

SOLVENCY AND FINANCIAL CONDITION REPORT

Phoenix Life Limited
For the year ended 31 December 2016

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SUMMARY

INTRODUCTION AND BACKGROUND

Phoenix Life Limited ('PLL' or 'the Company') is an insurance undertaking and a private company limited by shares, incorporated, registered and domiciled in the United Kingdom ('UK'). The principal activity of the Company is the transaction of life insurance and pension business, which, with the exception of vesting pension annuity business, and protection business under the SunLife brand, is largely in run-off.

The Company is authorised by the Prudential Regulation Authority ('PRA') and is regulated by the Financial Conduct Authority ('FCA') and the PRA.

The Company is a subsidiary of Phoenix Life Holdings Limited ('PLHL'), which is the highest European Economic Area ('EEA') insurance holding company of Phoenix Group. The ultimate parent undertaking is Phoenix Group Holdings ('PGH') which is registered in the Cayman Islands and has its principal place of business in Jersey, therefore outside of the EEA, and is listed on the London Stock Exchange. Unless otherwise specified, references to 'Group' or 'PLHL Group' mean PLHL and all of its subsidiary undertakings, which include the Company, and reference to 'Phoenix' or 'Phoenix Group' means PGH and all of its subsidiary undertakings.

Reference to 'Phoenix Life' or the 'Life Companies' means PLL, Phoenix Life Assurance Limited ('PLAL') and AXA Wealth Limited ('AWL'). A simplified Phoenix structure chart is presented in section A.1.2.1.

Following the implementation of Solvency II on 1 January 2016, this is the Company's first Solvency and Financial Condition Report ('SFCR') in accordance with the regulations. The SFCR and the accompanying Quantitative Reporting Templates ('QRTs') provide detailed information of the Company's business and performance, governance, risk profile and capital position.

BASIS OF PREPARATION

The QRTs and the disclosures in the SFCR have been prepared in accordance with all applicable PRA rules and Solvency II regulations, hereafter referred to as 'the regulations'.

Certain sections of the SFCR require information based on the recognition and measurement principles applicable under the relevant Generally Accepted Accounting Principles ('GAAP') as presented in the financial statements. The Company's financial statements are prepared in accordance with International Financial Reporting Standards ('IFRS'), issued by the International Accounting Standards Board ('IASB'), and which have been adopted for use by the European Union ('EU').

The SFCR is presented in pound sterling ('£') rounded to the nearest million, which is consistent with the presentation in the Company's IFRS financial statements.

The SFCR excludes disclosures required by the regulations which are not applicable to the Company; these include, but are not limited to:

- information on non-life business;
- information on Solvency II insurance Special Purpose Vehicles ('SPVs');
- information on the Volatility Adjustment and transitional measures on risk-free interest rates;
- information on significant branches within the meaning of the regulations; and
- Standard Formula and full Internal Model ('IM') QRTs and related disclosures as the Company's Solvency Capital Requirement ('SCR') at 31 December 2016 were calculated partially on a Standard Formula and partially on an IM basis.

As permitted by the regulations, comparison of information reported in the previous reporting period has not been presented in the SFCR for the year ended 31 December 2016. Comparatives will be presented for the first time in the SFCR for the year ending 31 December 2017.

2016 KEY PERFORMANCE INDICATORS

The Company's 2016 key performance indicators ('KPI') are set out below. As the Company operated a PIM as at 31 December 2016 due to the reinsurance of AWL business, the SFCR and attached QRTs have been prepared on this basis. In March 2017, certain approvals from the PRA have been received that have had significant effect on the Company's capital position. These comprise:

- Approval to recalculate the Transitional Measure on Technical Provisions ('TMTP') as at 31 December 2016; and
- IM approval for the AWL business.

In order to illustrate the impacts of the above, pro forma information has been included on the Company's capital position (see below and Appendix 2 for further details) that assumes the events set out above took place at 31 December 2016. This pro forma basis provides a more appropriate analysis of the Company's capital position, consistent with the basis by which solvency is being managed for the Company. Pro forma disclosures provided below and throughout the document are unaudited.

SUMMARY

Continued

2016 KEY PERFORMANCE INDICATORS CONTINUED

	31 December 2016 (actual)	31 December 2016 (pro forma)
Solvency II surplus	£793 million	£698 million
Ratio of Eligible Own Funds to Solvency Capital Requirement	128%	127%
Shareholder capital coverage ratio	150%	148%
Operating profit	£400 million	£400 million

Solvency II surplus is defined as Eligible Own Funds in excess of the SCR.

The shareholder capital coverage ratio demonstrates the extent to which shareholders' Eligible Own Funds cover the SCR, after adjusting to exclude Own Funds and the associated SCR relating to unsupported with-profit funds.

The operating profit is based on the IFRS financial statements of the Company for the year ended 31 December 2016. Further details on key drivers of the operating profit are included in section A.2.

The information contained in the detailed sections of the SFCR is based on the actual position. A further analysis of the pro forma position is presented in Appendix 2.

STRATEGY AND BUSINESS MODEL

Phoenix Group is the largest UK consolidator of closed life insurance funds with assets under management of £76 billion and more than 6 million policyholders. Phoenix Group aims to be recognised as the 'industry solution' for the safe, innovative and profitable decommissioning of closed life funds.

Key strategic areas of focus are to:

- manage capital through effective management of risks, capital allocation against them and robust capital policies;
- drive value through management actions in order to increase value or accelerate the release of capital; and
- improve customer outcomes in terms of value, service and security.

The Company has a wide range of legacy products written across different funds. The features of each policy influence whether it is the policyholder or the shareholder who is exposed to the risks and rewards of a policy. The Company operates four material Solvency II lines of life insurance business based on the characteristics of the different products administered. Further details on these Lines of Business ('LoB'), all of which are underwritten in the UK, with the exception of the euro denominated business written by the Company's registered branch in the Republic of Ireland, are included in section A.1.3.

Reinsurance arrangements, both internal and external to the Group, are in place to cover certain blocks of immediate and deferred annuities and some permanent health, critical illness and term assurance risks and annuities.

During 2016, the Company maintained ten with-profit funds and a Matching Adjustment ('MA') portfolio.

OPERATING STRUCTURE

The Company's strategic priorities are aligned to Phoenix Group's closed life fund business model and are supported by an operating structure that reduces risk, complexity and cost, improves investment performance, and enhances customer service through efficient partnership with the Company's outsourced partners.

Based in Wythall, Birmingham, the Company has a track record of successfully integrating acquired life insurance businesses and has developed a leading edge operating model and infrastructure into which acquired funds can be integrated.

GOVERNANCE

The Board is responsible for managing the overall direction and performance of the Company. It is also ultimately accountable for compliance with the Solvency II requirements.

The Board is committed to high standards of corporate governance and is supported by the appropriate Board committees and management committees. Further details on the governance structure of the Board and its committees are included in section B.1.

There were no significant changes to governance arrangements during the year.

RISK PROFILE

Phoenix Group operates a standardised Risk Management Framework ('RMF') for the identification and assessment of the risks it may be exposed to, and the amount of capital that should be held in relation to those exposures. The Group defines a risk appetite framework covering the level of risk it is willing to accept in pursuit of its strategic objectives in the areas of policyholder security and conduct, earnings volatility, liquidity, and the control environment. Such risk appetite is applied by the Company.

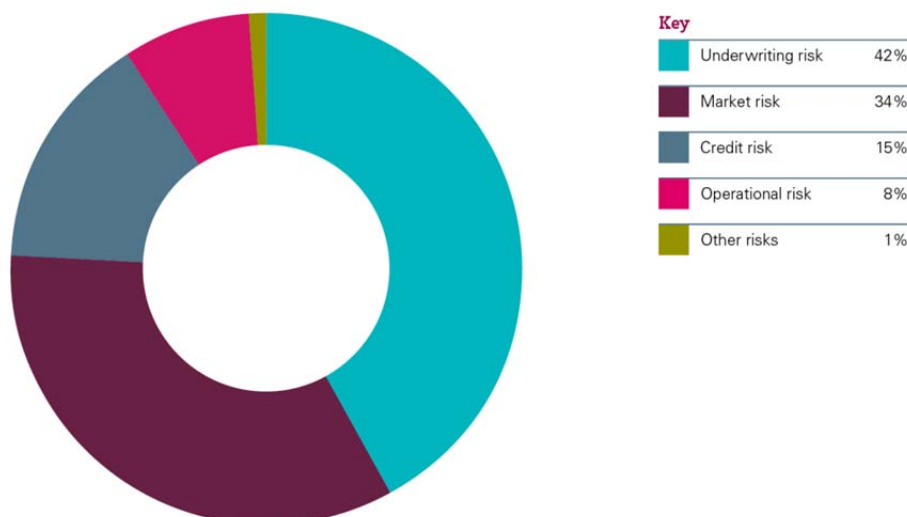
SUMMARY

Continued

RISK PROFILE CONTINUED

SOLVENCY CAPITAL REQUIREMENT BY RISK CATEGORY

The following chart shows the composition of the partial IM undiversified SCR components on an actuals basis (i.e. excluding the approvals from the PRA in March 2017) as at 31 December 2016. See section E.2.1.



During the year ended 31 December 2016, the following key changes to risk exposure have taken place.

On 1 November 2016, Phoenix Group completed the acquisition of AXA Wealth's pensions and protection businesses. The acquisition comprised a pensions and investments business ('Embassy'), offering a range of propositions catering to both individual and corporate requirements, and SunLife, a leader in the over 50s protection sector. Following the acquisition, substantially all of the risks and rewards of the existing and new business of AWL (that was not subject to existing reinsurance arrangements) were reinsured to the Company. The reinsured business increased mortality, lapse and persistency risk for the Company, although this provides a natural hedge to the longevity book in the Company. It also resulted in acceptance of new business underwriting risk from business sold, and reinsured into the Company, by AWL under the SunLife brand.

Markets were particularly turbulent over the course of the year and were also affected by the EU Referendum and the US election. Yields on UK government debt and swap rates fell markedly in the first half of 2016 and then rallied towards the end of the year. The Company prepared for this potential outcome by reducing residual interest rate exposure using a combination of interest rate swaps and swaptions. The position continues to be closely monitored and managed, and the Company has actively continued hedging such market risks in response to ongoing market turbulence.

A transfer, under Part VII of the Financial Services and Market Act 2000 ('Part VII'), of a block of with-profit annuities was completed to ReAssure Life Limited ('RLL'), delivering benefits from the release of expense reserves and a decrease in capital requirements for counterparty credit default and expense risks.

The Company entered into a £2 billion longevity swap on a portfolio of immediate annuities, realising Solvency II surplus benefits as a result of a reduction in longevity risk capital required, thereby increasing the financial resilience of the Company.

The Company continued to enhance its capital position under Solvency II by further optimising its MA portfolio through strategic asset allocation ('SAA') whilst delivering Solvency II surplus benefits.

CAPITAL POSITION

Following the implementation of Solvency II on 1 January 2016, the Company's capital is managed on a Solvency II basis. The Company's Own Funds, SCR and Solvency II surplus are further explained in section E.

QUALITY OF OWN FUNDS

Eligible Own Funds represent the available capital to support the SCR of the Company under Solvency II.

A total of 93% (pro forma 93%) of the Eligible Own Funds are unrestricted Tier 1, and principally comprise ordinary share capital, share premium, surplus funds and the reconciliation reserve. This includes TMTP which are included in the calculation of Basic Own Funds as Tier 1 capital following the PRA's approval for the Company to apply the measures. This allows for a transitional deduction on technical provisions, which is the difference between the net technical provisions calculated in accordance with the current regulations and the net technical provisions calculated in accordance with the legacy Solvency I regime.

SUMMARY

Continued

CAPITAL POSITION CONTINUED

QUALITY OF OWN FUNDS CONTINUED

At 31 December 2016, the Own Funds include a transitional deduction of £2.3 billion (pro forma £1.8 billion) and a risk margin of £1.2 billion (pro forma £1.1 billion). The run-off of the transitional deduction over time will be partly offset by the reduction of the risk margin, therefore mitigating any resulting impact on the Solvency II surplus. Excluding the unsupported with-profit funds, the transitional deduction and risk margin were £1.6 billion and £0.9 billion respectively (pro forma £1.3 billion and £0.8 billion).

The Company also obtained the PRA's approval to apply MA, which allows the Company to use a higher discount rate when valuing liabilities that meet strict eligibility criteria, with the effect of increasing Own Funds and reducing the SCR. Further details are set out in section D.2.7.1.

SOLVENCY CAPITAL REQUIREMENT

The SCR is the amount of capital to be held by an insurer per the regulations, following a risk-based approach. The SCR by key risk categories on an actuals basis, as at 31 December 2016, is set out in the chart above.

The pro forma SCR includes an adjustment to reflect the impact of including AXA business into the IM, following receipt of the PRA's approval to do so.

SOLVENCY II SURPLUS

Solvency II surplus is the excess of Eligible Own Funds over the SCR.

As noted above, pro forma adjustments have been applied to the actual position to include the impacts of recalculation of TMTP as at 31 December 2016 and approval of the IM following the significant change in risk profile as a result of new reinsurance arrangements with AWL.

The position reflects the run-off of TMTP since 1 January 2016, for one full year. Further details on the run-off methodology are included in section D.2.7.2.

The Company's capital position as at 31 December 2016 is presented below:

	Own Funds £m	Solvency Capital Requirement £m	Solvency II surplus £m
Actual position reported in Own Funds Quantitative Reporting Template	3,613	(2,820)	793
Adjustments:			
Impact of Transitional Measures on Technical Provisions recalculation	(322)	109	(213)
Impact of IM Approval to incorporate AXA business	8	110	118
Pro forma capital position at 31 December 2016	3,299	(2,601)	698

SHAREHOLDER CAPITAL COVERAGE RATIO

As mentioned above, the shareholder capital coverage ratio demonstrates the extent to which shareholders' Eligible Own Funds cover the SCR, after adjusting to exclude amounts relating to unsupported with-profit funds.

Surpluses that arise in with-profit funds, whilst not included in the surplus, are available to absorb economic shocks. This means that the headline surplus is resilient to economic stresses.

Excluding the SCR and Own Funds relating to the unsupported with-profit funds, the shareholder capital coverage ratio is 150% (pro forma 148%) as at 31 December 2016.

SUMMARY

Continued

CAPITAL POSITION CONTINUED

SENSITIVITIES AND SCENARIO ANALYSIS

As part of the Company's internal risk management processes, the regulatory capital requirements under Solvency II are tested against a number of financial scenarios. The results of such stress testing are provided below and demonstrate the resilience of the Company's pro forma Solvency II surplus. As the pro forma basis provides a more appropriate analysis of the Company's capital position on a look forward basis, the results of the stresses are based on the pro forma position.

	Solvency II surplus (pro forma, as above) £m
Base: 1 January 2017¹	698
Following a 20% fall in equity markets	691
Following a 15% fall in property values	663
Following a 55bps interest rates rise ²	708
Following an 80bps interest rates fall ²	698
Following a 150bps credit spread widening ³	614
Following a 6% decrease in annuitant mortality rates ⁴	512
Following a 10% increase in assurance mortality rates	605
Following a 10% change in lapse rates ⁵	624

¹ Assumes stress occurs on 1 January 2017.

² Assumes recalculation of transitionals.

³ Credit stress equivalent to an average 150bps spread widening across ratings, 10% of which is due to defaults/downgrades.

⁴ Equivalent of six months' increase in longevity applied to the annuity portfolio.

⁵ Assumes most onerous impact of a 10% increase/decrease in lapse rates across different product groups.

FUTURE DEVELOPMENTS

During 2017, the Phoenix Group is focused on the smooth transition and efficient integration of the AWL and Abbey Life Assurance Company Limited ('ALAC') businesses, which were acquired in 2016, into its operating platform that will deliver planned capital and expense synergies whilst maintaining / improving the high quality of service to policyholders.

The Company's long-term life insurance business, with the exception of vesting pension annuities and protection business under the SunLife brand, is in gradual run-off. The risk remains that the Company will be impacted by macroeconomic uncertainty or the evolving regulatory environment. The Company will continue to identify and implement new management actions to improve and maintain a robust capital position, whilst enhancing value for both policyholders and shareholders.

DIRECTORS' RESPONSIBILITY STATEMENT

DIRECTORS' RESPONSIBILITY STATEMENT

PHOENIX LIFE LIMITED

Approval by the Board of Directors of the Solvency and Financial Condition Report

Financial period ended 31 December 2016

We acknowledge our responsibility for preparing the SFCR in all material respects in accordance with the PRA Rules and the Solvency II regulations.

We are satisfied that:

- a) throughout the financial year in question, the Company has complied in all material respects with the requirements of the PRA rules and Solvency II regulations as applicable to the Company; and
- b) it is reasonable to believe that the Company has continued so to comply subsequently and will continue so to comply in future.



Andrew Moss

Director and Chief Executive Officer

For and on behalf of the Board of Directors

Date: 12 May 2017

AUDITOR'S REPORT

AUDITOR'S REPORT

Report of the external independent auditor to the Directors of Phoenix Life Limited ('the Company') pursuant to Rule 4.1 (2) of the External Audit Chapter of the PRA Rulebook applicable to Solvency II firms

REPORT ON THE AUDIT OF THE RELEVANT ELEMENTS OF THE SOLVENCY AND FINANCIAL CONDITION REPORT

Opinion

Except as stated below, we have audited the following documents prepared by the Company as at 31 December 2016:

- The 'Valuation for solvency purposes' and 'Capital Management' sections of the Solvency and Financial Condition Report of the Company as at 31 December 2016 ('the Narrative Disclosures subject to audit'); and
- Company templates S.02.01.02, S.12.01.02, S.22.01.21, S.23.01.01 and S.28.01.01 ('the Templates subject to audit').

The Narrative Disclosures subject to audit and the Templates subject to audit are collectively referred to as the 'relevant elements of the Solvency and Financial Condition Report'.

We are not required to audit, nor have we audited, and as a consequence do not express an opinion on, the Other Information which comprises:

- Information contained within the relevant elements of the Solvency and Financial Condition Report set out about above which are, or derive from, the Solvency Capital Requirement as identified in the Appendix to this report.
- The 'Business and performance', 'System of governance' and 'Risk profile' elements of the Solvency and Financial Condition Report.
- Company templates S.05.01.02 and S.25.02.21.
- Information calculated in accordance with the previous regime used in the calculation of the transitional measure on technical provisions and as a consequence all information relating to the transitional measures on technical provisions as set out in the Appendix to this report.
- The written acknowledgement by management of their responsibilities, including for the preparation of the Solvency and Financial Condition Report ('the Responsibility Statement').

To the extent the information subject to audit in the relevant elements of the Solvency and Financial Condition Report includes amounts that are totals, sub-totals or calculations derived from the Other Information, we have relied without verification on the Other Information.

In our opinion, the information subject to audit in the relevant elements of the Solvency and Financial Condition Report of Phoenix Life Limited as at 31 December 2016 is prepared, in all material respects, in accordance with the financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based, as modified by relevant supervisory modifications and as supplemented by supervisory approvals and determinations.

This report is made solely to the Directors of the Company in accordance with Rule 2.1 of External Audit Chapter of the PRA Rulebook for Solvency II firms. Our work has been undertaken so that we might report to the Directors those matters that we have agreed to state to them in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Directors for our work, for this report, or for the opinions we have formed.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ISAs (UK & I) including ISA (UK) 800 and ISA (UK) 805 and applicable law. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the Solvency and Financial Condition Report in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Conclusions relating to going concern

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

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

AUDITOR'S REPORT

Continued

AUDITOR'S REPORT CONTINUED

Emphasis of Matter – Basis of Accounting

We draw attention to the 'Valuation for solvency purposes', 'Capital Management' and other relevant disclosure sections of the Solvency and Financial Condition Report, which describe the basis of accounting. The Solvency and Financial Condition Report is prepared in compliance with the financial reporting provisions of the PRA Rules and Solvency II regulations, and therefore in accordance with a special purpose financial reporting framework. The Solvency and Financial Condition Report is required to be published, and its intended users include but are not limited to the PRA. As a result, the Solvency and Financial Condition Report may not be suitable for another purpose. Our opinion is not modified in respect of this matter.

Other Information

The Directors are responsible for the Other Information. Our opinion on the relevant elements of the Solvency and Financial Condition Report does not cover the Other Information and we do not express an audit opinion or any form of assurance conclusion thereon.

In connection with our audit of the Solvency and Financial Condition Report, our responsibility is to read the Other Information and, in doing so, consider whether the Other Information is materially inconsistent with the relevant elements of the Solvency and Financial Condition Report, or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify such inconsistencies or misstatements we are required to determine whether there is a material misstatement in the relevant elements of the Solvency and Financial Condition Report or the Other Information. If, based on the work we have performed, we conclude that there is a material misstatement of the Other Information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Directors or the Solvency and Financial Condition Report

The Directors are responsible for the preparation of the Solvency and Financial Condition Report in accordance with the financial reporting provisions of the PRA rules and Solvency II regulations on which they are based as modified by the relevant supervisory modifications and as supplemented by supervisory approvals and determinations made by the PRA under section 138A of FSMA, the PRA Rules and Solvency II regulations.

The Directors are also responsible for such internal control as they determine is necessary to enable the preparation of a Solvency and Financial Condition Report that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report

It is our responsibility to form an independent opinion as to whether the relevant elements of the Solvency and Financial Condition Report are prepared, in all material respects, with financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based.

Our objectives are to obtain reasonable assurance about whether the relevant elements of the Solvency and Financial Condition Report are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with ISAs (UK & I) 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 decision making or the judgement of the users taken on the basis of the Solvency and Financial Condition Report.

A further description of our responsibilities for the audit of the Company's financial statements is located on the Financial Reporting Council's website at: <https://www.frc.org.uk/Our-Work/Audit-and-Actuarial-Regulation/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Auditors-responsibilities-for-audit/Description-of-auditors-responsibilities-for-audit.aspx>. The same responsibilities apply to our audit of the Solvency and Financial Condition Report.

Other Matter

The Company has authority to calculate its Solvency Capital Requirement using an internal model ('the Model') approved by the PRA in accordance with the Solvency II Regulations. In accordance with PRA Rules, we are not required to audit the inputs to or outputs from the Model, or assess whether the Model is being applied in accordance with the Company's application or approval order.

Report on Other Legal and Regulatory Requirements.

In accordance with Rule 4.1 (3) of the External Audit Chapter of the PRA Rulebook for Solvency II firms, we are also required to consider whether the Other Information is materially inconsistent with our knowledge obtained in the audit of the Company's statutory financial statements. 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 in this regard.

AUDITOR'S REPORT

Continued

AUDITOR'S REPORT CONTINUED



Ernst & Young LLP

London

15 May 2017

The maintenance and integrity of the Phoenix Group Holdings web site is the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the Solvency and Financial Condition Report since it was initially presented on the web site.

Appendix – relevant elements of the Solvency and Financial Condition Report that are not subject to audit

The relevant elements of the Solvency and Financial Condition Report that are not subject to audit comprise:

- The following elements of template S.02.01.02:
 - Row R0640: Technical provisions – health (similar to life) – risk margin
 - Row R0680: Technical provisions – life (excluding health and index-linked and unit-linked) – risk margin
 - Row R0720: Technical provisions – Index-linked and unit-linked – risk margin
- The following elements of template S.12.01.02
 - Row R0100: Technical provisions calculated as a sum of BE and RM – Risk margin
 - Rows R0110 to R0130 – Amount of transitional measure on technical provisions
- The following elements of template S.22.01.21
 - Column C0030 – Impact of transitional measure on technical provisions
 - Row R0010 – Technical provisions
 - Row R0090 – Solvency Capital Requirement
- The following elements of template S.23.01.01
 - Row R0580: SCR
 - Row R0740: Adjustment for restricted own fund items in respect of matching adjustment portfolios and ring fenced funds
- The following elements of template S.28.01.01
 - Row R0310: SCR
- Elements of the Narrative Disclosures subject to audit identified as 'unaudited'.

SECTION A

IN THIS SECTION

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SECTION A

BUSINESS AND PERFORMANCE

A.1 BUSINESS

A.1.1 INFORMATION REGARDING THE UNDERTAKING

The Company is a private company limited by shares, incorporated, registered and domiciled in the UK.

The Company is regulated by the PRA and the FCA. The contact details for the PRA and FCA are:

Bank of England Prudential Regulation Authority 20 Moorgate London EC2R 6DA	Financial Conduct Authority 25 The North Colonnade London E14 5HS
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The Company is an insurance subsidiary of PLHL, the highest EEA insurance holding company, which has its head office in the UK. The PLHL group is also regulated by the PRA and FCA.

The name and contact details of the Company's external auditor are:

Ernst & Young LLP
25 Churchill Place
Canary Wharf
London
E14 5EY

A.1.2 LEGAL AND ORGANISATIONAL STRUCTURE

A.1.2.1 Legal structure

The persons who were direct or indirect holders of qualifying holdings (i.e. where a shareholder has 10% of more of voting rights) in the Company at any time during the reporting period and at 31 December 2016 were:

Pearl Life Holdings Limited

From 1 January 2016 to 31 December 2016, Pearl Life Holdings Limited ('PeLHL') held 100% of the issued share capital of the Company and was entitled to exercise 100% of the voting power at any general meeting of the Company.

Impala Holdings Limited

From 1 January 2016 to 31 December 2016, Impala Holdings Limited held 100% of the issued share capital of PeLHL, and was entitled to exercise 100% of the voting power at any general meeting of Pearl Life Holdings Limited.

Phoenix Life Holdings Limited

From 1 January 2016 to 31 December 2016, PLHL held 100% of the issued share capital of Impala Holdings Limited, and was entitled to exercise 100% of the voting power at any general meeting of Impala Holdings Limited.

PGH (LCA) Limited

From 1 January 2016 to 31 December 2016, PGH (LCA) Limited held 50% of the issued share capital of PLHL, and was entitled to exercise 50% of the voting power at any general meeting of PLHL.

PGH (LCB) Limited

From 1 January 2016 to 31 December 2016, PGH (LCB) Limited held 50% of the issued share capital of PLHL, and was entitled to exercise 50% of the voting power at any general meeting of PLHL.

Phoenix Group Holdings

From 1 January 2016 to 31 December 2016, PGH held 100% of the issued share capital of PGH (LCA) Limited and PGH (LCB) Limited, which between them held 100% of the shares of PLHL. During the year, PGH was entitled to exercise 100% of the voting power at any general meeting of PGH (LCA) Limited and PGH (LCB) Limited, which between them held 100% of the shares of PLHL. There are no qualifying holdings in PGH and hence no further qualifying holdings in the Company.

All of the above are incorporated, registered and domiciled in the UK, except for PGH, which is incorporated in the Cayman Islands, and registered and domiciled in Jersey.

SECTION A

Continued

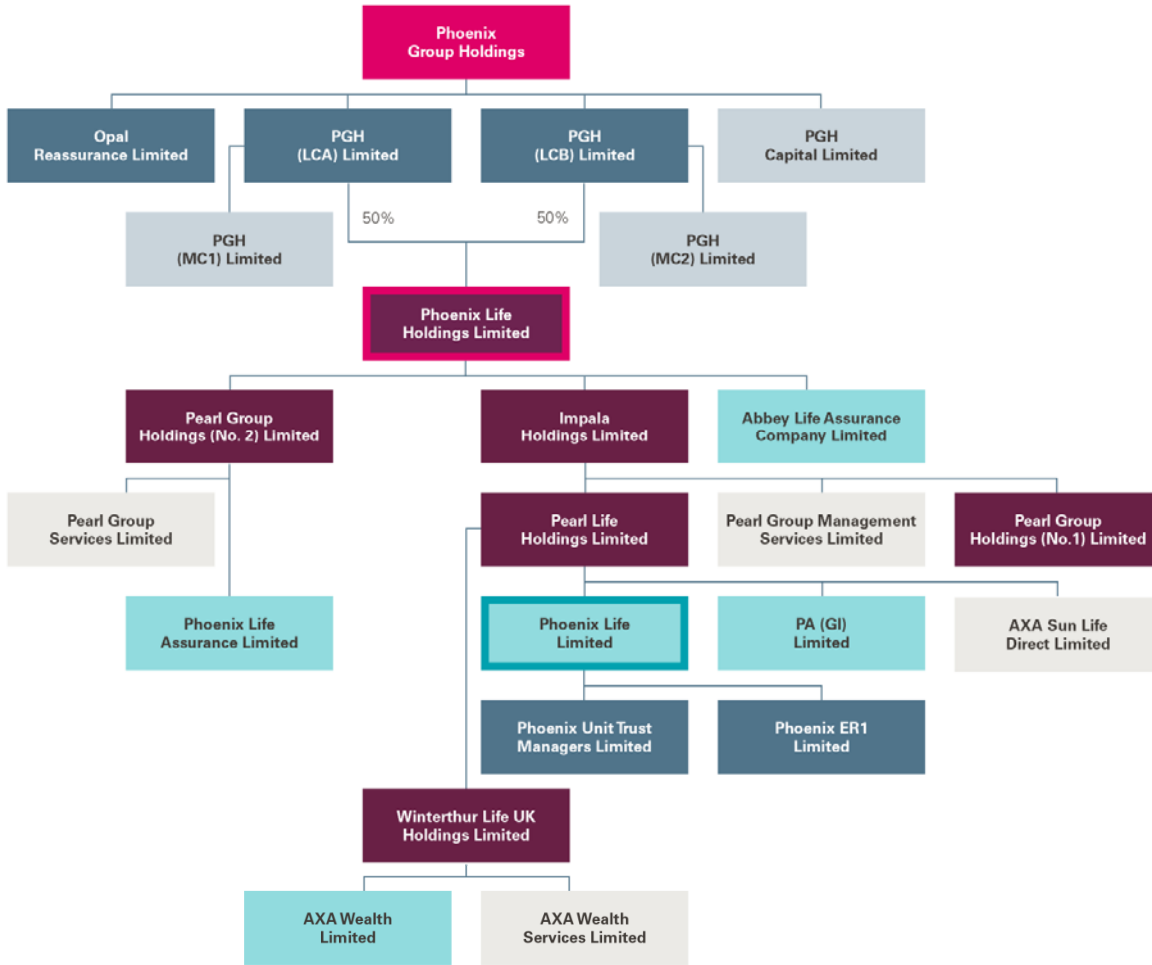
BUSINESS AND PERFORMANCE CONTINUED

A.1 BUSINESS CONTINUED

A.1.2 LEGAL AND ORGANISATIONAL STRUCTURE CONTINUED

A.1.2.1 Legal structure Continued

A simplified structure chart as at 31 December 2016 is provided below, and shows the Company's position within the legal structure of the Phoenix Group. All shareholdings are 100% unless shown otherwise.



Key to structure

- Phoenix Life Holdings Limited – highest EEA insurance parent undertaking
- Phoenix Life Limited
- UK Solvency II regulated insurance companies
- PLHL Group corporate entities
- Management services
- Phoenix Group Holdings – the ultimate parent undertaking headquartered outside the EEA in Jersey
- Financial institutions
- Other companies

SECTION A

Continued

BUSINESS AND PERFORMANCE CONTINUED

A.1 BUSINESS CONTINUED

A.1.2 LEGAL AND ORGANISATIONAL STRUCTURE CONTINUED

A.1.2.2 Material related undertakings of the Company

The material related undertakings of the Company are listed below. There are no other material subsidiaries of the Company.

Entity name	Legal form	Country	Ownership interest and voting rights
Phoenix Unit Trust Managers Limited	Company limited by shares	GB	100%
Phoenix ER1 Limited	Company limited by shares	GB	100%

Phoenix Unit Trust Managers Limited ('PUTM') is 100% owned and is regulated by the FCA. It is an authorised fund manager operating a range of Undertakings for Collective Investment in Transferable Securities ('UCITS') unit trusts, of which the Company is a majority unitholder. It is a private company, limited by shares.

Phoenix ER1 Limited ('PER1L') is 100% owned. The principal activity of PER1L is to hold the beneficial interest in a number of Equity Release Mortgages ('ERM') on behalf of its parent company, the Company. It is a private company, limited by shares.

A.1.3 MATERIAL LINES OF BUSINESS AND GEOGRAPHICAL AREAS

The Company operates four material lines of insurance business, described below, based on the characteristics of the different products administered. All business is underwritten in the UK, with the exception of the euro denominated business written by the Company's registered branch in the Republic of Ireland.

Reinsurance arrangements are in place with companies both internal and external to the Phoenix Group to cover certain blocks of immediate and deferred annuities, some permanent health, critical illness and term assurance risks and some unitised with-profit contracts.

A.1.3.1 Insurance with profit participation

The insurance with profit participation LoB comprises conventional with-profit products and unitised with-profit products.

A with-profit, or participating, policy is one where the policyholder participates in the profits of the fund. An insurer aims to distribute part of its profit to the with-profit policyholders in the form of bonuses. The value of such distributions is based on, among other things, the performance of the underlying pool of assets. Policy pay-outs are generally subject to a minimum guarantee and are 'smoothed' to lessen the impact of changes in the underlying value of the assets in the short term. With-profit products are primarily either endowments or deferred annuities. Endowments may be single or regular premium policies with minimum guaranteed sums on death or maturity, while deferred annuities are accumulation vehicles for pensions with beneficial tax treatment at retirement age.

All with-profit policies are entitled to potential incremental bonuses throughout the life of the policy as well as a terminal, or final, bonus. The terminal bonus represents the policyholder's final share of the assets of the fund. Any available surplus held in a with-profit fund may only be used to meet the requirements of the fund itself or be distributed in defined proportions to the fund's policyholders and the shareholders. For example, the traditional with-profit fund, with a 90:10 policyholder/shareholder split, entitles policyholders to a 90% share and its shareholders to a 10% share of the profits in any bonus declared.

The majority of the Company's with-profit funds are 90:10 funds, with one 100:0 fund.

A.1.3.2 Index-linked and unit-linked insurance

The value of unit-linked products is linked directly to the performance of the underlying assets. The policyholder typically bears all of the investment risk with unit-linked products. The benefits attributable to the policyholder are determined by reference to the investment performance of a specified pool of assets. The policyholder elects which units to purchase within a diversified open-ended fund. Unit-linked funds include personal and group pension plans and feature regular and single premium savings. They operate on a similar basis to mutual funds, with a fee often charged based on the value of the funds.

Customers do not legally own the underlying assets or the units themselves; they own a contract (the policy) with a right to a benefit. The value of that benefit is determined by reference to the prices of their chosen funds.

The Company's unit-linked business comprises contracts with and without options and guarantees.

A.1.3.3 Health insurance

The Company's health insurance business comprises individual and group income protection products, income protection riders and stand-alone critical illness protection products, and includes contracts with and without options and guarantees.

SECTION A

Continued

BUSINESS AND PERFORMANCE CONTINUED

A.1 BUSINESS CONTINUED

A.1.3 MATERIAL LINES OF BUSINESS AND GEOGRAPHICAL AREAS CONTINUED

A.1.3.4 Other life insurance

This LoB includes all remaining underwritten business and comprises conventional non-profit products, protection policies such as life and disability policies that pay out lump sums on death or disability, group life, level and fixed escalation annuities in payment, deferred annuities and index-linked annuities.

For the Company, the majority of the business included in this LoB is annuity business. Annuities generally provide a fixed specified income stream over the life of the policyholder. Annuities are mainly written within non-profit funds. For these annuities, the Company is exposed to all investment and demographic risks and is generally entitled to retain 100% of the incremental investment returns from the assets backing this business.

A.1.4 SIGNIFICANT BUSINESS AND OTHER EVENTS

During 2016, the following significant events took place, which impacted the Company:

A.1.4.1 Acquisition of AXA Wealth Limited

On 1 November 2016, the Phoenix Group acquired 100% of the issued share capital of AWL, AXA Wealth Services Limited, AXA Sun Life Direct Limited, Winterthur Life UK Holdings Limited and AXA Trustee Services Limited from AXA UK plc.

Following the acquisition of AWL by PeLHL, the Company's immediate parent, substantially all of the risks and rewards of the existing and new business of AWL (that was not subject to existing reinsurance arrangements) was reinsured to the Company under two reinsurance agreements. On 10 November 2016, the Company received a capital contribution of £227 million from PeLHL to facilitate the funding of the reinsurance agreements.

The reinsurance of AXA Wealth business into the Company, effective November 2016, led to a significant change to the Company's risk profile. In particular, this business was required to be included on a Standard Formula basis, leading to the SCR of the Company being calculated under a PIM basis as at 31 December 2016.

On 10 March 2017, the PRA approved significant updates to the IM following the reinsurance of AXA Wealth business into the Company. These updates allow the capital requirements of the reinsured AXA Wealth business to be calculated on an IM basis rather than a Standard Formula basis, and so allow the Company to move back to a full IM basis, effective from March 2017. As the approval took place subsequent to the balance sheet date, the impact as at 31 December 2016 has been captured on a pro forma basis in Appendix 2.

A.1.4.2 Longevity swap agreement

On 19 December 2016, the Company entered into a longevity swap agreement with Reinsurance Group of America ('RGA') in respect of a portfolio of in-force immediate annuities of £2.0 billion.

A.1.4.3 Annuity liabilities transfer

On 31 July 2014, the Company entered into a reinsurance agreement, effective from 1 January 2014 to reinsure certain portfolios of the Company's annuity liabilities to RLL (' (formerly Guardian Assurance Limited) in exchange for the transfer of financial assets of £1.8 billion. The annuity in-payment liabilities were held in the Company's with-profit funds. On 30 December 2016, the reinsurance agreement was replaced by a formal scheme under Part VII of the Financial Services and Market Act 2000 to transfer the annuity liabilities to ReAssure Limited, a fellow subsidiary of RLL.

A.1.4.4 Pension buy-in

On 19 December 2016, the Company entered into a 'Buy-In' agreement with the Group's PGL Pension Scheme ('PGLPS'), which converted an existing longevity swap arrangement with PGLPS into a bulk annuity contract. The Company assumed certain additional risks in respect of benefits payable to the beneficiaries covered by the longevity swap arrangement, including the investment risk associated with the assets covering those benefits. At the date of the transaction, the additional liabilities assured were £1.2 billion.

A.1.4.5 Recalculation of Transitional Measure on Technical Provisions

The TMTP allows insurers to recognise the impact of increased technical provisions calculated under the Solvency II regime compared to the previous regime on a gradual basis over 16 years. Further details are included in section D.2.7.2.

Initial approval for the use of the TMTP was granted by the PRA on 6 December 2015. The regulations require all firms to recalculate their TMTP every two years after 1 January 2016, or more frequently under circumstances where the risk profile of the business changes.

The Company has had two recalculation applications approved by the PRA during 2016. These were:

- a recalculation as at 30 June 2016 due to a material fall in yields over the first half of 2016; and
- a recalculation as at 1 November 2016 due to the reinsurance of the AWL business into the Company, which materially changed the risk profile of the Company.

SECTION A

Continued

BUSINESS AND PERFORMANCE CONTINUED

A.1 BUSINESS CONTINUED

A.1.4 SIGNIFICANT BUSINESS AND OTHER EVENTS CONTINUED

A.1.4.5 Recalculation of Transitional Measure on Technical Provisions Continued

During March 2017, a further recalculation of TMTP (determined as at 31 December 2016) was approved by the PRA due to the approval for the extension of the Company's MA portfolio and implementation of the longevity swap agreements. Due to the timing of this approval, the impact of this latest recalculation has not been included in the actual position in the QRTs or the SFCR for 31 December 2016. However, for information, this impact of recalculating the TMTP as at this date is shown in Appendix 2.

A.1.4.6 Matching Adjustment Portfolio

On 15 December 2016, the Company gained regulatory approval from the PRA to enable the scope of assets and liabilities eligible for MA in the MA portfolio to be extended.

A.1.4.7 IFRS Reserving Methodology

During 2016, changes have been made to the assumptions and estimates used in the valuation of IFRS insurance contract liabilities to more closely align the IFRS reserving methodology with the Solvency II requirements. As the Company manages its capital on a Solvency II basis, the changes mean that the IFRS results more closely reflect the way the business is managed and the Company's risk hedging strategies. The changes have resulted in a favourable impact of £109 million to operating profit; however the impact varies by underlying LoB.

A.1.4.8 Other events

Dividends totalling £165 million were paid during the year. During March 2017, an interim dividend of £160 million was approved by the Board.

A.2 UNDERWRITING PERFORMANCE

A summary of the Company's performance during the year ended 31 December 2016 is presented below and in sections A.3 and A.4. The information is presented on an IFRS basis in line with the Company's financial statements.

Year ended 31 December 2016	Section	£m
Operating profit	A.2.1	400
Total investment return variances and economic assumption changes	A.3.1	(116)
Other income and expense items:		
Amortisation of acquired-in-force business and reinsurance asset	A.4.1	(20)
Finance costs attributable to owners	A.4.1	(15)
Other non-operating items	A.4.1	20
Total other income and expenses	A.4.1	(15)
IFRS profit before tax attributable to shareholders		269

A detailed analysis of the current period performance is presented in the sections that follow.

Operating profit

Operating profit is a non-GAAP performance measure of the underwriting activities of the Company, as well as a key metric for managing the business. Operating profit is considered an appropriate measure of the underlying performance of the Company's business as it excludes the impact of short-term economic volatility and other one-off items.

This measure incorporates an expected return, including a longer-term return of financial investments backing shareholder and policyholder funds over the period (as set out in the IFRS financial statements), with consistent allowance for the corresponding expected movements in liabilities. It also includes the shareholder share of bonus of the with-profit funds.

Operating profit includes the effects of variances in experience for non-economic items such as mortality and expenses, and the effects of changes in non-economic assumptions. It also incorporates the impacts of significant management actions where such actions are consistent with the Company's core operating activities (for example, actuarial modelling enhancements and data reviews). The operating profit excludes investment return variances and economic assumption changes, other non-operating items and shareholder tax.

SECTION A

Continued

BUSINESS AND PERFORMANCE CONTINUED

A.2 UNDERWRITING PERFORMANCE CONTINUED

Investment return variances and economic assumption changes

Variances between actual and expected investment returns, and the impact of changes in economic assumptions on the valuation of liabilities are accounted for outside of the operating profit and presented in profit before tax attributable to shareholders.

The negative investment return variances and economic assumption changes of £116 million are primarily driven by a loss of £104 million arising on equity hedging positions held following equity market gains in the period. The equity market gains are not reflected in the IFRS balance sheet as they will emerge in future years as profits on corresponding insurance business (these gains are in respect of future profits, which are not recognised in the IFRS balance sheet).

In addition there is an adverse impact of £40 million from falling yields. Offsetting this is a benefit of £44 million from an increase in expected future inflation levels where the rise in the value of index-linked assets more than offsets the rise in expense reserves and index-linked liabilities.

Other income and expenses

Other income and expense items, which are excluded from operating profit, comprise:

- amortisation and impairment of intangible assets;
- finance costs attributable to owners; and
- other non-operating items such as financial impacts of mandatory regulatory change, integration, restructuring, or other significant one-off projects, and any other items, which, in Management's view, should be disclosed separately by virtue of their nature or incidence.

Information on premiums, claims and expenses is not used as a primary measure of underwriting performance by the Company; however the relevant information split by LoB is presented in the S.05.01.02 QRT included in Appendix 1.2.

A.2.1 ANALYSIS OF CURRENT PERIOD OPERATING PROFIT

As noted earlier, operating profit incorporates an expected return. The expected return on investments is based on opening economic assumptions applied to the funds under management at the beginning of the reporting period. Expected investment return assumptions are derived actively, based on risk-free yields at the start of each financial year.

The long-term risk-free rate used as the basis for deriving the long-term investment return is set by reference to the European Insurance Occupational Pensions Authority ('EIOPA') swap curve after the credit risk adjustment (included in the EIOPA swap curve) is removed and 10 basis points ('bps') is added to reflect the actual asset holdings including gilts. A risk premium of 350bps is added to the risk-free yield for equities, 250bps for properties, 150bps for other fixed interest assets and 50bps for gilts.

The principal assumptions underlying the calculation of the long-term investment return are:

	%
Equities	5.8
Properties	4.8
Gilts	2.8
Other fixed interest	3.8

An analysis of the current period operating profit split by material LoB is presented below. All of the operating profit arises in the UK.

Year ended 31 December 2016	£m
Insurance with profit participation	50
Index-linked and unit-linked insurance	33
Health insurance	28
Other life insurance (predominantly annuities and protection business)	276
Total operating profit by Line of Business	387
Long-term return on surplus assets	13
Total operating profit	400

The operating profit of £50 million on insurance with profit participation business represents the shareholders' one-tenth share of the total bonuses of the 90:10 with-profit funds. This is equivalent to one-ninth of the value of bonuses paid to policyholders.

SECTION A

Continued

BUSINESS AND PERFORMANCE CONTINUED

A.2 UNDERWRITING PERFORMANCE CONTINUED

A.2.1 ANALYSIS OF CURRENT PERIOD OPERATING PROFIT CONTINUED

The operating profit on index-linked and unit-linked insurance of £33 million has arisen from margins earned on unit-linked business of £31 million, a positive impact from the change in IFRS reserving methodology (section A.1.4.7) of £24 million, a loss of £16 million due to demographic experience variances during the period and a loss of £4 million following strengthening of the persistency assumption.

The operating profit on health insurance is primarily due to the change in IFRS reserving methodology.

The operating profit of £276 million on other life insurance is generated from spreads earned on annuities, expected investment return, release of margins and other non-economic experience variances and assumption changes. The profit for the period includes expected return of £34 million, £55 million in relation to recognising additional liquidity premium, £46 million in relation to a change in the deferred annuities reserving basis, £46 million demographic assumption changes and a £55 million impact from the change in IFRS reserving methodology.

The long-term return on surplus assets of £13 million reflects the asset mix, which is primarily cash-based assets, fixed interest securities and interest receivable on loans to Group companies.

A.3 INVESTMENT PERFORMANCE

A.3.1 ANALYSIS OF INVESTMENT RETURN VARIANCES AND ECONOMIC ASSUMPTION CHANGES

The investment performance measure used by the Company is the investment return variances and economic assumption changes. These represent the impact of short-term volatility and amounted to a negative impact of £116 million for the year to 31 December 2016 (see section A.2 for details).

The Company has continued to maintain a robust and resilient capital position against a backdrop of volatile market movements during 2016, reflecting political uncertainties. Swap yields fell significantly across all durations with the 15-year swap rate decreasing by c.73 bps during the period. Credit spreads narrowed across ratings and implied future inflation rates increased during the year. The FTSE All Share Index closed 16.8% ahead of the 31 December 2015 position. The Company continues to undertake management actions to mitigate the effects of market volatility to ensure that the Company maintains a stable capital position.

A.3.2 INVESTMENT INCOME AND EXPENSES

The table below presents the actual investment income split by asset class and the component of such income. Expenses are shown in total as they all relate to investment management fees.

The actual investment return includes investment returns for the benefit of both the policyholders and shareholders.

Year ended 31 December 2016	Investment income/(expenses) components					
	Interest £m	Dividend £m	Rent £m	Fair value gains & losses £m	Other £m	Total £m
Investment income by asset category:						
Fixed and variable rate income securities	342	–	–	973	–	1,315
Equities	–	10	–	21	–	31
Loans and deposits	21	–	–	23	–	44
Derivatives	–	–	–	735	–	735
Collective investment schemes	3	147	–	(472)	29	(293)
Participations	–	300	–	2,198	20	2,518
Investment property	–	–	21	27	–	48
Cash and deposits	3	–	–	–	1	4
Other assets	1	–	–	–	5	6
Investment return	370	457	21	3,505	55	4,408
Investment management expenses and transaction costs						(105)
Total net investment return after deduction of investment expenses						4,303

All investment gains and losses are recognised in the income statement. There are no amounts recognised directly in equity.

SECTION A

Continued

BUSINESS AND PERFORMANCE CONTINUED

A.3 INVESTMENT PERFORMANCE CONTINUED

A.3.2 INVESTMENT INCOME AND EXPENSES CONTINUED

The other investment income of £55 million predominantly includes rebates on collective investment schemes of £28 million. The other income on other assets arises from UK Commercial Property Trust, which is a participation of the Company. The remaining income and gains arises from invested assets.

A.3.3 INFORMATION ON SECURITISATION

The Company has direct investments in securitisation vehicles as at 31 December 2016 of £646 million. The total investment return on these investments is £60 million.

Any indirect exposures via the collective investment schemes falls within the unit-linked and with-profit funds where such investments are held primarily for the benefit of the policyholders and are not deemed significant.

A.4 PERFORMANCE OF OTHER ACTIVITIES

A.4.1 OTHER MATERIAL INCOME AND EXPENSES

Other material income and expense items are outlined below:

Year ended 31 December 2016	£m
Amortisation of acquired in-force business and reinsurance asset	(20)
Finance costs attributable to shareholders	(15)
Other non-operating items	20
Total other income and expenses	(15)

Acquired in-force business of £388 million has been recognised on the IFRS balance sheet following various Part VII transfers to the Company from 2006 to 2012. This is amortised over the estimated life of the contracts on a basis which recognises the emergence of the economic benefits. The remaining estimated life of the contracts is approximately 24 years. The amortisation charge for the period was £(17) million. The balance of £(3) million relates to the amortisation charge for the period on a reinsurance asset of £102 million, which was recognised upon the inception of the reinsurance agreement with AWL on 1 November 2016 (see section A.1.4). This asset is being amortised over a number of years on a basis which recognises the emergence of the economic benefits.

Finance costs attributable to shareholders of £(15) million relate to a £200 million 7.25% unsecured subordinated loan. Further details are included in section D.3.2.

Other non-operating items of £20 million include a £31 million gain following completion of the 'Buy-In' agreement with PGLPS and £26 million positive impact from the longevity swap agreement with RGA, both of which are described further in section A1.4. These items have been partially offset by the recognition of a £22 million loss on the completion of the reinsurance agreement with AWL, £8 million loss for a provision in relation to capping exit charges for personal pension schemes following FCA guidance, £6 million loss following transfer of non-profit business out of the with-profit funds and a £1 million adverse impact of other one-off items.

A.4.2 LEASING ARRANGEMENTS

Leases, where a significant portion of the risks and rewards of ownership are retained by the lessor, are classified as operating leases. The Company has operating leases both as lessor and as lessee. The Company has no financial leases.

The Company primarily leases out investment properties as lessor. Rental income from these operating leases is recognised as income in the income statement on a straight-line basis over the period of the lease. For the period ended 31 December 2016, rental income of £21 million is included in total investment return.

Where the Company is the lessee, payments made under operating leases net of any incentives received from the lessor are charged to the income statement on a straight-line basis over the period of the lease. Operating lease rentals charged within administrative expenses amount to £1 million during the period.

A.5 ANY OTHER INFORMATION

There is no further material information to be disclosed regarding business and performance.

SECTION B

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SECTION B

SYSTEM OF GOVERNANCE

B.1 GENERAL INFORMATION ON THE SYSTEM OF GOVERNANCE

This section provides information on the system of governance in place for the Company and any material changes that have taken place over the reporting period.

Details of the structure of the Board are provided, with a description of its main roles and responsibilities and those of the relevant committees, as well as a description of the main accountabilities and responsibilities of all key functions.

B.1.1 SYSTEM OF GOVERNANCE

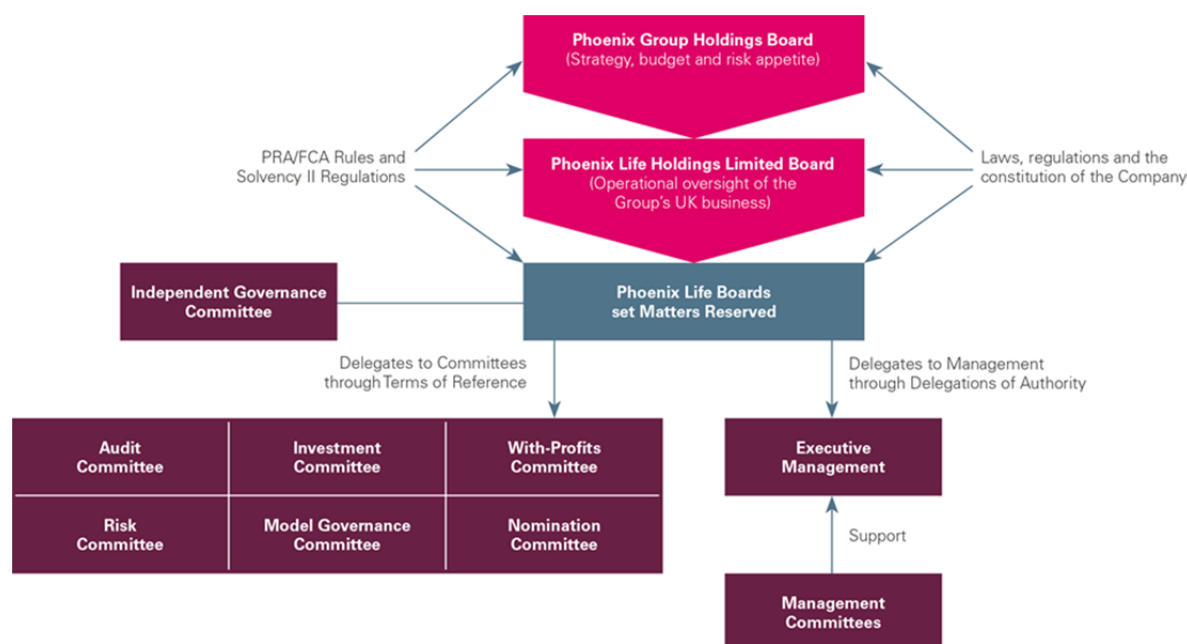
The objective of the Company's governance model is to ensure that management is empowered to run the business on a day-to-day basis in accordance with the authority delegated by the Board, whilst ensuring that Directors are able to discharge their statutory and regulatory responsibilities, and that the Board has appropriate oversight and supervision of the Company's business.

The approach adopted is that:

- The Board has the power to manage the Company in accordance with laws and regulations.
- The Board sets 'Matters Reserved' which are matters which must be submitted to the Board for approval.
- The Board delegates authority to committees of the Board through the approval of the terms of reference of these committees.
- The Board delegates powers to management through delegations of authority.
- Management committees support executive management in making decisions pursuant to the authority they have been delegated (and are also used to review proposals before they are presented to the Board or its committees).
- A system of Solvency II key functions (Actuarial, Internal Audit, Risk and Compliance) operates within the Company. Their duties and responsibilities are allocated, segregated and coordinated in line with Phoenix Group policies. In addition, the Internal Audit function reports directly to the Board Audit Committee for the Company. Further details about the roles and responsibilities of the key functions are provided later in sections B.3.1, B.4.2, B.5. and B.6. There are also a number of other key functions in the Group including Group Finance, Treasury, Group Tax, Legal Services, Human Resources, Corporate Communications, Strategy and Corporate Development, Investor Relations and Company Secretariat.

B.1.2 BOARD AND COMMITTEE STRUCTURE

The diagram below summarises the governance and delegation structure of the Company in place as at 31 December 2016.



The principal change to the Company's system of governance during the period was the establishment of the Nomination Committee on 27 January 2016. Further details about the role, duties and responsibilities of this committee are provided in section B.1.3.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.1 GENERAL INFORMATION ON THE SYSTEM OF GOVERNANCE CONTINUED

B.1.2 BOARD AND COMMITTEE STRUCTURE CONTINUED

B.1.2.1 Role and responsibilities of the Board

The role of the Board is to:

- Provide entrepreneurial leadership of the Company within a framework of prudent and effective controls which enable risk to be assessed and managed.
- Set the Company's strategic aims, ensure that the necessary financial and human resources are in place for the Company to meet its objectives, and review management performance.
- Uphold the Company's values and standards and ensure that its obligations to its shareholders, policyholders and other stakeholders are understood and met.

The Board is responsible and accountable for strategic matters (within the strategy set by the PGH Board), oversight of management and the performance of the Company's business.

B.1.2.2 Composition of the Board

As at 31 December 2016, there were nine Board members (five Non-Executive Directors ('NEDs'), including the Chairman of the Board, and four Executive Directors).

The names of the individuals (and, if relevant, their date of resignation) who served as Directors of the Company at any point during the year are shown below:

Name	Position	Date of appointment	Date of resignation
Mike Urmston	Chairman, Non-Executive Director	11 November 2009	–
Stephen Clarke	Non-Executive Director	12 October 2015	–
Jonathan Evans	Non-Executive Director	2 November 2009	31 August 2016
John Lister	Non-Executive Director	1 September 2016	–
Diana Miller	Senior Independent Director	21 May 2015	–
Shamira Mohammed	Executive Director	7 October 2014	–
Andrew Moss	Executive Director	10 June 2010	–
Nicholas Poyntz-Wright	Non-Executive Director	3 May 2016	–
Mike Ross	Non-Executive Director	12 June 2008	31 March 2016
Wayne Snow	Executive Director	8 August 2013	–
Simon True	Executive Director	2 September 2013	–

B.1.3 COMMITTEE FRAMEWORK

The Board has established and delegated specific responsibilities to the following standing committees of the Board:

- Audit Committee;
- Investment Committee;
- Independent Governance Committee;
- Model Governance Committee ('MGC');
- Nomination Committee;
- Risk Committee; and
- With-Profits Committee.

The Independent Governance Committee and With-Profits Committee are each chaired by an independent member of the committee who is not a Director. Both of these committees have a number of independent members who are not Directors.

The other standing committees of the Board are chaired by NEDs.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.1 GENERAL INFORMATION ON THE SYSTEM OF GOVERNANCE CONTINUED

B.1.3 COMMITTEE FRAMEWORK CONTINUED

Details of the composition and role/duties of each standing committee of the Board are outlined below:

Committee	Composition	Role, duties and responsibilities
Audit Committee	<p>Non-Executive Chairman</p> <p>Non-Executive Directors (2)</p> <p>At least one member of the Committee must be determined by the Board to have recent and relevant financial experience.</p> <p>Meetings are held at least four times a year at appropriate times in the reporting cycle or more frequently as circumstances require.</p> <p>At least once a year, without the presence of executive management, the Committee meets separately with each of the external auditors, the head of Internal Audit, the Chief Executive Officer ('CEO'), Chief Risk Officer ('CRO') and the Finance Director to discuss matters relating to its remit and any issues arising from the audit.</p> <p>The Committee Chairman reports formally to the Board on proceedings after each meeting, on all matters within its duties and responsibilities.</p>	<ul style="list-style-type: none"> – Monitor the overall integrity of financial reporting. – Review the overall effectiveness of the Company's internal control and risk management system and the Internal Audit function. – Agree the nature and scope of external audits and to oversee the relationship with the external auditors. – Monitor and review the effectiveness of the Finance function and the integrity of financial reporting. – Approve the remit of the Group Internal Audit ('GIA') function.
Investment Committee	<p>Non-Executive Chairman</p> <p>Non-Executive Directors (2)</p> <p>Executive members (7)</p> <p>Meetings are held at least four times a year or more frequently as circumstances require and reports on the key activities of the Committee are provided to the Board and other committees of the Board as required.</p>	<ul style="list-style-type: none"> – Establish and implement investment strategy and to regularly review investment and Asset Liability Management ('ALM') strategy whilst ensuring customers are treated fairly. – Initiate or review proposals for material changes in investment direction, and to approve such changes. – Review relative investment performance and to oversee the governance of the relationships between the Company and all investment managers, including oversight and review of fees, fee structures and Service Level Agreements. – Have oversight and review the appropriateness of investment mandates. – Liaise with management committees which have responsibility for the shareholder impact of investment matters and also with the With-profit Committee which has responsibility for the policyholder impact of investment matters.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.1 GENERAL INFORMATION ON THE SYSTEM OF GOVERNANCE CONTINUED

B.1.3 COMMITTEE FRAMEWORK CONTINUED

Committee	Composition	Role, duties and responsibilities
Independent Governance Committee	<p>Independent Non-Executive Chairman</p> <p>Independent Non-Executive Members (2)</p> <p>Company representatives (2)</p> <p>The majority of the members of the Committee including the Chair must be independent of the Company.</p> <p>Meetings are held at least four times a year at appropriate times or more frequently as circumstances require.</p> <p>The Committee Chairman reports formally to the Board on proceedings after each meeting, on all matters within its duties and responsibilities.</p>	<ul style="list-style-type: none"> – Act in the interest of members of the contract-based workplace pension schemes operated by the Company and assess the ongoing value for money delivered by them.
Model Governance Committee	<p>Non-Executive Chairman</p> <p>Non-Executive Directors (2)</p> <p>Executive members (6)</p> <p>Meetings are held at least four times a year at appropriate times in the reporting cycle or more frequently as circumstances require.</p> <p>The Committee Chairman reports in writing to the Board on proceedings after each meeting on all matters within the Committee's duties and responsibilities.</p>	<ul style="list-style-type: none"> – Monitor the strategic direction and overall governance of the IM used by the Company. – Provide assurance to the Board on the ongoing appropriateness, performance and effectiveness of the IM.
Nomination Committee	<p>Non-Executive Chairman</p> <p>Senior Independent Director</p> <p>Chief Executive</p> <p>Meetings are held at least at least twice a year and at such other times as the Committee Chairman shall require.</p> <p>The Committee Chairman reports formally to the Board on proceedings after each meeting, on all matters within the Committee's duties and responsibilities.</p>	<ul style="list-style-type: none"> – Lead the process for appointments and ensure that the Board retains an appropriate balance of skills, knowledge, experience and diversity to support the strategic objectives of the Company. – Ensure there is a formal, rigorous and transparent approach to the appointment of Directors including maintaining an effective framework for succession planning. – Approve proposals for the appointment or removal of Directors to/from the Board. – Regularly review the structure, size and composition of the Board and make recommendations with regard to any changes that are deemed necessary. – Identify and nominate candidates to fill Board vacancies as and when they arise, and give consideration to succession planning. – Review annually the time required from NEDs and recommend the re-appointment to the Board of any NED at the end of their specified term of office.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.1 GENERAL INFORMATION ON THE SYSTEM OF GOVERNANCE CONTINUED

B.1.3 COMMITTEE FRAMEWORK CONTINUED

Committee	Composition	Role, duties and responsibilities
Risk Committee	<p>Non-Executive Chairman</p> <p>Non-Executive Directors (4)</p> <p>Meetings are held at least three times a year at appropriate times or more frequently as circumstances require.</p> <p>At least once a year, without the presence of Executive Management, the Committee meets the CRO.</p> <p>The Committee Chairman reports formally to the Board on proceedings after each meeting, on all matters within the Committee's duties and responsibilities.</p>	<ul style="list-style-type: none"> – Advise the Board on all risk matters including risk appetite and tolerance in setting the future strategy. – Maintain the RMF, reviewing the risk appetite framework and limits. – Approve the overall risk management strategy and principal risk policies including monitoring compliance. – Oversight of the design and execution of the stress and scenario testing framework, and also ensuring that risks to the business plan are adequately identified and assessed through stress testing and scenario analysis.
With-Profits Committee	<p>Independent Non-Executive Chairman</p> <p>Non-Executive Members (2)</p> <p>Non-Executive Director</p> <p>Executive member</p> <p>Meetings are held on a quarterly basis or more frequently if required (usually shortly before a scheduled Board meeting).</p> <p>Following each meeting, the Board receives an update on the matters considered by the Committee and the decisions/recommendations made by the Committee.</p>	<ul style="list-style-type: none"> – Support the Board in discharging its governance responsibilities in relation to compliance with the Principles and Practices of Financial Management ('PPFM'). – Assess, report on, and provide clear advice and, where appropriate, recommendations to the Board on the way in which each with-profits fund is managed and whether this is properly reflected in the PPFM and on any other issue which the Board or Committee considers that with-profits policyholders might reasonably expect the Committee to be involved. – Provide independent judgement in the assessment of PPFM compliance and how any competing or conflicting rights and interests of policyholders and, if applicable, shareholders have been addressed. – Consider all major transactions involving the Company (for example Part VII transfers, reinsurances, outsourcing) to the extent to which they impact upon with-profit policyholders. – Consider at the request of the Board all proposals for the exercise of discretion in respect of non-profit policies and the conduct and overall approach to treating customers fairly.

The MGC has delegated the tasks required under the regulations to the Actuarial, Finance and Risk departments in accordance with their current responsibilities under a three lines of defence model (further details are included in section B.3.2). The RMF is underpinned by the operation of the governance model with clearly defined roles and responsibilities for Boards and their committees, management oversight committees and the Group Risk and GIA functions.

In their role as the first line of defence, the Finance and Actuarial departments have delegated responsibility for:

- design, implementation, operation and use of the IM;
- operation of the validation framework in line with the requirements set by the Risk Management function;
- documenting the IM process and any subsequent changes; and
- informing the Board about the performance of the IM, its limitations, areas needing improvement, and the status of activity to address previously identified weaknesses.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.1 GENERAL INFORMATION ON THE SYSTEM OF GOVERNANCE CONTINUED

B.1.3 COMMITTEE FRAMEWORK CONTINUED

In its role as second line of defence, the Risk function has delegated responsibility for governance and oversight of the IM, including but not limited to:

- sponsorship of the model governance policy;
- ownership of the IM validation framework;
- independent validation of the design, implementation and operation of the IM, including compliance with the model governance policy; and
- in relation to independent validation activity performed and summary reports produced, informing the Board about the performance of the IM, suggesting areas needing improvement, and providing a review of the Finance and Actuarial departments' reporting in relation to weaknesses and limitations of the IM, and the activity to improve previously identified weaknesses.

B.1.4 KEY FUNCTIONS

Solvency II defines 'function' within a system of governance, as an internal capacity to undertake practical tasks and to operate a system of governance which includes the Risk Management function, the Compliance function, the Internal Audit function and the Actuarial function.

The key functions which operate within the Group are as follows:

- Risk Management function (see section B.3.1 for further details);
- Compliance function (see section B.4.2 for further details);
- Internal Audit function (see section B.5 for further details); and
- Actuarial function (see section B.6 for further details).

Their duties and responsibilities are allocated, segregated and coordinated in line with Phoenix Group Policies and are reflected in their descriptions of tasks and responsibilities. This ensures that all the important duties are covered and that unnecessary overlaps are avoided.

Further details on how the key functions have the necessary authority, resources and operational independence to carry out their tasks and how they report to and advise the Board are detailed in the sections which cover each function (see sections B.3, B.4, B.5 and B.6).

B.1.5 REMUNERATION POLICY

The Group has one consistent remuneration policy for all levels of employees and this policy is made available to all staff. Therefore the same remuneration policy principles guide reward decisions for all Group employees, including Executive Directors, although remuneration packages differ to take into account appropriate factors in different areas of the business.

The Group-wide remuneration policy is overseen by the Remuneration Committee of PGH ('RemCo'). Further details on this Committee can be found on page 54 of the 2016 PGH Annual Report and Accounts and on the governance pages of the PGH website.

The policy focuses on ensuring sound and effective risk management and supports management in the operation of their business through the identification of minimum standards and key controls.

The key principles of the remuneration policy, which apply across the Group, are set out below.

- A) Attract, retain and motivate quality staff** – management keep remuneration practices under review to ensure that these support promotion of the long-term interests of the Group and its stakeholders, and adequately and fairly reward staff.
- B) Remuneration is positioned appropriately against external benchmarks** – remuneration is benchmarked against independent third party data at appropriate intervals.
- C) Remuneration is aligned to the long-term success of the Group** – performance-related components of remuneration are aligned to measures which reflect achievement of the Group's long-term success and strategy.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.1 GENERAL INFORMATION ON THE SYSTEM OF GOVERNANCE CONTINUED

B.1.5 REMUNERATION POLICY CONTINUED

- D) Proportion of variable pay is appropriate and balanced**, and has due regard to any impact of risk. The ratio of fixed to variable remuneration will differ depending on the specific incentive schemes in operation across the business. However, the Group seeks to ensure that an appropriate balance between fixed and variable remuneration is maintained for all employees, with the fixed proportion being sufficient to allow variable pay to operate on a fully-flexible basis, including the possibility of no payments of variable remuneration in a year. For 'Identified Staff' subject to the regulatory requirements (further details on whom are included in section B.2) there is also an appropriate balance between annual and long-term incentives, with the deferral of annual incentives into shares and all incentives including provision for the application of malus and clawback where appropriate.
- E) Independence and strong governance in decision-making processes** – as the policy is overseen by RemCo, this ensures an appropriate level of independent challenge given RemCo exclusively comprises independent NEDs. Certain roles within control functions (Risk, Compliance, Internal Audit and Actuarial) are also subject to different variable pay arrangements which exclude any linkage to financial performance for annual incentives.

B.1.5.1 Variable remuneration plans

Annual Incentive Plan

All permanent members of staff participate in a Group-wide Annual Incentive Plan ('AIP'). This is subject to a mixture of corporate (financial and strategic) and personal (individual objectives) performance measures for all staff. This represents a balanced scorecard which includes customer metrics in addition to financial and personal measures.

The quantum of and the balance between corporate and personal performance measures varies between different levels of staff.

The corporate performance measures apply on a Group-wide basis to produce a 'corporate factor' in calculating AIP outcomes. For 2016, the selected performance measures for the corporate element of the AIP are as follows:

Performance Metric	Weighting of Corporate Measure
Corporate measures for AIP in 2016	
Operating companies' cash generation	50%
Operating profit	25%
Customer experience	25%

For 2017, the balance of corporate performance measures will be revised so that operating profit no longer applies and the sole financial measure is operating companies' cash generation. Both the cash generation and customer experience weightings will be increased.

Performance Metric	Weighting of Corporate Measure
Corporate measures for AIP in 2017	
Operating companies' cash generation (increases from 50% in 2016)	71%
Customer experience (increases from 25% in 2016)	29%

The personal element remains unchanged from 2016 and is determined by line managers in accordance with an established performance appraisal grading structure.

One-third of AIP outcomes for all material risk-takers subject to the regulatory requirements are deferred for a period of three years under the Deferred Bonus Share Scheme. For 2017's AIP, the level of deferral will increase to 40% of AIP outcomes for members of the Executive Committee ('ExCo').

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.1 GENERAL INFORMATION ON THE SYSTEM OF GOVERNANCE CONTINUED

B.1.5 REMUNERATION POLICY CONTINUED

B.1.5.1 Variable remuneration plans Continued

Long-term incentive plan

The Group operates a long-term incentive plan ('LTIP') for selected senior members of staff.

RemCo sets performance measures for each LTIP grant. Performance measures include an appropriate mix of measures based on growth in suitable performance conditions set at the time of grant. Performance measures are subject to additional underpin requirements which permit the RemCo to reduce or prevent vesting in appropriate circumstances.

The weightings of the LTIP performance measures for 2016 are summarised below. Each performance measure is assessed over the period of three financial years from 2016 to 2018.

Performance Measure	Weighting of Performance Measure
Cumulative cash generation	50%
Total shareholder return	50%
Total	100%

All 2016 LTIP awards are subject to further underpinning measures relating to debt and risk management within the Group. This underpin will be extended for 2017. LTIP awards include consideration of customer satisfaction and, in exceptional cases, personal performance.

The relative total shareholder return measure is calculated against the constituents of the FTSE 250 (excluding investment trusts) with vesting commencing at median (25% of this part of the award) and full vesting at upper quintile levels, subject to an underpin regarding underlying financial performance.

The weightings for LTIP measures will be unchanged for 2017 LTIP awards.

B.1.6 OTHER ARRANGEMENTS AND MATERIAL TRANSACTIONS

B.1.6.1 Description of pension arrangements

All members of staff are invited to participate in the Group defined contribution scheme or Group Personal Pension arrangements that are open at that time. A legacy Abbey Life defined benefit pension scheme also remains open to a closed population of former Abbey Life employees. Where an individual is impacted by annual or lifetime limits on contribution levels to qualifying pension plans, the balance could be taken as a cash supplement (reduced for the impact of employers' National Insurance Contributions).

The Group does not operate any discretionary pension benefits. Death in Service benefits are provided to all staff.

B.1.6.2 Material transactions with shareholders and the Board

Details of a capital contribution received and dividend paid to the Company's parent company is included in sections A.1.4.1 and A.1.4.8 respectively. There were no other transactions with shareholders, members of the Boards or persons who exercise significant influence on the Company.

B.2 FIT AND PROPER REQUIREMENTS

This section provides information on the specific requirements concerning skills, knowledge and expertise applicable to the persons who effectively run the undertaking or hold other key functions; and how they are assessed to be 'fit and proper'.

B.2.1 SENIOR INSURANCE MANAGERS REGIME

Following industry consultation, the UK regulators introduced the Senior Insurance Managers Regime ('SIMR'), applicable to all PRA and dual regulated entities (i.e. PRA and FCA) in response to the Solvency II requirements, which came into effect on 1 January 2016.

The associated regulatory requirements of this regime apply to all staff within the Group (including the Company), who are employed within a key function, defined as one which is essential for the successful operation of the business. Whilst all employees (with the exception of those engaged in facilities and catering activity) are subject to elements of the regime, the most significant impact is upon senior management (in particular, ExCo and Phoenix Management Board ('PMB') Approved Persons and the NEDs. In total, this equates to circa 40 roles across the Group.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.2 FIT AND PROPER REQUIREMENTS CONTINUED

B.2.1 SENIOR INSURANCE MANAGERS REGIME CONTINUED

The Company ensures the associated requirements are met through the effective implementation of the Phoenix Approved Person Framework, and associated documentation, policies and processes. This framework covers the following:

- Alignment of controlled functions (i.e. the activities performed by the Approved Persons) roles to the SIMR;
- Authorisation process for pre-approved controlled function, notified functions (for example, a NED in a role not requiring pre-approval) and key function holders;
- Demonstration and maintenance of fitness and propriety;
- Application and demonstration of the applicable conduct standards across the business; and
- Evidence and maintenance of competence via the Phoenix performance management process.

With regards to the specific requirements concerning skills, knowledge and expertise to the initial and ongoing skills analysis, all individuals complete a relevant induction programme at appointment. As part of the recruitment process they also have a competency assessment and agree an appropriate development plan. Once in role, senior managers, with accountability in respect of the Life Companies and/or PA(GI) Limited, are subject to the Group's annual performance management process in addition to the annual fit and proper process, implemented for all Approved Persons, Senior Insurance Manager functions and key function holders.

B.2.2 PROCESS FOR ASSESSING FITNESS AND PROPRIETY

The Group has a number of policies and processes established which apply to all regulated entities, and provide appropriate guidance and governance to ensure that those effectively running the Company have and maintain appropriate fit and proper status during their appointment. These policies and processes include the requirements to:

- Identify and maintain accurate records of all Approved Persons, sufficient to meet the requirements of the FCA and PRA.
- Ensure new appointments are appropriately authorised, including skills analysis and competence assessment.
- Maintain a Group Approved Persons Framework to provide direction and guidance to the Group's Approved Persons ensuring they understand and can evidence how they meet their regulatory requirements.
- Complete periodic assessments of Approved Persons to determine their ongoing competence, including consideration of performance development rating, Disclosure and Barring Service ('DBS') check and financial self-certification.
- Maintain an effective performance management framework, ensuring that the performance of employees is effectively managed.
- Motivate and retain the right employees through appropriate reward structures.
- Deliver an appropriate organisational culture through embedding appropriate values and behaviours.
- Identify, plan and implement effective learning and development activities.
- Provide guidance, information and advice regarding the requirements, expectations and obligations of an Approved Person role.

Evidence of adherence to these standards is monitored on a quarterly basis and recorded within the Group centralised risk management system.

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT

This section provides a description of the Group's risk management system including information on how the Risk Management functions are implemented and integrated into the organisational structure and decision-making processes of the Group.

The PGH Group Board is accountable for the Group's RMF, which is implemented consistently across all Group subsidiaries, including the Company. Ultimate accountability for compliance with the regulations rests with the PLHL Board, however each Life Company Board has responsibility for its own entity complying with the regulations.

B.3.1 RISK MANAGEMENT FUNCTION

The Group Risk function is headed by the CRO, who reports directly to the Group CEO.

The Group Risk function has the primary responsibility for supporting the PGH, PLHL and Life Company Boards and the various committees (as detailed in section B.1.2.3) in meeting their risk management responsibilities.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.1 RISK MANAGEMENT FUNCTION CONTINUED

The Group Risk function is split into three teams, covering the following areas:

Operational and regulatory risk: This team is responsible for oversight of operational risk within the Group. This includes regulatory responsibility for all the Group's authorised undertakings and accountability for the successful implementation of all compliance activities. This team is also responsible for ensuring that the RMF is used by the Group to identify, assess, manage, monitor and report the operational risks it faces in achieving its strategic objectives. This responsibility extends across the business, including all Outsourced Service Providers ('OSPs').

Financial risk: This team is responsible for oversight of all financial risks within the Group. This includes ensuring that the RMF is used by the Group to identify, assess, manage, monitor and report the financial risks it faces in achieving its strategic objectives. This team also has responsibility for independently validating that the Group's IM continues to meet the regulatory requirements, including documentation requirements.

PRA/FCA relationship: This team is responsible for managing the relationship with the regulators, including the co-ordination and tracking of the interactions with the PRA and FCA, and arranging preparation for Supervisory Risk Assessment visits.

B.3.2 RISK MANAGEMENT FRAMEWORK

The Group has developed a RMF, which seeks to establish a coherent and interactive set of arrangements and processes to support the effective management of risk throughout the Group.

During the year, the Group continued to strengthen the RMF to meet the evolving regulatory requirements including Solvency II and the UK Corporate Governance Code.

The framework has been embedded within the Group functions and Phoenix Life and plans for the proportionate roll-out across the Company, ALAC and AWL are being developed. Plans for the roll-out of the RMF over the newly acquired business will, where relevant, take account of the plans for the integration of operations into the Phoenix business model and be the focus of activity in 2017.

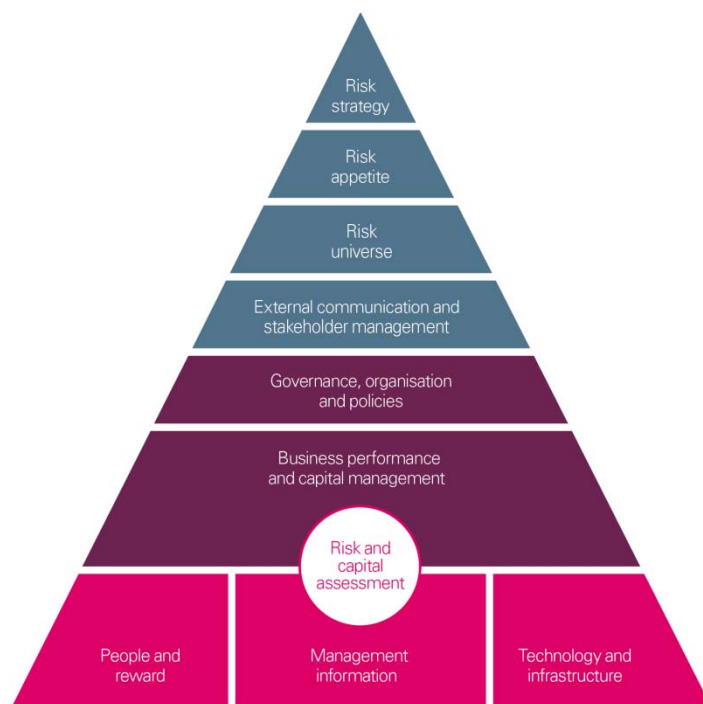
SECTION B Continued

SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.2 RISK MANAGEMENT FRAMEWORK CONTINUED

The RMF comprises ten components as illustrated below:



The outputs of the RMF provide assurance that all risks are being appropriately identified and managed effectively and that an independent assessment of management's approach to risk management is being performed.

Group Risk conducts an annual assessment of the Group's adherence to the RMF that provides assurance to management and the Boards that the RMF has been implemented consistently and is operating effectively across the Group.

Further details of the ten components of the RMF are set out below.

RISK STRATEGY

The Group's risk strategy provides an overarching view of how risk management is incorporated consistently across all levels of the business, from decision-making to strategy implementation.

It assists the business in achieving its strategic objectives by supporting a more stable, well managed business with improved customer and shareholder outcomes.

This is achieved not by risk avoidance, but through the identification and management of an acceptable level of risk (its risk appetite) and by ensuring that the Group is appropriately rewarded for the risks it takes.

To ensure that all risks are managed effectively, the Group is committed to:

- embedding a risk aware culture;
- maintaining a strong system of internal controls;
- enhancing and protecting customer and shareholder value through continuous and proactive risk management;
- maintaining an efficient capital structure; and
- ensuring that risk management is embedded into day-to-day management and decision-making processes.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.2 RISK MANAGEMENT FRAMEWORK CONTINUED

RISK APPETITE

The Group's risk appetite is the level of risk the Group is willing to accept in pursuit of its strategic objectives. The statements below encapsulate the Group's risk appetite for policyholder security and conduct, earnings volatility, liquidity and the Group's control environment:

Capital – The Group and each Life Company will hold sufficient capital to meet regulatory requirements in a number of asset and liability stress scenarios.

Cash flow – The Group will seek to ensure that it has sufficient cash flow to meet its financial obligations and will continue to do this in a volatile business environment.

Shareholder value – The Group will take action to protect shareholder value.

Regulation – The Group and each Life Company will, at all times, operate a strong control environment to ensure compliance with all internal policies and applicable laws and regulations, in a commercially effective manner.

Conduct – The Group has zero appetite for deliberate acts of misconduct, including omissions that result in customer detriment, reputational damage and/or pose a risk to the FCA statutory objectives.

The risk appetite and control framework supports the Group in operating within the boundaries of these statements by limiting the volatility of key parameters under a range of adverse scenarios agreed with the Board. Risk appetite limits are chosen which specify the maximum acceptable likelihood for breaching the agreed limits. Assessment against these limits is undertaken through extensive scenario and reverse stress testing.

RISK UNIVERSE

A key element of effective risk management is ensuring that the business has a complete and robust understanding of the risks it faces. These risks are defined in the Group's Risk Universe.

The Risk Universe allows the Group to deploy a common risk language, allowing for meaningful comparisons to be made across the business.

There are three levels of Risk Universe categories. The highest Risk Universe category is Level 1 and includes:

- strategic risk;
- customer risk;
- financial soundness risk;
- market risk;
- credit risk;
- insurance risk; and
- operational risk.

Embedded within these categories, and customer risk in particular, are the conduct risks faced by the Group and its customers. These risks are separately monitored and reported on across the organisation to ensure that conduct risk receives appropriate emphasis and oversight.

The Group has developed a PGH Board approved risk appetite statement to manage conduct risk. The appetite statement is supported by the assessment of all conduct-related risks faced by the Group on a quarterly basis. This regular assessment and reporting enables the Group to be forward-looking and proactive in the management of Conduct risk.

SECTION B Continued

SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.2 RISK MANAGEMENT FRAMEWORK CONTINUED

Section C of this SFCR contains a summary of the risk profile of the Company. The summary in section C is structured in accordance with the risk categories of the Solvency II Directive, which are different from the risk categories set out above. The following table provides a mapping between the different sets of risk categories in section B.3 and section C:

Section B – Phoenix Group Risk Universe	Section C – Risk Profile	Comment
Strategic risk	Other material risks	Exposure to strategic risk is considered in section C 'Other material risks'
Customer risk	Other material risks	Exposure to customer risk is considered in section C 'Other material risks'
Financial soundness risk	Liquidity risk	Liquidity risk is a sub-category of financial soundness risk. The other material components of financial soundness risk (capital management risk and tax risk) are considered in section C 'Other material risks'
Market risk	Market risk	No difference
Credit risk	Credit risk	No difference
Insurance risk	Underwriting risk	Section C 'Underwriting risk' includes all components of insurance risk (mortality risk, longevity risk, morbidity risk, expense risk, lapse risk and policyholder behaviour risk)
Operational risk	Operational risk	Not applicable
Not applicable	Other material risks	Section C 'Other material risks' considers exposure to Risk Universe categories not already covered in parts of section C

EXTERNAL COMMUNICATION AND STAKEHOLDER MANAGEMENT

The Group has a number of internal and external stakeholders, each of whom has an active interest in the Group's performance, including how risks are managed. Significant effort is made to ensure that the Group's stakeholders have appropriate, timely and accurate information to support them in forming the views of the Group.

The Life Companies and the Group are subject to the requirements of regulators and have obligations to customers in terms of their reasonable benefit expectations and maintaining the security of the assets backing those obligations.

GOVERNANCE

Overall responsibility for approving, establishing and embedding the RMF rests with the PGH Board. The PGH Board recognises the critical importance of having an efficient and effective RMF and appropriate oversight of its operation. There is a clear organisational structure in place with documented, delegated authorities and responsibilities, from the PGH Board to the PLHL Board, Life Company Boards and the Executive Committee. Further details are included in section B.1.

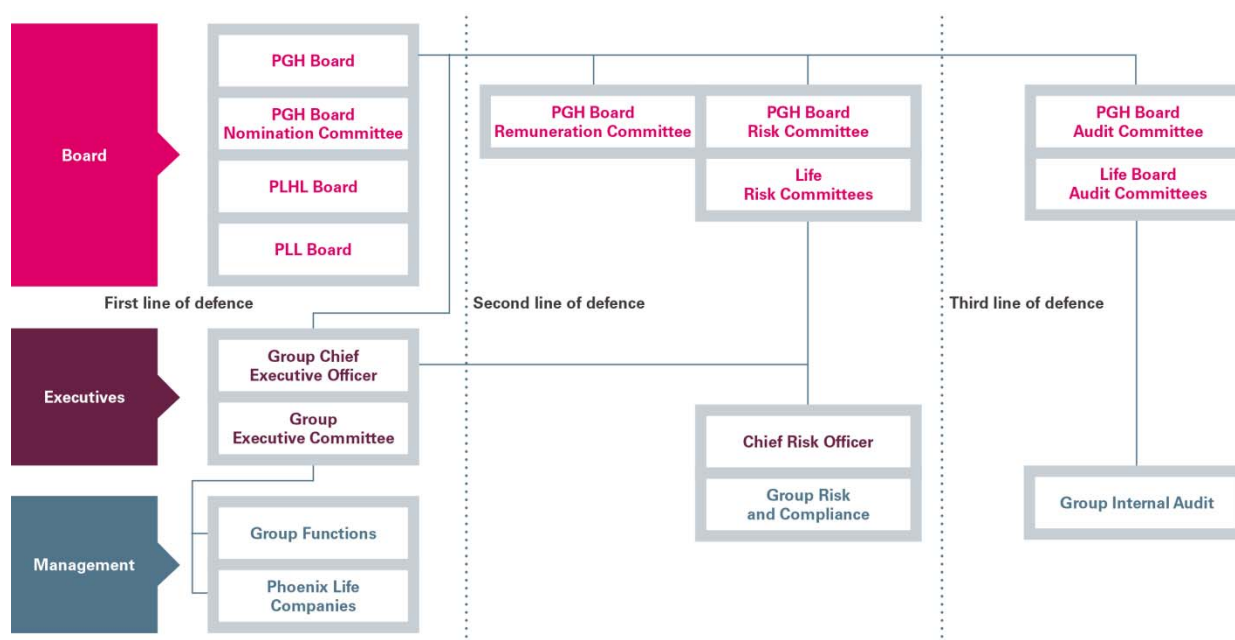
SECTION B Continued

SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.2 RISK MANAGEMENT FRAMEWORK CONTINUED

The RMF is underpinned by the operation of a three lines of defence model with clearly defined roles and responsibilities for statutory Boards and their committees, management oversight committees, Group Risk and GIA. This is illustrated by the diagram below:



Note – In the diagram above, Phoenix Life Companies refers to the management of the Phoenix Life Division, including the Service Companies, PUTM and the newly acquired business in ALAC and AWL.

First line: Management – Management of risk is delegated from the Board to the Group CEO, ExCo members and through to business managers. A series of business unit management oversight committees operate within the Group. They are responsible for implementation of the RMF and ensuring the risks associated with the business activities are identified, assessed, controlled, monitored and reported.

Second line: Risk oversight – Risk oversight is provided by the Group Risk function, the Group Board Risk Committee and the Phoenix Life Risk Committee.

Third line: Independent assurance – Independent verification of the adequacy and effectiveness of the internal controls and risk management is provided by the GIA function, which is supported by the Board Audit Committee.

ORGANISATION

The Group CRO manages the Group Risk function and has responsibility for the implementation and oversight of the Group's RMF. The Group Risk function has responsibility for oversight over financial, operational and regulatory risk. The PRA/FCA relationship team manages the relationship and interactions with the Group's primary regulators and reports to the Group CRO.

Details on the IM governance and organisation are included in section B.3.4.

POLICIES

The Group policy framework comprises a set of policies that support the delivery of the Group's strategy by establishing operating principles and expectations for managing the key risks to the Group's business. The policy set is mapped to the Group Risk Universe and contains the minimum control standards to which each business unit must adhere to and against which they report compliance.

The policies define:

- the individual risks the policy is intended to manage;
- the degree of risk the Group is willing to accept, which is set out in the policy risk appetite statements;
- the minimum controls required in order to manage the risk to an acceptable level; and
- the frequency of the control's operation.

Each policy is the responsibility of a member of the ExCo who is charged with overseeing compliance throughout the Group.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.2 RISK MANAGEMENT FRAMEWORK CONTINUED

BUSINESS PERFORMANCE AND CAPITAL MANAGEMENT

The Annual Operating Plan ('AOP') is assessed to ensure that the Group operates within the stated risk appetite. Business performance is routinely monitored with consolidated reporting against performance targets.

The Group operates a capital management policy where capital is allocated across risks where capital is held as a mitigant and the amount of risk capital required is reviewed regularly.

RISK AND CAPITAL ASSESSMENT

The Group operates a standardised assessment framework for the identification and assessment of the risks it may be exposed to and how much capital should be held in relation to those exposures. This framework is applicable across the Group and establishes a basis, not only for the approach to risk assessment, management and reporting but also for determining and embedding capital management at all levels of the Group in line with Solvency II requirements.

Risk assessment activity is a continuous process and is performed on the basis of identifying and managing the significant risks to the achievement of the Group's objectives.

Stress and scenario tests are used extensively to support the assessment of risks and provide analysis of their financial impact.

Independent reviews conducted by Group Risk provide further assurance to management and Board that individual risk exposures and changes to our risk profile are being effectively managed.

QUALITATIVE INFORMATION ON MATERIAL RISKS

The Company's principal risks and uncertainties are detailed in the table below, together with their potential impact and mitigating actions which are in place. As economic changes occur and the industry and regulatory environment evolves, the Group will continue to monitor the potential impact of these principal risks and uncertainties facing the Group.

Risk	Impact	Mitigation
In times of severe market turbulence, the Company may not have sufficient capital or liquid assets to meet its cash flow obligations or may suffer a loss in value	<p>The emerging cash flows of the Company may be impacted during periods of severe market turbulence by the need to maintain appropriate levels of regulatory capital. The impact of market turbulence may also result in a material adverse impact on the Company's capital position.</p> <p>Since the introduction of Solvency II and a swaps based discount rate, the Company is more sensitive to movements in swap yields, relative to gilts.</p>	<p>The Company undertakes regular monitoring activities in relation to market risk exposure, including limits in each asset class, cash flow forecasting and stress and scenario testing. In response to this, the Company has implemented de-risking strategies to mitigate against unwanted customer and shareholder outcomes.</p> <p>The Company's excess capital position continues to be closely monitored and managed, particularly in the low interest rate environment.</p>
Adverse changes in experience versus actuarial assumptions	<p>The Company has liabilities under annuities and other policies that are sensitive to future longevity, mortality and persistency rates. For example, if our annuity policyholders live for longer than expected, then their benefits will be paid for longer. The amount of additional capital required to meet those additional liabilities could have a material adverse impact on the Company's ability to meet its cash flow obligations.</p>	<p>The Company undertakes regular reviews of experience and annuitant survival checks to identify any trends or variances in assumptions.</p> <p>The Company continues to actively manage its longevity risk exposures, which includes the use of reinsurance contracts to maintain this risk within appetite.</p>

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.2 RISK MANAGEMENT FRAMEWORK CONTINUED

QUALITATIVE INFORMATION ON MATERIAL RISKS CONTINUED

Risk	Impact	Mitigation
Significant counterparty failure	<p>Assets held to meet obligations to policyholders include debt securities. Phoenix Life is exposed to deterioration in the actual or perceived creditworthiness or default of issuers.</p> <p>This risk is reflected in the higher expected return, or spread, over less risky assets.</p> <p>An increase in credit spreads on debt securities, particularly if it is accompanied by a higher level of actual or expected issuer defaults, could adversely impact the value of the Company's assets.</p> <p>The Company is also exposed to trading counterparties failing to meet all or part of their obligations, such as reinsurers failing to meet obligations assumed under reinsurance arrangements.</p>	<p>The Company regularly monitors its counterparty exposure and has specific limits relating to individual exposures, counterparty credit rating, sector and geography. Where possible, exposures are diversified through the use of a range of counterparty providers. All material reinsurance and derivative positions are appropriately collateralised and guaranteed.</p>
Changes in the regulatory and legislative landscape may impact the financial position of the Company	<p>The conduct-focused regulator has had a greater focus on customer outcomes. This may continue to challenge existing approaches and/or may result in remediation exercises where the Company cannot demonstrate that it met the expected customer outcomes in the eyes of the regulator.</p> <p>Changes in legislation such as the Pensions Freedoms and taxation can also impact the Group's financial position.</p>	<p>The Company puts considerable effort into managing relationships with its regulators so that it is able to maintain a forward view regarding potential changes in the regulatory landscape. The Company assesses the risks of regulatory change and the impact on our operations and lobbies where appropriate.</p>
The Group fails to effectively integrate the acquired businesses	<p>The challenge of integrating two new businesses into the Group could introduce structural or operational inefficiencies that result in Phoenix failing to generate the expected outcomes for policyholders or value for shareholders.</p>	<p>The financial and operational risks of target businesses were assessed as part of the acquisition phase. Integration plans are developed and resourced with appropriately skilled staff to ensure that the target operating models are delivered in line with expectations.</p>

The Company's senior management and Board also take emerging risks into account when considering potentially adverse outcomes and appropriate management actions prior to the risk crystallising. Some of the current emerging risks the Group considers are listed in the table below:

Risk Title	Description	Risk Universe category
Regulatory thematic reviews	The unknown consequences and the potential impact, including retrospective activity, as a result of Thematic Reviews conducted by the regulators.	Customer
Political risk	Unexpected changes in the legislative environment and the impacts on financial markets driven by the political agenda following the UK's decision to leave the EU.	Strategic
Market Disruptors	The impact of alternative providers in the market or those with more comprehensive digital propositions.	Strategic

PEOPLE AND REWARD

Effective risk management is central to the Group's culture and its values. Processes are operated that seek to measure both individual and collective performance and discourage incentive mechanisms which could lead to undue risk taking. Training and development programmes are in place to support employees in their understanding of the operation of the RMF.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.2 RISK MANAGEMENT FRAMEWORK CONTINUED

MANAGEMENT INFORMATION

Overall monitoring and reporting against the Risk Universe takes place in business unit management committees and Boards. This is then reported to the PMB, Phoenix Life Companies Board, PLHL Board and the PGH Board via regular risk reporting.

The PGH Board Risk Committee and the Phoenix Life Risk Committee receive a consolidated risk report on a quarterly basis, detailing the risks facing the Group. Both committees are also provided with regular reports on the activities of the Group Risk function.

TECHNOLOGY AND INFRASTRUCTURE

The Group employs market-leading risk systems to support the assessment and reporting of the risks it faces. This enables management to document key risks and controls and evidence the assessment of them at a frequency appropriate to the operation of the control.

B.3.3 OWN RISK AND SOLVENCY ASSESSMENT PROCESS

The Company carries out an Own Risk and Solvency Assessment ('ORSA') to assess its risk profile on an ongoing basis. The ORSA process is made up of a number of components which operate at regular frequencies, either within the Life Companies, at PLHL Group level or both.

Each Life Company and the PLHL Group produce an ORSA report. Each report is reviewed and approved by the Boards at least annually.

Such reporting includes an assessment of:

- the specific key risks to the business;
- the overall risk profile at any point in time;
- how that risk profile is expected to change over time (i.e. forward looking perspective);
- the SCR, derived from the Group's approved IM; and
- whether triggers for an ad-hoc ORSA are likely to be hit within the short term, considering current capital positions and the risk profile outlook.

Each ORSA process has an agreed owner and governance route for review and/or approval of the output. The Group's policy for performing and documenting the ORSA is set out in the Group's ORSA framework, which is reviewed at least annually.

In producing the ORSA report, senior management consider risk, capital and return coherently within the context of the business strategy, on a forward looking basis. The ORSA is a fundamental part of the strategic risk and capital management processes of the business to prompt consideration of management actions and help shape strategic decision-making.

The ORSA results are reported through the Group's management committee structure in accordance with the agreed terms of reference.

The Group operates an IM to calculate its capital requirement and hence its own solvency needs. The ORSA process runs alongside the IM, and under these processes, capital is allocated across risks where capital is held as a mitigant.

SECTION B Continued

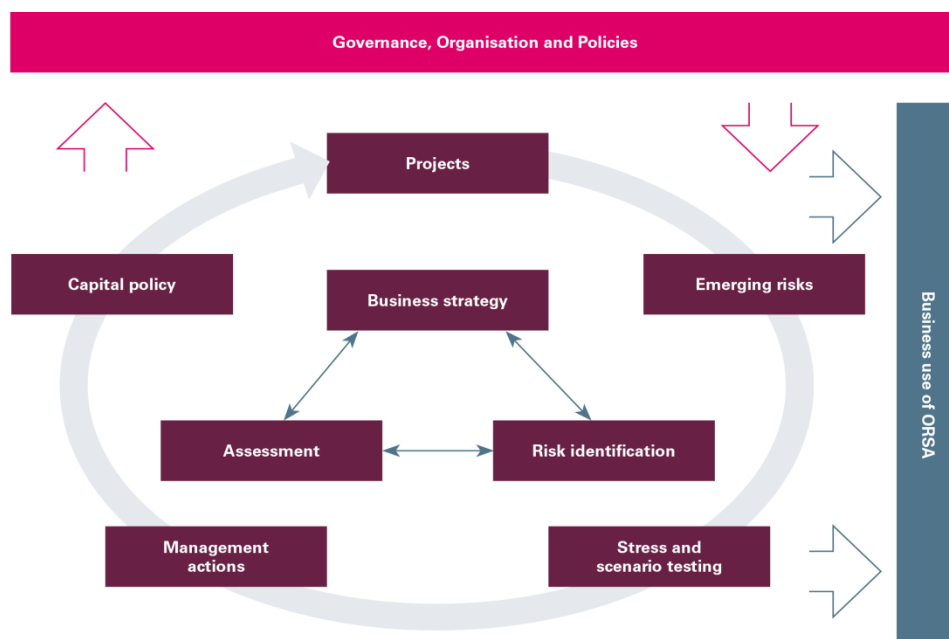
SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.3 OWN RISK AND SOLVENCY ASSESSMENT PROCESS CONTINUED

B.3.3.1 ORSA process

The process followed in undertaking the ORSA is illustrated below:



Business strategy is at the core of the ORSA process. The Company holds a strategy day at least once a year and this is informed by updated projections of the annual operating plan and an assessment of those projections against the Company's external targets and KPIs.

The risk appetite is set for both policyholder and shareholder risks. This is typically on an annual basis and occurs at the beginning of each ORSA cycle. The Company sets its capital policy in alignment with its policyholder risk appetite.

There is an ongoing evaluation of the risk profile, capital requirements and Own Funds. The risk profile evaluation is a process that operates throughout the business to report on changes to key risks in the context of the Group's risk appetite.

Solvency is monitored on a daily basis within the Life Companies. This is then collated to produce a weekly estimation of Group solvency and a quarterly evaluation of Own Funds and capital requirements.

Financial projections are prepared at a base level, and subjected to stress and scenario testing as follows;

- sensitivity testing;
- risk appetite testing;
- quantitative and qualitative scenario testing; and
- reverse stress testing.

Analysis is also performed to understand the impact of any loss of MA and/or TMTP on technical provisions.

The Group operates a series of management oversight committees which together provide governance over all steps in the ORSA process. The Boards are responsible for the ORSA reports, which document the outcome and results of the ORSA processes to support the Boards' decision-making.

The ORSA process is integrated to the management and decision-making processes by:

- engagement and reinforcement at management committees;
- regular review (at least quarterly) of ORSA management information;
- production of one ORSA report per year linked to strategy and the AOP process;
- continuous improvements to the order/cycle of connected processes and the approach to and timing of reporting to the Boards; and
- maintenance of the ORSA record (provides evidence for the performance of the ORSA processes as described by the Framework, documents Board or committee discussion and sign off, and records actions arising), which heightens awareness of the significance and role of each recorded process in the ORSA cycle.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.3 RISK MANAGEMENT SYSTEM, INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT CONTINUED

B.3.4 RISK MANAGEMENT SYSTEM AND INTERNAL MODEL GOVERNANCE

The MGC is a Committee of the PLHL and Life Companies' Boards and supports the Boards in ensuring that they receive appropriate information to ensure that the IM is operating properly on a continuous basis.

More details of the governance process of the IM are set out in section B.1.2.3.

The performance and ongoing appropriateness of the IM is monitored by way of ongoing validation of IM methodology, risk calibrations and operational processes, in line with the system of governance set out in the model governance policy, standards and associated framework documents.

The Life Finance and Actuarial departments produce IM risk calibration recommendations and IM results. These departments operate internal review and validation processes. The validation outcomes are summarised as part of each IM valuation cycle in a self-certification report which assess compliance with Solvency II requirements and IM assurance principles.

Senior management and the relevant management committees review the risk calibration recommendations and the IM results.

Group Risk independently validates all aspects of the IM over a two-year rolling period, with particular emphasis on risk calibration recommendations and the underlying methodologies and operation of the IM.

Risk calibration reports, IM results and self-certification reports are reviewed by the MGC on behalf of the Boards. The MGC also receives a quarterly opinion from Group Risk on the continued appropriateness, performance and effectiveness of the IM together with regular independent assurance from GIA that the IM processes are operating as intended.

A summary of the MGC reviews are provided to the Life Companies' and Group Boards who approve risk calibration recommendations and IM results.

B.4 INTERNAL CONTROL SYSTEM

B.4.1 INTERNAL CONTROL FRAMEWORK

The Group's internal control system is outlined in the internal control framework and is implemented consistently across the Group. The internal control framework places reliance on the effective operation of the three lines of defence model described in section B.3.2 which is a recognised approach in supporting effective corporate governance and oversight.

There are five key elements to the effective operation of the internal control framework to enable Lines 1, 2 and 3 to fully discharge their responsibilities.

Identification of the key controls within the business to effectively manage risks within risk appetite, which is undertaken as part of the annual Group policy refresh process. This includes identification of the Minimum Control Standards ('MCSs') required in order to manage risk within appetite.

For each MCS defined, a clear articulation of the expected evidence to support the assertion that the MCS is operating effectively.

Self-assessment by designated control owners of the operating effectiveness of each MCS on a quarterly basis.

Implementation of a proportionate programme of controls assurance activity by Line 1 supported by further review and assurance activities by Lines 2 and 3, which includes half-yearly completion of the internal control self-assessment process ('ICSA').

Reporting on MCS performance to provide assurance and management information to all stakeholders confirming that the controls are operating as expected or highlighting exceptions. This in turn enables the data to be incorporated and referenced with Line 1 and Line 2 risk reporting.

Each of these elements is an integral part of the RMF as outlined in section B.3, in particular risk appetite, governance, organisation and policies, management information, and technology and infrastructure.

B.4.2 THE COMPLIANCE FUNCTION

The Compliance function is undertaken by the Compliance Monitoring team which sits within the Operational and Regulatory Risk team under Group Risk. This is an independent function in the second line of defence and provides assurance to the Boards that the Group is operating within a compliant framework. Whilst compliance with regulation remains the responsibility of senior management assigned to specific roles, the Compliance function ensures that the appropriate mechanisms exist to support management in discharging their responsibilities to this end. In addition, the Compliance function provides assurance through its Line 2 compliance monitoring programme and is responsible for identifying and assessing the impacts of new regulations and disseminating these to the relevant parties.

An annual compliance monitoring plan is developed through a risk-based approach and approved by the Phoenix Life Risk Committee. This plan includes specific Solvency II requirements as determined through the regulations or internally, which is in addition to the independent validation in relation to the IM.

SECTION B Continued

SYSTEM OF GOVERNANCE CONTINUED

B.4 INTERNAL CONTROL SYSTEM CONTINUED

B.4.2 THE COMPLIANCE FUNCTION CONTINUED

The regulatory Risk Policy and Guidance team monitor regulatory and industry developments which may impact the Group and its policyholders and ensure that these developments are identified in a timely manner, interpreted, cascaded appropriately, and that relevant actions are agreed and effectively implemented. The team, which supports both Group functions and Life Companies' functions, monitors the delivery of actions, providing challenge, oversight and senior management assurance around the effective management of regulatory risk in this regard.

B.5 INTERNAL AUDIT FUNCTION

The primary role of the GIA function is to support the Board and Executive Management in protecting the assets, reputation and sustainability of the organisation. This is achieved by assessing whether all significant risks are identified and appropriately reported, assessing whether they are adequately controlled and challenging Executive Management to improve the effectiveness of governance, risk management and internal controls.

GIA operates in compliance with the International Standards for the Professional Practice of Internal Auditing, the Internal Audit Code of Ethics and the recommendations from the Committee on Internal Audit Guidance for Financial Services.

B.5.1 STRUCTURE OF INTERNAL AUDIT

A summarised structure chart for the Internal Audit function is shown below:



B.5.2 ROLES AND RESPONSIBILITIES OF INTERNAL AUDIT

The internal audit scope is unrestricted and there are no aspects of the organisation which GIA is prohibited from reviewing. Key business risk areas and industry themes identified both internally and externally, will be prioritised to receive more extensive coverage, regular ongoing review and opinion formation.

The function has a number of responsibilities, including the following:

- Production of internal audit plans: GIA plans, and material changes to plans, are approved by the PGH Board Audit Committee ('GBAC') and Life Company Board Audit Committees ('Life BACs') (further details are included in section B.1.2.3). They have the flexibility to deal with unplanned events to allow GIA to prioritise emerging risks. Changes to the audit plan are considered through GIA's ongoing assessment of risk.
- Reporting results: GIA's reporting to the GBAC and Life BACs includes details of significant control weaknesses, root-cause analysis, themes and a view on the adequacy of management's remediation plans. Bi-annually, GIA provides an opinion on the strength of the design and operation of the Risk Management/Internal Control Framework.
- Oversight of Internal Audit functions: In the case of the Group's OSPs, GIA operates a risk-based oversight model to ensure the activities of the outsourced internal audit functions meet GIA standards (which are aligned to Chartered Institute of Internal Audit standards).

B.5.3 REPORTING

GIA attend, and issue reports to the GBAC and Life BACs (see section B.1.6) and any other governing bodies and Board committees as appropriate.

GIA's reporting to the GBAC and Life BACs includes significant control weaknesses, root-cause analysis, themes and a view on management's remediation plans. Bi-annually, GIA provides an opinion on the strength of the design and operation of the Risk Management/Internal Control Framework (and the associated Risk, Control and Assurance standards).

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.5 INTERNAL AUDIT FUNCTION CONTINUED

B.5.4 INDEPENDENCE AND OBJECTIVITY OF THE INTERNAL AUDIT FUNCTION

In order to maintain its independence and objectivity from the activities it reviews, GIA ensures the following:

The Group Head of Internal Audit ('GHIA') reports to the GBAC (through the chair) and to the CEO on a day-to-day basis. The GBAC chair is the final approval point for recommendations made by the CEO regarding the performance objectives, appraisal, appointment or removal of the GHIA, as well as the overall compensation package of the GHIA which is further ratified by the RemCo.

The remuneration of the GHIA and the senior Internal Audit managers is structured in a manner such that it avoids conflicts of interest, does not impair independence and objectivity and is not directly or exclusively linked to the short-term performance of the organisation.

GIA has the right to attend and observe all or part of executive management meetings and any other key management decision-making forums. It also has sufficient and timely access to all Board and executive management information and a right of access to all of the organisation's records, necessary to discharge its responsibilities.

Effective risk management, Compliance and other assurance functions are an essential part of the Group's corporate governance structure. GIA is independent of these functions and is neither responsible for, nor part of, them. In evaluating the effectiveness of internal controls and risk management processes, in no circumstances does GIA rely exclusively on the work of these other assurance providers, and always examines for itself, an appropriate sample of the activities under review. To the extent that GIA places reliance, this is only after a thorough evaluation of the effectiveness of those functions in relation to the area under review.

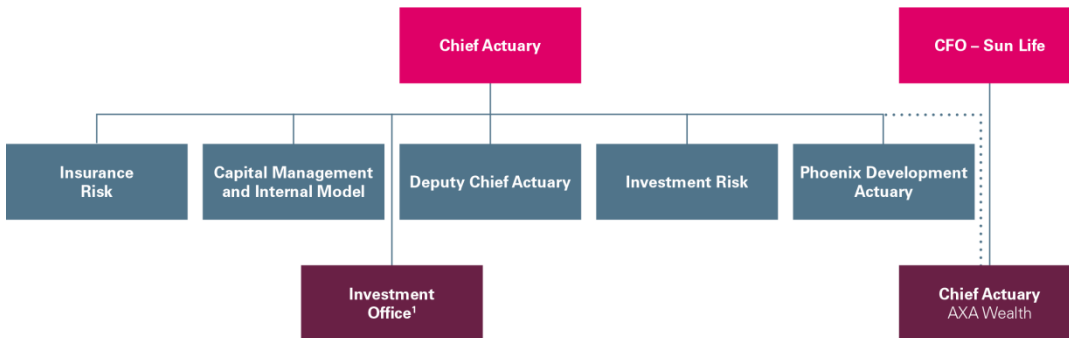
B.6 ACTUARIAL FUNCTION

B.6.1 ORGANISATIONAL STRUCTURE

The Actuarial function is performed by the Life Actuarial department. This department is headed by the Phoenix Life Chief Actuary. This department provides a range of actuarial services and advice to the Board and management team. The Life Actuarial and Group Actuarial departments collectively support the Group Boards.

B.6.2 LIFE ACTUARIAL DEPARTMENT

A structure chart for the Life Actuarial department is provided below.



1. Investment Office responsibilities are primarily related to investment strategy and management of assets and not directly actuarial in nature. Further discussions of this team's activities are therefore not considered in this section.

The Phoenix Life Deputy Chief Actuary is Chief Actuary of the Company.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.5 INTERNAL AUDIT FUNCTION CONTINUED

B.6.2 LIFE ACTUARIAL DEPARTMENT CONTINUED

B.6.2.1 Key team roles within Life Actuarial department

A summary of the role of each team within the Life Actuarial department is outlined below.

Capital Management

The Capital Management team's role is to ensure that an appropriate amount of capital is held in each of the Life Companies. The team oversees a capital policy, which is designed to achieve the following objectives:

- To provide appropriate security for policyholders and meet all regulatory capital requirements while not retaining unnecessary excess capital; and
- To ensure sufficient liquidity to meet obligations to policyholders and other creditors.

The capital policy framework comprises a suite of capital management policies that govern the allocation of capital throughout the Group to achieve these objectives under a range of stress conditions. The policy suite is defined with reference to policyholder security, creditor obligations, dividend policy and regulatory capital requirements.

This team also operates a daily solvency monitoring process which estimates how the solvency of the companies has changed since the last full valuation. These results are reported daily to senior management and monthly to management committees and boards. The team also ensures processes are in place to escalate any breaches of the SCR and identify remedial actions.

Internal Model team

The IM team works with other teams within the business to ensure that the Phoenix PIM remains in line with the PRA-approved model. This includes managing the regulatory approval process for any changes required to models, methodology and reporting processes in line with the latest regulatory and industry requirements.

In particular, the team recommends the methodology for calculating Solvency II regulatory capital and co-ordinates an opinion on the adequacy and reliability of the technical provisions. Where required, the team also co-ordinates any application required for recalculation of the TMTP.

This team is also responsible for the oversight of the Life Actuarial department's compliance with the risk reporting requirements of the RMF.

Investment Risk team

The primary role of the Investment Risk team is to ensure assets that back liabilities are appropriately matched. This work considers cash flow matching, hedging via use of derivatives, and review of asset mixes and investment strategy. Other key roles include providing support for shareholder and policyholder related projects, management actions and managing the associated ALM implications.

Insurance Risk team

The Insurance Risk team is involved in all areas of managing longevity, mortality, persistency and morbidity risk. Longevity and persistency risk are key risks to which the Company is exposed and effective management of these is critical to meeting Phoenix's objectives.

The team ensures appropriate management of insurance risk by developing a risk management strategy, conducting experience investigations, setting best estimate and Solvency II stress assumptions and reporting and oversight of activities in other functions relating to insurance risk.

The team is also responsible for new business pricing which includes significant annuity and protection for new business volumes.

Project developments

The team lead and provide technical support for the planning and execution of a wide range of strategic projects to meet Company objectives. Projects include intra group and external Part VII transfers and a variety of other projects for example, sale of the Company's subsidiaries, developing new insurance arrangements, and with-profit initiatives. A 'Part VII transfer' is a court-sanctioned legal transfer of some or all of the policies of one company to another.

The Life Actuarial department provides project support to all parts of the Group.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.6 ACTUARIAL FUNCTION CONTINUED

B.6.2 LIFE ACTUARIAL DEPARTMENT CONTINUED

B.6.2.2 Key responsibilities of the Actuarial function under Solvency II

This section provides an overview of the key responsibilities of the Actuarial function under Solvency II which are to:

- inform stakeholders about the reliability and adequacy of the calculation of technical provisions;
- express an opinion on the overall underwriting policy;
- express an opinion on the adequacy of reinsurance arrangements; and
- contribute to the effective implementation of the risk management system.

Reliability and adequacy of technical provisions

The Life Actuarial department plays a critical role in determining the technical provisions across the following key areas:

- Methodology, and resulting modelling requirements;
- Data;
- Assumptions;
- Calculations; and
- Validation.

Ultimately, the Life Actuarial department is responsible for presenting the final technical provisions results to the Board for approval.

The Life Actuarial department is responsible for overseeing the calculation of technical provisions which are performed by the Life Finance department. The role of the Life Finance department and the interaction with Life Actuarial is summarised briefly below.

Role of the Life Finance department

The Life Finance department is responsible for ensuring the technical provisions have been calculated in accordance with the regulations. As part of this work, the Life Finance department is responsible for:

- implementation of model and methodology developments;
- setting best estimate demographic and expense assumptions;
- the accuracy and reliability of liability data and asset data required to calculate the technical provisions;
- running the models and processes used to calculate the technical provisions;
- initial review of the technical provision results and understanding the key drivers for changes since the previous valuation; and
- operation of validation controls, such profit and loss attribution, which is used to identify the sources of profit and/or loss that have arisen during each quarter, and comparison of actual results with projected results from the solvency monitoring process.

Best estimate assumptions and any model and methodology changes are subject to approval from the Actuarial Technical Committee ('ATC'), which is chaired by the Phoenix Life Chief Actuary. The ATC Committee consists of the Deputy Chief Actuary and other senior members of the Life Actuarial, Life Finance and Group Actuarial departments. For material model and methodology changes, further approval from the MGC is then sought. For both best estimate assumptions and all model and methodology changes, final approval is sought from the Board.

The Life Actuarial department reviews and challenges the technical provisions produced by the Life Finance departments and reports on the reliability and adequacy of these to the Boards. The appropriateness of the technical provisions for use in the balance sheet is assessed by carrying out detailed review of the technical provisions, which may include studying the control reports and the valuation report, which includes an analysis of the profit and loss attribution. Control reports formally document the key validations and checks performed in the technical provisions and SCR valuation process and outline issues identified and any mitigating actions and weaknesses and limitations.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.6 ACTUARIAL FUNCTION CONTINUED

B.6.2 LIFE ACTUARIAL DEPARTMENT CONTINUED

B.6.2.2 Key responsibilities of the Actuarial function under Solvency II Continued

Reinsurance arrangements

The Life Actuarial department is responsible for forming an overall opinion on the adequacy of reinsurance arrangements. This is to ensure that existing arrangements operate effectively and provide the intended risk mitigation. It also includes the monitoring of the credit quality of reinsurance counterparties.

This opinion is largely guided by the oversight responsibilities and activities performed by the Group's Reinsurance Management Committee ('RMC'). The RMC conducts annual reviews of the reinsurance strategy with consideration given to the Company's risk limits, risk profile and effectiveness of risk transfer. The RMC may propose changes to reinsurance arrangements consistent with the risk appetite developed and adopted by the Group.

Underwriting policy

The Life Actuarial department is also responsible for forming an overall opinion on the underwriting policy. This is to ensure that the underwriting policy and practices in place are appropriate to the risk appetite of the Group and that the technical provisions are determined in a consistent manner.

This opinion is largely guided by the oversight responsibilities and activities performed by the New Business and Pricing Committee and the MCS imposed by the Group's insurance risk policy.

Contribution to the risk management system

The Life Actuarial department contributes to the implementation of key parts of the RMF which includes:

- methodology to calculate the IM SCR;
- ongoing development of the IM;
- review and challenge of the calculated SCR results, which, similar to technical provisions, are calculated by the Life Finance department;
- ongoing management of risks faced by the Life Companies and Group by considering capital policy, ALM and investment strategy.
- managing and monitoring the Life Company balance sheets; and
- developing, reviewing, and implementing management actions that may be called upon to improve the financial soundness of the Life Companies and the Group.

The Life Chief Actuary, Deputy Chief Actuary and other senior members of the Actuarial department also sit on or chair a number of key internal governance committees.

This role within the governance process ensures the function is well placed to contribute to the development, monitoring and improvement (where necessary) of the Group's risk management system.

B.6.2.3 Reporting of Actuarial department activities to the Boards

The key tasks undertaken by the Actuarial department are reported to the Boards and other key stakeholders annually in the 'Actuarial Function Report'.

This report describes the results and outcomes of the key tasks performed by the Actuarial department, along with any material deficiencies arising from them, and highlights where further details regarding recommendations made to address any material deficiencies can be found.

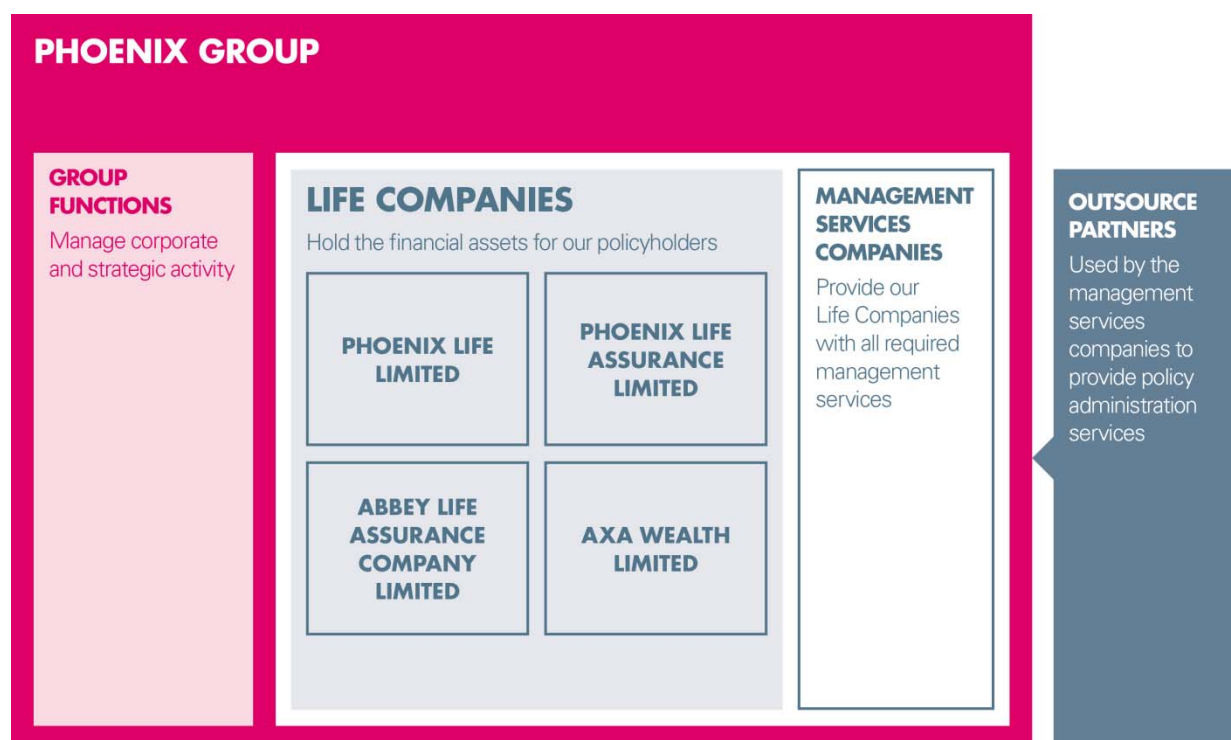
SECTION B

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SYSTEM OF GOVERNANCE CONTINUED

B.7 OUTSOURCING

This section provides information on the material outsourcing arrangements undertaken by the Group, and details the outsourcing policy. The diagram below presents the operating structure of the Group and the interaction with the outsource partners.



B.7.1 SERVICE PROVIDER RELATIONSHIPS

One of the Group's key strategic decisions is to outsource to providers who deliver a range of key services. All service providers are carefully selected following appropriate due diligence.

The Group operates a supplier oversight model, which is a defined MCS within the sourcing and procurement policy detailed in section B.7.2 below. The sourcing model allows for all providers of service to be categorised based upon their risk and materiality to the business. The policy details the minimum standards which the Group are required to employ in establishing and overseeing suppliers, with particular focus on those suppliers who are deemed to be critical and strategically important. All critical and strategically important suppliers have been identified within a supplier management model which defines the manner in which each supplier is overseen.

The contracts for strategically important and critical suppliers fully define the requirements of them as a provider of services to the Group. These contracts make clear the obligations which are placed on each supplier.

A contingency framework is also in place and recognises that there are risks associated with OSP failure/default which the Group may be accountable for. This framework is reviewed on an annual basis and outputs of any reviews are shared with the FCA.

These OSPs have scale and common processes, often across multiple clients, which provide several benefits for the Group, including reducing investment requirements, improving the technology used within our administrative capability, and reducing our operational risk.

Specialist roles such as Finance, Actuarial, Risk and Compliance and oversight of the OSPs are retained in-house, ensuring the management services companies and Life Companies retain full control over the core capabilities necessary to manage and integrate closed life funds.

SECTION B

Continued

SYSTEM OF GOVERNANCE CONTINUED

B.7 OUTSOURCING CONTINUED

B.7.1 SERVICE PROVIDER RELATIONSHIPS CONTINUED

B.7.1.1 Management services agreements ('MSAs') with service companies

The services provided across the Group's outsourcers are as follows:

The service companies are responsible for providing Life Companies with all required management services. A key role of the management service companies is the management of relationships with the outsource partners on behalf of the Life Companies. As the number of policies held by the Group gradually declines over time, the fixed cost base of our operations as a proportion of policies will increase. The risk is managed by putting in place long-term arrangements for third party policy administration. By paying a fixed price per policy to our outsource partners, we reduce this fixed cost element of our operations and convert to a variable cost structure.

B.7.1.2 Policy administration

Full policy administration for our policyholders, including:

- call centre handling;
- policy servicing; and
- claims handling.

Policy administration services are all principally UK based, and fall under FCA jurisdiction, with the exception of a small book of policyholders (less than 25,000) administered by IFDS who are based in Dublin, who still fall under FCA jurisdiction. The Company's outsource providers of policy administration are listed below.

Diligenta

Established in 2005, Diligenta are a UK-based subsidiary of Tata Consultancy Services ('TCS'), and a leading provider of business process services for the life and pensions industry. Specifically, Diligenta provide life and pensions business process services to our policyholders delivering contact centre, policy servicing and claims administration for 3 million live policyholders. In managing the Phoenix account, Diligenta operate out of two principal UK locations, Peterborough and Liverpool, and are supported by overseas locations in India.

Capita Life and Pensions

A major supplier of business process services to the UK life and pensions industry. Specifically Capita Life and Pensions provide life and pensions business process services to our policyholders delivering contact centre, policy servicing and claims administration for 1.5 million live policyholders. In managing the Phoenix account, Capita operate out of one principal UK location, Glasgow, and are supported by overseas locations in India.

HCL (formerly Liberata)

A smaller, but critical, UK regulated business process service relationship with HCL (150k live policy holders) operating out of Romford and are supported by overseas locations in India.

Internal Financial Data Services (IFDS)

A smaller, but critical, UK regulated business process service relationship (25k live policyholders) operating out of Dublin.

B.7.1.3 Fund Accounting and Investment Management

Service providers are used which provide the Life Companies with:

- Fund accounting and custody services; and
- Investment management of assets owned by the Life Companies under agreed Investment Management Agreements and associated mandates.

Investment, Fund Accounting and Custody Services are all operated by service providers who are UK based. The Group's outsource providers of these services are listed below:

HSBC

Provide end-to-end securities services incorporating fund accounting and custody services. In managing the Phoenix account, HSBC operate out of one principal UK location, Glasgow.

Standard Life Investments

A leading provider of investment management services, providing services to the Company.

Henderson Global Investors

A global investment company regulated by the FCA, providing services to the Company.

SECTION B

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SYSTEM OF GOVERNANCE CONTINUED

B.7 OUTSOURCING CONTINUED

B.7.2 SOURCING AND PROCUREMENT POLICY

Sourcing is the structuring of the supply base, including the evaluation, selection and appointment of suppliers to support the operating model of the organisation and key functions. Procurement is the acquisition of goods or services to meet specific business needs and the creation of commercial and legal agreements to fulfil specific requirements.

The Group has a sourcing and procurement policy in place which seeks to manage sourcing and procurement risk (the risk of reductions in earnings and/or value through financial or reputation loss associated with procuring services and managing service providers).

The policy covers the Group's Minimum Controls Standards which are to be adhered to when evaluating, selecting, implementing and managing suppliers in order to ensure risk is managed appropriately. The policy also contains the key risks associated with sourcing and procurement and the minimum control standards in place to mitigate those risks to within an acceptable risk appetite. This aligns with the Risk and Control Framework operated across the Group to manage risk. Further details on the Risk and Control Framework can be found in section B.3.

B.7.3 BOARD OVERSIGHT

Management oversight committees are in place to oversee outsource providers. A material outsourcer report is produced monthly, and presented to the Operations Committee on a quarterly basis.

Risk and control reporting, including the outsourcer view is maintained through the completion of a line 1 risk report (an outcome report, aligned to the Phoenix Risk Universe and RMF). This report is reviewed and approved by the Phoenix Management Board on a monthly basis and is submitted to the relevant Risk Committee on a quarterly basis.

B.8 ANY OTHER INFORMATION

B.8.1 SYSTEM OF GOVERNANCE – ASSESSMENT OF ADEQUACY

Overall, it has been deemed that the system of governance in place within the Group is adequate to meet the requirements of the regulations, demonstrated by the framework described herein.

There is no further material information to be disclosed regarding the system of governance.

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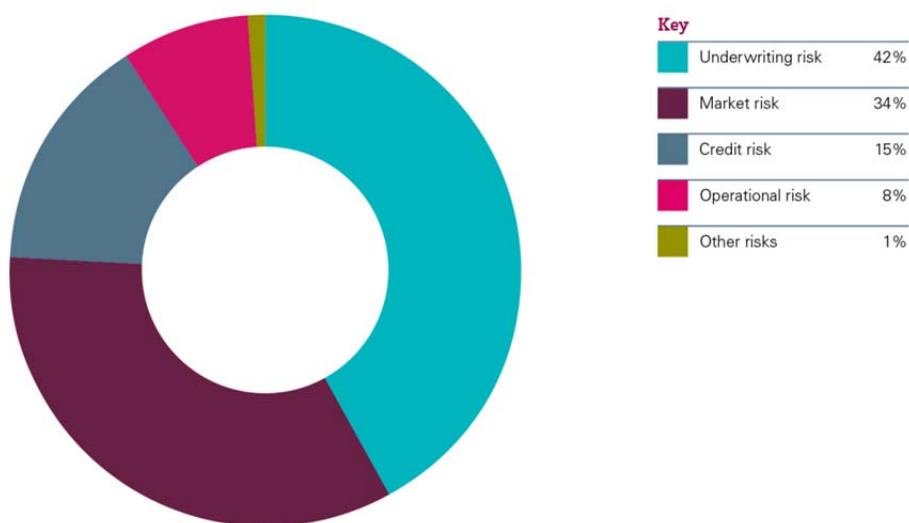
SECTION C

RISK PROFILE

Section B.3 set out the risk management system including information on how the Risk Management function is implemented and integrated into the organisational structure and decision-making processes of the Group (including the Company).

This section provides information on the risk profile of the Company, including for each category of risk, description of the measures used to assess these risks, material risk exposures, concentrations and risk mitigation techniques. Sensitivity analysis for each category of risk is also provided.

The following chart shows the composition of the PIM undiversified SCR components on an actuals basis (i.e. excluding the approvals from the PRA in March 2017) as at 31 December 2016.



Further details regarding the SCR can be found in section E.1.

SECTION C

Continued

RISK PROFILE CONTINUED

C.1 UNDERWRITING RISK

C.1.1 RISK EXPOSURE

Underwriting risk refers to the risk that the frequency or severity of insured events may be worse than expected and includes expense risk. Contracts underwritten by the Company include the following sources of underwriting risk described in the table below:

Risk source	Description
Mortality risk (including catastrophe risk)	Higher than expected number of death claims on assurance products and occurrence of one or more significant claims.
Longevity risk	Lower than expected number of deaths experienced on annuity products or greater than expected improvements in annuitant mortality.
Morbidity risk	Higher than expected number of inceptions on critical illness or income protection policies and lower than expected termination rates on income protection policies.
Expense risk	Unexpected timing or value of expenses incurred.
Lapse risk (including persistency risk)	Adverse movement in either surrender rates or persistency rates on policies, leading to losses. This includes the risk of greater than expected policyholder option exercise rates giving rise to increased claims costs.

During the period ended 31 December 2016, the following key changes in underwriting risk exposure have taken place:

- A reduction in longevity risk, due to the reinsurance of a block of immediate annuities to RGA as detailed in section A.1.4.4.
- A reduction in expense risk and counterparty credit default risk exposure to RLL, following successful completion of a Part VII transfer.
- An increase in mortality risk arising from the acquisition of AWL, and subsequent reinsurance of business into the Company.
- An increase in lapse risk arising from the acquisition of AWL, and subsequent reinsurance of business into the Company.
- The acceptance of new business underwriting risk arising from new business sold, and reinsured into the Company, by AWL.
- A fall in interest rates over 2016 leading to an increase in longevity and persistency risk, together with a further increase in longevity risk following successful completion of a 'Buy-In' agreement with the Group's PGL Pension Scheme ('PGLPS'), partially offset by the reduction in longevity described above.

C.1.2 RISK MEASUREMENT

The Company uses several methods to assess and monitor underwriting risk exposures both for individual types of risks insured and the overall risks. These methods include the PIM, experience analyses, external data comparisons, sensitivity analyses, scenario analyses and stress testing.

The risk capital requirement for underwriting risk is assessed using the Company's PRA approved PIM, which is calibrated to withstand a stress event to a 99.5% confidence level over a one-year period.

As of 31 December 2016, underwriting risk represented 42% of the Company's total undiversified SCR, as shown in the chart at the beginning of section C.

C.1.3 RISK CONCENTRATION

The Company is not exposed to any material concentration of underwriting risk. For all underwriting risks described above, The Company's exposure is spread across a diversified portfolio of products with approximately 3.7 million individual policyholders. No individual policyholder contract size is large enough to represent a material concentration as a proportion of the company's total risk exposure.

C.1.4 RISK MITIGATION

The Company seeks to manage its exposure to underwriting risk by establishing minimum control standards and supporting practices that align with its agreed principles. Risk appetite statements have been established for underwriting risks and the risk exposures are monitored against agreed limits.

The hedging of underwriting risk through reinsurance and other forms of risk transfer is used to manage the overall level of exposure to underwriting risk. The Company has c£2.8 billion of reinsurance recoverables, with the largest exposure being to Reinsurance Group of America (RGA) (c£2.0 billion). The majority of the underwriting risk that has been ceded is annuitant longevity risk, which has been transferred by a mixture of conventional reinsurance treaties and longevity swaps.

The ongoing effectiveness of the reinsurance ceded externally by the Life Companies is monitored on an ongoing basis by the RMC.

SECTION C

Continued

RISK PROFILE CONTINUED

C.1 UNDERWRITING RISK CONTINUED

C.1.5 SENSITIVITY ANALYSIS

Insurance liabilities are sensitive to the assumptions which have been applied in their calculation, such as mortality, longevity and lapse rates. Sometimes allowance must also be made for the effect on future assumptions of management or policyholder actions in certain economic scenarios. This could lead to changes in the assumed asset mix or future bonus rates.

The most significant underwriting risk sensitivities arise from mortality, longevity and lapse risk. As of 31 December 2016, the following sensitivities were estimated. The sensitivities presented allow for the impact to both the Own Funds and the SCR.

- A decrease of 6% in base annuitant mortality rates, with all other variables held constant, would result in a decrease in the Solvency II surplus capital of £207 million.
- A 10% change in lapse rates, with all other variables held constant, would result in a decrease in the Solvency II surplus capital of £75 million. This assumes the most onerous impact of a 10% increase/decrease in lapse rates across different product groups.
- A 10% increase in assurance mortality, with all other variables held constant, would result in a decrease in the Solvency II surplus capital of £93 million.

C.2 MARKET RISK

C.2.1 RISK EXPOSURE

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market influences. The Company is exposed to the following sources of market risk:

Risk source	Description
Interest rate risk	The risk that the fair value of future cash flows of a financial instrument will fluctuate relative to the respective liability due to the impact of changes in market interest rates and the associated guarantees on certain contracts of insurance.
Equity risk	The risk of reduction in earnings and/or value, from unfavourable movements in equity asset values and/or equity volatility. In this context, equity assets should be taken to include shares, equity derivatives and equity collectives (OEICs, unit trusts, investment trusts).
Property risk	The risk of reduction in earnings and/or value, from unfavourable movements in property asset values and/or property volatility. In this context, property assets should be taken to include direct property investment, shares in property companies, property collectives (OEICs, unit trusts, investment trusts) and structured property assets.
Gilt swap spread risk	The risk of reduction in earnings and/or value, from unfavourable movements in the spread between government bond yields and swap rates used to discount insurance liabilities.
Inflation risk	The risk of reduction in earnings and/or value, due to inflation, e.g. price inflation or wage inflation, leading to an unanticipated change in insurance cost.
Currency risk	The risk of reduction in earnings and/or asset and liability values, arising solely as a consequence of changes to currency exchange rates.
Alternative assets risk	The risk of reduction in earnings and/or value, from unfavourable movements in the value and/or volatility of investments in alternative asset classes. In this context, alternative asset classes can be taken to include hedge funds, private equity funds, equity release mortgages, infrastructure loans, commercial mortgage loans, local authority loans, and infrastructure investments.

Markets have seen increased volatility during 2016, reflecting the results of the referendum on the UK's membership of the EU and the US presidential election. Yields on UK government debt and swap rates fell markedly in the first half of 2016 and then rallied towards the end of the year. In response to such volatility, the Company reduced the exposure to further reductions in interest rates using a combination of interest rate swaps and swaptions. The position continues to be closely monitored and managed, particularly in the low interest environment.

SECTION C

Continued

RISK PROFILE CONTINUED

C.2 MARKET RISK CONTINUED

C.2.2 RISK MEASUREMENT

The Company uses several methods to assess and monitor market risk exposures both for market risk categories and for the aggregate exposure to all market risks. These methods include monitoring of asset portfolio composition, interest rate mismatch risk metrics, strategic asset allocation, and hedge effectiveness. In addition, risk is measured using the PIM, sensitivity analyses, scenario analyses and stress testing.

The risk capital requirement for market risk is assessed using the Company's PIM, which is calibrated to withstand a stress event to a 99.5% confidence level over a one-year period.

As of 31 December 2016, market risk represented 34% of the Company's total undiversified SCR, as shown in the chart at the beginning of section C.

C.2.3 PRUDENT PERSON PRINCIPLE REQUIREMENTS

The policies and procedures in place for market risk include control standards which have been designed to ensure compliance with the Prudent Person Principle requirements of the Solvency II Directive. Compliance with the relevant policies is monitored on an ongoing basis (see section B for more details on governance).

Examples of the minimum conduct standards include:

- Responsibility for agreeing the strategic asset allocation rests with the Life Company Boards, with input from SLI, the Phoenix Life Investment Committee, Investment Management Committee ('IMC') and the Actuarial function.
- Investments for unit-linked and index-linked contracts are governed by the relevant investment mandates which meet the overarching requirements of Group policies, as well as close-matching rules and policy-specific requirements.
- Derivatives are used in many of the Company's funds, within policy guidelines agreed by the Board. Derivatives are primarily used for risk hedging purposes or for efficient portfolio management.

More details on how the Company achieves compliance with the requirements, (in particular, having the appropriate risk management capability for the invested assets, investments appropriate for the nature and term of the liabilities, use of derivatives for risk mitigation, diversification, and concentration risk) are described below in section C.2.5.

C.2.4 RISK CONCENTRATION

The concentrations to equity and property are managed through the Group's strategic asset allocation process, with the allocation to each asset class being agreed by the Board.

The operation of agreed market risk concentration limits at fund level ensures that the Company (as well as the Group overall) is not overly exposed to any single country, sector or individual counterparty.

C.2.5 RISK MITIGATION

Interest rate risk

Interest rate risk is managed by matching assets and liabilities where practicable and by entering into derivative arrangements for hedging purposes where appropriate. This is particularly the case for the health and other life insurance funds including MA annuity funds. For participating business, some element of increased exposure to interest rate risk is permitted where it is consistent with the principles of treating customers fairly. The with-profit funds of the Company provide capital to allow such mismatching to be effected. In practice, the Company maintains an appropriate mix of fixed and variable rate instruments (including cash and derivatives) according to the underlying insurance or investment contracts and will review this at regular intervals to ensure that overall exposure is kept within the risk profile agreed for each particular fund. This also requires the maturity profile of these assets to be managed in line with the liabilities to policyholders.

With-profit business and non-participating business within the with-profit funds are exposed to interest rate risk as guaranteed liabilities are valued relative to market interest rates and investments include fixed interest securities and derivatives. For with-profit business the profit or loss arising from mismatches between such assets and liabilities is largely offset by increased or reduced discretionary policyholder benefits dependent on the existence of policyholder guarantees. The contribution of these funds to the Company result is determined primarily by either the shareholders' share of the declared annual bonus or by the shareholders' interest of any change in the value of the capital advanced to the Company's with-profit funds. In certain 'supported' with-profit funds, the Company provides capital support to the fund. The capital is exposed to all economic movements until the estate is rebuilt to cover the required capital, at which point the fund becomes 'unsupported'.

In the non-participating funds and particularly MA annuity funds, policy liabilities' sensitivity to interest rates are matched primarily with fixed and variable rate income securities and derivatives, with the result that sensitivity to changes in interest rates is low.

SECTION C

Continued

RISK PROFILE CONTINUED

C.2 MARKET RISK CONTINUED

C.2.5 RISK MITIGATION CONTINUED

Equity and property risk

The Company's objective in holding equity and property assets is to earn higher long-term returns by investing in a diverse portfolio of equities and properties. Portfolio characteristics are analysed regularly and price risks are actively managed in line with investment mandates. The Company's equity holdings are diversified across industries and concentrations in any one company or industry are limited.

Equity and property price risk is managed through the agreement and monitoring of financial risk profiles that are appropriate for each of the Company's life funds in respect of maintaining adequate regulatory capital and treating customers fairly. This is largely achieved through asset class diversification and within the Company's ALM framework through the holding of derivatives or physical positions in relevant assets to hedge equity risk where appropriate.

Inflation risk

The Company is exposed to inflation risk through annuity policies, which may provide for benefits, which take account of changes in the level of experienced and implied inflation, and also through the Company's cost base. The Company seeks to manage inflation risk through the holding of derivatives, such as inflation swaps, or physical positions in relevant assets, such as index-linked gilts.

Gilt-swap spread risk

The Company accepts some residual exposure to gilt-swap spread risk. This exposure arises where UK gilts are held as assets but policyholder liabilities are discounted using the EIOPA risk-free reference rate, which is based on the swap curve. The exposure to gilt-swap spread risk is managed, in order to stay within the overall risk appetite of the Company.

Currency risk

The Company's financial assets are primarily denominated in the same currencies as its insurance and investment liabilities. Thus, the main foreign exchange risk arises from recognised assets denominated in currencies other than those in which insurance and investment liabilities are expected to be settled and, indirectly, from the earnings of UK companies arising abroad.

The Company has some exposure to overseas assets which is not driven by liability considerations. The purpose of this exposure is to reduce overall risk whilst maximising returns by diversification. This exposure is limited and managed through investment mandates which are subject to the oversight of the investment committees of the Boards of each life company. Fluctuations in exchange rates from certain holdings in overseas assets are hedged against currency risks although the amounts are not considered material.

Alternative assets risk

The Life Companies hold alternative assets as part of wider diversified portfolios investing in more conventional asset classes. The risks are managed in accordance with the ALM framework, taking into account the asset liability matching targets and risk appetite of the funds in question.

The MA portfolio includes exposure to Equity Release Mortgages ('ERM'). The interest rate risk in respect of these illiquid assets is matched to liabilities in order to leave a low residual interest rate risk exposure. The potential adverse loss in respect of these illiquid assets is modelled using bespoke in-house models reflecting the specificities of these asset classes.

The ongoing effectiveness of market risk mitigation is monitored on an ongoing basis by the IMC.

C.2.6 SENSITIVITY ANALYSIS

As of 31 December 2016, the most significant market risk sensitivity arises from interest rate risk, equity and property; their outcomes are set out below. The sensitivities presented allow for the impact to both the Own Funds and the SCR.

- An increase of 55bps in interest rates, with all other variables held constant, would result in an increase in the Solvency II surplus capital of £121 million.
- A decrease of 80bps in interest rates, with all other variables held constant, would result in a decrease in the Solvency II surplus capital of £221 million.
- A 20% fall in equity prices, with all other variables held constant, would result in a decrease in the Solvency II surplus capital of £6 million.
- A 15% fall in property prices, with all other variables held constant, would result in a decrease in the Solvency II surplus capital of £34 million.

The interest rate sensitivities assume that a recalculation of TMTP is triggered and thus, the change in risk margin is offset by a change in transitional measures.

Sensitivity of surplus capital to fluctuations in currency exchange rates is not considered significant, since unhedged exposure to foreign currency is relatively low.

SECTION C

Continued

RISK PROFILE CONTINUED

C.3 CREDIT RISK

C.3.1 RISK EXPOSURE

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge its obligations. These obligations can relate to both on and off balance sheet assets and liabilities. The Company is exposed to the following sources of credit risk:

Risk source	Description
Spread risk	The risk of reduction in earnings and/or value, arising from changes in the spread between corporate bond yields and gilt yields or corporate bond yields and the swap curve.
Investment counterparty risk	The risk of reduction in earnings and/or value, arising from counterparty defaults (and/or credit rating downgrades) on investments such as bonds, derivatives and cash deposits. This also includes the residual risk of credit risk mitigation techniques being less effective than expected. For example, 'gap risk' where collateral fails to move in line with liabilities following a default event.
Reinsurance counterparty risk	<p>The risk of reduction in earnings and/or value, arising from the failure of reinsurance counterparties to meet their contractual obligations by way of default or delayed claim settlements.</p> <p>On 19 December 2016, the Company entered into a longevity swap agreement with RGA in respect of a portfolio of in-force immediate annuities of £2 billion.</p> <p>Following the acquisition of AWL by PeLHL, the Company's immediate parent, substantially all of the risks and rewards of the existing and new business of AWL (that was not subject to existing reinsurance arrangements) was reinsured to the Company under two reinsurance agreements.</p>
Outsourcer default risk	The risk of reduction in earnings and/or value, arising from default by firms providing outsourced services such as administration and investment management.
Stock-lending risk	The risk of reduction in earnings and/or value, arising as a result of borrowers defaulting on their obligation to return the original stock and the risk arising from the investment of the collateral received in lieu of the borrowed stock.

C.3.2 RISK MEASUREMENT

The Company uses several methods to assess and monitor credit exposures. These methods include monitoring of asset portfolio composition, single name counterparty monitoring, and Value-at-Risk (VaR) modelling. In addition, risk is measured using the PRA approved IM, sensitivity analyses, scenario analyses and stress testing.

The risk capital requirement for credit risk is assessed using the IM, which is calibrated to withstand a stress event to a 99.5% confidence level over a one-year period.

As of 31 December 2016, credit risk represented 15% of the Company's total undiversified SCR, as shown in the chart at the beginning of section C.

C.3.3 PRUDENT PERSON PRINCIPLE REQUIREMENTS

The Company's policies and procedures in place for credit risk include control standards designed to ensure compliance with the Prudent Person Principle requirements of the regulations, and such compliance is monitored on an ongoing basis (see section B for more details on the system of governance).

More details on how the Company achieves compliance with the requirements, (in particular, having the appropriate risk management capability for the invested assets, investments appropriate for the nature and term of the liabilities, use of derivatives for risk mitigation, diversification, and concentration risk) are described in section C.3.5.

SECTION C

Continued

RISK PROFILE CONTINUED

C.3 CREDIT RISK CONTINUED

C.3.4 RISK CONCENTRATION

Concentration of credit risk exists where the Company has significant exposure to an individual counterparty or a group of counterparties with similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic and other conditions. The Company has most of its counterparty risk within its life business and this is monitored by the counterparty limits contained within the investment guidelines and investment management agreements. Counterparty risk in respect of over-the-counter ('OTC') derivative counterparties is monitored using a potential future maximum exposure metric.

A breakdown of the credit portfolio by credit rating is given below:

Rating	Market Value £m	Percentage of total %
Cash	236	2.0
AAA	1,123	9.3
AA	6,983	58.0
A	1,895	15.8
BBB	1,314	10.9
Non-Investment Grade	26	0.2
Unrated Bonds	452	3.8
Total	12,029	100.0

As of 31 December 2016, the largest counterparty exposures in the Company's asset portfolio were:

Top 10 single name credit exposures	Exposure £m
UK Government	6,167
European Investment Bank	570
Santander UK PLC	138
KFW	120
Electricite de France SA	106
HSBC Holdings Plc	104
Heathrow Funding Ltd	97
Barclays Bank Plc	90
Bundesrepub Deutschland	87
Network Rail	87

The Company is exposed to concentration risk in respect of reinsurance ceded to external counterparties, although this is largely mitigated by collateral arrangements with the reinsurers. The largest reinsurance exposure is with RGA.

The Company is also exposed to concentration risk with outsource partners. This is due to the nature of the outsourced services market. The Company operates a policy to manage outsourcer service counterparty exposures and the impact from default is reviewed regularly by executive committees and measured through the IM stress and scenario testing. Exposure to the default of outsourced policy administration services is further partially mitigated through letters of credit and parent company guarantees. Further details on the Company's outsourcing arrangements can be found in section B.7.

C.3.5 RISK MITIGATION

Credit risk is managed by monitoring aggregate exposures to individual counterparties, through appropriate credit risk diversification and via the investment mandates. The Company manages the level of credit risk it accepts through credit risk tolerances in line with Group policy. In certain cases, protection against exposure to particular credit risk types may be achieved through the use of derivatives. The credit risk borne by the shareholder on with-profit policies is dependent on the extent to which the underlying insurance fund is reliant on shareholder support.

The ongoing effectiveness of credit risk mitigation described above is monitored on an ongoing basis by the IMC and the RMC.

Further specific mitigation techniques include the following:

SECTION C

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RISK PROFILE CONTINUED

C.3 CREDIT RISK CONTINUED

C.3.5 RISK MITIGATION CONTINUED

Matching adjustment portfolio

The Company has MA approval in respect of blocks of non-participating immediate annuity business. Credit risk and MA is managed via the investment mandates and MA eligible assets.

Reinsurers

The Company cedes insurance risk in the normal course of business. The Company has policies and procedures in place for the management of reinsurance counterparty default risk, including the design of new treaties and the regular monitoring of reinsurance counterparties via the RMC.

Collateral

The Company receives and pledges collateral in the form of cash or non-cash assets in respect of derivative contracts and reinsurance arrangements in order to reduce the credit risk of these transactions. The amount and type of collateral required where the Company receives collateral depends on an assessment of the credit risk of the counterparty.

Outsourcers

The Company receives services from different suppliers in relation to policy administration, asset management and fund accounting services. As a result of receiving services from suppliers the Company is exposed to the risk of default. Risk capital is assessed under a 'Multiple Policy Administration Outsourcer failure and default' scenario.

The selected scenario considers a situation where a number of policy administration suppliers defaulting on contractual obligations and becoming insolvent. Risk capital is assessed using expert judgement, based on an established methodology and is reviewed and agreed through management oversight committees, and up to the MGC.

The risk capital assessment takes account of the supplier's operating model, control factors, and other forms of protection (such as parental letters of credit used to mitigate the risk of certain outsourcers).

C.3.6 SENSITIVITY ANALYSIS

As of 31 December 2016, the following sensitivities were estimated. The sensitivities presented allow for the impact to both the Own Funds and the SCR.

An average 150bps widening of credit spreads (weighted average across ratings), with broadly 10% of the spread widening attributed to defaults and downgrades, would result in a decrease in the Company Solvency II surplus capital of £83 million.

C.4 LIQUIDITY RISK

C.4.1 RISK EXPOSURE

Liquidity risk is defined as the failure of the Company to maintain adequate levels of financial resources to enable it to meet its obligations as they fall due. The Company has exposure to liquidity risk as a result of normal business activities, specifically the risk arising from an inability to meet short-term cash flow requirements. This may arise because of a failure to effectively monitor and manage liquidity risk or by experiencing a severe unpredictable stress event that may impact upon the ability to meet its financial obligations as they fall due.

The Company does not hold risk capital against liquidity risk. Liquidity risk is managed by holding an appropriate proportion of the assets in liquid form, with the proportion determined based on cash flow projections and stress testing (as described in the risk mitigation section).

Over the reporting period ended 31 December 2016, the following key change in liquidity risk exposure has taken place:

- The reinsurance put in place with AWL transfers profits and losses arising in the AWL business to PLL, which are now taken into account when considering the Company's liquidity risk exposure.

C.4.2 RISK MEASUREMENT

Regular monitoring of liquidity takes place in order to establish that all liquidity management activities have been processed appropriately, and to ascertain available liquidity.

The Company carries out a monthly forecast of liquidity resources and restrictions for the next 12-month period, which is provided to the Board. Regular monitoring of ongoing compliance with cash buffers, with any appropriate corrective actions undertaken, is reported to the Board.

The Company also carries out a monthly forecast of liquidity resources and restrictions over the following 12-month period and over the five-year planning horizon taking account of all expected cash flows. This measures the ability to provide a buffer to cover any short-term derivative collateral calls and any longer-term derivative collateral calls under a 1-in-10 likelihood market stress scenario.

In addition to the monthly monitoring described above, the Company determines working capital accounts for each fund based on liquidity stress testing and maintains a forecast of liquid resources against two years of policyholder claims.

SECTION C

Continued

RISK PROFILE CONTINUED

C.4 LIQUIDITY RISK CONTINUED

C.4.2 RISK MEASUREMENT CONTINUED

Monitoring activities include a review of appropriate liquidity risk measures (for example, VaR), as agreed by the Board. Over the reporting period ended 31 December 2016, the monthly monitoring described above was enhanced to include the liquidity risk arising from the Company's reinsurance with AWL.

C.4.3 EXPECTED PROFITS IN FUTURE PREMIUMS

Own Funds are used to cover the SCR; further details can be found in section E.1. The value of liabilities takes into account expected future premium payments even if the policyholder is not contractually committed to make them. This methodology for valuing liabilities therefore implicitly allows for any expected profits in future premiums ('EPIFP') which, acts to reduce the liability value.

As at 31 December 2016, the Company's total EPIFP was £293 million and is included as a component of the reconciliation reserve. This comprised mainly future profits arising on protection and unit-linked business.

C.4.4 RISK CONCENTRATION

Uncertainty of cash outflows for the Company arises primarily as a result of mass lapse risk and catastrophe risk. However, the Company is not exposed to material concentrations of liquidity risk due to it holding sufficient liquidity to cover fluctuations in cash outflows.

The Company is also exposed to potential collateral calls for derivative assets held, which may arise from large movements in yields or equity indices or the longevity swap arrangement with RGA.

C.4.5 RISK MITIGATION

The Company Board has defined a number of governance objectives and principles and the liquidity risk frameworks of each subsidiary are designed to ensure that:

- Liquidity risk is managed in a manner consistent with the Board's strategic objectives, risk appetite and PPFM.
- Cash flows are appropriately managed and the reputation of the Group is safeguarded.
- Appropriate information on liquidity risk is available to those making decisions.

The Company's policy is to maintain sufficient liquid assets of suitable credit quality at all times including, where appropriate, access to borrowings so as to be able to meet all foreseeable current liabilities as they fall due in a cost-effective manner. Forecasts are prepared monthly to predict the required liquidity levels over both the short- and medium-term allowing management to respond appropriately to changes in circumstances.

The vast majority of the Company's derivative contracts are traded OTC and have a two-day collateral settlement period. The Company's derivative contracts are monitored daily, via an end-of-day valuation process, to assess the need for additional funds to cover margin or collateral calls.

Liquid assets are held in appropriate accounts to cover internally set buffers to meet collateral calls on derivative assets. This is monitored on a monthly basis.

Some of the Company's commercial property investments and cash and cash equivalents are held through collective investment schemes. The collective investment schemes have the power to restrict and/or suspend withdrawals, which would, in turn, affect liquidity. To date, the collective investment schemes have continued to process both investments and realisations in a normal manner and have not imposed any restrictions or delays. However, during 2016, some of the commercial property collectives included restrictions on withdrawals immediately following the outcome of the EU referendum vote.

A significant proportion of the Company's financial assets are held in gilts, cash, supranationals and investment grade securities which the Company considers sufficient to meet the liabilities as they fall due. The vast majority of these investments are readily realisable since most of them are quoted in an active market.

For unit-linked contracts the Company matches all the liabilities with assets in the portfolio on which the unit prices are based. There is therefore no interest, price, currency or credit risk for the Company on these contracts. In extreme circumstances, the Company could be exposed to liquidity risk in its unit-linked funds. This could occur where a high volume of surrenders coincides with a tightening of liquidity in a unit-linked fund to the point where assets of that fund have to be sold to meet those withdrawals. Where the fund affected consists of property, it can take several months to complete a sale and this would impede the proper operation of the fund. In these situations, the Company considers its risk to be low since there are steps that can be taken first within the funds themselves (e.g. restrictions on withdrawals) both to ensure the fair treatment of all investors in those funds and to protect the Company's own risk exposure.

The ongoing effectiveness of liquidity risk mitigation described above is monitored on an ongoing basis by the IMC and the Finance and Capital Committee ('FCC').

SECTION C

Continued

RISK PROFILE CONTINUED

C.4 LIQUIDITY RISK CONTINUED

C.4.6 STRESS TESTING

Liquidity stress testing is carried out on a monthly basis in the Company. As of 31 December 2016, the stress testing demonstrated that the Company holds sufficient liquid assets to cover internally agreed liquidity buffers to meet collateral calls under a market risk stress scenario with '1-in-10' probability, which is within the Company's risk appetite.

C.5 OPERATIONAL RISK

C.5.1 RISK EXPOSURE

Operational risk is defined as the risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people related or external events.

The main sources of operational risk are customer treatment risk and model risk.

Over the reporting period ending 31 December 2016, the following key changes in the qualitative operational risk exposure for the Company have taken place:

- A reduction in Financial Crime (Anti Money Laundering) risk exposure, following improvement in the related control framework within the OSPs.
- A reduction in regulatory compliance exposure within our OSPs following the steady reduction in the number of customer related incidents outstanding.
- Ongoing uncertainty regarding customer treatment and regulatory compliance risk pending the publication of regulatory reviews/announcements, and ongoing marketplace developments such as pension reforms.

C.5.2 RISK MEASUREMENT

The risk capital requirement for operational risk is assessed using the Group's PRA approved IM, which is calibrated to withstand a stress event to a 99.5% confidence level over a one-year period. The methodology is based on scenarios assessed by experts within the business.

From a qualitative perspective, the operational risks for both the Group and Life Companies are regularly reported to management oversight committees and the MGC.

As at 31 December 2016, operational risk represented 8% of the Company's total undiversified SCR, as shown in the chart at the beginning of section C.

C.5.3 RISK CONCENTRATION

Across the universe of operational risks, the Group's largest operational risk concentrations are: Customer Treatment Risk and Model Risk.

The Company also has concentrations of operational risk that are driven by its business model to outsource to specialist providers of key services covering: customer services administration, investment management, certain finance middle office activities, and asset custody.

Concentration risk in this respect is defined and managed in line with the Group's Sourcing Strategy which is refreshed on an annual basis.

From a geographical perspective the Company is not exposed to any material concentration of operational risk, as our OSPs operate from multiple locations within the UK and offshore, ensuring that within individual OSPs effective business continuity solutions which meet the requirements of the Company can be maintained.

C.5.4 RISK MITIGATION

The Company seeks to manage its exposure to operational risk by establishing minimum control standards (and supporting practices where appropriate) for each risk category. These minimum control standards are defined within individual PGH Group risk policies covering each of these risk categories and are designed to ensure that the Group operates within the low level qualitative risk appetite statements that are defined within those Policies. Periodic reporting by risk owners monitors risk exposure against these agreed limits.

The Group Risk Policies, and the minimum control standards outlined within them, are key mitigants used to manage the Group's operational risk exposure. In addition to these, the Group also places reliance upon:

- The transfer of operational risk to our OSPs as part of the outsourcing of non-core activities, with the obligations/liabilities for each outsource arrangement outlined in the relevant contract.
- The Group's corporate insurance policy and letters of credit, which provide cover in respect of a variety of operational risks including product mis-selling and premises.

SECTION C

Continued

RISK PROFILE CONTINUED

C.5 OPERATIONAL RISK CONTINUED

C.5.4 RISK MITIGATION CONTINUED

All key elements of operational risk mitigation are taken account of on a prudent basis against those operational risk SCR scenarios in which subject matter experts assess that a valid claim could be made. The approach to insurance in the capital model is conservative, with haircuts made for mismatches, willingness of insurer to pay out and residual term of policy from date of a risk event occurring.

The ongoing effectiveness of operational risk mitigation described above is monitored on an ongoing basis by the OC.

C.5.5 STRESS TESTING

Stress testing at the 99.5th percentile confidence level is used to determine the operational risk capital requirements, using the PRA approved IM, the results of which are shown in the summary of the SCR in section E.2.

In addition, as part of the Group's monitoring of the risk appetite position, the impact on the surplus capital position of a '1-in-10' event is stress tested. As of 31 December 2016, the Company was able to cover their capital requirements following a '1-in-10' all-risk event.

C.6 OTHER MATERIAL RISKS

Other material risks which should be highlighted are summarised below. As of 31 December 2016, other material risks represented 1% of the Company's total undiversified SCR, as shown in the chart at the beginning of section C.

C.6.1 TAX RISK

Tax risk is defined as the risk of financial or reputational loss arising from lack of liquidity, funding or capital due to an unforeseen tax cost, or by the inappropriate reporting and disclosure of information in relation to taxation. Tax risk is managed by maintaining an appropriately-staffed tax team who have the qualifications and experience to make judgements on tax issues, augmented by advice from external specialists where required. The Group has a formal tax risk policy, which sets out its risk appetite in relation to specific aspects of tax risk, and which details the controls the Group has in place to manage those risks. These controls are subject to a regular review process. The Group's subsidiaries have exposure to tax risk through the annual statutory and regulatory reporting and through the processing of policyholder tax requirements.

C.6.2 GEOPOLITICAL INSTABILITY RISK

The business environment and capital markets are exposed to an increased risk of geopolitical instability due to uncertainty surrounding the UK's exit from the EU, the outcomes of the US elections, and the uncertain outcome of various European elections taking place in 2017. Given that risk capital is already held in respect of capital markets risks, the Company does not believe any additional risk capital needs to be held in respect of this geopolitical instability, however, the risks will be monitored closely.

C.6.3 CUSTOMER RISK

Customer risk is defined as the risk of reductions in expected earnings and / or value to the Company or customers, through financial, reputational or operational losses as a result of:

- Failure to have in place an appropriate culture, structures, governance and frameworks across the Group to drive ethical and responsible behaviours, attitudes and decision-making focussed on customer interests and outcomes.
- Failure to understand the customers' experience, behaviours and needs and act in their interests ensuring they are treated fairly, in line with our strategic objectives, and supported in making good financial decisions.
- Inappropriate conduct or poor customer treatment or experience (including poor advice).

The FCA has had a greater focus on customer outcomes. This may continue to challenge existing approaches and/or may result in remediation exercises where the Company cannot demonstrate that it met the expected customer outcomes in the eyes of the regulator. Changes in legislation such as the Pension Freedoms and taxation can also impact the Company's financial position.

The Company puts considerable effort into managing relationships with its regulators so that it is able to maintain a forward view regarding potential changes in the regulatory landscape. The Company assesses the risks of regulatory and legislative change and the impact on our operations and lobbies where appropriate.

SECTION C

Continued

RISK PROFILE CONTINUED

C.6 OTHER MATERIAL RISKS CONTINUED

C.6.4 STRATEGIC RISK

Strategic risk is defined as the risk to earnings arising from a sub-optimal business strategy, or the sub-optimal implementation of the plan as agreed by the Board. In assessing strategic risk, consideration is given to both external and internal factors.

From a Phoenix Group perspective, the challenge of integrating two new businesses (ALAC and AWL) could introduce structural or operational inefficiencies that results in Phoenix failing to generate the expected outcomes for policyholders or value for shareholders. The financial and operational risks of target businesses were assessed as part of the acquisition phase. Integration plans are being developed and resourced with appropriately skilled staff to ensure that the target operating models are delivered in line with expectations. Failure to meet Group targets may lead to resource constraints that could impact on the delivery of integration plans within agreed timescales, and therefore reduce the expected outcomes for the Company.

C.7 ANY OTHER INFORMATION

There is no further material information to be disclosed regarding the Company's risk profile.

SECTION D

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SECTION D

VALUATION FOR SOLVENCY PURPOSES

This section covers the valuation of assets (section D.1), technical provisions (section D.2) and other liabilities (section D.3) on the Solvency II balance sheet. Their valuation is determined in line with the regulations. The balance sheet QRT S.02.01.02 is included at Appendix 1.1.

Sections D.1.2 and D.3.2 provide separately for each material class of assets and liabilities (excluding technical provisions), a description of the bases, methods and main assumptions used in their valuation for solvency purposes. An explanation of differences to the IFRS financial statements is also provided. All classes of assets and liabilities presented are consistent to the S.02.01.02 balance sheet QRT.

The Solvency II value of the assets and liabilities are set out together with a 'statutory accounts value' Column.

The recognition and valuation methods used for the completion of the 'statutory accounts value' column are as used by the Company in their financial statements in accordance with IFRS. Some reclassification of line items has taken place, to align disclosures with the Solvency II presentation format. This means that the 'statutory accounts value' column may not directly agree to line items on the financial statements of the Company.

Some of the assets and liabilities are determined using alternative valuation methods, which use non-observable market inputs. Further details are included in section D.4.1.

D.1 ASSETS

D.1.1 INTRODUCTION

This section covers the valuation of assets on the Solvency II balance sheet.

The table below sets out the Solvency II value of the assets and compares this to the 'statutory accounts value' column. The 'statutory accounts value' column is in line with the Company's financial statements, although presentational adjustments have been included where necessary, to enable comparison to the 'Solvency II value' column.

Assets	Note	Solvency II value £m	Statutory accounts value £m	Difference £m
Deferred acquisition costs	1	–	13	(13)
Intangible assets	2	–	165	(165)
Deferred tax assets	3	4	7	(3)
Investments (other than assets held for index-linked and unit-linked contracts)	4	27,454	27,454	–
Property (other than for own use)		351	351	–
Holdings in related undertakings, including participations		12,879	12,879	–
Equities		160	160	–
Bonds		11,793	11,793	–
Collective investment undertakings		343	343	–
Derivatives		1,863	1,863	–
Deposits other than cash equivalents		65	65	–
Assets held for index-linked and unit-linked contracts	5	10,035	10,035	–
Loans and mortgages	6	625	625	–
Reinsurance recoverables	7	2,751	2,387	364
Insurance and intermediaries receivables	8	8	8	–
Reinsurance receivables	8	33	132	(99)
Receivables (trade, not insurance)	9	232	326	(94)
Cash and cash equivalents	10	142	142	–
Total assets		41,284	41,294	(10)

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.1 ASSETS CONTINUED

D.1.2 ASSET VALUATION BASES, METHODS AND MAIN ASSUMPTIONS

The Company's Solvency II valuation principles (including the bases, methods and main assumptions) for each asset class are set out below. Unless otherwise stated (i.e. where there are differences to the 'statutory account value' column) the valuation methods included in IFRS are consistent with the valuation methods of the regulations.

Note	Balance sheet item	Solvency II valuation principles for each material asset class
1	Deferred acquisition costs	Deferred acquisition costs are valued at zero unless they can be sold separately and it can be demonstrated that there is value for the same or similar assets (i.e. that a value has been derived from quoted prices in active markets). This does not meet the above criteria and therefore is valued at zero.
2	Intangible assets (other than goodwill)	<p>Intangible assets are valued at zero unless the intangible assets can be sold separately and it can be demonstrated that there is value for the same or similar assets (i.e. that a value has been derived from quoted prices in active markets).</p> <p>Acquired PVIF (present value of in-force business acquired) is the only intangible asset of the Company. This does not meet the above criteria and therefore is valued at zero.</p> <p>For IFRS all intangible assets are measured on the balance sheet at cost less accumulated amortisation and any impairment loss recognised to date.</p>
3	Deferred tax assets	<p>Deferred tax is determined on temporary differences between the fair value of assets and liabilities on the Solvency II balance sheet and their tax base at the valuation date.</p> <p>The tax base is the value as determined under IFRS. This means deferred tax should be provided on temporary differences between the IFRS and the Solvency II balance sheet. As a result, Solvency II deferred tax is incremental to that included in the IFRS financial statements.</p> <p>All valuation differences between the IFRS and Solvency II balance sheets are identified and deferred tax is calculated, where appropriate, on these differences.</p> <p>Under IFRS, deferred tax is provided for on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not provided in respect of temporary differences arising from the initial recognition of goodwill and the initial recognition of assets or liabilities in a transaction that is not a business combination and that, at the time of the transaction, affected neither accounting nor taxable profit. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates and laws enacted or substantively enacted at the period end.</p> <p>A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.</p> <p>Further details on the origin of the deferred tax assets are provided in section D.1.3.</p>

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.1 ASSETS CONTINUED

D.1.2 ASSET VALUATION BASES, METHODS AND MAIN ASSUMPTIONS CONTINUED

Note	Balance sheet item	Solvency II valuation principles for each material asset class
4	Investments (other than assets held for index-linked and unit-linked contracts)	<p>In line with IFRS, the value of Investments (other than assets held for index-linked and unit-linked contracts) is determined using fair value methodology as follows:</p> <ul style="list-style-type: none"> – For financial instruments traded in active markets (such as exchange traded securities and derivatives), fair value is based on quoted market prices at the period end provided by recognised pricing services. Market depth and bid-ask spreads are used to corroborate whether an active market exists for an instrument. – Where quoted market prices are not available, quoted market prices for similar assets or liabilities are used to determine the fair value. – Where either of the above are not possible, alternative valuation methods are used to determine fair value. Where discounted cash flow techniques are used, estimated future cash flows are based on contractual cash flows using current market conditions and market-calibrated discount rates and interest rate assumptions for similar instruments. – Certain financial instruments are determined by valuation techniques using non-observable market inputs based on a combination of independent third party evidence and internally developed models. Further details are included in section D.4.1. <p>The determination as to whether a market is active is based on the transactions for that asset taking place with sufficient frequency and volume to provide pricing information on an ongoing basis. It therefore considers factors such as the bid-offer spread and the market depth.</p> <p>Investment assets are shown including accrued interest, which is reclassified here from Receivables (trade not insurance) in both the 'Solvency II value' and 'statutory accounts value' columns.</p> <p>Further details on each item within investments are outlined below.</p> <p>Property (other than for own use)</p> <p>Commercial investment properties are valued at fair value, being market value determined by independent property valuers having appropriate recognised professional qualifications and recent experiences in the location and category of the property being valued. The residential property reversions, interests in customers' properties that the Company will realise upon their death, are valued using a DCF model based on the Company's proportion of the current open market value, discounted for the lifetimes of the policyholders. Further details are included in section D.4.1. The Company has no material leasing arrangements.</p> <p>Holdings in related undertakings, including participations</p> <p>Holdings in related undertakings, including participations, principally comprise Collective investment undertakings where the Company holds greater than 20% interest. Any investments in Collective investment undertakings related to unit-linked contracts are included as Assets held for index-linked and unit-linked contracts.</p> <p>Where the Company holds a less than 20% interest in an investment fund this interest is included within Collective investment undertakings.</p> <p>Listed equities</p> <p>Equity instruments listed on a recognised stock exchange are valued using quoted market prices.</p> <p>Unlisted equities</p> <p>In relation to hedge fund and private equity investments, non-observable third party evidence in the form of net asset valuation statements are usually used as the basis for the valuation. Adjustments may be made to the net asset valuation where other evidence, for example recent sales of underlying investments in the fund, indicates this is required.</p> <p>Further details on alternative valuation methods are included in section D.4.1.</p>

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.1 ASSETS CONTINUED

D.1.2 ASSET VALUATION BASES, METHODS AND MAIN ASSUMPTIONS CONTINUED

Note	Balance sheet item	Solvency II valuation principles for each material asset class
4	Investments (other than assets held for index-linked and unit-linked contracts) continued	<p>Bonds</p> <p><i>Government bonds</i> Government bonds are valued using quoted market prices at the period end provided by recognised pricing sources.</p> <p><i>Corporate bonds</i> For corporate bonds listed on a recognised stock exchange, quoted market prices are used. For other corporate bonds, these instruments are valued using pricing data received from external pricing providers or in some cases using broker quotes where observable market data is unavailable.</p> <p><i>Structured notes</i> For structured notes, standard valuation models (based on a discounted cash flow approach) are used, as by their nature and complexity, they have no external market. Inputs into such models are based on observable market data where applicable.</p> <p><i>Collateralised securities</i> For collateralised securities listed on a recognised stock exchange, quoted market prices are used. For other collateralised securities, these instruments are valued using pricing data received from external pricing providers or in some cases broker quotes where observable market data is unavailable. The majority of the investments are valued using alternative valuation methods and further details are included in section D.4.1.</p> <p>This also includes £395 million in relation to the securitisation of ERM loans. Since the ERM loans are recognised on the balance sheet, the corresponding liability for beneficial interest in ERM loans is also held on-balance sheet within Financial liabilities other than debts owed to credit institutions.</p> <p>Collective Investment Undertakings The Company receives valuations from the investment managers of the underlying funds, based on quoted market prices. Where quoted prices are not available they are estimated using pricing models. Where pricing models are used, inputs are based on market-related data at the period end.</p> <p>Where the Company holds a greater than 20% interest in an investment fund this interest is recognised within Holdings in related undertakings, including participations. Where the interest is less than 20% it is included within Collective Investment Undertakings.</p> <p>Derivative assets The fair value of over-the-counter assets is estimated using pricing models, with inputs based on market-related data at the period end. The fair value of exchange traded securities is based on quoted market prices at the period end provided by recognised pricing services.</p> <p>Deposits other than cash and cash equivalents Deposits other than cash and cash equivalents comprise short-term deposits that cannot be used to make payments before a specific maturity date or without any penalty or restriction.</p>
5	Assets held for index-linked and unit-linked contracts	Assets held for index-linked and unit-linked contracts are measured based on the fair value of the underlying assets and liabilities (other than technical provisions) held within such funds.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.1 ASSETS CONTINUED

D.1.2 ASSET VALUATION BASES, METHODS AND MAIN ASSUMPTIONS CONTINUED

Note	Balance sheet item	Solvency II valuation principles for each material asset class
6	Loan and mortgages	Loans and mortgages are valued at fair value. This includes accrued interest, which is reclassified here from Receivables (trade not insurance) in both the 'Solvency II value' and 'statutory accounts value' columns. They primarily comprise £432 million of investment in ERM and £188 million of loans to Group companies.
7	Reinsurance recoverables	The value of reinsurance recoverables is dependent on the expected claims and benefits arising under the related reinsured policies. To the extent that the Solvency II valuation of the related technical provisions differs to the valuation under IFRS, the valuation of the related reinsurance recoverable will also be impacted. Further details on the calculation approach for Solvency II reinsurance recoverables are included in section D.2.8.
8	Insurance and intermediaries receivables Reinsurance receivables	Given their short-term nature, the carrying amount per the financial statements is considered to represent the fair value for these assets, other than: Reinsurance receivables include a £99 million reinsurance asset in the 'statutory accounts value' column related to the reinsurance of AWL business into the Company following the acquisition of AWL. Technical provisions include a corresponding amount and the reinsurance asset is therefore excluded under Solvency II.
9	Receivables (trade, not insurance)	The receivables (trade, not insurance) balance principally comprises cash collateral pledged, trade and broker balances and current tax/group relief, all of which are valued at fair value. The 'statutory account value' column includes prepayments valued in line with IFRS principles. However, no value is ascribed for certain prepayments under Solvency II, where they cannot be sold separately to a third party. Investment (including loan) assets and liabilities shall include the value of accrued interest. Therefore, accrued income and interest related to these assets and liabilities respectively are reclassified accordingly in both the 'Solvency II value' and 'statutory accounts value' columns.
10	Cash and cash equivalents	Cash and cash equivalents comprise cash balances that are usable for all forms of payments without penalty or restriction.

D.1.3 DEFERRED TAX ASSETS

The deferred tax asset on Solvency II balance sheet of £4 million is valued by reference to forecast future taxable profits, and is comprised as shown in the table below. The deferred tax asset is treated as Tier 3 capital in Basic Own Funds. Further details are set out in section E.1.

Item	Deferred tax asset value £m	Further details
Expense and deferred acquisition costs carried forward	3	The tax impact of future expense deductions, which are expected to reverse over a period of seven years.
Accelerated capital allowances	1	The tax impact of future capital allowances and are expected to reverse over a maximum of ten years.
Total Solvency II deferred tax assets	4	

The Finance Act 2014 set the rate of corporation tax at 20% from 1 April 2015. The Finance (No. 2) Act 2015 announced a reduction in the rate from 20% to 19% from 1 April 2017, with a further reduction from 19% to 18% from 1 April 2020. The Finance Act 2016, which was substantively enacted on 15 September 2016, announced a further reduction in the rate from 18% to 17% from 1 April 2020. Consequently, a blended rate of tax has been used for the purposes of providing for deferred tax, where appropriate.

Deferred income tax assets are recognised for tax losses carried forward only to the extent that realisation of the related tax benefit is probable. As at 31 December 2016, there were no unrecognised deferred tax assets on capital losses.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS

This section provides separately for each LoB the value of technical provisions, including the amount of the Best Estimate Liability ('BEL') and the risk margin, as well as a description of the bases, methods and main assumptions used in the valuation of technical provisions.

As outlined in section A.1.3 the LoBs relevant to the Company are:

- insurance with profit participation;
- index-linked and unit-linked insurance;
- health insurance; and
- other life insurance.

There is no non-life business.

This section also includes a quantitative and qualitative explanation of material differences between the bases, methods and main assumptions used by the Group for the valuation of technical provisions for solvency purposes and those used for their valuation in IFRS.

D.2.1 INTRODUCTION

The technical provisions tables presented in this section are as at 31 December 2016.

The Company has PRA approval to apply TMTP and MA, and as a result the technical provisions detailed in this section are inclusive of these.

The TMTP allows firms to apply a transitional deduction to their technical provisions. Transitional measures are aimed at providing a smooth transition between the previous Solvency I regulatory regime and the Solvency II regulatory regime in order to enhance stability in the insurance sector. Solvency I technical provisions are determined using a Pillar 2 ICA basis. The initial calculation was as at 1 January 2016, but recalculation is allowed where material changes in risk profile have occurred. Further detail on the TMTP and any recalculations can be found in section D.2.7.2 and Appendix 2.

The MA is applied to the risk-free curve used for discounting liabilities in the MA portfolio only and has the effect of reducing technical provisions. Further detail on the application of the MA can be found in section D.2.7.1.

For all business, no allowance is currently made for the Volatility Adjustment or transitional measure on interest rates.

D.2.2 TECHNICAL PROVISIONS BY LINE OF BUSINESS

This section provides technical provisions split by Solvency II LoB.

Table D.2.2a Technical provisions by Line of Business

The following table summarises the technical provisions at 31 December 2016 by Solvency II LoB, including the amount of the BEL and risk margin. It includes the TMTP calculation as at 1 November 2016, but does not include any TMTP recalculation approved after 31 December 2016 (see section D.2.7.2).

Technical provisions by Line of Business	Insurance with-profit participation £m	Index-linked and unit linked insurance £m	Health insurance £m	Other life insurance £m	Total technical provisions £m
Best estimate liabilities	13,725	9,971	138	11,585	35,419
Risk margin	343	46	13	766	1,168
Gross technical provisions pre TMTP	14,068	10,017	151	12,351	36,587
TMTP adjustment	(833)	(143)	(22)	(1,270)	(2,268)
Gross technical provisions post TMTP	13,235	9,874	129	11,081	34,319

The gross technical provisions shown here include gross BEL but with a net of reinsurance risk margin. This is in line with the presentation in the QRTs.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.2 TECHNICAL PROVISIONS BY LINE OF BUSINESS CONTINUED

Table D.2.2b Material differences between IFRS and Solvency II technical provisions

The table below outlines separately for each LoB, material differences between the bases, methods and main assumptions used for Solvency II and those used for IFRS. During 2016, a new methodology was introduced to valuing technical provisions under an IFRS basis making it more consistent with the Solvency II basis.

There is a movement of £(2,103) million from the gross technical provisions calculated for IFRS of £36,423 million to the gross technical provisions calculated for Solvency II of £34,319 million. The material differences between the IFRS and Solvency II technical provisions are outlined in the table below:

Technical provisions – IFRS to Solvency II reconciliation	Notes	Insurance with-profit participation £m	Index-linked and unit- linked insurance £m	Health insurance £m	Other life insurance £m	Total technical provisions £m
IFRS technical provisions – gross		14,714	10,493	139	11,077	36,423
IFRS reinsurance		(139)	(77)	(77)	(2,094)	(2,387)
IFRS technical provisions – net		14,575	10,416	62	8,983	34,036
Change to discount curve	1	179	2	1	94	276
Change in restriction for negative sterling reserves	2	(42)	(314)	–	–	(356)
MA on non-MA funds	3	–	–	–	61	61
Demographic margin	4	–	(13)	–	(340)	(353)
Annuity profit margin	5	63	–	–	9	72
Policyholders' share of estate	6	(969)	–	–	1	(968)
Prepayments	7	(58)	–	–	(36)	(94)
Other	8	(192)	(168)	(1)	355	(6)
Solvency II BEL – net		13,556	9,923	62	9,127	32,668
Add risk margin		343	46	13	766	1,168
Deduct transitional adjustments		(833)	(143)	(22)	(1,270)	(2,268)
Solvency II technical provisions – net		13,066	9,826	53	8,623	31,568
Solvency II reinsurance		169	48	76	2,458	2,751
Solvency II technical provisions – gross		13,235	9,874	129	11,081	34,319

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.2 TECHNICAL PROVISIONS BY LINE OF BUSINESS CONTINUED

Table D.2.2b Material differences between IFRS and Solvency II technical provisions Continued

Note	Technical provision item	Comment
1	Change to discount curve	Liabilities are valued using a discount rate derived from the swap curve with a credit risk adjustment of 17 bps under Solvency II. For IFRS they are valued using a swap +10bps curve.
2	Change in restriction for negative sterling reserves	The term 'sterling reserves' represents reserves set aside to cover future cash flow obligations on unit-linked policies, over and above the value of units held. For Solvency II, negative sterling reserves are allowed as a reduction to technical provisions. For IFRS, sterling reserves are set at a minimum of zero.
3	MA on non-MA funds	In addition to the adjustment in the MA portfolio, an adjustment is made to the IFRS technical provisions in the Non-MA portfolio for liabilities backed by Solvency II eligible assets, representing an estimate for the allowance of liquidity expected to be earned on such assets. This adjustment is not made under Solvency II.
4	Demographic margin	A margin for demographic risk is included within the IFRS technical provisions. This item is based on a percentage of undiversified demographic risk capital, relating to mortality, longevity and persistency. Solvency II does not require this margin to be held over and above best estimate.
5	Annuity profit margin	Annuity profit margin includes future profits expected to be recognised when deferred annuities vest from the with-profit funds into the MA portfolio. Under Solvency II, there is no allowance for the reserving of the profit margin; for IFRS it is shown within unallocated surplus.
6	Policyholders' share of estate	The proportion of the with-profit estate which is expected ultimately to be distributed to policyholders is included within technical provisions on the IFRS basis. For Solvency II, it is recognised as surplus funds (being accumulated profits which have not been made available for distribution to policyholders or other beneficiaries) and is not recognised within technical provisions but instead as an item of Own Funds. Further details are included in section E.1.2.3.
7	Prepayments	Under IFRS, the Company recognises prepayment assets in respect of payments made to other group entities to transfer the risk associated with certain expenses. In order to avoid profits being created on inception of these payments, an offsetting amount is held within technical provisions, which is then released in line with the associated prepayment. Under Solvency II, no prepayment asset is recognised on the grounds that it is not considered to have any economic value. As a consequence, the offsetting amount held within technical provisions is also released.
8	Other	The 'other' line is mainly made up of a reallocation of reserves in the with-profit funds between the two bases. Otherwise, this includes small items of other differences all less than £1 million.

D.2.3 BASES, METHODOLOGY AND MAIN ASSUMPTIONS USED FOR BEST ESTIMATE LIABILITY

Technical provisions represent the value of policyholder obligations if these were to be transferred to a third party at the valuation date. The approach to valuing actuarial liabilities is to use BEL plus risk margin. The alternative 'Technical Provisions as a whole' approach to valuing liabilities is not used.

Sections D.2.3 to D.2.10 sets out in detail the bases, methodology and main assumptions used to derive the BEL. Risk margin methodology is covered in section D.2.11.

All data used to calculate technical provisions is assessed for appropriateness, completeness and accuracy. Where there are any material weaknesses, limitations or errors associated with data, these are flagged in control and validation reports along with details of any rectifying adjustments made.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.3 BASES, METHODOLOGY AND MAIN ASSUMPTIONS USED FOR BEST ESTIMATE LIABILITY CONTINUED

D.2.3.1 Best Estimate Liability

BEL is calculated gross, without deduction for amounts recoverable on reinsurance contracts. Amounts recoverable are valued separately, recognised as a reinsurance asset and calculated in the same manner as the BEL (see section D.2.9 for further details).

A rider contract is an additional provision attached to an insurance policy. For example a term assurance rider contract may be attached to a unit-linked pension policy. For policies which have attaching rider contracts, the rider contracts are separated from the main contract for valuation purposes. This ensures appropriate assumptions are used to value the rider contract.

All assumptions are updated to reflect current economic conditions and demographic experience. Material changes in the relevant assumptions made in the calculation of technical provisions are covered in section D.2.5.

The following section details the methodology and key assumptions used to calculate the BEL.

D.2.3.2 Overview of methodology

A cash flow projection model is used to calculate BEL. This projects cash inflows and outflows required to meet the obligations to policyholders over their lifetime, taking into account the Company's regulatory duty to treat its customers fairly.

The projection of future cash flows is performed using realistic assumptions regarding future experience. The relevant demographic assumptions include expected future trends in mortality, longevity, lapse rates and option take up rates. An allowance is also made for future expenses.

The model takes account of the time value of money through discounting at an appropriate risk-free rate (see section D.2.3.3 below). The assessment of the expected cash flows underlying the BEL takes into account any taxation payments which are charged to policyholders, or which would be required to be made to settle the insurance obligations.

In certain specific circumstances, the best estimate may be negative (e.g. for some protection business where the value of future premiums exceed future claims and expenses). A negative BEL is permitted under the regulations.

D.2.3.3 Discount rates

For the purpose of calculating the Solvency II technical provisions, nominal discount rates (based on swap rates) prescribed by EIOPA are used. These rates vary by currency of liabilities. The vast majority of the Company's insurance obligations are denominated in sterling.

An adjustment (also specified by EIOPA) is made to the swap curve for credit risk. At 31 December 2016, the sterling credit risk adjustment was -17 bps at each duration. For euros the adjustment was -10 bps. Also, for a significant proportion of the annuities within non-profit business, the discount rate is adjusted to include allowance for the MA.

D.2.3.4 Tax assumptions

Tax assumptions have been updated as a result of the 2016 Finance Bill reducing tax rates from 1 April 2017.

From 1 April 2017, the mainstream tax rate will drop to 19% and from 1 April 2020 it will drop to 17%.

D.2.3.5 Contract boundaries

Under the regulations, the liability cash flows that need to be considered within the BEL are those that fall within the 'contract boundary'. Depending on the features of the contract type the contract boundary can vary (e.g. the contract boundary may be the original maturity date, the next policy anniversary or the valuation date).

For substantially all products the contract boundary used in the calculation of BEL is the original contractual maturity term. The boundary used is based on a product level assessment which has been performed against the regulations.

D.2.3.6 Grouping of liability data

Policies are grouped into model points to improve computational efficiency. Groups are selected so that the model points appropriately allow for the risk characteristics of the individual policies and do not distort the valuation of BEL.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.4 CALCULATION

The following sub-sections outline how each type of BEL is valued.

D.2.4.1 Insurance with profit participation

The BEL is typically calculated as the sum of:

- asset shares –the value (as at the valuation date) of the underlying policy cash flows accumulated at the investment returns earned historically on assets backing those policies;
- the market-consistent cost of guarantees and smoothing as these may give rise to policy payments greater than the asset shares; and
- other with-profit future policyholder related liabilities, which includes future discretionary benefits and any remaining options and guarantees.

Cost of option and guarantees

A range of options and guarantees exist. As the cost of an option or guarantee will vary depending on future economic conditions, stochastic methods are used to value them (see section D.2.6 for further details) and these are added to the BEL.

Investment mix of asset shares

As the value of options and guarantees can depend on the projected asset share, the stochastic model requires assumptions about the current and future mix of investments held within the asset shares. These assumptions reflect the asset share pools as described in each with-profit fund's PPFM.

The change to the asset mix of these asset share pools varies over time as described in the PPFM; certain funds will retain a static mix based on the assets backing asset shares at the valuation date, others will vary from an initial mix to a long-term strategic mix.

D.2.4.2 Other life insurance (including health)

The BEL for the annuity business represents the present value of future annuity payments and associated policy administration expenses less any future premiums payable. For non-pension annuities, the annuity payments may include policyholder tax on the income element of any payments. For liabilities in the MA portfolio, a MA is added to the risk-free rates used for discounting liability cash flows.

For other business, BEL represents a realistic estimate of the present value of the difference between the projected claims, plus expenses and premium income.

D.2.4.3 Index-linked and unit-linked insurance

The BEL for unit-linked business represents a realistic assessment of the present value of claim payments plus expenses, less future allocated premiums and related premium charges.

D.2.5 DEMOGRAPHIC AND EXPENSE ASSUMPTIONS

All demographic and expense assumptions are determined on a best estimate basis (i.e. they include no allowance for prudence). Any changes to external factors are also taken into account when determining best estimate assumptions.

Assumptions are set in accordance with the regulations. In particular, they:

- are applicable to homogenous risk groups and LoBs;
- are in line with the Company's knowledge of the business and practices for managing the business; and
- ensure appropriate allowance for anticipated trends or future changes in both the Company and portfolio specific factors as well as legal, technological, social, economic or environmental factors.

Typically, assumptions are reviewed annually; however for less material assumptions, the updates may be less frequent.

The assumption setting process typically involves analysing experience data from the last five years. This ensures data is detailed enough to allow credible statistical analysis to be performed and any emerging trends to be identified.

For example, in order to set a particular assumption for a particular group of policies, the annual percentage of policies subject to the relevant decrement (i.e. lapses, death) over the last five years is typically considered. The actual rates observed over the last five years are then compared to the best estimate assumption being used to value the BEL. Where the best estimate assumption is materially out of line with actual experience, changes to the best estimate assumption are considered.

Validations are performed to ensure the experience data is accurate, relevant and credible, including the use of other industry data (e.g. industry trend data) where appropriate, to supplement the Company's experience data.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.5 DEMOGRAPHIC AND EXPENSE ASSUMPTIONS CONTINUED

Expert judgement is applied to assess the impact on the proposed assumption of one-off events and likely future policyholder behaviour. It is also used where there is insufficient credible experience/other data to set the assumption.

Key best estimate demographic assumptions are:

- 1) Mortality (using base table and future improvement rates);
- 2) Lapse rates;
- 3) Early retirement rates;
- 4) Option take-up rates (e.g. early retirement options and Guaranteed Annuity Options ('GAO')); and
- 5) Morbidity.

Other less material best estimate assumptions include conversion from premium paying to paid-up status.

D.2.5.1 Mortality

Base annuitant mortality

The base table mortality assumption review for annuitants is based on the mortality experience over a five year period.

Criteria used to subdivide fund level data into homogenous risk groups are gender and ex-entity (i.e. the original company that sold the policy to the policyholder). However, for impaired life annuities, underwriting class is also used.

The mortality tables currently in use are PCXA00 and RXV00 as these tables are most representative of the underlying company's experience over the key age range. A base mortality multiplier is then applied so that the assumptions align to the underlying experience.

PCXA00 and RXV00 are examples of standard mortality tables used by Life Companies to value technical provisions. Adjustments are made to these tables to reflect mortality improvements from the date they were published to the current valuation date.

A separate allowance is made for future mortality improvements applicable after the valuation date, which is detailed below.

Pre-vesting mortality

Pre-vesting mortality assumptions apply to products such as term assurance and endowments.

The assumption review is based on mortality experience over a five-year period. Criteria used to subdivide fund level data are gender, product group, smoker status and ex-entity.

A base mortality multiplier that varies by gender is applied to a standard mortality table. Adjustments may be made to the mortality table to take account of changes in mortality improvements since the table was published.

Base multiplier and mortality assumptions are selected that are in line with the underlying experience data. In some cases, age specific percentages are used where they better match experience.

The main standard mortality tables currently in use are A1967-70, AX80, AX92, TX92, AXC00, and PCXA00.

Additionally, company specific tables are used to value term policies and certain individual policies which include total and permanent disability benefits.

Future improvement in mortality rates

For immediate annuities, deferred annuities or products with GAO's / Guaranteed Minimum Pension ('GMP') guarantees and whole of life and term assurance business within SunLife, a separate allowance for future improvements in mortality rates is made when calculating technical provisions.

Assumptions for future mortality improvements are analysed by comparing the number of expected deaths predicted by industry projection models with those predicted by the current base assumptions.

When setting the assumption for future improvements in mortality rates, homogenous risk groups were chosen. These groupings were chosen to appropriately balance the homogeneity and credibility of the available experience data. Expert judgement is used to assess any trends evident in the projected annual death rate.

The published projection model currently in use is based on the CMI 2014 mortality projections model with some allowance for the lower level of future improvements suggested by the CMI 2015 model.

D.2.5.2 Lapse rates

The assumption review is based on lapse experience over a five-year period. The criteria used to subdivide fund level data are product type and premium payment status (i.e. regular premium or single premium/paid-up). Where experience data is insufficient to perform a credible analysis, the experience from similar products may be aggregated. The analysis is carried out by splitting policies into homogeneous risk groups and identifying an assumption for the group as a whole.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.5 DEMOGRAPHIC AND EXPENSE ASSUMPTIONS CONTINUED

D.2.5.3 Early retirement rates

The assumption review is based on experience over five-year period. The criteria used to subdivide fund level data are product type and ex-entity.

In setting the assumptions, allowance is made for known or anticipated trends (e.g. changes in early retirement rates as a result of low interest rate environment and changes in pensions legislation from the Pensions' Freedoms Act).

D.2.5.4 Option take-up rates

The current best estimate assumptions for GAO take-up rates are based on experience data, with added weight given to the most recent experience particularly since the 2014 Budget announcement where the requirement to take policy benefits in the form of an annuity was removed in the Pensions Freedoms Act. Given the significance of this change, it will take some time for sufficient experience to build-up to produce a stable take-up rate assumption.

GAO liabilities are valued using a stochastic model. The take-up rate varies depending on the projected interest rate at policy maturity date in each stochastic scenario. An upper and lower bound apply to the take-up rate based on the degree to which the guarantee is in the money (i.e. by how much the guaranteed annuity rate exceeds the current market annuity rate).

The GAO take-up rates have been reviewed for all funds. The assumed take-up rates across the different funds currently lie between 50% and 80%.

D.2.5.5 Morbidity

A multiplier that varies by gender, age and deferred period is applied to the standard table, to ensure a good fit to the underlying experience data. Further multiplicative adjustments are made to certain classes of business to allow for smoker status, occupational class and planned retirement age. This multiplier is based on the mortality experience over a five-year period. Currently, the CMIR 12 standard morbidity table is used for all health business. Current assumptions have recently been compared with the results of an industry benchmarking survey, to demonstrate consistency with peer insurers.

D.2.5.6 Expense assumptions

Future expense assumptions are set on a going concern basis, which assumes that new vesting annuity business will be written in future, but that other LoBs are closed to new business.

The future expenses assumptions include:

- *MSA fees payable to the Group's Service Companies* – These MSAs typically specify a charge for each policy type/fund together with associated increase rates (e.g. RPI + 1%);
- *Direct and project costs* – Within the expense assumptions, allowance is made for direct costs (i.e. costs directly attributed to the business) and some project costs. Any project costs not allowed for in expense assumptions are held as an actuarial provision within the overall calculation of BEL;
- *Investment management expenses* – These fees may be explicit inputs to the valuation models, or in some cases they are applied via reductions to the investment returns used to calculate BEL. For with-profit funds investment expenses are set by considering the underlying asset mix of the asset shares and those assets backing other liabilities and Own Funds;
- *Acquisition expenses* – e.g. commission relating to future premium payments; and
- *Overhead expenses* – these are allocated in a realistic and objective manner and on a consistent basis over time to the parts of the best estimate to which they relate.

D.2.6 STOCHASTIC MODEL

D.2.6.1 Economic Scenario Generators

An Economic Scenario Generator ('ESG') developed by a third party supplier has been used to support the stochastic valuation of all material options and guarantees in the with-profit funds. A stochastic methodology is required for options and guarantees due to their potential volatility and asymmetric behaviour under different sets of future economic scenarios. The stochastic methodology involves valuing the options and guarantees under 1,000 different future economic scenarios and then averaging over all scenarios. The central scenario in the ESG is equal to the single deterministic scenario used to value all non-profit and unit-linked business.

The ESG generates projected asset returns consistent with asset prices observed in financial markets and assumes no arbitrage opportunities exist. The calibration of the parameters and scenarios is consistent with the relevant risk-free interest rate term structure used to calculate the BEL provided by EIOPA. Where possible, the ESG has been calibrated to assets from deep, liquid and transparent markets which are appropriate to the nature of the funds' options and guarantees.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.6 STOCHASTIC MODEL CONTINUED

D.2.6.2 Management actions

The methods and techniques for the estimation of future cash flows take account of potential future actions taken by management. The management actions allowed for are determined and justified in accordance with the regulations.

Management actions are mainly relevant to with-profit liabilities and, in the calculation of technical provisions, primarily relate to discretion over the amount of annual and final bonuses. In each ESG scenario, the level of annual future reversionary bonus applied to benefits is determined dynamically, and is set at a level such that the final bonus is targeted at a specified percentage of the guaranteed benefit.

Some reversionary bonuses are guaranteed at a specified minimum. Where this is the case the model uses the dynamic methodology as above, but applies a floor of the guaranteed minimum.

The final bonus rates are typically assumed to be adjusted in each scenario so as to correspond to the rate that can be covered by the difference between the asset share and the guaranteed benefit, including any reversionary bonuses. The overall final bonus is subject to a minimum of zero.

D.2.6.3 Policyholder actions

The impact of policyholder actions is considered primarily in relation to GAO option take-up rates, as these take-up rates are expected to be correlated with the financial benefit gained from the option, which is in turn highly correlated with the level of interest rates.

The central GAO take-up rate assumptions in the stochastic models are supported by the analysis of historical data. This analysis takes into account the following:

- how beneficial exercise of the option was and will be to policyholders under circumstances at the time of exercising the option;
- the influence of past and future economic conditions;
- the impact of past and future management actions; and
- any other circumstances that are likely to have influenced the decisions on whether to exercise the option (e.g. changes in legislation such as the Pensions' Freedom Act introduced in April 2015).

D.2.7 MATCHING ADJUSTMENT AND TRANSITIONAL MEASURES

The Company has regulatory approval for the application of:

- the MA to liabilities in the MA portfolio; and
- the TMTP.

D.2.7.1 Matching Adjustment

The application of the MA allows insurers to use a higher discount rate, based on the underlying assets, when valuing liabilities that meet strict eligibility criteria, with the effect of increasing Own Funds and reducing the SCR.

The MA is based on the expected yield from eligible assets held to back eligible liabilities, less a margin for defaults and downgrades. It is applied as a flat increase to the Solvency II basic risk-free curve used to discount liabilities.

The calculation of the MA requires EIOPA specified assumptions for the basic risk-free curve and fundamental spreads. The fundamental spread is the part of a bond yield attributable to the cost of defaults and downgrades. These assumptions are combined with the MA portfolio asset and liability cash flows to generate the MA. The assets and liabilities in the MA portfolio meet the MA eligibility criteria as set out in the regulations.

Liabilities in the MA portfolio consist mainly of sterling denominated non-profit immediate and deferred annuities. There is also a relatively small block of euro denominated immediate annuities. The immediate and deferred annuities provide policyholders with a mixture of level and inflation linked benefits.

At the current valuation date, the following asset types are held in the MA portfolio: fixed and index-linked government bonds, supranational bonds, corporate bonds, ERM notes issued by the ERM Special Purpose Vehicle, interest rate swaps, gilt total return swaps and cash. These are all MA eligible assets.

The financial impact of assuming a reduction in the MA to nil is shown in the S.22.01.21 QRT in Appendix 1.4.

D.2.7.2 Transitional Measure on Technical Provisions

Transitional measures allow insurers to recognise the impact of increased technical provisions calculated under the Solvency II regime compared to the previous Solvency I regime (using the Pillar 2 ICA basis) on a gradual basis over 16 years. The Company's technical provisions calculated under Solvency II exceed those calculated under the Solvency I regime for two main reasons. Firstly, the Solvency II requirement to include a risk margin within technical provisions did not exist under Solvency I. Secondly the requirement to use a swap-based risk-free curve to discount liabilities for Solvency II reporting (compared to a higher gilt based risk-free curve used under Solvency I) has led to an increase in the BEL valuation.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.7 MATCHING ADJUSTMENT AND TRANSITIONAL MEASURES CONTINUED

D.2.7.2 Transitional Measure on Technical Provisions Continued

The TMTP is a deduction from the amount of Solvency II technical provisions and is included as part of Tier 1 Basic Own Funds. In summary, the initial deduction is calculated as the difference between Solvency II technical provisions and Solvency I technical provisions as at 1 January 2016. The deduction runs off linearly to zero over the course of the 16-year transitional period, unless a faster pace of run-off is required where the actual run-off of the business is higher than 1/16 per annum over a 16-year period. As the Company is largely closed to new business, run-off of the risk margin and technical provisions are expected to at least partly offset the impact of the run-off of the TMTP. One year's run-off has been included as at 31 December 2016.

The regulations require all firms to recalculate their transitionals every two years after 1 January 2016 and the reported transitionals should be updated to reflect their recalculation.

The regulations also permit, subject to regulatory approval, the initial TMTP to be recalculated more frequently under circumstances where the risk profile of the business changes.

The Company has had two recalculation applications approved by the PRA during 2016 (as set out in section A.1.4.5).

These were:

- a recalculation as at 30 June 2016 due to a material fall in yields over the first half of 2016; and
- a recalculation as at 1 November 2016 due to the reinsurance of the AWL business into the Company.

During March 2017, a further recalculation of TMTP (determined as at 31 December 2016) was approved by the PRA in light of the approval of a further MA application and the transaction of a further longevity reinsurance agreement in respect of a portfolio of annuity business. Due to the timing of receipt of this approval, the impact of this latest recalculation has not been included within the QRTs or the SFCR for 31 December 2016. However, for information purposes, this impact is presented in Appendix 2.

For presentational purposes, the TMTP is split between a deduction from BEL and a deduction from risk margin. Movements in TMTP will not necessarily match movements in BEL or risk margin, partly due to potential differences in run-off pattern and partly due to TMTP only being recalculated infrequently. Differences in movements between the risk margin and the TMTP allocated to risk margin have led to the post-transitional risk margin shown on the balance sheet being negative; this has largely been caused by movements in interest rates.

The impact of reducing the TMTP to zero on key metrics on the Solvency II balance sheet (including technical provisions, Own Funds and SCR) is shown in QRT S.22.01.21 in Appendix 1.4.

In addition to impacting the technical provisions, any change in TMTP also affects the SCR. This is due to the impact of the change in TMTP on both the loss absorbing capacity of deferred tax ('LACDT') and the additional management actions applied in the SCR calculation, which can be used to reduce losses under stressed conditions.

D.2.8 RECOVERABLES ON REINSURANCE CONTRACTS

The amounts recoverable on reinsurance contracts are recognised as a reinsurance asset on the Solvency balance sheet and calculated in the same manner as the BEL. The amounts recoverable are adjusted to take account of expected losses due to default of the counterparty which is described below.

D.2.8.1 Assessment of reinsurers' default risk (counterparty default adjustment)

The regulations require that an adjustment is made to the value of the reinsurance asset to reflect the risk that a reinsurer may default on its obligations. This adjustment is known as the counterparty default adjustment.

A simplified method is used to calculate the counterparty default adjustment. The simplified calculation applies a best estimate probability of reinsurer default to the difference between the reinsured BEL and any collateral held under the arrangement. Further adjustments are then made to reflect the recovery rate from the reinsurer in excess of the collateral and the average duration of liabilities transferred.

There is no reinsurance with Solvency II Special Purpose Vehicles.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.9 SIMPLIFICATIONS

Where it is proportionate, the Company adopts various simplifications in the calculation of BEL. These simplifications are split across the calculation methodology, and simplifications incorporated into the valuation models.

The most material areas where such simplifications are adopted are listed below.

D.2.9.1 Methodology simplifications

This section describes the main simplifications within the Company's methodology for calculating the Solvency II BEL. However, neither is considered to have a material impact on BEL.

Dynamic policyholder behaviour

The moneyiness of guarantees (i.e. how valuable they are to policyholders) will vary with economic conditions. In the stochastic model dynamic policyholder behaviour is modelled in respect of the GAO take-up rates, where the take-up rate varies depending on the level of projected interest rates at the policyholder's retirement date.

Variation in economic conditions would also affect the lapse and surrender rates. However, due to lack of relevant experience data and modelling complexity, dynamic lapse and surrender rates are not currently modelled

Counterparty default adjustment

The methodology set out in section D.2.8.1 above is a simplification permitted by the regulations.

D.2.9.2 Modelling simplifications

Substantially all of the Company's BEL is calculated using probability weighted averages of future cash flows. However, simplified valuation techniques have been used in certain circumstances. These simplifications are typically used where material uncertainty exists around the size, incidence or timing of liability cash flows or, where further model development is required for a more robust assessment. Examples include provisions set aside to cover items such as additional service fees, data issues, project implementation costs, impacts of system changes, impacts of regulation changes, unknown claims and litigation costs.

The Company uses the skills, knowledge and experience of actuaries, accountants and other subject matter experts to perform the assessments, which are carried out in accordance with the Group's internal framework on expert judgement.

The proportion of gross BEL calculated using simplified methods was 5%.

D.2.10 UNCERTAINTY ASSOCIATED WITH THE VALUE OF TECHNICAL PROVISIONS

The key sources and level of uncertainty associated with the BEL component of technical provisions are described below. The sources and level of uncertainty associated with the risk margin component are described in section D.2.11.3.

The key sources and level of uncertainty associated with the BEL component of technical provisions are:

- uncertainty of demographic and economic assumptions;
- uncertainty in the timing and frequency of insured events;
- uncertainty in claim amounts, including uncertainty caused by path dependency (i.e. where the cash flows depend not only on circumstances such as economic conditions on the cash flow date, but also on those circumstances at previous dates);
- uncertainty in claims inflation;
- uncertainty in the amount of expenses and expense inflation;
- uncertainty in the actions that are assumed to be taken by management in response to changes in market conditions;
- uncertainty in expected future developments; and
- uncertainty in policyholder behaviour.

Some of this uncertainty is addressed by using a stochastic model. In particular, use of a stochastic model enables both the intrinsic and time value associated with options and guarantees to be determined with greater certainty. Use of a stochastic model also enables key dynamic policyholder behaviour and key management actions to be modelled.

Uncertainty may also emanate from the use of best estimate assumptions. For example, demographic best estimate assumptions are typically based on an analysis of past experience with adjustments to allow for expected future trends and developments. However, these assumptions may not be borne out in practice for a number of reasons, including:

- Lack of credible historical data upon which to base the assumption. This may require experience data from different homogenous risk groups being grouped, the use of relevant and credible industry data, or the assumption being set by expert judgement.
- Allowance for future trends being different from expected.
- Random variation.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.10 UNCERTAINTY ASSOCIATED WITH THE VALUATION OF TECHNICAL PROVISIONS CONTINUED

Any simplifications and approximations made when setting non-economic assumptions take into account the sensitivity and materiality of the assumption.

An indication of the level of uncertainty associated with a particular assumption can be achieved by testing the sensitivity of BEL to that assumption. The table below shows the increase in BEL that would result from a strengthening of each key demographic assumption at the 1-in-10 probability level (i.e. the probability of the best estimate assumption being outside of this level is 10% respectively). These impacts allow for the current risk mitigation techniques (e.g. reinsurance) in place.

Assumption	Increase in Best Estimate Liabilities
	£m 1-in-10 probability level
Longevity (base table)	188
Longevity (future improvements)	451
Mortality	90
Lapses	362
Expenses	53

No uncertainty is assumed to result from the basic risk-free curve used in the calculation of BEL, as this is specified by the regulations.

D.2.11 RISK MARGIN

The risk margin calculation represents the additional amount above the BEL that is required to be held under the Solvency II regulations. It is calculated at a value to proxy for the amount of compensation above BEL that a third party (i.e. the reference undertaking) would require to take over those liabilities.

The Company uses a simplified methodology to calculate the risk margin, as described in section D.2.11.1 below.

D.2.11.1 Methodology overview

The calculation of the risk margin for the undertaking is based on a 6% per annum cost of capital applied to the projected reference undertaking SCR. The reference undertaking SCR is based on non-hedgeable risks only. The definition of non-hedgeable risks for the reference undertaking SCR includes:

- underwriting risk with respect to the existing business;
- credit risk with respect to reinsurance contracts counterparties, policyholders and any other material exposures related to existing business; and
- operational risk, including tax and regulatory risk.

A 'full' calculation of the risk margin would involve:

- a 'full' calculation of the reference undertaking SCR over all future time periods; and
- a calculation of the risk margin at entity level and allocating a subsequent allocation to each LoB.

However, in practice, a simplified bottom up approach is used such that the risk margin is initially calculated at fund LoB level by:

- allocating the time zero reference undertaking SCR to each fund and further by LoB. This allocation makes allowance for the expected contribution of each LoB from individual risks, management actions, diversification benefits and also non-linearity. Non-modelled risks are allocated in a simplified way using LoB weightings based on modelled BEL; and
- applying a 6% cost of capital charge to the 'projected' fund level LoB reference undertaking SCR and discounting. For this purpose the fund level LoB reference undertaking SCR is typically projected using an annuity factor that is based on the run-off profile of the BEL for each LoB.

The entity risk margin is then the sum of the LoB risk margins across all funds.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.2 TECHNICAL PROVISIONS CONTINUED

D.2.11 RISK MARGIN CONTINUED

D.2.11.2 Validation of simplified approach and level of uncertainty

In order to understand the impact of the simplification used to allocate the SCR to LoB, alternative methods of allocating the SCR to LoB have been investigated (e.g. the impact of allocating non-modelled risks to LoB using policy counts instead of the BEL). However, this demonstrated that the risk margin results were relatively insensitive to the alternative allocation methods that were tested.

In order to understand the impact of the simplification used to represent the projection of the SCR, alternative run-off approaches were also assessed. In particular:

- Realistic run-off patterns for key non-market risks. Simplified models were used to produce run-off patterns for key risks and are validated by comparing them to BEL run-off profiles. This showed that the current approach was likely to be prudent for the key risks.
- Alternative proxies to run-off the SCR were used (e.g. sum assured) and the sensitivity of the risk margin calculation was assessed. This showed that the risk margin results were relatively insensitive to the alternative run-off patterns tested.

D.2.11.3 Uncertainty associated with the risk margin

Uncertainty attached to the risk margin calculation primarily stems from its unduly high sensitivity to interest rate movements. Sensitivity to interest rates arises because there is a significant second order impact from interest rate movements on the longevity risk SCR and because risk-free rates are used to discount the projected reference undertaking SCRs. This is a general industry-wide concern of which the UK regulator and EIOPA have been made aware. However, a material change in interest rates may trigger a recalculation of the TMTP (see section D.2.7.2), subject to regulatory approval, which would currently act to offset much of the volatility in the risk margin calculation.

Some uncertainty also relates to the simplifications used by the Company to calculate the risk margin. However, based on the results of the validation investigations described above, the level of this uncertainty is currently deemed immaterial.

D.3 OTHER LIABILITIES

D.3.1 INTRODUCTION

This section covers the valuation of other liabilities on the Solvency II balance sheet.

The table below sets out the Solvency II value of the liabilities and compares this to the 'statutory accounts value' column. The 'statutory accounts value' column is in line with the Company's financial statements, although presentational adjustments have been included where necessary, to enable comparison to the 'Solvency II value' column. These numbers align to the liabilities on the S.02.01.01 annual balance sheet QRT.

Liabilities	Note	Solvency II value £m	Statutory accounts value £m	Difference £m
Technical provisions (BEL/risk margin and excl reinsurance)	1	34,319	36,422	(2,103)
Other technical provisions	2	–	540	(540)
Provisions other than technical provisions	3	3	3	–
Deposits from reinsurers	4	392	392	–
Deferred tax liabilities	5	224	58	166
Derivatives	6	546	546	–
Debts owed to credit institutions	7	1,273	1,273	–
Financial liabilities other than debts owed to credit institutions	8	392	392	–
Insurance and intermediaries payables	9	306	306	–
Reinsurance payables	9	8	8	–
Payables (trade, not insurance)	10	148	164	(16)
Subordinated liabilities (not in Basic Own Funds)	11	–	200	(200)
Subordinated liabilities (in Basic Own Funds)	11	238	–	238
Total liabilities		37,849	40,304	(2,455)

Some of the liabilities (mainly financial instruments) are determined using alternative valuation methods, which use non-observable market inputs. Further details are included in section D.4.3.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.3 OTHER LIABILITIES CONTINUED

D.3.2 LIABILITY VALUATION BASES, METHODS AND MAIN ASSUMPTIONS

Note	Balance sheet item	Solvency II valuation principles for each material liability class
1	Technical provisions (Best Estimate Liabilities/risk margin and excl reinsurance)	Details regarding the valuation of technical provisions are covered in section D.2.
2	Other technical provisions	For IFRS, unallocated surplus, which comprises the excess of assets over the policyholder liabilities of the with-profit funds, is included here. This represents amounts which have yet to be allocated to shareholders since the unallocated surplus attributable to policyholders has been included within technical provisions. For Solvency II, no liability is held for this, and as such it forms part of Own Funds.
3	Provisions (other than technical provisions)	A provision is recognised when the Company has a present legal or constructive obligation, as a result of a past event, which is likely to result in an outflow of resources and where a reliable estimate of the amount of the obligation can be made. If the effect is material, the provision is 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.
4	Deposits from reinsurers	Deposits from reinsurers are valued in line with IFRS, using a discounted cash flow methodology.
5	Deferred tax liabilities	<p>Deferred tax is determined on temporary differences between the value of assets and liabilities on the Solvency II balance sheet and their tax base at the valuation date. The tax base is the value as determined under IFRS. This means that deferred tax is required to be provided on temporary differences between the IFRS and the Solvency II balance sheet.</p> <p>The valuation differences are identified between the IFRS and Solvency II balance sheets on a 'line by line' basis. Deferred tax is calculated, where required, on these differences.</p> <p>The differences can primarily be attributed to the different valuation methods applied under Solvency II and IFRS for technical provisions.</p> <p>Further details on deferred tax liabilities are provided in section D.3.3.</p>
6	Derivatives	The fair values of OTC derivatives are estimated using pricing models, with inputs based on market-related data at the period end. The fair value of exchange-traded securities is based on quoted market prices at the period end provided by recognised pricing services.
7	Debts owed to credit institutions	<p>Debts owed to credit institutions comprise £1,149 million for obligations for repayment of collateral received and £124 million for refinancing loans.</p> <p>Obligations for repayment of collateral received</p> <p>Obligations for repayment of collateral received are valued at fair value.</p> <p>It is the Company's practice to obtain collateral to mitigate the counterparty risk related to OTC derivatives and certain reinsurance transactions, usually in the form of cash or marketable financial instruments. Where the Company receives collateral in the form of marketable financial instruments which it is not permitted to sell or re-pledge except in the case of default, it is not recognised on the balance sheet.</p> <p>Refinancing loans</p> <p>Refinancing loans, related to the property reversions held in Property other than own use, are held at fair value for both Solvency II and IFRS on the basis that they incorporate an embedded derivative. They are valued using a model which does not include any allowance for changes in Own Credit Standing ('OCS'), as it has a variable rate of return.</p> <p>When valuing liabilities for Solvency II, no adjustment is made to take account of any changes in the Company's OCS since inception. They are valued at initial recognition in accordance with IFRS, but a subsequent adjustment for changes in OCS is not applicable.</p>

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.3 OTHER LIABILITIES CONTINUED

D.3.2 LIABILITY VALUATION BASES, METHODS AND MAIN ASSUMPTIONS CONTINUED

Note	Balance sheet item	Solvency II valuation principles for each material liability class
8	Financial liabilities other than debts owed to credit institutions	This is a liability with PER1L, a subsidiary company, which relates to the ERM arrangement. Given PER1L is a conduit to this structure and is fully owned by PLL, it negates the requirement to adjust for changes in the Company's OCS since inception on the payable to PER1L. Hence, IFRS fair value is an appropriate Solvency II fair value.
9	Insurance and intermediaries payables Reinsurance payables	Given the short-term nature of insurance/reinsurance payables, Solvency II fair value is assumed to be equal to cost.
10	Payables (trade not insurance)	<p>The payables (trade not insurance) balance principally comprises a negative cash balance due to timing, intercompany balances, current tax and other sundry items. These are valued in line with IFRS.</p> <p>For the 'Statutory accounts value' column, Payables (trade not insurance) includes deferred income reserves of £16 million. These are valued at zero under Solvency II as they cannot be sold separately and it cannot be demonstrated that there is value for the same or similar assets (i.e. that a value has been derived from quoted prices in active markets).</p>
11	Subordinated liabilities (not in Basic Own Funds) Subordinated liabilities (in Basic Own Funds)	<p>The subordinated liabilities comprise a £200 million Tier 2 external borrowing. Interest is payable at 7.25% annually. As the loan has a fixed rate of return and is not traded in an active market, its Solvency II fair value is based on a discounted cash flow ('DCF') methodology, to adjust for changes in the Company's OCS since inception. This results in a £38 million difference due to the different valuation used for Solvency II purposes and the valuation used for IFRS.</p> <p>Subordinated loans classified as liabilities or equity in the IFRS balance sheet, and which satisfy the relevant Solvency II Own Funds classification criteria, are included as a contribution to the Solvency II Own Funds even though they are included as liabilities on the Solvency II balance sheet. This means however that these liabilities are shown as subordinated liabilities (not in Basic Own Funds) in the 'statutory accounts value' column and as subordinated liabilities (in Basic Own Funds) in the 'Solvency II value' column.</p> <p>Subordinated liabilities are recognised at their clean value, with related accrued interest held as a liability in the balance sheet, where applicable.</p> <p>The instrument outlined above is added back as subordinated liabilities in Basic Own Funds, and further details can be found in section E.1.</p>

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.3 OTHER LIABILITIES CONTINUED

D.3.3 DEFERRED TAX LIABILITIES

The deferred tax liability on the Solvency II balance sheet of £224 million is comprised as shown in the table below:

Item	Deferred tax liability value £m	Further details
Unrealised gains on investments	2	This liability relates to tax liabilities on capital gains, which are expected to crystallise over a period of seven years.
IFRS transitional adjustments	23	The liability relates to profits still to be brought into tax following the change to the basis of taxation for Life Companies from the PRA Regulatory Return to the IFRS Accounts from 1 January 2013. The profits are brought into tax on a straight-line basis over a 10-year period ending in 2022.
Transitional Measure on Technical Provisions	170	This liability relates to tax that is anticipated to arise on the release of TMTP, which initially reduces the Solvency II technical provisions to align with Solvency I technical provisions. The liability arises as the TMTP reverses over a 16-year period from 2016 to 2032. Further details on the TMTP are included in section D.2.7.2.
Shareholder future bonus transfers	46	This liability relates to tax liabilities which will arise on the future shareholder's share of bonuses from the with-profit funds.
Technical provisions	84	This liability relates to the difference in valuation of technical provisions between the IFRS accounts and Solvency II at the balance sheet date. The liability will arise as the IFRS and Solvency II technical provisions valuation and assumptions align in future reporting periods as claims arise.
Risk margin	(101)	This is a specific Solvency II deferred tax asset that relates to the future tax deductions with respect to the risk margin. Further details on risk margin can be found in section D.2.
Total Solvency II deferred tax liabilities	224	

There are no unrecognised deferred tax liabilities at 31 December 2016.

D.4 ALTERNATIVE METHODS FOR VALUATION

This section provides information on alternative valuation methods used by the Company. Sections D.1.2 and D.3.2 identified the assets and liabilities valued using this approach. Further information is provided below on the justification for the use of alternative valuation methods, the assumptions underlying this approach and an assessment of the valuation uncertainty.

There have been no significant changes in the recognition, estimations or valuation base methods used for financial assets and liabilities during the reporting period.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.4 ALTERNATIVE METHODS FOR VALUATION CONTINUED

D.4.1 ALTERNATIVE VALUATION METHODS – ASSETS

Some of the Company's financial instruments are valued using alternative valuation methods, which utilise a combination of observable and non-observable market inputs. All of the alternative valuation methods described below follow accepted market practice.

Asset	Solvency II value £m	Alternative valuation method	Assumption
Assets held for index-linked and unit-linked contracts – equities	343	Market approach, which uses prices and other relevant information generated by market transactions involving identical or similar assets, liabilities or group of assets and liabilities. Valuation techniques consistent with the market approach include matrix pricing.	Various assumptions depending on equity investment, fund or property.
Property (other than for own use)	351	Royal Institution of Chartered Surveyors ('RICS') Appraisal and Valuation Manual and a discounted cash flow model.	As per RICS valuation manual and professional judgement of independent valuers; for the property reversionary loans, mortality rates, discount rate, future growth in house prices are used.
Holdings in related undertakings incl participations	612	Net asset value of holdings in fellow Group entities.	Net asset value of related undertaking.
Equities – listed	5	Quoted price, but low spread or depth of quote.	Depth and spread.
Equities – unlisted	5	Broker quotes; company financial statements.	Broker quote.
Corporate bonds	341	Price available from a recognised pricing source, but with high bid-offer spread, or low depth of quote.	Various assumptions depending on bond.
Government bonds	405	Combination of observable and non-observable market inputs including modelling.	Depth and spread; Comparable gilt, and spread applied.
Structured notes	1	Price available from a recognised pricing source, but with high bid-offer spread, or low depth of quote.	Depth and spread.
Collateralised securities	8	Price available from a recognised pricing source, but with high bid-offer spread, or low depth of quote.	Depth and spread.
Collective investment undertakings	51	Non-observable market input, primarily net asset value statements.	Net asset value.
Derivatives	1,796	Market approach, which uses prices and other relevant information generated by market transactions involving identical or similar assets, liabilities or group of assets and liabilities. Valuation techniques consistent with the market approach include matrix pricing. All observable market inputs.	Various assumptions used depending on derivative, including interest rate curve, discount curve and implied volatility.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.4 ALTERNATIVE METHODS FOR VALUATION CONTINUED

D.4.1 ALTERNATIVE VALUATION METHODS – ASSETS CONTINUED

Asset	Solvency II value £m	Alternative valuation method	Assumption
Loans and mortgages	624	<p>ERM: Internally developed discounted cash flow models using appropriate assumptions corroborated with external market data where possible.</p> <p>Intra-group loans: Discounted cash flow model, with the discount rates based on market observable rates.</p> <p>Other loans: Income approach, which converts future amounts, such as cash flows or income or expenses, to a single current amount. The fair value shall reflect current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option pricing models and the multi-period excess earnings method.</p>	<p>ERM: swap curve, house price index, loan prepayments</p> <p>Intra group loans: discount rate</p> <p>Other loans(i.e. policy loans): Various assumptions depending on loan, including yields, house price index and prepayment rates.</p>

In relation to investments in hedge funds and private equity investments (which are included within the table above in holdings in related undertakings incl participations, collective investment undertakings and equities – unlisted), non-observable third party evidence in the form of net asset valuation statements are used as the basis for the valuation. Other valuation methods include broker statements, and an illiquidity discount applied to a proxy quoted price. Adjustments may be made to the net asset valuation where other evidence, for example recent sales of the underlying investments in the fund, indicates this is required.

Securities that are valued using broker quotes, which cannot be corroborated across a sufficient range of quotes, are considered to be valued using non-observable market data.

For a small number of investment vehicles and debt securities, standard valuation models are used, as due to their nature and complexity they have no external market. Inputs into such models are based on observable market data, where applicable.

D.4.2 FINANCIAL INSTRUMENT SENSITIVITIES

Further details regarding the impact of significant changes in valuation inputs, including a sensitivity analysis showing how these changes affect the assets, are set out below. All figures quoted reflect the impact to both the assets valuation and the Basic Own Funds of the sensitivity being applied.

Equities and collectives

Certain investments in equities (including private equity) and collective investment schemes (including hedge funds) are valued using net asset statements provided by independent third parties and therefore no sensitivity analysis has been prepared. The fair value of these assets is £611 million.

Government bonds

The Company has investments in local authority loans with a value of £46 million. The valuation is based on the value of comparable gilts. An additional spread is applied in order to reflect investment duration / credit risk. This additional spread is based on monthly market data for a local authority loan, which is applied across the portfolio using gilt of matching duration. An increase in the spread of 25bps would decrease the valuation by £1 million. A decrease in the spread of 25bps would not significantly increase the valuation.

Loans and mortgages

Within loans and mortgages there are two portfolios of equity release mortgages with a fair value of £432 million. These are modelled using a deterministic discounted cash flow model and incorporate the Black-Scholes model to capture the fair valuation of the no negative equity guarantee. The valuation is sensitive to movement in the swap curve. An increase in yields of 100bps would decrease the value by £42 million. A decrease in yields of 100bps would increase the value by £47 million. Loans and mortgages include £188 million of intragroup loans, which do not have material sensitivities.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.4 ALTERNATIVE METHODS FOR VALUATION CONTINUED

D.4.2 FINANCIAL INSTRUMENT SENSITIVITIES CONTINUED

Investment properties

The fair value measurement of investment properties (included in property (other than for own use)) uses alternative valuation methods based on the inputs to the valuation techniques used. The following table shows the valuation techniques used in measuring the fair value of the investment properties, the significant non-observable inputs used, the inter-relationship between the key non-observable inputs and the fair value measurement of the investment properties:

Description	Valuation techniques	Significant non-observable inputs	Range (weighted average)
Commercial investment property	RICS valuation	Expected income per sq.ft.	£4.91–£99.97 (£22.62)
		Capitalisation rate	4.72%–9.96% (6.12%)
		Mortality	130% IFL92C15 – Female
Residential property reversions	DCF model and RICS valuation		130% IML92C15 – Male
		Future growth in-house prices	5-year RPI estimate + 1% margin
		Discount rates	5-year Gilt Spot Rate + 1.7% margin

The residential property reversions, interests in customers' properties that the Company will realise upon their death, are valued using a DCF model based on the Company's proportion of the current open market value, discounted for the lifetimes of the policyholders. The open market value is measured by independent local property surveyors having appropriate recognised professional qualifications with reference to the condition of the property and local market conditions. The individual properties are valued internally and indexed using regional house price indices to the balance sheet date. The discount rate is a risk-free rate appropriate for the duration of the asset, adjusted for liquidity and mortality risk. Assumptions are also made in the valuation for future movements in property prices. The treatment of the related refinancing loan is set out in section D.4.3.

The estimated fair value of the commercial properties held by the Company would increase (decrease) if:

- the expected income were to be higher (lower); or
- the capitalisation rate were to be lower (higher).

The fair value of the residential property reversions would increase (decrease) if the market value of the property was to be higher (lower) or the life expectancy of the policyholders were to increase (decrease). Under the sensitivity to mortality rates going down (effectively longer life expectancy) the value of the fixed and shared reversion reserves increases, increasing the asset value. The fair value is also sensitive to discount rate and house prices as follows:

- an increase of 1% in the house price inflation rate would increase the fair value by £8 million;
- a decrease of 1% in the house price inflation rate would decrease the fair value by £7 million;
- an increase of 1% in the discount rate would decrease the fair value by £7 million; and
- a decrease of 1% in the discount rate would increase the fair value by £8 million.

Derivatives

Derivative positions are valued using standard valuation models, combining observable and non-observable market inputs. They are subject to price verification against independent sources. They are not subject to sensitivity analysis.

SECTION D

Continued

VALUATION FOR SOLVENCY PURPOSES CONTINUED

D.4 ALTERNATIVE METHODS FOR VALUATION CONTINUED

D.4.3 ALTERNATIVE VALUATION METHODS – LIABILITIES

As outlined in section D.4.2 the Group uses alternative valuation techniques using non-observable market inputs for certain financial liabilities. These are used to value refinancing loans, which are based on a combination of independent third party evidence and internally developed models. All of the alternative valuation methods described below follow accepted market practice.

Liabilities	Solvency II value £m	Alternative valuation method	Assumption
Deposits from reinsurers	392	DCF approach, using a market observable discount rate.	Contractual cash flows discounted using a swaps-based risk-free curve.
Derivatives	531	Market approach, which uses prices and other relevant information generated by market transactions involving identical or similar assets, liabilities or group of assets and liabilities. Valuation techniques consistent with the market approach include matrix pricing. All observable market inputs.	Various assumptions used depending on derivative, including interest rate curve, discount curve and implied volatility.
Debts owed to credit institutions	124	Refinancing loan: Internally developed model using a combination of observable and non-observable market inputs.	Various assumptions including discount rate (based on asset duration, adjusted for liquidity / mortality risk) and house price inflation (regional indices).
Subordinated liabilities in Basic Own Funds	238	DCF approach, using a market observable discount rate adjusted to exclude the effect of changes in OCS.	Contractual cash flows. Discounted using a selected reference gilt yield. Changes in OCS are excluded by reference to the spread to the reference gilt at issue.

The valuation of property reversion loans is sensitive to key assumptions of the discount rate and the house price inflation rate, as follows:

- an increase of 1% in the discount rate would decrease the fair value by £(4) million;
- a decrease of 1% in the discount rate would increase the fair value by £4 million;
- an increase of 1% in the house price inflation rate would increase the fair value by £4 million; and
- a decrease of 1% in the house price inflation rate would decrease the fair value by £(4) million.

D.5 ANY OTHER INFORMATION

There is no further material information to be disclosed regarding the valuation of assets and liabilities for solvency purposes.

SECTION E

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SECTION E

CAPITAL MANAGEMENT

E.1 OWN FUNDS

This section provides information on the Own Funds, including changes over the reporting period, the SCR and explanation of material differences between equity under IFRS and the excess of assets over liabilities for solvency purposes.

E.1.1 MANAGEMENT OF OWN FUNDS

Following the implementation of the regulations from 1 January 2016, the Company's capital is managed on a Solvency II basis.

A Solvency II capital assessment involves valuation in line with Solvency II principles of the Company's Own Funds and a risk-based assessment of the Company's SCR, based on the Company's PIM. Solvency II surplus is the excess of Eligible Own Funds over the SCR.

The Company holds an amount of Eligible Own Funds that is greater than the SCR to allow for adverse events in the future that may use capital and might otherwise cause the Company to fail the minimum level of regulatory capital, the Minimum Capital Requirement ('MCR').

For the management of Own Funds, the Company adheres to a capital management framework that is consistent across the Group.

The Capital Management Framework for managing Own Funds is designed to achieve the following objectives:

- Provide appropriate security for policyholders and meet all regulatory capital requirements while not retaining unnecessary excess capital.
- Ensure sufficient liquidity to meet obligations to policyholders and other creditors.
- Optimise the overall financial leverage ratio to maintain an investment grade credit rating.
- Meet the dividend expectations of shareholders.

The Group and its insurance subsidiaries operate under a suite of capital management policies that govern the allocation of capital throughout the Group to achieve the framework objectives under a range of stress conditions. The policy suite considers policyholder security, creditor obligations, dividend policy and regulatory capital requirements. There have been no material changes to the Group's policy suite over the reporting period.

A liquidity policy is set by the Board and monitored each month at both executive and Board level. The policy ensures sufficient liquidity to meet creditor and dividend obligations through the combination of cash buffers and cash flows. Volatility in the latter is monitored at executive and Board level through stress and scenario testing. Where cash flow volatility is judged to be in excess of the Board's risk appetite, de-risking activities are undertaken. Also see section C.4 on liquidity risk.

A capital policy is also set by the Board and the capital position is monitored by management on a daily basis, to ensure there is sufficient capital to meet the SCR under a range of stress conditions at a '1-in-10' level. The capital policy is managed according to the risk profile and financial strength of the Company.

The Company's future performance is projected over a five-year planning horizon as part of the AOP process.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.1 OWN FUNDS CONTINUED

E.1.2 STRUCTURE AND QUALITY OF OWN FUNDS

The table below summarises the solvency position at 31 December 2016. The Own Funds QRT S.23.01 can be found in Appendix 1.5.

Description	Section reference	Unrestricted Tier 1 £m	Tier 2 £m	Tier 3 £m	Total £m
Ordinary share capital	E.1.2.3	69	–	–	69
Share premium account related to ordinary share capital	E.1.2.3	1	–	–	1
Surplus funds	E.1.2.3	1,522	–	–	1,522
Reconciliation reserve (pre-availability restrictions)	E.1.2.3	1,839	–	–	1,839
Deferred tax assets	E.1.2.3	–	–	4	4
Excess of assets over liabilities		3,431	–	4	3,435
Subordinated liabilities	E.1.2.3	–	238	–	238
Total Basic and Available Own Funds before deductions		3,431	238	4	3,673
Ring Fenced Fund restriction	E.1.2.4	(60)	–	–	(60)
Eligible Own Funds to meet SCR after deductions		3,371	238	4	3,613
SCR	E.2.1				(2,820)
Solvency II surplus					793
Ratio of Eligible Own Funds to SCR	E.1.2.1				128%
Shareholder capital coverage ratio	E.1.2.2				150%
Eligible Own Funds to meet MCR	E.2.1	3,371	140	–	3,511
MCR					(705)
Excess over MCR	E.2.1				2,806
Ratio of Eligible Own Funds to MCR	E.2.3				498%

As shown in the above table, Own Funds are split into tiers in line with the regulations. There are three tiers based on both permanence and loss absorbency (Tier 1 being the highest quality).

The regulations impose limits on the amount of each tier that can be held to cover capital requirements with the aim of ensuring that the items will be available if needed to absorb any losses that may arise. This means that they need to be sufficient in amount, quality and liquidity to be available when the liabilities they are to cover arise. Items with a fixed duration or a right to redeem early may not be available when needed. Similarly, obligations to pay distributions or interest will reduce the amount available. The rules on 'tiering' are designed to reflect the existence of such features.

E.1.2.1 Overview of solvency position

As at 31 December 2016, the Solvency II surplus is £793 million, with a ratio of Eligible Own Funds to SCR of 128%. The excess of Eligible Own Funds after deductions over the MCR is £2,806 million, with a ratio of Eligible Own Funds to MCR of 498%.

93% of the Eligible Own Funds after deductions is unrestricted Tier 1, and is principally comprised of ordinary share capital, share premium, surplus funds and the reconciliation reserve. This includes TMTP which are included in the calculation of Basic Own Funds as Tier 1 capital. The determination of the Eligible Own Funds available to meet the MCR requires the application of specific quantitative limits on the tiering of available capital. Application of these tests as at 31 December 2016 result in a £97 million restriction to Tier 2 capital as a result of it being in excess of the required 20% of MCR. Tier 3 capital cannot be used to meet the MCR, so a further £4 million restriction applies.

No ancillary own funds are included as at 31 December 2016.

All the required SCR quantitative limits have been complied with, and result in no restrictions; nor are any Own Funds required to be relegated to lower tiers.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.1 OWN FUNDS CONTINUED

E.1.2 STRUCTURE AND QUALITY OF OWN FUNDS CONTINUED

E.1.2.2 Shareholder capital coverage ratio

The Solvency II surplus excludes surpluses arising in the with-profit funds of £60 million. In the calculation of the surplus, the SCR of the with-profit funds is included, but the related Own Funds are recognised only to a maximum of the SCR amount, and so the £60 million surplus is excluded.

Surpluses that arise in with-profit funds, whilst not included in the surplus, are available to absorb economic shocks. This means that the headline surplus is resilient to economic stresses.

Excluding the SCR and Own Funds relating to unsupported with-profit funds, the Solvency II shareholder capital coverage ratio is 150% as at 31 December 2016. This is consistent with that reported externally by the Group and is a more appropriate measure of the shareholder exposure.

E.1.2.3 Basic Own Funds

The Basic Own Funds before deductions total £3,673 million and comprise ordinary share capital, share premium, surplus funds, a reconciliation reserve, subordinated liabilities and deferred tax assets. Further details regarding each Basic Own Funds item are set out below.

Ordinary share capital

The issued and fully paid ordinary share capital of £69 million is treated as unrestricted Tier 1 Own Funds, as it meets Tier 1 requirements.

Share premium account related to ordinary share capital premium

The share premium related to ordinary share capital of £1 million is treated as unrestricted Tier 1 Own Funds, as it meets Tier 1 requirements.

Surplus funds

Surplus funds in the with-profit funds represents accumulated profits, which have not yet been made available for distribution to policyholders or other beneficiaries. Surplus funds can only be included in Eligible Own Funds up to the value of the SCR they are used to support, and restriction is required to be made by deduction from the reconciliation reserve (see section E.1.2.4).

The Basic Own Funds include surplus funds of £1,522 million which are classified as Tier 1 unrestricted Own Funds.

Reconciliation reserve

The reconciliation reserve is treated as Tier 1 Own Funds and is calculated as follows:

Reconciliation Reserve as at 31 December 2016	£m
Excess of assets over liabilities	3,435
Deduct Other Basic Own Funds items	
Ordinary share capital	(69)
Share premium	(1)
Surplus funds	(1,522)
Deferred tax asset – Tier 3	(4)
Reconciliation reserve pre availability restrictions	1,839
Ring Fenced Fund restriction (see section E.1.2.4)	(60)
Reconciliation Reserve Total (as shown on Own Funds QRT)	1,779

Deferred tax assets

Deferred tax assets of £4 million are included as Tier 3 Own Funds. Further details regarding the composition of the deferred tax asset is included in section D.1.3.

Subordinated liabilities

Scottish Mutual Assurance Limited issued £200 million subordinated loan notes in 2001. With effect from 1 January 2009, as part of the Part VII transfer, these loan notes were transferred into the shareholder fund of the Company. The earliest repayment date of the loan notes is 25 March 2021 and thereafter on each fifth anniversary so long as the notes are outstanding. These notes qualified as lower Tier 2 capital under the Solvency I regime, but did not meet the full criteria set out in the regulations in order to be treated as either Tier 1 or Tier 2 capital. Under the regulations, the notes have transitioned into Solvency II as Tier 2 Own Funds. The transitional period ends 31 December 2026.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.1 OWN FUNDS CONTINUED

E.1.2 STRUCTURE AND QUALITY OF OWN FUNDS CONTINUED

E.1.2.3 Basic Own Funds Continued

As outlined in section D.3, the subordinated loan notes are valued using a discounted cash flow model under Solvency II, which eliminates the impact of any change in OCS since inception from their fair value under IFRS, which results in £238 million contributing to Tier 2 Group Own Funds as at 31 December 2016. Performing this calculation at 31 December 2016 has resulted in a revaluation of £7 million in the year.

As the subordinated liability is classified as Tier 2 at 31 December 2016, further details regarding the principal loss absorbency mechanism complying with Article 71(1) (e) of the Commission Delegated Regulation (EU) 2015/35 have not been included as this Article relates to paid-in subordinated liabilities classified as Tier 1 only.

Changes to subordinated liabilities

The table below outlines the changes in subordinated liabilities over the year.

Movement in subordinated liabilities	£m
At 1 January 2016	231
Revaluation	7
Closing 31 December 2016 subordinated debt	238

E.1.2.4 Availability restrictions

As shown in the reconciliation reserve in E.1.2.3, there is a deduction to Own Funds of £60 in respect of a Ring Fenced Fund ('RFF') restriction. Further details of the restriction are included below.

Ring Fenced Fund restriction

The regulations specify that certain Own Funds items in RFFs and MA portfolios should be restricted. This means they can only be included in the calculation of solvency at an amount less than or equal to the RFF/MA portfolio notional SCR.

All of the with-profit funds are treated as RFFs. The items of Own Funds within each RFF are the value of surplus funds, future shareholder transfers, and shareholder capital support received. There is one MA portfolio in the Company, this is an annuity fund and any Own Funds above SCR in the MA portfolio are also restricted and would be shown as a deduction to the reconciliation reserve.

The total excess of assets over liabilities for the RFFs and the MA portfolio are £2,224 million, and this is restricted by the £60 million RFF restriction. There are no restrictions to the MA portfolio at 31 December 2016.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.1 OWN FUNDS CONTINUED

E.1.3 ANALYSIS OF MOVEMENT IN CAPITAL POSITION

The table below provides an analysis of significant changes in the capital position during the year, including Own Funds.

Analysis of movement in solvency position (£m)	Own Funds £m	Own Funds after RFF Restriction £m	Entity Solvency Capital Requirement £m	Solvency II surplus £m
Opening position at 1 January 2016	3,201	2,999	(2,556)	443
– Management actions	209	209	174	383
– Expected run-off	0	(40)	137	97
– Demographic experience variances (including changes to assumptions)	(88)	(88)	69	(19)
– Policyholder estate distributions	(198)	29	7	36
– Model and methodology changes	(161)	(11)	(35)	(46)
Earnings before economic variances	(238)	99	352	451
– Economic variances	246	108	(259)	(151)
Total earnings	8	207	93	300
Other capital movements				
– Movements in risk margin and transitionals	361	304	(51)	253
– Intragroup capital flows	4	4	(71)	(67)
– Impact of acquisitions	27	27	(235)	(208)
– Capital contribution from Group	237	237	-	237
– Dividend payment	(165)	(165)	-	(165)
Closing position at 31 December 2016	3,673	3,613	(2,820)	793

The commentary below outlines the significant movements in the Solvency II surplus, which is calculated as the Own Funds after RFF restriction less SCR.

Management actions

Management actions throughout the year have increased the Solvency II surplus by £383 million. Significant items include the implementation of a longevity swap, economic hedges put in place to reduce the SCR and the extension of the MA.

Expected run-off

Policy run-off over the year resulted in the release of the related SCR requirements and increased the Solvency II surplus by £97 million.

Demographic experience variances (including changes to assumptions)

Actuarial assumptions have been reviewed throughout the year to incorporate recent demographic experience, leading to changes in the best estimate assumptions for longevity, persistency and GAO take-up rate. Coupled with experience variances observed in the year this has led to a £(19) million change in the Solvency II surplus.

Policyholder estate distributions

Distribution to policyholders of the inherited estate in the strong with-profit funds has increased the Solvency II surplus by £36 million due to the associated amounts attributable to shareholders.

Model and methodology changes

Model and methodology changes made during the year have led to a £(46) million change in the Solvency II surplus, comprising ongoing efficiency improvements to the actuarial models.

Economic variances

Economic variances over the year have been mostly driven by the decrease in yields, though there are some impacts from equity movements and changes in credit spreads. This has changed the Solvency II surplus by £(151) million.

Movements in risk margin and transitional adjustments

Changes over the year in the value of the risk margin and transitional adjustments held within the Company have impacted the Solvency II surplus by £253 million. Actual risk margin and transitional adjustment values are shown in section D.2.2. The transitional adjustments were recalculated on 1 November as a result of the acquisition of AWL and have been reduced by 1/16th in respect of the 16-year run-off period specified in the EIOPA requirements.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.1 OWN FUNDS CONTINUED

E.1.3 ANALYSIS OF MOVEMENT IN CAPITAL POSITION CONTINUED

Intragroup capital flows

Intragroup capital flows increased the Solvency II surplus by £(68) million. During the year, the total size of the loan from the Company to PGH has increased by £71 million. As the SCR assumes there will be no repayment of any Group loan, a repayment increases the Solvency II surplus. The remaining amount relates to interest received on other loans that remain in place.

Impact of acquisitions

On 1 November 2016, the Group completed the acquisition of AXA Wealth's pensions and protection businesses. Following the acquisition, substantially all of the risks and rewards of the existing and new business of AWL (that was not subject to existing reinsurance arrangements) was reinsured to the Company in exchange for a premium paid to AWL. This premium amount is based on the negative BEL under Solvency II of the reinsurance, leading to a £(208) million change in excess over SCR within the Company, principally driven by the increase in SCR resulting from the reinsurance.

Capital contribution from Group

As detailed in section A.1.4.1, to offset the impact on the Solvency II surplus of the AWL reinsurance, the Company received a capital contribution from PeLHL of £237 million.

Dividend payment

Dividends totalling £165 million were paid during the year to the Company's parent.

E.1.4 RECONCILIATION OF IFRS NET ASSETS TO EXCESS OF ASSETS OVER LIABILITIES UNDER SOLVENCY II

The table below provides an analysis of the key differences between the equity under IFRS and the excess of assets over liabilities under Solvency II. Qualitative explanations are detailed in the sections referenced below:

Reconciliation of IFRS equity to Excess of assets over liabilities

	Section	31 December 2016 £m
Total equity per IFRS		990
Valuation differences:		
Assets increase/(decrease):		
Intangible assets / Deferred acquisition costs	D.1.2	(178)
Reinsurance recoverables	D.1.2	364
Reinsurance receivables	D.1.2	(99)
Receivables (prepayments)	D.1.2	(94)
Deferred tax assets	D.1.2	(3)
Total asset valuation differences		(10)
Liabilities (increase)/decrease:		
Technical provisions	D.2.2	2,103
Other technical provisions (unallocated surplus)	D.2.2	540
Deferred tax liabilities	D.3.3	(166)
Payables (deferred income)	D.3.2	16
Loan revaluation	D.3.2	(38)
Total liability valuation differences		2,455
		2,445
Excess of assets over liabilities	E.1.2	3,435

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.2 SOLVENCY CAPITAL REQUIREMENT AND MINIMUM CAPITAL REQUIREMENT

E.2.1 SOLVENCY CAPITAL REQUIREMENT

The SCR for the Company as at 31 December 2016 is presented below:

Analysis of Solvency Capital Requirement – 31 December 2016		£m
Risk categories		
Underwriting risk (i.e. insurance risk)		2,722
Market risk		2,227
Credit risk		998
Operational risk		503
Other risks		53
Total undiversified SCR		6,503
Diversification benefits		(3,335)
Management actions		(149)
LACDT		(202)
Subsidiary risk capital		3
SCR		2,820

All amounts in the table above are determined on a PIM basis (see section E.4 for further details) and are subject to ongoing supervisory assessment. The above table differs from the S.25.02.21 QRT in Appendix 1.6 due to a different approach to the split of diversification benefits.

Risk categories

The definitions for each of the risks are provided below. The components and sources of each of the risks and the methods used to assess, measure and monitor each of the risks are included in section C of this report.

Underwriting risk (i.e. insurance risk) is the risk that the frequency, timing, and/or severity of insured events may be worse than expected. The main sources of insurance risk are mortality risk, longevity risk, morbidity risk, expenses risk and lapse risk. More details on these risks are included in section C.1.

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market influences. Market risk comprises interest rate risk, currency risk and other price risk (comprising equity risk, property risk, inflation risk and alternative asset class risk). More details regarding the definitions of the specific risks, risk measurement and mitigation techniques are included in section C.2.

Credit risk is the risk that a party to a financial instrument will cause financial loss for the other party by failing to discharge an obligation. These obligations can relate to both on and off balance sheet assets and liabilities. The principal sources of credit risk for the Group include spread risk, investment counterparty risk, reinsurance counterparty risk, outsourcer default risk and stock-lending risk. More details on these risks are provided in section C.3.

Liquidity risk is defined as the failure of the Company to maintain adequate levels of financial resources to enable it to meet its obligations as they fall due. The Company has exposure to liquidity risk as a result of normal business activities, specifically the risk arising from an inability to meet short-term cash flow requirements. More details on these risks are provided in section C.4.

Operational risk is the risk of reduction in earnings and/or value, through financial or reputation loss, from inadequate or failed internal processes and systems, or from people related or external events. Details of the sources of operational risk are provided in section C.5.

Other risks comprise mainly tax risk and further details are provided in section C.6.

Diversification benefits arise when the adverse outcome from one risk can be offset by a more favourable outcome from another risk, where those risks are not perfectly correlated. Diversification benefits are determined using a correlation matrix.

Non-linearity arises when there is interdependency between risks, such that the combined impact of two or more risks occurring together does not equal the sum of the impacts from each of the risks occurring in isolation.

Management actions primarily apply to with-profit funds. Such actions include reducing reversionary and terminal bonus rates, removing past conditional estate distributions, and increasing asset share/guarantee charges under stressed conditions. The management actions assumed for each fund are consistent with the fund's PPFM.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.2 SOLVENCY CAPITAL REQUIREMENT AND MINIMUM CAPITAL REQUIREMENT CONTINUED

E.2.1 SOLVENCY CAPITAL REQUIREMENT CONTINUED

LACDT represents the change in value of deferred tax assets and liabilities which would result from an instantaneous loss in Own Funds equal to the SCR (before LACDT adjustment).

Subsidiary risk capital relates to Phoenix Unit Trust Managers Limited ('PUTM'), a subsidiary of PLL.

Other adjustments

Diversification benefits, non-linearity, management actions and LACDT are discussed further in section E.4 below.

E.2.2 CHANGES IN SOLVENCY CAPITAL REQUIREMENT

Explanation for any material changes in the SCR are set out in section E.1.3.

E.2.3 MINIMUM CAPITAL REQUIREMENT

As set out in section E.1.2, the Company's MCR as at 31 December 2016 is £705 million.

The MCR is calculated according to a formula prescribed by the Solvency II regulations and initially requires calculation of the 'linear MCR' which is determined by applying a prescribed set of factors to different components of the technical provisions and the amount of capital at risk. However, the MCR is subject to a floor of 25% of the SCR or EUR 3.7 million, whichever is higher, and a cap of 45% of the SCR.

The components of the overall calculation of the MCR as at 31 December 2016 are:

Calculation of Minimum Capital Requirement – 31 January 2016	£m
MCR before the application of floors and caps	209
MCR cap (45% of SCR)	1,269
MCR floor (higher of 25% of SCR or EUR 3.7m)	705
MCR (post application of floors and caps)	705

The changes in MCR during the reporting period are set out below:

Analysis of change in Minimum Capital Requirement	£m
1 January 2016	639
31 December 2016	705
Movement in MCR	66

The MCR at both current and previous reporting periods is based on the floor of 25% of SCR; hence the change in SCR is the driver for the change in MCR.

E.3 USE OF THE DURATION-BASED EQUITY RISK SUB-MODULE IN THE CALCULATION OF THE SOLVENCY CAPITAL REQUIREMENT

The Company does not use the equity risk sub-module in the calculation of the SCR. The UK has not implemented the member state option in the regulations to permit the use of this sub module for the Standard Formula calculation.

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED

This section outlines the purpose of the IM, its scope, methodology and assumptions, key differences between Standard Formula and IM, and the nature and appropriateness of data used.

E.4.1 SCOPE OF INTERNAL MODEL

Coverage

Prior to the acquisitions of AWL and ALAC, the Group and all Life Companies operated on a full IM basis. However, following these acquisitions an 'interim' PIM will apply to the Group as AWL and ALAC capital requirements are required to be determined on a Standard Formula basis until the PRA approves the Internal Model Application Process (IMAP) planned for these blocks of business. The IM approval for AWL was received in March 2017 (see Appendix 2 for further details).

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.1 SCOPE OF INTERNAL MODEL CONTINUED

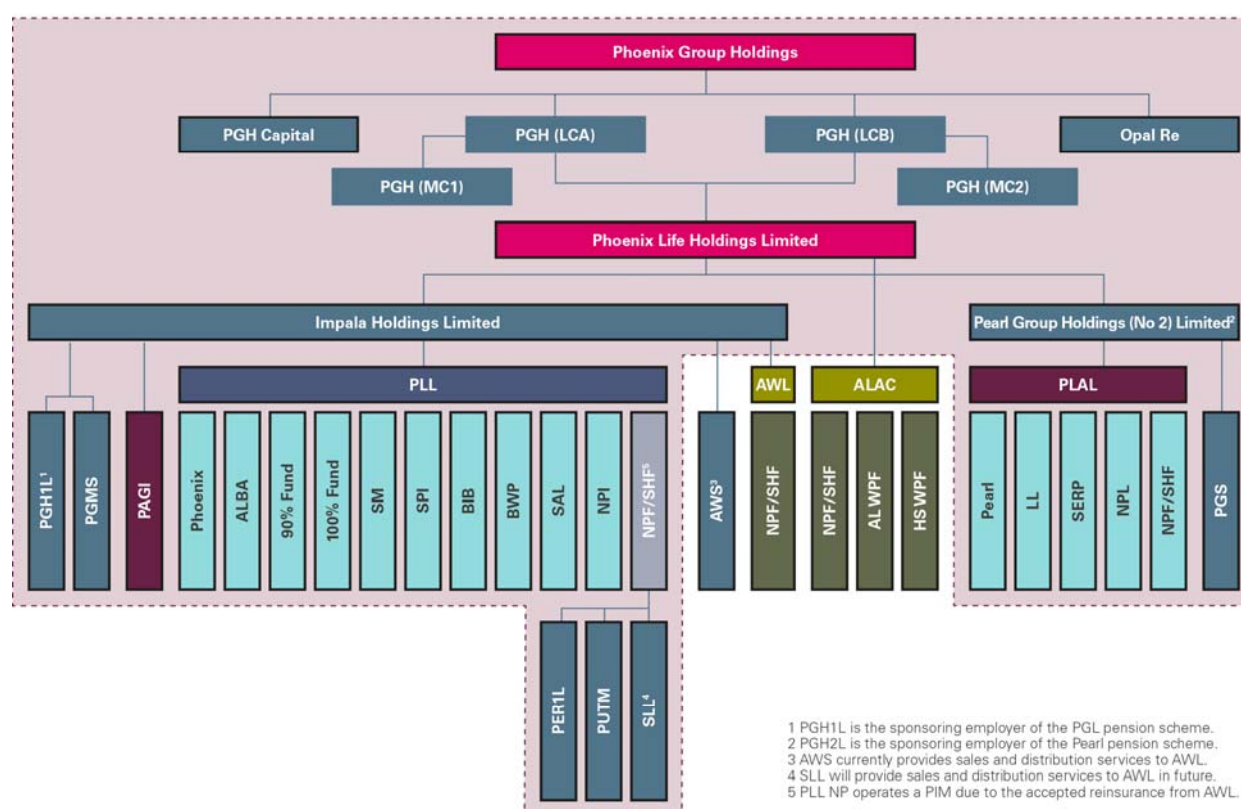
Coverage Continued

For the Life Companies (including ALAC) the following status applies at December 2016:

Life Company	YE16 status	Reason
PLL	Partial Internal Model	Risk capital for the AWL reinsurance arrangement is required to be determined on a Standard Formula basis. Risk capital for other business is determined on an IM basis.
PLAL	Full Internal Model	Full IM, as no risks related to AWL / ALAC have been transferred to the Company.
AWL	Standard Formula	Standard Formula applies until IMAP approved by PRA.
ALAC	Standard Formula	Standard Formula applies until IMAP approved by PRA.

As shown in the table, the Company operates under a PIM, as some business from AWL is reinsured into the non-MA portfolio within the Company, and the risk capital for these reinsured liabilities is required to be determined on a Standard Formula basis. For all other business within the Company a full IM applies

The diagram below sets out a simplified view of the current Phoenix Group structure at the current valuation date, which details the entities within the scope of the Group PIM.



Key to structure

Internal Model Fund	Internal Model Entity	Standard Formula Fund	Partial Internal Model Entity	Major Business Unit
Non-insurance Entity	Group Partial Internal Model	Standard Formula Entity	Partial Internal Model Fund	Internal Model Scope

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.1 SCOPE OF INTERNAL MODEL CONTINUED

Risk categories

A key element of the Group's risk strategy is to ensure that each Life Company has a robust understanding of the risks it faces. This is achieved through regular monitoring and reporting of risks. Further details are included in section B.3.

All key risks (i.e. those forming part of the Standard Formula and risks specific to the Life Companies and Group) in the Risk Universe are within the scope of the IM.

Capital is held against all risks within the Risk Universe, unless:

- the risk is one that would not be expected to impact Own Funds; or
- exposure to the risk is not significant; or
- there is a dedicated risk management process in place to ensure that the risk exposure remains non-material or is unlikely to arise at all.

Justification for not holding capital for any risks within the Risk Universe is documented and approved by senior management. This position is re-assessed periodically or sooner if specified trigger events have occurred.

E.4.2 USES OF THE INTERNAL MODEL

The IM is widely used and plays an important role in the system of governance (in particular, the risk management system), decision-making, solvency capital assessment and allocation of capital.

IM outputs (principally the balance sheet and stress and scenario analysis) are used to inform decisions which impact the risk profile or capital requirements. These decisions include, but are not limited to:

Setting risk appetite

As outlined in section B.3, the Company sets its risk appetite to manage risks which is reviewed annually. Risk appetite establishes the boundaries within which the Company is willing to operate, and the amount of risk that it wishes to accept.

The risk appetite statement is regularly reviewed through scenario analysis which covers a range of material risks from the Risk Universe. Results are regularly presented to the Board.

Informing risk reporting

The risk reporting framework summarises the risk profile of the Company and is regularly presented to management committees and the Board. Each report is structured around the Risk Universe and summarises key risk management information, including the risk appetite dashboard and a breakdown of risk capital by individual risk categories.

Setting capital management policy

Capital management policies are set in order to provide an additional level of solvency protection over the SCR. Capital policies are set by reference to risk appetite scenarios and reviewed annually.

Decision-making in respect of Group funding

Outputs from the IM are used as the basis for recommendations regarding the release of cash up to the Group, for payment of dividends to shareholders or to meet other obligations within the Group.

Informing decisions on significant projects and strategic activity

When determining the viability of a project (for example, a funds merger or acquisition) or a change in strategy, the impacts on financial metrics will be a key consideration which utilise outputs from the IM.

Establishing the Annual Operating Plan

The AOP is used to review the expected financial performance of the Company and to ensure it remains aligned with the overall strategy and risk appetite. This involves the production of financial projections using a central set of assumptions. Stress and scenario testing is completed in line with the risk appetite framework. Further details on stress and scenario testing are included in section C.

Setting investment strategy

Outputs from the IM are used for setting investment strategy. The investment of assets is a core activity that allows the Company to enhance value and meet policyholder expectations. The Company generates value through investing in a range of asset classes. Policies are in place that set out the strategy to be followed to manage the various investment risks.

Setting assumptions

Assumptions are required to be set for the Company's modelled risks. These assumptions are derived from a range of sources, which include IM outputs, experience analysis, industry benchmarking and expert judgement. Setting of assumptions is subject to extensive governance review and sign-off.

Other uses

In addition to the above uses, IM outputs are also used in the production of outputs for external reporting, tax planning, and setting the remuneration policy.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.3 PARTIAL INTERNAL MODEL

As described in section E.4.1 above, at the valuation date the Company operated under a PIM.

The PIM SCR calculation for the Company requires combining the Standard Formula SCR component with the IM SCR component. This approach simply involves summing the Standard Formula results for AWL reinsured liabilities with the IM SCR for all other business – i.e. no diversification benefits between the Company and AWL reinsurance are recognised.

As noted in section A.1.4.1, the Company received approval for its full IM on 10 March 2017.

E.4.4 CALCULATION OF PROBABILITY DISTRIBUTION FORECAST

Overview

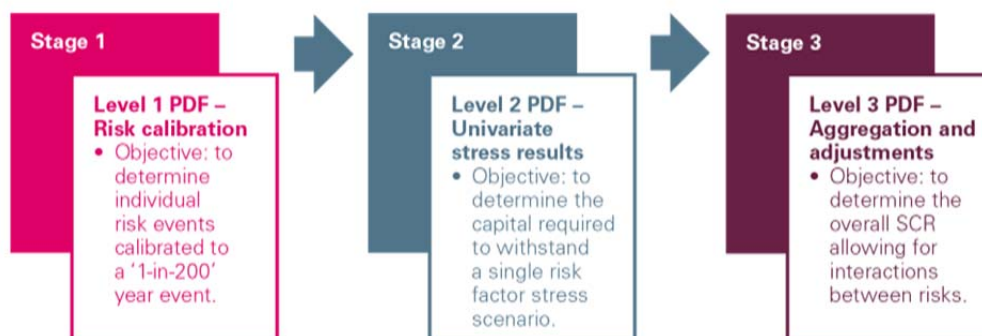
A key input required to calculate the SCR is the Probability Distribution Forecast ('PDF') for a particular risk or group of risks. The PDF determines the range of possible outcomes for the risk(s) being modelled and the associated probability attached to each outcome.

The calculation of the IM SCR requires an assessment of the capital required in a 1-in-200 one-year stress event and also for stress events with different likelihoods. PDFs are utilised for this assessment. The Group's methodology requires the PDF to be determined at three different levels, namely the Level 1, Level 2 and Level 3 PDFs.

The Group's IM applies a univariate approach to assess the impact of individual risk events, where the financial impact of each individual risk event (or stress) is combined with the financial impact of other risks through the use of a correlation matrix. Further adjustments for the impact of combination risks, management actions and tax are also made.

For example the risk capital for equity risk, property risk and longevity risk are firstly determined in isolation using the Level 1 and Level 2 PDFs for each risk. The risk capital determined from the Level 2 PDF for each of these risks is then combined with the risk capital for all other risks via the correlation matrix in order to determine the overall SCR, which is determined from the Level 3 PDF.

Further details on the Level 1, 2 and 3 PDFs are summarised below:



Stage 1 – Level 1 PDF – Risk Calibration

The first stage in the calculation of capital requirements is the calibration of all risk factors covered by the IM. The output of this process is the Level 1 PDF for each risk factor, which is used to determine individual risk events at the '1-in-200' probability level. For example, at the 1-in-200 probability level, the Level 1 PDF calibration for equity risk may imply a Y% fall in equity values.

Level 1 PDFs will be refined on a regular basis through the results of the annual experience investigations (and any other relevant analysis). Level 1 PDFs are subject to governance by a number of senior committees including the Actuarial Technical Committee (a Committee chaired by the Life Company Chief Actuary) and the MGC.

Market risks

The majority of market risks are assessed and calibrated through Phoenix's market calibration model. In this case, full Level 1 PDFs are produced by fitting statistical distributions based on analyses of empirical data.

For those market risks not calculated using the market calibration model, a mixture of experience analysis and expert judgement are used to calculate best estimate and 1-in-200 one-year events.

Non-market risks

The Level 1 PDF for longevity trend risk is output using the Lee Carter stochastic model. A full distribution of events (and hence full Level 1 PDF) is therefore produced.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.4 CALCULATION OF PROBABILITY DISTRIBUTION FORECAST CONTINUED

Stage 1 – Level 1 PDF – Risk Calibration Continued

Some non-market risks are assumed to be normally distributed (e.g. mortality), and a mixture of experience analysis and expert judgement are used to calculate best estimate and 1-in-200 one-year events. Additional points are identified through curve fitting as necessary.

For other risks not assumed to be normally distributed (e.g. persistency), points are calculated at best estimate, '1-in-10' and 1-in-200' one-year points, with additional points also considered as necessary. Points are derived using the results of experience analysis and expert judgement.

Operational Risk

Operational risk emanates from a series of underlying sub-risks (e.g. model risk, data risk, fraud risk) which are combined to determine the overall Level 2 PDF for this risk. An overall Level 1 PDF is not produced.

Stage 2 – Level 2 PDF – Univariate stress results

The IM uses the risk calibrations established in stage 1 to assess the capital required to cover each single risk factor ('univariate') stress scenario.

For example the capital required to cover a Y% fall in equity values is determined by comparing the Own Funds (i.e. the difference between assets and liabilities) in the base position with the stressed value of the Own Funds (i.e. the difference between excess of assets over liabilities following a Y% fall in equity values).

Stage 3 – Level 3 PDF – Aggregation and adjustments

As the Company is exposed to a large number of risks, a correlation matrix approach is used to aggregate the univariate risks by allowing for dependencies between risks. The aggregated SCR is then further adjusted for additional 'non-linear' (i.e. second order) impacts caused when all risks occur at the same time in the aggregate scenario, the impact of additional (i.e. non-dynamic) management actions that can be used to reduce losses under stressed conditions and the LACDT.

E.4.5 METHODOLOGY AND ASSUMPTION DIFFERENCES BETWEEN STANDARD FORMULA AND INTERNAL MODEL

This section includes an explanation of the main differences in methodologies and underlying assumptions used in the Standard Formula and the IM components of the PIM SCR.

1. Structural model differences

The structure of the Standard Formula and the IM methodology are similar in that:

- for each univariate risk the stressed value of assets and liabilities are compared with the unstressed value of assets and liabilities to determine the univariate SCR; and
- univariate risk capital amounts are aggregated to produce an overall SCR using correlation matrices.

However, under the Standard Formula, univariate SCR's are aggregated at a risk module level, and a second correlation matrix is then used to further aggregate across risk modules. The IM aggregates all univariate stress SCRs through a single correlation matrix.

2. Differences in the nature of risks considered and application of the stress

The main differences between the assessment of risks under the IM and Standard Formula are that the IM is based on the assessment of risks relevant to the Company rather than prescribed stresses under the Standard Formula.

The key differences in the risks considered and the stresses applied are set out below.

Strategic risk

Univariate Stress	Internal Model	Standard Formula	Main differences
Strategic risk	Risk capital is held to recognise the costs that could be incurred if some investment management agreements are dissolved.	No equivalent stress is required under the Standard Formula.	No requirement to hold risk capital under Standard Formula.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.5 METHODOLOGY AND ASSUMPTION DIFFERENCES BETWEEN STANDARD FORMULA AND INTERNAL MODEL CONTINUED

Market risk

Univariate Stress	Internal Model	Standard Formula	Main differences
Interest rate risk	<p>Three stresses are applied that consider:</p> <ul style="list-style-type: none"> – a shift in rates across all terms; – a twist in the yield curve; – a shift in short and longer-term rates. <p>For each stress both upwards and downwards movements are considered.</p> <p>Real yields are stressed separately (see inflation risk below).</p>	<p>A term dependent interest rate stress that considers both upwards and downwards movements in interest rates.</p> <p>As no change to market implied inflation is assumed, real yields are also stressed.</p>	<p>The IM approach looks at a wider range of yield curve movements and applies a more onerous stress than the Standard Formula.</p> <p>The IM also considers changes to the level of implied interest rate volatility.</p> <p>Real yields are stressed separately under the IM.</p>
Gilt spread risk	<p>This stress considers the impact of a movement in gilt yields relative to swaps yields.</p>	<p>No equivalent stress under Standard Formula.</p>	<p>The IM captures the risk that liabilities which are valued using swap rates, will move differently to the value of any gilt assets held. Separate stresses apply to nominal and real gilts.</p>
Currency risk	<p>This stress considers the most onerous impact of an upwards and downwards movement in the exchange rates.</p>	<p>As for IM.</p>	<p>Application of the stress is the same for both Standard Formula and IM. The calibration of the stress may differ across the two metrics.</p>
Equity risk	<p>This stress considers the most onerous impact of an upwards and downwards movement in the equity values.</p> <p>Changes to the level of implied equity volatility also considered.</p>	<p>A fall to equity values that is varied (via the equity dampener) to reflect market conditions at the valuation date.</p>	<p>No explicit equity dampener applies under the IM.</p> <p>IM also considers changes to the level of implied equity volatility.</p>
Property risk	<p>This stress considers the most onerous impact of an upwards and downwards movement in property values.</p> <p>Changes to the level of implied property volatility also considered.</p>	<p>A fall in property values.</p>	<p>The IM also considers changes to the level of implied property volatility.</p>
Alternative Asset Risk	<p>This stress considers the most onerous impact of an upwards and downwards movement in the value of alternative assets (e.g. hedge funds).</p> <p>Changes to the level of implied alternative asset volatility also considered.</p>	<p>No equivalent stress under the Standard Formula.</p> <p>Alternative investments are considered as part of the equity risk stress under Standard Formula.</p>	<p>The IM captures the alternative asset risk separately and also considers changes to the level of their implied volatility.</p>
Inflation risk	<p>This stress considers a shift and a twist in the real yield curve.</p> <p>Allowance for inflation volatility stress on PGL liabilities included.</p>	<p>No inflation stress under the Standard Formula.</p>	<p>No requirement to hold risk capital under Standard Formula</p>

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.5 METHODOLOGY AND ASSUMPTION DIFFERENCES BETWEEN STANDARD FORMULA AND INTERNAL MODEL CONTINUED

Market risk Continued

Univariate Stress	Internal Model	Standard Formula	Main differences
Concentration risk	No explicit concentration risk capital is held under the IM.	Formulaic calculation that considers the market risk of loss or adverse change in assets and liabilities due to the accumulation of exposures with the same counterparty. The calculation varies based on the creditworthiness of the counterparty.	Within the IM, concentration risk is allowed for implicitly within other risk modules, namely equity risk, property risk, credit spread risk and counterparty risk. This is implemented through the assumption setting process used to calibrate the risks to a 1 in 200 one-year event.

Credit risk

Feature	Internal Model	Standard Formula	Main differences
Market Credit spread risk	Considers both a widening and narrowing of credit spreads to corporate bond type assets.	Stress considers a widening of credit spreads to corporate bond type assets. A separate stress applies to securitisations. For credit derivatives the stress is bi-directional.	Under the IM, securitisations are treated as corporate bond type assets. The IM considers both spread widening and spread narrowing.
Counterparty default risk	Loss given default as calculated under Standard Formula except that: i) allowance is made for the impact of default on the risk margin; and ii) there is no allowance for risk mitigation benefits. Outsourcer default risk is a bespoke calculation recognising the importance and the stability of the outsourcer concerned.	Counterparties are stressed under prescribed rules. The loss given default calculation allows for the amount of loss, probability of loss (based on credit worthiness) and recoverability. Loss given default calculation also allows for risk mitigation benefit.	Outsourcer arrangements are not included in Standard Formula because they are not classified as risk mitigating under this basis.

Insurance risk

Feature	Internal Model	Standard Formula	Main differences
Mortality (and catastrophe) risk	Mortality: Flat percentage increase in mortality rates for all policyholders where mortality risk is significant. Catastrophe stress: Absolute increase in the rate of policyholders dying over the following year.	As for IM.	The application of the stress is the same for both Standard Formula and IM. The calibration of the stress may differ across the two metrics.
Longevity risk	Two separate stresses are performed that consider: – changes in base table mortality; and – future mortality improvements.	Only base table mortality rates are stressed with no stress to future mortality improvement assumptions.	There is no stress for improvements in mortality under the Standard Formula. This stress is not applied to pension schemes under the Standard Formula (this also applies to all other underwriting risks in the Standard Formula).

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.5 METHODOLOGY AND ASSUMPTION DIFFERENCES BETWEEN STANDARD FORMULA AND INTERNAL MODEL CONTINUED

Insurance risk Continued

Feature	Internal Model	Standard Formula	Main differences
Lapse risk	Two separate lapse stress components are considered: <ul style="list-style-type: none"> – each product is assessed as being exposed to either an increase or decrease in lapse rates, together with an increase in GAO take-up rates; and – a mass lapse stress. 	The most onerous of the following three stresses: <ul style="list-style-type: none"> – an increase in lapse rates for all policies together with a fall in GAO take-up rates – a decrease in lapse rates for all policies together with an increase in GAO take-up rates; and – a mass lapse scenario. 	The IM approach assesses the most onerous direction of the lapse stress at a product level, whereas the Standard Formula benefits from cross-subsidies between products for each direction.
Expense risk	A percentage increase in expenses and expense inflation.	An immediate percentage increase in expenses together with an increase to expense inflation.	Investment management costs are not stressed under the IM.

Financial Soundness risk

Feature	Internal Model	Standard Formula	Main differences
Liquidity risk	Tests are performed on the ability of the Company to meet liability cash flows with existing liquid assets. If failed, additional capital is held.	No equivalent stress under Standard Formula.	No risk capital is required under Standard Formula.
Tax risk	Risk capital considers an increase in tax rates and the risk of challenges from HMRC in respect of previously submitted tax returns.	No equivalent stress under Standard Formula.	No risk capital is required under Standard Formula.

Customer risk

Feature	Internal Model	Standard Formula	Main differences
Customer risk	Scenario approach focused around workshops with subject matter experts. Customer risk Solvency Capital Requirement is aggregated within Operational risk Solvency Capital Requirement.	This risk is captured under operational risk which uses a formulaic approach.	Standalone assessment of customer risk under the IM, which requires looking through to the underlying customer risks.

Operational risk

Feature	Internal Model	Standard Formula	Main differences
Operational risk	For model risk a frequency/severity approach is used to assess risk capital. For other sub risks a scenario approach focused around workshops with subject matter experts is used to determine the severity of stress events.	Operational risk under Standard Formula uses a formulaic approach.	IM approach looks through to the underlying operational risks. In contrast, Standard Formula uses a formulaic approach as a proxy.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.5 METHODOLOGY AND ASSUMPTION DIFFERENCES BETWEEN STANDARD FORMULA AND INTERNAL MODEL CONTINUED

3. Differences in aggregation including dependencies between risks

The IM aggregation process has a number of specific design features which are set out in the table below:

Feature	Internal Model	Standard Formula
Allowance for non-linearity	A non-linearity adjustment is made to reflect the difference between the loss incurred if all risks occur simultaneously and the sum of the losses incurred if each risk had occurred separately.	No explicit allowance.
LACDT	As per Standard Formula, although methodology differences apply.	Explicit adjustment for LACDT.
Diversification between funds	No diversification is allowed for unsupported ring fenced funds. For other funds the directional choice of each risk driver depends on the most onerous risk for non-ring fenced funds.	No inter-fund diversification benefits are allowed for with ring fenced funds and with MA portfolios. The directional choice of each risk driver depends on the most decisive risk at an Entity or Group level.

4. Management actions

Management actions primarily apply to with-profit funds. The management actions available for use in the calculation of the SCR for each with-profit fund are consistent with those actions set out in the funds' PPFM.

The SCR for a with-profit fund will allow for 'dynamic' management actions and additionally may allow for 'non-dynamic' management actions.

The dynamic management actions reflect those actions that form part of normal working practice and these are always 'switched-on' in base and stress model runs. For example, in the calculation of base and stressed technical provisions, annual and reversionary bonus rates will vary in each of the stochastic simulations used to value with-profit liabilities.

Non-dynamic management actions are additional actions that are not considered part of normal day-to-day working practice. For example, past conditional estate distributions may be removed or asset share/guarantee changes may be increased to levels above those assumed in the base technical provisions.

The management actions methodology in the IM and Standard Formula are summarised in the table below:

Feature	Internal Model	Standard Formula
SCR management actions	For each univariate stress dynamic management actions are consistent with those assumed as part of the technical provisions. No allowance for non-dynamic management actions is made in univariate stresses. For the aggregate scenario dynamic management actions are consistent with those assumed as part of the technical provisions. Non-dynamic management actions can then subsequently be used to offset the part of the SCR caused by negative estate. Apart from removal of conditional estate distributions, non-dynamic management actions cannot be used to offset non-chargeable risks events.	For each univariate stress in the net Basic SCR ('nBSCR'), dynamic management actions are allowed. Non-dynamic management actions can then subsequently be used to offset the part of the SCR caused by a negative estate. No allowance for management actions is made in the gross Basic SCR ('BSCR'). The difference between the BSCR calculation and nBSCR calculation is used to derive the loss absorbing capacity of technical provisions.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.5 METHODOLOGY AND ASSUMPTION DIFFERENCES BETWEEN STANDARD FORMULA AND INTERNAL MODEL CONTINUED

Risk Mitigating Techniques

Risk mitigating techniques represent arrangements that have been entered into with the aim of transferring part or all of the risk associated with a particular element of the business. These techniques aim to mitigate against:

- market/credit risks – through the use of instruments such as derivatives, or other such options, which can provide mitigation against equity risk, credit risk, property risk, interest rate risk and currency risk; and
- underwriting risks – through the use of reinsurance arrangements.

Whilst these arrangements aim to reduce the exposure to market/credit and underwriting risks, they will also introduce additional default risk in relation to the arrangement counterparty(s). This risk is managed in many cases through the use of collateral arrangements.

Under Solvency II, there are strict criteria that must be met in order for an instrument to qualify as risk mitigating.

Differences between the IM and Standard Formula methodology are summarised in the table below:

Feature	Internal Model	Standard Formula
Criteria for risk mitigation to be taken into account	The requirements applied under the IM are less prescriptive, but are broadly consistent with the Standard Formula (with the exception of basis risk – see below).	There is a strict list of requirements that must be met for risk mitigation, as identified within the regulations.
Financial risk mitigation	The risk mitigating instrument and the asset/liability being hedged will be stressed as a package under the IM, with an allowance for any basis risk.	Where fully risk mitigating, both the risk mitigating instrument and the asset/liability being hedged are not stressed. Where not fully risk mitigating, the asset/liability being hedged will be stressed as a package, provided that the instrument is not subject to material basis risk. If not deemed risk mitigating, or the instrument is subject to material basis risk, then no capital benefit will be recognised for the instrument under stress. For bonds and Credit Default Swaps ('CDS') this would result in the biting stresses being in opposite directions.
Basis risk	Basis risk is captured through reductions in the effectiveness of the risk mitigating instrument under the relevant stressed conditions. This is achieved by allowing only a proportion of the change in the movement of the risk mitigating instrument under stressed conditions.	Only risk mitigating instruments with no (or immaterial) basis risk shall provide a capital benefit under the Standard Formula SCR.
Insurance risk mitigation	Phoenix considers all of its reinsurance arrangements to be fully risk mitigating.	If reinsurance arrangements are risk mitigating, then the value of the reinsurance asset will be re-valued under each stress in line with the reinsured liabilities. If the arrangement is partially risk mitigating, the reinsurance asset will be re-valued under each stress to the extent that the associated (stressed) collateral covers the risk exposure. If the arrangement is not risk mitigating, the reinsurance asset is not stressed, but the reinsured liabilities will be stressed.

SECTION E

Continued

CAPITAL MANAGEMENT CONTINUED

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED CONTINUED

E.4.5 METHODOLOGY AND ASSUMPTION DIFFERENCES BETWEEN STANDARD FORMULA AND INTERNAL MODEL CONTINUED

5. Other differences

Key differences between IM and Standard Formula methodology are summarised in the table below:

Feature	Internal Model	Standard Formula
Internal loans (Covering both asset and liability)	The value of these loans (and associated accrued income) is fully written off within the risk capital assessment, with no allowance for diversification with any other risks.	Group loans are stressed according to the credit spread risk and interest rate risk modules.

E.4.6 RISK MEASURES AND TIME PERIODS USED IN THE INTERNAL MODEL

The risk measures and time periods used in the IM are in line with those set out by the regulations i.e. the SCR is assessed by considering the capital resources that are required to ensure that the Own Funds are sufficient to meet a stress event calibrated to a 99.5% confidence level over a one year period. In practice stress events are assumed to occur instantaneously rather than over a one-year period.

E.4.7 NATURE AND APPROPRIATENESS OF DATA

The main data items used in the IM is:

- internal and external data used to calibrate the Level 1 PDF's and correlation matrices used as part of the IM SCR aggregation methodology; and
- policy liability data, asset data, product terms and conditions and reinsurance data, which are used to value Own Funds under base and stress conditions.

All data used in the IM are assessed for appropriateness, completeness and accuracy. To support this, a number of controls are in place. These controls are set out in the Data Management Framework that outlines how data is handled, managed and controlled before being used in the IM. In addition, periodic controls are applied to validate the ongoing appropriateness of the data. Regular controls are applied each time the data is extracted and whenever data is manipulated or transformed. Examples of the types of controls performed include data integrity checks, independent source checks and reasonability and consistency checks.

The results of applying the controls are captured in validation reports. Weaknesses and limitations are logged and prioritised for future development activity. Any Expert Judgements applied during the process are logged.

E.5 NON-COMPLIANCE WITH THE MINIMUM CAPITAL REQUIREMENT AND NON-COMPLIANCE WITH THE SOLVENCY CAPITAL REQUIREMENT

The Company held Own Funds in excess of both the SCR and MCR throughout the reporting period and therefore fully complied with capital requirements.

As part of the Group's RMF, various controls are in place to ensure continuing compliance with capital requirements. These include:

- Holding a capital buffer (i.e. 'Capital Policy') above the SCR to provide resilience under a range of stress conditions. The amount of the capital buffer is set and monitored by the Company Board and reflects the risk profile and financial strength of the Company. In situations where the amount of the capital buffer is breached, the Company Board is obliged to identify remedial actions to restore the excess assets to the required buffer in a timely manner. To this end, the Company Board, no less frequently than annually, approve thresholds that would trigger the remedial actions. These thresholds are calculated both including and excluding any potential recalculation of TMTP since the most recent approved recalculation.
- Monitoring solvency on a weekly basis, with results reported daily to senior management and monthly to management committees and boards.
- Projecting solvency positions to the end of the year on a monthly basis, so as to provide an early view of potential capital shortfalls.
- Monitoring of balance sheet sensitivities, which are produced on a monthly basis and distributed to the senior management.
- Subjecting the solvency positions of the Company to reverse stress testing (RST) at least annually. The RST exercise provides an assessment of policyholder security by testing the combined strength of the funds available to Company to enable regulatory capital requirements under stress conditions to be met.

E.6 ANY OTHER INFORMATION

There is no further material information to be disclosed regarding the Company's Own Funds, SCR and MCR.

APPENDIX AND ADDITIONAL INFORMATION

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APPENDIX AND ADDITIONAL INFORMATION

GLOSSARY

ANNUAL OPERATING PLAN ('AOP')	The Group's 5 year strategic plan approved by the Board.
ASSET LIABILITY MANAGEMENT ('ALM')	Management of mismatches between assets and liabilities within risk appetite.
BEST ESTIMATE LIABILITY ('BEL')	The probability weighted average of future cash flows, taking into account of the time value of money (expected present value of future cash-flows), using the relevant interest rate term structure and taking into account economic and non-economic assumptions.
BLACK-SCHOLES	A mathematical model used to calculate the value of an option.
CLOSED LIFE FUND	A fund that no longer accepts new business. The fund continues to be managed for the existing policyholders.
EIOPA	European Insurance and Occupational Pensions Authority.
FAIR VALUE	The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
FINANCIAL CONDUCT AUTHORITY ('FCA')	The body responsible for supervising the conduct of all financial services firms and for the prudential regulation of those financial services firms not supervised by the Prudential Regulation Authority ('PRA'), such as asset managers and independent financial advisers.
GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ('GAAP')	A common set of accounting principles, standards and procedures that companies must follow when they compile their financial statements.
INTERNATIONAL FINANCIAL REPORTING STANDARDS ('IFRS')	Accounting standards, interpretations and the framework adopted by the International Accounting Standards Board ('IASB').
INTERNAL MODEL ('IM')	The agreed methodology and model, approved by the PRA, to calculate the Solvency Capital Requirement ('SCR') pursuant to Solvency II.
LINE OF BUSINESS ('LoB')	The applicable lines of business as prescribed by Annex I of Commission Delegated Regulation (EU) 2015/35.
LONG TERM GUARANTEE MEASURES	the extrapolation of risk-free interest rates, the Matching Adjustment ('MA'), the Volatility Adjustment ('VA'), the extension of the recovery period in case of non-compliance with the SCR, the transitional measures on the risk-free interest rates and the Transitional Measure on Technical Provisions ('TMTP').
LONG-TERM INCENTIVE PLAN ('LTIP')	The part of an executive's remuneration designed to incentivise long-term value for shareholders through an award of shares with vesting contingent on employment and the satisfaction of stretching performance conditions linked to Group strategy.
MANAGEMENT SERVICE AGREEMENT ('MSA')	Contracts that exist between the Phoenix Life and management services companies or between management services companies and their outsource partners.
MATCHING ADJUSTMENT ('MA')	An allowance, subject to PRA's approval that allows insurers to use a higher discount rate, based on the underlying assets, when valuing liabilities that meet strict eligibility criteria.
OPERATING PROFIT	Operating profit is non-GAAP measure that is considered a more representative measure of performance than IFRS profit or loss after tax as it provides long-term performance information unaffected by short term economic volatility.
OWN FUNDS	Basic Own Funds comprise the excess of assets over liabilities valued in accordance with the Solvency II principles and subordinated liabilities which qualify to be included in Own Funds under the Solvency II rules. Eligible Own Funds are the amount of Own Funds that are available to cover the Solvency Capital Requirements after applying prescribed quantitative limits and transferability and fungibility restrictions to Basic Own Funds.
PARTIAL INTERNAL MODEL ('PIM')	A methodology of calculating SCR partially on an approved Internal Model basis and partially on a Standard Formula basis
PART VII TRANSFER	The transfer of insurance policies under Part VII of Financial Services and Markets Act 2000 ('FSMA') 2000. The insurers involved can be in the same corporate group or in different groups. Transfers require the consent of the High Court, which will consider the views of the PRA and FCA and of an Independent Expert.

APPENDIX AND ADDITIONAL INFORMATION

GLOSSARY CONTINUED

PRUDENTIAL REGULATION AUTHORITY ('PRA')	The body responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. The PRA and FCA use a Memorandum of Understanding to co-ordinate and carry out their respective responsibilities.
PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT ('PPFM')	A publicly available document which explains how the Company's with-profit business is run. As part of demonstrating that customers are treated fairly, the Board certifies that the PPFM has been complied with.
RISK MARGIN	The amount used to ensure that the value of the technical provisions is equivalent to the amount that a Life Company would be expected to require in order to take over and meet insurance and reinsurance obligations.
SOLVENCY II	A new regime for the prudential regulation of European insurance companies that came into force on 1 January 2016.
SOLVENCY II SURPLUS	The excess of Eligible Own Funds over the Solvency Capital Requirement.
SOLVENCY CAPITAL REQUIREMENT ('SCR')	SCR relates to risks and obligations to which the Group is exposed and calibrated so that the likelihood of a loss exceeding the SCR is less than 0.5% over one year. This ensure that capital is sufficient to withstand a broadly '1-in-200' event.
STANDARD FORMULA	A set of calculations prescribed by the regulations for generating the SCR.
TECHNICAL PROVISIONS	The sum of the Best Estimate Liabilities and the Risk Margin. Technical provisions include Transitional Measures on Technical Provisions where firms have received PRA approval to apply the deduction.
TRANSITIONAL MEASURE ON TECHNICAL PROVISIONS ('TMTP')	An allowance, subject to the PRA's approval, to apply a transitional deduction to technical provisions. The transitional deduction corresponds to the difference between net technical provisions calculated in accordance with Solvency II principals and net technical provisions calculated in accordance with the previous regime. It is expected to decrease linearly over a period of 16 years starting from 1 January 2016 to 1 January 2032. TMTP is an item of Own Funds.

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016)

This report has been prepared in conjunction with the following QRTs, which are included below:

- S.02.01.02 Balance sheet.
- S.05.01.02 Premiums, claims and expenses by line of business.
- S.12.01.02 Life and Health SLT Technical Provisions.
- S.22.01.21 Impact of long term guarantees and transitional measures.
- S.23.01.01 Own Funds.
- S.25.02.21 Solvency Capital Requirement – for undertakings on a partial Internal Model; and
- S.28.01.01 Minimum Capital Requirement – only life or only non-life insurance or reinsurance activity.

All public disclosure QRTs shown in the Appendices are presented in sterling (£) rounded to the nearest thousands.

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.1 – S.02.01.02 BALANCE SHEET

		Solvency II value
		C0010
Assets		
Intangible assets	R0030	
Deferred tax assets	R0040	4,480
Pension benefit surplus	R0050	
Property, plant & equipment held for own use	R0060	
Investments (other than assets held for index-linked and unit-linked contracts)	R0070	27,453,772
Property (other than for own use)	R0080	350,781
Holdings in related undertakings, including participations	R0090	12,878,747
<i>Equities</i>	<i>R0100</i>	<i>160,104</i>
Equities – listed	R0110	155,543
Equities – unlisted	R0120	4,562
<i>Bonds</i>	<i>R0130</i>	<i>11,793,242</i>
Government Bonds	R0140	7,242,808
Corporate Bonds	R0150	3,899,804
Structured notes	R0160	887
Collateralised securities	R0170	649,742
Collective Investments Undertakings	R0180	343,166
Derivatives	R0190	1,862,615
Deposits other than cash equivalents	R0200	65,117
Other investments	R0210	
Assets held for index-linked and unit-linked contracts	R0220	10,034,372
Loans and mortgages	R0230	624,905
Loans on policies	R0240	1,831
Loans and mortgages to individuals	R0250	
Other loans and mortgages	R0260	623,074
Reinsurance recoverables from:	R0270	2,751,164
Non-life and health similar to non-life	R0280	
Non-life excluding health	R0290	
Health similar to non-life	R0300	
Life and health similar to life, excluding health and index-linked and unit-linked	R0310	2,703,895
Health similar to life	R0320	76,685
Life excluding health and index-linked and unit-linked	R0330	2,627,211
Life index-linked and unit-linked	R0340	47,269
Deposits to cedants	R0350	
Insurance and intermediaries receivables	R0360	8,331
Reinsurance receivables	R0370	32,988
Receivables (trade, not insurance)	R0380	232,226
Own shares (held directly)	R0390	
Amounts due in respect of own fund items or initial fund called up but not yet paid in	R0400	
Cash and cash equivalents	R0410	141,865
Any other assets, not elsewhere shown	R0420	
Total assets	R0500	41,284,103

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.1 – S.02.01.02 BALANCE SHEET CONTINUED

		Solvency II value
		C0010
Liabilities		
Technical provisions – non-life	R0510	
Technical provisions – non-life (excluding health)	R0520	
TP calculated as a whole	R0530	
Best estimate	R0540	
Risk margin	R0550	
Technical provisions – health (similar to non-life)	R0560	
TP calculated as a whole	R0570	
Best estimate	R0580	
Risk margin	R0590	
TP – life (excluding index-linked and unit-linked)	R0600	24,445,110
Technical provisions – health (similar to life)	R0610	129,279
TP calculated as a whole	R0620	
Best estimate	R0630	136,677
Risk margin	R0640	(7,399)
TP – life (excluding health and index-linked and unit-linked)	R0650	24,315,831
TP calculated as a whole	R0660	
Best estimate	R0670	24,602,760
Risk margin	R0680	(286,929)
TP – index-linked and unit-linked	R0690	9,873,523
TP calculated as a whole	R0700	
Best estimate	R0710	9,890,877
Risk margin	R0720	(17,354)
Contingent liabilities	R0740	
Provisions other than technical provisions	R0750	3,167
Pension benefit obligations	R0760	
Deposits from reinsurers	R0770	391,937
Deferred tax liabilities	R0780	224,738
Derivatives	R0790	546,612
Debts owed to credit institutions	R0800	1,273,028
Financial liabilities other than debts owed to credit institutions	R0810	391,653
Insurance & intermediaries payables	R0820	306,351
Reinsurance payables	R0830	8,616
Payables (trade, not insurance)	R0840	146,544
Subordinated liabilities	R0850	237,885
Subordinated liabilities not in BOF	R0860	
Subordinated liabilities in BOF	R0870	237,885
Any other liabilities, not elsewhere shown	R0880	
Total liabilities	R0900	37,849,164
Excess of assets over liabilities	R1000	3,434,939

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.2 – S.05.01.02 PREMIUMS, CLAIMS AND EXPENSE BY LINE OF BUSINESS

	Line of Business for: life insurance obligations					Life reinsurance obligations	Total
	Health insurance	Insurance with profit participation	Index-linked and unit-linked insurance	Other life insurance	Life reinsurance		
						C0210	
Premiums written							
Gross	R1410	12,331	112,471	157,041	1,680,331	28,754	1,990,927
Reinsurers' share	R1420	375	3,526	60,118	31,072		95,090
Net	R1500	11,956	108,945	96,923	1,649,259	28,754	1,895,837
Premiums earned							
Gross	R1510	12,331	112,471	157,041	1,680,331	28,754	1,990,927
Reinsurers' share	R1520	375	3,526	60,118	31,072		95,090
Net	R1600	11,956	108,945	96,923	1,649,259	28,754	1,895,837
Claims incurred							
Gross	R1610	19,810	1,410,450	613,645	621,630	292,118	2,957,652
Reinsurers' share	R1620	10,621	115,211	140,433	101,256		367,521
Net	R1700	9,189	1,295,239	473,212	520,373	292,118	2,590,132
Changes in other technical provisions							
Gross	R1710						
Reinsurers' share	R1720						
Net	R1800						
Expenses incurred	R1900	495	68,031	38,063	74,076	15,342	196,008
Other expenses	R2500						
Total expenses	R2600						196,008

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.3 – S.12.01.02 LIFE AND HEALTH SLT TECHNICAL PROVISIONS

		Index-linked and unit-linked insurance			
		Insurance with profit participation	Contracts without options and guarantees		Contracts with options or guarantees
		C0020	C0030	C0040	C0050
Technical provisions calculated as a whole	R0010				
Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default associated to TP as a whole	R0020				
Technical provisions calculated as a sum of BE and RM					
Best Estimate					
Gross Best Estimate	R0030	13,715,290		7,307,571	1,060,620
Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default	R0080	169,759		11,861	35,408
Best estimate minus recoverables from reinsurance/SPV and Finite Re	R0090	13,545,532		7,295,710	1,025,212
Risk Margin	R0100	342,175	8,400		
Amount of the transitional on Technical Provisions					
Technical Provisions calculated as a whole	R0110				
Best estimate	R0120	(350,812)		(59,224)	(9)
Risk margin	R0130	(482,348)	(25,754)		
Technical provisions – total	R0200	13,224,305	8,291,604		

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.3 – S.12.01.02 LIFE AND HEALTH SLT TECHNICAL PROVISIONS CONTINUED

		Other life insurance			Total (Life other than health insurance, incl. Unit-Linked)	
		Contracts without options and guarantees	Contracts with options or guarantees	Accepted reinsurance		
		C0060	C0070	C0100	C0150	
Technical provisions calculated as a whole	R0010				0.00	
Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default associated to TP as a whole	R0020				0.00	
Technical provisions calculated as a sum of BE and RM						
Best Estimate						
Gross Best Estimate	R0030		9,683,085	2,113,474	1,401,028	35,281,067
Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default	R0080		1,784,837	672,615		2,674,480
Best estimate minus recoverables from reinsurance/SPV and Finite Re	R0090		7,898,247	1,440,859	1,401,028	32,606,588
Risk Margin	R0100	665,522		138,691		1,154,788
Amount of the transitional on Technical Provisions						
Technical Provisions calculated as a whole	R0110					0
Best estimate	R0120		(197,426)	(126,768)	(53,191)	(787,430)
Risk margin	R0130	(812,279)			(138,691)	(1,459,072)
Technical provisions – total	R0200	11,325,608		1,347,837		34,189,354

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.3 – S.12.01.02 LIFE AND HEALTH SLT TECHNICAL PROVISIONS CONTINUED

		Health insurance (direct business)			
		Contracts without options and guarantees	Contracts with options or guarantees	Health reinsurance (reinsurance accepted)	Total (Health similar to life insurance)
		C0160	C0170	C0180	C0200
		C0210			
Technical provisions calculated as a whole	R0010				0.00
Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default associated to TP as a whole	R0020				0.00
Technical provisions calculated as a sum of BE and RM					
Best Estimate					
Gross Best Estimate	R0030		138,306	0	138,306
Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default	R0080		78,537	-1,853	76,685
Best estimate minus recoverables from reinsurance/SPV and Finite Re	R0090		59,768	1,853	61,621
Risk Margin	R0100	12,934			12,934
Amount of the transitional on Technical Provisions					
Technical Provisions calculated as a whole	R0110				0
Best estimate	R0120		(1,628)	0	(1,628)
Risk margin	R0130	(20,332)			(20,332)
Technical provisions – total	R0200	129,279			129,279

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.4 – S.22.01.21 IMPACT OF LONG-TERM GUARANTEES AND TRANSITIONAL MEASURES

		Amount with Long Term Guarantee measures and transitionals	Impact of transitional on technical provisions	Impact of transitional on interest rate	Impact of volatility adjustment set to zero	Impact of matching adjustment set to zero
		C0010	C0030	C0050	C0070	C0090
Technical provisions	R0010	34,318,633	2,268,462			628,013
Basic own funds	R0020	3,612,550	(2,036,793)			(605,868)
Eligible own funds to meet Solvency Capital Requirement	R0050	3,612,550	(2,036,793)			(605,868)
Solvency Capital Requirement	R0090	2,820,479	(358,976)			573,439
Eligible own funds to meet Minimum Capital Requirement	R0100	3,511,209	(2,018,844)			(634,540)
Minimum Capital Requirement	R0110	705,120	(89,744)			143,360

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.5 – S.23.01.01 – OWN FUNDS

		Total	Tier 1 - unrestricted	Tier 1 - restricted	Tier 2	Tier 3
		C0010	C0020	C0030	C0040	C0050
Basic own funds before deduction for participations in other financial sector as foreseen in article 68 of Delegated Regulation 2015/35						
Ordinary share capital (gross of own shares)	R0010	69,088	69,088			
Share premium account related to ordinary share capital	R0030	546	546			
Initial funds, members' contributions or the equivalent basic own – fund item for mutual and mutual-type undertakings	R0040					
Subordinated mutual member accounts	R0050					
Surplus funds	R0070	1,521,556	1,521,556			
Preference shares	R0090					
Share premium account related to preference shares	R0110					
Reconciliation reserve	R0130	1,778,995	1,778,995			
Subordinated liabilities	R0140	237,885			237,885	
An amount equal to the value of net deferred tax assets	R0160	4,480				4,480
Other own fund items approved by the supervisory authority as basic own funds not specified above	R0180					
Own funds from the financial statements that should not be represented by the reconciliation reserve and do not meet the criteria to be classified as Solvency II own funds						
Own funds from the financial statements that should not be represented by the reconciliation reserve and do not meet the criteria to be classified as Solvency II own funds	R0220					
Deductions						
Deductions for participations in financial and credit institutions	R0230					
Total basic own funds after deductions	R0290	3,612,550	3,370,185	0	237,885	4,480
Ancillary own funds						
Unpaid and uncalled ordinary share capital callable on demand	R0300					
Unpaid and uncalled initial funds, members' contributions or the equivalent basic own fund item for mutual and mutual – type undertakings, callable on demand	R0310					
Unpaid and uncalled preference shares callable on demand	R0320					
A legally binding commitment to subscribe and pay for subordinated liabilities on demand	R0330					
Letters of credit and guarantees under Article 96(2) of the Directive 2009/138/EC	R0340					
Letters of credit and guarantees other than under Article 96(2) of the Directive 2009/138/EC	R0350					
Supplementary members calls under first subparagraph of Article 96(3) of the Directive 2009/138/EC	R0360					
Supplementary members calls – other than under first subparagraph of Article 96(3) of the Directive 2009/138/EC	R0370					
Other ancillary own funds	R0390					
Total ancillary own funds	R0400					
Available and eligible own funds						
Total available own funds to meet the SCR	R0500	3,612,550	3,370,185		237,885	4,480
Total available own funds to meet the MCR	R0510	3,608,069	3,370,185		237,885	
Total eligible own funds to meet the SCR	R0540	3,612,550	3,370,185		237,885	4,480
Total eligible own funds to meet the MCR	R0550	3,511,209	3,370,185		141,024	
SCR	R0580	2,820,479				
MCR	R0600	705,120				
Ratio of eligible own funds to SCR	R0620	128%				
Ratio of eligible own funds to MCR	R0640	498%				

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.5 – S.23.01.01 – OWN FUNDS CONTINUED

		C0060
Reconciliation reserve		
Excess of assets over liabilities	R0700	3,434,939
Own shares (held directly and indirectly)	R0710	
Foreseeable dividends, distributions and charges	R0720	
Other basic Own Fund items	R0730	1,595,670
Adjustment for restricted Own Fund items in respect of matching adjustment portfolios and ring fenced funds	R0740	60,274
Reconciliation reserve	R0760	1,778,995
Expected profits		
Expected profits included in future premiums (EPIFP) – Life Business	R0770	292,512
Expected profits included in future premiums (EPIFP) – Non-life business	R0780	
Total Expected profits included in future premiums (EPIFP)	R0790	292,512

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.6 – S.25.02.21 – SOLVENCY CAPITAL REQUIREMENT – FOR UNDERTAKINGS USING THE STANDARD FORMULA AND PARTIAL INTERNAL MODEL

Unique number of component	Components description	Calculation of the Solvency Capital Requirement	Amount modelled
C0010	C0020	C0030	C0070
10700I	Market Spread Risk	923,865	914,954
11000I	Market risk excluding spread risk	985,690	962,317
19900I	Diversification within Market Risk	(153,669)	(148,969)
20000I	Counterparty Risk	66,453	62,528
30000I	Life underwriting Risk	1,672,752	1,450,942
70100I	Operational Risk	495,009	491,571
80150I	Other Risks	0	0
80190I	Other Risks	235,535	235,535
80200I	Non-dynamic management actions	(149,882)	(149,882)
80300I	Loss-absorbing capacity of deferred tax	(201,803)	(201,803)
80400I	Other Adjustments	798	798
Calculation of Solvency Capital Requirement		C0100	
Total undiversified components	R0110	3,874,747	
Diversification	R0060	(1,054,268)	
Capital requirement for business operated in accordance with Art. 4 of Directive 2003/41/EC	R0160	0	
Solvency Capital Requirement excluding capital add-on	R0200	2,820,479	
Capital add-on already set	R0210	0	
Solvency capital requirement	R0220	2,820,479	
Other information on SCR			
Amount/estimate of the overall loss-absorbing capacity of technical provisions	R0300	(1,559,398)	
Amount/estimate of the overall loss-absorbing capacity of deferred taxes	R0310	(201,803)	
Capital requirement for duration-based equity risk sub-module	R0400	0	
Total amount of Notional Solvency Capital Requirements for remaining part	R0410	1,020,411	
Total amount of Notional Solvency Capital Requirement for ring fenced funds	R0420	1,506,232	
Total amount of Notional Solvency Capital Requirement for matching adjustment portfolios	R0430	757,467	
Diversification effects due to RFF nSCR aggregation for article 304	R0440	0	

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 1 – QUANTITATIVE REPORTING TEMPLATES (31 DECEMBER 2016) CONTINUED

APPENDIX 1.7 – S.28.01.01 – MINIMUM CAPITAL REQUIREMENT – ONLY LIFE OR ONLY NON-LIFE INSURANCE OR REINSURANCE ACTIVITY

Linear formula component for life insurance and reinsurance obligations		Background information	
		Life activities	
MCR calculation Life		Net (of reinsurance/ SPV) best estimate and TP calculated as a whole	Net (of reinsurance/ SPV) total capital at risk
		C0050	C0060
Obligations with profit participation – guaranteed benefits	R0210	7,098,251	
Obligations with profit participation – future discretionary benefits	R0220	6,106,709	
Index-linked and unit-linked insurance obligations	R0230	9,864,210	
Other life (re)insurance and health (re)insurance obligations	R0240	8,809,980	
Total capital at risk for all life (re)insurance obligations	R0250		13,500,788
		MCR components	
		Non-life activities	Life activities
		C0010	C0040
MCRNL Result	R0010		
MCRL Result	R0200		208,596
Overall MCR calculation			C0070
Linear MCR	R0300		208,596
SCR	R0310		2,820,479
MCR cap	R0320		1,269,215
MCR floor	R0330		705,120
Combined MCR	R0340		705,120
Absolute floor of the MCR	R0350		3,332
Minimum Capital Requirement	R0400		705,120

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 2 – PRO FORMA INFORMATION REFLECTING RECALCULATION OF TMTP AND INTERNAL MODEL APPROVAL

In March 2017, certain approvals from the PRA have been received that have had significant effect on the Company's capital position. These comprise:

- Approval to recalculate the Transitional Measure on Technical Provisions ('TMTP') as at 31 December 2016; and
- IM approval in connection to the AWL business.

In order to illustrate the impacts of the above, pro forma adjustments have been made to the information presented in the QRTs set out in Appendix 1 and the various sections of the SFCR on a basis that assumes that these actions took place on as at 31 December 2016 (see below for further details). This pro forma position is considered to provide a more appropriate analysis of the Company's capital position and the management of the Company going forward.

As previously set out, all information contained throughout the QRTs set out in Appendix 1 and the various sections of the SFCR excludes these pro forma adjustments, unless expressly specified. This section sets out the impact of these adjustments to all the relevant sections of the SFCR.

Recalculation of TMTP

As described in section D.2.7.2, the Company has the PRA's approval to apply TMTP. This allows for a deduction from the amount of Solvency II technical provisions, of the difference between the net technical provisions calculated in accordance with the Solvency II rules and the net technical provisions calculated in accordance with the previous Solvency I regime. The deduction is expected to decrease over 16 years from 1 January 2016 to 1 January 2032 in line with business run-off. The regulations require all insurers to recalculate TMTP every two years after 1 January 2016. In addition, the regulations permit the initial TMTP to be recalculated more frequently under circumstances where the risk profile of the business changes. Such a recalculation requires PRA approval.

During March 2017, a further recalculation of TMTP (determined as at 31 December 2016) was approved by the PRA in light of the approval of a further Matching Adjustment application and the transaction of a further longevity reinsurance agreement in respect of a portfolio of annuity business. Due to the timing of receipt of this approval, the impact of this latest recalculation has not been included within the QRTs or the SFCR for 31 December 2016. However, the impact has been presented below for information purposes.

As can be observed in the tables below, in addition to impacting the technical provisions, any change in TMTP also affects the SCR. This is due to the impact of the change in TMTP on both the LACDT and the additional management actions applied in the SCR calculation, which can be used to reduce losses under stressed conditions.

Internal Model Approval

In December 2015, the Company was granted the PRA's approval for use of its IM to assess capital requirements. The capital assessment of the acquired AWL businesses remained on a Standard Formula basis as at 31 December 2016. Therefore, the actual Solvency II position of the Company as at that date is based partially on the IM and partially on Standard Formula for the business reinsured from AWL. In March 2017, the PRA approved the IM application for the AWL business reinsured into the Company.

The pro forma adjustments in respect of the IM approval include allowance for a reduction in risk margin and a partly offsetting reduction of the TMTP. Although this TMTP recalculation has not been approved by the PRA, including it gives a more appropriate analysis of the Company's capital position.

SECTION A: BUSINESS AND PERFORMANCE

The approvals received since 31 December 2016 do not impact the information set out in this section.

SECTION B: SYSTEM OF GOVERNANCE

As set out in section B.1.4 the MGC is a Committee of the Company's Board. Its terms of reference have been extended to include the acquired AWL business.

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 2 – PRO FORMA INFORMATION REFLECTING RECALCULATION OF TMTP AND INTERNAL MODEL APPROVAL CONTINUED

SECTION C: RISK PROFILE

The table below sets out the changes to the risk categories of the Company, as a result of applying the pro forma adjustment.

Analysis of Solvency Capital Requirement – 31 December 2016	31 December 2016 actual £m	% of total undiversified Solvency Capital Requirement	Impact of TMTP recalculation £m	AWL business approved Internal Model £m	Total Solvency Capital Requirement on a pro forma basis £m	% of total undiversified Solvency Capital Requirement pro forma
Risk categories						
Underwriting risk (i.e. insurance risk)	2,722	42%	–	(22)	2,700	42%
Market risk	2,227	34%	–	(10)	2,217	34%
Credit risk	998	15%	–	5	1,003	15%
Operational risk	503	8%	–	(3)	500	8%
Other risk	53	1%	–	2	55	1%
Total undiversified risks	6,503	100%	–	(28)	6,475	100%
Diversification benefits	(3,335)		(14)	(82)	(3,431)	
Management actions	(149)		(127)	–	(276)	
Loss-absorbing capacity of deferred tax	(202)		32	–	(170)	
Subsidiary risk capital	3		–	–	3	
Total Solvency Capital Requirement	2,820		(109)	(110)	2,601	

The sensitivities included in section C have also been recalculated to allow for these pro forma adjustments.

The revised sensitivity results are set out in section E of this Appendix below.

SECTION D: VALUATION FOR SOLVENCY PURPOSES

The assets and liabilities for the Company are set out in sections D.1.1 and D.2.1 respectively. The table below shows the impact of the pro forma adjustments on the 31 December 2016 balance sheet.

	31 December 2016 actual £m	Impact of TMTP recalculation £m	AXA business approved Internal Model £m	Total balance sheet on a pro forma basis £m
Assets	41,284	–	–	41,284
Best Estimate Liabilities	35,419	–	–	35,419
Risk Margin	1,168	–	(67)	1,101
TMTP	(2,268)	395	60	(1,813)
Other liabilities	3,530	(31)	–	3,499
Liabilities	37,849	364	(7)	38,206
Excess of assets over liabilities	3,435	(364)	7	3,078

The impact of the reduction in the Solvency II surplus of the Company is set out in further detail in section E below.

APPENDIX AND ADDITIONAL INFORMATION

Continued

APPENDIX 2 – PRO FORMA INFORMATION REFLECTING RECALCULATION OF TMTP AND INTERNAL MODEL APPROVAL CONTINUED

SECTION E: CAPITAL MANAGEMENT

The table below sets out the pro forma Solvency II capital position of the Company as at 31 December 2016, after allowing for the impact of the TMTP recalculation.

	31 December 2016 actual £m	Impact of TMTP recalculation (Tier 1) £m	AXA business approved Internal Model (Tier 1) £m	Total capital position on a pro forma basis £m
Excess of assets over liabilities	3,435	(364)	7	3,078
Subordinated liabilities	238	–	–	238
Total Available Own Funds before deductions	3,673	(364)	7	3,316
Ring fenced fund restriction	(60)	43	1	(16)
Eligible Own Funds to meet Solvency Capital Requirement after deductions	3,613	(322)	8	3,299
Solvency Capital Requirement	(2,820)	109	110	(2,601)
Solvency II surplus	793	(213)	118	698
Ratio of Eligible Own Funds to Solvency Capital Requirement	128%			127%
Shareholder capital coverage ratio	150%			148%

On a pro forma basis the excess of Eligible Own Funds after deductions over the SCR is £698 million, with a ratio of Eligible Own Funds to SCR of 127%.

All changes as a result of applying the pro forma adjustments impact the Company's Tier 1 capital, meaning a slight reduction to the 31 December 2016 position, with 92% of the Eligible Own Funds after deductions being Tier 1.

All required SCR quantitative limits continue to be complied with, and results in no restrictions nor are any Own Funds required to be relegated to lower tiers.

As the MCR is comfortably met, further details on applying the pro forma adjustments have not been included in this section.

Excluding the SCR and Own Funds relating to the unsupported with-profit funds, the shareholder coverage ratio is 143% on a pro forma basis.

As set out in section C, as part of the Company's internal risk management processes, the regulatory capital requirements under Solvency II are tested against a number of financial scenarios. The results of such stress testing are provided below and demonstrate the resilience of the Company's pro forma Solvency II surplus. As earlier noted, the pro forma basis provides a more appropriate analysis of the Company's capital position and the management of the Company going forward.

	Solvency II surplus (pro forma) £m
Base: 1 January 2017¹	698
Following a 20% fall in equity markets	691
Following a 15% fall in property values	663
Following a 55bps interest rates rise ²	708
Following a 80bps interest rates fall ²	698
Following a 150bps credit spread widening ³	614
Following 6% decrease in annuitant mortality rates ⁴	512
Following 10% increase in assurance mortality rates	605
Following a 10% change in lapse rates ⁵	624

¹ Assumes stress occurs on 1 January 2017.

² Assumes recalculation of transitionals.

³ Credit stress equivalent to an average 150bps spread widening across ratings, 10% of which is due to defaults/downgrades.

⁴ Equivalent of six months' increase in longevity applied to the annuity portfolio.

⁵ Assumes most onerous impact of a 10% increase/decrease in lapse rates across different product groups.



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