

# **FRIENDS LIFE LIMITED**

**(formerly Friends Provident Life and Pensions Limited)**

**COMPANY INCORPORATED IN ENGLAND AND WALES  
REGISTRATION NUMBER 4096141**

## **REPORT AND ACCOUNTS**

**For the year ended 31 December 2011**

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**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**REPORT AND ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2011**

<b>CONTENTS</b>	<b>PAGE</b>
Directors, company secretary, registered office, auditors	2
Report of the Directors	3
Statement of directors' responsibilities	10
Independent auditor's report	11
Profit and loss account – Technical account – Long-term business	12
Profit and loss account – Non-technical account	13
Statement of total recognised gains and losses	13
Balance sheet – assets	14
Balance sheet – liabilities	15
Notes to the financial statements	16
1 Accounting policies	16
2 Use of judgments, estimates and assumptions	25
3 Segmental information	28
4 Outward reinsurance premiums	30
5 Net investment return	30
6 Other technical income, net of reinsurance	31
7 Other technical charges, net of reinsurance	31
8 Part VII transfer of business	32
9 Exceptional loss	32
10 Net operating expenses	33
11 Taxation	34
12 Dividend	35
13 Investments	35
14 Investments in Group undertakings and participating interests	40
15 Present value of acquired in-force business	42
16 Assets attributable to the long-term business fund	42
17 Other debtors	42
18 Deferred acquisition costs	43
19 Called up share capital	43
20 Preference shares	43
21 Other equity – Step-up Tier One Insurance Capital Securities (STICS)	44
22 Reconciliation of movement in total shareholders' funds and statement of movements in reserves	44
23 Policyholder liabilities	45
24 Technical provisions	46
25 Risk management objectives and policies for mitigating risk	52
26 Provisions for other risks and charges	68
27 Amounts due to reinsurers	69
28 Creditors arising out of reinsurance operations	69
29 Other creditors including taxation and social security	69
30 Guarantees	70
31 Directors' emoluments	71
32 Related party transactions	71
33 Contingent liabilities	72
34 Commitments	72
35 Post balance sheet events	72
36 Ultimate parent undertaking	73

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**REPORT AND ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2011**

**BOARD OF DIRECTORS**

E B BOURKE MBA, FIA  
D E HYNAM BA (Hons)  
L C J'AFARI-PAK BA OXON, ACA, Solicitor  
A M PARSONS ACA, BEng  
M R B VERSEY MA, FIA

**COMPANY SECRETARY**

Friends Life Secretarial Service Limited

**REGISTERED OFFICE**

Pixham End  
Dorking  
Surrey  
RH4 1QA

**AUDITORS**

Ernst & Young LLP  
1 More London Place  
London  
SE1 2AF

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**REPORT OF THE DIRECTORS**  
**REGISTRATION NUMBER 4096141**

**PRINCIPAL ACTIVITY**

Friends Life Limited (the Company) is a wholly owned subsidiary of Friends Life FPL Limited (FPL)

The Company changed its name from Friends Provident Life and Pensions Limited on 1 December 2011. Friends Life FPL Limited changed its name from Friends Provident Limited on 1 July 2011. Friends Life FPL Limited is a wholly owned subsidiary of Friends Life Group plc (FLG). FLG changed its name from Friends Provident Holdings (UK) plc on 1 July 2011.

These name changes follow on from the introduction of the new operating brand, Friends Life, which was launched in March 2011.

The Company operates as part of the UK segment of Friends Life Group (the Group) – further information is contained in the 2011 report and accounts of FLG. The Group's principal activities comprise manufacturing and administering life and pensions products in the UK and related international markets. This encompasses the UK protection market, UK group pensions and vesting annuity market and international savings and investments, pensions and protection markets.

The Company's ultimate parent and controlling company is Resolution Limited.

The Company is authorised by the Financial Services Authority (FSA) to transact ordinary long-term insurance business in the United Kingdom. At the start of the year the Company was the holding company of Friends Provident Life Assurance Limited (FPLA), Friends Life and Pensions Limited (FLP) and Friends Provident Reinsurance Services Limited (FPR). FLP prior to 1 December 2011 was called Friends Provident Pensions Limited (FPP).

The Company acquired the entire issued share capital and business of Bupa Health Assurance Limited on 31 January 2011 from Bupa Investment Limited and its parent Bupa Finance plc. On the 1 December Bupa Health Assurance Limited changed its name to Friends Life BHA Limited (BHA).

In addition, ownership of Friends Life Company Limited (FLC) transferred to the Company on 18 March 2011 from Friends Life Group plc and ownership of Friends Life Assurance Society Limited (FLAS) transferred to the Company on 21 March 2011.

On 30 November 2011 the Company acquired 100% of the shares in Winterthur Life UK (WLUK) from FLG.

On 1 December 2011, the long-term business of FPLA and BHA and some of the long-term business of FLP was transferred to the Company via a business transfer scheme under Part VII of the Financial Services and Markets Act 2000 (FSMA).

On 24 November 2011 FPR was de-authorised by the FSA and was put into liquidation on 2 December 2011.

**TRANSFER OF BUSINESS**

It has been the intention of the Group to merge a number of its smaller companies into the Company via a business transfer scheme under Part VII of the Financial Services and Markets Act 2000 (FSMA). On 18 November 2011 final Court approval was received to transfer to the Company the complete long-term funds of FPLA and BHA and all of the liabilities and assets of equivalent regulatory value, plus deferred acquisition costs, and deferred front end fees relating to the following business of FLP,

- Immediate annuities that had been reinsured out of the Company,
- All but an insignificant proportion of the life business, and
- All pension protection business

The purpose of the Scheme was to simplify the corporate structure of the Group and to enhance its capital efficiency.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**REPORT OF THE DIRECTORS (continued)**

**TRANSFER OF BUSINESS (continued)**

The Scheme was implemented on 1 December 2011 and resulted in £4,234m of assets and £3,827m of liabilities being transferred into the Company. The transfer resulted in the carrying value of the Company's investment in FPLA and BHA being written down to nil.

Implementation of the Scheme resulted in the recapture of a number of existing intra-group reinsurance contracts between FPLA, FLP and the Company, and the transfer to the Company of the rights and obligations of FPLA and FLP under other intra-group and external treaties.

A new fund was created by the Company for the transfer of the closed with-profits fund of FPLA. The Company now manages two with-profits funds – the Friends Life FP With-Profits Fund and the Friends Life FPLA Closed Fund. All other transfers under the Scheme were either to the Company's Non Profit or Shareholders Fund.

**RESULTS AND BUSINESS REVIEW**

**Operational structure**

The Company largely operates in the UK individual and group protection, savings and investment and annuity markets.

**Acquisitions made by the Company during 2011**

- (a) The Company acquired the entire issued share capital and business of BHA on 31 January 2011 from Bupa Investment Limited and its parent Bupa Finance plc for a consideration of £168m which was funded from surplus capital held.
- (b) The Company purchased FLC for £2,972m on 18 March 2011 from FPL. The purchase was financed by
  - (i) the issue of £2,266m shares to FPL,
  - (ii) transferring loan liabilities totalling £306m with FLC from FPL to the Company (of which £88m is in respect of the acquisition of the right to receive payments under the contingent loan and the remainder is part payment for FLC), and
  - (iii) an intercompany account for the remaining £400m.
- (c) The Company purchased FLAS for £417m on 21 March 2011 from FPL. The purchase was financed by issuing £299m shares to FPL and by the transferring of a loan liability of £118m with FLAS from FPL to the Company.
- (d) The Company acquired the entire issued share capital and business of WLUK on 30 November 2011 from Friends Life Group plc for a consideration of £316m, representing £286m purchase and £30m capital injection, which was funded by Friends Life Group plc providing a loan of £200m to the Company and the remainder from surplus capital held.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**REPORT OF THE DIRECTORS (continued)**

**RESULTS AND BUSINESS REVIEW (continued)**

**Trading performance and outlook**

The Company's results show 'earned premiums, net of reinsurance' have increased by 632% to £1,955m (2010 £267m), due to the recapture of an existing intra-group reinsurance agreement – Phoenix 6 (the reinsurance of unit linked life business to FPLA from the Company) was recaptured resulting in a premium of £1,585m. Only premiums from insurance contracts are included within the long-term business technical account. Fee and commission income generated by investment contracts has decreased by 4% to £27m (2010 £28m) as a result of improved margins on products sold.

New business premiums on an APE basis (APE represents gross new regular premiums plus 10% of gross new single premiums) have decreased by 24% to £13m (2010 £17m) including both insurance and investment contracts, mainly through reduced group protection sales.

The market is evolving, and its structure from 2013 onwards is uncertain due to the Retail Distribution Review (RDR) (to be effective end 2012) and the introduction of auto-enrolment, whereby all employees above the age of 18 earning more than £5,000 are automatically enrolled into the employer's defined contribution scheme or NEST.

**Financial performance**

The profit on ordinary activities before tax as set out on page 13 is £521m (2010 profit of £191m). The transfer from the long-term business technical account to the non-technical account is a profit of £258m (2010 £50m). This amount includes tax movements arising within the long-term funds. The transfer for the year results from

	2011 Surplus £m	2010 Surplus £m
Basis changes	123	(1)
New business strain	(36)	(50)
Surplus arising from existing business	25	65
One off items	(73)	(41)
Surplus/(loss) on shareholders' retained capital	10	(10)
Deferred tax	-	(1)
Corporation tax	38	68
Transfer of assets equal to 60% surplus arising on the FP With-Profits Fund	-	22
1/9 <sup>th</sup> cost of bonus to with-profit policyholders of the FP With-Profits Fund	13	6
<b>FSA surplus</b>	<b>100</b>	<b>58</b>
Deferred acquisition costs	12	(2)
Deferred front end fees	(3)	-
Basis changes	(26)	(22)
Policyholder liability adjustments	(29)	(4)
Deferred taxation	76	24
Valuation of assets	(7)	(3)
Transfer of assets equal to 60% surplus arising on the FP With-Profits Fund	(10)	-
Business transfer in	143	
Other	2	(1)
<b>UK GAAP transfer to the non-technical account</b>	<b>258</b>	<b>50</b>

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**REPORT OF THE DIRECTORS (continued)**

**RESULTS AND BUSINESS REVIEW (continued)**

**Financial performance (continued)**

Shareholders' and other equity holders' funds have increased to £4,643m (2010 £2,258m) representing total recognised gains of £627m (2010 £289m), less dividend payments of £575m and £200m (2010 £462m), step-up tier one insurance capital securities (STICS) interest of £32m (2010 £32m) and an increase in share capital of £2,565 (2010 nil)

The majority of the Key Performance Indicators (KPI) used to manage the Group are not monitored at a standalone entity level. The one KPI that the Company is managed with is the Free Asset Ratio (FAR)

**Financial strength**

Assets and liabilities of the with-profits funds are calculated on a realistic basis. Other policyholder liabilities (including options and guarantees) are valued using a market-consistent stochastic model.

The FAR, a common measure of financial strength, is the ratio of assets less liabilities (including actuarial reserves but before the required regulatory solvency margin) expressed as a percentage of actuarial reserves. On a FSA regulatory basis (which is a different basis to the UK GAAP basis under which the accounts have been prepared), this increased to 44.6% at the end of 2011 (2010 23.8%) and available assets to meet capital requirements increased to £6,539m from £2,869m. This results from the acquisitions made by the Company during the year.

External agencies regularly perform independent assessments of the financial strength of life companies and publish their ratings.

Current ratings are

- Standard & Poor's rating A- (strong) with ratings watch negative outlook
- Fitch's rating A+ (strong) with positive stable outlook
- Moody's rating A3 (strong) with ratings watch positive outlook

The Company targets its financial strength ratings in the single A range and expect them to remain there for the foreseeable future.

**Risks**

The Group actively manages its risk profile. A formalised risk management framework drives the identification and mitigation of strategic, financial and operational risks to support the achievement of its objectives. Risks are predominantly managed at a Group level rather than an individual company level.

The principal inherent risks and uncertainties that the Group (and the Company) has been exposed to during 2011 and an overview of its approach to managing these exposures is listed below.

**Economic conditions**

The Group is exposed to volatile and uncertain economic conditions as these will give rise to changes in the values of the assets and liabilities of its insurance businesses. Adverse or uncertain economic conditions also impact the willingness of consumers to buy and continue to hold the Group's products. The Group is particularly impacted by conditions in the UK and other European countries as a result of its operations and investment assets being focused in these countries.

The Group's business model is designed to mitigate the impact of market conditions through measures including the matching of assets and liabilities, the use of financial instruments to reduce the volatility of returns on assets, diversification in the product portfolio, and ensuring the operating companies within the Group are robustly capitalised. The Group also actively monitors changes in the economic environment to enable proactive management of impacts to relevant markets.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**REPORT OF THE DIRECTORS (continued)**

**RESULTS AND BUSINESS REVIEW (continued)**

**Risks (continued)**

**Integration and restructuring**

The Group is exposed to the risk of failing to integrate and successfully restructure the financial services businesses that it acquires, and to achieve project specific objectives

Through the business planning process the Group determines the volume of change initiatives that can be delivered and prioritises initiatives for inclusion. The Group operates robust project management disciplines to identify and manage the interdependencies between initiatives, to set and monitor budgets, to manage the deployment of resources and to monitor delivery of outputs

**Completion of the UK Life Project**

The Group's business model is founded on delivering the UK Life Project. The Project is expected to have three phases – acquisition, restructuring and exit. The acquisition phase is considered to be substantially complete and the restructuring phase is on-going. The Group is now seeking to develop options for its exit from the UK Life Project

**Regulatory change and compliance**

The Group operates in a highly regulated financial services market which has a significant impact/influence on both strategic decisions and ongoing day-to-day management of acquired businesses. Unanticipated changes in legal requirements (including taxation) and regulatory regimes, or the differing interpretation and application of regulation over time, may have detrimental effects on the Group. The Group faces regulatory uncertainty over the next few years with the implementation of Solvency II, introduction of auto-enrolment and the Retail Distribution Review

Additionally in March 2011 the European Court of Justice (ECJ) announced that it had upheld the ruling on gender discrimination that results in insurers not being able to use gender related information to calculate insurance premiums and benefits. The ECJ has declared that the adoption of unisex premiums and benefits will apply with effect from 21 December 2012. A transitional period has been granted to allow insurance companies sufficient time to adjust to the new legal framework and adapt its products and pricing policies accordingly. The Group has carried out a preliminary assessment of the ruling, but it is too early to quantify the impact at this stage. The Group will adopt the new requirements by 21 December 2012

The Group bases its business strategy on prevailing regulation and known/planned change. To mitigate the risk of legislation or regulation adversely impacting its business, the Group engages with regulatory and legislative authorities and support lobbying activity conducted by relevant industry groups. The Group has processes in place to identify regulatory and legislative change and to monitor the timely implementation of new requirements

**Changes in Taxation Law**

The Group may be affected by changes in tax legislation and interpretation of tax law. In addition to relevant corporation taxes, life insurance companies with the group are subject to specific rules governing the taxation of policyholders, and amendment to these rules may impact the business. To mitigate the risk of taxation changes on its business, the Group engages with the relevant tax and legislative authorities and supports lobbying activity undertaken by industry groups

From 1 January 2013, there is expected to be a major change in the UK corporate tax regime applicable to life insurance companies. Draft legislation was issued for consultation in December 2011. The Group's assessment is that the draft legislation proposed would not have a material adverse impact on the corporate tax position of the Group

**Mortality and other assumption uncertainties**

The writing of life assurance and pension business by the Group's insurance businesses necessarily requires the setting of assumptions for future experience of factors such as mortality/longevity, lapse/persistence rates, valuation interest rates, credit defaults and expense levels



**FRIENDS LIFE LIMITED**  
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**REPORT OF THE DIRECTORS (continued)**

**Risks (continued)**

The Group takes a prudent approach to evaluating the appropriate level of provisions and capital for these risks and the assumptions are subject to rigorous and ongoing review. Stress and scenario testing is used to validate the appropriateness of key assumptions to single events and combinations of extreme events including economic conditions, investment performance, lapse and mortality/morbidity events.

**FLG reliance on outsourcing**

As part of the Group's strategy for increasing operational efficiency, opportunities are considered for outsourcing the administration of its insurance businesses. In November 2011 the Group materially extended its existing outsourcing arrangements in respect of IT and customer services by entering into a long-term contract with Diligenta. This had the effect of substantially increasing the reliance of the Group on outsource service providers.

The financial risks facing the Company are further discussed in note 25 to the financial statements.

**SHARE CAPITAL**

In March 2011 the issued share capital was increased to £3,219m from £654m by the issue of £2,565m shares as part of the acquisition of FLC and FLAS from FPL. Further information is disclosed in the section headed 'Acquisitions made by the Company in 2011' included as part of the 'Results and business review' within this report. As explained in note 35(a), the directors are proposing to undertake a capital reduction in 2012.

**DIVIDEND**

Interim dividends of £575m and £200m in respect of 2011 were paid by the Company on 23 March and 2 November respectively (2010: £180m, £112m and £170m on 29 March 2010, 30 June 2010 and 16 August 2010 respectively).

After the capital reduction has been approved, it is the intention of the directors to recommend an interim dividend of £350m (note 35(a)).

**DIRECTORS**

Mark Versey was appointed as director on 3 May 2011. Trevor Matthews resigned as a director on 2 June 2011. All other directors named on page 2 held office throughout the year.

**COMPANY SECRETARY**

Diana Monger resigned as company secretary on 16 June 2011. Friends Life Secretarial Services Limited was appointed as company secretary on 16 June 2011.

**FRIENDS LIFE LIMITED**  
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**REPORT OF THE DIRECTORS (continued)**

**EMPLOYEES**

Friends Provident Management Services Limited (FPMS) provides the Company's services and administration and either employs staff engaged in these activities or outsources the provision of the activities to Friends Life Services Limited (FLS) which is another group service company which employs staff. Accordingly, the Company has no direct employees. The average number of employees of FPMS and FLS is disclosed in the accounts of these entities.

**STATEMENT OF DISCLOSURE OF INFORMATION TO THE AUDITOR**

The directors who held office at the date of approval of this Report of the Directors confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditor is unaware, and each director has taken all the steps that he/she ought to have taken as a director to make himself/herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

**AUDITOR**

In accordance with section 487 of the Companies Act 2006, the Company has dispensed with the obligation to reappoint its auditor annually and Ernst & Young LLP (E&Y) will therefore continue in office.

**DIRECTORS AND OFFICERS – INDEMNITY AND INSURANCE**

A parent company, Friends Life Group plc (FLG), maintains insurance cover with respect to directors' and officers' liabilities. In addition, qualifying third party indemnity arrangements (as defined in section 234 of the Companies Act 2006) are in force for the benefit of directors within the Group and were in force for the benefit of former directors of the Group during 2011. Copies of the indemnity are available for inspection at the company's registered office.

**CREDITOR PAYMENT POLICY**

Services and supplies to the Company are made through a fellow Group undertaking, FPMS, and accordingly, the Company does not have any trade creditors.

**USE OF FINANCIAL INSTRUMENTS**

Further information on the Company's risk management process and the policies for mitigating certain risks are set out on pages 52 to 67 within note 25. Details of the financial instruments used for these purposes are also disclosed in note 25.

**STATEMENT OF GOING CONCERN**

The financial statements have been prepared on a going concern basis. In assessing whether the going concern basis is appropriate, the directors have considered the information contained in the financial statements, the latest business plan profit forecasts, the latest working capital forecasts and estimated forecast solvency. These forecasts have been subject to sensitivity tests and the directors are satisfied that the Company has adequate resources to continue in operational existence for the foreseeable future. Key information in respect of the Company's business activities, financial performance (including financial strength), and risks is set out on pages 3 to 8 of the financial statements. In addition, note 25 to the financial statements sets out in detail the Company's risk management objectives and policies for mitigating risks including liquidity risk.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**REPORT OF THE DIRECTORS (continued)**

**STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE REPORT OF THE DIRECTORS AND THE FINANCIAL STATEMENTS**

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

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with UK Generally Accepted Accounting Practice (UK accounting standards and applicable law).

The financial statements are required by law to give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the directors are required to

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

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect fraud and other irregularities.

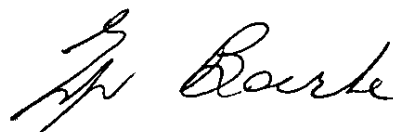
The directors confirm that they have complied with these requirements.

Pixham End  
Dorking  
Surrey  
RH4 1QA

20 March 2012

Registered Number 4096141

ON BEHALF OF THE BOARD



**E B BOURKE**  
**DIRECTOR**

## **INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF FRIENDS LIFE LIMITED**

We have audited the financial statements of Friends Life Limited for the year ended 31 December 2011, which comprise the Profit and Loss Account, the Balance Sheet, the statement of Total Recognised Gains and Losses and the related notes 1 to 36. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

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

### **Respective responsibilities of directors and auditor**

As explained more fully in the Statement of Directors' Responsibilities set out on page 10, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

### **Scope of the audit of the financial statements**

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

### **Opinion on financial statements**

In our opinion the financial statements

- give a true and fair view of the state of the Company's affairs as at 31 December 2011 and of its profit for the year then ended,
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, and
- have been prepared in accordance with the requirements of the Companies Act 2006.

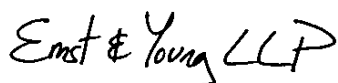
### **Opinion on other matters prescribed by the Companies Act 2006**

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

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

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

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



Stuart Wilson (Senior statutory auditor)  
for and on behalf of Ernst & Young LLP, Statutory Auditor  
London  
20 March 2012

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**PROFIT AND LOSS ACCOUNT**  
**FOR THE YEAR ENDED 31 DECEMBER 2011**

<b>TECHNICAL ACCOUNT – LONG-TERM BUSINESS</b>		<b>2011</b>	<b>2010</b>
	<b>Notes</b>	<b>£m</b>	<b>£m</b>
<b>Earned premiums, net of reinsurance</b>			
Gross premiums written	3	489	460
Outward reinsurance premiums	4	1,466	(193)
		1,955	267
<b>Investment income</b>	5	834	901
<b>Unrealised gains on investments</b>	5	43	725
<b>Gain on Part VII transfer of business</b>	8	143	-
<b>Other technical income, net of reinsurance</b>	6	54	51
<b>Total technical income</b>		<b>3,029</b>	<b>1,944</b>
<b>Claims incurred, net of reinsurance</b>			
Claims paid			
- gross amount		1,381	1,190
- reinsurers' share		(240)	(380)
		1,141	810
Change in the provision for claims			
- gross amount		(5)	17
- reinsurers' share		-	(1)
		(5)	16
<b>Net claims incurred</b>		<b>1,136</b>	<b>826</b>
<b>Change in other technical provisions, net of reinsurance</b>			
Long-term business provision, net of reinsurance			
- gross amount	23,24	(305)	74
- reinsurers' share	23	(34)	8
		(339)	82
Technical provisions for linked liabilities, net of reinsurance			
- gross amount	23,24	(405)	934
- reinsurers' share	23	2,141	(338)
		1,736	596
<b>Change in other technical provisions, net of reinsurance</b>		<b>1,397</b>	<b>678</b>
<b>Net operating expenses</b>	10	180	215
<b>Investment expenses and charges</b>	5	54	38
<b>Other technical charges, net of reinsurance</b>	7	62	119
<b>Tax attributable to the long-term business</b>	11	(65)	-
<b>Transfer to the fund for future appropriations</b>		7	18
		238	390
<b>Total technical charges</b>		<b>2,771</b>	<b>1,894</b>
<b>Balance on the technical account – long-term business</b>		<b>258</b>	<b>50</b>

**Notes:**

All amounts above are in respect of continuing operations

The notes on pages 16 to 73 form an integral part of these financial statements

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**PROFIT AND LOSS ACCOUNT**  
**FOR THE YEAR ENDED 31 DECEMBER 2011**

<b>NON-TECHNICAL ACCOUNT</b>	<b>Notes</b>	<b>2011 £m</b>	<b>2010 £m</b>
Balance on the long-term business technical account		258	50
Tax change/(credit) attributable to balance on long-term business technical account	11	6	(5)
<b>Profit before tax from long-term business</b>		<b>264</b>	<b>45</b>
Investment income	5	1,147	131
Gains on Part VII transfer of business	8	264	-
Unrealised (losses)/gains on investments	5	(4)	30
Investment expenses and charges	5	(442)	(15)
Exceptional item	9	(708)	-
<b>Profit on ordinary activities before tax</b>		<b>521</b>	<b>191</b>
Tax on profit on ordinary activities	11	28	1
<b>Profit on ordinary activities after tax</b>	<b>22</b>	<b>549</b>	<b>192</b>
<b>Attributable to:</b>			
Ordinary shareholders	22	517	160
Other equity holders	21,22	32	32
		<b>549</b>	<b>192</b>

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES**  
**FOR THE YEAR ENDED 31 DECEMBER 2011**

	<b>Notes</b>	<b>2011 £m</b>	<b>2010 £m</b>
<b>Attributable to ordinary shareholders</b>			
Profit for the financial year	22	517	160
Increase in surplus on revaluation of investments in shareholder subsidiaries	22	78	97
<b>Total recognised gains relating to the year</b>		<b>595</b>	<b>257</b>
<b>Attributable to other equity holders</b>			
Profit for the financial year	22	32	32
<b>Total recognised gains relating to the year</b>		<b>32</b>	<b>32</b>
<b>Total recognised gains</b>		<b>627</b>	<b>289</b>

**Notes:**

All of the amounts above are in respect of continuing operations

The notes on pages 16 to 73 form an integral part of these financial statements

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**BALANCE SHEET AS AT 31 DECEMBER 2011**

LIABILITIES	Notes	2011 £m	2010 £m
<b>Capital and reserves</b>			
Called up share capital	19,22	3,219	654
Revaluation reserve	22	284	206
Profit and loss account	22	629	887
Other equity	21,22	511	511
		4,643	2,258
<b>Fund for future appropriations</b>		255	217
<b>Technical provisions</b>			
Long-term business provision	23,24	13,854	12,176
Claims outstanding		49	17
		13,903	12,193
<b>Technical provisions for linked liabilities</b>	23,24	8,681	8,284
<b>Provisions for other risks</b>	26	16	15
<b>Deposits received from reinsurers</b>		-	1,605
<b>Amounts due to reinsurers</b>	27	1,800	-
<b>Financial liability</b>			
Preference shares	20	300	300
<b>Creditors</b>			
Creditors arising out of direct insurance operations		41	30
Creditors arising out of reinsurance operations	28	57	2
Other creditors including taxation and social security	29	1,731	828
		1,829	860
<b>Accruals and deferred income</b>		13	3
<b>TOTAL LIABILITIES</b>		31,440	25,735

Approved by the Board on 20 March 2012 and signed on its behalf by



E B BOURKE  
DIRECTOR

The notes on pages 16 to 73 form an integral part of these financial statements

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**BALANCE SHEET AS AT 31 DECEMBER 2011**

<b>ASSETS</b>	<b>Notes</b>	<b>2011 £m</b>	<b>2010 £m</b>
<b>Investments</b>			
Land and buildings	13	353	341
Investments in Group undertakings and participating interests	14	5,541	2,802
Other financial investments	13	14,107	11,982
		<b>20,001</b>	<b>15,125</b>
 <b>Present value of acquired in-force business</b>	 15	 25	 28
 <b>Assets held to cover linked liabilities</b>	 13	 4,379	 3,336
<b>Reinsurers' share of technical provisions</b>			
Long-term business provision	23	2,242	489
Claims outstanding		37	5
Technical provisions for linked liabilities	23	4,301	6,553
		<b>6,580</b>	<b>7,047</b>
 <b>Debtors</b>			
Debtors arising out of direct insurance operations			
- Policyholders		11	4
- Intermediaries		5	4
Other debtors	17	103	64
		<b>119</b>	<b>72</b>
 <b>Other assets</b>			
Cash at bank and in hand		46	6
 <b>Prepayments and accrued income</b>			
Accrued interest and rent		110	115
Deferred acquisition costs	18	180	6
		<b>290</b>	<b>121</b>
<b>TOTAL ASSETS</b>		<b>31,440</b>	<b>25,735</b>

The notes on pages 16 to 73 form an integral part of these financial statements



**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS**

**1. ACCOUNTING POLICIES**

**(a) Basis of preparation**

The financial statements have been prepared in accordance with Schedule 3 of the Large and Medium-sized Companies and Groups (Accounts and Reports) and Regulations 2008 (SI 2008/410) made under the Companies Act 2006 with the exception set out in note 1(n) and comply with the Association of British Insurers (ABI) Statement of Recommended Practice on Accounting for Insurance Business (SORP) December 2005 (as amended in December 2006)

As explained in the Report of the Directors, these financial statements have been prepared on a going concern basis. In considering whether the Company accounts should be prepared under the going concern basis, the directors have considered the information contained in these financial statements, the latest business plan profit forecasts for the Company, the latest working capital forecasts for the Company and estimated forecast solvency. These forecasts have been subject to sensitivity tests given the current uncertain economic outlook and the directors are confident that the Company has adequate resources to continue in operational existence for the foreseeable future. Accordingly, the directors continue to adopt the going concern basis in preparing these financial statements.

The financial statements have also been prepared in accordance with applicable accounting standards and under the historical cost convention as modified by the revaluation of land and buildings, derivatives and financial assets and liabilities at fair value through profit and loss as set out in notes 1(n), 1(t) and 2(d).

In accordance with Financial Reporting Standard (FRS) 1 Cash Flow Statements (Revised 1996), the Company is exempt from preparing a cash flow statement on the grounds that it is a wholly owned undertaking of a parent which provides a cash flow statement in its consolidated financial statements which are publicly available.

The Company is exempt under section 400 of the Companies Act 2006 from the obligation to prepare group accounts as the Company is a wholly owned subsidiary of Resolution Limited in whose consolidated accounts the Company is included. Accordingly, the financial statements present information about the Company as an individual entity and not about its group.

The Company has applied all applicable accounting standards and interpretations effective at 31 December 2011. There have been no new standards, changes to standards and interpretations which are effective for accounting periods beginning on or after 1 January 2011 that have had a material impact on these financial statements.

All accounting policies have been reviewed for appropriateness in accordance with FRS 18 Accounting Policies. The principal accounting policies set out below have been applied consistently throughout the year.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**1. ACCOUNTING POLICIES (continued)**

**(b) Product classification**

**(i) Insurance contracts**

Contracts under which the Company accepts significant insurance risk from another party (the policyholder), by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder are classified as insurance contracts. Insurance risk is risk other than financial risk. Financial risk is the risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of price or rates, a credit rating or credit index or other variable. Insurance contracts may transfer some financial risk.

Once a contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly during the period. As a general guideline, the Company defines a significant insurance risk as the possibility of having to pay benefits, on the occurrence of an insured event, that are more than 5% greater than the benefits payable if the insured event did not occur.

**(ii) Investment contracts**

Policyholder contracts not considered insurance contracts are classified as investment contracts. Contracts currently classified as investment contracts are either unit-linked or contracts with Discretionary Participation Features (DPF) with no significant insurance risk. The latter are mainly unitheld with-profits contracts.

A contract with DPF is a contractual right held by a policyholder to receive, as a supplement to guaranteed minimum payment, additional payments:

- that are likely to be a significant portion of the total contractual payments, and
- whose amount or timing is contractually at the discretion of the issuer and that are contractually based on
  - the performance of a specified pool of contracts, or a specified type of contract, or
  - realised and/or unrealised investment returns on a specified pool of assets held by the issuer, or
  - the profit or loss of the company that issues the contracts

**(c) Foreign currencies**

Transactions in foreign currencies are translated to Sterling at the foreign exchange rates ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to Sterling at the exchange rate ruling at the balance sheet date, and any exchange differences arising are taken to the profit and loss account. Non-monetary assets and liabilities measured at historical cost in a foreign currency are translated using the exchange rate at the date of the transaction and are not subsequently restated. Non-monetary assets and liabilities stated at fair value in a foreign currency are translated at the rate on the date the fair value was determined.

When a gain or loss on a non-monetary item is recognised directly in equity, any exchange component of that gain or loss is recognised directly in equity. Conversely, when a gain or loss on a non-monetary item is recognised in the profit and loss account, any exchange component of that gain or loss is recognised in the profit and loss account.

**(d) Premiums**

Premium income in respect of single premium insurance policies and pensions business, not subject to contractual regular premiums, is accounted for when the premiums are received. For all other insurance contracts, premium income is accounted for in the year in which it falls due. Further details relating to the classification of new business premiums are included in note 3(b).

**(e) Reinsurance**

Amounts due to and from reinsurers are accounted for in a manner consistent with the relevant reinsurance contract. Premiums ceded and claims reimbursed are presented on a gross basis.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**1 ACCOUNTING POLICIES (continued)**

**(f) Fee and commission income**

Investment contract policyholders are charged for policy administration services, investment management services and for surrenders. Investment management services comprise primarily fees and charges from unit-linked investments.

These fees and charges are recognised as revenue in the period in which the services are rendered.

Front-end fees are charged at the inception of certain investment contracts and are recognised as income over the expected term of the contract on a straight line basis with the unrecognised amount at the end of the year presented as a liability.

Regular fees charged to the policyholder periodically (monthly, quarterly or annually) are recognised on a straight-line basis over the period in which the service is rendered.

Fee and commission income is included in the long-term business technical account as part of 'other technical income'.

**(g) Investment income**

All income received from investments is recognised in the profit and loss account and includes dividends, interest, rental income, the movement in financial assets and investment properties at fair value through the profit and loss account.

Dividend income from listed and unlisted securities is recognised as income when the right to receive payment is established. For listed securities this is the date the security is listed as ex-dividend. For unlisted securities this is the due date of payment.

Interest income is recognised as income as it accrues, taking into account the relevant coupon rate, an applicable floating rate, or for loan assets at amortised costs, the effective yield of the asset. Under the effective interest rate method, interest income includes the amortisation of any discount or premium and capitalised issue costs.

Realised gains and losses on investments are calculated as the difference between the net sales proceeds and the carrying value of the investment determined in accordance with the accounting policies applicable to the investment.

Investment income relating to investments, which are directly connected with the carrying on of long-term business, is recorded in the long-term business technical account. Other than long-term business, investment income is recorded in the non-technical account.

**(h) Unrealised gains and losses on investments**

Unrealised gains and losses on investments represent the difference between the valuation of investments designated as fair value through the profit and loss, derivatives and land and buildings, at the balance sheet date and their original cost, or if they have been previously fair valued, the valuation at the last balance sheet date. The movement in unrealised gains and losses recognised in the period also includes the reversal of unrealised gains and losses recognised in earlier accounting periods in respect of investment disposals in the current period.

Unrealised gains and losses relating to investments, which are directly connected with the carrying on of long-term business, are recorded in the long-term business technical account. With the exception of unrealised gains and losses on investments in shareholder subsidiaries, which are recognised directly in equity, non long-term business realised gains and losses and permanent diminutions in the value of shareholder subsidiaries are recorded in the non-technical account.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**1. ACCOUNTING POLICIES (continued)**

**(i) Claims and surrenders**

Insurance claims reflect the cost of all claims incurred during the year on insurance contracts, including claims handling costs. Death claims and surrenders are recognised on the basis of notifications received. Maturities and annuity payments are recorded when due. Claims and benefits recorded are accrued to the policyholder and included within insurance and investment contract liabilities.

Claims handling costs include internal and external costs incurred in connection with the negotiation and settlement of claims. Internal costs include all direct expenses of the claims department and any general administrative costs directly attributable to the claims function.

Reinsurance recoveries are accounted for in the same period as the related claim.

**(j) Transaction costs**

Transaction costs in respect of brokers fees, stamp duty fees and other expenses on investments are charged to profit and loss in the period in which they are payable.

**(k) Bonuses**

Bonuses charged to the long-term business technical account in a given period comprise reversionary bonuses declared in respect of that period, which are provided within the calculation of the long-term business provision, and terminal bonuses paid, which are included within claims paid.

**(l) Taxation**

Taxation in the non-technical account and long-term business technical account is based on profits and income for the period as determined in accordance with the relevant tax legislation, together with adjustments to provisions for prior periods. Tax payable is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Current taxation relating to items recognised directly in equity is recognised in equity and not in the profit and loss account.

Provision is made for deferred taxation liabilities, using the liability method, on all material timing differences, including fair valuation adjustments recognised through profit and loss, as the investments are fair valued. Deferred taxation is calculated at the rates at which it is expected that the tax will arise and discounted to take into account the likely timing of payments and pattern of expected realisation of investments. Deferred tax liabilities are discounted using gilt yield rates appropriate to the estimated year in which the timing differences are expected to reverse. Deferred taxation is recognised through profit and loss for the period.

Deferred tax assets are recognised to the extent that they are regarded as recoverable.

The transfer of the balance on the long-term business technical account to or from the non-technical account is grossed up by the actual tax charge on the surplus on the long-term business technical account.

**(m) Intangible assets**

Licences acquired are capitalised in the balance sheet at cost and amortised through profit and loss over their expected useful economic life. Charges for amortisation and any changes for impairment are recorded in 'other technical charges'.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**1. ACCOUNTING POLICIES (continued)**

**(n) Investments**

Investments are shown in the balance sheet as follows

**(i) Land and buildings**

Investment properties and properties occupied by the Group are measured at fair value at least annually at the balance sheet date. Fair values are measured by external independent valuers on the basis of open market value using methods set out in the Royal Institution of Chartered Surveyors (RICS) Red Book. The valuations used are based on valuation techniques using multiples of future rental incomes. The rental multiples are based on multiples observed in recent similar transactions in the market. Key assumptions include occupancy and rental income.

In accordance with Statement of Standard Accounting Practice (SSAP) 19 Investment Properties, no depreciation is provided in respect of freehold investment properties or amortisation in respect of leasehold properties with over 20 years to expire. This is a departure from the requirements of the Companies Act 2006 which requires all properties to be depreciated. However, these properties are held solely for investment purposes and the directors consider that systematic annual depreciation would be inappropriate. Depreciation or amortisation is only one of the factors reflected in the annual valuations of properties, and the amounts which might otherwise have been shown cannot reasonably be separately identified or quantified. The accounting policy adopted is therefore necessary for the financial statements to give a true and fair view.

**(ii) Other financial investments**

The Company classifies its financial investments into the following two categories: financial investments at fair value through profit and loss and loans receivable. The classification depends on the purpose for which the investments were acquired or originated.

Purchases and sales of financial investments are recognised on the date the Company commits to purchase or sell the investment, generally the trade date.

A transfer of a financial asset is accounted for as a derecognition only if substantially all of the asset's risks and rewards of ownership are transferred or control is transferred in the event that not substantially all of the asset's risks and rewards of ownership are transferred. However, if substantially all of the risks and rewards are retained, the asset is not derecognised. Control is transferred if the transferee has the practical ability to sell the asset unilaterally without needing to impose additional restrictions on the transfer.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**1. ACCOUNTING POLICIES (continued)**

**(n) Investments (continued)**

**(ii) Other financial investments (continued)**

- **Financial assets at fair value through profit and loss**

Financial assets at fair value through profit or loss comprise assets which are designated as such on initial recognition, and derivatives, which are classified as held for trading

Financial assets are designated upon initial recognition at fair value through profit or loss as they are managed individually or together on a fair value basis

All financial assets at fair value through profit or loss are measured at fair value. The fair value on initial recognition is generally the consideration given, excluding any transaction costs directly attributable to their acquisition, which are expensed. Movements in fair value are taken to the profit and loss account as investment return in the period in which they arise. Financial assets carried at fair value are initially recognised at fair value and subsequently remeasured at fair value based on quoted bid prices where such prices are available from a third party in a liquid market. If quoted bid prices are unavailable, the fair value of the financial asset is estimated using cash flow models.

Fair values for unlisted securities are derived from cash flow or other models designed to reflect the specific circumstances of the issuer. Securities for which fair value cannot be measured reliably are recognised at cost less impairment.

Where derivatives qualify for hedge accounting, recognition of any resultant gain or loss depends on the nature of the item being hedged and of the hedge.

- **Loans receivable**

Loans receivable represent 'Loans secured by mortgages'

Loans are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans are measured on initial recognition at the fair value of the consideration given plus incremental costs that are incurred on the acquisition of the investment. Subsequent to initial recognition, loans are either measured at amortised cost using the effective interest rate method with any difference between cost and redemption value being amortised through the profit and loss account over the period of the borrowings, or, if they meet the criteria for designation at fair value through profit or loss, and are so designated on initial recognition, they are measured at fair value.

The amortised cost is the present value of estimated future cash flows discounted at the effective interest rate at the date of acquisition or origination of the loan.

The carrying value of a loan is reviewed for impairment at each reporting date. If there is objective evidence of impairment, for example there is a default or delinquency in payment, the impairment loss is calculated and recognised.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**1. ACCOUNTING POLICIES (continued)**

**(o) Investments in Group undertakings and participating interests**

Shares in and loans to Group undertakings and participating interests are held at current value

**(p) Present value of acquired in-force business (PVIF)**

On acquisition of an external portfolio of insurance contracts or investment contracts the net present value of the Company's interest in the expected pre-tax cash flows of the in-force business is capitalised in the balance sheet as an intangible asset. PVIF is amortised over the anticipated lives of the related contracts.

The carrying value of the asset is assessed annually using current assumptions in order to determine whether any impairment has arisen compared to the amortised acquired value based on assumptions made at the time of the acquisition. Any amortisation or impairment charge is recorded in the long-term business technical account within 'other technical charges'.

**(q) Other financial assets**

Other financial assets primarily include insurance and other debtors, including amounts due from Group undertakings and cash at bank.

Insurance and other debtors are recognised when due and are carried at fair value. Cash at bank is also reported at fair value at the balance sheet date.

**(r) Deferred acquisition costs**

For both insurance contracts and investment contracts with Discretionary Participation Features (DPF), acquisition costs comprise all direct and indirect costs arising from writing the contracts, which are incurred during a financial period. Acquisition costs are amortised over the life of the contracts where their recovery has not been reflected in the valuation of policyholder liabilities, but only to the extent that they are recoverable out of future margins.

The rate of amortisation of acquisition costs on such contracts is proportional to the future margins expected to emerge in respect of the related policies, over the life of those policies.

For investment contracts without DPF, acquisition costs comprise all incremental costs that are directly related to the writing of the contract, which are incurred during a financial period, and are amortised on a straight-line basis over the lifetime of the contract if they are recoverable out of future margins.

Annual impairment reviews are performed to identify whether there are any circumstances that might indicate impairment. If such circumstances exist, the carrying values are adjusted to the recoverable amounts and any resulting impairment losses are charged to profit and loss.

**(s) Funds for future appropriations (FFA)**

The FFA in the with-profits funds is presented as a liability and comprises all funds available for allocation, either to policyholders or to shareholders, the allocation of which has not been determined at the balance sheet date.

All insurance and investment contract liabilities within the with-profits funds are valued on a realistic basis and therefore included amounts attributable in respect of future bonuses. Such amounts are estimated in accordance with the published PPFM and represent a constructive obligation. The realistic liabilities include an estimate of the fair value of policyholder options and guarantees. The unallocated surplus within the with-profits funds represents the excess of assets of the fund relative to the realistic liabilities and other current liabilities not included within realistic liability measurement. The unallocated surplus can be considered to represent the working capital of the funds combined with the value of future transfers to shareholders from the with-profits funds.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**1. ACCOUNTING POLICIES (continued)**

**(t) Financial liabilities**

The Company classifies financial liabilities as either financial liabilities at fair value through profit and loss or financial liabilities carried at amortised cost. The amortised cost of a financial liability is the amount at which the financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount.

Financial liabilities at fair value through profit and loss, such as investment contracts, are designated on initial recognition when one of the following criteria is satisfied:

- it eliminates or significantly reduces an accounting mismatch caused by financial assets and financial liabilities being measured on a different basis,
- the financial liability contains or may contain an embedded derivative.

A financial liability is recognised when, and only when, the Company becomes a party to the contractual provisions of a financial instrument. A financial liability is derecognised when, and only when, the obligation specified in the contract is discharged or cancelled or expires.

FRS 27 Life Assurance, does not allow the decrease of actuarial liabilities in respect of capital units.

**(u) Insurance contracts**

Insurance contract liabilities are disclosed separately from investment contract liabilities in the balance sheet. Technical provisions disclosed in the balance sheet for the long-term business, claims outstanding and linked liabilities represent amounts only for insurance contracts. Correspondingly, the change in other technical provisions in the long-term business technical account for long-term business and linked liabilities, including reinsurance amounts, is for insurance contracts only.

For UK operations the liabilities are calculated based on the relevant Financial Services Authority (FSA) rules contained in the Prudential Sourcebook for Insurers.

For the conventional with-profits policies, the liabilities to policyholders are determined in accordance with the Realistic Balance Sheet (RBS) regulations and in accordance with the principles contained in FRS 27. These liabilities include both declared bonus and constructive obligations for future bonuses not yet declared (excluding the shareholders' share of future bonuses) and includes the cost of options and guarantees measured on a market-consistent basis. The RBS basis of calculation does not recognise deferred acquisition costs, but allows for future profits of non-profit and unit-linked business written in the with-profits funds to be recognised. The calculation of liabilities to policyholders includes a deduction for the present value of in-force business on the with-profits policyholders' share of non-profit business written within the with-profits funds.

The calculation of liabilities to policyholders for non-profit contracts includes explicit allowance for future expenses and allow for lapses where appropriate.

The value of unit-linked insurance contract liabilities includes provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to policyholders.

The provision for insurance contract liabilities can never be definitive as to the overall level of liabilities or their timing and is subject to regular reassessment.

The Company carries out an annual liability adequacy test on its insurance liabilities less related deferred acquisition costs and other related intangible assets to ensure that the carrying amount of its liabilities is sufficient in the light of estimated future cash flows. Where a shortfall is identified, an additional provision is made.



**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**1. ACCOUNTING POLICIES (continued)**

**(v) Investment contracts**

Investment contracts are either unit-linked or contracts with a Discretionary Participation Feature (DPF) (mainly unitised with-profits contracts) that have no significant insurance risk

A unit-linked investment contract is recognised at fair value through the profit and loss account. The fair value is calculated as the number of units allocated to policyholders in each of the unit-linked funds multiplied by the bid price of the units which reflects the fair value of the assets in the fund at the balance sheet date. In addition to this the fair value of the investment contract liability includes a provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to the policyholders. Provision is made for renewal commissions at the inception of an investment contract as intermediaries are not required to perform any service once the policy is accepted.

Unitised with-profits investment contracts are measured using RBS principles as amended by FRS 27.

Investment contracts with DPF held within the with-profits funds (which are mainly unitised with-profits contracts) are measured on a basis consistent with a measurement basis for insurance contracts held within those funds.

Balances representing eligible surplus that has not yet been allocated to shareholders, or policyholders with DPF contracts, are retained as a policyholders' liability.

**(w) Classification of financial instruments between debt and equity**

The classification of financial instruments between debt and equity is based on the principles in FRS 25 rather than the instruments' legal form or their commercial intent. The Company applies these principles when classifying its financial instruments. In order to be classified as debt, the financial instrument, in situations where the contract will not be settled by the Company's own shares, must have a contractual obligation to:

- (i) deliver cash or another financial asset to another entity, or
- (ii) exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the Company.

For some instruments the contractual obligation to pay cash or another financial asset is dependant on the occurrence or non-occurrence of some future event. If this event is out of the control of the Company, then this usually means that the instrument still meets its definition of debt. However, if the Company is only required to settle the obligation in the event of liquidation or if the likelihood of the event occurring (or not occurring) is so remote that it is extremely unlikely that the obligation will be triggered then the Company treats the instruments as equity, as required by FRS 25 Financial instruments – recognition and measurement. Payments on instruments classified as equity are not treated as expenses but as an appropriation of profit.

**(x) Other financial liabilities**

Other financial liabilities primarily include creditors arising out of insurance and reinsurance operations and other obligations due to Group undertakings or third parties. These are reported at the estimated amounts required to settle the obligation at the balance sheet date.

**(y) Dividends**

Dividends approved by ordinary shareholders are recognised as a liability on the date of approval and dividends declared by directors are recognised on the date of payment. Dividends are charged directly to equity.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**2. USE OF JUDGMENTS, ESTIMATES AND ASSUMPTIONS**

The Company makes judgments in the application of critical accounting policies that affect the reported amounts of assets and liabilities. The Company also makes key assumptions about the future and other sources of uncertainty. These are continually evaluated and based on historical experience and other factors, including expectations of future events that are considered to be reasonable under the circumstances.

**(a) Product classification**

Contracts are classified as either 'insurance contracts' or 'investment contracts' based on the significance of insurance risk present in the contract with consequential impacts on the accounting policies applied to the valuation of policyholder liabilities, deferral of acquisition costs and pattern of revenue recognition.

**(b) Liabilities arising from insurance contracts and investment contracts with DPF**

Determination of the ultimate liabilities of insurance contracts or investment contracts with DPF arising is a critical accounting estimate. There are several sources of uncertainty that need to be considered in determining the key assumptions made in estimating the liabilities that the Company will ultimately pay on claims made and on maturity of the policies.

The most significant assumptions are

- mortality, morbidity and persistency assumptions,
- for with-profits policies the stochastic model used to value liabilities is sensitive to risk-free rates, assumed asset volatilities and the assumed correlation between asset volatilities. Risk-free rates are set in accordance with current market gilt rates,
- valuation interest rate for annuities in payment – fixed interest assets, predominantly corporate bonds, are held to match the expected benefit outgo of the annuity portfolio. The excess yields on corporate bonds over that on gilts are called bond spreads and these reflect compensation for the higher risk of default (credit risk premium) and lower liquidity (liquidity premium) compared to gilts. One of the key judgements is the assessment of how much of the spread is attributable to liquidity premium. The illiquidity premium is derived by deducting an allowance for defaults (based on an analysis of historical defaults) from the total bond spread. This approach is consistent with current industry practice,
- other valuation interest rates have been calculated by reference to changes in consistent economic indices. The impact of these liability changes on surplus, is generally to offset some or all of the corresponding impact on the value of fixed-interest assets backing the liabilities,
- for guaranteed annuity options the cost depends on assumptions such as the level of policy discontinuance and the tax-free cash take-up rate, and
- changes in assumptions behind the valuation techniques for assets that are not quoted in active markets could have a significant impact on the value of assets that are backing insurance and investment contract liabilities.

**(c) Impairment testing**

Assets, other than those held at fair value through profit and loss, are reviewed where there is an indication of possible impairment. For most assets this requires the Company to estimate future cash flows and discount these amounts using a suitable rate which reflects the risk of those cash flows. In projecting cash flows, the most significant assumptions include investment market conditions, sales and margins, expenses, policy/client lapses, discount rates, and terminal values.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**2. USE OF JUDGMENTS, ESTIMATES AND ASSUMPTIONS (continued)**

- (d) **Fair value determination of financial instruments at fair value through the profit and loss account**  
Financial assets are designated at fair value as they are managed on a fair value basis. Financial liabilities such as investment contracts are designated at fair value to eliminate mismatch with corresponding assets that are managed on a fair value basis.

Fair values of financial assets that are quoted in active markets are based on bid prices for the assets held. When independent prices are not available, fair values are determined using valuation techniques which refer to market observable data. These include comparison with similar instruments when market observable prices are available.

Corporate bond valuations are generally obtained from brokers and pricing services. Where the number of transactions has declined under the current market conditions, valuations have become more subjective. Bond prices provided by pricing services are based on the best estimate of market price determined by market makers based on a variety of factors and are considered to be observable prices. In determining fair value, market makers will take into account transactions they have observed in identical or similar assets as well as movements in market indices and any other factors that they regard as relevant. In some cases, consensus prices have been based on fewer and potentially more historic transactions.

Fair values of private equity investments are based on the revaluation of the underlying investments using International Private Equity and Venture Capital Valuation (IPEVC) guidelines. The valuations use earnings multiples reflecting similar multiples applying to quoted investments.

Methods considered when determining fair values of unlisted shares and other variable securities include discounted cash flow techniques and net asset valuation.

The value of derivatives is estimated by applying valuation techniques, using pricing models or discounted cash flow methods. Where pricing models are used, inputs – including future dividends, swap rates and volatilities – based on market data at the balance sheet date are used to estimate derivative values. Where discounted cash flow techniques are used, estimated future cash flows and discount rates are based on current market swap rates.

For units in unit trusts and shares in open-ended investment companies, fair value is calculated using published bid values.

Participation in investment pools mainly relates to property investments. Property is independently valued in accordance with the Royal Institute of Chartered Surveyors' (RICS Red Book) guidelines on the basis of open market values as at each year end.

- (e) **Deferred tax assets**  
In assessing deferred tax assets, an estimate of probable future taxable profits is made, against which the temporary differences, being the carry forward of excess tax expenses, and tax losses are utilised. These involve management's best estimate based on past profit experience, adjusted for possible future deviations that management consider might occur.

- (f) **Fair value determination of investment properties and owner occupied properties**  
Investment properties and properties occupied by Group companies are measured at fair value at least annually at the balance sheet date. Fair values are measured by external independent valuers on the basis of open market value using methods set out in the RICS Red Book.

The valuations used are based on valuation techniques using multiples of future rental incomes. The rental multiples are based on multiples observed in recent similar transactions in the market. Key assumptions include occupancy and rental income.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**2. USE OF JUDGMENTS, ESTIMATES AND ASSUMPTIONS (continued)**

**(g) Changes in accounting estimates**

**2011** The total impact of changes in accounting estimates amounted to a £96.9m increase in profit, as follows

- **One-off basis changes: expense assumptions**

Expense assumptions have been updated to reflect recent experience. This has resulted in a £35.3m contribution to profit in 2011.

- **One-off basis changes: persistency**

The profile of lapse assumptions has been changed to reflect the most recently observed experience. The impact on profit before tax is an increase of £6.5m from a decrease in liabilities to policyholders.

- **One-off basis changes: mortality/morbidity**

Mortality and morbidity assumptions have been updated to reflect recent experience. This has resulted in a £69.3m contribution to profit in 2011, most of which is attributable to limiting the assumed benefits paid for income protection policies to a percentage of the sum assured.

- **Tax equalisation**

The liability to policyholders includes an amount reflecting the fair value of the tax cost arising from investment losses which may ultimately be attributable to policyholders. The impact on profit before tax for the year is a charge of £14.2m.

**2010** The total impact of changes in accounting estimates amounted to a £7.8m increase in profit, as follows

- **One-off basis changes: expense assumptions**

There have been no changes to expense assumptions and consequently no impact on profit.

- **One-off basis changes: lapses**

The profile of lapse assumptions has been changed to reflect the most recently observed experience. The impact on profit before tax is a decrease of £1.0m from an increase in liabilities to policyholders.

- **One-off basis changes: mortality**

The assumption as to future improvements in annuitant longevity has been strengthened. The impact on profit before tax is a decrease of £22.2m from an increase in liabilities to policyholders.

- **Tax equalisation**

The liability to policyholders includes an amount reflecting the fair value of the tax benefit arising from investment losses which will ultimately be attributable to policyholders of £31m.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**3. SEGMENTAL INFORMATION**

The information reported for 2011 include amounts for the month of December relating to business transferred to the Company on 1 December 2011 following the Part VII transfer of business (as explained in the Report of the Directors)

	2011 £m	2010 £m
Gross written premiums on insurance contracts and investment contract deposits	790	839
Less investment contract deposits written	(301)	(379)
<b>Gross written premiums per the long-term business technical account</b>	<b>489</b>	<b>460</b>
<b>Analysed:</b>		
Direct insurance premiums	308	298
Inwards reinsurance premiums	181	162
<b>Gross written premiums per the long-term business technical account</b>	<b>489</b>	<b>460</b>

**(a) Direct insurance premiums written by type**

	Regular premiums		Single premiums		Total	
	2011 £m	2010 £m	2011 £m	2010 £m	2011 £m	2010 £m
<b>Individual</b>						
Protection	168	160	-	-	168	160
Savings and investment	90	94	2	-	92	94
Pensions	14	13	1	2	15	15
Annuities	-	-	2	2	2	2
<b>Total individual premiums</b>	<b>272</b>	<b>267</b>	<b>5</b>	<b>4</b>	<b>277</b>	<b>271</b>
<b>Group</b>						
Protection	28	27	-	-	28	27
Pensions	3	-	-	-	3	-
<b>Total group premiums</b>	<b>31</b>	<b>27</b>	<b>-</b>	<b>-</b>	<b>31</b>	<b>27</b>
<b>Total life and pensions</b>	<b>303</b>	<b>294</b>	<b>5</b>	<b>4</b>	<b>308</b>	<b>298</b>

	2011 £m	2010 £m
Premiums from non-participating contracts	138	111
Premiums from participating contracts	123	143
Premiums from investment linked contracts	47	44
<b>Total life and pensions</b>	<b>308</b>	<b>298</b>

**(b) New business written by type**

The new business written for the purpose of this note includes premiums on all types of contracts written by the Company (including gross premiums on investment contracts, which have not been included as part of the 'gross premiums written' in the long-term business technical account, under paragraph 162 of the ABI SORP)

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**3. SEGMENTAL INFORMATION (continued)**

**Gross new business written**

	Regular premiums		Single premiums		APE	
	2011	2010	2011	2010	2011	2010
	£m	£m	£m	£m	£m	£m
<b>Individual</b>						
Savings and investment	1	-	3	1	1	-
Pensions	-	-	66	76	7	8
Annuities	-	-	3	4	-	-
<b>Total individual premiums</b>	<b>1</b>	<b>-</b>	<b>72</b>	<b>81</b>	<b>8</b>	<b>8</b>
<b>Group</b>						
Protection	2	5	-	-	2	5
Pensions	2	3	5	13	3	4
<b>Total group premiums</b>	<b>4</b>	<b>8</b>	<b>5</b>	<b>13</b>	<b>5</b>	<b>9</b>
<b>Total life and pensions</b>	<b>5</b>	<b>8</b>	<b>77</b>	<b>94</b>	<b>13</b>	<b>17</b>

The new Life & Pensions APE represents gross new regular premiums plus 10% of gross new single premiums. In classifying new business premiums the following basis of recognition is adopted:

- (i) single new business premiums consist of those contracts under which there is no expectation of continuing premiums being paid at regular intervals,
- (ii) regular new business premiums consist of those contracts under which there is an expectation of continuing premiums being paid at regular intervals, including repeated or recurrent single premiums where the level of premiums is defined or where a regular pattern in the receipt of premiums has been observed,
- (iii) non-contractual increments under existing group pensions schemes are classified as new business premiums,
- (iv) transfers between products where open market options are available are included as new business, and
- (v) regular new business premiums are included on an annualised basis.

**(c) Life and pensions gross premiums**

	2011	2010
	£m	£m
<b>Source</b>		
United Kingdom	489	460
	<b>489</b>	<b>460</b>
<b>Destination</b>		
United Kingdom	444	457
Rest of the World	45	3
	<b>489</b>	<b>460</b>

**(d) Life and pensions new business**

	Regular premiums		Single premiums	
	2011	2010	2011	2010
	£m	£m	£m	£m
<b>Source</b>				
United Kingdom	5	8	77	94
	<b>5</b>	<b>8</b>	<b>77</b>	<b>94</b>
<b>Destination</b>				
United Kingdom	4	8	75	94
Rest of the World	1	-	2	-
	<b>5</b>	<b>8</b>	<b>77</b>	<b>94</b>

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**3. SEGMENTAL INFORMATION (continued)**

**(e) Profit on ordinary activities before tax**

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
<b>Source</b>		
United Kingdom	521	191
	521	191
<b>Destination</b>		
United Kingdom	500	190
Rest of the World	21	1
	521	191

**(f) Net assets**

The net assets supporting the Rest of the World geographical segment are the same as those supporting the United Kingdom segment and therefore have not been separated

**4. OUTWARD REINSURANCE PREMIUMS**

Outward reinsurance premiums of £1,466m (2010 £(193)m) are net of reinsurance premium rebates and net of a provision for clawbacks, of £2m (2010 £1m)

The aggregate of all reinsurance balances in the long-term business technical account for the year ended 31 December 2011 is negative £401m (2010 positive £518m). As a result of the Scheme transfer (note 8), certain internal reinsurance arrangements between the Company and FPLA and FLP were no longer required and were recaptured

**5. NET INVESTMENT RETURN**

	<b>Technical account</b>		<b>Non-technical account</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>Investment income</b>				
Income from land and buildings	17	14	-	-
Income from Group undertakings	12	81	1,147	116
Income from other investments (i)	526	557	-	15
Gains on the realisation of investments	279	249	-	-
	834	901	1,147	131
<b>Unrealised gains/(losses) on investments</b>	43	725	(4)	30
<b>Investment expenses and charges</b>				
Investment management expenses	(28)	(24)	(1)	(1)
Interest to Group undertakings	(14)	(14)	(34)	-
Other interest	(7)	-	-	-
Interest paid to reinsurers	(5)	-	-	-
Preference dividend	-	-	(14)	(14)
Losses on the realisation of investments	-	-	(393)	-
	(54)	(38)	(442)	(15)
<b>Total net investment return</b>	823	1,588	699	146

(i) Includes £1m (2010 £2m) arising from investments not held at fair value through the profit and loss account

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**5. NET INVESTMENT RETURN (continued)**

Included in 'total net investment return' is an amount of £523m (2010 £569m) that represents interest and dividends on investments classified as 'fair value through profit and loss' and an amount of £72m loss (2010 £1,004m profit) that represents realised and unrealised losses on other financial investments classified as 'fair value through profit and loss'

Included in 'unrealised gains/(losses) on investments' is a gain of £49m (2010 £7m loss) arising on investments classified as 'fair value through profit and loss' that is determined using valuation techniques

**6. OTHER TECHNICAL INCOME, NET OF REINSURANCE**

Other technical income in the long-term business technical account comprises

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
Friends Life and Pensions Limited (FLP) management charge	27	23
Fee and commission income from service activities	27	28
	<u>54</u>	<u>51</u>

**7. OTHER TECHNICAL CHARGES, NET OF REINSURANCE**

Other technical charges in the long-term business technical account comprise

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
Amortisation of present value of acquired in-force business	3	2
Interest payable to Friends Provident Life Assurance Limited (FPLA)	39	103
Unit management charges payable to FPLA	20	14
	<u>62</u>	<u>119</u>



**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**8. PART VII TRANSFER OF BUSINESS**

On 1 December 2011, the complete business of FPLA and BHA and some of the long-term business of FLP was transferred into the Company in accordance with the Part VII Scheme described in the Report of the Directors. No fair value adjustments have been considered necessary to reflect the transaction, as this is not considered an acquisition under FRS 6 Acquisitions and Mergers.

The movements in the profit and loss account during the year represent the transfer of the following assets and liabilities under the Scheme:

	FPLA £m	BHA £m	FLP £m	Total £m
<b>Long-term insurance business</b>				
Other financial investments	408	69	1,820	2,297
Assets held to cover linked liabilities	1,476	25	1	1,502
Cash at bank and in hand	23	(15)	-	8
Deferred acquisition costs	162	-	-	162
Deferred front end fees	(7)	-	-	(7)
Net current liabilities	(63)	(18)	(2)	(83)
Amounts due to reinsurers	-	-	(1,787)	(1,787)
Fund for future appropriations	(32)	-	-	(32)
Long-term business provision, net of reinsurance	(263)	32	(31)	(262)
Technical provisions for linked liabilities, net of reinsurance	(1,476)	(25)	(1)	(1,502)
Surplus assets transferred to shareholders' fund	(96)	(57)	-	(153)
<b>Gain on Part VII transfer of business (in the technical account)</b>	<b>132</b>	<b>11</b>	<b>-</b>	<b>143</b>
<b>Shareholders' fund</b>				
Surplus assets transferred from long-term fund	96	57	-	153
Other financial investments	68	43	-	111
Cash at bank and in hand	1	-	-	1
Net current liabilities	(1)	-	-	(1)
<b>Gain on Part VII transfer of business (in the non-technical account)</b>	<b>164</b>	<b>100</b>	<b>-</b>	<b>264</b>

**9. EXCEPTIONAL LOSS**

	£m
Write down of investment in subsidiaries due to Part VII transfer of business	(708)
<b>Exceptional loss</b>	<b>(708)</b>

There is no tax on the exceptional item.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**10. NET OPERATING EXPENSES**

Friends Provident Management Services Limited (FPMS) provides the Company's services and administration and either employs staff engaged in these activities or outsources the provision of the activities to Friends Life Services Limited (FLS) which is another group service company which employs staff

- (a) **Net operating expenses in the long-term business technical account**, including those on investment contracts, comprise

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
Acquisition costs	79	93
Change in deferred acquisition costs (see note 18)	(12)	2
Administrative expenses	113	120
<b>Net operating expenses</b>	<b>180</b>	<b>215</b>

Total commissions for direct insurance accounted for by the Company during the year amounted to £17m (2010 £4m)

- (b) **Auditor's remuneration**

	<b>2011</b>	<b>2010</b>
	<b>£000</b>	<b>£000</b>
Audit fees – excluding VAT	503	420
Other fees pursuant to legislation	83	70
	<b>586</b>	<b>490</b>

The Company is exempt under SI 2008/489 from the obligation to disclose fees in respect of 'Other services' as the Company is a subsidiary of Friends Life Group plc which prepares consolidated financial statements. Fees paid to the Company's auditor, Ernst & Young LLP and its associates for services other than the statutory audit of the Company and other Group undertakings are disclosed in note 7(b) of the consolidated accounts of Friends Life Group plc

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**11 TAXATION**

**Profit and loss account**

United Kingdom and overseas taxation has been charged in profit and loss on assessable profits and income, on the bases and rates appropriate to the various classes of business

**(a) Tax charged to the long-term business technical account and non-technical account comprises:**

	<b>Technical account</b>		<b>Non-technical account</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>Current taxation</b>				
United Kingdom corporation tax of 26.5% (2010 28%)	20	29	(34)	(2)
Adjustment in respect of prior years	(2)	(21)	-	-
	18	8	(34)	(2)
Overseas taxation	1	1	-	-
Tax charge attributable to balance on the long-term business technical account	-	-	6	(5)
<b>Total current taxation</b>	<b>19</b>	<b>9</b>	<b>(28)</b>	<b>(7)</b>
<b>Deferred taxation</b>				
Origination and reversal of timing differences	(95)	(13)	-	6
Effect of discount	11	4	-	-
<b>Total deferred taxation</b>	<b>(84)</b>	<b>(9)</b>	<b>-</b>	<b>6</b>
<b>Total taxation</b>	<b>(65)</b>	<b>-</b>	<b>(28)</b>	<b>(1)</b>

**(b) Factors affecting tax charge for the year**

The tax assessed for the year is lower than the standard rate of corporation tax in the UK 26.5% (2010 28%)

The differences are explained below

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
<b>Profit on ordinary activities before tax</b>	<b>521</b>	<b>191</b>
Profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 26.5% (2010 28%)	138	53
Effects of		
Origination and reversal of timing differences	-	6
Gain on Part VII transfer, not taxable	(70)	-
Income not taxable	(391)	(70)
Deductions not allowable	295	4
<b>Current tax charge for the period</b>	<b>(28)</b>	<b>(7)</b>

**(c) Balance sheet**

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
<b>Deferred taxation asset</b>		
At 1 January	4	1
Acquired in the year	(2)	-
Charge in year	95	7
<b>At 31 December before discounting</b>	<b>97</b>	<b>8</b>
Discount acquired in the year	2	-
Effect of discounting	(11)	(4)
<b>At 31 December</b>	<b>88</b>	<b>4</b>

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**11. TAXATION (continued)**

Details of the deferred tax asset are given below

	2011 £m	2010 £m
Fair valuation of investments	57	(15)
Discount on fair valuation of investments	(4)	2
Tax on intangible assets	(2)	(2)
Tax losses carried forward	85	29
Discount on tax losses carried forward	(12)	(7)
Tax on regulatory changes	4	(2)
Deferred acquisition costs (including those on investment contracts)	(44)	(1)
Discount on deferred acquisition costs (including those on investment contracts)	4	-
<b>Discounted deferred taxation asset</b>	<b>88</b>	<b>4</b>

**Recognised deferred tax assets**

The deferred tax asset is recognised due to there being sufficient taxable income emerging in the future periods against which to relieve tax losses

**Unrecognised deferred tax assets**

Deferred tax assets of £16m (2010 £16.5m) have not been recognised as it is probable that there will be insufficient suitable profits emerging in future periods against which to relieve them

**12. DIVIDEND**

	2011 £m	2010 £m
2011 dividends totalling 24p per ordinary share (2010 71p)	775	462

**13. INVESTMENTS**

	2011		2010	
	Fair value £m	Cost £m	Fair value £m	Cost £m
<b>Land and buildings</b>				
Owner occupied				
Freehold	26	54	28	54
Long leasehold	2	4	3	4
Other				
Freehold	325	127	310	127
<b>Total land and buildings</b>	<b>353</b>	<b>185</b>	<b>341</b>	<b>185</b>
<b>Other financial investments</b>				
Shares and other variable-yield securities and OEICs	2,903	2,676	2,814	2,336
Debt securities and other fixed-income securities	9,775	9,188	7,606	7,483
Other loans	3	3	3	3
Deposits with credit institutions	1,137	1,137	1,375	1,375
Derivative financial instruments	289	160	184	133
<b>Total other financial investments</b>	<b>14,107</b>	<b>13,164</b>	<b>11,982</b>	<b>11,330</b>
<b>Assets held to cover linked liabilities</b>	<b>4,379</b>	<b>3,276</b>	<b>3,336</b>	<b>2,817</b>

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**13. INVESTMENTS (continued)**

On 1 December 2011 assets with a value of £3,910m were transferred to the Company under the provision of the Part VII Scheme detailed in the Report of the Directors

In the carrying amounts above, £13,614m (2010 £13,194m) is expected to be recovered more than 12 months after the balance sheet date

Included in 'other financial investments' and 'assets held to cover linked liabilities' are investments designated as 'fair value through profit and loss' with a fair value at the year end of £18,483m (2010 £15,315m)

Fair value of listed investments included in 'other financial investments' shown above comprise

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
Shares and other variable-yield securities and OEICs	2,544	2,448
Debt securities and other fixed-income securities	7,953	7,515
	<b>10,497</b>	<b>9,963</b>

Fair value of listed investments included in 'assets held to cover linked liabilities' amounted to £3,613m (2010 £3,161m)

The extent and nature of derivative instruments held are as follows

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
Interest rate swaps	157	70
Inflation rate swaps	3	-
Futures backing equities	11	11
Equity options	113	96
Swaptions	5	7
	<b>289</b>	<b>184</b>

**Determination of fair value hierarchy**

In accordance with the revised requirements of FRS 29 Financial Instruments Disclosures, financial assets at fair value have been classified into three categories as set out below. Financial assets at fair value include shares and other variable-yield securities, government securities, corporate bonds (including ABS), derivative financial instruments and deposits with credit institutions

**Level 1 – quoted prices (unadjusted) in active markets for identical assets** An active market is one in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. Examples include listed equities and bonds in active markets and quoted unit trusts/OEICs

**Level 2 – inputs other than quoted prices included within level 1 that are observable for the asset, either directly (ie as prices) or indirectly (ie derived from prices)** This category generally includes assets that are priced based on models using market observable inputs. Examples include certificates of deposit and derivatives

**Level 3 – inputs for the asset that are not based on observable market data** Assets with single price feeds and/or limited trading activity are included in this category. Examples include unlisted equities and private equity

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**13. INVESTMENTS (continued)**

**Determination of fair value hierarchy (continued)**

The majority of the Company's assets held at fair value are valued based on quoted market information or market observable data. Approximately 2% (3% excluding unit-linked) are based on valuation techniques where significant observable market data is not available or the price is not observable from current market transactions. However, the fair value measurement objective of these assets remains the same, that is, an exit price from the perspective of the Company.

The revised requirements of FRS 29 also require financial liabilities at fair value to be categorised into the above level 1, 2 or 3 hierarchies. Financial liabilities at fair value include unit-linked contracts, amounts due to reinsurers, net asset value attributable to unit-holders (minority interest in the OEICs that are consolidated) and derivative financial instruments. The classifications take into account the types of inputs used to determine the fair value measurements. For unit-linked funds this has been undertaken on a fund by fund basis. For the net asset value attributable to unit holders, this has been analysed in the same proportion as the underlying consolidated investments categorisation.

An analysis of financial assets and liabilities held at fair value in accordance with the fair value hierarchy is set out below. The table shows both the total financial assets and liabilities and the total excluding unit-linked assets and liabilities as shareholders have no direct exposure to profits or losses on unit-linked assets (other than through investment management fees).

31 December 2011	Including unit-linked				Excluding unit-linked			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
<b>Financial assets held at fair value</b>								
Shares and other variable-yield securities and OEICs	5,537	155	362	6,054	2,451	90	362	2,903
Debt securities and other fixed-income securities								
- Government securities	4,182	3	-	4,185	4,014	3	-	4,017
- Corporate bonds	2,613	2,803	-	5,416	2,412	2,703	-	5,115
- Asset backed securities	124	544	10	678	117	516	10	643
Deposits with credit institutions	1,225	2	-	1,227	1,137	-	-	1,137
Other loans	-	-	3	3	-	-	3	3
Derivative financial instruments	11	278	-	289	11	278	-	289
<b>Total financial assets held at fair value</b>	<b>13,692</b>	<b>3,785</b>	<b>375</b>	<b>17,852</b>	<b>10,142</b>	<b>3,590</b>	<b>375</b>	<b>14,107</b>
<b>Financial liabilities held at fair value</b>								
Unit-linked liabilities	-	5,478	-	5,478	-	-	-	-
Amounts due to reinsurers	-	1,800	-	1,800	-	1,800	-	1,800
Derivative financial instruments	-	73	-	73	-	71	-	71
<b>Total financial liabilities held at fair value</b>	<b>-</b>	<b>7,351</b>	<b>-</b>	<b>7,351</b>	<b>-</b>	<b>1,871</b>	<b>-</b>	<b>1,871</b>
<b>31 December 2010</b>								
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
<b>Financial assets held at fair value</b>								
Shares and other variable-yield securities and OEICs	5,155	83	378	5,616	2,368	71	375	2,814
Debt securities and other fixed-income securities								
- Government securities	3,686	-	-	3,686	3,534	-	-	3,534
- Corporate bonds	2,766	904	9	3,679	2,591	835	8	3,434
- Asset backed securities	107	536	20	663	102	517	19	638
Deposits with credit institutions	1,391	69	-	1,460	1,375	-	-	1,375
Other loans	-	-	3	3	-	-	3	3
Derivative financial instruments	11	173	-	184	11	173	-	184
<b>Total financial assets held at fair value</b>	<b>13,116</b>	<b>1,765</b>	<b>410</b>	<b>15,291</b>	<b>9,981</b>	<b>1,596</b>	<b>405</b>	<b>11,982</b>
<b>Financial liabilities held at fair value</b>								
Unit-linked liabilities	-	3,336	-	3,336	-	-	-	-
Derivative financial instruments	-	34	-	34	-	33	-	33
<b>Total financial liabilities held at fair value</b>	<b>-</b>	<b>3,370</b>	<b>-</b>	<b>3,370</b>	<b>-</b>	<b>33</b>	<b>-</b>	<b>33</b>

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**13. INVESTMENTS (continued)**

**Determination of fair value hierarchy (continued)**

**Transfers between level 1 and level 2**

During the period, debt securities amounting to £109m (2010 £1,437m) were transferred from level 1 to level 2 and £31m (2010 £61m) from level 2 to level 1. There were no significant transfers between level 1 and level 2 for other financial assets.

**Level 3 transfers**

The following table shows a reconciliation of level 3 financial assets which are recorded at fair value

	At 1 January 2011 £m	Total losses in the profit and loss account £m	Purchases £m	Sales £m	Transfers to level 1 and level 2 £m	At 31 December 2011 £m	Total losses for the period included in profit or loss for assets held at 31 December 2011 £m
<b>Financial assets held at fair value</b>							
Shares and other variable-yield securities and OEICs	378	(15)	5	(6)		362	(17)
Debt securities and other fixed-income securities							
- Corporate bonds (including ABS)	29	(1)	-	(3)	(15)	10	-
Other loans	3	-	-	-	-	3	-
	410	(16)	5	(9)	(15)	375	(17)

	At 1 January 2010 £m	Total gains in the profit and loss account £m	Purchases £m	Sales £m	Transfers to level 1 and level 2 £m	At 31 December 2010 £m	Total losses for the period included in profit or loss for assets held at 31 December 2010 £m
<b>Financial assets held at fair value</b>							
Shares and other variable-yield securities and OEICs	458	11	92	(44)	(139)	378	(4)
Debt securities and other fixed-income securities							
- Corporate bonds (including ABS)	91	6	21	(22)	(67)	29	(3)
Other loans	3	-	-	-	-	3	-
	552	17	113	(66)	(206)	410	(7)

The transfer of bonds from level 3 to level 1 and 2 during the year represent items that are now regularly priced using observable input.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**13. INVESTMENTS (continued)**

**Level 3 sensitivity analysis**

	<b>31 December 2011</b>		<b>31 December 2010</b>	
	<b>Carrying amount</b>	<b>Effect of reasonably possible alternative assumptions</b>	<b>Carrying amount</b>	<b>Effect of reasonably possible alternative assumptions</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
Unit-linked investments	-	-	5	-
Shares and other variable-yield securities	362	72	375	76
Corporate bonds (including ABS)	10	1	27	3
Other loans	3	-	3	-
	<b>375</b>	<b>73</b>	<b>410</b>	<b>79</b>

For unit-linked assets the policyholder bears the investment risk and any change in asset values is matched by a broadly equivalent change in liability. Consequently there is no significant net impact on shareholder profit from changes to underlying assumptions used to value these assets.

For shares and other variable-yield securities, although the values are based on the latest information available, these instruments are subject to fluctuations in the market and the current prices could reasonably be expected to be higher or lower by approximately 20%.

For corporate bonds it could reasonably be expected that the current prices could be higher or lower by approximately 10% to reflect changes in the credit ratings of the underlying bonds, or movements in interest rates.



**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**14 INVESTMENTS IN GROUP UNDERTAKINGS AND PARTICIPATING INTERESTS**

	Shares in Group undertakings £m	Loans to Group undertakings £m	Shares in participating interests and joint ventures £m	Total £m
<b>Current value</b>				
At 1 January 2011	2,522	276	4	2,802
Additions	3,825	3	-	3,828
Disposals	(33)	(15)	-	(48)
Impairment – Part VII	(708)	-	-	(708)
Impairment – Other	(393)	-	-	(393)
Revaluations	60	-	-	60
<b>At 31 December 2011</b>	<b>5,273</b>	<b>264</b>	<b>4</b>	<b>5,541</b>
<b>Cost</b>				
At 1 January 2011	1,938	276	13	2,227
Additions	3,824	3	-	3,827
Disposals	(30)	(15)	-	(45)
Impairment	(708)	-	-	(708)
<b>At 31 December 2011</b>	<b>5,024</b>	<b>264</b>	<b>13</b>	<b>5,301</b>

	Shares in Group undertakings £m	Loans to Group undertakings £m	Shares in participating interests and joint ventures £m	Total £m
<b>Current value</b>				
At 1 January 2010	2,654	402	7	3,063
Additions	-	-	1	1
Disposals	(256)	(126)	-	(382)
Revaluations	124	-	(4)	120
<b>At 31 December 2010</b>	<b>2,522</b>	<b>276</b>	<b>4</b>	<b>2,802</b>
<b>Cost</b>				
At 1 January 2010	2,194	402	12	2,608
Additions	-	-	1	1
Disposals	(256)	(126)	-	(382)
<b>At 31 December 2010</b>	<b>1,938</b>	<b>276</b>	<b>13</b>	<b>2,227</b>

The value of 'investment in Group undertakings' increased during 2011 resulting from the acquisition of BHA on 31 January, FLC on 18 March, FLAS on 21 March and WLUK on 30 November. On 1 December 2011 the Part VII Scheme transfer, as disclosed in the Report of the Directors, reduced the current values of FPLA, FLP and BHA and the cost of FPLA and BHA.

On 2 December 2011 FPRE entered into liquidation. As at 31 December 2011 the value of this company was £nil.

Further information regarding acquisitions made by the Company during the year is found on page 4 of the directors report.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**14. INVESTMENTS IN GROUP UNDERTAKINGS AND PARTICIPATING INTERESTS (continued)**

Principal Group undertakings and participating interests of the Company at 31 December 2011 are shown below. Except where stated, each of these direct holdings are incorporated in England and Wales and are all ordinary shares which carry one voting right.

**Group undertakings held by the shareholder fund**

Friends Life Assurance Society Limited (formerly named Sun Life Assurance Society plc)	100%
Friends Life Company Limited (formerly named Axa Sun Life plc)	100%
Friends Life and Pensions Limited (formerly named Friends Provident Pensions Limited)	100%
Friends Provident International Limited (incorporated in the Isle of Man)	100%
Winterthur Life UK Limited	100%

**Group undertakings held in the long-term funds**

Friends Provident Investment Holdings plc	100%
Friends Life FPG Limited (formerly named Friends Provident Group Limited)	100%
London Capital Holdings Limited	
Ordinary shares - Direct holding	65%
- Indirect holding *	35%
Deferred shares - Direct holding	84%
- Indirect holding *	16%

**Group undertakings held in assets held to cover linked liabilities**

The Friends Provident Commercial Property Company (Guernsey) Limited (incorporated in Guernsey)	100%
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**Joint venture held in the long-term funds**

Tenet Group Limited	21%
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\* held in subsidiary

A number of subsidiaries, which in the directors' opinion do not materially affect the results or assets of the Company are omitted from the above table. In accordance with Section 410(2)(a) of the Companies Act 2006, a full list of subsidiaries will be annexed to the next annual return filed at Companies House.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**15. PRESENT VALUE OF ACQUIRED IN-FORCE BUSINESS**

	<b>£m</b>
<b>Cost</b>	
At 1 January 2011	72
<b>At 31 December 2011</b>	<b>72</b>
<b>Amortisation</b>	
At 1 January 2011	44
Amortisation during year	3
<b>At 31 December 2011</b>	<b>47</b>
<b>Net book value</b>	
At 1 January 2011	28
<b>At 31 December 2011</b>	<b>25</b>
	<b>£m</b>
<b>Cost</b>	
At 1 January 2010	72
<b>At 31 December 2010</b>	<b>72</b>
<b>Amortisation</b>	
At 1 January 2010	42
Amortisation during year	2
<b>At 31 December 2010</b>	<b>44</b>
<b>Net book value</b>	
At 1 January 2010	30
<b>At 31 December 2010</b>	<b>28</b>

**16. ASSETS ATTRIBUTABLE TO THE LONG-TERM FUND**

Of the 'total assets' shown on the balance sheet on page 14, £25,518m (2010 £23,176m) is attributable to the long-term business fund

**17. OTHER DEBTORS**

	<b>2011 £m</b>	<b>2010 £m</b>
<b>Amounts falling due within one year</b>		
Investment income receivable	6	6
Taxation recoverable	-	29
Investments sold for subsequent settlement	-	3
Amounts due from Group undertakings	3	22
Other debtors	6	-
Deferred taxation (note 11)	88	4
	<b>103</b>	<b>64</b>

All 'other debtors' amounts are expected to be recovered within 12 months after the balance sheet date, except for 'amounts due from Group undertakings' that have no fixed payment terms

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**18. DEFERRED ACQUISITION COSTS**

	Insurance contracts		Investment contracts		Total	
	2011	2010	2011	2010	2011	2010
	£m	£m	£m	£m	£m	£m
At 1 January	-	-	6	8	6	8
Deferred in the period	4	-	-	-	4	-
Amortisation charge for the year	(3)	-	(4)	(1)	(7)	(1)
Other movements	13	-	2	(1)	15	(1)
Part VII Scheme transfer	76	-	86	-	162	-
<b>At 31 December 2011</b>	<b>90</b>	<b>-</b>	<b>90</b>	<b>6</b>	<b>180</b>	<b>6</b>

Acquisition expenses that do not meet the criteria for deferral are expensed directly as incurred

**19. CALLED UP SHARE CAPITAL**

	2011	2010
	£m	£m
<b>Authorised</b>		
4,264,892,056 (2010 1,700,000,000) ordinary shares of £1 each	4,265	1,700
<b>Allotted and fully paid</b>		
3,218,642,056 (2010 653,750,000) ordinary shares of £1 each	3,219	654

2,266m £1 ordinary shares were issued at par to FPL on 18 March 2011 as part of the acquisition of FLC  
299m of £1 ordinary shares were issued at par to FPL on 21 March 2011 as part of the acquisition of FLAS

**20. PREFERENCE SHARES**

	2011	2010
	£m	£m
300,000,000 (2010 300,000,000) 4 8125% non-cumulative preference shares of £1 each	300	300

Under FRS 25 Financial Instruments Presentation, it is necessary to treat the £300m non-cumulative preference shares as debt, as a contractual obligation exists to pay the shareholders the preference dividend. The preference shares are perpetual shares and are only redeemable at the option of the Company on 21 November 2019 or on any dividend date thereafter.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**21. OTHER EQUITY – STEP-UP TIER ONE INSURANCE CAPITAL SECURITIES (STICS)**

	2011 £m	2010 £m
At 1 January	511	511
Interest charged	32	32
Interest paid	(32)	(32)
<b>At 31 December</b>	<b>511</b>	<b>511</b>

On 27 June 2005, the Company issued £495m of STICS, which will bear interest from 30 June 2005 to 30 June 2015 at a rate of 6.302%. The STICS have no maturity date but are redeemable in the whole or part at the option of the Company on 1 July 2015, thereafter on every fifth anniversary of this date.

The STICS are perpetual securities and are not redeemable at the option of the holders at any time. For each coupon period after 1 July 2015, the STICS will bear interest that is reset every five years. The STICS are carried at £511m, being £500m principal less unrealised issue costs of £5m, plus interest due of £16m not yet paid to STICS holders. Interest is payable annually in arrears on 30 June of each year. Under FRS 25 it is necessary to treat STICS as equity as there is no requirement to settle the obligation in cash or another financial asset.

**22. RECONCILIATION OF MOVEMENT IN TOTAL SHAREHOLDERS' FUNDS AND STATEMENT OF MOVEMENTS ON RESERVES**

	Share capital £m	Share premium £m	Revaluation reserve £m	Profit and loss account £m	Other equity reserve (STICS) £m	Total £m
At 1 January 2011	654	-	206	887	511	2,258
Profit for the year	-	-	-	517	32	549
Issue of share capital	2,565	-	-	-	-	2,565
Dividends	-	-	-	(775)	-	(775)
Increase in surplus on revaluation of investments in subsidiaries	-	-	78	-	-	78
Interest paid on STICS	-	-	-	-	(32)	(32)
<b>At 31 December 2011</b>	<b>3,219</b>	<b>-</b>	<b>284</b>	<b>629</b>	<b>511</b>	<b>4,643</b>

	Share capital £m	Share premium £m	Revaluation reserve £m	Profit and loss account £m	Other equity reserve (STICS) £m	Total £m
At 1 January 2010	654	721	109	468	511	2,463
Profit for the year	-	-	-	160	32	192
Capital reduction	-	(721)	-	721	-	-
Dividends	-	-	-	(462)	-	(462)
Increase in surplus on revaluation of investments in subsidiaries	-	-	97	-	-	97
Interest paid on STICS	-	-	-	-	(32)	(32)
<b>At 31 December 2010</b>	<b>654</b>	<b>-</b>	<b>206</b>	<b>887</b>	<b>511</b>	<b>2,258</b>

There is no tax provided on the revaluation of investments in subsidiaries.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**23. POLICYHOLDER LIABILITIES**

	Long-term business provision £m	Technical provisions for linked liabilities £m
<b>At 1 January 2011</b>		
Gross	12,176	8,284
Reinsurance	(489)	(6,553)
<b>Net</b>	<b>11,687</b>	<b>1,731</b>
<b>Movement in year</b>		
Gross	(305)	(1,438)
Reinsurance	(34)	2,585
<b>Net</b>	<b>(339)</b>	<b>1,147</b>
<b>Transfer under the Part VII scheme</b>		
Gross	1,983	1,391
Reinsurance	(1,719)	111
<b>Net</b>	<b>264</b>	<b>1,502</b>
<b>At 31 December 2011</b>		
Gross	13,854	8,681
Reinsurance	(2,242)	(4,301)
<b>Net</b>	<b>11,612</b>	<b>4,380</b>
	Long-term business provision £m	Technical provisions for linked liabilities £m
<b>At 1 January 2010</b>		
Gross	12,102	7,946
Reinsurance	(497)	(6,215)
<b>Net</b>	<b>11,605</b>	<b>1,731</b>
<b>Movement in year</b>		
Gross	74	338
Reinsurance	8	(338)
<b>Net</b>	<b>82</b>	<b>-</b>
<b>At 31 December 2010</b>		
Gross	12,176	8,284
Reinsurance	(489)	(6,553)
<b>Net</b>	<b>11,687</b>	<b>1,731</b>

On 1 December 2011 liabilities with the value of £1,767m were transferred to the Company under the provision of the Part VII Scheme

As a result of the transfer, certain internal reinsurance arrangements between the Company and FPLA and FLP were no longer required and were recaptured. This resulted in a reduction in the Company's reinsurers' share of technical provisions for linked liabilities of £1,546m and reinsurers' share of the long-term business provision of £302m.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**23. POLICYHOLDER LIABILITIES (continued)**

As unit-linked investment contracts are deposit accounted for, the change in technical provisions for linked liabilities recorded in the technical account for long-term business does not equal the movement in the technical provisions for linked liabilities

The difference is explained below

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
Change in technical provisions for linked liabilities per technical account	1,736	596
Net premiums	162	213
Net claims paid	(728)	(782)
Other technical income	(23)	(27)
<b>Change in linked liabilities</b>	<b>1,147</b>	<b>-</b>

**24. TECHNICAL PROVISIONS**

**(a) Insurance contract liabilities**

Included in the carrying amount of technical provisions in respect of insurance contract liabilities, is £9,428m (2010 £7,635m) that is expected to be settled more than 12 months after the balance sheet date

Reviews for pension transfers and opt-outs have now been substantially completed. An amount of £nil (2010 £4m) remains within the long-term business provision in respect of residual associated costs and contingencies. No change to the expected future costs of the review has been assumed in 2011 or 2010.

**(b) Method used for reserving for both insurance contracts and investment contracts with DPF**

The liability for insurance contracts and investment contracts with a discretionary participation feature (DPF) is calculated on the basis of recognised actuarial methods having due regard to actuarial principles and best practice. The methodology takes into account risks and uncertainties of the particular classes of long-term business written.

Calculations are generally made on an individual policy basis, however, in addition there are global provisions which are calculated using statistical or mathematical methods. These results are expected to be approximately the same as if an individual insurance/investment liability was calculated for each contract.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**24. TECHNICAL PROVISIONS (continued)**

**(c) With-profits contracts**

Options and guarantees are features of life assurance and pensions contracts that confer potentially valuable benefits to policyholders. They are not unique to with-profits funds and can arise in non-participating funds. They can expose an insurance company to two types of risk: insurance (such as mortality/morbidity) and financial (such as market prices/interest rates). The value of an option or guarantee comprises two elements: the intrinsic value and the time value. The intrinsic value is the amount that would be payable if the option or guarantee was exercised immediately. The time value is the additional value that reflects the possibility of the intrinsic value increasing in future, before the expiry of the option or guarantee. Under FSA rules all options and guarantees must be valued and included in policyholder liabilities. For funds within the FSA's realistic capital methodology, options and guarantees are valued on a market consistent stochastic basis that takes into account both the time value and the intrinsic value of the options and guarantees.

Following the transfer of the closed with-profits fund from FPLA, this fund has been valued on a realistic basis which resulted in this fund's FFA reducing from £32m to £2m at 31 December 2011.

All material options and guarantees are valued stochastically and included in the liabilities. There are two main types of guarantees and options within the with-profits funds: maturity guarantees and guaranteed annuity options. Maturity guarantees are in respect of conventional with-profits business and unitised with-profits business and represent the sum assured and reversionary bonuses declared to date. For certain with-profits pension policies there are options guaranteeing the rates at which annuities can be purchased. The cost of the maturity guarantees and guaranteed annuity options have been calculated as:

	<b>31 December 2011</b>	<b>31 December 2010</b>
	<b>£m</b>	<b>£m</b>
Maturity guarantees	439	311
Guaranteed annuity options	609	475

**(d) Process used for assumptions**

**(i) Economic assumptions**

Details regarding the economic assumptions used in the stochastic model for the valuation of with-profits policyholder liabilities are set out below.

The cost of with-profits guarantees is most sensitive to the assumed volatility of future returns on asset shares, the level of future interest rates and the rates of discontinuance on these policies. The guarantee cost in respect of guaranteed annuity options is most sensitive to the level of future interest rates, future mortality rates, assumed rates of discontinuance and early retirements, and the assumptions relating to the exercise of the tax free cash option on these policies. Further details on these assumptions are provided below.

The cost of the with-profit guarantees is assessed using a market consistent stochastic model (using a Barrie & Hibbert model as the economic scenario generator) and is calculated using 2,000 simulations.



**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**24. TECHNICAL PROVISIONS (continued)**

**(d) Process used for assumptions (continued)**

**(i) Economic assumptions (continued)**

The model is calibrated using the gilt risk-free curve assuming interest rates of between 0.22% and 3.24% per annum and implied volatilities in the market as shown in the table below

**Swaption implied volatilities**

**31 December 2011**

Option term UK Sterling	10 years	Swap term		
		15 years	20 years	25 years
10 years	18%	18%	18%	18%
15 years	15%	16%	16%	16%
20 years	14%	14%	14%	14%
25 years	13%	13%	13%	13%

**31 December 2010**

Option term UK Sterling	10 years	Swap term		
		15 years	20 years	25 years
10 years	15%	15%	14%	14%
15 years	15%	14%	13%	13%
20 years	13%	13%	12%	12%
25 years	12%	12%	11%	11%

For equity capital return and property total return implied volatilities are shown in the table below

Option term	31 December 2011		31 December 2010	
	Equities	Property	Equities	Property
5 years	27%	15%	27%	16%
10 years	27%	15%	28%	16%
15 years	27%	15%	28%	16%

The cost of guarantees also depends on management actions that would be taken under various scenarios. The regular bonus rate is set each year such that, by maturity, guaranteed benefits are targeted as a prescribed fraction of the total asset share, leaving the remaining portion of the asset share to be paid as a final bonus. This management action is in line with the Companies' PPFMs and is programmed into the models.

The guarantee cost in respect of guaranteed annuity options is assessed using a market consistent stochastic model and values both the current level of the guaranteed annuity rate benefit (allowing for future improvements in annuitant mortality) and the time value due to uncertainty in future interest rates. The guarantee cost in each scenario is the value of the excess annuity benefit provided by the options, relative to an annuity purchased in the open market. In estimating the future open market annuity rate, the model allows for stochastic variation in interest rates and for future mortality improvements. The stochastic interest rate assumption reflects that implied by current market interest rate derivative prices. Future annuitant mortality within the with-profits balance sheet has been derived from the premium basis at which annuities can be purchased from FLP, which allows for future mortality improvements.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**24. TECHNICAL PROVISIONS (continued)**

**(d) Process used for assumptions (continued)**

**(i) Economic assumptions (continued)**

The guaranteed annuity options cost also depends upon other factors such as policy discontinuance and the take up rate for the options

The factors are based on recent experience adjusted to reflect industry benchmarks and to anticipate trends in policyholder behaviour. A summary of the key assumptions is as set out below

Policy discontinuances lapse, early retirement and paid-up rates vary by policy type and period and have been based on recent experience

Policy lapses and paid up rates are generally in the ranges shown below

	2011 % pa	2010 % pa
Pensions – lapses	1% to 6.5%	1% to 5%
Life – lapses	3% to 15%	3% to 15%
Mortgage endowments – lapses	14%	14%
With-profits bonds – lapses	20%	20%
Pensions – paid-up	4% to 17%	4% to 17%
Life – paid-up	0.5% to 2%	0.5% to 2%

Early retirement rates vary by age band and policy type and are set based on recent experience

Tax free cash option where a guaranteed annuity option is more valuable than the cash equivalent it is assumed that 18% to 27% of the benefit of the option is taken tax-free depending on the type of business (2010 18% to 27%). This is based on recent experience

**(ii) Non-economic assumptions**

The provision for insurance contracts and investment contracts with DPF liabilities is sensitive to the principal assumptions in respect of mortality, morbidity and maintenance expenses (except for net premium valuations), persistency and guaranteed annuity option take-up rates, although the relative sensitivity will vary depending on the insurance or investment contract

Long-term estimates of future mortality and morbidity assumptions are based on standard tables wherever possible but adjusted to reflect the Company's own experience. Expense assumptions are based on recent experience

Experience investigations for mortality, morbidity, persistency, guaranteed annuity option take-up rates and maintenance expenses are performed at least annually for major product classes. Where industry analysis indicates that changes in expected future mortality/morbidity or other assumptions factor patterns mean that claim costs are likely to rise in the future, then this is taken into account in the liability calculation

No benefit is taken in regulatory reserves where industry analysis indicates that future trends are likely to reduce claim costs in the future

Liabilities to policyholders in respect of non-profit insurance policies, primarily protection and annuity products have been valued using the gross premium method

Single premium group income protection contracts have been valued at 90% of the last three years' premiums plus an allowance for outstanding claims in respect of earlier premiums

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**24. TECHNICAL PROVISIONS (continued)**

**(e) Valuation interest rates**

The impact of all interest rate changes on liabilities is included within the impact of economic basis changes in note 2

The impact of these liability changes on surplus is generally to offset some or all of the corresponding impact on the value of fixed interest assets backing the liabilities

**(i) Conventional with-profits business**

As explained above, with-profits business is valued in accordance with the FSA's realistic reporting regime

As disclosed in the Report of the Directors, during the year, the FPLA closed with-profits fund was transferred from FPLA to the Company due to an intra-group reorganisation. Its valuation has therefore changed in accordance with the FSA's realistic reporting regime due to an intra-group reorganisation. The effect of this has been to increase reported liabilities by £27m

**(ii) Annuities in payment**

Fixed interest assets, predominantly corporate bonds, are held to match the expected benefit outgo of the annuity portfolio. The excess yields on corporate bonds over that on gilts are called bond spreads and these reflect compensation for the higher risk of default (credit risk premium) and lower liquidity (liquidity premium) compared to gilts. One of the key judgements is the assessment of how much of the spread is attributable to the liquidity premium.

The liquidity premium assumed on backing assets in the derivation of valuation interest rates for annuities in payment is derived by taking the overall spread on a bond and deducting an allowance for defaults (called the credit defaults deduction) with the remainder of the spread being treated as liquidity premium. The credit default deduction is based on

- historical defaults and recovery experience,
- a margin for prudence, and
- an additional short-term recessionary allowance

**(iii) Other than conventional with-profits business**

Valuation interest rates for other than conventional with-profits business are shown in table below. The comparatives for 2010 have been adjusted to include amounts transferred from FPLA.

		31 December 2011	31 December 2010
		%	%
	Class of Business		
Life	Endowment and Whole Life in NP funds	1.90	2.80
	Protection	1.90	2.80
	Endowment and Whole Life in WP Funds	2.30	2.60
Income Protection	Income Protection	1.90	3.00
Pensions	Annuities in payment	3.57 - 4.09	4.46 - 4.81
	Protection	2.40	3.50
	Individual and Group Pensions in NP Funds	2.40	3.50
	Individual and Group Pensions in WP Funds	2.90	3.30

Certain products can have positive or negative reserves. The interest rate used for these products is 1.4% to 3.5% (2010: 2.3% to 5.0%) depending on which is more onerous.

Other valuation interest rates have been calculated in the same way as in previous years, by reference to changes in consistent economic indices.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**24. TECHNICAL PROVISIONS (continued)**

**(f) Mortality and morbidity assumptions**

Insurance contract liabilities allow for mortality and morbidity risk by making assumptions about the proportion of policyholders who die or become sick. Allowance for future mortality has been made using the following percentages of the standard published tables

	2011	2010
Term assurances – smoker	83% TMS00(5) / 77% TFS00(5)	93% TMS00(5) / 88% TFS00(5)
Term assurances – non-smoker	99% TMN00(5) / 72% TFN00(5)	93% TMN00(5) / 86% TFN00(5)
Critical illness	CIBT02 <sup>(i)</sup>	CIBT02 <sup>(i)</sup>
Other life assurances	120% AM/FC00 ult	120% AM/FC00 ult
Unutilised policies (life regular premium)	130% AM/FC00 ult	130% AM/FC00 ult
Unutilised policies (other)	110% AM/FC00 ult	110% AM/FC00 ult
Pension policies	65% AMC00 ult / 55% AFC00 ult	65% AMC00 ult / 55% AFC00 ult
Individual income protection	60% AM/AF80 ult <sup>(ii)</sup>	60% AM/AF80 ult <sup>(ii)</sup>
Individual pension annuities in payment	PCMA/PCFA00 <sup>(iii)</sup>	RM/FV00 <sup>(iii)</sup>
Group pension annuities in payment	PCMA/PCFA00 <sup>(iii)</sup>	PCMA/PCFA00 <sup>(iii)</sup>

(i) The percentages of the table used differ by sex and smoker status. Future deterioration in morbidity is allowed for by assuming claim rates increase by 1.25% per annum and 1.50% per annum for males and females respectively.

(ii) Individual income protection sickness and recovery rates are based on percentages of CMI 12 (male and female) published tables. Rates differentiate by smoker status, deferred period and occupational class.

(iii) Age related percentages of the mortality tables are used. Future improvements in mortality are based on the following percentages of the average of CMI's Medium Cohort:

- Males – 100% subject to a minimum improvement of 2.1% per annum
- Females – 75% subject to a minimum improvement of 1.8% per annum

Lapse rates for conventional and income protection business are based on recent experience with a prudent margin and are generally in the ranges shown below:

Level term assurance	2% to 8%
Decreasing term assurance	8% to 15%
Income protection	8% to 14%

In determining liabilities for with-profits business, it is assumed that a proportion of policies is discontinued (surrendered, lapsed or converted paid-up) in each future year. The relevant rates vary by product and duration.

**(g) Investment contracts**

The provision for linked contracts is equal to the value of units, underlying assets, share index or reference value. The fund liabilities at the balance sheet date are adjusted to take account of the effect of discounting for the time value of future tax on unrealised gains on assets held in the fund. There is no significant difference between carrying values and maturity values of investment contract liabilities.

Included in the carrying amount of technical provisions in respect of investment contract liabilities, is £11,534m (2010: £10,447m) that is expected to be settled more than 12 months after the balance sheet date.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS**

**Risks to which the Company is exposed**

The Company in the course of doing business, is exposed to the following categories of risk

- **Financial risks** these are risks relating to the financial management of the business, the economy and other external events which result in the Company being unable to meet its financial obligations, and include market, credit, liquidity and insurance risks,
- **Operational risks** these are risks of losses arising from inadequate or failed internal processes, personnel or systems, or from external events. Operational risks include regulatory, financial crime, people, legal, outsourcing, information technology and business protection risks,
- **Strategic risks** these are risks related to a flawed business strategy, inaccurate or untimely business planning management information, adverse or inappropriate strategic business decisions, mergers and acquisition activity and unplanned new business volumes,
- **Environmental risks** these are risks due to exposure to forces in the external environment, and the response to these forces, that could significantly deter the organisation from achieving its overall objectives and strategy, and
- **Group risks** these are risks of losses or reputational damage due to the activities of a Group member, including any business unit or subsidiary

This note presents information about the Company's exposure to financial risks and the Company's objectives, policies and processes for measuring and managing risk. Further quantitative disclosures are included throughout these financial statements

**Capital management**

The Company's capital comprises of equity shareholders' funds, preference shares and STICS

The Company is a regulated entity subject to a number of regulatory capital tests. Total available capital resources are calculated on a realistic basis for its with-profits funds. The Company has complied with all regulatory capital requirements throughout the financial year

Capital and solvency is measured using the regulations prescribed by the Financial Services Authority (FSA). These regulatory capital tests are based upon required levels of solvency capital (Capital Resources Requirement (CRR)) and a series of prudent assumptions in respect of type of business written by the Company

A reconciliation of equity under UK Generally Accepted Accounting Practice (UK GAAP) attributable to equity holders of the Company and the excess of available capital resources to cover long-term insurance business is set out below

	<b>2011</b>	<b>2010</b>
	<b>£m</b>	<b>£m</b>
<b>Equity shareholders' funds per the balance sheet (UK GAAP basis)</b>	4,643	2,258
Adjusted for		
Lower Tier 2 Debt	700	-
Reduction in WPICC due to realistic value of future transfers out of WPF	289	317
Step-up tier one insurance capital securities	300	300
Adjustments to subsidiary values	(401)	(1,197)
Deferred acquisition costs	(139)	(2)
Deferred tax	(148)	(35)
Deferred front end fees	11	2
Acquired present value of in-force business	(12)	(14)
Financial reinsurance	39	-
Policy liability differences	24	(19)
Difference in valuation of assets	(28)	(22)
Less		
Long-term insurance capital requirement of the non profit fund	(259)	(133)
Capital requirements of subsidiary companies	(3,146)	(340)
<b>Excess of available capital resources to cover long-term insurance business (per FSA Return, Form 2)</b>	<b>1,873</b>	<b>1,115</b>

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(a) Quantitative risk exposure**

A summary of how each risk is mitigated is provided below with, where appropriate, quantitative information on the exposure to that risk

The table below shows the sensitivity to the regulatory capital surplus (sensitivities are symmetrical unless otherwise disclosed)

	Note	2011 £m	2010 £m
<b>Excess of available capital resources to cover long-term insurance business (per FSA Return, Form 2)</b>		1,873	1,115
10% reduction in market values of equity and property assets	(i)	6	1
10% increase in market values of equity and property assets	(i)	(7)	(1)
1% reduction in risk-free rates with corresponding change in fixed interest asset values	(ii)	43	(8)
1% increase in risk-free rates with corresponding change in fixed interest asset values	(ii)	(90)	11
100 basis points increase in corporate bond spreads	(iii)	(43)	(49)

- (i) A fall in equity and property values affects the impact on the value of future charges of movements in equity and property values in linked funds
- (ii) A rise in interest rates reduces both the value of fixed interest assets and the value of liabilities. The converse is true of a fall in interest rates. Therefore the net impact is significantly less than the impact on assets alone
- (iii) The excess yields on corporate bonds over that on gilts are called bond spreads and these reflect compensation for the higher risk of default (credit risk premium) and lower liquidity (liquidity premium) compared to gilts

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(b) Market risk**

Market risk is defined within the market risk policy as 'The risk that movements in economic and investment market factors, excluding those due from changing perceptions of counterparty creditworthiness, impact adversely the value of, or income from, shareholder and policyholder funds.'

Market risks can be categorised into the following risks drivers which correspond to the sub-modules through which they are modelled within the internal Model. These are equity risk, property risk, yield risk, corporate bond credit risk, volatility risk and foreign exchange risk.

Market risk arises on guarantees and options offered on certain of the Company's products. As described within the section on policyholder liabilities (see note 23), the Company is exposed to guarantees on bonus additions that become more valuable as investment values fall and where the cost of hedging increases. In addition, the Company is exposed to guaranteed cash and annuity options on certain pension policies that become more valuable as interest rates fall and where the cost of hedging increases.

Shareholders' earnings are further exposed to market risk to the extent that the income from policyholder funds is based on the value of financial assets held within those unit-linked or with-profits funds.

The Company manages market risk attaching to assets backing specific policyholder liabilities and to assets held to deliver income and gains for the shareholder. Within the unit-linked funds and with-profits funds, the Company manages market risk so as to provide a return in line with the expectations of policyholders. The principal objective for shareholder assets is to manage them so that they meet the capital requirements of the Company, and support its future strategic and operational objectives.

The Board sets appetite for market risk for each of the different asset classes taking account of the risk appetite set by the Resolution Limited Board. Consideration is given to the objectives of the asset pools to which they relate and the nature of the liabilities backed by those assets.

The following summarises the key actions undertaken by the Company to manage market risk.

The Group Market Risk Policy sets out how market risk should be managed by the Company and is primarily owned by Group Chief Investment Officer. As part of the annual refresh of risk policies, the Group Chief Risk Officer, supported by the Group Head of Financial Risk, is responsible for ensuring that the policy is reviewed.

The Market Risk Policy is further embedded in the business through the operation of Investment Limits. These specify the permitted asset classes for investment, the limits for exposures to asset classes including bond exposures, cash exposures, derivative exposures, equity and other exposures, and also limits in relation to interest rate risk, inflation risk, foreign exchange risk, implied equity and interest rate volatility. The relevant limits are also reflected in investment guideline documents which are maintained for each fund.

To support the setting of Investment Limits, the Asset and Liability Management (ALM) function is responsible for carrying out strategic asset allocation studies on each block of business within a three year life cycle. This review considers risk appetite, capital requirements and other metrics.

The Investment Oversight Committee a sub-committee of the Group Board oversees investment policy and strategy, which the Company controls primarily through the use of investment fund mandates. Day-to-day implementation of investment policy and strategy is managed predominantly by F&C Asset Management plc (F&C).

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(b) Market risk (continued)**

Mandates are set for each fund within the Company taking account of the relevant factors outlined above. Unit-linked funds are managed in line with their underlying objectives as set out in policyholder contracts. The mandates seek to limit exposure to market risk by using some or all of the following mechanisms:

- restrictions on the asset classes held,
- restrictions on the maximum exposure to any one issuer, and
- defined sector, country or regional limits

F&C managed funds may hold equity derivatives to facilitate efficient portfolio management where their use is provided for in the relevant fund mandates. Currency forwards and other derivatives may also be held to manage currency risk, but only if permitted by individual fund mandates. The Company may seek to reduce investment risk by holding derivatives (without disproportionately increasing other types of risk).

Non F&C managed unit-linked funds may use derivatives for the purpose of efficient portfolio management and risk reduction in accordance with policyholder contracts and marketing literature relevant to the funds.

In addition to the mandates, the Company undertakes a programme of asset/liability management. For example, in order to manage the impact of interest rate changes on profit, corporate bonds and gilts are held to match the duration, profile and cash flows of annuity and permanent health insurance policies.

In order to manage the exposure arising from guarantees and options, the Company has purchased a number of derivatives, including interest rate swaps, equity put options, currency forwards, inflation swaps, interest rate swaptions and equity futures to manage exposures to movements in equity prices or interest rates. Hedge accounting has not been applied to these derivatives, as movements in the fair value of these instruments will be offset by the movement in the valuation of the liability. As noted, the majority of these guarantees arise within the Company's with-profits funds and so any fair value movement will be reflected in the fund for future appropriations rather than within shareholders' funds. In addition, derivatives are used to manage guarantees in respect of non profit business.

The following provides additional information on the exposure to equity and property risk, foreign exchange risk, interest rate risk and credit risk.



**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(b) Market risk (continued)**

**(i) Equity and property risk**

Equity and property risk, as defined above, is accepted in accordance with agreed risk appetite in order to achieve the desired level of return from policyholder assets

Asset allocation within the With-Profits Fund is actively managed. For the first half of 2011 the strategic proportion of equities and property backing asset shares (equity backing ratio or "EBR") for whole Fund was set at 50%. With effect from 30 June 2011 the strategic EBR was increased to 55% for the post-demutualisation business and was maintained at 50% for the pre-demutualisation business.

At 31 December 2011, the EBR was 48% for pre demutualisation business (31 December 2010 49%) and 53% for post demutualisation business (31 December 2010 49%).

There are no Market Value Reductions (MVRs) currently in place for the fund.

The risk appetite and risk management framework of the With-Profits Fund are in line with FLL's commitment to fair treatment of all its customers and the published Principles and Practices of Financial Management underlying the Fund.

For with-profits and unit-linked policies, the policyholders bear the majority of the investment risk and any change in asset values is matched by a broadly equivalent change in the realistic liability. However charges, which are expressed as a percentage of fund values, are impacted by movements in asset values and therefore falling values still have an adverse effect on shareholders and in adverse circumstances shareholders may be obliged to provide additional support to the with-profits funds. Throughout 2011 there has been no direct exposure to equity risk within the Company shareholders funds.

In their decision-making on equity investments, F&C will assess the extent of equity risk required or allowed by the fund as set out in the fund objectives and relative to defined performance benchmarks. The management of equity investments by non F&C fund managers will be performed in accordance with the objectives of the fund as set out in policy contracts and marketing literature.

**(ii) Foreign exchange risk**

The Company is exposed to foreign exchange risk through its investment in foreign operations, fee income derived from financial instruments denominated in currencies other than its measurement currency (pounds Sterling) and revenues receivable in foreign currencies. Consequently the Company is exposed to the risk that the exchange rate of its measurement currency relative to other currencies may change in a manner that has an adverse effect on the value of the Company's financial assets and liabilities. This risk is accepted, as being within the Company's agreed risk appetite given the relative materiality of the exposure.

The net exposure to foreign exchange risk through investment in overseas equities is currently small, and exposure through debt securities is limited due to restrictions through limits placed by Investment mandates. For unit-linked contracts and with-profits policies (to the extent that currency risk on overseas equities held by the with-profits funds are only partially hedged), currency risk is borne by the policyholder. As noted above, the shareholders are subject to currency risk only to the extent that income from policyholder funds is based on the value of the financial assets held in those funds. The liability for non-linked insurance contracts in currencies other than Sterling is immaterial.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(b) Market risk (continued)**

**(iii) Interest rate risk**

The Company is exposed to fair value interest rate risk where changes to interest rates result in changes to fair values rather than cash flows, for example fixed interest rate loans and assets. Conversely, floating rate loans expose the Company to cash flow interest rate risk. The Company makes use of derivatives to manage interest rate risk. In the case of swaps and swaptions the Company holds both

- receiver interest rate swaps (where fixed payments are received in return for floating payments being paid) – increases to interest rates increase cash flows payable and reduce fair value, and
- payer interest rate swaps (where floating payments are received in return for fixed payments being paid) – reductions to interest rates reduce cash flows receivable and reduce fair value

However, both types of swaps and payer swaptions are held in order to reduce net asset-liability rate risk which would otherwise arise

Bond-related performance benchmarks within fund mandates are generally set so that asset profiles broadly match liability profiles hence the interest-rate is minimised

Day to day investment decisions around the management of interest rate risk and its impact on the value of the Company's investments are largely undertaken on behalf of the Company by F&C, within the boundaries set by fund mandates. In its decision making on gilt and corporate bond investments, F&C will assess the extent of interest rate risk allowed by the fund as set out in the fund objectives and relative to defined performance benchmarks

The ALM function is responsible for monitoring and managing net asset-liability interest rate risk for the Company

The Company may also be exposed to interest rate risk on its strategic investments and on any debt issuance. As part of any proposal for strategic investment or debt capital raising, the interest rate risk to which the Company is exposed will be given careful consideration as one of the factors impacting on the final recommendation. Ultimate approval for any strategic investments or debt raising rests with the Resolution Limited Board

**(iv) Volatility risk**

The Company is exposed to the risk of loss or of adverse change in the financial position arising from changes in the market implied volatility used to value realistic liabilities

Swaptions and equity put options are held to mitigate interest rate volatility and implied equity volatility risk impacting the value of guarantees

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(c) Credit risk**

Credit risk includes the following seven elements

- investment credit risk – financial loss arising from a change in the value of an investment due to a rating downgrade, default, or widening of credit spreads. Changes in credit spreads are also affected by the liquidity of the stock and market expectations in respect of whether any option embedded within it will be exercised, but since the liquidity and effects related to embedded options are usually closely related to credit risk, these risks are managed as credit risk,
- derivative counterparty risk – financial loss arising from a derivative counterparty's default, or the deterioration of the derivative counterparty's financial position,
- reinsurance counterparty risk – financial loss arising from a reinsurer's default, or the deterioration of the reinsurer's financial position,
- deposit risk – financial loss arising from a deposit institution's default, or the deterioration of the deposit institution's financial position,
- loan risk – financial loss arising from a debtor's inability to repay all, or part, of its loan obligations to the Company or the deterioration of the debtor's financial position,
- country risk – financial loss arising from economic agents in a sovereign foreign country, including its government, being unable or unwilling to fulfil their international obligations due to a shortage of foreign exchange or another common reason such as currency inconvertibility, and
- settlement risk – financial loss arising from the failure or substantial delay of an expected settlement in a transfer system to take place, due to the party other than the Company defaulting/not delivering on its settlement obligations

The Company will take on investment credit risk and loan risk when it is deemed financially beneficial to do so in support of the financial objectives

The Company is exposed to investment credit risk on its investment portfolio (in line with the Company's risk appetite), primarily from investments in corporate bonds and asset backed securities. Creditworthiness assessment for new and existing investments is largely undertaken on behalf of the Company by F&C. In their decision making, F&C will assess the extent of investment credit risk allowed by each fund as set out in the fund mandates and relative to defined performance benchmarks

The majority of the Company's corporate bond portfolio is highly rated (see table on page 61)

Derivatives purchased over the counter have the potential to expose the Company to substantial credit risk but this risk is significantly reduced through collateral arrangements with counterparties. The ALM function is responsible for recommending derivative strategies to the Board, and assisting other finance teams to put in place the appropriate internal management processes. The Company endeavours only to transact over the counter derivatives with highly rated counterparties

The Company is exposed to reinsurance counterparty risk of three different types

- as a result of debts arising from claims made but not yet paid by the reinsurer,
- from reinsurance premium payments made to the reinsurer in advance, and
- as a result of reserves held by the reinsurer which would have to be met by the Company in the event of default

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(c) Credit risk (continued)**

In addition, there is potential for the Company's credit risk exposure to increase significantly under adverse insurance risk events, e.g. if the Company received a large number of claims for which it needed to recover amounts from its reinsurers. In order to mitigate reinsurance counterparty risk, the Company gives consideration to the credit quality of a reinsurer before incepting a reinsurance treaty. To facilitate this process, a list of acceptable reinsurers is maintained.

The Company is exposed to credit risk on the balances deposited with banks in the form of cash, certificates of deposit and money market instruments. Money market instruments issued by parties other than banks, such as commercial paper, are also covered under this heading. The primary risk is borrower quality, this is mitigated by limiting holding in any one issuer.

The Company is exposed to loan risk in several different areas, the most material of which are

- loans to Independent Financial Advisers (IFAs) as part of strategic investments,
- other strategic loans,
- loans to appointed representatives,
- loans to brokers,
- agency debt (including debt arising as a result of clawback of commission),
- policyholder debt, and
- rental income due

In general, these quantitative credit exposures are relatively low but they can bear relatively high likelihoods of default.

The Company is exposed to country risk in a number of key areas, the most significant of which is bonds issued by foreign governments in non-domestic currency. The mandates that govern all F&C managed funds restrict the purchase of foreign government bonds to only those that exceed a minimum level of credit worthiness.

The management of country risk on the creditworthiness of the investments is largely undertaken on behalf of the Company by F&C.

Settlement risk is a form of credit risk that arises at the settlement of a transaction, as a result of a counterparty failing to perform its obligations. The Company is exposed to settlement risk in the following key areas:

- bank transfers, including foreign exchange transactions,
- the purchase or sale of investments,
- the purchase or sale of property,
- the purchase, sale or expiry of exchange-traded derivatives or the transfer of periodic payments under these contracts, and
- the settlement of derivative contracts

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(c) Credit risk (continued)**

**Objectives in managing credit risk**

To mitigate credit risk

- investment mandates for many funds will have a prescribed minimum credit rating of bonds that may be held and will generally prohibit investment in bonds of below specified minimum ratings, subject to some discretion where assets are downgraded. Investing in a diverse portfolio reduces the impact from individual companies defaulting,
- counterparty limits are set for investments, cash deposits, foreign exchange trade exposure and stock lending,
- all over the counter derivative transactions are covered by collateral, with minor exceptions, and
- the Company regularly reviews the financial security of its reinsurers, and
- in some cases, derivatives are held to protect against the risk of credit default or internal hedge solutions have been implemented

The exposure to individual counterparties is limited to specific percentages of total non-linked assets in the long-term fund, based on regulatory categorisation of counterparties

Concentrations of credit risk might exist where the Company has significant exposure to 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

An indication of the Company's exposure to credit risk is the quality of the investments and counterparties with which it transacts. The Company is most exposed to credit risk on debt and other fixed-income securities, derivative financial instruments, deposits with credit institutions, reinsurance arrangements and cash at bank. Debt and other fixed-income securities mainly comprise government bonds and corporate bonds. The Company monitors the quality of its corporate bonds and sovereign debt holdings

The following table gives an indication of the level of creditworthiness of those categories of assets which are neither past due nor impaired and are most exposed to credit risk using principally ratings prescribed by Standard & Poor's and Moody's. Assets held within unit-linked funds have been excluded from the table below as the credit risk on these assets is borne by the policyholders rather than the shareholders. Government bonds have also been excluded. The carrying amount of assets included in the balance sheet represents the maximum credit exposure

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(c) Credit risk (continued)**

The increase in value for AA debt securities between 2010 and 2011 can be explained by assets backing £1 8bn of reinsured immediate annuities which were transferred from FLP under the Part VII business transfer scheme (see note 27)

**As at 31 December 2011**

	AAA	AA	A	BBB	BB	B	Not rated	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Debt securities and other fixed-interest securities	1,260	2,261	1,199	690	150	2	196	5,758
Derivatives	-	-	289	-	-	-	-	289
Reinsurers' share of technical provisions – claims outstanding	-	37	-	-	-	-	-	37
Deposits with credit institutions	13	585	539	-	-	-	-	1,137
Cash at bank and in hand	-	41	5	-	-	-	-	46
<b>Total</b>	<b>1,273</b>	<b>2,924</b>	<b>2,032</b>	<b>690</b>	<b>150</b>	<b>2</b>	<b>196</b>	<b>7,267</b>
<b>%</b>	<b>18%</b>	<b>40%</b>	<b>28%</b>	<b>9%</b>	<b>2%</b>	<b>-</b>	<b>3%</b>	<b>100%</b>

**As at 31 December 2010**

	AAA	AA	A	BBB	BB	B	Not rated	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Debt securities and other fixed-interest securities	1,281	627	1,291	494	169	2	208	4,072
Derivatives	11	8	165	-	-	-	-	184
Reinsurers' share of technical provisions – claims outstanding	-	5	-	-	-	-	-	5
Deposits with credit institutions	265	617	493	-	-	-	-	1,375
Cash at bank and in hand	-	4	2	-	-	-	-	6
<b>Total</b>	<b>1,557</b>	<b>1,261</b>	<b>1,951</b>	<b>494</b>	<b>169</b>	<b>2</b>	<b>208</b>	<b>5,642</b>
<b>%</b>	<b>27%</b>	<b>22%</b>	<b>35%</b>	<b>9%</b>	<b>3%</b>	<b>-</b>	<b>4%</b>	<b>100%</b>

The Company holds collateral in respect of over the counter derivatives. Such collateral held by the Company consists of gilts, non-sterling government bonds and cash. Collateral is valued at bid price.

The exposure of the Company to the debt of the governments of Greece, Ireland, Italy, Portugal and Spain in shareholder and annuity funds at 31 December 2011 is set out in the table below. There is no exposure to Greece. Where the Company holds securities issued by financial companies, it has considered the Company's financial strength and the ability of the domicile government to provide financial support in the event of stress.

	2011	
	Corporate debt £m	Total £m
Ireland	1	1
Portugal	-	-
Italy	6	6
Spain	9	9
<b>Total</b>	<b>16</b>	<b>16</b>

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(c) Credit risk (continued)**

The following table shows the amounts of 'debtors' and 'prepayments and accrued income' excluding deferred acquisition costs (DAC) and 'deferred fees and charges' (DFF) that are neither past due nor impaired, past due but not impaired and those where provision for impairment has been made. No other financial assets were either past due or impaired at the end of the year. However, some issuers of subordinated bonds in which the Company has holdings have suspended or announced that they intend to suspend the payment of coupons. Assets held in unit-linked funds have been excluded from the table.

As at 31 December 2011	Debtors and prepayments and accrued income (excluding DAC and DFF)
<b>Financial assets neither past due nor impaired</b>	87.7%
<b>Financial assets that are past due:</b>	
0-3 months past due	9.4%
3-6 months past due	0.0%
6-12 months past due	2.3%
More than 12 months past due	0.0%
<b>Impaired financial assets for which provision is made</b>	0.6%
<b>Total before provision for impairment (£m)</b>	280

As at 31 December 2010	Debtors and prepayments and accrued income (excluding DAC and DFF)
<b>Financial assets neither past due nor impaired</b>	94.4%
<b>Financial assets that are past due:</b>	
0-3 months past due	4.1%
3-6 months past due	0.2%
6-12 months past due	0.1%
More than 12 months past due	1.1%
<b>Impaired financial assets for which provision is made</b>	0.2%
<b>Total before provision for impairment (£m)</b>	224

For the majority of over the counter derivative transactions undertaken by the Company, collateral is received from the counterparty if the sum of all contracts held with the counterparty are in-the-money (i.e. it is being valued as an asset). The Company has a legal right to this collateral if the counterparty does not meet its obligations but has no economic benefit from holding the assets and the counterparty may substitute at any time the collateral delivered for another asset of the same value and quality. It is repayable if the contract terminates or the contract's fair value falls. Contractual agreements between the Company and each counterparty exist to protect the interests of each party, taking into consideration minimum threshold, asset class of collateral pledged and the frequency of valuation. At 31 December 2011 the fair value of such collateral held was £229m (2010: £144m). No collateral received from the counterparty has been sold or re-pledged.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(c) Credit risk (continued)**

As part of the Part VII transfer on 1 December FLL took on the reinsurance agreement with Windsor Life Assurance Company Limited from FLP

Reinsurance assets include an amount of £1,800m (2010 £1,666m) which relates to a reinsurance agreement with Swiss Re, as set out in note 27. The asset is secured by collateral arrangement with HSBC offering protection should any counterparty supporting the reinsurance agreement default. An investment Management Agreement is in place between the Company and Swiss Re to govern the suitability of collateral assets. As at 31 December 2011 the value of such collateral was £1,807m (2010 £1,674m).

The value of the reinsurance and underlying collateral are reviewed annually to ensure that the future payments received from the loan note continue to match the best estimate liability cash flows. The review process is ongoing but the current expectation is that there will be no need for a payment by the reinsurer to increase the value of the loan note and collateral (2010 nil). Should a payment be necessary it is expected that this would take place in April 2012.

**(d) Liquidity risk**

Liquidity risk is the risk that an entity, although solvent, either does not have sufficient financial resources available to it in order to meet its obligations when they fall due, or can secure them only at excessive cost.

The Company faces two key types of liquidity risk:

- shareholder liquidity risk (liquidity within funds managed for the benefit of shareholders, including shareholders' interests in long-term funds), and
- policyholder liquidity risk (liquidity within funds managed for the benefit of policyholders)

The overall objective of shareholder liquidity risk management is to ensure there are sufficient funds available to meet the cash flows needs of the business. The overall objective of policyholder liquidity risk is to ensure that sufficient liquid funds are available to meet cash flow requirements under all but the most extreme scenarios (the exception being the property funds where a six month notice period is required for switches and withdrawals).

The Company will meet shareholder liquidity needs arising in a number of key areas. For example:

- the ability to support the liquidity requirements arising from new business,
- the capacity to maintain dividend payments/loan repayments and interest etc,
- the ability to deal with the liquidity implications of strategic initiatives, such as merger and acquisition activity,
- the capacity to provide financial support across the Group, and
- the ability to fund its day-to-day cash flow requirements

The overall objective of shareholder liquidity risk management is to ensure that there is sufficient liquidity over short (up to one year) and medium time horizons to meet the needs of the business.

For policyholder funds, liquidity needs arise from a number of potential areas, including:

- a short-term mismatch between cash flows arising from assets and cash flow requirements of liabilities,
- having to realise assets to meet liabilities during stressed market conditions,
- investments in illiquid assets such as property and private placement debt,
- higher than expected level of lapses/surrenders caused by economic shock, adverse reputational issues or other events, and
- higher than expected payments of claims on insurance contracts



**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(d) Liquidity risk (continued)**

The overall objective of policyholder liquidity risk management is to ensure that sufficient liquid funds are available to meet cash flow requirements under all but the most extreme scenarios

Liquidity risk is managed in the following way

- a credit facility with a syndicate of banks exists to enable cash to be raised in a relatively short time-span,
- credit risk of cash deposits is managed by applying counterparty limits and imposing restrictions over the credit ratings of third parties with whom cash is deposited,
- assets of a suitable maturity and marketability are held to meet policyholder liabilities as they fall due,
- limits are set on the level of investment in securities that are not readily realisable. These are typically restricted to 5% of non-linked assets, and
- the implementation of temporary restrictions for the withdrawal of funds, such as extension of the notice periods of switches and restriction withdrawals from property funds

The following table details the undiscounted contractual net cash flows in respect of financial and insurance liabilities. Where contracts have a surrender value (i.e. the policy is theoretically payable on demand) the current surrender value is disclosed within the 'within one year' or 'payable on demand' column

As at 31 December 2011

		Contractual undiscounted cash flows		
		Within 1 year or payable on demand	1-5 years	More than 5 years
	Carrying value £m	£m	£m	£m
<b>Non-derivative financial liabilities</b>				
Technical provisions	13,903	9,317	870	4,348
Technical provisions for linked liabilities	8,681	8,681	-	-
Amounts due to reinsurers	1,800	1,800	-	-
Creditors arising out of direct insurance operations	41	41	-	-
Creditors arising out of reinsurance operations	57	57	-	-
Other creditors (excluding derivative financial liabilities)	10	10	-	-
Accruals and deferred income	13	13	-	-
<b>Derivative financial liabilities</b>				
Interest rate swaps	69	-	-	69
Futures backing equities	2	2	-	-

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(d) Liquidity risk (continued)**

**As at 31 December 2010**

		Contractual undiscounted cash flows		
		Within 1 year or payable on demand	1-5 years	More than 5 years
	Carrying value £m	£m	£m	£m
<b>Non-derivative financial liabilities</b>				
Technical provisions	12,193	9,383	589	2,739
Technical provisions for linked liabilities	8,284	8,284	-	-
Amounts due to reinsurers	1,605	1,605	-	-
Creditors arising out of direct insurance operations	30	30	-	-
Creditors arising out of reinsurance operations	2	2	-	-
Other creditors (excluding derivative financial liabilities)	5	5	-	-
Accruals and deferred income	3	3	-	-
<b>Derivative financial liabilities</b>				
Interest rate swaps	31	-	-	31
Inflation rate swaps	1	-	-	1
Futures backing equities	1	1	-	-
Forward currency contracts	1	1	-	-

All unit-linked liabilities arising from insurance contract and investment contract liabilities are payable on demand and have to be included in the column 'within 1 year or payable on demand'

Amounts expected to be settled from the 'fund for future appropriations' (FFA) are excluded from the analysis above as there is no contractual obligation to settle the liability. Of the carrying amount on the balance sheet in respect of the FFA, £225m (2010: £203m) is expected to be settled more than 12 months after the balance sheet date.

'Amounts due to Group undertakings' have not been included in the analysis as they do not have any fixed repayment terms.

**(e) Insurance risk**

Insurance risk includes the following areas:

- mortality risk – risk of loss arising due to policyholder deaths experience being different from expectations, or for annuities, risk of annuitants living longer than expected (called annuity longevity risk),
- morbidity risk – risk of loss arising due to policyholder health experience being different from expectations,
- persistency risk – risk of loss arising from lapse experience being different from expectations,
- expense risk – risk of loss due to expense experience being different from expectations, and
- option risk – risk of loss arising from experience of take-up of guarantees and options being different from expectations.

The Company actively pursues mortality risk, longevity risk and morbidity risk in those areas where it believes it has a competitive advantage in managing these risks to generate shareholder value (without compromising the interests of policyholders, and the need to treat customers fairly). Lapse risk and expense risk are taken on when it is deemed financially beneficial for the Company to do so, or where the taking of these risks is in support of the Group's strategic objectives.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(e) Insurance risk (continued)**

Underpinning the Company's management of insurance risk is

- adherence to an approved underwriting policy that takes into account the level of risk that the Company is prepared to accept,
- controls around the development of products and their pricing, and
- regular analysis of actual mortality, morbidity and lapse experience which feeds into the development of products and policies. If the analysis changes expectations of future liability cash flows, periodic adjustments are made to asset cash flows to maintain the asset liability match

Risks in excess of agreed underwriting limits may be reinsured. The Company's objective is to purchase reinsurance in the most cost-effective manner from reinsurers whose creditworthiness is deemed appropriate.

Substantially all insurance contracts, and the majority of the combined insurance and investment contract portfolio, are written in the UK and so results are sensitive to changes in the UK insurance market and tax regime. Otherwise the Company sells a diverse range of products to a diverse group of people. Overseas Life Assurance Business (OLAB) is the only overseas business.

Note 24 describes the main insurance contracts written by the Company and the basis of setting assumptions in measuring insurance liabilities, which takes into account the risks above. The following sections describe how policy cash flow risks are managed.

**(i) Mortality and morbidity risk**

- Life assurance – Most insurance policies other than annuities and deferred annuity policies include life assurance. When pricing policies, an assumption is made as to the likelihood of death during the policy term and this assumption is reviewed as part of the annual valuation of policies. To the extent that actual mortality experience is worse than that anticipated in pricing (and subsequently in the insurance liability valuation) a loss will be made. The risk is greater for those policies such as term assurance where the maturity or surrender benefit is small in relation to the death benefit. Other policies that have a savings element, such as endowment assurance, have significant liabilities relating to the maturity benefit, particularly as the policy approaches maturity. Contractual terms for unit-linked and unitised with-profits products include provision for increases in mortality charges.
- Critical illness – The Company writes a number of critical illness policies that pay out in the event of a policyholder's ill health. As for life assurance, the amount payable on ill health can be significantly higher than the amount payable if the policy is surrendered.
- Income protection – The two main risks related to income protection are an increase in the frequency of claims (the inception rate) and an increase in the average length of the claim (a reduction in recovery rate). Most income protection policies are regular premium with the premium and cover fixed at inception. Some group policies allow premiums to be reviewed but the premium rates are usually guaranteed for three years.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**25. RISK MANAGEMENT OBJECTIVES AND POLICIES FOR MITIGATING RISKS (continued)**

**(e) Insurance risk (continued)**

**(i) Mortality and morbidity risk (continued)**

- **Annuities** – If annuitants live longer than expected on average, profits will reduce. In most cases there is an initial guarantee period in which, in the event of death, annuity payments continue to be made to dependants or the policyholder's estate and many policies are written so that when the first life dies the benefit continues, often at a reduced level. These features tend to reduce the volatility of results to random fluctuations in experience but not the impact of a general increase in longevity.

Deferred annuities are subject to a similar risk from the impact of longevity, the only difference being that the risk of adverse impact is greater given that the annuity is payable further into the future. However, most of these policies are with-profits and the impact would be offset by a reduction in the unallocated surplus, with relatively little resulting impact on shareholder profits.

Annuity risk reduced through a reinsurance agreement with Swiss Re put in place in April 2007. The agreement covers annuity contracts written between July 2001 and December 2006. The Swiss Re agreement covers annuity contracts valued at £1,799m at 31 December 2011 (2010 £1,666m). This was transferred into the Company from Friends Life and Pensions Limited through a Part VII transfer.

**(ii) Persistency and option risk**

Persistency experience varies over time as well as from one type of contract to another. Factors that will cause lapse rates to vary over time include changes in investment performance of the assets underlying the contract where appropriate, regulatory changes that make alternative products more attractive (or incentivise advisers to be more or less active in recommending policyholders to switch provider), customer perceptions of the insurance industry in general and the Company in particular, and the general economic environment.

The valuation of the Company's guarantees and options is described in note 30. As stated in that note, the cost of guaranteed annuity options is dependent on decisions made by policyholders such as policy discontinuance and tax-free cash take-up. These assumptions are set by reference to recent experience.

**(iii) Expense risk**

The whole of the impact of changes in expense levels is borne by shareholders with the following exceptions:

- In 2009 the charges made to the Company's with-profits fund for managing policies were reviewed to reflect market rates at the time. Pre-demutualisation with-profits policyholders will bear the impact of any resulting changes to charges, and
- The FPLA Closed With-Profits Fund with-profits policyholders bear the full expense risk for the fund.

Contractual terms for unit-linked and unitised with-profits products include provision for increases in charges. Certain expenses (such as fees and commissions) are fixed at the time a contract is written.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**26. PROVISIONS FOR OTHER RISKS AND CHARGES**

	£m
<b>Vacant properties</b>	
At 1 January 2011	12
Charge in year	1
Utilised in year	-
<b>At 31 December 2011</b>	<b>13</b>
<b>Review of mortgage endowment complaints</b>	
At 1 January 2011	1
Release in year	-
Utilised in year	-
<b>At 31 December 2011</b>	<b>1</b>
<b>Review of other sales</b>	
At 1 January 2011	2
Charge in year	-
Utilised in year	-
<b>At 31 December 2011</b>	<b>2</b>
<b>Total at 1 January 2011</b>	<b>15</b>
<b>Total at 31 December 2011</b>	<b>16</b>

**Vacant properties**

The Company holds leases for a number of vacant and sub-let properties previously occupied by the Group. Provision has been made for the residual lease commitments and for other outgoings where significant, after taking into account the existing and expected sub-tenant arrangements. The remaining terms of the leases are up to 10 years. Assumptions as to whether each leasehold property may be sub-let or assigned in the future have been made. The discount rate applied to expected future cash flows is 2.5% (2010: 4%). The utilised in the year amounted to £200k.

**Mortgage endowment complaints**

Provision has been established for the estimated likely cost of redress, including administrative costs, arising from the review of the suitability of mortgage endowment policies. In addition to the accounting provision of £1m (2010: £1m), an actuarial reserve of £2m (2010: £2m) was held in the long-term business provision at 31 December 2010 in respect of estimated further endowment complaints.

The majority of the mortgage endowment redress provisions is expected to be settled in the next year.

**Review of other sales**

Provisions have been established for the estimated likely redress arising from the review of other sales. In addition to the accounting provision of £1m (2010: £2m), an actuarial reserve of £3m (2010: £3m) was held in the long-term business provision in respect of future estimated complaints.

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**27. AMOUNTS DUE TO REINSURERS**

A reinsurance agreement was transferred to the Company as part of the Part VII Scheme transfer that was originally entered into by FLP

During April 2007 FLP entered into a reinsurance treaty with Windsor Life Assurance Company Limited, a subsidiary of Swiss Re. The agreement, which took effect from 1 January 2007, reinsures the mortality and investment risk, but not expense risk, of 100% of FLP's in-force annuity book as at 31 December 2006. Business written after 31 December 2006 was not reinsured under the treaty.

The amount due to Windsor Life Assurance Company Limited which is now included within the Company's balance sheet represents future reinsurance premiums payable and is accounted for as a financial liability at fair value through profit and loss to avoid a valuation mismatch with the assets backing the liability.

Included in the carrying amount of £1,800m is £1,682m (2010 £1,547m) that is expected to be settled more than 12 months after the balance sheet date.

**28. CREDITORS ARISING OUT OF REINSURANCE OPERATIONS**

As detailed in the Report of the Directors and note 8 to the accounts, a business scheme transfer under Part VII of the Financial Services and Markets Act 2000 (FSMA) was completed on 1 December 2011 transferring all business of FPLA to the Company. In addition, the two reinsurance agreements listed below transferred to the Company with effect from 1 December 2011.

- (a) On 1 January 2010, FPLA entered into a financial reinsurance agreement with Munich Reinsurance Company who advanced a total of €33.75m in respect of certain German pension business.

The loan repayments are contingent on the emergence of future margins on policies whilst the policy remains in force or alternatively, reimbursement of commissions if the policy lapses or is surrendered. The loan arrangement will terminate on the earlier of the balance outstanding by receipt of sufficient repayments as defined above, or upon policies reaching the end of their reduced allocation periods. Each month an interest charge will be applied on the loan at the annual rate of 3 month EURIBOR + 3.35%.

- (b) On 1 January 2011, FPLA entered into a Financial Reinsurance agreement with Munich Reinsurance Company who advanced a total of €28.3m in respect of certain German pension business.

The loan repayments are contingent on the emergence of future margins on policies whilst the policy remains in force or alternatively, reimbursement of commissions if the policy lapses or is surrendered. The loan arrangement will terminate on the earlier of the balance outstanding by receipt of sufficient repayments as defined above, or upon policies reaching the end of their reduced allocation periods. Each month an interest charge will be applied on the loan at the annual rate of 3 month EURIBOR + 3.50%.

Loan repayments on the emergence of surplus of £0.2m have been made in the year.

**29. OTHER CREDITORS INCLUDING TAXATION AND SOCIAL SECURITY**

	2011 £m	2010 £m
<b>Amounts falling due within one year</b>		
Taxation	8	-
Amounts due to Group undertakings	942	789
Other creditors	81	39
	<b>1,031</b>	<b>828</b>

**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**29. OTHER CREDITORS INCLUDING TAXATION AND SOCIAL SECURITY (continued)**

	2011 £m	2010 £m
<b>Amounts falling due after one year</b>		
Lower Tier 2 Debt	700	-
	700	-

**30. GUARANTEES**

- (a) 6.875% Step-up Tier one Insurance Capital Securities (STICS) issued by Friends Life Group plc (2003 STICS)

On 21 November 2003, Friends Life FPL Limited issued £300m of STICS, which bear interest from 21 November 2003 to 20 November 2019 at a rate of 6.875%. The 2003 STICS have no maturity date but are redeemable at the option of the issuer on 21 November 2019 and thereafter on the coupon payment date falling on or nearest successive fifth anniversaries of this date. The 2003 STICS are perpetual securities and are not redeemable at the option of the holder at any time. The 2003 STICS are irrevocably guaranteed on a subordinated basis by the Company.

On 6 July 2009, as part of its reorganisation of the Group, Friends Life FPG Limited was substituted for Friends Life FPL Limited as the issuer of the 2003 STICS. On 14 December 2010, as part of its restructuring of the Group, Friends Life Group plc was substituted for Friends Life FPG Limited as the issuer of the 2003 STICS.

The guarantee is intended to provide the holder with rights against the Company in respect of the guaranteed payments which are as nearly as possible equivalent to those which they would have had if the 2003 STICS had been directly issued preference shares of the Company.

This guarantee does not meet the definition of a financial guarantee under FRS 26 Financial instruments – recognition and measurement, as the Company is able to defer its obligation to make payments under the guarantee to holders of STICS for an unlimited period, and the holders have no right to enforce the obligation on the Company.

- (b) 6.292% Step-up Tier one Insurance Capital Securities (STICS) issued by Friends Life Group plc (2005 STICS)

On 27 June 2005, Friends Life FPL Limited issued £500m of STICS, which bear interest from 30 June 2005 to 30 June 2015 at a rate of 6.292%. The 2005 STICS have no maturity date but are redeemable at the option of the issuer on 1 July 2015 and thereafter on every fifth anniversary of this date. The 2005 STICS are perpetual securities and are not redeemable at the option of the holder at any time. The 2005 STICS are guaranteed on a limited and subordinated basis by the Company.

On 6 July 2009, as part of its reorganisation of the Group, Friends Life FPG Limited was substituted for Friends Life FPL Limited as the issuer of the 2005 STICS. On 14 December 2010, as part of its restructuring of the Group, Friends Life Group plc was substituted for Friends Life FPG Limited as the issuer of the 2005 STICS.

The guarantee is intended to provide the holder with rights against the Company in respect of the guaranteed payments which are as nearly as possible equivalent to those which they would have had if the 2005 STICS had been directly issued preference shares of the Company.

This guarantee does not meet the definition of a financial guarantee under FRS 26 Financial instruments – recognition and measurement, as the Company is able to defer its obligation to make payments under the guarantee to holders of STICS for an unlimited period, and the holders have no right to enforce the obligation on the Company.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**30. GUARANTEES (continued)**

On 21 May 2009, Friends Life FPL Limited carried out a financial restructuring by exchanging £90m of its £300m 6 875% Step-Up Tier one Insurance Capital Securities issued on 21 November 2003 (the 2003 STICS) and £232m of its £500m 6 292% Step-Up Tier one Insurance Capital Securities issued on 30 June

On 6 July 2009, as part of its reorganisation of the Group, Friends Life FPG Limited was substituted for Friends Life FPL Limited as the issuer of Notes. On 14 December 2010, as part of its restructuring of the Group, Friends Life Group plc was substituted for Friends Life FPG Limited as the issuer of the Notes

- (1) Friends Life FPL Limited changed its name from Friends Provident Limited on 1 July 2011
- (2) Friends Life FPG Limited changed its name from Friends Provident Group Limited on 1 July 2011
- (3) Friends Life Group plc changed its name from Friends Provident Holdings (UK) plc on 1 July 2011

**31. DIRECTORS' EMOLUMENTS**

The directors are employed and paid by companies in the Group and their directorships are held as part of that employment. The directors received total remuneration for the year of £2,910,000 (2010 £6,595,000). Amounts for annual bonus payments to the directors for the year ended 2011 will be approved by the Resolution Limited Remuneration Committee after the signing of these accounts. The 2011 total remuneration therefore does not include amounts relating to this element. Directors are paid for services to the Group and it is impractical to isolate the element of total remuneration relating to the Company.

During the year six (2010 six) directors received retirement benefits under a defined contribution scheme and no directors (2010 one) had retirement benefits accruing under a defined benefit scheme.

Ms E B Bourke, Mr D E Hynam, Mr T J Matthews and Mr A M Parsons were directors of Friends Life Group plc, during the year. Their emoluments, which relate to their services to the Group as a whole, are disclosed in the financial statements of that company.

**Highest paid director**

The total remuneration payable to directors includes £859,000 (2010 £2,160,000) in respect of the highest paid director, of which £nil (2010 £nil) relates to long-term incentive schemes. This is the total of the costs incurred by the Group in respect of the highest paid director due to it being impractical to isolate the element of total remuneration relating to the Company. Pension contributions to money purchase schemes include £7,000 (2010 £16,000) for the highest paid director. The highest paid director is not a member of a defined benefit pension scheme (2010 not a member).

**32. RELATED PARTY TRANSACTIONS**

The Company is a wholly owned subsidiary undertaking of Resolution Limited. The results of both the Company and its subsidiaries are consolidated in the results of Resolution Limited, the Company's ultimate parent and controlling company, whose financial statements are publicly available. Accordingly, the Company is exempt from the requirements of FRS 8 Related Party Disclosures, concerning the disclosure of transactions with fellow wholly owned subsidiary undertakings, which qualify as related parties within the Group.

A number of key management personnel, and their close families, have long-term insurance policies with the Company. Such policies are on normal commercial terms which are also available to other members.



**FRIENDS LIFE LIMITED**  
(formerly Friends Provident Life and Pensions Limited)

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**32. RELATED PARTY TRANSACTIONS (continued)**

of staff. The Board has considered the financial effect of such insurance policies and concluded that they are not material to the Company or the individuals concerned.

**33. CONTINGENT LIABILITIES**

The Company has made provision for the estimated cost of settling complaints in respect of past sales (see note 26). Although the provisions are regularly reviewed, the final outcome could be different from the provisions established as these costs cannot be calculated with certainty and are influenced by external factors beyond the control of management. Such uncertainties include future regulatory actions, media attention and investment performance. The majority of the uncertainty relates to endowment mortgages although a number of other products are being reviewed as an ongoing process. It is expected that the majority of endowment cases requiring compensation will be settled in the next two years.

The FSA and other regulatory bodies may wish, in future, to examine the suitability of past sales and associated administration of products that could affect the Company and the industry in general. The directors of the Company also conduct ongoing reviews of such products. As a result, it is possible that additional unprovided liabilities could arise.

**34. COMMITMENTS**

**31 December 2011**

	Due within one year	Due 2-5 years £m	Due over 5 years £m	Total £m
Equity investments	38	81	-	119

**31 December 2010**

	Due within one year	Due 2-5 years £m	Due over 5 years £m	Total £m
Equity investments	64	93	-	157

Commitments represent guarantees or commitments made by the Company to portfolio companies.

**35. POST BALANCE SHEET EVENTS**

**(a) Capital reduction**

The directors are proposing to undertake a capital reduction in order to increase the level of distributable reserves in the Company. It is proposed to reduce the issued share capital of the Company to £100m creating an additional £3,119m of distributable reserves. During 2011, the distributable reserves of the Company were adversely impacted by the Part VII transfers and the proposed capital reduction, which will be by way of a directors' solvency statement, will bring the share capital of the Company more into line with other Group companies.

**(b) Dividend**

After the capital reduction has been approved, it is the intention of the directors to recommend an interim dividend of £350m.

**FRIENDS LIFE LIMITED**  
**(formerly Friends Provident Life and Pensions Limited)**

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

**35. POST BALANCE SHEET EVENTS (continued)**

**(c) New life tax regime**

HMRC have stated that draft legislation in respect of the new UK tax regime applicable to life insurance business is to be published in the Finance Bill on 29 March 2012. This follows the significant announcements previously made in the 2011 Budget and initial draft legislation published for consultation on 6 December 2011. The legislation is expected to take effect from 1 January 2013.

The company has made a preliminary analysis of the impact of the new legislation on the deferred tax assets and liabilities as at 31 December 2011. The net overall impact is an additional deferred tax liability of £20m, arising from the items described below.

Under the new tax regime, losses in respect of the company's pension business will be measured at the full corporation tax rate (currently measured at the basic rate of income tax). The tax value of losses would increase by £1m (based on the latest enacted corporation tax rate of 25%). This is offset by the loss of the deferred tax asset of £4m in respect of life assurance trade losses where these do not exceed pension business losses in the same entity.

Application of the draft transitional provisions would result in a further deferred tax liability of £17m, which would unwind over 10 years, in accordance with the transitional provisions. This relates to the with-profit fund deficit in the company which arose in 2002. This additional deferred tax liability is stated net of recognition of pension business losses in the company which are not currently being recognised.

Other deferred tax assets and liabilities of the company as at 31 December 2011 are not expected to be materially affected by the new legislation.

**(d) Changes in rates of corporation tax**

A gradual reduction in the UK corporation tax rate from 28% to 24% over four years was announced in the Emergency Budget of 22 June 2010. Subsequently, a further 1% reduction in the UK corporation tax was announced in the Budget of 23 March 2011, starting with a 2% reduction to 26% on 1 April 2011 and further 1% decreases over the next 3 years, resulting in a 23% UK corporation tax rate from 1 April 2014. The Finance Act 2011 enacted the rate reduction to 25% with effect from April 2012, the effect of which is to increase the 2011 closing deferred tax asset by £0.3m. Subsequent reductions will be dealt with by future legislation. The benefit to the Company's net assets from the further 2% reduction in the rate is estimated at approximately £0.4m in total and will be recognised as the legislation is substantively enacted.

**36. ULTIMATE PARENT UNDERTAKING**

The Company's ultimate parent undertaking is Resolution Limited, which is incorporated in Guernsey. Copies of the Group Report and Accounts of Resolution Limited can be viewed via its website at [www.resolution.gg](http://www.resolution.gg).

The smallest group in which the results of the company are consolidated is that headed by Friends Life Group plc. Copies of the Group Report and Accounts of Friends Life Group plc can be viewed at its website at [www.friendslife.co.uk](http://www.friendslife.co.uk).