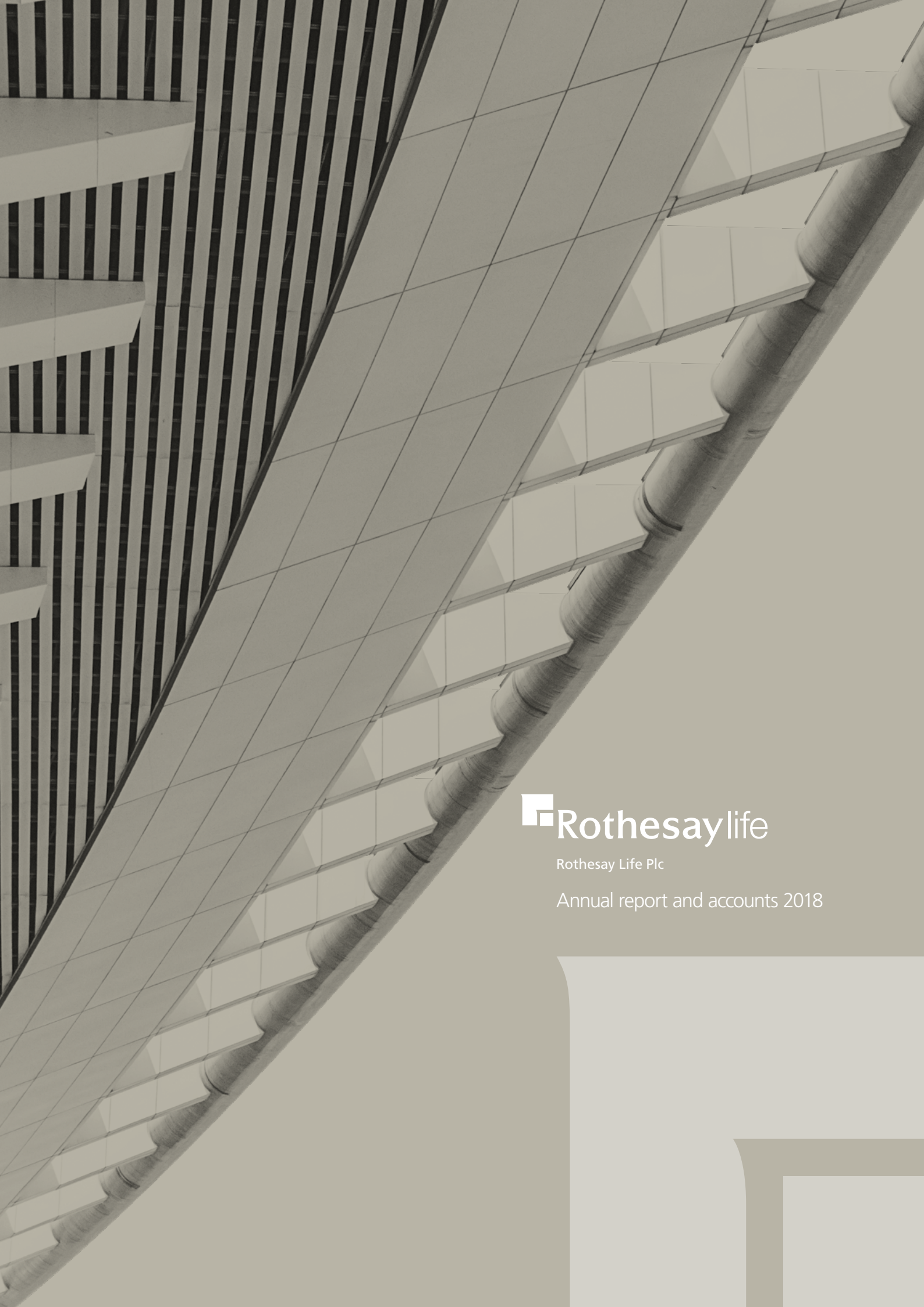


Rothesaylife

Rothesay Life Plc

Annual report and accounts 2018

About us

Who we are

Rothesay Life is one of the leading providers of regulated insurance solutions in the UK market for pensions de-risking. With over £36bn of assets under management and insuring the annuities of over 770,000 individuals.

What we do

We think originally and work diligently to help pension schemes and insurance companies to de-risk and to achieve long-term pension security for 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.

Strategic report

The Directors present their Annual Report and the audited financial statements for Rothesay Life Plc registered number 06127279 (RLP or the Company). The financial statements are presented for the year ended 31 December 2018. Comparative information has been presented for the year ended 31 December 2017.

The Company operates as part of the Rothesay Holdco UK Limited Group (RHUK or The Group).

Principal activities

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

RLP provide unique solutions for clients seeking to mitigate financial and longevity risk, aiming to create structures that are tailor-made to suit the needs of scheme members, trustees and corporates.

RLP is a leading provider of regulated insurance solutions in the UK market for pensions de-risking. Established in 2007, the Company has grown to become one of the largest annuity providers in the UK market, with over £36bn of assets under management and insuring the annuities of over 770,000 individuals. RLP's business strategy is focused around three key areas:

i) Protect the security of policyholder benefits.
ii) Grow through writing value driven new business.
iii) Safeguard its brand and culture.

Operational highlights

RLP has delivered a strong performance in 2018 which included these key highlights:

Purchase of £12bn of annuities: The Company successfully completed the reinsurance of a £12bn block of in-force annuity business from Prudential plc (the 'Prudential transaction'). This was the largest transaction of its type in the UK and was funded through £380m of new equity injected into RHUK and £350m of Restricted Tier 1 (RT1) notes.

The transaction is structured initially as a reinsurance contract and covers around 340,000 individual policyholders who will remain customers of Prudential and continue to be serviced by Prudential until the Court-sanctioned transfer which is anticipated to take place during 2019.

New business: In addition to the Prudential transaction, the Company assisted five pension schemes to de-risk their liabilities taking new business premiums to a record level for the Company of £13.2bn (2017: £1.2bn).

IFRS pre-tax profit: Following completion of the Prudential transaction, RLP chose to de-risk the underlying assets and reinvest cautiously to take advantage of attractive market opportunities. Investments completed to date have out-performed RLP's underwriting assumptions and it expects significant further IFRS profits to arise as it invests the remaining assets. While widening credit markets have dampened profits to £114m (2017: £330m), they also present opportunities to invest at more attractive levels.

Assets under management: The Company's assets under management increased by 51% to £36.3bn (2017: £24.1bn), largely as a result of the Prudential transaction.

Equity release mortgages: By funding new equity release mortgages and through the purchase of in-force books of equity release mortgages, most notably the acquisition of an £860m portfolio of equity release mortgages from UK Asset Resolution (UKAR), RLP has increased the value of its investment in equity release mortgages to £1.9bn (2017: £539m).

Partial internal model and solvency position: The Company received approval from the PRA to use its partial internal model (PIM) for modelling the solvency capital requirement (SCR) for credit and counterparty risk from 31 December 2018. As at 31 December 2018, the Company's SCR coverage was 180% (2017: 163%).

Credit rating: RLP was assigned an insurance financial strength rating of A3 by Moody's Investors Service and A+ by Fitch Ratings.

The statement of financial position is set out on page 23.

Review of 2018 and looking ahead

2018 has been a good year for RLP. RLP started the year by successfully executing the purchase of a £12bn annuity portfolio from Prudential Plc in March, the largest such transaction ever completed in the UK. This transaction has taken its total assets under management to £36.3bn as at 31 December 2018 (2017: £24.1bn). The transaction was notable not only for its size, but for the swift and seamless execution helping facilitate Prudential's strategic demerger of its UK business.

RLP's capital position remains robust with SCR coverage of 180% (2017: 163%). RLP aims to maintain SCR coverage above 130% so its capital position provides significant surplus capital for new business and future dividends.

In addition to the Prudential transaction, RLP also executed five other bulk annuity transactions, including the transaction with the Toshiba Pension and Assurance Scheme, generating total new business premiums for the year of £13.2bn (2017: £1.2bn). RLP now insures the pensions of over 770,000 individuals and make annual pension payments of £1.9bn, making RLP the largest specialist annuity insurer in the UK.

RLP's primary objective remains helping pension schemes and insurance companies to de-risk their pension liabilities. RLP's focus is on making sure that the Company pays policyholders accurately and on time and that policyholders can be confident in the long-term security of their retirement benefits. Protecting the interests of clients and policyholders requires a relentless focus on risk and capital management, particularly during times of market stress.

In July RLP obtained strong investment grade credit ratings of A+ from Fitch Ratings and A3 from Moody's Investors Service. These ratings are a testament to the strength and long-term viability of RLP's business and its business model. Both the agencies highlight the Company's risk, capital and asset management capabilities as strong positive drivers of the ratings. The ratings have also facilitated access to the public capital markets, something RLP took advantage of in September by successfully issuing £350m of RT1 notes.

In December RLP received approval to use a PIM for the calculation of the Company's SCR for credit and counterparty risk. Use of the model ensures that the Company's capital models are aligned to the risks that the Company is taking, thereby assisting in delivering security for policyholders.

Development of the PIM involved a detailed assessment of the risk profile of each of the asset classes in which the Company invests and of the Company's counterparties. Each risk then needed to be modelled in order to understand the potential impact and to assess the solvency capital required in relation to credit and counterparty risk. Given the granular and detailed nature of the model, development of the PIM has taken many months of effort from across the business, so obtaining approval of the PIM represents an important milestone.

RLP was delighted to receive the award for "Best Life Insurer/Annuity Provider 2018" from the Insurance Investment Exchange, for the second year in a row, as well as Risk.net's award for "Insurer of the Year 2019".

The new ventures that the Company initiated over past years have also started to bear fruit. RLP has now funded £1.9bn of equity release mortgages having started at the end of 2016. By providing funding to back equity release mortgages through a number of strategic partners, the Company is helping older people 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.

Performance

Following completion of the Prudential transaction, RLP chose to de-risk the underlying assets and reinvest cautiously to take advantage of attractive market opportunities. Investments completed to date have out-performed RLP's underwriting assumptions and it expects significant further profits to arise as it invests the remaining assets. While widening credit markets have dampened IFRS profit before tax for 2018 to £114m (2017: £330m), they also present further opportunities to invest at more attractive levels.

Outlook

2018 was a record year for the UK bulk annuity market in terms of volume of transactions, with premiums exceeding £21bn (excluding the £12bn annuity portfolio acquired from Prudential Plc).

Competition has remained intense during the year, with some of the business transacted by RLP's competitors during the year being written at pricing levels that would not have met the Company's return thresholds. RLP has remained disciplined in the execution of its strategy, as careful business selection remains a critical aspect of the business strategy.

Improved pension scheme funding as a result of strong equity performance, rising interest rates and recovery plans means that the outlook for the bulk annuity market going into 2019 is probably the strongest the Company has seen, with a number of large and exciting opportunities in the pipeline. Potential market volatility as a result of the political outlook in the UK remains the biggest barrier to market volumes in 2019 exceeding 2018.

The outlook for back-book transactions also looks positive. Most UK insurance companies have exited the individual annuity market, which means that their annuity portfolios are no longer core. As a result, RLP believes that there are likely to be a number of opportunities to acquire back-books of annuities over the next few years. RLP's successful experience with the Prudential, Aegon and Zurich transactions puts RLP in a leading position to execute future transactions.

Risk, capital and asset management

RLP anticipate that market uncertainty and volatility will continue to increase in the first half of 2019 as the political process of negotiating and finalising the details of the UK's proposed exit from the EU is completed, global tensions play out and quantitative easing is unwound. The Company is therefore fortunate in having market-leading risk management systems that allow it to be proactive and to navigate even the most difficult markets with agility, ensuring the Company meets its obligations while preserving capital to grow and generate value for its investors. In the midst of significant market volatility in connection with Brexit and other global instability, having such detailed real-time information is critical for the successful and efficient operation of any insurance business. Continued investment in the systems and people to manage the risks RLP assumes on behalf of its customers is a key part of its strategy.

RLP's risk and capital management framework is intended to ensure that the Company identifies and understands all of the inherent risks in the liabilities the Company insures and the assets in which it invests. RLP then looks for the most efficient and effective methods of managing these risks. This involves hedging market risks, such as interest rate, currency and inflation, using derivatives and asset liability matching and hedging longevity risk using reinsurance, where RLP has reinsured 78% of its exposure. Stress testing and scenario planning means that RLP can be confident that the business can withstand adverse stresses, including as a result of a "hard" Brexit. Mitigating risk is not only efficient under the Solvency II regime, but is also consistent with RLP's risk appetite. RLP believe that it is prudent to hedge market and longevity risk exposures, as long as this is done with robust collateral provisions to mitigate counterparty risk. RLP also look to invest in assets where credit risk is mitigated through the use of collateral and legal/structural protections, whilst maximising the liquidity premium RLP can generate.

Policyholders

Providing over 770,000 policyholders with a safe and secure pension is at the heart of what RLP does.

RLP takes pride in the quality of the service it provides so it was vital that the transition from Zurich and Aegon to RLP went smoothly following the Court-sanctioned transfers. RLP is now working on ensuring a similar successful outcome for the policyholders who will transfer from Prudential to RLP.

During the year, RLP became the first insurance company to have gained Accreditation by the Pensions Administration Standards Association (PASA), an independent body dedicated to improving standards in pensions administration. The quality of service RLP provides to its policyholders is also reflected in the high level of customer satisfaction and consistently low levels of upheld complaints.

RLP's in-house operations team works closely with its various administration partners to automate processes and minimise the risk of errors. The close integration of its 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.

A hard Brexit may mean that the Company is prohibited from paying claims to its EU policyholders and it is therefore developing contingency plans for ensuring continuity of payment for its small block of Irish annuitants and for its ex-pat policyholders.

People and culture

During the year RLP has continued to build its in-house asset management function and other key areas of the business. RLP has also strengthened control and support functions by, for example, appointing a new Chief Auditor and a new Chief Technology Officer and by bringing the Chief Actuary function in-house.

The high level engagement of RLP's people and the breadth of the expertise within the team across insurance, pensions, actuarial, investment management, operations and technology is the defining factor in RLP's success. This was illustrated by the successful execution of the Prudential transaction, a testament to the strong teamwork and seamless operations that RLP has developed.

New business origination & underwriting

The new business team works with insurance companies, pension schemes and their advisors to help them to de-risk and to achieve long-term pension security for all of RLP's policyholders, whilst at the same time ensuring an appropriate return taking into account the associated risks and capital required. RLP's focus on business selection is critical to the success of the Company.

The Company has experience of sourcing annuities across the full spectrum of deal structures:

- Bulk pension buy-ins and buy-outs.
- Reinsurance of annuity portfolios followed by transfer of the business.
- Acquisition of annuity companies.

Competition has remained intense during the year, with some of the business transacted by competitors during the year being written at pricing levels that would not have met RLP's return thresholds. During 2018, the Company looked at over 60 new business opportunities, focusing its attentions on the deals that worked best for all stakeholders.

RLP were particularly pleased to be selected by Prudential to assist them in transitioning towards a more capital efficient, de-risked business model as this demonstrated their confidence in RLP's execution capabilities.

Each and every transaction RLP does, 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 liabilities ahead of completion. RLP's in-house underwriting team comprises actuarial, pensions, operational, trading, investment and legal expertise, all of whom have extensive experience in their respective areas.

Cautious underwriting combined with detailed legal and operational due diligence performed by specialist teams is intended to achieve maximum pre-deal certainty. RLP's risk management systems allow it to assess and monitor the impact of transactions in advance of completion. This allows the Company to provide certainty of pricing for clients by locking-in the economics of a deal and also protects the Company's balance sheet by ensuring consistent quality of origination and allowing it to hedge risks appropriately as soon as new business is written.

By the end of 2018, in addition to the Prudential transaction, the Company had assisted five pension schemes to de-risk their liabilities, taking new business premiums to £13.2bn (2017: £1.2bn).

Investment management

RLP's in-house team is responsible for the management of the £36.3bn asset portfolio. The team is responsible for sourcing assets consistent with the Company's long-term investment strategy.

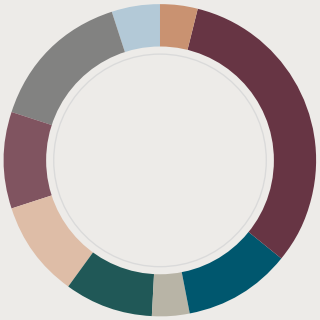
RLP has long-term annuity liabilities that are backed by fixed-income assets. Given the illiquid nature of it's liabilities, the Company is a buy and hold investor. Adverse movements in its investment portfolio are offset by movements in its insurance liabilities, leading to reduced exposure to market volatility.

The Company is adversely impacted by defaults and hence it looks to maximise recoveries by making highly secured or collateralised investments. Under Solvency II, the Company is also exposed to risk of downgrades as capital requirements are driven by ratings. As a result, the Company looks to invest in assets with low risk of downgrade or where an investment would still provide attractive returns following a downgrade.

A large amount of the portfolio is, by design, highly secured, but less liquid. In order to manage liquidity risk, the Company holds substantial liquidity buffers at all times to protect the firm against potential liquidity calls. To achieve this, the Company 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.

The Company 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. The use of derivatives to hedge market risk, combined with its use of collateral to mitigate credit and counterparty risk, means that collateral management forms an integral part of the Company's activities. RLP monitors collateral closely and stress tests collateral that backs investments to ensure security is not compromised due to market moves.

Asset portfolio



Cash	4%
UK and other sovereigns	32%
Supranational and quasi sovereign	11%
Other	4%
Corporate bonds	9%
Infrastructure	10%
Other secured lending	10%
Secured residential lending	15%
ERM	5%

The Company has a dedicated in-house team focused on ensuring that the assets in which it invests are secure through their inherent credit worthiness or structural features such as collateral, covenants and other security features. The team consists of origination, structuring, legal, trading, risk, modelling, operations and capital expertise. 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.
- Asset related risks are well understood.
- 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.

The Company's overall credit default risk is mitigated by investing in liquid, low-risk government and supranational bonds and less liquid highly secured or collateralised investments. The Company also has a holding of corporate bonds. The average rating of the Company's investment portfolio is AA.[1]

A breakdown of the investment portfolio is shown in the diagram above and described in more detail below:

- **Government and supranational bonds:** A large part of the portfolio is invested in low-risk government bonds and supranational bonds. This portion of the portfolio backs RLP's very long-dated cash flows but is also available to meet collateral calls and cash requirements. It is made up as follows:
  - UK and other sovereign bonds (gilts and other government guaranteed bonds) – 32%.
  - Supranational and quasi sovereign debt – 11%.
- **Secured residential lending:** 15% of the portfolio is invested in loans secured against property. This includes covered bonds, loans secured on ground rents and social housing.
- **Equity release mortgages (ERM):** Equity release mortgages now represent 5% of the portfolio, a substantial increase compared to 2017. This has been achieved through a combination of strategic partnerships with originators and distributors as well as purchase of in-force blocks, most notably the acquisition of an £860m portfolio of equity release mortgages from UKAR.
- **Infrastructure:** 10% 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 secured lending:** 10% of the portfolio is invested in loans secured against other collateral including commercial real estate.
- **Corporate bonds:** Given the significant growth in the Company's assets under management, the Company has decided to include a 9% exposure to a diversified portfolio of corporate bonds.
- **Other:** 4% of the portfolio is held in cash and money market funds, with the remaining 4% consisting of a range of fixed interest investments including negative basis trades and loans to US and UK higher education and other non-profit organisations.

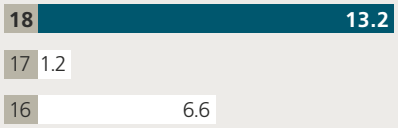
1 Average rating is based on ratings used for Solvency II purposes and ignores equity release mortgages which are unrated in their unsecuritised form.

Key Performance Indicators

The Board and management have adopted key performance indicators to provide a high level indication of the Company's aggregate performance.

New business premiums (£bn)

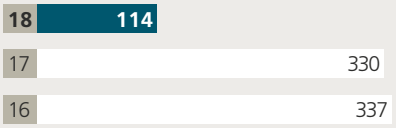
£13.2bn



New business premiums are a key indicator of the Company's growth and realisation of its strategic objectives. The Company includes bulk annuity premiums and acquisition of back-books through reinsurance or company acquisition in new business premiums. 2018 was a record year for the Company for new business as a result of the Prudential transaction.

IFRS profit before tax (£m)

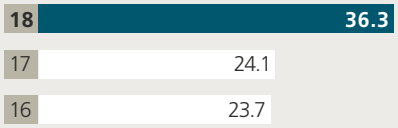
£114m



IFRS profit before tax is RLP's 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. Following completion of the Prudential transaction RLP chose to de-risk the underlying assets and reinvest cautiously to take advantage of attractive market opportunities. Investments completed to date have out-performed RLP's underwriting assumptions and RLP expects significant further profits to arise as RLP invests the remaining assets. While widening credit markets have dampened profits for 2018 to £114m (2017: £330m), they also present further opportunities to invest at more attractive levels.

Assets under management (£bn)

£36.3bn



Assets under management provides a useful measure for the size of the business as it is calculated by taking total assets and adjusting for reinsurance assets, derivatives and collateralised financing. Assets under management increased largely as a result of the Prudential transaction and other new business.

SCR coverage at RLP (%)

180%

The SCR coverage shows the way in which RLP is capitalised compared to the regulatory requirement demonstrating the solvency of the Company. The Company aims to maintain SCR cover of at least 130%. SCR coverage ratio increased from 163% as at 31 December 2017 to 180% as at 31 December 2018 despite writing the Prudential transaction.

Customer satisfaction (%)

98%

RLP prides itself on the quality of service that it's policyholders receive and are pleased that 98% of policyholders responding to feedback surveys rate the service as excellent or good for the year 2018, despite the significant growth in size of the business[1].

1 Policyholder feedback surveys are sent to all policyholders following any interaction with them (apart from complaints and bereavement).

The Company's assets under management increased from £24.1bn as at 31 December 2017 to £36.3bn as at 31 December 2018 largely as a result of new business. These numbers can be derived from the table below by adjusting for reinsurance, derivatives and collateralised financing:

Assets under management	2018	2017
Total assets	**50,214**	38,266
Less reinsurance assets	**(43)**	(168)
Less payables and financial liabilities	**(13,855)**	(13,960)
Assets under management	**36,316**	24,138

Capital management

The Company's capital resources are of critical importance. RLP'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 Company;
- to satisfy its regulatory obligations;
- to match the profile of its assets and liabilities, taking account of the risk inherent in the business;
- to allocate capital efficiently to support new business growth;
- to retain financial flexibility by maintaining strong liquidity; and
- to provide an appropriate return to shareholders.

Under the Solvency II regime, the Company 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.

In practice, it is the Pillar 1 requirement which is more onerous and which has a direct impact on the Company's ability to pay dividends. The Company aims to maintain at least 130% of the regulatory minimum requirement. As at 31 December 2018, the Company had an SCR coverage ratio of 180% (31 December 2017: 163%).

The Company 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, RLP is required to hold sufficient assets to meet:

- the Company's technical provisions, being:
  - the liabilities of the Company 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.

Approval of the PIM has allowed the Company to restructure its holding of equity release mortgages to make them eligible for inclusion in the matching adjustment fund (a restructure that is ignored for IFRS purposes). This has improved liquidity within RLP and has increased the matching adjustment used. The Company 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 those required to meet the technical provisions are known as Own Funds.

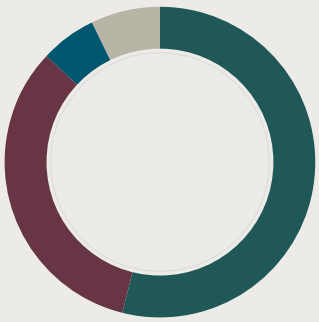
Capital management continued

As part of the transitional arrangements in relation to the introduction of Solvency II, the Company 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 Company changes materially. The Company made such an application as at 31 December 2018 in association with approval of the PIM. The impact of re-calculation was to reduce the transitional to £609m net of the associated impact of tax on Own Funds and allowing for amortisation of 1/16th on 1 January 2017 and 1/16th on 1 January 2018 (2017: £1,009m allowing for amortisation of 1/16th on 1 January 2017). Transitional solvency relief is now only 40% of the risk margin (2017: 87%).

The Company's SCR is calculated using a PIM approved for use from 31 December 2018. The PIM means that the Company's bespoke models are used for calculation of credit and counterparty risk capital and ensures 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 Company's investment strategy. The standard formula is used to calculate the SCR for all other risk components and for aggregation across risk components.

Use of the PIM led to a 16% reduction in the SCR, which has in turn contributed to the improved SCR coverage. However the reduction in transitional means that adoption of the PIM has had limited impact on the Company's surplus over the SCR. The diagram on the right provides a breakdown of the SCR post-diversification benefit between modules. Life underwriting risk relates mainly to longevity risk. Market risk is primarily spread risk, i.e. the risk that credit spreads widen.

RLP SCR 31 December 2018



Market risk	54%
Life underwriting risk	33%
Counterparty default risk	6%
Operational risk	7%

As at 31 December 2018 SCR coverage at RLP increased from 163% on 31 December 2017 to 180% on 31 December 2018. The issuance by RLP of £350m of RT1 bonds helped offset the new business strain associated with the Prudential transaction and, as noted above SCR coverage has improved largely as a result of the adoption of the PIM.

In December, the PRA published Policy Statement 31/18 'Solvency II: Equity release mortgage' and the final Supervisory Statement (SS) 3/17 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages'. The Company can already meet the Effective Value Test and, if implemented today, the statement would have no impact on the Company's solvency position. In addition, the pricing of new equity release mortgages already reflects the full impact of the statement.

Further information on the Company's solvency position will be provided in the 2018 Solvency and Financial Condition Report when it is published.

Risk management

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

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

The risk management framework is intended to ensure that RLP identifies and understands all of the risks inherent in the business. Where appropriate, longevity reinsurance, asset liability matching and hedging strategies are used to manage that risk and to optimise use of capital. RLP also looks to mitigate credit risk through investing in assets that benefit from collateral and structural protections.

Throughout 2018 the Company continued to invest in the risk and compliance functions to meet the needs of the Company and to be able to respond robustly to the changing nature of the uncertainties facing the Company.

Risk management framework

The Company has an embedded risk management framework (RMF) which ensures that every member of staff knows how they contribute to the effective management of all types of risks. During the year further improvements have been made to several areas of the RMF, including enhancing the management of insurance risks such as longevity, operational risk and market risks including credit and property risk.

The RMF informs and is directed by the Company's business strategy. Risk management considerations are integral to setting business strategy, as the Company seeks to optimise its risk-adjusted returns and create shareholder value whilst also meeting the expectations of its customers. The RMF ensures both clear ownership and strong oversight of all of the Company's risks, both quantifiable and non-quantifiable.

Board risk appetite and culture

RLP'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.

RLP's strategic approach is to de-risk its business in order to achieve attractive risk adjusted returns. RLP aims to protect regulatory surplus and minimise balance sheet volatility by hedging longevity risk and adopting a cautious approach to investment.

Risk taking is therefore limited to circumstances where the Company believes that it fully understand the inherent and residual risks, where it is able to manage them within prudent, observable levels and where incurring the risks provides sufficient value to its stakeholders.

The Company aims to substantially mitigate the financial risks in its 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 Company believes it has a comparative advantage.

The risk appetite statement sets out the types of risk that the Company is willing to be exposed to in order to meet its strategic objectives. They are categorised as:

- **Desired** – risks that are core to the business model;
- **Tolerated** – risks that the Company incurs as a result of the business model but tries to mitigate or manage in some way; or
- **Undesired** – risks that the Company will seek to avoid or fully eliminate where possible.

All possible risks are considered as part of defining the overall risk universe for the Company, with each risk categorised as above and assigned an executive risk owner.

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, or changes in longevity or other expectations.			●
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.	●		

Risk appetite quantification and limit framework

The risk limit framework was enhanced in 2018 and 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 the 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 the overall risk appetite and capital position. Limits are constantly reviewed and regularly reported against.

Risk governance framework

RLP's risk governance arrangements strengthen the risk-taking and risk management of the business by adding challenge, oversight and independent assurance. During 2018, this framework was enhanced to ensure compliance with the Senior Managers and Certification Regime (SMCR). RLP adopts the principles of a 'three lines of defence' 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. RLP 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 Company'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 the 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 Company 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 coordination 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.

Policies, processes, procedures and key controls

RLP's risks are grouped into one of six categories: strategy, insurance, market, credit, operational and liquidity risk. RLP has developed appropriate processes and documented procedures, appropriate controls and other risk mitigation techniques in order to manage them effectively. The Company 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

RLP monitors it's risk exposures against risk appetite as well as management actions on a continuous basis to confirm that it's risk mitigations are effective. RLP then reports 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 Company is currently exposed, in addition to emerging risks that may impact the Company in the future.

Capability, resources and risk culture

RLP seeks to attract and retain the highest quality talent in the industry. The effectiveness of it's risk management depends upon the high quality of staff employed by RLP 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 ORSA 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 Company's business plans. The ORSA is an important input to the Company's strategic planning cycle.

The Company 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 RLP thinks of and manages risk is constantly evolving. The CRO is responsible for developing the RMF to ensure that risk management remains effective.

Changes in the Company's risk profile and emerging risks

2018 saw the Company continue to grow, including the successful completion of a deal to transfer around £12bn of liabilities from Prudential. The Company now manages the retirement benefits of over 770,000 members.

The Company has continued its strategy of investment in a diverse range of assets, including providing investment to critical UK infrastructure assets such as Thames Tideway Scheme. The Company has also continued to grow its exposure to equity release mortgages, through funding new origination as well as acquiring back-books of mortgages. The Company sources assets globally in order to achieve its targeted risk-adjusted returns, and has increased its capabilities in the US market while also enhancing its expertise in the domestic corporate debt markets.

This evolving investment strategy, together with the backdrop of political uncertainty, market volatility and increasing uncertainty over future life expectancy, has meant that the Company's proactive approach to risk management has continued to be crucial in delivering to the Company's strategic objectives and ensuring continued financial security for RLP's policyholders.

The Company has continued to strengthen its control functions and the risk function, bringing in additional experts in credit risk as well as bringing the Chief Actuary role in-house for the first time.

There continue to be changes in accounting regulation, asset trading markets, pensions and tax, the effects of which are highly uncertain. For example, during 2018 the PRA consulted on changes to the treatment of equity release mortgages under Solvency II which led to publication of Policy Statement 31/18 'Solvency II: Equity release mortgages', and the final Supervisory Statement (SS) 3/17 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages'. As noted earlier, the Company can already meet Effective Value Test and, if implemented today, the statement would have no impact on the Company's solvency position. However the risk remains that the PRA or other regulators make changes in the future which do adversely impact the Company's model.

Brexit

As a UK insurer serving the domestic market, the Company's business model is largely unaffected by the UK's decision to leave the EU. However, the Company does have a small portfolio of Irish annuities which the Company is looking to transfer to an EU-domiciled insurer during 2019 and RLP also has a number of ex-pat policyholders based outside the UK. In the unlikely event that RLP is prevented from making payments to such policyholders then RLP will look to take reasonable steps to ensure continuity of pension payment.

The Company has reviewed its investment portfolio, suppliers and counterparties in the context of a "hard" Brexit and taken action to minimise any impact and ensure contract continuity.

The continued uncertainty over the UK's future political and financial relationship with the EU and the potential implications for financial markets, provide investment challenges for all UK insurers. A hard Brexit could have adverse financial impact on the Company but regular stress testing of the balance sheet ensures that the financial and solvency impact of such an exit is within its risk tolerances. Further information on sensitivities can be found in note 9 (financial investments), note 12 (market risk) and note 20 (insurance contract liabilities).

Longer term

The Company has identified a number of emerging risks that could impact the business over the medium to long-term. Geopolitical risk continues to be high across Europe and the US, driven by changes in government or in the evolving global relationships.

Over the longer term there are risks relating to climate change and how this could impact the Company's investments, and emerging or changing drivers of population mortality, including antimicrobial resistance, new screening technologies, dementia management and scope for pharmacological breakthroughs. The Company's investment policy requires consideration of the potential impact of climate change on new investments.

The Company continues to manage its affairs prudently such that it is not over-exposed to one particular risk and so that it only accepts risks which it understands and where it is adequately rewarded for accepting the risk.

Principal risks and uncertainties facing the Company

The Company's primary risks are credit, insurance, liquidity and market (economic) 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. More details can be found in notes 12,13, 14 and 20 of the financial statements:

Risks and uncertainties	Trend and outlook	Mitigation
Credit risk	The Company is exposed to the credit risk of financial counterparties. This is increasing in-line with the growth in the balance sheet, and will continue to increase in future.	The Company carefully selects the investments it makes in order to generate an adequate risk-adjusted return, has a preference for investments with structured protection such as collateral, and may purchase external credit protection to mitigate the impact of any defaults. The Company maintains a highly experienced market-facing team as well as a second-line internal credit risk team who regularly monitor and assess the credit risk associated with its investments. Where assets are unrated, the credit risk team also makes an independent assessment of the appropriate internal credit rating.
Political risk	The focus remains on the UK's decision to leave the EU and the associated uncertainty, but there are continued political risks globally. Domestically there are risks associated with a potential change in government and with regulation of financial services. The government's planned reform of the leasehold market could have an adverse impact on the Company's loans secured on ground rents.	The Company continues to actively monitor the political landscape. Where appropriate, the Company carries out lobbying activities or responds to consultations which may directly impact it. Strategic decisions take into account the overall political landscape. The Company's potential exposure to leasehold reform is mitigated by structural protections in the loans advanced.
Longevity risk	This year mortality across the UK was heavier than expected, and the outlook remains very uncertain with factors including spending on the NHS, the efficacy of influenza vaccines and even the weather driving short-term fluctuations, and with new technologies and advances in medical science expected to drive mortality improvements in the future.	The Company invests in both people and modelling capabilities to understand its experience and to help predict what could happen in the future. The Company aims to reinsure a majority of its longevity exposure, and specifically works with reinsurers who are longevity experts. As at 31 December 2018 the Company had reinsured 78% of its longevity risk (2017: 82%).

Risks and uncertainties	Trend and outlook	Mitigation
Counterparty default risk	The Company carefully manages its counterparty exposures and works with a range of third parties. The outlook is stable.	The Company prefers to work with highly rated and stable counterparties, and to diversify counterparty exposures where appropriate. Derivative and reinsurance contracts are subject to margining requirements to ensure exposures are appropriately collateralised. The Company actively monitors counterparties for downgrade risk, and may also purchase credit protection to mitigate specific exposures.
Economic risk	Short-term economic risks are expected to be dominated by the result of the UK's decision to leave the EU, and by the nature of the future trading relationship with the bloc. This may impact for example, exchange rates and interest rates, impacting on the types of assets the Company can source to back its liabilities as well as the value of the assets it currently holds. The Company has more exposure to residential property risk through the growth in its equity release mortgages.	The Company monitors interest rate risk and foreign exchange risk closely, and uses derivatives to hedge the risks. It also undertakes regular scenario testing, for example in relation to Brexit, to understand the impact of potential combinations of stresses. Assets and liabilities are matched as closely as possible, including using inflation-linked assets to meet inflation-linked liabilities. Residential property risk is reduced through strict underwriting criteria, covering for example the quality of the underlying property and loan-to-value limits by age of borrower. RLP has also established prudent reserves covering the potential cost of the no negative equity guarantee.
Liquidity risk	As the Company continues to deploy its assets according to its long-term investment strategy, RLP's holding of illiquid assets will increase.	The Company 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.
Operational risk	The Company expects to complete the Court-sanctioned transfers of the block of business from the Prudential in 2019, the third major insurance block to be acquired, following similar deals with Aegon and Zurich. The Company continues to grow through writing new business and the number of staff employed is expected to increase in the short-term as a result. Cyber and financial crime risk continue to be heightened.	The Company has no appetite for material operational risk losses, and has a strong control environment to limit these risks as far as possible. Scenario analysis covering a variety of potential operational risk events is regularly carried out. The Company seeks to mitigate cyber risk through robust processes and controls including data protection, penetration testing and staff training, and maintains ISO27001 accreditation. Where the Company outsources some of its responsibilities, it undertakes thorough due diligence in advance of appointment and then has a strong programme of oversight.
Strategic and regulatory risk	The emergence of defined benefit consolidator schemes could prove a threat to the bulk annuity market if consolidator schemes become a viable alternative means of de-risking pension liabilities for well-funded pension schemes or companies. Further developments in relation to GMP equalisation may impose additional costs and liabilities on the Company.	The Company seeks to have a regular dialogue with regulators in order to ensure compliance, as well as the ability to react quickly to any unanticipated developments. The Company seeks to have an open and transparent relationship with regulators at all times. The Company participates in industry bodies and consultations to ensure that its interests are protected for the benefit of its stakeholders. Provisions in relation to GMP equalisation were increased following the recent judgement and the Company considers that these will be adequate.

Viability statement

The Board of Directors has assessed the prospects for the Company 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 Company's strategic business plan as well as the Company's ORSA. The strategic business plan is centered around the Company's projected new business targets, with assumptions about pricing, reinsurance, revenue generation, expenses and leverage based on the Company'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 Company's back-book.

The Company's own views of risks and associated capital requirements have been investigated through the ORSA process, including considering how future changes to the Company's risk profile and also external influences may impact on the 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 RLP's ability to execute the business plan. Scenarios considered include the potential financial impact of a hard Brexit. The ORSA demonstrates the robustness of the Company'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 Company is well capitalised on both a regulatory and economic capital basis.

Based on the results of this analysis, the Board of Directors has a reasonable expectation that the Company 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.

Date of authorisation of issue

The financial statements were authorised for issue by the Board of Directors on 13 February 2019.

ON BEHALF OF THE BOARD

A.M. Stoker
Chief Financial Officer

13 February 2019

Report of the Directors

The Directors present their Annual Report and the audited financial statements for RLP, registered number 06127279, (the Company or RLP) for the year ended 31 December 2018. Comparative information has been presented for the year ended 31 December 2018.

1. Results

The results for RLP for the year are set out in the statement of comprehensive income on page 22.

2. Dividends

The Directors have recommended and paid interim dividends of £500m during the year ended 31 December 2018 (2017: £370m). The Directors have recommended no payment of a final dividend in respect of the year ended 31 December 2018 (2017: £nil). Please refer to note 27 to the financial statements for additional detail.

3. Registered office

RLP is registered in the United Kingdom. The registered office and principal place of business is Level 25, The Leadenhall Building, 122 Leadenhall Street, London EC3V 4AB.

4. 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		
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		
T. L. Miller		
T. J. Pearce		
C. D. Pickup		
W. J. Robertson		
A. M. Stoker		

5. 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 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 RLP during the year and at the date of approval of the financial statements.

6. 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 are 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.

7. Independent auditors

The Company has passed elective resolutions in accordance with the Companies Act 1985 to dispense with the holding of annual general meetings, the laying of accounts and reports before general meetings and the annual reappointment of auditors. PricewaterhouseCoopers LLP will, accordingly, continue in office as auditors of the Company pursuant to Section 487(2) of the Companies Act 2006.

8. Statement of Directors' responsibilities

The Directors are responsible for preparing the strategic report, the 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 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.

Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

9. Internal control and risk management systems

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

- management ensures that processes are appropriately followed, documented and controlled;
- 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 financial statements. The Audit Committee is kept appraised of such developments;
- the Company's results are subject to various levels of review by management; and
- the Audit Committee and the Board review the draft financial statements, strategic report and the 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 financial statements.

10. Date of authorisation of issue

The financial statements were authorised for issue by the Board of Directors on 13 February 2019.

ON BEHALF OF THE BOARD

A.M. Stoker
Chief Financial Officer

13 February 2019

Independent auditors' report to the members of Rothesay Life Plc

Report on the audit of the financial statements

Opinion

In our opinion, Rothesay Life Plc's financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2018 and of its profit and cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the financial statements, included within the Annual Report and Accounts 2018, Report of the Directors and Financial Statements (the "Annual Report"), which comprise: the statement of financial position as at 31 December 2018; the statement of comprehensive income, the cash flow statement, the statement of changes in equity for the year then ended; the accounting policies; and the notes to the financial statements, including the Appendix and Glossary of Terms.

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

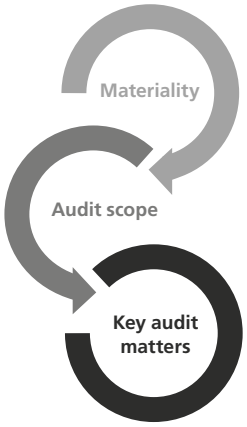
We remained independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities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

Other than those disclosed in note 7 to the financial statements, we have provided no non-audit services to the Company in the period from 1 January 2018 to 31 December 2018.

Our audit approach

Overview



Overall materiality: £35 million (2017: £30 million), equates to 1.38% of total equity as shown in the statement of financial position.

The Company is a UK based legal entity, and we performed a full scope audit of the Company's financial statements.

We identified the following key audit matters applicable for the Company:

Valuation of insurance contract liabilities, specifically:
- Longevity assumptions.
- Credit default risk assumptions.

Valuation of investments classified as Level 3 under IFRS 13.

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.

Capability of the audit in detecting irregularities, including fraud

Based on our understanding of the Company and its industry, we identified that the principal risks of non-compliance with laws and regulations related to breaches of UK and European regulatory principles, such as those governed by the Prudential Regulation Authority and the Financial Conduct Authority (see page 9 of the Annual Report), and we considered the extent to which non-compliance might have a material effect on the financial statements of the Company. We also considered those laws and regulations that have a direct impact on the financial statements of the Company such as the Companies Act 2006, the Prudential Regulation Authority's regulations, the Pensions Regulator legislation and UK tax legislation.

We also evaluated management's incentives and opportunities for fraudulent manipulation of the financial statements (including the risk of override of controls), and determined that the principal risks were related to posting inappropriate journal entries, such as increasing revenue or the capital position of the Company, management bias in accounting estimates and judgmental areas of the financial statements such as the valuation of life insurance contract liabilities and the valuation of investments classified as Level 3 under IFRS 13. Audit procedures performed by the engagement team included:

- Discussions with the Board, management, Internal Audit, senior management involved in the Risk and Compliance function and the Company's legal function, including consideration of known or suspected instances of non-compliance with laws and regulation and fraud;
- Assessment of matters reported on the Company's whistleblowing register and the results of management's investigation of such matters;
- Reading key correspondence with, the Prudential Regulation Authority and the Financial Conduct Authority in relation to compliance with laws and regulations;
- Reviewing relevant meeting minutes including those of the Risk Committee;
- Reviewing data regarding policyholder complaints, the Company's register of litigation and claims, internal audit reports, compliance reports in so far as they related to non-compliance with laws and regulations and fraud;
- Procedures relating to the valuation of life insurance contract liabilities, in particular longevity and credit default risk assumptions, and the valuation of investments classified as level 3 under IFRS 13 described in the related key audit matter below;
- Identifying and testing journal entries; and
- Designing audit procedures to incorporate unpredictability around the nature, timing or extent of our testing.

There are inherent limitations in the audit procedures described above and the further removed non-compliance with laws and regulations is from events and transactions reflected in the financial statements, the less likely we would become aware of it. Also, the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one arising from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

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(c) Critical accounting policies and the use of estimates and note 20 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 default risk assumptions given they are the most significant and judgemental assumptions.	The work to address the valuation of the insurance contract liabilities included the following procedures: • On a sample basis, agreed the underlying data used in the valuation model 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; • Tested the key judgements involved in the preparation of the manually calculated components of the liability. We focused on the consistency in treatment and methodology period-on-period 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 Company's industry peers; and • Assessed the disclosures in the financial statements. Further testing was also conducted on the longevity and credit default risk assumptions as set out below. **From the evidence obtained, we consider the valuation of insurance contract liabilities to be reasonable.**

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 Company's own historic experience and available market data in the calculation of the appropriate assumptions. For the rate of mortality improvement, this includes the latest model and datasets from the Continuous Mortality Investigation (CMI) Bureau, CMI2017. Whilst the Company manages the extent of its exposure to longevity risk through reinsurance, we consider the longevity assumptions underpinning gross insurance contract liabilities to be a key audit matter, especially given the mono-line nature of the Company's insurance business.	In addition to the procedures above, in respect of the longevity assumptions: • We tested the methodology and results of the annual experience studies, including those in relation to new liability trades (notably the Prudential transaction in 2018); • Assessed the appropriateness of expert judgements used in the development of the mortality improvement assumptions. For example, the selection and parameterisation of the CMI model including the choice of the smoothing parameter, long term rate and prudential margin; • We compared the longevity assumptions selected by the Company against those used by their peers; and • Assessed the disclosure of the longevity assumptions and the commentary to support the profit arising from changes in these assumptions over 2018. **From the evidence obtained, we found the assumptions to be appropriate.**
Credit default risk assumptions Rothesay has significant holdings in complex and illiquid investments. The deduction from the valuation rate of interest for credit default risk for these assets is judgemental and is generally lower than the corresponding credit default risk deduction on a typical unsecured credit portfolio. This reflects the Company'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 risk assumptions: • Tested the methodologies used to derive the assumptions (including prudential margin) with reference to relevant rules and actuarial guidance; and by applying our industry knowledge and experience. This included the adoption in 2018 of certain methodologies, models and calibrations from the Company's approved Solvency II Partial Internal Model; • Validated significant assumptions used by management against market observable data (to the extent available and relevant) and our experience of market practices; • Compared the assumptions selected against those adopted by peers using our annual survey of the market (to the extent available); and • Assessed the disclosure of the credit default risk assumptions and the commentary to support the profit arising from changes in these assumptions over 2018. **From the evidence obtained, we found the assumptions to be appropriate.**
Valuation of investments classified as level 3 under IFRS 13 *Refer to note 1(c) Critical accounting policies and the use of estimates and note 9 Financial investments* The investments classified as level 3 are a material balance and comprise investments in commercial mortgage loans, ground rents and equity release mortgages. The equity release mortgage portfolio has increased significantly in the current year following the acquisition of the UK Asset Resolution portfolio as well as continued new originations. The valuations of Level 3 investments 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.	The work to address the valuation of investments included the following procedures: • 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; • Reviewed management's methodology and assumptions, including yield curves, discounted cash flows, property growth rates, longevity assumptions and liquidity premiums as relevant to each asset class; • Engaged our relevant experts to assess the reasonableness and appropriateness of management's methodology; • Understood the valuation models used by management; • Independently revalued a sample of investments; • Tested inputs into the valuation to external sources, where possible; and • Assessed the disclosures in the financial statements. **From the evidence obtained, we consider the valuations 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 Company, the accounting processes and controls, and the industry in which it operates.

The Company is a regulated insurance Company. 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 the Company that monitor the procedures carried out by the service providers. This gave us the evidence we needed for our opinion on the Rothesay Life plc 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:

Overall materiality	£30 million. (2017: £30 million)
How we determined it	1.38% of total equity.
Rationale for benchmark applied	We consider 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 agreed with the Audit Committee that we would report to them misstatements identified during our audit above £1.75 million (2017: £1.5 million) as well as misstatements below that amount 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 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 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 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.

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 2018 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 Company and its 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, 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 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 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 financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the Audit Committee, we were appointed by the Directors on 26 February 2007 to audit the financial statements for the year ended 30 November 2007 and subsequent financial periods. There was a competitive tender process conducted by the Audit Committee during 2016 and we were reappointed as auditors for the year ended 31 December 2017. The period of total uninterrupted engagement is 12 years, covering the years ended 30 November 2007 to 31 December 2018.

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

13 February 2019

Statement of comprehensive income

For the year ended 31 December 2018

	Note	2018 £m	2017 £m
Income			
Gross premiums written	2	**13,424**	1,447
Less: premiums ceded to reinsurers		**(1,369)**	(781)
Net premiums written		**12,055**	666
Investment return	3	**140**	773
Total revenue		**12,195**	1,439
Expenses			
Policyholder claims		**(1,876)**	(1,479)
Less: reinsurance recoveries		**1,275**	736
Change in insurance contract liabilities		**(10,694)**	330
Change in the reinsurers' share of insurance contract liabilities		**(567)**	(500)
Net claims and change in insurance liabilities		**(11,862)**	(913)
Acquisition and administration expenses	4	**(158)**	(146)
Finance costs	5	**(61)**	(50)
Total expenses		**(12,081)**	(1,109)
Profit before tax		**114**	330
Income tax expense	8	**(17)**	(53)
Profit for the year		**97**	277

All income and expenses are related to continuing operations.

The 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 – 31 form an integral part of these financial statements.

Statement of financial position

As at 31 December 2018

	Note	2018 £m	2017 £m
Assets			
Investment in subsidiaries	30	**1**	–
Property, plant and equipment		**2**	3
Financial investments	9	**49,163**	37,312
Reinsurance assets	16	**43**	168
Accrued interest and prepayments	17	**497**	302
Receivables	18	**357**	339
Cash and cash equivalents	19	**151**	142
Total assets		**50,214**	38,266
Equity and liabilities			
Share capital	24	**410**	264
Tier 1 notes	25	**347**	–
Share premium	26	**1,353**	549
Retained earnings	26	**435**	838
Total equity		**2,545**	1,651
Liabilities			
Reinsurance liabilities	16	**673**	231
Insurance contract liabilities	20	**32,435**	21,741
Payables and financial liabilities	21	**13,855**	13,960
Borrowings	22	**647**	647
Deferred tax liabilities	23	**2**	2
Accruals and deferred income		**57**	34
Total liabilities		**47,669**	36,615
Total equity and liabilities		**50,214**	38,266

Notes 1 – 31 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 13 February 2019 and signed on its behalf by:

A.M. Stoker
Chief Financial Officer

13 February 2019

Company number 06127279

Statement of changes in equity

For the year ended 31 December 2018

	Share capital £m	Share premium £m	Tier 1 notes £m	Retained earnings £m	Total Equity £m
As at 1 January 2018	**264**	**549**	**–**	**838**	**1,651**
Tier 1 note issuance	**–**	**–**	**347**	**–**	**347**
Share issuance	**146**	**804**	**–**	**–**	**950**
Profit for the financial year	**–**	**–**	**–**	**97**	**97**
Dividends paid	**–**	**–**	**–**	**(500)**	**(500)**
As at 31 December 2018	**410**	**1,353**	**347**	**435**	**2,545**

For the year ended 31 December 2017

	Share capital £m	Share premium £m	Retained earnings £m	Total Equity £m
As at 1 January 2017	264	549	931	1,744
Profit for the financial year	–	–	277	277
Dividends paid		–	(370)	(370)
As at 31 December 2017	264	549	838	1,651

Cash flow statement

For the year ended 31 December 2018	Note	2018 £m	2017 £m
Cash flows from operating activities			
Profit for the financial year		**97**	277
Adjustments for non-cash movements in net profit for the year			
Depreciation		**1**	1
Amortisation of debt costs		**–**	(2)
Interest income	3	**(956)**	(649)
Interest expense	5	**61**	50
Income tax expense	8	**17**	53
Net (increase)/decrease in operational assets			
Financial investments[1]		**(11,849)**	1,030
Reinsurance asset		**124**	269
Receivables		**(19)**	182
Prepayments		**(83)**	–
Net increase/(decrease) in operational liabilities			
Insurance contract liabilities		**10,688**	(330)
Claims outstanding		**6**	1
Reinsurance liabilities		**443**	231
Financial liabilities		**(1)**	(1,387)
Other payables		**(82)**	(172)
Accruals and deferred income		**23**	3
Net cash flows used in operating activities		**(1,530)**	(443)
Interest paid		**(62)**	(48)
Interest received[1]		**843**	621
Tax paid		**(38)**	(62)
Cash flows (used)/from operating activities		**(787)**	68
Cash flows from/(used in) financing activities			
Proceeds from issuance of debt	22	**–**	300
Proceeds from issuance of RT1 notes (net of issuance costs)	25	**347**	–
Proceeds from issuance of ordinary share capital (including share premium)	24	**950**	–
Dividends paid	27	**(500)**	(370)
Net cash inflows/(outflows) from financing activities		**797**	(70)
Cash flows from investing activities			
Acquisition of property, plant and equipment		**–**	(1)
Investment in subsidiary		**(1)**	–
Repayment of investment in subsidiary		**–**	2
Net cash (outflows)/inflow from investing activities		**(1)**	1
Net increase/(decrease) in cash and cash equivalents		**9**	(1)
Cash and cash equivalents at 1 January		**142**	143
Cash and cash equivalents at 31 December	19	**151**	142

1 £10m of life to date accrued interest on equity release mortgages which was included in the accrued interest balance at 31 December 2017 has been reclassified to be included in the fair value of financial investments, as these are not receivable until the equity release mortgage is repaid. The Company believes that this is a more appropriate representation.

Note 1 – General information and basis of preparation

(a) General information

RLP is a registered public 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 financial statements 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 financial statements of the Company are presented in sterling (£) rounded to the nearest million (£m) except where otherwise stated. The Company statement of financial position is presented on page 23.

The Company presents its statement of financial position broadly in order of liquidity. An analysis regarding recovery or settlement more than 12 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) Critical accounting policies and the use of estimates

During the preparation of the financial statements the Company 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 in the process of applying the Company's accounting policies. Matters of significant judgement are considered to be:

- The assessment of whether the Company controls underlying entities and investments (see note 11).
- Assessment of the significance of insurance risk transferred to the Company in determining whether a contract should be accounted for as an insurance or investment contract (see note 1(d)).
- The assessment of whether the Company has transferred the risk and rewards of ownership of financial assets during securitisations (see note 29).

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.
- Measurement of insurance contract liabilities (see note 20).

In accordance with IAS 1 and published FRC guidance, within each of the relevant notes the Company 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 2019; and
- explanation of any changes made to past assumptions if the uncertainty is unresolved.

(d) Contract classification

The Company 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 Company's insurance contracts are accounted for using generally accepted accounting principles within the UK industry. The Company 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 Company continues to apply the principles.

Note 1 – General information and basis of preparation continued

(e) 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 – Segmental analysis

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

The Company 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 Company'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 Company's operations are materially within the United Kingdom. The split between regular premiums and single premiums is shown below:

	Regular premiums		Single premiums	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Group pension bulk annuities	**263**	263	**928**	978
Assumed reinsurance premiums	**–**	–	**12,233**	206
Total gross premiums written	**263**	263	**13,161**	1,184

Single premiums are made up of new business premiums of £13,100m and £61m of premiums adjustments.

The Company conducts a relatively small number of individual transactions each year. These transactions are one-off in nature and the Company's business plans do not anticipate conducting a significant amount of repeat business. The assumed reinsurance premiums for 2018 mainly relate to the Prudential transaction.

Note 3 – 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 of investments held at the statement of financial position date of each financial year and their purchase price.

	2018 £m	2017 £m
Interest income on financial investments at fair value through profit and loss	**956**	649
Unrealised (losses)/gains on financial investments	**(686)**	14
Realised (losses)/gains on financial investments	**(93)**	131
Investment management expenses	**(37)**	(21)
Total investment return	**140**	773

Interest income has increased in line with the growth in assets under management. The unrealised losses during the period were mainly due to the impact of widening credit spreads and rising interest rates.

The increase in investment management expenses reflects the growing size of the Company's investment as well as the impact of origination fees on equity release mortgages.

Note 4 – Acquisition and administration 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 acquisition and administration expenses of the statement of comprehensive income which have been included in arriving at the profit before tax:

	2018 £m	2017 £m
Acquisition costs	**102**	83
Administration expenses – recurring	**36**	21
Administration expenses – project and other one-off expenses	**20**	42
Total operating expenses	**158**	146

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

	2018 £m	2017 £m
Solvency II costs	**1**	12
Reinsurance fees	**8**	19
Costs associated with recapitalisation of the Group	**–**	2
Other	**11**	9
	20	42

The following items have been included in operating expenses:

	2018 £m	2017 £m
Depreciation	**1**	1
Operating lease rental expense for office premises	**2**	2
	3	3

Note 5 – Finance costs

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

	2018 £m	2017 £m
Interest payable on collateral	**7**	3
Interest payable on collateralised agreements and financing	**9**	17
Total interest payable on collateral and collateralised agreements	**16**	20
Interest payable on third party borrowings	**20**	20
Interest payable on borrowings from participating interests	**25**	10
Total borrowing costs	**45**	30
Net finance costs	**61**	50

Note that for the purposes of IFRS, the RT1 notes are treated as equity rather than debt (see note 25).

Note 6 – Employee information

All persons involved in the Company's operations are employed by a wider group undertaking, Rothesay Pensions Management Limited (RPML). The charges made by RPML for all the services provided (personnel and other) to the Company are included in the management fees charged by group undertakings.

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

	2018 £000s	2017 £000s
Directors' remuneration		
Aggregate emoluments	**4,217**	2,408
Company pension contributions to money purchase schemes	**27**	19
Total Directors' remuneration	**4,244**	2,427
Highest paid Director		
Total amount of emoluments	**1,865**	1,100
Company pension contributions to money purchase schemes	**7**	7
Total highest paid Director	**1,872**	1,107

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 2018 Directors received no emoluments for non-qualifying services which are required to be disclosed. Three Directors have been granted shares in respect of long-term incentive schemes. No Directors have exercised options during the year.

Note 7 – Auditors' remuneration

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

	2018 £000s	2017 £000s
Remuneration receivable by the Company's auditors for the audit of the Company financial statements	**661**	475
Remuneration receivable by the Company's auditors for the audit of the financial statements of the Company's subsidiaries	**–**	7
Total audit	**661**	482
Audit related assurance services	**199**	236
Other assurance services	**196**	2,370
Total fees	**1,056**	3,088

Other assurance services provided in 2018 include work in relation to the issuance of the RT1 notes, and independent validation of the Company's PIM. A significant element of the assurance services in relation to the Company's PIM was undertaken in 2017, hence the decrease in fees year on year. These services are all in compliance with applicable independence rules and the Company considered that the external auditor was best placed to provide these services because of their understanding of the Company.

Note 8 – 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, or paid to or recovered from other Group companies in respect of group relief surrendered or received. 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.

Note 8 – Income tax expense continued

The major components of the income tax expense for the years ended 31 December 2018 and 2017 are:

(a) Tax charged in the statement of comprehensive income

	2018 £m	2017 £m
Current income tax:		
UK corporation tax	**19**	54
Adjustment in respect of prior period	**(2)**	–
Total current income tax	**17**	54
Deferred tax:		
Origination and reversal of temporary differences	**–**	(1)
Total deferred tax	**–**	(1)
Total tax expense reported in the statement of comprehensive income	**17**	53

(b) Reconciliation of the total tax charge

The tax expense in the statement of comprehensive income for the year and the standard rate of corporation tax in the UK of 19% (2017: 19.25%) is reconciled below:

	2018 £m	2017 £m
Profit on ordinary activities before taxation	**114**	330
Tax calculated at UK standard rate of corporation tax of 19% (2017:19.25%)	**22**	63
Adjustment in respect of prior period	**(2)**	–
Difference in accounting and tax valuation basis	**5**	–
Utilisation of losses surrendered by group undertakings	**(8)**	(10)
Total tax expense reported in the statement of comprehensive income	**17**	53

Note 9 – 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. Fair value is considered consistent with the risk management of the portfolio.

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 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 deposit, loans secured on property and collateralised agreements and financing.

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 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, property prices and bid/offer inputs based on market evidence.

Financial instruments such as corporate debt securities, covered bonds, government, sub sovereign and agency obligations, certificate of deposits 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.

Note 9 – Financial investments continued

Certain financial instruments, including collateralised agreements and financing, loans secured on property and equity release mortgage 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 Company 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 Company uses derivative contracts for the purposes of efficient portfolio management and to mitigate the risk of adverse market movements. The Company'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 Company 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 Company 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.

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 Company's statement of financial position) when i) the rights to receive cash flows from the investment have expired; or ii) the Company 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 Company has transferred substantially all the risks and rewards of the asset, or (b) the Company has transferred control of the investment.

When the Company 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 Company continues to recognise the transferred investment to the extent of the Company's continuing involvement. In that case, the Company 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 Company 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 Company 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, as the securities are managed on a fair value basis. The collateral can be in the form of cash or securities.

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

Note 9 – Financial investments continued

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

	2018 £m	2017 £m
Financial investments carried at fair value through profit and loss, designated at initial recognition.	**49,163**	37,312

Determination of fair value and fair value hierarchy

The Company 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 Company 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.

The following tables show an analysis of financial investments recorded at fair value by level of the fair value hierarchy for 2018 and 2017 (please refer to note 21 for financial liabilities):

31 December 2018	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Collective investment schemes	**1,379**	**–**	**–**	**1,379**
Government sub sovereign and agency obligations	**4,694**	**10,989**	**364**	**16,047**
Corporate bonds and other corporate debt	**–**	**11,732**	**1,091**	**12,823**
Derivative assets (see note 10)	**–**	**11,450**	**1**	**11,451**
Collateralised agreements and financing	**–**	**2,028**	**–**	**2,028**
Loans secured on property	**–**	**–**	**3,376**	**3,376**
Equity release mortgages	**–**	**–**	**1,897**	**1,897**
Certificate of deposits	**–**	**162**	**–**	**162**
Total financial investments at fair value	**6,073**	**36,361**	**6,729**	**49,163**

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 (see note 10)	–	10,735	–	10,735
Collateralised agreements and financing	–	2,402	–	2,402
Loans secured on property	–	–	3,409	3,409
Equity release mortgages[1]	–	–	539	539
Certificate of deposits	–	161	–	161
Total financial investments at fair value	5,072	27,607	4,633	37,312

1 £529m of equity release mortgages which were classified as loans secured on property as at 31 December 2017 have been separately identified following the increased significance of this asset class. £10m of life to date accrued interest on equity release mortgages which was included in the accrued interest balance at 31 December 2017 has been reclassified to be included in the fair value of equity release mortgages, as these are not receivable until the equity release mortgage is repaid and the Company believes that this is a more appropriate representation.

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

Approximately 14% (2017: 12%) 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.

Note 9 – Financial investments 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 (excluding equity release mortgages which are discussed in the equity release mortgages section of note 9):

	Government sub sovereign and agency obligations £m	Corporate debt £m	Loans secured on property £m	Derivatives £m	Total £m
At 1 January 2018	**–**	**685**	**3,409**	**–**	**4,094**
Total gains in the statement of comprehensive income:					
Unrealised (losses)/gains	**–**	**(15)**	**(87)**	**1**	**(101)**
Transfer into Level 3	**–**	**–**	**–**	**–**	**–**
Transfer out of Level 3	**–**	**–**	**–**	**–**	**–**
Net purchases/additions	**364**	**421**	**54**	**–**	**839**
At 31 December 2018	**364**	**1,091**	**3,376**	**1**	**4,832**
At 1 January 2017	–	338	2,911	–	3,249
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	–	–	–	–	–
Net purchases/additions	–	161	222	–	383
At 31 December 2017	–	685	3,409	–	4,094

Please note the 2017 disclosure has been restated to remove equity release mortgages as these have been disclosed elsewhere in note 9. Please see note 21 for details of Level 3 derivative liabilities.

The Company's policy is to determine the relevant categorisation of financial assets and liabilities at least annually and, where availability of inputs has changed, transfers will be made between levels. There were no transfers of financial instruments between Level 2 and 3 of the fair value hierarchy (2017: £357m of assets were transferred from Level 2 to Level 3).

Equity release mortgages

Equity release mortgages allow the borrowers to take equity from their homes either as a lump sum or in smaller, regular amounts. The total amount, capital plus interest, is repaid when the borrower dies or move into long-term care. All equity release mortgage loans provide a 'no negative equity guarantee' (NNEG), which means that the mortgage repayment amounts (loan principal plus interest on redemption) are subject to a maximum of the sale proceeds of the property on which the loan is secured.

Equity release mortgages are valued using a discounted cash flow model by projecting future net cash flows on a closed form basis allowing for demographic assumptions, consistent with those used for insurance contracts adjusted for transfer to long-term care, prepayment rates, future expenses and potential cost of providing the NNEG. Cash flows are then discounted at a risk-free rate plus illiquidity premium inferred from market observed levels.

The NNEG can be thought of as a series of options written by the Company which allow the equity release mortgage holders to extinguish their loan by selling their property back to the Company at the current market value and at the point at which the mortgage must be redeemed (typically on death or transfer to long term care), even when property values are lower than the outstanding loan balance.

Sensitivities to interest rates and house prices are shown later in this note as these are the most material assumptions given the way in which the potential cost of the no negative guarantee is derived.

Given the various assumptions used in valuing the equity release mortgages, the instruments are recorded as Level 3 assets. The table on the next page provides an analysis of the movement in the value of equity release mortgages. New business includes both the acquisition of back-books of equity release mortgages, such as the £860m portfolio of equity release mortgages from UKAR, and new origination through strategic partners. The change in economic assumptions includes the impact of changes in interest rates and property prices. The change in demographic assumptions includes the impact of changes in pre-payment rates and assumed mortality.

Note 9 – Financial investments continued

	2018 £m	2017 £m
Carrying amount at 1 January	**539**	10
Increase in respect of new business	**1,380**	519
Redemptions/repayments	**(76)**	(1)
Accrued interest for the year	**50**	11
Change in economic assumptions	**3**	–
Change in demographic assumptions	**1**	–
Closing balance at 31 December	**1,897**	539

The table below provides a summary of the cash flows arising from the equity release mortgage portfolio based on the above assumptions:

	2018 £m	2017 £m
Less than 1 year	**135**	42
1 to 5 years	**471**	153
Over 5 years	**1,291**	344
	1,897	539

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:

	2018		2017	
	Asset £m	Related liability £m	Asset £m	Related liability £m
Government and agency obligations	**965**	**779**	1,873	1,405
Total collateralised agreements	**965**	**779**	1,873	1,405

A number of these agreements matured during 2018 and have not been replaced leading to the reduction in the amount shown.

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 Company's obligations to repurchase the transferred assets at a future date is recognised in other liabilities. The Company 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 exposure to certain OTC derivatives is collateralised through cash. As at 31 December 2018, the total cash collateral received was £1,128m (2017: £1,264m). Other OTC contracts are collateralised with fixed income securities which are not recognised on the balance sheet of the Company.

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

The table on the next page 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 on the next page also shows the potential impact on profit before tax (PBT) of the same alternative assumptions, assuming that all other pricing inputs remain constant:

Note 9 – Financial investments continued

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

Impact on financial assets and PBT	Main assumptions	Sensitivity	Current FV £m	2018 (Decrease)/ Increase in FV £m	(Decrease)/ Increase in PBT £m
Financial assets					
Corporate bonds and other corporate debt	Discount rate	+50bps yield to maturity	1,091	(58)	(18)
		-50bps yield to maturity	1,091	63	20
Government sub sovereign and agency obligations	Discount rate	+50bps yield to maturity	364	(11)	(2)
		-50bps yield to maturity	364	12	2
Loans secured on property	Liquidity premium	+25bps yield to maturity	3,376	(187)	–
		-25bps yield to maturity	3,376	206	–
Loans secured on property[1]	Property prices	+10% change in property prices	3,376	10	14
		-10% change in property prices	3,376	(19)	(28)
Equity release mortgages	Liquidity premium	+25bps yield to maturity	1,897	(94)	–
		-25bps yield to maturity	1,897	102	–
Equity release mortgages	House prices	+10% change in house prices	1,897	39	44
		-10% change in house prices	1,897	(50)	(56)
Derivative assets	Expected defaults	+50bps credit default spread	1	–	–
		-50bps credit default spread	1	–	–

Impact on financial assets and PBT	Main assumptions	Sensitivity	Current FV £m	2017 (Restated)[2] (Decrease)/ Increase in FV £m	(Decrease)/ Increase in PBT £m
Financial assets					
Corporate bonds and other corporate debt	Discount rate	+50bps yield to maturity	685	(36)	(11)
		-50bps yield to maturity	685	39	12
Loans secured on property	Discount rate	+25bps yield to maturity	3,409	(205)	(21)
		-25bps yield to maturity	3,409	227	23
Equity release mortgages	Liquidity premium	+25bps yield to maturity	539	(13)	–
		-25bps yield to maturity	539	14	–
Equity release mortgages	House prices	+10% change in house prices	539	5	5
		-10% change in house prices	539	(3)	(3)
Derivative assets	Expected defaults	+50bps credit default spread	–	–	–
		-50bps credit default spread	–	–	–

1. The comparative sensitivity for 2017 was not disclosed because the way in which the fair value of loans secured on property was determined in 2017 was less sensitive to the property value of the underlying collateral than the approach used in 2018.
2. Restated to split out equity release mortgages to be consistent with the disclosure shown for 2018.

Note 10 – Derivatives

The Company uses derivative financial instruments as part of its risk management strategy and to hedge its solvency position. The objectives include managing exposure to market, foreign currency, inflation and interest rate risks on assets and liabilities (see also note 12). The total net fair value of the Company's derivative asset and liabilities as at 31 December 2018 is a liability of £339m (2017: a liability of £430m).

The following table shows the fair value of derivative financial instruments, recorded as assets or liabilities, together with their notional amounts.

	2018			2017		
	Assets £m	Liabilities £m	Notional amount £m	Assets £m	Liabilities £m	Notional amount £m
Derivatives held for risk management:						
Interest rate swap	**9,356**	**(9,532)**	**200,403**	8,941	(9,260)	127,801
Inflation swap	**1,570**	**(1,620)**	**34,871**	1,591	(1,633)	31,837
Currency swap	**497**	**(597)**	**37,889**	185	(173)	15,787
Credit derivative	**22**	**(34)**	**2,049**	13	(92)	3,009
Foreign currency forwards	**6**	**(7)**	**2,073**	5	(7)	1,128
Total	**11,451**	**(11,790)**	**277,285**	10,735	(11,165)	179,562

Note 10 – Derivatives continued

Derivatives are used solely for efficient portfolio management and risk management purposes, allowing market risks to be hedged in line with RLP's 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 Company 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 the risk exposure. As such, the notional amount should not be considered as an indicator of the market risk exposure generated by the derivative portfolio. Derivatives where the fair value is positive are recognised as an asset and where the fair value is negative they are recognised as a liability.

The Company's exposure under derivative contracts is closely monitored as part of the overall management of the Company's market risk (see also note 12).

Note 11 – Investment in unconsolidated structured entities

The Company 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 Company does not have the power to affect their returns.

The Company has interests in unconsolidated structured entities as described below:

- loans granted to and notes issued by special purpose vehicles (SPVs) secured by the assets held by the SPV such as commercial or residential real-estate;
- debt securities issued by SPVs secured by financial receivables; and
- loans granted to SPVs secured by financial receivables.

As at 31 December 2018 the total interest in such entities, reflected on the Company's statement of financial position and classified as financial investments held at fair value through profit or loss was £4,825m (2017: £4,480m). The recorded fair value represents the Company's maximum loss exposure to these unconsolidated structured entities. The £345m increase in the balance was predominantly driven by three new positions in corporate bonds, government guaranteed bonds and upsizes of existing positions contributing £447m of increased investment partially offset by mark-to-market losses of £104m in relation to existing positions.

A summary of the Company's interest in unconsolidated structured entities is provided below:

	2018 £m	2017 £m
Government sub sovereign and agency obligations	**75**	–
Corporate bonds and other corporate debt	**1,319**	979
Loans secured on property	**3,431**	3,501
Total	**4,825**	4,480

Note 12 – Market risk

The Company is exposed to market risk through its financial assets and financial liabilities. This risk, described below, is managed in accordance with risk management policies and procedures established by the Company. Please see page 9 to 13 of the strategic review for further detail on risk management arrangements and the governance framework within the Company.

Market risk is the risk of changes in the value of the Company's net position due to changes in market prices. Financial investments are accounted for at fair value and, therefore, fluctuate on a daily basis. Certain liabilities are also exposed to market risk. 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 closely by matching assets and liabilities and by using interest rate swaps. Consideration is given to both the Company's IFRS and solvency risk positions when determining the appropriate hedging strategy.
- Inflation rate risk results from mismatches in the index linkage of liabilities and assets. Profits and losses are generated through changes to the level, slope and curvature of inflation curves. The risk is hedged by closely matching assets and liabilities and by using inflation swaps.
- Currency rate risk results from mismatches in the denomination of liabilities 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. Where the property risk becomes more material then prudent allowance is made for this within the credit risk adjustment.

Note 12 – Market risk continued

The Company 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 CRO and the risk function, which is independent of management and reports to the CEO and the Chairman of the BRC, 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 2018 **Change in variables**	**Impact on PBT £m**	Impact on equity Up to a year £m
(+) 1 basis point	**(0.30)**	(0.24)
(-) 1 basis point	**0.30**	0.24

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

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 2018 **Change in variables**	**Impact on PBT £m**	Impact on equity Up to a year £m
(+) 1 basis point	**(0.45)**	(0.37)
(-) 1 basis point	**0.45**	0.37

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

Note 13 – Credit risk

The Company is exposed to credit risk through its financial assets and financial liabilities.

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 RLP holds. 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 third parties.

Management is responsible and accountable for managing credit risks within prescribed limits. 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.

The Chief Credit Officer, who is independent of first 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 BRC.

Please see page 9 of the strategic review for further detail on risk management arrangements within the Company.

Note 13 – Credit risk continued

Risk mitigants

The Company 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 mitigate the credit exposures on derivatives and collateralised agreement transactions, the Company obtains collateral from counterparties on an upfront or contingent basis. The Company also enters into netting agreements with counterparties that permit it to offset receivables and payables with such counterparties for transaction settlements and upon a counterparty default.

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

Credit exposures

The Company'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 investment in money market funds. To mitigate the risk of credit loss, the Company diversifies its exposure and places its deposits with multiple banks, typically with minimum ratings in the 'A' rating category. The Company only invests in 'AAA' rated money market funds.

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

Collateralised agreements. Collateralised agreements are reported at fair value or contractual value before consideration of collateral received on the balance sheet. The Company 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 Company's credit exposure on the transactions is significantly lower than the amounts recorded on the balance sheet. The Company also has credit exposure on repurchase agreements and securities loaned, which are liabilities on its statement of financial position, to the extent that the collateral pledged for these transactions exceeds the amount of cash received.

Other credit exposures. The Company is exposed to credit risk from its receivables from third parties. Receivables from counterparties are generally comprised of collateralised receivables related to derivatives or collateralised agreements transactions and have minimal credit risk due to the value of the collateral received. In addition, the Company 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.

Note 13 – Credit risk continued

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 IAS 32.

	2018 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
Investment in subsidiaries	1	–	–	–	1
Property, plant and equipment	2	–	–	–	2
Collective investment schemes	1,379	–	–	–	1,379
Government sub sovereign and agency obligations	16,047	–	–	–	16,047
Corporate bonds and other corporate debt	12,823	–	–	–	12,823
Derivative assets	11,451	(8,149)	(567)	(2,731)	4
Collateralised agreements and financing	2,028	–	(13)	(2,015)	–
Loans secured on property	3,376	–	–	(3,376)	–
Equity release mortgages	1,897	–	–	(1,897)	–
Certificate of deposits	162	–	–	–	162
Reinsurance assets	43	–	–	–	43
Accrued income and prepayments	497	–	–	–	497
Receivables	357	–	–	–	357
Cash and cash equivalents	151	–	–	–	151
Total	**50,214**	**(8,149)**	**(580)**	**(10,019)**	**31,466**
Derivative liabilities	(11,790)	8,149	315	3,105	(221)
Collateralised financing agreements	(779)	–	–	779	–
Total	**(12,569)**	**8,149**	**315**	**3,884**	**(221)**

	2017 restated)[1] 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[1]	3,409	–	–	(3,409)	–
Equity release mortgages[1]	539	–	–	(539)	–
Certificate of deposits	161	–	–	–	161
Reinsurance assets	168	–	–	–	168
Accrued income and prepayments[1]	302	–	–	–	302
Receivables	339	–	–	–	339
Cash and cash equivalents	142	–	–	–	142
Total	38,266	(7,727)	(704)	(8,649)	21,186
Derivative liabilities	(11,165)	7,483	283	3,146	(253)
Collateralised financing agreements	(1,405)	244	–	1,161	–
Total	(12,570)	7,727	283	4,307	(253)

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 the overall derivative exposure. The overall exposure can be seen in note 10.

1 £529m of equity release mortgages which were classified as loans secured on property as at 31 December 2017 have been separately disclosed. £10m of accrued interest on equity release mortgages which was included in the accrued interest balance at 31 December 2017 has been reclassified to be included in the fair value of equity release mortgages.

Note 13 – Credit risk continued

Right of offset

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

Netting under master netting agreements of £8,149m (2017: £7,727m) reflects the offsetting of derivative assets with liabilities for which the Company 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 Company has received total security collateral and charges of £10,570m (2017: £9,685m) of which £10,019m (2017: £8,649m) has been applied against net exposure, leaving excess of £551m (2017: £1,036m). Security collateral exposes the Company to further market and credit risk. This is mitigated through the use of haircuts and over collateralisation.

Credit default swaps have been purchased to protect the Company from the default of some of its counterparties. The table on the previous page does not reflect the protection provided. The Company 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 below shows the Company's gross and net credit exposure based on external ratings. The external rating is generally based on the median of the ratings assigned by Standard & Poor's, Moody's and Fitch. This is consistent with the Company's approach under Solvency II.

Net credit exposure is primarily higher rated 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 as well as unsecured corporate bonds.

£268m (2017: £325m) of the total net credit exposure relates to bonds, rated investment grade or lower, held within negative basis packages, for which maturity, currency and reference obligation matched credit default swap protection is held. The net credit exposure and external rating does not reflect the credit default protection in place.

Other net credit exposures rated non-investment grade, excluding negative basis packages positions, are mitigated by the use of collateral.

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

	2018 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	7,432	–	–	–	7,432
AA	13,574	(891)	–	–	12,683
A	16,140	(6,319)	(402)	(2,015)	7,404
BBB	6,726	(939)	(178)	(2,654)	2,955
BB	61	–	–	–	61
B	37	–	–	–	37
Unrated	6,244	–	–	(5,350)	894
Total	50,214	(8,149)	(580)	(10,019)	31,466

Note 13 – Credit risk continued

	2017 (restated)[1] 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	11,440	(342)	–	–	11,098
A	12,411	(6,478)	(525)	(2,003)	3,405
BBB	4,987	(907)	(179)	(2,698)	1,203
BB	81	–	–	–	81
B	44	–	–	–	44
Unrated	4,738	–	–	(3,948)	790
Total	38,266	(7,727)	(704)	(8,649)	21,186

1 At 31 December 2017 £1.4bn of collateralised agreements with an 'A' credit rating were incorrectly classified as 'BBB' and £26m of collateralised agreements with a 'BBB' rating were incorrectly classified as 'AA'.

The unrated financial assets of £6,244m (2017: £4,738m) reflect investments in issuers that are not externally rated. During the year, the Company 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 Company's independent credit risk function under a framework which has been externally validated. Under this framework 40% of the unrated balance is rated 'AAA', 3% rated 'AA', 18% rated 'A' and 6% rated 'BBB'. The remaining 33% includes the financing of equity release mortgages.

Note 14 – Liquidity risk

The Company is exposed to liquidity 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 Company. Please see page 9 of the strategic review for further detail on risk management arrangements within the Company.

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 Company is capable of honouring all cash flow commitments on both an ongoing basis and in a stressed scenario, without incurring significant cost or business disruption.

The Company 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 Company 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 Company 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 Company 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 Company 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.

The risk function has primary responsibility for ensuring an appropriate framework is in place for assessing, monitoring and managing liquidity risk. The liquidity risk management framework requires liquid assets to be held to meet a wide range of stressed market conditions which consider all material sources of liquidity risk present on the balance sheet. Liquidity is managed for the Company as a whole, in addition to at a Solvency II fund level. 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 BRC.

Note 14 – Liquidity risk continued

The following table details the Company's financial liabilities and assets by contractual maturity including interest that was accrued where the Company 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 20. The table excludes equity release mortgages which are included in note 9.

	2018			
	Less than 1 year £m	1 to 5 years £m	Over 5 years £m	Total £m
Financial assets				
Financial investments	3,514	5,174	38,578	47,266
Accrued income and prepayments	497	–	–	497
Receivables	357	–	–	357
Cash and cash equivalents	151	–	–	151
	4,519	5,174	38,578	48,271
Financial liabilities				
Financial liabilities	289	950	11,330	12,569
Payables	1,286	–	–	1,286
Borrowings	100	–	547	647
Accruals and deferred income	57	–	–	57
	1,732	950	11,877	14,559
Net	2,787	4,224	26,701	33,712

	2017 (restated)			
	Less than 1 year £m	1 to 5 years £m	Over 5 years £m	Total £m
Financial assets				
Financial investments	1,783	3,770	31,220	36,773
Accrued income and prepayments	302	–	–	302
Receivables	339	–	–	339
Cash and cash equivalents	142	–	–	142
	2,566	3,770	31,220	37,556
Financial liabilities				
Financial liabilities	903	1,173	10,494	12,570
Payables	1,390	–	–	1,390
Borrowings	100	–	547	647
Accruals and deferred income	34	–	–	34
	2,427	1,173	11,041	14,641
Net	139	2,597	20,179	22,915

Note 15 – Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Company manages operational risk through the development and maintenance of a comprehensive internal control environment, supported by regular risk and control self-assessments led by the second line, which allow residual risk levels to be measured and control enhancements to be developed if required.

The Company also uses scenario analysis to explore key areas of operational risk, ensuring that the implications of adverse operational risk events crystallising are well understood and that, where appropriate, additional controls or contingency plans are introduced to improve operational resilience.

The Company has significant outsourcing arrangements in place, which are subject to extensive due diligence at the point of entering into them, but also to ongoing review, with oversight provided by the Third Party Oversight Committee. Oversight of these arrangements considers both the performance of the third party with respect to service level agreements, and also their ongoing credit-worthiness.

Note 16 – 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 assets/liabilities represent the discounted value of the premiums payable under the reinsurance contracts less the discounted value of the reinsurance claims payable. Premiums are recognised in the 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 Company may not receive all outstanding amounts due under the terms of the contract and the event has a reliably measurable impact on the amounts that the Company will receive from the reinsurer. Any impairment loss is recorded in the statement of comprehensive income.

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

	2018 £m	2017 £m
Reinsurance asset	**43**	168
Reinsurance liabilities	**(673)**	(231)
Total reinsurance of insurance contract liabilities	**(630)**	(63)

Under the outward reinsurance contracts, the Company 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 part of the insurance contract liabilities, 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 as part of the insurance contract liabilities 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 20. 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 20, with the main change being to move to the 2017 update of the CMI improvement model, along with a recalibration of the model. Reinsurance contracts are valued as the net position comparing the discounted value of the fixed leg being paid to the floating leg moving with expected prudent mortality being received. Due to recent mortality experience the mortality assumptions have been adjusted such that the underlying lives are not expected to live as long. As such the floating leg being received has become less valuable with the result that more of the reinsurance treaties have moved from being assets to liabilities. This affects all contracts including those that started as reinsurance liabilities or have remained as reinsurance assets. The total amount of reinsurance held over the year has increased over the year due to reinsurance covering new business. Overall the proportion of the insurance liability reinsured has fallen slightly, as shown in note 20.

At 31 December 2018 and 31 December 2017, the Company conducted an impairment review of the reinsurance assets and found no impairment necessary.

Note 17 – Accrued interest and prepayments

	2018 £m	2017 £m
Accrued interest[1]	**346**	234
Prepaid expenses	**151**	68
Total accrued interest and prepayments	**497**	302

1 £10m of accrued interest on equity release mortgages which was included in the accrued interest balance at 31 December 2017 has been reclassified to be included in the fair value of equity release mortgages.

Note 18 – Receivables

	2018 £m	2017 £m
Deposits pledged as collateral to third parties	**333**	286
Amounts due from group undertakings	**6**	3
Other receivables	**18**	50
Total receivables	**357**	339

All receivables are due within one year. The fair value of receivables is £357m (2017: £339m).

The net exposure to certain OTC derivatives is collateralised through cash posted, as per the terms of the OTC contracts. At 31 December 2018, the total cash collateral posted was £333m (2017: £286m). Further details of the full extent of collateral usage can be found in the credit risk disclosure in note 13.

Note 19 – Cash and cash equivalents

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

	2018 £m	2017 £m
Cash at bank and in hand	**151**	142
Total cash and cash equivalents	**151**	142

Note 20 – Insurance contract liabilities

Insurance contract liabilities are determined by the Company's actuaries using methods and assumptions recommended by the actuarial function of RLP and approved by the Board. 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 Company continues to apply the principles. The Company 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 the 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 previous solvency basis, where applicable the Company recognises negative mathematical reserves on its regular premium longevity risk transfer arrangements.

The Company is exposed to insurance risk through its insurance contract liabilities. This risk, described below, is managed in accordance with risk management policies and procedures established by the Company. Please see page 9 of the strategic review for further detail on risk management arrangements and the governance framework within the Company.

Insurance risk is the risk of changes in the value of the Company's net position due to changes in the insurance contract liabilities. Insurance risk may occur either through changes in actual demographic experience or revised expectations of future experience. The main categories of insurance risk include the following:

- Demographic risk arises from current mortality or spouse experience being lighter than the results of historic experience investigations on which assumptions are based. The risk is hedged by external reinsurance.
- Longevity improvement risk represents the risk of future mortality rates improving at a faster rate than assumed. The risk is hedged by external reinsurance.
- Expense risk results from future expenses required to maintain the business being higher than expected. This risk is managed through budgeting and expense management exercises.

Note 20 – Insurance contract liabilities continued

The Company manages the demographic and longevity improvement elements of insurance risk by transferring a significant proportion of insurance risk with a number of reinsurers. As at 31 December 2018, 78% of longevity risk was reinsured (2017: 82%). The CRO, Chief Actuary and the risk function, which is independent of management and reports to the CEO and the Chairman of the BRC, have responsibility for ensuring an appropriate framework is in place for assessing, monitoring and managing insurance risk. Risks are monitored and controlled through strong oversight and independent control and support functions across the business.

Key valuation assumptions

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

(a) Mortality assumptions

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

	2018		2017	
	Pensions originated	**Insurance originated**	Pensions originated	Insurance originated
Males	**94.8% S2PMA**	**100.2% PMA08**	96.1% S2PMA	104.3% PMA08
Females	**94.8% S2PFA**	**100.2% PFA08**	96.1% S2PFA	104.3% PFA08

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

Recent mortality experience is analysed annually for each pension scheme and insurance originated contracts. The last review was carried out during 2018. The best estimate base mortality assumptions used in the valuation are based on this actual mortality experience. The changes to the single equivalent rates over 2018 reflect the inclusion of new business along with the results of the experience investigations.

For pension scheme originated business, mortality assumptions are generally set with reference to a Rothesay specific 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 (CMI) of the Institute and Faculty of Actuaries. The S2 tables are based on industry-wide experience.

For insurance originated annuities, a combination of bespoke mortality tables and the CMI 2008 series of annuitant mortality tables are used to value the liabilities. These have been expressed for reporting purposes as an equivalent to the CMI 2008 series tables. These incorporate the effect of selection adjustments for relevant policies.

	Future mortality improvements (including margins)	
	2018	2017
Males	**CMI_2017_M[3.0%; Sκ=7.5]**	CMI_2016_M[3.5%; Sκ=7.75]
Females	**CMI_2017_F[3.0%; Sκ=7.5]**	CMI_2016_F[3.5%; Sκ=7.75]

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. In 2018, mortality improvement assumptions were updated to reflect recent mortality improvements including adoption of the CMI 2017 improvement model. For both 2018 and 2017 an advanced calibration of the model has been used. The chosen long-term improvement rate assumption varies by age using a bespoke calibration that tapers non-linearly from age 70 to 0% at age 120. The best estimate long-term rates have remained unchanged from 2017.

Note 20 – Insurance contract liabilities continued

Prudent margins are applied to the demographic basis through the Sκ factor and the long-term rate to reflect the fact that future experience may differ from that assumed. Prudent margins have been reshaped during 2018 with more prudence applied to initial improvement rates and a reduction in the long-term prudent margin. This has led to a net increase in the overall margin.

The overall impact of the change to future improvement modelling, including margins, led to a reduction in the net insurance liabilities of £110m.

(b) Economic assumptions including 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 as at 31 December 2018. For the purposes of this calculation, any assets held by LT Mortgage Financing Limited or Rothesay MA No.1 Limited are treated as if they were held directly and intercompany arrangements ignored.

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

	2018	2017
Equivalent valuation rate of interest	**2.44% p.a.**	2.32% p.a.

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. (2017: 3bps p.a).

The asset yield used to calculate the valuation rate of interest has been reduced to reflect credit default risk, where applicable adjusted for the prudent expected recoveries in the event of default and, for some asset classes, the cost of rebalancing the portfolio following a downgrade. This deduction in yield is determined separately for each individual asset, reflecting the risk to the return being achieved on the asset. The equivalent rate of interest shown includes allowance for the yield deduction shown in the following table.

The table below shows the average yield deduction before the application of the 2.5% prudential margin at 31 December 2018 and 31 December 2017 by asset category:

	Average yield deduction	
Asset class	**2018**	2017
UK government approved securities	**0 bps**	0 bps
Secured lending	**11 bps**	5 bps
Supranational/other sovereign	**29 bps**	21 bps
Secured residential lending	**28 bps**	24 bps
Corporate bonds (without covering credit default swaps)	**62 bps**	46 bps
Infrastructure	**75 bps**	73 bps
Equity release mortgages	**146 bps**	28 bps[1]
Other[2]	**10 bps**	26bps
Overall yield reduction	**31 bps**	19bps

1 At 31 December 2017, ERMs were included in secured residential lending for disclosure purposes due to the small size of the holding. Separating ERMs out from secured residential lending has not changed the average yield deduction from secured residential lending from 2017.
2 Corporate bonds after allowance for covering credit default swaps have been reallocated into 'other' for 2017 and 2018 as the holding now represents less than 1% of total assets.

The increase in the average yield reduction has arisen as a result of the change in asset mix (including the impact of new equity release mortgages) and the decision to increase the allowance for credit default risk as credit spreads widened during the period. This has been partially offset by the impact of changes made to the methodology used to derive the credit default yield deduction for 2018, particularly for the more bespoke assets. For these assets, the methodology has been aligned to that used under the PIM which makes greater allowance for the individual risks and mitigants. This change, together with the change in the derivation of the NNEG described below, resulted in a reduction in the credit default allowance of 2 bps (equivalent to £82m reduction in net insurance liabilities).

Allowance is made for the risks associated with equity release mortgages through the valuation of the NNEG and this is included in the overall yield deduction above. The calculation of the NNEG is described in note 9 is calculated on a prudent basis allowing for future property price growth at a rate equivalent to 1.59% net of dilapidation costs and cost of sale (2017: 0.87%) and house price volatility equivalent to 13% (2017: 13%). The increase in the yield deduction over the year despite the change in assumed property price growth rate has been driven by the acquisition of more seasoned ERM loans over the period.

Note 20 – Insurance contract liabilities continued

An important actuarial assumption relates to the future rate of escalation of certain annuity benefits, but as the Company 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 Company of actual or assumed changes in these rates is relatively small.

(c) Expense assumptions

An allowance is made for future overhead maintenance expenses following an investigation into the total costs incurred by the Company during 2018 and the projected 2019 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 together with the long-term business overhead expenses expressed as an amount per policy. On average an allowance of £30 per policy per annum (31 December 2017: £35 per policy per annum) is made with additional allowances for short-term project costs and investment management expenses. While the per policy expense provision has reduced, the overall allowance for expenses has increased materially as the policy count has doubled over the year. The per policy cost has fallen as a result of economies of scale.

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 (2017: 0.25% p.a.).

(d) Member option and dependants assumptions

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 2018 the modelling of member options has been improved to separately allow for the probability that deferred annuitants choose to transfer their benefits each year. In prior years, this was allowed for by assuming an equivalent level of overall take-up occurred immediately prior to starting pension payments. The main impact of this modelling update is to change the profile of the cash flows assumed to be paid as the same cash flows are used to derive the lump sums and the annuities. The cash flow profile also impacts the composition of the basket of assets used to derive the valuation rate of interest (see 20(b) on the previous page).

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 taking their benefits in the future. All other individuals who have passed the scheme normal retirement date are assumed to start receiving pension payments immediately.

(e) Movement in insurance contract liabilities

The table below details the change in the gross and net insurance contract liabilities over the year. The release of liabilities line reflects claims paid, release of prudent margins and unwind of discounting over the year.

	2018			2017 (restated)		
	Insurance liabilities £m	**Reinsurance assets/ (liabilities) £m**	**Net liabilities £m**	Insurance liabilities £m	Reinsurance assets/ (liabilities) £m	Net liabilities £m
Carrying amount at 1 January	**21,741**	**(63)**	**21,804**	22,071	437	21,634
Increase in respect of new business	**12,890**	**(43)**	**12,933**	1,040	6	1,034
Release of liabilities	**(1,286)**	**(124)**	**(1,162)**	(1,043)	5	(1,048)
Effect of assumption changes	**(918)**	**(401)**	**(517)**	(324)	(511)	187
Other	**8**	**1**	**7**	(3)	–	(3)
Closing balance at 31 December	**32,435**	**(630)**	**33,065**	21,741	(63)	21,804

Note 20 – Insurance contract liabilities continued

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

Net (decrease)/increase in liabilities Change in assumptions used	2018 £m	2017 (restated) £m
Valuation rate of interest	**(401)**	325
Inflation	**(10)**	(96)
Effect of economic assumption changes	**(411)**	229
Demographics	**(133)**	(77)
Member options	**(20)**	–
Expenses	**47**	35
Effect of non-economic assumption changes	**(106)**	(42)
Total effect of assumption changes	**(517)**	187

As shown previously the valuation rate of interest increased by 12bps over the year, which led to the £401m decrease in the liability shown.

The movement in the demographic assumptions shown reflects the changes to base mortality, mortality improvement and other demographic assumption changes applied during the year, leading to a £133m decrease in net liabilities. Details of change in the assumptions are shown in section (a). £110m of the total is due to changes in assumed future longevity improvements, including adoption of CMI 2017.

For 2018, the impacts of non-economic assumption changes have been shown using consistent discounting. The effect of demographic assumption changes shown for 2017 has been restated to use a consistent methodology. This has resulted in the impact of demographic assumption changes for 2017 reducing by £83m and the release of insurance liabilities in the previous table in section (e) increasing by £83m.

As described in section (d), changes were made to the modelling of the assumed take-up of member options, resulting in a reduction in net liabilities of £20m.

Additional expense reserves set up to support new business have been reflected through the increase in net insurance liabilities in respect of new business. Expense assumptions were strengthened further during the second half of 2018, increasing the net liabilities by £47m, including the allowance for new project provisions.

(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.

2018	Change in assumptions	(Decrease)/increase in net liabilities £m	Increase/(decrease) in PBT £m	Impact on equity £m
Annuitant mortality	**+5% qx**	**(172)**	**171**	**139**
Annuitant mortality	**–5% qx**	**181**	**(179)**	**(145)**
Interest rate	**+100bps**	**(3,752)**	**26**	**21**
Interest rate	**–100bps**	**4,661**	**292**	**236**
Inflation	**+100bps**	**1,320**	**26**	**21**
Inflation	**–100bps**	**(1,256)**	**82**	**66**
Credit default assumption[1]	**+10bps**	**(320)**	**(206)**	**(167)**
Credit default assumption	**–10bps**	**329**	**209**	**170**
Changes in property prices[2]	**+10%**	**9**	**59**	**47**
Changes in property prices	**–10%**	**(15)**	**(84)**	**(68)**
Expenses	**+10%**	**95**	**(95)**	**(77)**

1 For 2018 the credit default assumption sensitivity excludes secured assets where the main risk is to underlying property prices.
2 For assets excluded from the credit default sensitivity in 2018 a sensitivity is shown to a change in the property value of the underlying collateral. The liability impact reflects the second order impact on the credit default assumption of this change. For 2017 these assets are included within the credit default assumption sensitivity as the portfolio then had materially less property sensitivity and the default allowances used were less sensitive to property values.

Note 20 – Insurance contract liabilities continued

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)

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

Given current interest rates, the -100bps interest rate sensitivity does not mean that interest rates are assumed to fall below zero (2017: assumed to fall below zero for four 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 valuation rate of interest.

The table below shows the impact of reinsurance on the sensitivity to mortality risk, a reduction of 78% (2017: 82%).

2018	**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**	**(782)**	**611**	**(171)**
Annuitant mortality	**–5% qx**	**835**	**(656)**	**179**

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

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:

	2018			
	Less than 1 year £m	**1 to 5 years £m**	**Over 5 years £m**	**Total £m**
Insurance contract liability cash flows	**1,918**	**6,715**	**23,802**	**32,435**
Reinsurance asset cash flows	**5**	**15**	**(63)**	**(43)**
Reinsurance liability cash flows	**65**	**260**	**348**	**673**
	1,988	**6,990**	**24,087**	**33,065**

Note 20 – Insurance contract liabilities continued

	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

Note 21 – Payables and financial liabilities

	2018 £m	2017 £m
Derivative financial instruments	**11,790**	11,165
Collateralised financing agreements	**779**	1,405
Total financial liabilities	**12,569**	12,570
Deposits received as collateral from third parties	**1,128**	1,264
Amounts due to group undertakings	**50**	33
Current tax payable	**17**	38
Other payables	**91**	55
Total payables	**1,286**	1,390
Total payables and financial liabilities	**13,855**	13,960

Financial liabilities are recorded at fair value (see note 9), of which £0.5m are valued using Level 3 techniques (2017: £1m). The remainder are valued using Level 2 techniques.

Payables and financial liabilities of £1,575m (2017: £2,293m) for the Company are all due within one year.

The net exposures to certain OTC derivatives are collateralised through cash. As at 31 December 2018, the total cash collateral received for the Company was £1,128m (2017: £1,264m). Other OTC contracts are collateralised with fixed income securities which are not recognised on the statement of financial position for the Company.

Note 22 – 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 Company's borrowings are as follows:	**2018 £m**	2017 £m
Subordinated loans from participating interests	**398**	398
Subordinated loan notes	**249**	249
Total borrowed	**647**	647

Note 22 – Borrowings continued

The carrying amounts, fair values and features of the Company's borrowings are summarised in the table below:

Notional amount	Issue date	Redemption date	Callable at par at the option of the Company from	Coupon	Carrying amount 2018 £m	Carrying amount 2017 £m	Fair value 2018 £m	Fair value 2017 £m
Subordinated loans from participating interests								
£100m	21 December 2012	Lender has option to convert to equity from 21 December 2022	21 December 2017 and every six months thereafter	6m£L plus 4.25%	**100**	100	**93**	95
£300m	19 September 2017	19 September 2028	19 September 2023 and annually thereafter	3m£L plus 5.95%	**298**	298	**287**	305
Subordinated loans								
£250m	22 October 2015	22 October 2025	22 October 2025	8.00%	**249**	249	**283**	303

For the period ended 31 December 2018, an interest expense of £45m (2017: £30m) was recognised in the statement of comprehensive income in respect of these borrowings.

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 2017 £m	Cash flows £m	Non-cash flows £m	31 December 2018 £m
Subordinated loans from participating interests	398	–	–	**398**
Subordinated loan notes	249	–	–	**249**
Total borrowings	647	–	–	**647**

	31 December 2016 £m	Cash flows £m	Non-cash flows £m	31 December 2017 £m
Affiliate subordinated loan	100	–	(100)	–
Subordinated loans from participating interests	–	300	98	398
Subordinated loan notes	249	–	–	249
Total borrowings	349	300	(2)	647

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

Note 23 – Deferred tax 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:

	2018 £m	2017 £m
Temporary differences between the financial statements and the tax deductions	**(2)**	(2)
Total temporary differences	**(2)**	(2)

The movements in the deferred tax balances were as follows:

	2018 £m	2017 £m
At 1 January	**(2)**	(3)
Capital allowances	**–**	1
At 31 December	**(2)**	(2)

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

Unrecognised deferred tax balances:

	2018 £m	2017 £m
Timing differences	**4**	–
	4	–

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

	2018 £m	2017 £m
At 1 January	**–**	–
Timing differences	**4**	–
At 31 December	**4**	–

Note 24 – Share capital

At 31 December 2018 and 31 December 2017 share capital comprised:

	2018		2017	
	No.	£m	No.	£m
Authorised share capital (ordinary shares of £1 each)	**410,322,556**	**410**	264,380,809	264

In order to ensure that RLP remained appropriately capitalised following the Prudential transaction, on 14 March 2018 the Company allotted 145,941,747 shares to RHUK for total cash consideration of £950m, reflecting share premium of £804m.

Note 25 – Restricted Tier 1 notes

Under IFRS the RTI notes meet the definition of equity and are therefore recognised as such. The coupon payments are recognised directly in shareholders' equity (and outside the profit after tax result) upon payment. The coupon is treated as an allowable tax expense in the tax computation of the Company upon payment.

	2018 £m	2017 £m
Loan notes issued through public debt markets	**347**	–
	347	–

On 5 September 2018, the Company issued £350m of RT1 notes with a fixed 6.875% coupon payable semi-annually in arrears. The notes were issued through the public debt markets. The notes were initially recognised at the fair value of the consideration received less transaction costs directly attributable to the issuance.

The notes are callable on or after 5 September 2028. If the notes are not repaid on that date, a fixed rate of interest per annum will be reset. The notes are direct, unsecured and subordinated obligations of the issuer.

The Company has the option to cancel the coupon payment which becomes mandatory upon breach or non-compliance with the Company SCR, a breach of the minimum capital requirement (MCR) or where the Company has insufficient distributable reserves.

The full principal amount of each note is irrevocably and automatically reduced to zero on a permanent basis if RLP determines at any time that:

(i.) eligible Own Fund items are less than or equal to 75% of the SCR;
(ii.) eligible Own Fund items are less than or equal to 100% of the MCR; or
(iii.) a breach of the SCR has occurred and has not been remedied within three months.

Proceeds of this issuance were used to fund a dividend from RLP to RHUK in order to partially repay the bank debt held at RHUK.

Note 26 – Share premium account and reserve

	Share premium £m	Retained earnings £m
At 1 January 2018	**549**	**838**
Profit for the financial year	**–**	**97**
Share issuance	**804**	**–**
Dividends paid	**–**	**(500)**
At 31 December 2018	**1,353**	**435**

	Share premium £m	Retained earnings £m
At 1 January 2017	549	931
Profit for the financial year	–	277
Dividends paid	–	(370)
At 31 December 2017	549	838

Note 27 – Dividends

Final dividends are recognised when they are approved by the shareholders. Interim dividends are recognised in the year that they are paid. These dividends are debited directly to equity.

	2018 £m	2017 £m
Interim ordinary share dividends	**500**	370
	500	370

The Directors have recommended and paid interim dividends of £500m in respect of the year ending 31 December 2018 (2017: £370m).

Note 28 – Capital management

The Company's capital resources are of critical importance. The Company'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 Company;
- to satisfy its regulatory obligations;
- to match the profile of its assets and liabilities, taking account of the risk inherent in the business;
- to allocate capital efficiently to support new business growth;
- to retain financial flexibility by maintaining strong liquidity; and
- to provide an appropriate return to shareholders.

From 1 January 2016, the Company was required to operate under the new Solvency II regime. The Company had sufficient capital available to meet its regulatory capital requirements at all times during the year to 31 December 2018.

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

- The Company's technical provisions, being:
  - the liabilities of the Company 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 (known as the solvency capital requirement or SCR).

Transitional solvency relief was re-calculated as at both 31 December 2017 and 31 December 2018 and amortises by 1/16th each year from 1 January 2017. As at 31 December 2018, solvency estimates allow for amortisation of 2/16ths of transitional solvency relief (2017: 1/16th).

The Company received approval to use a PIM from 31 December 2018, so from that date the SCR relating to credit and counterparty risk is calculated using the Company's bespoke models and the standard formula is used to calculate the SCR for all other risk components and for aggregation across risk components.

Capital in excess of that required to meet the technical provisions is known as Own Funds. As at 31 December 2018, Own Funds for the Company were £3,894m (2017: £2,844m) made up as follows:

	2018 £m	2017 £m
Total IFRS equity	**2,545**	1,651
Liability valuation differences and other regulatory adjustments	**691**	529
Total Tier 1	**3,236**	2,180
Solvency II debt valuation	**658**	664
Total Tier 2	**658**	664
Own Funds	**3,894**	2,844

The Company holds both debt and equity to optimise its capital structure and improve shareholder return. During 2018, £950m of equity and £350m of RT1 notes were issued by the Company. During the prior year, the Company issued £300m of Tier 2 debt.

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 Company seeks to mitigate these risks through the close matching of asset and liability cash flows, and 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 29 – Related parties disclosures

Ultimate holding company

At the financial statement date, the immediate and ultimate parent company was RHUK, which is incorporated in the United Kingdom. Group financial statements are prepared for RHUK, copies of which can be obtained from the Company Secretary, Level 25, The Leadenhall Building, 122 Leadenhall Street, London EC3V 4AB.

Related party transactions

Prior to the acquisition of Goldman Sachs' shareholding by MassMutual, Blackstone and GIC the Company 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.

Details of such transactions are as follows.

	2018 £m	2017 £m
Statement of comprehensive income		
Realised/unrealised losses on financial assets and liabilities	**–**	(131)
Income from money market securities held in collective investment schemes	**–**	1
Interest on collateralised agreements and financing	**–**	34
Service fee charges	**–**	(11)
Investment management and charges	**–**	(7)

The Company 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 in December 2017.

	2018 £m	2017 £m
Statement of comprehensive income		
Change in the reinsurers' share of insurance contract liabilities and reinsurance recoveries	**(3)**	(1)
Finance costs	**(25)**	10
Operating expenses	**(1)**	–
Statement of financial position		
Reinsurance liabilities	**4**	1
Borrowings	**398**	398
Capital	**1,763**	492

Transactions with key management personnel

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

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

	2018 £m	2017 £m
Salaries, bonus and other employee benefits	**20**	15
Equity-based compensation payments	**4**	2
Total transactions	**24**	17

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

Note 29 – Related parties disclosures continued

The tables below represents transactions between RLP and its subsidiary RAL, its parent RHUK and other group companies RPML and Rothesay Asset Management US LLC.

Transactions with RPML	2018 £m	2017 £m
Statement of comprehensive income		
Cost transfer	**(68)**	(55)
Statement of financial position		
Other payables	**47**	33

Transactions with RHUK	2018 £m	2017 £m
Statement of comprehensive income		
Interest income	**–**	4
Cost transfer	**3**	3
Statement of financial position		
Other receivables	**6**	3
Capital	**1,764**	815
Dividends	**500**	370

Transactions with Rothesay Asset Management US LLC	2018 £m	2017 £m
Statement of comprehensive income		
Transaction fee	**(1)**	–
Servicing fee	**(2)**	–
Statement of financial position		
Other payables	**3**	–

Transactions with LTMF

During December 2018, £1.3bn of the equity release mortgage loans were transferred from RLP to its subsidiary LT Mortgage Financing Limited (LTMF). LTMF became the beneficial owner in the equity release mortgage loans in exchange for the issue of loan notes. These transactions took place on an arm's length basis using the fair value of the equity release mortgages. Under IAS 39 the loans cannot be derecognised from the Company as RLP effectively maintains all the risk and rewards and control of the mortgages after the securitisations through the loan notes. The IFRS 4 liability discount rate, including the credit default yield deductions, is consistent with the equity release mortgages ignoring the securitisation.

Transactions with Rothesay MA No. 1 Limited

During December 2018, £778m of ground rent loans were transferred from RLP to its subsidiary Rothesay MA No 1 Limited (RMAL). RMAL became the beneficial owner in the ground rent loans in exchange for the issue of loan notes. These transactions took place on an arm's length basis using the fair value of the ground rent loans. Under IAS 39 the loans cannot be derecognised from the Company as RLP effectively maintains all the risk and rewards and control of the loans after the securitisations through the loan notes. The IFRS 4 liability discount rate, including the credit default yield deductions, is consistent with the ground rent loans ignoring the securitisation.

Note 30 – 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 RLP and the subsidiaries listed in the following table:

Company Undertakings	Country of incorporation	Primary business operation	2018 £m	2017 £m	2018 % Equity interest	2017 % Equity interest
Rothesay Assurance Limited (formerly known as MetLife Assurance Limited)	UK	Service company	**–**	–	**100%**	100%
LT Mortgage Financing Limited	UK	Service company	**1**	–	**100%**	100%
Rothesay MA No.1 Limited	UK	Service company	**–**	–	**100%**	–

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

The above subsidiary undertakings are registered in the United Kingdom. The registered office and principal place of business for all subsidiary undertakings is Level 25, The Leadenhall Building, 122 Leadenhall Street, London EC3V 4AB.

LT Mortgage Financing Limited which was incorporated in 2015 but remained dormant since that date, began trading during 2018.

Note 30 – Investments in subsidiaries continued

Rothesay MA No.1 Limited was incorporated during October 2018.

On 3 October 2016, the PRA granted an application to cancel the permissions of Rothesay Assurance Limited. As it is no longer needed, the Company has begun proceedings to voluntarily liquidate Rothesay Assurance Limited.

Note 31 – 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:

	2018 £m	2017 £m
Not later than one year	**2**	2
Later than one year and no later than five years	**18**	8
Later than five years	**37**	4
Total minimum lease payments	**57**	14

The Company plans to re-locate its UK-based operations to The Post Building during 2019 in order to accommodate the growth of the business. As a result:

- The Company has entered into a lease for space in The Post Building
- The Company has exercised its break clause under the lease for Level 25 of The Leadenhall Building
- The Company has identified a potential new tenant for Level 32 of The Leadenhall Building and is in negotiations to terminate the lease

The lease payments shown in the table above include all payments under the lease for Level 32 and the new lease for space in The Post Building.

Other commitments

During previous years the Company executed transactions to purchase partly funded bonds. During 2018 the Company purchased additional partly funded bonds. The Company also signed up to a number of multi-year contracts. The Company expects to pay a further £258m within the next five years (2017: £153m), £90m of this being due within 12 months of the financial reporting date (2017: £46m).

	2018 £m	2017 £m
Not later than one year	**90**	46
Later than one year and no later than five years	**168**	107
Later than five years	**–**	–
Total other commitments	**258**	153

On 20 December 2018 the Company signed an agreement under which it has committed to fund a £689m loan to a third party secured on commercial real estate providing all conditions precedent to draw down are met. The borrower must draw down the loan before 15 February 2019, when the agreement lapses.

Appendix – Changes in IFRSs

Adoption of new or amended standards

The Company has considered the following new standards and changes to existing standards which are relevant to the Company's operations, and became effective for financial years beginning on or after 1 January 2018. These amendments have all been endorsed by the EU and have had no material impact on the Company financial statements.

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 replaced the incurred loss impairment model used previously.

The Company has taken the deferral option mentioned in the IFRS 4 Insurance contract amendment and will adopt the standard on the effective date of the new insurance contract standard 1 January 2022. The Company will therefore continue to apply IAS 39, 'Financial Instruments: Recognition and measurement', instead of adopting IFRS 9. The exemption applies to the Company because its activities are 'predominantly connected with insurance'.

The temporary exemption allows the Company to avoid the temporary volatility that may result from adopting IFRS 9 before the forthcoming new insurance contracts standard. The Company 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.

The assessment of whether activities are predominantly connected with insurance was initially performed at the annual reporting date immediately preceding 1 April 2016. There are two tests which an insurer needs to pass before it can consider its activities predominantly connected with insurance:

1. Assess whether the carrying amount of liabilities arising from contracts within IFRS 4's scope is significant, compared to the total carrying amount of all its liabilities.
2. Compare the total carrying amount of all liabilities connected with insurance with the total carrying amount of all its liabilities. As at 31 December 2015, Rothesay Life Plc's liabilities connected with insurance exceeded 90% of its total liabilities.

The exemptions continue to be applicable at 31 December 2018.

The Company holds all financial investments at fair value through profit and loss, please see note 9 for disclosure of fair values. Financial assets including accrued interest and prepayments which are not held at fair value are deemed to be held at a value which is a reasonable approximation of its fair value and therefore no further disclosures have been provided.

Credit risk exposure is provided for total assets in note 13 – Credit risk.

The deferral option is only applicable to RLP and therefore all other subsidiary entities have adopted IFRS 9 and copies of the annual accounts of those entities are publicly available on the Companies House website or can be obtained from the Company Secretary, Level 25, The Leadenhall Building, 122 Leadenhall Street, London EC3V 4AB.

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 the 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 was 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.

Adoption of new or amended standards continued

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.

As insurance is specifically excluded from the standard, these changes will have no impact on the Company.

IFRS 2 Share based payments

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

Annual improvements 2014–2016 cycle

These improvements are effective from 1 January 2018 and have not had a material impact on the Company. 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).

New or revised standards 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 Company has not early adopted any of these standards.

IAS 40 Investment property

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

IFRIC 22

This interpretation considers how to determine the date of the transaction when applying the standard on foreign currency translations, IAS 21. The interpretation applies where an entity either pays or receives consideration in advance for foreign currency-denominated contracts. The Company is not expected to be impacted by this change.

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. 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 assets; 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 Company has assessed the impact of the change in standard as follows:

- During November 2018 the Company gave notice in relation to the lease of Level 25 of The Leadenhall Building and therefore the IFRS 16 balance sheet recognition is no longer relevant.
- The Company will recognise a right of use asset in relation to Level 32 of The Leadenhall Building.
- The Company will recognise a right of use asset in relation to a lease executed in November 2018 in relation to new premises.

The expected total balance sheet impact is recognition of a right of use asset to the value of £42.5m, and a lease liability of a similar amount.

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 2022, following the IASB Boards decision subject to due process. 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 Company is currently assessing the impact.

New or revised standard not yet effective continued

Amendment to IAS 28 – long-term interests in associates and joint ventures

The amendment will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2019. The amendment has not yet been adopted by the EU. Investors could have long-term interests (for example, preference shares or long-term loans in an associate or joint venture). The IASB was asked to clarify whether these long-term interests are within the scope of IFRS 9, and whether IFRS 9 impairment requirements are applicable. The Company is not expected to be impacted by the IAS 28 amendment.

Amendment to IAS 19 'employee benefits'

The amendment to IAS 19 will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2019. The amendment has not yet been adopted by the EU. The amendment requires an entity:

- To use updated assumptions to determine current service costs and net interest for the remainder of the period after a plan amendment, curtailment or settlement.
- To recognise in profit or loss as part of past service cost, or a gain or loss on settlement, any reduction in a surplus, even if that surplus was not previously recognised because of the impact of the asset ceiling.

Changes in the terms or membership of a defined benefit plan might result in a plan amendment or a curtailment or settlement. The Company is not expected to be impacted by the amendment.

Annual improvements 2015–2017

These improvements are effective from 1 January 2019 and are not expected to have a material impact on the Company. They include: IFRS 3, 'Business combinations' (the amendments clarify that obtaining control of a business that is a joint operation, is a business combination), IFRS 11, 'Joint arrangements' (the amendments clarify that the party obtaining joint control of a business that is a joint operation should not re-measure its previously held interest in the joint operation at fair value at the acquisition date), IAS 12, 'Income taxes' (the amendment clarifies that the income tax consequences of dividends on financial instruments classified as equity should be recognised according to where the past transactions or events that generated distributable profits were recognised), IAS 23, 'Borrowing costs' (the amendments clarify that if a specific borrowing remains outstanding after the related qualifying asset is ready for its intended use or sale, it becomes part of the general borrowings).

IFRIC 23

The interpretation is effective from annual periods beginning on or after 1 January 2019. This interpretation clarifies how the recognition and measurement requirements of IAS 12 'Income taxes', are applied where there is uncertainty over income tax treatments. The interpretation is not expected to have a material impact on the Company.

Glossary of terms

Acquisition costs	Acquisition costs (shown in note 4) comprise the expenses associated with the origination of new business, including annual compensation for employees.
Administration expenses – recurring	Administration costs (shown in note 4) represent the cost of administering the in-force book of business. They include both outsourcing costs and other costs incurred by the Company.
Age standardised mortality rate	The weighted average of age-specific mortality rates, where the weights are the proportion of lives by age.
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 Company. Can be derived by taking total assets and adjusting for reinsurance assets, derivative liabilities and collateralised liabilities.
Assumed reinsurance premiums	Premiums received by RLP in respect of reinsurance inwards, i.e. a policy where RLP is acting as the reinsurer.
Best estimate liability (BEL)	The liabilities of the Company 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.
Borrowing costs	Interest payable on borrowings. This is a subset of the finance costs show in note 5.
Brexit	The UK's planned exit from the European Union.
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.
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 one-year period.
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.
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 Company's financial statements.

Glossary of terms
continued

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 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.
Longevity reinsurance (%)	The longevity reinsurance percentage provides an indication of the extent to which the Company is protected from fluctuations in longevity through reinsurance. It is derived from the IFRS sensitivity analysis.
Longevity risk	The risk that a company could be exposed to a higher payout as a result of increasing life expectancy.
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.
New business	New insurance contracts and reinsurance inwards sold during the period. Includes business acquired through purchase of companies.
New business premium	Premium paid on new business transacted during the period and (from 2018 onwards) adjustments to new business premiums from prior periods. New business premiums and regular premium income make up gross premiums written.
Non-recurring and project expenditure	Administration – project and other one-off expenses (shown in note 4).
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 Company'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.
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.
RHUK	Rothesay Holdco UK Limited.
Risk margin	Under Solvency II, the cost of transferring non-hedgeable risks.
RLP	Rothesay Life Plc.
RMAL	Rothesay MA No.1 Limited.
RPML	Rothesay Pensions Management Limited. The Company'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 Company is required to hold the greater of the capital required under the new Solvency II Pillar 1 framework and the capital required under RLP's own economic capital models Solvency II Pillar 2.
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.
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.
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 Company does not have the power to affect their returns.
Yield	A measure of the income received from an investment compared to the price paid for the investment. Normally expressed as a percentage.

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