Innovating to secure the future

Rothesaylife

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. Established in 2007, Rothesay Life 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.

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.

Highlights

Key statistics

Assets under management (£bn)
£36.3bn
2017: £24.2bn

Invested in the UK economy[1] (£bn)
£21.5bn
2017: £14.5bn

MCEV (£bn)
£3.4bn
2017: £2.3bn

Number of people insured
772,665
2017: 382,257

Paid to policyholders in 2018 (£bn)
£1.9bn
2017: £1.5bn

Business highlights

Purchase of £12bn of annuities: The Group 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 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 Group assisted five pension schemes to de-risk their liabilities taking new business premiums to a record level for the Group of £13.2bn (2017: £1.2bn).

IFRS pre-tax profit: Following completion of the Prudential transaction, we chose to de-risk the underlying assets and reinvest cautiously to take advantage of attractive market opportunities. Investments completed to date have out-performed our underwriting assumptions and we expect significant further IFRS profits to arise as we invest the remaining assets. While widening credit markets have dampened profits to £102m (2017: £312m), they also present opportunities to invest at more attractive levels.

Assets under management: The Group's assets under management increased by 50% to £36.3bn (2017: £24.2bn), 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), we have increased the value of our investment in equity release mortgages to £1.9bn (2017: £539m).

Market Consistent Embedded Value (MCEV): The Group's MCEV has increased by 50% to £3,441m (2017: £2,301m), driven largely by the Prudential transaction and associated equity injection.

Partial internal model and solvency position: The Group 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 Group's SCR coverage was 181% (2017: 169%) and Rothesay Life Plc's coverage was 180% (2017: 163%).

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

People: We have continued to invest in the business through recruitment across the Group at all levels, including the appointment of a new Chief Technology Officer, a new Chief Auditor and a new in-house Chief Actuary.

1 Rothesay Life has invested £21.5bn (2017: £14.5bn) in projects which benefit the UK such as transport, infrastructure, education and social housing. This excludes the Group's holding of gilts.

Our business model

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

We are professionals experienced in the defined benefit pensions market, the annuity reinsurance market and in corporate acquisitions.

Our markets

Bulk annuity market

Bulk annuities represent the Group's core market. We create bespoke solutions to serve the £2 trillion UK bulk annuity market[1].The market is projected to see increasing annual volumes as more and more pension schemes seek to secure their long-term pension obligations.

Bulk annuity buy-in

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

Bulk annuity buy-out

The most common approach to permanently settling pension liabilities is to purchase a bulk annuity covering 100% of scheme benefits. Once data cleaning is complete, individual annuity policies are issued to each pension scheme member. The scheme can then be wound up.

Wholesale annuity market

Solvency constraints and the bifurcation of UK insurance into asset management and risk businesses continues to drive strategic opportunities for the Group to acquire annuity books. These may include both bulk annuity contracts and individual annuities.

Reinsurance and Part VII transfer

Where annuity books are held with other insurance liabilities, the first step is to put in place a reinsurance contract covering the individual annuity contracts to be acquired. The individual contracts are then transferred to RLP via a Court-sanctioned process. Books acquired from Zurich and Aegon transferred to RLP in June 2017 and we are working towards transferring the Prudential book during 2019.

Company acquisition

Where the annuity book is held in a separate company, acquisition of the portfolio might be via acquisition of the whole company, as with Paternoster in 2011 and MetLife's bulk annuity business in 2014. The liabilities will then be transferred into RLP and the acquired company wound up.

1 Source: The Pensions Regulator Purple Book 2017.

Our DNA – what drives us

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

1 Intellectual curiosity

We look to blend talent, intellect and technology to deliver success and security for policyholders – The Group's market leading technology provides us with a comprehensive understanding of the drivers of performance and allows us to risk manage the balance sheet in real time.

2 Providing certainty

We aim for certainty of business outcomes in order to deliver security and predictability – The Group focuses on protecting the balance sheet. By preserving and recycling capital, we not only ensure that we meet our promises to policyholders, but also protect shareholder equity.

3 Focusing together

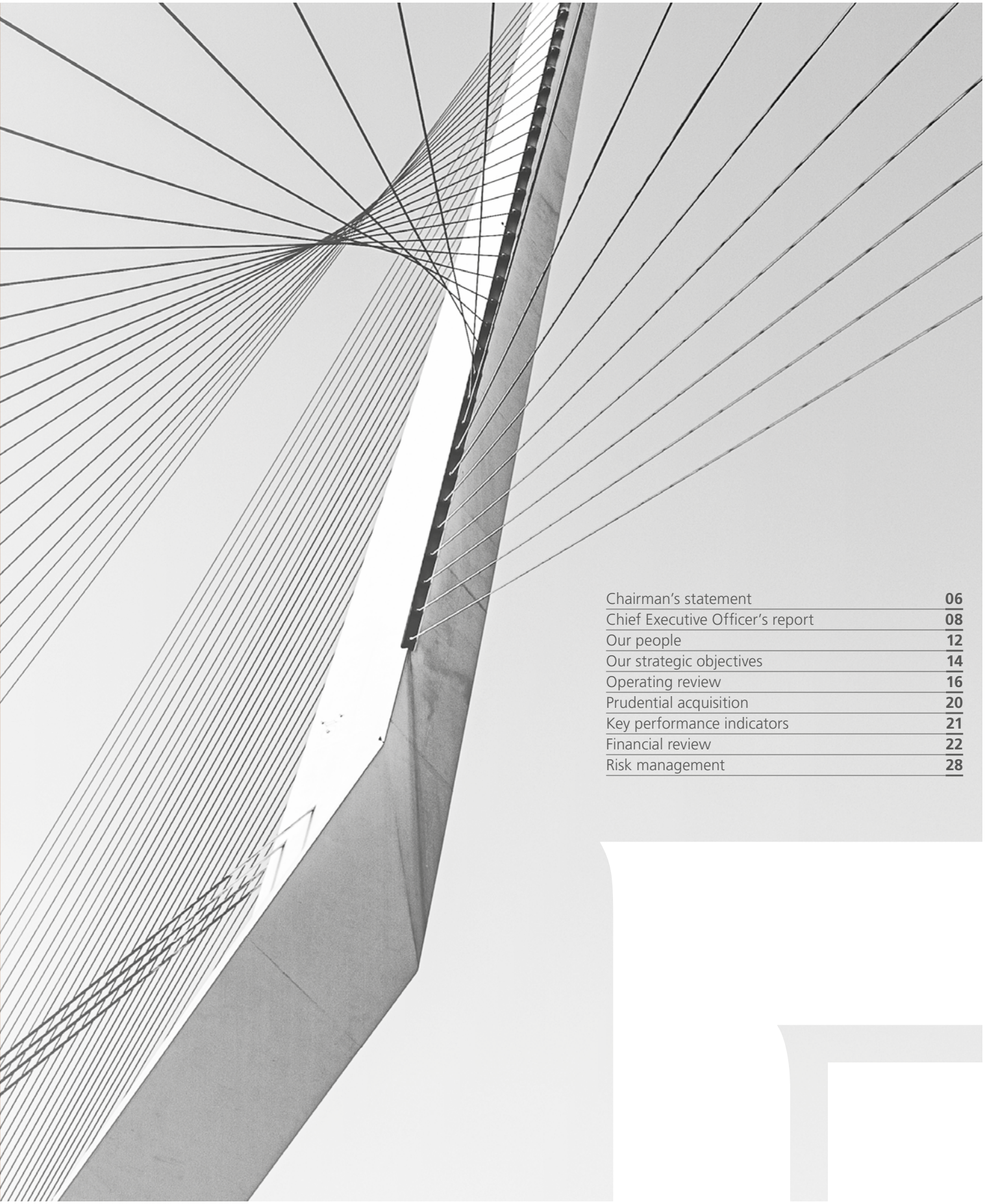
We are a team that is driven in what we do, aiming to spend our time and focusing our efforts on creating value and managing risk – An absence of functional silos means that all parts of the business contribute to decision making and helps to ensure that all angles are considered in order to create solutions that meet the needs of our policyholders.

4 Delivering success

We aim to be entrepreneurial and agile in order to deliver successful outcomes for all stakeholders – Lack of hierarchy, a hard working team and focus means that decisions can be taken quickly and execution certainty can be provided to our policyholders.

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

Strategic report



Chairman's statement

A step change for the business

The Prudential transaction means that 2018 was a record year for new business.

I am delighted to introduce Rothesay Life's annual report for 2018. 2018 was dominated by the previously announced acquisition of £12bn of annuities from Prudential plc. The acquisition led to an increase in assets under management to £36.3bn and a 50% increase in MCEV to £3.4bn including the £380m of capital provided by the Group's institutional shareholders to help finance the deal.

Performance

We have chosen to de-risk the assets received at the time of the Prudential transaction and subsequently have reinvested cautiously to take advantage of attractive market opportunities. Investments completed to date have out-performed our underwriting assumptions and we expect significant further IFRS profits to arise as we invest the remaining assets. While widening credit markets have dampened profit before tax for the Group to £102m (2017: £312m), they also present opportunities to invest at more attractive levels.

In addition to the new equity provided by institutional shareholders to back the Prudential transaction, the Group's regulated insurance company, RLP issued £350m of RT1 notes. This has ensured that the solvency position of the Group remains strong, with Group SCR coverage of 181%.

Governance and culture

As Chairman of Rothesay Life, I have continued to focus on ensuring strong corporate governance supported by an effective risk management framework. The Board has supported me in this, contributing fully at meetings and making themselves available at short notice where business transactions have required it.

The Board has also spent a considerable amount of time on the development of the Group's PIM. The PIM helps ensure that the amount of regulatory capital held to back the Group's investments is appropriately calibrated to reflect risk and diversification. I am pleased to say that after significant effort by management and detailed review by the Prudential Regulation Authority, the PIM has been approved for use from 31 December 2018.

Following Richard Berliand's appointment as Chairman designate of TP ICAP plc, Richard has decided to stand down as independent Non-Executive Director of the Group from March 2019. I would like to thank Richard

for his contribution as an independent Non-Executive Director and Chairman of the Customer & Conduct Committee.

Our shareholders

The sale by Goldman Sachs of its stake in Rothesay Life at the end of 2017 meant that the Group was left with a long-term, stable shareholder base consisting of Blackstone, GIC and MassMutual. Access to capital from these shareholders meant that we could rapidly execute the Prudential transaction. They each contributed new equity in proportion to their existing holding and facilitated the ability for Rothesay Life to provide certainty of timely execution to the Prudential.

I would like to take this opportunity to thank the shareholders for their ongoing support of the business.

Our policyholders

During 2018, in addition to the Prudential transaction, we have assisted five pension schemes in de-risking their liabilities, including the transaction with the Toshiba Pension and Assurance Scheme.

Work has begun on the Court-sanctioned process in relation to the transfer of the underlying assets and policy liabilities from Prudential to Rothesay Life and we anticipate that the transfer will take place in 2019 subject to regulatory and Court approval.

The Group prides itself on the quality of the service it provides and I am pleased to say that this is borne out by our customer service statistics – over 98% of customers surveyed rate the quality of service received as good or excellent.

Assets under management

£36.3bn

2017: £24.2bn | +50%

Number of people insured

772,665

2017: 382,257 | +102%

Charitable activity

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

In addition, on an annual basis we choose a charity of the year which has special significance to one of our people. In 2018 our charity of the year was The Sick Children's Trust. Rothesay Life has also supported a number of other charities including the London Community Foundation, Great Ormond Street Hospital and Ickle Pickles.

Our people

Our business benefits from the hard work and professionalism of the team at Rothesay Life, which enable us to focus on delivering security and value to our policyholders and shareholders. Our employees are the defining factor in our success and I would like to take this opportunity to thank them for their continuing contribution.

Looking forward

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

I look forward to working with Addy and the team during 2019 and to welcoming new policyholders to Rothesay Life from Prudential when the transfer is approved.

Naguib Kheraj
Chairman
13 February 2019

Age UK

"Age UK is extremely grateful for the continued support of Rothesay Life. Our aim is to be here for older people when they need us most, and with over 2.5 million older people feeling they have no one to turn to for help and advice, Rothesay Life's support has never been more needed.

In 2018, Rothesay Life sponsored Age UK's For Later Life Conference, enabling us to engage hundreds of health and social care professionals, policymakers and older campaigners themselves in critical discussions about the future of health care in the UK. Funding from Rothesay Life also allowed Age UK to produce thousands of copies of our information guide on bereavement, enabling us to support older people at one of life's most difficult moments.

In addition, Rothesay Life's sponsorship of Love Christmas, Age UK's annual celebrity carol concert, meant we could hold an amazing evening at St Paul's Cathedral, raising over £80,000 on the night and engaging over 2,000 supporters.

Our partnership over the last four years is testament to Rothesay Life's commitment to ensuring a brighter future for older people in the UK. We're delighted to be your chosen charity and look forward to working with you in the future – thank you so much!"

Chief Executive Officer's report

Long-term security

Rothesay Life is now the leading specialist insurer of pension liabilities. We continue to grow and remain well placed to capitalise on the opportunities ahead.

2018 has been a great year for Rothesay Life. We 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 our total assets under management to £36.3bn as at 31 December 2018 (2017: £24.2bn). 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.

Our capital position remains robust with Group SCR coverage of 181% (2017: 169%) and RLP SCR coverage of 180% (2017: 163%). We aim to maintain SCR coverage above 130%, so our capital position provides significant surplus capital for new business and future dividends.

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

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

In July we 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 our business and our business model. Both the agencies highlight our 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 we took advantage of in September by successfully issuing £350m of RT1 notes.

In December we received approval to use a PIM for the calculation of the Group's SCR for credit and counterparty risk. Use of the model ensures that the Group's capital models are aligned to the risks that the Group 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 Group invests and of the Group'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.

We were 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 we initiated over past years have also started to bear fruit. We have 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 Group 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.

The Group's US subsidiary, Rothesay Asset Management US LLC, which opened at the end of 2017, has also begun to help us source investments in the United States consistent with our investment strategy. The US market presents a range of attractive investment opportunities for our growing business, including commercial real estate loans and asset-backed financing.

IFRS profit before tax (£m)

£102m

2017: £312m | -67%

MCEV (£bn)

£3.4bn

2017: £2.3bn | +50%

Group SCR coverage (%)

181%

2017: 169% | +12%

Equity release mortgages (£bn)

£1.9bn

2017: £0.5bn | +280%

Chief Executive Officer's report continued

Group performance

Following completion of the Prudential transaction we chose to de-risk the underlying assets and reinvest cautiously to take advantage of attractive market opportunities. Investments completed to date have out-performed our underwriting assumptions and we expect significant further profits to arise as we invest the remaining assets. While widening credit markets have dampened IFRS profit before tax for 2018 to £102m (2017: £312m), they also present further opportunities to invest at more attractive levels.

Continued focus on value and risk in underwriting led to 50% MCEV growth, up £1.1bn to £3.4bn (2017: £2.3bn). More can be found on our financial performance in the Chief Financial Officer's review on page 22.

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 our competitors during the year being written at pricing levels that would not have met our return thresholds. We have remained disciplined in the execution of our strategy, as careful business selection remains a critical aspect of our business strategy.

Improved pension scheme funding as a result of strong equity performance, rising interest rates and recovery plans mean that the outlook for the bulk annuity market going into 2019 is probably the strongest we have 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.

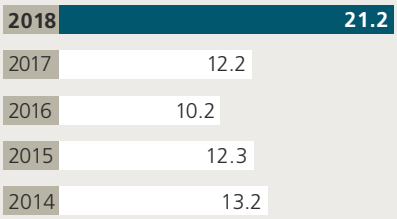
The outlook for back-book transactions also looks positive. Most UK insurance companies have exited the individual annuity market, which means that their annuity portfolios are no longer core. As a result, we believe that there are likely to be a number of opportunities to acquire back-books of annuities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

Risk, capital and asset management

We 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. We are therefore fortunate in having market-leading risk management systems that allow us to be proactive and to navigate even the most difficult markets with agility, ensuring we meet our obligations while preserving capital to grow and generate value for our 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 we assume on behalf of our customers is a key part of our strategy.

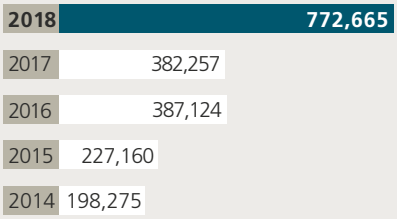
Our risk and capital management framework is intended to ensure that we identify and understand all of the inherent risks in the liabilities we insure and the assets in which we invest. We then look for the most efficient and effective methods of managing these risks. This involves hedging market risks, such as interest rate, currency and inflation, using derivatives and asset liability matching and hedging longevity risk using reinsurance, where we have reinsured 78% of our exposure. Stress testing and scenario planning means that we 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 our risk appetite. We 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. We 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 we can generate.

Bulk annuity market volumes



2018 data sourced from LCP, based on publicly disclosed deals as at 23 January 2019. Prior year data sourced from LCP and Hymans market reports.

Total lives insured



Our policyholders

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

We take pride in the quality of the service we provide, so it was vital that the transition from Zurich and Aegon to Rothesay Life went smoothly following the Court-sanctioned transfers. We are now working on ensuring a similar successful outcome for the policyholders who will transfer from Prudential to Rothesay Life.

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

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

A hard Brexit may mean that we are prevented from paying claims to our EU policyholders and we are therefore developing contingency plans for ensuring continuity of payment for our small block of Irish annuitants and for our ex-pat policyholders.

Our shareholders

2018 was our first year under the joint ownership of Blackstone, GIC and MassMutual. All three provided us with new equity to support the Prudential transaction and we are delighted that our core shareholder group remains the same following the sale by Goldman Sachs of its holding in 2017.

This long-term support from our shareholders allows us to provide clients with a full range of solutions on a large scale, as well as taking advantage of strategic opportunities as they arise.

Our people

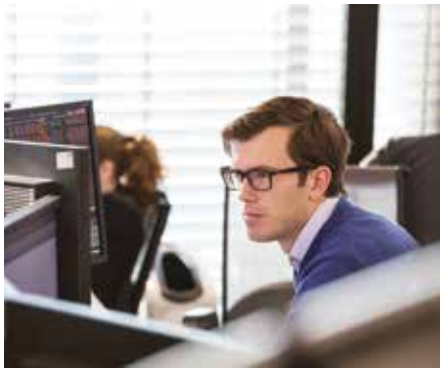
At the end of 2018, the Group had 210 employees, an increase of 17% from 2017.

During the year we have continued to build our in-house asset management function and other key areas of the business. We have also strengthened control and support functions 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 of engagement of our people and the breadth of the expertise within the team across insurance, pensions, actuarial, investment management, operations and technology is the defining factor in our success. This was illustrated by the successful execution of the Prudential transaction, a testament to the strong teamwork and seamless operations that we have developed.

Finally, I would like to take this opportunity to thank our people and our administration partners for their efforts during the year.

Addy Loudiadis
Chief Executive Officer
13 February 2019



Our people build our business

We have built our business on the foundation of long-term relationships, seeking to avoid short-term opportunism. We focus on recruiting and retaining the people we need to deliver innovative insurance solutions and service excellence.

Building the team that builds our business

To meet the demands from significant balance sheet growth and increasing policyholder numbers, we have continued with significant levels of recruitment. Key hires in 2018 have enabled us to continue to deliver on our investment strategy and further bolster our risk management framework. Although we have seen increased staff turnover during 2018, it remains below industry average, and is expected as the organisation grows.

Our New York office is growing, increasing from one employee at the end of last year to four by the end of 2018. Year-on-year increases in graduate numbers have also strengthened our capability pipeline for the future.

Investing in our people

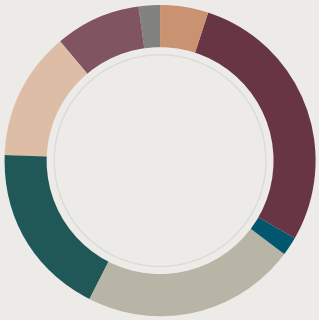
In 2018 we delivered a comprehensive learning and development agenda, designed to help our employees to thrive and to fulfil their career ambitions. Our people are encouraged to own their career development and select their learning activities from the programmes which have been tailored to Rothesay Life's requirements. We continue to partner with suppliers to deliver onsite training and learning platforms that augment the technical skills and soft skills of our people.

We have invested in the wellness of our employees and their families. This year we held Rothesay's first Wellness Fair to promote all our health benefits, including subsidised gym memberships, private medical insurance, free health assessments, flu jabs and comprehensive online resources. This has been reinforced through our initiatives this year, including activity challenges and sporting events in line with our corporate social responsibility agenda. When surveyed, 85% of our people said that they believed that Rothesay Life supports the health and wellbeing of its employees.

Average employee turnover (%)

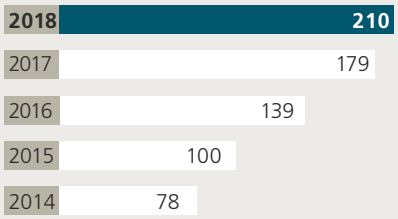
11.8%

Headcount split by department



- Management
- Operations (including HR)
- Rothesay Asset Management US LLC
- Investment
- Finance, legal and internal audit
- Risk and compliance
- Business development and pricing
- Technology

Growth in headcount



Engaging our employees

In 2018 we have continued our focus on strengthening internal communications and building a central hub for information. This has been key to helping new hires become part of the team.

This year we undertook our first employee engagement survey, achieving a response rate of 81% of those surveyed. The results demonstrate high levels of engagement, with 94% of respondents saying that they were proud to work at Rothesay and 87% saying that they were treated with respect by their colleagues.

The survey has also helped us identify areas where we can do better and this will be a focus for 2019.

Giving back

Each year we support a number of charities and we encourage our employees to support charities personal to them through our matched giving policy, which gives everyone an annual matched allowance of £1,000. We are proud that so many people have engaged in fundraising and social events designed to give back to the community.

This year, we also selected our first employee nominated "charity of the year". In January we gave employees the opportunity to nominate and vote for a charity that would become our employee charity of the year. The Sick Children's Trust has become the first charity we have partnered with using this process and through various fundraising activities Rothesay Life and our employees have made a positive impact on the lives of families that are supported by the charity.

Delivering sustainable shareholder value

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

Strategic objectives

1 Protect the security of policyholder benefits

We apply a conservative, risk capital-based approach to managing our balance sheet and strive for excellence in our operations to protect the long-term security of our policyholders' benefits.

Progress in 2018

- Maintained robust solvency position.
- Obtained approval to use a PIM which better aligns regulatory capital to the Group's conservative business model.
- Following approval of the PIM, the Group restructured our investment in equity release mortgages in order that some of the exposure can be moved into the matching adjustment fund, thereby improving liquidity of the Group and allowing better diversification of risks.
- Raised £350m of RT1 debt, improving the quality of the capital supporting the business and allowing repayment of the bank debt raised at the time of the Prudential transaction.

SCR coverage at RLP (%)

180%

Our focus in 2019

- Continue to maintain robust solvency position, particularly against the backdrop of economic and political uncertainty.
- Embed use and understanding of the PIM across the Group.
- Begin work on extending the PIM to cover other risks.

Risks

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

Strategic objectives

2 Grow through writing value-driven new business

We pursue growth by focusing on high-quality new business which meets our return thresholds and risk tolerance. We remain disciplined in our approach, which benefits from proven execution capabilities across pensions, insurance and corporate acquisitions.

Progress in 2018

- The purchase of a £12bn annuity portfolio from Prudential Plc in March, the largest such transaction ever completed in the UK, represented a step change for the Group. As noted elsewhere, this resulted in new business strain on an IFRS basis in the first half of 2018. Investments completed to date have outperformed our underwriting assumptions and we expect significant further profits to arise as we invest the remaining assets.
- The Group also assisted five pension schemes to de-risk their liabilities but remained disciplined in new business pricing (with some of the business transacted by our competitors during the year being written at pricing levels that would not have met our return thresholds).

MCEV new business profit (£m)

£453m

Our focus in 2019

- Continue to target new business which meets our return thresholds and risk tolerance.
- Continue to deploy assets according to the Group's long-term investment strategy.
- Our shareholders have demonstrated their willingness to provide new equity to support attractive new business opportunities, allowing us to continue to provide clients with a full range of solutions on a large scale, as well as taking advantage of strategic opportunities as and when they arise.

Risks

- Strategic risk – the risk that changes in the operating environment means that we are unable to write value-driven new business, including the risk that competitors are able to undercut our pricing.
- Operational risk – the risk arising from inadequate pricing processes.

Strategic objectives

3 Safeguard our brand and culture

We have built our business on the foundation of long-term relationships and avoided short-term opportunism. We focus on recruiting and retaining the best and most relevant talent to protect this culture and ensure we can maintain excellence in delivery to policyholders, counterparties and partners.

Progress in 2018

- Recruited 53 talented individuals across all areas of the Group, including for our new US operation.
- Rationalised administration outsourcing arrangements following the Aegon transaction.
- Maintained low complaint rates and high customer satisfaction despite significant growth in the business.

Employees proud to work at Rothesay Life (%)

94%

Our focus in 2019

- Ensure that the service received by Prudential policyholders is unaffected by the transfer to Rothesay Life and that ultimately policyholders can benefit from the same high quality service experienced by our existing customers.
- Further recruit to continue to grow our asset origination capabilities, our in-house internal audit team and our in-house IT capabilities.

Risks

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

New business and underwriting

Careful business selection remains a critical aspect of our business strategy.

2018 new business premiums (£bn)

£13.2bn

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

The Group 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 our competitors during the year being written at pricing levels that would not have met our return thresholds. During 2018, the Group looked at over 60 new business opportunities, focusing our attentions on the deals that worked best for all our stakeholders.

We 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 Rothesay Life's execution capabilities (for further detail see page 20).

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

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

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

Operations

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

Service standards (%)

98%

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

Pensions Administration Standards Association (PASA): In 2018 we became the first insurance company to have gained Accreditation by PASA, an independent body dedicated to improving standards in pensions administration.

We continue to follow a strategic outsourcing model for the provision of administration services. Key to delivery of excellent customer service is our robust oversight of our third party administrators, Willis Towers Watson, JLT Employee Benefits and Capita Employee Solutions, all of whom are well established pension administrators. Our three strategic partnerships provide us with both scale and contingency capabilities. Each administrator has dedicated teams exclusively for Rothesay Life, with all calls and policyholder interaction carried out in the UK.

During 2018 we have rationalised our administration outsourcing arrangements, successfully migrating 1,800 policyholders from HS Administration Services and 5,800 policyholders from JLT's Edinburgh office to Capita Employee Solutions. We have also reviewed and rationalised the personal data we hold to ensure compliance with the General Data Protection Regulation (GDPR), writing to a quarter of a million policyholders in the process.

We have a high degree of automation and technology that allows our outsourced administration platforms to interact with our risk management systems to minimise discrepancies and ensure the highest levels of customer service. During 2018 we continued to invest in automation and efficiency projects to ensure we have a robust control environment to mitigate cyber risk and to manage existing and future business without compromising our high service levels and our continued commitment to our policyholders.

The Operations team oversees and manages the third party administrators through a series of robust and well established processes. If issues are identified, we work closely with our servicing partners to resolve them as efficiently as possible and to implement any remediation plans, as necessary. During 2018 all three administrators exceeded their target service levels for most of the year.

Our complaint levels continue to remain low, with just 0.76 complaints received per 1,000 policyholders, of which only 0.23 complaints per 1,000 policyholders were upheld. All complaints are reviewed by the Operations team and reported to our Customer & Conduct Committee which is chaired by Richard Berliand, an independent Non-Executive Director.

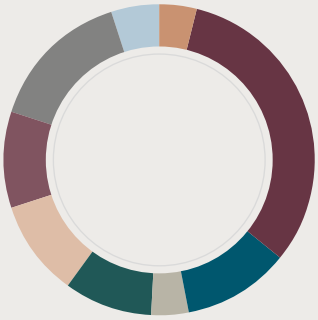
Customer satisfaction levels remain high with excellent policyholder feedback and 98% of policyholders responding to our surveys rating our service as 'Excellent' or 'Good'.

A key focus for 2019 will be continuing to work closely with the Prudential teams to prepare for the expected transfer of Prudential policyholders and seven reinsurance contracts following the final Court hearing later in the year. It is vital that the service received by Prudential policyholders is unaffected by the transfer to Rothesay Life and that ultimately policyholders can benefit from the same high-quality service experienced by our existing customers.

Investment management

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

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%

Nationwide equity release mortgages

During 2018 Rothesay Life entered into a strategic partnership with Nationwide Building Society, offering equity release mortgages to their existing and future members. Both organisations have shared goals to address the needs of a changing and ageing population, with equity release mortgages forming part of an ongoing plan by Nationwide Building Society to support people in or approaching retirement.

The strength of Nationwide's brand should help bring equity release mortgages further into the mainstream market. Equity release mortgages meet the needs of an age group that has not been well catered for by mainstream mortgage lenders and remain underserved by standard mortgage products.

Rothesay Life continues to manage the risk associated with equity release mortgages through a conservative approach to property underwriting, a focus on lower loan to value ratios and ensuring that the headline consumer rates are at or around the best in the market in order to attract the best quality customers.

Rothesay Life has long-term annuity liabilities that are backed by fixed income assets. Given the illiquid nature of our liabilities, the Group is a buy and hold investor. Adverse movements in our investment portfolio are offset by movements in our insurance liabilities, leading to reduced exposure to market volatility.

The Group is adversely impacted by defaults and hence we look to maximise recoveries by making highly secured or collateralised investments. Under Solvency II, the Group is also exposed to risk of downgrades as capital requirements are driven by ratings. As a result, the Group 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 Group holds substantial liquidity buffers at all times to protect the firm against potential liquidity calls. To achieve this, the Group 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 Group adopts a market consistent approach to reserving for residual credit risks and adopts a dynamic strategy of monitoring and re-hedging these risks where possible as they arise. The use of derivatives to hedge market risk, combined with our use of collateral to mitigate credit and counterparty risk, means that collateral management forms an integral part of the Group's activities. We monitor collateral closely and stress test collateral that backs investments to ensure security is not compromised due to market moves.

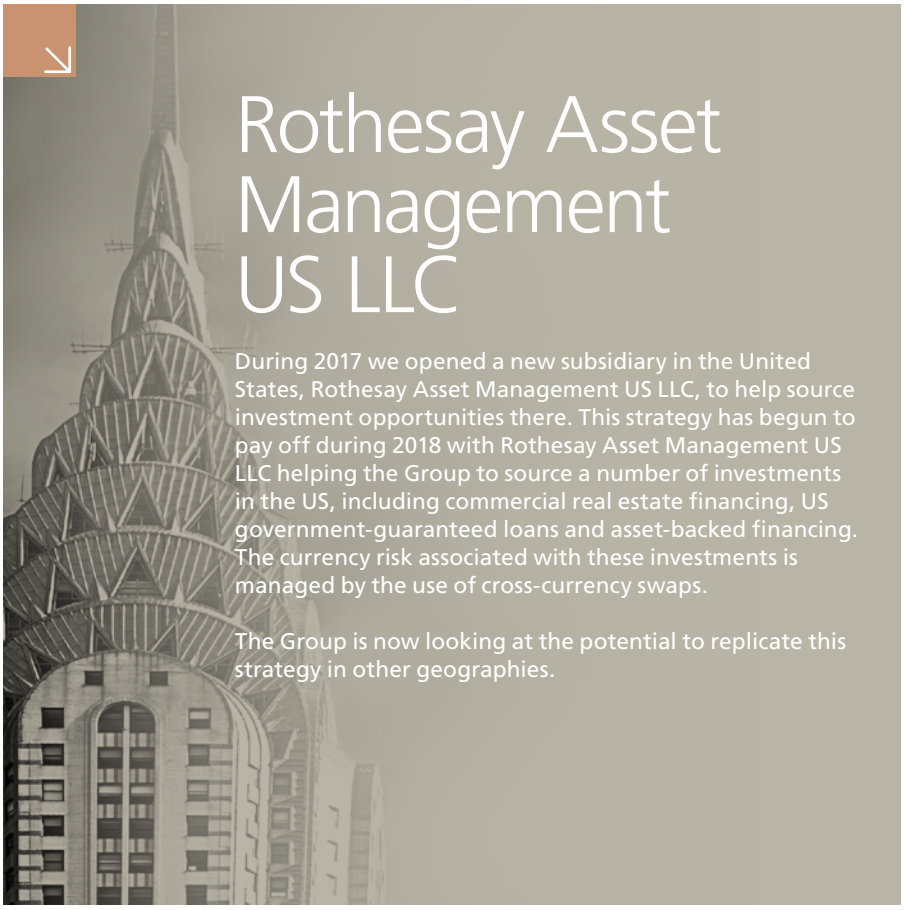
The Group has a dedicated in-house team focused on ensuring that the assets in which we invest are secure through their inherent credit worthiness or structural features such as collateral, covenants and other security features. The team consists of origination, structuring, legal, trading, risk, modelling, 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 Group'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 Group also has a holding of corporate bonds. The average rating of the Group's investment portfolio is AA[1]. A breakdown of the investment portfolio is shown in the diagram on the previous page 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 our 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 the 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 Group's assets under management, the Group 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.



Rothesay Asset Management US LLC

During 2017 we opened a new subsidiary in the United States, Rothesay Asset Management US LLC, to help source investment opportunities there. This strategy has begun to pay off during 2018 with Rothesay Asset Management US LLC helping the Group to source a number of investments in the US, including commercial real estate financing, US government-guaranteed loans and asset-backed financing. The currency risk associated with these investments is managed by the use of cross-currency swaps.

The Group is now looking at the potential to replicate this strategy in other geographies.

Supporting our clients with their strategic objectives

On 14 March 2018, Prudential Plc announced that in line with its strategy to transition towards a more capital efficient, de-risked business model, M&G Prudential had agreed to the sale of its £12bn portfolio of annuities to Rothesay Life. The capital benefit of the transaction will be retained within the Prudential Group to support its UK demerger process.

Given the importance of the transaction to Prudential's strategy, Prudential needed to be confident that the transaction could be executed quickly and efficiently by their deadline. Rothesay Life's successful experience with the £6.4bn Aegon and £1.1bn Zurich transactions meant that we were able to give Prudential that confidence.

In the event, by close of business on the day that the transaction was signed and announced, we had recorded the details of all the annuity liabilities covered by the sale as well as the assets to be received from Prudential on our risk management systems. This meant that we were immediately able to dynamically hedge the risks associated with the £12bn of annuities acquired.

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 effective date of a Part VII transfer.

Capital support for the transaction was provided by the Group's shareholders, with £380m of new equity being issued. The Group then borrowed an additional £500m from a syndicate of third party banks. The new equity and the proceeds from the loan were then injected into RLP as equity.

After RLP was assigned an insurance financial strength rating of A3 by Moody's Investors Service and A+ by Fitch Ratings, RLP raised £350m of RT1 notes. The proceeds were paid as a dividend from RLP to the Group holding company, Rothesay Holdco UK Limited (RHUK), and used to repay bank debt. Following regulatory approval of the PIM, a further £150m was paid as a dividend from RLP to RHUK and the rest of the syndicated bank debt was repaid.

Our new policyholders

We anticipate that responsibility for the majority of Prudential's policyholders and the associated reinsurance contracts will transfer to the Group during 2019, subject to Court approval. Work is ongoing to make sure that the service received by policyholders is unaffected by the transfer and that ultimately policyholders can benefit from the same high-quality service experienced by our existing customers.

Positive feedback from a transferring Aegon policyholder:

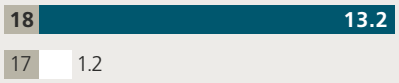
"I have had excellent service from your firm. I have moved pension provider several times since I retired and your firm has given by far the best service."

Key performance indicators

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

New business premiums (£bn)

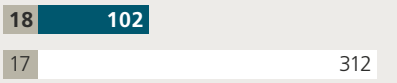
£13.2bn



New business premiums are a key indicator of the Group's growth and realisation of our strategic objectives. The Group 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 Group for new business as a result of the Prudential transaction.

IFRS profit before tax (£m)

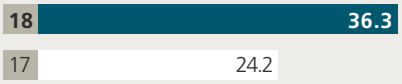
£102m



IFRS profit before tax is our primary measure of profitability, capturing all recurring and non-recurring items and in particular market fluctuations which have a direct impact on distributable reserves and capital. Following completion of the Prudential transaction we chose to de-risk the underlying assets and reinvest cautiously to take advantage of attractive market opportunities. Investments completed to date have out-performed our underwriting assumptions and we expect significant further profits to arise as we invest the remaining assets. While widening credit markets have dampened profits for 2018 to £102m (2017: £312m) they also present further opportunities to invest at more attractive levels.

Assets under management (£bn)

£36.3bn



Assets under management provide 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.

MCEV (£bn)

£3.4bn

The MCEV provides an indication of the value of the business by measuring the risk-adjusted value of the in-force business, allowing for the unwind of margins. The MCEV increased by 50% largely as a result of writing the Prudential transaction and the associated equity injection.

SCR coverage at RLP (%)

180%

SCR coverage shows the way in which RLP is capitalised compared to the regulatory requirement, demonstrating the solvency of the Group. The Group 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%

We pride ourselves on the quality of service that our 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).

Financial review

Record growth

2018 was dominated by the Prudential transaction, which took the Group's assets under management to £36.3bn as at 31 December 2018 and has led to MCEV of the Group growing to £3.4bn. The Prudential transaction also meant that 2018 was a record year for new business with new business premiums for the year of £13.2bn (2017: £1.2bn).

The financial review describes the financial performance of Rothesay Holdco UK Limited and its subsidiaries (the Group) and highlights the key drivers of the movements in the Group's consolidated statement of comprehensive income and consolidated statement of financial position. It also describes the Group's capital position.

Financial performance

The Group achieved an operating profit before tax of £355m (2017: £382m) and a profit before tax of £102m (2017: £312m). The Group focuses on profit before tax as its primary measure of profitability because this metric includes recurring and non-recurring items as well as market fluctuations and has a direct impact on distributable reserves.

With credit spreads on assets at relatively low levels and concern about potential deterioration in credit markets, the Group has taken the decision to remain overweight in gilts and cash. Investments completed to date have out-performed our underwriting assumptions but over £2bn of assets remain to be invested according to the Group's long-term investment strategy. As we invest the assets received from the Prudential transaction and other new business in line with our long-term investment strategy we expect to generate significant additional IFRS profits.

The financial performance analysis shown in the table opposite involved apportioning the items in the income statement across the various drivers of profit. The analysis is intended to provide an explanation for the way in which profits have been generated. When taken together, the items in the financial performance analysis reconcile to the IFRS profit before tax. More explanation of the line items can be found in the glossary.

New business profits in the analysis are calculated assuming full investment of premiums and the impact of any under-deployment is reported in the table as a deduction from the management of in-force book. New business profit for the year assuming full investment of premiums was £361m (2017: £141m).

The impact of under-deployment of premiums is offset by profits of over £200m being generated on the in-force book and changes in assumptions for 2018, notably £106m as a result of changes to demographic and expense assumptions and £82m as a result of updating the allowance for credit risk in the valuation rate of interest (see note 23). The result shown in the table is a profit of £128m from management of the in-force book (2017: £339m).

Given the significant growth in the Group's assets under management, the Group has increased our exposure to corporate bonds. As corporate bond spreads widened during 2018 (i.e. bond prices fell), we increased the provision for credit default risk resulting in the Group making economic losses of £178m (2017: a profit of £14m).

Income statement highlights

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

Gross premiums written

The Group's gross premiums written increased from £1,447m in 2017 to £13,424m in 2018. This comprises:

- single premiums of £13,161m (2017: £1,184m) from the Prudential transaction and the bulk annuity deals transacted during the year; and
- regular premiums of £263m (2017: £263m) generated on the in-force inwards longevity reinsurance business written in prior years.

Net premiums written

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

Net premiums written increased from £666m in 2017 to £12,055m in 2018, as a result of the increase in new business.

Investment return

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

Interest received on financial assets net of interest payable on financial liabilities increased from £645m in 2017 to £956m in 2018, reflecting the growth in the size of the business.

The net movement in the fair value of assets including realised gains was a loss of £779m in 2018 compared to a gain of £145m in 2017. The fall in the value of assets in 2018 was due to a combination of rising interest rates and widening credit spreads and was largely offset by a similar reduction in insurance liabilities. Investment expenses increased from £21m in 2017 to £36m in 2018, in part due to the costs associated with the origination of equity release mortgages.

Financial performance
(Alternative analysis of profit generation)

£m	2018	2017
New business profit (with assets invested)	**361**	141
Management of in-force book	**128**	339
Acquisition costs	**(105)**	(85)
Administration expenses	**(36)**	(21)
Experience variance	**2**	(1)
Other	**5**	9
Operating profit before tax	**355**	382
Borrowing costs	**(55)**	(36)
Non-recurring and project expenditure	**(20)**	(48)
Economic (losses)/profits	**(178)**	14
IFRS profit before tax	**102**	312

Income statement highlights

£m	2018	2017
Gross premiums written	**13,424**	1,447
Net premiums written	**12,055**	666
Investment return	**141**	769
Total revenue	**12,196**	1,435
Claims paid	**(601)**	(743)
Change in insurance liabilities	**(11,261)**	(170)
Operating expenses	**(161)**	(154)
Finance costs	**(71)**	(56)
Total claims and expenses	**(12,094)**	(1,123)
Profit before tax	**102**	312
Income tax	**(17)**	(51)
Profit after tax	**85**	261

Financial review continued

Claims paid

Claims paid represent the total payments due to policyholders during the year (£1.9bn) less the reinsurers' share of such claims (£1,275m). Net claims paid decreased by £142m from £743m in 2017 to £601m in 2018.

Change in net insurance liabilities

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

The increase in net insurance liabilities of £11,261m in 2018 compared to an increase in net insurance liabilities of £170m in 2017. The increase in 2018 was largely due to the Prudential transaction and other new business, partially offset by the run-off of the liabilities, changes in economic conditions and changes to reserving assumptions, particularly the impact of updates to longevity assumptions (see note 23).

Acquisition costs

Acquisition costs comprise the expenses associated with the origination of new business, including annual compensation for employees. Acquisition costs increased from £85m in 2017 to £105m in 2018 as a result of the growth in the scale of operations and the costs associated with the Prudential transaction.

Administration expenses

Administration expenses represent the cost of administering the in-force book of business. These increased from £21m in 2017 to £36m in 2018, broadly in line with the growth of the business.

Other expenditure

Other expenditure amounted to £20m in 2018 (2017: £48m). This includes reinsurance fees of £9m (2017: £19m), costs relating to our Solvency II project of £1m (2017: £12m) and other one-off project costs of £10m (2017: £9m).

Finance costs

Finance costs mainly represent interest payable on borrowings. The interest payable on borrowings (i.e. excluding interest on collateral) increased from £36m in 2017 to £55m in 2018 as a result of additional borrowing towards the end of 2017 and during 2018. Borrowing during the year consisted of the £350m RT1 notes issued on 5 September 2018 and the £500m loan from a syndicate of banks raised at the time of the Prudential transaction and repaid in December 2018. Note that for the purposes of IFRS accounting, the RT1 notes are treated as equity, and interest on these notes is not included in finance costs.

Income tax

The Group's income tax charge decreased from £51m in 2017 to £17m in 2018, as a result of the decrease in profits. Taxation is discussed further below.

Balance sheet highlights

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

Assets

Total assets increased from £38.4bn as at 31 December 2017 to £50.2bn as at 31 December 2018. These aggregate numbers include derivative assets which net off against derivative liabilities and uncollateralised financing assets which net off against the associated liabilities.

Assets under management increased from £24.2bn 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.

Reinsurance provisions remain relatively low compared to insurance contract liabilities because the Group's reinsurance contracts are all longevity swap reinsurance under which the Group pays regular premiums in return for being entitled to make regular claims. Although some of the Group's reinsurance is an asset on an IFRS basis because projected claims exceed the regular premiums due on some contracts, overall the reinsurance represents a net liability of £630m (2017: Net liability of £63m). The liability increased as a result of reinsurance associated with the Prudential transaction and the change in longevity assumptions as detailed in note 23.

Balance sheet highlights

£m	2018	2017
Financial investments	**49,174**	37,312
Reinsurance assets	**43**	168
Other assets	**1,016**	894
Total assets	**50,233**	38,374
Share capital and share premium	**829**	448
RT1 notes	**347**	–
Capital contribution reserve	**10**	5
Retained earnings	**1,385**	1,300
Total equity	**2,571**	1,753
Insurance contract liabilities	**32,435**	21,741
Reinsurance liabilities	**673**	231
Payables	**13,849**	13,965
Borrowings	**647**	647
Other	**58**	37
Total liabilities	**47,662**	36,621
Total equity and liabilities	**50,233**	38,374

Assets under management

£m	2018	2017
Total assets	**50,233**	38,374
Less reinsurance assets	**(43)**	(168)
Less payables and financial liabilities	**(13,849)**	(13,965)
Assets under management	**36,341**	24,241

Total equity

The increase in total equity (an increase of £818m from £1,753m at 31 December 2017 to £2,571m at 31 December 2018) was driven by the new equity injected by our institutional shareholders at the time of the Prudential transaction, the RT1 note issuance and the increase in retained earnings.

Liabilities

Insurance contract liabilities increased from £21.7bn at 31 December 2017 to £32.4bn at 31 December 2018, largely as a result of the Prudential transaction and other new business, partially offset by the run-off of the liabilities, the change in economic conditions and changes to reserving assumptions, particularly the impact of updates to longevity assumptions (see note 23).

Payables decreased by £116m from £14.0bn at 31 December 2017 to £13.9bn at 31 December 2018. Payables are dominated by derivative financial instruments and collateralised financing agreements. Derivatives are used to manage market and credit risk. The derivative liability as at 31 December 2018 of £11.8bn (2017: £11.1bn) nets off against the derivative assets of £11.5bn (2017: £10.7bn).

The liabilities associated with collateralised financing agreements as at 31 December 2018 decreased by £0.6bn to £0.8bn (2017: £1.4bn) and can be partially netted off against the value of the associated collateralised financing assets of £2bn (2017: £2.4bn). Collateralised financing is used by the Group to enable investment in shorter-term assets and to generate liquidity.

Borrowings have remained stable over the year because the RT1 notes are treated as equity from an IFRS perspective. At the time of the Prudential transaction, the Group borrowed £500m from a syndicate of banks to ensure the ongoing capital strength of RLP and to provide flexibility. However, this was repaid in the last quarter of 2018, funded from £500m of dividends paid from RLP to RHUK.

Changes to accounting standards

The International Accounting Standards Board has announced that subject to due process, the implementation of IFRS 17 the accounting standard for insurance contracts will be delayed until 1 January 2022. The standard will have a significant impact on the way the Group's results are reported and work will continue during 2019 on preparing for implementation.

The Group has taken the deferral option in relation to IFRS 9 and will adopt the standard on the effective date of the new insurance contract standard.

Less material is the new standard on leases, IFRS 16. Reporting as at 30 June 2019 will be in accordance with the new standard, which will see assets and liabilities increasing by a similar amount to reflect the value of leases entered into by the Group (see Appendix – Changes in IFRSs).

Market consistent embedded value

The Group prepares supplementary financial statements on an MCEV basis because we consider that embedded value reporting provides investors with a useful measure of the future profit streams of the Group's in-force long-term business. The Group's MCEV has increased by 50% from £2,301m at 31 December 2017 to £3,441m at 31 December 2018 and is summarised in the table below. Adjustments allow for Group borrowings and other Group adjustments. These adjustments increased from a deduction of £603m at 31 December 2017 to a deduction of £974m at 31 December 2018 due to the issuance of £350m of RT1 notes (which for MCEV purposes are treated as debt).

The Group's MCEV has increased as a result of the value of new business, notably the Prudential transaction, new equity, surplus arising on existing business and changes in assumptions (see below). The value on an MCEV basis of new business written in 2018 was £453m (2017: £177m).

The shareholders' equity on an MCEV basis is consistent with the sum of the shareholders' equity on an IFRS basis, the value of in-force business as shown above and debt valuation differences of £353m as at 31 December 2018 (2017: £56m).

Further information on the Group's MCEV can be found in the 2018 Market Consistent Embedded Value Report when it is published. The methodology and assumptions used are consistent with those set out in last year's MCEV supplementary financial statements except that assumptions have been updated to reflect prevailing economic conditions and recent demographic experience. For MCEV purposes, liabilities are discounted at the risk free-rate plus a liquidity premium adjustment (where applicable). The liquidity premium adjustment used at 31 December 2018 was 115bps, after the deduction of investment management costs (2017: 104bps).

Taxation

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

The Group makes a significant tax contribution in the UK, with £183m remitted to UK tax authorities in 2018 (2017: £187m). The Group had an effective corporation tax rate of 18.4% during 2018 (2017: 16.4%). Other taxes include property taxes, employer payroll taxes and irrecoverable indirect taxes.

Market consistent embedded value

£m	2018	2017
Net worth of RLP	**3,193**	2,298
Value of in-force business	**1,222**	606
Less: debt and Group adjustments	**(974)**	(603)
MCEV	**3,441**	2,301

Taxes paid

£m	2018	2017
Corporation tax	**38**	62
Other taxes	**1**	1
Taxes collected	**144**	124
Total remitted	**183**	187

Taxes collected are those taxes that the Group is obliged to collect from employees and policyholders, namely income tax, employee national insurance contributions and annuitant payroll taxes.

Capital management

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

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

Under the Solvency II regime, the Group and its insurance company subsidiary, RLP, are 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 Group's ability to pay dividends. The Group aims to maintain at least 130% of the regulatory minimum requirement. As at 31 December 2018, the Group had an SCR coverage ratio of 181% (31 December 2017: 169%).

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

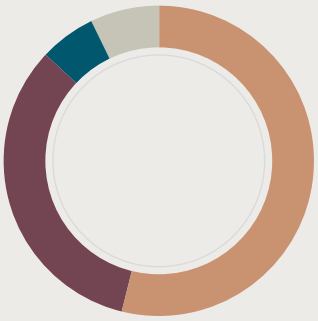
Under Pillar 1, we are required to hold sufficient assets to meet:

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

Firms with illiquid liabilities such as annuity business can discount these illiquid liabilities using the risk-free rate plus what is known as the 'matching adjustment'. The matching adjustment is broadly equivalent to the illiquidity premium that can be earned on the illiquid assets held to back illiquid liabilities. Approval of the PIM has allowed the Group to restructure our 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 Group applies the matching adjustment in calculating the BEL for almost all of its single premium insurance business. The remaining liabilities are discounted at the risk-free rate. Assets in excess of those required to meet the technical provisions are known as Own Funds.

As part of the transitional arrangements in relation to the introduction of Solvency II, the Group is permitted to take credit for transitional solvency relief which amortises linearly to zero, falling by 1/16th on 1 January 2017 and again each year thereafter. An application can be made to re-calculate the amount of transitional solvency relief that can be taken if the risk profile of the Group changes materially. The Group made such an application as at 31 December 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

RLP SCR 31 December 2018



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

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 Group's SCR is calculated using a PIM approved for use from 31 December 2018. The PIM means that the Group'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 risk inherent in the types of highly secured and collateralised investments which are core to the Group'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 Group's surplus over the SCR. The diagram on the previous page 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.

The solvency positions of the Group and RLP are summarised in the table below. Group SCR coverage increased from 169% at 31 December 2017 to 181% at 31 December 2018 and 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 notes helped offset the new business strain associated with the Prudential transaction and, as noted above, SCR coverage has improved as a result of the adoption of the PIM.

In December, the PRA published 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'. The Group can already meet the Effective Value Test and, if implemented today, the statement would have no impact on the Group's solvency position. In addition, the pricing of new equity release mortgages already reflects the full impact of the statement.

Further information on the Group's solvency position can be found in the 2018 Solvency and Financial Condition Report when it is published.

Solvency position of the Group and RLP

£m	Group 2018	Group 2017	RLP 2018	RLP 2017
Tier 1 capital	**3,260**	2,280	**3,236**	2,180
Tier 2 capital	**658**	664	**658**	664
Own funds available to meet SCR	**3,918**	2,944	**3,894**	2,844
SCR	**2,163**	1,745	**2,163**	1,743
Surplus above SCR	**1,755**	1,199	**1,731**	1,101
SCR coverage	**181%**	169%	**180%**	163%
SCR coverage without transitional solvency relief	**153%**	111%	**152%**	105%

Risk management

Central to our success

The management of risk is central to the success of the business. Every member of staff knows that he or she is responsible for the identification and management of risk.

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

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

The risk management framework is intended to ensure that we identify and understand 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. We also look to mitigate credit risk through investing in assets that benefit from collateral and structural protections.

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

Risk management framework

The Group 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.

Further detail on the components of our RMF is provided below. The RMF informs and is directed by the Group's business strategy. Risk management considerations are integral to setting business strategy, as we seek to optimise our risk-adjusted returns and create shareholder value whilst also meeting the expectations of our customers. The RMF ensures both clear ownership and strong oversight of all of the Group's risks, both quantifiable and non-quantifiable.

Board risk appetite and culture

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

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

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

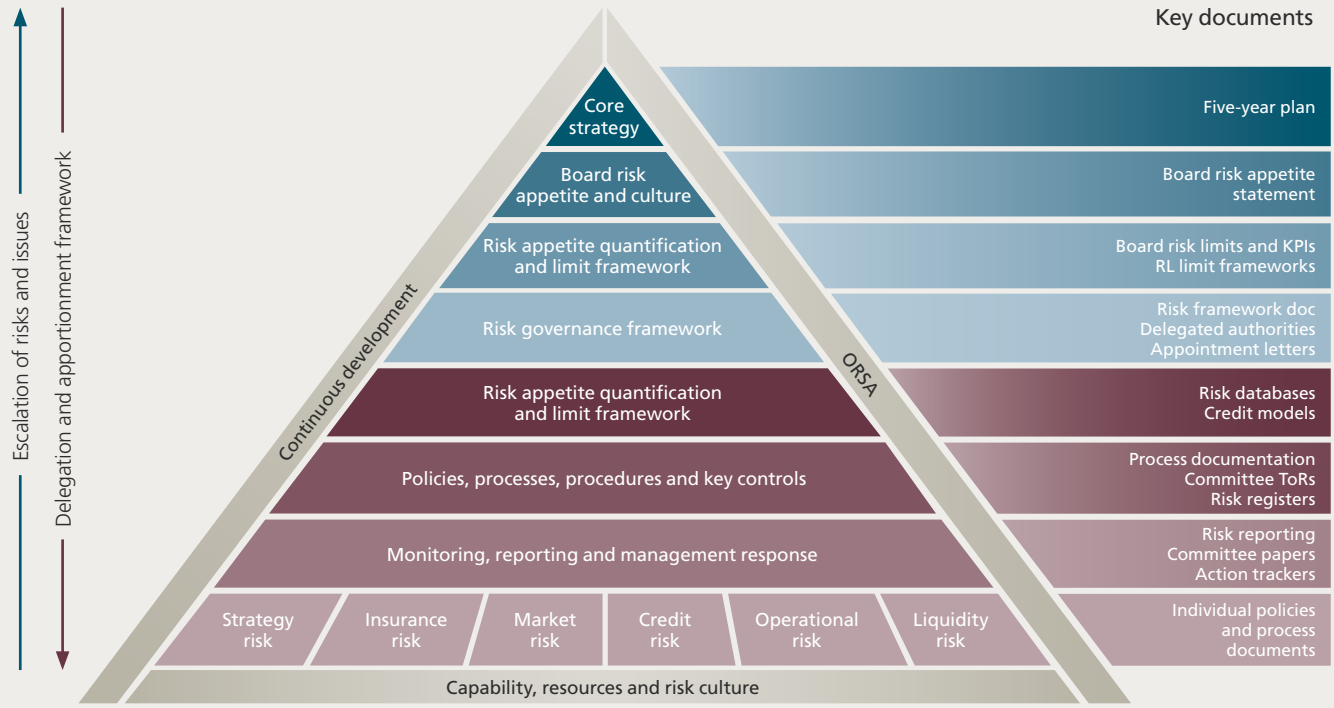
We aim to substantially mitigate the financial risks in our portfolio in order to protect policyholders, lock-in value and to safeguard capital surplus such that excess capital may be deployed into attractive risk-adjusted new business opportunities where the Group believes it has a comparative advantage.

Our risk appetite statement sets out the types of risk that we are willing to be exposed to in order to meet our strategic objectives. They are categorised as:

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

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

Risk management framework



Risk management continued

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 our risk exposures breaching the Board's risk appetite. Limits exist in relation to market, credit, counterparty, liquidity, demographic and longevity risks and are sized with reference to our overall risk appetite and capital position. Limits are constantly reviewed and regularly reported against.

Risk governance framework

Rothesay Life's risk governance arrangements strengthen the risk-taking and risk management of the business by adding challenge, oversight and independent assurance. During 2018, this framework was enhanced to ensure compliance with the Senior Managers and Certification Regime (SMCR). Rothesay Life 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. Rothesay Life also makes the distinction between:
  - the risk-taking functions, including investment and new business origination; and
  - the control functions, whose responsibility it is to ensure the integrity of the Group's operations and reporting. These include operations, finance and legal.
- **Second line:** Risk oversight is provided by the Chief Risk Officer (CRO), his team and risk management committees. The executive-level Working Level Risk Committee (WLRC) is chaired by the CRO and consists of relevant senior managers working within a delegated risk management framework. This Committee, and its sub-committees, review all material new investment, hedging or liability transactions, and is supported by a number of other committees which focus on risks arising from new activities, methodology and assumptions underlying our financial modelling and the management of third party suppliers.
- **Third line:** Independent verification of the adequacy and effectiveness of the internal risk and control management systems is provided by the Internal Audit function.

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

Systems and infrastructure

The Group operates an integrated system infrastructure which captures all assets and liabilities centrally and provides us with the capability to report and monitor risk daily at both the portfolio and the individual transaction level. Close 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

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

		Risk preference		
Risk type	**Definition**	**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.	●		

which set out the principles and standards for risk identification, measurement, mitigation, control and monitoring.

Monitoring, reporting and management response

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

Capability, resources and risk culture

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

Own Risk and Solvency Assessment (ORSA)

The 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 Group's business plans. The ORSA is an important input to the Group's strategic planning cycle.

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

Continuous development

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

Changes in the Group's risk profile and emerging risks

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

The Group has continued its strategy of investment in a diverse range of assets, including providing investment to critical UK infrastructure assets such as the Thames Tideway Scheme. The Group has also continued to grow its exposure to equity release mortgages, through funding new origination as well as acquiring back-books of mortgages. The Group 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 Group's proactive approach to risk management has continued to be crucial in delivering to the Group's strategic objectives and ensuring continued financial security for our policyholders.

The Group 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 Group can already meet the Effective Value Test and, if implemented today, the statement would have no impact on the Group's solvency position. However the risk remains that the PRA or other regulators make changes in the future which do adversely impact the Group's business model.

Brexit

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

The Group 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 Group but regular stress testing of the balance sheet ensures that the financial and solvency impact of such an exit is within our risk tolerances. Further information on sensitivities can be found in note 12 (financial investments), note 15 (market risk) and note 23 (insurance contract liabilities).

Longer term

The Group 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 evolving global relationships.

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

The Group 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.

Risk management continued

Principal risks and uncertainties facing the Group

The Group'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 15, 16, 17 and 23 of the financial statements:

Risks and uncertainties	Trend and outlook	Mitigation
Credit risk	The Group 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 Group 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 Group 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 Group's loans secured on ground rents.	The Group continues to actively monitor the political landscape. Where appropriate, the Group carries out lobbying activities or responds to consultations which may directly impact it. Strategic decisions take into account the overall political landscape. The Group'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 Group invests in both people and modelling capabilities to understand its experience and to help predict what could happen in the future. The Group aims to reinsure a majority of its longevity exposure, and specifically works with reinsurers who are longevity experts. As at 31 December 2018 the Group had reinsured 78% of its longevity risk (2017: 82%).
Counterparty default risk	The Group carefully manages its counterparty exposures and works with a range of third parties. The outlook is stable.	The Group 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 Group 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 Group can source to back its liabilities as well as the value of the assets it currently holds. The Group has more exposure to residential property risk through the growth in its equity release mortgages.	The Group monitors interest rate risk and foreign exchange risk closely, and uses derivatives to hedge the risks. We also undertake 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. We have also established prudent reserves covering the potential cost of the no negative equity guarantee.

Risks and uncertainties	Trend and outlook	Mitigation
Liquidity risk	As the Group continues to deploy its assets according to our long-term investment strategy, our holding of illiquid assets will increase.	The Group has a comprehensive liquidity management framework that ensures sufficient liquidity is held to meet collateral outflows as well as projected expenses and other outflows in extreme market conditions.
Operational risk	The Group expects to complete the Court-sanctioned transfers of the block of business from Prudential in 2019, the third major insurance block to be acquired, following similar deals with Aegon and Zurich. The Group 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 Group 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 Group seeks to mitigate cyber risk through robust processes and controls including data protection, penetration testing and staff training, and maintains ISO27001 accreditation. Where the Group outsources some of its responsibilities, we undertake through due diligence in advance of appointment and then have 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. Future developments in relation to GMP equalisation may impose additional costs and liabilities on the Group.	The Group 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 Group seeks to have an open and transparent relationship with regulators at all times. The Group 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 Group considers that these will be adequate.

Viability statement

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

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

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

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

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

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

The governance report provides an overview of the Group's approach to governance, including how the Board oversees the business for the benefit of policyholders, shareholders and other stakeholders by promoting long-term sustainable growth and by ensuring that risk and capital management processes remain robust.

Governance report

Naguib Kheraj
Chairman

Robust corporate governance

I am pleased to report that robust corporate governance has remained a priority as the Group continues to grow.

Corporate governance highlights:

- Review and approval of the Prudential transaction and associated equity and bank debt financing.
- Review and approval of the PIM application.
- Review and approval of the issuance of £350m of RT1 notes.
- Overseeing the employee engagement survey and considering the results and proposed response.
- Review and approval of the acquisition of the £860m portfolio of equity release mortgages.

The Board

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

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

There were no changes to the Board over 2018, apart from the resignation of Glenn Earle in January. As noted earlier, Richard Berliand has decided to stand down as an independent Non-Executive Director from March 2019 and work has commenced to identify his replacement.

Shareholders

The ultimate shareholders of RHUK are:

- The Blackstone Group L.P. – 35.85%
- GIC Private Limited – 35.85%
- MassMutual Financial Group – 24.67%

The shareholder Directors provide an important contribution to the Board and the overall performance of the Group.

The Shareholder Agreement sets out a number of reserved matters, including:

- Changes to the rights of shareholders.
- Issuance of new equity or debt.
- Material changes to the business strategy of the Group.
- Material acquisitions or disposals.

How the Board operates

The Board is led by the Chairman, Naguib Kheraj. Naguib was appointed to the Board on 1 October 2014 and became Chairman on 18 December 2017.

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

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

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

- Group strategy and business plans.
- Material new investments and new insurance trades.
- Acquisitions and disposals.
- The constitution of Board committees.
- Capital management policy including dividend policy.
- Other key Group policies.

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

How the Board spent its time in 2018

The Board met formally seven times during 2018 for scheduled meetings, in addition to meeting on at least six other occasions on an ad hoc basis to discuss, amongst other things, material transactions and the issuance of RT1 notes.

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

- An update from the CEO on business performance and outlook.
- Reports from sub-committee chairmen.
- An update on the Group's financial performance.
- Updates from the risk and compliance functions.
- Discussion on material new investments and liability transactions.
- Discussion of key initiatives such as development of the PIM and system development.
- Board legal and governance update.

The Board held a strategy off-site event during the year outside of the formal Board meeting schedule. This event focused on strategic growth opportunities for the Group over the next few years, particularly in the light of the Prudential transaction.

The Board spent time in formal meetings as well as separate sessions discussing the calibration and development of the Group's PIM and approved the model for submission.

The Board also oversaw the employee engagement survey and considered the results and management's proposed response.

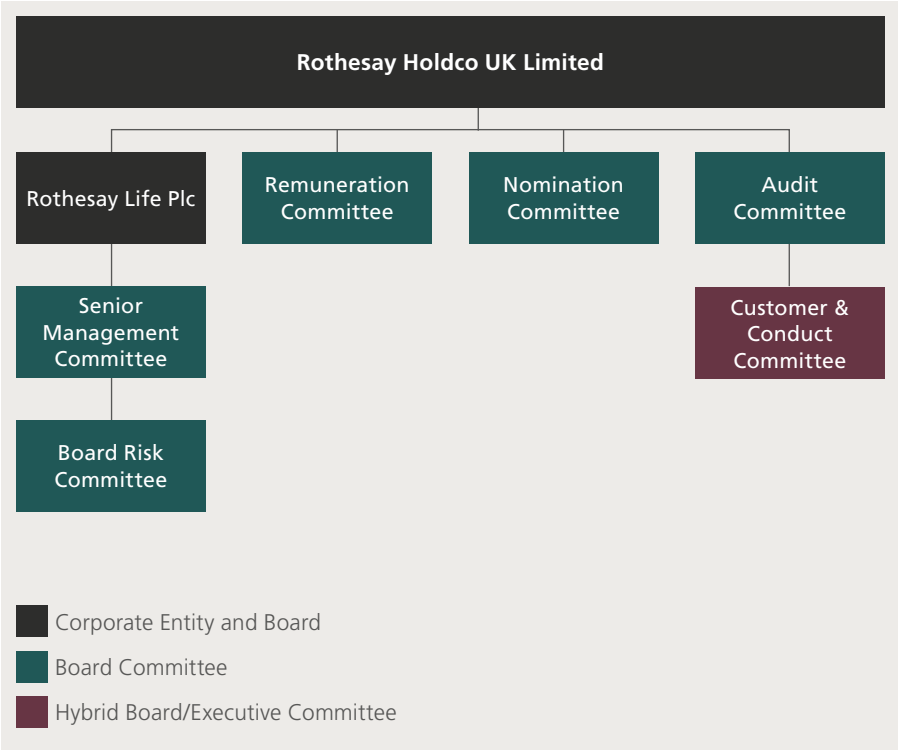
Members of the Board visited the Group's third party administrators to see at first hand the service that is being provided to our policyholders.

Board performance and effectiveness

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

- one-to-one briefing sessions for independent Non-Executive Directors on the report and accounts;
- training sessions on the Group's approach to managing cyber risk, Solvency II and an update on accounting and regulatory developments, including further training on IFRS 17; and
- additional internal model training sessions for individual Directors.

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal Board Effectiveness Review during 2018 but intends to do so in 2019.



Board of Directors

Naguib Kheraj

Independent Non-Executive Director and Chairman

Appointed October 2014

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

Antigone (Addy) Loudiadis

Chief Executive Officer

Appointed November 2013

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

Thomas (Tom) Pearce

Managing Director

Appointed August 2013

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

Andrew Stoker

Chief Financial Officer

Appointed December 2014

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

Constant (Stan) Beckers

Independent Non-Executive Director and Chairman of Board Risk Committee.

Appointed October 2017

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

Richard Berliand

Independent Non-Executive Director and Chairman of Customer & Conduct Committee

Appointed October 2014

Richard Berliand is a member of the Supervisory Board of Deutsche Börse AG, Senior Independent Director of Man Group plc and a Board member of Saranac Partners Limited. He was previously with J P Morgan for 23 years, most recently as global head of the Cash Equities and Prime Services businesses. Richard is also Chairman of the Customer & Conduct Committee. During the first quarter of 2019 Richard will join the Board of TP ICAP PLC as a Non-Executive Director and Chairman designate.

Raymond (Ray) King

Independent Non-Executive Director

Appointed April 2014

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

Therese (Terry) Miller

Independent Non-Executive Director

Appointed September 2017

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

Charles Pickup

Independent Non-Executive Director

Appointed November 2013

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

William (Bill) Robertson

Independent Non-Executive Director and Chairman of Audit Committee

Appointed January 2016

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

Qasim Abbas

Non-Executive Director

Appointed December 2013

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

Timothy (Tim) Corbett

Non-Executive Director

Appointed November 2013

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

Robin Jarratt

Non-Executive Director

Appointed December 2013

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

Audit Committee report

Bill Robertson
Chairman of the Audit Committee

Monitoring robustness

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

Committee members

Bill Robertson (Chairman)
Richard Berliand
Ray King
Terry Miller
Charles Pickup
Robin Jarratt

I am pleased to present the Audit Committee's report for the year ended 31 December 2018. I became Chairman of the Committee during 2016.

The Committee is responsible for assisting the Board in fulfilling its oversight responsibilities for the financial reporting process, the system of internal control, the internal and external audit processes and the Group's process for monitoring compliance with laws and regulations and the business principles. The Committee has unrestricted access to management and external advisors to help discharge its duties. It is satisfied that in 2018 it received adequate, reliable and timely information to perform its responsibilities effectively.

Committee membership and attendance

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

The Committee met on six occasions in 2018 at appropriate times in the financial and regulatory reporting audit cycle. The Chairman of the Board, CEO, Chief Financial Officer (CFO), CRO, Chief Actuary, Chief Auditor, Chief Compliance Officer and representatives of PwC regularly attended committee meetings. Other members of senior management were also invited to attend as appropriate to present reports. During the year the Committee held regular private sessions with, the Chief Auditor, the Chief Compliance Officer and PwC without management present.

A number of Committee members are also members of or regular attendees at the Board Risk Committee. This ensures effective co-ordination across the two committees.

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

Committee responsibilities

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

- Review the effectiveness of the Group's internal controls.
- Monitor and review the effectiveness of the Group's internal audit function in the context of the Group's overall risk management system.
- Review the effectiveness of the system for monitoring compliance with laws and regulations.
- Oversee the activities of the Customer & Conduct Committee, which focuses on regulatory conduct and the fair treatment of customers.
- Review the effectiveness of the system for risk governance and monitoring.
- Monitor the integrity of the financial statements of the Group.
- Monitor the integrity of the Group's Solvency II reporting, including quantitative reporting templates, the Solvency and Financial Condition Report (SFCR) and the Regulatory Supervisory Report (RSR).
- Consider and recommend the appointment, re-appointment and removal of external auditors of the Group.
- Review the Group's whistleblowing arrangements for its employees.
- Consider and recommend to the Board the assumptions underlying the financial statements.

Committee activities during 2018

The work of the Committee during 2018 fell under five main areas: financial statements and accounting policies, internal control, regulatory compliance, oversight of the internal audit function and oversight of the external audit.

Significant accounting issues considered by the Committee

Issue	Committee's response
Longevity and credit default assumptions used to determine the valuation of insurance liabilities The inherent uncertainty involved in setting the assumptions used to determine the insurance liabilities for the Group, particularly in relation to longevity and credit defaults, represent the most significant area of judgement due to the potential impact these assumptions have on the financial statements.	The Committee focused on assumptions made in relation to new assets and liabilities and on management's proposed changes to reserving assumptions, particularly in relation to longevity and credit default. Longevity assumptions: The Committee reviewed available data illustrating recent trends in longevity experience in the UK population, the longevity experience on different blocks of business, industry benchmarking data and reinsurer pricing. The Committee carefully considered the extent to which the recent slowdown in longevity improvements should be reflected in assumptions going forward. Credit default assumptions: The Committee reviewed the methodology used to determine credit default assumptions and considered the analysis produced as part of PIM development and available industry benchmarking data. The Committee recognises that the deduction for credit default risk on the assets held by the Group is generally lower than the corresponding credit default deduction on a typical unsecured credit portfolio but feels this is appropriate due to the low probability of default and/or the expectation of higher recover through collateralisation. The Committee concluded that the assumptions used are appropriate for the determination of the insurance liabilities. As 78% of the longevity risk is reinsured, the Group has visibility over pricing for the majority of its liabilities.
Valuation of investments classified as Level 3 under IFRS 13 The valuation of Level 3 assets is based on either inputs into a valuation model or observable prices for proxy positions. This is inherently complex and requires the use of significant management judgement. Furthermore, the balances are material to the financial statements.	The Committee has reviewed and approved the Group's valuation policy. The Committee also receives and reviews a report from the finance function setting out the way in which all Level 3 assets have been valued and the range of plausible valuations. The Committee has been particularly focused on the valuation of equity release mortgages, particularly in the light of the Group's acquisition of the portfolio of ERMs from UKAR and the PRA's 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'. The Committee concluded that there are appropriate controls surrounding the valuation of Level 3 assets and that they are valued appropriately for inclusion in the financial statements.

Audit Committee report continued

Financial statements and accounting policies

The Committee reviewed the Group's financial announcements, the annual report and accounts, the MCEV disclosures, the half-year results and the going concern assumptions in relation to the annual report and accounts.

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

The Committee also reviewed SFCR and the RSR. This included oversight of the Group's use of transitional solvency relief during the year, including re-calculation as a result of the Prudential transaction and adoption of the PIM for the calculation of the SCR.

The Committee reviewed the key assumptions used in calculating both the long-term insurance liabilities and the MCEV, particularly in relation to the annuities acquired from Prudential. Key assumptions included the annuity mortality assumptions, the credit default allowance on the investment portfolio, the valuation of illiquid assets and the prudence requirements around the IFRS assumptions. The table on the previous page provides more detail on significant accounting issues considered by the Committee. The Committee also considered refinements to the way in which policyholder options are modelled.

The Committee reviewed the Group's tax policy, tax strategy statement and reporting on payment practices and performance under regulations made under Section 3 of the Small Business, Enterprise and Employment Act 2015.

Internal control

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

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

Regulatory compliance

The Committee received regular compliance updates, including:

- Updates from the compliance function on the way in which Rothesay Life ensures compliance with relevant laws and regulations, including anti-money laundering and anti-bribery, and on the implications of changes.
- Updates on preparations for and subsequent compliance with the new European General Data Protection Regulation (GDPR).
- Updates on Solvency II compliance including the operation of the matching adjustment fund and calculation of transitional capital relief.
- Updates on contingency planning for Brexit, in particular in relation to the Group's Irish policyholders.
- Updates on preparations for meeting the new Senior Managers & Certification Regime (SMCR).
- Updates from the Group's Customer & Conduct Committee (see below).

The Customer & Conduct Committee

The Customer & Conduct Committee focuses on regulatory conduct and the fair treatment of customers and is chaired by an independent Non-Executive Director, Richard Berliand.

In addition to receiving compliance updates, the activity of the Customer & Conduct Committee during the year included:

- Reviewing the performance of the Group's third party administrators, including customer complaints.
- Approving the framework for the calculation of transfer values and other factors.
- Approving the initiative to offer annuitants with small annuities the option of exchanging their annuity for cash lump sums.
- Reviewing the Group's policies in relation to equity release mortgages.

Internal audit

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

After a thorough selection process, including interview by the Chairman of the Audit Committee, the Audit Committee approved the appointment of the new Chief Auditor who joined in May 2018. The Chief Auditor reports directly to the Chairman of the Committee and her remuneration is approved by the Remuneration Committee. On a day-to-day basis she also reports to the CFO and Managing Director. The Group operates a co-sourcing approach to internal audit using external advisors to supplement the in-house internal audit team. During 2016, the Group re-tendered these services with the result that EY was appointed.

The internal audit plan for 2018 was regularly reviewed and approved by the Committee with internal audits being planned and prioritised following a risk-based assessment of the business. The audits undertaken include, audits of:

- Cyber security arrangements.
- Operational processes in relation to equity release mortgages and commercial real estate loans.
- End-to-end reinsurance processes.
- Process and controls at Capita, one of the Group's third party administrators.
- Tax governance arrangements.
- GDPR readiness and embeddedness.
- The Group's policy framework.
- The Group's approach to financial crime prevention and oversight of personal account dealing.
- New business pricing.

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

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

In November, the Committee considered and approved the internal audit plan for 2019.

External audit

The Committee ran a competitive tender process during 2016 and reappointed PwC as its auditors from the 2017 year end. Under European law and subject to the outcome of the Competition and Markets Authority's review of the audit market, the external audit contract must be put out for tender again no later than for the 2027 year end at which time the Group will not be permitted to reappoint PwC.

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

During 2018 the Committee performed its annual review of the independence, effectiveness and objectivity of the auditor by evaluating the auditor against a range of criteria. The Committee concluded that PwC met the standards expected of it.

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

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

Other assurance services provided in 2018 include work in relation to the issuance of the RT1 notes and independent validation of the Group's PIM. A significant element of the assurance services in relation to the Group'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 Group considered that the external auditor was best placed to provide these services because of their understanding of the Group.

Committee performance and effectiveness

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal Board Effectiveness Review during 2018. However, the Audit Committee has reviewed its terms of reference and considered its effectiveness during the year. It also identified a number of other improvements which have been made during the year or will be made during 2019.

The fees paid to PwC for the year ended 31 December 2018 are summarised in the table below:

£'000's	**2018**	2017
Audit of the financial statements of the Group and its subsidiaries	**714**	534
Total audit	**714**	534
Audit related assurance services	**271**	369
Other assurance services	**196**	2,361
Total fees	**1,181**	3,264

Board Risk Committee report

Stan Beckers
Chairman of the Board Risk Committee

Managing risk

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

Committee members

Constant Beckers (Chairman)
Naguib Kheraj
Ray King
Charles Pickup
Bill Robertson
Qasim Abbas

I am pleased to present the Board Risk Committee's report for the year ended 31 December 2018. I took over chairing the Committee at the end of 2017.

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

Committee responsibilities

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

- Monitoring the Group's overall risk appetite and tolerance.
- Reviewing the Group's risk framework and risk policies, standards and limits within the overall risk appetite and tolerance and recommending such to the Board.
- Considering the Group's process for determining risk appetite and tolerance, monitoring compliance with approved risk tolerance levels and policies and the resultant action in respect of policy breaches.
- Monitoring and analysing the Group's material risk exposures, including insurance, market, credit, operational, liquidity, reputational, economic and regulatory capital risks in the context of the Group's risk methodologies.
- Commissioning management's actions to monitor and control risk exposures.
- Undertaking the Group's stress-testing and monitoring management's response to such results.
- Receiving notification of material breaches of risk limits and approving the proposed remedial action where such cases are escalated to the Board Risk Committee.
- Reviewing and approving any new material liability transactions to be executed by the Group which meets the criteria established by the Board and applicable policies.
- Reviewing and approving any new asset transactions that fall outside existing approval limits to be executed by the Group which meets the criteria established by the Board and applicable policies.

- Advising the Board on the risks inherent in strategic transactions and business plans and the impact on the Group's risk appetite and tolerance.
- Reviewing the Group's capability to identify and manage new types of risk.
- Considering the remit of the Group's risk function and ensuring it has adequate resources and appropriate access to information to enable it to perform its function effectively.
- Evaluating whether the Group's risk function has adequate independence.
- Reviewing the effectiveness of the risk function and its resourcing upon any significant one off increase in risk exposures or increase in assets under management by 20% or more.
- Providing oversight to the risk function and receiving reports from the risk function in relation to Solvency II requirements in respect of systems of governance and risk management.
- Monitoring and reviewing reports from the WLRC and CRO.
- Reviewing key assumptions underlying economic capital calculations, individual capital assessments and the risk and solvency assessments and reviewing any major regulatory submissions involving capital.

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

Committee membership and attendance

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

The Committee met for six scheduled meetings during 2018 in addition to meeting on several other occasions on an ad hoc basis to discuss material transactions.

The Chairman, CEO, Managing Director, CRO, CFO, General Counsel, Chief Auditor and other Non-Executive Directors regularly attended Committee meetings. Other members of senior management were also invited to attend as appropriate to present reports. During the year the Committee held regular private sessions with the Chief Auditor and the Chief Risk Officer without management present.

Committee activities during 2018

Risk appetite monitoring

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

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

Risk management and governance

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

- Compliance with risk limits, including in relation to liquidity.
- Stress testing and potential impact of emerging risks.
- Market risk exposures.
- Operational risk events.
- Assessment and monitoring of cyber risk.
- Economic capital coverage.
- The results of the regular risk and control self-assessment.

During 2018, the Committee reviewed the Group's risk appetite statement, a number of risk-related policies, the Group's RMF and the Group's ORSA. The Committee also reviewed and approved the Group's longevity reinsurance strategy and the Group's recovery and resolution plans.

The Committee monitored the potential impact of the UK leaving the EU and associated contingency planning. It also considered the potential impact of the planned reform of leasehold on the Group's loans secured on ground rents.

The Committee reviewed the Group's preparations for mandatory clearing of derivatives and in response to Interbank Offered Rates (IBOR) reform.

New transactions

The Committee reviewed the Group's asset deployment approach and associated limits, including the increase in the risk limit in relation to equity release mortgages.

The Committee considered the implications of the Prudential transaction and the acquisition of the equity release mortgage portfolio from UKAR. The Committee also considered the implications of the issuance of RT1 notes by RLP.

Partial internal model

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

Committee performance and effectiveness

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal Board Effectiveness Review during 2018.

Setting remuneration policy

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

I am pleased to present the Remuneration Committee's report for the year ended 31 December 2018. I became Chairman of the Committee at the end of 2017.

Committee membership and attendance

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

The Committee met on four occasions in 2018. The CEO, Managing Director and the CFO also regularly attended part of Committee meetings as appropriate and relevant.

Committee members

Naguib Kheraj (Chairman)
Constant Beckers
Terry Miller
Qasim Abbas
Tim Corbett
Robin Jarratt

Committee responsibilities

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

The Group's remuneration policy is intended to:

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

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

Senior management also benefit from their holdings of restricted H shares. These shares are entitled to a proportion of shareholder returns in excess of agreed hurdles in the event of a material change of control.

Committee activities during 2018

The Committee oversaw the design of the employee engagement survey and considered ways in which the Group's performance management approach could be improved. The Committee also oversaw the selection of a new independent remuneration advisor.

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

The Committee reviewed the composition of the material risk taker population four times this year and their individual performance was discussed at the year end.

In order to ensure that the Employee Benefit Trust (EBT) holds sufficient shares to meet future vesting of equity awards, the Committee has approved the terms of an offer by the EBT to acquire a proportion of the shares held by management. This will be implemented in early 2019.

Committee performance and effectiveness

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal Board Effectiveness Review during 2018.

Naguib Kheraj
Chairman of the Remuneration Committee

Appointing new talent

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

I am pleased to present the Nomination Committee's report for the year ended 31 December 2018. I became Chairman of the Committee at the end of 2017.

Committee membership and attendance

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

The Committee met twice in 2018, with further approvals being made via email communication. The CEO, Managing Director and General Counsel also regularly attended Committee meetings.

Committee members

- Naguib Kheraj (Chairman)
- Richard Berliand
- Ray King
- Charles Pickup
- Qasim Abbas
- Tim Corbett
- Robin Jarratt

Committee responsibilities

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

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

Committee activities during 2018

The Committee approved plans to facilitate the continuous development of Directors.

The Committee also reviewed the composition of the various Board committees.

Committee performance and effectiveness

Given the changes to the composition of the Board at the end of 2017, the Group did not undertake a formal Board Effectiveness Review during 2018.

Naguib Kheraj
Chairman of the Nomination Committee

The financial statements set out the consolidated results for Rothesay Holdco UK Limited (RHUK) and its subsidiaries for the year ended 31 December 2018.

Financial statements

Report of the Directors

The Directors present their Annual Report and the audited consolidated financial statements for Rothesay Holdco UK Limited, registered number 08668809, (the Company or RHUK) for the year ended 31 December 2018. Comparative information has been presented for the year ended 31 December 2017.

1. Results

The consolidated results for RHUK and its subsidiaries (the Group) for the year are set out in the consolidated statement of comprehensive income on page 58.

2. Dividends

The Directors have recommended no payment of interim dividends during the year ended 31 December 2018 (2017: £nil). The Directors have recommended no final ordinary dividend in respect of the year ended 31 December 2018 (2017: £nil).

3. Registered office

The financial statements include the financial statements of RHUK and its subsidiaries: Rothesay Pensions Management Limited, Rothesay Life Plc, Rothesay Assurance Limited, LT Mortgage Financing Limited, Rothesay Asset Management UK Limited, Rothesay MA No.1 Limited and Rothesay Asset Management US LLC.

The Company and all subsidiary undertakings, with the exception of Rothesay Asset Management US LLC, are registered in the United Kingdom. The registered office and principal place of business for RHUK and its UK subsidiary undertakings is Level 25, The Leadenhall Building, 122 Leadenhall Street, London EC3V 4AB. The registered office for Rothesay Asset Management US LLC is Corporate Trust Center, 1209 Orange Street, Wilmington, Delaware 19801, New Castle County.

4. 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 Group Directors and senior management against personal financial exposure that they may have incurred in their capacity as such. These include qualifying third party indemnity provisions (as defined under Section 234 of the Companies Act 2006) in force for the benefit of the Directors of the Group during the year 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 is aware, there is no information relevant to the audit of which the Company's auditors are unaware; and
- each of the Directors has taken all the steps that he/she ought to have taken as a Director to make himself/herself aware of any information relevant to the audit and to establish that the Company's auditors are aware of that information.

7. Independent auditors

PricewaterhouseCoopers LLP will continue in office as auditors of the Company pursuant to Section 487(2) of the Companies Act. Resolutions to reappoint PricewaterhouseCoopers LLP as auditor to the Group and to authorise the Directors to determine their remuneration are proposed.

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 it is inappropriate to presume that the Company will continue in business.

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

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

9. Internal control and risk management systems

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

- 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 consolidated financial statements. The Audit Committee is kept appraised of such developments;
- the Group's results are subject to various levels of review by management; and
- the Audit Committee and the Board review the draft consolidated financial statements, strategic report and report of the Directors. The Audit Committee receives reports from management and the external auditors on significant judgements, changes in accounting policies, changes in accounting estimates and other pertinent matters relating to the consolidated financial statements.

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. Loudiadis
Chief Executive Officer

13 February 2019

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

Report on the audit of the financial statements

Opinion

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

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

We have audited the financial statements, included within the Annual Report and Accounts 2018 (the "Annual Report"), which comprise: the Consolidated and Company statements of financial position as at 31 December 2018; the Consolidated statement of comprehensive income, the Consolidated and Company cash flow statement and the Consolidated and Company statements 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 Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

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

Other than those disclosed in note 8 to the financial statements, we have provided no non-audit services to the Group or the Company in the period from 1 January 2018 to 31 December 2018.

Our audit approach

Overview

Overall Group materiality: £40million (2017: £30million), equates to 1.56% of total equity as shown in the Consolidated statement of financial position.

Overall Company materiality: £18.2million (2017: £9.5million), equates to 1% of total assets as shown in the Company statement of financial position.

The Group consists of 8 legal entities. We performed a full scope audit of the Group's financial statements in accordance with our materiality and risk assessment.

This assessment identified two full scope components; Rothesay Life Plc and Rothesay Pensions Management Limited.

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

Valuation of insurance contract liabilities, specifically:
- longevity assumptions; and
- credit default risk assumptions.

Valuation of investments classified as Level 3 under IFRS 13.

Report on the audit of the financial statements continued

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 Group and 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 28 of the Annual Report), and we considered the extent to which non-compliance might have a material effect on the financial statements of the Group and Company. We also considered those laws and regulations that have a direct impact on the financial statements of the Group and Company such as the Companies Act 2006, the Prudential Regulation Authority's regulations, the Pensions Regulator legislation, the UK tax legislation

We also evaluated management's incentive 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 capital position of the Group and Company, management bias in accounting estimates and judgmental areas of the financial statements such as the valuation of life insurance contact 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 Group's and 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 Group's and 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 Group's and 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.

Report on the audit of the financial statements continued

Key audit matter	How our audit addressed the key audit matter
Valuation of insurance contract liabilities *Refer to note 1(d) Critical accounting policies and the use of estimates and note 23 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 focused 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 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 Group's industry peers; and • Assessed the disclosures in the financial statements. Further testing was also conducted on the longevity and credit default assumptions as set out below. **From the evidence obtained, we consider the valuation of insurance contract liabilities to be reasonable.**
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 utilises the Group'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 Group 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 Group'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 Group 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 and methodology to be appropriate.**

Report on the audit of the financial statements continued

Key audit matter	How our audit addressed the key audit matter
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 Group's view of the security held against the asset class which in itself is an area of judgement.	In addition to the procedures above, in respect of the credit default assumptions: • 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 Group'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); • Tested the analysis of the movement in credit default risk assumption prepared by management for each asset class based on current market data and developments in the asset portfolio; 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 and methodology to be appropriate.**
Valuation of investments classified as Level 3 under IFRS 13 *Refer to note 1(d) Critical accounting policies and the use of estimates and note 12 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 valuation 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 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 assumptions and methodology used to be appropriate.**

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

How we tailored the audit scope

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

The Rothesay Group consists of seven subsidiary companies and the parent Company; Rothesay Holdco UK Limited. Of the seven subsidiary companies in the Group, the most significant component is Rothesay Life Plc, which conducts all insurance business on behalf of the Group. Rothesay Pensions Management Limited is responsible for administrative activities of the Group which primarily consists of processing wages and salaries for the Group. We determined the remaining entities to be immaterial to the Rothesay Group financial statements.

For the audit of the Group, Rothesay Life Plc and Rothesay Pensions Management Limited are considered full scope components and results in 96% coverage of total assets and 99% of consolidated profit before tax.

Report on the audit of the financial statements continued

Materiality

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

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

	Group financial statements	Company financial statements
Overall materiality	£40 million (2017: £30million).	£18.2 million (2017: £9.5 million).
How we determined it	1.56% of total equity.	1% of total assets.
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 consider that total assets is the primary measure used by the shareholders in assessing the performance of the entity and is a generally accepted auditing benchmark for the purpose of the Company financial statements.

For each component in the scope of our Group audit, we allocated a materiality that is less than our overall Group materiality. The range of materiality allocated to the two components was £35 million to Rothesay Life Plc and £1.4 million to Rothesay Pensions Management Limited. Certain components were audited to a local statutory audit materiality that was also less than our overall Group materiality.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £2 million (Group audit) (2017: £1.5 million) and £0.9 million (Company audit) (2017: £0.5 million) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern

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

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

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

Reporting on other information

The other information comprises all of the information in the Annual Report 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.

Report on the audit of the financial statements continued

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

Responsibilities for the financial statements and the audit

Responsibilities of the Directors for the financial statements

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

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

Auditors' responsibilities for the audit of the financial statements

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

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

Use of this report

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

Other required reporting

Companies Act 2006 exception reporting

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

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

Financial statements

Consolidated statement of comprehensive income

For the year ended 31 December 2018

	Note	2018 £m	2017 £m
Income			
Gross premiums written	3	**13,424**	1,447
Less: premiums ceded to reinsurers		**(1,369)**	(781)
Net premiums written		**12,055**	666
Investment return	4	**141**	769
Total revenue		**12,196**	1,435
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	5	**(161)**	(154)
Finance costs	6	**(71)**	(56)
Total expenses		**(12,094)**	(1,123)
Profit before tax		**102**	312
Income tax expense	9	**(17)**	(51)
Profit for the year		**85**	261

All income and expenses are related to continuing operations.

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

Notes 1–33 form an integral part of these financial statements.

Consolidated statement of financial position

As at 31 December 2018

	Note	2018 £m	2017 £m
Assets			
Property, plant and equipment		**2**	3
Financial investments	12	**49,174**	37,312
Deferred tax asset	26	**1**	1
Reinsurance assets	19	**43**	168
Accrued interest and prepayments	20	**497**	302
Receivables	21	**353**	337
Cash and cash equivalents	22	**163**	251
Total assets		**50,233**	38,374
Equity and liabilities			
Share capital	27	**3**	2
Tier 1 notes	28	**347**	–
Employee benefit trust	27	**(19)**	(20)
Share premium	29	**845**	466
Capital contribution reserve	29	**10**	5
Other reserves	29	**1,385**	1,300
Total equity		**2,571**	1,753
Liabilities			
Reinsurance liabilities	19	**673**	231
Insurance contract liabilities	23	**32,435**	21,741
Payables and financial liabilities	24	**13,849**	13,965
Borrowings	25	**647**	647
Accruals and deferred income		**58**	37
Total liabilities		**47,662**	36,621
Total equity and liabilities		**50,233**	38,374

Notes 1–33 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. Loudiadis
Chief Executive Officer

13 February 2019
Company number 08668809

Consolidated statement of changes in equity

For the year ended 31 December 2018

	Share capital £m	Share premium £m	Tier 1 notes £m	Capital contribution reserve £m	Profit and loss reserve £m	Reorganisation reserve £m	Employee scheme treasury shares £m	Total equity £m
As at 1 January 2018	**2**	**466**	**–**	**5**	**1,168**	**132**	**(20)**	**1,753**
Profit for the financial year	**–**	**–**	**–**	**–**	**85**	**–**	**–**	**85**
Share issuance	**1**	**379**	**–**	**–**	**–**	**–**	**–**	**380**
Vesting of stock appreciation plan	**–**	**–**	**–**	**(2)**	**–**	**–**	**–**	**(2)**
Tier 1 note issuance	**–**	**–**	**347**	**–**	**–**	**–**	**–**	**347**
Employee benefit trust	**–**	**–**	**–**	**–**	**–**	**–**	**1**	**1**
Capital contribution	**–**	**–**	**–**	**7**	**–**	**–**	**–**	**7**
As at 31 December 2018	**3**	**845**	**347**	**10**	**1,253**	**132**	**(19)**	**2,571**

For the year ended 31 December 2017

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

Consolidated 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		**85**	261
Adjustments for non-cash movements in net profit for the year			
Depreciation		**1**	1
Amortisation of debt costs		**3**	–
Share based payments	10	**8**	5
Interest income	4	**(956)**	(645)
Interest expense	6	**71**	56
Income tax expense	9	**17**	54
Deferred tax credit	9	**–**	(3)
Net (increase)/decrease in operational assets			
Financial investments[1]		**(11,861)**	1,033
Reinsurance asset		**124**	269
Receivables		**(16)**	155
Prepayments		**(83)**	5
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		**(95)**	(172)
Accruals and deferred income		**20**	6
Net cash flows used in operating activities		**(1,546)**	(460)
Interest paid		**(73)**	(58)
Interest received[1]		**844**	619
Tax paid		**(38)**	(62)
Cash flows (used)/from operating activities		**(813)**	39
Cash inflows from financing activities			
Repayment of borrowings	25	**(500)**	(240)
Proceeds from issuance of debt	25	**–**	300
Proceeds from borrowings	25	**498**	–
Proceeds from issuance of Tier 1 notes (net of issuance costs)	28	**347**	–
Proceeds from issuance of ordinary share capital (including share premium)	27	**380**	1
Net cash inflows from financing activities		**725**	61
Cash outflows from investing activities			
Acquisition of property, plant and equipment		**–**	(1)
Net cash outflows from investing activities		**–**	(1)
Net (decrease)/increase in cash and cash equivalents		**(88)**	99
Cash and cash equivalent at 1 January		**251**	152
Cash and cash equivalents at 31 December	22	**163**	251

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 Group believes that this is a more appropriate representation.

Financial statements

Company statement of financial position

As at 31 December 2018

	Note	2018 £m	2017 £m
Assets			
Investment in subsidiaries	32	**1,780**	819
Financial investments		**11**	–
Receivables		**30**	29
Cash and cash equivalents		**–**	100
Total assets		**1,821**	948
Equity			
Share capital	27	**3**	2
Share premium	29	**845**	466
Capital contribution reserve		**11**	5
Retained earnings		**948**	461
Total equity		**1,807**	934
Liabilities			
Other payables		**14**	10
Accruals and deferred income		**–**	4
Total liabilities		**14**	14
Total equity and liabilities		**1,821**	948

Notes 1–33 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. Loudiadis
Chief Executive Officer

13 February 2019
Company number 08668809

Company statement of changes in equity

For the year ended 31 December 2018

	Share capital £m	Share premium £m	Capital contribution reserve £m	Profit and loss reserve £m	Total equity £m
As at 1 January 2018	**2**	**466**	**5**	**461**	**934**
Loss for the financial year	**–**	**–**	**–**	**(13)**	**(13)**
Dividends	**–**	**–**	**–**	**500**	**500**
Capital contribution	**–**	**–**	**8**	**–**	**8**
Vesting of stock appreciation plan	**–**	**–**	**(2)**	**–**	**(2)**
Share issuance	**1**	**379**	**–**	**–**	**380**
As at 31 December 2018	**3**	**845**	**11**	**948**	**1,807**

For the year ended 31 December 2017

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

Financial statements

Company cash flow statement

For the year ended 31 December 2018

	Note	2018 £m	2017 £m
Cash flows from operating activities			
Loss for the financial year	2	**(13)**	(16)
Adjustments for non-cash movements in net profit for the year			
Amortisation of debt costs		**2**	–
Interest expense		**10**	10
Net (increase)/decrease in operational assets			
Financial investments		**(11)**	–
Receivables		**–**	(6)
Accrued interest and prepayments		**–**	5
Net (decrease)/increase in operational liabilities			
Other payables		**4**	(21)
Accruals and deferred income		**(5)**	4
Net cash flows used in operating activities		**(13)**	(24)
Interest paid		**(10)**	(10)
Cash flows used in operating activities		**(23)**	(34)
Cash flows used in financing activities			
Repayment of borrowings	25	**(500)**	(240)
Dividends received		**500**	370
Investment in subsidiaries	32	**(955)**	–
Proceeds from borrowings	25	**498**	–
Proceeds from issuance of ordinary share capital	27	**380**	–
Net cash flows from financing activities		**(77)**	130
Net (decrease)/increase in cash and cash equivalents		**(100)**	96
Cash and cash equivalent at 1 January		**100**	4
Cash and cash equivalents at 31 December		**–**	100

Note 1 – General information and basis of preparation

(a) General information

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

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

(b) Basis of preparation

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

The consolidated and separate financial statements of the Company are presented in sterling (£) rounded to the nearest million (£m) except where otherwise stated. The separate Company statement of financial position is presented on page 62.

The Group 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) Basis of consolidation

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

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

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

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

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

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

(d) Critical accounting policies and the use of estimates

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

Judgements are decisions which management has made in the process of applying the Group's accounting policies. Matters of significant judgement are considered to be:

- The assessment of whether the Group controls underlying entities and investments (see note 14).
- Assessment of the significance of insurance risk transferred to the Group in determining whether a contract should be accounted for as an insurance or investment contract (see note 1(e)).

Note 1 – General information and basis of preparation continued

(d) Critical accounting policies and the use of estimates continued

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 23).

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

- the assumptions made and the uncertainties around these;
- how sensitive the assets and liabilities are to these assumptions;
- expected resolution of the uncertainty and the range of possible outcomes for the financial year ending 31 December 2019; and
- explanation of any changes made to past assumptions if the uncertainty is unresolved.

(e) Contract classification

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

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

(f) Foreign currencies

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

Note 2 – Company loss

The loss for the financial year of the Company was £13m (2017: loss of £16m). As permitted by Section 408 of the Companies Act 2006, the Company's statement of comprehensive income has not been included in these financial statements.

Note 3 – Segmental analysis

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

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

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

	Regular premiums		Single premiums	
	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 premium adjustments.

The Group conducts a relatively small number of individual transactions each year. These transactions are one-off in nature and the Group'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 4 – Investment return

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

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

Realised gains and losses on investments carried at fair value are calculated as the difference between net sales proceeds and purchase price. Movements in unrealised gains and losses on investments represent the difference between the fair value 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**	645
Unrealised (losses)/gains on financial investments	**(686)**	14
Realised (losses)/gains on financial investments	**(93)**	131
Investment management expenses	**(36)**	(21)
Total investment return	**141**	769

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

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

Note 5 – 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 section of the consolidated statement of comprehensive income which have been included in arriving at the profit before tax:

	2018 £m	2017 £m
Acquisition costs	**105**	85
Administration expenses – recurring	**36**	21
Administration expenses – projects and other one-off expenses	**20**	48
Total operating expenses	**161**	154

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 Company	**–**	8
Other	**11**	9
	20	48

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 6 – 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 borrowings from participating interests	**25**	10
Interest payable on third party borrowings	**30**	26
Total borrowing costs	**55**	36
Net finance costs	**71**	56

Note that for the purposes of IFRS, the RT1 notes are treated as equity rather than debt (see note 28).

Note 7 – Employee information

	2018 No.	2017 No.
Average number of staff employed during the year	**195**	159
Employees by department at year end		
Management	**10**	9
Business development and pricing	**18**	20
Investment	**51**	40
Operations (including HR)	**58**	50
Technology	**8**	5
Finance, legal and internal audit	**38**	34
Risk and compliance	**27**	21
	210	179

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

	2018 £m	2017 £m
Wages and salaries	**58**	43
Social security costs	**8**	12
Other pension costs	**2**	1
Total employee benefits expense	**68**	56

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

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

	2018 £000s	2017 £000s
Directors' remuneration		
Aggregate emoluments	**8,662**	5,405
Company pension contributions to money purchase schemes	**56**	55
Total Directors' remuneration	**8,718**	5,460
Highest paid Director		
Total amount of emoluments	**3,833**	2,261
Company pension contributions to money purchase schemes	**13**	13
Total highest paid Director	**3,846**	2,274

Note 7 – Employee information continued

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 8 – Auditors' remuneration

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

	2018 £000s	2017 £000s
Remuneration receivable by the Company's auditors for the audit of the consolidated and Company financial statements	**28**	27
Remuneration receivable by the Company's auditors for the audit of the financial statements of the Company's subsidiaries	**686**	507
Total audit	**714**	534
Audit-related assurance services	**271**	369
Other assurance services	**196**	2,361
Total fees	**1,181**	3,264

Other assurance services provided in 2018 include work in relation to the issuance of the RT1 notes and independent validation of the Group's PIM. A significant element of the assurance services in relation to the Group'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 Group considered that the external auditor was best placed to provide these services because of their understanding of the Group.

Note 9 – Income tax expense

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

The major components of income tax expense for the years ended 31 December 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	**–**	(3)
Total deferred tax	**–**	(3)
Total tax expense in the consolidated statement of comprehensive income	**17**	51

(b) Reconciliation of the total tax charge

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

	2018 £m	2017 £m
Profit on ordinary activities before taxation	**102**	312
Tax calculated at UK standard rate of corporation tax of 19% (2017: 19.25%)	**20**	60
Disallowed expenditure	**(1)**	–
Adjustment in respect of prior period	**(2)**	–
Permanent differences	**–**	1
Temporary differences	**–**	(10)
Total tax expense reported in the consolidated statement of comprehensive income	**17**	51

Note 10 – Share based payments

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

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

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

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

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

The activity related to these SARs is set out below:

	2018 No. of SARs	2017 No. of SARs
	Future service requirement	Future service requirement
Outstanding at the beginning of the year	**–**	35,162
Vested during the year	**–**	(35,162)
Outstanding at the end of the year	**–**	–

Expenses of £nil (2017: £1.2m) have been charged to the profit and loss account of the Group during the year in relation to the RLSIP.

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

The Group issued RSUs to the employees under the RHUK SIP, primarily in connection with year-end compensation. These RSUs vest and deliver as outlined in the applicable RSU agreements. Vesting is subject to the recipient not having left employment or having left employment as a result of death, permanent illness or redundancy. During 2017 the vesting of some RSUs was accelerated as part of the recapitalisation. Delivery of the RSUs is in the form of shares or an equivalent amount of cash (determined at the absolute discretion of the Remuneration Committee). All RSUs have a future service requirement. The activity related to these RSUs is set out below:

	2018 No. of RSUs	2017 No. of RSUs
Outstanding at the beginning of the year	**12,468,328**	7,724,559
Forfeited during the year	**(156,417)**	(26,248)
Vested during the year	**(2,062,675)**	(2,013,763)
Granted during the year	**5,202,847**	6,783,780
Outstanding at the end of the year	**15,452,083**	12,468,328

The fair value of the RSUs is determined by taking 100% of the Group MCEV and dividing by the number of ordinary shares. The weighted average fair value of the RSUs at 31 December 2018 was £2.83 (31 December 2017: £2.23). Expenses of £7.7m (2017: £3.8m) have been charged to profit and loss of the Group during the year in relation to the RHUK SIP.

Note 11 – Pension contributions

The Group operates a defined contribution pension scheme, sponsored by Rothesay Pensions Management Limited and contributions to the scheme are charged to the statement of comprehensive income as they accrue.

The amount charged for the financial year was £1.9m (2017: £1.4m). The outstanding contributions as at 31 December 2018 were £nil (2017: £nil).

Note 12 – 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 consolidated statement of financial position at fair value with net changes in fair value presented in investment income. Transaction costs, which are incremental costs that are directly attributable to the acquisition of a financial asset, are expensed. Financial investments include collective investment schemes, government, sub sovereign and agency obligations, derivative assets, corporate bonds and other corporate debt, certificates of 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.

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

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

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

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

Note 12 – Financial investments continued

Derecognition

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

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

Collateralised agreements and financing

Collateralised agreements (securities purchased under agreements to re-sell and deposits placed as collateral for stock borrowed) and collateralised financing (securities sold under agreements to repurchase and deposits received as collateral for stock loans) are treated as collateralised financing transactions and are carried at fair value through profit and loss under the fair value option, 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 Group in the form of securities is not derecognised from the consolidated statement of financial position, whilst collateral received in the form of securities is not recognised on the consolidated statement of financial position. If collateral received is subsequently sold, the obligation to return the collateral and the cash received are recognised in the consolidated statement of financial position.

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

	2018 £m	2017 £m
Financial investments carried at fair value through profit and loss, designated at initial recognition	**49,174**	37,312

Determination of fair value and fair value hierarchy

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

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

The fair value of certain debt securities classified as Level 3 instruments is determined using inputs that are not based on observable market data. One of the most significant inputs is liquidity premiums. The valuation model discounts future cash flows using interest rate swap curves in addition to a spread to reflect the associated credit risk and liquidity premiums. 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 24 for financial liabilities):

31 December 2018

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Collective investment schemes	**1,390**	**–**	**–**	**1,390**
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 13)	**–**	**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	**6,084**	**36,361**	**6,729**	**49,174**

Note 12 – Financial investments continued

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 13)	–	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 we believe 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.

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 12):

	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 disclosures have been restated to remove equity release mortgages as these have been disclosed elsewhere in note 12. Please see note 24 for details of Level 3 derivative liabilities.

The Group's policy is to determine the relevant categorisation of financial assets and liabilities at least annually and, where availability of inputs has changed, transfer 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.

Note 12 – Financial investments continued

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 Group which allow the equity release mortgage holders to extinguish their loan by selling their property back to the Group 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 below 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 our 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.

	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 Group's obligations to repurchase the transferred assets at a future date is recognised in other liabilities. The Group remains exposed to interest rate risk and credit risk on these pledged instruments. The counterparties recourse is not limited to the transferred assets.

The net 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 Group.

Note 12 – Financial investments continued

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

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

			2018		
Impact on financial assets and PBT	**Main assumptions**	**Sensitivity**	**Current FV £m**	**(Decrease)/ Increase in FV £m**	**(Decrease)/ Increase in PBT £m**
Financial assets					
Corporate bonds and other corporate debt	Discount rate	+50bps 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**	**–**	**–**

			2017 (Restated)[2]		
Impact on financial assets and PBT	Main assumptions	Sensitivity	Current FV £m	(Decrease)/ Increase in FV £m	(Decrease)/ Increase in PBT £m
Financial assets					
Corporate bonds and other corporate debt	Discount rate	+50bps 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 13 – Derivatives

The Group 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 15). The total net fair value of the Group's derivative asset and liabilities as at 31 December 2018 is a liability of £339m (2017: a liability of £430m).

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

Note 13 – Derivatives continued

	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

Derivatives are used solely for efficient portfolio management and risk management purposes, allowing market risks to be hedged in line with our risk appetite. The notional amount shown reflects the gross notional of derivative contracts. Under IFRS certain restrictions apply in relation to the offset of assets and liabilities. The Group does not consider that it meets these restrictions and therefore presentation is gross. Hence multiple derivative contracts which generate offsetting risk positions inflate the size of the notional amount reported, but do not increase our risk exposure. As such, the notional amount should not be considered as an indicator of the market risk exposure generated by the derivative portfolio. 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 Group's exposure under derivative contracts is closely monitored as part of the overall management of the Group's market risk (see also note 15).

Note 14 – Investment in unconsolidated structured entities

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

The Group 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 our total interest in such entities, reflected on the Group'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 Group'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 Group'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 15 – Market risk

The Group 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 Group. Please see pages 28 to 33 of the strategic review for further detail on risk management arrangements and the governance framework within the Group.

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

The Group manages market risk by diversifying exposures, controlling position sizes through limits and regular stress and scenario testing and establishing economic hedges in related securities, derivatives and insurance liabilities. The 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 16 – Credit risk

The Group 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 we hold. Credit risk also arises from cash placed with banks or money market funds, collateralised financing transactions, (i.e. resale and repurchase agreements) and receivables from 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 28 of the strategic review for further detail on risk management arrangements and the governance framework within the Group.

Risk mitigants

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

To mitigate the credit exposures on derivatives and collateralised agreement transactions, the Group obtains collateral from counterparties on an upfront or contingent basis. The Group 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 Group does not have sufficient visibility into a counterparty's financial strength, or when it believes a counterparty requires support from its parent company, the Group may obtain third party guarantees of the counterparty's obligations. The Group also mitigates its investment and counterparty credit risk using credit derivatives.

Credit exposures

The Group's credit exposures are described further below.

Cash and cash equivalents. Cash and cash equivalents include both interest bearing and non-interest bearing deposits and investment in money market funds. To mitigate the risk of credit loss, the Group diversifies its exposure and places its deposits with multiple banks, typically with minimum ratings in the 'A' rating category. The Group only invests in 'AAA' rated money market funds.

Derivatives. Derivatives are reported at fair value on a gross basis by counterparty in the Group's financial statements unless the Group has current legal rights of set-off and also intends to settle on a net basis. 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 Group bears credit risk related to sale and repurchase agreements and securities borrowing only to the extent that cash advanced to the counterparty exceeds the value of the collateral received or charges over assets. Therefore, the Group's credit exposure on the transactions is significantly lower than the amounts recorded on the balance sheet. The Group also has credit exposure on repurchase agreements and securities loaned, which are liabilities on its consolidated statement of financial position, to the extent that the collateral pledged for these transactions exceeds the amount of cash received.

Other credit exposures. The Group is exposed to credit risk from its receivables from 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 Group invests in assets that are typically highly rated, or assets where there is underlying structural security in the event of a default. These assets include supranationals, sovereign bonds, sub sovereign bonds, covered bonds, higher education bonds, infrastructure assets, unsecured corporate bonds and secured residential lending.

Reinsurance. Long-term business is ceded to reinsurers under collateralised contracts to transfer part of the insurance risk associated with the underlying insurance contracts. The amounts that will be recoverable from reinsurers 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.

Note 16 – 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
Property, plant and equipment	2	–	–	–	2
Collective investment schemes	1,390	–	–	–	1,390
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
Deferred tax assets	1	–	–	–	1
Accrued income and prepayments	497	–	–	–	497
Receivables	353	–	–	–	353
Cash and cash equivalents	163	–	–	–	163
Total	**50,233**	**(8,149)**	**(580)**	**(10,019)**	**31,485**
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
Deferred tax assets	1	–	–	–	1
Accrued income and prepayments[1]	302	–	–	–	302
Receivables	337	–	–	–	337
Cash and cash equivalents	251	–	–	–	251
Total	38,374	(7,727)	(704)	(8,649)	21,294
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)

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 16 – Credit risk continued

Within the table on the previous page, derivative liabilities are only included to the extent they net against derivative assets. Therefore, the amount of derivative assets shown after offsetting netting arrangements does not represent our overall derivative exposure. Our overall exposure can be seen in note 13.

Right of offset

The Group 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 Group has a right to set off in the event of default. Cash and security collateral have been offset to the extent there are credit exposures on the balance sheet.

The Group has received total security collateral and charges of £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 Group 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 Group from the default of some of its counterparties. The table on the previous page does not reflect the protection provided. The Group calls margins, receivable in cash and gilt instruments, against this exposure and other derivative positions.

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

The table below shows the Group'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 Group's approach under Solvency II.

Net credit exposure is primarily in 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	7,444	–	–	–	7,444
AA	13,579	(891)	–	–	12,688
A	16,146	(6,319)	(402)	(2,015)	7,410
BBB	6,726	(939)	(178)	(2,654)	2,955
BB	61	–	–	–	61
B	37	–	–	–	37
Unrated	6,240	–	–	(5,350)	890
Total	50,233	(8,149)	(580)	(10,019)	31,485

Note 16 – 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	12,520	(6,478)	(525)	(2,003)	3,514
BBB	4,987	(907)	(179)	(2,698)	1,203
BB	81	–	–	–	81
B	44	–	–	–	44
Unrated	4,737	–	–	(3,948)	789
Total	38,374	(7,727)	(704)	(8,649)	21,294

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 £6,240m (2017: £4,737m) reflect investments in issuers and issues that are not externally rated. During the year, the Group invested in unrated financial assets which are highly secured and subject to very low credit risk. For the purpose of Solvency II, unrated assets are internally rated by the Group's independent credit risk function under a framework which has been externally validated. Under this framework 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 17 – Liquidity risk

The Group 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 Group. Please see page 28 of the strategic review for further detail on risk management arrangements and the governance framework within the Group.

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

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

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

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

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 Group 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 17 – Liquidity risk continued

The following table details the Group's financial liabilities and assets by contractual maturity including interest that was accrued where the Group is entitled to repay the liability before its maturity. Financial assets and liabilities are presented at their fair value (with the exception of receivables, cash, accrued interest and borrowings) as this is consistent with the values used in the liquidity risk management of these instruments. The table excludes insurance liability and reinsurance cash flows which are included in note 23. The table also excludes equity release mortgages which are included in note 12.

	2018			
	Less than 1 year £m	1 to 5 years £m	Over 5 years £m	Total £m
Financial assets				
Financial investments	**3,525**	**5,174**	**38,578**	**47,277**
Accrued income and prepayments	**497**	**–**	**–**	**497**
Receivables	**353**	**–**	**–**	**353**
Cash and cash equivalents	**163**	**–**	**–**	**163**
	4,538	**5,174**	**38,578**	**48,290**
Financial liabilities				
Financial liabilities	**289**	**950**	**11,330**	**12,569**
Payables	**1,280**	**–**	**–**	**1,280**
Borrowings	**100**	**–**	**547**	**647**
Accruals and deferred income	**58**	**–**	**–**	**58**
	1,727	**950**	**11,877**	**14,554**
Net	**2,811**	**4,224**	**26,701**	**33,736**

	2017			
	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	337	–	–	337
Cash and cash equivalents	251	–	–	251
	2,673	3,770	31,220	37,663
Financial liabilities				
Financial liabilities	903	1,173	10,494	12,570
Payables	1,395	–	–	1,395
Borrowings	100	–	547	647
Accruals and deferred income	37	–	–	37
	2,435	1,173	11,041	14,649
Net	238	2,597	20,179	23,014

Note 18 – Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Group 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 Group 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 Group 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 19 – 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 consolidated statement of comprehensive income as 'Premiums ceded to reinsurers' when due.

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

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

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

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

Under the outward reinsurance contracts, the Group has committed to pay fixed cash flows to the reinsurer for each policy covered. In exchange, the reinsurers will pay cash flows that are linked to the actual longevity of the underlying policies. The contracts are generally collateralised for changes in longevity expectations and movements in market rates. Where a contract is collateralised no additional reserves are held, as 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 23. 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 23, 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 23.

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

Note 20 – 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 21 – Receivables

	2018 £m	2017 £m
Deposits pledged as collateral to third parties	**333**	286
Other receivables	**20**	51
Total receivables	**353**	337

All receivables are due within one year. The fair value of receivables is £353m (2017: £337m).

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 16.

Note 22 – Cash and cash equivalents

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

	2018 £m	2017 £m
Cash at bank and in hand	**163**	251
Total cash and cash equivalents	**163**	251

Note 23 – Insurance contract liabilities

Insurance contract liabilities are determined by the Group'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 Group continues to apply the principles. The Group seeks to make prudent assumptions relating to expected future experience based on current market conditions and recent experience. The assumptions used incorporate prudent margins to reflect the inherent uncertainty that actual experience may be less favourable than our best estimate.

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

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

The Group 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 Group. Please see page 28 of the strategic review for further detail on risk management arrangements and the governance framework within the Group.

Insurance risk is the risk of changes in the value of the Group'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 23 – Insurance contract liabilities continued

The Group 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 Group's insurance contract liability valuations. Note that insurance contract liabilities include reinsurance inwards, i.e. where the Group has reinsured a third party insurer.

(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%; SK=7.5]**	CMI_2016_M[3.5%; SK=7.75]
Females	**CMI_2017_F[3.0%; SK=7.5]**	CMI_2016_F[3.5%; SK=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.

Prudent margins are applied to the demographic basis, through the S_K 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 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 net insurance liabilities of £110m.

Note 23 – Insurance contract liabilities continued

(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 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 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	**0bps**	0bps
Secured lending	**11bps**	5bps
Supranational/other sovereign	**29bps**	21bps
Secured residential lending	**28bps**	24bps
Corporate bonds (without covering credit default swaps)	**62bps**	46bps
Infrastructure	**75bps**	73bps
Equity release mortgages	**146bps**	28bps[1]
Other[2]	**10bps**	26bps
Overall yield reduction	**31bps**	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 for secured residential lending for 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 deductions 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 2bps (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 12 and 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.

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

Note 23 – Insurance contract liabilities continued

(c) Expense assumption

An allowance is made for future overhead maintenance expenses following an investigation into the total costs incurred by the Group 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 23(b) on 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

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	**2018 £m**	2017 (restated) £m
Change in assumptions used		
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

Note 23 – Insurance contract liabilities continued

As shown previously, the valuation rate of interest increased by 12bps over the year, which led to the £401m decrease in the net 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 the 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
Change in property prices[2]	+10%	9	59	47
Change 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.

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 Group 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.

Note 23 – Insurance contract liabilities continued

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**

	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 24 – 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
Current tax payable	**17**	38
Other taxes and social security costs	**8**	7
Other payables	**127**	86
Total payables	**1,280**	1,395
Total payables and financial liabilities	**13,849**	13,965

Financial liabilities are recorded at fair value (see note 12), of which £0.5m are valued using Level 3 techniques (2017: £1m). The remainder are valued using Level 2 techniques.

Note 24 – Payables and financial liabilities continued

Payables and financial liabilities of £1,569m (2017: £2,298m) 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 was £1,128m (2017: £1,264m). Other OTC contracts are collateralised with fixed income securities which are not recognised on the consolidated statement of financial position for the Group.

Note 25 – Borrowings

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

The Group's borrowings are as follows:

	2018 £m	2017 £m
Subordinated loans from participating interests	**398**	398
Subordinated loan notes	**249**	249
Total borrowed	**647**	647

In March 2018, the Group entered into a £500m three-year term loan facility with a syndicate of third party banks. On 10 October 2018, £350m of this facility was repaid using the proceeds of the RT1 note issuance in RLP. On 12 December 2018 the remaining £150m of the facility was repaid using the proceeds from a dividend from RLP. The £300m revolving credit facility entered into in March 2017 remains effective but undrawn.

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

					Carrying amount		Fair value	
Notional amount	Issue date	Redemption date	Callable at par at the option of the Group from	Coupon	**2018 £m**	2017 £m	**2018 £m**	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 £55m (2017: £36m) was recognised in the consolidated 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
Third party syndicated loan	238	(240)	2	–
Affiliate subordinated loan	100	–	(100)	–
Subordinated loans from participating interests	–	300	98	398
Subordinated loan notes	249	–	–	249
Total borrowings	587	60	–	647

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

Note 26 – Deferred tax assets/(liabilities)

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

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

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

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

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

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

Deferred tax balances comprise:

	2018 £m	2017 £m
Temporary differences between the financial statements and the tax deductions	**1**	1
Total temporary differences	**1**	1

The movements in the deferred tax balances were as follows:

	2018 £m	2017 £m
At 1 January	**1**	(2)
Recognition of previously unrecognised deferred tax asset	**–**	1
Timing difference	**–**	1
Capital allowances	**–**	1
At 31 December	**1**	1

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

The Group has unrecognised deferred tax assets in respect of:

	2018 £m	2017 £m
Temporary differences in relation to equity-based compensation	**–**	–
Total temporary differences	**–**	–

Note 26 – Deferred tax assets/(liabilities) continued

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

	2018 £m	2017 £m
At 1 January	–	2
Temporary difference in relation to equity-based compensation	–	(2)
At 31 December	**–**	–

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

Note 27 – Share capital

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

	2018		2017	
	No.	£m	No.	£m
Ordinary share capital of £0.001 each	**1,214,827,671**	**1.2**	1,034,034,369	1.0
Preference share capital of £0.001 each	**1,214,827,671**	**1.2**	1,034,034,369	1.0
Restricted shares of £0.001 each	**70,000,000**	**0.1**	70,000,000	0.1
Authorised share capital	**2,499,655,342**	**2.5**	2,138,068,738	2.1

In order to ensure that the Group remained appropriately capitalised following the Prudential transaction, on 14 March 2018 the Company allotted the following shares to existing institutional shareholders for total cash consideration of £380m, reflecting share premium of £379m:

- 145,713,416 A ordinary shares of £0.001 each
- 35,079,886 C ordinary shares of £0.001 each
- 180,793,302 preference shares of £0.001 each

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

The ordinary shares issued are analysed into the following categories:

	2018		2017	
	No.	£m	No.	£m
A £0.001 Ordinary	**943,519,813**	**0.9**	797,806,397	0.8
B £0.001 Ordinary	**44,159,475**	**0.1**	44,159,475	0.1
C £0.001 Ordinary	**227,148,383**	**0.2**	192,068,497	0.1
Total	**1,214,827,671**	**2.4**	1,034,034,369	1.0

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

Note 27 – Share capital continued

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

Number of shares	2018 No.	2017 No.
At 1 January	**2,138,068,738**	2,068,098,739
Ordinary share issuance	**180,793,302**	–
Preference share issuance	**180,793,302**	–
Cancellation of D shares	**–**	(30,001)
Restricted share issuance	**–**	70,000,000
At 31 December	**2,499,655,342**	2,138,068,738

Employee benefit trust

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

The table below provides an analysis of the movement in the number of B ordinary shares held by the Trust.

Number of shares	2018 No.	2017 No.
At 1 January	**12,783,445**	13,389,921
Shares acquired from employees	**42,849**	242,716
Shares issued to employees as RSUs vest	**(1,093,188)**	(849,192)
At 31 December	**11,733,106**	12,783,445

Note 28 – Restricted Tier 1 notes

Under IFRS the RT1 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 Group upon payment.

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

On 5 September 2018, the Group 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 Group has the option to cancel the coupon payment which becomes mandatory upon breach or non-compliance with RLP's SCR, a breach of the minimum capital requirement (MCR) or where the Group 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 29 – Share premium account and reserve

	Share premium £m	Capital contribution reserve £m	Employee scheme treasury shares £m	Profit and loss reserve £m	Reorganisation reserve £m
At 1 January 2018	**466**	**5**	**(20)**	**1,168**	**132**
Profit for the financial year	**–**	**–**	**–**	**85**	**–**
Share issuance	**379**	**–**	**–**	**–**	**–**
Vesting of stock appreciation rights	**–**	**(2)**	**–**	**–**	**–**
Employee share scheme	**–**	**–**	**1**	**–**	**–**
Capital contribution	**–**	**7**	**–**	**–**	**–**
At 31 December 2018	**845**	**10**	**(19)**	**1,253**	**132**

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

The capital contribution reserve arose as a result of the SARs granted in relation to the RLSIP (see note 10).

Note 30 – Capital management

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

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

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

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

- The Group's technical provisions, being:
  - the liabilities of the Group calculated on a best estimate basis (the BEL); plus
  - the risk margin; less
  - available transitional solvency relief.
- The capital required to meet a 1-in-200-year stress (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 Group 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 Group's bespoke models and the standard formula is used to calculate the SCR for all other risk components and for aggregation across risk components.

Note 30 – Capital management continued

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 Group were £3,918m (2017: £2,944m) made up as follows:

	2018 £m	2017 £m
Total IFRS equity	**2,571**	1,753
Liability valuation differences and other regulatory adjustments	**689**	527
Total Tier 1	**3,260**	2,280
Solvency II debt valuation	**658**	664
Total Tier 2	**658**	664
Own Funds	**3,918**	2,944

The Group holds both debt and equity to optimise its capital structure and improve shareholder return. During 2018, £380m of equity and £350m of RT1 notes were issued by the Group. During the prior year, the Group 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 Group 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 31 – Related parties disclosures

Ultimate holding companies

The companies with an economic interest in RHUK are:

- The Blackstone Group L.P.: 35.85%
- GIC Private Limited: 35.85%
- MassMutual Financial Group: 24.67%

The remaining percentage is owned by the Directors, management, employees and the Trust (see note 27). Percentages are based on economic interest in RHUK.

Related party transactions

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

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 charges	**–**	(7)

Note 31 – Related parties disclosures continued

The Group entered into various transactions with fellow participating interests which are subject to common control from the same source. The table below includes a transaction with an affiliate that became a related party as a result of the recapitalisation 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	**513**	282

Transactions with key management personnel

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

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

	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 to The Blackstone Group L.P., GIC Private Limited and MassMutual Financial Group for consideration of £60m.

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

Transactions with RPML	2018 £m	2017 £m
Statement of financial position		
Other receivables	**8**	7
Capital	**11**	5

Transactions with RLP	2018 £m	2017 £m
Statement of comprehensive income		
Finance costs	**–**	(4)
Cost transfer	**(3)**	(3)
Statement of financial position		
Other payables	**6**	3
Capital	**1,764**	814
Dividends	**500**	370

Transactions with Rothesay Asset Management UK	2018 £m	2017 £m
Capital	**5**	–

Note 31 – Related parties disclosures continued

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 deduction, is consistent with the equity release mortgages ignoring the securitisation.

Transactions with Rothesay MA No.1 Limited

During December 2018, £778m of the 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 deduction, is consistent with the ground rent loans ignoring the securitisation.

Note 32 – Investments in subsidiaries

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

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

Group undertakings	Country of incorporation	Primary business operation	**2018 £m**	2017 £m	**2018 % equity interest**	2017 % equity interest
Rothesay Pensions Management Limited	UK	Service company	**11**	5	**100%**	100%
Rothesay Life Plc (formerly known as Rothesay Life Limited)	UK	Life insurance	**1,764**	814	**100%**	100%
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%**	–
Rothesay Asset Management UK Limited	UK	Service company	**5**	–	**100%**	100%
Rothesay Asset Management US LLC	US	Service company	**5**	–	**100%**	100%

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

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

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

LT Mortgage Financing Limited, which was incorporated in 2015 but remained dormant since that date, began trading during 2018. 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 now no longer needed, the Group has begun proceedings to voluntarily liquidate Rothesay Assurance Limited.

Note 33 – Financial commitments and contingencies

Operating lease commitment

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

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

Note 33 – Financial commitments and contingencies continued

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 Group 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 Group has entered into a lease for space in The Post Building.
- The Group has exercised its break clause under the lease for Level 25 of The Leadenhall Building.
- The Group 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 Group executed transactions to purchase partly funded bonds. During 2018 the Group purchased additional partly funded bonds. The Group also signed up to a number of multi-year contracts. The Group 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 Group signed an agreement under which we have committed to fund a £689m loan to a third party secured on commercial real estate providing all conditions precedent to drawdown are met. The borrower must drawdown the loan before 15 February 2019, when the agreement lapses.

Adoption of new or amended standards

The Group has considered the following new standards and changes to existing standards which are relevant to the Group's operations, and became effective for financial years beginning on or after 1 January 2018. These amendments have all been endorsed by the EU and have had no material impact on the Group 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 Group has taken the deferral option included in the IFRS 4 Insurance contract amendment and will adopt the standard on the effective date of the new insurance contract standard, now expected to be 1 January 2022. The Group will therefore continue to apply IAS 39, 'Financial Instruments: Recognition and measurement', instead of adopting IFRS 9. The exemption applies to the Group because its activities are 'predominantly connected with insurance'.

The temporary exemption allows the Group to avoid the temporary volatility that may result from adopting IFRS 9 before the forthcoming new insurance contracts standard. The Group has made an initial assessment of the impact of IFRS 9 and does not expect there to be a material impact on the measurement of financial assets and liabilities.

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 exemption is applicable at 31 December 2018.

The Group holds all financial investments at fair value through profit and loss; please see note 12 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 16 – Credit risk.

The deferral option is only applicable to Rothesay Life Plc and therefore all other Group entities have adopted IFRS 9 and copies of the annual accounts of those Group 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.

Appendix – Changes in IFRSs continued

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 Group. The standard has not impacted on the financial statements of Rothesay Pensions Management Limited or Rothesay Asset Management UK, the Group's service companies.

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 Group is not materially impacted.

Annual improvements 2014 – 2016 cycles

These improvements are effective from 1 January 2018 and are not applicable to the Group. They include: Amendments to IFRS 1, 'First time adoption of IFRS' (deletes the short-term exemptions covering transition provisions of IFRS 7, IAS 19 and IFRS 10), IFRS 12 'Disclosures of interests in other entities' and IAS 28 'Investments in associates and joint ventures' (allows venture capital organisations, mutual funds, unit trusts and similar entities to elect measuring their investments in associates or joint ventures at fair value through profit or loss).

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 Group 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 Group 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 Group 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 Group has assessed the impact of the change in standard as follows:

- During November 2018 the Group 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 Group will recognise a right of use asset in relation to Level 32 of The Leadenhall Building.
- The Group 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 lease liability of a similar amount.

IFRS 17 Insurance contracts

The standard is expected to be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2022, following the IASB's Board 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 Group is currently assessing the impact.

New or revised standards 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 Group 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 Group 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 Group. 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 Group.

Glossary of terms

Acquisition costs	Acquisition costs comprise the expenses associated with the origination of new business, including annual compensation for employees.
Administration expenses – recurring	Administration costs (shown in note 5) represent the cost of administering the in-force book of business. They include both outsourcing costs and other costs incurred by the Group.
Age standardised mortality rate	The weighted average of age-specific mortality rates, where the weights are 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 Group. Can be derived by taking total assets and adjusting for reinsurance assets, derivative liabilities and collateralised liabilities.
Assumed reinsurance premiums	Premiums received by the Group in respect of reinsurance inwards, i.e. a policy where RLP is acting as the reinsurer.
Best estimate liability (BEL)	The liabilities of the Group calculated on a best estimate basis under Solvency II, i.e. where all the assumptions made in the calculation are best estimate.
Bid price	A bid price is the price a buyer is willing to pay for a security.
Borrowing costs	Interest payable on borrowings. This is a subset of the finance costs shown in note 6.
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.
Capital contribution reserve	The capital contribution reserve arose as a result of the stock appreciation rights granted in relation to the Rothesay Life share incentive plan.
Collateralised agreements/investments	Loans secured on property or other collateral.
Collective investment schemes	A way of investing money alongside other investors.
Corporate bonds and other corporate debt	These are debt securities issued by corporations which are not guaranteed by governments.
Covered bonds	Covered bonds are debt securities issued by a bank or mortgage institution and collateralised against a pool of assets.
Credit risk	The risk of loss or of adverse change in the financial situation resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors.
Currency risk	The risk that asset or liability values, cash flows, income or expenses will be affected by changes in exchange rates. Also referred to as foreign exchange risk.
Deferred annuities	Annuities or pensions due to be paid from a future date or when the policyholder reaches a specified age.
Demographics	Statistical data relating to the population and particular groups within it.
Distributable profits	A company's profits available for distribution are its accumulated realised profits.
Economic capital	Represents management's internal risk-based calculation of the capital required to remain solvent for a 99.8% confidence level over a one-year period.

Economic profits	In the analysis of financial performance, economic profits are calculated by considering the change in assets and liabilities attributable to changes in economic conditions (e.g. interest rates, credit spreads, defaults, inflation) allowing for the cost of hedging. The release of credit default allowances over time is included in the management of in-force book.
Employee benefit trust (EBT)	A trust established to purchase and hold shares of the Company for delivery under employee share schemes.
Equity-based compensation	Share based transactions awarded under incentive plans.
Equity release mortgages	Mortgages extended to older customers (aged 55 and over) against their residential property at low loan to value percentage. Unlike a typical residential mortgage, no interest is paid monthly by the customer. Instead, the interest is simply added to the principal loan amount with the loan only repayable on death or entry into long-term care of the last remaining homeowner.
EU referendum (Brexit vote)	A UK vote which took place on 23 June 2016 where the country voted to leave the European Union.
Experience variance	In the analysis of financial performance, experience variance is calculated by considering the change in liabilities as a result of actual experience being different from that assumed on a best estimate basis (e.g. policyholders living longer than assumed). The release of prudent margins is included in the management of in-force book.
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 Group's consolidated financial statements.
Investment return	Comprises all interest income on financial investments at fair value through profit and loss, realised investment gains and losses and movements in unrealised gains and losses, as well as expenses directly related to investments executed during the year.
Liquidity premium	An addition to the risk-free rate used when projecting investment returns and discounting cash flows on certain types of contracts where the liabilities are illiquid and have cash flows that are predictable.
Liquidity premium adjustment	In calculating the MCEV, liabilities are discounted using the risk-free rate plus a liquidity premium adjustment, designed to capture the component of yield on a portfolio of assets that is attributable to liquidity rather than credit risk.
Liquidity risk	The risk of being unable to realised investments and other assets in order to settle financial obligations when they fall due.
LTMF	LT Mortgage Financing Limited.

Glossary of terms continued

Longevity reinsurance (%)	The longevity reinsurance percentage provides an indication of the extent to which the Group 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.
Management of in-force book	Profits or losses generated on the in-force book of business. In the analysis of financial performance, the management of in-force book is calculated by considering the impact on the assets and liabilities that can be attributed to the expected release of prudent margins, investment return on surplus assets and the impact on profit of management actions such as new investments. The management of the in-force book also includes the impact of assumption changes (other than those attributable to changes in economic conditions).
Market consistent embedded value (MCEV)	Provides an indication of the value of business written by measuring the risk-adjusted value of the in-force business, allowing for the unwind of margins.
Market risk	The risk of loss or of adverse change resulting, directly or indirectly, from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments.
Matching adjustment	The matching adjustment, a concept in Solvency II, is broadly equivalent to the illiquidity premium that can be earned on the illiquid assets held to back illiquid liabilities.
MCEV new business profit (%)	The MCEV new business profit provides an indication of the profitability of new business by expressing the value on an MCEV basis of new business as a percentage of new business premium.
Mortality tables	A table which shows for each age, what the probability is that a person of that age and gender will die before their next birthday.
Net premiums	Life insurance premiums, net of reinsurance premiums paid to third-party reinsurers.
Net worth	Under MCEV, the value of equity plus the value of borrowings on an IFRS basis.
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.
New business profit	In the analysis of financial performance, new business profit is calculated on an IFRS basis by comparing the premium received with the insurance liabilities taken on. The discount rate used in calculating the insurance liabilities assumes full deployment of premiums according to the Group's investment strategy. The impact of any under-deployment (i.e. the difference between this number and the new business profit calculated based on the assets received as the premium) is reported as a deduction from the management of in-force book.
Non-hedgeable risk	Under MCEV, risks not already allowed for in the time value of options and guarantees or PVFP. The allowance includes the impact of both non-hedgeable financial and non-financial risks. No allowance has been made within the CNHR for symmetric risks as these are diversifiable by investors.
Non-recurring and project expenditure	Administration – project and other one-off expenses. (see note 5)
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 which removes the distorting impact of market fluctuations and exceptional expenses.
Operational risk	The risk arising from inadequate or failed internal processes, personnel or systems, or from external events.
Own funds	Available capital under the Solvency II regime.
Own risk and solvency assessment (ORSA)	An assessment of the risk to which the business is exposed as well as solvency forecasting in a range of scenarios, including consideration of the stresses that could jeopardise the Group's business plans.
Partial internal model	Under Solvency II, insurer's own model used to calculate the solvency capital requirement in relation to particular risks approved by the PRA.
Part VII transfers	Court-approved transfer of a portfolio of contracts from one entity to another.
Pillar I	Under Solvency II, represents the solvency capital requirement calculated using a standard formula or (partial) internal model.
Prudential Regulation Authority (PRA)	The PRA is a UK regulatory body responsible for prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms.
qx	qx is actuarial notation used to represent the probability of a life aged x dying during the year.
RAL	Rothesay Assurance Limited. Now being wound up.
Regular premiums	Payments of premium made regularly over the duration of the policy.
Reinsurance	Protection sold to or purchased from another insurance company.
Reorganisation reserve	Reflects the impact of the Group reorganisation in 2013 which led to an increase in reserves of £132m, reflecting the excess of consolidated net assets to the historical cost of investment in subsidiary entities.
RHUK	Rothesay Holdco UK Limited.
Risk margin	Under Solvency II, the cost of transferring non-hedgeable risks.
RLP	Rothesay Life Plc, the Group's regulated life company.
RMAL	Rothesay MA No.1 Limited.
RPML	Rothesay Pensions Management Limited, the Group's service company.
Secured investments	Bespoke investments where very high levels of collateral have been negotiated and returns are generated through illiquidity premium.
Single premiums	Single premium policies of insurance are those that require only a single lump sum payment from the policyholder.
Solvency capital requirement (SCR)	Under Solvency II, capital requirement to withstand a 1-in-200 year event.
SCR coverage ratio	Own Funds divided by SCR. Measure of surplus above capital requirement.
Solvency II	The solvency regime applicable from 1 January 2016. Under Solvency II, the Group is required to hold the greater of the capital required under the new Solvency II Pillar 1 framework and the capital required under our own economic capital models Solvency II Pillar 2.
Stock appreciation rights (SARs)	Method for companies to give their management or employees a bonus if the company performs well. SARs resemble employee stock options in that the employee benefits from an increase in stock price.
Strategy risk	The risk of loss in future earnings and capital arising from changes in the competitive, economic, legal or political environment, changing customer behaviour, or a failure to select appropriate strategic or long-term business plans.

Glossary of terms continued

Subordinated loan	A fixed interest issue or debt that ranks below other debt in order of priority for repayment if the issuer is liquidated. Holders are compensated for added risk through higher rates of interest. Under EU insurance regulation, subordinated debt is not treated as a liability and counts towards the coverage of the required minimum margin of solvency with limitations.
Surrender	The termination of a life insurance policy or annuity contract at the request of the policyholder after which the policyholder receives the cash surrender value, if any, of the contract.
Third party administration (TPA) agreement	Contract with pensions administrator to process claims and payroll on behalf of RLP.
Unconsolidated structured entities	A structured entity is an entity that has been designed so that voting or similar rights are not the dominating factor in deciding who controls the entity. These structured entities have not been consolidated as the Group does not have the power to affect their returns.
Value of in-force business	Consists of the following components: in MCEV, present value of future profits, time value of financial options and guarantees, frictional costs of required capital and cost of residual non-hedgeable risks.
Yield	A measure of the income received from an investment compared to the price paid for the investment. Normally expressed as a percentage.

Notes

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