Innovating to secure the future

Rothesaylife

Annual report and accounts 2017

About us

Who we are

Rothesay Life is a provider of regulated insurance solutions in the UK market for pensions de-risking. Established in 2007, Rothesay Life has grown to become one of the largest annuity providers in the UK market, with over £24bn of assets under management and insuring the annuities of over 380,000 individuals.

What we do

We think originally and work diligently to allow pension schemes and insurance companies to de-risk and to achieve long-term pension security for all our policyholders. Our deep-rooted expertise, real time risk management and forward-thinking approach gives us the ability to create sophisticated and robust insurance solutions tailored for each client.

For more information
www.rothesaylife.com

Highlights

Business highlights

New business: Assisted seven pension schemes and insurers to de-risk their liabilities, including follow on transactions to existing deals, generating premiums of £1.2bn.

Business transfers: Successfully migrated the annuity portfolios acquired from Zurich UK Life and Aegon N.V., ensuring continuity of service and increasing the number of customers whose pensions are paid directly by Rothesay Life by 200,000.

IFRS pre-tax profit: Generated IFRS pre-tax profit of £312m (Year ending 31 December 2016: £328m) and increased assets under management to £24.2bn (31 December 2016: £23.7bn), making us one of the largest annuity funds in the UK.

Market Consistent Embedded Value (MCEV): Increased the MCEV by 6% to £2,301m (Year ending 31 December 2016: £2,173m), through a disciplined approach to new business and cautious risk management.

Recapitalisation: Completed the recapitalisation of the Group, creating a long term, stable shareholder base, enabling the Group to take advantage of strategic opportunities to grow the business.

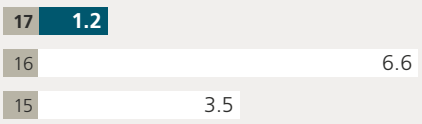
People: Invested in the business through recruitment across the Group at all levels in order to ensure that we have the capacity to achieve our strategic goals.

Solvency position: Remained cautious in investment markets and focused on pro-active risk management which contributed to the Group's robust solvency position. As at 31 December 2017, the Group's SCR coverage was 169% (31 December 2016: 164%) and Rothesay Life Plc's coverage was 163% (31 December 2016: 180%).

Key performance indicators

New business premium

£1.2bn



New business premiums are a key indicator of the Group's growth and realisation of its strategic objectives. New business sales include premiums written as bulk annuities, reinsurance and liabilities acquired through acquisitions. The Group's strict approach to new business selection meant that volumes were lower than in prior years.

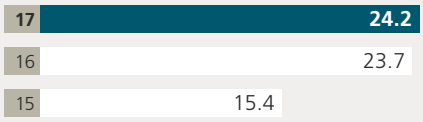
IFRS profit before tax

£312m

IFRS profit before tax is our primary measure of profitability, capturing all recurring and non-recurring items and in particular market fluctuations which have a direct impact on distributable reserves and capital. IFRS profit before tax was £312m, a strong result reflecting new business in 2017 and deployment of premiums received in 2016.

Assets under management

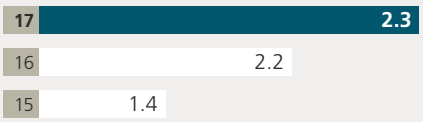
£24.2bn



Assets under management measures the total financial investments, including cash. It provides a useful measure for the size of the business. Assets under management increased as a result of new business and changes in market conditions partly offset by the run-off of liabilities.

MCEV

£2.3bn



The MCEV provides an indication of the value of the business written by measuring the risk-adjusted value of the in-force business, allowing for the unwind of margins. The MCEV increased by 6% as a result of writing attractive new business.

SCR coverage at RLP (%)

163%

The SCR coverage in the operating life company represents the regulatory coverage ratio. The Group aims to maintain SCR cover of at least 130% at the operating company. SCR coverage ratio fell from 180% as at 31 December 2016 to 163% as at 31 December 2017 as a result of paying a dividend of £370m to RHUK.

Customer satisfaction

98%

The number of our policyholders has significantly increased and, despite work volumes broadly doubling each year, we are proud that 98% of our policyholders have rated the quality of our service as either excellent or good.

We no longer consider that economic capital coverage is a key performance metric of the Group because the Pillar 1 capital requirement is the materially-binding capital constraint.

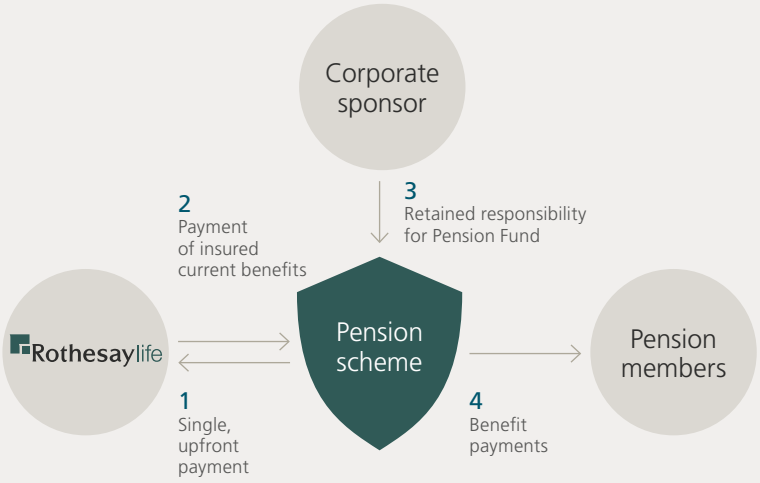
Overview

Company overview

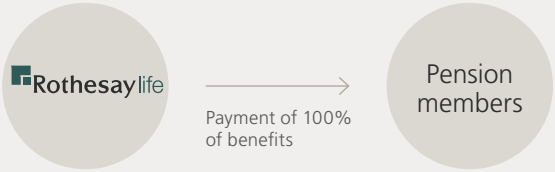
We create bespoke solutions that secure the long-term pension obligations of our clients and strive to provide the highest levels of service to support our policyholders through their retirement.

Bulk Annuity (Buy-in)

Held as an asset of the pension scheme, a pension buy-in is a bulk annuity contract that covers all or some of the benefits for a subset of scheme members. The bulk annuity contract protects the scheme against increases in the longevity of covered beneficiaries, as well as insulating the scheme from changes in investment returns, interest rates and inflation. The buy-in can be tailored to transfer specific risks if required.



After issuance of annuity policies to members



Bulk Annuity (Buy-out)

The most common approach to permanently settling pension liabilities is to purchase a bulk annuity covering 100% of scheme benefits and then split the bulk annuity into individual annuity policies for each pension scheme member. The scheme can then be wound up.

Key statistics

Our robust capital position and disciplined approach to risk management has helped us deliver another strong set of results and leaves us well positioned for future growth.

Assets under management
£24.2bn

Invested in the UK economy
£14.5bn

MCEV
£2.3bn

Number of people insured
382,257

Paid to policyholders in 2017
£1.5bn

Our DNA – what drives us

By meeting the needs of our clients, our own success will follow. We aim to do the right things in the right way through:

For more information
See pg 16-17

1 Intellectual curiosity

We look to blend talent, intellect and technology to deliver success and security for policyholders.

2 Providing certainty

We aim for certainty of business outcomes in order to deliver security and predictability.

3 Focusing together

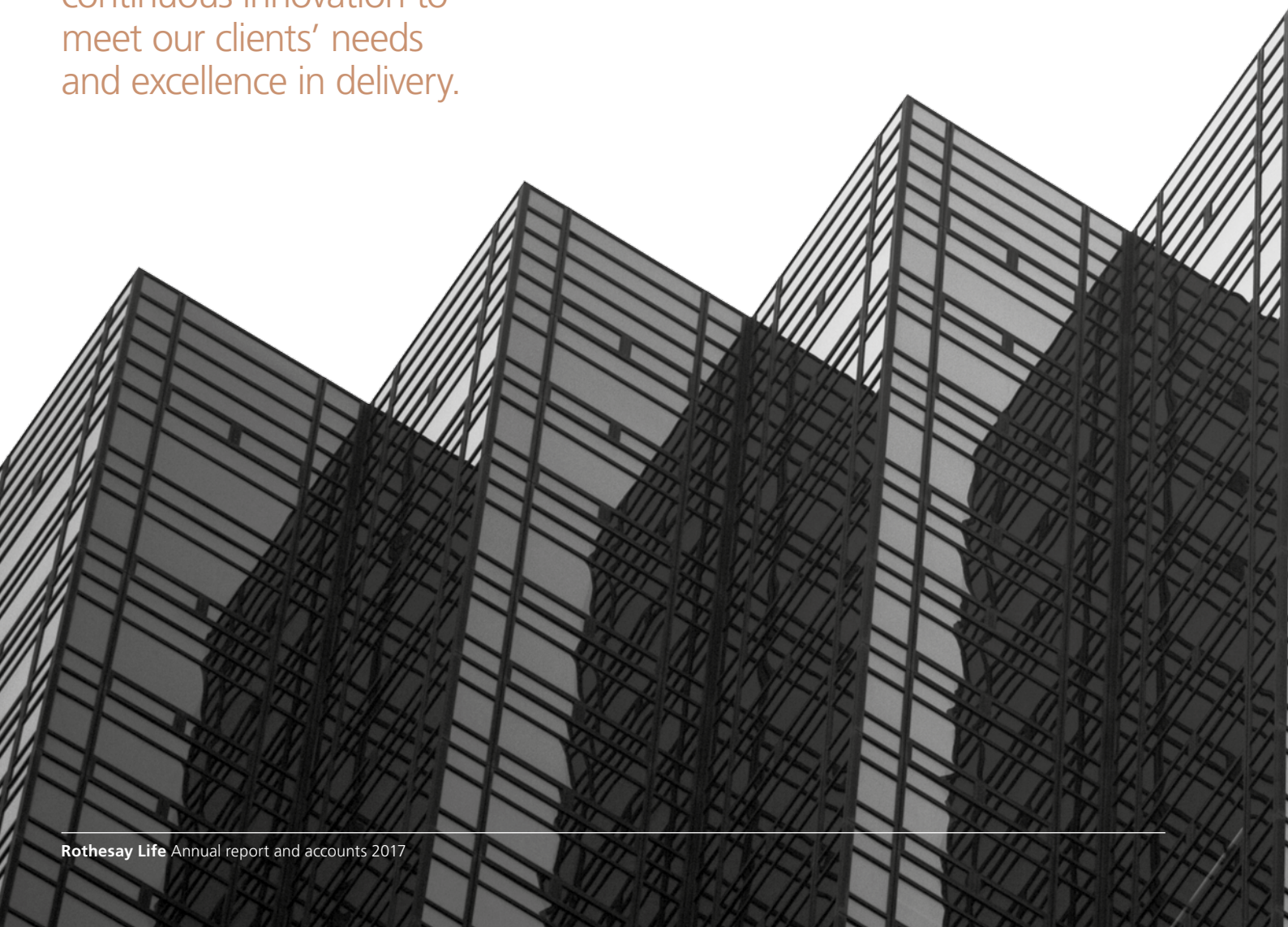
We are a team that is driven in what we do, aiming to spend our time and focusing our efforts on creating value and managing risk.

4 Delivering success

We aim to be entrepreneurial and agile in order to deliver successful outcomes for all stakeholders.

Strategic report

Rothesay Life's business model has been established on the core pillars of high-tech and sophisticated risk management, conservative investment philosophy, continuous innovation to meet our clients' needs and excellence in delivery.



Chairman's statement

Continuing growth

2017 has been a year of continuing growth and corporate development. The robustness of our business model has enabled continuing success in challenging market conditions.

Naguib Kheraj
Chairman

I am delighted to have been invited to be Chairman at such a crucial time in the growth of Rothesay Life. For the last ten years, Goldman Sachs has supported the creation and then growth of the business to being a market-leading provider of regulated insurance solutions for pension de-risking. Given the size and maturity of the Group, Goldman Sachs felt that the time was right to sell its remaining stake in the business. We were delighted that the Group's remaining shareholders accordingly increased their investment in the business, providing support for the Group's continuing strategic aspirations. The recapitalisation of the Group provides us with a long term, stable shareholder base to take the business forward, allowing us to continue to provide clients with a full range of solutions on a large scale, as well as taking advantage of strategic opportunities to grow the business. The transaction announced with Prudential Plc on 14 March 2018 is an example of such an opportunity (please see further details on page 9).

Goldman Sachs will remain an important advisor and trading partner to the Group over the long term and Rothesay Life will continue to benefit from use of Goldman Sachs' risk management systems and IT infrastructure.

I would like to take this opportunity to thank my predecessor, Ray King, who has overseen and led a strengthening of governance in the Group. I am pleased to say that Ray has agreed to continue to serve as an Independent Non-Executive Director of the Group.

As a result of the recapitalisation, Dermot McDonogh stepped down from the Board in December 2017. I would like to thank Dermot for his contribution as Goldman Sachs' representative on the Board.

Performance

The Group has reported profits of £312m before tax and a solvency position that remains strong with Group SCR coverage of 169%. Assets under management have grown to £24.2bn and MCEV has increased by 6% to £2,301m.

The Group has also received a dividend of £370m from its regulated insurance subsidiary, Rothesay Life Plc (RLP). This has allowed the Group to repay the £240m of bank debt raised to provide bridging capital for the Aegon transaction during 2016. Rather than paying the remaining funds out of RHUK as a dividend, the funds were held at RHUK to allow the Group to take advantage of strategic opportunities to grow the business.

Our policyholders

During 2017, we have assisted seven pension schemes and insurance companies to de-risk their liabilities.

In June 2017, we welcomed over 200,000 individual policyholders to Rothesay Life (from Zurich UK Life and Aegon N.V.). The successful migration of the business, following approval of the Part VII transfers, means that they experienced continuity of service and that in the future they will benefit from the same high quality service experienced by our existing customers.

Governance and culture

The Group's performance remains rooted in our continuing focus on meeting the needs of our policyholders, the quality of our business selection and our ability to remain flexible in the way in which we source and execute transactions. This is supported and overseen by a strong and effective governance structure designed to ensure that risk and capital management processes remain robust.

During 2017, Therese (Terry) Miller and Constant (Stan) Beckers joined the Board as Independent Non-Executive Directors of the Group. Terry and Stan bring a wealth of financial services expertise and experience to the Board.

Glenn Earle stepped down from the Board in January 2018. I would like to thank Glenn for his contribution as an Independent Non-Executive Director and Deputy Chairman.

Charitable activity

Rothesay Life's chosen charity is Age UK, the UK's largest charity dedicated to helping everyone make the most of later life. The charity helps more than six million people every year, providing companionship, advice and support for older people who need it most. We are delighted to be supporting Age UK's vital work through a range of sponsorships.

Our people

Since joining the Board of Rothesay Life, I have worked closely with the people at Rothesay Life. I have been impressed by the hard work and professionalism of the team, which enable us to focus on delivering security and value to our policyholders and shareholders. Our employees are the defining factor in our success and I would like to take this opportunity to thank them for their continuing contribution.

Looking forward

From a new business perspective, opportunities in the UK remain exciting. The pipeline in our core pension de-risking market is strong and support from our shareholders means that we are well positioned to take advantage of strategic opportunities to grow the business as they arise.

I look forward to working with Addy and the wider Board in the next phase of Rothesay's development.

Naguib Kheraj
Chairman

22 March 2018

Chosen charity

"Age UK is proud to be Rothesay Life's chosen charity. Our mission is to help everyone make the most of later life. With more of us living longer, the demand for Age UK's support is growing by the day. This is why Rothesay Life's support is vital and so valued. In the last year alone Rothesay Life's sponsorship of Age UK's Love Christmas Carol concert enabled us to engage over 1,000 supporters to raise tens of thousands of pounds to help fund our work tackling loneliness. Rothesay Life has also funded the production and distribution of over 35,000 advice guides, giving much-needed information and support to older people and their families when they need it most.

Our partnership really is living proof of Rothesay Life's commitment to improving the wellbeing and security of our older generation. We're extremely grateful for your commitment and generosity – thank you Rothesay Life!"

Hannah Lee – Head of Corporate Fundraising – Age UK.

age UK
Love later life

Assets under management
£24.2bn

Number of people insured
382,257

Long-term security

The disciplined execution of our strategy has ensured another successful year and leaves us well placed to capitalise on the opportunities ahead.

Addy Loudiadis
Chief Executive Officer

Rothesay Life exists primarily to de-risk the liabilities of pension schemes and insurance companies. Our focus is on making sure that we pay our policyholders accurately and on time and that policyholders can be confident in the long-term security of their retirement benefits. Protecting the interests of our clients and policyholders requires a relentless focus on risk and capital management and this becomes particularly important during times of market stress.

For much of 2017, the markets remained challenging. Rothesay has successfully navigated through volatile market conditions whilst preserving and protecting our capital position and continuing to pursue growth and our business plans.

Our investment in technology and systems continues to allow us to be pro-active and navigate even the most difficult markets with agility, ensuring we meet our obligations while preserving capital to grow and generate value for our investors. The time and resource invested over many years by our specialist teams to generate detailed real-time balance sheet and solvency data has proven to be invaluable against such a backdrop and allows us to both manage our in-force business and continue our growth through new business. We have and will continue to develop the investment capabilities of our asset management businesses and to invest in the systems and people to manage the risks we assume on behalf of our customers.

At the same time, we are also planting the seeds for our future growth by expanding our capabilities, be that through funding equity release mortgages, opening a new US office or through exploring potential expansion of product lines and markets.

Group performance and outlook

As described in the Chief Financial Officer's review, Rothesay has delivered a strong financial performance in 2017. The disciplined execution of our strategy and the strength of opportunities in our target markets have been the key pillars of our success.

Whilst volumes in the bulk annuity market reached record levels, we have exercised our strict business selection procedures to ensure we only target those transactions where we can add value and which meet our return targets. Increased competition has meant that some of the business that has been transacted by our competitors in 2017 would not have met our return thresholds. However the outlook for the bulk annuity market going into 2018 is strong, with a number of large and exciting opportunities in the pipeline. This will be boosted further by any rise in long-term real interest rates as this would make pension de-risking more affordable for most pension schemes.

Our new business volume for the year was £1.2bn (31 December 2016: £6.6bn) and this combined with investment of premiums received during 2016 helped us to generate IFRS profit before tax of £312m (Year ending 31 December 2016: £328m). Our capital position remains robust with Group SCR coverage of 169% (31 December 2016: 164%). Continued focus on value and risk in underwriting led to 6% MCEV growth, up £0.1bn to £2.3bn (31 December 2016: £2.2bn).

Rothesay's growing in-force business continues to support cash generation. This, together with capital support from our shareholders, puts us in an excellent position to pursue disciplined growth over the foreseeable future. The Group manages the solvency ratio at RLP to a range of 130% to 150%. The ongoing capital strength of RLP meant that RLP was able to pay dividends of £370m to Group whilst maintaining appropriate solvency coverage. This dividend allowed the Group to repay £240m of bank debt. The remaining funds will be held at RHUK to allow the Group to take advantage of strategic opportunities to grow the business, particularly via the acquisition of back-books of annuities. Were the Board to determine that such funds were not required for business growth then they would be returned to shareholders.

The outlook for back-book transactions looks positive. A number of UK insurance companies have exited the individual annuity market which means that their annuity portfolios are no longer core. As a result, we believe that there are likely to be a number of opportunities to acquire back-books of annuities over the next few years. Our successful experience with the £6.4bn Aegon and £1.1bn Zurich transactions puts us in a leading position to execute future transactions. The transaction announced with Prudential Plc on 14 March 2018 is an example of such a transaction (see side bar).

On 14 March 2018, Prudential Plc announced the sale of £12bn of its annuity portfolio to Rothesay Life Plc, the largest transaction of its type in the UK and taking the Group's assets under management to £37bn.

The transaction is structured initially as a reinsurance contract and covers over 400,000 policyholders who will remain customers of Prudential and continue to be serviced by Prudential until the effective date of a Part VII transfer.

Capital support for the transaction has been provided by Rothesay Life's shareholders with £380m of new equity being provided. In addition, the Group has borrowed £500m from a syndicate of third party banks. The new equity and the proceeds from the loan have been injected into RLP as equity. After allowing for the re-calculation of transitional solvency relief, solvency coverage was estimated to be 147% at RHUK on 14 March 2018 and 166% at RLP. Solvency at RLP is higher than at Group because the bank loans do not count as solvency capital for RHUK.

IFRS profit before tax

£312m

Market consistent embedded value

£2.3bn

Chief Executive Officer's report continued

Risk, capital and asset management

Our risk and capital management framework has been developed around the ethos of isolating and identifying each of the inherent risks in the liabilities we insure and the assets in which we invest, and to then identify the most efficient and appropriate methods of managing those risks. This involves hedging certain risks, such as interest rate and inflation risks where we hedge the risks to within our tolerance thresholds, and longevity risk where we have reinsured 82% of our exposure. It also involves ensuring we invest in assets that minimise credit risk through the use of collateral and legal/structural protections, whilst maximizing the liquidity premium we can generate.

We took advantage of market conditions in 2017 to bolster our capital position by issuing a £300m Tier 2 bond from RLP through a private placement and entering into a £300m revolving credit facility with our key relationship banks. Both of these will supplement our ability to undertake new business.

Mitigating risk is not only efficient under the new solvency regime but also consistent with our economic view that it is prudent to hedge risk exposures, as long as this is done with robust collateral provisions to mitigate counterparty risk.

Our highly quantitative approach helps us identify low risk and capital efficient investments and take advantage of relative value opportunities across the spectrum. This year we have continued to successfully increase our allocation to loans secured on commercial real estate both in the UK and overseas. We have also increased our funding of equity release mortgages substantially, generating £519m of new volume for the year through a combination of strategic partnerships with various originators and distributors as well as purchases of in-force blocks. By providing funding to back equity release mortgages, the Group is helping pensioners to access the equity in their houses, without the need for them to move. Mortgages are written with a no negative equity guarantee which means that borrowers don't have to worry about the liability growing above the value of the house.

On the asset management front, I am pleased to announce that we have opened a new subsidiary in the United States – Rothesay Asset Management US LLC. The Company has been established to help the Group to source investment opportunities in the United States such as commercial real estate financing, commercial loans and asset-backed financing. We believe that the US market presents many attractive investment opportunities for our growing business.

Our policyholders

We pride ourselves on the quality of the service we provide so it was vital that the transition from Zurich UK Life and Aegon N.V. to Rothesay Life went smoothly following the approval of the Part VII transfers. A seamless transition was achieved through the hard work of our in-house team and the dedicated team at our new third party administrator.

We now serve and provide pensions to over 380,000 individuals, making us one of the largest annuity providers in the UK. The quality of service we provide to our policyholders is reflected in the high level of customer satisfaction and consistently low levels of upheld complaints.

In common with the rest of the industry, we have seen an increase in the number of deferred annuitants opting to take a transfer value. Where possible, we try to facilitate access to pension freedoms by, for example, allowing policyholders to take transfers right up to their retirement age.

Rothesay's in-house operations team works closely with our various administration partners to automate processes and minimize the risk of errors. The close integration of our administration systems and risk management systems helps to ensure both accuracy of payments to policyholders as well as making sure risks are managed in real-time.

Our shareholders

During 2017, our founding shareholder, Goldman Sachs, decided to sell down their remaining stake to a combination of our other shareholders, namely Blackstone, GIC and MassMutual. I am delighted that our core shareholder group remains the same and has provided this strong vote of support and confidence in the management team and business model. The long-term support from our shareholders allows us to provide clients with a full range of solutions on a large scale, as well as taking advantage of strategic opportunities as they arise.

At the same time, I would like to acknowledge all the support, inspiration and ideas that Goldman Sachs has provided to the business. From our founding to the present – they have been an integral part of our development and we literally would not be here without them. Goldman Sachs will remain an important advisor and trading partner to the Group and Rothesay Life will continue to benefit from Goldman Sachs' risk management systems and IT infrastructure.

Our people

At the end of 2017, Rothesay Life had 179 permanent employees, a significant increase that reflects the success of our business model, growth in the scale of the business and the support we have from our investors and stakeholders to continue our development. During the year we have continued to build our in-house asset management function and other key areas of the business. We have also strengthened control and support functions.

The skills of our people and the breadth of the expertise within the team across insurance, pensions, actuarial, investment management, operations and technology is the defining factor in our success.

I would like to thank our people for their contribution in 2017 and I look forward to 2018 with enthusiasm about the opportunities that await. I am confident that we are well positioned to capitalise on them. The transaction with Prudential Plc is an example of this.

Addy Loudiadis
Chief Executive Officer

22 March 2018

Strategic report

How our business works

We create bespoke solutions that secure the long-term pension obligations of our clients and strive to provide the highest levels of service to support our policyholders through their retirement.

What we do

Technology

Technology underpins all aspects of our business. We employ sector-leading systems to manage our balance sheet real-time ensuring we control risk proactively and make careful underwriting decisions.

People

Our people are our most valuable asset. We recruit carefully and have developed a culture of hard work, high standards, integrity, curiosity and dedication.

Partners

We aim to treat our clients, policyholders, counterparties and service providers as partners, cherish long-term relationships and avoid short-term opportunism.

Innovation

We continuously seek to do what we do in a better and smarter way. We pride ourselves on our ability to solve problems for our clients and set market-leading precedents.

How we do it

Our business model

Rothesay Life has been established on the core pillars of high-tech and sophisticated risk management, conservative investment philosophy, continuous innovation to meet clients' needs and excellence in delivery.

Our existing clients include the pension schemes and members associated with high profile and blue-chip companies including Aegon, British Airways, Civil Aviation Authority, General Motors, GKN, InterContinental Hotels, Philips, Rank, RSA and Zurich.

1 New business origination

Rothesay Life's dedicated and experienced new business team sources new wholesale annuity business from across a broad opportunity set, promotes the Group and maintains long-term relationships.

For more information See pg 18-19

2 Underwriting

Cautious and controlled risk underwriting is combined with detailed legal and operational due diligence carried out by specialist Rothesay Life teams to achieve maximum pre-deal certainty.

For more information See pg 18-19

3 Investment management

Rothesay Life's investment team identifies long-term investments which lock in returns to back annuities while minimising the exposure of the business to credit and market risks.

For more information See pg 20-21

4 Operations & administration

A high degree of automation and technology allows our outsourced administration platforms to interact with our risk systems to minimise discrepancies and ensure that policyholders are paid accurately and on time and that they receive the highest levels of customer service.

For more information See pg 22-23

5 Risk management

Sophisticated systems ensure daily capital and risk reporting which allow Rothesay Life's investment team to manage the balance sheet dynamically, react appropriately to evolving market conditions and maintain capital efficiency.

For more information See pg 30-37

Our markets

Rothesay Life is a wholesale annuity writer. We are professionals experienced in the defined benefit pensions market, the annuity reinsurance market and in corporate acquisitions.

Bulk annuity market

The £2 trillion bulk annuity and pension buy-out market represents our core organic new business growth market. The market is supported by substantial structural underpins and is projected to see annual volumes of over £15bn a year over the near term with even greater flow likely as interest rates rise.

Reinsurance and M&A

Solvency constraints and the bifurcation of UK insurance into asset management and risk businesses continues to drive secondary annuity book transactions.

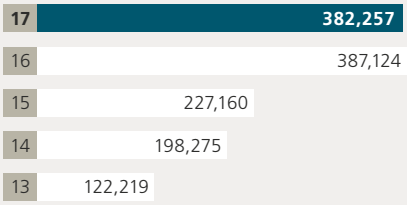
Selected clients & counterparts

How we generate and retain value for stakeholders

Policyholders

Providing security to our policyholders and insuring their future pensions is our primary concern. We look after over 380,000 people and take pride in the levels of service we provide and the strength of our capital position to ensure we can meet our future obligations whatever the market backdrop.

Total lives insured



Shareholders

By focusing on protecting our balance sheet through preserving and recycling capital, we not only ensure we meet our promises to policyholders but also protect the resources we use to invest in growth. Investing these resources cautiously without ever compromising our stance on risk offers our investors stable, long-term returns.

Our strategic objectives

Our strategy is designed to protect the security of our obligations to policyholders and to generate and deliver sustainable shareholder value.

Strategic objectives	Progress in 2017
1 Protect the security of policyholder benefits We apply a conservative, risk capital-based approach to managing our balance sheet and strive for excellence in our operations to protect the long-term security of our policyholders' benefits.	• Maintained robust solvency position. • Good progress on the development of the partial internal model. • Excess capital at RLP meant that a dividend of £370m was paid from RLP to RHUK to pay off bank debt. SCR coverage at RLP 163%
2 Grow through writing value-driven new business We pursue growth by focussing on high quality new business which meets our return thresholds and risk tolerance. We remain disciplined in our approach which benefits from proven execution capabilities across pensions, insurance and corporate acquisitions.	• Disciplined underwriting led to £1.2bn of new business across pensions and insurance. • Includes upsize of three existing deals. • Capital retained at RHUK to allow the Group to take advantage of strategic opportunities. MCEV new business profit £177m
3 Safeguard our brand and culture We have built our business on the foundation of long-term relationships and avoided short-term opportunism. We focus on recruiting and retaining the best and most relevant talent to protect this culture and ensure we can maintain excellence in delivery to policyholders, counterparties and partners.	• Administration of over 200,000 Zurich UK Life and Aegon N.V. policyholders was transferred to Capita Employee Benefits Ltd. • Recruited 47 talented individuals across all areas of the Group, including for our new US operation. Headcount growth 26%

Our focus in 2018

Risks

- Continue to maintain robust solvency position.
- Obtain approval for partial internal model to ensure that regulatory capital is better aligned to the Group's conservative business model.

- Market and credit risk – the risk of loss from fluctuations in the level of market prices of assets, liabilities and financial instruments as a result of changes in market conditions or credit standing of counterparties.
- Insurance risk – the risk of loss arising from inadequate provisioning assumptions.
- Liquidity risk – the risk of being unable to realise investments in order to settle financial obligations when they fall due.

For more information
See pg 30-37

- We are not a league table-driven company and each transaction is chosen on its individual merits.
- The recapitalisation allows the Group to continue to enjoy long-term support from our shareholders, allowing us to continue to provide clients with a full range of solutions on a large scale, as well as taking advantage of strategic opportunities.

- Strategic risk – the risk that changes in the operating environment means that we are unable to write value-driven new business.
- Operational risk – The risk arising from inadequate pricing processes.

- Evolve the relationship with Goldman Sachs from shareholder to long-term partner.
- Continue to recruit to ensure that the Group is appropriately resourced to meet its strategic objectives.

- Operational risk – the risk arising from inadequate or failed internal processes, personnel or systems.
- Conduct risk – the risk arising from unfair treatment of customers.

Our people are our most valuable asset

Our commitment to attracting and retaining talent is fundamental to our success. We continue to build our in-house capabilities and 47 new members of the team joined us in 2017.

We are proud of our ability to retain great people and we continue to invest in our growing workforce. As a successful and fast growing business, we can offer our people opportunities to realise their potential and make a tangible contribution from very early on in their time with us.

Rewarding and retaining our people.

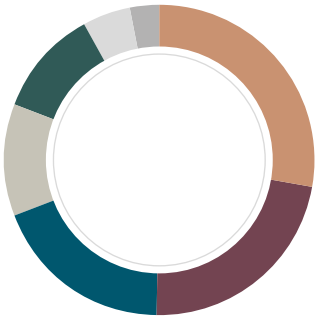
We are committed to delivering market leading remuneration and benefits designed to reward strong personal performance, support health and wellbeing, provide financial protection and a choice of lifestyle benefits to support at home and work.

Most of our employees have equity participation in the business.

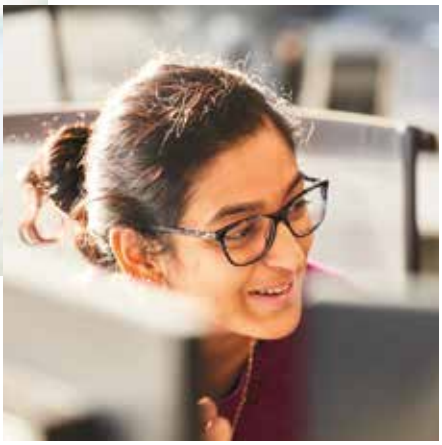
Investing in the team.

2017 saw an increase in training and development activity across the business with a key focus on our next generation leaders, first time people managers, our graduates and our early stage career professionals.

Headcount split by department



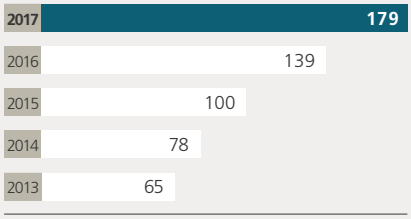
Management	9
Operations	50
Investment	40
Finance and legal	34
Risk and compliance	21
Marketing and pricing	20
Technology	5



A comprehensive digital resource library with e-learning activites, articles and videos was launched in 2017 along with a full day corporate induction for all new joiners in their first three months.

2017 saw the launch of an internal communications platform. This provides us with an intranet platform to ensure we are able to share news and information with the growing workforce but also develop a greater sense of community and involvement with Corporate Social Responsibility activities.

Growth in headcount



Average annual attrition

5.7%

Our DNA – what drives us

Our policyholders' interests always come first. If we serve our clients well, our own success will follow. To do this we are driven to do the right things in the right way through:

1 Intellectual curiosity

We look to blend talent, intellect and technology to deliver success and security for policyholders.

2 Providing certainty

We aim for certainty of business outcomes in order to deliver security and predictability.

3 Focusing together

We are a team that is driven in what we do, aiming to spend our time and focusing our efforts on creating value and managing risk.

4 Delivering success

We aim to be entrepreneurial and agile in order to deliver successful outcomes for all stakeholders.

New business origination & underwriting

We are not driven by sales volumes but rather the quality of the transactions that we execute each year. Our job is to find opportunities to help clients meet their objectives whilst at the same time ensuring an appropriate return taking into account the associated risks and capital required. Our focus on business selection is critical to the success of Rothesay Life.

2017 New business volume

£1.2bn

Selected awards

PENSIONS AWARDS 2016 WINNER

Risk.net Buy-Side Awards 2016 | Winner Insurer of the Year

One of the largest de-risking transactions of 2017

Each and every transaction we do, no matter how large or small, undergoes the same meticulous approach to underwriting, involving the evaluation and quantification of the key risks associated with acquiring the annuity liabilities ahead of completion. Our in-house underwriting team comprises actuarial, pensions, operational, trading, investment and legal expertise, all of whom have extensive experience in their respective areas.

The new business origination team has a particular focus on a solution-driven approach, with extensive experience and demonstrated capability to de-risk pension schemes and insurance company liabilities through the full spectrum of deal structures (buy-ins, buy-outs, longevity swaps, reinsurance followed by Part VII transfers, acquisitions, etc.).

The underwriting process incorporates extensive due diligence consistent with the highest standards in the industry in advance of execution to both quantify and mitigate operational and data-related risks.

Rothesay's integrated asset-liability risk management framework and sophisticated systems allow us to assess investment opportunities real-time using prevailing market conditions.

Our thorough approach to underwriting combined with the experience of the team and sophisticated systems mean that transactions can be executed quickly and efficiently. This also allows us to provide certainty of pricing for clients by locking-in the economics of a deal and also protects the Group's balance sheet by ensuring consistent quality of origination.

During 2017, it was more important than ever for us to remain disciplined and focused on selecting the optimal transactions. A competitive market environment impacted pricing and tight credit spreads impacted investment opportunities. Whilst the volume of new business we executed was significantly lower than in 2016 – which was a record year for us due to the £6.4bn Aegon transaction – we are pleased with the quality of the business we executed and were particularly pleased that a number of transactions were with existing clients – a demonstration of their confidence in our service and execution.

A scheme with amplified risks

In 2012 the Post Office was separated from the Royal Mail and the UK government became responsible for the pension liabilities accrued up until 1 April 2012. After 2012, assets and liabilities started to build up for the Post Office employees in the Post Office Limited section of the Royal Mail Pension Plan. As only Post Office employees at 1 April 2012 were included in this section, the duration of the liabilities is exceptionally long for a pension scheme at 30 years, resulting in significant exposure to interest rate, inflation and longevity risk.

Risk transfer to Rothesay Life

With the Post Office section closing to accrual on 31 March 2017 the Trustee decided that it needed to reduce the risk involved in providing the promised pension benefits and starting engaging with insurers. With the help of their advisers Lane Clark and Peacock, this culminated in the Trustee delivering a £450m portfolio of long-dated gilts as payment for a bulk annuity contract with Rothesay Life in July 2017. The process of moving from early enquiries through to closure in July 2017 involved many detailed steps. Careful consideration of a wide range of complex issues was needed in order to complete a risk transfer in a controlled fashion.

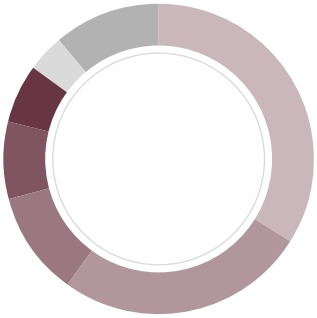
The annuity contract means that the Trustee has almost completely de-risked the Post Office section and its reliance on the Post Office as the sponsor.

Given the ultra-long nature of these pension liabilities, part of which increases each year in line with the Consumer Price Index (CPI), a key aspect to the transaction was Rothesay Life's ability to source long-dated assets and, in particular, to source CPI-linked cash flows. This meant Rothesay Life was able to offer an attractive price so the Trustee could lock into a favourable position and provide long-term benefit security to members.

Investment management

Rothesay Life has an in-house team responsible for the management of the £24bn asset portfolio. The team is responsible for sourcing investments that help us to extract value from illiquidity and secure returns by sourcing, structuring and investing in low-risk assets that benefit from collateral, hedging arrangements or other security features.

Asset portfolio



UK sovereign	34%
Secured residential lending	26%
Other secured lending	11%
Supranational and quasi sovereign	8%
Infrastructure	6%
Cash	4%
Other	11%

Asset-based Infrastructure loan

Rothesay Life participated in a £1bn financing of 750 new train vehicles to be built by Bombardier and leased to the South Western Rail franchise. The investment benefits from security over a core, homogeneous fleet of 90 trains designed to serve one of the UK's busiest and most profitable rail networks, with conservative underwriting and strong cashflow coverage. This was Rothesay Life's first private infrastructure loan.

United Utilities – North West England

Rothesay Life helped restructure legacy RPI-linked bonds of 26 year term into CPI-linked private placement bonds of 31 and 40 year term. This was a strategic transaction for both parties to replace RPI-linked assets with CPI as United Utilities have revenues that are linked to CPI and Rothesay Life has liabilities with CPI-linkage. It was the first capital markets 30yr+ transaction with CPI inflation. The transaction allowed United Utilities to lock-in a capital markets solution to hedge their revenue increases into the future.

Rothesay Life has long-term annuity liabilities which are backed by fixed-income assets. The Group has a dedicated in-house team focused on ensuring that the assets we invest in are secure through both their inherent credit-worthiness and additional structural features that we negotiate and incorporate within our investments.

The Group's overall credit default risk is mitigated by investing in a combination of liquid, low-risk government bonds and less liquid highly-secured or collateralised investments:

- **Government and supranational bonds:** 42% of the portfolio is invested in low-risk government bonds and supranational bonds. This portion of the portfolio backs our very long-dated cashflows but is also available to meet collateral calls and cash requirements.
- **Secured investments:** 37% of the portfolio is invested in loans secured against property or other collateral. Many of these investments are bespoke where very high levels of collateral have been negotiated and returns are generated through illiquidity premium. During 2017 we have increased our funding of equity release mortgages substantially, generating £519m of new volume for the year through a combination of strategic partnerships with various originators and distributors as well as purchase of in-force blocks.
- **Infrastructure:** 6% of the portfolio is invested in regulated infrastructure such as water, energy and transportation. These investments are typically long-dated and backed by ring-fenced and low-risk income streams.
- **Other:** The remaining 15% of the portfolio consists of cash and fixed income instruments. This includes a portfolio of corporate bonds which is managed by M&G.

Collateral management:

The use of derivatives to hedge market risk combined with our investment in loans secured by collateral means that collateral management forms an integral part of the Group's activities. We monitor collateral closely and stress test collateral that backs investments to ensure security is not compromised due to market moves.

Liquidity management:

A large amount of the portfolio is, by design, highly secured, but less liquid. In order to manage liquidity risk, the Group holds substantial liquidity buffers at all times to protect the firm against potential liquidity calls. To achieve this, Rothesay Life operates a liquidity management framework which stress-tests and reports liquidity continually to ensure sufficient cash and liquid securities (primarily gilts) are available at all times to meet obligations.

Industry-leading expertise:

The Rothesay Life in-house investment team consists of origination, structuring, legal, trading, risk, modelling, operations and capital expertise. We have built the team by hiring talent from the financial services industry to focus on sectors such as real estate, infrastructure, structured finance and government.

During 2017, we opened a new subsidiary in the United States, Rothesay Asset Management US LLC. The Company has been established to help the Group to source investment opportunities in the United States such as commercial real estate financing, commercial loans and asset-backing financing. We believe that the US market presents a multitude of attractive investment opportunities for our growing business.

Operating the team in-house is critical to the success of the business as it ensures:

- Assets and liabilities are managed in an integrated manner.
- Regulatory capital and risk are a dynamic consideration in decision-making.
- Investment opportunities feed into new business underwriting real-time which reduces uncertainty of anticipated returns.

Key principles

1. As a buy-to-hold investor, the Group is less exposed to market volatility as adverse movements in our investment portfolio are offset by movements in our insurance liabilities. Under Solvency II, the Group is exposed to risk of downgrades as capital requirements are driven by rating.
2. The Group adopts a market consistent approach to reserving for residual credit risks and adopts a dynamic strategy of monitoring and re-hedging these risks where possible as they arise.
3. Given the significant growth in the Group's assets under management, the Group has decided to include a small exposure to a diversified portfolio of corporate bonds in our investment mix. Given M&G's strength in this area, the corporate bond portfolio is managed by them with close oversight from Rothesay Life.

4 Operations

The Operations team at Rothesay Life is integral to establishing and maintaining an effective and robust control environment. The team's primary focus is ensuring that we pay our policyholders accurately and on time.

Service Standards

98%

of our policyholders rated our service as 'Excellent' or 'Good'

Complaints upheld

0.14

Throughout 2017, we received fewer than 0.14 upheld complaints per 1,000 policyholders

Positive feedback from our policyholders:

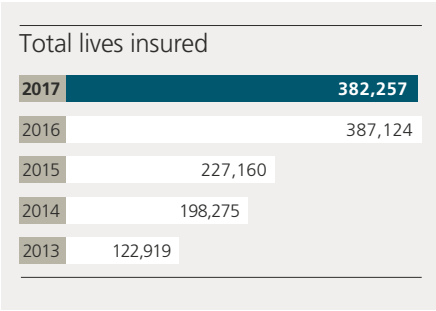
"I have had excellent service from your firm. I have moved pension provider several times since I retired and your firm has given by far the best service".

Part VII transfers of the annuity business from Zurich and Aegon

Long-term security and service for an additional 200,000 policyholders

Our business model involves the use of third party administrators to provide policyholder administration. We have agreed rigourous service levels with these administrators and continuously monitor their performance against them. We have a high level of oversight of our third party administrators through regular governance meetings and on-site operational reviews. We continue to invest in automation and efficiency projects to ensure we have a robust control environment to manage existing and future business without compromising our high service levels and our continued commitment to our policyholders.

We continue to partner with Willis Towers Watson (WTW) and Jardine Lloyd Thompson (JLT), and have added a new administration partner in 2017, Capita Employee Benefits (Capita). Capita provides fully automated payroll functionality for annuity in payment business. Partnering with these administrators allows us to ensure we maintain our excellent policyholder service, manage and protect our customers' data, and guard our brand and reputation. In this way, we can ensure that pension schemes and insurance companies that are entrusting their members and policyholders to us can be confident that their members and policyholders will be appropriately treated.



In June 2017, administration and payroll obligations for over 200,000 policyholders transferred to Rothesay Life following approval of the Part VII transfers of the annuity business of Zurich UK Life and Aegon N.V. At the same time, associated reinsurance arrangements were implemented across five reinsurance counterparties, including three reinsurers that were new to the Group. A seamless transition was achieved through the hard work of the Operations team and the dedicated team at Capita.

Rothesay Life is now responsible for over 380,000 policyholders, including indirect beneficiaries under our buy-in arrangements. The chart to the left provides a summary of the number of policyholders insured by Rothesay Life and demonstrates the increase over recent years. In 2017, we paid out more than £1.4bn in pension benefits to our policyholders.

For the Operations team, policyholder experience remains paramount and we continue to focus on providing a best-in-class service. This is reflected in our service levels, excellent policyholder feedback and low complaint numbers. All processes follow the 'Treating Customers Fairly' principles and we seek to exceed the standards and guidelines set out by the Financial Conduct Authority (FCA), the Pensions Regulator and the Association of British Insurers (ABI). Rothesay Life is also now a member of the Pensions Administration Standards Association (PASA), an independent body dedicated to improving standards in pensions administration. Oversight of the Group's conduct towards customers is the responsibility of the Customer and Conduct Committee which meets regularly and is chaired by Richard Berliand, an Independent Non-Executive Director.

During 2017 both WTW and JLT have again exceeded their target service levels. Working with Capita we have achieved a seamless transitional from Aegon N.V. and Zurich UK Life. Formal service levels have been agreed with Capita and these will take effect from January 2018, recognising the completion of the implementations of both the Zurich UK Life and Aegon N.V. back-books. Across all three of our administrators, the results of policyholder surveys remain extremely positive, with over 98% of all respondents rating the quality of our overall service as 'Excellent' or 'Good'. These results were achieved even though the number of our policyholders significantly increased.

Our complaint levels also continue to remain low with just 0.51 complaints received per 1,000 policyholders of which only 0.14 complaints per 1,000 policyholders were upheld. Our complaints-per-policyholder ratio remains market leading and is something of which we are extremely proud. We take all complaints seriously and conduct a full root cause analysis with process improvements implemented, where required.

In June 2017, Rothesay Life executed two Part VII transfers. Operationally this meant taking on full administration and payroll commitments onto our platform and risk management model. Robust governance and planning was vital for annuity businesses of these sizes which included daily payrolls and pension increases.

Key areas of focus during the implementation phase to ensure seamless migration included:

- vigorous data interrogation and system testing with a number of months of parallel payroll processing;
- fully documented suite of work instructions, procedures & processes;
- working closely with HMRC to minimise any tax impact to our policyholders; and
- working in partnership with the incumbent and our administrator with full oversight of the process.

All transition stages were independently audited to ensure we were operationally ready to proceed with the Part VII transfers and provide our policyholders with continuation of service, and without detriment to our existing membership.

We are now successfully paying over 5,000 policyholders every day across four different tax jurisdictions.

200,000

policyholders transferred to Rothesay Life and successful migration of five reinsurance treaties

Another strong performance

Our financial results demonstrate the Group's continuing ability to write profitable new business and deploy assets to generate strong returns whilst navigating changeable market conditions.

Andrew Stoker
Chief Financial Officer

The financial review describes the Group's financial performance and highlights the key drivers of the movements in the Group's consolidated statement of comprehensive income and consolidated statement of financial position. It also describes the Group's capital position.

Financial performance

The Group achieved an operating profit before tax of £382m (Year ending 31 December 2016: £321m) and a profit before tax of £312m (Year ending 31 December 2016: £328m). The Group focuses on profit before tax as its primary measure of profitability because this metric includes recurring and non-recurring items as well as market fluctuations and has a direct impact on distributable reserves and capital.

The financial performance analysis shown in the table opposite involved apportioning the items in the income statement between the various components of profit. We have therefore not provided a reconciliation between the operating profit and the income statement.

New business volumes in 2017 were significantly lower than in 2016 (a reduction in single premiums from £6,610m in 2016 to £1,176m in 2017) mainly because of the Aegon transaction in 2016. In addition, the core bulk annuity market during 2017 was very competitive due to pressure from new entrants making it difficult to source business that met our return thresholds. As a result, new business operating profits fell from £416m in 2016 to £141m in 2017. Profits are calculated assuming full deployment of premiums and any under-deployment is reported as a deduction from the management of the in-force book.

As the premiums received in the Aegon transaction had not been fully invested at the end of 2016, we reported a loss of £26m from the management of the in-force book in that year. Profits from the management of the in-force book in 2017 were £339m and include the impact of fully deploying the premiums received in 2016 as well as changes in assumptions.

Economic profits represent the change in profit as a result of changes in market conditions. The Group's approach to risk management meant that in 2017 the Group made a relatively small profit of £14m from changes in market conditions (Year ending 31 December £2016: £80m).

Income statement highlights

The key line items in the consolidated statement of comprehensive income for the Group (shown below) can be explained as follows:

Gross premiums written

The Group's gross premiums written fell from £6,877m in 2016 to £1,447m in 2017. This comprises:

- single premiums of £1,184m (Year ending 31 December 2016: £6,610m); and
- regular premiums of £263m (Year ending 31 December 2016: £267m) generated on the in-force inwards longevity reinsurance business written in prior years.

Net premiums written

Net premiums written represent the gross premiums written less the regular premiums ceded to reinsurers.

Net premiums written fell from £6,177m in 2016 to £666m in 2017, largely as a result of the fall in gross premiums.

Investment return

The investment return comprises interest received on financial assets, interest payable on financial liabilities and the net gains and losses on financial assets and liabilities, partially offset by investment expenses.

Interest received on financial assets net of interest payable on financial liabilities increased from £530m in 2016 to £645m in 2017, reflecting the growth in the size of the business.

The net movement in the fair value of assets including realised gains was a gain of £145m in 2017 compared to a gain of £2,272m in 2016. The gain in the value of assets in 2016 was due to the fall in interest rates and credit spread tightening and was largely offset by a similar increase in insurance liabilities. Investment expenses increased to £21m in 2017 from £4m in 2016.

Claims paid

Claims paid represent the total payments due to policyholders during the year (£1.5bn) less the reinsurers' share of such claims (£736m).

Net claims paid decreased by £48m from £791m in 2016 to £743m in 2017, reflecting the increase in reinsurance of pensioner liabilities.

Change in insurance liabilities

Change in insurance liabilities represents the change in the Group's gross insurance liabilities less the change in the value of the Group's reinsurance assets.

The increase in insurance liabilities of £170m in 2017 compared to an increase in insurance liabilities of £7,701m in 2016. The main drivers of the change in 2017 were an increase as a result of new business offset by the run-off of liabilities and the impact of the change in demographic assumptions. The increase in 2016 was largely due to the Aegon transaction.

Acquisition costs

Acquisition costs comprise the expenses associated with the origination of new business, including annual compensation for employees. Acquisition costs increased from £65m in 2016 to £85m in 2017 as a result of the growth in the scale of operations.

Administration expenses

Administration expenses represent the cost of administering the in-force book of business. These increased from £17m in 2016 to £21m in 2017 broadly in line with the growth of the business.

IFRS financial performance

£m	2017	2016
New business operating profit	141	416
Management of in-force book	339	(26)
Acquisition costs	(85)	(65)
Administration expenses	(21)	(17)
Experience variance	(1)	1
Other	9	12
Operating profit before tax	**382**	321
Finance costs	(36[1])	(43)
Non-recurring and project expenditure	(48)	(30)
Investment and economic profits	14	80
Profit before tax	**312**	328

1. In the table above, finance costs have been adjusted for 2017 to reflect only interest paid on borrowings and to exclude £20m of interest payable on collateral (as shown in note 7).

Income statement highlights

£m	2017	2016
Gross premiums written	1,447	6,877
Net premiums written	666	6,177
Investment return	769	2,798
Total revenue	**1,435**	8,975
Claims paid	(743)	(791)
Change in insurance liabilities	(170)	(7,701)
Operating expenses	(154)	(112)
Finance costs	(56)	(43)
Total claims and expenses	**(1,123)**	(8,647)
Profit before tax	**312**	328
Income tax	(51)	(66)
Profit after tax	**261**	262

Financial review continued

Other expenditure

Other expenditure amounted to £48m in 2017 (Year ending 31 December 2016:£30m). This includes reinsurance fees of £19m (Year ending 31 December 2016: £9m), which under IFRS are required to be categorised as expenses, costs relating to our Solvency II project of £12m (Year ending 31 December 2016: £12m), costs relating to the recapitalisation of the Company £8m (Year ending 31 December 2016: £nil), and other one-off project costs of £9m (2016: £9m).

Finance costs

Finance costs mainly represent interest payable on borrowings. The interest payable on borrowings (i.e. excluding interest on collateral) increased from £31m in 2016 to £36m in 2017 as a result of additional borrowing during the year.

Income tax

The Group's income tax charge decreased from £66m in 2016 to £51m in 2017, as a result of the decrease in profits and a reduction in the effective tax rate. Taxation is discussed further on next page.

Balance sheet highlights

The key line items in the consolidated statement of financial position for the Group (shown below) can be explained as follows:

Assets

Total assets decreased from £39.7bn as at 31 December 2016 to £38.4bn as at 31 December 2017. These aggregate numbers include derivative assets which net off against derivative liabilities and uncollateralised financing assets which net off against the associated liabilities.

Assets under management increased from £23.7bn as at 31 December 2016 to £24.2bn as at 31 December 2017 largely as a result of new business. These numbers can be derived from the table below by adjusting for reinsurance, derivatives and collateralised financing.

Reinsurance provisions remain relatively low compared to insurance contract liabilities because the Group's reinsurance contracts are all longevity swap reinsurance under which the Group pays regular premiums in return for being entitled to make regular claims. The value of reinsurance moved from being an asset of £437m at 31 December 2016 to being a net liability of £63m at 31 December 2017. This is due to the change in longevity assumptions detailed in note 21.

Total equity

The increase in total equity (an increase of £268m from £1,485m at 31 December 2016 to £1,753m at 31 December 2017) was driven by the increase in retained earnings.

Liabilities

Insurance contract liabilities decreased from £22.1bn at 31 December 2016 to £21.7bn at 31 December 2017. The main drivers of the change in 2017 were the run off of the business and the change in demographic assumptions partially offset by increases as a result of new business.

Payables decreased by £1.5bn from £15.5bn at 31 December 2016 to £14.0bn at 31 December 2017. Payables are dominated by derivative financial instruments and collateralised financing agreements. Derivatives are used to manage market and credit risk. The derivative liability as at 31 December 2017 of £11.1bn (31 December 2016: £12.0bn) nets off against the derivative assets of £10.7bn (31 December 2016: £11.7bn).

The liabilities associated with collateralised financing agreements as at 31 December 2017 decreased by £0.5bn to £1.4bn (31 December 2016: £1.9bn) and can be partially netted off against the value of the associated collateralised assets of £2.4bn (31 December 2016:£3.0bn). Collateralised financing is used by the Group to enable investment in shorter term assets and to generate liquidity.

Borrowings have increased by a net £60m from £587m at 31 December 2016 to £647m at 31 December 2017. During the year, the Group repaid £240m of third party syndicated loan notes because these notes did not contribute to the solvency capital of the Group. This was funded from the £370m dividend paid from RLP to RHUK. RLP subsequently placed a £300m floating rate Tier 2 bond to optimise its capital structure.

Balance sheet

£m	31 December 2017	31 December 2016
Financial investments	37,302	38,346
Reinsurance assets	168	437
Other assets	904	925
Total assets	**38,374**	39,708
Share capital and share premium	448	447
Capital contribution reserve	5	3
Retained earnings	1,300	1,035
Total equity	**1,753**	1,485
Insurance contract liabilities	21,741	22,071
Reinsurance liabilities	231	–
Payables	13,965	15,532
Borrowings	647	587
Other	37	33
Total liabilities	**36,621**	38,223
Total equity and liabilities	**38,374**	39,708

Assets under management

£m	31 December 2017	31 December 2016
Total assets	38,374	39,708
Less reinsurance assets	(168)	(437)
Less payables and financial liabilities	(13,965)	(15,532)
Assets under management	**24,241**	23,739

Market consistent embedded value (MCEV)

The Group's MCEV has increased by 6% from £2,173m at 31 December 2016 to £2,301m at 31 December 2017. This is summarised in the table to the right. The significant IFRS profit from the management of in-force made during the year led to an increase in net assets on an MCEV basis and a commensurate reduction in the value of in-force. Adjustments allow for Group borrowings and other Group adjustments.

The change in adjustments of £16m reflects the change in the value of the debt and the repayment of the £240m syndicated bank loan and the new £300m privately placed subordinated debt.

The value on an MCEV basis of the new business written in 2017 was £177m (Year ending 31 December 2016: £330m).

Taxation

The Group's tax strategy is designed to ensure compliance with the tax laws of those countries in which the Group operates (primarily the UK). Any tax planning undertaken has commercial and economic substance and has regard to the Group's corporate responsibilities and brand and the potential impact on shareholders, policyholders and other stakeholders. We do not undertake planning that is contrived or artificial. The Group has zero tolerance for tax evasion of any kind.

The Group makes a significant tax contribution in the UK, with £187m remitted to UK tax authorities in 2017 (Year ending 31 December 2016: £111m). The Group had an effective corporation tax rate of 16.4% during 2017 (Year ending 31 December 2016: 20.2%). Other taxes include property taxes, employer payroll taxes and irrecoverable indirect taxes.

Taxes collected are those taxes that the Group is obliged to collect from employees and policyholders, namely income tax, employee national insurance contributions and annuitant payroll taxes. The increase was largely driven by the significant growth in the number of individual policyholders paid directly by the Group.

IFRS profit before tax

£312m

MCEV

£2.3bn

Market Consistent Embedded Value

£m	31 December 2017	31 December 2016
Net assets	2,298	2,093
Value of in force	606	699
Less: adjustments	(603)	(619)
MCEV	**2,301**	2,173

Taxes paid

£m	2017	2016
Corporation tax	62	72
Other taxes	1	2
Taxes collected	124	37
Total remitted	**187**	111

Financial review continued

Capital management

The Group's capital resources are of critical importance. The Group's capital management framework is designed to meet the following objectives:

- to maintain financial strength in adverse conditions;
- to give customers long-term confidence in the Group;
- to satisfy our regulatory obligations;
- to match the profile of our assets and liabilities, taking account of the risk inherent in the business;
- to allocate capital efficiently to support new business growth; and
- to retain financial flexibility by maintaining strong liquidity.

Under the Solvency II regime, the Group is required to hold the greater of the capital required under the new Solvency II Pillar 1 framework and the capital required under its own economic capital models, Solvency II Pillar 2.

The Group also ensures that its insurance company subsidiary, RLP, is capitalised to the greater of the economic capital requirement and the regulatory Pillar 1 position. In practice, it is the Pillar 1 requirement which is more onerous and the Group aims to maintain at least 130% of the regulatory minimum requirement in RLP. As at 31 December 2017, RLP had an SCR coverage ratio of 163% (31 December 2016: 180%).

The Group has implemented a dynamic capital management framework which uses interest rate and other hedging to target stability of the IFRS balance sheet under normal conditions and seeks to manage both the IFRS and solvency balance sheets as conditions deteriorate.

Under Pillar 1, we are required to hold sufficient assets to meet:

- The Group's technical provisions, being:
  - the liabilities of the Group calculated on a best estimate basis (the BEL); and
  - the cost of transferring non-hedgeable risks (known as the Risk Margin); plus
- The capital required to meet a 1-in-200 year stress (calculated on a prescribed basis and known as the solvency capital requirement or SCR).

Firms with illiquid liabilities such as annuity business can discount these illiquid liabilities using the risk-free rate plus what is known as the 'matching adjustment'. The matching adjustment is broadly equivalent to the illiquidity premium that can be earned on the illiquid assets held to back illiquid liabilities. The Group applies the matching adjustment in calculating the BEL for almost all of its single premium insurance business. The remaining liabilities are discounted at the risk-free rate.

Assets in excess of that required to meet the technical provisions are known as Own Funds.

As part of the transitional arrangements in relation to the introduction of Solvency II, the Group is permitted to take credit for transitional solvency relief which amortises linearly to zero, falling by 1/16th on 1 January 2017 and again each year thereafter. An application can be made to re-calculate the amount of transitional solvency relief that can be taken if the risk profile of the Group changes materially. The Group made such an application as at 31 December 2017 as transitional solvency relief must be re-calculated every two years. The impact of re-calculation was to increase the transitional from £908m on 30 June 2016 when the transitional was last re-calculated to £1,009m net of the associated impact of tax on Own Funds and allowing for amortisation of 1/16th on 1 January 2017.

The Group's SCR is calculated using the standard formula. The diagram opposite provides a breakdown of the SCR post-diversification benefit between modules. Life underwriting relates mainly to longevity risk. Market risk is primarily spread risk, i.e. the risk that credit spreads widen.

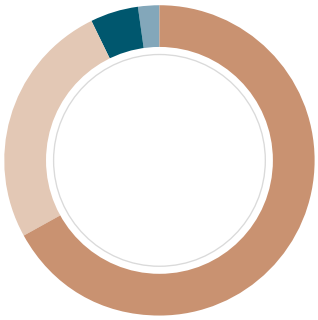
The Group is in the process of applying to use its own model for calculating the SCR in relation to credit and counterparty risk but intends using the standard formula for all other risks (a 'partial internal model'). The Group is applying to use a partial internal model to ensure that the allocation of capital to investment is consistent with the low risk inherent in the types of highly secured and collateralised investments which are core to the Group's investment strategy. Approval of the partial internal model will allow the Group to restructure our holding of equity release mortgages to make them eligible for inclusion in the matching adjustment fund.

The solvency position of the Group and RLP is summarised in the table below. Note that for the purpose of reporting as at 31 December 2016, allowance was made for amortisation of 1/16th of transitional solvency relief (being £57m) whereas we are now allowing for amortisation on 1 January 2017 in order that reporting is consistent with the Solvency and Financial Condition Report.

Solvency position of the Group and RLP

	Group		RLP	
£m	31 December 2017	31 December 2016	31 December 2017	31 December 2016
Tier 1 capital	2,280	2,265	2,180	2,526
Tier 2 capital	664	361	664	361
Own Funds available to meet SCR	2,944	2,626	2,844	2,887
SCR	1,745	1,603	1,743	1,603
Surplus above SCR	1,199	1,023	1,101	1,284
SCR coverage	169%	164%	163%	180%

RLP SCR 31 December 2017



Market risk	67%
Life underwriting risk	26%
Operational risk	5%
Counterparty default risk	2%

Group SCR coverage increased from 164% at 31 December 2016 to 169% at 31 December 2017. The change in SCR coverage is shown in the table to the right. All numbers are shown net of tax impacts. In order to provide a like-for-like comparison, the opening position has been adjusted to allow for the impact of re-calculating the transitional as at 31 December 2016. The change in transitional between 31 December 2016 and 31 December 2017 is then split between the management of in-force book and economic profits to reflect the fact that part of the change is due to changes in the investments backing the in-force book and part is due to changes in economic conditions.

The capital difference between RLP and RHUK in 2017 arises because proceeds from the dividend paid to RHUK are being held at RHUK to allow the Group to take advantage of strategic opportunities to grown the business, particularly via the acquisition of back-books of annuities. The difference in 2016 arose from the fact that the syndicated bank loan of £240m issued by RHUK did not contribute to the Group's own funds.

The table to the right provides a range of sensitivities as at 31 December 2017. Where applicable, allowance has been made for the impact of recalculating transitional solvency relief. Interest rates are assumed to fall progressively and hedging adjusted accordingly.

Change in SCR coverage

	2017	2016
Opening position (adjusted for the impact of transitional re-calculation)	**164%**	158%
Amortisation of 1/16th of transitional on 1 January 2017	**(4%)**	–
New business (on a fully deployed basis)	**(5%)**	(14%)
Management of in-force book	**5%**	33%
Acquisition costs and administration expenses	**(5%)**	(5%)
Other (including experience variance)	**(1%)**	1%
Finance costs	**(2%)**	(3%)
Non-recurring and project expenditure[1]	**(2%)**	(3%)
Economic profits	**2%**	(15%)
Share issuance	**–**	12%
Debt issuance	**17%**	–
RHUK SCR coverage	**169%**	164%
Capital differences between RLP and RHUK	**(6%)**	16%
RLP SCR coverage	**163%**	180%

1. Including the impact of funding the Employee Benefit Trust.

31 December 2017	Change in assumptions	Impact on surplus over SCR £m	Impact on coverage ratio %
Interest rate	**+100bps**	**278**	**36%**
Interest rate	**-100bps**	**(51)**	**(16%)**
Inflation	**+100bps**	**(57)**	**(9%)**
Inflation	**-100bps**	**118**	**14%**
Spread widening	**+100bps**	**(290)**	**(9%)**
Annuitant mortality	**-5%qx**	**(89)**	**(6%)**
Annuitant mortality	**+5%qx**	**82**	**6%**
Expenses	**+10%**	**(50)**	**(3%)**

31 December 2016	Change in assumptions	Impact on surplus over SCR £m	Impact on coverage ratio %
Interest rate	+100pbs	215	26%
Interest rate	-100bps	(83)	(15%)
Inflation	+100bps	(9)	(6%)
Inflation	-100bps	58	8%
Spread widening	+100bps	(114)	1%
Annuitant mortality	-5%qx	(81)	(6%)
Annuitant mortality	+5%qx	76	6%
Expenses	+10%	(41)	(3%)

Central to our success

The management of risk is central to the success of the business. Every member of staff knows that he or she is responsible for the identification and management of risk. The Group's governance arrangements strengthen this principle by adding challenge, oversight and independent assurance from the second and third lines of defence.

Peter Shepherd
Chief Risk Officer

During 2017, the Group further invested in growing the size and capabilities of the risk function to ensure that the function is well equipped to challenge and support the business as it continues to grow in line with the Group's business plan.

Risk Management Framework

The Group looks to embed proactive and effective risk management across the organisation via the Risk Management Framework (RMF). During the year several areas of the RMF have been enhanced to further strengthen Rothesay Life's risk management. These include liquidity risk management and the management of non-financial risks such as model risk and outsourcing risk.

Further detail on the components of our RMF is provided on the next page. The RMF informs and is directed by the Group's business strategy. Risk management considerations are integral to setting business strategy, as we seek to optimise our risk-adjusted returns and create shareholder value whilst also meeting the expectations of our customers.

Core strategy

The Group's risk management principles are driven by the key objectives of the business:

- to ensure that our liabilities to policyholders can be met in a full and timely manner over a very long-term;
- to maintain our financial strength and capitalisation;
- to produce stable earnings from our in-force business;
- to protect and increase the value of our shareholders investment; and
- to safeguard Rothesay Life's reputation.

Board risk appetite and culture

Rothesay Life's risk appetite expresses the types of risk that the Board is willing to be exposed to in pursuing strategic objectives. The Board's risk appetite sets the tone for the culture of risk management throughout the organisation.

Our strategic approach is to de-risk our business in order to achieve attractive risk-adjusted returns. We aim to protect regulatory surplus and minimize balance sheet volatility by hedging longevity risk and adopting a cautious approach to investment.

Risk taking is therefore limited to circumstances where we believe that we fully understand the inherent and residual risks, where we are able to manage them within prudent, observable levels and where incurring the risks provides sufficient value to our stakeholders.

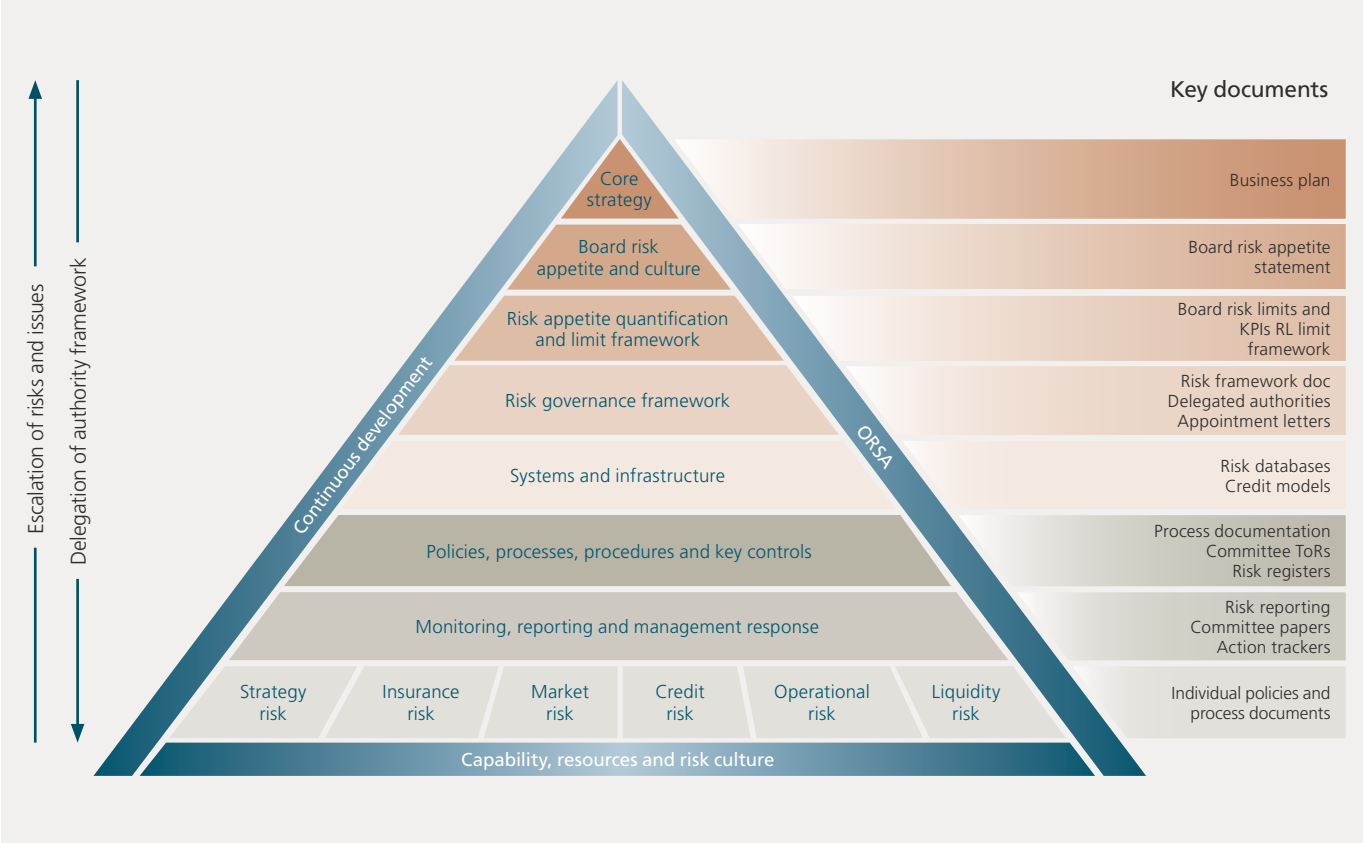
We aim to substantially mitigate the financial risks in our portfolio in order to protect policyholders, lock-in value and to safeguard capital surplus such that excess capital may be deployed into attractive risk-adjusted new business opportunities where the Group believes it has a comparative advantage.

The risk appetite categorises risks as Desired, Tolerated or Undesired. First order risks that are core to our business model (desired), second-order risks that we incur as a result of our business model but seek to mitigate or manage to influence risk/return (tolerated) and second-order risks that we seek to fully eliminate to the extent possible (undesired).

Risk appetite quantification and limit framework

The risk limit framework is intended to ensure the stability of earnings and solvency position of the business. Risk appetite is translated into quantifiable limits and early warning triggers that prompt management action to avoid our risk exposures breaching the Board's risk appetite. Limits exist in relation to market, credit, counterparty, liquidity, demographic and longevity risks and are sized with reference to our overall risk appetite and capital position.

Risk management framework



Risk management continued

Risk governance framework

Rothesay Life's risk governance arrangements strengthen the risk-taking and risk management of the business by adding challenge, oversight and independent assurance. Rothesay Life adopts the principles of a 'Three Lines of Defence' governance model for risk management that provides a consistent, transparent and clearly documented allocation of accountability and segregation of functional responsibilities.

- **First line:** Day-to-day risk management is delegated from the Board to the CEO and, through a system of delegated authorities, to business managers. Rothesay Life also makes the distinction between:
  - the risk-taking functions, including investment and new business origination; and
  - the control functions, whose responsibility it is to ensure the integrity of the Group's operations and reporting. These include operations, finance and legal.
- **Second line:** Risk oversight is provided by the Chief Risk Officer (CRO), his team and risk management committees. The executive level Working Level Risk Committee (WLRC) is chaired by the CRO and consists of relevant senior managers working within a delegated risk management framework. This Committee, and its sub-committees, review all material new investment, hedging or liability transactions and is supported by a number of other committees which focus on risks arising from new activities, methodology and assumptions underlying our financial modelling and the management of third party suppliers.
- **Third line:** Independent verification of the adequacy and effectiveness of the internal risk and control management systems is provided by the Internal Audit function.

The Board has overall responsibility for the management of the exposure to risks and is supported by the Board Risk Committee (BRC) whose membership consists entirely of Non-Executive Directors and looks to ensure that the management of the business is conducted within the delegated risk framework from the main Board.

Systems and infrastructure

The Group operates an integrated system infrastructure which captures all assets and liabilities centrally and provides us with the capability to report and monitor risk daily at both the portfolio and the individual transaction level. Close co-ordination of underwriting, reinsurance, investment and risk hedging functions ensures risk management is central to all aspects of the business, and that new business pricing reflects latest market conditions, hedging costs, investment opportunities as well as comprehensive liability analysis.

Risk type	Definition	Risk Preference		
		Undesired	Tolerated	Desired
Strategy risk	The risk of loss in future earnings and capital arising from changes in the competitive, economic, legal or political environment, changing customer behaviour, or a failure to select appropriate strategic or long-term business plans.			●
Insurance risk	The risk of loss or of adverse change in the value of insurance liabilities, due to inadequate pricing and provisioning assumptions.			●
Market risk	The risk of loss or of adverse change resulting, directly or indirectly, from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments.		●	
Credit risk	The risk of loss or of adverse change in the financial situation, resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors.			●
Liquidity risk	The risk of being unable to realise investments and other assets in order to settle financial obligations when they fall due.	●		
Operational risk	The risk arising from inadequate or failed internal processes, personnel or systems, or from external events.	●		

Policies, processes, procedures and key controls

Our risks are grouped into one of six categories: strategy, insurance, market, credit, operational and liquidity risk. Rothesay Life has developed appropriate processes and documented procedures, appropriate controls and other risk mitigation techniques in order to manage them effectively. The Group policy framework ensures that an appropriate suite of risk management policies is maintained which set out the principles and standards for risk identification, measurement, mitigation, control and monitoring.

Monitoring, reporting and management response

We monitor our risk exposures against risk appetite as well as management actions on a continuous basis to confirm that our risk mitigations are effective. We then report our monitoring to oversight committees and individuals with responsibility for risk management in order to inform business decisions. Monitoring considers both those risks to which the Group is currently exposed, in addition to emerging risks that may impact the Group in the future.

Capability, resources and risk culture

Rothesay Life seeks to attract and retain the highest quality talent in the industry. The effectiveness of our risk management depends upon the high quality of staff employed by Rothesay Life and the strong risk culture and risk management practices. Consequently, training is conducted so that everyone understands their role in how to manage risk effectively and risk management is considered as part of all performance reviews.

Own risk and solvency assessment (ORSA)

The Own Risk and Solvency Assessment is undertaken at least annually and involves an assessment of the risks to which the business is exposed as well as solvency forecasting in a range of scenarios, including consideration of the stresses that could jeopardise the Group's business plans. The ORSA is an important input to the Group's strategic planning cycle.

The Group also runs a number of stress tests on a weekly basis. The stresses have been developed so as to provide coverage over the key risks implicit within the portfolio at the time. Examples of stresses currently applied to the portfolio include issuer default stresses, property stresses, credit spread widening, credit downgrades and market risk stresses on liquidity outflows.

Continuous development

The way we think of and manage risk is constantly evolving. The CRO is responsible for developing the RMF to ensure that risk management remains effective.

Risk management continued

Principal risks and uncertainties facing the Group

The Group's primary risks are credit, insurance, liquidity, and market risk. An overview of these and other risks associated with the business including an outline of how each were mitigated is provided in the table below:

Level 1 risk	Level 2 risks	Description	Mitigation
Credit	Default risk Downgrade risk Concentration risk Migration risk Recovery risk Counterparty risk	The Group's investments include government debt, government guaranteed debt, supranational debt, corporate debt, secured debt and secured loans. Therefore the Group is exposed to varying degrees of credit risk. The Group also enters into longevity reinsurance (unfunded swaps) and over-the-counter (OTC) derivative transactions (credit, interest and inflation swaps) to manage market and insurance risks. The Group is therefore exposed to the credit risk of these counterparties.	The Group's strategy seeks to mitigate credit risk in a number of ways: • Investing in low-risk asset classes such as government guaranteed and other highly-rated bonds. • Investing in asset classes with security and other structural mitigation which protects Rothesay against loss in the event of a borrower default, including over-collateralisation. • Derivative contracts are subject to margining requirements to ensure changes in their fair value are appropriately collateralised. Where there is residual gap risk, the value of each contract is adjusted to reflect their credit riskiness. • Diversification of assets and counterparties. • Purchase of credit protection. • Active monitoring of assets and counterparties including for downgrade risk.
Insurance	Longevity risk Expense risk Demographic risks	The projection of annuity obligations used for pricing and reserving requires a number of actuarial assumptions to be made. Similar to other bulk annuity providers, the performance of the Group's business will primarily depend on the actual experience of mortality rates and longevity improvements. Systemic changes in mortality rates could arise, for example, from a cure for a major disease (e.g. cancer) being found in the near term.	Longevity risk is mitigated through: • Strict underwriting criteria and the use of reinsurance targeting a majority of insured lives. Assumptions used in the projections are determined using historic experience, rating models or reinsurance pricing. Given the nature of the larger bulk annuities that the Group writes, the assumptions used can be derived specifically from the population under consideration. • All reinsurance contracts entered by the Group have been implemented through the use of unfunded longevity swaps where no initial premium outlay is required. 82% of longevity risk was hedged as at 31 December 2017.
Liquidity	Liquidity risk Market function risk	A lack of liquidity within the business may both prevent the Group from being able to pay annuity obligations as amounts fall due, and also may limit the Group's ability to satisfy collateral calls on derivative contracts as they arise.	The Group has a comprehensive liquidity management framework that ensures sufficient liquidity is held to meet collateral outflows as well as projected expenses and other outflows, in extreme market conditions. The Group models conservative instantaneous market shocks on a daily basis to a range of parameters and scenarios, measuring both the impact on asset values and movements in the value of derivatives and required collateral. The Group manages exposure to the ineffective functioning of the market via maintaining conservative liquidity buffers as well as diversification of market counterparties and asset types.

Level 1 risk	Level 2 risks	Description	Mitigation
Market	Interest rate risk Inflation risk Spread risk Exchange rate risk Property risk	The Group acquires market risk through its core activities: • Mismatches in sensitivity of assets and liabilities to the movement of future interest rate expectations. • The Group's annuity payments are linked to published inflation indices (UK RPI, UK CPI) and may be subject to caps and floors which gives rise to inflation rate and inflation volatility exposure. • A proportion of the Group's pension obligations and investment assets are denominated in non GBP currencies. • A proportion of the Group's investments, in particular loans secured on commercial real estate and equity release financing, are exposed to property prices either in the event of the borrower defaulting (in the case of the former) or on death of the borrower (in the case of the latter).	The Group actively hedges market risks. Exposures are constructed by analysing the sensitivity of all assets and liabilities to movements in each of the underlying market risks. • Interest rate, inflation and exchange rate risks are hedged to appropriate tolerances on a continuous basis. • For interest rate risk the Group hedges the IFRS balance sheet under normal conditions, with increasing focus on the Solvency II balance sheet during times of volatility or as solvency deteriorates. • Credit spread risk is managed through active monitoring and management of the asset portfolio as well as index and single name hedges where appropriate. • Property risk is reduced through strict underwriting criteria, covering for example the quality of the underlying real estate and loan-to-value limits by age of borrower for equity release mortgages. The Group also monitors and stresses aggregate property risk exposure.
Operational	General process failure risk Tax and financial reporting risk Business continuity risk Cyber risk Model risk	The Group is exposed to operational risk, which is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. In particular, this includes the failure of key outsourcing arrangements, business disruption, cyber risk, fraud and loss of key management. The Group is reliant on the use of external parties to provide some services, for example policyholder administration, middle and back office services and core risk management systems. The Group is therefore exposed to the potential failure of these outsourcing partners. The Group employs financial models in its day to day activities to inform and manage the business. Material errors in these models could expose the Group to losses and/or reputational damage. A change in regulations relating to taxation or financial reporting could result in the Group paying more taxes or, being sanctioned for its approach to taxation and/or reputational damage.	The Group mitigates operational risk through its RMF and in particular: • The risk and control self-assessment process which ensures that risks are appropriately identified and controlled. • Scenario analysis covering a variety of potential operational risk events. • Regular reporting, monitoring and oversight of operational risk events. • A sub-committee of the WLRC oversees the monitoring of third party suppliers according to a regular review cycle. • Model risk is managed via a model control framework that identifies, validates and monitors models that are material to the Group. • The Group seeks to mitigate cyber risk through robust processes and controls including data protection, penetration testing and staff training. Recognising the importance of Cyber risk management, the Group maintains ISO27001 accreditation. • The Group seeks to mitigate taxation and financial reporting risk by focusing on compliance with relevant tax laws and financial reporting regulations. • The Group will not undertake tax planning that is contrived or artificial and the Group seeks to have an open, fair and proactive relationship with tax authorities at all times.

Risk management continued

Level 1 risk	Level 2 risks	Description	Mitigation
Strategy	Business model risk Customer risk Regulatory risk Reputational risk	A change in the regulatory, legal or political environment may have consequences on the Group's business model, operations and financial performance. The Group is subject to UK regulation, in particular the Group is required to comply with capital adequacy requirements. In addition, the UK's referendum vote to leave the EU means that there is significant uncertainty about the future regulatory framework for UK insurers. Furthermore, the Group's application to use a partial internal model is dependent on regulatory approval. Political and regulatory developments may significantly impact the business and economic environment that the Group operates in. The Group now has over 200,000 individual policyholders and is therefore exposed to conduct risk associated with unfair treatment of customers.	The Group is based in the UK and conducts almost all of its business in the UK. The Group maintains a regular dialogue with regulators in order to ensure compliance, as well as the ability to react quickly to any unanticipated developments. The Group seeks to have an open and transparent relationship with regulators at all times. The Group participates in industry bodies and consultations to ensure its interests are protected for the benefit of policyholders. A sub-committee of the Board oversees Customer and Conduct risk to ensure the Group meets the highest standards. The Group considers that the UK leaving the EU will have no material direct impact on its operations and is currently putting in place plans to ensure that we can continue to pay the pensions of our EU-based policyholders (around 7,000 policyholders). The Group maintains contingency plans for adverse outcomes such as a "Hard Brexit", which includes the second order impact on our investment and derivative portfolio.

Changes in the Group's risk profile and emerging risks

2017 was a less volatile year than 2016 with more benign markets but lower new business volumes for the Group. The Group has deployed assets during the year and increased its asset allocation to corporate bonds, funding of equity release mortgages and commercial real estate loans. The Group has recruited experienced staff and developed its risk management framework to effectively manage these risks.

During the year Rothesay strengthened its recovery and resolution framework through the development of a comprehensive toolkit of actions that may be taken in order to improve solvency or liquidity at times of stress. In addition the Rothesay operating model has been mapped in detail, including the interconnectedness of entities within the Group and the use of external vendors, allowing a robust resolution plan to be put in place in the extremely unlikely event that Rothesay was to enter into solvent run-off in the future.

The Group has identified a number of emerging risks that could impact the business over the longer-term. These principally relate to potential political and regulatory change in the UK, as well as Europe and the US, including the continued uncertain impacts of the UK's decision to leave the EU, and the fiscal impacts of the ongoing political change. Ongoing regulatory change across accounting regulation, derivative markets, asset markets and with respect to the UK's departure from the EU represents another source of emerging risk for the Group.

The Group has navigated these changes well and as a result the risk profile of the Group has not materially changed over the course of the year. The Group has made significant progress in further building its risk management capabilities in order to prepare for future growth and the challenges these emerging risks may bring.

Viability statement

The Board of Directors has assessed the prospects for the Group over a longer period than the 12 months required by the 'Going Concern' provision. In making this assessment the Directors have considered both the current liquidity and solvency position as well as the potential risks, the mitigation of these and the impact these could have on liquidity and solvency.

The Board of Directors conducted this review for a period of five years, which is consistent with the Group's strategic business plan as well as the Group's ORSA. The strategic business plan is centered around the Group's projected new business targets, with assumptions about pricing, reinsurance, revenue generation, expenses and leverage based on the Group's existing business and target operating model. In certain scenarios where there is very material new business growth, the plan also assumes that new equity would be issued. IFRS pre-tax profits are driven by two key sources: new business profitability and profit emergence of the Group's back-book.

The Group's own view of risk and associated capital requirements have been investigated through the ORSA process including considering how future changes to the Group's risk profile and also external influences, may impact on our solvency needs and ability to execute the business plan.

The forward-looking scenarios test the impact of a number of stresses and scenarios that may impact Rothesay's ability to execute the business plan. The ORSA demonstrates the robustness of the Group's solvency and the way in which the business plan would need to be adapted to respond to adverse conditions. Management and the Board believe that the Group is well capitalised on both a regulatory and economic capital basis.

Based on the results of this analysis, the Board of Directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities and obligations as they fall due over the five year period of the assessment.

Governance report

The Board of Rothesay Life, together with management, is responsible for ensuring security of our obligations to our policyholders and generating and delivering sustainable shareholder value through the management of the Group's business.

The Governance Report provides an overview of Rothesay Life's approach to governance, including how the Board oversees the business for the benefit of shareholders by promoting long-term, sustainable growth and policyholders through ensuring the risk and capital management processes remain robust.

Governance report

Chairman's Introduction

I was pleased to have been appointed Chairman of the Group following Ray's decision to step down as Chairman. The Group takes corporate governance extremely seriously and my fellow Directors and I are committed to ensuring that robust governance remains a priority as the Group continues to grow.

Naguib Kheraj
Chairman

The Board

A robust Board with an effective committee structure facilitates the governance framework of our Group.

The Board comprises 13 Directors – the Chairman, three shareholder Directors, six Independent Non-Executive Directors and three Executive Directors.

Changes to the Board over 2017 and to the date of this report are summarised in the table below:

1 September 2017	Terry Miller appointed as an Independent Non-Executive Director
1 October 2017	Stan Beckers appointed as an Independent Non-Executive Director
18 December 2017	Following the change of control of the Group, Dermot McDonogh stands down as a shareholder Director
18 December 2017	Ray King stands down as Chairman of the Board and Naguib Kheraj takes up the role. At the same time, Naguib assumes chairmanship of the Nomination and Remuneration Committees and Stan Beckers assumes chairmanship of the Board Risk Committee (subject to PRA approval)
10 January 2018	Glenn Earle stands down

Shareholders

Following the sale by Goldman Sachs of its remaining stake in the Group to the other shareholders, the ultimate shareholders of RHUK are:

- The Blackstone Group L.P. 35.5%
- GIC Private Limited 35.5%
- MassMutual Financial Group 24.9%

The shareholder Non-Executive Directors provide a valuable contribution to the overall performance of the Group.

How the Board operates

The Board is led by the Chairman. This role was held by Ray King during 2017 until 18 December 2017 when Ray stood down as Chairman and Naguib Kheraj was appointed.

Day-to-day management of the Group is led by Addy Loudiadis, the Chief Executive Officer.

The Board is responsible to shareholders, policyholders, the PRA and other stakeholders for the overall performance of the Group. The Board's role is to provide oversight and direction to the senior management team and to ensure that there is an appropriate risk and control framework for the Group.

The Board has a schedule of matters reserved for its consideration and approval including:

- Group strategy and business plans;
- material new investments and new insurance trades;
- acquisitions and disposals;
- the constitution of Board committees;
- capital management policy including dividend policy; and
- other key Group policies.

The Board is supported by the Audit Committee, the Board Risk Committee, the Remuneration Committee and the Nomination Committee. In the following sections of the Governance report, the Chairmen of these committees provide a report on activity in the year.

How the Board spent its time in 2017

The Board met formally six times during 2017 in addition to meeting on at least six other occasions on an ad hoc basis to discuss, amongst other things, material transactions, and the recapitalisation of the Group. The Board spent time ensuring that the contractual arrangements in relation to use of Goldman Sachs' risk management system and IT infrastructure remained appropriate following recapitalisation of the Group.

The Board agenda is set by the Chairman and generally includes:

- an update from the Chief Executive on business performance;
- reports from sub-committee Chairmen;
- an update on the Group's financial performance;
- updates from the risk and compliance functions;
- discussion on material new investments and liability transactions;
- discussion of key initiatives such as development of the partial internal model and the Part VII transfers; and
- board legal and governance update.

The Board held two strategy off-site events during the year outside of the formal Board meeting schedule. These events focused on strategic growth opportunities for the Group over the next few years, particularly in the light of the recapitalisation of the Group.

The Board held four training sessions during the year, focusing on Solvency II, operations, hedging strategy and accounting standards.

The Board spent time in formal meetings as well as two separate sessions discussing the calibration and development of the Group's partial internal model.

Board performance and effectiveness

The Board recognises that the continuous development of Directors is important to the Board's performance and effectiveness. During the year, the following development activities took place:

- one-to-one briefing sessions for Independent Non-Executive Directors on the report and accounts;
- training sessions on the Group's approach to managing market risk, the differences between the various financial and capital regimes under which the Group operates and an update on accounting and regulatory developments; and
- induction training sessions for Stan Beckers and Terry Miller.

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal board effectiveness review during 2017. However as part of Naguib's preparations for taking on the role of Chairman, he interviewed each of the Directors about ways in which effectiveness could be improved and he will implement changes over the course of 2018 accordingly. Changes were made during 2017 in response to the effectiveness review undertaken in 2016 including more time being spent at Board meetings on people development and strategy.

Governance report

Board of Directors

Naguib Kheraj
Chairman and Independent Non-Executive Director

Appointed October 2014

Naguib Kheraj is a Senior Advisor to the Aga Khan Development Network and serves on the Boards of various entities within the Network. Naguib is also Deputy Chairman of Standard Chartered, a member of the investment committee of Wellcome Trust and a member of the finance committee of Oxford University press. Naguib began his career at Salomon Brothers and went on to hold a number of senior positions at leading financial institutions. At Barclays he served as Group Finance Director and Vice-Chairman and in various leadership positions and was CEO of JP Morgan Cazenove.

Antigone (Addy) Loudiadis
Chief Executive Officer

Appointed November 2013

Addy Loudiadis is the founder and Chief Executive Officer of Rothesay Life. Prior to establishing the business in 2007, Addy was a partner of Goldman Sachs and served as the co-head of the Investment Banking Division in Europe. Before moving to Investment Banking, Addy was head of European Fixed Income Sales at Goldman Sachs, having joined in 1994.

Thomas (Tom) Pearce
Managing Director

Appointed August 2013

Tom Pearce is Managing Director and a co-founder of Rothesay Life, responsible for strategy and business development. Prior to the establishment of the Company in 2007, Tom was previously in the European Financing Group at Goldman Sachs responsible for UK Life insurance. Tom joined Goldman Sachs in 2000 in European Fixed Income.

Andrew Stoker
Chief Financial Officer

Appointed December 2014

Andrew Stoker is the Chief Financial Officer of Rothesay Life following his appointment in 2014. At Rothesay Life, Andrew has responsibility for the finance, actuarial and HR functions. Andrew was previously a partner in EY's risk and actuarial practice and prior to that was Chief Actuary at Lucida plc. Andrew has also held roles at PwC, Tillinghast and Legal & General.

Constant (Stan) Beckers
Independent Non-Executive Director

Appointed October 2017

Stan Beckers retired from his role as Chief Executive Officer of NN Investment Partners B.V. in 2017, having previously been Co-Head of Blackrock Solutions at Blackrock Advisors (UK) Limited and, prior to that, had spent six years with Barclays Global Investors Ltd, most recently as Chief Investment Officer of Scientific Active Equity Europe. Stan started his career at BARRA (now MSCI BARRA) where, over a 20 year period, he established and managed its non-US operations. Stan was previously a Non-Executive Director of Robeco N.V. and a Non-Executive Director of Kas Bank N.V.

Richard Berliand
Independent Non-Executive Director

Appointed October 2014

Richard Berliand is Deputy Chairman of the Supervisory board of Deutsche Börse AG and a Board member of its Eurex subsidiaries, Senior Independent Director of Man Group plc and a Board member of Saranac Partners Limited. He is also advisor to the Commodity Futures Trading Commission in Washington. He was previously with JP Morgan for 23 years, most recently as global head of the Cash Equities and Prime Services businesses. Richard is also Chairman of the Customer and Conduct Committee.

Board and Committee membership

- Group Board
- RLP Board
- Audit Committee
- Board Risk Committee
- Remuneration Committee
- Nomination Committee
- Chairman of Committee ☆

Raymond (Ray) King
Independent Non-Executive Director

Appointed April 2014

Ray King is currently a Non-Executive Director and audit chair of Saga plc and is now a Non-Executive Director of Rothesay Life, having stepped down as Chairman in December 2017. Previously he held Non-Executive Directorships at Infinis Energy plc and Friends Provident plc, He also previously been a board member of the Financial Reporting Council, a panel member at the Competition and Markets Authority and a non-executive on the board at the ABI. Ray ended his executive career as Group CEO of Bupa, having previously been Finance Director. Earlier in his career he held senior management roles at Diageo/Guinness plc, Southern Water plc and ICI plc, having qualified as a chartered accountant with PwC.

Therese (Terry) Miller
Independent Non-Executive Director

Appointed September 2017

Terry Miller is a Non-Executive Director and the Senior Independent Director of Galliford Try Plc, a Non-Executive Director of Goldman Sachs International Bank and a Director and Trustee of the Invictus Games Foundation. She was previously General Counsel of The London Organising Committee of the Olympic and Paralympic Games (LOCOG) and a Non-Executive Director of the British Olympic Association. Prior to her LOCOG appointment, she was with Goldman Sachs for 17 years, most recently as International General Counsel.

Charles Pickup
Independent Non-Executive Director

Appointed November 2013

Charles Pickup was previously a partner in the Risk Consulting and Software division of Towers Watson (formerly Tillinghast) and acted as Actuarial Function Holder (AFH) for Lucida plc, Countrywide and Blackrock. Prior to this Charles worked at Commercial Union and Prudential Bache Securities specialising in UK life insurance.

William (Bill) Robertson
Independent Non-Executive Director

Appointed January 2016

Bill Robinson was previously the global life Chief Risk Officer and Global Life Chief Actuary for Zurich Financial Services and also held various senior positions at Aegon. Prior to this, Bill was a partner at Hymans Robertson and Head of actuarial at Scottish Amicable.

Qasim Abbas
Non-Executive Director

Appointed December 2013

Qasim Abbas is a Senior Managing Director with Blackstone's Tactical Opportunities Group. Since joining Blackstone, Qasim has primarily focused on financial institutions across Europe. Prior to joining Blackstone in 2012, Qasim was a portfolio manager with Trafalgar Asset Managers where he was responsible for real estate and mortgage debt instruments.

Timothy (Tim) Corbett
Non-Executive Director

Appointed November 2013

Tim Corbett is Executive Vice President and Chief Investment Officer of Massachusetts Mutual Life Insurance Company. Tim is responsible for MassMutual's overall investment strategy and has oversight of the company's Investment Account. Prior to joining MassMutual in May 2011, Tim had been Chief Investment Officer and head of Pension Fund Management with the State of Connecticut Treasurer's Officer since 2009.

Robin Jarratt
Non-Executive Director

Appointed December 2013

Robin Jarratt is Head of the Global Private Credit group at GIC. Robin has responsibility for all private credit investment by the firm in the US, Europe and Asia. Robin is a member of GIC PE's Management and Investment Committee.

Monitoring robustness

The Audit Committee plays a key role in monitoring the robustness of the Group's systems and controls.

Bill Robertson, Chairman of the Audit Committee

Bill Robertson
Chairman of the Audit Committee

I am pleased to present the Audit Committee's report for the year ended 31 December 2017. I became Chairman of the Committee during 2016.

The Committee is responsible for assisting the Board of Directors in fulfilling its oversight responsibilities for the financial reporting process, the system of internal control, the internal and external audit processes and the Group's process for monitoring compliance with laws and regulations and the business principles. The Committee has unrestricted access to management and external advisors to help discharge its duties. It is satisfied that in 2017 it received adequate, reliable and timely information to perform its responsibilities effectively.

Committee membership and attendance

The Committee has a majority of independent Non-Executive Directors with an appropriate mix of expertise and experience.

The Committee met on six occasions in 2017 at appropriate times in the financial and regulatory reporting audit cycle. The CFO, CRO, Chief Compliance Officer, Chief Operating Officer and representatives of PwC and EY regularly attended committee meetings. Other members of senior management were also invited to attend as appropriate to present reports. During the year the Committee held regular private sessions with EY and PwC without management present.

It is worth noting that a number of Committee members are also members of or regular attendees at the Board Risk Committee. This ensures effective co-ordination across the two committees.

As Chairman of the Committee, I report on matters dealt with at each Committee to the subsequent scheduled Board meeting.

Significant accounting issues considered by the Committee

Issue	Committee's response
Longevity and credit default assumptions used to determine the valuation of insurance liabilities: The inherent uncertainty involved in setting the assumptions used to determine the insurance liabilities for the Group, particularly in relation to longevity and credit defaults, represent the most significant area of judgement due to the potential impact these assumptions have on the financial statements.	The Committee focused on assumptions made in relation to new assets and liabilities and on management's proposed changes to reserving assumptions, particularly in relation to longevity and credit default. Longevity assumptions: The Committee reviewed available data illustrating recent trends in longevity experience in the UK population, the longevity experience on different blocks of business, industry benchmarking data and reinsurer pricing. Credit default assumptions: The Committee reviewed the methodology used to determine credit default assumptions and considered available industry benchmarking data. The Committee recognises that the deduction for counterparty default risk on the assets held by the Group is generally lower than the corresponding credit default deduction on an typical unsecured credit portfolio but feel this is appropriate due to the low probability of default and the expectation of higher recover through collateralisation. The Committee concluded that the assumptions used are appropriate for the determination of the insurance liabilities. As 82% of the longevity risk is reinsured, the Group has visibility over pricing for the majority of its liabilities.
Valuation of investments classified as Level 3 under IFRS 13: The valuation of Level 3 assets is based on either inputs into a valuation model or observable prices for proxy positions. This is inherently complex and requires the use of significant management judgement. Furthermore, the balances are material to the financial statements.	The Committee has reviewed and approved the Group's valuation policy. The Committee also receives and reviews a report from the finance function setting out the way in which all Level 3 assets have been valued and the range of plausible valuations. The Committee has been particularly focused on the valuation of loans secured on equity release mortgages and ground rents. The Committee concluded that there are appropriate controls surrounding the valuation of Level 3 assets and that they are valued appropriately for inclusion in the financial statements.

Committee responsibilities

The Committee's main responsibilities on behalf of the Group are to:

- review the effectiveness of the Group's internal controls;
- monitor and review the effectiveness of the Group's internal audit function in the context of the Group's overall risk management system;
- review the effectiveness of the system for monitoring compliance with laws and regulations;
- review the effectiveness of the system for risk governance and monitoring;
- monitor the integrity of the financial statements of the Group;
- monitor the integrity of the Group's Solvency II reporting, including quantitative reporting templates, the Solvency and Financial Condition report (SFCR) and the Regulatory Supervisory Report (RSR);
- consider and recommend the appointment, re-appointment and removal of external auditors of the Group;
- review the Group's arrangements for its employees to raise concerns about possible wrongdoings; and
- consider and recommend to the Board the assumptions underlying the financial statements.

Audit Committee Report continued

Committee activities during 2017

The work of the Committee during 2017 fell under five main areas: financial statements and accounting policies, internal control, regulatory compliance, oversight of the internal audit function and oversight of the external audit.

Financial statements and accounting policies

The Committee reviewed the Group's financial announcements, the Annual Report and Accounts, the half-year results and the going concern assumptions in relation to the Annual Report and Accounts.

An important focus of the Committee is assisting the Board in ensuring that the Annual Report and Accounts, taken as a whole, are fair, balanced and understandable and provide the information necessary for shareholders to assess the company's position and performance, business model and strategy.

The Committee also reviewed the relevant Solvency II disclosures including the SFCR and the RSR. This included oversight of the Group's use of transitional solvency relief during the year.

The Committee reviewed the key assumptions used in calculating both the long-term insurance liabilities and the MCEV. This included the annuity mortality assumptions, the credit default allowance on the investment portfolio and the prudence requirements around the IFRS assumptions. The table on the previous page provides more detail on significant accounting issues considered by the Committee.

The Committee also reviewed the Group's tax policy and strategy statement.

Internal control

Alongside the Board Risk Committee, the Committee seeks to ensure that the Group operates within a framework of prudent and effective controls.

The Committee is supported in its oversight of the control framework by regular reports from the Internal Audit function (see internal audit section).

Regulatory compliance

The Committee received regular compliance updates, including:

- updates from the Compliance function on the way in which Rothesay Life ensures compliance with relevant laws and regulations, including anti-money laundering and anti-bribery, and on the implications of changes;
- updates on preparations for meeting the new European General Data Protection Regulation (GDPR);
- updates on Solvency II compliance including the operation of the matching adjustment fund and calculation of transitional capital relief;
- an update on the Group's compliance with the Senior Insurance Managers Regime; and
- updates from the Group's Customer & Conduct Committee, which focuses on regulatory conduct and the fair treatment of customers and is chaired by an Independent Non-Executive Director, Richard Berliand.

Internal audit

The Internal Audit function assists the Committee in fulfilling its oversight responsibilities. The Internal Audit Policy sets out the objectives, scope and responsibilities of the Internal Audit function and how it maintains independence from the first and second line management of the Group. The Committee reviews, and approves, the Internal Audit Policy annually.

The Chief Auditor reports directly to the Chairman of the Committee and their remuneration is approved by the Remuneration Committee. The Group operates a co-sourcing approach to internal audit using external advisors to supplement the in-house internal audit team. During 2016, the Group re-tendered these services with the result that EY was appointed. The Committee has reviewed and approved arrangements for overseeing the internal audit function in the absence of the Chief Auditor. The Chairman of the Audit Committee interviewed the new Chief Auditor who will join in May 2018.

The internal audit plan for 2017 was reviewed and approved by the Committee with internal audits being planned and prioritised following a risk-based assessment of the business. The reviews undertaken included:

- audit of operational oversight of loans secured by ground rents;
- audit of the project to transfer administration of the annuities acquired from Zurich and Aegon to Capita;
- audit of asset origination and trading processes;
- audit of the Group's disaster recovery and business continuity processes;
- audit of compliance monitoring processes; and
- audit of market and operational risk management processes.

The Committee received regular reports from Internal Audit on the audits that have been carried out, management's response to findings and progress in addressing identified issues.

During the year, the Committee assessed whether the Internal Audit function was effective and concluded it was. This included the Committee satisfying itself that the Internal Audit function has the access to the appropriate resources.

In November the Committee considered and approved the internal audit plan for 2018.

External audit

The Committee ran a competitive tender process during 2016 and reappointed PwC as its auditors from 2017 year end. Under European Law the external audit contract must be put out for tender again no later than for 2027 year end at which time the Group will not be permitted to re-appoint PwC.

Lee Clarke became the Group's external audit partner from the 2015 year end. Under the new Ethical Standards, Key Audit Partners are required to rotate every 5 years.

During 2017 the Committee performed its annual review of the independence, effectiveness and objectivity of the auditor by evaluating the auditor against a range of criteria.

The Committee has approved an External Auditor Policy (which was reviewed during the year) which aims to:

- preserve the independence and objectivity of the external auditors in performing the statutory audits;
- ensure the effectiveness of the external auditors; and
- avoid any conflict of interest by outlining both the types of services that the external auditors can and cannot undertake and the considerations that should be applied in assessing potential conflicts of interest.

Other assurance services provided in 2017 include assurance in relation to the Group's solvency disclosures, a review of the Group's internal credit rating function and independent validation of the Group's partial internal model. These services are all in compliance with applicable independence rules and the Group felt that the external auditor was best placed to provide these services because of their understanding of the Group.

Committee performance and effectiveness

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal Board Effectiveness Review during 2017. However the Audit Committee has reviewed its terms of reference and considered its effectiveness during the year. It also identified a number of other potential improvements.

The fees paid to PwC for the year ended 31 December 2017 are summarised in the table below:

£'000's	Year ended 31 Dec 2017	Year ended 31 Dec 2016
Audit of the financial statements of the Group and its subsidiaries	616	470
Total audit	**616**	**470**
Audit related assurance services	287	487
Other assurance services	2,361	1,158
Total fees	**3,264**	2,115

Managing risk

The Board Risk Committee is responsible for the operation of the Group's risk management framework.

Stan Beckers, Chairman of the Board Risk Committee (subject to PRA approval)

Stan Beckers
Chairman of the Board Risk Committee

I am pleased to present the Board Risk Committee's report for the year ended 31 December 2017. I took over chairing the Committee at the end of 2017.

The Committee's primary responsibilities are the ongoing monitoring and control of all risks associated with the activities of the Group, within the parameters set by the Board and as set out in the risk and investment policies of the Group. The Committee is also responsible for the oversight of the executive level Working Level Risk Committee (WRLC) and its sub-committees.

Committee responsibilities

The Committee carries out the following duties on behalf of the Board in respect of the Group:

- monitoring the Group's overall risk appetite and tolerance;
- reviewing the Group's risk framework and risk policies, standards and limits within the overall risk appetite and tolerance and recommending such to the Board;
- considering the Group's process for determining risk appetite and tolerance, monitoring compliance with approved risk tolerance levels and policies and the resultant action in respect of policy breaches;
- monitoring and analysing the Group's material risk exposures, including insurance, market, credit, operational, liquidity, reputational economic and regulatory capital risks in the context of the Group's risk methodologies;
- commissioning management's actions to monitor and control risk exposures;
- undertaking the Group's stress-testing and monitoring management's response to such results;

- receiving notification of material breaches of risk limits and approving the proposed remedial action where such cases are escalated to the Board Risk Committee;
- reviewing and approving any new material liability transactions to be executed by the Group which meets the criteria established by the Boards and applicable policies;
- reviewing and approving any new asset transactions that fall outside existing approval limits to be executed by the Group which meets the criteria established by the Boards and applicable policies;
- advising the Board on the risks inherent in strategic transactions and business plans and the impact on the Group's risk appetite and tolerance;
- reviewing the Group's capability to identify and manage new types of risk;
- considering the remit of the Group's risk function and ensuring it has adequate resources and appropriate access to information to enable it to perform its function effectively;
- evaluating whether the Group's risk function has adequate independence;
- reviewing the effectiveness of the risk function and its resourcing upon any significant one off increase in risk exposures or increase in assets under management by 20% or more;
- providing oversight to the risk function and receiving reports from the risk function in relation to solvency II requirements in respect of systems of governance and risk management;
- reviewing periodic updates from the head of compliance;
- monitoring and reviewing reports from the WLRC and CRO; and
- reviewing key assumptions underlying economic capital calculations, individual capital assessments and the risk and solvency assessments and reviewing any major regulatory submissions involving capital.

The Committee is supported in its duties by the WLRC, and its sub-committees, which is responsible for the on-going monitoring and control of all financial risks, insurance risks and operational risks associated with the activities of the Group. The WLRC membership consists of 14 members and is chaired by the CRO.

Committee membership and attendance

The Committee has a majority of Independent Non-Executive Directors with an appropriate mix of expertise and experience.

The Committee met for six scheduled meetings during 2017 in addition to meeting on several other occasions on an ad hoc basis to discuss material transactions.

The Chairman, CEO, Managing Director, CRO, CFO, General Counsel, representatives of EY and other Non-Executive Directors regularly attended committee meetings. Other members of senior management were also invited to attend as appropriate to present reports.

Committee activities during 2017

Risk appetite monitoring

The Committee received regular, detailed reports on key risk exposures and the drivers of risk throughout the Group.

The Committee monitored the Group's exposure against the Group's overall risk appetite.

Risk management and governance

The Committee received regular reports from the WLRC and the CRO. This allowed the Committee to monitor the way in which risk was being managed by the Group. Regular reporting includes:

- compliance with risk limits, including in relation to liquidity;
- stress testing and potential impact of emerging risks;
- market risk exposures;
- operational risk events;
- assessment and monitoring of cyber risk;
- economic capital coverage; and
- the results of the regular risk and control self-assessment.

During 2017 and in line with the recent growth of the Group's balance sheet, the Committee oversaw a continuing increase in the resourcing of the risk management function including the recruitment of a new Chief Actuary who will join in April 2018 and who will also have oversight of insurance risk management. The Committee was also involved in revamping the framework for liquidity risk management and setting of risk appetite.

The Committee reviewed the Group's response to developments in the ground rents markets and continued to monitor the Group's approach to hedging interest rates and inflation.

The Committee also oversaw development of the Group's recovery and resolution plans, as well as monitoring the potential impact of the UK leaving the EU.

New transactions

The Committee considered the implications of the change in the recapitalisation of the Group from a risk management perspective, including the implications of the issuance of subordinated debt by RLP.

The Committee reviewed the Group's asset deployment approach and associated limits, including the increase in the risk limit in relation to equity release mortgages. The Committee approved the Group's increasing exposure to commercial real estate loans and the associated monitoring that is being undertaken.

Solvency II

During 2017, the Committee reviewed a number of risk-related policies, the Group's risk management framework and the Group's ORSA.

The Committee also oversaw the model validation work done in relation to the Group's partial internal model by the risk function and PwC.

Committee performance and effectiveness

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal Board Effectiveness Review during 2017.

The Committee has made a number of improvements during 2017 including having a pre-meeting without management to better focus the time spent in Committee meetings.

Setting remuneration policy

The Remuneration Committee is responsible for ensuring that the Group's remuneration policy appropriately rewards and incentivises management and staff.

Naguib Kheraj, Chairman of the Remuneration Committee

I am pleased to present the Remuneration Committee's report for the year ended 31 December 2017. I became Chairman of the Committee at the end of 2017.

Committee membership and attendance

The Committee is composed solely of Non-Executive Directors with an appropriate mix of expertise and experience. Membership includes representation from the Group's three shareholders in order to ensure that remuneration structures have their support. The Independent Non-Executive Directors form a majority given the Chairman's casting vote.

The Committee met on four occasions in 2017. The CEO, Managing Director, General Counsel, the CFO and the Committee's independent advisor also regularly attended part of committee meetings as appropriate and relevant.

Committee responsibilities

The Committee is responsible for reviewing and making recommendations to the Board regarding the remuneration policy of the Group and for reviewing compliance with the policy in so far as it relates to senior managers and other employees. Within the context of the policy the Committee is specifically responsible for making recommendations for the remuneration packages of the Independent Non-Executive Directors, Executive Directors and other senior managers of the Group. The Committee is further responsible for monitoring the level and structure of remuneration for the wider employees of the Group.

The Group's remuneration policy is intended to:

- promote sound and effective risk management;
- align individuals' incentives with multi-year performance;
- discourage excessive or concentrated risk-taking;
- allow the Group to attract and retain proven talent; and
- align aggregate remuneration with the performance of the Group as a whole and encourage teamwork.

This is achieved by ensuring that variable remuneration is linked to the Group's KPIs adjusted for current and future risks. The CRO provides input to the annual appraisal process and financial metrics are ignored when evaluating the performance of second and third line staff. Remuneration packages combine a base salary, cash bonuses and a long-term share-based incentive plan (the RHUK SIP). The remuneration policy includes provision for part of the cash bonus to be deferred and the RHUK SIP ensures that stock vests and is delivered over several years. Any bonus that has been deferred is capable of a downwards adjustment or forfeiture and the rules of the RHUK SIP have now been amended to ensure that equity awarded in the future can be clawed back even after vesting.

Committee activities during 2017

The Committee reviewed and approved the new management incentive framework designed as part of the recapitalisation of the Group, including the issue of H Shares.

The Committee made recommendations for the remuneration packages of the Chairman and other senior managers of the Group. It also reviewed the recommendations of management in relation to the compensation for employees of the wider Group.

The Committee reviewed the composition of material risk taker population four times this year and their individual performance was discussed in detail at mid-year and year end. The committee had full oversight of all the relevant shareholding changes in relation to the change of control process and any allocation of future shareholdings.

Committee performance and effectiveness

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal Board Effectiveness Review during 2017.

Nominations Committee Report

Appointing new talent

The Nomination Committee is responsible for ensuring that the Group's Board and management team have the appropriate mix of expertise and experience.

Naguib Kheraj, Chairman of the Nomination Committee

I am pleased to present the Nomination Committee's report for the year ended 31 December 2017. I became Chairman of the Committee at the end of 2017.

Committee membership and attendance

The Committee is composed of Non-Executive Directors with an appropriate mix of expertise and experience.

The Committee met on one occasion in 2017 with further approvals being made via email communication. The CEO, Managing Director, HR Director and General Counsel also regularly attended committee meetings.

Committee responsibilities

The Committee is responsible for monitoring the balance of skills, knowledge experience, independence and diversity on the Board, identifying and recommending Board, Board committee and senior management appointments to the Boards of the various Group entities, as appropriate and monitoring succession plans for the Executive Directors and the development plans of senior management within the Group.

The responsibilities of the Committee include reviewing the structure, size and composition of the Board of Directors, identifying and nominating candidates to fill Board vacancies as and when they arise and approving senior management appointments.

Committee activities during 2017

The Committee approved plans to facilitate the continuous development of Directors. The Committee also considered a potential conflict of interest raised by one of the independent Non-Executive Directors.

During 2017, the Committee approved the appointment of two new Independent Non-Executive Directors, Terry Miller and Stan Beckers having undertaken a skills audit evaluating the Directors' skills against the Group's needs to determine where additional skills and experience would be most beneficial.

The Committee oversaw the re-appointment of Charles Pickup as an Independent Non-Executive Director and the appointment of Naguib Kheraj as Chairman of the Group following the decision by Ray King to step down as Chairman. The Committee also oversaw the changes in Committee membership arising from this change and the departure of Glenn Earle and Dermot McDonogh.

Committee performance and effectiveness

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal Board Effectiveness Review during 2017.

Financial statements

Financial statements

Report of the Directors

The Directors present their Annual Report and the audited consolidated financial statements for Rothesay Holdco UK Limited, registered number 08668809, (the Company or RHUK) for the year ended 31 December 2017. Comparative information has been presented for the year ended 31 December 2016.

1. Results

The consolidated results for RHUK and its subsidiaries (the Group) for the year are set out in the consolidated statement of comprehensive income on page 61.

2. Dividends

The Directors have recommended no payment of interim dividends during the year ended 31 December 2017 (2016: £nil). The Directors have recommended no final ordinary dividend in respect of the year ended 31 December 2017 (2016: £nil).

3. Registered office

The financial statements include the financial statements of RHUK and its subsidiaries; Rothesay Pensions Management Limited, Rothesay Life Plc (formerly known as Rothesay Life Limited), Rothesay Assurance Limited (formerly known as MetLife Assurance Limited), LT Mortgage Financing Limited, Rothesay Asset Management UK Limited and Rothesay Asset Management US LLC. The Company and all subsidiary undertakings, with the exception of Rothesay Asset Management US LLC, are registered in the United Kingdom. The registered office and principal place of business for RHUK and its UK subsidiary undertakings is Level 25, The Leadenhall Building, 122 Leadenhall Street, London, EC3V 4AB. The registered office for Rothesay Asset Management US LLC is Corporate Trust Center, 1209 Orange Street, Wilmington, Delaware 19801, New Castle County.

4. Post balance sheet events

On 14 March 2018, Prudential Plc announced the sale of £12bn of its annuity portfolio to Rothesay Life Plc, the largest transaction of its type in the UK and taking the Group's assets under management to £37bn. The transaction is structured initially as a reinsurance contract and covers over 400,000 policyholders who will remain customers of Prudential and continue to be serviced by Prudential until the effective date of a Part VII transfer.

Capital support for the transaction has been provided by the Group's shareholders with £380m of new equity being provided. In addition, the Group has borrowed £500m from a syndicate of third party banks. The new equity and the proceeds from the loan have been injected into RLP as equity.

5. Directors

The Directors of the Company who served throughout the year and to the date of this report, except where noted, were:

Name	Appointed	Resigned
S. Q. Abbas		
C. Beckers	1 October 2017	
R. D. A. Berliand		
M. T. Corbett		
R. A. De Beir Jarratt		
G. P. J. Earle		10 January 2018
N. Kheraj		
R. King		
A. Loudiadis		
D. W. McDonogh		18 December 2017
T. L. Miller	1 September 2017	
T. J. Pearce		
C. D. Pickup		
W. J. Robertson		
A. M. Stoker		

6. Qualifying third party indemnities

The Articles of Association of the Company provide for the Directors and officers of the Company to be indemnified in respect of liabilities incurred as a result of their office. The Company also provides certain protections for Group Directors and senior management against personal financial exposure that they may have incurred in their capacity as such. These include qualifying third party indemnity provisions (as defined under section 234 of the Companies Act 2006) in force for the benefit of the Directors of the Group during the year.

7. Disclosure of information to auditors

In the case of each of the persons who are Directors of the Company at the date when this report was approved:

- so far as each of the Directors is aware, there is no information relevant to the audit of which the Company's auditors are unaware; and
- each of the Directors has taken all the steps that he/she ought to have taken as a Director to make himself/herself aware of any information relevant to the audit and to establish that the Company's auditors are aware of that information.

8. Independent auditors

PricewaterhouseCoopers LLP will continue in office as auditors of the Company pursuant to Section 487(2) of the Companies Act 2006 and paragraph 44 of Schedule 3 to the Companies Act 2006 (Commencement No.3 Consequential Amendment, Transitional Provisions and Savings) Order 2007. Resolutions to reappoint PricewaterhouseCoopers LLP as auditor to the Group and to authorise the Directors to determine their remuneration are proposed.

9. Statement of Directors' responsibilities

The Directors are responsible for preparing the Strategic Report, Report of the Directors and the financial statements in accordance with applicable laws and regulations. Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU. Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that year. In preparing these financial statements, the Directors are required to:

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

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

The Directors are responsible for the maintenance and integrity of the Company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

10. Internal control and risk management systems

The Group has established internal control and risk management systems in relation to the process for preparing consolidated financial statements. The key features of these internal control and risk management systems are:

- The risk function and management conduct checks on internal controls half yearly.
- The Internal Audit function reviews and assesses controls on an ongoing basis.
- Management regularly monitors and considers developments in accounting regulations and best practice in financial reporting and, where appropriate, reflects developments in the consolidated financial statements. The Audit Committee is kept appraised of such developments.
- The Group's results are subject to various levels of review by management.
- The Audit Committee and the Board review the draft consolidated financial statements, Strategic Report and Report of the Directors. The Audit Committee receives reports from management and the external auditors on significant judgements, changes in accounting policies, changes in accounting estimates and other pertinent matters relating to the consolidated financial statements.
- The financial statements are subject to external audit.

11. Date of authorisation of issue

The financial statements were authorised for issue by the Board of Directors on 22 March 2018.

On behalf of the board

A. Loudiadis
Chief Executive Officer

22 March 2018

Independent auditors' report to the members of Rothesay Holdco UK Limited

Report on the audit of the financial statements

Opinion

In our opinion, Rothesay Holdco UK Limited's Group financial statements and Company financial statements (the financial statements):

- give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2017 and of the Group's profit and the Group's and the Company's cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union and, as regards the Company's financial statements, as applied in accordance with the provisions of the Companies Act 2006; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements, included within the Annual Report and Accounts 2017 (the Annual Report), which comprise:

- the consolidated and Company statements of financial position as at 31 December 2017;
- the consolidated statement of comprehensive income for the year then ended;
- the consolidated and Company statements of changes in equity and the statements of cash flows for the year then ended; and
- the notes to the financial statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non–audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the Company.

Other than those disclosed in note 9 to the financial statements, we have provided no non-audit services to the group or the Company in the period from 1 January 2017 to 31 December 2017.

Our audit approach

Overview

- Overall Group materiality: £30 million, which represents 1.7% of IFRS total equity.
- Overall Company materiality: £9.5 million, based on 1% of total assets.

The Group consists of seven legal entities. We performed a full scope audit of the Group's financial statements in accordance with our materiality and risk assessment.

Our risk assessment identified the following key audit matters applicable for the Group:

- Valuation of insurance contract liabilities, specifically:
  - longevity assumptions; and
  - credit default risk assumptions.
- Valuation of investments classified as Level 3 under IFRS 13.

We determined that there were no key audit matters applicable to the Company to communicate in our report.

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements. In particular, we looked at where the Directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. We gained an understanding of the legal and regulatory framework applicable to the Group and the industry in which it operates, and considered the risk of acts by the Group which were contrary to applicable laws and regulations, including fraud. We designed audit procedures to respond to the risk, recognising that the risk of not detecting a material misstatement due to fraud is higher that the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

We focused on laws and regulations that could give rise to a material misstatement in the Group and Company financial statements, including but not limited to, the Companies Act 2006, the Listing Rules, the Prudential Regulation Authority's regulations and the UK tax legislation.

Our tests included, but were not limited to, review of the financial statement disclosures to underlying supporting documentation, review of correspondance with and reports to the regulators, review of correspondence with legal advisors, enquiries of management and review of internal audit reports in so far as they related to the financial statements. There are inherent limitations in the audit procedures described above and the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it.

We did not identify any key audit matters relating to irregularities including fraud. As in all of our audits, we also addressed the risk of management override of internal controls, including testing journals and evaluating whether there was evidence of bias by the Directors that represented a risk of material misstatement due to fraud.

Key audit matters

Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. This is not a complete list of all risks identified by our audit.

Key audit matter	How our audit addressed the key audit matter
Valuation of insurance contract liabilities *Refer to note 1(d) Critical accounting policies and the use of estimates and note 21 Insurance contract liabilities* The inherent uncertainty involved in setting the assumptions used to determine the insurance liabilities represents a significant area of management judgement for which small changes in assumptions can result in material impacts to the valuation of these liabilities. As part of our consideration of the entire set of assumptions we focussed particularly on longevity assumptions and credit assumptions given they are the most significant and complex assumptions.	The work to address the valuation of the insurance contract liabilities included the following procedures: • On a sample basis, agreed the underlying data to source documentation. • Using our actuarial specialist team members, we applied our industry knowledge and experience and we compared the methodology, models and assumptions used against recognised actuarial practices. • Understood and tested the governance process in place to determine the insurance contract liabilities, including testing the associated financial reporting control framework. • We tested the key judgements and controls over the preparation of the manually calculated components of the liability. We focused on the consistency in treatment and methodology period-on-period across life insurance funds, and with reference to recognised actuarial practice. • We used the results of an independent PwC annual benchmarking survey of assumptions to further challenge the assumption setting process by comparing certain assumptions used relative to the Group's industry peers. • Further testing was also conducted on the longevity and credit default assumptions as set out on the next page. **Based on the work performed, we consider the valuation of insurance contract liabilities to be reasonable.**

Independent auditors' report to the members of Rothesay Holdco UK Limited continued

Report on the audit of the financial statements continued

Key audit matter	How our audit addressed the key audit matter
Longevity assumptions Annuitant mortality and specifically longevity improvement continues to be an area of judgement, especially given recent trends in the UK market which suggest for certain populations a slowing in the rate of mortality improvement. Management utilise the Group's own historic experience and available market data in the calculation of the appropriate assumption. For the rate of mortality improvement this includes the latest model and datasets from the Continuous Mortality Investigation (CMI) bureau. Whilst the Group manages the extent of its exposure to longevity risk through reinsurance, we consider the longevity assumptions underpining gross insurance contract liabilities to be a key audit matter, especially given the mono-line nature of Rothesay's insurance business.	**In addition to the procedures above, in respect of the longevity assumptions:** • We understood and tested the governance process in place to determine the methodology and assumptions. • We tested the methodology used by management to derive the assumptions with reference to relevant rules and actuarial guidance and by applying our industry knowledge and experience. • We assessed the results of the internal experience investigations carried out by management for the annuity business to determine whether they provided support for the assumptions used by management. • We assessed the results of the investigations carried out by management to calibrate the CMI rates of mortality improvement to determine whether they provided support for the assumptions used by management. • We compared the mortality assumptions selected by the Group against those used by their peers. **From the evidence obtained, we found the assumptions and methodology to be appropriate.**
Credit default assumptions Rothesay has significant holdings in complex and illiquid investments. The deduction from the valuation rate of interest for counterparty default risk for these assets is judgemental and is generally lower than the corresponding credit default deduction on a typical unsecured credit portfolio. This reflects the Group's view of the security held against the asset class which in itself is an area of judgement.	**In addition to the procedures above, in respect of the credit default assumptions:** • We tested the methodologies used to derive the assumptions with reference to relevant rules and actuarial guidance; and by applying our industry knowledge and experience. • We validated significant assumptions used by management against market observable data (to the extent available and relevant) and our experience of market practices. • We compared the assumptions selected against those adopted by peers using our annual survey of the market (to the extent available). • We tested the default risk assumption movement analysis prepared by management for each asset class based on current market data and developments in the asset portfolio. **From the evidence obtained, we found the assumptions and methodology to be appropriate.**
Valuation of investments classified as Level 3 under IFRS 13 *Refer to note 1(d) Critical accounting policies and the use of estimates and note 16 Fair value* The valuation of investments classified as Level 3 is typically based on either inputs into a valuation model or observable prices for proxy positions. This is inherently complex and requires the use of significant management judgement. Furthermore, the balances are material to the financial statements. This comprises investments in social housing bonds, commercial mortgage loans, ground rents, equity release mortgages and long dated derivatives.	The work to address the valuation of investments included the following procedures: • We understood and validated the design adequacy and operating effectiveness of management's controls, including the monthly price verification process and controls over the accuracy of data inputs. For a sample of investments we: • Reviewed management's valuation methodology, including engaging our valuation experts to assess the reasonableness and appropriateness of the methodology applied; • Understood the valuation models used by management; • Independently revalued a sample of each type of investment; • Tested inputs into the valuation to external sources, where possible. **Based on the work performed and the evidence obtained, we consider the assumptions and methodology used to be appropriate.**

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the Group and the Company, the accounting processes and controls, and the industry in which they operate.

The Group operates substantially out of a single location and includes a single regulated insurance company, Rothesay Life Plc, and the service company, Rothesay Pensions Management Limited. A number of activities are outsourced to third party providers including claims administration, investment administration, payroll and hosting of the information technology infrastructure.

In order to gain appropriate audit evidence we performed a combination of testing the internal controls over financial reporting and testing transactions and balances to supporting evidence. In respect of the outsourced service providers we were able to gain appropriate audit evidence through a combination of evaluating the providers' published assurance reports on internal control, performing our own testing at the administrators and testing controls operated by Group that monitor the procedures carried out by the service providers. This gave us the evidence we needed for our opinion on the Rothesay Holdco UK Limited financial statements as a whole.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Company financial statements
Overall materiality	£30 million.	£9.5 million.
How we determined it	Based on our professional judgement, we determined materiality for the financial statements as a whole of £30 million, which represents 1.7% of IFRS total equity.	1% of total assets.
Rationale for benchmark applied	We consider IFRS total equity to be the most appropriate benchmark as it represents the residual interest that can be ascribed to shareholders after policyholder assets and corresponding liabilities have been accounted for. We compared our materiality against other relevant benchmarks, such as total assets, total revenue and profit before tax to ensure the materiality selected was appropriate for our audit.	We believe that total assets is the primary measure used by the shareholders in assessing the performance of the entity, and is a generally accepted auditing benchmark.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £1.5 million (Group audit) and £0.5 million (Company audit) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern

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

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

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's and Company's ability to continue as a going concern.

Reporting on other information

The other information comprises all of the information in the Annual Report and Accounts 2017 other than the financial statements and our auditors' report thereon. The Directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic Report and Report of the Directors, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Independent auditors' report to the members of Rothesay Holdco UK Limited continued

Report on the audit of the financial statements continued

Based on the responsibilities described above and our work undertaken in the course of the audit, ISAs (UK) require us also to report certain opinions and matters as described below.

Strategic Report and Report of the Directors

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Report of the Directors for the year ended 31 December 2017 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the Group and parent Company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Report of the Directors.

Responsibilities for the financial statements and the audit

Responsibilities of the Directors for the financial statements

As explained more fully in the Statement of Directors' Responsibilities set out on page 55, the Directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The Directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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

Auditors' responsibilities for the audit of the financial statements

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

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Other required reporting

Companies Act 2006 exception reporting

Under the Companies Act 2006 we are required to report to you if, in our opinion:

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

We have no exceptions to report arising from this responsibility.

Appointment

We were appointed by the Directors on 26 February 2007 to audit the financial statements for the period ended 30 November 2007 and subsequent financial periods. The period of total uninterrupted engagement is 11 years, covering the period ended 30 November 2007 to 31 December 2017. There was a competitive tender process conducted by the Audit Committee during 2016 and PwC were reappointed as auditors for the year ended 31 December 2017.

Lee Clarke (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
22 March 2018

- The maintenance and integrity of the Rothesay Life website is the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
- Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Consolidated statement of comprehensive income

For the year ended 31 December 2017

	Note	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Income			
Gross premiums written	3	1,447	6,877
Premiums ceded to reinsurers		(781)	(700)
Net premiums written		666	6,177
Investment return	4	769	2,798
Total revenue		1,435	8,975
Expenses			
Claims and change in insurance contract liabilities	5	(1,149)	(9,248)
Change in the reinsurers' share of insurance contract liabilities and reinsurance recoveries	5	236	756
Net claims and change in insurance contract liabilities	5	(913)	(8,492)
Operating expenses	6	(154)	(112)
Finance costs	7	(56)	(43)
Total operating expenses		(210)	(155)
Profit before tax		312	328
Income tax expense	10	(51)	(66)
Profit for the financial year		261	262

All income and expenses are related to continuing operations.

The consolidated statement of comprehensive income includes all income and expenses for the year. The Company has no items required to be reported in other comprehensive income, therefore a separate comprehensive income statement has not been presented.

Notes 1 – 34 form an integral part of these financial statements.

Financial statements

Consolidated statement of financial position

As at 31 December 2017

	Note	31 December 2017 £m	31 December 2016 £m
Assets			
Property, plant and equipment	14	3	3
Financial investments	15	37,302	38,346
Deferred tax asset	24	1	–
Reinsurance assets	17	168	437
Accrued interest and prepayments	18	312	278
Receivables	19	337	492
Cash and cash equivalents	20	251	152
Total assets		38,374	39,708
Equity and liabilities			
Share capital	26	2	2
Employee benefit trust	27	(20)	(20)
Share premium	27	466	465
Capital contribution reserve	27	5	3
Other reserves	27	1,300	1,035
Total equity		1,753	1,485
Liabilities			
Reinsurance liabilities	17	231	–
Insurance contract liabilities	21	21,741	22,071
Payables and financial liabilities	22	13,965	15,532
Borrowings	23	647	587
Deferred tax liabilities	24	–	2
Accruals and deferred income		37	31
Total equity and liabilities		38,374	39,708

Notes 1 – 34 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 22 March 2018 and signed on its behalf by:

A. Loudiadis
Chief Executive Officer

22 March 2018
Company number 08668809

Consolidated statement of changes in equity

For the year ended 31 December 2017

	Share capital £m	Share premium £m	Capital contribution reserve £m	Profit and loss reserve £m	Reorganisation reserve £m	Employee scheme treasury shares £m	Total equity £m
As at 1 January 2017	2	465	3	903	132	(20)	1,485
Profit for the financial year	–	–	–	261	–	–	261
Share issuance	–	1	–	–	–	–	1
Vesting of stock appreciation plan	–	–	(4)	4	–	–	–
Capital contribution	–	–	6	–	–	–	6
As at 31 December 2017	**2**	**466**	**5**	**1,168**	**132**	**(20)**	**1,753**

For the year ended 31 December 2016

	Share capital £m	Share premium £m	Capital contribution reserve £m	Profit and loss reserve £m	Reorganisation reserve £m	Employee scheme treasury shares £m	Total equity £m
As at 1 January 2016	2	266	5	637	132	–	1,042
Profit for the financial year	–	–	–	262	–	–	262
Share issuance	–	199	–	–	–	–	199
Employee benefit trust	–	–	–	–	–	(20)	(20)
Vesting of stock appreciation plan	–	–	(4)	4	–	–	–
Capital contribution	–	–	2	–	–	–	2
As at 31 December 2016	2	465	3	903	132	(20)	1,485

Financial statements

Consolidated cash flow statement

For the year ended 31 December 2017

	Note	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Cash flows from operating activities			
Profit for the financial year		261	262
Adjustments for non cash movements in net profit for the year			
Depreciation	14	1	1
Share based payments	11	5	3
Interest income	4	(645)	(530)
Interest expense	7	56	43
Income tax expense	10	54	67
Deferred tax credit	10	(3)	(1)
Net decrease/(increase) in operational assets			
Financial investments		1,043	(13,754)
Reinsurance asset		269	(163)
Receivables		155	(133)
Accrued interest and prepayment		5	–
Net (decrease)/increase in operational liabilities			
Insurance contract liabilities		(330)	7,863
Claims outstanding		1	1
Reinsurance liabilities		231	–
Financial liabilities		(1,387)	5,154
Other payables		(172)	500
Accruals and deferred income		6	5
Net cash flows used in operating activities		(450)	(682)
Interest paid		(58)	(51)
Interest received		609	423
Tax paid		(62)	(72)
Cash flows from operating activities		39	(382)
Cash inflows from financing activities			
Repayment of borrowings	25	(240)	–
Proceeds from issuance of debt	25	300	238
Proceeds from issuance of ordinary share capital	26	1	200
Net cash inflows from financing activities		61	438
Cash outflows from investing activities			
Acquisition of property, plant and equipment	14	(1)	(2)
Net cash outflows from investing activities		(1)	(2)
Net increase in cash and cash equivalents		99	54
Cash and cash equivalent at 1 January		152	98
Cash and cash equivalents at 31 December	20	251	152

Company statement of financial position

As at 31 December 2017

	Note	31 December 2017 £m	31 December 2016 £m
Assets			
Investment in subsidiaries	32	819	814
Accrued interest and prepayments		–	5
Receivables		29	22
Cash and cash equivalents		100	4
Total assets		948	845
Equity			
Share capital	26	2	2
Share premium	27	466	465
Capital contribution reserve		5	–
Retained earnings		461	107
Total equity		934	574
Liabilities			
Other payables		10	33
Borrowings		–	238
Accruals and deferred income		4	–
Total equity and liabilities		948	845

Notes 1 – 34 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 22 March 2018 and signed on its behalf by:

A. Loudiadis
Chief Executive Officer

22 March 2018
Company number 08668809

Financial statements

Company statement of changes in equity

For the year ended 31 December 2017

	Share capital £m	Share premium £m	Capital contribution reserve £m	Profit and loss reserve £m	Total equity £m
As at 1 January 2017	2	465	–	107	574
Loss for the financial year	–	–	–	(16)	(16)
Dividends	–	–	–	370	370
Capital contribution	–	–	5	–	5
Share issuance	–	1	–	–	1
As at 31 December 2017	**2**	**466**	**5**	**461**	**934**

For the year ended 31 December 2016

	Share capital £m	Share premium £m	Profit and loss reserve £m	Total equity £m
As at 1 January 2016	2	266	114	382
Loss for the financial year	–	–	(7)	(7)
Share issuance	–	199	–	199
As at 31 December 2016	2	465	107	574

Company cash flow statement

For the year ended 31 December 2017

	Note	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Cash flows from operating activities			
Loss for the financial year		(16)	(7)
Adjustments for non cash movements in net profit for the year			
Interest expense		10	7
Net (increase)/decrease in operational assets			
Receivables		(6)	(21)
Accrued interest and prepayments		5	–
Net increase in operational liabilities			
Other payables		(21)	21
Accruals and deferred income		4	–
Net cash flows used in operating activities		(24)	–
Interest received		–	–
Interest paid		(10)	(13)
Cash flows from operating activities		(34)	(13)
Cash inflows from financing activities			
Repayment of borrowings	25	(240)	–
Dividends received		370	–
Investment in subsidiaries		–	(430)
Proceeds from issuance of debt		–	238
Proceeds from issuance of ordinary share capital		–	200
Net cash inflows from financing activities		130	8
Net increase/(decrease) in cash and cash equivalents		96	(5)
Cash and cash equivalent at 1 January		4	9
Cash and cash equivalents at 31 December		100	4

Notes to the financial statements

Note 1 – General information and basis of preparation

(a) General information

RHUK is the ultimate holding company of the Rothesay group of companies. RHUK is a registered Limited company incorporated and domiciled in the United Kingdom. The Company's registered office and principal place of business is Level 25, The Leadenhall Building, 122 Leadenhall Street, London, EC3V 4AB.

All accounting policies, where relevant, have been included within the specific note disclosures.

(b) Basis of preparation

The consolidated financial statements of the Group and those of the Company have been prepared and approved by the Directors in accordance with IFRSs as adopted by the EU and those parts of the Companies Act 2006 applicable to those reporting under IFRS. The accounting policies have been applied consistently. The financial statements have been prepared on a going concern basis as disclosed within the Strategic Report.

The consolidated and separate financial statements of the Company are presented in sterling (£) rounded to the nearest million (£m) except where otherwise stated. The separate Company statement of financial position is presented on page 65.

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

Assets and liabilities are offset and the net amount reported in the statement of financial position only when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liability simultaneously. Income and expenses are not offset in the income statement unless required or permitted by IFRS.

(c) Basis of consolidation

The consolidated financial statements comprise the financial statements of the Group as at 31 December each year.

Subsidiaries are fully consolidated from the date of acquisition, being the date on which the Group obtains control, and continue to be consolidated until the date when such control ceases. Assets, liabilities, income and expenses of a subsidiary acquired or disposed of during the year are included in the statement of comprehensive income from the date the Group gains control until the date the Group ceases to control the subsidiary. The financial statements of the subsidiaries are prepared for the same reporting year as the parent company, using consistent accounting policies.

All intra-group balances, transactions, income and expenses and profits and losses resulting from intra-group transactions and dividends, are eliminated in full.

Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if and only if the Group has:

- power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee);
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect its returns.

The Group re-assesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

(d) Critical accounting policies and the use of estimates

During the preparation of the consolidated financial statements the Group selects accounting policies and makes estimates and assumptions that impact on the items reported and their presentation. The Audit Committee reviews the reasonableness of these judgements and assumptions as well as the appropriateness of the accounting policies applied.

Judgements are decisions which management has made using its best estimates of certain amounts. Matters of significant judgement are considered to be:

- the assessment of whether the Group controls underlying entities and investments (see note 13);
- assessment of the significance of insurance risk transferred to the Group in determining whether a contract should be accounted for as an insurance or investment contract (see note 1(e));
- evaluating whether a provision or contingent liability should be recognised (see note 33); and
- calculation and recognition of deferred taxes (see note 24).

Note 1 – General information and basis of preparation continued

In accordance with IAS 1 and published FRC guidance within each of the relevant notes the Group has included the following information:

- the assumptions made and the uncertainties around these;
- how sensitive the assets and liabilities are to these assumptions;
- expected resolution of the uncertainty and the range of possible outcomes for the financial year ending 31 December 2018; and
- explanation of any changes made to past assumptions if the uncertainty is unresolved.

Estimates are based on evidence available at the accounting date and opinions provided by subject matter experts. Actual results may vary from the estimates provided. As new facts become available estimates will be updated. Items considered particularly susceptible to changes in estimates are noted below:

- fair value of financial investments where quoted market prices are not available; and
- measurement of insurance contract liabilities (see note 21).

(e) Contract classification

The Group has classified all of its policyholder contracts as insurance contracts in accordance with IFRS 4 Insurance Contracts. Insurance contracts are contracts which transfer significant insurance risk to the insurer at the inception of the contract.

As permitted by IFRS 4 Insurance Contracts, the liabilities of the Group's insurance contracts are accounted for using generally accepted accounting principles within the UK industry. The Group applies the modified historic statutory solvency basis (MSSB) of reporting as set out in the revised Statement of Recommended Practice (SORP) issued by the Association of British Insurers (ABI) in November 2005 (amended in December 2006). The SORP was withdrawn with effect for accounting periods beginning on or after 1 January 2015 but the Group continues to apply the principles.

(f) Foreign currencies

Transactions denominated in foreign currencies are translated into sterling at rates of exchange ruling on the date the transaction occurred. Monetary assets and liabilities denominated in foreign currencies are translated into sterling at rates of exchange ruling at the financial statement date. Gains and losses on exchange are recognised in operating expenses.

Note 2 – Company loss

The loss for the financial year of the Company was £16m (2016: loss of £7m). As permitted by section 408 of the Companies Act 2006, the Company's statement of comprehensive income has not been included in these financial statements.

Note 3 – Segmental analysis

Segmental information is presented on the same basis as internal financial information used by the Group to evaluate operating performance. An operating segment is a component of the Group that engages in business activities from which it earns revenues and incurs expenses. Minor operating segments are combined to derive the Group's reportable segments in accordance with the requirements of IFRS 8.

The Group writes both single and regular premium business. Single (single payment of premium which covers the life of the policy) and regular premiums (payments of premium made regularly over the duration of the policy) are recognised when they fall due.

All of the Group's business risks and returns are within one business segment (i.e. long-term insurance business). This includes the premiums generated on inwards reinsurance contracts. The Group's operations are materially within the United Kingdom. The split between regular premiums and single premiums is shown below:

	Regular premiums		Single premiums	
	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Group pension bulk annuities	263	267	978	21
Assumed reinsurance premiums	–	–	206	6,589
Total gross premiums written	263	267	1,184	6,610

Single premiums are made up of new business premiums of £1,176m and £8m of premium adjustments.

The Group conducts a relatively small number of individual transactions each year. These transactions are all one-off in nature and the Group's business plans do not anticipate conducting a significant amount of repeat business. Revenue concentration items have not therefore been disclosed.

Notes to the financial statements continued

Note 4 – Investment return

Investment return comprises all interest income on financial investments at fair value through profit and loss, realised investment gains and losses and movements in unrealised gains and losses, as well as expenses directly related to investments executed during the year.

Dividends on money market securities held in collective investment schemes are included as investment income on the date the units are created. Interest is accounted for on an accruals basis.

Realised gains and losses on investments carried at fair value are calculated as the difference between net sales proceeds and purchase price. Movements in unrealised gains and losses on investments represent the difference between the fair value at the statement of financial position date and their cost.

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Interest income on financial investments at fair value through profit and loss	645	530
Unrealised gains on financial investments	14	2,045
Realised gains on financial investments	131	227
Investment expenses	(21)	(4)
Total investment return	**769**	2,798

The Group's total investment return has decreased since 2016, which is primarily due to the large fall in interest rates over 2016 compared to relatively stable interest rates in 2017.

Note 5 – Net claims and change in insurance contract liabilities

Annuity payments are accounted for when they fall due for payment. Surrenders are accounted for when paid or, if earlier, on the date when the policy ceases to be included within the calculation of the insurance contract liabilities. Death claims and all other claims are accounted for when notified.

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Claims paid		
Gross claims paid	(1,479)	(1,384)
Reinsurance recoveries	736	593
Total claims paid	(743)	(791)
Change in insurance contract liabilities		
Gross change in insurance contract liabilities	330	(7,864)
Change in reinsurance recoveries	(500)	163
Total change in insurance contract liabilities	(170)	(7,701)
Net claims and change in insurance contract liabilities	(913)	(8,492)

The change in net insurance liabilities in 2017 was an increase of £170m compared to an increase in net insurance liabilities of £7,701m in 2016. The main drivers of the change in 2017 were new business offset by the run off of the business and the changes in demographic assumptions.

Note 6 – Operating expenses

The costs of acquiring new business are expensed during the financial year in which the premium is earned and the costs incurred.

This note gives further details of items included in the operating expenses section of the consolidated statement of comprehensive income which have been included in arriving at the profit before tax:

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Acquisition costs	85	65
Administration expenses – recurring	21	17
Administration expenses – projects and other one-off expenses	48	30
Total operating expenses	**154**	112

The following items have been included in administration expenses – projects and other one-off expenses:

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Solvency II costs	12	12
Part VII transfers	–	5
Reinsurance fees	19	9
Costs associated with the recapitalisation of the Company	8	–
Other	9	4
	48	30

The following items have been included in operating expenses:

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Depreciation	1	1
Operating lease rental expense for office premises	2	1
	3	2

Note 7 – Finance costs

Finance costs consist of finance costs and interest payable on financial liabilities. Finance costs are accounted for on an accruals basis.

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Interest payable on collateral	3	4
Interest payable on collateralised agreements and financing	17	8
Interest payable on borrowings from participating interest	10	–
Interest payable on third party borrowings	26	26
Interest payable on borrowings from affiliates	–	5
Net finance costs	**56**	43

Debt issuance expenses associated with the issue of subordinated loan notes are recognised over the term of the loan.

As a result of the recapitalisation of the Company, the affiliate was reclassified as a participating interest.

Notes to the financial statements continued

Note 8 – Employee information

	Year ended 31 December 2017 No.	Year ended 31 December 2016 No.
Average number of staff employed during the year	159	120
Employees by department at year end		
Management	9	9
Marketing and pricing	20	16
Investment	40	31
Operations	50	35
Technology	5	6
Finance and legal	34	28
Risk and compliance	21	14
	179	139

Group staff costs during the financial year (including Directors' salaries) are as follows:

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Wages and salaries	43	36
Social security costs	12	4
Other pension costs	1	1
Total employee benefits expense	56	41

The key management personnel who have the authority and responsibility for planning, directing and controlling the activities of the Group include its Directors.

Directors' emoluments in respect of qualifying services to the Group were as follows:

	Year ended 31 December 2017 £000s	Year ended 31 December 2016 £000s
Directors' remuneration		
Aggregate emoluments	5,405	6,232
Company pension contributions to money purchase schemes	55	55
Total Directors' remuneration	5,460	6,287
Highest paid Director		
Total amount of emoluments	2,261	2,664
Company pension contributions to money purchase schemes	13	13
Total highest paid Director	2,274	2,677

In accordance with the Companies Act 2006, Directors' emoluments above represent the proportion of total emoluments paid or payable in respect of qualifying services. This total does not include the value of equity awards in accordance with the provisions of Schedule 5 of SI 2008/410.

During 2017 Directors received no emoluments for non-qualifying services which are required to be disclosed. Four Directors have been granted shares in respect of long term incentive schemes. No Directors have exercised options during the year.

Note 9 – Auditors' remuneration

Fees paid and payable to the Group's auditors are as follows:

	Year ended 31 December 2017 £000s	Year ended 31 December 2016 £000s
Remuneration receivable by the Company's auditors for the audit of the consolidated and Company financial statements	109	27
Remuneration receivable by the Company's auditors for the audit of the financial statements of the Company's subsidiaries	507	443
Total audit	616	470
Audit related assurance services	287	487
Other assurance services	2,361	1,158
Total fees	3,264	2,115

Audit related assurance services provided in 2017 principally reflect assurance in relation to solvency disclosures and the audit of the Group's MCEV result.

Other assurance services provided in 2017 include a review of the Group's partial internal model. These services are all in compliance with applicable independence rules and were approved by the Audit Committee.

Note 10 – Income tax expense

Income tax assets and liabilities for the current year and prior years are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and laws used to compute the amount are those that are enacted or substantively enacted by the financial statement date. Management uses previous experience and the advice of professional firms when assessing tax risks.

The major components of income tax expense for the years ended 31 December 2017 and 2016 are:

(a) Tax charged in the statement of comprehensive income

Group	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Current income tax:		
UK corporation tax	54	67
Total current income tax	54	67
Deferred tax:		
Origination and reversal of temporary differences	(3)	(1)
Total deferred tax	(3)	(1)
Total expense in the consolidated statement of comprehensive income	51	66

(b) Reconciliation of the total tax charge

The tax expense in the consolidated statement of comprehensive income for the year and the standard rate of corporation tax in the UK of 19.25% (2016: 20%) is reconciled below:

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Profit on ordinary activities before taxation	312	328
Tax calculated at UK standard rate of corporation tax of 19.25% (2016: 20%)	60	65
Permanent differences	1	–
Temporary differences	(10)	1
Total tax expense reported in the consolidated statement of comprehensive income	51	66

Notes to the financial statements continued

Note 11 – Share based payments

The cost of equity-based transactions with employees is measured based on grant-date sale value. Share based employee awards that require future services are amortised over the relevant service period. Expected forfeitures are included in determining share based employee compensation expenses.

The fair value is determined at grant date and expensed on a straight-line basis over the vesting period in profit and loss. At each reporting date the Group revises its estimate of the number of shares that are expected to be issued and recognises the impact of the revision of original estimates.

In the case of shares, the fair value is assumed to be the market price, and the company revises the value each reporting date.

Rothesay Life (Cayman) Limited, a former indirect shareholder of the Group, sponsored a stock incentive plan, the Rothesay Life (Cayman) Limited Stock Appreciation Rights (SARs) plan (the RLSIP), which provides for grants of conditional rights over assets which are equivalent in value to certain equity rights of RHUK.

The former indirect shareholder issued SARs to the Group's employees under the RLSIP, primarily in connection with the partial sale of RHUK by the Goldman Sachs Group Inc. in 2013. SARs were valued based on the sale price at the date of grant. Payment under SARs has been made by Goldman Sachs in Goldman Sachs Group Inc. stock. The SARs vested in four instalments on 31 December 2015, 31 December 2016, 5 September 2017 and 31 December 2017. Delivery of the underlying assets was conditional on the grantees satisfying certain vesting and other requirements outlined in the award agreements.

The activity related to these SARs is set out below:

	31 December 2017 No. of SARs	31 December 2016 No. of SARs
	Future service requirement	Future service requirement
Outstanding at the beginning of the year	35,162	70,323
Vested during the year	(35,162)	(35,161)
Outstanding at the end of the year	–	35,162

Expenses of £1.2m (2016: £3.0m) have been charged to the profit and loss account of the Group during the year in relation to the RLSIP.

During the year ended 31 December 2015, RHUK created a further stock incentive plan, the Long Term Stock Incentive Plan (RHUK SIP) which provided for grants of restricted stock units (RSUs).

The Company issued RSUs to the employees under the RHUK SIP, primarily in connection with year-end compensation. These RSUs vest and deliver as outlined in the applicable RSU agreements. Employee RSU agreements provide that vesting is accelerated in certain circumstances, such as upon retirement, death and extended absence. During 2017 the vesting of some RSUs was accelerated as part of the recapitalisation. Delivery of the underlying shares of common stock is conditional on the grantees satisfying certain vesting and other requirements outlined in the award agreements. All RSUs have a future service requirement. The activity related to these RSUs is set out below:

	31 December 2017 No. of RSUs	31 December 2016 No. of RSUs
	Future service requirement	Future service requirement
Outstanding at the beginning of the year	7,724,559	3,243,291
Forfeited during the year	(26,248)	(28,938)
Vested during the year	(2,013,763)	–
Granted during the year	6,783,780	4,510,206
Outstanding at the end of the year	12,468,328	7,724,559

The fair value of the RSUs granted in relation to the RHUK SIP during the year ended 31 December 2017 was £15.1m (31 December 2016: £9.5m). Expenses of £3.8m (2016: £1.3m) have been charged to profit and loss of the Group during the year in relation to the RHUK SIP.

Note 12 – Pension contributions

The Group operates a defined contribution pension scheme and contributions to the scheme are charged to the statement of comprehensive income as they accrue.

The amount charged for the financial year was £1.4m (2016: £1.2m). The outstanding contributions as at 31 December 2017 were £nil (2016: £0.05m).

Note 13 –Investment in unconsolidated structured entities

The Group has interests in investments which are classified under IFRS as unconsolidated structured entities. A structured entity is an entity that has been designed so that voting or similar rights are not the dominating factor in deciding who controls the entity, such as when voting rights might relate to administrative tasks only and the relevant activities are directed by means of contractual arrangement. Structured entities include those entities that have restricted activities or a narrow and well-defined objective. These structured entities have not been consolidated as the Group does not have the power to affect their returns.

As at 31 December 2017, our total interest in such entities, reflected on the Group's consolidated statement of financial position and classified as financial investments held at fair value through profit or loss, was £4,480m (2016: £4,223m). The recorded fair value represents Rothesay's maximum loss exposure to these unconsolidated structured entities. The £257m increase in the balance was predominantly driven by four new positions in loans secured on property contributing £294m in addition to mark-to-mark movements of £(37m) to existing positions.

Note 14 – Property, plant and equipment

Equipment is stated at cost less accumulated depreciation and accumulated impairment losses. Depreciation is calculated on a straight line basis over the useful life of the following classes of assets:

- *Computer equipment: 3 years.*
- *Furniture and fittings: 5 years.*

	Computer Equipment £m	Furniture and Fittings £m	Total £m
Cost			
As at 1 January 2017	0.3	4.1	4.4
Additions	0.2	0.8	1.0
As at 31 December 2017	**0.5**	**4.9**	**5.4**
Accumulated depreciation			
As at 1 January 2017	0.2	0.9	1.1
Charge for the year	0.1	1.0	1.1
As at 31 December 2017	**0.3**	**1.9**	**2.2**
Net book value			
As at 31 December 2017	**0.2**	**3.0**	**3.2**
As at 31 December 2016	0.1	3.2	3.3

Notes to the financial statements continued

Note 15 – Financial investments

Financial investments are classified, at initial recognition, as financial investments at fair value through profit or loss, with the exception of receivables, cash, and accrued interest which are carried at amortised cost.

Financial investments at fair value through profit and loss

Financial investments at fair value through profit or loss are both financial investments held for trading and financial investments designated upon initial recognition at fair value. Financial investments at fair value through profit or loss are carried in the consolidated statement of financial position at fair value with net changes in fair value presented in investment income. Transaction costs, which are incremental costs that are directly attributable to the acquisition of a financial asset, are expensed. Financial investments include collective investment schemes, government, sub sovereign and agency obligations, derivative assets, corporate bonds and other corporate debt, certificates of deposits, loans secured on property and collateralised agreements and financing.

Derecognition

A financial investment (or, where applicable, a part of a financial investment or part of a group of similar financial investments) is primarily derecognised (i.e. removed from the Group's consolidated statement of financial position) when i) the rights to receive cash flows from the investment have expired; or ii) the Group has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass-through' arrangement; and either (a) the Group has transferred substantially all the risks and rewards of the asset, or (b) the Group has transferred control of the investment.

When the Group has transferred its rights to receive cash flows from an investment or has entered into a pass-through arrangement, it evaluates if and to what extent it has retained the risks and rewards of ownership. When it has neither transferred all of the risks and rewards of the investment nor transferred control of the investment, the Group continues to recognise the transferred investment to the extent of the Group's continuing involvement. In that case, the Group also recognises an associated liability. The transferred investment and the associated liability are measured on a basis that reflects the rights and obligations that the Group has retained. Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Group could be required to repay.

Collateralised agreements and financing

Collateralised agreements (securities purchased under agreements to re-sell and deposits placed as collateral for stock borrowed) and collateralised financing (securities sold under agreements to repurchase and deposits received as collateral for stock loans) are treated as collateralised financing transactions and are carried at fair value through profit and loss under the fair value option. The collateral can be in the form of cash or securities.

Cash collateral is recognised/derecognised when received/paid. Collateral posted by the Group in the form of securities is not derecognised from the consolidated statement of financial position, whilst collateral received in the form of securities is not recognised on the consolidated statement of financial position. If collateral received is subsequently sold, the obligation to return the collateral and the cash received are recognised in the consolidated statement of financial position.

The Group's financial investments are grouped in a single category:

	31 December 2017 £m	31 December 2016 £m
Financial investments carried at fair value through profit and loss	37,302	38,346

This is made up of:

	31 December 2017 £m	31 December 2016 £m
Collective investment schemes	1,028	860
Government, sub sovereign and agency obligations[1]	12,019	12,743
Corporate bonds and other corporate debt[1]	7,019	6,727
Derivative assets	10,735	11,709
Collateralised agreements and financing[2]	2,402	3,049
Loans secured on property[2]	3,938	3,105
Certificates of deposit	161	153
Total financial investments	37,302	38,346

Collective investment schemes represent money market funds with same day liquidity.

1. £2.3bn of investments as at 31 December 2016 which were categorised as corporate bonds and other corporate debt have been reclassified to government, sub sovereign and agency obligations to be consistent with Rothesay's solvency disclosures.
2. £3.1bn of investments, that include loans secured on residential and commercial properties, as at 31 December 2016 which were categorised as collateralised agreements and financing have been separately identified to loans secured on property to reflect the substance of these investments.

Note 16 – Fair value

The fair value of a financial instrument is the amount that would be received on the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, i.e. the exit price. Financial investments are marked to bid prices and financial liabilities are marked to offer prices. Fair value measurements do not include transaction costs. Fair value gains or losses are included in investment income.

The best evidence of fair value is a quoted price in an active market. If listed prices or quotations are not available, fair value is determined by reference to prices for similar instruments, quoted prices or recent transactions in less active markets, or internally developed models that primarily use, as inputs, market based or independently sourced parameters, including but not limited to interest rates, volatilities, equity or debt prices, foreign exchange rates, credit curves and funding rates. The fair value of certain financial investments and financial liabilities require valuation adjustments for counterparty credit quality, funding risk, transfer restrictions, illiquidity and bid/offer inputs.

Financial instruments such as corporate debt securities, covered bonds, government, sub sovereign and agency obligations and certain money market instruments are valued by verifying to quoted prices, recent trading activity for identical or similar instruments, broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. Consideration is given to the nature of the quotations (e.g. indicative or firm) and the relationship of recent market activity to the prices provided from alternative pricing sources. Valuation adjustments are typically made (i) if the cash instrument is subject to regulatory or contractual transfer restrictions and/or (ii) for other premiums and discounts that a market participant would require to arrive at fair value. Valuation adjustments are generally based on market evidence.

Certain financial instruments, including collateralised agreements and financing, have one or more significant valuation inputs that are not observable. Absent evidence to the contrary, these instruments are initially valued at transaction price, which is considered to be the best initial estimate of fair value. When a pricing model is used, the model is adjusted so that the model value of the cash instrument at inception equals the transaction price. Subsequently, the Group uses other methodologies to determine fair value, which vary based on the type of instrument. Valuation inputs and assumptions are changed when corroborated by substantive observable evidence, including values realised on sales.

The Group's derivative contracts consist primarily of over the counter (OTC) derivatives. OTC derivatives are generally valued using market transactions and other market evidence, including market based inputs to models, calibration to market clearing transactions, broker or dealer quotations or other alternative pricing sources with reasonable levels of price transparency. Consideration is given to the nature of the quotations (e.g. indicative or firm) and the relationship of recent market activity to the prices provided from alternative pricing sources.

Where models are used, the selection of a particular model to value an OTC derivative depends on the contractual terms of and specific risks inherent in the instrument, as well as the availability of pricing information in the market. Valuation models require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, loss severity rates and correlations of such inputs. For OTC derivatives that trade in liquid markets, model selection does not involve significant management judgement because outputs of models can be calibrated to market clearing levels.

Certain OTC derivatives are valued using models which utilise inputs that can be observed in the market, as well as unobservable inputs. Unobservable inputs typically include certain correlations as well as credit spreads, that are long dated or derived from trading activity in inactive or less liquid markets. Following the initial valuation of such derivatives, the Group updates the observable inputs to reflect observable market changes. Unobservable inputs are changed when corroborated by evidence such as similar market transactions, third party pricing services and/or broker or dealer quotations or other empirical market data. In circumstances where the Group cannot verify the model value by reference to market transactions, it is possible that a different valuation model could produce a materially different estimate of fair value.

Determination of fair value and fair values hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:

- Level 1: inputs are unadjusted quoted prices in active markets to which the Group had access at the measurement date for identical unrestricted assets and liabilities.
- Level 2: inputs to valuation techniques are observable either directly or indirectly.
- Level 3: one or more inputs to valuation techniques are significant and unobservable.

The fair value of certain debt securities classified as Level 3 instruments is determined using inputs that are not based on observable market data. One of the most significant inputs is liquidity premiums. The valuation model discounts future cash flows using interest rate swap curves in addition to a spread to reflect the associated credit risk and liquidity premiums.

Notes to the financial statements continued

Note 16 – Fair value continued

The following tables show an analysis of financial instruments recorded at fair value by level of the fair value hierarchy for 2017 and 2016:

31 December 2017

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Collective investment schemes	1,028	–	–	1,028
Government, sub sovereign and agency obligations	4,044	7,975	–	12,019
Corporate bonds and other corporate debt	–	6,334	685	7,019
Derivative assets	–	10,735	–	10,735
Collateralised agreements and financing	–	2,402	–	2,402
Loans secured on property	–	–	3,938	3,938
Certificate of deposits	–	161	–	161
Total financial investments at fair value	5,072	27,607	4,623	37,302
Derivative liabilities	–	11,164	1	11,165
Collateralised financing agreements	–	1,405	–	1,405
Total financial liabilities at fair value	–	12,569	1	12,570

31 December 2016

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Collective investment schemes	860	–	–	860
Government, sub sovereign and agency obligations[1]	5,695	7,048	–	12,743
Corporate bonds and other corporate debt[1]	–	6,389	338	6,727
Derivative assets	–	11,709	–	11,709
Collateralised agreements and financing[2]	–	3,049	–	3,049
Loans secured on property[2]		194	2,911	3,105
Certificate of deposits	–	153	–	153
Total financial investments at fair value	6,555	28,542	3,249	38,346
Derivative liabilities	–	12,048	1	12,049
Collateralised financing agreements	–	1,908	–	1,908
Total financial liabilities at fair value	–	13,956	1	13,957

1. £2.3bn of Level 2 investments as at 31 December 2016 which were categorised as corporate bonds and other corporate debt have been reclassified to government, sub sovereign and agency obligations Level 2 to be consistent with Rothesay's solvency disclosures.
2. £3.1bn of investments, that include loans secured on residential and commercial properties, as at 31 December 2016 which were categorised as collateralised agreements and financing have been separately identified as loans secured on property to reflect the substance of these investments.

Approximately 12% (2016: 8%) of the total financial assets recorded at fair value are valued based on estimates and recorded as Level 3 investments. Where estimates are used, these are based on a combination of independent third-party evidence and internally developed models, calibrated to market observable data where possible. While such valuations are sensitive to estimates, it is believed that changing one or more of the assumptions to reasonably possible alternative assumptions would not change the fair value significantly.

Note 16 – Fair value continued

The following table shows a reconciliation of the opening and closing recorded amounts in relation to the Level 3 financial instruments recorded at fair value:

	Corporate Debt £m	Loans secured on property £m	Derivatives £m	Total £m
At 1 January 2017	**338**	**2,911**	**(1)**	**3,248**
Total gains in the statement of comprehensive income:				
Unrealised gains	**26**	**79**	**–**	**105**
Transfer into Level 3	**160**	**197**	**–**	**357**
Transfer out of Level 3	**–**	**–**	**–**	**–**
Purchases/additions	**161**	**751**	**–**	**912**
At 31 December 2017	**685**	**3,938**	**(1)**	**4,622**
At 1 January 2016	182	1,939	(8)	2,113
Total gains in the statement of comprehensive income:				
Unrealised gains	81	403	7	491
Transfer into Level 3	–	338	–	338
Transfer out of Level 3	(38)	–	–	(38)
Purchases/additions	113	231	–	344
At 31 December 2016	338	2,911	(1)	3,248

There have been no transfers between Level 1 and Level 2 during the year.

During the year, the Group transferred certain financial instruments between Level 2 and Level 3 of the fair value hierarchy. The recorded amount of the total assets transferred from Level 2 to Level 3 is £357m (31 December 2016: £338m) and from Level 3 to Level 2 is £nil (31 December 2016: £38m). The reason for the movement is a change in the availability of observable market transactions for the same or similar instruments.

Sensitivity of Level 3 financial investments measured at fair value to changes in key assumptions

The following table shows the impact on the fair value (FV) of Level 3 instruments of using reasonably possible alternative assumptions by class of instrument. Since part of any spread movement is likely to be included in the derivation of the valuation rate of interest, changes in fair value of assets also impact liabilities. The table below also shows the potential impact on profit before tax (PBT) of the same alternative assumptions assuming that all other pricing inputs remain constant:

			2017		
Impact on financial assets, liabilities and PBT	Main assumptions	Sensitivity	Current FV £m	(Decrease)/ Increase in FV £m	(Decrease)/ Increase in PBT £m
Financial assets					
Corporate bonds and other corporate debt	Discount rate	+50bps interest rate	**685**	**(34)**	**(11)**
		-50bps interest rate	**685**	**38**	**12**
Loans secured on property	Discount rate	+25bps interest rate	**3,938**	**(220)**	**(21)**
		-25bps interest rate	**3,938**	**242**	**23**
Loans secured on property	House price	+10% change in house price	**3,938**	**5**	**5**
		-10% change in house price	**3,938**	**(3)**	**(3)**
Derivative assets	Expected defaults	+50bps credit default spread	**–**	**–**	**–**
		-50bps credit default spread	**–**	**–**	**–**
Financial liabilities					
Derivative liabilities	Expected defaults	+50bps credit default spread	**1**	**1**	**1**
		-50bps credit default spread	**1**	**(1)**	**(1)**

Notes to the financial statements continued

Note 16 – Fair value continued

Impact on financial assets, liabilities and PBT	Main assumptions	Sensitivity	2016 Current FV £m	(Decrease)/ Increase in FV £m	(Decrease)/ Increase in PBT £m
Financial assets					
Corporate bonds and other corporate debt	Discount rate	+50bps interest rate	338	(33)	(9)
		-50bps interest rate	338	36	10
Loans secured on property	Discount rate	+25bps interest rate	2,911	(192)	(17)
		-25bps interest rate	2,911	213	19
Loans secured on property	House price	+10% change in house price	–	–	–
		-10% change in house price	–	–	–
Derivative assets	Expected defaults	+50bps credit default spread	–	–	–
		-50bps credit default spread	–	–	–
Financial liabilities					
Derivative liabilities	Expected defaults	+50bps credit default spread	(1)	1	1
		-50bps credit default spread	(1)	(1)	(1)

Note 17 – Reinsurance assets/liabilities

Long term business is ceded to reinsurers under contracts to transfer part of the insurance risk associated with the underlying insurance contracts. Such contracts are accounted for as insurance contracts provided the risk transfer is significant.

The amounts that will be recoverable from reinsurers are estimated based upon the gross provisions, having due regard to collectability. The recoverability of reinsurance recoveries is assessed having regard to market data on the financial strength of the reinsurance company. The reinsurers' share of claims incurred in the profit and loss account reflects the amounts received or receivable from reinsurers in respect of claims paid or incurred during the year. Reinsurance liabilities are primarily premiums payable for reinsurance contracts and are recognised in the consolidated statement of comprehensive income as 'Premiums ceded to reinsurers' when due.

Collateral received on reinsurance assets is accounted for in line with collateral received on financial investments.

Reinsurance assets are reviewed for impairment at each reporting date, or more frequently when an indication of impairment arises during the financial reporting year. Impairment occurs when there is objective evidence as a result of an event that occurred after initial recognition of the reinsurance asset that the Group may not receive all outstanding amounts due under the terms of the contract and the event has a reliably measurable impact on the amounts that the Group will receive from the reinsurer. Any impairment loss is recorded in the consolidated statement of comprehensive income.

The reinsurers' share of the insurance contract liabilities is as follows:

	31 December 2017 £m	31 December 2016 £m
Reinsurance assets	168	437
Reinsurance liabilities	(231)	–
Total reinsurance of insurance contract liabilities	(63)	437

Under the outward reinsurance contracts, the Group has committed to pay fixed cash flows to the reinsurer for each policy covered. In exchange, the reinsurers will pay cash flows that are linked to the actual longevity of the underlying policies. The contracts are generally collateralised for changes in longevity expectations and movements in market rates. Where a contract is collateralised no additional reserves are held as the expected loss on default would be expected to be covered by the collateral. For the contracts where no collateral is held an additional counterparty default allowance is held to reflect the risk of loss on default. The calculation of the allowance considers the probability of default of the counterparty along with the expected level of collateral available to be reclaimed in the event of default.

An analysis of the movement in reinsurance of insurance contract liabilities is included in note 21. Some reinsurance contracts have moved from being reinsurance assets to reinsurance liabilities during the year. This is due to the change in the mortality assumptions detailed in note 21. Reinsurance contracts are valued as the net position comparing the discount value of a fixed leg being paid to a floating leg moving with expected prudent mortality being received. As the mortality assumptions have been adjusted such that the underlying lives are not expected to live as long, the floating leg being received has become less valuable. This effects all contracts including those that have remained as reinsurance assets.

At 31 December 2017 and 31 December 2016, the Group conducted an impairment review of the reinsurance assets and found no impairment necessary.

Note 18 – Accrued interest and prepayments

	31 December 2017 £m	31 December 2016 £m
Accrued interest	244	209
Prepaid expenses	68	69
Total accrued interest and prepayments	**312**	278

Note 19 – Receivables

	31 December 2017 £m	31 December 2016 £m
Deposits pledged as collateral to third parties	286	491
Other receivables	51	1
Total receivables	**337**	492

All receivables are due within one year. The fair value of receivables is £337m (2016: £492m).

The net exposure to certain OTC derivatives is collateralised through cash posted, as per the terms of the OTC contracts. At 31 December 2017, the total cash collateral posted was £286m (2016: £491m). Further details of the full extent of collateral usage can be found in the credit risk disclosure in note 29.

Note 20 – Cash and cash equivalents

The cash at bank and in hand of the Group at the year end is as follows:

	31 December 2017 £m	31 December 2016 £m
Cash at bank and in hand	251	152
Total cash and cash equivalents	**251**	152

Note 21 – Insurance contract liabilities

Insurance contract liabilities are determined by the Group's actuaries using methods and assumptions recommended by the actuarial function of Rothesay Life Plc (RLP) and approved by the Board, and using recognised actuarial methods with due regard to the actuarial principles laid down in Directive 2002/83/EC. They are calculated using the historic statutory solvency basis required to comply with the reporting requirements under the Financial Services and Markets Act 2000 and in accordance with the SORP on Accounting for Insurance Business issued by the ABI in December 2005 and revised in December 2006. The SORP has been withdrawn with effect for accounting periods beginning on or after 1 January 2015 but the Group continues to apply the principles. The Group seeks to make prudent assumptions relating to expected future experience based on current market conditions and recent experience. The assumptions used incorporate prudent margins to reflect the inherent uncertainty that actual experience may be less favourable than our best estimate.

Insurance contract liabilities have been determined using the gross premium method of valuation. They are calculated as the discounted value of projected future claim payments (as determined by reference to the contractual arrangements with policyholders at an individual member level) adjusted for future administration costs and investment management expenses determined using prudent assumptions less the present value of future premiums (a schedule of agreed, guaranteed payments) under the longevity swap arrangements. Projected future claim payments allow for the effects of mortality. The administration costs are reflective of recent costs and expenses budgeted for the future.

In accordance with the previous solvency basis, the Group recognises negative mathematical reserves on its regular premium longevity risk transfer arrangements.

Key valuation assumptions

This note details the assumptions with the greatest impact on the Group's insurance contract liability valuations. Note that insurance contract liabilities include reinsurance inwards, i.e. where the Group has reinsured a third party insurer.

Notes to the financial statements continued

Note 21 – Insurance contract liabilities continued

(a) Mortality assumptions

Mortality bases have been determined separately for each insurance contract. The resulting assumptions are equivalent to using the base mortality and improvement assumptions set out in the table below:

	31 December 2017		31 December 2016	
	Pensions originated	Insurance originated	Pensions originated	Insurance originated
Males	96.1% S2PMA	104.3% PMA08	97.5% S2PMA	104.5% PMA08
Females	96.1% S2PFA	104.3% PFA08	97.5% S2PFA	104.5% PFA08

	Mortality improvements	
	31 December 2017	31 December 2016
Males	CMI_2016_M[3.5%; Sκ=7.75]	CMI_2014_M[2.4%]
Females	CMI_2016_F[3.5%; Sκ=7.75]	CMI_2014_F[2.4%]

For pension scheme originated business, ultimate mortality has been used in all cases and mortality improvements are applied assuming mortality rates are as at 2007. For insurance originated business the stated base mortality basis incorporates the effect of selected adjustments for relevant policies and mortality improvements are applied assuming mortality rates are as at 2008.

Recent mortality experience is analysed annually for each pension scheme and insurance originated contracts (individually or grouped). The last review was carried out during 2017. The best estimate base mortality assumptions used in the valuation are based on this actual mortality experience.

For pension scheme originated business mortality assumptions are set with reference to a bespoke suite of mortality tables. These have been expressed for reporting purposes as an equivalent to the CMI S2 series of mortality tables drawn up by the Continuous Mortality Investigation Bureau (CMIB) of the Institute and Faculty of Actuaries. The S2 tables are based on industry-wide experience.

For the blocks of insurance originated annuities bespoke mortality tables and the CMI 08 series of annuitant mortality tables are used to value the liabilities. These have been expressed for reporting purposes as an equivalent to the CMI 08 series tables.

Allowance is made for future improvements in annuitant mortality with reference to statistical analysis of historical rates of mortality improvements, expert judgement of future changes in mortality improvements, industry benchmarking and reinsurance pricing. During 2017 the mortality improvement assumptions were updated to reflect the latest mortality improvement model as released by the CMIB, CMI_2016. This model allows the user to choose the level of smoothing applied to historic mortality improvements (Sκ parameter). A value of Sκ=7.75 has been chosen as a reasonable level of smoothing given recent changes to population level mortality improvements and the inherent uncertainty in mortality improvements by socio economic class. The chosen long term improvement rate assumption varies by age using a bespoke calibration that tapers non-linearly from age 67 to 0% at age 120. These rates have remained unchanged from 2016, although the equivalent single long term rate as applied to the core model has increased.

The base table assumptions for pension scheme business in force throughout the period have been weakened during 2017 following heavier than expected experience over the period analysed.

Prudent margins are then applied to the demographic basis to reflect the fact that future experience for the schemes may differ from that assumed. Prudent margins have been updated in 2017 to better reflect the cost of reinsuring the associated risk. Gross of reinsurance this has led to a modest reduction in reserves of slightly over 1% but on a net basis has not led to a material change due to the changes increasing reserves for areas of the book which are less reinsured. This change has contributed to the overall reduction in the value of the reinsurance contracts, leading to some reinsurance contracts switching from being reinsurance assets to reinsurance liabilities.

(b) Valuation rate of interest

The valuation rate of interest used to discount the cash flows for the purpose of valuing insurance contract liabilities is based on the yield obtainable on the basket of assets matching the applicable insurance contract liabilities at 31 December 2017.

The result is equivalent to using the valuation rate of interest set out in the table below:

	31 December 2017	31 December 2016
Equivalent rate of interest	2.32% pa	2.40% pa

This reflects a 2.5% prudential margin applied to the risk adjusted internal rate of return obtained on the basket of matching assets and an allowance for investment management expenses of 3bps p.a. (31 December 2016: 3bps p.a).

The asset yield used to calculate the valuation rate of interest has been reduced to reflect counterparty default risk; where applicable adjusted for the prudent expected recoveries in the event of default. This reduction in yield is determined separately for each individual asset reflecting the risk to the return being achieved on the asset.

Note 21 – Insurance contract liabilities continued

The table below shows the average yield deduction at 31 December 2017 and 31 December 2016 by asset category:

Asset class	Average yield reduction 2017	2016
UK Government approved securities	0 bps	0 bps
Corporate bonds after allowance for covering credit default swaps	0 bps	0 bps
Secured lending	5 bps	9 bps
Supranational/other sovereign	21 bps	19 bps
Secured residential lending	24 bps	24 bps
Corporate bonds (without covering credit default swaps)	46 bps	52 bps
Infrastructure	73 bps	84 bps
Other	41 bps	47 bps
Overall yield reduction	19 bps	19 bps

Overall, the deduction for counterparty default risk on the assets held by the Group is generally lower than the corresponding credit default deduction on a typical unsecured credit portfolio. This is due to a significant proportion of the portfolio being invested in assets with either a low probability of default due to government guarantees or expectation of higher recovery in the event of default through collateralisation, recourse to specific assets or credit default swap protection.

(c) Expenses

An allowance is made for future overhead maintenance expenses following an investigation into the total costs incurred by the Group during 2017 and the projected 2018 expenses. As part of this investigation, these costs have been split between acquisition and maintenance expenses. The long term business provisions include an allowance to provide for the expenses payable under the Third Party Administration agreements (TPA) together with the long term business overhead expenses expressed as an amount per policy. On average an allowance of £35 per policy per annum (31 December 2016: £32 per policy per annum) is made with additional allowances for short-term project costs and investment management expenses.

Within these expense provisions, an allowance for future expense inflation has been provided to cover the impact of both salary and price inflation. The future rate of expense inflation is assumed to be RPI (as implied by the RPI swap curve) plus an addition at each duration of 0.25% p.a. for all expenses (31 December 2016: 0.25% p.a. or 1.00% p.a depending on the provider).

(d) Other assumptions

An important actuarial assumption relates to the future rate of escalation of certain benefits, but as the Group is holding appropriate matching assets (such as index-linked bonds and inflation-linked swaps with associated caps and floors), the impact on the overall financial position of the Group of actual or assumed changes in these rates is relatively small.

A number of other, less financially significant, actuarial assumptions are made in determining the provisions. These assumptions include, inter alia, the proportion of deferred and immediate annuitants assumed to have a dependant eligible for contingent benefits, dependant's age difference and the proportion of deferred annuitants opting to take a proportion or all of their benefit as a lump sum. For 2017 a modest increase to the assumed number of members surrendering their entire benefit has been made to reflect an increase in the number of members exercising this option. The assumptions are modelled to reflect a proportion of the maximum pension commencement lump sum that a member can choose to take tax free when reaching retirement, along with the probability of the whole pension being converted to a lump sum prior to retirement. The main impact of the assumption is to change the profile of the cash flows assumed to be paid as the value of the lump sums reflect a discount value of the same cash flows as projected using the assumptions to value the liability as an annuity.

When deferred annuitants have passed the scheme normal retirement date and have been subject to an in depth tracing exercises and yet remain untraced, a prudent allowance has been made for the probability of them retiring in the future. All other individuals who have passed the scheme normal retirement date are assumed to retire immediately.

(e) Movement in insurance contract liabilities

	31 December 2017			31 December 2016		
	Insurance liabilities £m	Reinsurance assets/ (liabilities) £m	Net liabilities £m	Insurance liabilities £m	Reinsurance assets £m	Net liabilities £m
Carrying amount at 1 January	22,071	437	21,634	14,207	274	13,933
Increase in respect of new business	1,040	6	1,034	6,503	117	6,386
Release of liabilities	(960)	5	(965)	(1,093)	1	(1,094)
Effect of non-economic assumption changes	(589)	(464)	(125)	(139)	(142)	3
Effect of economic assumption changes	182	(47)	229	2,599	187	2,412
Other	(3)	–	(3)	(6)	–	(6)
Closing Balance at 31 December	21,741	(63)	21,804	22,071	437	21,634

The table above details the change in the gross and net insurance contract liabilities over the year. The table on the next page provides a further split of the net impact of the most significant assumption changes.

Notes to the financial statements continued

Note 21 – Insurance contract liabilities continued

The release of liabilities line reflects claims paid, release of prudent margins and unwind of discounting over the year.

Effect of changes in assumptions and estimates during the year

The following table shows the impact on the insurance contract liabilities, net of reinsurance, of changes in the assumptions used:

Net Increase/ (decrease) in liabilities Change in assumptions used	31 December 2017 £m	31 December 2016 £m
Valuation rate of interest	325	2,114
Inflation	(96)	298
Effect of economic assumption changes	**229**	2,412
Demographics (including member options)	(160)	(46)
Expenses	35	49
Effect of non-economic assumption changes	**(125)**	3
Total change in assumptions used	**104**	2,415

As shown previously the valuation rate of interest decreased by 8bps over the year which led to the £325m increase in the liability shown.

The movement in the demographic assumptions shown reflects the changes to base mortality, mortality improvement, dependants' assumptions and take up of member options applied during the year leading to a £160m decrease in net liabilities.

(f) Sensitivity analysis

The schedule below provides an analysis of the reasonably possible movements in key assumptions that would have a material impact on liabilities (net of reinsurance), profit before tax (PBT) and equity. The analysis is based on a change in a single assumption whilst holding all other assumptions constant. The analysis assumes an instantaneous shock to the assumptions other than for the interest rate sensitivity where the impact of dynamic hedging is allowed for as interest rates change.

31 December 2017	Change in assumptions	(Decrease)/ increase in net liabilities £m	Increase/ (decrease) in PBT £m	Impact on equity £m
Annuitant mortality	+5% qx	(104)	104	84
Annuitant mortality	-5% qx	109	(109)	(88)
Interest rate	+100bps	(2,723)	(25)	(20)
Interest rate	-100bps	3,476	343	277
Inflation	+100bps	1,157	65	52
Inflation	-100bps	(1,110)	85	69
Credit default assumption	+10bps	(114)	(112)	(90)
Credit default assumption	-10bps	117	111	90
Expenses	+10%	66	(66)	(54)

31 December 2016	Change in assumptions	(Decrease)/ increase in net liabilities £m	Increase/ (decrease) in PBT £m	Impact on equity £m
Annuitant mortality	+5% qx	(85)	85	68
Annuitant mortality	-5% qx	88	(88)	(71)
Interest rate	+100bps	(2,685)	32	25
Interest rate	-100bps	3,406	254	203
Inflation	+100bps	1,030	117	94
Inflation	-100bps	(1,026)	51	41
Credit default assumption	+10bps	(102)	(114)	(91)
Credit default assumption	-10bps	108	111	89
Expenses	+10%	58	(58)	(46)

The sensitivities shown capture non-linearity effects, which may be significant following large market movements. The risk management strategy adopted can result in the Group being immunised to market movements in either direction.

The -100bp interest rate sensitivity assumes interest rates fall below zero for the period up to 4 years (31 December 2016: 6 years).

The credit default assumption sensitivity has been calculated assuming a change in the credit spreads on non risk free assets with no associated change in the valuation rate of interest.

Note 21 – Insurance contract liabilities continued

The table below shows the impact of reinsurance on the sensitivity to mortality risk, a reduction of 82% (31 December 2016: 86%).

31 December 2017	Change in Assumptions	(Decrease)/ increase in insurance liability £m	Increase/ (decrease) in reinsurance asset £m	Net (decrease) / Increase in liabilities (net of reinsurance) £m
Annuitant mortality	+5% qx	(578)	474	(104)
Annuitant mortality	-5% qx	619	(510)	109

31 December 2016	Change in Assumptions	(Decrease)/ increase in insurance liability £m	Increase/ (decrease) in reinsurance asset £m	Net (decrease) / Increase in liabilities (net of reinsurance) £m
Annuitant mortality	+5% qx	(577)	493	(85)
Annuitant mortality	-5% qx	618	(530)	88

The annuitant mortality sensitivity is defined in terms of a qx stress where qx represents the probability of a life dying during the year. As such in the annuitant mortality stress it is assumed that in each year 5% more or fewer people survive to the end of each year than had previously been assumed.

(g) Timing of cash flows

The table below shows the discounted insurance liability cash flows, which are expected to arise during each year:

	31 December 2017			
	Less than 1 year £m	1 to 5 years £m	Over 5 years £m	Total £m
Insurance contract liability cash flows	1,048	3,968	16,725	21,741
Reinsurance asset cash flows	17	65	(250)	(168)
Reinsurance liability cash flows	31	127	73	231
	1,096	4,160	16,548	21,804

	31 December 2016			
	Less than 1 year £m	1 to 5 years £m	Over 5 years £m	Total £m
Insurance contract liability cash flows	1,030	3,836	17,205	22,071
Reinsurance asset cash flows	52	198	(687)	(437)
	1,082	4,034	16,518	21,634

Note 22 – Payables and financial liabilities

	31 December 2017 £m	31 December 2016 £m
Derivative financial instruments	11,165	12,049
Collateralised financing agreements	1,405	1,908
Deposits received as collateral from third parties	1,264	921
Deposits received as collateral for derivatives from participating interest	–	547
Current tax payable	38	46
Other taxes and social security costs	7	38
Other payables	86	23
Total payables and financial liabilities	13,965	15,532

Payables and financial liabilities of £2,298m (2016: £2,257m) are all due within one year.

The net exposures to certain OTC derivatives are collateralised through cash. As at 31 December 2017, the total cash collateral received was £1,264m (2016: £1,468m). Other OTC contracts are collateralised with fixed income securities which are not recognised on the consolidated statement of financial position for the Group.

Notes to the financial statements continued

Note 23 – Borrowings

Borrowings are recognised initially at fair value, net of transaction costs incurred. Borrowings are subsequently stated at amortised cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method. Transaction costs are amortised over the period of the borrowings.

The Group's borrowings are as follows:

	31 December 2017 £m	31 December 2016 £m
Third party syndicated loan	–	238
Affiliate subordinated loan	–	100
Subordinated loans from participating interest	398	–
Subordinated loan notes	249	249
Total borrowed	**647**	587

The amounts outstanding at 31 December 2017 include £100m of floating rate perpetual callable loan notes, £249m unsecured subordinated loan notes and £300m of floating rate subordinated loan notes. The Group repaid the £240m three year term loan facility agreement provided by a syndicate of third party banks on 16 May 2017.

The £100m of floating rate perpetual callable loan notes included in subordinated loans from participating interest were callable at par on 21 December 2017 and are callable every 6 months thereafter. They carry deferrable interest at sterling LIBOR plus 425bps per annum. The notes are unsecured and classified as qualifying dated Tier 2 securities for the purpose of the Group's regulatory capital requirements. The notes have been reclassified to subordinated loan notes from a participating interest following the recapitalisation on 18 December 2017. The notes have a carrying value of £100m and a fair value of £95m (31 December 2016: £100m).

The £250m subordinated loan notes mature in 2025 with a fixed 8% coupon paid annually in arrears. The notes are unsecured and classified as qualifying dated Tier 2 securities for the purpose of the Group's regulatory capital requirements. The notes were issued and initially recognised at fair value of £249m being issue proceeds of £250m less capitalised issue costs of £1m.

At 31 December 2017 the notes have a carrying value of £249m (31 December 2016: £249m) which is calculated based on an amortised cost basis, and a fair value of £303m (31 December 2016: £258m), as determined by traded levels. The notes are issued through the public debt markets.

On 19 September 2017 the Group issued £300m of floating rate subordinated loan notes which mature in 2028 with interest at LIBOR plus 595bps paid quarterly in arrears. The notes are callable at par on 19 September 2023 and every year thereafter. The notes are unsecured and classified as qualifying dated Tier 2 securities for the purpose of the Group's regulatory capital requirements. The notes were issued to a participating interest. The notes were issued and initially recognised at fair value of £298m being issue proceeds of £300m less capitalised issue costs of £2m. At 31 December 2017 the notes have a carrying value of £298m and a fair value of £305m.

For the year ended 31 December 2017, an interest expense of £36m (Year ended 31 December 2016: £30m) was recognised in the consolidated statement of comprehensive income in respect of these borrowings.

In March 2017, Rothesay signed a new £300m revolving credit facility with a syndicate of third party banks. The facility can be drawn to provide support but would not impact the Group's solvency position. The facility has not been utilised at the year end.

Note 24 – Deferred tax assets/(liabilities)

Deferred income tax is provided using the liability method on temporary differences at the financial statement date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax and liabilities are recognised for all taxable temporary differences except:

- *When the deferred income tax liability arises from the initial recognition of goodwill or from an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit or loss nor taxable profit or loss; and*
- *In respect of taxable temporary differences associated with investments in subsidiary undertakings, associates and interests in joint ventures, when the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.*

The carrying amount of deferred income tax assets is reviewed at each financial reporting date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilised. Unrecognised deferred income tax assets are reassessed at each financial reporting date and are recognised to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the year when the asset is realised or the liability settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the financial reporting date.

Deferred income tax assets and deferred tax liabilities are offset, if a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred income tax relates to the same taxable entity and the same taxation authority.

Deferred tax balances comprise:

	31 December 2017 £m	31 December 2016 £m
Temporary differences between the financial statements and the tax deductions	1	(2)
Total temporary differences	1	(2)

The movements in the deferred tax balances were as follows:

	2017 £m	2016 £m
At 1 January	(2)	(3)
Recognition of previously unrecognised deferred tax asset	1	–
Timing difference	1	–
Transitional adjustments	–	1
Capital allowances	1	–
At 31 December	1	(2)

Deferred tax assets are only recognised to the extent that based on management's assessment, they are regarded as recoverable.

The Group has unrecognised deferred tax assets in respect of:

	31 December 2017 £m	31 December 2016 £m
Temporary differences in relation to equity based compensation	–	2
Total temporary differences	–	2

The movements in the unrecognised deferred tax balances were as follows:

	31 December 2017 £m	31 December 2016 £m
At 1 January	2	3
Temporary difference in relation to equity based compensation	(2)	(1)
At 31 December	–	2

All temporary differences reversed during the year ended 31 December 2017 following the final vesting of the RLSIP.

Notes to the financial statements continued

Note 25 – Reconciliation of borrowings

The table below provides a reconciliation between opening and closing balances in the statement of financial position for liabilities arising from financing activity:

	31 December 2016 £m	Cash flows £m	Non cash flows £m	31 December 2017 £m
Third party syndicated loan	238	(240)	2	–
Affiliate subordinated loan	100	–	(100)	–
Subordinated loans from participating interest	–	300	98	398
Subordinated loan notes	249	–	–	249
Total borrowings	587	60	–	647

The affiliate subordinated loan has been reclassified to subordinated loans from participating interest following the recapitalisation on 18 December 2017.

Note 26 – Share capital

At 31 December 2017 and 31 December 2016 share capital comprised:

	31 December 2017		31 December 2016	
	No.	£m	No.	£m
Ordinary Share Capital of £1.00 each	–	–	30,001	–
Ordinary Share Capital of £0.001 each	1,034,034,369	1.0	1,034,034,369	1.0
Preference Share Capital of £0.001 each	1,034,034,369	1.0	1,034,034,369	1.0
D Ordinary non-voting Capital of £0.001 each	–	–	–	–
Restricted shares of £0.001 each	70,000,000	0.1	–	–
Authorised share capital	2,138,068,738	2.1	2,068,098,739	2.0

Immediately prior to the acquisition of Goldman Sachs' shareholding by MassMutual, Blackstone and GIC on 18 December 2017, the following changes occurred:

- 147,971,258 A ordinary shares were re-designated as E ordinary shares.
- The coupon on the preference shares was reduced from 12% to 7% per annum. This means that the preference shares are now entitled to a preferential cumulative dividend of an amount equal to 12% per annum between 18 December 2013 and 18 December 2017 and 7% per annum thereafter in each case compounding annually and payable on wind up of the Company. The shares are non-voting but have the right to receive notice of meetings.

On 18 December 2017, the following changes then occurred:

- The 30,001 £1.00 ordinary shares were subdivided into 30,001,000 D ordinary non-voting shares of £0.001 each.
- 18,767,052 B ordinary shares, 76,426,000 C ordinary shares, 25,076,880 E ordinary shares and 36,954,000 F ordinary shares were re-designated as A ordinary shares.
- 875,277 A ordinary shares, 18,500,842 B ordinary shares and 172,692,378 E ordinary shares were re-designated as C ordinary shares.
- 70,000,000 £0.001 restricted H shares were issued and purchased by management for a total cash consideration of £0.2m, at a premium of £0.1m.
- The D ordinary shares of £0.001 were re-classified as deferred shares and then subsequently cancelled.

The restricted H shares are not entitled to participate in dividends but are entitled to receive a proportion of shareholder returns in excess of agreed hurdles in the event of a material change of control. All classes of shares have been fully paid.

Note 26 – Share capital continued

The ordinary shares issued are analysed into the following categories:

	31 December 2017		31 December 2016	
	No.	£m	No.	£m
A £0.001 Ordinary	797,806,397	0.8	789,429,000	0.8
B £0.001 Ordinary	44,159,475	0.1	81,427,369	0.1
C £0.001 Ordinary	192,068,497	0.1	76,426,000	0.1
D £1.00 Ordinary	–	–	30,001	–
E £0.001 Ordinary	–	–	49,798,000	–
F £0.001 Ordinary	–	–	36,954,000	–
Total	1,034,034,369	1.0	1,034,064,370	1.0

The A, B, and C ordinary shares entitle the holder to participate in dividends. All ordinary shares entitle the holder to share in the proceeds of winding up of the Company in proportion to the number of and amounts paid on the shares held. Only the A shares have full voting rights. The other classes of shares have limited voting rights.

The table below provides an analysis of the effective movement in the number of shares:

Number of shares	31 December 2017 No.	31 December 2016 No.
At 1 January	2,068,098,739	1,800,000,001
Ordinary share issuance	–	34,064,369
Preference share issuance	–	234,034,369
Cancellation of D shares	(30,001)	–
Restricted share issuance	70,000,000	–
At 31 December	2,138,068,738	2,068,098,739

Employee benefit trust

On 6 January 2016 the Company established an employee benefit trust, The Rothesay Employee Share Trust (The Trust). The Trust was established to purchase and hold shares of the Company for delivery of employee share schemes. Shares owned by the Trust are included at cost in the consolidated statements of financial position and are shown as a deduction from shareholders equity. They are disclosed as employee scheme shares until they vest.

The table below provides an analysis of the movement in the number of B ordinary shares held by the Trust. Every B ordinary share is stapled to a preference share.

Number of shares	31 December 2017 No.	31 December 2016 No.
At 1 January	13,389,921	–
Shares acquired from employees	242,716	13,389,921
Shares issued to employees as RSUs vest	(849,192)	–
At 31 December	12,783,445	13,389,921

Notes to the financial statements continued

Note 27 – Share premium account and reserve

	Share premium £m	Capital contribution reserve £m	Employee scheme treasury shares £m	Profit and loss reserve £m	Reorganisation reserve £m
At 1 January 2017	**465**	**3**	**(20)**	**903**	**132**
Profit for the financial year	–	–	–	261	–
Share issuance	1	–	–	–	–
Vesting of stock appreciation rights	–	(4)	–	4	–
Capital contribution	–	6	–	–	–
At 31 December 2017	**466**	**5**	**(20)**	**1,168**	**132**

	Share premium £m	Capital contribution reserve £m	Employee scheme treasury shares £m	Profit and loss reserve £m	Reorganisation reserve £m
At 1 January 2016	266	5	–	637	132
Profit for the financial year	–	–	–	262	–
Share issuance	199	–	–	–	–
Vesting of stock appreciation rights	–	(4)	–	4	–
Employee scheme treasury shares	–	–	(20)	–	–
Capital contribution	–	2	–	–	–
At 31 December 2016	465	3	(20)	903	132

The capital contribution reserve arose as a result of the SARs granted in relation to the RLSIP (please see note 11).

Note 28 – Derivatives

The Group uses derivative financial instruments as part of its asset/liability risk management. It enters into derivative contracts to match the insurance contract liabilities arising on the insurance and reinsurance contracts that it issues.

The following table shows the fair value of derivative financial instruments, recorded as assets or liabilities, together with their notional amounts. The notional amount, recorded gross, is the amount of a derivative's underlying assets, reference rate or index and is the basis upon which changes in the value of derivatives are measured. The notional amounts indicate the volume of transactions outstanding at the year end and are indicative of neither the market risk nor the credit risk.

	31 December 2017			31 December 2016		
	Assets £m	Liabilities £m	Notional amount £m	Assets £m	Liabilities £m	Notional amount £m
Derivatives held for risk management:						
Interest rate swap	8,941	(9,260)	127,801	9,891	(10,096)	101,692
Inflation swap	1,591	(1,633)	31,837	1,450	(1,496)	26,762
Currency swap	185	(173)	15,787	334	(379)	16,052
Credit derivative	13	(92)	3,009	23	(65)	3,028
Foreign currency forwards	5	(7)	1,128	11	(13)	633
Total	**10,735**	**(11,165)**	**179,562**	11,709	(12,049)	148,167

Derivatives are used solely for risk management purposes, allowing market risks to be hedged in line with our risk appetite. The notional amount shown reflects the gross notional of derivative contracts. Under IFRS certain restrictions apply in relation to the offset of assets and liabilities. The Group does not consider that it meets these restrictions and therefore presentation is gross. Hence multiple derivative contracts which generate offsetting risk positions inflate the size of the notional amount reported, but do not increase our risk exposure. As such, the notional amount should not be considered as an indicator of the market risk exposure generated by the derivative portfolio.

The Group's exposure under derivative contracts is closely monitored as part of the overall management of the Group's market risk (see also note 29). As of 31 December 2017, the Group had material positions in the following types of derivatives:

Interest rate swaps

Interest rate swaps are contractual agreements between two parties to exchange movements in interest rates. Typically, for an interest rate swap, a floating rate interest stream will be exchanged for a fixed rate or vice versa. The payment flows are usually netted against each other, with the difference being paid by one party to the other.

Note 28 – Derivatives continued

Inflation swaps and options

The Group uses inflation swaps and options to hedge the inflation linked insurance benefits.

Currency swaps

In a currency swap, the Group pays a specified amount in one currency and receives a specified amount in another currency. Currency swaps are mostly gross–settled and are generally used to swap non-sterling cash flows into sterling.

Credit derivatives

The Group uses credit derivatives to hedge counterparty risk on some of its assets in the event of default of corporate or sovereign bonds.

Forwards and futures

Forwards and futures contracts are contractual agreements to buy or sell a specified financial instrument at a specific price and date in the future. Forwards are customised contracts traded in the over-the-counter market. Futures contracts are transacted in standardised amounts on regulated exchanges and are subject to daily cash margin requirements. The main differences in the risk associated with forward and futures contracts are credit risk and liquidity risk. The Group has credit exposure to the counterparties of forward contracts. The credit risk related to future contracts is considered minimal because the cash margin requirements of the exchange help ensure that these contracts are always honoured. Forward contracts are settled gross and are, therefore, considered to bear a higher liquidity risk than the futures contracts which are settled on a net basis. Both types of contracts result in market risk exposure.

Interest rate swaptions

An interest rate swaption is an option contract that gives the buyer the right but not the obligation to enter into an underlying interest rate swap. The swaption buyer pays a premium to the seller at the initiation of the contract.

Note 29 – Financial risk management

The Group is exposed to financial risk through its financial assets, financial liabilities and insurance contract liabilities. These risks, described below, are managed in accordance with risk management policies and procedures established by the Group. Please see page 30 of the Strategic review for further detail on risk management arrangements and the governance framework within the Group.

Market risk

Market risk is the risk of changes in the value of the Group's net position due to changes in market prices. Financial investments are accounted for at fair value and, therefore, fluctuate on a daily basis. Categories of market risk include the following:

- Interest rate risk arises from discounting cash flow mismatches across all future dates. Profits and losses are generated through changes in the level, slope and curvature of interest rate curves. The risk is hedged by matching assets and liabilities and by using interest rate swaps.
- Inflation rate risk results from mismatches in the index linkage of annuities and assets. Profits and losses are generated through changes to the level, slope and curvature of inflation curves. The risk is hedged by matching assets and liabilities and by using inflation swaps.
- Currency rate risk results from mismatches in the denomination of annuities and assets. Profits and losses are generated due to changes in the level of foreign exchange rates. The risk is hedged using spot foreign exchange and cross currency swaps.
- Property risk results from investments that are secured on commercial or residential properties. Profits and losses may be generated by material movements in spot, or forward property prices. This risk is mitigated through strict underwriting criteria, aggregated risk monitoring and low loan to value limits.

The Group manages market risk by diversifying exposures, controlling position sizes through limits and regular stress and scenario testing and establishing economic hedges in related securities, derivatives and insurance liabilities. The Chief Risk Officer (CRO) and the risk function, which is independent of management and reports to the Chief Executive Officer and the Chairman of the Board Risk Committee, has responsibility for ensuring an appropriate framework is in place for assessing, monitoring and managing market risk. Risks are monitored and controlled through strong oversight and independent control and support functions across the business.

Interest rate risk sensitivity analysis

31 December 2017 Change in variables	Impact on PBT £m	Impact on equity Up to a year £m
(+) 1 basis point	(0.24)	(0.20)
(-) 1 basis point	0.24	0.20

Notes to the financial statements continued

Note 29 – Financial risk management continued

31 December 2016 Change in variables	Impact on PBT £m	Impact on equity Up to a year £m
(+) 1 basis point	(0.63)	(0.50)
(-) 1 basis point	0.63	0.50

There was no change in the method used for deriving sensitivity information and significant variables during the year.

Inflation rate risk sensitivity analysis

31 December 2017 Change in variables	Impact on PBT £m	Impact on equity Up to a year £m
(+) 1 basis point	(0.38)	(0.30)
(-) 1 basis point	0.38	0.30

31 December 2016 Change in variables	Impact on PBT £m	Impact on equity Up to a year £m
(+) 1 basis point	0.04	0.03
(-) 1 basis point	(0.04)	(0.03)

Credit risk

Credit risk represents the potential for loss, or solvency deterioration, due to the default or deterioration in credit quality of a counterparty or an investment we hold. Credit risk also arises from cash placed with banks or money market funds, collateralised financing transactions, (i.e. resale and repurchase agreements) and receivables from customers and counterparties.

The Chief Credit Officer, who is independent of 1st line management and reports to the CRO, has responsibility for ensuring an appropriate framework is in place for assessing and monitoring credit risk. All credit exposures are actively monitored by the risk function, including the use of regular sector and position reviews and a number of early warning indicators, resulting in regular reporting to the investment team and key governance bodies such as the Board Risk Committee.

Management is responsible and accountable for managing credit risks within prescribed limits. They have in depth knowledge of the credit positions, underlying models and the instruments available to hedge the credit exposures.

Effective management of credit risk requires disciplined underwriting, accurate and timely information, strong collateral management, a high level of communication and knowledge of customers, countries, industries and products.

Risk mitigants

The Group manages credit risk in its investment portfolio by diversifying exposures across and within sectors, controlling position sizes through limits, and regular monitoring and oversight of investments.

To reduce the credit exposures on derivatives and collateralised agreement transactions, the Group enters into netting agreements with counterparties that permit it to offset receivables and payables with such counterparties that enable it to obtain collateral from them on an upfront or contingent basis and/or terminate transactions if the counterparty's credit rating falls below a specified level.

When the Group does not have sufficient visibility into a counterparty's financial strength or when it believes a counterparty requires support from its parent company, the Group may obtain third party guarantees of the counterparty's obligations. The Group also mitigates its investment and counterparty credit risk using credit derivatives.

Note 29 – Financial risk management continued

Credit exposures

The Group's credit exposures are described further below.

Cash and cash equivalents. Cash and cash equivalents include both interest bearing and non-interest bearing deposits and money market funds. To mitigate the risk of credit loss, the Group diversifies exposure and places its deposits with banks typically assigned minimum ratings in the A rating category and AAA rated money market funds. Cash deposits with banks rated lower than the A category are subject to approval by the Board Risk Committee, in line with Group's liquidity policy.

OTC derivatives. Derivatives are reported at fair value on a gross basis by counterparty in the Group's financial statements unless the Group has current legal rights of set off and also intends to settle on a net basis. OTC derivatives are risk managed using the risk processes, measures and limits described above.

Collateralised agreements. The Group bears credit risk related to sale and repurchase agreements and securities borrowing only to the extent that cash advanced to the counterparty exceeds the value of the collateral received or charges over assets. Therefore, the Group's credit exposure on the transactions is significantly lower than the amounts recorded on the balance sheet (which represents fair value or contractual value before consideration of collateral received). The Group also has credit exposure on repurchase agreements and securities loaned, which are liabilities on its consolidated statement of financial position, to the extent that the collateral pledged for these transactions exceeds the amount of cash received.

Other credit exposures. The Group is exposed to credit risk from its receivables from customers and counterparties. Receivables from counterparties are generally comprised of collateralised receivables related to customer securities transactions and have minimal credit risk due to the value of the collateral received. In addition, the Group invests in assets that are typically highly rated, or assets where there is underlying structural security in the event of a default. These assets include supranationals, sovereign bonds, sub sovereign bonds, covered bonds, higher education bonds, infrastructure assets, unsecured corporate bonds and secured residential lending.

Reinsurance. Long term business is ceded to reinsurers under collateralised contracts to transfer part of the insurance risk associated with the underlying insurance contracts. The amounts that will be recoverable from reinsurers is estimated based upon the gross provisions, having due regard to collectability. The recoverability of reinsurance recoveries is assessed having regard to market data on the financial strength of the reinsurance company.

The following table identifies the amounts covered by enforceable netting arrangements (netting under master netting agreements, cash collateral and security collateral) but do not qualify for netting under IAS32.

	31 December 2017				
		Related amounts not offset			
	Amounts of financial assets presented in the statement of financial position £m	Netting under master netting agreements £m	Cash collateral £m	Security collateral and charges £m	Net credit exposures £m
Property, plant and equipment	3	–	–	–	3
Collective investment schemes	1,028	–	–	–	1,028
Government, sub sovereign and agency obligations	12,019	–	–	–	12,019
Corporate bonds and other corporate debt	7,019	–	–	–	7,019
Derivative assets	10,735	(7,483)	(542)	(2,705)	5
Collateralised agreements and financing	2,402	(244)	(162)	(1,996)	–
Loans secured on property	3,938	–	–	(3,938)	–
Certificate of deposits	161	–	–	–	161
Reinsurance assets	168	–	–	–	168
Deferred tax assets	1	–	–	–	1
Accrued income and prepayments	312	–	–	–	312
Receivables	337	–	–	–	337
Cash and cash equivalents	251	–	–	–	251
Total	38,374	(7,727)	(704)	(8,639)	21,304

Notes to the financial statements continued

Note 29 – Financial risk management continued

	31 December 2016 Related amounts not offset				
	Amounts of financial assets presented in the statement of financial position £m	Netting under master netting agreements £m	Cash collateral £m	Security collateral and charges £m	Net credit exposures £m
Property, plant and equipment	3	–	–	–	3
Collective investment schemes	860	–	–	–	860
Government, sub sovereign and agency obligations[1]	12,743	–	–	–	12,743
Corporate bonds and other corporate debt[1]	6,727	–	–	–	6,727
Derivative assets	11,709	(8,485)	(651)	(2,559)	14
Collateralised agreements and financing[2]	3,049	(496)	(260)	(2,293)	–
Loans secured on property[2]	3,105	–	–	(3,105)	–
Certificate of deposits	153	–	–	–	153
Reinsurance assets	437	–	–	–	437
Accrued income and prepayments	278	–	–	–	278
Receivables	492	–	–	–	492
Cash and cash equivalents	152	–	–	–	152
Total	39,708	(8,981)	(911)	(7,957)	21,859

1. £2.3bn of investments which were categorised as corporate bonds and other corporate debt have been reclassified to government, sub sovereign and agency obligations to be consistent with Rothesay's solvency disclosures.
2. £3.1bn of investments, that include loans secured on residential and commercial properties, as at 31 December 2016 which were categorised as collateralised agreements and financing have been separately identified as loans secured on property to reflect the substance of these investments.

Within the above table derivative liabilities are only included to the extent they net against derivative assets. Therefore, the amount of derivative assets shown after offsetting netting arrangements does not represent our overall derivative exposure. Our overall exposure can be seen in note 28 Derivatives.

Right of offset

The Group has the right of offset for certain financial assets and liabilities.

Netting under master netting agreements of £7,727m (2016: £8,981m) reflects the offsetting of derivative assets with liabilities for which the Group has a right to set off in the event of default. Cash and security collateral have been offset to the extent there are credit exposures on the balance sheet.

The Group has received total security collateral and charges of £9,685m (2016: £9,229m) of which £8,639m (2016: £7,957m) has been applied against net exposure, leaving excess of £1,046m (2016: £1,272m). Security collateral exposes the Group to further market and credit risk. This is mitigated through the use of haircuts and over collateralisation.

Credit default swaps and total return swaps (which contain credit protection) have been purchased to protect the Group from the default of corporate bonds and other investments, or counterparties. The table above does not reflect the protection provided. The Group calls margins, receivable in cash and gilt instruments, against this exposure and other derivative positions.

In a distressed situation the value of collateral may vary depending on credit quality and interest rates. The effectiveness of collateral as a credit risk mitigant will depend on the operational expertise of the collateral manager and the ability to seize, value and sell the collateral in a distressed scenario.

The table on the next page shows the Group's gross and net credit exposure based on external ratings. As at 31 December 2016 the rating used was the lowest of Standard & Poor's, Moody's and Fitch ratings. The approach has been modified for 31 December 2017 to be consistent with our Solvency II approach taking the median of the three ratings. In line with industry standards, Stability Ratings are used to rate the Money Market funds in which the Group invests. £325m (2016: £355m) of the total net credit exposure relates to bonds held within negative basis packages, for which maturity, currency and reference obligation matched credit default swap protection is held.

Net credit exposure is primarily in AAA and AA bonds. AAA assets include supranational bonds, sub sovereigns, covered bonds, US not-for-profit private universities and certificates of deposit. AA assets include gilts. Other net credit exposures rated A and BBB include investments in regulated infrastructure assets and English social housing bonds, which are secured on property assets.

Note 29 – Financial risk management continued

Net credit exposures rated non-investment grade are mitigated by the use of collateral or credit default swap.

As of current and prior year end there were no financial assets past due or impaired.

	31 December 2017 Related amounts not offset				
	Amounts of financial assets presented in the statement of financial position £m	Netting under master netting agreements £m	Cash collateral £m	Security collateral £m	Net credit exposures £m
Exposure to credit risk by rating					
AAA	4,565	–	–	–	4,565
AA	11,466	(342)	–	–	11,124
A	11,109	(6,478)	(525)	(2,003)	2,103
BBB	6,372	(907)	(179)	(2,698)	2,588
BB	81	–	–	–	81
B	44	–	–	–	44
Unrated	4,737	–	–	(3,938)	799
Total	38,374	(7,727)	(704)	(8,639)	21,304

	31 December 2016 Related amounts not offset				
	Amounts of financial assets presented in the statement of financial position £m	Netting under master netting agreements £m	Cash collateral £m	Security collateral £m	Net credit exposures £m
Exposure to credit risk by rating					
AAA	4,157	–	–	–	4,157
AA	12,488	(348)	–	–	12,140
A	13,679	(7,478)	(575)	(2,113)	3,513
BBB	3,075	(1,155)	(336)	(247)	1,337
BB	2,535	–	–	(2,448)	87
B	95	–	–	(44)	51
Unrated	3,679	–	–	(3,105)	574
Total	39,708	(8,981)	(911)	(7,957)	21,859

The unrated financial assets of £4,737m (2016: £3,679m) reflect investments in issuers and issues that are not externally rated. During the year, the Group invested in unrated financial assets which are highly secured and subject to very low credit risk.

For the purpose of Solvency II, unrated assets are internally rated by the Group's independent credit risk function under a framework which has been externally validated. Under this framework 54% of the unrated balance is rated AAA, 11% rated AA, 13% rated A and 10% rated BBB. The remaining 12% relates to financing of equity release mortgages.

Liquidity risk

Liquidity risk arises where timing differences and/or uncertainties occur between cash inflows and cash outflows. The objective of liquidity management is to ensure that the Group is capable of honouring all cash flow commitments on both an on-going basis and in a stressed scenario, without incurring significant cost or business disruption.

The Group liquidity policy is designed to ensure the availability of sufficient funds to meet cash flow requirements on a timely basis via:

- Maintenance of substantial excess liquidity. The Group seeks to enter into long term, illiquid investments that match its liabilities in order to maximise the value of the illiquidity premium. To mitigate residual liquidity risk the Group maintains substantial excess liquidity to meet a broad range of potential cash outflows in a stressed environment including collateral outflows and financing obligations.
- Conservative asset/liability management. The Group seeks to maintain funding sources that are sufficiently long term in order to withstand a prolonged or severe liquidity stressed environment without having to rely on asset sales.

The liquidity management framework is designed to ensure that a prudent level of liquidity is maintained on a spot basis, but also under stressed market conditions at which time liquidity may leave the Group through collateral outflows and ongoing business obligations such as expenses and undrawn investments. A suite of market stresses are considered as part of the liquidity management framework, against which limits are applied by the Board.

Notes to the financial statements continued

Note 29 – Financial risk management continued

The risk function has primary responsibility for ensuring an appropriate framework is in place for assessing, monitoring and managing liquidity risk. Risks are monitored and controlled through strong oversight and independent control and support functions across the business.

Management is responsible and accountable for managing liquidity risks within prescribed limits that are set by the Board and are overseen by the Board Risk Committee.

The following table details the Group's financial liabilities and assets by contractual maturity including interest that was accrued where the Group is entitled to repay the liability before its maturity. Financial assets and liabilities are presented at their fair value (with the exception of receivables, cash, accrued interest and borrowings) as this is consistent with the values used in the liquidity risk management of these instruments. The table excludes insurance liability and reinsurance cash flows which are included in note 21.

	31 December 2017			
	Less than 1 year £m	1 to 5 years £m	Over 5 years £m	Total £m
Financial assets				
Financial investments	1,793	3,829	31,680	37,302
Accrued income and prepayments	301	1	10	312
Receivables	337	–	–	337
Cash and cash equivalents	251	–	–	251
	2,682	3,830	31,690	38,202
Financial liabilities				
Financial liabilities	903	1,173	10,494	12,570
Payables	1,395	–	–	1,395
Borrowings	100	–	547	647
Accruals and deferred income	37	–	–	37
	2,435	1,173	11,041	14,649
Net	247	2,657	20,649	23,553

	31 December 2016			
	Less than 1 year £m	1 to 5 years £m	Over 5 years £m	Total £m
Financial assets				
Financial investments	2,246	3,805	32,295	38,346
Accrued income and prepayments	73	22	183	278
Receivables	492	–	–	492
Cash and cash equivalents	152	–	–	152
	2,963	3,827	32,478	39,268
Financial liabilities				
Financial liabilities	682	1,769	11,506	13,957
Payables	1,575	–	–	1,575
Borrowings	–	238	349	587
Accruals and deferred income	29	2	–	31
	2,286	2,009	11,855	16,150
Net	677	1,818	20,623	23,118

Collateralised agreements

Assets are transferred under repurchase and securities lending agreements with other financial institutions. The nature and carrying amounts of the assets (all carried at fair value) subject to repurchase and securities lending agreements as well as their related liabilities are as follows:

	31 December 2017		31 December 2016	
	Asset £m	Related liability £m	Asset £m	Related liability £m
Government and agency obligations	1,873	1,405	2,347	1,908
Total collateralised agreements	1,873	1,405	2,347	1,908

Note 29 – Financial risk management continued

As the substance of these transactions is secured borrowings and repurchase agreements the asset collateral continues to be recognised in full and the related liability reflecting the Group's obligations to repurchase the transferred assets at a future date is recognised in other liabilities. The Group remains exposed to interest rate risk and credit risk on these pledged instruments. The counterparties recourse is not limited to the transferred assets.

The net exposures to certain OTC derivatives are collateralised through cash. As at 31 December 2017, the total cash collateral received was £1,264m (2016: £1,468m). Other OTC contracts are collateralised with fixed income securities which are not recognised on the balance sheet of the Group.

Note 30 – Capital management

The Group's capital resources are of critical importance. The Group's objectives in managing its capital are:

- to maintain financial strength in adverse conditions;
- to give customers long-term confidence in the Group;
- to satisfy our regulatory obligations;
- to match the profile of our assets and liabilities, taking account of the risk inherent in the business;
- to allocate capital efficiently to support new business growth; and
- to retain financial flexibility by maintaining strong liquidity.

From 1 January 2016, the Group was required to operate under the new Solvency II regime. The Group had sufficient capital available to meet its regulatory capital requirements at all times during the year ended 31 December 2017.

Under the Solvency II regime, the Group is required to hold sufficient assets to meet:

- The Group's technical provisions, being;
  - the liabilities of the Group calculated on a best estimate basis (the BEL); plus
  - the risk margin; less
  - available transitional solvency relief.
- The capital required to meet a 1-in-200-year stress (calculated on a prescribed basis and known as the Solvency Capital requirement or SCR).

Capital in excess of that required to meet the technical provisions is known as Own Funds. As at 31 December 2017, Own Funds for the Group are £2,944m (Own Funds as at 31 December 2016: £2,626m) made up as follows:

	31 December 2017 £m	31 December 2016 (restated) £m
Total IFRS equity	1,753	1,485
Liability valuation differences and other regulatory adjustments	527	780
Total Tier 1	2,280	2,265
Solvency II debt valuation	664	361
Total Tier 2	664	361
Own Funds	2,944	2,626

Note that for the purpose of reporting as at 31 December 2016, allowance was made for the amortisation of 1/16th of transitional solvency relief (being £57m) whereas we are now allowing for amortisation on 1 January 2017 in order that reporting is consistent with the Solvency and Financial Condition Report.

The Group holds both debt and equity to optimise its capital structure and improve shareholder return. During the prior year, £200m of equity was issued by the Group. During 2017, the Group issued £300m of Tier 2 debt.

Notes to the financial statements continued

Note 30 – Capital management continued

The table below provides an analysis of the movement in Own Funds net of tax.

Movement in Own Funds	31 December 2017 £m	31 December 2016 (restated) £m
Opening balance	**2,626**	1,902
Amortisation of 1/16th of transitional on 1 January	**(57)**	–
Opening balance as at 1 January	**2,569**	1,902
New business	**78**	288
Management of in-force book	**100**	232
Acquisition costs and administration expenses	**(88)**	(65)
Demographic experience variance	**(1)**	1
Economic profits	**74**	140
Non recurring expenses	**(40)**	(24)
Finance costs	**(30)**	(36)
Share issuance	**–**	199
Employee based trust	**–**	(20)
Capital contribution	**5**	3
Debt issuance	**300**	–
Other	**(23)**	6
Closing balance as at 31 December	**2,944**	2,626

Allowance for transitional solvency has been re-calculated as at 31 December 2017 as approved by the PRA.

As part of the transitional arrangements in relation to the introduction of Solvency II, the Group is permitted to take credit for transitional solvency relief which amortises to zero over the next 16 years. The results make allowance for the first linear reduction in transitional as applied on 1 January 2017.

The capital position is sensitive to changes in market conditions, due to changes in the value of the assets and the effect that changes in investment conditions may have on the value of the liabilities. The Group seeks to mitigate these risks through the use of derivative hedges and reinsurance. Management monitors market conditions and emerging longevity experience on a regular basis. As these conditions change, management will take remedial action such as adjustment of hedging strategies and redeployment of assets as appropriate.

Note 31 – Related parties disclosures

Ultimate holding companies

The companies with an economic interest in RHUK are:

- The Blackstone Group L.P.: 35.5%
- GIC Private Limited: 35.5%
- MassMutual Financial Group: 24.9%

The remaining percentage is owned by the Directors, management, employees and The Trust (see note 26). Percentages are based on economic interest in RHUK.

During the year ended 31 December 2016 the corporate shareholders existing at that time subscribed for £200m of equity in the Group.

Related party transactions

Prior to the acquisition of Goldman Sachs' shareholding by MassMutual, Blackstone and GIC the Group entered into various transactions with former fellow participating interests all within The Goldman Sachs Group, including Goldman Sachs International, Goldman Sachs and Co, the Goldman Sachs Group Inc., Goldman Sachs Asset Management International and Rothesay Life (Cayman) Limited.

Note 31 – Related parties disclosures continued

Details of such transactions are as follows. Closing balances in respect of these transactions are only shown for 31 December 2016.

	31 December 2017 £m	31 December 2016 £m
Statement of comprehensive income		
Realised/unrealised losses on financial assets and liabilities	(131)	(936)
Income from money market securities held in collective investment schemes	1	2
Interest on collateralised agreements and financing	34	37
Service fee charges	(11)	(4)
Investment management charges	(7)	(8)
Statement of financial position		
Derivative financial assets and liabilities	–	(2,085)
Collateralised agreements and financing	–	935
Collective investments schemes	–	860
Accrued interest	–	9
Amounts payable to related party	–	(547)
Capital		
Ultimate parent company	–	468
Capital contribution	–	3

The nominal value of derivatives contracts outstanding with related parties as at 31 December 2017 was £nil (2016: £35,431m).

During the year the Group entered into various transactions with fellow participating interests which are subject to common control from the same source. The table below includes a transaction with an affiliate that became a related party as a result of the recapitalisation.

	31 December 2017 £m	31 December 2016 £m
Statement of comprehensive income		
Change in the reinsurers' share of insurance contract liabilities and reinsurance recoveries	(1)	–
Finance costs	10	–
Statement of financial position		
Reinsurance liabilities	1	–
Borrowings	398	–
Capital		
Ultimate parent company	282	–

Transactions with key management personnel

Key management personnel comprise the Directors of the Company, Directors of subsidiary undertakings and certain members of senior management.

There are no material transactions between the Group and its key management personnel other than transactions discussed below:

	31 December 2017 £m	31 December 2016 £m
Salaries, bonus and other employee benefits	15	15
Equity based compensation payments	2	1
Total transactions	17	16

On 19 February 2016 members of key management personnel and their families sold £1.00 B ordinary shares to an Employee Benefit Trust set up by Rothesay Holdco UK Limited for consideration of £14m.

On 18 December 2017 members of key management personnel and their families sold stapled £0.001 B ordinary shares and £0.001 preference shares to The Blackstone Group L.P., GIC Private Limited and MassMutual Financial Group for consideration of £60m.

Notes to the financial statements continued

Note 31 – Related parties disclosures continued

The tables below represent transactions between RHUK and its subsidiaries RPML and RLP.

Transactions with RPML

	31 December 2017 £m	31 December 2016 £m
Statement of financial position		
Other receivables	7	1
Capital	5	–

Transactions with RLP

	31 December 2017 £m	31 December 2016 £m
Statement of comprehensive income		
Finance costs	(4)	–
Cost transfer	(3)	–
Statement of financial position		
Other payables	3	30
Capital	814	814
Dividends	370	–

Note 32 – Investments in subsidiaries

Investments in subsidiary undertakings are stated at cost less provision for impairment in the Company's financial statements.

The financial statements include the financial statements of RHUK and the subsidiaries listed in the following table:

Group Undertakings	Country of incorporation	Primary business operation	2017 £m	2016 £m	2017 % equity interest	2016 % equity interest
Rothesay Pensions Management Limited	UK	Service company	5	–	100%	100%
Rothesay Life Plc (formerly known as Rothesay Life Limited)	UK	Life insurance	814	814	100%	100%
Rothesay Assurance Limited (formerly known as MetLife Assurance Limited)	UK	Service company	–	3	100%	100%
LT Mortgage Financing Limited	UK	Service company	–	–	100%	100%
Rothesay Asset Management UK Limited	UK	Service company	–	–	100%	N/A
Rothesay Asset Management US LLC	US	Service company	–	–	100%	N/A

Subsidiaries are held at lower of cost and net realisable value.

The above subsidiary undertakings, with the exception of Rothesay Asset Management US LLC, are registered in the United Kingdom. The registered office and principal place of business for all UK subsidiary undertakings is Level 25, The Leadenhall Building, 122 Leadenhall Street, London, EC3V 4AB.

Rothesay Asset Management US LLC is registered in Delaware, United States of America. The registered office is Corporate Trust Center, 1209 Orange Street, Wilmington, Delaware 19801, New Castle County.

LT Mortgage Financing Limited has remained dormant during 2017. On 3 October 2016 the PRA granted an application to cancel the permissions of Rothesay Assurance Limited. As it is now no longer needed, the Group has begun proceedings to voluntarily liquidate Rothesay Assurance Limited.

Note 33 – Financial commitments and contingencies

Operating lease commitment

A lease is classified as an operating lease if it does not transfer substantially all the risk and rewards incidental to ownership.

Payments made under operating leases, net of any investments received from the lessor, are charged to profit and loss on a straight line basis over the term of the lease. When the lease includes a rent free period, the lessee recognises the aggregate benefit of the incentive as a reduction of rental expense over the lease term on a systematic basis.

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

	31 December 2017 £m	31 December 2016 £m
Not later than one year	2	1
Later than one year and no later than five years	8	8
Later than five years	4	6
Total minimum lease payments	**14**	15

The Group signed a new lease during prior year for an additional floor of The Leadenhall Building to accommodate the growth of the business.

Other commitments

During previous years the Group executed transactions to purchase partly funded bonds. An additional such bond was purchased during the year ended 31 December 2017. The Group expects to pay a further £153m within the next 5 years (2016: £173m), £46m of this being due within 12 months of the financial reporting date (2016: £25m).

	31 December 2017 £m	31 December 2016 £m
Not later than one year	46	25
Later than one year and no later than five years	107	148
Later than five years	–	–
Total other commitments	**153**	173

Note 34 – Post Balance Sheet events

On 14 March 2018, Prudential Plc announced the sale of £12bn of its annuity portfolio to Rothesay Life Plc, the largest transaction of its type in the UK and taking the Group's assets under management to £37bn. The transaction is structured initially as a reinsurance contract and covers over 400,000 policyholders who will remain customers of Prudential and continue to be serviced by Prudential until the effective date of a Part VII transfer.

Capital support for the transaction has been provided by the Group's shareholders with £380m of new equity being provided. In addition, the Group has borrowed £500m from a syndicate of third party banks. The new equity and the proceeds from the loan have been injected into RLP as equity.

Appendix – Changes in IFRSs

Adoption of new or amended standards

The Group has adopted the following new standards and changes to existing standards which are relevant to the Group's operations, and became effective for financial years beginning on or after 1 January 2017. These amendments have all been endorsed by the EU and have had no material impact on the Group financial statements.

IAS 12 Income taxes

The amendments clarify the requirements for recognising deferred tax assets on unrealised losses. The amendments clarify the accounting for deferred tax where an asset is measured at fair value and that fair value is below the asset's tax base. The amendments also clarify certain other aspects of accounting for deferred tax assets.

IAS 7 Cash flow statements

The amendment to IAS 7 introduces an additional disclosure that will enable users of financial statements to evaluate changes in liabilities arising from financing activities. The amendment is part of the IASB's disclosure initiative, which continues to explore how financial statement disclosure can be improved.

New or revised standard not yet effective

The following new or revised standards, in issue, were not yet effective, or in some cases not yet endorsed by the EU. The Group has not early adopted any of these standards.

IFRS 2 Share based payments

This amendment addresses the accounting for cash-settled, share based payments and equity-settled awards that include a 'net settlement' feature in respect of withholding taxes. The Group is not expected to be materially impacted.

IAS 40 Investment property

These amendments clarify when assets are transferred to, or from, investment properties. The Group is not expected to be impacted by this change.

IFRS 9 Financial instruments

The final version of IFRS 9 includes requirements on the classification and measurement of financial assets and liabilities; it also includes an expected credit losses model that replaces the incurred loss impairment model used currently in addition to the final hedging component of IFRS 9 that was issued in November 2013. IFRS 9 will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2018 and allows early adoption. The Group has taken the deferral option and will adopt the standard on the effective date of the new insurance contract standard 1 January 2021. The Group will therefore continue to apply IAS 39, 'Financial Instruments: Recognition and measurement', instead of adopting IFRS 9. The exemption applies to the Group because its activities are 'predominantly connected with insurance'. The temporary exemption allows the Group to avoid the temporary volatility that may result from adopting IFRS 9 before the forthcoming new insurance contracts standard. The Group has made an initial assessment of the impact of IFRS 9 and does not expect there to be a material impact on the measurement of financial assets and liabilities. There will however be additional disclosures made in the financial statements.

IFRS 15 Revenue from contracts with customers

IFRS 15, as issued in May 2014, establishes a new five-step model that will apply to revenue earned from a contract with a customer, regardless of the type of revenue or industry. The principles in IFRS 15 provide a more structured approach to measuring and recognising revenue and will be applied using the following five steps:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognise revenue when (or as) the Company satisfies a performance obligation.

This new revenue standard, which is jointly issued by IASB and the United States Financial Accounting Standards Board (FASB), is applicable to all companies and will supersede the current revenue recognition requirements under IFRS.

IFRS 15 will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2018. The new standard will affect most entities that apply IFRS or US GAAP. The areas expected to provide the greatest impact are: transfer of control, variable consideration, licences, time value of money, contract costs and disclosures.

Amendments to the standard were issued to clarify the guidance on identifying performance obligations, accounting for licences of intellectual property and the principal versus agent assessment (gross versus net revenue presentation permitted). New and amended illustrative examples have been added for each of these areas of guidance. The IASB has also included additional practical expedients related to transition to the new revenue standard. The amendments do not change the core principles of IFRS 15, however they clarify some of the more complex aspects of the standard.

IFRS 15 Revenue from contracts with customers continued

As insurance is specifically excluded from the standard these changes will have no impact on the Group. The standard is not expected to impact on the financial statements of Rothesay Pensions Management Limited, the Group's service company.

IFRS 16 Leases

The standard will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted, but only in conjunction with IFRS 15 Revenue from Contracts with customers. IFRS 16 replaces the current guidance in IAS 17. Under IAS 17, lessees were required to make a distinction between a finance lease (on balance sheet) and an operating lease (off balance sheet). IFRS 16 now requires lessees to recognise a lease liability reflecting future lease payments and a 'right-of-use asset' for virtually all lease contracts. The IASB has included an optional exemption for certain short-term leases and leases of low-value asset; however, this exemption can only be applied by lessees. The new standard will affect both the balance sheet and related ratios, such as debt/equity ratios. The Group has assessed the impact of the operating leases for floors 25 and 32 of The Leadenhall Building. These are not expected to have a material impact on the financial statements of the Group.

IFRS 17 Insurance contracts

The standard will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2021. Earlier application is permitted. Once effective, IFRS 17 replaces IFRS 4 Insurance Contracts that was issued in 2005. The overall objective of IFRS 17 is to provide a more useful and consistent accounting model for insurance contracts among entities issuing insurance contracts globally. The IFRS 17 model combines a current balance sheet measurement of insurance contract liabilities with the recognition of profit over the period that services are provided. Certain changes in the estimates of future cash flows and the risk adjustment are also recognised over the period that services are provided. Entities will have the option to present the effect of changes in discount rates either in profit and loss or in other comprehensive income. The standard will have a material impact on the way in which insurance company results are reported and the Group is currently assessing the impact.

Annual improvements 2014-2016 cycle

These improvements are effective from 1 January 2018 and are not expected to have a material impact on the Group. They include: Amendments to IFRS 1, 'First time adoption of IFRS (deletes the short-term exemptions covering transition provisions of IFRS 7, IAS 19 and IFRS 10), IFRS 12 'Disclosures of interests in other entities' and IAS 28 'Investments in associates and joint ventures' (allows venture capital organisations, mutual funds, unit trusts and similar entities to elect measuring their investments in associates or joint ventures at fair value through profit or loss).

MCEV statements

Market consistent embedded value

Supplementary financial statements

The Group has prepared supplementary financial statements on a Market Consistent Embedded Value (MCEV) basis. The results have been prepared in accordance with the European Insurance CFO Forum Market Consistent Embedded Value Principles (MCEV Principles) (Copyright © Stichting CFO Forum Foundation 2008) which were published in 2008 and revised in October 2009 and May 2016. Consistent with the MCEV Principles revision in May 2016 an explicit allowance has been made for the new European regulatory regime (Solvency II).

The Group considers that embedded value reporting provides investors with a useful measure of the future profit streams of the Group's in-force long-term business and is a valuable supplement to statutory accounts.

Group statement of financial position

As at 31 December 2017

	31 December 2017 £m	31 December 2016 £m
Assets		
Value of in-force business	606	699
Financial investments and property, plant and equipment	37,304	38,349
Accrued interest and prepayments	312	278
Reinsurance assets	168	437
Receivables	337	492
Cash and cash equivalents	251	152
Total assets	38,978	40,407
Total equity	2,301	2,173
Liabilities		
Reinsurance liabilities	231	–
Insurance contract liabilities	21,741	22,071
Payables and financial liabilities	13,965	15,532
Borrowings	703	598
Deferred tax liabilities	–	2
Accruals and deferred income	37	31
Total liabilities	36,677	38,234
Total equity and liabilities	38,978	40,407

The notes on pages M5 to M10 form an integral part of these supplementary financial statements.

MCEV statements

Reconciliation of shareholders' equity on IFRS basis to shareholders' equity on MCEV basis

The shareholders' equity on an MCEV basis is consistent with the sum of the shareholders' equity on an IFRS basis, the value of in-force business (VIF) as shown on page M08 and any debt valuation differences as shown on page M07.

The debt valuation difference arises as a result of the market value approach under MCEV which differs from amortised cost valuation under IFRS.

Group MCEV analysis of earnings (net of tax)

For the year ended 31 December 2017

	Covered business (MCEV) £m	Non covered business (IFRS) £m	Total Group MCEV £m
Opening MCEV	2,434	(261)	2,173
Capital and dividends flows	(370)	370	–
Adjusted opening MCEV	2,064	109	2,173
Operating MCEV earnings	149	–	149
Non-operating MCEV earnings	(12)	(9)	(21)
Total MCEV earnings	137	(9)	128
Other movements in IFRS net equity	–	–	–
Closing MCEV	2,201	100	2,301

For the year ended 31 December 2016

In the table below, opening adjustments reflect the impact of adopting the revised MCEV principles as at 1 January 2016:

	Covered business (MCEV) £m	Non covered business (IFRS) £m	Total Group MCEV £m
Opening MCEV	1,447	(2)	1,445
Opening adjustments	(36)	–	(36)
Adjusted opening MCEV	1,411	(2)	1,409
Operating MCEV earnings	357	–	357
Non-operating MCEV earnings	666	(259)	407
Total MCEV earnings	1,023	(259)	764
Other movements in IFRS net equity	–	–	–
Closing MCEV	2,434	(261)	2,173

MCEV statements

Notes to the MCEV supplementary financial statements

1. Basis of preparation

The Group's primary financial statements have been prepared in accordance with IFRS. The MCEV supplementary financial statements have been prepared to allow for Solvency II.

Comparative information has been provided as at 31 December 2016.

Covered business

The covered business includes all business written by RLP. This business falls under the definition of long-term insurance business for UK regulatory purposes.

The adjustments applied to arrive at the Group MCEV are the market value of other entities within the Group.

As at 31 December 2016 the Group adjustment included the deduction of £240m of debt from Rothesay Holdco UK Limited which was issued during 2016. This was repaid during 2017 with the proceeds of an intra group dividend from RLP.

New business

For MCEV purposes new business is defined as:

- premiums from the sale of new policies written throughout the year; and
- non-contractual increments on existing policies, transacted during the year.

Acquisitions are presented separately within the new business section. For the dates shown there were no acquisitions.

Methodology

The MCEV is the sum of the net worth of the Group companies plus the value of in-force business.

a. Net worth

The net worth consists of the required capital plus the free surplus of the Group. Free surplus is defined as the assets over and above the level of required capital, described below.

b. Value of in-force (VIF)

VIF consists of the following components:

- present value of future profits;
- time value of financial options and guarantees;
- frictional costs of required capital; and
- cost of residual non-hedgeable risks.

c. Present value of future profits (PVFP)

The PVFP reflects the distributable profits, net of tax payable, calculated on an IFRS basis rather than on a Solvency II basis. The PVFP has not been updated to reflect Solvency II technical provisions to retain consistency with the payment of tax. Solvency II allowances are made through the definition of required capital and the associated frictional costs of required capital elements of the MCEV. The alternative presentation of calculating the PVFP on a Solvency II basis would not change the total MCEV however the constituents would differ, in particular, there would be a transfer from PVFP to free surplus.

d. Time value of financial options and guarantees (TVFOG)

There are no material financial options and guarantees, and therefore the time value is nil.

The basis for policyholder options is generally set by the Group to be profit-neutral. Where there are specific contractual clauses that diverge from this, these have been appropriately allowed for within the PVFP.

The Group currently has no guaranteed surrender terms exercisable at the unilateral discretion of the pension schemes. Some counterparties are able to surrender conditional upon certain solvency events. However for the purposes of the MCEV, it is assumed that the Group continues to meet these solvency requirements and hence no value is placed on these surrender rights.

e. Frictional costs of required capital

Frictional costs are calculated by projecting forwards the future levels of required capital as set out in the assumption section (g) on page M07. Tax on investment return and investment expenses are payable on the assets backing required capital up until the point that they are assumed to be released to shareholders.

f. Cost of residual non-hedgeable risk (CNHR)

CNHR covers risks not already allowed for in the TVFOG or in the PVFP. No allowance has been made within the CNHR for symmetric risks as these are diversifiable by investors.

1. Basis of preparation continued

The risks which contribute to the CNHR component of MCEV are:

- Counterparty default risk: the risk of losses following the failure of counterparties, for example for longevity reinsurance and over the counter derivative transactions.
- Expense risk: the risk that the amount of expenses incurred differs from current projections.
- Operational risk: the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

These are considered to be asymmetric risks, of which operational risk is the most material element. We have allowed for diversification benefits to the extent that these are identifiable.

The Group's demographic risks exhibit no material asymmetry. Appropriate allowance has been made within the PVFP for these risks; therefore no further allowance has been made in the CNHR.

The CNHR has been presented as an equivalent average cost of capital charge across all residual non hedgeable risks considered to be asymmetric (as defined above), after allowing for diversification between these risks. The capital charge has been calculated in line with Rothesay's Own Risk and Solvency Assessment (ORSA). This capital requirement has been modelled as running off in line with the cash flow profile of the best estimate liabilities excluding the longevity swap cash flows.

The resulting annual capital charge is 3.6% (31 December 2016: 3.5%).

g. Tax

The projected cash flows take into account all tax which the Group expects to pay using the following tax rates;

	31 December 2017	31 December 2016
2016	–	20.00%
2017	19.25%	19.25%
2018	19.00%	19.00%
2019	19.00%	19.00%
2020	17.50%	17.50%
2021 +	17.00%	17.00%

h. Consolidation adjustments

Group entities have been incorporated at the market value.

The Group MCEV is net of external debt.

Assumptions

Economic assumptions

a. Reference rates

In setting the risk-free rate a mid-price swap yield curve is used as shown in the table below:

Term (years)	1	5	10	20	30	50
31 December 2017	0.65%	1.04%	1.29%	1.48%	1.44%	1.27%
31 December 2016	0.55%	0.87%	1.26%	1.49%	1.45%	1.26%

For annuity business, swap rates are adjusted for a 'liquidity premium' in deriving the reference rates. The liquidity premium is applied as a term specific addition to the swap curve set out above. The derivation uses a target investment mix and therefore aims to consider the types of investments in which the Group invests, but does not correspond exactly to the current asset holdings.

The liquidity premium is calculated on a daily basis and considers the spread over the risk-free rate observable for various asset classes. An appropriate deduction is made to the spread for credit risk. The deductions make reference to market observable credit risk information and the resulting deduction is prudent relative to historical defaults.

The in-force liquidity premium adjustment as at 31 December 2017 was 104bps, after the deduction of investment management costs. The comparable liquidity premium adjustment as at 31 December 2016 was 116bps.

No liquidity premium is used in the valuation of longevity swap contracts.

The liquidity premium on new business is calculated at the point of sale and is determined using an approach consistent with that assumed for the in-force business.

Notes to the MCEV supplementary financial statements continued

1. Basis of preparation continued

b. Expenses

Expenses attributed to covered businesses have been included in the MCEV calculations. Future expense assumptions include an allowance for third party administration, investment management and maintenance expenses as well as project expenses. On average an allowance of £32 per policy per annum (31 December 2016: £29 per policy per annum) is made with additional allowances for short-term project costs and investment management expenses.

No future productivity gains have been anticipated. Where subsidiary companies provide administration, investment management or other services to our life businesses, the value of profits or losses arising from these services have been included in the embedded value of new business.

c. Expense inflation

Internal and third party administration expenses are projected to increase at RPI, plus a margin where appropriate.

As at 31 December 2016 the assumed rate of future expense inflation is equivalent to 3.57% (31 December 2016: 3.76%).

For internal service companies the fees charged to the life company reflect the underlying expenses incurred.

d. Exchange rates

The Group has a small amount of euro denominated liabilities. These cash flows have been converted to GBP using levels implied from cross currency swap quotes.

Non-Economic assumptions

e. Demographic assumptions

Assumed future mortality has been derived from an analysis of experience with a view to giving a best estimate of future experience. Where appropriate this has been adjusted for anticipated future changes in experience, that is improvements in future policyholder longevity are allowed for.

Recent mortality experience has been analysed for each pension scheme and reinsurance contracts at the end of 2016. Where the data was considered statistically credible, the mortality assumptions used in the valuation are based on this actual mortality experience. Where the data is not statistically credible, the Group has taken into account reinsurance quotes and proprietary socio-demographic models, based on postcode and other factors. A consistent approach has been used to derive the demographic assumptions used for new business written during 2017. The demographic assumptions are consistent with those used for the valuation of the insurance contract liabilities as described in note 21, excluding any margins for prudence applied.

f. Non-hedgeable risk

For the balance sheet a charge of 3.6% (3.5% at 31 December 2016) has been applied to the group-diversified capital required on a 1-in-200 one-year basis over the remaining lifetime of in-force business. The capital levels used are projected to be sufficient to cover non-hedgeable risks at the 99.5% confidence. The level of the diversified capital requirement to which the charge is applied is £237m (£253m at 31 December 2016). The resulting CNHR is £92m (31 December 2016: £99m).

g. Required capital

The projected level of required capital to support the business is derived from the Group's capital management policy, which is to hold sufficient assets to meet the higher of:

- Solvency II Pillar 1 Technical Provisions (net of transitional measures) plus 130% of RLP's Solvency Capital Requirement (SCR).
- Best estimate liabilities plus the economic capital requirement.

The economic capital requirement calculates the one year value-at-risk to a 99.8% confidence interval. The Group's capital requirement is driven by 130% of RLP's SCR.

h. Valuation of debt

Borrowings in the MCEV consolidated statement of financial position are valued at their market value as determined by traded levels.

	31 December 2017 £m	31 December 2016 £m
Face value	650	590
Amortised costs	(3)	(3)
IFRS valuation	**647**	587
Face value	650	590
Effect of marking to market	53	8
Market value/fair value	**703**	598

1. Basis of preparation continued

The debt valuation difference arises as a result of the market value approach under MCEV which differs from amortised cost valuation under IFRS.

During the period, the Group repaid £240m of debt.

2. Group embedded value

	31 December 2017 £m	31 December 2016 £m
Net worth	2,298	2,093
Value of in-force business		
Present value of future profits	826	899
Frictional cost of required capital	(128)	(102)
Cost of non-hedgeable risks	(92)	(98)
Value of in-force business	606	699
Sub-debt	(703)	(358)
MCEV of RLP	2,201	2,434
Debt	–	(240)
Net assets/(liabilities) of other Group companies	100	(21)
Group MCEV	2,301	2,173

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

For the year ended 31 December 2017

	Net Worth £m	VIF £m	Debt £m	MCEV impact £m	Group adjustments £m	MCEV £m
Opening MCEV	2,093	699	(358)	2,434	(261)	2,173
New business value	(79)	256	–	177	–	177
Management of In-force book	461	(420)	–	41	–	41
Expenses	(68)	–	–	(68)	–	(68)
Demographic experience variance	(1)	–	–	(1)	–	(1)
Operating MCEV earnings	313	(164)	–	149	–	149
Economic variances	14	73	(45)	42	–	42
Other non-operating variances	(122)	(2)	(300)	(424)	361	(63)
Total MCEV earnings	205	(93)	(345)	(233)	361	128
Closing MCEV	2,298	606	(703)	2,201	100	2,301

For the year ended 31 December 2016

	Net worth £m	VIF £m	Debt £m	MCEV impact £m	Group adjustments £m	MCEV £m
Opening MCEV	1,370	435	(358)	1,447	(2)	1,445
Solvency II model adjustment	22	(58)	–	(36)	–	(36)
Adjusted opening MCEV	1,392	377	(358)	1,411	(2)	1,409
New business value	31	299	–	330	–	330
Management of in-force book	267	(194)	–	73	–	73
Expenses	(47)	–	–	(47)	–	(47)
Demographic experience variance	1	–	–	1	–	1
Operating MCEV earnings	252	105	–	357	–	357
Economic variances	64	124	–	188	–	188
Other non-operating variances	385	93	–	478	(259)	219
Total MCEV earnings	701	322	–	1,023	(259)	764
Closing MCEV	2,093	699	(358)	2,434	(261)	2,173

Notes to the MCEV supplementary financial statements continued

3. Covered business analysis of movement in embedded value (net of tax) continued

Commentary

The new business value shows the incremental MCEV, at the point of sale, from single premium bulk annuity transactions over 2017.

The management of in force book reflects assumption changes (both VIF and liability valuation) and includes profits made through the year due to changes to demographic assumptions, asset trading activities, expected returns and demographic releases, data cleanse exercises and other data movements. As detailed in note 21 there were significant changes to the demographic assumptions this year which included a weakening of the base mortality and a change to the CMI 16 longevity improvements model. All non-economic assumption changes applied on an IFRS basis, other than the change to the prudent margins which are not applied under the base cash flow projections for MCEV, also impacted the MCEV projected cash flows.

Expenses reflect the actual maintenance expenses along with acquisition expenses that have not been allocated against new business profits.

Demographic experience variance represents the impact on MCEV of actual experience during the year relative to the expected assumptions at the start of the year.

Economic variances arise from market movements in credit spreads, illiquidity premium, interest rates and inflation compared to expectations. Market conditions were more stable during 2017 than the previous year.

Other non-operating variances net worth includes £300m of debt capital issued by RLP during the year. A £370m dividend was paid from RLP to RHUK during the year. £240m of loan's held at RHUK were repaid during the year. In addition, the movement in net worth from non-operating variances also reflects debt financing costs and non-recurring expenses net of tax.

4. Value of new business over the year ended 31 December 2017

The following table sets out the after-tax value of new business for the year ended 31 December 2017, calculated at the point of sale:

	31 December 2017 £m	31 December 2016 £m
Net worth	(79)	31
Present value of future profits	261	335
Frictional cost of required capital	(5)	(14)
Cost of non-hedgeable risks	–	(22)
Group MCEV for new business	**177**	330

£1.2bn of new business premiums were written in the year ending 31 December 2017 (31 December 2016: £6.6bn). This excludes regular premiums generated on the in-force inwards longevity reinsurance business written in prior years.

Economic and demographic assumptions have been used at the point of sale. The MCEV modelling assumptions for new business are consistent with those used for the in-force business, as described in the basis of preparation.

The net worth does not reflect the impact of managing the new and acquired business, such as profits arising from investing assets received as premiums through the rest of the financial year.

The weighted average liquidity premium at point of sale for new business written during the year ending 31 December 2017 was 109bps (31 December 2016: 129bps). This is slightly higher than the total in-force assumption at 31 December 2017 due to changes in market conditions during the year.

5. Sensitivities

The following tables show the sensitivity of the total MCEV to:

- 1% increase and decrease in the risk-free rate of interest. No floor has been applied to the risk-free rate of interest in these sensitivities. The impact of dynamic hedging is allowed for as interest rates change.
- 1% increase and decrease in inflation. The covers both expense inflation and benefit inflation.
- 10 basis point increase and decrease in long term credit default assumptions. This stress has not been applied to UK government guaranteed debt or supranational bonds.
- Required capital equal to 100% of SCR.
- No sensitivity to swaption implied volatility has been shown as the Group has no risk to swaption implied volatilities.
- No sensitivity to equity or property has been shown as the Group does not directly invest in these asset classes.
- Annuity base mortality 5% higher and lower than the central case (i.e. 105% and 95%, respectively, of the central mortality rates).
- Expenses 10% higher than the central case (i.e. 110% of the central assumption). Maintenance, third party administration, investment management and project expenses have all been subjected to the stress. There is no change to expense inflation assumption.
- No sensitivity to lapse rates has been shown as the Group is not exposed to the lapse of future premiums.

5. Sensitivities continued

In calculating the change in Solvency II capital required in each scenario it assumed that the transitional has been recalculated and that the Financial Resource Requirement which underpins the liability to Solvency I Pillar I does not bite.

Sensitivities at 31 December 2017

	Net worth £m	VIF £m	Debt & group adjustments £m	MCEV £m
As reported	2,298	606	(603)	2,301
Economic assumptions				
interest rates +1%	(20)	(41)	18	(43)
interest rates -1%	277	121	(19)	379
inflation +1%	52	62	–	114
inflation -1%	69	(87)	–	(18)
credit default +10bps	(90)	1	–	(89)
credit default -10bps	90	–	–	90
Required capital equal to 100% of SCR	–	30	–	30
Non-economic assumptions				
Base mortality -5%	(88)	9	–	(79)
Base mortality +5%	84	(8)	–	76
Expenses +10%	(54)	16	–	(38)

Sensitivities at 31 December 2016

	Net worth £m	VIF £m	Debt & group adjustments £m	MCEV £m
As reported	2,093	699	(619)	2,173
Economic assumptions				
interest rates +1%	25	(39)	16	2
interest rates -1%	203	74	(18)	259
inflation +1%	94	23	–	117
inflation -1%	41	(66)	–	(25)
credit default +10bps	(91)	11	–	(80)
credit default -10bps	89	(8)	–	81
Required capital equal to 100% of SCR	–	30	–	30
Non-economic assumptions				
Base mortality -5%	(71)	5	–	(66)
Base mortality +5%	68	(5)	–	63
Expenses +10%	(46)	15	–	(31)

The impact on the MCEV, including new business, has been presented as follows:

- The net worth is calculated based on the impact on IFRS profit and is consistent with the note 21 of the financial statements net of tax. The tax impact of the IFRS profit; taken by applying the current tax rate at 31 December 2017, of 19.25%, to the pre-tax profit figure. A simplified approach has been taken to the treatment of any potential deferred tax asset created under the shock, as it has been assumed that losses have offset profit created in the current accounting period.
- The VIF component of the MCEV; which is the sum of the PVFP, Frictional Cost of Capital and Cost of Non-hedgeable Risk.
- The debt and group adjustments include the effect of marking the £250m of fixed debt to market in the interest sensitivities.

In each sensitivity calculation all other assumptions remain unchanged unless otherwise stated.

The sensitivities above include the new business written over the year. The risk profile of the new business written was materially similar to that of the in-force business. The impact of the sensitivities applied to new business in isolation can therefore be simplified as the same proportional impacts as those shown in the previous table.

MCEV statements

Statement of Directors' responsibilities

In respect of the MCEV basis supplementary financial statements

When compliance with the MCEV Principles is stated, those principles require the Directors to prepare supplementary information in accordance with the methodology contained in the CFO Forum Principles and to disclose and explain any non-compliance with the guidance included in the CFO Forum Principles.

In preparing this supplementary information, the Directors have done so in accordance with these CFO Forum Principles and have also fully complied with all the guidance included therein. Specifically, the Directors have:

- determined assumptions on a realistic basis, having regard to past, current and expected future experience and to relevant external data, and then applied them consistently;
- made estimates that are reasonable and consistent;
- provided additional disclosures when compliance with the specific requirements of the CFO Forum Principles is insufficient to enable users to understand the impact of particular transactions, other events and conditions and the Group's financial position and financial performance;
- prepared the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business; and
- established internal controls as they determine is necessary to enable the preparation of consolidated supplementary financial statements that are free from material misstatement, whether due to fraud or error.

The supplementary financial statements were approved by the Board of Directors on 22 March 2018 and were signed on its behalf by:

Andrew Stoker
Chief Financial Officer

22 March 2018

Independent auditors' report to the Directors of Rothesay Holdco UK Limited

Report on the audit of the consolidated supplementary financial statements

Our opinion

In our opinion, the Rothesay Holdco UK Limited's consolidated supplementary financial statements for the year ended 31 December 2017 have been prepared, in all material respects, in accordance with the Market Consistent Embedded Value (MCEV) Principles issued in June 2008, as amended in October 2009 and May 2016 (CFO Forum Principles) and the basis of preparation set out on pages M05 to M08.

We have audited the MCEV consolidated supplementary financial statements of Rothesay Holdco UK Limited (the Company) for the year ended 31 December 2017 which comprise the Group statement of financial position, the reconciliation of shareholder equity on IFRS basis to shareholders equity on MCEV basis, the Group MCEV analysis of earnings (net of tax) and the notes to the MCEV supplementary financial statements which have been prepared in accordance with the European Insurance CFO Forum MCEV Principles issued in June 2008 as amended in October 2009 and May 2016 (CFO Forum Principles) and the basis of preparation set out on page M05 to M08 which should be read in conjunction with the Group's financial statements.

Basis of opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (IASs(UK)), including ISA (UK) 800, and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the consolidated supplementary financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the Company in accordance with the ethical requirements that are relevant to our audit of the consolidated supplementary financial statements in the UK, which includes the FRC's Ethical Standard as applicable to public interest entities and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Emphasis matter – basis of preparation

In forming our opinion on the consolidated supplementary financial statements, which is not modified, we draw attention to the basis of preparation on pages M05 to M08. The consolidated supplementary financial statements are prepared by the Company because the Company believes that embedded value reporting provides investors with a useful measure of the future profit streams of the Company's in-force long-term business. As a result, the consolidated supplementary financial statements may not be suitable for another purpose.

Conclusions relating to going concern

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

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

However, because not all future events or conditions can be predicted, this statement is not guarantee as to the Company's ability to continue as a going concern.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the consolidated supplementary financial statements and our auditors' report thereon. The Directors are responsible for the other information. Our opinion on the consolidated supplementary financial statements does not cover the other information and, accordingly, we do not express an audit opinion or any other form of assurance thereon.

In connection with our audit of the consolidated supplementary financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated supplementary financial statements or our knowledge obtained in the audit, or otherwise appears to be materially missated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

MCEV statements

Independent auditors' report to the Directors of Rothesay Holdco UK Limited continued

Responsibilities for the supplementary financial statements and the audit

Responsibilities of the Directors for the consolidated supplementary financial statements

As explained more fully in the statement of Directors' responsibilities in relation to the Market Consistent Embedded Value basis supplementary information, the Directors are responsible for the preparation of the consolidated supplementary financial statements in accordance with the MCEV basis set out in the basis of preparation on pages M05 to M08. The Directors are also responsible for such internal control as they determine is necessary to enable the preparation of consolidated supplementary financial statements that are free from material misstatement, whether due to fraud or error.

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

Auditors' responsibilities for the audit of the consolidated supplementary financial statements

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

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

Use of this report

This report, including the opinion, has been prepared for and only for the Company's Directors in accordance with our engagement letter dated 18 October 2017 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come, including without limitation under any contractual obligations of the Company, save where expressly agreed by our prior consent in writing.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Chartered Accountants

London
22 March 2018

Glossary of terms

Acquisition costs	Acquisition costs comprise the expenses associated with the origination of new business, including annual compensation for employees.
Administration expenses	Administration costs represent the cost of administering the in-force book of business.
Annuity	A series of regular payments made to an individual until their death. Payments may be indexed.
Assets under management	Assets being managed by the Group. Can be derived by taking total assets and adjusting for reinsurance assets, derivative liabilities and collateralised liabilities.
Assumed reinsurance premiums	Premiums received by Group in respect of reinsurance inwards, i.e. a policy where RLP is acting as the reinsurer.
Best estimate liability (BEL)	The liabilities of the Group calculated on a best estimate basis under Solvency II, i.e. where all the assumptions made in the calculation are best estimate.
Bid price	A bid price is the price a buyer is willing to pay for a security.
Bulk annuity	A bulk annuity, sometimes referred to as a bulk purchase annuity, is a contract between a defined benefit pension scheme and an insurance company, whereby an insurance company insures some or all of the annuities being paid by the pension scheme.
Capital contribution reserve	The capital contribution reserve arose as a result of the stock appreciation rights granted in relation to the Rothesay Life share incentive plan.
Collateralised agreements/ Investments	Loans secured on property or other collateral.
Collective investment schemes	A way of investing money alongside other investors.
Corporate bonds and other corporate debt	These are debt securities issued by corporations which are not guaranteed by governments.
Covered bonds	Covered bonds are debt securities issued by a bank or mortgage institution and collateralised against a pool of assets.
Credit risk	The risk of loss or of adverse change in the financial situation resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors.
Currency risk	The risk that asset or liability values, cash flows, income or expenses will be affected by changes in exchange rates. Also referred to as foreign exchange risk.
Deferred annuities	Annuities or pensions due to be paid from a future date or when the policyholder reaches a specified age.
Demographics	Statistical data relating to the population and particular groups within it.
Distributable profits	A company's profits available for distribution are its accumulated realised profits.
Economic capital	Represents management's internal risk-based calculation of the capital required to remain solvent for a 99.8% confidence level over a 1-year period.
Economic profits	Represent the change in profit as a result of changes in market conditions.
Employee benefit trust (EBT)	A trust established to purchase and hold shares of the company for delivery under employee share schemes.
Equity based compensation	Share based transactions awarded under incentive plans.
Equity release mortgages	Mortgages extended to older customers (aged 55 and over) against their residential property at low loan to value percentage. Unlike a typical residential mortgage, no interest is paid monthly by the customer. Instead, the interest is simply added to the principal loan amount with the loan only repayable on death or entry into long-term care of the last remaining homeowner.
EU referendum (Brexit)	A UK vote which took place on 23 June 2016 where the country voted to leave the European Union.
Fair value	Amount that would be received on sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Finance costs	Represent interest payable on borrowings.

Glossary

Glossary of terms continued

Frictional costs of required capital	Additional costs to a shareholder, on an MCEV basis, of holding the assets backing required capital within an insurance company rather than directly in the market. The additional costs allowed for are the tax costs and any additional investment expenses on the assets backing the required capital. These costs are explicitly deducted from the present value of future premiums.
Government, sub sovereign and agency obligations	A bond issued by a country's government or corporate debt which is guaranteed by a government to repay borrowed money at a specific time.
Gross premiums written	Premiums received by RLP on new business and generated through regular premiums.
In-force	An insurance policy or contract reflected on records that has not expired, matured or otherwise been surrendered or terminated.
Infrastructure	Investments in infrastructure such as water, energy and transportation.
Insurance risk	The risk of loss or of adverse change in the value of insurance liabilities, due to inadequate pricing and provisioning assumptions.
International Financial Reporting Standards (IFRS)	Accounting standards that are applied in preparing the Group's consolidated financial statements.
Investment return	Comprises all interest income on financial investments at fair value through profit and loss, realised investment gains and losses and movements in unrealised gains and losses, as well as expenses directly related to investments executed during the year.
Liquidity premium	An addition to the risk-free rate used when projecting investment returns and discounting cash flows on certain types of contracts where the liabilities are illiquid and have cash flows that are predictable.
Liquidity risk	The risk of being unable to realise investments and other assets in order to settle financial obligations when they fall due.
LTMF	LT Mortgage Financing Limited. Currently dormant.
Longevity risk	The risk that a company could be exposed to a higher pay out as a result of increasing life expectancy.
Management of in-force book	Profits or losses generated on the in-force book of business.
Market consistent embedded value (MCEV)	Provides an indication of the value of business written by measuring the risk-adjusted value of the in-force business, allowing for the unwind of margins.
Market risk	The risk of loss or of adverse change resulting, directly or indirectly, from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments.
Matching adjustment	The matching adjustment, a concept in Solvency II, is broadly equivalent to the illiquidity premium that can be earned on the illiquid assets held to back illiquid liabilities.
Mortality tables	A table which shows for each age, what the probability is that a person of that age and gender will die before their next birthday.
Net premiums	Life insurance premiums, net of reinsurance premiums paid to third-party reinsurers.
Net worth	The market value of the shareholders' funds and the shareholders' interest in the surplus held in the long-term business funds, determined on a statutory IFRS basis at 31 December 2017 (or statutory solvency basis, with inadmissible assets included, for comparative periods).
New business	New insurance contracts and reinsurance inwards sold during the period. Includes business acquired through purchase of companies.
New business operating profit	Profit generated on business transacted during the period.
New business premium	Premium paid on new business transacted during the period.
Non-hedgeable risk	Under MCEV, risks not already allowed for in the time value of options and guarantees or PVFP. The allowance includes the impact of both non-hedgeable financial and non-financial risks. No allowance has been made within the CNHR for symmetric risks as these are diversifiable by investors.
Offer price	Price at which a market maker is prepared to sell a specific security.

Operating profit before tax	Measure of profitability, capturing new business profit, in-force profit and assumption changes, but excluding market fluctuations and exceptional expenses.
Operational risk	The risk arising from inadequate or failed internal processes, personnel or systems, or from external events.
Own Funds	Available capital under the Solvency II regime.
Own risk and solvency Assessment (ORSA)	An assessment of the risk to which the business is exposed as well as solvency forecasting in a range of scenarios, including consideration of the stresses that could jeopardise the Group's business plans.
Partial internal model	Under Solvency II, insurer's own model used to calculate the solvency capital requirement in relation to particular risks approved by the PRA.
Part VII transfers	Court-approved transfer of a portfolio of contracts from one entity to another.
Pillar I	Under Solvency II, represents the solvency capital requirement calculated using a standard formula, or (partial) internal model.
Present value of future profits (PVFP)	Present value of the distributable profits to shareholders, in MCEV arising from the in-force covered business projected on a best estimate basis and discounted during the risk free rate adjusted for the liquidity premium.
Prudential Regulation Authority (PRA)	The PRA is a UK regulatory body responsible for prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms.
qx	qx is actuarial notation used to represent the probability of a life aged x dying during the year.
RAL	Rothesay Assurance Limited. Now being wound up.
Regular premiums	Payments of premium made regularly over the duration of the policy.
Reinsurance	Protection sold to or purchased from another insurance company.
Reorganisation reserve	Reflects the impact of the Group reorganisation in 2013 which led to an increase in reserves of £132m reflecting the excess of consolidated net assets to the historical cost of investment in subsidiary entities.
RHUK	Rothesay Holdco UK Limited.
Risk margin	Under Solvency II, the cost of transferring non-hedgeable risks.
RLP	Rothesay Life Plc. The Group's regulated life company.
RPML	Rothesay Pensions Management Limited. The Group's service company.
Secured investments	Bespoke investments where very high levels of collateral have been negotiated and returns are generated through illiquidity premium.
Single premiums	Single premium policies of insurance are those that require only a single lump sum payment from the policyholder.
Solvency capital requirement (SCR)	Under Solvency II, capital requirement to withstand a 1-in-200 year event.
SCR coverage ratio	Own funds divided by SCR. Measure of surplus above capital requirement.
Solvency II	The solvency regime applicable from 1 January 2016. Under Solvency II, the Group is required to hold the greater of the capital required under the new solvency II Pillar 1 framework and the capital required under our own economic capital models Solvency II Pillar 2.
Stock appreciation rights (SARs)	Method for companies to give their management or employees a bonus if the company performs well. SARs resemble employee stock options in that the employee benefits from an increase in stock price.
Strategy risk	The risk of loss in future earnings and capital arising from changes in the competitive, economic, legal or political environment, changing customer behaviour, or a failure to select appropriate strategic or long-term business plans.

Glossary

Glossary of terms continued

Subordinated loan	A fixed interest issue or debt that ranks below other debt in order of priority for repayment if the issuer is liquidated. Holders are compensated for added risk through higher rates of interest. Under EU insurance regulation, subordinated debt is not treated as a liability and counts towards the coverage of the required minimum margin of solvency with limitations.
Surrender	The termination of a life insurance policy or annuity contract at the request of the policyholder after which the policyholder receives the cash surrender value, if any, of the contract.
Third party administration (TPA) agreement	Contract with pensions administrator to process claims and payroll on behalf of RLP.
TVFOG	Time value of financial options and guarantees in MCEV.
Unconsolidated structured entities	A structured entity is an entity that has been designed so that voting or similar rights are not the dominating factor in deciding who controls the entity. These structured entities have not been consolidated as the Group does not have the power to affect their returns.
Value of in force business	Consists of the following components; in MCEV present value of future profits, time value of financial options and guarantees, frictional costs of required capital and cost of residual non-hedgeable risks.
Yield	A measure of the income received from an investment compared to the price paid for the investment. Normally expressed as a percentage.

Notes

Notes

Rothesay Life Plc,
Level 25, The Leadenhall Building,
122 Leadenhall Street, London,
EC3V 4AB

www.rothesaylife.com

T: 020 7770 5300