Scottish Widows Limited

Annual Report and Accounts
2019

Member of Lloyds Banking Group

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COMPANY INFORMATION

Board of Directors

N E T Prettejohn (Chairman)

A M Blance
J R A Bond
W L D Chalmers
K Cheetham
J E M Curtis
J C S Hillman*
J F Hylands
A Lorenzo*
C J G Moulder
S J O'Connor
G E Schumacher

* denotes Executive Director

Company Secretary

J M Jolly

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Company Registration Number

03196171

GROUP STRATEGIC REPORT

The Directors present their strategic report on Scottish Widows Limited ("the Company") and its subsidiary undertakings (together referred to as "the Group") for the year ended 31 December 2019. The Company is limited by share capital.

The Group contributes to the results of the Insurance and Wealth Division of Lloyds Banking Group plc ("LBG"). Scottish Widows was founded in 1815, and since then we have been focused on helping customers protect themselves today whilst preparing for a secure financial future. Our objective is to be the best insurance and retirement savings business for customers; providing simple, trusted, value for money products accessible through our customers' preferred channels.

As we look to the future, we see the external environment evolving rapidly. The rapid pace of technological change, new regulation and increased competition are driving significant changes in customer needs and expectations. As a customer-driven business, we see these as opportunities. Our strategic plan responds to all of these challenges and transforms the Group for success in a digital world.

We have identified the following strategic priorities focused on the financial needs and behaviours of the customer of the future and our progress against those priorities are:

Delivering a leading customer experience

- Scottish Widows now offers its standard annuities on the open market allowing a wider range of customer to access the product and secure income for retirement. Aiming to achieve a 15 per cent market share by end of 2020.
- Successful migration of c.400,000 policies from a number of legacy systems to a single platform managed by our partner Diligenta, enabling customers to better manage their policies with Scottish Widows.
- New 'Plan and Protect' life and critical illness cover launched in 2019 helps create financially resilient families by understanding their needs and protecting what matters most, providing a safety net if the worst happens.
- Scottish Widows won 5 star service awards at the Financial Adviser Service Awards for the fourth consecutive year.

Digitising the Group

- Significant progress on Single Customer View; with individual pension customers added in 2019. Over 5 million customers now able to access their insurance products alongside their bank account.

Maximising the Group's capabilities

- Continued progress towards target of growing open book assets under administration by £50 billion by the end of 2020, with strong customer net inflows of £18 billion (including Zurich transfer) in 2019. Cumulative net inflows of £30 billion and market movements give overall growth of £37 billion since the start of the current strategic plan in 2018.
- Sourced £0.6 billion of new long-term assets in collaboration with Commercial Banking to support five bulk annuity transactions, generating over £2 billion of new business premiums.

Our strategy will enable us to transform ourselves into a **digitised**, **simple**, **low risk**, **customer focused**, UK financial services provider.

Our strong foundations, differentiated business model and our great, highly engaged team will enable sustainable success in a digital world and ensure we continue to help Britain prosper.

Our Insurance Strategy will create a scalable and efficient business and deliver value for money propositions for our customers that are aligned to clear and growing customer needs.

LBG, including the Group, aspires to conduct business in a way that values and respects the human rights of all the stakeholders we work with. LBG, including the Group, complies with all relevant legislation, including the UK Modern Slavery Act.

Principal activities

The principal activity of the Group is the undertaking of ordinary long-term insurance and savings business and associated investment activities in the United Kingdom. The Group also has freedom of services overseas through branches, which administer a relatively small amount of business, principally in Germany. This business is administered through a subsidiary, Scottish Widows Europe S.A. ("SWE"). The Group offers a wide range of life insurance products such as annuities, pensions, whole life, term life and investment type products through independent financial advisors, the LBG network and direct sales. The Group also reinsures business with insurance entities external to the Group and LBG.

Result for the Year

The result for the year ended 31 December 2019 is a Group loss after tax £(21)m (2018 profit: £389m). The result is reflective of market conditions during the year but includes lower income due to changes in equity hedging strategy to reduce capital and earnings volatility, assumption changes, along with the sale of business to Schroders Personal Wealth (SPW).

On the Balance Sheets, Group and Company have seen a £21bn increase in both assets and liabilities as a result of the acquisition of pensions business from the Zurich Insurance Group.

The Directors consider the result to be satisfactory in light of these factors.

GROUP STRATEGIC REPORT (continued)

The United Kingdom leaving the European Union

Following the UK's exit from the EU, significant negotiation is now required on the terms of the future trade agreement. As a result, the possibility of a limited or no deal at the end of the transition period remains and could manifest in prolonged business uncertainty across the UK, including the financial services sector. The continued lack of clarity over the UK's eventual relationship with the EU and other foreign countries, and ongoing challenges in the Eurozone, including weak growth raises additional uncertainty for the UK economic outlook. The Group's response to these risks and uncertainty includes contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts. Also a no deal EU exit outcome has been analysed to identify impacts and assess robustness of contingency plans.

Coronavirus

Our business has primarily a UK focus and the outbreak of Covid-19, in line with its global impact, is expected to adversely impact the UK economy as well as causing volatility in global financial markets. As the situation continues to evolve, so does our assessment of the risks and the degree to which they might crystallise. The Company's resilience to such events is regularly reviewed through stress and scenario testing; plans to continue to operate critical business processes are in place and are being reviewed in light of the Covid-19 outbreak.

Climate Change

Strategy

The UK is committed to the vision of a sustainable, low carbon economy, and the successful transition is of strategic importance to the Group. When reporting on our strategic progress, we support the Taskforce on Climate-Related Financial Disclosure (TCFD) framework, and plan to achieve full disclosure by 2022.

Our ambition

LBG has set seven leadership ambitions to support the UK's transition to a sustainable future. Those that are relevant to the Group are:

- Pensions & Investments: be a leading UK pension provider that offers our customers sustainable investment choices, and challenges companies we invest in to behave more sustainably and responsibly.
- Our Own Footprint: be part of a leading UK bank in reducing our own carbon footprint and challenging our suppliers to ensure our own consumption of resources, goods and services is sustainable.

Progress

Throughout 2019, we have been actively reviewing asset exposures by type and continue to make enhancements to existing Stewardship policies and procedures. Much of our engagement activity is currently undertaken through 3rd party asset managers.

In addition to our own stewardship activity, our investment managers will work with Investee Companies to influence their strategy and approach, liaising with management and voting on resolutions, with a clear focus on enhancing a company's Environmental, Social and Governance (ESG) approach.

Metrics and targets

As part of our TCFD implementation plan we are developing our approach to reporting appropriate metrics and targets during 2020. Initially we will consider our exposure to carbon intensive sectors and the subsequent risks. This will be used to support a long term reporting framework, enabling us to track our performance against our sustainability strategy, and disclose the financial impact of climate change related risks and opportunities.

Risk management

Climate risk is a key emerging risk for the Group. Our approach to identifying and managing climate risks is founded on embedding it into our existing Risk Management Framework, and integrating through policies, authorities and risk control mechanisms. During 2019, we updated our TCFD implementation plan to incorporate PRA supervisory expectations and refine deliverables, with further resource invested in the programme.

Governance

Given the importance of our ambitions, our governance structure provides clear oversight and ownership of the sustainability strategy, implementation of the TCFD recommendations and adherence to the evolving regulatory requirements on climate risk.

Further details of the LBG approach of transitioning to a low carbon economy can be found in the Lloyds Banking Group Annual Report and Accounts, which can be downloaded via www.lloydsbankinggroup.com.

GROUP STRATEGIC REPORT (continued)

Key performance indicators

Funds under management

Funds under management relating to policyholder liabilities were £153.7bn (2018: £116.5bn). The movement reflects the acquisition of the Zurich UK Workplace Pensions business, net flows from policyholders and investment returns for the period.

Solvency II

Our business model maximises the capital benefits from risk diversification available under Solvency II, the use of our Internal Model to calculate our Solvency Capital Requirement and the use of the Matching Adjustment, which has a beneficial impact on the level of regulatory capital we hold in relation to annuities business.

As agreed with the Prudential Regulation Authority ("PRA"), the wider Insurance and Wealth division submitted a single Own Risk and Solvency Assessment ("ORSA") for 2018 covering the Group headed by Scottish Widows Group Limited, and the assessment of own risks and solvency needs of the Company is therefore covered by that assessment. The ORSA report for 2018 was submitted to the PRA in March 2019.

The Directors believe that the Company currently has adequate capital resources and will continue to do so in the foreseeable future. On a Solvency II basis the regulatory surplus of the Company in excess of capital requirements is £2.9bn (2018: £2.4bn).

The Solvency II pre year-end dividend ratio for the Insurance Group of 170 percent (2018: pre dividend position: 167 percent) represents the shareholder view of Solvency II surplus. During 2019, benefits arose from capital generation on existing business and the positive impact of capital initiatives, primarily allowing for the equity hedging program within the calculation of Solvency II capital requirements. These were partially offset by capital invested in new business, including the acquisition of Zurich business through a Part VII Transfer, and the negative impacts of market movements. In addition, the Company paid dividends of £300m in February 2019 (2018: £540m in February 2018, £225m in July 2018 and £1,000m in December 2018). Further information on the capital position of the Company is given in note 38.

During the year, the Group has delivered Solvency II reporting in respect of full annual quantitative reporting for 31 December 2018, as well as the narrative reporting required by Solvency II. The Company has a waiver from the PRA exempting it from preparing a single Solvency and Financial Condition Report ("SFCR") and instead the Company reported publicly through a Group SFCR for Scottish Widows Group Limited that was published in May 2019.

Liquidity

The Company regularly monitors its liquidity position to ensure that, even under stressed conditions, the Company has sufficient liquidity to meet its obligations and remain within the approved risk appetite. As at 31 December 2019, the Company had liquidity coverage of 143% (2018: 193%). Liquidity methodology and reporting is compliant with Solvency II.

Present value of new business premiums ("PVNBP")

Life and pensions sales (PVNBP) for the year were £17,515m (2018: £14,384m). PVNBP increased 22 percent driven by increases in new members in existing workplace schemes, increased auto enrolment workplace contributions, bulk annuities and the acquisition of Zurich UK Workplace Pensions and Saving Business.

Non-financial KPIs

The Directors consider non-financial KPIs in respect of the Group's strategic priorities. Where relevant, non-financial KPIs are presented below against the strategic priorities presented in this report.

	2019	**2018**	**2017**
Customer satisfaction (net promoter score) (Strategic priority: Delivering a leading customer experience)	43	39	39
Customer complaints (FCA reportable complaints per 1,000 policies) (Strategic priority: Delivering a leading customer experience)	0.97	0.85	0.81
Colleague engagement index (% favourable) (Strategic priority: Maximising the Group's capabilities)	69	70	61

Other Sources where KPIs are presented

The Group also forms part of LBG's Insurance and Wealth Division. The development, performance and position of the Insurance and Wealth Division are presented within LBG's annual report, which does not form part of this report.

The Directors consider that the above are the key performance indicators which are appropriate to the principal activity of the Group. These, together with other metrics which cover customer, operational measures and capital, are included in the balanced scorecard which is used to measure all aspects of the performance of the business. In addition, the Directors are of the opinion that the information contained in the Company's Solvency II reporting on capital resources and requirements and regular actuarial reports, in conjunction with the information presented in the financial statements as a whole, provide the management information necessary for the Directors to understand the development, performance and position of the business of the Company and the Group.

GROUP STRATEGIC REPORT (continued)

Review of the business

In addition to the progress made against the strategic initiatives summarised earlier there are other areas that are worthy of note and these are described below. Decisions taken in the areas described below and in pursuit of our strategy are brought to the Board for due consideration and approval.

Acquisition of Zurich UK Workplace Pensions and Savings Business and Zurich Part VII Transfer Scheme

On 12 October 2017, the Group entered into an agreement to acquire the UK workplace pensions and savings business from the Zurich Insurance Group. The acquisition is a key enabler to accelerate the Group's development of its financial planning and retirement business and on completion of the Part VII transfer, has brought around £21bn of assets under administration.

The savings business was acquired by Scottish Widows Administration Services Limited ("SWAS"), a subsidiary undertaking, on 3 April 2018. The Company also acquired the pensions business, with a net asset value of £6m, on 1 July 2019. The transfer of the pensions business followed court approval of an insurance business transfer scheme, under Part VII of the Financial Services and Markets Act 2000. £7m of consideration was prepaid in the prior year and the remaining £9m of consideration was paid during 2019. During the year the Group has recognised of £10m of goodwill and £6m of acquired VIF in respect of the acquisition. Further information can be found in note 44.

Following completion of the Part VII transfer scheme, integration of the new pensions business is progressing to plan.

Outsourcing of long-standing customer administration platform

The outsourcing contract with Diligenta was signed on 19 September 2017. The service improvement activity under the contract has delivered the two life and pensions system data migration events which were scheduled in 2019 to plan. Further life and pension system data migrations are planned through to mid 2021.

Investment strategy

As part of its efficient balance sheet management, the Group is focused on investments that improve risk adjusted returns and provide more diversification of assets to match its liabilities. In particular, the Group continues to identify investment opportunities in long term, low risk higher yielding illiquid assets available both within LBG and from the origination of new loan assets, leveraging the capabilities of LBG as appropriate. This is expected to continue to deliver significant increased investment returns and enhance the competitiveness of our annuity business without increasing credit risk beyond the Group's risk appetite.

Bulk Annuities

We have continued to support corporate customers in de-risking their balance sheets, with the successful completion of a further five (2018: nine) bulk annuity transactions, bringing in £2.1bn (2018: £1.9bn) of liabilities from third party pension schemes.

Scottish Widows Master Trust

As auto-enrolment continues to have a positive impact on the nation's saving, the Group reached another significant milestone in September 2019 with the authorisation (by The Pensions Regulator) of the Scottish Widows Master Trust. This now sits alongside a full range of choices for workplace and individual customer needs, helping them to save for their financial future and retirement.

UK's exit from the European Union and the SWE Part VII Transfer Scheme

The Company has formed a new Luxembourg based company – SWE as its primary contingency plan for mitigating the risks which have arisen from the UK's exit from the EU. SWE is a subsidiary of the Company and the existing European business transferred to SWE via an insurance business transfer scheme, under Part VII of the Financial Services and Markets Act 2000. On the 14 March 2019, the High Court approved the Part VII transfer of the European business to SWE. The transfer was effective 29 March 2019 and the business was transferred on this date and, as such, the Company accounted for the operations of the European business as discontinued operations in 2018. The assets and liabilities of the European business were reclassified in the Company balance sheet as assets and related liabilities held for sale in 2018. For 2019 the results reflect that SWE includes the assets and liabilities of the European business that were transferred through the insurance business transfer scheme. SWE remains a wholly owned subsidiary of the Company and so there is minimal impact on the Group as a result of the transfer of the European business from the Company to SWE.

As part of the transfer process SWE issued share capital to the Company sufficient for it to cover its relevant capital requirement and risk margin. The total capital issued by SWE was £71m (€81m) and was subscribed for in cash. On 19 September 2019 SWE issued additional share capital to the Company of £27m (€30m), in the form of share premium subscribed for in cash. On 23 December 2019 SWE issued additional share capital to the Company of £59m (€70m), in the form of share premium subscribed for in cash.

Strategic partnership with Schroders

On 23 October 2018 LBG announced a strategic partnership with Schroders plc. The new joint venture company, Schroders Personal Wealth aims to provide a market-leading wealth proposition to address the growing gap in the advice market. In order to support the launch of the joint venture Scottish Widows Unit Trust Managers Limited ("SWUTM"), a subsidiary undertaking, transferred the management of £12.5bn of wealth-related assets to a subsidiary of the joint venture company, Scottish Widows Schroder Personal Wealth ACD Limited ("SPWACD").

In exchange for the transfer of the rights to manage the funds, SWUTM received £192m in cash consideration. As part of the transfer SWUTM ceased to act as the Authorised Corporate Director (ACD) for the Investment Portfolio Investment Company with Variable Capital (ICVC) and Multi-Manager ICVC. This responsibility transferred to SPWACD on 9 December 2019.

GROUP STRATEGIC REPORT (continued)

Review of the business (continued)

New asset managers

In 2018, LBG terminated and settled its partnership agreements with Aberdeen Asset Management plc, a subsidiary of Standard Life Aberdeen plc ("SLA"). In October 2018, LBG entered into new asset management agreements with BlackRock and Schroders plc. The Group was subject to arbitration with SLA regarding LBG's termination of a series of contracts under which SLA managed assets on behalf of the Group. SLA will continue to manage our property and tracker funds until April 2022.

Outlook

The Directors consider that the Group and Company's principal activities will continue to be unchanged in the foreseeable future.

Principal risks and uncertainties

Details of key risks are set out in note 38. Key risks include economic and political uncertainty alongside operational risk which is heightened by the current level of change being undertaken to execute our strategy. Risks and uncertainties to our strategic plan, both positive and negative, are considered by product through the planning process.

In addition, as described in note 28, during the ordinary course of business the Group is subject to complaints and threatened or actual legal proceedings (including class or Group action claims) brought by or on behalf of current or former employees, customers, investors or other third parties, as well as legal and regulatory reviews, challenges, investigations and enforcement actions, both in the United Kingdom and overseas.

All such material matters are periodically reassessed, with the assistance of external professional advisors where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed to properly assess the situation, and no provisions are held in relation to such matters. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

Section 172(1) Statement and Statement of Engagement with Other Stakeholders

In accordance with the Companies Act 2006 (the 'Act') (as amended by the Companies (Miscellaneous Reporting) Regulations 2018), the Directors provide the following statement describing how they have had regard to the matters set out in section172(1) of the Act, when performing their duty to promote the success of the Company under section 172. Further details on key actions in this regard are also contained within the Directors' Report on page 10 and the Corporate Governance Report on page 11.

In accordance with the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended by the Companies (Miscellaneous Reporting) Regulations 2018), the following statement also provides details of how the Directors have engaged with and had regard to the interest of key stakeholders. The Group is a subsidiary of LBG, and as such follows many of the processes and practices of LBG, which are further referred to in this statement where relevant.

The Directors' acknowledge that one of the primary responsibilities of the Board is to ensure the strategy of the Group, as aligned to that of LBG, achieves long-term success and generates sustainable returns, central to which is ensuring engagement with stakeholders, and considering in all instances the long-term implications of decisions made, acting at all times to maintain the highest possible standards of conduct. This approach has during the course of the year been central to the activities of the Directors, as discussed below.

Customers

The Directors ensure the Group as part of LBG works toward achieving LBG's customer ambitions, to treat all customers fairly, and make it easy for customers to find, understand and access products that are right for them. To ensure Directors truly understand the needs of customers, every opportunity is taken to consider direct customer feedback and related management information, including as part of the Directors' strategic decision making process. The Directors undertook Digital Lab visits designed to bring senior leaders across LBG closer to customers. The Directors have also worked to ensure the business of the Group is undertaken in line with the objectives of LBG's annually agreed customer plans, with the Directors regularly reviewing customer complaints to understand areas where improvements can be made in responding to complaints. LBG regularly benchmarks amongst its customers the performance of itself and its subsidiaries, including the Group, and uses this insight along with a range of internal and external research to ensure ongoing improvement in customer experience. The Directors ensure the Group plays an active part in LBG's wider customer ambitions, as acknowledged in the Group's strategy, which during the course of the year has included the ongoing development of market leading digital propositions, more personalised customer propositions and better experience for customers across all channels.

Shareholders

The Group is a wholly owned subsidiary of LBG, forming part of LBG's Insurance and Wealth division. As a wholly owned subsidiary, the Directors ensure that the strategy, priorities, processes and practices of the Group are fully aligned where appropriate to those of LBG, ensuring that the interests of LBG as the Group's sole shareholder are duly acknowledged. Further information in respect of the relationship of LBG with its shareholders is included within the Strategic Report within the LBG Annual Report and Accounts for 2019, available on the LBG website.

GROUP STRATEGIC REPORT (continued)

Section 172(1) Statement and Statement of Engagement with Other Stakeholders (continued)

Communities and the Environment

The Directors acknowledge that the Group, as part of one of the largest retail and commercial financial services providers in the UK, has responsibilities to invest in the communities in which it operates, to help them prosper economically and build social cohesion by tackling disadvantage. The Group participates in all related LBG initiatives, with the Directors' ensuring the Group plays an appropriate role in LBG's related Helping Britain Prosper Plan. Further information in respect of the LBG approach to engaging with and contributing to the communities in which it operates is included within the Strategic Report within the LBG Annual Report and Accounts for 2019. Additional information on LBG's Helping Britain Prosper Plan is available on the LBG website.

The Responsible Business Committee of the Board of LBG is responsible for overseeing LBG's performance, including that of the Group, as a Responsible Business, by providing oversight of and support for LBG's strategy and plans for embedding responsible business as part of both LBG's and the Group's purpose to Help Britain Prosper. Priorities during the year have included ongoing focus on three key areas aligned to LBG's Bank of the Future strategy. These included consideration of the progress of the Lloyds Bank Academy and the external initiative 'future.now', both designed to boost digital skills in the UK. Progress against agreed sustainability strategy was considered, where consistent progress was made in achieving targets such as providing support for the EV1000 electric vehicles initiative. Consideration was also given to the relationship between LBG and its charitable foundations, in particular the work they do in the communities in which LBG and the Group operate. Further information in respect of LBG's and the Group's Responsible Business activities is included on pages 26 to 35 of the LBG Annual Report and Accounts for 2019, available on the LBG website, along with further discussion of the work of LBG's Responsible Business Committee.

Suppliers

The Group's approach to supplier management is part of that of LBG, which works with around 3,100 active suppliers of varying sizes, most in professional services sectors such as IT, cyber, operations, management consultancy, legal, HR, marketing and communication. The Group and LBG seek to improve the experience of suppliers, with feedback regularly sought on related assurance processes to ensure continual improvement in the process. Suppliers are also encouraged to express their satisfaction or otherwise, and have access to LBG and the Group's whistleblowing service.

In 2019 LBG's supplier expenditure was £5.9 billion, with 95 per cent of third party suppliers being located in the UK. Importance is placed on having the right supplier framework to operate responsibly. LBG's Sourcing & Supply Chain Management Policy applies to all businesses, divisions, and subsidiaries of LBG, including the Group, with the Directors assuming ultimate responsibility for its application as relevant to the Group. This Policy has been designed to assist in managing the inherent risk in outsourcing services, and dealing with third party suppliers. Suppliers are required to adhere to relevant LBG policies and comply with LBG's Code of Supplier Responsibility which can be found on the LBG website. This defines expectations for responsible business behaviour, underpinning the efforts of the Group and LBG to share and extend good practice. All material contracts are subject to rigorous cost management governance with regular review of key supplier risks.

Regulators

The Group and its Directors have a strong, open and transparent relationship with relevant regulators and other authorities, and liaise regularly both directly and as part of LBG to ensure the business is aligned to the evolving regulatory framework. Key areas of focus have included ensuring robust prudential standards and supervision arrangements in place, ensuring the fair treatment of customers, adapting to changes in regulatory requirements, recovery and resolution, and preparations for the UK's withdrawal from the EU.

The Board has received regular updates on regulatory interaction, providing a view of key areas of focus, alongside progress made addressing regulatory actions. During 2019 LBG colleagues had regular meetings with the regulators, representing the interests of the Group as required, in addition to the Financial Conduct Authority and Prudential Regulation Authority's annual attendance at the Board. Engagement continues with the regulators through proactive meetings to discuss various key themes such as achieving a customer centric culture, transformation and change, operational and financial resilience and credit risk. The status of regulatory relationships continues to be closely monitored, enhancing proactive engagement across key regulatory changes and areas of focus. The approach of LBG, including that of the Company, to managing regulatory change is discussed further on page 11 of the LBG Annual Report and Accounts for 2019, available on the LBG website.

On behalf of the Board of Directors

J C S Hillman

Director

20 March 2020

DIRECTORS' REPORT

The Directors present the audited consolidated financial statements of the Company and the Group. The Company is a limited Company, domiciled and incorporated in the United Kingdom. The Group also has freedom of services overseas through branches, which administer a relatively small amount of business, principally in Germany. This business is administered through a subsidiary, SWE. Details of all the subsidiary undertakings and the European business Part VII Transfer Scheme to SWE are given in note 16 and note 44.

Results and dividend

The result for the year ended 31 December 2019 is a Group loss after tax £(21)m (2018 profit: £389m). The result is reflective of market conditions during the year but includes lower income due to changes in equity hedging strategy to reduce capital and earnings volatility, assumption changes, along with the sale of business to Schroders Personal Wealth (SPW). The Directors consider the result for the year to be satisfactory in light of these factors. Further information on the results of the Group, and future prospects of the business, are provided in the Group Strategic Report.

During the year, £300m interim dividends (2018: £1,765m) were paid. The Directors recommend no payment of a final dividend in respect of the year ended 31 December 2019 (2018: nil). Details of dividends paid during the year are given in note 36.

Post balance sheet events

An interim dividend of £560m in respect of the year ending 31 December 2020 was declared on 06 February 2020 and paid to Scottish Widows Group Limited on 12 February 2020.

Further information on post balance sheet events is set out in note 43.

Directors

The names of the current Directors are listed on page 3. Changes in Directorships during the year and since the end of the year are as follows:

J R A Bond	(appointed 24 July 2019)
G E Schumacher	(appointed 24 July 2019)
M G Culmer	(resigned 1 August 2019)
W L D Chalmers	(appointed 9 August 2019)
M Harris	(resigned 5 December 2019)
J C S Hillman	(appointed 10 December 2019)
J Pfaudler	(resigned 18 December 2019)

Particulars of the Directors' emoluments are set out in note 39.

Directors' indemnities

Lloyds Banking Group plc has granted to the Directors of the Company a deed of indemnity through deed poll which constituted 'qualifying third party indemnity provisions' for the purposes of the Companies Act 2006. The deed was in force during the whole of the financial year and at the date of approval of the financial statements. Directors no longer in office but who served on the Board of the Company at any time in the financial year had the benefit of this contract of indemnity during that period of service. The indemnity remains in force for the duration of a Director's period of office. The deed indemnifies the Directors to the maximum extent permitted by law.

The deed for existing Directors is available for inspection at the registered office of Lloyds Banking Group plc. In addition, the Group has in place appropriate Directors and Officers Liability Insurance cover which was in place throughout the financial year.

Disclosure of information to auditors

Each person who is a Director at the date of approval of this report confirms that, so far as the Director is aware, there is no relevant audit information of which the Company's auditors are unaware and each Director has taken all the steps that they ought to have taken as a Director in order to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information. This confirmation is given, and should be interpreted in accordance with, the provisions of the Companies Act 2006.

Future developments

Future developments are detailed within the Group Strategic Report and also in note 42.

Employees

Prior to the disposal of Scottish Widows Services Limited ("SWSL"), which resulted in the Group no longer directly employing any staff, the Group followed LBG employee practices. LBG is committed to providing employment practices and policies which recognise the diversity of the workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief. In the UK, LBG belongs to the major employer groups campaigning for equality for all staff, including Employers' Forum on Disability, Employers' Forum on Age and Stonewall. LBG is also represented on the Board of Race for Opportunity and the Equal Opportunities Commission. Involvement with these organisations enables LBG to identify and implement best practice for staff.

DIRECTORS' REPORT (continued)

Employees (continued)

LBG encourages and gives full and fair consideration to job applications from people with a disability and are unbiased in the way it assesses, selects, appoints, trains and promotes people. LBG encourages job applications from those with a disability and continues to run a work experience programme with Remploy to support people with disabilities wanting to enter the workplace.

LBG is committed to continuing the employment of, and for arranging appropriate training for, employees of the Company who have become disabled persons during the period when they were employed by the Company.

Employees are kept closely involved in major changes affecting them through such measures as team meetings, briefings, internal communications and opinion surveys. These meetings, briefings and internal communications also serve to achieve a common awareness of the financial and economic factors that affect the performance of the Company and the Group. There are well established procedures, including regular meetings with recognised unions, to ensure that the views of employees are taken into account in reaching decisions. Schemes offering share options or the acquisition of shares are available for most staff, to encourage their financial involvement in LBG.

Political contributions

During the year, the Group made no political contributions (2018: nil).

Corporate Governance Report

Approach to Corporate Governance

In accordance with the Large and Medium-sized Companies and Group (Accounts and Reports) Regulations 2008 (as amended by the Companies (Miscellaneous Reporting) Regulations 2018) (the 'Regulations'), for the year ended 31 December 2019, the Group has in its corporate governance arrangements applied the Wates Corporate Governance Principles for Large Private Companies (the 'Principles'). The following section explains the Group's approach to corporate governance, and its application of the Principles.

Fundamental to the Group's strategy are high standards of corporate governance. A Corporate Governance Framework is in place for the Scottish Widows Group of companies, of which the Group is a part, which sets the approach and applicable standards in respect of the Group's corporate governance arrangements whilst addressing the matters set out in the Principles.

This includes the matters reserved to the Board, and the matters the Board has chosen to delegate to management, including decision making on operational matters such as those relating to credit, liquidity and the day to day management of risk, and the governance requirements of the operation of the Company outside of LBG's Ring Fenced Bank. Governance arrangements, including the Corporate Governance Framework, are reviewed at least annually to ensure they remain fit for purpose. The Corporate Governance Framework of the Group further addresses the requirements of the Principles as follows.

Principle One – Purpose and Leadership

The Board is collectively responsible for the long term success of the Group. It achieves this by agreeing the Group's strategy, within the wider strategy of LBG, and overseeing delivery against it. The Group's strategy is discussed further in the Strategic Report on pages 4 to 9. The Board also assumes responsibilities for the management of the culture, values and wider standards of the Group, within the equivalent standards set by LBG.

Consideration of the needs of all stakeholders is fundamental to the way the Group operates, as is maintaining the highest standards of business conduct, which along with ensuring delivery for customers is a vital part of the corporate culture. The Group's approach is further influenced by the need to build a culture in which everyone feels included, empowered and inspired to do the right thing for customers. To this end, the Board plays a lead role in establishing, promoting and monitoring the company's corporate culture and values, with the Corporate Governance Framework ensuring such matters receive the level of prominence in Board and Executive decision making which they require. The Group's corporate culture and values closely align to those of LBG, which are discussed in more detail on page 74 of the LBG annual report and accounts for 2019.

Principle Two – Board Composition

The Group is led by a Board comprising a Non-Executive Chairman, independent Non-Executive Directors and Executive Directors, further details of the directors can be found on page 3. The Board considers its composition regularly, and is committed to ensuring it has the right balance of skills and experience. The Board considers its current size and composition is appropriate to the Group's circumstances. The Board places great emphasis on ensuring its membership reflects diversity in its broadest sense, for example five out of twelve directors are women. New appointments are made on merit, taking account of the specific skills and experience, independence and knowledge needed to ensure a rounded Board and the diversity benefits each candidate can bring overall. There are a range of initiatives to help provide mentoring and development opportunities for female and BAME executives within LBG, and to ensure unbiased career progression opportunities. Progress on diversity objectives is monitored by the Board and built into its assessment of executive performance.

The Board is supported by its committees, the operation of which is discussed below, which make recommendations to the Board on matters delegated to them, in particular in relation to internal control, risk, financial reporting and remuneration matters. Each committee has written terms of reference setting out its delegated responsibilities. Each committee comprises individuals with appropriate skills and experiences and is chaired by an experienced chairman. The committee chairs report to the Board at each Board meeting.

The Board periodically undertakes reviews of its effectiveness, which provide an opportunity to consider ways of identifying greater efficiencies, ways to maximise strengths and highlights areas of further development. The effectiveness reviews are commissioned by the Chairman of the Board, assisted by the Company Secretary. In addition to considering the effectiveness of the Board, the effectiveness of the Board committees is also considered. The Chairman also ensures that the individual performance of individual directors is reviewed.

DIRECTORS' REPORT (continued)

Corporate Governance Report (continued)

Principle Three – Director Responsibilities

The Directors assume ultimate responsibility for all matters, and along with senior management are committed to maintaining a robust control framework as the foundation for the delivery of good governance, including the effective management of delegation though the Corporate Governance Framework. Policies are also in place in relation to potential conflicts of interest which may arise.

The Board is supported by its committees which make recommendations on matters delegated to them under the Corporate Governance Framework. The management of all committees is in keeping with the basis on which meetings of the Board are managed, with open debate, and adequate time for members to consider proposals which are put forward. The Chairman of the Board and each Board committee assumes responsibility with support from the Company Secretary for the provision to each meeting of accurate and timely information.

Principle Four – Opportunity and Risk

The Board oversees the development and implementation of the Group's strategy, within the context of the wider strategy of LBG, which includes consideration of all strategic opportunities.

The Board is also responsible for the long term sustainable success of the Group, generating value for its shareholders and ensuring a positive contribution to society. The Board agrees the Group's culture, purpose, values and strategy, within that of LBG more widely, and agrees the related standards of the Group, again within the relevant standards of LBG. Further specific aims and objectives of the Board are formalised within the Corporate Governance Framework.

Strong risk management is central to the strategy of the Group, which along with a robust risk control framework acts as the foundation for the delivery of effective management of risk. The Board agrees the Group's risk appetite, within the wider risk appetite of LBG, and ensures the Group manages risk effectively, delegating related authorities to individuals through the Corporate Governance Framework and the further management hierarchy. Board level engagement, coupled with the direct involvement of senior management in risk issues ensures that escalated issues are promptly addressed and remediation plans are initiated where required. The Group's risk appetite, principles, policies, procedures, controls and reporting are managed in conjunction with those of LBG, and as such are regularly reviewed to ensure they remain fully in line with regulations, law, corporate governance and industry best practice. The Group's principle risks are discussed further on page 77.

Principle Five – Remuneration

The Remuneration Committee of LBG (the 'Remuneration Committees'), assume responsibility for the Group's approach to remuneration. This includes reviewing and making recommendations on remuneration policy as relevant to the Group, ranging from the remuneration of directors and members of the Executive to that of all other colleagues employed by the Group. This includes colleagues where the regulators require the Group to implement a specific approach to their remuneration, such as Senior Managers and other material risk takers. The activities of the Remuneration Committees extend to matters of remuneration relevant to subsidiaries of the Group, where such subsidiary does not have its own remuneration committees.

Principle Six – Stakeholders

The Group as part of LBG operates under LBG's wider Responsible Business approach, which acknowledges that the Group has a responsibility to help address the economic, social and environmental challenges which the UK faces, and as part of this understand the needs of the Group's external stakeholders, including in the development and implementation of strategy. Central to this is LBG's Helping Britain Prosper plan, in which the Group participates, which seeks to gather stakeholder views through a dedicated materiality study, as overseen by LBG's Responsible Business Committee.

In 2019, the Responsible Business Committee determined that the Group and LBG continued to demonstrate responsibility as a key priority, including keeping customers' data safe, supporting vulnerable customers, lending responsibly, supporting businesses and working with suppliers. The approach of the Board in respect of its non colleague stakeholders is described in the separate statement made in compliance with the Regulations, on page 8.

Going concern

The going concern of the Company and the Group is dependent on successfully maintaining adequate levels of capital and liquidity. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have considered a number of key dependencies which are set out in note 38 under principal risks and uncertainties: funding and liquidity in note 38(c)(5) and capital position in note 38(c)(4) and additionally have considered projections (including stress testing) for the Group's capital and funding position. Having consulted on these, the Directors conclude that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Hedging and financial risk management

Disclosures relating to hedge accounting are included within note 1 and note 20 to the accounts; disclosures relating to financial risk management are included in note 38 to the accounts and are therefore incorporated into this report by reference.

DIRECTORS' REPORT (continued)

Information incorporated by reference

The following additional information forms part of the Directors' Report, and is incorporated by reference.

Content		Section
Disclosures required under the Companies Act 2006 and the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008	Statement of other stakeholder engagement	Strategic report
Disclosures required by the Financial Conduct Authority's Disclosure and Transparency Rule 7.2.5R	Corporate Governance Statement - internal control and risk management systems	Note 38 (Risk Management)

Independent auditors

PricewaterhouseCoopers LLP are deemed to be reappointed under section 487(2) of the Companies Act 2006.

Statement of Directors' responsibilities

The Directors are responsible for preparing the Annual Report and Accounts in accordance with applicable law and regulation.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union and Company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. 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 Group and Company and of the profit or loss of the Group and Company for that period. In preparing the financial statements, the Directors are required to:

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

The Directors are also responsible for safeguarding the assets of the Group and Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group and Company's transactions and disclose with reasonable accuracy at any time the financial position of the Group and Company and enable them to ensure that the financial statements comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

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. A copy of the financial statements is placed on our website www.scottishwidows.co.uk.

Each of the Directors whose names are listed on page 3 confirms that, to the best of their knowledge:

– the Group and Company financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and financial performance of the Group and Company; and

– the Group strategic report on pages 4 to 9, and the Directors' Report on pages 10 to 13 include a fair review of the development and performance of the business and the position of the Group and Company, together with a description of the principal risks and uncertainties that it faces.

On behalf of the Board of Directors

J C S Hillman

Director

20 March 2020

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SCOTTISH WIDOWS LIMITED

Report on the audit of the financial statements

Opinion

In our opinion, Scottish Widows 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 2019 and of the Group's loss 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 and, as regards the group financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements, included within the Annual Report and Accounts (the "Annual Report"), which comprise: the Group and Company balance sheets as at 31 December 2019; the consolidated statement of comprehensive income, the Group and Company statements of cash flows, and the Group and Company statements of changes in equity for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

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

Basis for opinion

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

Independence

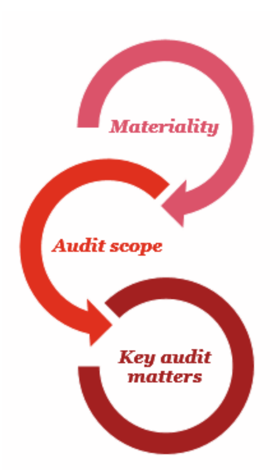
We remained independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to public interest entities, and we have fulfilled our other ethical responsibilities in accordance 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 10 to the financial statements, we have provided no non-audit services to the Group or the Company in the period from 1 January 2019 to 31 December 2019.

Our audit approach

Overview



- Overall Group materiality: £44.7 million (2018: £48.3 million), based on 1.45% of net assets (2018: 1.4% of net assets adjusted for certain one-off items).
- Overall Company materiality: £42.4 million (2018: £45.9 million), based on 1.45% of net assets (2018: 1.4% of net assets adjusted for certain one-off items), capped to reflect its allocation of materiality for the purpose of the Group audit.

- The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment, the financial significance of components and other qualitative factors (including history of misstatement through fraud or error).
- We performed audit procedures over one component we considered financially significant in the context of the Group (full scope audit) and over seven components specific audit procedures were performed on certain account balances and transactions.
- We also performed other procedures including testing entity level controls and analytical review procedures to mitigate the risk of material misstatement in the insignificant components.
- Procedures were also performed at the Group level over the Group consolidation process.

- Determination of significant actuarial assumptions for the valuation of life insurance liabilities (Group and Company).
- Valuation of conduct Provisions (Group and Company).
- Valuation of illiquid financial instruments (Group and Company).

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SCOTTISH WIDOWS LIMITED (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.

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, and we considered the extent to which non-compliance might have a material effect on the financial statements. We also considered those laws and regulations that have a direct impact on the preparation of the financial statements such as the Companies Act 2006, Financial Conduct Authority's regulations, the Prudential Regulation Authority's regulations and UK tax legislation. We evaluated management's incentives and opportunities for fraudulent manipulation of the financial statements (including the risk of override of controls), and determined that the principal risks were related to posting inappropriate journal entries to increase revenue of the Group and Company, and management bias in accounting estimates and judgmental areas of the financial statements such as the valuation of insurance contract liabilities, conduct provisions and the valuation of illiquid financial instruments. Audit procedures performed by the Group engagement team included:

- Discussions with the Insurance Board, management, internal audit, senior management involved in the Risk and Compliance functions 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;
- Evaluation and testing the operating effectiveness of management's entity level controls designed to prevent and detect irregularities;
- Reading key correspondence with, reports to and meetings 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 Insurance Board and its key sub- committees (including the Risk Oversight Committee and the Insurance Audit Committee);
- Reviewing data regarding policyholder complaints, the Group's and Company's register of litigation and claims, internal audit reports;
- Identifying and testing journal entries, in particular any journal entries posted with unusual account combinations, posted on unusual days, posted by infrequent users, posted by senior management or posted with descriptions indicating a higher level of risk;
- Challenging assumptions and judgements made by management in their accounting estimates, in particular in relation to the valuation of life insurance liabilities; conduct risk and provisions and the valuation of illiquid financial instruments (see related key audit matters below); and
- Designing audit procedures to incorporate unpredictability around the nature, timing or extent of our testing Including the testing of balances that would not normally be in the scope of our audit on the grounds of materiality.

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

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.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SCOTTISH WIDOWS LIMITED (continued)

Key audit matter	How our audit addressed the key audit matter
Determination of significant actuarial assumptions for valuation of life insurance liabilities - Group and Company *Refer to page 35 (Accounting Policies) and pages 39, 58 and 68 to 76 (Critical accounting estimates and judgments in applying accounting policies and Notes 25 and 37).* The valuations of the Group's insurance and participating investment contracts ("insurance contract liabilities") are dependent on a number of subjective and complex assumptions about future experience and events, both internal and external to the business. Small changes in each of these assumptions can result in a material impact on the financial statements. The key assumptions we have focussed on are: • **Longevity:** these assumptions reflect how long policyholders receiving annuity payments are expected to live and how that might change over time. There are two main components to the longevity assumptions: ◦ Base mortality assumption: this component is derived using past mortality experience. Judgment is required when determining the level of prudence used. ◦ Mortality improvement assumption: this component is determined using an external model issued by the Institute and Faculty of Actuaries. The Group has adopted the most recent available model and dataset (CMI 2018); however, significant judgment is required to make adjustments to the model to reflect the profile of the Group's annuitants. • **Maintenance expenses:** these assumptions reflect the expected future expenses that will be required to maintain policies existing at the balance sheet date to maturity. Judgment is required to identify all expenses which are attributable to the Group's insurance business, identify the subset of total expenses that are required to maintain the in-force insurance policies, to allocate these expenses between product types and to make adjustments where the best estimate is that these expenses will change in the future. • **Credit default:** This set of assumptions reflect the credit default risk associated with the assets held to back the portfolio of annuity liabilities. The assumptions are used to derive the valuation interest rate (VIR) which is used in the calculation of the annuity liabilities. There is a significant level of judgment applied in order to set this assumption, including the reference period from which to use observed market default rates.	We understood and tested key controls and governance around the processes for setting economic and non-economic assumptions. We found that the key controls for the setting of assumptions, including those operating over the experience analysis data relating to the significant assumptions where applicable, were designed and implemented effectively. Therefore, we were able to place reliance on these controls for the purposes of our financial statement audit. Our actuarial specialists assessed the reasonableness of the actuarial assumptions, including considering and challenging management's rationale for judgments applied and any reliance placed on industry information. Where appropriate, assumptions are benchmarked by comparing to the Group's peers in the insurance market whilst overlaying an understanding of the specific policy features of the Group's business. For longevity, we assessed the appropriateness of how the Group's own experience and industry data were used in setting future assumptions and compared resulting life expectancies to benchmarking data. We also assessed the treatment of different socio-economic groups of policyholders within the mortality improvement basis and the consideration of observed 2019 population mortality experience. We performed the following procedure over maintenance expenses: • We assessed the appropriateness of the judgments in respect of costs deemed to be non-attributable to insurance business, such as recharges to the Group from Lloyds Banking Group which were not considered to be required to maintain the insurance policies in force at the balance sheet date; • We evaluated the sufficiency of future project-related costs attributable to the Group's in-force business, such as estimates of costs of implementation of future accounting standards; • We reviewed the adjustments to expenses to reflect the impact of the Group's outsourcing agreements, increased costs due to the mandatory ring-fencing of the Group's insurance business from the wider Lloyds Banking Group; and • We assessed the allocation of costs to product types and the resulting per-policy expense assumptions. For credit default assumptions, we assessed the appropriateness of the methodology, including consideration of the allowance of prudence, the market default data and current economic conditions. Based on the evidence obtained for all of the assumptions discussed above, we found that the methodologies, modelled assumptions, data used within the models and overlays to modelled outputs to be appropriate.

Valuation of illiquid financial instruments - Group and Company

Refer to pages 28 and 32 to 33 (Accounting Policies) and pages 39, 56 to 57, 79 to 84 and 86 to 92 (Critical accounting estimates and judgments in applying accounting policies and Notes 22, 38(c) (1) and 38(c)(3)

The Group and Company continue to expand their significant portfolio of illiquid investment securities. The portfolio includes infrastructure, social housing, education and commercial real estate loans, equity release mortgages, and agricultural loans.

Models have been developed to value these financial instruments. The inputs to these models require judgement to determine the discount rates applied to the future contractual cash flows, particularly in respect of the credit risk of the borrowers. Small changes in the assumptions made by management could result in a material impact on the valuation of these portfolios.

Key data utilised by management in the valuation models used to value each of these asset types - including key loan or mortgage data, and market available indice and reference bond data - has been tested to ensure its accuracy. We used our valuations experts to review the valuation models. This included:

- an assessment of the appropriateness of the valuation methodologies;
- a review of the application of the approved valuation methodologies in the valuation models used; and
- an assessment of the reasonableness of the fair value of the assets, with reference to market information.

Our audit work in respect of the valuation of infrastructure, social housing, education, commercial real estate and agricultural loans included evaluating the assumptions over the credit risk of the borrowers used in formulating the discount rate for the future cash flows against our own expectations.

Our audit work in respect of the valuation of equity release mortgages included evaluating the assumptions over mortality and notional interest rates used in formulating the discount rate for the future cash flows against our own expectations.

We are satisfied that the models and assumptions used are reasonable for the year end reporting valuation of the complex financial instruments.

Valuation of conduct provisions - Group and Company

Refer to page 36 (Accounting Policies) and pages 39 and 59 to 60 (Critical Accounting estimates and judgements in applying accounting policies and Note 28)

Matters relating to conduct of business practices, and specifically the Group and Company's anticipated customer redress payments, operational costs and regulatory fines continue to be significant. Provisions have been made by the Group and the Company in respect of conduct matters in recent years, most materially in relation to German claims.

The measurement of the provision is highly judgmental given the uncertainty over the volume of future complaints and the cost of redress which are considered to be significant management assumptions.

There is a financial reporting risk that German claims are not appropriately disclosed in the financial statements and that the valuation of the provision is misstated.

We understood and tested the key controls and management's processes for:

- Assessing whether provisions or disclosures were necessary; and
- We also tested the calculation and review of conduct provisions including governance processes and approval of model assumptions and outputs.

We found these key controls were designed, implemented and operated effectively and therefore we determined that we could place reliance on these key controls for the purposes of our audit.

For the provision identified:

- We challenged the assumptions set by management and used within the provision and tested their application to supporting evidence.
- Where appropriate, we checked the mathematical accuracy of management's calculations.
- We compared future expectations with past experience.
- We assessed the sensitivities disclosed within the Annual Report and Accounts.
- We read correspondence with the Financial Conduct Authority and Prudential Regulation Authority.
- We assess correspondence from external lawyers and discuss with internal legal counsel as appropriate.
- We read the minutes of key governance meetings and attended meetings of the Insurance Audit Committee and Risk Oversight Committee.

We are satisfied that the models and assumptions used are appropriate for a best estimate provision for year end reporting within a reasonable range, given current evidence available at this time.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SCOTTISH WIDOWS LIMITED (continued)

How we tailored the audit scope

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

The Group consists of one main life insurance Company, Scottish Widows Limited, and a number of subsidiaries, as set out on page 48, within note 16 to the consolidated financial statements. Scottish Widows Limited is comprised of three reporting units (being UK, Isle of Man and Europe), each of which represents a separate component. The subsidiaries of Scottish Widows Limited are aggregated into a number of reporting units. Each of these reporting units is also deemed to represent a separate component.

In establishing the overall approach to the Group audit, we determined the type of work that was required to be performed over each component. All audit work was undertaken by the Group engagement team.

One component (being the UK reporting unit of Scottish Widows Limited) was considered individually financially significant in the context of the Group's consolidated financial statements. It contributed greater than 90 per cent of Group net assets and greater than 95 per cent of Group premiums net of reinsurance, and was deemed to be a full scope component.

We considered the individual financial significance of other components in relation to primary statement account balances. We also considered the presence of any significant audit risks and other qualitative factors (including history of misstatements through fraud or error). Any component which contributes a significant proportion of one or more primary statement account balances was subject to specific audit procedures over those account balances (including components which contributed a significant portion of total impact). We performed such procedures over certain account balances and transactions within seven components, in addition to the UK reporting unit of Scottish Widows Limited.

Inconsequential components (defined as components which did not represent a reasonable possibility of a risk of material misstatement either individually or in aggregate and are also financially insignificant) were eliminated from further consideration for specific audit procedures although they were subject to Group level analytical review procedures. All remaining components which were neither inconsequential nor individually financially significant were subject to procedures which mitigated the risk of material misstatement including testing of entity level controls, information technology general controls and Group and component level analytical review procedures.

Components within the scope of our audit contributed 99 per cent of Group net assets and 100 per cent of Group premiums net of reinsurance.

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 judgment, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Company financial statements
Overall materiality	£44.7 million (2018: £48.3 million).	£42.4 million (2018: £45.9 million).
How we determined it	1.45% of net assets. (2018: 1.40% adjusted for certain one-off items)	1.45% of net assets. (2018: 1.40% adjusted for certain one-off items)
Rationale for benchmark applied	We believe that net assets is the most appropriate benchmark for Company and Group materiality because it is most relevant to the interest of LBG, the shareholder, being; management of capital held under Solvency II reporting; capacity to generate internal dividends up to Lloyds Banking Group Limited; the value of funds under management; and the liquidity of the business and its ability to meet the daily requirements of its policyholders. Company materiality has been capped at £42.4 million to reflect its allocation of materiality for the purpose of the Group audit.	

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 across components was between £4.8 million and £42.4 million. 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 £2.23 million (Group audit) (2018: £2.4 million) and £2.23 million (Company audit) (2018: £2.4 million) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SCOTTISH WIDOWS LIMITED (continued)

Conclusions relating to going concern

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.

We have nothing to report in respect of the above matters.

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 Group Strategic Report and Directors' Report, 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.

Group Strategic Report and Directors' Report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Group Strategic Report and Directors' Report for the year ended 31 December 2019 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 Group Strategic Report and Directors' Report.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SCOTTISH WIDOWS LIMITED (continued)

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of Directors' responsibilities set out on page 13, 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:

a. we have not received all the information and explanations we require for our audit; or

b. 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

c. certain disclosures of directors' remuneration specified by law are not made; or

d. 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 30 April 2009 to audit the financial statements for the year ended 31 December 2009 and subsequent financial periods. The period of total uninterrupted engagement is 11 years, covering the years ended 31 December 2009 to 31 December 2019.

Sue Morling (Senior Statutory Auditor)

for and on behalf of PricewaterhouseCoopers LLP

Chartered Accountants and Statutory Auditors

Bristol

20 March 2020

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2019

	Note	2019 £m	2018 £m
		Group	*Group*
Revenue			
Gross earned premiums	3	9,320	8,794
Premiums ceded to reinsurers		(329)	(271)
Premiums net of reinsurance		8,991	8,523
Fee and commission income	4	232	242
Investment income	5	4,115	4,022
Net gain/(loss) on assets and liabilities at fair value through profit or loss	6	11,525	(8,200)
Gain on transfer of business	7	192	—
Other operating income	8	180	122
Total revenue		25,235	4,709
Expenses			
Gross claims and benefits paid		(8,703)	(8,503)
Claims recoveries from reinsurers		301	260
		(8,402)	(8,243)
Change in liabilities arising from insurance contracts and participating investment contracts	25	(12,669)	4,658
Change in liabilities arising from non-participating investment contracts		(2,681)	625
Change in assets arising from reinsurance contracts held	18	1,909	(425)
Change in unallocated surplus	26	(22)	(10)
		(13,463)	4,848
Net (profit)/loss attributable to external interests in collective investment vehicles		(1,824)	842
Operating expenses	9	(1,202)	(1,426)
Expenses for asset management services received		(190)	(220)
Finance costs	11	(85)	(89)
		(3,301)	(893)
Total expenses		(25,166)	(4,288)
Profit before tax – continuing operations		69	421
Taxation charge	12	(90)	(6)
(Loss)/profit after tax – continuing operations		(21)	415
Loss after tax – discontinuing operations	44	—	(26)
(Loss)/profit for the year		(21)	389
Other comprehensive (loss)/income			
Items that will not subsequently be reclassified to profit or loss			
Remeasurements of retirement benefit obligations, net of tax due to discontinued operations	29 (c)	—	26
		—	26
Items that may subsequently be reclassified to profit or loss			
Currency translation differences		17	(10)
		17	(10)
Other comprehensive income, net of tax		17	16
Total comprehensive (loss)/income for the year		(4)	405
Total comprehensive (loss)/income arising from continuing operations		(4)	405
Total comprehensive (loss)/income for the year		(4)	405

The notes set out on pages 25 to 109 are an integral part of these financial statements.

BALANCE SHEETS AS AT 31 DECEMBER 2019

		31 December 2019		31 December 2018	
	Note	£m	£m	£m	£m
		Group	*Company*	*Group*	*Company*
ASSETS					
Intangible assets including insurance intangible assets	13	102	65	98	62
Deferred costs	14	1,635	1,625	1,652	1,637
Current tax recoverable	15	50	41	—	—
Investment in subsidiaries	16	—	624	—	467
Investment properties	17	3,523	132	3,729	184
Assets arising from reinsurance contracts held	18	23,557	23,563	7,860	7,860
Other assets	19	120	95	91	87
Derivative financial instruments	20	3,968	3,894	3,157	3,129
Loans and receivables at amortised cost	21	997	619	2,674	2,196
Assets classified as held for sale	44	—	—	—	2,165
Investments at fair value through profit or loss	22	137,157	127,862	116,781	104,943
Cash and cash equivalents	23	276	98	174	41
Total assets		171,385	158,618	136,216	122,771
EQUITY AND LIABILITIES					
Capital and reserves attributable to the Group's equity shareholder					
Share capital	24	70	70	70	70
Share premium		1	1	1	1
Retained profits		3,013	3,085	3,317	3,628
Total equity		3,084	3,156	3,388	3,699
Liabilities					
Insurance contracts and participating investment contract liabilities	25	110,919	110,599	98,252	96,117
Unallocated surplus	26	412	412	390	390
		111,331	111,011	98,642	96,507
Future profits on non-participating business in the With Profits Funds	27	(49)	(49)	(28)	(28)
Current tax liabilities	15	—	—	86	74
Deferred tax liabilities	15	266	265	210	209
Provisions for other liabilities and charges	28	141	80	259	211
Accruals and deferred income	30	35	24	37	21
Subordinated debt	31	1,795	1,820	1,769	1,799
Non-participating investment contract liabilities	32	37,456	37,455	13,855	13,825
Derivative financial instruments	20	3,445	3,434	2,719	2,681
Other financial liabilities	33	1,889	1,422	2,331	1,608
External interests in collective investment vehicles		11,966	—	12,944	—
Borrowings	34	3	—	4	—
Lease Liabilities	40	23	—	—	—
Liabilities directly associated with assets classified as held for sale	44	—	—	—	2,165
Total liabilities		168,301	155,462	132,828	119,072
Total equity and liabilities		171,385	158,618	136,216	122,771

The notes set out on pages 25 to 109 are an integral part of these financial statements.

The financial statements on pages 21 to 22 were approved by the Board on 20 March 2020.

J C S Hillman, Director

STATEMENTS OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2019

		2019		2018	
	Note	£m	£m	£m	£m
		Group	*Company*	*Group*	*Company*
Cash flows from operating activities					
Net Profit/(loss) before tax[1]		69	(219)	391	498
Adjusted for:					
Amortisation of intangible assets	13	16	13	9	7
Finance costs	11	85	82	89	88
Dividends received		—	(7)	—	(74)
Gain on transfer of business		—	(157)	—	(81)
Acquisition of Zurich savings business	44	(9)	(9)	—	—
Net decrease/(increase) in operating assets and liabilities	35	491	819	(220)	469
Impact of transition to IFRS 9		—	—	(5)	(2)
Remeasurements of retirement benefit obligations	29	—	—	31	—
Repayment of subordinated debt		53	53	—	—
Currency translation differences		17	(15)	(10)	(10)
Taxation paid		(170)	(68)	(240)	(156)
Net cash flows generated from operating activities		552	492	45	739
Cash flows from investing activities					
Addition of intangible assets	13	(20)	(16)	(38)	—
Acquisition of Zurich savings business	44	9	9	—	—
Cash held in disposed subsidiary	44	—	—	(99)	—
Proceeds from disposal of subsidiary	44	—	—	95	95
Investment in subsidiary	16	—	—	—	(75)
Dividends received		—	7	—	74
Net cash flows (used in)/generated from investing activities		(11)	—	(42)	94
Cash flows from financing activities					
Dividends paid	36	(300)	(300)	(1,765)	(1,765)
Repayment of subordinated debt	31	(53)	(53)	—	—
Finance costs paid	11	(85)	(82)	(89)	(88)
Net cash flows used in financing activities		(438)	(435)	(1,854)	(1,853)
Net increase/(decrease) in cash and cash equivalents		103	57	(1,851)	(1,020)
Cash and cash equivalents at the beginning of the year		170	41	2,021	1,061
Net cash and cash equivalents at the end of the year	23	273	98	170	41

[1] Group profit before tax comprises £69m in respect of continuing operations and a Group loss before tax of nil in respect of discontinued operations (2018: Group profit before tax of £421m in respect of continuing operations and a loss before tax of £30m in respect of discontinued operations).

The notes set out on pages 25 to 109 are an integral part of these financial statements.

Discontinued operations

The impact of the Group's discontinued operations on the above cash flow statement is as follows:

	2019	2018
	£m	£m
	Group	*Group*
Net cash flows used in investing activities	—	(99)
Net decrease cash and cash equivalents	—	(99)

The net cash flows used in investing activities at the end of the prior year represents cash held in the disposed subsidiary at 2017 year end.

STATEMENTS OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2019

Group

	Note	Share capital £m	Share premium £m	Retained profits £m	Total equity £m
Balance as at 1 January 2018		70	1	4,677	4,748
Profit for the year		—	—	389	389
Other comprehensive income					
Remeasurement of retirement benefit obligations/assets, net of tax due to discontinued operations		—	—	26	26
Currency translation		—	—	(10)	(10)
Total comprehensive income for the year		—	—	405	405
Dividend		—	—	(1,765)	(1,765)
Balance as at 31 December 2018		70	1	3,317	3,388
Loss for the year		—	—	(21)	(21)
Other comprehensive loss					
Currency translation		—	—	17	17
Total comprehensive loss for the year		—	—	(4)	(4)
Dividend		—	—	(300)	(300)
Balance as at 31 December 2019		70	1	3,013	3,084

Company

	Note	Share capital £m	Share premium £m	Retained profits £m	Total equity £m
Balance as at 1 January 2018		70	1	4,835	4,906
Total comprehensive income for the year		—	—	569	569
Currency translation differences		—	—	(11)	(11)
Dividend		—	—	(1,765)	(1,765)
Balance as at 31 December 2018		70	1	3,628	3,699
Total comprehensive loss for the year		—	—	(229)	(229)
Currency translation differences		—	—	(14)	(14)
Dividend		—	—	(300)	(300)
Balance as at 31 December 2019		70	1	3,085	3,156

Not all of the above amounts can be distributed to the equity holder since the Company is required to meet regulatory capital requirements. Further details are given in note 38.

The notes set out on pages 25 to 109 are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies

The accounting policies adopted in the preparation of the financial statements, which have been consistently applied to all periods presented in these financial statements unless stated otherwise, are set out below.

(a) Basis of preparation

The financial statements of the Group and Company have been prepared:

(1) in accordance with the International Accounting Standards ("IASs") and IFRSs issued by the International Accounting Standards Board and the Standards and Interpretations ("SICs") and International Financial Reporting Interpretations issued by its IFRS Interpretations Committee ("IFRS IC"), as endorsed by the European Union;

(2) in accordance with those parts of the Companies Act 2006 applicable to companies reporting under IFRSs;

(3) in respect of the Group's and Company's With Profits Funds liabilities, which are measured using an assessment that uses the pre-Solvency II traditional regulatory assessment, grandfathered under IFRS 4 "Insurance Contracts"; and

(4) under the historical cost convention, as modified by the revaluation of investment properties and certain financial assets and financial liabilities at fair value through profit or loss, as set out in the relevant accounting policies.

The Directors are satisfied that the Group and Company have adequate resources to continue in business for the foreseeable future. Accordingly, the financial statements of the Group and Company have been prepared on a going concern basis.

In accordance with IAS 1 "Presentation of Financial Statements", assets and liabilities in the balance sheet are presented in accordance with management's estimated order of liquidity. Analysis of the assets and liabilities of the Group and Company into amounts expected to be received or settled within 12 months after the reporting date (current) and more than 12 months after the reporting date (non-current) is presented in the notes.

The Group has taken advantage of the provisions of section 408 of the Companies Act 2006 and has not disclosed a statement of comprehensive income and related notes in respect of the Company.

Standards and interpretations effective in 2019

The Group has adopted IFRS 16 'Leases' as at 1 January 2019. In accordance with the transitional provisions in IFRS 16(C7), the Group elected to apply the standard retrospectively with the cumulative effect of initial application being recognised at that date; comparative figures have not been restated. The adoption of IFRS 16 has not had a significant impact on the overall financial position of the Group. Further details are set out in note 40.

In applying IFRS 16 for the first time, the Group has used a practical expedient permitted by the standard with the use of a single discount rate for a portfolio of leases with reasonably similar characteristics. The Group has also elected not to apply IFRS 16 to contracts that were not identified as containing a lease under IAS 17 'Leases' and IFRIC 4 'Determining whether an Arrangement contains a Lease'.

Lease liabilities amounting to £16m in respect of ground rent commitments on investment properties previously accounted for as operating leases were recognised at 1 January 2019. These liabilities were measured at the present value of the remaining lease payments, discounted using the Group's incremental borrowing rate for these type of assets as at that date. The weighted-average borrowing rate applied to these lease liabilities was 5.69 per cent. The corresponding right-of-use asset of £16m was measured at an amount equal to the lease liabilities. The right-of-use asset and lease liabilities are included within investment properties and lease liabilities respectively. There was no impact on shareholders' equity.

The Group has adopted IFRIC 23 'Uncertainty over income tax' as at 1 January 2019. Adoption has had no significant impact on the financial position of the Group.

Details of standards and interpretations in issue but which have not been adopted early are set out at note 42.

(b) Basis of consolidation

The assets, liabilities and results of Group undertakings (including structured entities) are included on the basis of financial statements made up to the reporting date. Group undertakings include all entities controlled by the Group. The Group controls an entity when it has power over the entity, is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through the exercise of power. This generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of substantive rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity and the Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to any of these elements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(b) Basis of consolidation (continued)

Collective investment vehicles and limited partnerships ("investment vehicles") where the Group has control, in part through its long term funds, are consolidated. Control arises where the Group has substantive rights to remove the external decision maker of the investment vehicle, and has a significant exposure to variable returns from the beneficial interest it holds in the investment vehicle. Where a subsidiary or related party of the Group acts as the decision maker of an investment vehicle the Group considers a number of factors in determining whether it acts as principal and therefore controls the investment vehicle including: an assessment of the scope of the Group's decision making authority over the investment vehicle; the rights held by other parties including substantive removal rights without cause over the Group acting as decision maker; the remuneration to which the Group is entitled in its capacity as decision maker; and the Group's exposure to variable returns from the beneficial interest it holds in the investment vehicle.

Consolidation can be appropriate in circumstances where the Group has less than a majority beneficial interest. Where a collective investment vehicle is consolidated the interest of parties other than the Group are reported within liabilities as external interests in collective investment vehicles. Where a limited partnership is consolidated the non-controlling interest is reported in equity. Group undertakings are fully consolidated from the date on which the ability to exercise control is transferred to the Group and cease to be consolidated from the date on which the ability to exercise control ceases.

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Changes in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the Group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary is derecognised and any investment retained in the former subsidiary is remeasured to its fair value; the gain or loss that is recognised in profit or loss on the partial disposal of the subsidiary includes the gain or loss on the remeasurement of the retained interest.

Intragroup transactions, balances and gains and losses on transactions between Group companies have been eliminated.

All the financial statements included are uniformly prepared in conformity with IFRSs and the Group's accounting policies and have adopted consistent accounting policies as at 31 December 2019 and 31 December 2018.

(c) Product classification

The Group issues contracts that transfer insurance risk or financial risk or both.

Insurance contracts

Insurance contracts are those contracts which transfer significant insurance risk. Such contracts may also transfer financial risk. As a general guideline, the Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. Once a contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly over time.

Investment contracts

Any long term contracts not considered to be insurance contracts under IFRSs because they do not transfer significant insurance risk are classified as investment contracts. Such contracts are further analysed between those with and without a discretionary participation feature ("DPF"). Contracts containing a DPF are referred to as participating investment contracts and those without a DPF as non-participating investment contracts.

A DPF is a contractual right that gives investors the right to receive, as a supplement to guaranteed benefits, additional discretionary benefits or bonuses that are likely to be a significant portion of the total contractual benefits, through participation in the surplus arising from the assets held in the fund. The Group has the discretion within the constraints of the terms and conditions of the contract to allocate part of this surplus to the policyholders and part to the Group's shareholder. Participating investment contracts are accounted for in the same manner as insurance contracts in accordance with the requirements of IFRS 4 "Insurance Contracts".

Non-participating investment contracts are contracts that neither transfer significant insurance risk nor contain a DPF.

Hybrid contracts

For certain investment contracts, the contract can be partly invested in units which contain a DPF and partly in units without. Where switching levels for similar contracts are deemed to be significant, new investment contracts which contain an option to switch into investment contracts with DPF have been classified as participating investment contracts. Where the switching levels are not deemed to be significant, a new contract is split, with units containing a DPF being allocated as a participating investment contract and the units without a DPF as a non-participating investment contract. Investment contracts which were in force when IFRS was implemented in 2005 were classified according to the switching levels observed at the time and retain their original classification. For certain investment contracts, the contract can be partly invested in units which contain a DPF and partly without. Where the contract is split, part is allocated as a non-participating investment contract and part as a participating investment contract.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(c) Product classification (continued)

Financial assets and financial liabilities

Management determines the classification of its financial assets and financial liabilities at initial recognition. Management's policies for the recognition of specific financial assets and financial liabilities, as identified on the balance sheet, are set out under the relevant accounting policies.

On initial recognition, financial assets are classified as measured at amortised cost or fair value through profit or loss, depending on the Group's business model for managing the financial assets and whether the cash flows represent solely payments of principal and interest. The Group assesses its business models at a portfolio level based on its objectives for the relevant portfolio, how the performance of the portfolio is managed and reported, and the frequency of asset sales. Financial assets with embedded derivatives are considered in their entirety when considering their cash flow characteristics. The Group reclassifies financial assets when and only when its business model for managing those assets changes. A reclassification will only take place when the change is significant to the Group's operations and will occur at a portfolio level and not for individual instruments; reclassifications are expected to be rare.

The Group initially recognises loans, debt securities and subordinated liabilities when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either: substantially all of the risks and rewards of ownership have been transferred; or the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when the obligation is discharged, cancelled or expires.

Derivative assets (other than a derivative which is a designated and effective hedging instrument) are classified as held for trading. With the exception of derivative liabilities, no liabilities are classified as held for trading.

Transaction costs incidental to the acquisition of a financial asset are expensed through the statement of comprehensive income, within net gains and losses on assets and liabilities at fair value through profit or loss.

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet only when there is a legally enforceable right to offset the recognised amounts, both in the normal course of business and in the event of default, and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously.

(d) Fair value methodology

All assets and liabilities carried at fair value, or for which a fair value measurement is disclosed, are categorised into a "fair value hierarchy" as follows:

(i) Level 1

Valued using quoted prices in active markets for identical assets and liabilities to those being valued. An active market is one in which similar arm's length transactions in the instrument occur with both sufficient frequency and volume to provide pricing information on an ongoing basis. Examples include listed equities, listed debt securities, Open Ended Investment Companies ("OEICs") and unit trusts traded in active markets and exchange traded derivatives such as futures.

(ii) Level 2

Valued using inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices). If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

- Quoted prices for similar (but not identical) instruments in active markets;
- Quoted prices for identical or similar instruments in markets that are not active, where prices are not current, or price quotations vary substantially either over time or among market makers;
- Inputs other than quoted prices that are observable for the instrument (for example, interest rates and yield curves observable at commonly quoted intervals and default rates); and
- Inputs that are derived principally from, or corroborated by, observable market data by correlation or other means.

Examples of these are securities measured using discounted cash flow models based on market observable swap yields such as Over the Counter interest rate swaps, listed debt and restricted equity securities.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(d) Fair value methodology (continued)

(iii) Level 3

Valuations are based on mathematical models, market prices/data (where available) and subjective assumptions, including unobservable inputs. Unobservable inputs may have been used to measure fair value where observable inputs are not available. This approach allows for situations in which there is little, if any, market activity for the asset or liability at the measurement date (or market information for the inputs to any valuation models). Unobservable inputs reflect the assumptions the Group considers that market participants would use in pricing the asset or liability, for example private equity investments held by the Group and Company. 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.

Examples of Level 3 assets include portfolio of illiquid loans and advances to customers, investments in private debt funds, private equity shares and complex derivatives.

Further analysis of the Group's and Company's instruments held at fair value is set out at note 38. The Group's management, through a Fair Value Pricing Committee, review information on the fair value of the Group's financial assets and the sensitivities to these values on a regular basis.

Transfers between different levels of the fair value hierarchy are deemed to have occurred at the next reporting date after the change in circumstances that caused the transfer.

(e) Revenue recognition

Premiums

Premiums received in respect of life insurance contracts and participating investment contracts are recognised as revenue when they become payable by the policyholder and are shown before deduction of commission. Premiums ceded to reinsurers are recognised when the related gross premiums are recognised. Gross and ceded premiums are recorded through the relevant lines in the statement of comprehensive income.

Fee and commission income

The Group receives ongoing investment management fees which are recognised as revenue as the investment management services are provided on a daily basis throughout the life of the investment.

The Group also receives initial investment management fees in the form of an adjustment, or charge, to the amount invested. These fees are in respect of services rendered in conjunction with the issue and management of investment contracts where the Group actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the contract. These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Group defers these fees and recognises them on a straight-line basis over the estimated lives of the contracts unless there is evidence to support an alternative recognition basis. Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned. The income is recognised through the statement of comprehensive income, within fee and commission income. The liability is recognised in the balance sheet within accruals and deferred income until recognition criteria are met.

Investment income

Interest income for all interest-bearing financial instruments is recognised in the statement of comprehensive income as it accrues, within investment income.

Dividends receivable in respect of listed shares and collective investment vehicles are recognised on the date that these are quoted ex-dividend; other dividend income is recognised when the right to receive the dividend is established. All dividends received are recognised through the statement of comprehensive income, within investment income.

Rental income in respect of investment properties is recognised on a straight line basis over the term of the lease. The costs of incentives are recognised as a reduction of total income over the term of the lease on a straight line basis.

Net gains and losses on assets and liabilities at fair value through profit or loss

Net gains and losses on assets and liabilities at fair value through profit or loss includes both realised and unrealised gains and losses. Movements are recognised in the statement of comprehensive income in the period in which they arise.

Other operating income

Within other operating income are rebates of annual management charges from external fund managers. Rebates are recognised when they are earned, as performance obligations are satisfied.

(f) Accruals and deferred income

For non-participating investment contracts, the recognition of income is governed by IFRS 15. Income received for services to be provided in future periods is deferred and recognised in the statement of comprehensive income as the performance obligation is met. Estimation is required of the period that the business is expected to remain in force and prudent assumptions are required for contracts which do not have a fixed maturity date. Further information on this liability is given in note 30.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(g) Expense recognition

Claims

Claims are recorded as an expense on the earlier of the maturity date or the date on which the claim is notified. Claims recoveries from reinsurers are recognised when the related claims are recognised. Claims and claims recoveries are recognised through the relevant lines in the statement of comprehensive income. Claims handling costs and interest on late claims are also included in claims.

Operating expenses

Commission paid in respect of the business written by the Group is recognised through the statement of comprehensive income, within operating expenses. Where certain criteria are met, commission and other acquisition costs may be deferred. The circumstances under which such costs are deferred are set out at policy (j).

Other operating expenses are recognised in the statement of comprehensive income as incurred, within operating expenses.

Expenses for asset management services received

Expenses for asset management services received are recognised in the statement of comprehensive income as they accrue, within expenses for asset management services received.

Finance costs

Interest expense for all interest-bearing financial instruments is recognised in the statement of comprehensive income as it accrues, within finance costs.

(h) Leases

Assets leased to third parties, including properties leased to tenants, are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee, otherwise they are classified as operating leases. Operating lease rental income and expenditure are recognised on a straight-line basis over the life of the leases through the statement of comprehensive income, within investment income and operating expenses respectively. Properties leased out to tenants under operating leases are included in investment properties in the balance sheet.

The Group has ground rent commitments on its investment properties, these commitments are accounted for as leases. The lease payments are discounted using the Group’s incremental borrowing rate and the Group recognises the lease liabilities and a corresponding right-of-use asset in the balance sheet. The right-of-use asset is classified as investment property and is subsequently measured at fair value. Lease payments are allocated between the liability and finance cost. The finance cost is charged to profit or loss over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

(i) Intangible assets including insurance intangible assets

(i) Acquired value of in-force business

Insurance and investment contracts acquired in business combinations (other than business combinations of entities under common control) are initially measured at fair value at the time of acquisition and subsequently held at amortised cost. The initial fair value includes the recognition of an acquired value of in-force (“acquired VIF”) asset which reflects the present value of future cash flows expected from the business acquired. The asset is shown gross of attributable tax and a corresponding deferred tax liability has been established.

Amortisation of the acquired VIF balance and related tax is carried out on a best estimate basis over the estimated life of the contracts. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the acquired VIF balance is tested for impairment at each reporting date or when there is an earlier indication of impairment (further information on the Group’s impairment policy is set out at policy (s)). Such an asset is not recognised in respect of future profits on contracts written in the normal course of business.

(ii) Software development costs

Costs that are directly associated with the acquisition of software licences and the production of identifiable and unique software products controlled by the Group, and that is expected to generate economic benefits exceeding costs beyond one year, are recognised as intangible assets, subject to de minimis limits. Direct costs include the software development team’s employee costs and an appropriate portion of relevant overheads. All other costs associated with developing or maintaining computer software programmes are recognised through the statement of comprehensive income as an expense as incurred, within operating expenses.

Computer software development costs recognised as assets are valued at cost and amortised using the straight-line method over their expected useful lives, not exceeding a period of seven years. Subsequent expenditure is only capitalised when it increases the expected future economic benefits of the specific asset to which it relates. The amortisation charge for the year in respect of software licences and software development costs is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the assets is tested for impairment at each reporting date. Further information on the Group’s impairment policy is set out at policy (s).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(i) Intangible assets including insurance intangible assets

(iii) Goodwill

Goodwill arises on business combinations and represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the statement of comprehensive income.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the statement of comprehensive income and is not subsequently reversed. Further information on the Group's impairment policy is set out at policy (s). At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal.

(j) Deferred costs

(i) Deferred acquisition costs

The costs of acquiring new insurance contracts and participating investment contracts (excluding those assessed on a realistic basis - see note 37(1)(a)), which are incurred during a financial period but which relate to subsequent financial periods, are deferred to the extent that they are recoverable out of future revenue margins. The deferred acquisition cost asset is amortised over the lifetime of the related contracts on a straight line basis or based on the pattern of margins arising from these contracts unless there is evidence to support an alternative recognition basis. Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned.

The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the asset is tested for impairment at each reporting date. Deferred acquisition costs are reviewed by category of business at the end of each reporting period and are written-off where they are no longer considered to be recoverable.

(ii) Deferred origination costs

Costs which are directly attributable and incremental to securing new non-participating investment contracts are capitalised. This asset is subsequently amortised over the estimated contractual lifetime of each policy on a straight-line basis unless there is evidence to support an alternative recognition basis. Where an alternative recognition basis is applied, this is calculated by reference to experience information in respect of the period over which income from contracts is earned. The amortisation charge for the year is recognised through the statement of comprehensive income, within operating expenses. The carrying value of the asset is tested for impairment at each reporting date. Further information on the Group's impairment policy is set out at policy (s).

(k) Investment in subsidiaries

The Company owns a number of subsidiaries as set out in note 16. Certain subsidiaries do not form part of actively managed investment portfolios and the risks and rewards of owning those subsidiaries primarily rest with the shareholder of the Company, including such investments where ownership of the subsidiary is split between the Company's long-term fund and its shareholder fund. These subsidiaries are held initially at cost, being the fair value of the consideration given to acquire the holding, then subsequently at cost subject to impairment. Further information on the Group's impairment policy is set out at policy (s).

Certain subsidiaries, including holdings in collective investment vehicles, are held primarily as vehicles through which specific investments are held as part of the actively managed investment portfolios which are considered to be part of a business model that is managed and whose performance is evaluated on a fair value basis. Accordingly, such subsidiaries are carried at fair value and presented within investments at fair value through profit or loss in the Company (see policy q). Changes in their fair value are reflected in the statement of comprehensive income, within net gains and losses on assets and liabilities at fair value through profit or loss.

(l) Tangible fixed assets

All property (other than investment property) and equipment is stated at cost less accumulated depreciation and any impairment in value. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for its intended use. Subsequent costs are included in an asset's carrying value only when it is probable that future economic benefits related to the asset will flow to the Group and such costs can be measured reliably.

Depreciation of tangible fixed assets is calculated on a straight-line basis to allocate the difference between the cost and the estimated residual value over the estimated useful lives of these assets. The depreciation charge is recognised through the statement of comprehensive income, within operating expenses.

The periods generally applicable are:

- Buildings 40 years

Land is considered to have an indefinite useful life and is therefore not depreciated.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(l) Tangible fixed assets (continued)

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each reporting date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than the recoverable amount, it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

(m) Investment properties

Investment properties comprise freehold and long leasehold land and buildings, which are held either to earn rental income or for capital appreciation, or both, are initially measured at cost, being the fair value of the consideration given, including directly attributable transaction costs. Subsequently, on a periodic basis and at each reporting date, such properties are carried at fair value, being the open market value, as assessed by qualified external appraisers who have recent experience in the relevant location and the category of properties being valued. If this information is not available, alternative valuation methods such as discounted cash flow analysis or recent prices are used. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value.

Gains or losses arising from changes in the fair values of investment properties are recognised in the statement of comprehensive income in the period in which they arise, within net gains and losses on assets and liabilities at fair value through profit or loss.

Service charge income and expense are disclosed separately within the investment income and operating expense notes.

(n) Assets arising from reinsurance contracts held

The Group cedes reinsurance in the normal course of business. Where the reinsurance contract transfers significant insurance risk to the reinsurer, the assets arising from reinsurance contracts held are classified as insurance contracts. Where the reinsurance contract does not transfer significant insurance risk to the reinsurer, the assets arising from reinsurance contracts held are classified as a financial asset designated as fair value through profit or loss.

Assets arising from reinsurance contracts held – classified as insurance contracts

These assets are recognised within assets arising from reinsurance contracts held. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the underlying contracts and in accordance with the terms of each reinsurance contract. These balances are subject to an annual impairment review. Further information on the Group's impairment policy is set out at policy (s).

Changes in these assets are recognised on the face of the statement of comprehensive income, through change in assets arising from reinsurance contracts held.

Premiums ceded and claims reimbursed are recognised when corresponding insurance premium assumed and claims incurred. These items are disclosed separately on the face of the statement of comprehensive income.

Assets arising from reinsurance contracts held – at fair value through profit or loss

Amounts due from reinsurers in respect of contracts that do not transfer significant insurance risk to the reinsurer are measured as fair value through profit or loss as they are within a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis. These contracts, whilst legally reinsurance contracts, do not meet the definition of a reinsurance contract under IFRSs. Where this is the case, the amounts recoverable have been recognised as a financial asset within assets arising from reinsurance contracts held. Changes in these assets are recognised on the face of the statement of comprehensive income, through change in assets arising from reinsurance contracts held.

(o) Derivative financial instruments

Classification

Derivative financial instruments, including embedded derivatives, are held for trading, with the exception of derivatives which are designated as effective hedging instruments, which are held at fair value through profit or loss. Derivatives held for trading are used for the purposes of efficient portfolio management or to match contractual liabilities.

Recognition

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently re-measured at their fair value.

Measurement

Fair values are obtained from quoted market prices or, if these are not available, by using valuation techniques such as discounted cash flow models or other pricing models. Derivatives are carried as assets when the fair values are positive and as liabilities when the fair values are negative.

Changes in the fair value of derivatives are recognised in the statement of comprehensive income, through net gains and losses on assets and liabilities at fair value through profit or loss.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(o) Derivative financial instruments (continued)

Hedge accounting

In limited circumstances, derivatives are designated as fair value hedges. Hedge accounting allows one instrument, generally a derivative such as a swap, to be designated as a hedge of another instrument such as a loan.

Derivatives may only be designated as hedging instruments provided certain strict criteria are met. At the inception of a hedge, its terms must be clearly documented and there must be an expectation that the derivative will be highly effective in offsetting changes in the fair value of the hedged risk. The hedge documentation must also specify the methodology that will be used to measure effectiveness. Changes in the fair value of derivatives that are designated as fair value hedges are recorded in the statement of comprehensive income, through net gains and losses on assets and liabilities at fair value through profit or loss, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

The effectiveness of the hedging relationship must be tested throughout its life. A hedge is regarded as highly effective if the change in fair value of the hedge instrument and the hedge item are negatively correlated within a range of 80% to 125%, either for the period since effectiveness was last tested or for the period since inception. Where the hedge is highly effective, the net impact on the statement of comprehensive income is minimised. If, at a reporting date, it is concluded that the hedge is no longer highly effective in achieving its objective, the hedge relationship is terminated. Should this happen, changes in the fair value of the hedged item are no longer recognised in the statement of comprehensive income and the adjustment that has been made to the carrying amount of the hedged item is amortised to the statement of comprehensive income over the period to maturity of the hedged item.

Changes in the fair value of derivatives that qualify as a net investment hedge on foreign operations are taken to other comprehensive income when the hedge is deemed to be effective. The ineffective portion of any net investment hedge is recognised in the statement of comprehensive income immediately. The fair values of derivative instruments used for hedging purposes are disclosed in note 20.

All derivatives are presented as assets when their fair value is positive and as liabilities when their fair value is negative.

(p) Loans and receivables at amortised cost

Loans and receivables at amortised cost are financial assets, other than cash and cash equivalents that are held to collect contractual cash flows where those cash flows represent solely payments of principal and interest, a basic lending arrangement results in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Where the contractual cash flows introduce exposure to risks or volatility unrelated to a basic lending arrangement such as changes in equity prices or commodity prices, the payments do not comprise solely principal and interest.

Loans and receivables at amortised cost are initially recognised at fair value less directly attributable transaction costs and subsequently measured at amortised cost, subject to impairment. Further information on the Group’s impairment policy is set out at policy (s).

(q) Investments at fair value through profit or loss

Investments at fair value through profit or loss comprise debt, equity securities and loans and advances to banks.

Classification

Financial assets are classified at fair value through profit or loss where they are within a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis or they do not meet the criteria to be measured at amortised cost. All derivatives and equity instruments are carried at fair value through profit or loss.

Financial liabilities are measured at fair value through profit or loss where they are designated at fair value through profit or loss in order to reduce accounting mismatch or the liabilities are part of a group of liabilities (or assets and liabilities) which is managed, and its performance evaluated, on a fair value basis; or where the liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

Recognition

Purchases and sales of financial assets are recognised on the trade date, i.e. the date the Group commits to purchase the asset from, or deliver the asset to, the counterparty. Investments are initially recognised at cost, being the fair value of the consideration given, and are subsequently remeasured at fair value.

Measurement

The fair values of investments are based on current bid prices. If the market for a financial asset is not active, and also for unlisted securities, the Group establishes fair value by using valuation techniques. These include the use of similar arm’s length transactions and reference to other instruments that are substantially the same, making maximum use of market inputs and relying as little as possible on entity-specific inputs. Refer to note 1(d) Fair value methodology and note 38(c) Financial risk management for details of valuation techniques and significant inputs to valuation models.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(q) Investments at fair value through profit or loss (continued)

Measurement (continued)

In order to ensure that a fair value is recognised for unquoted or illiquid debt securities, the primary price source is an external broker valuation.

Deposits with cedants represents funds withheld under the terms of the reinsurance agreement between the Company and the subsidiary undertaking Scottish Widows Europe S.A. ("SWE"). Under that agreement the amount payable as premiums includes the investment incomes and gains earned by SWE on the funds withheld assets. The amount is remeasured to reflect the fair value of the underlying funds withheld assets.

Structured entities

The Group invests in structured entities arising from investments in investment properties held through limited partnerships. The unconsolidated limited partnerships are initially recognised at cost, being the fair value of the consideration given. After initial recognition, such assets are accounted for and measured at fair value, which equates to the relevant proportion of the published net asset value of the company. This valuation is based on open market valuations of the properties held by the limited partnership, as provided at the reporting date by independent valuers.

The Group holds investments in structured entities arising from investments in collective investment vehicles, carried at fair value. Some of these structured entities are consolidated, as set out at policy (b). Unconsolidated collective investment vehicles are carried at fair value.

(r) Cash and cash equivalents

Cash and cash equivalents includes cash at bank, short-term highly liquid investments with original maturities of three months or less (excluding such investments as otherwise meet this definition but which are held for investment purposes rather than for the purposes of meeting short-term cash commitments) and bank overdrafts where a legal right of set off exists.

Cash and cash equivalents that are held to collect contractual cash flows where those cash flows represent solely payments of principal and interest are measured at amortised cost. A basic lending arrangement results in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Cash and cash equivalents that are within a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis or do not meet the criteria to be measured at amortised cost are classified and measured as investments at fair value through profit or loss, as set out in policy (q).

(s) Impairment

Financial assets

The impairment charge in the statement of comprehensive income includes the change in expected credit losses for financial assets held at amortised cost and certain lease receivables. Expected credit losses are calculated by using an appropriate probability of default and applying this to the estimated exposure of the Group at the point of default after taking into account the value of any collateral held or other mitigants of loss.

At initial recognition, allowance is made for expected credit losses resulting from default events that are possible within the next 12 months (12-month expected credit losses). In the event of a significant increase in credit risk, allowance is made for expected credit losses resulting from all possible default events over the expected life of the financial instrument (lifetime expected credit losses). Financial assets where 12-month expected credit losses are recognised are considered to be Stage 1; financial assets which are considered to have experienced a significant increase in credit risk are in Stage 2; and financial assets which have defaulted or are otherwise considered to be credit impaired are allocated to Stage 3.

An assessment of whether credit risk has increased significantly since initial recognition considers the change in the risk of default occurring over the remaining expected life of the financial instrument. The assessment is unbiased, probability-weighted and uses forward-looking information consistent with that used in the measurement of expected credit losses. In determining whether there has been a significant increase in credit risk, the Group uses quantitative tests based on relative and absolute probability of default (PD) movements linked to internal credit ratings and other indicators of historic delinquency. However, unless identified at an earlier stage, the credit risk of financial assets is deemed to have increased significantly when more than 30 days past due. Where the credit risk subsequently improves such that it no longer represents a significant increase in credit risk since initial recognition, the asset is transferred back to Stage 1.

For financial instruments that are considered to have low credit risk, the credit risk is assumed to not have increased significantly since initial recognition. Financial instruments are considered to have low credit risk when the borrower is considered to have a low risk of default from a market perspective. Typically financial instruments with an external credit rating of investment grade are considered to have low credit risk.

Assets are transferred to Stage 3 when they have defaulted or are otherwise considered to be credit impaired. IFRS 9 contains a rebuttable presumption that default occurs no later than when a payment is 90 days past due. The Group uses this 90 day backstop.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(s) Impairment (continued)

Financial assets (continued)

The loss allowance for lease receivables and trade receivables without a significant financing component is measured at an amount equal to lifetime expected credit losses, in accordance with the simplified approach in IFRS 9.

A loan or receivable is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the statement of comprehensive income.

Non-financial assets

Assets that have an indefinite useful life, for example land, are not subject to depreciation or amortisation and are tested annually for impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its estimated recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows.

If there is objective evidence that an impairment loss has occurred, the amount of the loss is charged to the relevant line in the statement of comprehensive income in the period in which it occurs. Non-financial assets that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date.

(t) Taxes

Tax expense comprises current and deferred tax. Current and deferred tax are charged or credited in the income statement except to the extent that the tax arises from a transaction or event which is recognised, in the same or a different period, outside the income statement (either in other comprehensive income, directly in equity, or through a business combination), in which case the tax appears in the same statement as the transaction that gave rise to it.

Current tax

Current tax is the amount of corporate income taxes expected to be payable or recoverable based on the profit for the period as adjusted for items that are not taxable or not deductible, and is calculated using tax rates and laws that were enacted or substantively enacted at the balance sheet date.

Current tax includes amounts provided in respect of uncertain tax positions when management expects that, upon examination of the uncertainty by Her Majesty's Revenue and Customs (HMRC) or other relevant tax authority, it is more likely than not that an economic outflow will occur. Provisions reflect management's best estimate of the ultimate liability based on their interpretation of tax law, precedent and guidance, informed by external tax advice as necessary. Changes in facts and circumstances underlying these provisions are reassessed at each balance sheet date, and the provisions are re-measured as required to reflect current information.

Deferred tax

Deferred tax is recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the balance sheet. Deferred tax is calculated using tax rates and laws that have been enacted or substantively enacted at the balance sheet date, and which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax liabilities are generally recognised for all taxable temporary differences but not recognised for taxable temporary differences arising on investments in subsidiaries where the reversal of the temporary difference can be controlled and it is probable that the difference will not reverse in the foreseeable future. Deferred tax liabilities are not recognised on temporary differences that arise from goodwill which is not deductible for tax purposes.

Deferred tax assets are recognised to the extent it is probable that taxable profits will be available against which the deductible temporary differences can be utilised, and are reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are not recognised in respect of temporary differences that arise on initial recognition of assets and liabilities acquired other than in a business combination. Deferred tax is not discounted.

Allocation of tax charge between shareholder and policyholders

The tax expense in the statement of comprehensive income is analysed between policyholder and shareholder tax. This allocation is based on the definition of policyholders' share and shareholders' share of taxable profit under current UK tax rules.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(u) Share capital

Shares are classified as equity when there is no obligation to transfer cash or other assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

Dividends payable

Dividends payable on ordinary shares are recognised in equity in the period in which they are approved.

(v) Insurance contracts and participating investment contracts

The Group issues life insurance contracts to protect customers from the consequences of events (such as death, critical illness or disability) that would affect the ability of the customer or their dependants to maintain their current level of income and also issues pension and annuity contracts. Guaranteed claims paid on occurrence of the specified insured event are either fixed or linked to the extent of the economic loss suffered by the policyholder.

Insurance contracts or participating investment contracts in the Group's With Profits Funds

Liabilities of the Group's With Profits Funds, including guarantees and options embedded within products written by the funds, are accounted for under the realistic method in accordance with a pre-Solvency II traditional regulatory assessment, grandfathered under IFRS 4 "Insurance Contracts". Projected transfers out of the funds into other funds of the Group are not treated as insurance liabilities, but are recorded in unallocated surplus. Changes in the value of these liabilities are recognised in the statement of comprehensive income, through change in liabilities in insurance contracts and participating investment contract liabilities.

Liabilities for non-participating insurance contracts in the Group's With Profits Funds are measured using an assessment that uses the pre Solvency II traditional regulatory assessment. In addition, the realistic value of future profits on those contracts is recognised as an offset to the corresponding liabilities in the balance sheet, as future profits on non-participating business in the With Profits Funds. The movement in this balance is recognised in the statement of comprehensive income, through change in liabilities arising from insurance contracts and participating investment contracts.

Insurance contracts which are neither unit-linked nor in the Group's With Profits Funds

The liability is calculated by estimating the future cash flows over the duration of in-force policies and discounting them back to the valuation date, allowing for probabilities of occurrence. The liability will vary with movements in interest rates and with the cost of life assurance and annuity benefits where future mortality is uncertain. Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs. Changes in the value of these liabilities are recognised in the statement of comprehensive income, through change arising from insurance contracts and participating investment contract liabilities.

Insurance contracts which are unit-linked

Allocated premiums in respect of unit-linked contracts that are either insurance contracts or participating investment contracts are recognised as liabilities. These liabilities are increased or reduced by the change in the unit prices and are reduced by policy administration fees, mortality and surrender charges and any withdrawals. Non-unit reserves are also established for expected future expenses not covered by future margins, inadequacy of benefit charges to cover benefit claims, and inadequacy of guarantee charges to cover guarantees. Income consists of fees deducted for mortality, policy administration and surrender charges. Interest or changes in the unit prices credited to the account balances incurred in the period are charged as expenses in the statement of comprehensive income, through changes in liabilities arising from insurance contracts and participating investment contracts. Benefit claims in excess of the account balances incurred in the period are charged as expenses in the statement of comprehensive income, through gross claims and benefits paid.

Unallocated surplus

Any amounts in the With Profits Funds not yet determined as being due to policyholders or the equity holder and projected transfers out of the funds to other funds of the Group are recognised as an unallocated surplus which is shown separately from the other insurance liabilities.

Bonuses

Bonuses in a given year comprise:

- Unit price increases and new reversionary bonuses declared in respect of that year which are provided within the calculation of liabilities arising from insurance and participating investment contracts; and
- Terminal and interim bonuses paid out to policyholders on maturity and included within gross claims and benefits paid.

Equity Release Mortgages

The equity release mortgages held within a special purpose vehicle provide a no-negative equity guarantee which meets the definition of an insurance contract. The guarantee is embedded in the mortgage and included within the mortgage valuation; it is accounted for in accordance with IFRS 4 "Insurance Contracts" and is not unbundled or disclosed separately. The equity release mortgages are classified within a business model in line with policy (c) and held at fair value through profit or loss.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(w) Retirement benefit obligations

SWSL assumes the role of principal employer for the Scottish Widows Retirement Benefit Scheme ("SWRBS") pension scheme within LBG. SWSL was disposed of on 1 May 2018. Until the disposal, individuals employed by the Group may have been members of the SWRBS or of other pension schemes administered by LBG. All schemes are funded through payments to trustee-administered funds, determined, in the case of the defined benefit arrangements, by periodic actuarial calculations.

The Group contributed to both defined benefit and defined contribution elements of the pension schemes in question until the disposal of SWSL. A defined benefit plan is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and pensionable salary. A defined contribution plan is a pension plan under which the Group pays fixed contributions; there is no legal or constructive obligation to provide a specific benefit outcome.

Scottish Widows Retirement Benefit Scheme

A full actuarial valuation of this defined benefit scheme is carried out at least every three years with interim reviews in the intervening years; the valuation is updated to 31 December each year by a qualified actuary. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method by an independent, qualified actuary appointed by LBG.

The amount recognised in the balance sheet in respect of the defined benefit element of the pension scheme is the present value of the defined benefit obligation at the reporting date less the fair value of plan assets. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates equivalent to the market yields at the reporting date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid and that have terms to maturity that are approximate to the terms of the related pension asset/liability.

A surplus is only recognised to the extent that it is recoverable through a right to make reduced contributions in the future or to receive a refund from the scheme. The Group recognises any change in the effect of the surplus that can be recognised in other comprehensive income within remeasurements of the retirement benefit asset.

The Group recognises in profit or loss the current service cost of providing pension benefits and the net interest on the net defined benefit obligation. The current service cost is recognised within operating expenses.

The net interest on the net defined benefit obligation is recognised within finance costs, and is determined by applying the discount rate used to measure the net defined benefit obligation at the beginning of the period to the net defined benefit obligation at that date, taking account of changes in the net defined benefit obligation during the period as a result of contributions and benefit payments.

Past service costs are changes in the defined benefit obligation arising from plan amendments or curtailments and are recognised immediately in profit or loss, within operating expenses, when the plan amendment or curtailment occurs. The Group recognises the gain or loss on a settlement of the defined benefit obligation immediately in profit or loss when the settlement occurs.

The Group recognises in other comprehensive income, within remeasurements of the retirement benefit obligations, actuarial gains and losses arising from experience adjustments and changes in the actuarial assumptions, and the return on plan assets excluding the net interest on the net defined benefit obligation that is recognised in profit or loss.

Defined contribution schemes

Contributions made by the Group to defined contribution arrangements, including Your Tomorrow, are recognised in the statement of comprehensive income as an employee benefit expense when they are due, within operating expenses.

(x) Provisions for other liabilities and charges

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, when it is probable that the obligation will result in an outflow of resources to settle the obligation and when a reliable estimate of the amount of the obligation can be made. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessment of the time value of money and, where appropriate, the risks specific to the liability.

The Group recognises a provision for onerous contracts when the expected benefits to be derived from contracts are less than the unavoidable costs of meeting the obligations under the contracts.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless the likelihood of possible obligations arising is remote.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(y) Subordinated debt

Subordinated debt comprises dated and undated loan capital. They are recognised initially at fair value, being the issue proceeds net of transaction costs incurred. Subordinated debt is subsequently stated at amortised cost: any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the statement of comprehensive income through finance costs over the period of the liabilities using the effective interest rate applicable to the instrument. Both dated and undated subordinated debt is adjusted for hedged interest rate risk. Changes in the resulting value of this subordinated debt is accounted for as set out at policy (q). Interest payable is recognised in the statement of comprehensive income, through finance costs.

The subordinated guaranteed bonds are classified as a liability on the basis of the existence of a capital disqualification event considered to be a genuine settlement provision in the context of current uncertainty surrounding the direction of future regulatory rule developments.

(z) Non-participating investment contracts

The Group's non-participating investment contracts are primarily unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the reporting date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable. Investment income allocated to non-participating investment contracts is presented within investment income, with corresponding movements being included in change in non-participating investment contract liabilities.

Deposits and withdrawals are not accounted for through the statement of comprehensive income but are accounted for directly in the balance sheet as adjustments to the liability arising from non-participating investment contracts.

Fee and commission income in relation to non-participating unit linked investment business is presented within the statement of comprehensive income within fee and commission income.

(aa) Liability adequacy test

At each reporting date, liability adequacy tests are performed to ensure the adequacy of the insurance contracts and participating investment contract liabilities net of related deferred costs and acquired VIF. In performing these tests, current best estimates of future contractual cash flows, claims handling and policy administration expenses, as well as investment income from assets backing such liabilities, are used. Any deficiency is immediately charged to the statement of comprehensive income, initially by writing off the relevant assets and subsequently by establishing a provision for losses arising from the liability adequacy tests.

(ab) Other financial liabilities

Other financial liabilities are initially recognised at fair value less directly attributable transaction costs and subsequently measured at amortised cost. In practice, the carrying value of these balances equates to the fair value due to the short-term nature of the amounts included within other financial liabilities.

(ac) External interests in collective investment vehicles

External interests in collective investment vehicles which are accounted for by the Group as investments in subsidiaries as set out at policy (k) above are initially recognised, and subsequently measured at amortised cost. Due to the nature of these balances, the carrying value equates to the fair value. The fair value of holdings in these funds is determined at the valuation point applicable to the collective investment vehicles at the reporting date as set out under policy (q) above. Changes in the value of this balance are recognised in the statement of comprehensive income, through net profit attributable to external interests in collective investment vehicles.

(ad) Borrowings

Borrowings are recognised initially at fair value, being the issue proceeds net of transaction costs incurred. In practice, due to the nature of these balances, being bank overdrafts, the carrying value equates to the fair value of these liabilities as the borrowings are repayable on demand.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

1. Accounting policies (continued)

(ae) Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The consolidated financial statements are presented in pounds sterling, (rounded to the nearest million ("£m")), which is the company's presentation and functional currency.

Monetary items denominated in foreign currencies are translated into sterling at the exchange rates ruling at the reporting date. Non-monetary items denominated in foreign currencies that are measured at fair value are translated at the exchange rates ruling at the date when the current fair value is determined. Non-monetary items denominated in foreign currencies that are measured at historical cost are translated at the exchange rates ruling at the date of the transaction. Revenue transactions and those relating to the acquisition and realisation of investments have been translated at rates of exchange ruling at the time of the respective transactions. Any exchange differences are dealt with in that part of the statement of comprehensive income in which the underlying transaction is reported.

The results and financial position of the Group's foreign operations that have a functional currency different from the presentational currency are translated into sterling at foreign exchange rates ruling at the balance sheet date.

The income and expenses of foreign operations are translated into sterling at average exchange rates, unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions. Foreign exchange differences arising on the translation of foreign operations are recognised in other comprehensive income.

(af) Collateral

The Group receives or pledges collateral in the form of cash or securities in respect of derivative transactions it undertakes. The Group also receives collateral in the form of securities in respect of stock lending agreements, repurchase agreements, certain loans made to related parties and bulk annuity contracts. Collateral received is recognised as an asset on the balance sheet when the risks and rewards of ownership are substantially transferred to the Group. A corresponding liability for repayment of collateral is recognised in financial liabilities. Collateral received that is not recognised on the balance sheet is legally segregated from the assets of the Group. Collateral pledged continues to be recognised as an asset on the balance sheet unless the risks and rewards have been substantially transferred to the counterparty.

(ag) Discontinued operations

Non-current assets are classified as held for sale if the Group and Company will recover the carrying amount principally through a sale transaction rather than through continuing use and a sale is considered highly probable. Non-current assets classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. Assets and liabilities classified as held for sale are shown separately on the face of the balance sheet.

A discontinued operation is a cash generating unit or a group of cash generating units that has been disposed of or is classified as held for sale, and (a) represents a separate major line of business or geographical area of operations, (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or (c) is a subsidiary acquired exclusively with a view to resale. The results after tax of discontinued operations are shown as a single line item on the face of the statement of comprehensive income. See note 44 for further detail.

In order to fairly reflect the results and financial position of the Group and Company continuing operations and its discontinued operations, transactions that the continuing operations have with the discontinued operations are reported on the relevant line in the Group and Company statement of comprehensive income or balance sheet, with the matching transaction similarly reported in the discontinued operations statement of comprehensive income or balance sheet within the disposal entity. All such transactions fully eliminate within the Group and Company statutory consolidation and there is no net impact on profit before tax or equity.

2. Critical accounting judgments and estimates

The Group's management makes estimates and judgments that affect the reported amount of assets and liabilities. Estimates and judgments are continually evaluated and based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

Critical accounting estimates

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

2. Critical accounting judgments and estimates (continued)

(a) Insurance contracts and participating investment contract liabilities

The estimation of the ultimate liability arising from insurance contracts and participating investment contracts which are not unit-linked is the Group's most critical accounting estimate.

The liabilities of the Group's With Profits Funds are calculated using stochastic simulation models which value liabilities on a basis consistent with tradable market option contracts (a "market-consistent" basis). The liabilities are sensitive to both investment market conditions and changes to a number of non-economic assumptions, such as the level of take-up of options inherent in the contracts, mortality rates and lapses prior to dates at which a guarantee would apply.

For insurance contracts outside the With Profits Funds, the liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses, credit default and mortality. Discount rates used to value the liabilities for annuity business are set with reference to the risk adjusted yields on the underlying assets and for non-annuity business with reference to cash yields. The most critical non-economic assumptions are mortality rates in respect of annuity business written and levels of future expenses.

Such assumptions are based on recent actual experience, supplemented by industry information where appropriate. No critical accounting estimates apply for participating investment contracts as the contract liabilities arising outside of the With Profits Funds are almost entirely current unit values.

At each reporting date, the estimates and assumptions referred to above are reassessed for adequacy and changes will be reflected in adjustments to the liability, through the statement of comprehensive income. Further information on these assumptions is given in note 37.

(b) Deferred costs

For insurance contracts and participating investment contracts (excluding those assessed on a realistic basis - see note 37(1)(a)) acquisition costs which are incurred during a financial period but which relate to subsequent financial periods are deferred to the extent that they are recoverable out of future revenue margins. All other costs are recognised as expenses when incurred. The calculation of the deferred acquisition cost asset and its pattern of amortisation requires estimation of both the expected pattern of receipt of future revenue margins and the period that the business is expected to remain in force. Further information on this asset is given in note 14.

The recognition of costs and income in respect of non-participating investment contracts is governed by IFRS 15 "Revenue from Contracts with Customers". Under this standard, directly attributable and incremental costs to securing new business are capitalised and are then subsequently amortised over the period of the provision of the investment management services. Estimation is required of the period that the business is expected to remain in force and prudent assumptions are required for contracts which do not have a fixed maturity date.

(c) Fair value of financial instruments

In accordance with IFRS 7, the Group categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as Level 1 are valued using quoted market prices and therefore there is minimal judgment applied in determining fair value. However, the fair value of financial instruments categorised as Level 2 and, in particular, Level 3 is determined using valuation techniques. These valuation techniques involve management judgment and estimates, the extent of which depends on the complexity of the instrument and the availability of market observable information. Further details of these valuations are described in note 38.

(d) Provisions for other liabilities and charges

The Group continues to receive claims in Germany from customers relating to policies issued by the Company, under its former name of Clerical Medical Investment Group Limited but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s.

The German industry-wide issue regarding notification of contractual 'cooling off' periods has continued to lead to a similar number of claims in 2019 as 2018. The total provision made to 31 December 2019 is £656m (2018: £639m); utilisation has increased to £28m in the year ended 31 December 2019 (2018: £26m); the remaining unutilised provision as at 31 December 2019 is £101m (2018: £112m).

The validity of the claims facing the Group depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will only be known once all relevant claims have been resolved.

The Directors believe this provision represents an appropriate estimate of the financial impact based upon a series of assumptions, including the number of claims received from the respective populations of different classes of policies, the proportion upheld, and resulting legal and administration costs. Further information in relation to the provision is set out in note 28.

Critical judgments

The Directors also use judgment in the process of applying the Group's accounting policies. The following judgments have the most significant effect on the amounts recognised in the consolidated financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

2. Critical accounting judgments and estimates (continued)

(e) Taxation

Estimation of income taxes includes the assessment of recoverability of deferred tax assets. Deferred tax assets are only recognised to the extent they are considered more likely than not to be recoverable based on existing tax laws and forecasts of future taxable profits against which the underlying tax deductions can be utilised

With regard to the Group's and Company's deferred tax assets, a significant feature is the management judgment applied in determining the timing, sensitivities and probability of them crystallising. This judgment is based on tax forecasts reflecting new business assumptions, sensitivities and proposed management actions. Further information in relation to the Group's and Company's deferred tax assets is set out in notes 12 and 15.

3. Segmental analysis

In the opinion of the Directors, the Group operates in a single business segment, being the provision of long-term insurance and investment contracts, and therefore the following specific disclosure requirements under IFRS 8 "Operating Segments" are required. The table below provides a summary of the gross premiums written within the single business segment:

Group	**2019**	**2018**
	£m	**£m**
Regular premiums	4,596	3,369
Single premiums	4,724	5,425
Total	9,320	8,794

Further, a summary of the gross premiums written by the segment's main product types is shown below:

Group	**2019**	**2018**
	£m	**£m**
Bulk Annuities	2,042	1,753
Corporate pensions	4,645	4,165
Individual pensions	424	410
Retirement income	486	455
Protection	476	400
Investments	180	205
Retirement account	1,067	1,406
Total	9,320	8,794

Of the above gross written premiums, £83m (2018: £102m) relates to the European business with the remaining written in the UK.

4. Fee and commission income

Group	**2019**	**2018**
	£m	**£m**
Fund management and policy administration fees	223	235
Change in deferred income	9	7
Total	232	242

5. Investment income

Group	**2019**	**2018**
	£m	**£m**
Net income on investments at fair value through profit or loss	3,859	3,757
Interest income on LBG Group loans	38	36
Rental income on investment properties	191	197
Service charge income	14	14
Other	13	18
Total	4,115	4,022

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

6. Net gain/(loss) on assets and liabilities at fair value through profit or loss

Group	2019 £m	2018 £m
Derivative financial instruments at fair value through profit or loss	(79)	88
Investments at fair value through profit or loss	11,801	(8,480)
Investment properties at fair value through profit or loss	(109)	123
Fair value hedge adjustment in respect of swap	(73)	33
Foreign exchange	(15)	36
Total	11,525	(8,200)

7. Gain on transfer of business

During the year, SWUTM transferred the management of £12bn of wealth related assets to a related undertaking, SPWACD. Consideration of £192m was recognised as a gain on the transfer of this business.

Group	2019 £m	2018 £m
Consideration received	192	—
Total	192	—

8. Other operating income

Group	2019 £m	2018 £m
External rebates	95	97
Other	85	25
Total	180	122

9. Operating expenses

Group	2019 £m	2018 £m
Acquisition and origination costs in respect of insurance and investment contracts	114	141
Expenses for administration	953	784
	1,067	925
Fees and commissions payable	26	32
Change in deferred costs	17	4
Service charge expense	16	14
Pension risk premium	—	284
Amortisation of acquired VIF	13	7
Other	63	160
Total	1,202	1,426

In 2018, the Pension risk premium of £284m was incurred to transfer the Group's obligations in respect of the SWRBS to Lloyds Bank plc, a related party. This transaction is related to the disposal of subsidiary entities, see note 29.

All staff costs are reported within SWSL that was shown within assets classified as held for sale as a discontinued operation until disposal in 2018.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

9. Operating expenses (continued)

The following staff and other employee related costs were reported within SWSL as operating expenses prior to its disposal.

	2019	2018
	£m	£m
Wages and salaries	—	37
Share based payments	—	9
Social security costs	—	6
Other pension costs – defined contribution plan	—	5
Service costs – defined benefit plan	—	4
Total	—	61

During the year ended 31 December 2018 the Group received charges from SWSL relating to share-based payment schemes, all of which are equity settled. SWSL was disposed on the 1 May 2018.

The monthly average number of employees directly employed by the Group until the disposal on the 1 May 2018 of SWSL was as follows:

	2019	2018
UK	—	2,411
Total	—	2,411

10. Auditors' remuneration

Group	2019	2018
	£000	£000
Fees payable to the Group's auditors for the audit of the Company's annual financial statements and the consolidation	2,880	2,813
Fees payable to the Group's auditor and its associates for other services:		
Audit of subsidiaries	1,092	911
Audit-related assurance services	916	1,002
Non Audit Services	160	78
Total fees payable	5,048	4,804

11. Finance costs

Group	2019	2018
	£m	£m
Interest on swaps	(21)	(14)
Interest on subordinated debt	96	96
Other	10	7
Total	85	89

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

12. Taxation charge

(a) Current year tax charge

Group	2019 £m	2018 £m
Current tax:		
UK corporation tax	36	155
Overseas Tax	1	1
Adjustment in respect of prior years	(3)	(4)
Total current tax	34	152
Deferred tax:		
Reversal of temporary differences	56	(142)
Change in tax rate	(2)	(1)
Adjustment in respect of prior years	2	(3)
Total deferred tax	56	(146)
Total income tax charge	90	6

The policyholder tax benefit or expense is included in the income tax charge. Policyholder tax is a charge of £189m (2018: credit of £(22)m), including a prior year tax charge of nil (2018: charge of nil)

(b) Reconciliation of tax charge

Group	2019 £m	2018 £m
Profit before tax	69	421
Tax at 19% (2018: 19%)	13	80
Effects of:		
Non-taxable income	(51)	(61)
Policyholder tax	153	(17)
Adjustment in respect of prior years	(2)	(7)
Disallowable expenses	13	12
Change in tax rate	(2)	(1)
Non-taxable gain on transfer	(36)	—
Other	2	—
Total	90	6

(c) Tax recognised in other comprehensive income / (expense)

Group	2019			2018		
	Before tax £m	Tax expense £m	After tax £m	Before tax £m	Tax expense £m	After tax £m
Remeasurements of retirement benefit obligations / assets due to discontinued operations	—	—	—	31	(5)	26
Total	—	—	—	31	(5)	26

Further analysis of the remeasurements of retirement benefit obligations / assets in the above table is set out in note 29.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

13. Intangible assets including insurance intangible assets

	2019		2018	
	£m	£m	£m	£m
	Group	Company	Group	Company
Acquired VIF	61	55	68	62
Goodwill	15	10	5	—
Software development costs	26	—	25	—
Total	102	65	98	62

The recoverable amount of the goodwill relating to the Workplace Savings business has been based on a value-in-use calculation. The calculation uses pre-tax projections of future cash flows based upon budgets and plans approved by management covering a three-year period, the related run-off of existing business in force and a discount rate of 8 per cent. The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. New business cash flows beyond the three-year period have been extrapolated using a steady 2 per cent growth rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of goodwill to fall below its balance sheet carrying value.

Group	2019				2018			
	Acquired VIF	Goodwill	Software development costs	Total	Acquired VIF	Goodwill	Software development costs	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Cost								
At 1 January	657	5	27	689	651	—	—	651
Additions	6	10	4	20	6	5	27	38
At 31 December	663	15	31	709	657	5	27	689
Accumulated amortisation and impairment								
At 1 January	(589)	—	(2)	(591)	(582)	—	—	(582)
Amortisation during the year	(13)	—	(3)	(16)	(7)	—	(2)	(9)
At 31 December	(602)	—	(5)	(607)	(589)	—	(2)	(591)
Carrying amount								
At 31 December	61	15	26	102	68	5	25	98

The additions to intangible assets in 2019 arose from the Zurich Part VII Transfer Scheme. The additions to intangible assets in 2018 arose from the acquisition of the savings business of Zurich Insurance Group by SWAS during the year.

Company	2019			2018	
	Acquired VIF	Goodwill	Total	Acquired VIF	Total
	£m	£m	£m	£m	£m
Cost					
At 1 January	651	—	651	651	651
Additions	6	10	16	—	—
At 31 December	657	10	667	651	651
Accumulated amortisation and impairment					
At 1 January	(589)	—	(589)	(582)	(582)
Amortisation during the year	(13)	—	(13)	(7)	(7)
At 31 December	(602)	—	(602)	(589)	(589)
Carrying amount					
At 31 December	55	10	65	62	62

The addition to intangible assets in 2019 arose from the Zurich Part VII Transfer Scheme.

Of the above total for acquired VIF, £44m (2018: £50m) is expected to be recovered more than one year after the reporting date. The remaining amortisation period is 8 years (2018: 9 years).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

14. Deferred costs

		2019		2018	
		£m	£m	£m	£m
		Group	*Company*	*Group*	*Company*
Deferred acquisition costs	(a)	1,531	1,531	1,515	1,515
Deferred origination costs	(b)	104	94	137	122
Total		1,635	1,625	1,652	1,637

(a) Deferred acquisition costs

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	1,515	1,515	1,485	1,485
Amounts incurred during the year	186	186	170	170
Amortisation during the year	(160)	(160)	(84)	(84)
Write down of deferred costs	(10)	(10)	(56)	(56)
At 31 December	1,531	1,531	1,515	1,515

Of the above total, £1,389m for Group and Company (2018: £1,367m for Group and Company) is expected to be recovered more than one year after the reporting date.

(b) Deferred origination costs

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	137	122	171	152
Amounts incurred during the year	2	—	2	—
Amortisation during the year	(35)	(28)	(36)	(30)
At 31 December	104	94	137	122

Of the above total, £91m for Group and £83m for Company (2018: £97m for Group and £85m for Company) is expected to be recovered more than one year after the reporting date.

15. Tax assets and liabilities

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Current tax assets	50	41	—	—
Total tax assets	50	41	—	—
Current tax liabilities	—	—	86	74
Deferred tax liabilities	266	265	210	209
Total tax liabilities	266	265	296	283

The Group has made claims to recover historic UK taxes paid on overseas dividends. These claims may result in recovery of a material amount of taxes previously paid by the Company and the OEICs it consolidates, though the benefit of these claims remains uncertain pending ongoing litigation and other uncertainties. HMRC issued a briefing note in January 2020 on their intended approach to settling some of these claims. The tax assets recognised in these accounts reflect the Group's view of the impact of this guidance.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

15. Tax assets and liabilities (continued)

(a) Recognised deferred tax

Deferred tax assets and liabilities have been offset in the balance sheet where there is a legally enforceable right of offset. The tables below split the individual deferred tax assets and liabilities by type, before such netting.

The amounts are as follows:

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Deferred tax assets comprise:				
Expenses deductible in future periods	120	120	107	107
Accelerated capital allowances	—	—	2	2
Total deferred tax assets	120	120	109	109
Deferred tax liabilities comprise:				
Unrealised gains on investment assets	142	142	9	9
Deferred acquisition costs	125	125	147	147
Transitional adjustments on introduction of new life tax regime	110	110	151	151
Deferred tax on acquired VIF	9	8	12	11
Total deferred tax liabilities	386	385	319	318
Net deferred tax liabilities	266	265	210	209

Deferred tax assets for trading losses, expenses deductible in future periods and accelerated capital losses are recognised on the basis of future profit projections, which show sufficient future taxable profits to utilise these assets. Of the deferred tax assets included in the above table, nil for Group and Company (2018: nil for Group and Company) is expected to be realised within one year of the reporting date.

Of the deferred tax liabilities included in the above table, £63m for Group and Company (2018: £68m for Group and Company) is expected to be settled within one year of the reporting date.

Of the deferred tax assets and liabilities balances shown in the above table, £70m for Group and Company (2018: £110m for Group and Company), relating to 'transitional adjustments on introduction of new life tax regime' are expected to be settled more than one year after the reporting date.

As a result of legislation introduced in 2016, the UK corporation tax rate was due to reduce from 19% to 17% with effect from 1 April 2020. The impact of this reduction in tax rate, which is applicable to the calculation of deferred tax assets and liabilities at the reporting date, is reflected in the above table.

Within the March 2020 budget, the UK government stated its intention to maintain the corporation tax rate at 19 per cent on 1 April 2020. Had this rate change been substantively enacted at 31 December 2019, the effect would have been to increase the net deferred tax liability by £25m.

The tax charge/(credit) in the statement of comprehensive income relating to each item is as follows:

	2019	2018
	£m	£m
	Group	*Group*
Trading losses	—	22
Expenses deductible in future periods	(13)	9
Accelerated capital allowances	2	(1)
Unrealised gains/losses on investment assets	133	(107)
Deferred acquisition costs	(22)	(26)
Transitional adjustments on introduction of new life tax regime	(41)	(42)
Deferred tax on acquired VIF	(2)	(1)
Other	(1)	—
Total deferred tax charge/(credit)	56	(146)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

15. Tax assets and liabilities (continued)

(b) Unrecognised deferred tax

Deferred tax assets are recognised for tax loss carry forwards only to the extent that realisation of the related tax benefit is probable. The deferred tax assets not recognised are not subject to any expiry date.

Deferred tax assets have not been recognised in respect of excess expenses carried forward of £44m (2018: £241m) as there is insufficient certainty as to the availability of future profits.

16. Investment in subsidiaries

Company	2019 £m	2018 £m
At 1 January	467	392
Disposal of subsidiary	—	(1)
Acquisition of subsidiary	—	1
Investment in subsidiary	157	75
At 31 December	624	467

As part of the transfer process described in note 44, SWE issued £5m (€6m) of ordinary share capital to the Company. Further share premium of £152m (€175m) was issued during the year following the transfer process.

During the prior year, the Company disposed of the subsidiaries, SWSL and Scottish Widows Pensions Trustees Limited ("SWPTL") (see note 44).

On 26 February 2018, Scottish Widows Administration Services Limited ("SWAS") issued £75m of ordinary share capital to the Company.

On 3 April 2018, the Company acquired 100% of the share capital of Zurich Group Pensions Services Limited ("ZGPS"). ZGPS was later renamed to Scottish Widows Auto Enrolment Services Limited on the 13 April 2018.

On 24 October 2018, the Company acquired 100% of the share capital of Scottish Widows Europe SA ("SWE").

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

16. Investment in subsidiaries (continued)

All entities detailed below are wholly-owned, directly or indirectly, and transact insurance or reinsurance business, investment management activities or services in connection therewith, unless otherwise stated. Following are particulars of the Company's subsidiaries and associates:

Celsius European Lux 2 SARL	(3)	SCI Equinoxe	(12)
Clerical Medical Managed Funds Limited*	(20)	SCI Rambeateau CFF	(12)
Clerical Medical Non Sterling Property Company SARL	(3)	Scottish Widows Administration Services Limited	(13)
Clerical Medical Non Sterling Guadalix Holdco BV	(4)	Scottish Widows Administration Services (Nominees) Limited	(14)
Clerical Medical Non Sterling Guadalix Spanish Propco SL	(5)	Scottish Widows Auto Enrolment Services Limited	(13)
Clerical Medical Non Sterling Megapark Holdco BV	(4)	Scottish Widows Europe SA	(19)
Clerical Medical Non Sterling Megapark Propco SA	(5)	Scottish Widows Fund and Life Assurance Society	(14)
CM Venture Investments Limited	(6)	Scottish Widows Industrial Properties Europe BV	(15)
Dalkeith Corporation LLC	(7)	Scottish Widows Property Management Limited	(14)
Delancey Arnold UK Limited (50%)*	(8)	Scottish Widows Trustees Limited	(14)
Delancey Rolls UK Limited (50%)*	(8)	Scottish Widows Unit Trust Managers Limited	(17)
France Industrial Premises Holding	(9)	St Andrew's Life Assurance plc	(2)
General Reversionary and Investment Company (80%)	(2)	Saint Michel Holding Company No 1	(9)
The Great Wigmore Partnership (G.P.) Limited (50%)	(10)	Saint Michel Investment Property	(9)
The Great Wigmore Partnership (50%)	(10)	Saint Witz II Holding Company No 1	(9)
Great Wigmore Property Limited (50%)	(10)	Saint Witz II Investment Property	(9)
Halifax Life Limited	(11)	SWAMF (GP) Limited*	(1)
Oystercatcher Residential Limited*	(1)	SWAMF Nominee (1) Limited*	(1)
Rolls Development UK Limited (50%)*	(8)	SWAMF Nominee (2) Limited*	(1)
SARL Coliseum	(12)	SW No 1 Limited	(16)
SARL HIRAM	(12)	Thistle Investments (AMC) Limited	(18)
SAS Compagnie Fonciere de France	(12)	Thistle Investments (ERM) Limited	(18)
SCI Astoria Invest	(12)	Waverley Fund II Investor LLC	(7)
SCI de l'Horloge	(12)	Waverley Fund III Investor LLC	(7)

* In liquidation

The investments in subsidiaries included above are generally recoverable more than one year after the reporting date.

The ability of regulated entities to pay cash dividends to the Company or repay loans or advances is restricted by regulatory solvency requirements as well as Companies Act distributable reserves requirements. The ability of non-regulated entities to pay cash dividends to the Company or repay loans or advances is restricted by Companies Act distributable reserves requirements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

16. Investment in subsidiaries (continued)

Registered office addresses

(1) Ernst & Young 1 More London Place, London, SE1 2AF
(2) 33 Old Broad Street, London, EC2N 1HZ
(3) Citco REIF Services, 20 Rue de Poste, L-2346, Luxembourg
(4) Naritaweg 165, 1043 BW, Amsterdam, Netherlands
(5) Calle Pinar 7, 50Izquierda, 28006, Madrid, Spain
(6) RL360 House, Cooil Road, Douglas, Isle of Man, IM2 2SP
(7) Corporation Service Company, Suite 400, 2711 Centre Road, Wilmington, DE 19805, United States
(8) 4th Floor 4 Victoria Street, St. Albans, Hertfordshire, AL1 3TF
(9) SAB Formalities, 23 Rue de Roule, Paris, 75001, France
(10) 33 Cavendish Square, London, WIG 0PW
(11) Trinity Road, Halifax, West Yorkshire, HX1 2RG
(12) 8 Avenue Hoche, 75008, Paris, France
(13) 25 Gresham Street, London, EC2V 7HN
(14) 15 Dalkeith Road, Edinburgh, EH16 5BU
(15) Weena 340, 3012 NJ, Rotterdam, Netherlands
(16) Port Hamilton, 69 Morrison Street, Edinburgh, EH3 8YF
(17) Charlton Place, Andover, Hampshire, SP10 1RE
(18) 35 Great St. Helen's, London, EC3A 6AP
(19) 1, Avenue du Bois, L-1251, Luxembourg
(20) 1 More London Place, London, SE1 2AF

Collective investment vehicles and limited partnerships ("investment vehicles") where the Group has control, in part through its long term funds, are consolidated as set out in policy 1(b).

The table overleaf lists collective investment vehicles and limited partnerships which are considered to be related undertakings due to the Group holding of 20% or more.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

16. Investment in subsidiaries (continued)

Name Of Umbrella And Undertaking	% Held
HBOS International Investment Funds ICVC (i)	
North American Fund	95.07%
Far Eastern Fund	80.58%
European Fund	93.90%
International Growth Fund	52.53%
Japanese Fund	94.96%
HBOS Specialised Investment Funds ICVC (i)	
Cautious Managed Fund	51.84%
Ethical Fund	82.68%
Fund Of Investment Trusts	39.48%
Smaller Companies Fund	66.04%
Special Situations Fund	50.96%
HBOS UK Investment Funds ICVC (i)	
UK Equity Income Fund	61.07%
UK Growth Fund	62.31%
UK FTSE All-Share Index Tracking Fund	57.16%
HBOS Actively Managed Portfolio Funds ICVC (i)	
Diversified Return Fund	93.77%
Absolute Return Fund	93.37%
Dynamic Return Fund	96.64%
HBOS Property Investment Funds ICVC (i)	
UK Property Fund	47.63%
Scottish Widows Tracker And Specialist Investment Funds ICVC (ii)	
UK All Share Tracker Fund	91.93%
International Bond Fund	72.45%
UK Tracker Fund	45.90%
UK Fixed Interest Tracker Fund	95.79%
Emerging Markets Fund	88.50%
UK Index-Linked Tracker Fund	47.57%
UK Smaller Companies Fund	21.67%
Scottish Widows UK And Income Investment Funds ICVC (ii)	
UK Corporate Bond Fund	62.48%
UK Growth Fund	61.93%
Gilt Fund	97.01%
High Income Bond Fund	28.11%
Strategic Income Fund	65.02%
Environmental Investor Fund	71.83%
Ethical Fund	77.53%
Scottish Widows Overseas Growth Investment Funds ICVC (ii)	
Global Growth Fund	54.55%
European Growth Fund	89.20%
American Growth Fund	84.15%
Pacific Growth Fund	75.71%
Japan Growth Fund	94.07%
Scottish Widows Managed Investment Funds ICVC (ii)	
International Equity Tracker Fund	73.85%

Name Of Umbrella And Undertaking	% Held
Balanced Portfolio Fund	82.53%
Progressive Portfolio Fund	72.33%
Cautious Portfolio Fund	59.91%
Cash Fund	98.74%
Opportunities Portfolio Fund	91.89%
Scottish Widows Investment Solutions Funds ICVC (ii)	
European (Ex UK) Equity Fund	96.01%
Asia Pacific (Ex Japan) Equity Fund	98.68%
Japan Equities Fund	87.22%
US Equities Fund	100.00%
Fundamental Index UK Equity Fund	87.64%
Fundamental Index Global Equity Fund	95.87%
Fundamental Index Emerging Markets Equity Fund	94.93%
Fundamental Low Volatility Index Global Equity	98.15%
Fundamental Low Volatility Index Emerging Markets Equity	96.01%
Fundamental Low Volatility Index UK Equity	92.77%
Scottish Widows Income And Growth Funds ICVC (ii)	
Balanced Growth Fund	27.34%
UK Index Linked Gilt Fund	100.00%
Corporate Bond PPF Fund	100.00%
SW Corporate Bond Tracker	100.00%
Scottish Widows GTAA 1	83.89%
Corporate Bond 1 Fund	98.31%
Adventurous Growth Fund	73.32%
ACS Pooled Property (ii)	
Scottish Widows Pooled Property ACS Fund	99.87%
Scottish Widows Pooled Property ACS Fund 2	99.77%
Universe, The CMI Global Network (iii)	
CMIG GA 70 Flexible	100.00%
CMIG GA 80 Flexible	100.00%
CMIG GA 90 Flexible	100.00%
CMIG Focus Euro Bond	99.99%
European Enhanced Equity	100.00%
CMIG Access 80%	100.00%
Continental Euro Equity	97.75%
UK Equity	76.73%
US Enhanced Equity	90.28%
Japan Enhanced Equity	95.54%
Pacific Enhanced Basin	80.21%
Euro Bond	63.07%
US Bond	94.65%
US Currency Reserve	81.28%
Euro Currency Reserve	98.74%
Euro Cautious	86.27%
US Tracker	30.77%

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

16. Investment in subsidiaries (continued)

Name Of Umbrella And Undertaking	% Held
Aberdeen Liquidity Fund (Lux) (iv)	
Aberdeen Liquidity Fund (Lux) - Ultra Short Duration	33.97%
Aberdeen Investment ICVC (v)	
Aberdeen Global High Yield Bond Fund	23.29%
Aberdeen European Property Share Fund	36.72%
Aberdeen Sterling Opportunistic Corporate Bond Fund	34.16%
Aberdeen Sterling Bond Fund	81.93%
Aberdeen Investment ICVC II (v)	
Aberdeen Global Corporate Bond Tracker Fund	99.35%
Aberdeen Investment ICVC III (v)	
Aberdeen Global Emerging Markets Quantitative Equity Fund	60.65%
BNY Mellon Investments Funds ICVC (vi)	
Insight Global Multi-Strategy Fund	43.55%
Insight Global Absolute Return Fund	74.89%
Newton Multi-Asset Growth Fund	26.09%
Newton UK Opportunities Fund	53.51%
Newton UK Income Fund	26.66%
BNY Mellon US Opportunities Fund	36.79%
BNY Mellon Manages Funds II (vi)	
Absolute Insight Fund	83.87%
MGI Funds PLC (vii)	
Mercer Multi Asset Growth	66.83%
Mercer Diversified Retirement Fund	72.23%
Mercer Multi Asset Defensive Fund	62.08%
Mercer Multi Asset High Growth Fund	81.10%
Mercer Multi Asset Moderate Growth Fund	52.96%
MGI UK Equity Fund	34.38%
Invesco Perpetual Far Eastern Investment Series (viii)	
Invesco Perpetual Asian Equity Income Fund	22.57%
Invesco American Investment Series (viii)	
Invesco US Equity Fund (UK)	20.58%
Russell Investment Company Plc (ix)	
Russell Euro Fixed Income Fund	31.61%
Russell Sterling Bond Fund	42.36%
Russell U.S Bond Fund	53.83%
UBS Investment Funds ICVC (x)	
UBS Global Optimal Fund	29.19%
UBS UK Opportunities Fund	38.09%
BNP Paribas InstiCash (xi)	
BNP Paribas InstiCash GBP	45.19%

Name Of Umbrella And Undertaking	% Held
The TM Levitas Funds (xii)	
TM Levitas A Fund	41.91%
TM Levitas B Fund	37.11%
Multi-Manager ICVC (xiii)	
Multi Manager UK Equity Growth Fund	82.43%
Multi Manager UK Equity Income Fund	30.48%
Multi Manager UK Equity Focus Fund	20.24%
Investment Portfolio ICVC (xiii)	
IPS Income	20.87%
IPS Growth	23.54%
Balanced Solution	42.16%
Cautious Solution	31.92%
Discovery Solution	40.98%
Strategic Solution	53.29%
Dynamic Solution	55.16%
Defensive Solution	69.91%
Adventurous Solution	75.95%
Pan European Urban Retail Fund (xiv)	22.00%
SSGA UK Equity Tracker Fund (xv)	96.88%
SSGA Europe (Ex UK) (xv)	96.30%
SSGA Asia Pacific Tracker Fund (xv)	93.04%
SSGA North American Equity Fund (xv)	100.00%
Blackrock Balanced Growth Portfolio Fund (xvi)	36.23%
Blackrock UK Smaller Companies Fund (xvi)	20.93%
Schroder Gilt And Fixed Interest Fund (xvii)	23.78%
HLE Active Managed Portfolio Konservativ (xviii)	38.71%
HLE Active Managed Portfolio Dynamisch (xviii)	48.84%
HLE Active Managed Portfolio Ausgewogen (xviii)	35.85%
AgFe UK Real Estate Senior Debt Fund LP (xix)	77.96%
FAST UK Fund (xx)	31.69%
JPM Systematic Alpha (xxi)	21.26%
Lazard Developing Markets Fund (xxii)	88.59%
Nordea 1 GBP Diversified Return Fund (xxiii)	23.31%
Schroder Emerging Market Bond Fund (xxiv)	58.95%
Zurich Horizon Multi-Asset Fund V (xxv)	41.80%
Pemberton European Mid-Market Debt Fund II (xxvi)	100.00%
Schroder Sterling Liquidity Fund (xxvii)	46.27%
Aberdeen Private Equity Fund Of Funds (2007) Plc (xxviii)	96.11%

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

16. Investment in subsidiaries (continued)

Principle Place of Business:

(i) Trinity Road, Halifax, West Yorkshire, HX1 2RG
(ii) 15 Dalkeith Road Edinburgh EH16 5WL
(iii) 106, Route D'arlon, L-8210 Mamer, Grand Duchy Of Luxembourg
(iv) 35a, Avenue John F. Kennedy, L-1855 Luxembourg, Grand Duchy Of Luxembourg
(v) 1 Bread Street, Bow Bells House, London EC4M 9HH
(vi) 160 Queen Victoria Street, London EC4V 4LA
(vii) 70 Sir John Rogerson's Quay, Dublin 2, Ireland
(viii) Perpetual Park, Perpetual Park Drive, Henley-On-Thames, Oxfordshire RG9 1HH
(ix) 78 Sir John Rogerson's Quay, Dublin 2, Ireland
(x) 21 Lombard Street, London, EC3V 9AH
(xi) 10, rue Edward Steichen, L-2540 Luxembourg, Grand-Duche de Luxembourg
(xii) Exchange Building, St. John's Street, Chichester, West Sussex PO19 1UP
(xiii) 25 Gresham Street, London, EC2V 7HN
(xiv) Jackson House, 18 Saville Row, London, W1S 3PW
(xv) 20 Churchill Place, Canary Wharf, London E14 5HJ
(xvi) 12 Throgmorton Avenue, London EC2N 2DL
(xvii) 31 Gresham Street, London, EC2V 7QA
(xviii) 2, Boulevard Konrad Adenauer, L-1115 Luxemburg
(xix) 3rd Floor South, 55 Baker Street, London, W1U 8EW
(xx) 2a, Rue Albert Borschette, BP 2174, L-1021 Luxembourg
(xxi) S.à. r.l., 6, Route de Trèves, L-2633 Senningerberg, Luxembourg
(xxii) 50 Stratton Street, London W1J 8LL
(xxiii) 562, Rue de Neudorf, L-2220 Luxembourg
(xxiv) 5, Rue Höhenhof, L-1736, Senningerberg, Luxembourg
(xxv) The Grange, Bishops Cleeve, Cheltenham, GL52 8XX
(xxvi) 2 - 4, Rue Eugène Ruppert L-2453 Luxembourg
(xxvii) 10 Earlsfort Terrace, Dublin 2, Ireland D02 T380
(xxviii) 39/40 Upper Mount Street, Dublin 2, Ireland

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

17. Investment properties

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 31 December 2018	3,729	184	3,640	189
Adjustment on adoption of IFRS 16 (note 40)	16	—	—	—
At 1 January	3,745	184	3,640	189
Additions – new properties	8	—	64	1
Additions – subsequent expenditure on existing properties	52	1	62	—
Transfers from fellow Group company	—	—	20	—
Disposals	(173)	(47)	(179)	(12)
Net (loss)/gain from change in fair values	(109)	(6)	122	6
At 31 December	3,523	132	3,729	184

Rental income arising from investment properties during the year, included in investment income, amounted to: Group £191m (2018: £197m) and Company £10m (2018: £12m). The total future minimum rental payments receivable under non-cancellable leases, including subleases, are as follows:

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Within one year	164	7	163	10
Between one and two years	148	7	147	10
Between two and three years	137	7	128	10
Between three and four years	123	7	116	9
Between four and five years	114	7	103	9
Beyond five years	941	137	841	118
Total	1,627	172	1,498	166

Direct operating expenses (included within operating expenses) arising in respect of such investment properties during the year amounted to: Group £32m (2018: £23m) and Company £1m (2018: nil).

Expenditure on investment properties which did not generate rental income was: Group nil (2018: £1m) and Company nil (2018: nil). The carrying value of land held for development in Group is £36m (2018: £35m) and Company is nil (2018: nil). The carrying value of investment property under development in Group is £125m (2018: £163m) and Company is nil (2018: nil).

Due to the nature of the above assets, there is no fixed term associated with these investments. The investment properties are independently valued by Cushman Wakefield, Savills, or Knight Frank, on at least a quarterly basis for the purpose of determining the open market value of the properties.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

18. Assets arising from reinsurance contracts held

Assets arising from reinsurance contracts held can be analysed between those classified as insurance contracts and those classified as financial assets at fair value through profit or loss as follows:

Group	2019 Classified as			2018 Classified as		
	Re-insurance contracts	Fair value through profit or loss	Total	Re-insurance contracts	Fair value through profit or loss	Total
	£m	£m	£m	£m	£m	£m
At 1 January	728	7,132	7,860	565	7,812	8,377
Movement recognised through the statement of comprehensive income	(8)	1,917	1,909	163	(588)	(425)
Acquisition of business (note 44)	—	13,616	13,616	—	—	—
Other movements recognised directly through the balance sheet	—	172	172	—	(92)	(92)
At 31 December	720	22,837	23,557	728	7,132	7,860
Amounts in respect of liabilities arising from insurance and participating investment contracts	720	8,089	8,809	728	6,728	7,456
Amounts in respect of liabilities arising from non-participating investment contracts	—	14,748	14,748	—	404	404
Total	720	22,837	23,557	728	7,132	7,860

Company	2019 Classified as			2018 Classified as		
	Re-insurance contracts	Fair value through profit or loss	Total	Re-insurance contracts	Fair value through profit or loss	Total
	£m	£m	£m	£m	£m	£m
At 1 January	728	7,132	7,860	565	7,812	8,377
Movement recognised through the statement of comprehensive income	(2)	1,917	1,915	163	(588)	(425)
Transfers in	—	13,616	13,616	—	—	—
Other movements recognised directly through the balance sheet	—	172	172	—	(92)	(92)
At 31 December	726	22,837	23,563	728	7,132	7,860
Amounts in respect of liabilities arising from insurance and participating investment contracts	726	8,089	8,815	728	6,728	7,456
Amounts in respect of liabilities arising from non-participating investment contracts	—	14,748	14,748	—	404	404
Total	726	22,837	23,563	728	7,132	7,860

Assets arising from reinsurance contracts held include £22,052m for Group and Company (2018: £7,231m for Group and Company) that is expected to be settled more than one year after the reporting date.

During the year, the Group and Company acquired assets arising from reinsurance contracts held at fair value through profit or loss under the Zurich Part VII Transfer Scheme (see note 44), which are shown as acquisition of business in the tables above.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

19. Other assets

	2019		2018	
	£m	£m	£m	£m
	Group	Company	Group	Company
Prepayments	55	28	44	40
Other receivables	65	67	47	47
Total	120	95	91	87

20. Derivative financial instruments

In the normal course of business, the Group and Company enters into swap contracts, option contracts, index futures contracts and forward foreign exchange contracts. All such contracts are undertaken either for efficient portfolio management purposes or for the purpose of matching contractual liabilities. In addition, the Company has entered into a swap for the specific purpose of hedging movements in the fair value of certain subordinated debt, as described in note 31.

Swap contracts include currency, interest and inflation rate swaps. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. An interest or inflation rate swap is an agreement between two parties to exchange fixed and variable rate interest payments, based upon interest or inflation rates defined in the contract, without the exchange of the underlying principal amount.

Option contracts include index and single equity options. Such options represent a contract sold by one party to another party offering the right, but not the obligation, to buy or sell a financial asset at an agreed price on a specified future date or within a specified period of time.

Index futures contracts are used to hedge the investment portfolio against adverse movements in underlying markets or effecting policy switches between markets without the need to trade the underlying securities. Futures may also be used for the purposes of efficient portfolio management provided that their substance would otherwise be permitted as a series of direct transactions. Forward foreign exchange contracts are an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate.

Details regarding derivative financial instruments are given in the following tables:

Group	2019			2018		
	Contract Amount £m	**Fair value assets £m**	**Fair value liabilities £m**	**Contract Amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Derivative financial instruments held for trading:						
Swap contracts	37,633	3,124	(3,154)	36,753	2,367	(2,345)
Option contracts	2,744	448	(242)	6,983	434	(287)
Index futures contracts	6,388	44	(35)	6,829	81	(69)
Forward foreign exchange contracts	5,438	36	(14)	5,394	32	(18)
Derivative financial instruments designated as fair value hedges	1,500	316	—	1,500	243	—
Total	53,703	3,968	(3,445)	57,459	3,157	(2,719)

Company	2019			2018		
	Contract Amount £m	**Fair value assets £m**	**Fair value liabilities £m**	**Contract Amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Derivative financial instruments held for trading:						
Swap contracts	37,365	3,091	(3,154)	36,556	2,367	(2,344)
Option contracts	2,533	448	(241)	6,288	433	(285)
Index futures contracts	4,038	22	(31)	4,117	69	(42)
Forward foreign exchange contracts	3,454	17	(8)	2,690	17	(10)
Derivative financial instruments designated as fair value hedges	1,500	316	—	1,500	243	—
Total	48,890	3,894	(3,434)	51,151	3,129	(2,681)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

20. Derivative financial instruments (continued)

Derivative financial instrument fair value assets include £3,840m for Group and £3,808m for Company (2018: £2,991m for Group and £2,991m for Company) that is expected to be recovered more than one year after the reporting date.

Derivative financial instrument fair value liabilities include £3,359m for Group and £3,359m for Company (2018: £2,545m for Group and £2,544m for Company) that is expected to be settled more than one year after the reporting date.

The fair value hedges included in the above tables represent interest rate swaps in respect of the interest payments relating to subordinated debt issued by the Group. These instruments form part of hedge relationships with the subordinated debt issued.

Details of collateral accepted and pledged in respect of derivative financial instruments are given in note 38.

21. Loans and receivables at amortised cost

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Accrued income, dividend and rent	192	9	248	8
Loans to related parties	357	357	1,765	1,765
Other amounts due from related parties	56	40	57	65
Amounts receivable from direct insurance business	96	92	156	156
Other	296	121	448	202
Total	997	619	2,674	2,196

Of the above total, £351m for Group and Company (2018: £348m for Group and Company) is expected to be recovered more than one year after the reporting date. The carrying amount of loans to related parties is a reasonable approximation of fair value.

Within loans and receivables at amortised cost, the largest credit concentration is with Scottish Widows Group Ltd of £351m (2018: Lloyds Bank Plc of £1,400m). Further information in respect of credit risk, including credit concentration risk and collateral held against loans to related parties, is given in note 38.

22. Investments at fair value through profit or loss

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Shares and other variable yield securities	93,732	101,603	75,384	85,641
Debt and other fixed/variable income securities	32,366	15,299	31,033	12,738
Loans and Advances to Customers	8,804	8,250	7,845	7,259
Loans and Advances to Banks	2,255	1,203	2,519	1,470
Deposits with cedants	—	1,507	—	—
Transferred to assets held for sale	—	—	—	(2,165)
Total investments at fair value	137,157	127,862	116,781	104,943

Debt securities of £30,427m for Group and £14,684m for Company (2018: £29,018m for Group and £12,094m for Company) is expected to be recovered more than one year after the reporting date. Loans and Advances to Customers of £8,752m for Group and £8,199m for Company (2018: £7,179m for Group and £6,057m for Company) is expected to be recovered more than one year after the reporting date. Loans and Advances to Banks are short term in nature. Due to the nature of shares and other variable yield securities there is no fixed term associated with these securities. Included within the Company's shares and other variable yield securities are shares in subsidiary undertakings of £66,551m (2018: £62,858m), which are held at fair value through profit or loss.

During 2019, the Company acquired assets totalling £7,350m under the Zurich Part VII Transfer Scheme (see note 44).

During 2019, the Group acquired illiquid credit assets from, or issued by, parties within LBG totalling £255m (2018: nil). The Group also originated loans during the year totalling £306m (2018: £695m) and committed to lend a further £286m (2018: £231m). These credit assets are secured on Social Housing, Infrastructure, Education, Ground Rent and Commercial Real Estate portfolios. Further details on the credit risk and fair value measurement of these assets can be found in note 38.

All assets acquired from LBG were acquired at their fair value and further details on the credit risk and fair value measurement of these assets can be found in note 38.

As a result of the reclassification of the European business of the Company to assets and liabilities held for sale there was a reduction in investments at fair value through profit or loss for the Company in 2019. See note 44 for further detail.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

22. Investments at fair value through profit or loss (continued)

Deposits with cedants represents funds withheld for reinsurance premiums due to the Company under the reinsurance agreement with SWE.

Structured entities are consolidated when the Group has control in accordance with the consolidation policy set out in note 1(b).

Of the total Loans and advances to customers above £5,356m for Group (2018: £4,173m) and £4,803m for Company (2018: £4,256m) is secured on real estate. Of the Loans and advances to customers above, £6,739m (2018: £6,503m) for Group and 6,185 (2018: £6,584m) for Company was acquired from a related party. All transactions were completed at arm's length.

Within shares and other variable yield securities are cash funds of £250m for Group and £250m for Company (2018: £259m for Group and £259m for Company) representing collateral received and reinvested in relation to derivatives contracts and stocklending programmes, further details is given in note 38.

Interests in unconsolidated structured entities

Included within investments at fair value through profit or loss are investments in unconsolidated structured entities for Group of £37,988m (2018: £24,208m) arising from investments in collective investment vehicles and limited partnerships.

The collective investment vehicles and limited partnerships are primarily financed by investments from investors in the vehicles. The investments are carried at fair value and the Group's maximum exposure to loss is equal to the carrying value of the investment.

However, investments in collective investment vehicles and limited partnerships are primarily held to match policyholder liabilities and the majority of the risk from a change in the value of the Group's investment is matched by a change in policyholder liabilities. At 31 December 2019, the total net assets of unconsolidated collective investment vehicles and limited partnerships in which the Group held a beneficial interest were £2,361bn (2018: £2,435bn). During the year the Group has not provided any non-contractual financial or other support to these unconsolidated collective investment vehicles and limited partnerships (2018: none).

The Group sponsors a range of collective investment vehicles and limited partnerships where it acts as the decision maker over the investment activities and markets the funds under one of LBG's brands. The Group earns fees from managing the investments of these funds. The investment management fees that the Group earned from these sponsored unconsolidated collective investment vehicles and limited partnerships, including those in which the Group held no interest at 31 December 2019 was £96m (2018: £99m).

Interests in consolidated structured entities

The Group consolidates a number of structured entities, in accordance with the consolidation policy set out in note 1(b).

In 2015 the Company fully assumed a guarantee granted by SW Funding plc. The guarantee concerns a contractual arrangement with State Street Trustees Limited (SSTL), which acts as the Depositary of a consolidated structured entity, the Scottish Widows Property Authorised Contractual Scheme (SWACS). Under the terms of the contractual arrangement, the Company has indemnified SSTL against all losses suffered or incurred by SSTL arising out of or in relation to the scheme property of the SWACS, which consists of real property and for which SSTL is the legal owner. During the year, no losses have arisen and the Company has made no payment under this contractual arrangement (2018: none).

During the year, the Group has not provided any non-contractual financial support to consolidated structured entities and has no current intention of providing such support (2018: none).

23. Cash and cash equivalents

Cash and cash equivalents for the purposes of the statement of cash flows include the following:

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Cash at bank	274	97	166	34
Short term deposits	2	1	8	7
Cash at bank	276	98	174	41
Less: bank overdrafts note 34	(3)	—	(4)	—
Total	273	98	170	41

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

24. Share capital

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Issued and fully paid share capital:				
70,000,000 (2018: 70,000,000) ordinary shares of £1 each	70	70	70	70
Total	70	70	70	70

25. Insurance contracts and participating investment contract liabilities

An analysis of the change in liabilities arising from insurance contracts and participating investment contracts and reinsurers' share of insurance and participating investment contract liabilities is as follows:

Group	2019			2018		
	£m	£m	£m	£m	£m	£m
	Gross	*Reinsurance*	*Net*	*Gross*	*Reinsurance*	*Net*
At 1 January	98,252	(7,456)	90,796	102,916	(7,981)	94,935
New business	5,721	(45)	5,676	5,508	(42)	5,466
Changes in existing business	5,928	(1,325)	4,603	(9,617)	580	(9,037)
Assumption changes	1,018	17	1,035	(555)	(13)	(568)
At 31 December	110,919	(8,809)	102,110	98,252	(7,456)	90,796

Company	2019			2018		
	£m	£m	£m	£m	£m	£m
	Gross	*Reinsurance*	*Net*	*Gross*	*Reinsurance*	*Net*
At 1 January	96,117	(7,456)	88,661	102,916	(7,981)	94,935
New business	7,256	(45)	7,211	5,508	(42)	5,466
Changes in existing business	6,201	(1,331)	4,870	(9,617)	580	(9,037)
Assumption changes	1,025	17	1,042	(555)	(13)	(568)
Transferred to liabilities held for sale	—	—	—	(2,135)	—	(2,135)
At 31 December	110,599	(8,815)	101,784	96,117	(7,456)	88,661

Included in the value of gross new business written for Company is £1,534m relating to reinsurance premiums receivable from SWE in relation to inter-group reinsurance arrangements following the transfer of policies from SWL to SWE.

An analysis of the expected maturities of liabilities arising from insurance contracts and participating investment contracts is given in note 38. The portfolio is subject to a number of risks as set out in note 38.

As detailed in note 44, in the prior year, insurance contracts and participating investment contracts were reclassified to liabilities held for sale as part of the transfer of the European business of the Company to SWE. These liabilities were transferred to SWE during the current year under the SWE Part VII Transfer Scheme.

26. Unallocated surplus

An analysis of the change in unallocated surplus is as follows:

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	390	390	380	380
Change recognised through the statement of comprehensive income	22	22	10	10
At 31 December	412	412	390	390

Of the above total, £362m for Group and Company (2018: £341m for Group and Company) is expected to be settled more than one year after the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

27. Future profits on non-participating business in the With Profits Funds

An analysis of the change in future profits on non-participating business in the Scottish Widows With Profits Fund is as follows:

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
At 1 January	28	28	43	43
Change recognised through the statement of comprehensive income	21	21	(15)	(15)
At 31 December	49	49	28	28

£49m for Group and Company (2018: £28m for Group and Company) is expected to be recovered more than one year after the reporting date.

28. Provisions for other liabilities and charges

Group	2019			2018		
	German insurance business litigation	**Other**	**Total**	**German insurance business litigation**	**Other**	**Total**
	£m	£m	£m	£m	£m	£m
At 1 January	112	147	259	138	89	227
Increase in the year	17	29	46	—	126	126
Amount utilised in the period	(28)	(136)	(164)	(26)	(68)	(94)
At 31 December	101	40	141	112	147	259

Company	2019			2018		
	German insurance business litigation	**Other**	**Total**	**German insurance business litigation**	**Other**	**Total**
	£m	£m	£m	£m	£m	£m
At 1 January	112	99	211	138	87	225
Increase in the year	—	29	29	—	79	79
Amount utilised in the period	(19)	(88)	(107)	(26)	(67)	(93)
Transfers (to) / from fellow group undertakings	(53)	—	(53)	—	—	—
At 31 December	40	40	80	112	99	211

Of the above total, provisions for other liabilities and charges include £84m for Group and £32m for Company (2018: £175m for Group and £128m for Company) expected to be settled more than one year after the reporting date.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

28. Provisions for other liabilities and charges (continued)

Customer claims in relation to insurance business in Germany

The Group continues to receive claims in Germany from customers relating to policies issued by the Company, under its former name of Clerical Medical Investment Group Limited. The total provision made to 31 December 2019 is £656m (2018: £639m). Utilisation has increased to £28m in the year ended 31 December 2019 (2018: £26m); the remaining unutilised provision as at 31 December 2019 is £101m (2018: £112m).

The validity of the claims facing the Group depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will only be known once all relevant claims have been resolved. Claims received to date represent 10% of the relevant total policy population. Key metrics and sensitivities are highlighted in the table below:

Sensitivities	Actuals to date	Anticipated Future	Sensitivity
Number of claims	16,700	4,600	1,000 = £8m
Average uphold rate per claim	62 %	52 %	10% = £8m
Average redress per upheld claim	£42,000	£13,000	£1,000 = £3m
Administrative expenses	£161m	£21m	1 case = £1,700

The actuals to date include claims that have been received and provided for but not yet resolved. For future claims the anticipated average uphold rate, redress per upheld claim and administrative and legal expenses are consistent with the actual experience seen over the 12 months prior to the reporting date. This recent experience is more favourable compared with previous years due to time barring of more onerous types of claim and because most claims are now settled without recourse to litigation.

The Company has provided a 90 percent indemnity to SWE for future provision increases in respect of customer claims and expenses in relation to insurance business in Germany.

Other provisions

Other provisions include amounts for customer remediation costs, restructuring and third party contractual compensation. In the prior year this included provisions arising from the termination of the asset management agreements with Aberdeen Standard Investments. The provision was settled in full in the current year.

Contingent liabilities

Tax authorities

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities. This includes open matters where HMRC adopt a different interpretation and application of tax law which might lead to additional tax. A number of Group companies have an open matter in relation to a claim for Group relief of losses incurred in a former Irish banking subsidiary of LBG, which ceased trading on 31 December 2010. In the second half of 2013 HMRC informed LBG that their interpretation of the UK rules, permitting the offset of such losses, denies these claims; if HMRC’s position is found to be correct, management estimate that this would result in an increase in the Group’s current tax liability of approximately £20m (including interest). LBG does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due on the Group.

Outsourcing of long-standing customer administration platform

The outsourcing contract signed with Diligenta on 19 September 2017 provides for certain future payments which are contingent on contractual milestones being achieved. At 31 December 2019, no conditions exist for such payments to be made, and as such these payments are continued to be regarded as contingent in nature in continuation of the approach from 2017. A proportion of these costs (£14m) have been recognised already in insurance contract liabilities. The remainder relating the share of these future payments by investment business, will be expensed as incurred in future periods. Further, there are provisions whereby the Group has agreed to reimburse Diligenta for any severance costs, if and when a restructuring programme is initiated by Diligenta in relation to those employees transferring on 1 March 2018.

Final Salary Pension Schemes

Historically the Group has provided services to Final Salary Pension schemes and trustees including investment, actuarial, documentation and member administration. A number of claims have been brought against the Company after the expiry of the statutory limitation periods. Given the significant delays that have been experienced in the notification in these claims following the statutory limitation period, the potential number of incidents, the number of schemes they cover, and uncertainties associated with establishing liability, the ultimate cost cannot be determined with certainty. However, on the basis of the current information the Directors consider that any additional costs arising are not likely to have a material impact on the financial position of the Company and the Group.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

28. Provisions for other liabilities and charges (continued)

Contingent liabilities (continued)

Other legal actions and regulatory matters

During the ordinary course of business the Group is subject to complaints and threatened or actual legal proceedings (including class or Group action claims) brought by or on behalf of current or former employees, customers, investors or other third parties, as well as legal and regulatory reviews, challenges, investigations and enforcement actions, both in the United Kingdom and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisors where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed to properly assess the situation, and no provisions are held in relation to such matters. However, the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

29. Retirement benefit obligations

Scottish Widows Services Limited ("SWSL") is the principal employer of the Scottish Widows Retirement Benefit Scheme ("SWRBS") pension scheme. The Group's employees may be members of the SWRBS, which provides mainly defined benefits, or members of LBG Schemes, which provide defined benefits and/or defined contribution benefits to the members of those schemes. During the prior year, SWSL was disposed of in a sale to Lloyds Bank plc and the Group paid £284m to a related party to transfer the obligations in respect of SWRBS. Consequently, the parent company of SWSL is now outside the Group and the Group was released from the obligations of the SWRBS from 1 May 2018. The information in this note reflects this change.

(a) Scottish Widows Retirement Benefits Scheme

(i) Characteristics of the SWRBS

The SWRBS is a funded scheme in the UK, operated as a separate legal entity under trust law by Scottish Widows Pension Trustees Limited (the Trustee) in compliance with the Pensions Act 2004. A valuation exercise is carried out for the scheme at least every three years, whereby scheme assets are measured at market value and liabilities (technical provisions) are measured using prudent assumptions. If a deficit is identified a recovery plan is agreed between the parent company of SWSL and the Trustee and sent to the Pensions Regulator for review. The Group has not provided for these deficit contributions as SWSL is no longer part of the Group.

The Group was required to pay contributions to fund its obligations to the SWRBS until the disposal of SWSL on 1 May 2018. The Group has paid no contributions (2018: £36m) to the SWRBS in 2019. Employee contributions made during 2018 and 2019 were nil. The Group will not pay any future contributions.

The technical provisions liabilities differ from the liabilities assessed under IAS19, with technical provisions typically being more prudent. The IAS19 liabilities disclosed have been calculated by and independent, qualified actuary appointed by LBG.

The responsibility for the governance of the SWRBS lies with the Pension Trustees. The SWRBS is managed by a Trustee Board (the Trustee) whose role is to ensure that the SWRBS is administered in accordance with the SWRBS rules and relevant legislation, and to safeguard the assets in the best interests of all members and beneficiaries. The Trustee is solely responsible for setting investment policy and for agreeing funding requirements with the employer through the triennial valuation process. The Board of Trustees must be composed of representatives of LBG and plan participants in accordance with the SWRBS's regulations.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

29. Retirement benefit obligations (continued)

(a) Scottish Widows Retirement Benefits Scheme (continued)

(ii) Amounts in the Financial Statements of the SWRBS

Following the disposal of SWSL in 2018, no assets or liabilities were recognised in the Group's balance sheet in the current or prior year.

The following tables present an analysis of the amounts recognised in the Group's balance sheet prior to the disposal of SWSL in 2018:

	2019 £m	2018 £m
Movements in the defined benefit obligation		
At 1 January	—	1,248
Current service cost	—	4
Interest expense	—	11
Remeasurements:		
Actuarial gains – financial assumptions	—	(60)
Benefits paid	—	(43)
Defined benefit obligation derecognised on disposal of SWSL	—	(1,160)
At 31 December	—	—

The following tables provide an analysis of the SWRBS assets:

	2019 £m	2018 £m
Changes in the fair value of scheme assets		
At 1 January	—	1,171
Return on plan assets excluding amounts included in interest income	—	(29)
Interest income	—	11
Employer contributions	—	36
Benefits paid	—	(43)
Administrative costs paid	—	(1)
Scheme assets derecognised on disposal of SWSL	—	(1,145)
At 31 December	—	—

The expense recognised in the Statement of Comprehensive Income for the year ended 31 December comprised:

	2019 £m	2018 £m
Current service cost	—	4
Plan administration costs incurred in the year	—	1
Net expense recognised	—	5

The principal actuarial and financial assumptions used in valuations of the SWRBS were as follows:

	2018 %
Discount rate	2.74
Rate of inflation	
Retail Prices Index	3.13
Consumer Price Index	2.08
Rate of salary increases	—

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

29. Retirement benefit obligations (continued)

(a) Scottish Widows Retirement Benefits Scheme (continued)

(ii) Amounts in the Financial Statements of the SWRBS (continued)

	2018 Years
Life expectancy for member aged 60, on the valuation date:	
Men	27.2
Women	29.4
Life expectancy for member aged 60, 15 years after the valuation date:	
Men	28.3
Women	30.6

Risk exposure of SWRBS

The Group was exposed to the following risks in relation to the SWRBS scheme before the sale of SWSL and transfer of SWRBS obligations:

Inflation rate risk: The SWRBS's benefit obligations are linked to inflation both in deferment and once in payment. Higher inflation will lead to higher liabilities although this will be partially offset by holdings of inflation-linked gilts and, in most cases caps on the level of inflationary increases are in place to protect against extreme inflation.

Interest rate risk: The defined benefit obligation is determined using a discount rate derived from yields on AA-rated corporate bonds. A decrease in corporate bond yields will increase plan liabilities although this will be partially offset by an increase in the value of bond holdings and derivatives.

Longevity risk: The SWRBS obligations are to provide benefits for the life of the members so increases in life expectancy will result in an increase in the plans' liabilities.

Investment risk: SWRBS assets are invested in a diversified portfolio of debt securities, equities and other return-seeking assets. If the assets underperform the discount rate used to calculate the defined benefit obligation, it will reduce the surplus or increase the deficit. Volatility in asset values and the discount rate will lead to volatility in the net pension liability on the Group's balance sheet and in other comprehensive income. To a lesser extent this will also lead to volatility in the IAS 19 pension expense in the Group's statement of comprehensive income.

The ultimate cost of the defined benefit obligations will depend upon actual future events rather than the assumptions made. The assumptions made are unlikely to be borne out in practice and as such the cost may be higher or lower than expected.

(b) Guarantee to the trustees of SWRBS

Prior to 1 May 2018, the Company provided a guarantee to the trustees of SWRBS to explicitly cover the minimum legal funding obligations imposed on SWSL by Sections 75 and 75A of the Pensions Act 1995 and under the rules of the scheme. As a result, the Group was liable to its proportionate share of the deficit in the SWRBS at the relevant time (calculated as the cost of securing benefits with an insurer) in the event that SWRBS is wound up; the employer becomes insolvent; or an employer ceases to employ active members of SWRBS at a time when another employer continues to do so, but the associated debt is not apportioned to another employer. As part of the transaction to dispose of SWSL on 1 May 2018, the Company transferred this guarantee to a related party outside the Group.

(c) Defined contribution schemes

The SWRBS also includes a defined contribution section; most of the members have now transferred to the Your Tomorrow defined contribution section of the LBG Pension Scheme No. 1. During the year ended 31 December 2019, the charge to the Group's statement of comprehensive income in respect of the SWRBS was £15m (2018: £15m), representing the contributions payable by SWSL in accordance with the scheme's rules. There were no outstanding or prepaid contributions at 31 December 2019 (2018: none).

(d) Amounts recognised in other comprehensive income for total defined benefit schemes

Remeasurement effects recognised in other comprehensive income for the year ended 31 December are reconciled to the analyses of amounts recognised in the Group balance sheet as follows:

<u>Group</u>	2019			2018		
	Before tax £m	Tax expense £m	After tax £m	Before tax £m	Tax expense £m	After tax £m
SWRBS	—	—	—	31	(5)	26
Total	—	—	—	31	(5)	26

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

30. Accruals and deferred income

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Accrued expenses	9	7	6	3
Deferred income	24	15	31	18
Other	2	2	—	—
Total	35	24	37	21

Of the above total, £18m for Group and £12m for Company (2018: £25m for Group and £15m for Company) is expected to be settled more than one year after the reporting date.

31. Subordinated debt

The carrying value shown in the balance sheet is as follows:

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Subordinated debt	1,476	1,500	1,523	1,554
Issue costs	(13)	(13)	(14)	(14)
	1,463	1,487	1,509	1,540
Accrued interest on subordinated debt	50	50	50	50
Fair value hedge adjustment	282	283	210	209
Total	1,795	1,820	1,769	1,799

Movements in the carrying value are as follows:

	£m	£m
	Group	*Company*
At 1 January 2019	1,769	1,799
Changes in fair value	70	73
Other non-cash movements	9	1
Redemption of subordinated debt	(53)	(53)
At 31 December 2019	1,795	1,820

£1,500m of fixed rate subordinated notes were issued by the Company in April 2013, at a discount of £13m. Redemption is due in 2023 for £850m of the notes, and in 2043 for the remaining £650m. Interest is payable on a quarterly basis at a rate of 5.5% on the former and 7% on the latter. Repayment of the notes is subordinate to the claims of the Company's senior creditors, including all policyholders. The interest rate risk of the notes is managed using a derivative which is accounted for using hedge accounting, as set out in note 1(o).

On 5 November 2019 Clerical Medical Finance plc, a subsidiary of LBG, exercised its option to redeem £51m of 7.375% undated Subordinated Guaranteed Bonds, the proceeds of which had been loaned to the Company on a similar interest (7.610%) and repayment terms. The Company settled this loan on the same date as the aforementioned subordinated debt redemption.

The fair values of the subordinated debt of the Group and Company are as follows:

Group	2019		2018	
	£m	£m	£m	£m
	Carrying value	*Fair value*	*Carrying value*	*Fair value*
Undated subordinated debt	—	—	53	54
Dated subordinated debt	1,795	1,704	1,716	1,656
Total	1,795	1,704	1,769	1,710

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

31. Subordinated debt (continued)

Company	2019		2018	
	£m	£m	£m	£m
	Carrying value	*Fair value*	*Carrying value*	*Fair value*
Undated subordinated debt	—	—	53	53
Dated subordinated debt	1,820	1,704	1,746	1,657
Total	1,820	1,704	1,799	1,710

The fair value of undated subordinated debt has been calculated using published bid prices at the reporting date. The fair value of dated subordinated debt has been assessed by management with reference to published prices.

32. Non-participating investment contract liabilities

An analysis of the change in net liabilities arising from non-participating investment contracts is as follows:

Group	2019			2018		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
	£m	£m	£m	£m	£m	£m
At 1 January	13,855	(404)	13,451	15,447	(396)	15,051
New business	1,810	—	1,810	668	—	668
Changes in existing business	810	(728)	82	(2,260)	(8)	(2,268)
Acquisition of business (note 44)	20,981	(13,616)	7,365	—	—	—
At 31 December	37,456	(14,748)	22,708	13,855	(404)	13,451

Company	2019			2018		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
	£m	£m	£m	£m	£m	£m
At 1 January	13,825	(404)	13,421	15,447	(396)	15,051
New business	1,810	—	1,810	668	—	668
Changes in existing business	839	(728)	111	(2,260)	(8)	(2,268)
Acquisition of business (note 44)	20,981	(13,616)	7,365	—	—	—
Transferred to liabilities held for sale	—	—	—	(30)	—	(30)
At 31 December	37,455	(14,748)	22,707	13,825	(404)	13,421

During the year the Group and Company acquired liabilities arising from non-participating investment contracts under the Zurich Part VII Transfer Scheme (see note 44), which are shown as acquisition of business in the tables above.

An analysis of the contractual and expected maturities of liabilities arising from non-participating investment contracts is given in note 38.

As detailed in note 44, in the prior year non-participating investment contracts were reclassified to liabilities held for sale as part of the transfer of the European business of the Company to SWE.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

33. Other financial liabilities

	2019		2018	
	£m	£m	£m	£m
	Group	Company	Group	Company
Amounts payable in respect of direct insurance business	527	500	516	516
Amounts payable on reinsurance contracts	11	11	11	11
Due to related parties	233	304	366	372
Due to brokers	72	69	54	23
Collateral liability	616	316	885	372
Other	430	222	499	314
Total	1,889	1,422	2,331	1,608

Of the above total, nil for Group and nil for Company (2018: nil for Group and nil for Company) is expected to be settled more than one year after the reporting date.

The Group and Company has recognised assets and liabilities in relation to cash collateral received and reinvested in relation to derivatives contracts and stock lending programme. The liability is recognised as Collateral Liability within Other financial liabilities and the reinvestment assets as Reverse Repurchase Assets, within Loans and Receivables at Amortised Cost and liquidity funds within Investments at fair value through profit or loss.

34. Borrowings

	2019		2018	
	£m	£m	£m	£m
	Group	Company	Group	Company
Bank overdrafts	3	—	4	—
Total	3	—	4	—

The fair value of the balances set out above is not materially different to the carrying value due to the short-term nature of these balances.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

35. Net (increase)/decrease in operating assets and liabilities

	2019		2018	
	£m	£m	£m	£m
	Group	*Company*	*Group*	*Company*
Net (increase)/decrease in operating assets				
Deferred costs	17	12	4	—
Investment properties	206	52	(89)	5
Assets arising from reinsurance contracts held	(15,697)	(15,703)	517	517
Tangible fixed assets	—	—	13	—
Other Assets	(29)	(8)	(52)	(60)
Financial assets:				
Derivative financial instruments	(811)	(765)	308	295
Loans and receivables at amortised cost	1,677	1,577	1,363	672
Investments at fair value through profit or loss	(20,376)	(22,919)	6,596	8,498
Net (increase)/decrease in operating assets	(35,013)	(37,754)	8,660	9,927
Net increase/(decrease) in operating liabilities				
Insurance contracts and participating investment contract liabilities	12,667	14,482	(4,664)	(6,799)
Future profits on non-participating business in the With Profits Funds	(21)	(21)	15	15
Unallocated surplus	22	22	10	10
Provisions for other liabilities and charges	(118)	(131)	32	(14)
Accruals and deferred income	(2)	3	(12)	(9)
Financial liabilities:				
Subordinated debt	26	21	(26)	(37)
Non-participating investment contract liabilities	23,601	23,630	(1,592)	(1,622)
Derivative financial instruments	726	753	(428)	(377)
Other financial liabilities	(442)	(186)	(674)	(625)
External interest in collective investment vehicles	(978)	—	(1,541)	—
Lease liabilities	23	—	—	—
Net increase/(decrease) in operating liabilities	35,504	38,573	(8,880)	(9,458)
Net decrease/(increase) in operating assets and liabilities	491	819	(220)	469

36. Dividends paid

	2019	2018
	£m	£m
Total dividends paid on equity shares	300	1,765

The Company paid dividends of £300m in February 2019 (2018: £540m in February 2018, £225m in July 2018 and £1,000m in December 2018). The dividend paid in the year amounted to £4.29 per share (2018: £25.21 per share).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

37. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities

Policyholder liabilities can be analysed into With Profits Fund liabilities and non-participating fund liabilities. In accordance with FRS 103, the liabilities of the With Profits Funds are accounted for using the realistic capital regime of the PRA (realistic liabilities). All non-participating liabilities are accounted for using a traditional prospective actuarial discounted cash flow methodology.

(1) Processes used to determine key assumptions in respect of insurance and investment contracts

(a) Liabilities of the With Profits Funds calculated on a realistic basis

The Group and Company has With Profits Funds containing both insurance and participating investment contracts. The main components of the realistic liabilities are: with profits benefit reserves (i.e. the total asset shares for with profits policies); the costs of options and guarantees; and deductions levied against asset shares and the impact of smoothing policy.

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market consistent basis. The calculation of realistic liabilities uses best estimate assumptions of e.g. mortality, persistency and expenses.

The processes for determining the key assumptions are set out below, and unless otherwise stated, remain unchanged from the prior year:

Investment returns and discount rates

A stochastic economic scenario generator, which uses recognised asset models, provides future asset value and yield scenarios; these determine investment returns for each scenario. The economic scenario generator is calibrated to observable yield curves and option prices where possible. Nominal interest rates are modelled using a standard interest rate model, calibrated to risk-free yields. The risk-free yield is defined as the spot yield derived from the UK swap yield curve less a deduction for credit risk. The liabilities are valued by discounting projected future cash flows using the risk free yield.

Investment volatility

The volatility of future equity returns in excess of nominal interest rates has been calibrated to at-the-money forward options of up to 10 years term on appropriate indices. The indices used are the FTSE-100, the EuroStoxx-50, and the S&P 500. For property, no observable prices exist and so volatility has been derived from analysis of historic data.

Mortality

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are based on recent actual experience, industry tables and projection models, internal research and reinsurance terms.

Persistency

Persistency is a function of both the rate of policy termination and the rate at which policyholders stop paying regular premiums. The assumed levels of these rates are based on a combination of historical experience and management's views on future experience taking into consideration potential changes that may result from guarantees and options becoming more valuable under adverse market conditions.

Maintenance expenses

Allowance is made for the charges applied to the With Profits Funds and these are, for conventional with profits business, governed by the relevant Schemes of Transfer.

Guaranteed annuity option take-up rates

The guaranteed annuity option take-up rates are set with regard to the Company's recent actual experience, increased to reflect future uncertainties where the exercise of options by policyholders might increase liabilities.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

37. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(1) Processes used to determine key assumptions in respect of insurance and investment contracts (continued)

(b) Liabilities of the non-participating funds

(i) Insurance contracts and participating investment contracts

The liabilities of the Group and Company are determined on the basis of recognised actuarial methods. The methods used involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting these cash flows back to the valuation date allowing for probabilities of occurrence.

The liabilities will vary with movements in interest rates (this applies in particular to the cost of guaranteed benefits payable in the future) and with movements in the cost of life assurance and annuity benefits for which future mortality is uncertain.

Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality, costs and credit default. Generally, assumptions used to value the liabilities contain a margin for adverse deviation. This margin for adverse deviation is based on management's judgment and reflects management's views on the inherent level of uncertainty. The assumptions to which the liabilities are most sensitive are the interest rates used to discount the cash flows and the mortality assumptions, particularly those for annuitants.

The key assumptions used in the measurement of the non-participating fund liabilities are:

Interest rates

Discount rates used to value the liabilities for annuity business are set with reference to the risk adjusted yields on the underlying assets and for non-annuity business with reference to cash yields.

Mortality and morbidity

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and includes a margin for adverse deviation. Improvements in annuitant mortality are assumed to follow the CMI_2018 mortality projection model from the Actuarial profession's Continuous Mortality Investigation, with a long term rate of improvement of 2.8% per annum for female and 3.0% for males. The initial rates of improvement assumed are higher than from using the core approach. A higher than core smoothing parameter is also used.

Maintenance expenses

Allowance is explicitly made for future policy costs. Expense loadings are determined by reference to an internal analysis of current and expected future expense levels, plus a margin for adverse deviations. Explicit allowance is made for future expense inflation from the valuation date. No allowance is made for any expected reductions in expense levels that have not occurred at the valuation date.

For business covered by the Diligenta outsourcing contract the impact from this on maintenance costs is allowed for along with a prudent estimate of the associated costs required to deliver the guaranteed financial benefits from the contract. There is no allowance for prudence on contractual costs.

From 1 May 2018, to comply with Ring-Fenced Bank regulations, a mark-up of 4.5% on certain cost recharges from Lloyds banking Group has been included.

Persistency rates

Prudent lapse rate assumptions have been used for term assurance business and other business categories. For term assurance business if the projected liability is negative at any point in the projection of a policy a high lapse rate is assumed, otherwise a low lapse rate is assumed. On other business lines the prudent lapse rates are set at a product level by testing whether an increase or a decrease in lapse rates, relative to our central view, leads to higher reserves.

(ii) Non-participating investment contracts

These contracts are unit-linked, and the liability is determined as the value of the units allocated to the contracts.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

37. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions

(a) With Profits Funds

Assumptions are set for the realistic valuation of the Company's With Profits Funds. In addition, liabilities in respect of non-participating policies in the Scottish Widows With Profits Fund are also accounted for on the regulatory assessment.

(i) Investment returns and discount rates

In the realistic valuation of liabilities in calibrating the economic scenario generator, the risk-free yield curve is defined as the UK swap yield curve less a deduction for credit risk.

The following interest rates are assumed in the regulatory valuation of non-participating policies in the Scottish Widows With Profits Fund:

	Interest rate (net)	
Class of business	**2019**	**2018**
	%	**%**
Annuities in Payment	1.00	1.70
Deferred Annuities	0.90	1.30

(ii) Investment volatility (realistic liabilities only)

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2019, the 10 year equity-implied at-the-money assumption was 16.2% (18.0% as at 31 December 2018). The assumption for property volatility at 31 December 2019 was 12.7% (31 December 2018: 12.7%). The volatility of interest rates has been calibrated to the absolute implied volatility of Swaptions. This is broadly 0.55% as at 31 December 2019 (0.63% at 31 December 2018), based on an average of the at-the-money surface.

(iii) Mortality assumptions

The mortality assumptions for the main classes of business are set with regard to recent Group experience and general industry trends, all of which are adjusted for smoker status and age / sex specific factors. The mortality tables used in the valuation are summarised below.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

37. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(a) With Profits Funds (continued)

(iii) Mortality assumptions (continued)

With Profits Fund

Proposition	Product Type	Heritage	Category	2019 Assumption	2018 Assumption
Annuities					
Purchased Annuities	**Purchased (whole life)**	Scottish Widows	Males	Bespoke tables CMI2018_M_(7.25) 2%_0.6A_2013	Bespoke tables CMI17M_LTR2.0_C0.05 _80-110_2013
			Females	Bespoke tables CMI2018_F_(7.25) 1.8%_0.6A_2013	Bespoke tables CMI17F_LTR1.8_C0.05_ 80-110_2013
Pension Annuities	**Self-employed / personal pensions**	Scottish Widows & Clerical Medical	Males	Bespoke tables CMI2018_M_(7.25) 2%_0.6A_2013	Bespoke tables CMI17M_LTR2.0_C0.05 _80-110_2013
			Females	Bespoke tables CMI2018_F_(7.25) 1.8%_0.6A_2013	Bespoke tables CMI17F_LTR1.8_C0.05_ 80-110_2013
Other Annuities	**Deferred Annuities**	Scottish Widows & Clerical Medical	Males	Bespoke tables CMI2018_M_(7.25) 2%_0.6A_2013	Bespoke tables CMI17M_LTR2.0_C0.05 _80-110_2013
			Females	Bespoke tables CMI2018_F_(7.25) 1.8%_0.6A_2013	Bespoke tables CMI17F_LTR1.8_C0.05_ 80-110_2013
	Other Annuities in payment	Scottish Widows	Males	87% TMCL08 Ultimate CMI2018_M_(7.25) 2%_0.6A_2013	64% AMC00 Ultimate CMI17M_LTR2.0_C0.05 _80-110_2013
			Females	85% TFCL08 Ultimate CMI2018_F_(7.25) 1.8%_0.6A_2013	68% AFC00 Ultimate CMI17F_LTR1.8_C0.05_ 80-110_2013
Assurances					
Assurances	**Conventional With Profits**	Scottish Widows	Males		
			Smoker	85% TMSL08 Ultimate	68% AMS00 Ultimate
			Non smoker/ unknown	77% TMNL08 Ultimate	62% AMN00 Ultimate
			Females		
			Smoker	85% TFSL08 Ultimate	68% AFS00 Ultimate
			Non smoker	82% TFNL08 Ultimate	79% AFN00 Ultimate
			Unknown	84% TFCL08 Ultimate	67% AFC00 Ultimate
		Clerical Medical	Males	35% AMC00 Ultimate	35% AMC00 Ultimate
			Females	50% AFC00 Ultimate	50% AFC00 Ultimate
	Unitised Assurances	Scottish Widows	Males	42% TMCL08 Ultimate	36% AMC00 Ultimate
			Females	66% TFCL08 Ultimate	60% AFC00 Ultimate
		Clerical Medical	Males	79% AMC00 Ultimate	80% AMC00 Ultimate
			Females	83% AFC00 Ultimate	85% AFC00 Ultimate

With regard to the above and subsequent tables:

T80-110 means that the long term rate of mortality improvements in the CMI mortality projections model tapers linearly to zero between ages 80 and 110. The initial rate of improvement and smoothing parameter used are both higher than the core values in CMI_2018.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

37. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(a) With Profits Funds (continued)

(iv) Other assumptions

Deferred annuity contracts with a guaranteed-rate annuity option have been valued based upon an assumed rate of take-up of the guaranteed annuity option of 65% for business which is formerly Scottish Widows plc and 85% for business which is formerly Clerical Medical Investment Group Ltd, for the realistic assessment (75% for business which is formerly Scottish Widows plc and 85% for business which is formerly Clerical Medical Investment Group Ltd at 31 December 2018).

(b) Non-participating funds

The principal assumptions underlying the calculation of each of the business transferred in from Group companies in respect of non-participating fund liabilities are given below.

(i) Investment returns and discount rates

Class of business	Interest rate (net) 2019	2018
	%	%
Annuities in payment	1.71	2.48
Conventional life business and non-unit reserves on linked pre-2013 life business	0.46	0.64
Conventional life business and non-unit reserves on linked post-2013 life business and conventional pensions business and non-unit reserves on other linked pensions business	0.57	0.80

(ii) Mortality assumptions

The initial rate of improvement and smoothing parameter used are both higher than the core values in CMI_2018.

The mortality assumptions for the main classes of business are as follows:

Proposition Annuities	Product Type	Heritage	Category	2019 Assumption	2018 Assumption
Purchased Annuities	**Purchased (whole life)**	Scottish Widows & Clerical Medical	Males	94% Bespoke tables CMI2018_M_(7.25) 3%_0.6A_2013	94% Bespoke tables CMI17M_LTR3.0_C0.05 _85-110_2013
			Females	94% Bespoke tables CMI2018_F_(7.25) 2.8%_0.6A_2013	94% Bespoke tables CMI17F_LTR2.8_C0.05_ 85-110_2013
Pension Annuities	**Self-employed / personal pensions**	Scottish Widows & Clerical Medical	Males	94% Bespoke tables CMI2018_M_(7.25) 3%_0.6A_2013	94% Bespoke tables CMI17M_LTR3.0_C0.05 _85-110_2013
			Females	94% Bespoke tables CMI2018_F_(7.25) 2.8%_0.6A_2013	94% Bespoke tables CMI17F_LTR2.8_C0.05_ 85-110_2013
	Executive Pensions & Pension Annuities	Scottish Widows Clerical Medical & Halifax Life	Males	94% Bespoke tables CMI2018_M_(7.25) 3%_0.6A_2013	94% Bespoke tables CMI17M_LTR3.0_C0.05 _85-110_2013
			Females	94% Bespoke tables CMI2018_F_(7.25) 2.8%_0.6A_2013	94% Bespoke tables CMI17F_LTR2.8_C0.05_ 85-110_2013

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

37. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(b) Non-participating funds (continued)

i. Mortality assumptions

Proposition	Product Type	Heritage	Category	2019 Assumption	2018 Assumption
Annuities					
Other Annuities	**Group Scheme Annuities/ Transferred from LTSB**	Scottish Widows	Males	94% Bespoke tables CMI2018_M_(7.25) 3%_0.6A_2013	94% Bespoke tables CMI17M_LTR3.0_C0.05 _85-110_2013
			Females	94% Bespoke tables CMI2018_F_(7.25) 2.8%_0.6A_2013	94% Bespoke tables CMI17F_LTR2.8_C0.05_ 85-110_2013
	Deferred	Scottish Widows	Males	94% Bespoke tables CMI2018_M_(7.25) 3%_0.6A_2013	94% Bespoke tables CMI17M_LTR3.0_C0.05 _85-110_2013
			Females	94% Bespoke tables CMI2018_F_(7.25) 2.8%_0.6A_2013	94% Bespoke tables CMI17F_LTR2.8_C0.05_ 85-110_2013
		Clerical Medical & Halifax Life	Males	94% Bespoke tables CMI2018_M_(7.25) 3%_0.6A_2013	94% Bespoke tables CMI17M_LTR3.0_C0.05 _85-110_2013
			Females	94% Bespoke tables CMI2018_F_(7.25) 2.8%_0.6A_2013	94% Bespoke tables CMI17F_LTR2.8_C0.05_ 85-110_2013
	Other Annuities in payment	Scottish Widows & Clerical Medical	Males	94% Bespoke tables CMI2018_M_(7.25) 3%_0.6A_2013	94% Bespoke tables CMI17M_LTR3.0_C0.05 _85-110_2013
			Females	94% Bespoke tables CMI2018_F_(7.25) 2.8%_0.6A_2013	94% Bespoke tables CMI17F_LTR2.8_C0.05_ 85-110_2013

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

37. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(b) Non-participating funds (continued)

(iii) Mortality assumptions (continued)

Proposition	**Product Type**	**Heritage**	**Category**	**2019 Assumption**	**2018 Assumption**
Protection					
Whole of Life	**Protection for Life**	Scottish Widows	Males		
			Smoker	85% Bespoke table	89% Bespoke table
			Non smoker	79% Bespoke table	84% Bespoke table
			Females		
			Smoker	88% Bespoke table	88% Bespoke table
			Non smoker	85% Bespoke table	87% Bespoke table
Term Assurance	**Protection for Life**	Scottish Widows	Males		
			Smoker	100% TMSL08 Select	90% TMS00 Select
			Non smoker	99% TMNL08 Select	79% TMN00 Select
			Females		
			Smoker	106% TFNL08 Select	86% TFS00 Select
			Non smoker	89% TFNL08 Select	75% TFN00 Select
	Assurances	Scottish Widows	Males		
			Smoker	110% TMSL08 Ultimate	77% TMS00 Ultimate
			Non smoker/ unknown	94% TMNL08 Ultimate	64% TMN00 Ultimate
			Females		
			Smoker	99% TFSL08 Ultimate	79% TFS00 Ultimate
			Non smoker/ unknown	92% TFNL08 Ultimate	79% TFS00 Ultimate
		Clerical Medical	Males	29% TMC00 Ultimate	29% TMC00 Ultimate
			Females	40% TFC00 Ultimate	40% TFC00 Ultimate
		St Andrews Life	Males		
			Smoker	139% TMSL08 Ultimate	98% TMS00 Ultimate
			Non smoker/ unknown	139% TMNL08 Ultimate	98% TMN00 Ultimate
			Females		
			Smoker	108% TFSL08 Ultimate	86% TFS00 Ultimate
			Non smoker/ unknown	121% TFNL08 Ultimate	104% TFN00 Ultimate

Under the mortality assumptions adopted for personal/ self-employed business a male aged 65 will live on average for 24 years.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

37. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(2) Key assumptions (continued)

(b) Non-participating funds (continued)

(iii) Mortality assumptions (continued)

Proposition Pensions	Product Type	Heritage	Category	2019 Assumption	2018 Assumption
Pensions	**Unitised Pensions**	Scottish Widows	Males	76% TMCL08 Ultimate	53% AMC00 Ultimate
			Females	67% TFCL08 Ultimate	50% AFC00 Ultimate
	Retirement Account	Scottish Widows	Males	68% TMCL08 Ultimate	54% AM92 Ultimate
			Females	64% TFCL08 Ultimate	45% AF92 Ultimate
	UL Individual Pensions (Regular Premium & Single Premium)	Halifax Life	Males	50% AMC00 Ultimate	50% AMC00 Ultimate
			Females	53% AFC00 Ultimate	50% AFC00 Ultimate
	UL Group Pension	Halifax Life	Males	77% AMC00 Ultimate	77% AMC00 Ultimate
			Females	65% AFC00 Ultimate	63% AFC00 Ultimate
	Black Horse Life Pensions	Scottish Widows	Males		
			Smoker	64% TMSL08 Ultimate	54% AMS00 Ultimate
			Non smoker/ Unknown	101% TMNL08 Ultimate	72% AMN00 Ultimate
			Females		
			Smoker	77% TFSL08 Ultimate	61% AFS00 Ultimate
			Non smoker/ Unknown	98% TFNL08 Ultimate	69% AFN00 Ultimate

Proposition Savings and Investments	Product Type	Heritage	Category	2019 Assumption	2018 Assumption
Savings and Investments	**UL SP Investment Bonds**	St. Andrews Life	Males	55% AMC00 Ultimate	54% AMC00 Ultimate
			Females	80% AFC00 Ultimate	81% AFC00 Ultimate

Under the mortality assumptions adopted for personal/ self-employed business a male aged 65 will live on average for 24 years.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

37. Liabilities arising from insurance contracts and investment contracts – assumptions, change in assumptions and sensitivities (continued)

(3) The effect of changes in key assumptions

(a) With Profits Funds

There is no net impact on profit before tax of the changes in key assumptions within the With Profits Funds as any change in policyholder liabilities is offset by an equal and opposite movement in the unallocated surplus of the long-term business.

(b) Non-participating funds

Changes in certain key assumptions were made during the year with the following impacts on profit after tax:

Variable	**Impact on profit after tax**			
	2019		**2018**	
	£m	**£m**	**£m**	**£m**
	Group	Company	Group	Company
Mortality	158	158	164	164
Expenses	167	133	(46)	(46)
Lapses	(62)	(47)	(28)	(28)
Valuation interest rate	(46)	(64)	43	43
Inflation	137	180	(1)	(1)

(4) Sensitivity analysis (in respect of insurance and participating investment contracts only

(a) With Profits Funds

There is no net impact on profit before tax of the changes in key assumptions within the With Profits Funds as any change in policyholder liabilities is offset by an equal and opposite movement in the unallocated surplus of the long-term business.

(b) Non-participating funds

The following table demonstrates the effect of changes in key assumptions on profit after tax assuming that the other assumptions remain unchanged. In practice this is unlikely to occur, and changes in some assumptions may be correlated.

Variable		**Impact on profit after tax**			
	Change in variable	**2019**		**2018**	
		£m	**£m**	**£m**	**£m**
		Group	Company	Group	Company
Annuitant Mortality	5% reduction	(262)	(262)	(210)	(210)
Non-annuitant Mortality	5% reduction	11	11	9	9
Lapses	10% reduction	(29)	(29)	(33)	(33)
Future maintenance expenses and investment expenses	10% reduction	113	93	125	125
Interest rate – change in redemption yield(1)	0.25% reduction	(34)	(29)	(24)	(24)
Interest rate – change in valuation margin(2)	0.25% reduction	(468)	(468)	(378)	(378)

(1) This interest rate sensitivity shows the impact of a 0.25% movement in gilt yields and all of the consequential impacts on key economic assumptions including the investment returns, the valuation rates of interest and values of assets backing the business in question.

(2) This interest rate sensitivity shows, for annuity business, the impact of a change to the valuation rate of interest without a corresponding change to asset yields; this would increase the margin available to cover default and other risks.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management

The principal activity of the Group is the undertaking of ordinary long-term insurance and savings business and associated activities in the United Kingdom. The Group offers a wide range of life insurance products such as annuities, pensions, whole life, term life and investment type products through independent financial advisors, the LBG network and direct sales. The Company also reinsures business with insurance entities external to the Group.

The Group assesses the relative costs and concentrations of each type of risk and material issues are escalated to the appropriate Insurance executive committees and onto the Board if required.

This note summarises these risks and the way in which the Group manages them.

(a) Governance framework

The Group is part of LBG, which has established a risk management function with responsibility for implementing the LBG risk management framework (with appropriate Insurance focus) within the Group.

This enterprise-wide risk management framework for the identification, assessment, measurement and management of risk covers the full spectrum of risks that the Group and Company are exposed to, with risks categorised according to an approved LBG risk language. This covers the principal risks faced by the Group, including the exposures to market, insurance underwriting, model risk, credit, capital, liquidity, regulatory & legal, conduct, people, governance and operational risks. The performance of the Group, its continuing ability to write business and the strategic management of the business depend on its ability to manage these risks.

Responsibility for setting and managing risk appetite and risk policy resides with the Board. Risks are managed in line with LBG and Insurance risk policies. The Board has delegated certain risk matters to the Insurance Risk Oversight Committee (“ROC”) with operational implementation assigned to the Insurance and Wealth Risk Committee (“IWRC”).

The risk management approach aims to ensure effective independent checking or “oversight” of key decisions by operating a “three lines of defence” model. The first line of defence is line management, who have direct accountability for risk decisions. The Risk function provides oversight and challenge and is the second line of defence. Internal Audit, the third line of defence, provide independent assurance to the Insurance Audit Committee and the Board that risks are recognised, monitored and managed within acceptable parameters.

Policy owners, identified from appropriate areas of the LBG and Insurance business, are responsible for drafting risk policies, for ensuring that they remain up-to-date and for facilitating any changes. Policies are subject to at least an annual review. Limits are prescribed within which those responsible for the day to day management of each Group company can take decisions. Line management are required to follow prescribed reporting procedures to the bodies responsible for monitoring compliance with policy and controlling the risks.

(b) Risk appetite

Risk appetite is the amount and type of risk that the Board prefers, accepts or wishes to avoid and is aligned to group and LBG strategy. The Board has defined a framework for the management of risk and approved a set of risk appetite statements that cover financial risks (capital, insurance underwriting, credit, market and liquidity), operational risks, people, conduct risks, regulatory & legal risks, model risk and governance risks. The risk appetite statements set limits for exposures to the key risks faced by the business. Risk appetite is reviewed at least annually by the Board. Executive owned Tier 2 and Tier 3 limits sit beneath Board owned risk appetite (Tier 1) and are managed and governed within the Insurance business.

Experience against Risk Appetite is reported monthly (by exception) to each meeting of IWRC and ROC. Copies are also supplied regularly to the Group’s regulators as part of the close and continuous relationship. Reporting focuses on ensuring, and demonstrating to the Board, and their delegate the ROC that the Group is run in line with approved risk appetite. Any breaches of risk appetite require clear plans and timescales for resolution.

(c) Financial risks

The Group writes a variety of insurance and investment contracts which are subject to a variety of financial risks, as set out below. Contracts can be either single or regular premium and conventional (non-profit), With Profits or unit-linked in nature.

The Group is exposed to a range of financial risks through its financial assets, financial liabilities, assets arising from reinsurance contracts and liabilities arising from insurance and investment contracts. In particular, the key financial risk is that long-term investment proceeds are not sufficient to fund the obligations arising from its insurance and investment contracts. The most important components of financial risk are market, insurance underwriting, credit, capital and liquidity risk.

The Group manages these risks in a numbers of ways, including risk appetite assessment and monitoring of capital resource requirements. In addition, the Principles and Practices of Financial Management (“PPFMs”) set out the way in which the With Profits business is managed. The Group also uses financial instruments (including derivatives) as part of its business activities and to reduce its own exposure to market risk and credit risk.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

For With Profits business, subject to minimum guarantees, policyholders' benefits are influenced by the smoothed investment returns on assets held in the With Profits Funds. The smoothing cushions policyholders from daily fluctuations in investment markets. This process is managed in accordance with the published PPFMs.

The financial risks arising from providing minimum guaranteed benefits are borne in the With Profits Funds, but the Group bears financial risk in relation to the possibility that in extreme market conditions the With Profits Funds might be unable to bear the full costs of the guarantees. The amount of the guaranteed benefits increases as additional benefits are declared and allocated to policies.

For unit-linked business, policyholders' benefits are closely linked to the investment returns on the underlying funds. In the short term, profit and equity are therefore largely unaffected by investment returns on assets in internal unit-linked funds as any gains or losses will be largely offset by changes in the corresponding insurance and investment contract liabilities, provided that there is appropriate matching of assets and liabilities within these funds. However, any change in the market value of these funds will have an indirect impact on the Group and Company through the collection of annual management and other fund related charges. As markets rise or fall, the value of these charges rises or falls correspondingly.

For non-participating business, the principal market risk is interest rate risk, which arises because assets and liabilities may exhibit differing changes in market value as a result of changes in interest rates. Asset and liability matching is used to mitigate the impact of changes in interest rates where the difference is material.

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The summary of significant accounting policies (note 1) describes how the classes of financial instruments are measured and how income and expenses, including fair value gains and losses, are recognised.

The timing of the unwind of the deferred tax assets and liabilities is dependent on the timing of the unwind of the temporary timing differences, arising between the tax bases of the assets and liabilities and their carrying amounts for financial reporting purposes, to which these balances relate.

The sensitivity analyses given throughout this note are based on a change in an assumption while holding all other assumptions constant. In practice, this is unlikely to occur as changes in some of the assumptions may be correlated, for example changes in interest rates and changes in market values. The sensitivity analysis presented also represents management's assessment of a reasonably possible alternative in respect of each sensitivity, rather than worst case scenario positions.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk

Market risk is defined as the risk that our capital or earnings profile is affected by adverse market rates, in particular equity and credit spreads in Insurance business.

Investment holdings within the Group are diversified across markets and, within markets, across sectors. Holdings of individual assets are diversified to minimise specific risk and large individual exposures are monitored closely. For assets held with unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

Market risk policy is dependent on the nature of the funds in question, and can be broadly summarised as follows:

- Assets held in shareholder funds are invested in money market funds, gilts, loans and investment grade bonds. Assets held in excess of the Best Estimate of Liabilities are managed in line with the policies of LBG to optimise shareholder risk and return; with the exception of some credit assets to support the bulk annuity proposition these assets are deemed to be safe assets.
- Unit-linked assets are invested in accordance with the nature of the fund mandates. "Unit matching" is adopted on a significant proportion of unit-linked business, under which sufficient units are created to cover Solvency II technical provisions.
- Conventional non-profit liabilities are "close matched" as far as possible in relation to currency, nature and duration.
- With Profits Funds are managed in line with the published PPFMs. Benchmarks and minimum and maximum holdings in asset classes are specified to allow limited investment management discretion whilst ensuring adequate diversification. Swaps and swaptions provide significant protection to the With Profits Funds from the effects of interest rate falls in respect of the cost of guaranteed annuity rates.

Below is an analysis of assets and liabilities at fair value through profit or loss and assets and liabilities for which a fair value is required to be disclosed, according to their fair value hierarchy (as defined in note 1 (d)).

Group As at 31 December 2019

	Fair value hierarchy			
	Level 1 £m	**Level 2 £m**	**Level 3 £m**	**Total £m**
Investment properties	—	—	3,523	3,523
Assets arising from reinsurance contracts held at fair value through profit or loss	—	22,837	—	22,837
Shares and other variable yield securities	92,947	—	785	93,732
Debt and other fixed/variable income securities	11,878	20,205	283	32,366
Loans and advances to customers	—	—	8,804	8,804
Loans and advances to banks	—	2,255	—	2,255
Derivative financial assets	45	3,777	146	3,968
Total assets	104,870	49,074	13,541	167,485
Derivative financial liabilities	36	3,409	—	3,445
Liabilities arising from non-participating investment contracts	—	37,456	—	37,456
Subordinated debt	—	1,795	—	1,795
Total liabilities	36	42,660	—	42,696

For all financial instruments held at amortised cost by the Group and Company, carrying value is a reasonable approximation of fair value.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

Company As at 31 December 2019

	Fair value hierarchy			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	—	—	132	132
Assets arising from reinsurance contracts held at fair value through profit or loss	—	22,837	—	22,837
Shares and other variable yield securities	100,727	28	848	101,603
Debt and other fixed/variable income securities	7,394	6,978	927	15,299
Loans and advances to customers	—	—	8,250	8,250
Loans and advances to banks	—	1,203	—	1,203
Deposits with cedants	—	1,507	—	1,507
Derivative financial assets	22	3,726	146	3,894
Transfer of Assets held for sale	—	—	—	—
Total assets	108,143	36,279	10,303	154,725
Derivative financial liabilities	31	3,403	—	3,434
Liabilities arising from non-participating investment contracts	—	37,455	—	37,455
Subordinated debt	—	1,820	—	1,820
Total liabilities	31	42,678	—	42,709

For all financial instruments held at amortised cost by the Group and Company, carrying value is a reasonable approximation of fair value.

Group As at 31 December 2018

	Fair value hierarchy			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	—	—	3,729	3,729
Assets arising from reinsurance contracts held at fair value through profit or loss	—	7,132	—	7,132
Shares and other variable yield securities	74,718	—	666	75,384
Debt and other fixed/variable income securities	10,819	19,962	252	31,033
Loans and advances to customers	—	—	7,845	7,845
Loans and advances to banks	—	2,518	1	2,519
Derivative financial assets	90	3,028	39	3,157
Total assets	85,627	32,640	12,532	130,799
Derivative financial liabilities	132	2,587	—	2,719
Liabilities arising from non-participating investment contracts	—	13,855	—	13,855
Subordinated debt	—	1,769	—	1,769
Total liabilities	132	18,211	—	18,343

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

Company As at 31 December 2018

	Fair value hierarchy			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Investment properties	—	—	184	184
Assets arising from reinsurance contracts held at fair value through profit or loss	—	7,132	—	7,132
Shares and other variable yield securities	84,876	84	681	85,641
Debt and other fixed/variable income securities	5,345	6,511	882	12,738
Loans and advances to customers	—	—	7,259	7,259
Loans and advances to banks	—	1,470	—	1,470
Derivative financial assets	76	3,013	40	3,129
Transfer of Assets held for sale	(2,051)	—	(114)	(2,165)
Total assets	88,246	18,210	8,932	115,388
Derivative financial liabilities	103	2,578	—	2,681
Liabilities arising from non-participating investment contracts	—	13,825	—	13,825
Subordinated debt	—	1,799	—	1,799
Total liabilities	103	18,202	—	18,305

Assets arising from reinsurance contracts held at fair value through profit and loss are valued using the published price for the funds invested in. Participating investment contracts are not included above, on the basis that fair value and carrying value would not be materially different.

The derivative securities classified as Level 2 above have been valued using a tri-party pricing model as determined by the Pricing Source Agreement between Investment Manager(s) and the Third Party Administrator (State Street). Further detail on valuation is given in note 1(o).

Assets classified as Level 3 include portfolios of illiquid loans and advances to customers, investments in private debt funds and private equity assets, investment properties, investments in asset-backed securities and corporate debt instruments.

Private equity investments are valued using the financial statements of the underlying companies prepared by the general partners, adjusted for known cash flows since valuation and subject to a fair value review to take account of other relevant information. Property investment vehicles are valued based on the net asset value of the relevant Company which incorporates surveyors' valuations of property. Investment property is independently valued as described in note 17. Valuations are based on observable market prices for similar properties. Adjustments are applied, if necessary, for specific characteristics of the property, such as the nature, location, or condition of the specific asset. If such information is not available alternative valuation methods such as discounted cash flow analysis or recent prices in less active markets are used. Where any significant adjustments to observable market prices are required, the property would be classified as Level 3. Whilst such valuations are sensitive to estimates, it is believed that changing one or more of the assumptions to reasonably possible alternative assumptions would not change the fair value significantly.

The following valuation methods and sensitivity of valuation assumptions are applied to both the Group and the Company.

Loan assets

Loans classified as Level 3 within debt securities are valued using a discounted cash flow model. The discount rate comprises market observable interest rates, a risk margin that reflect loan credit ratings and calibrated to weighted average life on borrower level using sector bond spread curves for each rating, and an incremental illiquidity premium that is estimated by reference to historical spreads at origination on similar loans where available and established measures of market liquidity. Libor tenor and base rate options are valued by comparing the current tenor with the lowest tenor option (basis swap approach). Prepayment options are valued using a monthly time step binomial tree approach.

Unobservable inputs in the valuation model include an Illiquidity premium (2019 loan to bond spreads: 18.5bps to 51.5bps) and Inferred spreads (2019 credit spreads: 73.1bps to 140.5bps). The effect of applying reasonably possible alternative assumptions to the value of these loans would be to decrease the fair value by £332m (2018: £304m) or increase it by £345m (2018: £326m). There are no material interdependencies between the above assumptions.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

Equity release mortgages – ERM SPV

A portfolio of Equity Release Mortgages is securitised through a Special Purpose Vehicle into a Senior Note (A Note) and a Junior Note (B Note).

The value of the B Note is determined using a discounted cash flow approach with a spread based judging movements in the spread for comparable instruments against the changes in expected performance of the underlying portfolio of mortgages. The value of the A Note is derived from the value of the underlying portfolio, the value of the B note and the value of the remaining contracts of the Special Purpose Vehicle. These notes are classified as Level 3 within debt securities due to the unobservable parameters required in the valuation of the B note and in the valuation of the portfolio of mortgages.

The equity release mortgages are valued using a discounted cash flow approach. Decrements (mortality, voluntary early repayment, entry into long-term care) are used to determine the incidence of cash flows. The discount rate is based on a risk free rate plus a spread with the spread assessed by reference to the market for new Equity Release Mortgages, after adjusting for the relative risks associated with this portfolio of loans and those of a notional portfolio of new mortgages. In the assessment of the value of the risks, the No Negative Equity Guarantee for Equity Release Mortgages is valued using a time-dependent Black-Scholes model at £14.7m as at 31 December 2019 (Dec 2018: £16.7m).

Inputs in the valuation model include the gross interest rate applicable to a notional portfolio of new Equity Release Mortgages, risk free rates, residential property volatilities, property valuation haircuts and settlement lags as well as decrement assumptions on mortality, voluntary early repayment and entry into long-term care.

December 2019 Valuation Uncertainty calculations principally reflect uncertainty in the market rates for comparable notional portfolios and a range of decrement assumptions and their corresponding impacts on the value of the A Note and B Note. The range of notional portfolio rate assumptions was 3.26% to 4.94% (Dec 2018: 4.26% to 5.58%).

The effect of applying the aforementioned reasonably possible alternative assumptions in line with the ranges disclosed above on the A & B Notes would be to decrease the fair value by £6m (Dec 2018: £17m) or increase it by £12m (Dec 2018: £1m).

Private Credit Funds

SWL hold investments in two private credit funds that hold portfolios of loans to European medium-sized enterprises where loans are often backed by commercial real estate. The assets are classified as Level 3 and are included within equity securities. The underlying loan values, on which the investment values are based, are assessed by the fund manager on a discounted cash flow approach using spreads determined from the credit quality and illiquidity of the loans as compared to other credit assets. Our valuation uncertainty on these investments is assessed based on the valuation uncertainty characteristics of the underlying illiquid loans.

The effect of applying reasonably possible alternative assumptions to the value of these assets would be to decrease the fair value by £7m (Dec 2018: £6m) or increase it by £1m (Dec 2018: £2m).

Agricultural Loans – AMC SPV

A portfolio of agricultural loans is securitised through a Special Purpose Vehicle into a Senior Note (A Note) and a Junior Note (E Note). These notes are classified as Level 3 within debt securities. The underlying agricultural loans are valued using a discounted cash flow approach. The discount rate comprises market observable interest rates, a risk margin that reflect underlying loan credit ratings, a spread to represent the risks associated with the Agricultural sector (Via Utility bonds as a proxy) and an incremental illiquidity premium as well as a prepayment cost of capital premium. The discount rate is based on a risk free rate plus a spread to compensate for the risks associated with the loans, which is determined on a portfolio level.

Unobservable inputs in the Agriculture valuation model include: Generic spreads based of Merrill Lynch pool of bonds (change of +14.0bps and 0bps to base), Illiquidity premium (2019 loan to bond spreads: 18.5bps to 51.5bps), and Utility Securities inferred spreads (2019 spreads: -4bps to -34bps) and prepayment rates (2019 rates: 0.11% to 0.13% for 1-5yrs and 0.14% for 5+ yrs).

The effect of applying reasonably possible alternative assumptions to the valuation of the loans and senior note would be to decrease the fair value of the SPV by £12m or increase it by £9m . There are no material interdependencies between the above assumptions.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

Derivatives Unobservable inputs - Fair Value Hierarchy level 3

Complex derivatives can be transacted in order to hedge complex risks within other level 3 assets. Complex derivatives which have unobservable inputs, such as volatilities and correlations, in their valuation model are assessed as level 3.

Favourable and adverse scenarios are determined by stressing unobservable inputs into the valuation models, with reference to the valuations of the instruments they hedge where appropriate, in order to generate a plausible range of fair values that different market participants might apply

The effect of applying reasonably possible alternative assumptions to the value of these assets would be to decrease the fair value by £26m (Dec 2018: £30m) or increase it by £1m (Dec 2018: nil).

The table below shows movements in the assets and liabilities measured at fair value based on valuation techniques for which any significant input is not based on observable market data (Level 3 only).

Group

	2019		2018	
	£m	£m	£m	£m
	Assets	*Liabilities*	*Assets*	*Liabilities*
Balance at 1 January	12,532	—	12,235	—
Transfers in	421	—	703	—
Transfers out	(147)	—	(664)	—
Purchases	1,422	—	1,125	—
Disposals	(984)	—	(950)	—
Net gains recognised within net gains on assets and liabilities at fair value through profit or loss in the statement of comprehensive income	297	—	83	—
Balance at 31 December	13,541	—	12,532	—
Total unrealised gains for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	245	—	32	—

Company

	2019		2018	
	£m	£m	£m	£m
	Assets	*Liabilities*	*Assets*	*Liabilities*
Balance at 1 January	8,932	—	8,756	—
Transfers in	267	—	21	—
Transfers out	—	—	(85)	—
Purchases	1,355	—	953	—
Disposals	(649)	—	(521)	—
Assets held for sale	—	—	(114)	—
Net gains recognised within net gains on assets and liabilities at fair value through profit or loss in the statement of comprehensive income	398	—	(78)	—
Balance at 31 December	10,303	—	8,932	—
Total unrealised gains for the period included in the statement of comprehensive income for assets and liabilities held at 31 December	340	—	20	—

Total gains or losses for the period included in the statement of comprehensive income, as well as total gains or losses relating to assets and liabilities held at the reporting date, are presented in the statement of comprehensive income, through net gains/ losses on assets and liabilities at fair value through profit or loss.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

(i) Equity and property risk

The exposure of the Group's insurance and investment contract business to equity risk relates to financial assets and financial liabilities whose values will fluctuate as a result of changes in market prices other than from interest and foreign exchange fluctuations. This is due to factors specific to individual instruments, their issuers or factors affecting all instruments traded in the market. Accordingly, the Group monitors exposure limits both to any one counterparty and any one market.

From 2018, exposure to market risk has been managed by the implementation of unit matching and equity hedging to reduce the sensitivity of future dividend payments to market movements. Unit matching involves more effectively matching unit linked liabilities on a best-estimate view (as defined by Solvency regulations). This best-estimate view incorporates an allowance for expected future income and expenses, which are not fully allowed for under IFRS. As a result, this leads to a mismatch between IFRS statutory assets and liabilities in respect of market movements. For example, in the event of rising markets, a loss would now be recognised in the accounts as a result of this mismatch, which would be offset in the future due to higher income as fees are received.

The effect on the Group of changes in the value of investment property held in respect of investment contract liabilities due to fluctuations in property prices is negligible as any changes will be offset by movements in the corresponding liability.

The sensitivity analysis below illustrates how the fair value of future cash flows in respect of equities and properties, net of offsetting movements in insurance and investment contract liabilities, will fluctuate because of changes in market prices at the reporting date. The equity sensitivity includes the impact of unit matching and equity hedging which leads to a statutory profit, mainly due to the hedge payoff under falling markets.

	Impact on profit after tax and equity for the year	
	2019	**2018**
	£m	**£m**
10% (2018: 10%) decrease in equity prices	131	140
10% (2018: 10%) decrease in property prices	(5)	(5)

(ii) Interest rate risk

Interest rate risk is the risk that the value of future cash flows of a financial instrument will fluctuate because of changes in interest rates and the shape of the yield curve. Interest rate risk in respect of the Group's insurance and investment contracts arises when there is a mismatch in duration or yield between liabilities and the assets backing those liabilities.

The Group's interest rate risk policy requires that the maturity profile of interest-bearing financial assets is appropriately matched to the guaranteed elements of the financial liabilities.

A fall in market interest rates will result in a lower yield on the assets supporting guaranteed investment returns payable to policyholders. This investment return guarantee risk is managed by matching assets to liabilities as closely as possible. An increase in market interest rates will result in a reduction in the value of assets subject to fixed rates of interest which may result in losses, as a result of an increase in the level of surrenders, the corresponding fixed income securities have to be sold.

The effect of changes in interest rates in respect of financial assets which back insurance contract liabilities is given in note 37. The effect on the Group of changes in the value of investments held in respect of investment contract liabilities due to fluctuations in market interest rates is negligible as any changes will be offset by movements in the corresponding liability.

The sensitivity analysis below illustrates how the fair value of future cash flows in respect of interest-bearing financial assets, net of offsetting movements in insurance and investment contract liabilities, will fluctuate because of changes in market interest rates at the reporting date.

	Impact on profit after tax and equity for the year	
	2019	**2018**
	£m	**£m**
25 basis points (2018: 25 basis points) increase in yield curves	28	18
25 basis points (2018: 25 basis points) decrease in yield curves	(34)	(24)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(1) Market risk (continued)

(iii) Foreign exchange risk

Foreign exchange risk relates to the effects of movements in exchange markets including changes in exchange rates.

The Group's foreign currency exposure is driven by holding financial instruments to hedge changes in future investment management fees resulting from exchange rate movements. These investment management fees are based on charges to policyholder funds invested in overseas equities. The hedges are placed by the Company to reduce foreign exchange exposure in the SWL SII capital position.

Sensitivity analysis for the impact of a 10% depreciation of sterling against foreign currency shows a £(131)m impact for 2019 on profit after tax and equity (2018: nil).

With the exception of these holdings, the overall risk to the Group is minimal due to the following:

- The Group's principal transactions are carried out in pounds sterling;
- The Group's financial assets are primarily denominated in the same currencies as its insurance and investment contract liabilities; and
- Other than shareholder funds, all non-linked investments of the non-profit funds are in sterling or are currency matched. The effect on the Group of changes in the value of investments held in respect of investment contract liabilities due to fluctuations in foreign exchange rates is negligible as any changes will be offset by movements in the corresponding liability.

(2) Insurance underwriting risk

Insurance underwriting risk is defined as the risk of adverse developments in the timing, frequency and severity of claims for insured/underwritten events and in customer behaviour, leading to reductions in earnings and/or value.

The principal risk the Group faces under insurance contracts is that the actual claims and benefit payments exceed the amounts expected at the time of determining the insurance liabilities.

The nature of the Group's business involves the accepting of insurance underwriting risks which primarily relate to mortality, longevity, morbidity, persistency and expenses. When transacting new business, the Group underwrites policies to ensure an appropriate premium is charged for the risk or that the risk is declined.

The Group principally writes the following types of life insurance contracts:

- Life assurance – where the life of the policyholder is insured against death or permanent disability, usually for pre-determined amounts;
- Annuity products – where typically the policyholder is entitled to payments which cease upon death; and
- Morbidity products – where the policyholder is insured against the risk of contracting a defined illness.

For contracts where death is the insured risk, the most significant factors that could increase the overall level of claims are epidemics or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected. The possibility of a pandemic, for example one arising from influenza, is regarded as a potentially significant mortality risk. For contracts where survival is the insured risk, the most significant factor is continued improvement in medical science and social conditions that would increase longevity.

For contracts with fixed and guaranteed benefits and fixed future premiums, there are no mitigating terms and conditions that significantly reduce the insurance underwriting risk accepted. For participating investment contracts, the participating nature of these contracts results in a significant portion of the insurance underwriting risk being shared with the policyholder.

Insurance underwriting risk is also affected by the policyholders' right to pay reduced or no future premiums, to terminate the contract completely, to exercise a guaranteed annuity option or, for bulk annuity business, for pensioners to exercise options following retirement. As a result, the amount of insurance underwriting risk is also subject to policyholder behaviour. On the assumption that policyholders will make decisions that are in their best interests, overall insurance underwriting risk will generally be aggravated by policyholder behaviour. For example, it is likely that policyholders whose health has deteriorated significantly will be less inclined to terminate contracts insuring death benefits than those policyholders who remain in good health.

The Group has taken account of the expected impact of policyholder behaviour in setting the assumptions used to measure insurance and investment contract liabilities.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(2) Insurance underwriting risk (continued)

The principal methods available to the Group to control or mitigate longevity, mortality and morbidity risk are through the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed);
- Pricing-to-risk (new insurance proposals would usually be priced in accordance with the underwriting assessment);
- Demographics to accurately assess mortality risk;
- Claims management;
- Product design;
- Policy wording; and
- The use of reinsurance and other risk mitigation techniques.

Rates of mortality and morbidity are investigated annually based on the Group's recent experience. Future mortality improvement assumptions are set using the latest population data available. In addition, bulk annuity business pricing and valuation assumptions also consider underlying experience of the scheme where available. Where they exist, the reinsurance arrangements of each company in the Group are reviewed at least annually.

Persistency risk is the risk associated with the ability to retain long-term business and the ability to renew short-term business. The Group aims to reduce its exposure to persistency risk by undertaking various initiatives to promote customer loyalty. These initiatives are aimed both at the point of sale and through direct contact with existing policyholders, for example through annual statement information packs.

Further information on assumptions, changes in assumptions and sensitivities in respect of insurance and participating investment contracts is given in note 37.

(3) Credit risk

The risk that parties with whom we have contracted, fail to meet their financial obligations (both on and off balance sheet).

The Group accepts credit risk with a variety of counterparties through invested assets which are primarily used to back annuity business, cash in liquidity funds and bank accounts, derivatives and reinsurance. These are managed through a credit control framework which uses a tiered approach to set credit limits:

- Tier 1: Credit limits are set by the Insurance Board as part of the overall Insurance Risk Appetite.
- Tier 2: Insurance and Wealth Investment Strategy Committee ('IWISC') assists the IWISC Chair to set additional controls, sub limits and guidelines. These operate within the boundaries of the Board's Tier 1 Risk Appetite statements and are designed to assist the business with more efficient utilisation of higher level Board Risk Appetite statements in delivery of Insurance's investment strategy.
- Tier 3: Insurance Credit approvers have individual personal delegated authorities from the Insurance Board to approve exposures to individual counterparties. Amounts above these delegated authorities require approval by the Insurance Board.

Group exposure limits are set for the maximum single name concentration, industry sector, country of risk and portfolio quality. In addition, each individual counterparty exposure requires a counterparty limit or is within the criteria of an approved sanction matrix.

Group exposures are reported on a monthly basis to the Insurance Shareholder Investment Management Committee ('ISIM') and semi-annually to IWISC, and other senior committees. Any exceptions to limits must be approved in advance by the relevant authority that owns that limit, and any unapproved excesses notified to that authority as a breach.

A core part of the invested asset portfolio which backs the annuity business is invested in loan assets. These have predominately been purchased from LBG although the Group has also started originating new business. All loan assets are assessed and monitored using established robust processes and controls.

Reinsurance is primarily used to reduce insurance risk. However, it is also sought for other reasons such as improving profitability, reducing capital requirements and obtaining technical support. In addition, reinsurance is also used to offer policyholders access to third party funds via Investment Fund Links which we are unable to provide through other means. The Group's reinsurance strategy is to reduce the volatility of profits through the use of reinsurance whilst managing the insurance and credit risk within the constraints of the risk appetite limits.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

The Group has reinsurance on all significant lines of business where mortality, morbidity or property risks exceed set retention limits. This does not, however, discharge the Group's liability as primary insurer. If a reinsurer fails to pay a claim for any reason, the Group remains liable for the payment to the policyholder. All new material reinsurance treaties are subject to Board approval and reinsurance arrangements are reviewed annually to ensure that the reinsurance strategy is being achieved. Reinsurance for Investment Fund Links is not assessed as a counterparty exposure for the Group since with invested assets matching liabilities, any loss to the Group would only be the result of operational failures of internal controls and as such it is outside of the credit control framework described above.

Shareholder funds are managed in line with the Insurance Credit Risk Policy and the wider LBG Credit Risk Policy which set out the principles of the credit control framework outlined above.

Credit risk in respect of unit-linked funds and With Profits Funds is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for those funds.

The tables below analyse financial assets and reinsurance assets subject to credit risk exposure using Standard & Poor's rating or equivalent. For certain classes of assets, internally generated ratings have been used where external ratings are not available. This includes credit assets held in both shareholder and policyholder funds. No account is taken of any collateral held to mitigate the risk.

Group As at 31 December 2019

	Total	AAA	AA	A	BBB or lower	Not rated
	£m	£m	£m	£m	£m	£m
Stage 1 assets						
Cash and cash equivalents	276	1	17	204	48	6
Loans and receivables at amortised cost	483	—	—	403	—	80
Loss allowance	—	—	—	—	—	—
Exposure to credit risk	759	1	17	607	48	86
Simplified approach assets						
Loans and receivables at amortised cost	514	—	—	22	—	492
Loss allowance	(5)	—	—	—	—	(5)
Exposure to credit risk	509	—	—	22	—	487
Assets at FVTPL						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	22,837	—	—	22,551	286	—
Debt and other fixed/variable income securities	32,366	2,152	15,026	6,689	8,337	162
Derivative financial instruments	3,968	—	454	3,395	74	45
Loans and advances to customers	8,804	73	1,324	4,439	2,376	592
Loans and advances to banks	2,255	—	18	2,172	58	7
Other						
Reinsurance contracts	720	—	589	131	—	—
Total	72,218	2,226	17,428	40,006	11,179	1,379

Cash at bank, included with Stage 1 assets, is considered to have low credit risk.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

Group As at 31 December 2018

	Total	AAA	AA	A	BBB or lower	Not rated
	£m	£m	£m	£m	£m	£m
Stage 1 assets						
Cash and cash equivalents	174	1	24	122	18	9
Loans and receivables at amortised cost	2,312	—	—	1,789	—	523
Loss allowance	—	—	—	—	—	—
Exposure to credit risk	2,486	1	24	1,911	18	532
Simplified approach assets						
Loans and receivables at amortised cost	362	—	—	72	—	290
Loss allowance	(6)	—	—	(3)	—	(3)
Exposure to credit risk	356	—	—	69	—	287
Assets at FVTPL						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	7,132	—	—	7,111	21	—
Debt and other fixed/variable income securities	31,033	2,423	13,261	7,034	8,156	159
Derivative financial instruments	3,157	—	322	2,413	333	89
Loans and advances to customers	7,845	72	945	4,774	1,418	636
Loans and advances to banks	2,519	—	540	448	110	1,421
Other						
Reinsurance contracts	728	—	555	172	1	—
Total	55,256	2,496	15,647	23,932	10,057	3,124

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

Company As at 31 December 2019

	Total £m	AAA £m	AA £m	A £m	BBB or lower £m	Not rated £m
Stage 1 assets						
Cash and cash equivalents	98	—	—	53	45	—
Loans and receivables at amortised cost	411	—	—	402	—	9
Loss allowance	—	—	—	—	—	—
Exposure to credit risk	509	—	—	455	45	9
Simplified approach assets						
Loans and receivables at amortised cost	208	—	—	22	—	186
Loss allowance	(2)	—	—	—	—	(2)
Exposure to credit risk	206	—	—	22	—	184
Assets at FVTPL						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	22,837	—	—	22,551	286	—
Debt and other fixed/variable income securities	15,299	591	9,065	2,792	2,605	246
Derivative financial instruments	3,894	—	452	3,347	74	21
Loans and advances to customers	8,250	73	1,324	4,439	2,376	38
Loans and advances to banks	1,203	—	—	1,188	15	—
Deposits with cedants	1,507	—	—	—	—	1,507
Other						
Reinsurance contracts	726	—	595	131	—	—
Total	54,431	664	11,436	34,925	5,401	2,005

Cash at bank, included with Stage 1 assets, is considered to have low credit risk.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

Company As at 31 December 2018

	Total £m	AAA £m	AA £m	A £m	BBB or lower £m	Not rated £m
Stage 1 assets						
Cash and cash equivalents	41	—	7	21	13	—
Loans and receivables at amortised cost	1,838	—	—	1,797	—	41
Loss allowance	—	—	—	—	—	—
Exposure to credit risk	1,879	—	7	1,818	13	41
Simplified approach assets						
Loans and receivables at amortised cost	358	—	—	72	—	286
Loss allowance	(2)	—	—	(2)	—	—
Exposure to credit risk	356	—	—	70	—	286
Assets at FVTPL						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	7,132	—	—	7,111	21	—
Debt and other fixed/variable income securities	12,738	652	7,059	2,552	2,237	238
Derivative financial instruments	3,129	—	311	2,409	333	76
Loans and advances to customers	7,259	72	945	4,774	1,417	51
Loans and advances to banks	1,470	—	13	38	17	1,402
Transferred to Assets held for sale	(234)	—	—	—	—	(234)
Other						
Reinsurance contracts	728	—	555	172	1	—
Total	34,457	724	8,890	18,944	4,039	1,860

Amounts classified as "not rated" within assets arising from reinsurance contracts held principally relate to amounts due from other Group companies which are not rated by Standard & Poor's or an equivalent rating agency.

Expected credit losses are calculated using three key input parameters: the probability of default ("PD") (except for lifetime expected credit losses), the expected loss given default ("LGD") and the exposure at default ("EAD"). The probability of default and expected loss given default are determined using internally generated credit ratings. For lease receivables, the past due information is used to determine the expected loss given default.

Expected credit losses are measured on a collective basis for certain Groups of financial assets, such as control accounts, trade receivables and intercompany receivables, which are considered to be homogenous in terms of their risk of default.

Maximum credit exposure

The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss, which includes amounts held to cover unit-linked and With Profits Funds liabilities, is considered to be the balance sheet carrying amount.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

Group	2019			2018		
	Maximum exposure £m	Offset £m	Net exposure £m	Maximum exposure £m	Offset £m	Net exposure £m
Loans and receivables at amortised cost	997	—	997	2,674	—	2,674
Investments at fair value through profit or loss:						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	22,837	—	22,837	7,132	—	7,132
Debt securities	32,366	—	32,366	31,033	—	31,033
Derivative Financial Instruments	3,968	—	3,968	3,157	—	3,157
Loans and advances to customers	8,804	—	8,804	7,845	—	7,845
Loans and advances to banks	2,255	—	2,255	2,519	—	2,519
Reinsurance contracts	720	—	720	728	—	728
Cash and cash equivalents	276	—	276	174	—	174
At 31 December	72,223	—	72,223	55,262	—	55,262

Company	2019			2018		
	Maximum exposure £m	Offset £m	Net exposure £m	Maximum exposure £m	Offset £m	Net exposure £m
Loans and receivables at amortised cost	619	—	619	2,196	—	2,196
Investments at fair value through profit or loss:						
Assets arising from reinsurance contracts held classified at fair value through profit and loss	22,837	—	22,837	7,132	—	7,132
Debt securities	15,299	—	15,299	12,738	—	12,738
Derivative Financial Instruments	3,894	—	3,894	3,129	—	3,129
Loans and advances to customers	8,250	—	8,250	7,259	—	7,259
Loans and advances to banks	1,203	—	1,203	1,470	—	1,470
Deposits with cedants	1,507	—	1,507	—	—	—
Reinsurance contracts	726	—	726	728	—	728
Cash and cash equivalents	98	—	98	41	—	41
At 31 December	54,433	—	54,433	34,693	—	34,693

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

(i) Concentration risk

Credit concentration risk

Credit concentration risk relates to the inadequate diversification of credit risk.

Credit risk is managed through the setting and regular review of counterparty credit and concentration limits on asset types which are considered more likely to lead to a concentration of credit risk. For other asset types, such as UK government securities or investments in funds falling under the Undertakings for Collective Investment in Transferable Securities “UCITS” Directive, no limits are prescribed as the risk of credit concentration is deemed to be immaterial. This policy supports the approach mandated by the PRA for regulatory reporting.

At 31 December 2019 and 31 December 2018, the Group did not have any significant concentration of credit risk with a single counterparty or Group of counterparties where limits applied. With the exception of Government bonds and UCITS funds, the largest aggregated counterparty exposure is 0.2% (2018: 1.0% of the Group’s total assets).

	Total
	£m
Trade and other receivables:	
Amounts due from brokers	62
Amounts due from group undertakings	413
Other receivables	522
Cash and cash equivalents with financial institutions	276
Total	1,273

For other receivables, the largest single counterparty balance is with policyholders, which totals £71m.

Liquidity concentration risk

Liquidity concentration risk arises where the Group is unable to meet its obligations as they fall due or do so only at an excessive cost, due to over-concentration of investments in particular financial assets or classes of financial asset.

As most of the Group's invested assets are diversified across a range of marketable equity and debt securities in line with the investment options offered to policyholders it is unlikely that a material concentration of liquidity concentration could arise.

This is supplemented by active liquidity management in the Group, to ensure that even under stress conditions the Group has sufficient liquidity as required to meet its obligations. This is delegated by the Board to and monitored through the Insurance and Wealth Asset and Liability Committee (IWALCO), IWRC, ISIM and Banking and Liquidity Operating Committee (BLOC).

(ii) Collateral management

Collateral in respect of derivatives

The requirement for collateralisation of OTC derivatives, including the levels at which collateral is required and the types of asset that are deemed to be acceptable collateral, are set out in a Credit Support Annex (CSA), which forms part of the International Swaps and Derivatives Association (ISDA) agreement between the Company and the counterparty.

The CSA will require collateralisation where any net exposure to a counterparty exceeds the OTC counterparty limit, which must be established in accordance with the Derivatives Risk Policy (DRP). The aggregate uncollateralised exposure to any one counterparty must not exceed limits specified in the DRP. Where derivative counterparties are related, the aggregate net exposure is considered for the purposes of applying these limits.

Acceptable collateral is defined in each instance and must take into account the quality and appropriateness of the proposed collateral as well as being acceptable to the entity receiving the collateral. Collateral may include cash, corporate bonds, supranational debt and government debt.

Assets with the following carrying amounts have been pledged in accordance with the terms of the relevant CSAs entered into in respect of various OTC and other derivative contracts:

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

	2019		2018	
	£m	£m	£m	£m
	Group	Company	Group	Company
Financial assets:				
Investments at fair value through profit or loss	773	773	547	547
Cash and cash equivalents	369	369	378	378
Total	1,142	1,142	925	925

Collateral pledged in form of financial assets, is continued to be recognised in the balance sheet as the Group and Company retains all risks and rewards of the transferred assets. The Group and the Company has the right to recall any collateral pledged provided that this is replaced with alternative acceptable assets. The counterparty has right to repledge or sell the collateral in the absence of default by the Group and Company.

Cash collateral pledged where the counterparty retains the risks and rewards is derecognised from the balance sheet and a corresponding receivable is recognised for its return.

Where the Group and Company receives collateral in form of financial instruments for which the counterparty retains all risks and rewards, it is not recognised in the balance sheet. The fair value of financial assets accepted as collateral for OTC derivatives but not recognised in the balance sheet amounts to £1,191m (2018: £811m) by the Group and £1,191m (2018: £811m) by the Company, all of which is permitted to be sold or repledged in the absence of default. However the policy of the Group and Company is not to repledge assets, and hence no collateral was sold or repledged by the Group or Company during the year or in the prior year.

Where the Group and Company receives collateral in form of cash, it is recognised in the balance sheet along with a corresponding liability to repay the amount of collateral received within other financial liabilities. The amount of cash collateral received by the Group and Company amounts to £281m (2018: £259m) and £250m (2018: £259m) respectively.

Collateral in respect of Stock Lending

The Group and Company lend financial assets held in its portfolio to other institutions. The IWISC and its sub-committee Investment Management Operational Review Committee (IMOR) are responsible for setting the parameters of stock lending. Stock lending is permitted in accordance with the Insurance Stock Lending Policy. All stock lending takes place on an open/call basis, enabling the loan to be recalled at any time within the standard settlement terms of the market concerned.

The financial assets lent do not qualify for derecognition as the Group and Company retains all risks and rewards of the transferred assets except for the voting rights. The aggregate carrying value of securities on loan by the Group is £4,137m (2018: £3,962m) and by the Company is £573m (2018: £831m).

It is the Group's and Company's practice to obtain collateral in stock lending transactions. The accepted collateral can include cash, equities, certain bonds and money market instruments. On a daily basis, the fair value of collateral is compared to the fair value of stock on loan. The value of collateral must always exceed the value of stock on loan.

Where the Group and Company receives collateral in form of financial instruments for which counterparty retains all risks and rewards, it is not recognised in the balance sheet. The fair value of financial assets accepted as collateral but not recognised in the balance sheet amounts to £4,059m (2018: £4,232m) by the Group and £528m (2018: £873m) by the Company. The Group and the Company is not permitted to sell or repledge the collateral in the absence of default.

Where the Group and Company receives collateral in form of cash, it is recognised in the balance sheet along with a corresponding liability to repay the amount of collateral received within other financial liabilities. The amount of cash collateral received by the Group and Company amounts to £334m (2018: £622m) and £66m (2018: £109m) respectively.

There were no defaults in respect of stock lending during the year ended 31 December 2019 (2018: none) which required a call to be made on collateral.

Collateral in respect of Reverse Repurchase Agreement

The Group and Company entered into Reverse Repurchase Agreements whereby it purchased financial instruments with an agreement to resell them back to the counterparty at an agreed price. These transactions are in effect collateralised loans and are reported accordingly. The cash on loan is recognised as Loans and Receivables. The amount of cash on loan in this regard is £334m (2018: £622m) for the Group and £66m (2018: £109m) for Company.

The financial assets received as collateral are not recognised on the balance sheet as the counterparty retains all risks and rewards. The fair value of financial assets accepted as collateral amounted to is £349m (2018: £651m) for the Group and £69m (2018: £116m) for Company.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

Collateral in respect of Repurchase Agreement

A repurchase agreement between the Company and Lloyds Bank Corporate Markets PLC was terminated in the year with the collateral pledged returned to the Company (2018: Collateral pledged £137m for Group and Company).

Collateral in respect of loans to related parties

In 2019 the Company terminated a £1,400m collateralised loan agreement with Lloyds Bank PLC and the collateral held was returned to the counterparty. (2018: value of loan £1,400m, collateral held £1,860m for Group and Company).

Collateral in respect of Bulk Annuity Business

Acceptable collateral is defined in each instance and must take into account the quality and appropriateness of the proposed collateral as well as being acceptable to the entity receiving the collateral. Collateral may include cash, corporate bonds, supranational debt and government debt.

During 2019, the Company purchased Bulk Annuity contracts which provide buy in and buy out solutions to defined benefit pension schemes. To enter into the transaction some trustees may seek collateral to cover the counterparty default scenario. Collateral pledged in respect of Bulk Annuity business was £1,471m (2018: £1,504m) for Group and Company.

(iii) Offsetting

The following tables show financial assets and liabilities which have been set off in the balance sheet and those which have not been set off but for which the Group and the Company has enforceable master netting agreements in place with counterparties. They include Derivatives, Repurchase and Reverse Repurchase arrangements.

a) Derivatives

The derivative assets and liabilities in the tables below consist of OTC and exchange traded (ET) derivatives. The value of gross/net amounts for derivatives in the table below comprises those that are subject to master netting arrangements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32. As a result no amount has been set off in the balance sheet (2018: nil). Total derivatives presented in the balance sheet are shown in note 20.

The “financial instruments” amounts in the tables below show the values that can be set off against the relevant derivatives asset and liabilities in the event of default under master netting agreements. In addition, the Group and the Company holds and provides cash and securities collateral in respect of derivative transactions to mitigate credit risks.

In the tables below, the amounts of derivative assets or liabilities presented are offset first by financial instruments that have the right of offset under master netting with any remaining amount reduced by the amount collateral.

b) Repurchase and Reverse Repurchase Arrangements

The Group and the Company participates in repurchase (repo) and reverse repurchase arrangements (reverse repo). The gross/ net amount in the table shows the relevant assets that the Group and the Company has transferred to counterparties under these arrangements. Cash and non cash collateral is received by the Group and the Company for securities transferred. Cash collateral may be reinvested by the Group and Company through reverse repo against non cash collateral.

In the tables below, the amounts that are subject to repo and reverse repo are set off against the amount of collateral received according to the relevant legal agreements, showing the potential net amounts.

The actual fair value of collateral may be greater than amounts presented in the tables below in the case of over collateralisation.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

b) Repurchase and Reverse Repurchase Arrangements (continued)

Group as at 31 December 2019

				Related amounts where set off not permitted in the balance sheet (sub note 2)		
	Gross amounts of assets / liabilities	Amounts set off in the balance sheet	Net amounts presented in the balance sheet (sub note 1)	Financial instruments	Collateral	Potential net amounts if offset of related amounts permitted
	£m	£m	£m	£m	£m	£m
Financial assets						
OTC Derivatives	3,923	—	3,923	(2,352)	(1,499)	72
ET Derivatives	45	—	45	(7)	(38)	—
Reverse Repo	334	—	334	—	(349)	(15)
Financial liabilities						
OTC Derivatives	(3,409)	—	(3,409)	2,352	1,018	(39)
ET Derivatives	(36)	—	(36)	7	29	—

Group as at 31 December 2018

				Related amounts where set off not permitted in the balance sheet (sub note 2)		
	Gross amounts of assets / liabilities	Amounts set off in the balance sheet	Net amounts presented in the balance sheet (sub note 1)	Financial instruments	Collateral	Potential net amounts if offset of related amounts permitted
	£m	£m	£m	£m	£m	£m
Financial assets						
OTC Derivatives	3,067	—	3,067	(2,681)	(355)	31
ET Derivatives	89	—	89	(28)	(61)	—
Repo	135	—	135	—	(135)	—
Reverse Repo	622	—	622	—	(622)	—
Financial liabilities						
OTC Derivatives	(2,586)	—	(2,586)	2,681	(113)	(18)
ET Derivatives	(132)	—	(132)	28	104	—

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(3) Credit risk (continued)

b) Repurchase and Reverse Repurchase Arrangements (continued)

Company as at 31 December 2019

	Gross amounts of assets / liabilities	Amounts set off in the balance sheet	Net amounts presented in the balance sheet (sub note 1)	Related amounts where set off not permitted in the balance sheet (sub note 2) Financial instruments	Collateral	Potential net amounts if offset of related amounts permitted
	£m	£m	£m	£m	£m	£m
Financial assets						
OTC Derivatives	3,872	—	3,872	(2,352)	(1,467)	53
ET Derivatives	22	—	22	(1)	(20)	1
Reverse Repo	66	—	66	—	(69)	(3)
Financial liabilities						
OTC Derivatives	(3,403)	—	(3,403)	2,352	1,018	(33)
ET Derivatives	(31)	—	(31)	1	30	—

Company as at 31 December 2018

	Gross amounts of assets / liabilities	Amounts set off in the balance sheet	Net amounts presented in the balance sheet (sub note 1)	Related amounts where set off not permitted in the balance sheet (sub note 2) Financial instruments	Collateral	Potential net amounts if offset of related amounts permitted
	£m	£m	£m	£m	£m	£m
Financial assets						
OTC Derivatives	3,052	—	3,052	(2,681)	(355)	16
ET Derivatives	76	—	76	(19)	(57)	—
Repo	135	—	135	—	(135)	—
Reverse Repo	109	—	109	—	(109)	—
Financial liabilities						
OTC Derivatives	(2,578)	—	(2,578)	2,682	(114)	(10)
ET Derivatives	(103)	—	(103)	19	84	—

The following sub notes are relevant to the tables on this and the preceding page:

1. The value of net amounts presented in the balance sheet for derivatives comprises those derivatives held by the Group and the Company that are subject to master netting arrangements. Total derivatives presented in the balance sheet are shown in note 20.
2. The Group and the Company enters into derivative transactions with various counterparties which are governed by industry standard master netting agreements. The Group and the Company holds and provides cash and securities collateral in respective of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(4) Capital Risk

Capital risk is defined as the risk that the Group has a sub-optimal quantity or quality of capital or that capital is inefficiently deployed across the Group. The risk that:

- the Group, or one of its separately regulated subsidiaries, has insufficient capital to meet its regulatory capital requirements;
- the Group has insufficient capital to provide a stable resource to absorb all losses up to a confidence level defined in the risk appetite;
- the Group loses reputational status by having capital that is regarded as inappropriate, either in quantity, type or distribution; and/or
- the capital structure is inefficient.

The business of several of the companies within the Group is regulated by the PRA and the FCA. The PRA rules, which incorporate all Solvency II requirements, specify the minimum amount of capital that must be held by the regulated companies within the Group in addition to their insurance liabilities. Under the Solvency II rules, each insurance Company within the Group must hold assets in excess of this minimum amount, which is derived from an economic capital assessment undertaken by each regulated Company and the quality of capital held must also satisfy Solvency II tiering rules. This is reviewed on a quarterly basis by the PRA.

The Solvency II minimum required capital must be maintained at all times throughout the year. These capital requirements and the capital available to meet them are regularly estimated in order to ensure that capital maintenance requirements are being met.

The Group's objectives when managing capital are:

– to have sufficient capital to safeguard the Group's ability to continue as a going concern so that it can continue to provide returns for the shareholder and benefits for other stakeholders;

– to comply with the insurance capital requirements set out by the PRA in the UK;

– when capital is needed, to require an adequate return to the shareholder by pricing insurance and investment contracts according to the level of risk associated with the business written; and

– to meet the requirements of the Schemes of Transfer.

The capital management strategy is such that the integrated insurance business (comprising Scottish Widows Group Limited ("SWG") and its subsidiaries, including the Group) will hold capital in line with the stated risk appetite for the business, which is to be able to withstand a one in ten year stress event without breaching the capital requirements. At SWG level it is intended that all surplus capital above that required to absorb a one in ten year stress event will be distributed to LBG.

The Company's capital comprises all components of equity, movements in which are set out in the statement of changes in equity and includes subordinated debt (note 31).

The table below sets out the regulatory capital held at 31 December in each year for the Company on a Solvency II basis. The current year information is an estimate of the final result:

Company

	2019	2018
	£m	£m
Regulatory Capital held	7,724	7,944

All minimum regulatory requirements were met during the year.

(5) Liquidity risk

Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

Liquidity risk may result from either the inability to sell financial assets quickly at their fair values; or from an insurance liability falling due for payment earlier than expected; or from the inability to generate cash inflows as anticipated.

Liquidity risk has been analysed as arising from payments to policyholders (including those where payment is at the discretion of the policyholder) and non policyholder related activity (such as investment purchases and the payment of shareholder expenses).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(5) Liquidity risk (continued)

In order to measure liquidity risk exposure the Group's liquidity is assessed in a stress scenario. Liquidity risk is actively managed and monitored to ensure that, even under stress conditions, the Company and Group has sufficient liquidity to meet its obligations and remains within approved risk appetite. Liquidity risk appetite considers two time periods; three month stressed outflows are required to be covered by primary liquid assets; and one year stressed outflows are required to be covered by primary and secondary liquid assets. Primary liquid assets are gilts or cash, and secondary liquid assets are corporate bonds. The stressed outflows also make allowance for the increased collateral that needs to be posted under derivative contracts in stressed conditions. Liquidity risk is actively managed and monitored to ensure that, even under stress conditions, the Group has sufficient liquidity to meet its obligations and remains within approved risk appetite.

Liquidity risk is managed in line with the Insurance Liquidity Risk Policy and the wider LBG Funding and Liquidity Policy. Liquidity risk in respect of each of the major product areas is primarily mitigated as follows:

Annuity contracts

Assets are held which are specifically chosen to correspond to the expectation of timing of annuity payments. Gilts, corporate bonds, loans and, where required, derivatives are selected to reflect the expected annuity payments as closely as possible and are regularly rebalanced to ensure that this remains the case in future.

With Profits contracts

For With Profits business, a portfolio of assets is held in line with investment mandates which will reflect policyholders' reasonable expectations.

Liquidity is maintained within the portfolio via the holding of cash balances and a substantial number of highly liquid assets, principally gilts, bonds and listed equities.

Non-participating contracts

For unit-linked products, portfolios are invested in accordance with unit fund mandates. Deferral clauses are included in policyholder contracts to give time, when necessary, to realise linked assets without being a forced seller. As at 31 December 2019, there are no funds under management subject to deferral (2018: none).

For non-linked products other than annuity contracts, backing investments are mostly held in gilts with minimal liquidity risk. Investments are arranged to minimise the possibility of being a distressed seller whilst at the same time investing to meet policyholder obligations. This is achieved by anticipating policyholder behaviour and sales of underlying assets within funds.

Shareholder funds

For shareholder funds, liquidity is maintained within the portfolio via the holding of cash balances and a substantial number of highly liquid assets, principally gilts and bonds.

The following tables indicate the timing of the contractual cash flows arising from the Group and Company's financial liabilities, as required by IFRS 7. The table is based on the undiscounted cash flows of financial liabilities based on the earliest date on which the Group and Company are obliged to pay. The table includes both interest and principal cash flows.

Liquidity risk in respect of liabilities arising from insurance contracts and participating investment contracts has been analysed based on the expected pattern of maturities as permitted by IFRS 4 rather than by contractual maturity. A maturity analysis of liabilities arising from non-participating investment contracts based on expected contract maturities is also given as it is considered that this analysis provides additional useful information in respect of the liquidity risk relating to contracts written by the Group and Company.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(5) Liquidity risk (continued)

Group As at 31 December 2019			Contractual cash flows				
Liabilities	**Carrying amount**	**No stated maturity**	**Less than 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**More than 5 years**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Liabilities arising from non-participating investment contracts	37,456	—	37,456	—	—	—	—
External interests in collective investment vehicles	11,966	11,855	—	—	—	—	—
Derivatives held for trading	3,445	—	16	67	110	677	2,872
Subordinated debt	1,795	—	—	—	112	1,128	1,465
Borrowings	3	—	3	—	—	—	—
Lease liabilities	197	—	—	—	2	7	188
Other financial liabilities	1,889	297	1,557	28	7	—	—
Total	56,751	12,152	39,032	95	231	1,812	4,525

Group As at 31 December 2018			Contractual cash flows				
Liabilities	**Carrying amount**	**No stated maturity**	**Less than 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**More than 5 years**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Liabilities arising from non-participating investment contracts	13,855	—	13,855	—	—	—	—
External interests in collective investment vehicles	12,944	12,886	—	—	—	—	—
Derivatives held for trading	2,719	—	10	98	128	340	2,823
Subordinated debt	1,769	48	—	—	113	1,173	1,505
Borrowings	4	—	4	—	—	—	—
Other financial liabilities	2,331	260	1,884	28	159	—	—
Total	33,622	13,194	15,753	126	400	1,513	4,328

The contractual cash flow analysis set out above has been based on the earliest possible contractual date, regardless of the surrender penalties that might apply and has not been adjusted to take account of such penalties.

An analysis of the contractual cash flows in respect of insurance and investment contract liabilities by expected contract maturity, on a discounted basis, is shown below:

Group As at 31 December 2019						
	Total	**Less than 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**More than 5 years**
Maturity Analysis for liabilities arising from insurance and investment contracts	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Insurance and participating investment contracts	110,919	893	1,335	4,020	26,343	78,328
Non-participating investment contracts	37,456	334	360	1,596	8,077	27,089

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(5) Liquidity risk (continued)

Group As at 31 December 2018

Maturity Analysis for liabilities arising from insurance and investment contracts	Total £m	Less than 1 month £m	1-3 Months £m	3-12 months £m	1-5 years £m	More than 5 years £m
Insurance and participating investment contracts	98,252	1,147	1,496	5,039	23,678	66,892
Non-participating investment contracts	13,855	308	258	1,056	4,534	7,699

Company As at 31 December 2019 — **Contractual cash flows**

Liabilities	Carrying amount £m	No stated maturity £m	Less than 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	More than 5 years £m
Liabilities arising from non-participating investment contracts	37,455	—	37,455	—	—	—	—
Derivative financial instruments	3,434	—	10	62	110	677	2,872
Subordinated debt	1,820	—	—	—	92	1,147	1,490
Other financial liabilities	1,422	313	1,109	—	—	—	—
Total	44,131	313	38,574	62	202	1,824	4,362

Company As at 31 December 2018 — **Contractual cash flows**

Liabilities	Carrying amount £m	No stated maturity £m	Less than 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	More than 5 years £m
Liabilities arising from non-participating investment contracts	13,825	—	13,825	—	—	—	—
Derivative financial instruments	2,681	—	9	64	127	338	2,143
Subordinated debt	1,799	48	—	—	92	1,194	1,536
Other financial liabilities	1,608	257	1,215	—	136	—	—
Total	19,913	305	15,049	64	355	1,532	3,679

The contractual cash flow analysis set out above has been based on the earliest possible contractual date, regardless of the surrender penalties that might apply and has not been adjusted to take account of such penalties.

An analysis of liabilities arising from insurance and investment contracts by expected contract maturity, on a discounted basis, is shown below:

Company As at 31 December 2019

Maturity Analysis for liabilities arising from insurance contracts and investment contracts	Total £m	Less than 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	More than 5 years £m
Insurance and participating investment contracts	110,599	882	1,313	5,458	25,903	77,042
Non-participating investment contracts	37,455	334	360	1,593	8,070	27,098

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(c) Financial risks (continued)

(5) Liquidity risk (continued)

Company As at 31 December 2018	Total	Less than 1 month	1-3 months	3-12 months	1-5 years	More than 5 years
Maturity Analysis for liabilities arising from insurance and investment contracts	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Insurance and participating investment contracts	96,117	1,125	1,464	4,922	23,166	65,440
Non-participating investment contracts	13,825	308	257	1,052	4,519	7,689

(d) Non-financial risks

The Group faces a variety of non-financial risks through its operations and service provision. The Group manages these risks by following the embedded Risk Management Framework, which uses methodologies and systems consistent with those implemented across the Group. The various stages of the framework are:

Identification

- Risks identified in products, processes, channels, customers and people
- Emerging risks
- Changes to the risk profile through ongoing tracking, pricing reviews and monitoring of external factors
- Change Management at project, programme or portfolio level
- Implement Risk and Control Framework and standards, including loss estimation and provisioning

Measurement

- Evaluate risk exposure vs appetite
- Modelling and stress testing, including Internal Model outputs
- Actual vs expected losses
- Scenario analysis
- Reverse stress testing

Management

- Identify and operate controls
- Perform day-to-day control activities
- Ensure appropriate segregation of duties
- Control assessment and estimation of residual risk
- Controls testing activities including Sarbanes-Oxley and Own Risk and Solvency Assessment (ORSA) review
- Effectiveness reviews

Monitoring

- Performance vs risk appetite
- Internal Model performance monitoring
- Risk metrics on for example products, processes, customer experience, service, retention
- Change portfolio
- Regulatory and external environment
- Quality checking
- Action management

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(d) Non-financial risks (continued)

Reporting

- Monthly Executive Risk Reporting presented through the corporate governance structure leads to top down review and challenge evidenced via the Insurance Consolidated Risk Report
- Material Events escalation, including related actions
- ORSA reporting

The primary non-financial risk categories are:

Conduct risk

Conduct risk is defined as the risk of customer detriment across the customer lifecycle including: failures in product management, distribution and servicing activities; from other risks materialising, or other activities which could undermine the integrity of the market or distort competition, leading to unfair customer outcomes, regulatory censure, reputational damage or financial loss.

Governance risk

Governance risk is defined as the risk that the Group's organisational infrastructure fails to provide robust oversight of decision making and the control mechanisms to ensure strategies and management instructions are implemented effectively.

Model risk

The risk of financial loss, regulatory censure, reputational damage or customer detriment, as a result of deficiencies in the development, application and ongoing operation of Models and Ratings systems.

Operational risk

Operational risk is defined as the risk of loss from inadequate or failed internal processes, people and systems or from external events. As operational risk covers such a range of elements, there are secondary risk types within this area, including:

– **Change risk**

Change risk is defined as the risk that, in delivering its change agenda, the Group fails to ensure compliance with laws and regulation, maintain effective customer service and availability, and/or operate within the Group's risk appetite.

– **Cyber and information security**

The risk of financial loss, disruption or damage to the reputation of LBG from a malicious attack that impacts the confidentiality and/or integrity of electronic data or the availability of systems. The risk also to the security of information and data.

– **Data management**

The risk that the Group fails to effectively govern, manage and protect its data (or the data shared with Third Party Suppliers) impacting the Group's agility, accuracy, access and availability of data, ultimately leading to poor customer outcomes, loss of value to the Group and mistrust from regulators.

– **External service provision**

Failure in the provision of the formally agreed services (i.e. within the scope for the Group Service Provision Policy / supporting Procedures) which are required so Business Units meet their agreed deliverables.

– **Financial crime**

Financial crime is the risk of acts intended to bribe, corrupt, launder money, fund terrorist activity or circumvent sanctions intended for personal gain or to cause loss to another party, by customers/clients, suppliers, third parties or colleagues.

– **Financial reporting risk**

Financial reporting risk is defined as the risk that the Group suffers reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over business or finance processes impacting financial, prudential regulatory, and tax reporting, failure to manage the associated risks of changes in taxation rates, law, corporate ownership or structure and the failure to disclose timely and appropriate information in accordance with regulatory requirements.

– **Fraud**

The risk of acts of deception or omission intended for personal gain or to cause loss to another party, by customers/clients, third parties or colleagues,

– **Internal service provision**

The risk associated with the management of internal service arrangements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

38. Risk management (continued)

(d) Non-financial risks (continued)

– **IT systems**

The risk of failure in technology governance and the development, delivery and maintenance of effective IT solutions.

– **Operational resilience risk**

Operational resilience risk covers the risk that the Group fails to design resilience into business operations, underlying infrastructure and controls (people, process, technical) so that it is able to withstand external or internal events which could impact the continuation of operations, and fails to respond in a way which meets stakeholder expectations and needs when the continuity of operations is compromised.

– **Physical security risk**

The risk to the security of people and property (including damage (malicious or non-malicious) to LBG branches and buildings managed through Group Property).

– **Sourcing**

Sourcing risk covers the risk associated with the activity related to the agreement and management of services provided by third parties including outsourcing (excludes internal service arrangements).

People risk

People risk is defined as the risk that the Group fails to provide an appropriate colleague and customer centric culture, supported by robust regard and wellbeing policies and processes; effective leadership to manage colleague resources; effective talent and succession management; and robust control to ensure all colleague-related requirements are met.

Regulatory and legal risk

The risk of financial penalties, regulatory censure, criminal or civil enforcement action or customer detriment as a result of failure to identify, assess, correctly interpret, comply with, or manage regulatory and/or legal requirements.

(e) UK political uncertainties including EU exit

Following the UK's exit from the EU, significant negotiation is now required on the terms of the future trade agreement. As a result, the possibility of a limited or no deal at the end of the transition period remains and could manifest in prolonged business uncertainty across the UK, including the financial services sector. The continued lack of clarity over the UK's eventual relationship with the EU and other foreign countries, and ongoing challenges in the Eurozone, including weak growth raises additional uncertainty for the UK economic outlook. The Group's response to these risks and uncertainty is as follows:

- Internal contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts.
- As part of LBG, engagement with politicians, officials, media, trade and other bodies to reassure our commitment to Helping Britain Prosper.
- Committed investments for our new entity in the EU to ensure continuity of certain business activities, and contingency planning in relation to wider areas of impact
- No deal EU exit outcome analysed to identify impacts and assess robustness of contingency plans.

(f) Economic Risk

UK economic growth remains muted and the lack of clarity around an EU trade deal is likely to keep investment subdued. High levels of credit market liquidity have reduced spreads and weakened terms in some sectors, creating a potential under-pricing of risk and heightened risk of a market correction. The Group's response to these risks is as follows:

- Internal contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts, with a plan specifically for working through the potential impacts of the EU exit on the Group.
- Wide array of risks considered in setting strategic plans.
- Capital and liquidity are reviewed regularly through committees, ensuring compliance with risk appetite and regulatory requirements.
- The Group has a robust through the cycle credit risk appetite, including individual limit guidelines, specific sector appetite statements and policies, and affordability and indebtedness controls at origination. In addition to ongoing focused monitoring, we conduct portfolio deep dives and larger exposure reviews. We have enhanced our use of early warning indicators including sector specific indicators.

Additionally, the more recent coronavirus outbreak and related global health issues are already starting to impact economies and markets. Whilst the ultimate impact is currently unknown, we are exploring the credit risk impact, with a focus on illiquid assets, noting we have little exposure to retail, automobiles and manufacturing loans.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

39. Related party transactions

(a) Ultimate parent and shareholding

The Group's immediate parent undertaking is Scottish Widows Group Limited, a Company registered in the United Kingdom. Scottish Widows Group Limited has taken advantage of the provisions of the Companies Act 2006 and has not produced consolidated financial statements.

The ultimate parent undertaking and controlling party is Lloyds Banking Group plc, which is the parent undertaking of the only group to consolidate these financial statements. Once approved, copies of the consolidated Annual Report and Accounts of Lloyds Banking Group plc may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com.

(b) Transactions and balances with related parties

Transactions with other LBG companies

In accordance with IAS 24 "Related Party Disclosures", transactions and balances between Group companies have been eliminated on consolidation and have not been reported as part of the consolidated financial statements.

The Group has entered into transactions with related parties in the normal course of business during the year.

	2019			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	15	(300)	—	351
Other related parties	335	(822)	(1,831)	2,275

	2018			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	15	(1,765)	—	348
Other related parties	600	(894)	(1,419)	3,213

The Company has entered into transactions with related parties in the normal course of business during the year. Holdings by the Group, including consolidated OEIC investments, give rise to £574m (2018: £476m) of shares in the ultimate parent undertaking on the balance sheet, with associated transactions of £(30)m (2018: £14m) during the year.

	2019			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	15	(300)	—	351
Subsidiary	1,588	(88)	(1,612)	662
Other related parties	335	(743)	(1,826)	2,175

	2018			
	Income during period £m	Expenses during period £m	Payable at period end £m	Receivable at period end £m
Relationship				
Parent	15	(1,765)	—	348
Subsidiary	112	(193)	(6)	671
Other related parties	522	(1,037)	(2,376)	4,064

Further, amounts relating to other related parties of £3,418m due from OEICs investments were outstanding at 31 December 2019 (2018: £2,153m). The above balances are unsecured in nature and are expected to be settled in cash.

Included within the consolidated statement of comprehensive income were net (expense)/income amounts related to other parties of £330m (2018: £(139)m) from OEIC investments.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

39. Related party transactions (continued)

(b) Transactions and balances with related parties (continued)

Transactions with other LBG companies (continued)

Parent undertaking transactions relate to all reported transactions and balances with Scottish Widows Group Limited, the Group's immediate parent. Such transactions with the parent Company are primarily financing (through capital and sub-ordinated debt), provision of loans and payment of dividends.

Transactions with other related parties (which includes Subsidiary and Other categories above) are primarily in relation to operating and employee expenses.

Transactions between the Group and entity employing key management

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Company which, for the Company, are all Directors and Insurance and Wealth Executive Committee ("IWEC") members. Key management personnel, as defined by IAS 24, are employed by a management entity, transactions with this entity are as follows:

Key management compensation:

	2019 £m	**2019 £m**	**2018 £m**	**2018 £m**
	Group	*Company*	*Group*	*Company*
Short-term employee benefits	7	7	8	8
Share-based payments	2	2	2	2
Total	9	9	10	10

Included in short term employee benefits is the aggregate amount of emoluments paid to or receivable by Directors in respect of qualifying services of £3m (2018: £3m).

There were no retirement benefits accruing to Directors (2018: nil) under defined benefit pension schemes. Three Directors (2018: six Directors) are paying into a defined contribution scheme. There were no contributions paid to a pension scheme for qualifying services (2018: nil) for Group and Company.

Certain members of key management in the Group, including the highest paid Director, provide services to other companies within LBG. In such cases, for the purposes of this note, figures have been included based on an apportionment to the Group of the total compensation earned.

The aggregate amount of money receivable and the net value of assets received/receivable under share based incentive schemes in respect of Directors qualifying services was £1m (2018: £1m). During the year, two Director exercised share options (2018: 1 Directors) and three Directors received qualifying service shares under long term incentive schemes (2018: two Directors). Movements in share options are as follows:

	2019 £m Options	**2018 £m Options**
Outstanding at 1 January	15	13
Granted	8	6
Exercised	(4)	(3)
Forfeited	(4)	(1)
Outstanding at 31 December	15	15

Detail regarding the highest paid Director is as follows:

	2019 £m	**2019 £m**	**2018 £m**	**2018 £m**
	Group	*Company*	*Group*	*Company*
Apportioned aggregate emoluments	2	2	2	2
Apportioned share-based payments	1	1	1	1

The highest paid Director did not exercise share options during the year. (2018: The highest paid Director did exercise share options during the year).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

40. Lease liabilities

The Group has lease liabilities arising from ground rent commitments on its investment properties. The lease liabilities and related right-of-use assets are included in the balance sheet as follows:

	2019 £m	2019 £m	2018 £m	2018 £m
	Group	*Company*	*Group*	*Company*
Lease liabilities:				
Current	2	—	1	—
Non-current	21	—	186	—
Total	23	—	187	—

Interest expense relating to leases of nil (2018: nil) has been included in finance costs in the statement of comprehensive income. The total cash outflow in respect of leases in the year was £(1)m (2018 £(1)m).

A maturity analysis of lease liabilities is provided in note 38(c) (5) Liquidity Risk.

Prior to 1 January 2019 the Group applied IAS 17 ‘Leases’ and accounted for the ground rent commitments as operating leases. The total future minimum rental payments payable under non-cancellable leases for the comparative period are as follows:

	2018 £m	2018 £m
	Group	*Company*
Within one year	1	—
Between two and five years	4	—
Beyond five years	182	—
Total	187	—

The total of contingent rents recognised as income during the year was £(2)m (2018: £1m). The total of contingent rents recognised as operating expenses during the year was nil (2018: nil). Operating lease receipts and payments represent rental receivable and payable by the Group for certain of its properties. Generally the Group’s operating leases are for terms of 15 years or more.

41. Capital commitments

The Group and company has given an undertaking to provide up to £1,995m (2018: £1,574m) of capital to Private Credit Funds and at 31 December 2019, £1,808m had been drawn down (2018: £1,428m). The Group has also agreed £286m of undrawn loan commitments in 2019 (2018: £231m). £199m of this undrawn balance is to be drawn within one year (2018: £156m) and the remaining £87m will be drawn within three years (2018: £75m). The commitments are irrevocable if the borrowers meet the terms of the agreements. The Group has contracted for, but not paid for, £7m (2018: £33m) of development expenses for investment property. Of this amount, the Company has contracted for, but not paid for, nil (2018: nil).

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

42. Future accounting developments

The following pronouncements may have a significant effect on the Group's financial statements but are not applicable for the year ending 31 December 2019 and have not been applied in preparing these financial statements. Except as disclosed below, the full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	IASB effective date
IFRS 17 “Insurance Contracts”[1]	IFRS 17 replaces IFRS 4 ‘Insurance Contracts’ and is currently effective for annual periods beginning on or after 1 January 2021, although, following the Exposure Draft published on 26 June 2019, and the recent International Accounting Standards Board ("IASB") Board meeting on 17 March 2020, the IASB has proposed delaying implementation until 1 January 2023. IFRS 17 requires insurance contracts and participating investment contracts to be measured on the balance sheet as the total of the fulfilment cash flows and the contractual service margin. Changes to estimates of future cash flows from one reporting date to another are recognised either as an amount in profit or loss or as an adjustment to the expected profit for providing insurance coverage, depending on the type of change and the reason for it. The effects of some changes in discount rates can either be recognised in profit or loss or in other comprehensive income as an accounting policy choice. The risk adjustment is released to profit and loss as an insurer’s risk reduces. These requirements will result in changes to the timing of profit recognition for insurance and participating investment contracts issued by the Group and Company. The Group’s IFRS 17 project is progressing to plan. Work has focused on interpreting the requirements of the standard, developing methodologies and accounting policies, and assessing the required changes to reporting and other systems The development of the Group’s data warehousing and actuarial liability calculation processes required for IFRS 17 reporting is progressing in line with the Group’s plans. The standard will have a significant impact on the accounting for the insurance and participating investment contracts issued by the Group and Company. Presentation and disclosure for these contracts will be considerably different and more extensive than under IFRS 4.	Annual periods beginning on or after 1 January 2021
Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7)	The amendments modify specific hedge accounting requirements so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark on which the hedged cash flows and cash flows of the hedging instrument are based is not altered as a result of the uncertainties of the interest rate benchmark reform. These amendments are not expected to have a significant impact on the Group or Company.	Annual periods beginning on or after 1 January 2020

[1] At the date of this report, these pronouncements are awaiting European Union endorsement.

There are no other standards or interpretations that are not yet effective and that would be expected to have a material impact on the Group or Company.

43. Post balance sheet events

An interim dividend of £560m in respect of the year ending 31 December 2020 was declared on 06 February 2020 and paid to Scottish Widows Group on 12 February 2020.

As a result of legislation introduced in 2016, the UK corporation tax rate was due to reduce from 19% to 17% with effect from 1 April 2020. The impact of this reduction in tax rate, which is applicable to the calculation of deferred tax assets and liabilities at the reporting date, is reflected in the above disclosures.

Within the March 2020 budget, the UK government stated its intention to maintain the corporation tax rate at 19 per cent on 1 April 2020. Had this rate change been substantively enacted at 31 December 2019, the effect would have been to increase the net deferred tax liability by £25m.

Since the balance sheet date there has been a global pandemic from the outbreak of Coronavirus, which is causing widespread disruption to financial markets and normal patterns of business activity across the world including the UK. In view of its currently evolving nature, the Directors are unable to estimate its financial effect.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

44. Acquisitions, discontinued operations and disposals

(a) European business Part VII Transfer Scheme

The Company completed the transfer of the European business from the Company to SWE on 29 March 2019. The assets and liabilities of the European business were therefore classified as held for sale at 31 December 2018 and shown separately on the face of the balance sheet.

The business transferred includes insurance and participating investment contract liabilities. The policies relating to participating investment contracts participate in the CMIG With Profits Fund, and the transferring liability in relation to these policies has been reinsured back to that fund at the point of transfer. The value of assets transferred disclosed does not include any potential future estate distribution or unallocated surplus. Policyholders will retain their rights to participate in the CMIG With Profits Fund, including any share in estate distribution, through the reinsurance agreement.

The valuation of assets classified as held for sale and the liabilities directly associated with assets classified as held for sale was an estimate as at 31 December 2018, and the actual value of assets and liabilities transferred on the effective date is shown below.

The Company did not recognise any impairment relating to assets held for sale during 2018.

The transfer of the European business has no net impact on profit before tax or equity on the Company and the Group.

Balance sheets (Company)

The assets and liabilities of the European business at the disposal date were as follows:

	29 March 2019 £m
ASSETS	
Investments at fair value through profit or loss	1,864
Cash and cash equivalents	267
Other assets	72
Total Assets	2,203
LIABILITIES	
Insurance contracts and participating investment contract liabilities	2,085
Non-participating investment contract liabilities	29
Provisions for other liabilities	54
Other financial liabilities	35
Total liabilities	2,203

The assets and liabilities of the discontinued operations of the European business are as follows:

	2019 £m	2018 £m
ASSETS		
Investments at fair value through profit or loss	—	2,165
Total Assets	—	2,165
LIABILITIES		
Insurance contracts and participating investment contract liabilities	—	2,135
Non-participating investment contract liabilities	—	30
Total liabilities	—	2,165

As part of the transfer process SWE issued share capital to the Company sufficient for it to cover its relevant capital requirement and risk margin. The total capital issued by SWE was £71m (€81m) and was subscribed for in cash.

(b) Zurich Part VII Transfer Scheme

(i) Summary of acquisition

On 1 July 2019, the Company acquired pensions business from the Zurich Insurance Group. The acquisition is part of an agreement to acquire the UK workplace pensions and savings business from the Zurich Insurance Group. The acquisition will enable the Insurance and Wealth Division to accelerate the development of its financial planning and retirement business and has brought around £21bn of assets under administration to the Insurance and Wealth Division.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019

44. Acquisitions, discontinued operations and disposals (continued)

(b) Zurich Part VII Transfer Scheme (continued)

Details of the purchase consideration are as follows:

	£m
Amounts previously paid in cash	7
Purchase price adjustment	(5)
Contingent consideration settled during the year	14
Total purchase consideration	16

The purchase price adjustment is in respect of profit earned by Zurich Insurance Group from 3 April 2018 the date of the Part VII transfer scheme.

The assets and liabilities recognised as a result of the acquisition are as follows:

	£m
Insurance intangible asset (acquired VIF)	6
Investments at fair value through profit or loss	7,350
Other assets	7
Cash and cash equivalents	4
Loans and advances to banks	15
Assets arising from reinsurance contracts held	13,616
Non-participating investment contract liabilities	(20,981)
Other financial liabilities	(11)
Net identifiable assets acquired	6
Add goodwill	10
Net assets acquired	16

The goodwill is attributable to expected future value generated from growth of the business acquired. The goodwill is not tax deductible.

(i) Acquired receivables

The fair value of acquired trade receivables is £7m. The fair value is equal to carrying value, all of which is expected to be collectible.

(ii) Revenue and profit contribution

The acquired business contributed revenues of £22m and net profit of £2m to the Company for the period from 1 July to 31 December 2019.

If the acquisition had occurred on 1 January 2019, total proforma revenue and loss for the Group and Company for the year ended 31 December 2019 would have been £40m and (£1m) respectively.

(iii) Net cash outflow of acquisition

Outflow of cash to acquire the pensions business, net of cash acquired:

	£m
Cash consideration	16
Less balances acquired:	
Cash and cash equivalents	(4)
Net outflow of cash – investing activities	12