenix Group Holdings, a company incorporated in the Cayman Islands and resident in the United Kingdom. A copy of the financial statements of Phoenix Group Holdings can be obtained from the Company Secretary, Juxon House, 100 St Paul's Churchyard, London, EC4M 8BU.