Our Accounts

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Independent auditors' report to the members of Liverpool Victoria Friendly Society Limited

Year ended 31 December 2018

Report on the audit of the financial statements

Opinion

In our opinion, Liverpool Victoria Friendly Society Limited's group financial statements and Society financial statements (the "financial statements"):

- give a true and fair view of the state of the group's and of the Society's affairs as at 31 December 2018 and of the group's and the Society's income and expenditure and cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Friendly Societies Act 1992 and, as regards the group financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements, included within the Annual Report, which comprise: the group and Society statement of financial position as at 31 December 2018; the group and Society statement of comprehensive income, and the group and Society statement of cash flows for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

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

Basis for opinion

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

Independence

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

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

Other than those disclosed in note 13 to the financial statements, we have provided no non-audit services to the group or the Society in the period from 1 January 2018 to 31 December 2018.

Our audit approach

Context

Liverpool Victoria Friendly Society Limited (the 'Society') is an incorporated friendly society that, together with various subsidiaries, carries out insurance and financial services business in the UK. At the end of 2017 the group completed a strategic partnership with Allianz which resulted in 49% of the group's General Insurance business being sold to Allianz. Control has been retained at 31 December 2018 and consequently the General Insurance business has continued to be consolidated with Allianz's 49% stake being recognised as a non-controlling interest in the group's financial statements. The ongoing accounting treatment of the transactions entered into with Allianz together with external and internal changes impacting the valuation of the life and general insurance contract liabilities, have been key focus areas for our audit.

Overview

Materiality	• Overall group materiality: £33.8 million (2017: £36.5 million), based on 3% of Unallocated Divisible Surplus ('UDS'). • Overall Society materiality: £30 million (2017: £32.9 million), based on 3% of Unallocated Divisible Surplus ('UDS').
Audit scope	• The group consists of 26 active statutory entities, but primarily operates through three main trading entities (Liverpool Victoria Friendly Society Limited, Liverpool Victoria Insurance Company Limited and Highway Insurance Company Limited) at 15 locations across the UK. In our view, all three main trading entities required full scope audits of their complete financial information, due to their size and risk characteristics. • In addition to the group's head offices in Bournemouth, we visited 4 other locations. Our procedures performed at those other locations primarily focused on understanding the systems and controls in place over the recording and processing of new and renewal business and claims. • Taken together, the procedures we performed over the 3 main trading entities, balances included in a further 3 reporting units and the group consolidation entries accounted for over 88% of the group's Unallocated Divisible Surplus ('UDS'), and over 99% of the group's net earned premiums.
Key audit matters	• The valuation of long-term insurance contract liabilities (Group and Society: £9.6bn (2017: £9.9bn)). • The valuation of gross general insurance claims liabilities (Group: £1.5bn (2017: £1.6bn)). • The accounting of the General Insurance business and associated transactions following the 49% sale to Allianz in 2017 (Group).

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

Capability of the audit in detecting irregularities, including fraud

Based on our understanding of the group and industry, we identified that the principal risks of non-compliance with laws and regulations related to breaches of UK and European regulatory principles, such as those governed by the Prudential Regulation Authority and the Financial Conduct Authority (see page 38 of the Annual Report), and we considered the extent to which non-compliance might have a material effect on the financial statements of the group and Society. We also considered those laws and regulations that have a direct impact on the financial statements of the group and Society such as the Friendly Societies Act 1992 legislation, the Companies Act 2006, the UK Corporate Governance Code (voluntarily applied), the Prudential Regulation Authority's regulations, the UK tax legislation and equivalent local laws and regulations applicable to significant component teams, and we considered the extent to which non-compliance might have a material effect on the financial statements. We evaluated management's incentives and opportunities for fraudulent manipulation of the financial statements (including the risk of override of controls), and determined that the principal risks were related to posting inappropriate journal entries to increase revenue or reduce expenditure of the group and Society and management bias in accounting estimates and judgemental areas of the financial statements such as the valuation of long-term insurance contract liabilities and general insurance claims liabilities. The group engagement team shared this risk assessment with the component auditors so that they could include appropriate audit procedures in response to such risks in their work. Audit procedures performed by the group engagement team and/or component auditors included:

- Discussions with the Board, management, internal audit, senior management involved in the Risk and Compliance function and the group's and Society's legal function, including consideration of known or suspected instances of non-compliance with laws and regulation and fraud;
- Assessment of matters reported on the group's and Society's whistleblowing register including the quality and results of management's investigation of such matters;
- Reviewing correspondence between the Society and the Prudential Regulation Authority ('PRA') and Financial Conduct Authority in relation to compliance with laws and regulations. We also meet with the PRA to discuss compliance matters during the course of our audit;
- Reviewing Board minutes as well as relevant meeting minutes, including those of the With-Profits Committee, Risk Committee and the Reserving Committee;
- Reviewing data regarding policyholder complaints, the group's and Society's register of litigation and claims, internal audit reports, compliance reports in so far as they related to non-compliance with laws and regulations and fraud;
- Procedures relating to the valuation of long-term insurance contract liabilities and general insurance claims liabilities described in the related key audit matters below;
- Identifying and testing journal entries, in particular any journal entries posted with unusual account combinations, such as a credit to revenue and a debit to the balance sheet (other than to expected accounts being debtors and cash), which may be indicative of the overstatement or manipulation of revenue;
- Designing audit procedures to incorporate unpredictability around the nature, timing or extent of our testing; and
- Procedures over the valuation of one-off transactions specifically in respect of the forward contract and linked put option entered into with Allianz in 2017 described in the related key audit matter overleaf.

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

Key audit matters

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

<table>
<tr><th>Key audit matter</th><th>How our audit addressed the key audit matter</th></tr>
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The valuation of long-term insurance contract liabilities (Group and Society: £9.6bn (2017: £9.9bn))

Refer to page 61 (Audit Committee Report) and note 20 to the financial statements

The group and Society financial statements include liabilities for the estimated cost of settling benefits and claims associated with life products. We focused on this area because of the significance of these amounts in deriving the group and Society's result, and because of the use of a suite of economic and demographic data and assumptions, which are often highly subjective. In particular, we focused on the most judgemental assumptions having an impact on the liabilities, namely longevity assumptions (i.e. life expectancy of policyholders for annuity products) including management's use of the CMI 2017 projection model for the first time this year.

Included within these liabilities is a reserve of £34m in relation to the projected future impact of costs which will be retained by the continuing business upon separation of the general insurance business from the group. We paid particular focus to this reserve due to the fact that it has been derived outside of the standard actuarial models, and the assumptions regarding these future costs is highly judgemental.

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Our work to address the valuation of the long-term insurance contract liabilities was supported by our in-house life actuarial specialists and included the following procedures:

- We tested the underlying data, including key reconciliations, and this testing was performed with no material exceptions.
- We compared the methodology, models and assumptions used against recognised actuarial practises and underlying internal experience, and by applying our industry knowledge and experience, and found them to be reasonable.
- We performed an independent annual benchmarking survey, which allowed us to further challenge the assumptions setting process by comparing certain assumptions used relative to the Society's industry peers.

Specific areas of testing:

Longevity assumptions

In respect of longevity assumptions we:

- Base longevity: Verified the appropriateness and accuracy of data used by management to model base longevity for the Society's annuity portfolios. We reviewed management's assessments in calculating the assumptions based on that data and considered the extent to which the assumptions used were consistent with other sources of information, such as industry-wide mortality investigations.
- Future improvements: Considered the appropriateness of management's use of the CMI 2017 projection model. This included considering management's use of industry data to model longevity improvements for the Society's annuity contracts against the Society's own experience and verifying the data used. Our market benchmarking survey indicated the use of the CMI 2017 model is in line with the majority of other benchmark respondents.
- Used the above information to critically assess and challenge the judgements made by management and to determine whether there was any evidence of management bias.

Based on the work performed we found that the longevity assumptions used were supported by the evidence we obtained.

Additional expense reserve (£34m)

- We obtained supporting information to validate management's assumptions regarding the level of costs which will be retained post separation.
- Using this supporting information, we independently reperformed the calculation of the projected total impact of these costs, over the relevant future years, in order to determine an expected total reserve. This was then compared to management's booked reserve.

Based on the work performed we found that the additional expense reserve was within a range that we consider to be acceptable.

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Key audit matter	How our audit addressed the key audit matter
Valuation of gross general insurance contract liabilities (£1.5bn (2017: £1.6bn)) *Refer to page 62 (Audit Committee Report) and note 20 to the financial statements* The group financial statements include liabilities for the estimated cost of settling general insurance claims. These are included within insurance contract liabilities. We focused on this area due to the significance of these liabilities to the group's balance sheet and because of the inherent subjectivity of their valuation. In particular, we focused on: • The accuracy of claims data used to estimate the claims liabilities, in particular, the completeness of recorded claims and the consistency in setting case estimates; • Whether any changes to the underlying risk profile of the policies written (for example, the concentration of younger drivers or changes to postcode mix) are appropriately reflected in the estimation of claims liabilities; • The methodologies and assumptions used in estimating the costs of claims for general insurance products (mainly motor policies), in particular for those claims such as personal injury, which can take a long time to settle and where the amounts concerned can be large; and • Whether any trends in the underlying claims experience, whether driven by internal or market level factors, have been appropriately reflected in the estimates of future claim costs.	Our work to address the valuation of the general insurance claims liabilities was supported by our in-house non-life actuarial specialists, and included the following procedures: • We tested the completeness and accuracy of claims data used in the determination of the liabilities; and • We performed independent re-projection testing over 58% of claims liabilities and methodology and assumptions reviews over a further 20% and key indicator checks over 20%. We assessed whether the relevant data source selected by management was appropriate for use in the actuarial estimate of the contracted liabilities. **Specific areas of testing** **Completeness of recorded claims and consistency of case estimates** We tested the reconciliation of source claims data to that used in the actuarial modelling process. In order to assess the completeness of recorded claims, we observed claims being recorded directly onto the claims systems, and tested the operation of the controls over the handling of complaints. We tested the effectiveness of the quality assurance processes over the work of the claims handlers in order to determine whether claims were being assessed on a consistent basis and examined a sample of claims to obtain evidence that they were based on appropriate supporting information. **Consistency of risk exposure** We assessed management's assertion that there had been no significant changes in the risk profile for material lines of business by inspecting their analyses, discussing claims trends, examining the characteristics behind claims development, and utilising our own independent trend analyses. **Methodologies and assumptions** We carried out a substantial amount of our work on the claims liabilities at 30 September 2018, rolling forward our work to the year-end. We performed independent re-projection testing by independently selecting our own methodology and assumptions to estimate the reserves for some of the most significant components of the claims liabilities. We evaluated the methodology and assumptions used by management to estimate the most judgemental components of the claims liabilities. We took into account any changes to the types of risks underwritten by the business, which could increase the level of uncertainty and judgement in the estimates. Particular focus was given to the future potential Ogden rate change that will impact certain types of personal injury claims where we evaluated management's rationale for changing the assumed discount rate to 0% against government announcements and market practice and performed testing over source data on a sample basis to be able to conclude on the quantification of the adjustment to reserves resulting from the change in assumption. For lower risk categories of reserves we considered trends in various indicators such as paid to incurred ratios, incurred to ultimate ratios and other Key Performance Indicators ("KPIs"). Where we felt it was appropriate, we performed independent calculations to quantify the impact of differences between management's actuarial analysis or assumptions and those which we would have conducted or selected ourselves based on our understanding of market trends and the particular circumstances of the group. **Trends in the underlying claims experience** We considered the run-off of prior year liabilities, the sensitivity of the liabilities to alternative methods and assumptions and, where relevant, industry benchmarking. We also examined trends in ratios driven by internal or market level factors, including those between the initial case estimates and the final costs of settlement. *Based on the work performed, no evidence was identified to suggest issues with respect to the completeness and accuracy of claims data. Furthermore, we found the methodology and assumptions used in estimating the costs of claims were appropriate and supported by the evidence we obtained.*

Key audit matter	How our audit addressed the key audit matter
The accounting of the General Insurance business and associated transactions following the 49% sale to Allianz in 2017 (Group) *Refer to page 60 (Audit Committee Report) and note 12 to the financial statements* At the end of 2017 the group disposed of 49% of its holding in its General Insurance business to Allianz. The second phase of the transaction will result in a further stake being sold in two years' time and is based on an agreed valuation of £1.020bn for the entire General Insurance business. Should the Society choose to settle earlier, it has the flexibility to do so by exercising its put option. At 31 December 2018 control continues to be retained by the Society and therefore the General Insurance business has continued to be consolidated in the group's financial statements with Allianz's 49% stake being recognised as a non-controlling interest. Key matters we focused on as part of our audit included the following: Retention of control of the General Insurance business. Due to changes in facts and circumstances during the year, including new contracts entered into and a change in the composition of the General Insurance business Board, our work over the assessment of control by the group has required an increased level of scepticism due to the significant judgements management have made in their assessment; and Valuation of the forward contract and linked put option due to the application of valuation estimates and a significant level of management judgement.	**Accounting treatment of the General Insurance business in the group's financial statements** We reviewed accounting papers produced by management which evaluated whether control is retained by the Society at the year-end. This considered changes in facts and circumstances arising since the prior year including new contracts entered into and a change in the composition of the General Insurance business Board. We made our own assessment as to the most appropriate accounting treatment and used this as a basis to challenge the key judgements made by management, including the assessment of any management bias. We verified management's conclusion that the General Insurance business should continue to be consolidated at the year-end against requirements of the International Financial Reporting Standards. We assessed various factors in forming this conclusion including: • Evaluating whether contracts entered into with Allianz had been completed on an arm's length basis; and • Evaluating whether the change in composition of the General Insurance Board had an impact on the Society's power to influence. *Based on the work performed, we found that the evidence supporting management's accounting treatment for the General Insurance business to be consolidated in the group financial statements was appropriate and that the significant judgement applied had been appropriately assessed, presented and disclosed.* **Valuation of the forward contract and linked put option** Our work to address the valuation of the forward contract and linked put option was supported by our in-house valuation experts. Using a methodology used widely in the insurance industry, we independently developed a range of values within which we would expect the value of the financial instrument to lie. Our valuations were derived using market available information combined with the historic profit levels achieved by the general insurance business. *Based on the work performed we determined that the resultant valuation recognised in the group financial statements was acceptable.*

How we tailored the audit scope

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

The group is structured along two business units, being 'Life' (including Protection, Heritage and Retirement Solutions) and 'General Insurance'. The group's financial statements consist of a consolidation of 26 active statutory entities; but the group primarily operates through the three main trading entities; the Society, encompassing the 'Life' business unit and two general insurance companies, at 15 locations across the UK.

All three main trading entities are material to the group and were audited by the group engagement team. In establishing the overall approach to the group audit, we determine the type of work that we needed to perform at each entity to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the group financial statements as whole.

In addition to the group's head offices in Bournemouth, we visited four other locations, two of which were visited for the purposes of the Society audit. Our procedures performed at those other locations primarily focused on understanding the systems and controls in place over the recording and processing of new and renewal business and claims.

In our view, all three main trading entities required a full scope audit of their complete financial information, due to their size and risk characteristics. Taken together, the procedures we performed over the three main trading entities, balances included in a further 2 reporting units and the group consolidation entries accounted for over 88% of the group's Unallocated Divisible Surplus ('UDS'), and over 99% of the group's net earned premiums.

Materiality

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

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

	Group financial statements	Society financial statements
Overall materiality	£33.8 million (2017: £36.5 million).	£30 million (2017: £32.9 million).
How we determined it	3% of the group's Unallocated Divisible Surplus ('UDS').	3% of the Society's Unallocated Divisible Surplus ('UDS').
Rationale for benchmark applied	In arriving at this judgement we considered the financial measures which we believe to be most relevant to the members of the group as a body. Members' interests in the group are represented primarily by the UDS and, consequently, the UDS was considered to be the primary metric to use to determine materiality. We have also had regard to other measures such as the group's regulatory capital surplus and other performance metrics such as operating profit and have compared the level of audit work required to be performed over the group Statement of Comprehensive Income using these alternative benchmarks.	Consistent with the group we considered the financial measures, which we believe to be most relevant to the members of the Society as a body. Members' interests in the Society are represented primarily by the UDS and, consequently, the UDS was considered to be the primary metric to use to determine materiality. We have also had regard to other measures such as the Society's regulatory capital surplus and other performance metrics such as operating profit and have compared the level of audit work required to be performed over the Statement of Comprehensive Income using these alternative benchmarks.

For each component in the scope of our group audit, we allocated a materiality that is less than our overall group materiality. The range of materiality allocated across components was between £4.3 million and £33.5 million. Certain components were audited to a local statutory audit materiality that was also less than our overall group materiality.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £1.7 million (Group audit) (2017: £1.8 million) and £1.5 million (Society audit) (2017: £1.6 million) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Going concern

In accordance with ISAs (UK) we report as follows:

Reporting obligation	Outcome
We are required to report if we have anything material to add or draw attention to in respect of the directors' statement in the financial statements about whether the directors considered it appropriate to adopt the going concern basis of accounting in preparing the financial statements and the directors' identification of any material uncertainties to the group's and the Society's ability to continue as a going concern over a period of at least twelve months from the date of approval of the financial statements.	We have nothing material to add or to draw attention to. However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the group's and Society's ability to continue as a going concern. For example, the terms on which the United Kingdom may withdraw from the European Union, are not clear, and it is difficult to evaluate all of the potential implications on the group's trade, customers, suppliers and the wider economy.

Reporting on other information

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

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

With respect to the Directors' Report, we also considered whether it had been prepared in accordance with the Friendly Societies Act 1992 and the regulations made under it.

Based on the responsibilities described above and our work undertaken in the course of the audit, the Friendly Societies Act 1992 (FSA92) and ISAs (UK) require us also to report certain opinions and matters as described below (required by ISAs (UK) unless otherwise stated).

Directors' Report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements and has been prepared in accordance with the Friendly Societies Act 1992 and the regulations made under it. (FSA92)

In light of the knowledge and understanding of the group and the Society and their environment obtained in the course of the audit, we did not identify any material misstatements in the Directors' Report. (FSA92)

The directors' assessment of the prospects of the group and of the principal risks that would threaten the solvency or liquidity of the group

As a result of the directors' voluntary reporting on how they have applied the UK Corporate Governance Code (the "Code"), we are required to report to you if we have anything material to add or draw attention to regarding:

- The directors' confirmation on page 71 of the Annual Report that they have carried out a robust assessment of the principal risks facing the group, including those that would threaten its business model, future performance, solvency or liquidity.
- The disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated.
- The directors' explanation on pages 70 to 71 of the Annual Report as to how they have assessed the prospects of the group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We have nothing to report in respect of this responsibility.

Other Code Provisions

As a result of the directors' voluntary reporting on how they have applied the Code, we are required to report to you if, in our opinion:

- The statement given by the directors, on page 72, that they consider the Annual Report taken as a whole to be fair, balanced and understandable, and provides the information necessary for the members to assess the group's and Society's position and performance, business model and strategy is materially inconsistent with our knowledge of the group and Society obtained in the course of performing our audit.
- The section of the Annual Report on pages 60 to 62 describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.

We have nothing to report in respect of this responsibility.

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Directors' statement of responsibility set out on page 72, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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

Auditors' responsibilities for the audit of the financial statements

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

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

Use of this report

This report, including the opinions, has been prepared for and only for the Society's members as a body in accordance with Section 73 of the Friendly Societies Act 1992 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Other required reporting

Friendly Societies Act 1992 exception reporting

Under the Friendly Societies Act 1992 we are required to report to you if, in our opinion:

- we have not received all the information and explanations and access to documents we require for our audit; or
- adequate accounting records have not been kept by the group or Society; or
- the financial statements are not in agreement with the accounting records.

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the audit committee, we were appointed by the members on 29 May 2008 to audit the financial statements for the year ended 31 December 2008 and subsequent financial periods. The period of total uninterrupted engagement is 11 years, covering the years ended 31 December 2008 to 31 December 2018.

Other voluntary reporting

Going concern

The directors have requested that we review the statement on page 70 in relation to going concern as if the Society were a premium listed company. We have nothing to report having performed our review.

The directors' assessment of the prospects of the group and of the principal risks that would threaten the solvency or liquidity of the group

The directors have requested that we perform a review of the directors' statements on pages 71 and 70 that they have carried out a robust assessment of the principal risks facing the group and in relation to the longer-term viability of the group, as if the Society were a premium listed company. Our review was substantially less in scope than an audit and only consisted of making inquiries and considering the directors' process supporting their statements; checking that the statements are in alignment with the relevant provisions of the Code; and considering whether the statements are consistent with the knowledge and understanding of the group and Society and their environment obtained in the course of the audit. We have nothing to report having performed this review.

Directors' remuneration

The Society voluntarily prepares a Directors' Remuneration Report in accordance with the provisions that apply to companies subject to the Companies Act 2006. The directors requested that we audit the part of the Directors' Remuneration Report specified by the Companies Act 2006 to be audited as if the Society were a quoted company.

In our opinion, the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006.

Andrew G Hill (Senior Statutory Auditor)

for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London

21 March 2019

Statement of Comprehensive Income

Year ended 31 December 2018

	Notes	Group 2018 £m	Group 2017 Restated – see Note 1 £m	Society 2018 £m	Society 2017 Restated – see Note 1 £m
Gross earned premiums	5	**788**	835	**787**	835
Premiums ceded to reinsurers	5	**(246)**	(1,092)	**(246)**	(1,092)
Net earned premiums	5	**542**	(257)	**541**	(257)
Investment income	6	**300**	319	**363**	430
Net (losses)/gains on investments	7	**(605)**	394	**(612)**	379
Other income	8	**47**	37	**24**	22
Total income		**284**	493	**316**	574
Gross benefits and claims	9	**(904)**	(872)	**(903)**	(871)
Claims ceded to reinsurers	9	**238**	237	**238**	237
Net benefits and claims	9	**(666)**	(635)	**(665)**	(634)
Gross change in long-term contract liabilities, excluding mutual bonus	22	**539**	(590)	**538**	(590)
Change in long-term contract liabilities ceded to reinsurers	22	**(9)**	1,035	**(9)**	1,035
Change in non-participating value of in-force business	22	**10**	(30)	**10**	(30)
Net change in contract liabilities, excluding mutual bonus before change in economic basis	22	**540**	415	**539**	415
Change in economic basis	22	**–**	(48)	**–**	(48)
Net change in contract liabilities, excluding mutual bonus	22	**540**	367	**539**	367
Finance costs	10	**(24)**	(24)	**(23)**	(23)
Other operating and administrative expenses	11	**(224)**	(243)	**(196)**	(222)
Total other expenses		**(248)**	(267)	**(219)**	(245)
Total benefits, claims and expenses, excluding mutual bonus		**(374)**	(535)	**(345)**	(512)
(Loss)/profit before tax and mutual bonus from continuing operations		**(90)**	(42)	**(29)**	62
Mutual bonus		**(26)**	(26)	**(26)**	(26)
Income tax credit/(expense)	34	**31**	(20)	**31**	(24)
(Loss)/profit after tax and mutual bonus from continuing operations		**(85)**	(88)	**(24)**	12
Profit after tax from discontinued operations	12	**93**	134	**–**	–
Non-controlling interest		**(36)**	2	**–**	–
Transfer from/(to) the Unallocated divisible surplus	46	**28**	(48)	**24**	(12)
Profit for the year		**–**	–	**–**	–
Other comprehensive income					
Items that will be reclassified to profit or loss – discontinued operations					
Net loss on available for sale financial assets, net of tax	12	**(10)**	–	**–**	–
Items that will not be reclassified to profit or loss – continuing operations					
Re-measurements of defined benefit pension schemes, net of tax	39	**(29)**	19	**(27)**	19
Other comprehensive income, net of tax		**(39)**	19	**(27)**	19
Non-controlling interest		**5**	–	**–**	–
Transfer from/(to) the Unallocated divisible surplus	46	**34**	(19)	**27**	(19)
Total comprehensive income for the year		**–**	–	**–**	–

As a Friendly Society, all net earnings are for the benefit of participating policyholders and are carried forward within the Unallocated divisible surplus. Accordingly, there is no profit for the year shown in the Statement of Comprehensive Income.

The Group and the Society have not presented a Statement of Changes in Equity as there are no equity holders in either the Group or Society.

Statement of Financial Position

As at 31 December 2018

	Notes	Group 2018 £m	Group 2017 £m	Society 2018 £m	Society 2017 £m
Assets					
Pension benefit asset	39	**199**	178	**199**	178
Intangible assets	28	**47**	315	**8**	10
Investments in group undertakings	29	**–**	–	**896**	897
Property and equipment	27	**29**	37	**9**	7
Investment properties		**–**	3	**–**	3
Deferred acquisition costs	23	**–**	95	**–**	–
Reinsurance assets	24	**1,738**	2,305	**1,738**	1,747
Prepayments and accrued interest	31	**77**	124	**70**	71
Loans and other receivables	17	**407**	258	**84**	65
Insurance receivables	30	**41**	308	**40**	29
Corporation tax asset	35	**5**	–	**5**	–
Financial assets at fair value through income	14	**11,538**	13,853	**11,334**	11,875
Derivative financial instruments	15	**65**	81	**65**	80
Cash and cash equivalents (excluding bank overdrafts)		**412**	974	**392**	424
Assets held for sale	12	**3,367**	–	**–**	–
Total assets		**17,925**	18,531	**14,840**	15,386
Liabilities					
Unallocated divisible surplus	46	**1,127**	1,189	**999**	1,050
Participating insurance contract liabilities	20	**5,092**	5,279	**5,092**	5,279
Participating investment contract liabilities	16	**691**	746	**691**	746
Non-participating value of in-force business	21	**(303)**	(293)	**(303)**	(293)
		6,607	6,921	**6,479**	6,782
Non-participating insurance contract liabilities	20	**4,522**	7,078	**4,508**	4,635
Non-participating investment contract liabilities	16	**3,017**	3,071	**3,017**	3,071
		7,539	10,149	**7,525**	7,706
Non-controlling interest	47	**404**	373	**–**	–
Pension benefit obligation	39	**2**	–	**–**	–
Deferred tax liability	36	**78**	97	**78**	98
Provisions	40	**8**	20	**7**	13
Subordinated liabilities	18	**348**	358	**348**	348
Derivative financial instruments	15	**190**	193	**190**	187
Other financial liabilities	19	**59**	62	**59**	62
Corporation tax liability	37	**–**	20	**–**	9
Insurance payables	32	**28**	50	**28**	22
Trade and other payables	33	**146**	288	**126**	159
Liabilities directly associated with assets held for sale	12	**2,516**	–	**–**	–
Total liabilities		**17,925**	18,531	**14,840**	15,386

The financial statements on pages 98 to 189 were approved by the Board of Directors on 21 March 2019 and signed on its behalf by:

Michael Jones
Company Secretary

21 March 2019

Statement of Cash Flows

Year ended 31 December 2018

	Notes	Group 2018 £m	Group 2017 £m	Society 2018 £m	Society 2017 £m
Cash and cash equivalents at 1 January		**963**	783	**416**	460
Cash flows arising from:					
Operating activities					
Cash used in operating activities before movements in investments held at fair value through income or OCI	51	**(491)**	(735)	**(298)**	(732)
Net decrease/(increase) in investments held at fair value through income		**937**	19	**(60)**	395
Net increase in AFS financial assets at fair value through OCI		**(1,007)**	–	**–**	–
Cash used in operating activities		**(561)**	(716)	**(358)**	(337)
Proceeds from sale of investment properties		**4**	5	**4**	5
Dividend income received		**118**	117	**113**	109
Interest income received		**260**	303	**189**	213
Utilisation of provisions		**(9)**	(5)	**(6)**	(5)
Finance cost paid		**(1)**	(1)	**–**	–
Income tax paid		**(27)**	(13)	**(10)**	(12)
Net cash flows used in operating activities		**(216)**	(310)	**(68)**	(27)
Investing activities					
Net proceeds from purchase/sale of general insurance renewal rights		**–**	51	**–**	–
Increase in investment in group undertakings		**–**	–	**(6)**	(85)
Proceeds from sale of property and equipment		**6**	–	**–**	–
Dividend income received from group undertakings		**–**	–	**67**	94
Purchase of property, equipment and intangibles	27, 28	**(28)**	(38)	**(5)**	(3)
Net cash flows (used in)/generated from investing activities		**(22)**	13	**56**	6
Financing activities					
Proceeds from sale of stake in general insurance subsidiary		**–**	500	**–**	–
Interest paid on subordinated debt	10	**(23)**	(23)	**(23)**	(23)
Net cash flows (used in)/generated from financing activities		**(23)**	477	**(23)**	(23)
Net (decrease)/increase in cash and cash equivalents		**(261)**	180	**(35)**	(44)
Cash and cash equivalents at 31 December		**702**	963	**381**	416
Cash and cash equivalents comprise:					
Bank balances		**110**	108	**93**	76
Short-term bank deposits		**302**	866	**299**	348
Cash and cash equivalents per the Statement of Financial Position		**412**	974	**392**	424
Bank balances and short-term deposits attributable to discontinued operations	12	**319**	–	**–**	–
		731	974	**392**	424
Non-offsettable bank overdrafts (see note 33)		**(11)**	(11)	**(11)**	(8)
Bank overdrafts attributable to discontinued operations		**(18)**	–	**–**	–
Cash and cash equivalents per the Statement of Cash Flows		**702**	963	**381**	416

The Group and Society classifies the cash flows for the acquisition and disposal of financial assets and the net purchases/sales of investment properties as operating cash flows, as the purchases are funded from the cash flows associated with the origination of insurance and investment contracts.

Cash flows from discontinued operations are disclosed separately within Note 12.

Notes to the Financial Statements

Year ended 31 December 2018

Significant accounting policies

This section describes the LV= Group's significant accounting policies and accounting estimates that relate to the financial statements and notes as a whole. If an accounting policy or an accounting estimate relates to a specific note, the applicable accounting policy and/or accounting estimate is contained within the relevant note. These policies have been consistently applied to all years presented, unless otherwise stated.

1. Significant accounting policies

Basis of presentation

The Group financial statements consolidate the results of the Society and its subsidiary companies. The Group's and Society's financial statements conform to International Financial Reporting Standards (IFRS) and interpretations issued by the IFRS Interpretations Committee as published by the International Accounting Standards Board and adopted by the European Union. In addition the Society's financial statements comply with the Friendly Societies (Accounts & Related Provisions) Regulations 1994 (the Regulations).

In accordance with IFRS 4 on Insurance Contracts, the Group has applied existing accounting practices for insurance contracts and participating investment contracts modified as appropriate to comply with the IFRS framework and applicable standards. Further details are given in accounting policy c) below.

The financial statements have been prepared under the historical cost convention as modified by the revaluation of investment properties and financial assets and liabilities (including derivatives and non-participating investment contract liabilities) at fair value. Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). Unless otherwise noted, the consolidated financial statements are presented in millions of pounds sterling, which is the Group's presentation and functional currency.

Within the financial statements the Group uses the term Profit before tax to refer to Profit before tax, mutual bonus and UDS transfer as disclosed on the Statement of Comprehensive Income. This is to provide a more representative Profit before tax figure as described in the LV= use of Non-GAAP measures disclosed on page 87.

As described in the Directors' Report on page 70, after making enquiries, the directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. The Group therefore continues to adopt the going concern basis in preparing its consolidated financial statements.

Restatements

General insurance discontinued operations

On 28 December 2017 the Group entered into a transaction with Allianz whereby a majority stake in the LVGIG group (the general insurance business within the Group) is being sold to Allianz based on an agreed valuation of LVGIG of £1.020bn. The first stage was completed on 28 December 2017 with a minority interest of 49% in LVGIG being sold. The second stage will complete by 31 December 2019 following settlement of a forward contract to sell an additional 20.9% stake to Allianz unless the Group exercises its put option to Allianz over its remaining shareholding earlier.

At 31 December 2018 the Group retains control and consolidates LVGIG and its subsidiaries, however as the second stage will be completed within a year from the reporting date and will result in a loss of control, the LVGIG group is a disposal group that is classified as held for sale in accordance with IFRS 5, and presented as a discontinued operation. As a result the comparative Statement of Comprehensive Income is re-presented as if the LVGIG group had been discontinued from 1 January 2017.

Significant accounting estimates and judgements

The preparation of financial statements in accordance with IFRS requires the use of estimates. Where such estimates are complex they often involve a significant level of management judgement in applying those estimates. These significant accounting estimates are disclosed within the financial statements separately from those judgements that management have made in applying accounting policies.

The following areas involve significant judgement by management on policy application:

Area	Significant accounting judgements	Note
Consolidation	Continued consolidation of LVGIG Group	1
Insurance and participating investment contract liabilities	Changes in methodology	20
Reinsurance assets	Transfer of insurance risk for new reinsurance arrangements entered into	24
Pension benefit asset	Right to a refund from the pension scheme's assets	39

The following areas include significant estimates and assumptions, including the exercise of management judgement:

Area	Significant accounting estimates	Note
Fair value financial assets	Estimate of fair value where there is no or limited market data	14
Insurance and participating investment contract liabilities	Assumptions and adjustments used in determining insurance contract liabilities; Assessment of future options and guarantees; Estimate of ultimate cost of claims	20
Intangibles	Estimation of recoverable amount of each Cash Generating Unit	28
Pension benefit asset	Assumptions used to measure the pension benefit obligation	39

Notes to the Financial Statements (continued)

Year ended 31 December 2018

1. Significant accounting policies (continued)

Accounting policies

a) Consolidation

(i) Subsidiaries

Subsidiaries are all entities, over which the Group (directly or indirectly) has control.

The Group controls an entity when the Group has all of the following:

- power over the relevant activities of the entity, for example through voting or other rights;
- exposure to, or rights to, variable returns from its involvement with the entity; and
- the ability to affect those returns through the power over the entity.

The assessment of control is based on the consideration of all the facts and circumstances. The Group reassesses whether it controls an entity if facts and circumstances indicate that there are changes to one or more of the three elements of control.

Subsidiaries are fully consolidated from the date on which control is transferred to the Group using uniform accounting policies consistently applied across the Group. They are excluded from consolidation from the date on which control ceases.

The Group uses the purchase method of accounting to account for the acquisition of subsidiaries. Accordingly, the cost of an acquisition is measured as the fair value of the cash or other assets given, equity instruments issued and liabilities incurred or assumed at the date control passes. Identifiable assets acquired, liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest.

The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the Statement of Comprehensive Income for the period.

Intra-group transactions, balances and unrealised gains on intra-group transactions are eliminated on consolidation. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred.

Non-controlling interests are initially measured as the proportionate share of the subsidiary's identifiable net assets. The balance is subsequently increased by the amount of profit after tax attributable to the non-controlling interest during the period net of any dividends paid. As the Society is a mutual it has no equity, therefore non-controlling interests are presented within liabilities.

Details of the Society's subsidiaries are given in Note 43.

Significant accounting judgements

The Group has concluded that it continues to control LVGIG following the sale of 49% of the voting rights to Allianz, through consideration of power to influence the variable returns that the Group is exposed to. The Group has appointed five of the nine members of the LVGIG Board and holds 51% of the voting rights. Variable returns will be received in the form of dividends in proportion to shareholdings. Whilst Allianz does hold veto rights these are considered to be only protective in nature.

(ii) Associates and jointly controlled entities in property holding companies

Joint ventures are arrangements where the Group has joint control and rights to the net assets of the entity. The Group does not currently have any associates, which are all entities over which the Group has significant influence but not control, generally accompanying a shareholding of more than 20% and less than 50% of the voting rights.

For each investment in an associate or jointly controlled entity the Group determines whether to apply the equity method or to designate the investment at fair value through profit or loss in accordance with the exemption permitted under IAS 28 applicable to investment-linked insurance funds. The Group currently has a joint venture in an investment property holding company. Due to the nature of this joint venture the Group has taken the exemption to designate this investment at fair value through profit or loss within UK unlisted investments.

b) Disposal groups held for sale and discontinued operations

Disposal groups are classified as held for sale in accordance with IFRS 5 if their carrying amount will be recovered principally through a sale transaction rather than through continuing use and a sale is considered highly probable. A discontinued operation is a component of the business that has been disposed of or is classified as held for sale and that represents a separate major line of business, or is part of a single co-ordinated plan to dispose of such a line of business.

Assets within a disposal group that is classified as held for sale are measured at the lower of their carrying amount and fair value less costs to sell, except for assets such as deferred tax assets, assets arising from employee benefits, financial assets and investment property that are carried at fair value and contractual rights under insurance contracts, which are specifically exempt from this requirement. The overall disposal group is measured at the lower of carrying value and fair value less costs to sell.

The assets and liabilities of a disposal group classified as held for sale are presented separately from the other assets and liabilities in the Statement of Financial Position. Non-current assets within a disposal group are not depreciated or amortised from the point of classification as held for sale.

The results of discontinued operations are presented separately in the Statement of Comprehensive Income. It comprises the profit or loss after tax from discontinued operations together with the gain or loss after tax recognised on disposal; Other comprehensive income attributable to discontinued operations is also presented separately.

In the period in which an operation is first classified as discontinued, the Statement of Comprehensive Income and Statement of Cash Flows for the comparative prior period are re-presented to present those operations as discontinued.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

1. Significant accounting policies (continued)

Accounting policies (continued)

c) Contract classification

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

Insurance contracts are those contracts that transfer significant insurance risk. Such contracts may also transfer financial risk. As a general guideline, the Group defines as significant insurance risk the possibility of having to pay benefits on the occurrence of an insured event that are at least 10% more than the benefits payable if the insured event did not occur. Investment contracts are those contracts that transfer financial risk with no significant insurance risk.

All With-profits contracts have been classified as participating contracts as these contracts entitle the holder to receive, as a supplement to guaranteed benefits, additional benefits or bonuses:

- that are likely to be a significant portion of the total contractual benefits;
- whose amount or timing is contractually at the discretion of the Group; and
- that are contractually based on:
  (i) the performance of a specified pool of contracts or a specified type of contract;
  (ii) realised and/or unrealised investment returns on a specified pool of assets held by the fund; or
  (iii) the unallocated surplus of the fund that issues the contract.

Product classification

Business unit	Product classification			
	Insurance (Participating)	Insurance (Non-participating)	Investment (Participating)	Investment (Non-participating)
Life	n/a	**All Protection products** Significant insurance risk (primarily morbidity and mortality) is transferred from the policyholder to LV= whereby the policyholder is financially compensated on occurrence of the insured event (such as injury, illness or death). Policyholders are not entitled to a share of the surplus of the funds.	n/a	n/a
Life	**Flexible Guarantee Bond (FGB)** FGB funds include a significant death benefit. Policyholders are entitled to a share of the surplus of the With-profits fund.	**Retirement non-profit funds (fixed term / enhanced annuities)** Significant insurance risk is transferred (mortality / longevity) from the policyholder to LV=. Policyholders are not entitled to a share of the surplus of the funds.	n/a	**Unit-linked pensions, including SIPP** No significant insurance risk is transferred to LV=; the customer chooses their investment(s) and is exposed to the associated financial risk with no additional participation benefits.
Life	**LVFS Heritage (including RNPFN and Teachers Assurance Funds) With-profits life and pensions policies** These policies transfer significant insurance risk (mortality / longevity) from the policyholder to LV=. Policyholders are entitled to a share of the surplus of their respective With-profits fund.	**LVFS Heritage (including RNPFN and Teachers Assurance Funds) conventional non-profit life, pensions and annuities in payment** These policies transfer significant insurance risk (mortality / longevity) from the policyholder to LV=. Policyholders are not entitled to a share of the surplus of the funds.	**LVFS Heritage (including Teachers Assurance Fund) With-profits investments** These investment products provide the policyholder with market returns. The value paid to the policyholder is not significantly impacted by whether pay-out is on surrender, maturity ordeath, therefore this is not an insurance contract. The investments entitle the policyholder to a share of the surplus of the With-profits fund.	**LVFS Heritage (including RNPFN Fund) linked life and pensions** These products do not transfer significant insurance risk from policyholder to LV=. Policyholders are not entitled to a share of the surplus of the funds.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

1. Significant accounting policies (continued)

Accounting policies (continued)

Business unit	Product classification			
	Insurance (Participating)	Insurance (Non-participating)	Investment (Participating)	Investment (Non-participating)
General Insurance	n/a	**All general insurance products** Significant insurance risk is transferred from the policyholder to LV= whereby LV= will compensate the policyholder for any loss arising from an insured event (such as motor collisions, property damage). The customer does not participate in any options or guarantees and there is no fund to share in a surplus.	n/a	n/a

d) Foreign currencies

Investment assets and liabilities denominated in foreign currencies are translated to sterling at rates of exchange ruling at the end of the year. Purchases and sales of investments denominated in foreign currencies are translated at the rates prevailing at the dates of the transactions. Exchange gains and losses are dealt with in that part of the Statement of Comprehensive Income in which the underlying transaction is reported.

e) Financial assets and liabilities

Recognition

The Group classifies its financial assets and liabilities upon initial recognition as shown below. The classification is impacted by the nature of the instrument and the purpose for which the investments were acquired:

Category	Financial Instrument	Basis of classification	Subsequent Measurement	Recognition of change in fair value
Designated fair value through profit or loss (FVTPL) on initial recognition	Debt securities, Equity securities	Where the investment return is managed on the basis of the total return on investment.	Fair value using prices at the end of the period.	Income Statement – Net investment gains/(losses).
	Loans secured on residential and commercial property		Fair value on a discounted cash flow basis, taking into account no negative equity guarantees where relevant.	
	Non-participating investment contract liabilities	Designated as fair value in order to avoid a measurement inconsistency with the associated unit-linked financial assets.	Amount equal to the fair value of the associated unit-linked financial assets.	
Fair value through profit or loss Held for trading	Derivative assets/(liabilities)	Derivatives are classified as held for trading as required by IAS 39.	Carried at fair value. Asset/(liability) classification dependant on whether fair value is positive or negative.	Income Statement – Net investment gains/(losses).
Designated Available for sale (AFS) on initial recognition	Debt Securities	Newly invested assets within a separate investment portfolio (which are not held for trading) that are designated as AFS on initial recognition.	The asset is carried at fair value. Interest on debt securities is recorded using the effective interest method.	Other Comprehensive Income – items that may be reclassified to profit or loss.
Loans and receivables	Loans, reinsurance deposits, other deposits and financial assets arising from non-investment activities	Financial assets with fixed or determinable payments not quoted in an active market.	Amortised cost using the effective interest method.	Income Statement – Net investment gains/(losses) when realised or impaired.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

1. Significant accounting policies (continued)

Accounting policies (continued)

Category	Financial Instrument	Basis of classification	Subsequent Measurement	Recognition of change in fair value
Cash and cash equivalents	Cash and cash equivalents	Consist of cash and highly liquid investments that are readily convertible into a known amount of cash.	Carrying amounts at amortised cost.	n/a
Other financial liabilities	Subordinated debt	Financial liabilities with fixed or determinable payments and maturity date.	Amortised cost using the effective interest method.	n/a

The accounting policy for each type of financial asset or liability is included within the relevant note for the category.

All financial assets classified as Available for sale are held within the LVGIG group. As such these are included in Assets held for sale disclosed within the Discontinued operations in Note 12.

Derecognition

A financial asset is derecognised when:

- the rights to receive cash flows from the asset have expired; or
- the Group has transferred its rights to receive cash flows from the asset and has:
  - transferred the risks and rewards of the asset; or
  - transferred control of the asset.

A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

f) Liability adequacy testing

Long-term insurance and participating investment contract liabilities

At each reporting date, an assessment is made of whether the recognised long-term contract liabilities are adequate, using current estimates of future cash flows. If that assessment shows that the carrying amount of the liabilities (less related assets) is insufficient in light of the estimated future cash flows, the deficiency is recognised in the Statement of Comprehensive Income by setting up an additional liability.

General insurance

At each reporting date liability adequacy tests are performed to ensure the adequacy of insurance contract liabilities, net of related deferred acquisition costs. In performing these tests, current best estimates of future contractual cash flows and claims handling and administration expenses, as well as investment income from the assets backing such liabilities, are used. Any deficiency is immediately charged to the Statement of Comprehensive Income and an unexpired risk reserve is established.

g) Impairment of non-financial assets

Assets that have an indefinite useful life, for example goodwill, are not subject to amortisation and are tested annually for impairment. Assets that are subject to amortisation or depreciation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units).

Non-financial assets, other than goodwill, that suffered impairment are reviewed for possible reversal of the impairment at each reporting date.

h) Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and in hand, and short-term deposits with an original maturity of three months or less.

For the purpose of the Statement of Cash Flows, Cash and cash equivalents are as defined above but are shown net of outstanding bank overdrafts.

i) Collateral

Collateral is received or pledged in the form of cash collateral and non-cash collateral.

Cash collateral

Cash collateral received, which is not legally segregated from the Group, is recognised as an asset with a corresponding liability for its repayment in the Statement of Financial Position.

Cash collateral pledged, which is legally segregated from the Group, is derecognised from Cash and cash equivalents and a corresponding asset for its return is recognised in the Statement of Financial Position.

Non-cash collateral

Non-cash collateral received where the counterparty is not in default, that is neither sold nor repledged, is not recognised in the Statement of Financial Position. Non-cash collateral pledged where the Group is not in default is not derecognised from the Statement of Financial Position and remains within the appropriate asset classification.

j) Mutual bonus

The Mutual bonus declared by the Society is presented on the Statement of Comprehensive Income below Profit before tax and not within the Gross change in long-term contract liabilities. This is to provide a more representative Profit before tax figure as described in the LV= use of Non-GAAP measures disclosed on page 87. The impact on Gross changes in long-term contract liabilities is disclosed separately within Note 22.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

1. Significant accounting policies (continued)

Changes and future developments in accounting policies

a) New and amended standards adopted by the Group

The following new and amended standards that have been adopted by the EU for accounting periods beginning on or after 1 January 2018 have been adopted by the Group.

(i) New standards and interpretations

IFRS 15 'Revenue from contracts with customers'

IFRS 15 replaces IAS 18 'Revenue' and applies to non-insurance revenue, providing a principles based approach for revenue recognition that is underpinned by the achievement of performance obligations. At 31 December 2018 £47m (2017: £37m) of fee and commission income from the Group's continuing business is in the scope of the standard, of which £20m (2017: £22m) relates to asset management fees. The Group's previous accounting policy under IAS 18 for fee and commission income to recognise revenue over time as the services are provided is consistent with the requirements of IFRS 15, and accordingly no adjustments or restatement of prior periods have been necessary. Unbilled receivables and Contract assets replace accrued income whilst Contract liabilities replace deferred income; these are recognised when payments are received in phasing consistent with the pattern of revenue recognition. Disclosure of revenue from contracts with customers is included in Note 8.

IFRIC 22 'Foreign currency transactions and advance consideration'

IFRIC 22 clarifies that advanced payments for goods or services should be recognised using the spot rate on the date of the advanced payment / receipt and not retranslated at the date that the associated IFRS balance is recognised. This is consistent with how such transactions are accounted for by the Group, therefore this amendment does not impact the Group's financial statements.

(ii) Amendments to standards

IAS 28 'Investments in associates and joint ventures'

IAS 28 has been amended to clarify that the option to account for investments in associates at fair value through profit or loss where these investments are held by mutual funds, such as the Society, can be made separately for each investment, upon acquisition of each investment. Currently the Group has one such investment, and this is accounted for at fair value through profit or loss. As part of the general insurance transaction with Allianz, the group has a forward contract to sell a further 20.9% equity stake in LVGIG to Allianz by 31 December 2019, resulting in a remaining minority interest held by the Group. This amendment to IAS 28 clarifies that the Group will have the choice of whether to account for any retained investment in an associate using the equity method, or at fair value through profit or loss.

IAS 40 'Investment property'

IAS 40 has been amended to clarify the circumstances under which a property is deemed to have transferred between classification as Investment property in accordance with IAS 40, as owner occupied in accordance with IAS 16 'Property, plant and equipment' or inventory in accordance with IAS 2 'Inventories'. The only investment property held by the Group has been disposed of during 2018; therefore this amendment has no impact.

IFRS 12 'Disclosure of interests in other entities'

The IASB effective date for the amendment to IFRS 12 'Disclosure of Interests in Other Entities' was 1 January 2017 however it was adopted by the EU on 7 February 2018 and has therefore been adopted by the Group in 2018. IFRS 12 has been amended to clarify that even though entities are not required to present summarised financial information for investments that are classified as held for sale in accordance with IFRS 5, entities are still required to present all other information required by IFRS 12 for such investments. This amendment is relevant for the disclosures of the Group's investment in the general insurance subsidiaries which are presented as held for sale; therefore the Group will continue to disclose all other information required by IFRS 12 for the LVGIG group of businesses.

Amendment to IFRS 4 'Insurance contracts': Applying IFRS 9 'Financial instruments' with IFRS 4 'Insurance contracts'.

The amendment provides two approaches that can be applied by eligible insurers to address concerns arising from the different effective dates of IFRS 9 and IFRS 17 'Insurance Contracts'; the overlay approach and the temporary exemption from IFRS 9 until adoption of IFRS 17. The Group and the Society are eligible insurers and have taken the temporary exemption from IFRS 9.

As an insurer that has elected to apply the temporary exemption from IFRS 9, information is disclosed below regarding compliance with the criteria to apply the temporary exemption; and categories of financial asset to facilitate comparability with entities applying IFRS 9.

Compliance with the criteria for the temporary exemption from IFRS 9

The IFRS 4 amendment adopted in the reporting period permits insurance entities which meet the predominance ratio test to have a temporary exemption from IFRS 9 where this standard has not yet been adopted. The predominance ratio test is required to be performed at the reporting entity level, using the annual reporting date that immediately precedes 1 April 2016 (i.e. 31 December 2015).

The predominance ratio test of an entity's insurance liabilities against its total liabilities includes two tests:

1) The carrying amount of its liabilities arising from contracts within IFRS 4's scope must be significant compared to the total carrying amount of all of its liabilities; and
2) The carrying amount of the insurer's liabilities connected with insurance compared with the total carrying amount of all of its liabilities must be above a threshold. Liabilities connected with insurance include IFRS 4 liabilities, Investment contract liabilities measured at fair value through profit or loss (FVTPL) applying IAS 39 and other liabilities that are connected to these insurance and investment contracts.

The threshold for liabilities connected with insurance compared with total liabilities is:

- Greater than 90%, or
- Greater than 80% but less than or equal to 90% and the entity provides evidence that it does not have a significant activity that is unrelated to insurance.

The Group and the Society meet the criteria to apply the temporary exemption from IFRS 9 as the predominance ratio test is passed based on the 31 December 2015 financial statements.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

1. Significant accounting policies (continued)

Changes and future developments in accounting policies (continued)

The carrying value of liabilities within IFRS 4's scope at 31 December 2015 was significant at 80% (Society 77%) of total liabilities[1]. The 90% threshold for liabilities connected with insurance is passed by both the Group (93%) and the Society (93%) once non-participating investment contract liabilities are included as liabilities connected with insurance. As at 31 December 2018 the Group and the Society continue to meet the predominance ratio threshold. No subsequent reassessment of the predominance ratio test is required; however the liabilities within IFRS 4's scope and those connected with insurance at 31 December 2018 continue to exceed 90% of total liabilities.

Categories of financial assets

Separate disclosure is required of financial assets with contractual terms that give rise on specified dates to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding and not categorised as fair value through profit or loss (FVTPL) due to either being managed on a fair value basis or held for trading. Loans and receivables and Insurance receivables held by the Group and Society require separate disclosure within this category.

1 Total liabilities are liabilities per the Statement of Financial Position adjusted to exclude balances that would be categorised as equity in companies. This includes non-controlling interest.

The fair value at 31 December 2018 and the amount of change in the fair value during the reporting period of the Group and Society's financial assets are as follows:

Financial assets (associated with continuing operations)	Group: Fair value at 31 December 2018 £m	Group: Movement in fair value recognised in the Statement of Comprehensive Income £m	Society: Fair value at 31 December 2018 £m	Society: Movement in fair value recognised in the Statement of Comprehensive Income £m
1) Financial assets that meet the SPPI criteria and not classified as FVTPL				
Loans and other receivables	407	–	84	–
Short-term insurance receivables[2]	35	–	34	–
	442	**–**	**118**	**–**
2) All other financial assets				
Insurance receivables relating to OB pensions annuities held at FVTPL[2]	6	–	6	–
Financial assets at fair value through profit or loss	11,538	(600)	11,334	(600)
Derivative financial instruments – assets	65	(5)	65	(5)
Derivative financial instruments – liabilities	(190)		(190)	
	11,419	**(605)**	**11,215**	**(605)**

The following table represents the Group and Society's exposure to credit risk on financial assets that meet the SPPI criteria:

Financial assets (associated with continuing operations)	AA £m	A £m	Not rated £m	Past due but not impaired £m
Group				
Loans and other receivables	–	350	57	–
Short-term insurance receivables[2]	22	–	10	3
	22	**350**	**67**	**3**
Society				
Loans and other receivables	–	–	84	–
Short-term insurance receivables[2]	21	–	10	3
	21	**–**	**94**	**3**

2 The carrying amount of the financial asset measured applying IAS 39 is deemed to be a reasonable approximation of its fair value.

Note: In the case of financial assets held at amortised cost, the amounts disclosed are the carrying amounts applying IAS 39, before adjusting for any impairment allowances. The table above includes £70m (Society £97m) of short-term receivables that are not rated. The fair value of these financial assets at 31 December 2018 is equal to their carrying value.

In addition, within the discontinued operations that are classified in the Statement of Financial Position as Held for sale there are investment financial assets with a fair value of £1,095m (movement in fair value of £895m including fair value revaluations of £(12)m during the reporting period) that meet the definition for separate disclosure in category 1. Discontinued operations also hold short-term receivables of £294m. The investment assets are all deemed low credit risk with credit ratings above investment grade as follows: AAA: £296m, AA: £202m, A: £347m, BBB: £250m. In addition short-term receivables of £294m comprise £39m at AA credit rating and £255m that are not rated. The fair value of these financial assets at 31 December 2018 is equal to their carrying value.

The financial assets associated with discontinued operations that are held at FVTPL have a fair value of £754m (movement in fair value of £(701)m including fair value revaluations of £(24)m during the reporting period). The non-insurance subsidiaries within the Group have adopted IFRS 9 within their individual financial statements from 1 January 2018. Relevant consolidation adjustments have been made in the Group financial statements to ensure uniform accounting policies are applied within financial statements of the Group. IFRS 9 information can be obtained from the individual financial statements available on Companies House for the non-insurance subsidiaries listed in Note 43.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

1. Significant accounting policies (continued)

Changes and future developments in accounting policies (continued)

b) New standards and interpretations not yet adopted

A number of new standards and amendments to standards and interpretations are effective for annual periods beginning after 1 January 2019, and have not been applied in preparing these consolidated financial statements.

IFRS 16 'Leases'

Issued in January 2016, IFRS 16 replaces existing leases guidance, including IAS 17 'Leases', IFRIC 4 'Determining whether an Arrangement contains a Lease', SIC-15 'Operating Leases – Incentives' and SIC-27 'Evaluating the Substance of Transactions Involving the Legal Form of a Lease'.

Nature of change

IFRS 16 will result in almost all leases being recognised on the Statement of Financial Position by lessees, as the distinction between operating and finance leases is removed. Under the new standard, an asset (the right to use the leased item) and a financial liability to pay rentals are recognised. The only exceptions are short-term and low-value leases.

Lessees will also be required to remeasure the lease liability upon the occurrence of certain events (e.g. a change in the lease term, a change in future lease payments resulting from a change in an index or rate used to determine those payments). The lessee will generally recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset.

Previously, the Group recognised operating lease expense on a straight-line basis over the term of the lease, and recognised assets and liabilities only to the extent that there was a timing difference between actual lease payments and the expense recognised. The nature of expenses related to those leases will now change because the Group will recognise a depreciation charge for right-of-use assets and interest expense on lease liabilities.

There will not be a significant impact for leases previously recognised as finance leases.

Transition

The Group plans to apply IFRS 16 initially on 1 January 2019, using the modified retrospective approach. Therefore, the cumulative effect of adopting IFRS 16 will be recognised as an adjustment to the opening balance of retained earnings at 1 January 2019, with no restatement of comparative information. Furthermore for the lease that the Group classified as a finance lease under IAS 17, the carrying amount of the right-of-use asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying IAS 17.

The Group will elect to use the exemptions for lessees proposed by the standard on lease contracts for which the lease terms ends within 12 months as of the date of initial application, and lease contracts for which the underlying asset is of low value.

The Group intends to apply the practical expedient for lessees to rely on its assessment of whether leases are onerous applying IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' as at 31 December 2018 as an alternative to performing an impairment review. As a result the right-of-use asset recognised on 1 January 2019 is adjusted by the amount of any provision for onerous leases recognised in the Statement of Financial Position at 31 December 2018.

The Group plans to apply the practical expedient to grandfather the definition of a lease on transition. This means that it will apply IFRS 16 to all contracts entered into before 1 January 2019 and identified as leases in accordance with IAS 17 and IFRIC 4.

Impact on the Group's continuing business

As at the reporting date, the Group has non-cancellable operating lease commitments of £7m, see Note 42. Of these commitments, approximately £1m relate to leases which are short-term or of low value assets which will be recognised on a straight-line basis as an expense in profit or loss. For the remaining lease commitments the Group expects to recognise right-of-use assets of approximately £7m on 1 January 2019, and lease liabilities of £6m. The Group holds a lease classified as a finance lease under IAS 17 with an asset of £17m and a finance lease liability of £19m at 31 December 2018; these balances will become the value of the right-of-use asset and lease liability on transition to IFRS 16.

The actual impacts of adopting the standard on 1 January 2019 may change because the new accounting policies are subject to change until the Group presents its first financial statements following the date of initial application.

IFRS 17 'Insurance contracts'

Issued in May 2017, IFRS 17 replaces IFRS 4 'Insurance contracts'. The original effective date of IFRS 17 was 1 January 2021; however the IASB has proposed a one-year deferral subject to public consultation ahead of formal approval. This standard provides an accounting model for insurance contracts that is more useful and consistent for insurers. In contrast to the requirements in IFRS 4, which are largely based on grandfathering previous local accounting policies, IFRS 17 provides a comprehensive model for insurance contracts, covering all relevant accounting aspects. The core of IFRS 17 is the general model, supplemented by:

- A specific adaptation for contracts with direct participation features (the variable fee approach); and
- A simplified approach (the premium allocation approach) mainly for short-duration contracts.

The standard will have a material impact on the Group and Society and transitioning the Group and Society's accounting to the new standard will require significant effort.

IFRS 9 'Financial instruments'

IFRS 9 addresses the classification, measurement and recognition of financial assets and financial liabilities and replaces IAS 39. The effective date was 1 January 2018, however as noted on page 106, IFRS 9 has been deferred by the Group and Society in order to align adoption with that of IFRS 17. In line with the proposed deferral of the IFRS 17 effective date noted above, the IASB has also proposed that the temporary exemption from IFRS 9 for qualifying insurers be extended until 1 January 2022.

There are no other new or amended standards yet to be adopted by the Group that are expected to have a significant effect on the consolidated financial statements of the Group.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Segmental information

This section details the disclosures required under IFRS 8 Operating segments.

These segmental disclosures are based on operating segments that reflect the level within the Group at which key strategic and resource allocation decisions are made and the way in which operating performance is reported internally to the Group board of directors.

During the year regular reporting to the Group board of directors has changed to focus primarily on Solvency II capital metrics and this is reflected in the change in Key Performance Indicators on page 11. IFRS information reported to the board is now limited to IFRS based Operating profit, with reconciliation to the Statement of Comprehensive Income. The board now manages all Continuing operations as one business 'Life and Group'. Therefore segment reporting is disclosed for the two segments of 'Life and Group' and the discontinued general insurance business 'General insurance'.

Comparative segmental information has been restated to reflect this change.

2. Segmental information

Accounting for operating profit

Operating profit is a non-GAAP measure and is calculated as IFRS profit before tax, mutual bonus and UDS transfer adjusted for the following items:

- Central items including the impact of strategic transactions.
- Short-term investment fluctuations.
- Finance costs.

The activities of each operating segment are described below:

Life and Group

The principal activity of the Life and Group operating segment is the provision of Protection and Retirement Solutions products and managing the Heritage products and the Estate fund. The core products offered in Protection are Life, Critical Illness and Income Protection Insurance. The core products offered in Retirement Solutions are Fixed-Term Annuities, Self-Invested Personal Pensions (SIPPs), Equity Release Mortgages and Flexible Guarantee Bonds. Heritage products include legacy With-profits business (both Ordinary Branch and Industrial Branch), the ring-fenced RNPFN Fund, containing the business acquired from the Royal National Pension Fund for Nurses in 2001, and the ring-fenced TA Fund, containing the With-profits business acquired from Teachers Provident Society Limited in 2016. The Heritage products are no longer actively marketed, although the Society continues to sell newer With-profits products via the Life business channels.

General insurance – Discontinued operation

The principal activity is to underwrite general insurance business through both direct and broker distribution channels. The primary sources of premium income are from the sale of Motor and Home products. For 2018 reporting the general insurance segment results are disclosed as a discontinued operation within the analysis of segment Operating profit.

Transactions between reportable segments are on normal commercial terms, and are included within the reported segments.

The profit measure used by the Group board of directors to monitor performance is Operating profit. Operating profit by segment is shown in the table below, together with a reconciliation of operating profit to the IFRS profit/(loss) before tax.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

2. Segmental information (continued)

a) Segment profit

	2018 £m	2017 £m
Life	**60**	60
General insurance	**107**	120
Group items and strategic investment	**(31)**	(46)
Operating profit	**136**	134
Short-term investment fluctuations and related items	**(66)**	30
Finance costs	**(24)**	(24)
Central items	**(26)**	(18)
Profit before tax from continuing and discontinued operations	**20**	122
Less: Discontinued operations	**(110)**	(164)
Loss before tax from continuing operations	**(90)**	(42)

b) Major customers

The directors consider the Group's external customers to be individual policyholders. As such, the Group is not reliant on any individual customer.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Capital and risk management

This section details the capital and risk management approach of the Society and Group. The Group seeks to create value for its members by investing in the development of the business while maintaining an appropriate level of capital available. The risk appetite for each type of principal risk is set based on the amount necessary to meet the PRA's capital requirements.

3. Capital management

Policies and objectives

Capital is managed on both economic and regulatory bases to ensure the Group has sufficient funds to meet its business objectives, the promises made to members and policyholders and regulatory requirements.

The Group's key capital management objectives are:

(i) To ensure the Group's financial strength and to support the risks it takes on as part of its business;

(ii) To give confidence to policyholders and other stakeholders who have relationships with the Group;

(iii) To comply with capital requirements imposed by its UK regulator, the PRA, in association with the European Insurance and Occupational Pensions Authority (EIOPA) and Solvency II legislation; and

(iv) To ensure the Group's strategy can be implemented and is sustainable.

These objectives are reviewed at least annually and benchmarks are set by which to judge the adequacy of the Group's capital. The capital position is monitored against those benchmarks to ensure that sufficient capital is available to the Group.

The Group complied with all regulatory capital requirements that it was subject to throughout the reporting period.

Capital Management

Capital is monitored and managed at a Group and entity level. The Group manages capital resources under Solvency II at the level of Eligible own funds. Excluding RNPFN and Teachers ring-fenced funds, Eligible own funds were £1,637m for the Group (2017: £1,567m) and £1,457m for the Society (2017: £1,418m). Including RNPFN and Teachers ring-fenced funds, Eligible own funds were £1,732m for the Group (2017: £1,677m) and £1,552m for the Society (2017: £1,528m). The inclusion of the ring-fenced funds does not change the Group capital surplus. The large divergence between Group and Society Eligible own funds over the year is caused by the reporting treatment of the majority holding of the general insurance subsidiaries and corresponds to the Group solvency capital requirement reflecting the entire general insurance subsidiaries and not just the 51% holding.

The Group seeks to deploy capital where it believes the risk is properly rewarded. Asset and liability matching is extensively used and risks are hedged where the Group believes it would otherwise receive insufficient return for the risk taken or to reduce volatility.

The Group Solvency II results are not due to be submitted to the PRA until after the release of the Annual Report. As a result, the Eligible own funds figures disclosed above are based on the best estimate of the results at the Annual Report signing date and may differ to the results published as part of the annual Solvency Financial Condition Report.

Risk appetite

The Group has embedded its approach to risk management through its risk appetite. The risk appetite for capital management is that sufficient solvency capital is held to ensure that the Group can continue to trade following a severe adverse movement in markets or other risks. As at 31 December 2018, the capital risk appetite was set to target a Capital Coverage Ratio of 140%. See further details on risk management on pages 34 to 39.

Measurement and monitoring of capital

The capital position of the Group is monitored on a regular basis and reviewed formally on a monthly basis by the Group Asset and Liability Committee (ALCO). These objectives are reviewed and benchmarks are set by which to judge the adequacy of the Group's capital and ensure that sufficient capital is available.

The Group's capital requirements are forecast on a regular basis and compared against the available capital and the Group's minimum internal rate of return. The internal rate of return forecast to be achieved on potential investments is also measured against minimum required benchmarks taking into account the risks associated with the investment.

Methodology

Eligible own funds comprise the excess of the value of assets over the liabilities, as valued on a Solvency II basis. Subordinated debt issued by the Group is considered to be part of Eligible own funds, rather than a liability, as it is subordinate to policyholder claims.

Assets are valued at IFRS fair value with adjustments to remove intangibles and deferred acquisition costs, and to value reassurers' share of technical provisions consistent with the Solvency II regulations.

Liabilities are valued on a best estimate market consistent basis, with the application of a Matching Adjustment, for valuing qualifying annuity liabilities, and a Volatility Adjustment for other qualifying business. Transitional measure on technical provisions (TMTP) is recognised on the balance sheet and has been calculated on a basis approved by the Audit Committee which seeks to capture the differences between the total Financial Resources Requirement under the previous Solvency I regime and the new Solvency II regime.

The liabilities include the Risk Margin which represents an allowance for the cost of capital for a purchasing insurer taking on the portfolio of liabilities and residual risks that are deemed to be not hedgeable under Solvency II. This is calculated using a cost of capital of 6% as prescribed by EIOPA, and represents the cost to the purchaser of raising capital to meet the regulatory capital requirements.

The Solvency Capital Requirement (SCR) is the amount of capital required to cover the 1-in-200 worst projected future outcome in the year following the valuation, allowing for realistic management and policyholder actions and the impact of the stress on the tax position of the Group. This allows for diversification between the different businesses within the Group and between the risks to which they are exposed.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

3. Capital management (continued)

All non-insurance regulated businesses are included using their current regulatory surplus.

Allowance is made within the Solvency II Balance Sheet for the Group's defined benefit pension scheme using results on an IFRS basis.

Assumptions

The calculation of the Solvency II balance sheet and associated capital requirements requires a number of assumptions, including:

(i) assumptions required to derive the present value of best estimate liability cash flows. Non-market assumptions are broadly the same as those used to derive the Group's IFRS disclosures. Future investment returns and discount rates are those defined by EIOPA, which means that the risk free rates used to discount liabilities are market swap rates, with a 10 basis point deduction to allow for credit risk. For eligible annuity business, the liability discount rate includes a Matching Adjustment. For other eligible business, the liability discount rate includes a Volatility Adjustment;

(ii) assumptions regarding management actions. The only management actions allowed for are those that have been approved by the Board and are in place at the balance sheet date.

Use of and limitations of sensitivity analysis

Sensitivity analysis is used to determine the effect of a change in a key assumption while other assumptions remain unchanged. In reality, there is a correlation between the assumptions and other factors. It should also be noted that these sensitivities are non-linear, and larger or smaller impacts should not be interpolated or extrapolated from these results.

The sensitivity analysis does not take into consideration that the Group's assets and liabilities are actively managed. Additionally, the Solvency II position of the Group may vary at the time that any actual market movement occurs. For example, the Group's financial risk management strategy aims to manage the exposure to market fluctuations.

As investment markets move past various trigger levels, management actions could include selling investments, changing investment portfolio allocation, adjusting bonuses credited to policyholders, and taking other protective action.

Other limitations of sensitivity analysis include the use of hypothetical market movements to demonstrate potential risk that only represent the Group's view of possible near-term market changes that cannot be predicted with any certainty, and the assumption that all interest rates move in an identical fashion.

Stress and scenario testing

Due to the limitations of sensitivity analysis in isolation, the Group undertakes a series of stress and scenario tests to ensure the robustness of its solvency position in regard to different levels of new business growth, movements in investment markets and changes in other assumptions such as the expected lifetime of our enhanced annuity customers.

In looking at movements in investment markets the Group considers a number of single stresses (e.g. a significant fall in equities) but more importantly because investment markets are highly correlated consideration is given to how they will move together in stressed conditions. The Group uses the outcomes of the stress and scenario testing to develop the management actions that would be undertaken if capital or other performance measures move outside of the defined risk appetite.

In order to plan for the future operations of the Group, forecast plans are produced including stress and scenario testing to provide the board with assurance that the Group will be able to withstand adverse events if they arise.

Reconciliation of Group IFRS UDS to Solvency II Eligible own funds

The table below gives a reconciliation of Group IFRS Unallocated divisible surplus to the Group's Eligible own funds on a Solvency II basis.

The Group Solvency II results are not due to be submitted to the PRA until after the release of the Annual Report. As a result, the Group Solvency II results disclosed below are based on the best estimate of the results at the Annual Report signing date and may differ to the results published as part of the annual Solvency Financial Condition Report.

	2018 £m	2017 £m
IFRS Unallocated divisible surplus	**1,127**	1,189
Remove DAC, goodwill and other intangible assets and liabilities	**(405)**	(410)
Add subordinated debt treated as available capital	**372**	379
Insurance contract valuation differences	**356**	305
Difference in non-controlling interest calculation methods	**308**	279
Deferred tax adjustments	**25**	11
Other	**13**	6
Less net eligible own funds relating to ring-fenced funds	**(159)**	(192)
Eligible own funds (excluding ring-fenced funds)	**1,637**	1,567
RNPFN – eligible own funds	**112**	125
Restriction of own funds in respect of RNPFN	**(37)**	(34)
Teachers – eligible own funds	**47**	67
Restriction of own funds in respect of Teachers	**(27)**	(48)
Group Eligible own funds as submitted to the PRA	**1,732**	1,677

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control

The Group's primary business activities include the provision of insurance, investment and retirement products to UK-based customers. In providing these products the Group accepts and needs to manage risk. A description of these risks and how they relate to the Group's products is outlined below and the Group's approach to managing and controlling these risks through its governance and risk management framework is set out on pages 34 to 39.

As part of its risk management programme, the Group records its current and projected risk position across a defined set of risk categories. In addition a measure of the sensitivity on Profit before tax and Unallocated divisible surplus under both deterministic and stochastic scenarios is performed.

Management uses the insight gained through these sensitivities to help manage the Group's risk exposure and sustainability. The models, scenarios and assumptions used are reviewed regularly and updated as necessary including any interdependencies between risk types. This section includes the impact on the three measures of a sensitivity test that calibrates to a reasonably possible change in a single risk type.

Principal risks and categories

The Risk Management section of the Strategic Report on pages 34 to 39 sets out the principal risks and uncertainties that the Group faces. In addition, the Group uses a standard categorisation to group together similar risks. All such risks are subject to the same risk management and control framework. However, they impact the business and its financial performance in different ways. The following sections provide more detail on these main categories of risks and how they impact the Group.

a) Insurance risk

Insurance risk arises both from the claims commitment that the Group has made to its policyholders and the pricing assumptions made in respect of the policy of insurance. As such, this covers the following risks:

- The timing and the amount of the claim is uncertain and hence there is a risk that the exposure to loss arising from this claims experience is different to that anticipated.
- The product is priced assuming certain assumptions covering how long the policy will be maintained by the customer (persistency risk) and the cost of administering the product over its life cycle (expense risk). There is a risk that across the Group's insurance portfolio the actual experience is different to that assumed when the product is priced. This is more likely the longer the term of the product and therefore is usually only a significant factor in life insurance products.

Insurance concentration risk

The Group is not exposed to significant concentrations of insurance risk. Experience shows that the larger the portfolio of similar independent insurance contracts, the smaller the relative variability about the expected outcome will be. In addition, a more diversified portfolio is less likely to be affected by a change in any subset of the portfolio. The Group has developed its insurance underwriting strategies to diversify the type of insurance risks accepted and within each of these categories to achieve a sufficiently large population of risks to reduce the variability of the expected outcome. The Group writes a diverse mix of insurance business across a wide group of people and businesses. However, as the Group has substantially written all of its business in the UK, results are sensitive to demographic and economic changes arising in the UK.

The Group minimises the level of insurance concentration through the use of portfolio analysis and reinsurance.

The Group assesses its insurance risk in two broad categories: life insurance risk and general insurance risk and the specific components of each of these are further outlined below:

(i) Life insurance

The Group's life insurance activities primarily involve the provision of protection, retirement and savings products. These products are long term in nature and provide key benefits to the policyholder and their dependants.

A number of key assumptions are made when determining the future claims liability that will arise from these policyholder commitments. These are based on prior experience and latest forecasts in trends and patterns and include the future life expectancy and health of policyholders, the extent to which contracts will be terminated early, how much insurance contract administration costs will increase, growth in the value of investments, interest rates and tax rates.

Details of life insurance contract liabilities and associated valuation assumptions are disclosed in Notes 20 and 25 respectively.

Differences in actual experience versus the original key assumptions will give rise to liabilities that differ from those originally anticipated. In addition the assumptions made regarding the length of time the policy stays in force and the cost of administering the policy may vary from original assumptions. Wherever these outcomes vary from the original or most recent estimates they may give rise to a change in life insurance risk exposure, the primary life insurance risks prevalent within the Group's products are described below:

Mortality, longevity and morbidity

Life protection and annuity business is exposed to changes in life expectancy (mortality – reduced life expectancy, longevity – increased life expectancy) and health expectancy (morbidity) experience.

Protection product liabilities are exposed to mortality and morbidity risks whereby higher mortality rates and adverse morbidity will lead to increases in contract liabilities. Annuity product liabilities are exposed to longevity risk whereby contract liabilities will increase with life expectancy.

Mortality, longevity and morbidity risk is managed in the Group through the assessment of the risk associated with individual policyholders against a set of acceptance (underwriting) criteria, which may include an individual's medical history, occupation, smoking and drinking habits (i.e. indicators of life expectancy). The actual experience of policyholders is then regularly monitored to assess that the underwriting criteria remain appropriate and that the level of risk being assumed by the Group remains within its risk appetite.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Persistency

In pricing life insurance business, the Group makes assumptions as to how long the policyholder is likely to retain the product. Persistency risk arises from the actual experience being different to the assumptions. The level of persistency influences the ability to recover initial costs of sale from the premiums and charges that relate to the product. The Group is exposed to persistency risk whereby the profitability is adversely impacted by changes in the length of time that policies remain in force.

For certain Heritage products the level of persistency influences the estimated cost of guarantees and options. The risk for these products is that a larger proportion of the portfolio remains in-force to take advantage of these guarantees and options.

Persistency risk is managed in the Group through the assessment of the risk associated with different products against the assumptions used when pricing and subsequently valuing the insurance obligations. The actual lapse experience segmented into appropriate product groups is regularly monitored to assess whether the pricing and valuation assumptions remain appropriate and that the level of risk being assumed by the Group remains within its risk appetite.

Cash take-up

In pricing life insurance business, the Group makes assumptions as to how many policyholders are likely to take the lump sum cash option at retirement. Cash take-up risk arises from the actual experience being different to the assumptions. The level of cash take-up influences the future cost of the product, as the cost of paying a guaranteed annuity income for life is more onerous than the lump sum cash at retirement option.

Cash take-up risk is managed in the Group through the assessment of the risk associated with different products against the assumptions used when pricing and subsequently valuing the insurance obligations. The actual cash take-up experience, segmented into appropriate product groups, is regularly monitored to assess whether the pricing and valuation assumptions remain appropriate and that the level of risk being assumed by the Group remains within its risk appetite.

Expense

In pricing life insurance business, assumptions are made as to how long the Group will need to continue to service and maintain the product and communicate with the policyholder. The Group is exposed to the risk that the charges it deducts from policyholder benefits are not sufficient to cover the full extent of these expenses. In addition, the Group makes an assumption as to how much this service and maintenance will cost each year. Expense risk is the exposure from these assumptions on cost and duration varying from the assumed levels, with higher than expected expenses reducing profits.

The Group manages this risk through an ongoing assessment of the factors that will generate additional expenses in the product servicing costs and the average duration of life insurance products.

Reinsurance

In order to mitigate the mortality, longevity and morbidity risk within the Group's life insurance book described earlier, a proportion of mortality, longevity and morbidity risk is transferred via reinsuring policy commitments through agreements with reinsurance companies.

In December 2017, the Group reinsured a large portfolio of heritage deferred and immediate With-profits annuity policies (OB Pensions), with RGA, a leading global life reinsurer. The agreement covers specified levels of benefits, thereby significantly reducing the level of market and longevity risk associated with the portfolio, and was executed at a price that was lower than the best estimate value of the liabilities. The Group retains certain risks associated with the portfolio, primarily those related to expenses, discretionary benefits and policyholder optionality.

Life insurance concentration

The Group's exposure to life insurance risk is captured in the long-term insurance and investment contract liabilities set out below. The products listed below cover the Group's protection, annuity and pensions products and also the investment exposure arising from the Group's savings and investment products. The Society's exposure to life insurance risk is consistent with that of the Group.

	2018			2017		
Group	**Gross £m**	**Reinsurance £m**	**Net £m**	Gross £m	Reinsurance £m	Net £m
Whole life	**3,262**	**(44)**	**3,218**	3,242	(41)	3,201
Endowment	**345**	**–**	**345**	418	–	418
Term Assurance	**394**	**(438)**	**(44)**	316	(339)	(23)
Immediate and deferred annuity contracts	**4,305**	**(940)**	**3,365**	4,586	(1,004)	3,582
UWP pensions and protected retirement plans	**1,370**	**–**	**1,370**	1,388	–	1,388
Critical illness	**107**	**(92)**	**15**	98	(86)	12
Income protection	**197**	**(224)**	**(27)**	265	(277)	(12)
ISA	**95**	**–**	**95**	100	–	100
Other	**172**	**–**	**172**	212	–	212
	10,247	**(1,738)**	**8,509**	10,625	(1,747)	8,878
Long-term claims liabilities	**58**	**–**	**58**	50	–	50
Unit linked	**3,017**	**–**	**3,017**	3,071	–	3,071
	13,322	**(1,738)**	**11,584**	13,746	(1,747)	11,999

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Life insurance risk sensitivities

The table below sets out the impact on the Unallocated divisible surplus and Profit before tax for movements in key assumptions. The Society's exposure to life insurance risk is materially consistent with that of the Group.

Sensitivity analysis for the change in assumptions used in long-term insurance and investment contract liabilities	Impact on Profit before tax, mutual bonus and UDS transfer £m	Impact on the Unallocated divisible surplus £m
Increase in mortality rates by 10% – Non annuity products	**(8)**	**(8)**
Decrease in mortality rates by 10% – Annuity products	**(25)**	**(25)**
Increase in morbidity rates by 10%	**(25)**	**(25)**
Increase in persistency by 25%	**8**	**8**
Decrease in OB pensions cash take-up rates by 50%	**(70)**	**(70)**
Increase in expenses by 10%	**(46)**	**(46)**

The impact of an adverse or favourable movement in the assumptions is largely symmetric. The persistency sensitivity is performed as stresses to the persistency assumptions proportionally for all products and therefore implicitly allows for offsets between products exposed to different directional sensitivities.

(ii) General insurance

For 2018 reporting the General insurance business has been classified as a discontinued operation and the related assets and liabilities have been separately categorised on the Statement of Financial Position as "Assets held for sale" and "Liabilities directly associated with assets held for sale". For further details see Note 12.

The Group's insurance activities are primarily concerned with the pricing, acceptance and management of risks from its policyholders. In accepting risks the Group commits to paying claims and therefore these risks must be understood. The Group manages these risks through its underwriting strategy, reinsurance arrangements and proactive claims handling.

For a portfolio of insurance contracts where the theory of probability is applied to pricing and provisioning, the main risk that the Group faces under its insurance contracts is the risk that actual claims exceed the carrying value of the Group's claims reserves. The risk arises from the inherent uncertainties as to the occurrence, amount and timing of insurance claims. For general insurance contracts this is primarily represented by exposure to risks which may lead to significant claims in terms of frequency or value. These would include major weather events, subsidence and large single claims arising from either the motor business (injury claims) or Small and Medium Size Enterprise ('SME') business (liability and/or property claims). There is also a risk that the prices charged for unexpired risks to which the Group is contractually committed may prove to be insufficient to absorb the cost of the claims which they will generate and any related deferred acquisition cost. Procedures are in place to measure, monitor and control exposure to all these risks.

Reinsurance

Motor business is exposed to the risk of large bodily injury claims, where the claim amounts can be significant due to the cost of care required for the claimant. The Group has excess of loss reinsurance contracts which reduce its exposure to large claims. The Group's retention is £5m per claim (2017: £5m per claim).

Property business (domestic and commercial) is exposed to catastrophic risks such as those resulting from storms or floods as well as risks such as subsidence. The Group has reinsurance contracts which provide protection against catastrophic weather events.

SME business, which has now ceased to be sold, is exposed to large individual property losses and also to liabilities arising from employment and commercial activities. The Group has reinsurance contracts which provide protection against these liabilities.

In addition to the reinsurance contracts described above, the Group also has entered into a Loss Portfolio Transfer Agreement resulting in reinsurance of 20% of its booked general insurance reserves as at 31 December 2015. The Group has also historically entered into a 20% Quota Share reinsurance arrangement for 2016 to 2018 (each year treated separately). Similarly, an additional 20% Quota Share arrangement has been entered into for 2019. Whilst the primary driver of these transactions was efficient capital management, the contracts also have the effect of reducing the Group's exposure to general insurance concentration risk.

General insurance concentration

The table below sets out the Group's concentration of general insurance contract liabilities by type of contract:

	2018			2017		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Motor	**1,204**	**(388)**	**816**	1,349	(439)	910
Commercial	**245**	**(66)**	**179**	230	(70)	160
Household	**74**	**(20)**	**54**	54	(24)	30
Other	**5**	**(1)**	**4**	10	(10)	–
	1,528	**(475)**	**1,053**	1,643	(543)	1,100

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Claims development

The claims provision is the estimated cost of outstanding claims from expired risks. The provision is calculated largely from using the Group's historic claims development data.
How much the past claim development will reflect future claims development will be impacted by the following factors:

- Changes in actuarial processes and methodology.
- Changes in risk profile.
- Changes in underwriting, rating and policy conditions.
- Changes in legislation and regulation e.g. PPOs, Ministry of Justice reforms, changes to the Ogden discount rate, etc.
- Changes to internal operational processes.
- Changes in other external factors e.g. 'claims farming'/ accident management firms.

It is therefore important that the impact of these items on claims development is understood. Whilst every effort has been made to ensure the claims provision appropriately allows for such changes, there remains uncertainty in the eventual outcome as a result. This uncertainty can change from year to year depending on the timing and magnitude of these items.

The Group has identified the major uncertainties surrounding the future development of claims and where appropriate these have been allowed for explicitly. An additional provision is held within the claims provision in order to cover the uncertainty around further fluctuations in claim development with a given degree of confidence.

The Group's reserves are particularly susceptible to potential retrospective changes in legislation and new court decisions, both positively and adversely. An example of such would be a change in the Ogden discount rate. This is the discount rate set by the relevant government bodies and used by courts to calculate lump sum awards in personal injury cases.

Uncertainty in claims estimation is more significant for large personal injury claims on both a lump sum and a PPO basis, which for the latter include annually indexed payments that are typically made over the lifetime of the injured party.
Claims reserves for PPOs are held on a discounted basis and are sensitive to changes in this discount benefit. Large lump sum personal injury claims are heavily exposed to the Ogden Discount rate.

On 20 December 2018 the Civil Liability Bill received Royal Assent and is thus the Civil Liability Act, with a revised Ogden Discount Rate expected to be announced in the summer of 2019. The Act should ensure a more proportional rate is applied to lump sum settlements for personal injury claims as well as providing a framework for future reviews to the rate. Whilst the revised rate is not yet known the Group anticipates an increase from the current legislative rate of -0.75%, with the best estimate reserves being held at the equivalent of a 0% Ogden Discount Rate.

The table below provides a sensitivity analysis of the potential impact of a change on a discounting basis for PPO claims and changes to the Ogden discount rate for lump sum settlements on large personal injury claims. The sensitivities allow for a change in the single factor with all other assumptions left unchanged. Other potential risks beyond the ones described in the table could have an additional financial impact on the Group.

	Increase/(decrease) in Profit before tax, mutual bonus and UDS transfer		Increase/(decrease) in Unallocated divisible surplus	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Periodic Payment Orders (PPOs)				
Impact of a 1% increase in the discount rate used to value PPOs	**10**	*	**8**	*
Impact of a 1% reduction in the discount rate used to value PPOs	**(14)**	*	**(11)**	*
Lump sum personal injury settlements				
Impact of the Ogden discount rate moving to +0.5% p.a.	**21**	*	**17**	*
Impact of the Ogden discount rate moving to -0.5% p.a.	**(25)**	*	**(20)**	*

1 The PPO sensitivities relating to an increase or decrease in the discounting basis used for valuing such claims illustrating a movement in the time value of money on a net of reinsurance basis.

2 The Ogden discount rate sensitivities provides clarity of the impact on the claims provision if the discount rate were to increase beyond the best estimate assumption of 0% up to 0.5% or down to -0.5%.

3 The selection of these sensitivities should not be interpreted as a prediction.

* 2017 comparative not available

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Analysis of general insurance claims development

The tables below reflect the cumulative incurred claims including both claims notified and incurred but not reported ('IBNR') for each successive accident year at each Statement of Financial Position date, together with the cumulative payments to date. The Group aims to maintain appropriate reserves in order to protect against adverse future claims experience and developments.

Analysis of claims development – gross of reinsurance	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	2014 £m	2015 £m	2016 £m	2017 £m	2018 £m	Total £m
Initial estimate of gross provision	607	773	909	1,089	1,077	1,051	1,049	1,148	1,124	1,221	
One year later	589	825	915	1,042	1,015	1,000	1,100	1,089	1,082		
Two years later	589	841	902	1,018	999	982	1,070	1,042			
Three years later	588	835	895	992	986	968	1,008				
Four years later	603	825	892	981	998	937					
Five years later	599	829	876	999	952						
Six years later	598	830	892	984							
Seven years later	577	843	888								
Eight years later	578	842									
Nine years later	581										
Current estimate of cumulative claims	581	842	888	984	952	937	1,008	1,042	1,082	1,221	9,537
Cumulative payments to date	(576)	(799)	(871)	(956)	(886)	(879)	(883)	(852)	(758)	(629)	(8,089)
Liability recognised in the Statement of Financial Position for 2009 to 2018 accident years	5	43	17	28	66	58	125	190	324	592	1,448
Liability recognised in the Statement of Financial Position in respect of prior accident years											63
Claims handling provision											17
Gross general insurance claims liabilities as at 31 December 2018											**1,528**

Analysis of claims development – net of reinsurance	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	2014 £m	2015 £m	2016 £m	2017 £m	2018 £m	Total £m
Initial estimate of net provision	584	764	899	1,063	1,057	1,039	916	1,002	838	936	
One year later	578	805	899	1,024	995	934	1,008	836	831		
Two years later	565	821	893	1,003	943	923	939	817			
Three years later	562	808	888	964	937	918	890				
Four years later	577	798	874	955	947	885					
Five years later	570	797	863	964	903						
Six years later	566	791	869	952							
Seven years later	560	798	868								
Eight years later	559	807									
Nine years later	562										
Current estimate of cumulative claims	562	807	868	952	903	885	890	817	831	936	8,451
Cumulative payments to date	(559)	(792)	(860)	(937)	(859)	(840)	(798)	(676)	(608)	(499)	(7,428)
Liability recognised in the Statement of Financial Position for 2009 to 2018 accident years	3	15	8	15	44	45	92	141	223	437	1,023
Liability recognised in the Statement of Financial Position in respect of prior accident years											13
Claims handling provision											17
Net general insurance claims liabilities as at 31 December 2018											**1,053**

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

b) Financial markets risk

As a result of the insurance, investment and retirement products offered to policyholders the Group is exposed to financial markets through the investment of premiums and investment lump sums in various investment assets such as equities, gilts, corporate bonds and property.

Financial markets risk is defined as the risk that arises from adverse fluctuations or increased volatility in asset values, asset income or interest rates. This includes credit spread widening. The Group manages these risks through aligning the investment strategy, asset allocation and performance benchmarks with the Group's risk appetite and utilising asset liability matching and stochastic modelling techniques. These actions aim to match the risks arising from the liabilities under the Group's insurance and investment contracts with the risks inherent in its assets and the capital available to ensure the Group is able to meet policyholder commitments when they fall due and to achieve a sufficient return for members.

In addition to the actions summarised above the Group may also look to use derivative instruments particularly to assist in hedging policyholder guaranteed options and, where cost effective, to transfer risks it believes are either unrewarded or which it believes can be better managed by a third party. For example, derivatives are used to reduce exposure to fluctuations in interest rates, exchange rates and for efficient portfolio management purposes. The main derivatives used for this function are interest rate contracts (including interest rate swaps and options), forward foreign exchange contracts and equity derivatives (index futures and options) respectively. The Group does not hold derivatives for investment purposes, they are held purely as a risk management technique to manage financial market risk exposures within its investment holdings (see Note 15 on how these are used).

The investment management agreement between the Group and Columbia Threadneedle Investments specifies the limits for holdings in certain asset categories and currencies. Asset allocation and performance benchmarks are set, which ensure that each fund has an appropriate mix of assets and is not over or under exposed to a particular asset category, currency or specific investment. The Funds Management Group monitors the actual asset allocation and performance against benchmarks with oversight provided by Group ALCO and the Investment Committee.

The Group is not exposed to financial markets risk in respect of assets held to cover unit linked liabilities as these risks are borne by the holders of the contracts concerned, except to the extent that income from the fund based management charges levied on these contracts varies directly with the value of the underlying assets. Such assets are, however, prudently managed in order to meet policyholders' risk and reward expectations. In addition, regulatory requirements prescribe the type and quality of assets that can be held to support these liabilities.

The key types of financial markets risk to which the Group is exposed are set out in more detail in the following paragraphs. Sensitivities to key market risks are shown on page 120.

(i) Asset performance risk

Asset performance risk is the risk that the fair value or future cash flows of an asset or liability will fluctuate because of changes in market prices, other than those arising from interest rate or currency risks.

The Group is primarily exposed to asset performance risk arising from its investment in equities, property, gilts and corporate bonds.

Equity price risk

The Group is exposed to equity price risk from daily fluctuations in the market values of the equity portfolio. These assets are used to support contractual liabilities arising from investment and long-term insurance contracts. For investment and long-term linked insurance contracts the price movements are matched with corresponding movements in contractual obligations. For participating insurance contracts the aim is to achieve growth in excess of the obligations. For general insurance contracts, equities are held to achieve an investment return. Decreases in the market price of equities will negatively impact the profits and capital of the Group. The risks from investing in equities are managed by investing in a diverse portfolio of high quality securities ensuring that holdings are diversified across industries and concentrations in any one company or industry are limited by parameters established by the Investment Committee. In addition, the Group may use derivatives to reduce the level of equity price risk.

Property price risk

The Group is subject to property price risk due to its exposure to the residential and commercial property market through its equity release and commercial mortgage products, where sustained underperformance in property prices could result in proceeds on sale being exceeded by the mortgage debt at the date of redemption (see Note 14 for disclosures relating to loans secured on residential and commercial property). This risk is managed through limits on the maximum loan to value ratio and seeking to limit concentrations in particular geographic areas. In addition, monitoring of actual experience in house prices versus expected is undertaken.

Corporate bond price risk (Credit spread risk)

The credit spread risk represents the risk of adverse fluctuation in the values of assets and liabilities due to changes in the level of corporate bond credit spreads.

A widening in credit spreads, over and above risk-free yields, causes bond values to decrease. There is a partial offset where the value of certain insurance liabilities fall in value but the overall impact on IFRS profits is negative. Conversely a narrowing of credit spreads results in a positive impact on IFRS profits. The Group monitors credit spread risk by regularly reviewing its exposure to corporate bonds by sector (e.g. financial or non-financial), credit rating and duration and through its asset and liability matching tools.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

(ii) Interest rate risk

Interest rate risk is the risk that the Group is exposed to lower returns or loss as a direct or indirect result of fluctuations in the value of specific assets and liabilities arising from changes in underlying interest rates.

Interest rate risk arises primarily from the Group's investments in long-term debt and fixed income securities and their movement relative to the value placed on the insurance liabilities. A number of products sold by the Group have features that influence the Group's exposure to interest rate risk. These features include guaranteed surrender values, guaranteed annuity options and minimum surrender and maturity values, which can lead to the present value of claims being higher than the value of the backing assets, when interest rates change.

The Group manages interest rate risk by investing in fixed income securities which closely match the interest rate sensitivity of the liabilities, where such investments are available. The Group also makes use of derivatives in addition to physically held assets to manage the interest rate exposure resulting from the liabilities. The Group manages its exposure on both an IFRS basis and a regulatory capital basis under Solvency II, and currently focuses on regulatory capital. These derivatives are principally interest rate swaps and swaptions.

Exposure to interest rate risk is monitored using several techniques, including scenario testing, stress testing and asset liability duration control.

(iii) Investment concentration

Investment concentration risk arises through exposure to particular asset types, geographical markets, industry sectors, groups of business undertakings or similar activities. The Group may suffer losses in the investment portfolio as a result of over exposure to particular sectors engaged in similar activities or similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political and other conditions. The Group's trading activities are UK-based and associated insurance and investment contract liabilities are impacted by the UK marketplace and hence there is a high concentration in corresponding matching UK investment assets.

The Group invests in a portfolio of assets and seeks to maximise portfolio expected return for a given amount of portfolio risk, or equivalently minimise risk for a given level of expected return, by carefully choosing the proportions of various assets. The Investment Committee sets the Group's investment strategy and recommends to the Board the policy and limits required. Responsibility for implementation is delegated to the Chief Investment Officer, with day to day investment activities being undertaken by the Group's investment manager, Columbia Threadneedle Investments.

The Funds Management Group monitors the actual asset allocation and performance against benchmarks with oversight provided by Group ALCO and the Investment Committee.

Eurozone exposure

The table below shows the Group's exposure by country of incorporation of the counterparty at 31 December 2018. The Society's exposure to Eurozone risk is materially consistent with that of the Group.

	2018			2017		
	Sovereign £m	**Non Sovereign £m**	**Total £m**	Sovereign £m	Non Sovereign £m	Total £m
Italy	**–**	**30**	**30**	–	35	35
Spain	**–**	**64**	**64**	–	49	49
Other Eurozone	**124**	**1,378**	**1,502**	327	1,068	1,395
Total	**124**	**1,472**	**1,596**	327	1,152	1,479

The Group's combined exposure to Greece, Cyprus and Portugal is £1m (2017: £1m). Non-sovereign exposure includes £88m (2017: £102m) of subordinated debt.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

(iv) Foreign currency risk

The Group predominantly operates within the UK and is therefore not significantly exposed to currency exposures within its normal trading activities. However, the Group's investment strategy and policies allow for a limited level of investment in overseas markets, via both equities and fixed interest securities. The main currency exposures here are to the Euro and US dollar.

The risk to the Group is that the fair value or future cash flows of an overseas investment asset will change as a result of changes in foreign exchange rates. Currency risk is managed by the use of exposure limits and authorisation controls operated within the Group's risk management framework.

The table below summarises the Group's exposure, after hedging, to foreign currency exchange risk in sterling.

	2018			2017		
	Euro £m	US Dollar £m	Total £m	Euro £m	US Dollar £m	Total £m
Derivatives	–	(2)	(2)	–	(1)	(1)
Equity securities	5	123	128	13	122	135
Cash and cash equivalents	12	4	16	13	5	18
	17	125	142	26	126	152

The Society's exposure to foreign currency risk in 2018 amounted to £5m Euros and £125m US dollars (2017: £14m Euros and £126m US dollars).

A strengthening of the value of sterling against the foreign currency (increase in exchange rates), in which the investment asset is denominated, will lead to a devaluation of the asset value and any associated income flows. A weakening of the value of sterling against the foreign currency will have the reverse impact.

The sensitivity of investment assets to a 10% increase/decrease in Euro and US Dollar exchange rates, net of derivatives, is £2m (2017: £3m) and £13m (2017: £13m) respectively. In determining the percentage rates to use in this sensitivity the movements in the actual market rates of Euro and US Dollars during 2018 were taken into account. The above table incorporates all material currency risk to Profit before tax. Therefore, a 10% increase/decrease across all currencies could impact Profit before tax by up to £14m (2017: £15m).

Some foreign debt securities are denominated in sterling so bear no direct currency risk and have not been included within the above table.

(v) Summary of market risk sensitivities

The table below sets out the impact on Profit before tax and the Unallocated divisible surplus for movements in sectors of the market that the Group is invested in, net of derivatives, excluding the Group's defined benefit pension schemes. Explanation of the movements, and where the sensitivity for the Society is materially different to the Group, are provided below.

In determining the percentage rates to use in the sensitivity analysis reference has been made to those used for internal reporting within the Group. Where sensitivities have not been produced in both directions, the impact of the sensitivity in the other direction is materially consistent with the sensitivity provided.

	2018		2017	
Sensitivity analysis to movements in key market sectors	Impact on Profit before tax, mutual bonus and UDS transfer £m	Impact on the Unallocated divisible surplus £m	Impact on Profit before tax, mutual bonus and UDS transfer £m	Impact on the Unallocated divisible surplus £m
Equity values fall by 20%	(60)	(26)	(69)	(34)
Property values fall by 12.5%	(12)	(7)	(17)	(12)
Credit spreads increase by 100bps relative to swap yields	(82)	(74)	(89)	(83)
Government Bond spreads increase by 50bps relative to swap yields	(22)	(14)	(16)	(7)
Fixed interest yields fall by 50bps	30	13	38	20
Fixed interest yields increase by 100bps	(56)	(28)	(64)	(35)

Market sensitivities remain in line with last year with moderate reductions in exposures across most risks. Consistent with last year, the aim of the LVFS interest rate hedging strategy is to stabilise Solvency II post-TMTP surplus, including capital requirements.
In particular, the assets used to hedge the regulatory capital requirement exposure to interest rates materially affect the interest sensitivity on an IFRS basis, with no offsetting capital movement to counteract the movements in the assets.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

(v) Summary of market risk sensitivities (continued)

In addition, the general insurance business hedging strategy was updated over the year, where its holding of interest rate swaps were closed and replaced with longer duration corporate bond and gilts to better match its PPO exposure, increasing the Group's exposure to credit and government bond spreads relative to swap yields. However, the credit spread relative to swaps sensitivity reduced in aggregate over the year due to changes in the exposure of the non-profit annuity portfolio.

Asset values and, where appropriate, asset share changes are reflected in each sensitivity. With-profits future policy related liabilities are recalculated using these revised values and, where appropriate, economic scenarios generated by an asset model calibrated to the revised risk-free rate.

(vi) Fair value estimation

The following fair value estimation tables present the Group's and Society's assets and liabilities measured at fair value by level of the fair value measurement hierarchy at 31 December 2018.

Level 1 – quoted prices

The fair value of financial instruments included in the Level 1 category is based on the value within the bid-ask spread that is most representative of fair value quoted in an active market at the year-end date. An instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices represent actual and regularly occurring market transactions on an arm's length basis.

Level 2 – observable inputs

Level 2 financial instruments are not traded in an active market and their fair value is determined using valuation techniques. These valuation techniques maximise the use of data from observable current market transactions (where it is available) using pricing obtained via pricing services, even where the market is not active. It also includes financial assets with prices based on broker quotes.

Specific valuation techniques used to value financial instruments classified as Level 2 include:

- Derivatives are valued by discounted cash flow techniques, using observable yield curves and models such as Black Scholes using implied market forward rates and volatilities.
- Units in listed investment funds are valued using quoted prices from external pricing services.
- Debt securities are valued using quoted prices from external pricing services.
- Loans secured on commercial property are valued using discounted cash flows to reflect changes in underlying gilt yields and debt margins.
- Non-participating investment contract liabilities are valued on a basis consistent with the underlying assets in the investment fund.

Level 3 – significant unobservable inputs

If one or more of the significant inputs is not based on observable market data, the instrument is included in Level 3.

Specific valuation techniques used to value financial instruments and other financial investments held at fair value classified as Level 3 include:

- Private equity holdings are valued on a net asset value basis using unobservable external unit prices factoring in distributions or calls since the latest valuations. The private equity valuations are reviewed on a monthly basis by group treasury to ensure ongoing validity and accuracy.
- The fair value of the loans secured on residential property is determined using discounted cash flow projections. The expected value of redemptions are estimated based on the assumed prepayments over future time periods (months), mortality and long-term care entry rates including any early redemption charges. The expected redemptions are discounted at swap rates plus spread plus allowances for risk factors, liquidity and profit deferral. The full swap curve is used so each discount rate is matched to the appropriate cash flow. The risk factors in the discount rate are an allowance for the 'No Negative Equity Guarantee' provided to the policyholder with the loan, the value of which depends on the projection of the underlying property value and how this compares to the projected loan value. The assumptions used for prepayment, mortality and long-term care are based on the experience of the in-force book supported by industry data. The valuation is performed by the asset reporting team and reviewed by the Actuarial Asset Reporting Manager. The assumptions are set by the Board upon recommendation by the Audit Committee.

There were no changes to the valuation techniques during the year. There were no transfers between Levels 1 and 2 during the year.

The Group's policy is to recognise transfers into and out of fair value hierarchy levels as at the date of the event or change in circumstances that caused the transfer.

The valuation of all of the Group's investment holdings is performed by independent and qualified valuers.

Any changes to fair value are recognised within net gains/losses on investments within the Statement of Comprehensive Income with the exception of Investment contract liabilities where the movement is recognised within the Gross change in contract liabilities. Details of these gains/losses are disclosed within Notes 7 and 22 respectively.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Group	2018 Level 1 £m	2018 Level 2 £m	2018 Level 3 £m	2018 Total fair value £m	2017 Level 1 £m	2017 Level 2 £m	2017 Level 3 £m	2017 Total fair value £m
Financial assets								
Derivative financial instruments								
Interest rate swaps	–	52	–	52	–	69	–	69
Gilt forwards	–	3	–	3	–	4	–	4
Swaptions	–	–	–	–	–	–	1	1
Equity/index derivatives	–	10	–	10	–	7	–	7
	–	65	–	65	–	80	1	81
Financial assets held at fair value through income								
Shares, other variable yield securities and units in unit trusts								
– UK listed	1,244	5,511	–	6,755	1,973	5,656	–	7,629
– UK unlisted	–	–	78	78	–	–	91	91
– Overseas listed	108	–	–	108	117	–	–	117
– Overseas unlisted	–	–	33	33	–	–	42	42
Debt and other fixed income securities								
– UK listed	923	1,590	–	2,513	1,179	1,853	–	3,032
– Overseas listed	70	1,112	–	1,182	77	1,995	–	2,072
Loans secured on residential property	–	–	648	648	–	–	667	667
Loans secured on commercial property	–	221	–	221	–	200	–	200
Other	–	–	–	–	–	3	–	3
	2,345	8,434	759	11,538	3,346	9,707	800	13,853
Assets held for sale	235	1,514	–	1,749	–	–	–	–
	2,580	10,013	759	13,352	3,346	9,787	801	13,934
Financial liabilities								
Non-participating investment contract liabilities	–	3,017	–	3,017	–	3,071	–	3,071
Derivative financial instruments								
Cash flow swaps	–	184	–	184	–	186	–	186
Interest rate swaps	–	2	–	2	–	4	–	4
Gilt forwards	–	4	–	4	–	–	–	–
Equity/index derivatives	–	–	–	–	3	–	–	3
	–	190	–	190	3	190	–	193
	–	3,207	–	3,207	3	3,261	–	3,264

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Society	2018 Level 1 £m	2018 Level 2 £m	2018 Level 3 £m	2018 Total fair value £m	2017 Level 1 £m	2017 Level 2 £m	2017 Level 3 £m	2017 Total fair value £m
Financial assets								
Derivative financial instruments								
Interest rate swaps	–	52	–	52	–	68	–	68
Gilt forwards	–	3	–	3	–	4	–	4
Swaptions	–	–	–	-	–	–	1	1
Equity/index derivatives	–	10	–	10	–	7	–	7
	–	65	–	65	–	79	1	80
Financial assets held at fair value through income								
Shares, other variable yield securities and units in unit trusts								
– UK listed	1,055	5,510	–	6,565	1,309	5,535	–	6,844
– UK unlisted	–	–	78	78	–	–	91	91
– Overseas listed	108	–	–	108	112	–	–	112
– Overseas unlisted	–	–	33	33	–	–	42	42
Debt and other fixed income securities								
– UK listed	911	1,588	–	2,499	1,166	1,495	–	2,661
– Overseas listed	70	1,112	–	1,182	77	1,178	–	1,255
Loans secured on residential property	–	–	648	648	–	–	667	667
Loans secured on commercial property	–	221	–	221	–	200	–	200
Other	–	–	–	–	–	3	–	3
	2,144	8,431	759	11,334	2,664	8,411	800	11,875
	2,144	8,496	759	11,399	2,664	8,490	801	11,955
Financial liabilities								
Non-participating investment contract liabilities	–	3,017	–	3,017	–	3,071	–	3,071
Derivative financial instruments								
Cash flow swaps	–	184	–	184	–	186	–	186
Interest rate swaps	–	2	–	2	–	–	–	–
Gilt forwards	–	4	–	4	–	–	–	–
Equity/index derivatives	–	–	–	–	1	–	–	1
	–	190	–	190	1	186	–	187
	–	3,207	–	3,207	1	3,257	–	3,258

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

The table below presents the movements in Level 3 financial instruments for the year ended 31 December 2018.

Group	At 1 January 2018 £m	Total gains/(losses) recognised through income £m	Purchases £m	Sales £m	At 31 December 2018 £m	Unrealised gains/(losses) recognised through income in 2018 £m
Financial assets						
Derivative financial instruments						
Swaptions	1	–	–	(1)	–	–
	1	–	–	(1)	–	–
Financial assets held at fair value through income						
Shares, other variable yield securities and units in unit trusts						
– UK unlisted	91	(13)	–	–	78	(13)
– Overseas unlisted	42	(1)	–	(8)	33	3
Loans secured on residential property*	667	(6)	32	(45)	648	–
	800	(20)	32	(53)	759	(10)
	801	(20)	32	(54)	759	(10)

Group	At 1 January 2017 £m	Total gains/(losses) recognised through income £m	Purchases £m	Sales £m	At 31 December 2017 £m	Unrealised gains/(losses) recognised through income in 2017 £m
Financial assets						
Derivative financial instruments						
Swaptions	1	–	–	–	1	–
	1	–	–	–	1	–
Financial assets held at fair value through income						
Shares, other variable yield securities and units in unit trusts						
– UK unlisted	120	(7)	–	(22)	91	(3)
– Overseas unlisted	55	(8)	1	(6)	42	(10)
Loans secured on residential property*	685	5	35	(58)	667	–
	860	(10)	36	(86)	800	(13)
	861	(10)	36	(86)	801	(13)

* In relation to Loans secured on residential property, purchases represent loans advanced plus accrued interest and sales represent loans repaid.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Society	At 1 January 2018 £m	Total gains/(losses) recognised through income £m	Purchases £m	Sales £m	At 31 December 2018 £m	Unrealised gains/(losses) recognised through income in 2018 £m
Financial assets						
Derivative financial instruments						
Swaptions	**1**	**–**	**–**	**(1)**	**–**	**–**
	1	**–**	**–**	**(1)**	**–**	**–**
Financial assets held at fair value through income						
Shares, other variable yield securities and units in unit trusts						
– UK unlisted	**91**	**(13)**	**–**	**–**	**78**	**(13)**
– Overseas unlisted	**42**	**(1)**	**–**	**(8)**	**33**	**3**
Loans secured on residential property*	**667**	**(6)**	**32**	**(45)**	**648**	**–**
	800	**(20)**	**32**	**(53)**	**759**	**(10)**
	801	**(20)**	**32**	**(54)**	**759**	**(10)**

Society	At 1 January 2017 £m	Total gains/(losses) recognised through income £m	Purchases £m	Sales £m	At 31 December 2017 £m	Unrealised gains/(losses) recognised through income in 2017 £m
Financial assets						
Derivative financial instruments						
Swaptions	1	–	–	–	1	–
	1	–	–	–	1	–
Financial assets held at fair value through income						
Shares, other variable yield securities and units in unit trusts						
– UK unlisted	120	(7)	–	(22)	91	(3)
– Overseas unlisted	54	(7)	1	(6)	42	(10)
Loans secured on residential property*	684	6	35	(58)	667	–
	858	(8)	36	(86)	800	(13)
	859	(8)	36	(86)	801	(13)

* In relation to Loans secured on residential property, purchases represent loans advanced plus accrued interest and sales represent loans repaid.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Information about fair value measurements using significant unobservable inputs (Level 3)

Included below are the significant unobservable inputs that impact the valuation of the material level 3 assets and liabilities for the Group, these apply equally to the Society.

Group	Fair value at 31 December 2018 £m	Fair value at 31 December 2017 £m	Valuation technique(s)	Unobservable inputs	Range of unobservable inputs (probability – weighted average)	Relationship of unobservable inputs to fair value
Financial assets						
Derivative financial instruments						
Swaptions	–	1	Mark-to-model	Interest rate volatility	Could be several percentage points	Higher interest rate volatility results in higher contract value.
	–	1				
Financial assets held at fair value through income						
Shares, other variable yield securities and units in unit trusts						
– UK unlisted	**78**	91	Adjusted net asset method	Price per unit	Could vary significantly due to the range of holdings	The higher the price per unit, the higher the fair value.
				Distributions or calls since last valuation	Could vary significantly due to the range of holdings	The fair value varies on distributions/calls and period since last valuation.
– Overseas unlisted	**33**	42	Adjusted net asset method	Price per unit	Could vary significantly due to the range of holdings	The higher the price per unit, the higher the fair value.
				Distributions or calls since last valuation	Could vary significantly due to the range of holdings	The fair value varies on distributions/calls and period since last valuation.
Loans secured on residential property	**648**	667	Discounted cash flow	Spread	Varies based on cohorts of loans	The spread (together with the underlying risk free yield curve) forms the discount rate used to value the cashflows.
				Prepayments	Varies by policy year: min 3.2% – max 11.8%	Prepayment rate will determine the profile of expected cashflows.
				Mortality and long-term care assumptions	Annuitant mortality tables are applied	Mortality and long-term care rate will determine the profile of expected cashflows.
	759	800				
	759	801				

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Sensitivity to changes in unobservable inputs (Level 3)

The only financial instrument which is significantly impacted by reasonably possible changes in unobservable inputs is the loans secured on residential property. The loans secured on residential property are sensitive to changes in discount rate spread, which includes the profit and liquidity premium as well as the No Negative Equity Guarantee risk allowance.

The impact of reasonably possible alternative assumptions is shown in the table below:

		2018			2017		
		Reasonably possible alternative assumptions			Reasonably possible alternative assumptions		
	Unobservable input	Current fair value	Increase in fair value	Decrease in fair value	Current fair value	Increase in fair value	Decrease in fair value
Description		£m	£m	£m	£m	£m	£m
Loans secured on residential property	Discount rate +/- 50bps	**648**	**28**	**(26)**	667	33	(30)

c) Credit counterparty risk

Credit counterparty risk (credit risk) is defined as the risk of loss if another party fails to perform its obligations or fails to perform them in a timely fashion. Exposure to credit risk may arise in connection with a single transaction or an aggregation of transactions (not necessarily the same type) with a single counterparty.

The Group encounters credit counterparty risk from different sources, firstly within the business activities associated with its insurance, investment and retirement products and secondly in the financial assets held in the Group's investment portfolio.

Credit counterparty risk is managed via a Group policy and risk limits covering aspects such as total exposure, and concentration. Group counterparty exposures are monitored by Group ALCO, with ultimate oversight of risk being undertaken by the Risk Committee.

The main credit counterparty risks within the Group are as follows:

Investment counterparties

The key other source of credit risk arises from the assets held in the investment portfolio. The risk is that the investment counterparty enters financial difficulties and the fair value of the asset diminishes or the income stream is not paid; alternatively the counterparty becomes insolvent and the value of the asset is written off.

The investment portfolio contains a range of assets, including equities, corporate bonds and other fixed income securities and cash deposits. The credit counterparty risk policy stipulates approved counterparties, permitted investments and geographical territories, as well as detailing specific asset class exposure limits. These are implemented within the investment management agreement with Columbia Threadneedle Investments. The policy and agreements also require that asset holdings are within regulatory limits that restrict excessive concentrations with individual counterparties or with particular asset classes. In order to minimise its exposure to credit risk the Group invests primarily in higher graded assets, rated BBB and above.

In addition, the Group uses derivatives to transfer elements of financial markets risk exposures. Where possible, significant counterparty exposures from over-the-counter derivatives are mitigated by the use of collateral. The fair value of the derivative is matched by collateral received from the counterparty, which increases or reduces in line with the contract's fair value. The collateral can be sold or re-pledged by the Group and is repayable if the contract terminates or the contract's fair value decreases. Details of collateral received and pledged is included within the offsetting disclosure on page 129.

Loans secured on residential and commercial property

The retirement business provides residential and commercial mortgage lending and is exposed to credit risk arising from mortgage loans provided. This risk is managed by using the property as security against the loan, assessment of the risk and maintaining a low loan to value ratio. Aberdeen Standard Investments have replaced AgFe as the Group's mandated originator and asset manager for new commercial mortgages, and use their considerable expertise to source and underwrite loan prospects. AgFe continue to work with LV= in the ongoing management of the existing commercial mortgages which they previously sourced.

Note 14 provides further disclosure and provisions for 'No Negative Equity Guarantees' on equity release mortgages.

Reinsurance counterparties

Reinsurance agreements are entered into to transfer an element of potential insurance risk exposure from contract liabilities. This does not, however, discharge the Group's liability as primary insurer. If a reinsurer fails to pay a reinsurance claim, the Group remains liable for the payment to the policyholder. To manage this exposure the creditworthiness of reinsurers is considered by reviewing their financial strength prior to finalisation of any contract, which is then regularly reviewed. In addition, collateral is held to manage the counterparty exposure to the reinsurer.

Reinsurance concentration risk

Reinsurance concentration risk is minimised through contracting with a diverse range of reinsurance counterparties with credit ratings within our risk appetite. Reinsurance concentration risk is managed through reviewing the credit rating of reinsurance counterparties and exposure limits.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Insurance receivables

Insurance sales expose the Group to credit risk from policyholders and intermediaries for outstanding premiums. The creditworthiness of the intermediaries is assessed and credit limits are used to manage any potential concentration risk associated with individual counterparties.

The creditworthiness of policyholders who take out premium finance on general insurance products is assessed at the time of sale and outstanding premiums are monitored and collected via a dedicated budget accounts function.

No further credit risk provision is required in excess of the normal provision for doubtful receivables.

Credit exposures also arise within general insurance, where claims expense recoveries are due from other insurers' policyholders who are at fault for any repairs expense suffered by the Group's policyholders. These exposures are managed via a dedicated recoveries team and an industry wide compensation scheme is in place to provide cover for default by an individual insurer.

The tables below show the credit profile of the Group's assets. The credit risk profile of the Society is materially consistent with that of the Group.

	Neither past due nor impaired									
Credit risk exposure 2018	**AAA £m**	**AA £m**	**A £m**	**BBB £m**	**Below BBB £m**	**Not rated £m**	**Total £m**	**Past due but not impaired £m**	**Past due and impaired £m**	**Total £m**
Debt and other fixed income securities	**343**	**1,641**	**984**	**726**	**1**	**–**	**3,695**	**n/a**	**n/a**	**3,695**
Loans secured on residential and commercial property	**–**	**–**	**–**	**–**	**–**	**869**	**869**	**n/a**	**n/a**	**869**
Derivative assets	**–**	**–**	**–**	**–**	**–**	**65**	**65**	**n/a**	**n/a**	**65**
Loans and other receivables	**–**	**–**	**350**	**–**	**–**	**57**	**407**	**–**	**–**	**407**
Reinsurance assets	**–**	**1,728**	**1**	**–**	**–**	**9**	**1,738**	**–**	**–**	**1,738**
Insurance receivables	**–**	**28**	**–**	**–**	**–**	**10**	**38**	**3**	**–**	**41**
Cash and cash equivalents	**–**	**131**	**268**	**13**	**–**	**–**	**412**	**n/a**	**n/a**	**412**
	343	**3,528**	**1,603**	**739**	**1**	**1,010**	**7,224**	**3**	**–**	**7,227**

	Neither past due nor impaired									
Credit risk exposure 2017	AAA £m	AA £m	A £m	BBB £m	Below BBB £m	Not rated £m	Total £m	Past due but not impaired £m	Past due and impaired £m	Total £m
Debt and other fixed income securities	578	1,839	1,421	1,150	115	1	5,104	n/a	n/a	5,104
Loans secured on residential and commercial property	–	–	–	–	–	867	867	n/a	n/a	867
Derivative assets	–	–	–	–	–	81	81	n/a	n/a	81
Loans and other receivables	–	–	200	–	–	58	258	–	–	258
Reinsurance assets	–	2,227	73	–	–	5	2,305	–	–	2,305
Insurance receivables	–	18	17	–	–	265	300	7	1	308
Cash and cash equivalents	–	312	517	145	–	–	974	n/a	n/a	974
	578	4,396	2,228	1,295	115	1,277	9,889	7	1	9,897

In addition to amounts disclosed above for 2018, included within Assets held for sale on the Statement of Financial Position are £2,507m of assets exposed to credit risk relating to the general insurance business. Of these £2,251m are investment grade, with the remainder predominantly being Not rated balances due from policyholders.

Impairment

The Group reviews the carrying value of its financial assets held at amortised cost at each Statement of Financial Position date. If the carrying value of a financial asset is impaired, the carrying value is reduced through a charge to the Statement of Comprehensive Income.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Offsetting financial assets and financial liabilities

Financial assets and liabilities are offset in the Statement of Financial Position when the Group intends to apply a current legally enforceable right to offset. Master netting arrangements and collateral are utilised by the Group to minimise credit risk exposure.

The following financial assets and liabilities of the Group are subject to offsetting, enforceable master netting arrangements and similar agreements. The Society's exposure to credit risk associated with offsetting is materially consistent with that of the Group.

An analysis is included of netting arrangements which meet the offsetting criteria within IAS 32 and are set off in the Statement of Financial Position and related amounts which do not meet the criteria.

	Amounts recognised in the Statement of Financial Position			Related amounts not set off in the Statement of Financial Position		
As at 31 December 2018	**Gross amount £m**	**Amounts offset £m**	**Net amount £m**	**Financial Instruments* £m**	**Collateral pledged/ (received) £m**	**Net amount £m**
Financial assets						
Derivative financial assets	**65**	**–**	**65**	**(2)**	**(59)**	**4**
	65	**–**	**65**	**(2)**	**(59)**	**4**
Financial liabilities						
Derivative financial liabilities	**(190)**	**–**	**(190)**	**2**	**185**	**(3)**
Bank overdrafts	**(31)**	**21**	**(10)**	**–**	**–**	**(10)**
	(221)	**21**	**(200)**	**2**	**185**	**(13)**

	Amounts recognised in the Statement of Financial Position			Related amounts not set off in the Statement of Financial Position		
As at 31 December 2017	Gross amount £m	Amounts offset £m	Net amount £m	Financial Instruments* £m	Collateral pledged/(received) £m	Net amount £m
Financial assets						
Derivative financial assets	81	–	81	–	(79)	2
Cash and cash equivalents	24	(21)	3	–	–	3
	105	(21)	84	–	(79)	5
Financial liabilities						
Derivative financial liabilities	(193)	–	(193)	–	192	(1)
Bank overdrafts	(34)	24	(10)	–	–	(10)
	(227)	24	(203)	–	192	(11)

* Collateral requirements arising from derivatives between the Society and Goldman Sachs are managed on a net basis.

In accordance with IFRS 7 the collateral reported in the table above is limited to the amount reported in the Statement of Financial Position for the associated financial instrument.

Total collateral held by the Group in relation to derivative financial assets is £59m (2017: £79m) and is all cash collateral received (2017: split between cash collateral received of £62m and gilts received of £17m). No collateral received from the counterparty has been sold or repledged (2017: £nil).

Total collateral pledged by the Group is £185m (2017: £196m) and is split between corporate bonds pledged in relation to cash flow swaps of £184m (2017: £186m), and future margin of cash of £1m (2017: future margin of cash of £8m and cash collateral paid of £2m).

Collateral posted to LV= by the counterparty to a derivative contract which is valued as being 'in-the-money' can be drawn upon following certain events of default as defined in the relevant International Swaps and Derivatives Association (ISDA) agreement. This includes failure by the counterparty to comply with or perform any agreement or obligation defined in the ISDA or Credit Support Annex if such failure is not remedied within 30 days after notice of such failure is given. Bankruptcy of the counterparty to a trade could also result in collateral posted being drawn upon to mitigate any financial exposure to the Group.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

d) Liquidity risk

Liquidity risk is the risk that the Group cannot make payments as they become due because there are insufficient assets in cash form, or in a form that can be converted to cash in a timely fashion at close to fair market value.

The Group encounters potential liquidity risk exposures from its different business activities. It principally arises from its insurance and investment contracts and the timing of the associated policyholder commitments. In the general insurance business there is the potential for increased demand for cash, above normal claims expense patterns, for example to meet adverse UK weather events. In the life business increased demands for cash can also arise from events such as higher instances of death/sickness claims or mass surrenders/lapses of policies. In addition, the Group uses derivatives to transfer potential exposures on financial markets risks and certain derivative contracts, for example, interest rate swaps can result in additional collateral calls which must be met from liquid assets at short notice.

Liquidity is maintained at a prudent level, with a buffer to cover contingencies including the provision of temporary liquidity to subsidiary companies. A Group Liquidity Risk Policy and associated standards have been set to maintain sufficient liquid assets. At Group level there is a liquidity risk appetite statement which requires that sufficient liquid resources are maintained to cover net cash outflows under stressed conditions. This is captured in a liquidity cover ratio and is monitored by the Group ALCO.

The risk exposure is managed using several methods and techniques, which include:

- Maintaining forecasts of cash requirements and adjusting investment management strategies as appropriate to meet these requirements, both in the short and long term;
- Holding sufficient assets in investments which are readily marketable in a sufficiently short timeframe to be able to settle liabilities as these fall due;
- Forecasting additional cash demands under stressed conditions, including demands for collateral, and management actions to be taken to liquidate sufficient assets to meet the increased demands; and
- Appropriate matching of the maturities of assets and liabilities. The Group undertakes asset and liability management to ensure that the duration of liabilities is matched by assets.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

The table below summarises the maturity profile of the assets of the Group and Society on the expected recovery timing.

	Group			Society		
Maturity profile of assets 2018	**Within 1 year £m**	**Over 1 year £m**	**Total £m**	**Within 1 year £m**	**Over 1 year £m**	**Total £m**
Pension benefit asset	–	199	199	–	199	199
Intangible assets	–	47	47	–	8	8
Investments in group undertakings	–	–	–	–	896	896
Property and equipment	–	29	29	–	9	9
Reinsurance assets	1	1,737	1,738	1	1,737	1,738
Prepayments and accrued interest	77	–	77	70	–	70
Loans and other receivables	407	–	407	84	–	84
Insurance receivables	41	–	41	40	–	40
Corporation tax asset	5	–	5	5	–	5
Financial assets at fair value through income	6,757	4,781	11,538	6,567	4,767	11,334
Derivative financial instruments	4	61	65	4	61	65
Cash and cash equivalents	412	–	412	392	–	392
Assets held for sale	3,367	–	3,367	–	–	–
	11,071	6,854	17,925	7,163	7,677	14,840

	Group			Society		
Maturity profile of assets 2017	Within 1 year £m	Over 1 year £m	Total £m	Within 1 year £m	Over 1 year £m	Total £m
Pension benefit asset	–	178	178	–	178	178
Intangible assets	–	315	315	–	10	10
Investments in group undertakings	–	–	–	–	897	897
Property and equipment	–	37	37	–	7	7
Investment properties	3	–	3	3	–	3
Deferred acquisition costs	95	–	95	–	–	–
Reinsurance assets	53	2,252	2,305	–	1,747	1,747
Prepayments and accrued interest	124	–	124	71	–	71
Loans and other receivables	258	–	258	65	–	65
Insurance receivables	308	–	308	29	–	29
Financial assets at fair value through income	7,736	6,117	13,853	6,776	5,099	11,875
Derivative financial instruments	4	77	81	4	76	80
Cash and cash equivalents	974	–	974	424	–	424
	9,555	8,976	18,531	7,372	8,014	15,386

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

The tables below summarise the maturity profile of insurance contracts and financial liabilities of the Group and Society.

As permitted by IFRS 4, the maturity profiles for insurance and participating investment contracts are presented based on the estimated timing of the amounts recognised in the Statement of Financial Position.

The remaining financial liabilities are presented based on the undiscounted contractual obligations and as such will not tie into the balances disclosed within the Statement of Financial Position. Non-participating investment contract liabilities, accounted for in accordance with IAS 39, can be called upon immediately by the policyholder and are therefore presented as 'on demand'.

Group Maturity profile of financial, insurance and investment contract liabilities 2018	**Unit-linked (on demand) £m**	**Within 1 year £m**	**1-3 years £m**	**3-5 years £m**	**Over 5 years £m**	**Total £m**
Participating insurance contract liabilities	**–**	**466**	**770**	**687**	**3,169**	**5,092**
Participating investment contract liabilities	**–**	**47**	**59**	**55**	**530**	**691**
Non-participating value of in-force business	**(51)**	**(16)**	**(29)**	**(24)**	**(183)**	**(303)**
Non-participating insurance contract liabilities	**–**	**275**	**505**	**462**	**3,280**	**4,522**
Non-participating investment contract liabilities	**3,017**	**–**	**–**	**–**	**–**	**3,017**
Total insurance and investment contract liabilities	**2,966**	**772**	**1,305**	**1,180**	**6,796**	**13,019**
Financial liabilities						
– Derivative financial instruments	**–**	**4**	**–**	**1**	**185**	**190**
– Subordinated liabilities	**–**	**–**	**–**	**350**	**–**	**350**
– Other financial liabilities	**–**	**–**	**1**	**7**	**51**	**59**
Insurance payables	**–**	**28**	**–**	**–**	**–**	**28**
Trade and other payables	**–**	**120**	**2**	**2**	**21**	**145**
	2,966	**924**	**1,308**	**1,540**	**7,053**	**13,791**

Group Maturity profile of financial, insurance and investment contract liabilities 2017	Unit-linked (on demand) £m	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
Participating insurance contract liabilities	–	462	801	752	3,264	5,279
Participating investment contract liabilities	–	35	63	64	584	746
Non-participating value of in-force business	(23)	(17)	(31)	(26)	(196)	(293)
Non-participating insurance contract liabilities	–	258	498	485	3,409	4,650
General insurance claims liabilities	–	547	517	274	305	1,643
Non-participating investment contract liabilities	3,071	–	–	–	–	3,071
Total insurance and investment contract liabilities	3,048	1,285	1,848	1,549	7,366	15,096
Financial liabilities						
– Derivative financial instruments	–	6	(6)	27	166	193
– Subordinated liabilities	–	–	–	–	360	360
– Other financial liabilities	–	–	–	–	62	62
Insurance payables	–	50	–	–	–	50
Trade and other payables	–	213	4	2	22	241
	3,048	1,554	1,846	1,578	7,976	16,002

For investment and long-term linked insurance contracts (unit linked) the Group matches all the assets on which the unit prices are based with assets in the portfolio. The Group is responsible for ensuring there is sufficient liquidity within the asset portfolio to enable liabilities to unit linked policyholders to be met as they fall due.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

4. Risk management and control (continued)

Society **Maturity profile of financial, insurance and investment contract liabilities 2018**	**Unit-linked (on demand)**	**Within 1 year**	**1-3 years**	**3-5 years**	**Over 5 years**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**
Participating insurance contract liabilities	**–**	**466**	**770**	**687**	**3,169**	**5,092**
Participating investment contract liabilities	**–**	**47**	**59**	**55**	**530**	**691**
Non-participating value of in-force business	**(51)**	**(16)**	**(29)**	**(24)**	**(183)**	**(303)**
Non-participating insurance contract liabilities	**–**	**274**	**504**	**461**	**3,269**	**4,508**
Non-participating investment contract liabilities	**3,017**	**–**	**–**	**–**	**–**	**3,017**
Total insurance and investment contract liabilities	**2,966**	**771**	**1,304**	**1,179**	**6,785**	**13,005**
Financial liabilities						
– Derivative financial instruments	**–**	**4**	**–**	**1**	**185**	**190**
– Subordinated liabilities	**–**	**–**	**–**	**350**	**–**	**350**
– Other financial liabilities	**–**	**–**	**1**	**7**	**51**	**59**
Insurance payables	**–**	**28**	**–**	**–**	**–**	**28**
Trade and other payables	**–**	**119**	**–**	**–**	**–**	**119**
	2,966	**922**	**1,305**	**1,537**	**7,021**	**13,751**

Society Maturity profile of financial, insurance and investment contract liabilities 2017	Unit-linked (on demand)	Within 1 year	1-3 years	3-5 years	Over 5 years	Total
	£m	£m	£m	£m	£m	£m
Participating insurance contract liabilities	–	462	801	752	3,264	5,279
Participating investment contract liabilities	–	35	63	64	584	746
Non-participating value of in-force business	(23)	(17)	(31)	(26)	(196)	(293)
Non-participating insurance contract liabilities	–	257	496	484	3,398	4,635
Non-participating investment contract liabilities	3,071	–	–	–	–	3,071
Total insurance and investment contract liabilities	3,048	737	1,329	1,274	7,050	13,438
Financial liabilities						
– Derivative financial instruments	–	4	(6)	27	162	187
– Subordinated liabilities	–	–	–	–	350	350
– Other financial liabilities	–	–	–	–	62	62
Insurance payables	–	22	–	–	–	22
Trade and other payables	–	149	–	–	–	149
	3,048	912	1,323	1,301	7,624	14,208

e) Operational risk

Operational risk is defined as the potential for loss resulting from inadequate or failed internal processes, people and systems or from external events. It is inherent in every part of the business and covers a wide spectrum of issues. Senior management are responsible for ensuring that the material operational risks as relevant to their area of responsibilities are identified, assessed and managed using the approach as outlined in the Group LV= Risk Management Framework. A formal attestation process provides assurance about the effectiveness of the overall control environment and reports on any material exceptions.

Operational risk is unrewarded and is therefore inherently unattractive. LV= is highly exposed to operational failures because of the high level of customer service inherent in its business model. It therefore looks to limit and 'maintain' its exposure to operational risk and do so by establishing a robust control environment using a combination of assessment, testing and audit. The Group will always seek to uphold its brand image with customers, employees and other external parties and the Group has no appetite whatsoever for regulatory weaknesses or failings that lead to censure actions.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Performance

The notes included within this section focus on the performance and results of the Group and Society. Information on the income generated, benefits and claims paid, expenditure incurred and mutual bonus declared are presented here.

5. Net earned premiums

Accounting for net earned premiums

Written premiums include new business premiums plus ongoing regular premiums received for in-force policies. Furthermore an estimate is included for premiums due from intermediaries. Net earned premiums are arrived at following deductions for premiums payable to reinsurers and in general insurance, unearned premium is deferred.

Long-term insurance and participating investment contracts

Regular premiums on long-term insurance and participating investment contracts are recognised as income when due for payment. For single premium business, recognition occurs on the date from which the policy is effective.

General insurance contracts

General insurance premiums written reflect business coming into force during the year. Earned premium is written premium adjusted for unearned premium. Unearned premium is that proportion of a premium written in a year that relates to periods of risk after the Statement of Financial Position date. Unearned premiums are calculated on a time apportionment basis. The proportion attributable to subsequent periods is deferred as a provision for unearned premiums.

The general insurance business has been disclosed as a discontinued operation in 2018 and 2017 has been restated accordingly – see Note 12.

Non-participating investment contracts

Premiums and claims relating to non-participating investment contracts are not recognised in the Statement of Comprehensive Income but are recorded as contributions to and deductions from the non-participating investment contract liabilities recorded in the Statement of Financial Position.

	Group		Society	
	2018	2017 Restated - see Note 1	**2018**	2017
Gross earned premiums	**£m**	£m	**£m**	£m
Long-term insurance and participating investment contracts				
Single premium				
New business				
Investments and savings	**354**	420	**354**	420
Pensions and annuities	**170**	151	**170**	151
Regular premium				
New business				
Life and health protection	**33**	37	**33**	37
Existing in-force business				
Investments and savings	**28**	33	**28**	33
Pensions and annuities	**8**	9	**8**	9
Life and health protection	**195**	185	**194**	185
Gross earned premiums	**788**	835	**787**	835
Premiums ceded to reinsurers				
Long-term insurance premiums	**(246)**	(1,092)	**(246)**	(1,092)
	(246)	(1,092)	**(246)**	(1,092)
Net earned premiums	**542**	(257)	**541**	(257)
Gross written premiums for non-participating investment contracts which are deposit accounted for and not included above (refer to Note 16)	**456**	656	**456**	656

All contracts are written in the UK.

Recurrent single premium rebates from the Department for Work and Pensions are included as new business single premiums. Pensions vested into annuity contracts during the year are included as new annuity single premium business at the annuity purchase price. Where periodic premiums are received other than annually, the periodic new business premiums are stated on an annualised basis.

In December 2017 the Society and Group entered into a reinsurance arrangement in respect of the OB Pension portfolio. This increased Premiums ceded to reinsurers by £829m.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

6. Investment income

Accounting for investment income

Investment income includes dividends, interest from debt and other fixed income securities, interest on loans secured on residential and commercial property and interest on loans and receivables. Dividends are recorded on the date on which the shares are declared ex-dividend. Interest receivable from investments at fair value is accounted for on an accruals basis. Interest receivable on loans and receivables is calculated on an effective interest rate basis.

	Group		Society	
	2018	2017 Restated - see Note 1	2018	2017
	£m	£m	£m	£m
Income from investments at fair value through income:				
– Dividend income	**113**	109	**113**	109
– Interest income from debt and fixed interest securities	**141**	165	**141**	164
– Interest on loans secured on residential property	**34**	36	**34**	36
– Interest on loans secured on commercial property	**8**	9	**8**	9
Interest on loans and receivables	**4**	–	**–**	–
Interest income from group undertakings	**–**	–	**–**	18
Dividend income from group undertakings	**–**	–	**67**	94
	300	319	**363**	430

7. Net (losses)/gains on investments

Accounting for net (losses)/gains on investments

Realised gains and losses

Realised gains and losses on investments are calculated as the difference between net sales proceeds and purchase price.

Unrealised gains and losses

Unrealised gains and losses on investments represent the difference between the valuation of fair value assets at the Statement of Financial Position date and their valuation at the last Statement of Financial Position date or, where purchased during the year, the purchase price. A reversal is made of previously recognised gains or losses in respect of disposals made during the year.

	Group		Society	
	2018	2017 Restated - see Note 1	2018	2017
	£m	£m	£m	£m
Investment properties	**1**	3	**1**	3
Investments at fair value through income:				
– Debt securities	**(160)**	1	**(160)**	2
– Equity securities	**(432)**	419	**(432)**	419
– Derivatives at fair value through income	**(5)**	(36)	**(5)**	(36)
– Loans and mortgages	**(6)**	4	**(6)**	4
– Other	**(3)**	3	**(3)**	3
Investments in group undertakings	**–**	–	**(7)**	(16)
	(605)	394	**(612)**	379

Included within net (losses)/gains on investments are realised gains of £253m (2017: £568m) for the Group and realised gains of £253m (2017: £568m) for the Society.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

8. Other income

	Group		Society	
	2018	2017 Restated - see Note 1	2018	2017
	£m	£m	£m	£m
Revenue from contracts with customers				
Fee and commission income	**47**	37	**24**	22
	47	37	**24**	22
Other income from insurance contracts	**–**	–	**–**	–
	47	37	**24**	22

9. Net benefits and claims

Accounting for net benefits and claims

Net benefits and claims include amounts paid and also the change in provision for claims. Included within these are the related internal and external claims handling costs and also deductions for the expected value of recoveries. Reinsurance recoveries are accounted for in the same period as the related claim.

Long-term insurance and participating investment contracts

Maturity claims and regular annuity payments are accounted for when due for payment. Surrenders are accounted for on the earlier of the date when paid or when the policy ceases to be included within the long-term insurance contract liability. Death claims and other claims are accounted for when the Group is notified. The value of claims on participating contracts includes bonuses paid or payable.

General insurance contracts

Claims incurred comprise claims paid in the year and changes in the provisions for outstanding claims, including provisions for claims incurred but not reported together with any other adjustments to claims from previous years. The general insurance business has been disclosed as a discontinued operation in 2018 and 2017 has been restated accordingly – see Note 12.

It is likely that the final outcome will prove to be different from the original liability established. Provisions are adjusted at the Statement of Financial Position date to represent an estimate of the expected outcome.

	2018			2017		
	Gross	Reinsurance	Net	Gross Restated - see Note 1	Reinsurance Restated - see Note 1	Net Restated - see Note 1
Group	£m	£m	£m	£m	£m	£m
Long-term insurance and participating investment contracts						
Benefits and claims paid	**896**	**(232)**	**664**	868	(237)	631
Change in the provision for claims	**8**	**–**	**8**	4	–	4
Fair value adjustment to reinsurance receivable	**–**	**(6)**	**(6)**	–	–	–
	904	**(238)**	**666**	872	(237)	635
Net benefits and claims for non-participating investment contracts which are deposit accounted for and not included above (refer to Note 16)	**375**	**–**	**375**	366	–	366

	2018			2017		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
Society	£m	£m	£m	£m	£m	£m
Long-term insurance and participating investment contracts						
Benefits and claims paid	**895**	**(232)**	**663**	866	(237)	629
Change in the provision for claims	**8**	**–**	**8**	5	–	5
Fair value adjustment to reinsurance receivable	**–**	**(6)**	**(6)**	–	–	–
	903	**(238)**	**665**	871	(237)	634
Net benefits and claims for non-participating investment contracts which are deposit accounted for and not included above (refer to Note 16)	**375**	**–**	**375**	366	–	366

Notes to the Financial Statements (continued)

Year ended 31 December 2018

10. Finance costs

	Group		Society	
	2018	2017 Restated - see Note 1	2018	2017
	£m	£m	£m	£m
Interest expense on subordinated liabilities (see Note 18)	**23**	23	**23**	23
Other interest expense	**1**	1	**–**	–
	24	24	**23**	23

11. Other operating and administrative expenses

Accounting for other operating and administrative expenses

Other operating and administrative expenses are accounted for as incurred. Acquisition costs relate to the costs of acquiring new business during the financial year. These include all commission and incentive payments to sales staff and third parties incurred in writing new contracts.

	Group		Society	
	2018	2017 Restated - see Note 1	2018	2017
	£m	£m	£m	£m
Commission paid on acquisition of business	**57**	59	**50**	54
Amortisation and impairment of intangible assets	**4**	4	**3**	2
Depreciation on property and equipment	**4**	5	**2**	3
(Profit)/loss on disposal of property and equipment	**(3)**	1	**–**	1
Investment management expenses and charges	**9**	15	**10**	15
Auditors' remuneration (see Note 13)	**1**	1	**1**	1
Employee benefits expense (see Note 38)	**109**	255	**101**	249
Management charge allocated to group undertakings	**(45)**	(208)	**(58)**	(215)
Rent, rates and other facilities expense	**8**	11	**9**	12
Marketing and advertising	**7**	10	**7**	9
Other staff costs	**21**	16	**20**	15
IT costs	**25**	36	**25**	36
Fees	**28**	32	**27**	31
Other expenses	**3**	12	**3**	15
Claims handling cost recognised in Gross benefits and claims	**(4)**	(6)	**(4)**	(6)
	224	243	**196**	222

The £(45)m (2017: £(208m)) management charge allocated to group undertakings reported by the Group represents the amounts recharged to the discontinued operations during the year.

Included within rent, rates and other facilities expense are operating lease rentals of £1m (2017: £4m).

Notes to the Financial Statements (continued)

Year ended 31 December 2018

12. Discontinued operations

a) Description

On 28 December 2017 the Group entered into a transaction with Allianz whereby a majority stake in LVGIG group (the general insurance business within the Group) is being sold to Allianz based on an agreed valuation of LVGIG of £1.020bn. The first stage was completed on 28 December 2017 with a minority interest of 49% in LVGIG being sold and the £124m gain on disposal being recognised directly within the Unallocated divisible surplus as a transaction with owners that did not result in a loss of control – see Notes 46 and 47.

The second stage will complete by 31 December 2019 following settlement of a forward contract for sale of an additional 20.9% stake to Allianz unless the Group exercises its put option over its remaining shareholding earlier. The put option has been valued at a positive fair value of £17m at 31 December 2018 impacting Net losses on investments and Derivative financial instruments within the Discontinued operations and Assets held for sale disclosures in sections b) and c) respectively. Assumptions and judgement were used in the estimation of the fair value of the put option leading to significant levels of uncertainty associated with the reported fair value of £17m. The second stage of the transaction will result in a loss of control and therefore the associated gain or loss on disposal will be recognised in the Statement of Comprehensive Income.

At 31 December 2018 the Group retains control and continues to consolidate LVGIG and its subsidiaries, however as the second stage will be completed within a year from the reporting date and will result in a loss of control, the LVGIG group is a disposal group that is classified as held for sale in accordance with IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations', and presented as a discontinued operation.

The disposal group is measured at its carrying value as this is lower than the fair value of the agreed sale price less transaction costs.

b) Financial performance and cash flow information

Financial information relating to the discontinued operations for the years to 31 December 2018 and 2017 are presented below:

	2018 £m	2017 £m
Gross earned premiums	**1,610**	1,604
Premiums ceded to reinsurers	**(383)**	(363)
Net earned premiums	**1,227**	1,241
Investment income	**53**	55
Net losses on investments	**(24)**	(34)
Gain on sale of commercial business renewal rights	**–**	52
Other income	**56**	48
Total income	**1,312**	1,362
Insurance claims and loss adjustment expenses	**(1,033)**	(1,155)
Insurance claims and loss adjustment expenses recoverable from reinsurers	**175**	298
Net insurance claims	**(858)**	(857)
Gross operating and administrative expenses	**(417)**	(413)
Expenses recoverable from reinsurers	**73**	72
Net operating and administrative expenses	**(344)**	(341)
Finance costs	**–**	–
Total claims and expenses	**(1,202)**	(1,198)
Profit before tax from discontinued operations	**110**	164
Income tax expense	**(17)**	(30)
Profit for the year from discontinued operations	**93**	134
Other comprehensive loss for the year from discontinued operations, net of tax	**(10)**	–
Total comprehensive income for the year from discontinued operations	**83**	134

The net cash flows incurred by the LVGIG group are as follows:

	2018 £m	2017 £m
Net cash (outflow)/inflow from operating activities	**(149)**	215
Net cash (outflow)/inflow from investing activities	**(22)**	16
Net cash (outflow)/inflow from financing activities	**(64)**	9
Net cash (outflow)/inflow generated from discontinued operations	**(235)**	240

Notes to the Financial Statements (continued)

Year ended 31 December 2018

12. Discontinued operations (continued)

c) Assets held for sale

	2018 £m
Assets	
Intangible assets (see Note 28)	**271**
Property and equipment (see Note 27)	**5**
Deferred tax asset (see Note 36)	**2**
Deferred acquisition costs (see Note 23)	**86**
Reinsurance assets (see Note 20 f&g)	**490**
Prepayments and accrued interest	**51**
Loans and other receivables	**129**
Insurance receivables	**265**
Financial assets at fair value through income	**736**
AFS financial assets at fair value through OCI	**995**
Derivative financial investments	**18**
Cash and cash equivalents (excluding bank overdrafts)	**319**
Assets held for sale	**3,367**
Liabilities	
Insurance contract liabilities (see Note 20 f&g)	**2,283**
Provisions (see Note 40)	**8**
Subordinated liabilities	**11**
Corporation tax liability	**10**
Insurance payables	**28**
Trade and other payables	**176**
Liabilities directly associated with assets held for sale	**2,516**

13. Auditors' remuneration

	2018 £000	2017 £000
Audit of Society	**825**	896
Fees payable to the Society's auditors and its associates for other services:		
– Audit of subsidiaries	**803**	720
– Audit-related assurance services	**407**	457
– Other tax services	**8**	57
– Other non-audit services not covered above	**23**	205
	2,066	2,335

Included in the table above are costs of £843,000 (2017: £750,000) relating to the discontinued operations.

In addition to the amounts disclosed above, expenses relating to audit work of £75,000 (2017: £150,000) were paid to the auditors in respect of the year ended 31 December 2018.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Financial assets and liabilities

This section presents information relating to the financial assets and liabilities (excluding insurance contract-related assets and liabilities which are disclosed in Note 20) held by the Society and Group. These financial assets and liabilities are held at either fair value or amortised cost as defined by the Group's accounting policies.

14. Financial assets – Fair value through income

Accounting for financial assets and liabilities at fair value through income

Financial assets at fair value through income has two sub categories:

- Financial assets held for trading; and
- Those designated at fair value through income at inception.

Derivatives are classified at fair value through income as they are held for trading (see note 15). Financial assets designated at fair value through income at inception are part of a group of financial assets that are managed and their performance evaluated and reported to the board on a fair value basis in accordance with the Group's documented investment strategy. These assets are measured at market prices, or prices consistent with market ratings should no price be available. Day one gains are recognised only where valuations use data from observable markets. Any unrealised or realised gains or losses are taken to the Statement of Comprehensive Income, as fair value gains or losses, or realised gains or losses respectively, as they occur.

Financial assets at fair value through income include listed and unlisted investments, units in authorised unit trusts, open ended investment companies (OEICs), loans secured on residential and commercial property, and other investments.

Financial liabilities at fair value through income include derivative financial instruments and non-participating investment contract liabilities; see Notes 15 and 16 respectively.

The IFRS "fair value hierarchy" levels for financial assets and liabilities required under IFRS 13 are disclosed within Note 4.

Loans secured on residential property

The fair value of the loans secured on residential property (arising from the equity release mortgage business) is determined by discounting the expected cash flows which take into account the contractual interest rolled up on the loans, and expected repayment profiles based on assumed mortality and early loan repayment rates. The discount rate is based on the swap yield curve increased by a spread and an allowance for risks associated with the 'No Negative Equity Guarantee'.

The loans incorporate a 'No Negative Equity Guarantee' to customers. The contractual terms of these guarantees require the company to accept the lower of the market value of the customer's property and the value of the loan plus accrued interest at the date of redemption as full settlement of the mortgage. For almost all loans it is expected that the No Negative Equity Guarantee will not be invoked and the value of the loan plus accrued interest will be received.

The fair value of the guarantee is determined using a stochastic model.

The fair value of the loans is determined using assumptions for interest rates, future house price inflation and its volatility, mortality rates, long-term care rates and early loan repayment rates, to give management's best estimate view of the discounted value of cash flows required to settle any future financial obligation arising at the Statement of Financial Position date.

The loans secured on residential property within the Society are purchased from a subsidiary company that is authorised to initiate these loans. The purchase by the Society is at origination value plus 7% (which is expensed in the Society when paid).

Loans secured on commercial property

The fair value of the loans secured on commercial property is determined using discounted cash flows to reflect changes in underlying gilt yields and debt margins. Where the value is not expected to be recovered through ongoing loan payments, the fair value represents the recoverable value of the property in the market post transaction costs.

Significant accounting estimates

Fair value of financial assets

Market observable inputs are used wherever possible. Judgement is applied to determine whether a market is active; this is based upon the facts and circumstances of the relevant market. In the absence of an active market, estimation of fair value is achieved by using valuation techniques such as recent arm's length transactions, discounted cash flow analysis and option pricing models. For discounted cash flow analysis, estimated future cash flows and discount rates are based on current market information and rates applicable to financial instruments with similar yields, credit quality and maturity characteristics. This valuation will also take into account the marketability of the assets being valued.

Details of the key assumptions used in the absence of an active market are contained in the fair value estimation tables, as required by IFRS 13, disclosed in Note 4.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

14. Financial assets – Fair value through income (continued)

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Financial assets – Fair value through income				
Shares, other variable yield securities and units in unit trusts				
– UK listed	**6,755**	7,629	**6,565**	6,844
– UK unlisted	**78**	91	**78**	91
– Overseas listed	**108**	117	**108**	112
– Overseas unlisted	**33**	42	**33**	42
Debt and other fixed income securities				
– UK listed	**2,513**	3,032	**2,499**	2,661
– Overseas listed	**1,182**	2,072	**1,182**	1,255
Loans secured on residential property	**648**	667	**648**	667
Loans secured on commercial property	**221**	200	**221**	200
Other	**–**	3	**–**	3
	11,538	13,853	**11,334**	11,875
Assets held to cover linked liabilities included above	**3,066**	3,130	**3,066**	3,130

Included within the 2017 comparatives are amounts of £1,437m relating to the general insurance business. In 2018 these balances have been disclosed as Assets held for sale within Note 12. For details on exposure to foreign exchange currency risk see page 120.

15. Derivative financial instruments

Accounting for derivative financial instruments

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently re-measured at their fair value. There are no designated hedging relationships within the Group that qualify for hedge accounting, all are classified as held for trading. Derivatives are settled on a gross basis.

Changes in the fair value of derivative instruments are recognised immediately in gains or losses on investments in the Statement of Comprehensive Income for the period. Realised gains or losses are taken to the Statement of Comprehensive Income on occurrence.

The Group uses derivatives primarily to reduce its exposure to interest rate risk and to protect against fluctuations in equity values. The cash flow swaps improve asset-liability matching within the annuity fund.

	2018			2017		
Group	Contract/ notional amount £m	Fair value – asset £m	Fair value – liability £m	Contract/ notional amount £m	Fair value – asset £m	Fair value – liability £m
Interest rate swaps	**424**	**52**	**(2)**	811	69	(4)
Gilt forwards	**464**	**3**	**(4)**	624	4	–
Cash flow swaps	**1,005**	**–**	**(184)**	1,070	–	(186)
Swaptions	**–**	**–**	**–**	87	1	–
Forward exchange contracts	**–**	**–**	**–**	2	–	–
Equity/index derivatives	**110**	**10**	**–**	211	7	(3)
	2,003	**65**	**(190)**	2,805	81	(193)

Included within the 2017 comparatives is a net liability of £5m relating to the general insurance business. In 2018 these balances have been disclosed within Assets held for sale in Note 12.

	2018			2017		
Society	Contract/ notional amount £m	Fair value – asset £m	Fair value – liability £m	Contract/ notional amount £m	Fair value – asset £m	Fair value – liability £m
Interest rate swaps	**424**	**52**	**(2)**	444	68	–
Gilt forwards	**464**	**3**	**(4)**	624	4	–
Cash flow swaps	**1,005**	**–**	**(184)**	1,070	–	(186)
Swaptions	**–**	**–**	**–**	87	1	–
Equity/index derivatives	**110**	**10**	**–**	132	7	(1)
	2,003	**65**	**(190)**	2,357	80	(187)

Notes to the Financial Statements (continued)

Year ended 31 December 2018

16. Investment contract liabilities

Accounting for investment contract liabilities

Non-participating contracts

Investment contract liabilities are recognised when contracts are entered into and premiums are charged. These liabilities are initially recognised at transaction price excluding any transaction costs directly attributable to the issue of the contract. Designation at inception is at fair value in order to avoid a measurement inconsistency with the associated financial assets.

Deposits and withdrawals are recorded directly as an adjustment to the contract liability in the Statement of Financial Position, a method known as deposit accounting. Fees charged and investment income received are recognised in the Statement of Comprehensive Income when earned.

Fair value adjustments are measured at each reporting date and are recorded in the Statement of Comprehensive Income. Fair value is calculated as the number of units allocated to the policyholder in each unit linked fund multiplied by the unit price of those funds at the Statement of Financial Position date. The unit prices are determined with reference to the fund assets and liabilities, which are valued on a basis consistent with that used to measure the equivalent assets and liabilities in the Statement of Financial Position, adjusted for the effect of future tax arising from any unrealised gains or losses. For a contract that can be cancelled by the policyholder, the fair value cannot be less than the surrender value.

Participating contracts

Insurance and participating investment contract liabilities are valued using accounting policies consistent with those adopted prior to the transition to IFRS as permitted under IFRS 4 'Insurance contracts'. The accounting treatment of these contracts is described within Note 20.

a) Analysis of investment contract liabilities

		Group		Society	
	Notes	**2018 £m**	2017 £m	**2018 £m**	2017 £m
Non-participating investment contract liabilities	16b	**3,017**	3,071	**3,017**	3,071
Participating investment contract liabilities	16c	**691**	746	**691**	746
		3,708	3,817	**3,708**	3,817

b) Movement in non-participating investment contract liabilities

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Balance at 1 January	**3,071**	2,547	**3,071**	2,547
Deposits received from policyholders	**456**	656	**456**	656
Payments made to policyholders	**(375)**	(366)	**(375)**	(366)
Change in contract liabilities included in the Statement of Comprehensive Income	**(135)**	234	**(135)**	234
Balance at 31 December	**3,017**	3,071	**3,017**	3,071

The change in contract liabilities as shown in the Statement of Comprehensive Income comprises principally the allocation of the net investment return to policyholders of investment contracts less allowances for taxes.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

16. Investment contract liabilities (continued)

c) Movement in participating investment contract liabilities

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Balance at 1 January	**746**	690	**746**	690
Premiums received	**8**	9	**8**	9
Liabilities paid for deaths, maturities, surrenders, benefits and claims	**(36)**	(37)	**(36)**	(37)
Benefits and claims variation	**1**	1	**1**	1
Fees deducted	**(3)**	(4)	**(3)**	(4)
Accretion of investment income or change in unit prices	**(27)**	54	**(27)**	54
Adjustment due to changes in assumptions:				
– Investment return	**(1)**	1	**(1)**	1
– Expense	**–**	(3)	**–**	(3)
– Other basis changes	**6**	–	**6**	–
Other	**(9)**	23	**(9)**	23
Mutual bonus	**6**	7	**6**	7
Change to economic basis	**–**	5	**–**	5
Balance at 31 December	**691**	746	**691**	746

17. Loans and other receivables

Accounting for loans and other receivables

Loans and other receivables are initially measured at fair value and then subsequently measured at amortised cost using the effective interest rate method. Loans include secured notes and reverse repurchase agreements which represent the consideration paid to the borrower. Other receivables comprise amounts due to the Society from group undertakings and other receivables including outstanding investment sales and are recognised when due.

The Group assesses at each Statement of Financial Position date whether there is any indication that a loan or receivable, or a group of loans or receivables, is impaired. For loans, the amount of any impairment loss is measured as the difference between the carrying amount and the present value of future cash flows (discounted at the original effective interest rate). For receivables, where there is objective evidence that the carrying value is impaired then the impairment loss will be recognised in the Statement of Comprehensive Income.

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Secured loan notes	**200**	–	**–**	–
Reverse repurchase agreements	**150**	200	**–**	–
Cash collateral pledged	**1**	10	**1**	3
Amounts due from group undertakings	**5**	–	**33**	25
Investments receivable	**35**	26	**35**	20
Other receivables	**16**	22	**15**	17
	407	258	**84**	65

Included within the 2017 comparatives are amounts of £217m relating to the general insurance business. In 2018 these balances have been disclosed as Assets held for sale within Note 12.

In December 2018 a subsidiary of the Society invested in £200m of secured loan notes and £150m of reverse repurchase agreements, both of these investments mature in 2019.

The £5m amount due from group undertakings reported at Group level represents the balance due to the Group from the general insurance business that is classified as held for sale (see Note 12).

Details of impairments on financial assets held at amortised cost are included within the credit counterparty risk section (c) of Note 4. The carrying amounts disclosed above reasonably approximate fair value at the Statement of Financial Position date.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

18. Subordinated liabilities

Accounting for subordinated liabilities

Subordinated liabilities are initially measured at the fair value of the proceeds less attributable transaction costs. Subsequent to initial recognition they are measured at amortised cost. The transaction costs are amortised over the period to the expected redemption date on an effective interest rate basis. The amortisation charge is included in the Statement of Comprehensive Income within finance costs. An equivalent amount is added to the carrying value of the liability such that at the redemption date the value of the liability equals the redemption value.

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Subordinated notes (GBP 350m)	**348**	348	**348**	348
Subordinated notes (EUR 12m)	**–**	10	**–**	–
	348	358	**348**	348

All the subordinated liabilities are expected to be settled more than 12 months after the balance sheet date.

In 2013 the Society issued £350m of Fixed Rate Reset Subordinated Notes at par. The directly related costs of £4m incurred to issue the Notes have been capitalised as part of the carrying value and are being amortised using the effective interest rate basis over the period to the first call date in 2023. The effective interest rate on the £350m liability is 6.654% resulting in a £23m finance charge for the year (see Note 10).

The Notes have a maturity date of 22 May 2043 but the issuer has the option to redeem the Notes at the first call date of 22 May 2023 and at five yearly intervals thereafter up to the maturity date.

Interest is payable on the Notes at a fixed rate of 6.5% (£23m) per annum for the period until the first call date on 22 May 2023, payable annually in arrears on 22 May each year. If the Notes are not redeemed on 22 May 2023, the interest rate is reset on that date and at five yearly intervals thereafter at a rate equal to the five year gilt rate quoted on the day before the reset date plus an initial margin of 463 basis points and a step up margin of 100 basis points.

There is an option of cumulative deferral of interest at the issuer's discretion and mandatory interest deferral in the event that a regulatory deficiency interest deferral event has occurred or is continuing (breach of the applicable regulatory solvency capital requirement of the issuer or group) or would occur if payment of interest on the subordinated notes were to be made. Following any deferral of a principal or interest payment, the Society would be prevented from declaring any distribution to members which falls within the Mutual Bonus arrangements. The Society has the option to elect to defer payment of interest in whole or in part and this will not constitute a default or give the right to the noteholders or the trustee to accelerate repayment of the Notes or to take any enforcement action.

The €12m subordinated notes are issued by a subsidiary undertaking and are repayable in 2034. Interest on these Notes is payable at the 3 month euro deposit rate plus a margin of 365 basis points. The euro denominated notes are held by a general insurance subsidiary and for 2018 reporting are included within the Liabilities directly associated with assets held for sale in Note 12.

Subordinated liabilities are held in the Statement of Financial Position at amortised cost. The fair value at 31 December 2018 was £367m (2017: £405m). The valuation of the subordinated notes was determined by reference to the bid price obtained from the markets as at 31 December 2018. Management consider this to be representative of fair value.

19. Other financial liabilities

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Cash collateral received	**59**	62	**59**	62
	59	62	**59**	62

The carrying amounts disclosed above reasonably approximate fair value at the Statement of Financial Position date.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Insurance contract related assets and liabilities

This section presents information relating to insurance contract related assets and liabilities held by the Society and Group. The assumptions used in the valuation of the insurance contract liabilities are disclosed within Note 25 with sensitivities to these assumptions disclosed separately within Note 4.

20. Insurance contract liabilities

Accounting for insurance contract liabilities

Insurance contract liabilities are recognised for insurance contracts in existence at the end of the reporting period. Such liabilities are only derecognised when the obligation specified in the contract is discharged, cancelled or expires.

IFRS 4 Insurance Contracts permits the continued application, for income statement presentation and liability measurement purposes, of accounting policies that were being used at the date of transition to IFRS, except where a change is deemed to make the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. As such, the Group accounting for insurance contracts and participating investment contracts is in accordance with the Statement of Recommended Practice issued by the Association of British Insurers in December 2005, amended in December 2006 and withdrawn in December 2015. The Group continues to apply this Statement of Recommended Practice.

a) Long-term insurance contract liabilities and participating investment contract liabilities

(i) Participating business

Participating business includes both participating insurance and participating investment contract liabilities. The liabilities are calculated in accordance with the PRA's previous 'realistic' liability regime, which was the regime in place at the date of transition to IFRS. In particular, provision is made for all bonus payments (declared and future, reversionary and terminal) estimated, where necessary, in a manner consistent with the relevant fund's Principles and Practices of Financial Management (PPFM). The liabilities include an allowance for the time and intrinsic value of options and guarantees granted to policyholders and for future management actions.

The realistic participating liabilities are based on the aggregate value of policy asset shares reflecting past premiums, investment return, expenses and charges applied to each policy. Allowance is also made for policy-related liabilities such as guarantees, options and future bonuses calculated using a stochastic model simulating investment returns, asset mix, expense charges and bonuses.

In determining the realistic value of liabilities for participating contracts, the value of future profits on non-participating business written in the With-profits part of the fund is accounted for as part of the calculation. The present value of future profits on the non-participating business ('Non-participating value of the in-force business') is separately determined and its value is deducted from the sum of the liabilities for participating contracts and the Unallocated divisible surplus.

The non-participating value of the in-force business is separately disclosed within Note 21. Such an amount is not recognised for business written outside participating contract funds.

(ii) Non-participating business

The liability is calculated to comply with the reporting requirements under the PRA's handbook using a gross premium valuation method or a method at least as prudent as the gross premium method. This was the regime in place on adoption of IFRS. The Society and relevant subsidiaries have adopted the modified statutory solvency basis in the valuation of provisions for non-participating business.

Liabilities for non-participating business are either included within the long-term insurance contract liabilities or the investment contract liabilities, depending upon the product classification.

b) General insurance claims and insurance contract liabilities

For 2018 reporting these balances are included within 'Liabilities associated with assets held for sale' – see Note 12.

Claims incurred comprise claims and related internal and external claims handling costs paid in the year and changes in the provisions for outstanding claims, including provisions for claims incurred but not reported and related claims handling costs, together with any other adjustments to claims from previous years. Where applicable, deductions are made for recoveries from other parties.

Provision is made for the estimated cost of claims incurred but not settled, including the cost of claims incurred but not reported. The estimated cost of claims includes expenses to be incurred in settling claims and a deduction for the expected value of recoveries. However, given the inevitable uncertainty in establishing claims provisions, it is likely that the final outcome will prove to be different from the original liability established. Provisions are adjusted at the Statement of Financial Position date to represent a best estimate of the expected outcome.

Provisions are calculated allowing for reinsurance recoveries and a separate asset is recorded for the reinsurers' share of the provision.

Standard actuarial claims projection techniques are used to estimate outstanding claims. Such methods extrapolate the development of paid and incurred claims, recoveries from third parties, average cost per claim and ultimate claim numbers for each accident year, based upon the observed development of earlier years and expected loss ratios. The main assumption underlying these techniques is that past claims development experience can be used to project ultimate claims costs. In the case of PPOs, the annuity type structure of the claim payments mean that these have to be projected over a longer-term period and reserved for on a discounted basis accordingly. Allowance for one off occurrences or changes in legislation, policy conditions or portfolio mix, is also made in arriving at the estimated ultimate cost of claims, in order that it represents the most likely outcome, taking account of all the uncertainties involved. To the extent that the ultimate cost is different from the estimate, where experience is better or worse than that assumed, the surplus or deficit will be credited or charged to the Statement of Comprehensive Income in future years.

For general insurance contracts, provision is made, if required, for any anticipated claims and claims handling costs that are anticipated to exceed the unearned premiums, net of deferred acquisition costs. An estimate is made for future investment income arising from the unearned premiums, and used to reduce the unexpired risk provision. Unexpired risk surpluses and deficits are offset where business classes are managed together and a provision is made if an aggregate deficit arises.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

20. Insurance contract liabilities (continued)

Significant accounting estimates and judgements

The valuation of insurance contract liabilities requires management judgement in applying the appropriate accounting treatment and the use of estimates. Where the use of estimates involves management judgement, these are explained separately to judgements involving the application of accounting policies.

a) Long-term insurance contract liabilities and participating investment contract liabilities

(i) Significant accounting estimates

Estimate	Judgement applied to estimate
Assumptions and adjustments applied in the valuation of insurance liabilities The valuation of participating contract liabilities is based on assumptions reflecting the best estimate at the time. The valuation of non-participating insurance contracts is based on prudent assumptions; a separate calculation is also performed to assess the non-participating value of in-force business which is based on best estimate assumptions. All contracts are subject to liability adequacy tests, which reflects management's best current estimate of future cash flows. The assumptions used for mortality, morbidity and longevity are based on standard industry or reinsurers' tables. The assumptions used for investment returns and discount rates are based on current market yields. The assumptions used for expenses and persistency reflect product characteristics and are primarily based on relevant internal experience. The assumptions for mortality improvements are based on the latest version of the Institute and Faculty of Actuaries Continuous Mortality Investigation (CMI) Mortality Projections Model, referred to as CMI_2017. Due to the long-term nature of the liabilities, the estimates are subject to significant uncertainty.	The assumptions used for mortality, morbidity and longevity are adjusted where appropriate to reflect the Group's own experience. In particular, for impaired annuities the mortality assumptions are adjusted so as to allow for convergence to standard mortality at advanced ages. These adjustments vary according to lifestyle or medical condition, gender, age and duration in-force. The assumptions used for discount rates are adjusted for the Group's own risk exposure. Non-participating value of in-force business valuation makes allowance for a margin of risk and adverse deviation.
Assessment of future options and guarantees The value of options and guarantees on With-profits business is valued within the market-consistent discounted cash flow valuation, the most material of which are minimum benefit guarantees on LVFS With-profits business and guaranteed annuity options on RNPFN. Due to the asymmetric nature of these liabilities, stochastic valuation techniques are required. A market consistent economic scenario generator is used with a wide range of future economic conditions to capture the asymmetry, and a discounted cash flow model is used to derive a value of the liability at the valuation date. These techniques are widely used in the life insurance industry to value liabilities with embedded options and guarantees. The valuation models make appropriate allowance for both management and policyholder actions, where appropriate, including appropriate demographic assumptions on option or guarantee dates.	

(ii) Significant accounting judgements

Changes to methodology for long-term insurance contract liabilities and participating investment contract liabilities

A number of significant changes have been made during 2018:

- Further reviews of the Society's cost base, including an assessment of those costs retained by the existing business at the end of the Transitional Services Agreement with the general insurance business, have led to a provision of £34m being made against retained costs.
- Significant improvements have been made to the modelling of the Society's unit-linked business, to more accurately reflect assumed policyholder behaviour post Pensions Freedoms.
- Changes to FGB mass lapse and guarantee cancellation rates to anticipate policyholder reactions to changes in market conditions.

Details of all the long-term insurance and investment contract liabilities valuation assumptions and the non-participating value of in-force business valuation assumptions are disclosed separately within Notes 25 and 26 respectively.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

20. Insurance contract liabilities (continued)

Significant accounting estimates and judgements (continued)

b) General insurance claims and insurance contract liabilities

For 2018 reporting these balances are included within 'Liabilities associated with assets held for sale' – see Note 12.

(i) Significant accounting estimates

Estimate	Judgement applied to estimate
Estimate of ultimate cost of claims The estimation of the ultimate liability arising from claims made under insurance contracts is the most critical accounting estimate for the general insurance business. For general insurance contracts estimates are made for the expected ultimate cost of claims as at the Statement of Financial Position date and the cost of claims incurred but not yet reported. It can take a significant period of time before the ultimate cost of claims can be established with certainty, and the final outcome may be better or worse than that provided. There are several sources of uncertainty that need to be considered in the estimate of the liability that will ultimately be paid for such claims. In particular, motor insurance policies are exposed to claims for personal injury. Estimation of the ultimate cost of large personal injury claims is a complex process and cannot be done using conventional actuarial techniques given they typically exhibit low frequency and high severity. Significant factors that affect the personal injuries estimation process are legislation (e.g. the Ogden discount rate used to value lump sum settlements), judicial decisions and the long delay to settlement. Due to this uncertainty it is not possible to determine the future development of personal injury claims with the same degree of reliability as with other types of claims. Claims that have or are likely to settle on a Periodic Payment Order ('PPO') basis require a high degree of judgement due to the nature of the settlement, which has an annuity-type structure, i.e. they are typically paid annually over the claimant's life with mortality, inflation and investment returns being the key risks. Due to the settlement structure, payments have to be projected over a longer-term period and reserved for on a discounted basis accordingly. Therefore, the estimation of ultimate claims cost involves projecting mortality rates, discount rates and benefit indexation rates, which is unlike all other general insurance liabilities. On 20 December 2018 the Civil Liability Bill received Royal Assent and is thus the Civil Liability Act, with a revised Ogden Discount Rate expected to be announced in the summer of 2019. The Act should ensure a more proportional rate is applied to lump sum settlements for personal injury claims as well as providing a framework for future reviews to the rate. Whilst the revised rate is not yet known the Group anticipates an increase from the current legislative rate of -0.75%, with the best estimate reserves being held at the equivalent of a 0% Ogden Discount Rate. The rationale utilised in setting the best estimate rate has included: a review of the opinions and papers provided to date by the Government Actuarial Department (GAD) and the expected real returns from appropriate portfolios of assets. Large claims impacting each relevant business class are generally assessed separately, being measured either at the face value of the loss adjusters' estimates or projected separately in order to allow for the future development of large claims.	While management believes that the insurance contract liabilities carried at year end are adequate, the application of statistical techniques requires significant judgement. The estimation of these claims is based on historical experience projected forward. Where possible, the Group adopts multiple techniques to provide a best estimate of the required level of provisions. This assists in developing greater understanding of the trends inherent in the data being projected. The Group's estimates of losses and loss expenses are reached after a review of several commonly accepted actuarial projection methodologies, as well as more bespoke methods and a number of different bases to determine these provisions. These include methods based upon the following: • the development of previously paid claims, where payments to date are extrapolated for each prior year; • estimates based upon a projection of claims numbers and average cost; • incurred claims development, where incurred claims to date for each year are extrapolated based upon observed development of earlier years; and • expected loss ratios.

Provisions are initially calculated gross of any reinsurance recoveries. A separate estimate is made of the amounts that will be recoverable from reinsurers based upon the gross provisions and having due regard to collectability.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

20. Insurance contract liabilities (continued)

a) Analysis of insurance contract liabilities and reinsurance assets

Group	Note	2018 Gross £m	2018 Reinsurance £m	2018 Net £m	2017 Gross £m	2017 Reinsurance £m	2017 Net £m
Participating insurance contract liabilities							
Long-term insurance contract liabilities	20 b	**5,092**	**–**	**5,092**	5,279	–	5,279
Non-participating insurance contract liabilities							
Reinsurance relating to participating contracts*	20 b	**–**	**(897)**	**(897)**	–	(933)	(933)
Long-term insurance contract liabilities	20 c	**4,269**	**(695)**	**3,574**	4,371	(644)	3,727
Long-term linked insurance contract liabilities	20 d	**195**	**(146)**	**49**	229	(170)	59
Long-term claims liabilities	20 e	**58**	**–**	**58**	50	–	50
		4,522	**(1,738)**	**2,784**	4,650	(1,747)	2,903
General insurance unearned premiums	20 f	**–**	**–**	**–**	785	(15)	770
General insurance claims liabilities	20 g	**–**	**–**	**–**	1,643	(543)	1,100
		–	**–**	**–**	2,428	(558)	1,870
		4,522	**(1,738)**	**2,784**	7,078	(2,305)	4,773

Society	Note	2018 Gross £m	2018 Reinsurance £m	2018 Net £m	2017 Gross £m	2017 Reinsurance £m	2017 Net £m
Participating insurance contract liabilities							
Long-term insurance contract liabilities	20 b	**5,092**	**–**	**5,092**	5,279	–	5,279
Non-participating insurance contract liabilities							
Reinsurance relating to participating contracts*	20 b	**–**	**(897)**	**(897)**	–	(933)	(933)
Long-term insurance contract liabilities	20 c	**4,255**	**(695)**	**3,560**	4,356	(644)	3,712
Long-term linked insurance contract liabilities	20 d	**195**	**(146)**	**49**	229	(170)	59
Long-term claims liabilities	20 e	**58**	**–**	**58**	50	–	50
		4,508	**(1,738)**	**2,770**	4,635	(1,747)	2,888

* From December 2017 the Group entered into a reinsurance arrangement in respect of the OB Pension portfolio. The OB Pensions portfolio is a participating insurance contract liability, whereas the associated reinsurance is classified as non-participating as disclosed in the tables above.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

20. Insurance contract liabilities (continued)

b) Movement in long-term insurance contract liabilities – participating

Group and Society	2018 Gross £m	2018 Reinsurance £m	2018 Net £m	2017 Gross £m	2017 Reinsurance £m	2017 Net £m
Balance at 1 January	**5,279**	**–**	**5,279**	4,999	–	4,999
Premiums received	**27**	**–**	**27**	31	–	31
Liabilities paid for deaths, maturities, surrenders, benefits and claims	**(427)**	**–**	**(427)**	(444)	–	(444)
New business	**340**	**–**	**340**	403	–	403
Benefits and claims variation	**33**	**–**	**33**	57	–	57
Fees deducted	**(20)**	**–**	**(20)**	(23)	–	(23)
Accretion of investment income or change in unit prices	**(103)**	**–**	**(103)**	224	–	224
Adjustment due to changes in assumptions:						
– Mortality/morbidity/longevity	**(22)**	**–**	**(22)**	(44)	–	(44)
– Investment return	**(27)**	**–**	**(27)**	38	–	38
– Expense	**(1)**	**–**	**(1)**	(15)	–	(15)
– Lapse and surrender rates	**7**	**–**	**7**	1	–	1
– Other basis changes	**1**	**–**	**1**	–	–	–
Model changes	**9**	**–**	**9**	12	–	12
Other	**(14)**	**–**	**(14)**	(59)	–	(59)
Teachers Assurance (TA) fund special bonus	**(10)**	**–**	**(10)**	(9)	–	(9)
Mutual bonus	**20**	**–**	**20**	19	–	19
Change in economic basis	**–**	**–**	**–**	89	–	89
Balance at 31 December	**5,092**	**–**	**5,092**	5,279	–	5,279

b) Movement in non-participating reinsurance assets relating to long-term participating insurance contract liabilities

Group and Society	2018 Gross £m	2018 Reinsurance £m	2018 Net £m	2017 Gross £m	2017 Reinsurance £m	2017 Net £m
Balance at 1 January	**–**	**(933)**	**(933)**	–	–	–
Inception of OB pensions reinsurance contract	**–**	**–**	**–**	–	(847)	(847)
Liabilities paid for deaths, maturities, surrenders, benefits and claims	**–**	**10**	**10**	–	–	–
Benefits and claims variation	**–**	**3**	**3**	–	–	–
Accretion of investment income or change in unit prices	**–**	**(5)**	**(5)**	–	–	–
Adjustment due to changes in assumptions:						
– Mortality/morbidity/longevity	**–**	**9**	**9**	–	–	–
– Investment return	**–**	**19**	**19**	–	(9)	(9)
– Lapse and surrender rates	**–**	**1**	**1**	–	–	–
Model changes	**–**	**(2)**	**(2)**	–	–	–
Other	**–**	**1**	**1**	–	(1)	(1)
Change in economic basis	**–**	**–**	**–**	–	(76)	(76)
Balance at 31 December	**–**	**(897)**	**(897)**	–	(933)	(933)

Notes to the Financial Statements (continued)

Year ended 31 December 2018

20. Insurance contract liabilities (continued)

c) Movement in long-term insurance contract liabilities – non-participating

Group	2018 Gross £m	2018 Reinsurance £m	2018 Net £m	2017 Gross £m	2017 Reinsurance £m	2017 Net £m
Balance at 1 January	**4,371**	**(644)**	**3,727**	4,204	(474)	3,730
Premiums received	**170**	**(68)**	**102**	156	(61)	95
Liabilities paid for deaths, maturities, surrenders, benefits and claims	**(423)**	**92**	**(331)**	(393)	76	(317)
New business	**246**	**(163)**	**83**	156	(113)	43
Benefits and claims variation	**11**	**(3)**	**8**	30	(16)	14
Fees deducted	**(17)**	**(1)**	**(18)**	(16)	–	(16)
Accretion of investment income or change in unit prices	**59**	**(1)**	**58**	43	–	43
Adjustment due to changes in assumptions:						
– Mortality/morbidity/longevity	**(68)**	**67**	**(1)**	(6)	(9)	(15)
– Investment return	**(64)**	**13**	**(51)**	80	(6)	74
– Expense	**13**	**2**	**15**	24	–	24
– Lapse and surrender rates	**(2)**	**5**	**3**	13	(9)	4
– Other basis changes	**(27)**	**10**	**(17)**	14	–	14
Model changes	**4**	**(5)**	**(1)**	(2)	(4)	(6)
Other	**(4)**	**1**	**(3)**	18	(1)	17
Change in economic basis	**–**	**–**	**–**	50	(27)	23
Balance at 31 December	**4,269**	**(695)**	**3,574**	4,371	(644)	3,727

Society	2018 Gross £m	2018 Reinsurance £m	2018 Net £m	2017 Gross £m	2017 Reinsurance £m	2017 Net £m
Balance at 1 January	**4,356**	**(644)**	**3,712**	4,189	(474)	3,715
Premiums received	**170**	**(68)**	**102**	155	(61)	94
Liabilities paid for deaths, maturities, surrenders, benefits and claims	**(422)**	**92**	**(330)**	(391)	76	(315)
New business	**246**	**(163)**	**83**	156	(113)	43
Benefits and claims variation	**11**	**(3)**	**8**	30	(16)	14
Fees deducted	**(17)**	**(1)**	**(18)**	(16)	–	(16)
Accretion of investment income or change in unit prices	**59**	**(1)**	**58**	43	–	43
Adjustment due to changes in assumptions:						
– Mortality/morbidity/longevity	**(68)**	**67**	**(1)**	(6)	(9)	(15)
– Investment return	**(64)**	**13**	**(51)**	80	(6)	74
– Expense	**13**	**2**	**15**	24	–	24
– Lapse and surrender rates	**(2)**	**5**	**3**	13	(9)	4
– Other basis changes	**(27)**	**10**	**(17)**	14	–	14
Model changes	**4**	**(5)**	**(1)**	(2)	(4)	(6)
Other	**(4)**	**1**	**(3)**	17	(1)	16
Change in economic basis	**–**	**–**	**–**	50	(27)	23
Balance at 31 December	**4,255**	**(695)**	**3,560**	4,356	(644)	3,712

Notes to the Financial Statements (continued)

Year ended 31 December 2018

20. Insurance contract liabilities (continued)

d) Movement in long-term linked insurance contract liabilities

	2018			2017		
Group and Society	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Balance at 1 January	**229**	**(170)**	**59**	192	(127)	65
Premiums received	**42**	**(17)**	**25**	45	(18)	27
Liabilities paid for deaths, maturities, surrenders, benefits and claims	**(38)**	**25**	**(13)**	(41)	25	(16)
New business	**(18)**	**3**	**(15)**	15	(33)	(18)
Benefits and claims variation	**2**	**(1)**	**1**	6	(5)	1
Fees deducted	**(2)**	**–**	**(2)**	(2)	–	(2)
Accretion of investment income or change in unit prices	**1**	**–**	**1**	1	–	1
Adjustment due to changes in assumptions:						
– Mortality/morbidity/longevity	**(9)**	**9**	**–**	(14)	–	(14)
– Investment return	**(5)**	**2**	**(3)**	4	(1)	3
– Expense	**(1)**	**–**	**(1)**	5	–	5
– Lapse and surrender rates	**(1)**	**1**	**–**	4	(3)	1
– Other basis changes	**(5)**	**2**	**(3)**	–	–	–
Model changes	**–**	**–**	**–**	(3)	–	(3)
Other	**–**	**–**	**–**	3	–	3
Change in economic basis	**–**	**–**	**–**	14	(8)	6
Balance at 31 December	**195**	**(146)**	**49**	229	(170)	59

e) Movement in long-term claims liabilities

	2018			2017		
Group	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Balance at 1 January	**50**	**–**	**50**	46	–	46
Claims notified	**904**	**(232)**	**672**	872	(237)	635
Claims paid during the year	**(896)**	**232**	**(664)**	(868)	237	(631)
Balance at 31 December	**58**	**–**	**58**	50	–	50

	2018			2017		
Society	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Balance at 1 January	**50**	**–**	**50**	45	–	45
Claims notified	**903**	**(232)**	**671**	871	(237)	634
Claims paid during the year	**(895)**	**232**	**(663)**	(866)	237	(629)
Balance at 31 December	**58**	**–**	**58**	50	–	50

f) Movement in general insurance unearned premiums

	2018			2017		
Group	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Balance at 1 January	**785**	**(15)**	**770**	793	(17)	776
Premiums written in the year	**1,580**	**(383)**	**1,197**	1,596	(361)	1,235
Premiums earned during the year	**(1,610)**	**383**	**(1,227)**	(1,604)	363	(1,241)
Liabilities directly associated with assets held for sale	**(755)**	**15**	**(740)**	–	–	–
Balance at 31 December	**–**	**–**	**–**	785	(15)	770

g) Movement in general insurance claims liabilities

	2018			2017		
Group	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Balance at 1 January	**1,643**	**(543)**	**1,100**	1,563	(472)	1,091
Movement in claims incurred in prior accident years	**(253)**	**110**	**(143)**	(34)	(12)	(46)
Claims incurred in the current accident year	**1,221**	**(285)**	**936**	1,124	(286)	838
Claims paid during the year	**(1,083)**	**243**	**(840)**	(1,010)	227	(783)
Liabilities directly associated with assets held for sale	**(1,528)**	**475**	**(1,053)**	–	–	–
Balance at 31 December	**–**	**–**	**–**	1,643	(543)	1,100

Notes to the Financial Statements (continued)

Year ended 31 December 2018

21. Non-participating value of in-force business

Accounting for the non-participating value of in-force business

In determining the realistic value of liabilities for participating contracts as disclosed in Note 20, the value of future profits on non-participating business written in the With-profits part of the fund is accounted for as part of the calculation. The present value of future profits of the non-participating business ('non-participating value of in-force business') is separately determined and its value is deducted from the sum of the liabilities for participating contracts and the Unallocated divisible surplus. Such an amount is not recognised for business written outside participating contract funds.

The principal assumptions are disclosed separately within Note 26.

Analysis of non-participating value of in-force business

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Balance at 1 January	**293**	324	**293**	324
Premiums received	**(1)**	(1)	**(1)**	(1)
Liabilities paid for deaths, maturities, surrenders, benefits and claims	**(12)**	(14)	**(12)**	(14)
New business	**31**	41	**31**	41
Benefits and claim variation	**(6)**	(1)	**(6)**	(1)
Fees deducted	**(9)**	(6)	**(9)**	(6)
Accretion of investment income or change in unit prices	**(3)**	8	**(3)**	8
Adjustment due to changes in assumptions:				
– Mortality/morbidity/longevity	**(3)**	(17)	**(3)**	(17)
– Investment return	**(4)**	(4)	**(4)**	(4)
– Expense	**10**	(10)	**10**	(10)
– Lapse and surrender rates	**7**	(9)	**7**	(9)
– Other basis changes	**(6)**	(3)	**(6)**	(3)
Model changes	**9**	(5)	**9**	(5)
Other	**(3)**	(9)	**(3)**	(9)
Change in economic basis	**–**	(1)	**–**	(1)
Balance at 31 December	**303**	293	**303**	293

22. Net change in long-term contract liabilities and non-participating value of in-force business

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Gross decrease/(increase) in long-term contract liabilities				
Decrease/(increase) in long-term insurance contract liabilities - participating	**187**	(191)	**187**	(191)
Decrease/(increase) in investment contract liabilities - participating	**55**	(51)	**55**	(51)
Decrease/(increase) in long-term insurance contract liabilities - non-participating	**102**	(117)	**101**	(117)
Decrease/(increase) in investment contract liabilities - non-participating	**135**	(234)	**135**	(234)
Decrease/(increase) in long-term linked insurance contract liabilities	**34**	(23)	**34**	(23)
	513	(616)	**512**	(616)
Mutual bonus (disclosed separately on the Statement of Comprehensive Income)	**26**	26	**26**	26
	539	(590)	**538**	(590)
(Decrease)/increase in long-term contract liabilities ceded to reinsurers				
Increase in long-term insurance contract liabilities relating to non-participating contracts	**51**	143	**51**	143
(Decrease)/increase in long-term insurance contract liabilities relating to participating contracts	**(36)**	857	**(36)**	857
(Decrease)/increase in long-term linked insurance contract liabilities	**(24)**	35	**(24)**	35
	(9)	1,035	**(9)**	1,035
Increase/(decrease) in non-participating value of in-force business	**10**	(30)	**10**	(30)
Net change in contract liabilities before change in economic basis	**540**	415	**539**	415
Change in economic basis	**–**	(48)	**–**	(48)
Net change in contract liabilities	**540**	367	**539**	367

In December 2017 the Group entered into a reinsurance arrangement in respect of the OB Pension portfolio, this had an initial impact of £847m on Long-term contract liabilities ceded to reinsurers. For further details see Note 24.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

23. Deferred acquisition costs

Accounting for deferred acquisition costs

The proportion of the costs of acquiring new general insurance business which relate to unearned premiums are deferred and recognised as an asset to the extent that they are recoverable out of margins in future matching revenues.

Acquisition costs comprise all allowable costs incurred in writing new contracts. Deferred acquisition costs are amortised over a period which is consistent with the assessment of the expected pattern of receipt of future revenue margins for each product type.

All deferred acquisition costs are tested for recoverability at each reporting date. The carrying values are adjusted to recoverable amounts and any resulting impairment losses are charged to the Statement of Comprehensive Income.

Group	£m
At 1 January 2018	**95**
Acquisition costs deferred	**183**
Amortisation	**(192)**
Transfer to assets held for sale	**(86)**
At 31 December 2018	**–**
At 1 January 2017	102
Acquisition costs deferred	195
Amortisation	(202)
At 31 December 2017	95

Acquisition costs are costs of acquiring new business and include commissions, underwriting expenses and policy issue expenses. There were no deferred acquisition costs held by the Society in 2018 (2017: £nil).

24. Reinsurance assets

Accounting for reinsurance assets

Contracts entered into by the Group with reinsurers under which the Group is compensated for losses on the insurance contracts issued by the Group are classified as reinsurance contracts. A contract is only accounted for as a reinsurance contract where there is significant insurance risk transfer between the insured and the insurer. Reinsurance assets are the net contractual rights arising from cashflows due from and to reinsurance companies for ceded insurance liabilities. Amounts are estimated in a consistent manner with the gross reserves of the underlying policies and in accordance with the relevant reinsurance contract.

An impairment review is performed at the Statement of Financial Position date. Impairment occurs when there is evidence that the Group will not recover outstanding amounts under the contract, such losses being recorded immediately in the Statement of Comprehensive Income.

All reinsurance contracts are classified as non-participating as the Group and the reinsurer do not share in the returns on underlying items. This is consistent with the treatment of reinsurance contracts separate from the underlying contracts issued.

Significant accounting judgements

Classification of the Group's contracts with reinsurers as reinsurance contracts

Management have applied judgement in determining whether contracts entered into with reinsurers transfer significant insurance risk and can therefore be accounted for as reinsurance contracts. In making this judgement management review all terms and conditions of each contract and obtain the opinion of an independent expert where necessary.

In order for significant insurance risk to be transferred the following conditions must both be met:

- It is reasonably possible that the reinsurer may realise a significant loss from the contract; and
- There is a reasonable possibility of a significant range of outcomes from the contract.

In December 2017 the Society entered into a reinsurance arrangement in relation to the OB Pensions portfolio included within Participating insurance contract liabilities in Note 20. This was part of the strategy to de-risk the Solvency II balance sheet by reducing the longevity risk exposure and capital requirement. Management judged that significant insurance risk had been transferred to the reinsurer following a review of the terms and conditions of the contract.

The resulting reinsurance asset is disclosed below as the 'Reinsurers' share of long-term contract liabilities – participating'.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

24. Reinsurance assets (continued)

		Group		Society	
	Note	2018 £m	2017 £m	2018 £m	2017 £m
Reinsurers' share of provision for unearned premiums	20 a	–	15	–	–
Reinsurers' share of long-term insurance contract liabilities - non participating	20 a	**695**	644	**695**	644
Reinsurers' share of long-term insurance contract liabilities - participating	20 a	**897**	933	**897**	933
Reinsurers' share of long-term linked insurance contract liabilities	20 a	**146**	170	**146**	170
Reinsurers' share of claims liabilities	20 a	–	543	–	–
		1,738	2,305	**1,738**	1,747

For 2018 reporting the Reinsurers' share of provision for unearned premiums and Reinsurers' share of claims liabilities are included within Assets held for sale – see Note 12.

The carrying amounts disclosed above reasonably approximate fair value at the Statement of Financial Position date.

25. Long-term insurance and investment contract liabilities valuation assumptions

The basis of the calculation of the long-term insurance contract liabilities is described in the accounting policies. The liability is calculated separately for each life operation. Material judgement is required in calculating the liability. In particular there is discretion over the assumptions used. For participating business, the liability is calculated in accordance with the PRA's realistic capital regime. Non-participating liabilities are valued using a gross premium method.

In calculating the realistic liabilities, account has also been taken of future management actions consistent with those set out in the Principles and Practices of Financial Management.

The assumptions used to calculate the liability depend on the circumstances prevailing in each of the life operations. The assumptions used in determining the liability are estimated to give a result within the normal range of outcomes. To the extent that the ultimate cost differs to the amounts provided, for example where experience is worse than that assumed, the surplus or deficit will be credited or charged to the Statement of Comprehensive Income in future years.

When valuing options and guarantees the asset model used was the Moody's Market-Consistent Asset Model. This is a deflator model based on published financial economic theory that is capable of market-consistent valuations for multiple asset classes in multiple currencies. For this valuation it was calibrated to market data as at 31 December 2018 representative of the nature and term of the guarantees inherent in participating insurance contracts within the participating insurance contract funds.

The accounting policies for long-term insurance and investment contract liabilities are included within Notes 20 and 16 respectively. Sensitivities to changes in assumptions are included within Note 4.

a) Society

(i) Participating insurance contracts

For participating insurance contracts, a market consistent valuation is used to calculate the liability. This involves placing a value on liabilities similar to the market value of assets with similar cash flow patterns. The key assumptions used in this valuation are set out below.

Interest rates

The risk-free interest rates assumed are:

Year	2018	2017
5	**1.20%**	0.94%
15	**1.43%**	1.33%
25	**1.46%**	1.37%
35	**1.44%**	1.30%

These interest rates are gross of tax and investment expenses.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

25. Long-term insurance and investment contract liabilities valuation assumptions (continued)

Other assumptions

Best estimate assumptions are set for inflation, mortality, expenses and persistency. The future expense inflation assumption is modelled as RPI plus 0.1% (2017: RPI plus 0.5%) and RPI plus 1% (2017: RPI plus 1%) for business in the Teachers ring-fenced fund, where RPI in both 2018 and 2017 is modelled stochastically.

Benchmark asset mix for assets backing asset shares	2018				2017			
	Cash	Fixed interest	Equities	Property	Cash	Fixed interest	Equities	Property
Flexible Guarantee Funds Cautious	**2%**	**68%**	**20%**	**10%**	2%	68%	20%	10%
Flexible Guarantee Funds Balanced	**2%**	**48%**	**35%**	**15%**	2%	48%	35%	15%
Flexible Guarantee Funds Managed	**2%**	**33%**	**50%**	**15%**	2%	33%	50%	15%
All in One Bond Cautious Fund	**0%**	**80%**	**10%**	**10%**	0%	80%	10%	10%
All in One Bond Balanced Fund	**0%**	**30%**	**35%**	**35%**	0%	30%	35%	35%
All in One Bond Managed Fund	**0%**	**5%**	**85%**	**10%**	0%	5%	85%	10%
Other With-Profit	**3%**	**39%**	**49%**	**9%**	3%	39%	49%	9%

Mortality rate tables	2018	2017
Conventional Life Business	**85% AMC00/90% AFC00**	75% AM80 Females -3yrs
Conventional Pensions Business	**130% AMC00/AFC00 CMI_2017_1.5%/1.25% LT**	130% AMC00/AFC00 CMI_2016_ 1.5%/1.25% LT
Conventional Industrial Branch Business	**80% up to age 80, rising linearly to 100% at age 100, of ELT16**	80% up to age 80, rising linearly to 100% at age 100, of ELT16
Non-Unitised Accumulating Pensions Business	**85% AMC00/AFC00**	65% AM80
Unitised Accumulating Life Business	**85% AMC00/AFC00**	80% AM80/AF80
Unitised Accumulating Pensions Business	**85% AMC00/AFC00**	80% AM80
Unitised Accumulating Bond Business	**85% AMC00/AFC00**	80% AM80
Unitised Accumulating Life ISA Business	**85% AMC00/AFC00**	80% AM80 select/AF80 select
Heritage Annuities in Payment	**115% RMV00/121% RFV00 CMI_2017 1.5%/1.25% LT**	116% RMV00/116% RFV00 CMI_2016 1.5% /1.25% LT

Per policy expenses – regular premiums	2018	2017
Conventional Life Business	**£29.26**	£25.74
Conventional Pensions Business	**£45.12**	£29.95
Conventional Industrial Branch Business*	**£11.15**	£14.54
Non-Unitised Accumulating Pensions Business	**£45.12**	£29.95
Unitised Accumulating Life Business	**£29.26**	£25.74
Unitised Accumulating Pensions Business	**£45.12**	£29.95
Unitised Accumulating Bond Business	**£29.26**	£25.74
Unitised Accumulating Life ISA Business	**£29.26**	£25.74
Heritage Annuities in Payment	**£54.44**	£40.71

* The unit cost for IB business has been grossed-up to allow for a reduction made to the in-force data to reflect policies that are believed no longer likely to give rise to a claim.

Persistency – lapses, surrenders and paid up rates

A review of persistency is carried out annually. Assumptions for each product class are adjusted where necessary to reflect more recent experience.

Options and guarantees

Allowance is made in respect of cash commutation options on OB Pensions.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

25. Long-term insurance and investment contract liabilities valuation assumptions (continued)

(ii) Non-participating insurance contracts

Interest rate	2018	2017
Non-profit temporary assurances*	**1.35%**	1.25%
Whole of life assurances*	**1.35%**	1.25%
Permanent health insurance:		
a) active lives	**1.35%**	1.25%
b) claims reserves	**1.20%**	1.00%
Critical illness	**1.35%**	1.25%
Retirement Solutions annuities in payment MAP	**2.39%**	2.11%
Retirement Solutions annuities in payment non-MAP	**3.29%**	3.37%

* These interest rates are netted down at 20% tax for life contracts written before 1 January 2013.

Investment expenses	2018	2017
Non-profit temporary assurances*	**0.06%**	0.12%
Whole of life assurances*	**0.06%**	0.12%
Permanent health insurance:		
a) active lives	**0.06%**	0.12%
b) claims reserves	**0.06%**	0.12%
Critical illness	**0.06%**	0.12%
Retirement Solutions annuities in payment MAP	**0.11%**	0.19%
Retirement Solutions annuities in payment non-MAP	**0.03%**	0.03%

* These expenses are netted down at 20% tax for life contracts written before 1 January 2013.

Mortality rate tables	2018	2017
Non-profit temporary assurances*	**TMN00,TMS00/TFN00,TFS00 CMI_2017 1.5%/1.25% LT**	TMN00,TMS00/TFN00,TFS00 CMI_2016 1.5%/1.25% LT
Whole of life assurances (50+)*	**AMC00/AFC00 CMI_2017 1.5%/1.25% LT**	AMC00/AFC00 CMI_2016 1.5%/1.25% LT
Whole of life assurances (Lifetime+)*	**TMN00,TMS00/TFN00,TFS00 CMI_2017 1.5%/1.25% LT**	TMN00,TFN00/TMS00,TFS00 CMI_2016 1.5%/1.25% LT
Retirement Solutions annuities in payment**	**80.75% RMV00/RFV00 CMI_2017 1.5%/1.25% LT**	80.75% RMV00/RFV00 CMI_2016 1.5%/1.25% LT

* A series of duration and age-related adjustment factors are applied to the base mortality rates. These adjustments vary by product line and smoking status.

**The mortality rates for enhanced annuity contracts are adjusted so as to allow for convergence to standard mortality at advanced ages. These adjustments vary according to lifestyle or medical condition, gender, age and duration in-force.

Morbidity rate tables	2018	2017
Permanent health insurance		
a) active lives	**CMIR12**	CMIR12
b) claims reserves	**CMIR12**	CMIR12
Critical illness	**Reinsurer rates**	Reinsurer rates

A series of adjustments are made to the standard mortality and morbidity tables to take account of actual experience and publicly available market data. The adjustments for permanent health insurance vary by product line, age, smoking status, sickness duration, deferred periods and occupations.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

25. Long-term insurance and investment contract liabilities valuation assumptions (continued)

(ii) Non-participating insurance contracts (continued)

Per policy expenses – regular premiums	2018	2017
Non-profit temporary assurances	**£18.79**	£18.80
Whole of life assurances	**£18.79**	£18.80
Permanent health insurance:		
a) active lives	**£18.79**	£25.01
b) claims reserves (per policy in claim)	**£893.39**	£810.35
Critical illness	**£18.79**	£18.80
Retirement Solutions annuities in payment (life annuity)	**£59.88**	£44.67
Retirement Solutions annuities in payment (fixed term)	**£59.88**	£44.67

Options and guarantees

There are no significant options and guarantees in the non-participating business.

(iii) Investment and long-term linked insurance contracts

The provision for unit linked business is equal to the value of the assets to which the contracts are linked. This is classified as an investment product and the liability is included within the long-term investment contract liabilities.

Within insurance contract liabilities the provisions for index-linked permanent health insurance claims, index-linked temporary assurances and index-linked annuities in payment have been calculated using the same mortality and morbidity assumptions as used for the corresponding non-linked liabilities for both 2018 and 2017.

b) Society (originally Teachers)

(i) Participating insurance contracts

As part of the Teachers acquisition in 2016, the Society purchased the non-participating business from Teachers Assurance. The Teachers Assurance participating business remains within the ring-fenced TA Fund (see section e).

(ii) Non-participating insurance contracts

Interest rate

The interest rates for Teachers are set using an approach consistent with that described for the Society in section a (ii).

Mortality rate tables	2018	2017
Teachers annuities in payment	**55.25% RMV00/80.75% RFV00 CMI_2017 1.5%/1.25% LT**	55.25% RMV00/80.75% RFV00 CMI_2016 1.5%/1.25% LT

Per policy expenses	2018	2017
Teachers annuities in payment	**£59.88**	£31.33

Options and guarantees

There are no options and guarantees in the non-participating business.

(iii) Investment linked contracts

The provision for unit linked business is equal to the value of the assets to which the contracts are linked. This is classified as an investment product and the liability is included within the long-term investment contract liabilities. The provision for unit linked contracts is equal to the value of the units plus a non-unit liability consisting of a sterling reserve calculated by carrying out cash flow projections on appropriate bases.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

25. Long-term insurance and investment contract liabilities valuation assumptions (continued)

c) Liverpool Victoria Life Company Limited – Ordinary Long-Term Fund

(i) Participating insurance contracts

Liverpool Victoria Life Company Limited has no participating business.

(ii) Non-participating insurance contracts

Interest rate	2018	2017
Non-profit temporary assurances*	**1.35%**	1.25%
Other assurances*	**1.38%**	1.33%

* These interest rates are netted down at 20% tax.

Investment expenses	2018	2017
Non-profit temporary assurances*	**0.06%**	0.12%
Other assurances*	**0.08%**	0.11%

* These expenses are netted down at 20% tax.

Mortality rate tables	2018	2017
Non-profit temporary assurances*	**TMN00,TMS00/TFN00,TFS00 CMI_2017 1.5%/1.25% LT**	TMN00,TMS00/TFN00,TFS00 CMI_2016 1.5%/1.25% LT
Other assurances	**AM92/AF92**	AM92/AF92

* A series of duration and age-related adjustment factors are applied to the base mortality rates. These adjustments vary by product line and smoking status.

Per policy expenses – regular premiums	2018	2017
Non-profit temporary assurances	**£18.79**	£18.80
Other assurances	**£24.00**	£29.99

d) RNPFN fund

RNPFN denotes Royal National Pension Fund for Nurses, which is a ring-fenced fund. The free assets attributable to this fund are reported as insurance contract liabilities of the Society.

(i) Participating business

For participating insurance contracts, a market-consistent valuation is used to calculate the liability. This involves placing a value on liabilities similar to the market value of assets with similar cash flow patterns. The key assumptions used in this valuation are set out in the tables below.

Interest rates

The interest rates for RNPFN are set using an approach consistent with that described for the Society in section a(i).

Other assumptions

Best estimate assumptions are set for inflation, mortality, expenses and persistency. The future expense inflation assumption is modelled as RPI plus 0.1% (2017: RPI plus 0.5%), where RPI in both 2018 and 2017 is modelled stochastically.

Benchmark asset mix for assets backing asset shares	2018	2017
Cash	**4%**	4%
Fixed interest	**64%**	65%
UK Equities	**32%**	31%

Mortality rate tables	2018	2017
Conventional Life Business	**60% AM/F00 ult**	60% AM/F00 ult
Life Deferred Annuities	**50% AM/F00 ult**	50% AM/F00 ult
Pension Deferred Annuities	**50% AM/F00 ult**	50% AM/F00 ult
Unitised With-profits business	**60% AM/F00 ult**	60% AM/F00 ult

Notes to the Financial Statements (continued)

Year ended 31 December 2018

25. Long-term insurance and investment contract liabilities valuation assumptions (continued)

(i) Participating business (continued)

Per policy expenses – regular premiums	2018	2017
Conventional Life Business	**£29.26**	£25.74
Pensions Deferred Annuities	**£45.12**	£29.95
Life Deferred Annuities	**£29.26**	£25.74
Unitised With-profits ISA	**£29.26**	£25.74
Unitised With-profits Bond	**£29.26**	£25.74

Persistency – lapses, surrenders and paid up rates

A review of persistency is carried out annually. Assumptions are adjusted where appropriate to reflect more recent experience.

Options and guarantees

The provisions held in respect of guaranteed annuity options are determined on a market consistent basis. The total amount provided in respect of the future costs of the guaranteed annuity options was £82m (2017: £89m).

(ii) Non-participating business

Interest rate	2018	2017
Non-profits assurances*	**1.60%**	1.54%
Non-profits general deferred annuities*	**1.60%**	1.54%
Annuities in Payment (Life)*	**1.60%**	1.54%
Annuities in Payment (Pension)	**1.60%**	1.54%
Pension Deferred Annuities	**1.60%**	1.54%

* These interest rates are netted down at 20% tax for life contracts written before 1 January 2013.

Investment expenses	2018	2017
Non-profits assurances*	**0.06%**	0.17%
Non-profits general deferred annuities*	**0.06%**	0.17%
Annuities in Payment (Life)*	**0.06%**	0.17%
Annuities in Payment (Pension)	**0.06%**	0.17%
Pension Deferred Annuities	**0.06%**	0.17%

* These expenses are netted down at 20% tax for life contracts written before 1 January 2013.

Mortality rate tables	2018	2017
Non-profits assurances	**72.0% AM/F00 ult**	72.0% AM/F00 ult
Non-profits general deferred annuities	**42.5% AM/F00 ult**	42.5% AM/F00 ult
Annuities in Payment (Male)	**68.0% IML00 with CMI_2009 improvement model with a long-term improvement rate of 1.75%**	61.2% IML00 with CMI_2009 improvement model with a long-term improvement rate of 1.75%
Annuities in Payment (Female)	**75.7% IFL00 with CMI_2009 improvement model with a long-term improvement rate of 1.5%**	72.3% IFL00 with CMI_2009 improvement model with a long-term improvement rate of 1.5%
Pension Deferred Annuities	**42.5% AM/F00 ult**	42.5% AM/F00 ult

Appropriate adjustments were made to the standard mortality tables to take account of actual experience and publicly available market data.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

25. Long-term insurance and investment contract liabilities valuation assumptions (continued)

(iii) Linked fund

There are two main classes of contract included within the linked fund, one is classified as an insurance contract and the liability is included within the long-term unit linked insurance contract liabilities, the other is classified as an investment product and the liability is included within the investment contract liabilities. The provision for unit linked contracts is equal to the value of the units. A non-unit liability consisting mainly of a sterling reserve calculated by carrying out cash flow projections on appropriate bases is included within the liability for insurance contracts only.

Interest rate	2018	2017
Unit linked assurances*	**1.60%**	1.54%

* This interest rate is netted down at 20% tax for life contracts written before 1 January 2013.

Investment expenses	2018	2017
Unit linked assurances*	**0.06%**	0.17%

* This expense is netted down at 20% tax for life contracts written before 1 January 2013.

Mortality rate tables	2018	2017
Unit linked assurances	**72.0% AM/F00 ult**	72.0% AM/F00 ult

e) TA fund

The TA fund denotes the Teachers Assurance Fund, which is a ring-fenced fund. The free assets attributable to this fund are reported as insurance and investment contract liabilities of the Society.

(i) Participating contracts

For participating contracts, a market consistent valuation is used to calculate the liability. This involves placing a value on liabilities similar to the market value of assets with similar cash flow patterns. The key assumptions used in this valuation are set out below.

Interest rates

The risk-free interest rates assumed are:

Year	2018	2017
5	**1.20%**	0.94%
15	**1.43%**	1.33%
25	**1.46%**	1.37%
35	**1.44%**	1.30%

These interest rates are gross of tax and investment expenses.

Other assumptions

Best estimate assumptions are set for inflation, mortality, expenses and persistency. The future expense inflation assumption is modelled as RPI, where RPI in both 2018 and 2017 is modelled stochastically.

Benchmark asset mix for assets backing asset shares	2018	2017
Cash	**5%**	5%
Fixed interest	**35%**	35%
Equities	**53%**	53%
Property	**7%**	7%

Mortality rate tables	2018	2017
Conventional Life Business	**50% AM92 / 65% AF92**	50% AM92 / 65% AF92
Unitised Accumulating Life Business	**50% AM92 / 65% AF92**	50% AM92 / 65% AF92
Unitised Accumulating Bond Business	**50% AM92 / 65% AF92**	50% AM92 / 65% AF92
Unitised Accumulating Life ISA Business	**50% AM92 / 65% AF92**	50% AM92 / 65% AF92

Notes to the Financial Statements (continued)

Year ended 31 December 2018

25. Long-term insurance and investment contract liabilities valuation assumptions (continued)

(i) Participating contracts (continued)

Per policy expenses	2018	2017
Conventional Life Business	**£40.21**	£38.84
Unitised Accumulating Life Business	**£40.21**	£38.84
Unitised Accumulating Bond Business	**£40.21**	£38.84
Unitised Accumulating Life ISA Business	**£40.21**	£38.84

Persistency – lapses, surrenders and paid up rates

A review of persistency is carried out annually. Assumptions for each product class are adjusted where necessary to reflect more recent experience.

Options and guarantees

There are no guaranteed annuity or financial options within the contracts participating in the TA Fund.

26. Non-participating value of in-force business valuation assumptions

a) Society

Non-participating contracts

Interest rates

The earned rate and discount rate are set by reference to the risk free yield curve applicable at the valuation date with appropriate adjustments for an illiquidity premium and margins for risk and uncertainty, with the exception of Retirement Solutions annuities in payment where the earned rate is based on the IRR of the risk adjusted backing assets cashflows.

Mortality rate tables	2018	2017
Non-profit temporary assurances*	**TMN00,TMS00/TFN00,TFS00 CMI_2017 1.5%/1.25% LT**	TMN00,TMS00/TFN00,TFS00 CMI_2016 1.5%/1.25% LT
Whole of Life Assurances (50+)*	**AMC00/AFC00 CMI_2017 1.5%/1.25% LT**	AMC00/AFC00 CMI_2016 1.5%/1.25% LT
Whole of Life Assurances (Lifetime+)*	**TMN00,TMS00/TFN00,TFS00 CMI_2017 1.5%/1.25% LT**	TMN00,TMS00/TFN00,TFS00 CMI_2016 1.5%/1.25% LT
Retirement Solutions annuities in payment**	**95% RMV00/RFV00 CMI_2017 1.5%/1.25% LT**	95% RMV00/RFV00 CMI_2016 1.5%/1.25% LT
Unit linked pensions (original LVFS)	**80% AX92C20**	80% AX92C20
Teachers annuities in payment	**65% RMV00/95% RFV00 CMI_2017 1.5%/1.25% LT**	65% RMV00/95% RFV00 CMI_2016 1.5%/1.25% LT

* A series of duration and age-related adjustment factors are applied to the base mortality rates. These adjustments vary by product line and smoking status.

** The mortality rates for enhanced annuity contracts are adjusted so as to allow for convergence to standard mortality at advanced ages. These adjustments vary according to lifestyle or medical condition, gender, age and duration in-force.

Morbidity rate tables	2018	2017
Permanent health insurance:		
a) active lives	**CMIR12**	CMIR12
b) claims reserves	**CMIR12**	CMIR12
Critical illness	**Reinsurer rates**	Reinsurer rates

A series of adjustments are made to the standard mortality and morbidity tables to take account of actual experience and publicly available market data. The adjustments for permanent health insurance vary by product line, age, smoking status, sickness duration, deferred periods and occupations.

Persistency and unit costs

Persistency and unit costs assumptions are based on our best estimate of future experience. A review of persistency is carried out annually. Assumptions for each product class are adjusted where appropriate to reflect more recent experience.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Fixed assets and investments

This section gives detail on the tangible, intangible and investment assets of the Society and Group that are used to generate profit for the business.

27. Property and equipment

Accounting for property and equipment

Operational property and equipment are held at cost less accumulated depreciation. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for its intended use. Both property and equipment are depreciated to their estimated residual values on a straight line basis over their estimated useful lives. The periods used are as follows:

Freehold buildings and finance lease property	10 to 50 years
Leasehold property enhancements	10 years or lease term if shorter
Fixtures and fittings	3 to 10 years
IT equipment	3 to 8 years

Land is not depreciated.

Assets are written down to their recoverable amount where this is less than the carrying value.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each Statement of Financial Position date.

Group	Freehold and leasehold property £m	Leasehold property enhancements £m	Fixtures, fittings and IT equipment £m	Total £m
Cost:				
At 1 January 2018	**43**	**14**	**27**	**84**
Additions	**–**	**1**	**4**	**5**
Disposals	**(14)**	**(3)**	**(4)**	**(21)**
Transfer to assets held for sale	**–**	**(8)**	**(10)**	**(18)**
At 31 December 2018	**29**	**4**	**17**	**50**
Accumulated depreciation:				
At 1 January 2018	**19**	**10**	**18**	**47**
Provided in the year	**1**	**1**	**3**	**5**
Disposals	**(11)**	**(3)**	**(4)**	**(18)**
Transfer to assets held for sale	**–**	**(6)**	**(7)**	**(13)**
At 31 December 2018	**9**	**2**	**10**	**21**
Net book value at 31 December 2018	**20**	**2**	**7**	**29**
Cost:				
At 1 January 2017	43	15	28	86
Additions	–	1	1	2
Disposals	–	(2)	(2)	(4)
At 31 December 2017	43	14	27	84
Accumulated depreciation:				
At 1 January 2017	17	11	15	43
Provided in the year	2	1	4	7
Disposals	–	(2)	(1)	(3)
At 31 December 2017	19	10	18	47
Net book value at 31 December 2017	24	4	9	37

Included within the Freehold and leasehold property category above are assets held under finance leases with a net book value of £17m (2017: £18m).

Notes to the Financial Statements (continued)

Year ended 31 December 2018

28. Intangible assets

Accounting for goodwill and intangible assets

Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable net assets of the acquired subsidiary at the acquisition date and is included in intangible assets. Goodwill is reviewed for impairment at the end of the first full year of acquisition. Thereafter, it is tested at each Statement of Financial Position date for impairment against the recoverable amount (being the higher of value in use or fair value less costs of disposal) of the relevant cash generating unit and carried at cost less accumulated impairment losses.

Goodwill arising on acquisitions prior to 1998 has been eliminated against the Unallocated divisible surplus. Goodwill on acquisitions prior to 1 January 2006 (the date of transition to IFRS) is carried at its original cost less cumulative amortisation on that date, less any impairment subsequently incurred.

Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Present value of acquired in-force business (PVIF)

On acquisition of a portfolio of long-term insurance and investment contracts, the net present value of the Group's interest in the expected post-tax cash flows of the in-force business is capitalised as an intangible asset.

The carrying value of the asset is amortised, in line with the original expected run-off over a period of 10 years, based on the anticipated lives of the majority of the related contracts. Amortisation is stated net of any unwind of the discount rate. The carrying value of the asset is assessed annually using current assumptions in order to determine whether any impairment has arisen, compared to the amortised acquired value.

Other intangibles

Where an acquisition takes place that gives access to existing customers, distribution channels or the right to charge for investment or policy administration services, the fair value of these is recognised as an intangible asset.

The carrying value of the asset is amortised, on a straight line basis over its expected economic life. The expected economic life of other intangibles carried by the Group is determined by reference to acquired business, considering factors such as the remaining terms of agreements, the normal lives of related products and the competitive position, and lies within the range of 10 to 20 years. The carrying value of the asset is assessed annually for indications of impairment.

IT Software

Costs directly attributable to the development of software for internal use are capitalised as intangible assets if it is probable that the asset created will generate future economic benefits. Costs incurred to establish technological feasibility or to maintain existing levels of performance are recognised as an expense.

Software costs, including computer application software licences, are amortised using the straight line method over their useful lives (three to eight years). The amortisation periods used are reviewed annually. Software values are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Where the carrying amount is not recoverable the asset is written down immediately to the estimated recoverable amount, based on value in use calculations.

Any amortisation or impairment charges for all intangibles are recorded in the Statement of Comprehensive Income within Other operating and administrative expenses.

Significant accounting estimate

Impairment assessment of goodwill

The Group determines whether goodwill is impaired at least on an annual basis. This requires an estimation of the recoverable amount of the cash generating unit to which the goodwill is allocated. The Group has allocated the goodwill to two single cash generating units based on the key operating segments of the Group being the Long-term insurance business and the General insurance business, which is held for sale.

Details of the key assumptions used in the estimation of the recoverable amounts and the carrying value at the reporting date are contained at the end of this note.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

28. Intangible assets (continued)

Group	Goodwill £m	Other intangible assets £m	PVIF £m	Software and licence costs £m	Total £m
Cost:					
At 1 January 2018	**241**	**52**	**3**	**95**	**391**
Additions	**–**	**–**	**–**	**23**	**23**
Transfer to assets held for sale	**(186)**	**(25)**	**–**	**(108)**	**(319)**
At 31 December 2018	**55**	**27**	**3**	**10**	**95**
Accumulated amortisation:					
At 1 January 2018	**21**	**40**	**–**	**15**	**76**
Charge for the year	**–**	**3**	**1**	**16**	**20**
Transfer to assets held for sale	**–**	**(23)**	**–**	**(25)**	**(48)**
At 31 December 2018	**21**	**20**	**1**	**6**	**48**
Net book value at 31 December 2018	**34**	**7**	**2**	**4**	**47**
Cost:					
At 1 January 2017	241	51	3	59	354
Acquired through business combinations	–	1	–	–	1
Additions	–	–	–	36	36
At 31 December 2017	241	52	3	95	391
Accumulated amortisation:					
At 1 January 2017	21	37	–	5	63
Charge for the year	–	3	–	8	11
Impairment in year	–	–	–	2	2
At 31 December 2017	21	40	–	15	76
Net book value at 31 December 2017	220	12	3	80	315

Other intangible assets comprise the value of the future benefit derived from the acquired customer base of the Teachers business and the value of the Tomorrow/Retirement Solutions distribution channel, which are being amortised over periods varying between 10 and 20 years from the original acquisition date. These intangible assets will be fully amortised by 2027.

Of the £20m (2017: £11m) amortisation charge for the year, £4m (2017: £4m) is presented within Other operating and administrative expenses in the Statement of Comprehensive Income and £16m (2017: £7m) relates to the discontinued general insurance business (see note 12). There was no impairment charge in 2018 (2017: £2m).

Notes to the Financial Statements (continued)

Year ended 31 December 2018

28. Intangible assets (continued)

Impairment testing of goodwill

Goodwill is reviewed annually for impairment, or more frequently when there are indicators that impairment may have occurred, by comparing the carrying value to its recoverable amount. The recoverable amount of the cash generating unit is based on value in use calculations. The calculations are based upon discounting expected pre-tax cash flows at a risk-adjusted interest rate appropriate to the cash generating unit, the determination of both of which requires the exercise of judgement. The estimation of pre-tax cash flows is sensitive to the periods for which forecasts are available and to assumptions regarding the long-term sustainable cash flows. While forecasts are compared with actual performance and external economic data, expected cash flows reflect management's view of future performance.

Key assumptions used in the annual impairment testing of intangible assets

The key assumptions used for impairment testing are set out below.

The recoverable amount of the long-term insurance business has been determined using discounted cash flow predictions based on financial plans approved by management covering a five year period, with a terminal growth rate applied thereafter. Both the growth rates and the discount rates used are consistent with the ranges observed in the market place.

	2018	2017
	Long-term insurance	Long-term insurance
Assumptions		
Terminal growth rate	**1.5%**	1.5%
Pre-tax discount rate	**9%**	9%
Recoverable amount in excess of carrying value	**£116m**	£169m
Sensitivities		
Impact on recoverable amount of a 2% increase in pre-tax discount rate	**£57m**	£69m
Pre-tax discount rate required to eliminate headroom	**15%**	17%
Impact on recoverable amount of a 10% annual reduction in forecast cashflows	**£32m**	£38m
Reduction required in annual forecast cashflows to eliminate headroom	**36%**	44%

Notes to the Financial Statements (continued)

Year ended 31 December 2018

29. Investments in group undertakings

Accounting for investments in group undertakings

Shares in subsidiaries

The subsidiaries are held in the Society's Statement of Financial Position at cost less any provision for impairment. An assessment of the realisable value is made at the year end and, if the Directors assess that there has been a permanent fall in that value below the carrying value, a provision is made to bring the carrying value down to the assessed realisable value.

Loan stock in subsidiaries

Loan stock in subsidiaries is initially measured at fair value. Subsequent to initial recognition it is measured at amortised cost.

Society	2018 £m	2017 £m
Shares in subsidiaries		
Cost less provisions at 1 January	**887**	496
Additions	**1**	81
Conversion of loan stock to equity	**–**	326
Reduction in carrying value including impairment	**(7)**	(16)
	881	887
Loan stock in subsidiaries		
Cost at 1 January	**10**	306
Additions	**5**	4
Redemptions	**–**	(300)
	15	10
Shares and loan stock in subsidiaries at 31 December	**896**	897

The Society has examined the carrying value of its subsidiaries and concluded that an impairment of £7m (2017: £16m) was required in regard to these investments.

During 2017 £326m of loans and related interest owed to the Society by its subsidiary LV Capital PLC were converted to equity and a further £81m of capital was invested in subsidiaries of the Society.

Further details of the Group's loan stock are given in Note 48 and the Group's investments in Notes 43 and 44.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Other assets and liabilities

This section describes the other assets and liabilities arising from the life insurance business within the Society and the life insurance and general insurance businesses within the Group.

30. Insurance receivables

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Due from policyholders	**10**	190	**9**	10
Due from agents, brokers and intermediaries	**–**	82	**–**	–
Due from reinsurers	**31**	36	**31**	19
	41	308	**40**	29

Included within the 2017 comparatives are amounts of £279m relating to the general insurance business. In 2018 these balances have been disclosed as Assets held for sale within Note 12.

The carrying amounts disclosed above reasonably approximate fair value at the Statement of Financial Position date.

31. Prepayments and accrued interest

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Accrued interest	**63**	85	**56**	62
Prepayments	**14**	39	**14**	9
	77	124	**70**	71

Included within the 2017 comparatives are amounts of £47m relating to the general insurance business. In 2018 these balances have been disclosed as Assets held for sale within Note 12.

32. Insurance payables

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Due to policyholders	**18**	18	**18**	15
Due to brokers and intermediaries	**1**	1	**1**	–
Due to reinsurers	**9**	31	**9**	7
	28	50	**28**	22

Included within the 2017 comparatives are amounts of £28m relating to the general insurance business. In 2018 these balances have been disclosed as Liabilities directly associated with assets held for sale within Note 12.

The carrying amounts disclosed above reasonably approximate fair value at the Statement of Financial Position date.

33. Trade and other payables

Accounting for trade and other payables

Trade and other payables are recognised as they fall due. They are measured initially at fair value and subsequently at amortised cost. Premiums received for contracts with an inception date after the end of the period are held as deferred revenue.

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Bank overdrafts	**11**	11	**11**	8
Trade payables	**6**	17	**5**	16
Amounts owed to group undertakings	**–**	–	**6**	21
Other taxes and social security costs	**8**	56	**7**	10
Other creditors	**38**	42	**36**	31
Finance lease liabilities	**19**	19	**–**	–
Accruals	**64**	143	**61**	73
	146	288	**126**	159

Included within the 2017 comparatives are amounts of £126m relating to the general insurance business. In 2018 these balances have been disclosed as Liabilities directly associated with assets held for sale within Note 12.

The carrying amounts disclosed above reasonably approximate fair value at the Statement of Financial Position date.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Taxation

This section presents information relating to the tax charge and movements in the corporation and deferred tax assets and liabilities held by the Society and Group.

34. Income tax (credit)/expense

Income tax (credit)/expense

Income tax (credit)/expense recorded in the Statement of Comprehensive Income represents the current year corporation tax (credit)/charge. As a mutual, the corporation tax (credit)/charge for the Society relates to policyholder tax (receivable)/payable on the net investment return levied on certain types of business. Whereas for Group subsidiaries corporation tax is charged on trading profits arising in the year. The current year tax (credit)/charge excludes the deferred tax movement included within the re-measurement of the defined benefit pension scheme and available for sale financial assets in Other Comprehensive Income.

Current income tax

Current income tax liabilities and assets are measured at the amount expected to be paid to or recovered from the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted at the Statement of Financial Position date.

Deferred income tax

Deferred income tax is recognised, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the Statement of Financial Position date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled. Deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes assets and liabilities relate to income taxes levied by the same taxation authority on either the taxable entity or different taxable entities where there is an intention to settle the balances on a net basis.

a) Current year tax (credit)/charge

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Current tax				
Current year	**14**	39	**(3)**	16
Adjustment in respect of prior years	**(1)**	–	**(1)**	(1)
Total current tax	**13**	39	**(4)**	15
Deferred tax				
Temporary differences	**(27)**	7	**(27)**	9
Tax losses	**–**	4	**–**	–
Total deferred tax	**(27)**	11	**(27)**	9
Total income tax (credit)/expense	**(14)**	50	**(31)**	24
Income tax (credit)/expense attributable to:				
(Loss)/profit from continuing operations	**(31)**	20	**(31)**	24
Profit from discontinued operations	**17**	30	**–**	–
	(14)	50	**(31)**	24

b) Reconciliation of tax (credit)/charge

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
(Loss)/profit before tax, mutual bonus and UDS transfer from continuing operations	**(90)**	(42)	**(29)**	62
Profit before tax, mutual bonus and UDS transfer from discontinued operations	**110**	164	**–**	–
Profit/(loss) before tax, mutual bonus and UDS transfer*	**20**	122	**(29)**	62
Tax calculated at the average standard rate of corporation tax in the UK at 19% (2017: 19.25%)	**4**	23	**(5)**	12
Permanent differences				
Income and expenses not subject to tax	**8**	13	**–**	–
Mutual profit not subject to tax	**5**	(12)	**5**	(12)
Unprovided deferred tax movement	**–**	1	**–**	–
Policyholder I-E tax	**(30)**	25	**(30)**	25
Adjustment to current tax charge in respect of prior years	**(1)**	–	**(1)**	(1)
Total (credit)/charge	**(14)**	50	**(31)**	24

Notes to the Financial Statements (continued)

Year ended 31 December 2018

34. Income tax (credit)/expense (continued)

* As a Friendly Society, all net earnings are for the benefit of participating policyholders and are carried forward within the Unallocated divisible surplus (UDS), resulting in the profit for each financial year being zero. Therefore, the resulting (loss)/profit before tax required to be disclosed under IAS 12 will always be equal to the tax (credit)/charge being £14m loss (2017: £50m profit) and £31m loss (2017: £24m profit) for the Group and Society respectively. In order to present a more meaningful disclosure the (Loss)/profit before tax, mutual bonus and UDS transfer is disclosed in the tables above.

35. Corporation tax asset

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Corporation tax receivable	**5**	–	**5**	–
	5	–	**5**	–

36. Deferred tax liability

	Group £m	Society £m
Balance at 1 January 2018	**(97)**	**(98)**
Amounts recorded in the Statement of Comprehensive Income within profit for the year	**27**	**27**
Amounts recorded within Other Comprehensive Income	**(6)**	**(7)**
Transfer to assets held for sale	**(2)**	**–**
Balance at 31 December 2018	**(78)**	**(78)**

	Group		Society	
a) Analysis of deferred taxation temporary differences	**2018 £m**	2017 £m	**2018 £m**	2017 £m
Excess of depreciation	**–**	2	**–**	–
Temporary differences on expenses	**2**	3	**2**	4
Temporary differences on unrealised gains	**(11)**	(40)	**(11)**	(40)
Temporary difference on re-measurement of defined benefit pension scheme	**(69)**	(62)	**(69)**	(62)
Deferred tax liability	**(78)**	(97)	**(78)**	(98)
b) Deferred taxation asset not recognised				
Tax losses unrecognised	**8**	8	**–**	–
	8	8	**–**	–

The value of deferred tax liabilities expected to be settled after more than 12 months is £74m in the Group (2017: £87m) and £74m in the Society (2017: £88m).

The calculation of deferred tax balances at the year-end takes into account the reduction in the UK main corporation tax rate to 17%, substantively enacted on 6 September 2016 and effective from 1 April 2020.

The valuation and recoverability of deferred tax assets relating to capital allowances in excess of depreciation, temporary differences on expenses and taxable losses carried forward is dependent on the availability of future taxable profits within the Society and Group. Management forecasts currently support the future recoverability of deferred tax assets recognised in the Statement of Financial Position as at 31 December 2018.

37. Corporation tax liability

	Group		Society	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Corporation tax payable	**–**	20	**–**	9
	–	20	**–**	9

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Employee benefits

This section details the costs and commitments associated with employing our staff.

38. Employee benefits expense

Accounting for staff costs under IAS 19

The Society and Group apply IAS 19 Employee benefits in accounting for staff costs.

Short-term employee benefits

Salaries, accrued bonuses and social security costs are recognised over the period in which the employees provide the services to which the payments relate.

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Wages and salaries	**89**	218	**82**	213
Social security costs	**9**	21	**8**	21
Pension costs	**11**	16	**11**	15
	109	255	**101**	249

Of the £101m (2017: £249m) employee benefit expense in the Society, £34m (2017: £133m) is recharged to other Group companies, leaving £67m (2017: £116m) of staff costs directly relating to the Society.

Wages and salaries include charges for ongoing in flight long-term incentive plans (LTIPs) for Life and Group employees of £3.4m in 2018 (2017: £6.0m). The Group LTIP plan terms are described in the Report on Directors' Remuneration on page 77.

For the 2016-18 scheme the Group performance is below threshold for both growth in adjusted average pre-tax profits and Relative Investment Performance resulting in £nil payout for LVFS eligible employees in 2019.

On 29 December 2017, 3,717 employees (excluding contractors and temporary staff) from the Society transferred to Liverpool Victoria General Insurance Group Limited (LVGIG) under a TUPE arrangement. In 2018 the average number of employees employed by LVGIG was 3,680. These figures have been excluded from the table below.

The number of employees during the year, including executive directors, calculated on a monthly average basis, was as follows:

	Group		Society	
	2018	2017	**2018**	2017
	Number	Number	**Number**	Number
Member and customer contact	**902**	3,784	**860**	3,730
Administration	**1,092**	2,080	**1,041**	2,045
	1,994	5,864	**1,901**	5,775

Notes to the Financial Statements (continued)

Year ended 31 December 2018

39. Pension benefit asset/(obligation)

Accounting for pension benefits under IAS 19

For defined benefit schemes, the net surplus or deficit is calculated annually with the assets measured at fair value at the Statement of Financial Position date and the liabilities discounted at the rate of return available on high quality corporate bonds. The net surplus, to the extent recoverable, or deficit is recognised as a pension benefit asset or liability in the Statement of Financial Position. A separate liability for future funding requirements is recognised for a scheme where the Society does not have an unconditional right to any of the assets of the pension schemes which would remain following the schemes' termination.

The pension cost for the schemes is analysed between current service cost, past service cost, net interest on the net defined benefit liability and any gain or loss on settlement. Current service cost is the actuarially calculated present value of the benefits earned by the active employees in each period. Past service costs, relating to employee service in prior periods arising in the current period as a result of the introduction of, or improvement to, retirement benefits, are recognised in Other operating and administrative expenses on a straight-line basis over the period in which the increases in benefits vest or are earned.

All movements other than re-measurements in respect of the pension benefit obligation are recognised in Other operating and administrative expenses in the Statement of Comprehensive Income. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are recognised as re-measurements in Other Comprehensive Income in the period in which they arise.

For defined contribution plans, the Group pays contributions to two independently administered pension funds. The Group has no further payment obligations once the contributions have been paid. The contributions are recognised as an employee benefit expense when they are due.

Significant accounting estimates and judgements

a) Significant accounting estimate

Valuation of the defined benefit obligation

The valuations of the pension benefit obligations for the Group's three defined benefit schemes require actuarial assumptions about discount rates, inflation, longevity and future pension increases. Due to the long-term nature of these obligations, the estimates are subject to significant uncertainty.

Details of the principal assumptions used for each of the material defined benefit schemes are disclosed within the valuations of the individual schemes disclosed in sections (iv).

b) Significant accounting judgements

Recognition of defined benefit asset

Management have applied judgement in evaluating whether the net pension asset can be recognised for each of the pension schemes in accordance with the existing IFRIC 14, 'The limit on a defined benefit asset, minimum funding requirement and their interaction'.

Recognising a net pension asset under the current criteria of IFRIC 14 is allowable for both the LV and Ockham Pension Schemes because the terms of the pension scheme trust deeds state that the Society has an unconditional right to any assets of the schemes which ultimately remain following the schemes' termination, assuming the gradual settlement of the scheme liabilities over time until all members have left the schemes. No liability is recognised for future funding contributions as these will increase the recognised net pension asset when paid.

However this is not the case for the trust deed of the Teachers Assurance Group Pension Scheme, therefore the net pension asset for this scheme is not recognised and a liability is recognised for future funding contributions.

The IASB are continuing their research program during 2019 on an amendment to IFRIC 14. This amendment, once effective in future accounting periods, may impact the recognition of the pension fund surplus. Management will consider the implications of the amendment once it has been published.

Guaranteed Minimum Pension (GMP) equalisation

Management have applied judgement in evaluating a provision for the estimated costs arising following the high court ruling on the Lloyds Bank GMP equalisation case in October 2018. Guaranteed Minimum Pension (GMP) relates to service built up on or before 5 April 1997 and was intended to replicate features of state benefits which at the time were different for men and women. Past service cost represents our estimated liability to address inequalities in respect of GMP.

Defined benefit pension schemes

The Group operates three pension schemes with defined benefit sections, the LV= Employee Pension Scheme ("LV Scheme"), the Ockham Pension Scheme and the Teachers Assurance Group Pension Scheme. The Society is the principal employer for the LV Scheme and the Ockham Pension Scheme. Teachers Management Services Limited, a subsidiary of the Society, is the principal employer for the Teachers Assurance Group Pension Scheme. The LV Scheme and the Ockham Pension Scheme are both hybrid schemes with a defined benefit section and a defined contribution section.

Defined contribution pension schemes

All Society employees are eligible to join the defined contribution section of the LV Scheme. Employees contribute a minimum of 3% of salary. The employee contribution is double matched by the Society up to a maximum employer contribution of 14%. The assets of this scheme are held separately from those of the Group in an independently administered fund. The Group's contribution under this scheme during the year amounted to £9m (2017: £18m).

From 29 December 2017, employees who moved to LVGIG under a TUPE arrangement ceased to be members of the LV Scheme and joined the new My LVGIG Savings Plan, a Group Personal Pension plan. From this date all LVGIG employees were eligible to join the scheme. The Group's contribution under this scheme during the year amounted to £10m (2017: £nil).

Notes to the Financial Statements (continued)

Year ended 31 December 2018

39. Pension benefit asset/(obligation) (continued)

a) Summary of defined benefit schemes

Pension benefit asset/obligation	2018				2017			
	LV Scheme £m	Ockham £m	Teachers £m	Total £m	LV Scheme £m	Ockham £m	Teachers £m	Total £m
Asset	**186**	**13**	**–**	**199**	163	15	–	178
Obligation	**–**	**–**	**(2)**	**(2)**	–	–	–	–
	186	**13**	**(2)**	**197**	163	15	–	178

Re-measurements	2018				2017			
	LV Scheme £m	Ockham £m	Teachers £m	Total £m	LV Scheme £m	Ockham £m	Teachers £m	Total £m
Re-measurements	**(17)**	**(3)**	**(2)**	**(22)**	40	(5)	–	35
Income tax expense	**(8)**	**1**	**–**	**(7)**	(17)	1	–	(16)
Amount charged to Comprehensive Income	**(25)**	**(2)**	**(2)**	**(29)**	23	(4)	–	19
Cumulative re-measurements recognised in the Statement of Comprehensive Income	**176**	**(13)**	**(2)**	**161**	193	(10)	–	183

Further details of the Group's defined benefit pension schemes are disclosed below.

b) LV Scheme

(i) Information about the scheme

The final salary section of the LV scheme provides benefits to members in the form of a guaranteed level of pension payable for life. The level of benefits depends upon the member's length of service and their final salary.

The scheme assets are held in a separate trustee-administered fund to meet long-term pension liabilities to past and present employees.

The liabilities of the scheme are measured by discounting the best estimate of future cash flows to be paid out by the scheme using the projected unit method, which is an accrued benefits valuation method.

The scheme has a Corporate Trustee required to act in the best interests of the scheme's beneficiaries. The Trustee may be removed at the discretion of the Society, in its capacity as principal employer, provided that the board of any new trustee company comprises three directors representing the members, including one director who must be a pensioner and a further four directors selected by the Society. With the agreement of the Society, the directors of the Corporate Trustee may co-opt one other director.

The final salary section is closed to new entrants and was closed to future accrual for existing members on 30 June 2013, at which time they were eligible to join the defined contribution section of the scheme.

(ii) Net Statement of Financial Position	2018 £m	2017 £m
Present value of defined benefit obligation	**(1,254)**	(1,331)
Fair value of plan assets	**1,440**	1,494
Pension benefit asset at the end of the year	**186**	163

Notes to the Financial Statements (continued)

Year ended 31 December 2018

39. Pension benefit asset/(obligation) (continued)

b) LV Scheme (continued)

(iii) The movement in the net defined benefit asset over the year is as follows:	Present value of obligation £m	Fair value of plan assets £m	Total £m
At 1 January 2018	**(1,331)**	**1,494**	**163**
Pension costs:			
Current service cost	**(2)**	**–**	**(2)**
Interest (expense)/income	**(32)**	**37**	**5**
Past service cost	**(6)**	**–**	**(6)**
	(40)	**37**	**(3)**
Re-measurements:			
– Return on plan assets, excluding amounts included in interest (expense)/income	**–**	**(73)**	**(73)**
– Loss from changes in demographic assumptions	**(12)**	**–**	**(12)**
– Gain from changes in financial assumptions	**86**	**–**	**86**
– Experience loss	**(18)**	**–**	**(18)**
	56	**(73)**	**(17)**
Other movements:			
– Contributions by employer	**–**	**43**	**43**
– Benefits paid	**61**	**(61)**	**–**
	61	**(18)**	**43**
At 31 December 2018	**(1,254)**	**1,440**	**186**
At 1 January 2017	(1,308)	1,422	114
Pension costs:			
Current service cost	(1)	–	(1)
Interest (expense)/income	(37)	40	3
	(38)	40	2
Re-measurements:			
– Return on plan assets, excluding amounts included in interest (expense)/income	–	94	94
– Gain from changes in demographic assumptions	4	–	4
– Loss from changes in financial assumptions	(58)	–	(58)
	(54)	94	40
Other movements:			
– Contributions by employer	–	7	7
– Benefits paid	69	(69)	–
	69	(62)	7
At 31 December 2017	(1,331)	1,494	163

Notes to the Financial Statements (continued)

Year ended 31 December 2018

39. Pension benefit asset/(obligation) (continued)

b) LV Scheme (continued)

(iv) Principal assumptions used		2018	2017
Discount rate		**2.95%**	2.50%
RPI inflation		**3.25%**	3.20%
CPI inflation		**2.25%**	2.20%
Pension increases for in-payment benefits			
– RPI price inflation capped at 5% pa, floor of 3% pa		**3.45%**	3.45%
– RPI price inflation capped at 5% pa		**3.40%**	3.40%
– RPI price inflation capped at 2.5% pa		**2.50%**	2.50%
– CPI price inflation capped at 3.0% pa		**2.35%**	2.35%
Rate of (non-guaranteed minimum pension) increases in deferment		**2.25%**	2.20%
Cash commutation	Active at the time of scheme closure	**20%**	20%
	Deferred at the time of scheme closure	**20%**	20%
Scheme member valuation date		**31 March 2018**	31 March 2015

The discount rate and inflation rate assumptions for 2018 and 2017 have been set with reference to yield curves. The single rates disclosed above represent the weighted average equivalent rate based on the yield curve used. The pension increase assumptions disclosed represent spot rates on the yield curve at the approximate duration of the scheme's liabilities.

For 2018, mortality for members is assumed to follow LV specific Club Vita individual base tables, based on pooled experience during the period 2014 to 2016 (2017: LV specific Club Vita tables 2011 – 2013).

The table below shows the life expectancy assumptions used in the accounting assessments based on the average future life expectancy of a scheme member who is a pensioner aged 65 (non-pensioner is assumed to be 45 now).

Future life expectancy assumptions (in years) as at 31 December	2018	2017
Pensioner (currently aged 65)		
– Male	**22.6**	22.7
– Female	**24.4**	24.3
Non-pensioner (at age 65, currently aged 45)		
– Male	**23.6**	23.9
– Female	**25.8**	25.8

In all cases, as at 31 December 2018 CMI Core 2017 projections with a long-term rate of improvement of 1.50% a year have been applied (31 December 2017: CMI Core 2016 projections with a long-term rate of improvement of 1.50%).

(v) Sensitivity analysis: Impact on defined benefit obligation of making changes to key assumptions

	Change in assumption	Impact on defined benefit obligation
Discount rate	**Decrease by 0.5%**	**Increase by £115m (9%)**
RPI rate	**Increase by 0.5%**	**Increase by £86m (7%)**
Life expectancy	**Increase by 1 year**	**Increase by £44m (3%)**

The sensitivity analysis has been calculated by valuing the defined benefit obligation using the amended assumptions shown in the table above and keeping the remaining assumptions the same as disclosed in the principal assumptions table for the scheme, except in the case of the inflation sensitivity where other assumptions that depend on assumed inflation have also been amended correspondingly.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

39. Pension benefit asset/(obligation) (continued)

b) LV Scheme (continued)

(vi) Plan asset information

The following table shows a breakdown of the plan assets:

	2018				2017			
	Quoted £m	Unquoted £m	Total £m	%	Quoted £m	Unquoted £m	Total £m	%
Equities and unit trusts	**93**	**5**	**98**	**7**	99	7	106	7
Debt securities	**1,651**	**–**	**1,651**	**115**	1,687	–	1,687	113
Cash and cash equivalents	**125**	**–**	**125**	**9**	113	4	117	8
Real estate/property	**–**	**4**	**4**	**–**	–	5	5	–
Derivatives	**(16)**	**(454)**	**(470)**	**(33)**	21	(469)	(448)	(30)
Other	**–**	**32**	**32**	**2**	–	27	27	2
	1,853	**(413)**	**1,440**	**100**	1,920	(426)	1,494	100

The use of derivatives is predominantly gilt repos and swaps to hedge the interest and inflation exposure. A longevity swap also exists to mitigate the risk of higher than expected life expectancy arising on the bulk of members within the pensions in payment cohort. The longevity risk associated with pre-retirement members still remains largely with the scheme. In addition a proportion of the derivative exposure relates to a synthetic equity strategy used to gain exposure to global equity markets.

In determining and reviewing the Scheme's investment strategy, the Trustee adopts a Pensions Risk Management Framework (PRMF). This framework translates the principal goal of paying member benefits into measurable funding objectives and risk constraints, agreed by the Trustee. The PRMF is reviewed and monitored by the Trustee on at least a quarterly basis.

The Trustee's primary funding objective is to reach full funding on the Technical Provisions basis, with a long-term target of moving towards being fully funded on a Gilts +0.25% liability valuation basis by 2028 if possible. In setting the investment strategy, the Trustee aims to:

- Target an expected return on assets close to that required to meet the funding objectives within the PRMF;
- Manage the investment risk including that arising due to mismatch between assets and liabilities and limit the total risk on the Scheme below the risk budget set in the PRMF;
- Maintain suitable liquidity of assets such that the Scheme is not forced to buy and sell investments at particular times to pay member benefits or meet potential collateral calls.

Following the triennial scheme valuation which took place as at 31 March 2018, the Society as principal employer agreed, on behalf of participating employees, to make a one-off payment of £35,400,000 and to continue to pay monthly deficit reduction contributions of £416,667 until 31 March 2028 to meet the statutory funding objective*. In addition to these funding contributions, the Society continues to make payments of £179,019 per month towards the regular expenses of administering the defined benefit section of the Scheme plus payments equal to the pension protection fund (PPF) levies. The next formal valuation of the Scheme is due no later than 31 March 2021.

* The statutory funding objective is that the Scheme must have 'sufficient and appropriate' assets to meet the expected costs of providing members past service benefits.

(vii) Pension scheme risks

Through its defined benefit pension schemes the Group is exposed to a number of risks, the most significant of which are detailed below:

Asset volatility:	The plan liabilities are calculated using a discount rate set with reference to corporate bond yields; if plan assets underperform this yield, this will create a deficit. The plan assets are predominantly held in debt securities which match the liabilities with a small holding of equities that are expected to outperform corporate bonds in the long-term.
Changes in bond yields:	A decrease in corporate bond yields will increase plan liabilities, although this will be offset by an increase in the value of the scheme's bond holdings.
Inflation risk:	The majority of the scheme's benefit obligations are linked to inflation, therefore an increase in inflation will lead to an increase in liabilities. In most cases, caps on the level of inflationary increases and derivatives are in place to protect the scheme against significant rises in inflation.
Life expectancy:	The scheme's obligations are to provide benefits for the life of the member, so any increases in life expectancy will result in an increase in the scheme's liabilities. In 2012 the trustees of the LV Scheme entered into a longevity swap which mitigated the majority of this risk for the LV scheme.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

39. Pension benefit asset/(obligation) (continued)

b) LV Scheme (continued)

(viii) Expected maturity analysis of undiscounted pension benefits:

	Less than a year £m	Between 1-2 years £m	Between 2-5 years £m	Over 5 years £m	Total £m
At 31 December 2018	**50**	**42**	**134**	**2,018**	**2,244**

The weighted average duration of the gross defined benefit obligation is 17 years. The expected contributions to the scheme for the year ending 31 December 2019 are £7m.

c) Ockham Scheme

(i) Information about the scheme

The final salary section of the Ockham scheme provides benefits to members in the form of a guaranteed level of pension payable for life. The level of benefits depends upon the members' length of service and their final salary. The scheme is closed to new entrants and future accrual. The scheme assets are held in separate trustee-administered funds to meet long-term pension liabilities to past employees. The liabilities of the scheme are measured by discounting the best estimate of future cash flows to be paid out by the scheme using the projected unit method, which is an accrued benefits valuation method.

The scheme has a Corporate Trustee required to act in the best interests of the scheme's beneficiaries. The Trustee may be removed at the discretion of the Society, in its capacity as principal employer, provided that any new trustee board comprises two directors representing the members and up to four directors selected by the Society.

(ii) Net Statement of Financial Position

	2018 £m	2017 £m
Present value of defined benefit obligation	**(141)**	(149)
Fair value of plan assets	**154**	164
Pension benefit asset at the end of the year	**13**	15

(iii) The movement in the net defined benefit asset over the year is as follows:

	Present value of obligation £m	Fair value of plan assets £m	Total £m
At 1 January 2018	**(149)**	**164**	**15**
Pension costs:			
Interest (expense)/income	**(3)**	**4**	**1**
	(3)	**4**	**1**
Re-measurements:			
– Return on plan assets, excluding amounts included in interest (expense)/income	**–**	**(8)**	**(8)**
– Loss from changes in demographic assumptions	**(3)**	**–**	**(3)**
– Gain from changes in financial assumptions	**6**	**–**	**6**
– Experience gains	**2**	**–**	**2**
	5	**(8)**	**(3)**
Other movements:			
– Benefits paid	**6**	**(6)**	**–**
	6	**(6)**	**–**
At 31 December 2018	**(141)**	**154**	**13**
At 1 January 2017	(143)	163	20
Pension costs:			
Interest (expense)/income	(4)	4	–
	(4)	4	–
Re-measurements:			
– Return on plan assets, excluding amounts included in interest (expense)/income	–	3	3
– Loss from changes in financial assumptions	(8)	–	(8)
	(8)	3	(5)
Other movements:			
– Benefits paid	6	(6)	–
	6	(6)	–
At 31 December 2017	(149)	164	15

Notes to the Financial Statements (continued)

Year ended 31 December 2018

39. Pension benefit asset/(obligation) (continued)

c) Ockham Scheme (continued)

(iv) Principal assumptions used	2018	2017
Discount rate	**2.85%**	2.50%
RPI inflation	**3.25%**	3.20%
CPI inflation	**2.25%**	2.20%
Pension increases for in-payment benefits		
– RPI price inflation capped at 5% pa	**3.35%**	3.35%
– linked to RPI inflation	**3.35%**	3.35%
– fixed rate	**in line with scheme rules**	in line with scheme rules
Rate of (non-guaranteed minimum pension) increases in deferment	**2.25%**	2.20%
Cash commutation – Deferreds	**20%**	20%
Scheme member valuation date	**31 March 2018**	31 March 2015

The discount rate and inflation rate assumptions for 2018 and 2017 have been set with reference to yield curves. The single rates disclosed above represent the weighted average equivalent rate based on the yield curve used. The pension increase assumptions disclosed represent spot rates on the yield curve at the approximate duration of the scheme's liabilities.

Mortality rate assumptions are based on the same mortality tables as disclosed within the LV Scheme, but using Ockham specific individual base tables.

Future life expectancy assumptions (in years) as at 31 December	2018	2017
Pensioner (currently aged 65)		
– Male	**23.4**	23.5
– Female	**24.5**	24.5
Non-pensioner (at age 65, currently aged 45)		
– Male	**24.2**	24.6
– Female	**26.3**	26.2

(v) Sensitivity analysis: Impact on defined benefit obligation of making changes to key assumptions

	Change in assumption	Impact on defined benefit obligation
Discount rate	**Decrease by 0.5%**	**Increase by £11m (8%)**
RPI rate	**Increase by 0.5%**	**Increase by £7m (5%)**
Life expectancy	**Increase by 1 year**	**Increase by £5m (4%)**

The sensitivity analysis has been calculated by valuing the defined benefit obligation using the amended assumptions shown in the table above and keeping the remaining assumptions the same as disclosed in the principal assumptions table for the scheme, except in the case of the inflation sensitivity where other assumptions that depend on assumed inflation have also been amended correspondingly.

(vi) Plan asset information

Plan assets are comprised as follows:

	2018				2017			
	Quoted £m	Unquoted £m	Total £m	%	Quoted £m	Unquoted £m	Total £m	%
Equities and unit trusts	**68**	**–**	**68**	**44**	71	–	71	43
Debt securities	**79**	**–**	**79**	**51**	91	–	91	56
Derivative swaps	**–**	**1**	**1**	**1**	–	2	2	1
Cash and cash equivalents	**6**	**–**	**6**	**4**	–	–	–	–
	153	**1**	**154**	**100**	162	2	164	100

In determining and reviewing the Scheme's investment strategy, the Trustee adopts an objectives based approach. This translates the principal goal of paying member benefits into measurable funding objectives and risk constraints, agreed by the Trustee. These objectives are reviewed and monitored by the Trustee on a regular basis.

Our Accounts

Notes to the Financial Statements (continued)

Year ended 31 December 2018

39. Pension benefit asset/(obligation) (continued)

c) Ockham Scheme (continued)

The Trustee's primary funding objective is to reach full funding on the Technical Provisions basis, with a long-term target of moving towards being fully funded on a Gilts +0.25% liability valuation basis by 2028 if possible. In setting the investment strategy, the Trustee aims to:

- Target an expected return on assets close to that required to meet the funding objective;
- Manage the investment risk including that arising due to mismatch between assets and liabilities and limit the total risk on the Scheme below the risk budget;
- Maintain suitable liquidity of assets such that the Scheme is not forced to buy and sell investments at particular times to pay member benefits or meet potential collateral calls.

Following the triennial scheme valuation which took place as at 31 March 2018, the Society as principal employer agreed, on behalf of participating employees, to make annual deficit reduction contributions of £2,000,000, commencing 31 March 2019 until 31 March 2028 to meet the statutory funding objective. In addition to these funding contributions, the Society will make payments of £29,167 per month towards the regular expenses of administering the defined benefit section of the Scheme plus payments equal to the pension protection fund (PPF) levies.

The next formal valuation of the Scheme is due no later than 31 March 2021.

(vii) Pension scheme risks

Details of the pension scheme risks that the Group is exposed to are disclosed within the LV Scheme.

(viii) Expected maturity analysis of undiscounted pension benefits:

	Less than a year £m	Between 1-2 years £m	Between 2-5 years £m	Over 5 years £m	Total £m
At 31 December 2018	6	6	18	197	227

The weighted average duration of the defined benefit obligation is 15 years.

The expected contributions to the Ockham pension scheme for the year ending 31 December 2019 are £2m.

d) Teachers Assurance Group Pension Scheme

The Teachers Assurance Group Pension Scheme is a final salary pension scheme, which provides benefits to members in the form of a guaranteed level of pension payable for life. The level of benefits depends upon the member's length of service and their final salary.

The fair value of the plan assets was £33m (2017: £34m) and the present value of the obligations was £28m (2017: £30m) as at 31 December 2018. The surplus of £5m (2017: £4m) has not been recognised because under IFRIC 14, the wording of the scheme trust deed does not allow the Society the right to the scheme's assets following the scheme's termination. Future funding obligations have created a liability of £2m. The scheme is closed to new entrants and was closed to future accrual for existing members on 31 December 2015. Funding contributions of £375,000 were paid during the year (2017: £20,000) from the Teachers Assurance fund, a closed fund within the Society.

Following the triennial scheme valuation which took place as at 30 September 2017, Teachers Management Services Limited as principal employer agreed to make a one off payment during 2018 of £375,000 followed by monthly deficit reduction contributions of £25,000 running from January 2019 until September 2027. These contributions, which will also be made from the Teachers Assurance fund, have been recognised as a liability in accordance with IFRIC 14.

On 7 February 2019 the Trustee purchased a bulk annuity policy as an investment of the Scheme from an insurance company, Rothesay Life. The bulk annuity policy is designed to fully match the Scheme's liabilities, providing funding to the Scheme for all members' benefit payments as they fall due. The Teachers Assurance fund made a special contribution of £4.5m towards the cost of the policy.

Due to the immaterial nature of the Teachers scheme no detailed disclosures have been made.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Provisions, contingent liabilities and commitments

This section describes the provisions, contingent liabilities and commitments of the Society and Group arising from the ongoing life business and the exit from the banking and asset management businesses in prior years.

40. Provisions

Accounting for provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is more likely than not that an outflow of resources will be required to settle the obligation and the amount has been reliably estimated. Where the Group expects some or all of a provision to be reimbursed it is recognised as a separate asset when the reimbursement is certain.

Provisions are measured at the present value of the expenditure required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation.

The expense relating to provisions is presented in the Statement of Comprehensive Income.

Movement during the year on provisions	Group £m	Society £m
Balance at 1 January 2018	20	13
Provided during the year	7	1
Released during the year	(2)	(1)
Utilised during the year	(9)	(6)
Transfer to liabilities directly associated with assets held for sale	(8)	–
Balance at 31 December 2018	8	7

Provisions relate to:	Group 2018 £m	Group 2017 £m	Society 2018 £m	Society 2017 £m
Payment protection insurance	4	8	4	8
Restructuring	–	5	–	–
Onerous contracts on property leases	–	2	–	2
Compensation payable on customer complaints	1	1	–	–
Other	3	4	3	3
	8	20	7	13

Included within the 2017 comparatives are amounts of £5m relating to the general insurance business. In 2018 these balances have been disclosed as Liabilities directly associated with assets held for sale within Note 12.

The payment protection insurance (PPI) provision is held to cover future payments in respect of claims relating to PPI policies potentially mis-sold to customers. Given the assumptions made it is expected that up to £4m of payments will be set against this provision before the Financial Conduct Authority's claim deadline in August 2019.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

41. Contingent liabilities

Accounting for contingent liabilities

Contingent liabilities are disclosed if there is a possible future obligation as a result of a past event, or if there is a present obligation as a result of a past event but either a payment is not probable or the amount cannot be reasonably estimated.

The Society has granted a contingent loan facility to the RNPFN fund, a closed fund within the Society, up to a maximum of £100m (the value applying for 2018 was £60m), to be used in the event of a shortfall in the capital resources of that fund. The RNPFN fund is required to manage its capital in a manner so as not to require use of this facility and, if it is used, to repay it to the Society as soon as possible. While undrawn a charge for the facility is made at 1% per annum.

As part of the general insurance transaction with Allianz Holdings Plc, Liverpool Victoria Friendly Society Limited acts as guarantor to the obligations entered into by its wholly owned subsidiary, LV Capital PLC.

The Society has granted a guarantee to the trustees of the Teachers Assurance Group Pension Scheme, to guarantee the payment of certain contributions and payments to the scheme by Teachers Management Services Limited (TMS). TMS, a subsidiary of the Society, is the principal employer for the Scheme. Under the Instrument of Transfer executed by the Society and Teachers Provident Society Limited on 6 May 2016 (and effective from 1 June 2016) the Society has the ability to charge all liabilities relating to the scheme to the Teachers Assurance fund, a closed fund within the Society.

The Society has granted guarantees to the landlords of its leased properties, to guarantee that the tenants, subsidiaries of the Society, shall pay the rents reserved by the leases and observe and perform the tenant covenants of the leases and that if the tenants fail to do so, the Society shall pay or observe and perform them.

The Society has provided a guarantee in relation to a mortgage purchase agreement between its subsidiary LV Equity Release Limited and Phoenix Life Limited. In the event that the subsidiary fails to pay any amount in connection with the agreement, the Society would cover the payment and any loss incurred by the counterparty as a result.

42. Commitments

Accounting for assets held under leases

Where assets are financed by leasing arrangements and the risks and rewards are substantially transferred to the Group, such finance leases are treated as if the assets had been purchased outright and the corresponding liability to the lessor is included as an obligation in trade and other payables. The liability is based on the present value of the minimum lease payments at the inception of the lease. Depreciation on leased assets is charged to the Statement of Comprehensive Income on a straight line basis over the lower of the term of the lease or its estimated useful life. The capital element on finance leases is shown in the property and equipment note.

Lease payments are treated as consisting of capital and interest elements and the interest is charged to the Statement of Comprehensive Income.

All other leases are operating leases and the costs in respect of operating leases are charged on a straight line basis over the lease term. The value of any lease incentive received to take on an operating lease (for example, rent free periods) is recognised as a prepayment and is released over the life of the lease.

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Capital commitments	**9**	14	**9**	13
Operating lease commitments	**7**	14	**7**	8
Finance lease commitments	**19**	19	**–**	–
Other financial commitments	**91**	32	**91**	26
	126	79	**107**	47

Included within the 2017 Group comparatives are amounts of £12m relating to the general insurance business.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

42. Commitments (continued)

Capital commitments

Capital commitments relate to authorised and contracted commitments payable but not provided for regarding financial investment and property and equipment.

Operating lease commitments

The Group leases various properties under non-cancellable operating lease agreements. The leases have varying terms, escalation clauses and renewal rights.

Finance lease commitments

Finance lease commitments relate to a property with a remaining lease term of 22 years. The lease is on a fixed repayment basis and no arrangements have been entered into for contingent payments. The Group's obligations under finance leases are secured by the lessors' charges over the leased assets.

	2018			2017		
Group	Gross liability £m	Finance charge £m	Present value £m	Gross liability £m	Finance charge £m	Present value £m
Minimum lease payments						
Within one year	**1**	**–**	**1**	1	–	1
Between one and five years	**5**	**(3)**	**2**	5	(3)	2
Over five years	**21**	**(5)**	**16**	22	(6)	16
	27	**(8)**	**19**	28	(9)	19

Other financial commitments

The Group has entered into several long-term contracts following service outsourcing which will end no later than 2023. These contracted commitments have not been provided for in the financial statements.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Scope of consolidation

This section presents information on the Group's investments in subsidiaries, joint ventures, associates and structured entities. Detail is also given of the Unallocated divisible surplus of the Society and Group.

43. Subsidiary undertakings

All subsidiary undertakings are included in the consolidation. The proportion of the voting rights in the subsidiary undertakings held directly by the parent company do not differ from the proportion of ordinary shares held. The Group and all principal undertakings are incorporated and domiciled in England and Wales. All holdings are in relation to ordinary shares. The registered office is County Gates, Bournemouth BH1 2NF.

Name	Principal activity	Percentage held by Group	Percentage held by non-controlling interests
Subsidiaries directly owned by the Society			
Frizzell Financial Services Limited (Note 1)	Property management	100%	0%
LV Life Services Limited (Note 1)	Management services	100%	0%
LV Commercial Mortgages Limited (Note 1)	Commercial mortgages	100%	0%
NM Pensions Trustees Limited (Note 1)	Self-invested personal pension (SIPP) administrator	100%	0%
Liverpool Victoria Financial Advice Services Limited (Note 1)	Financial advice services	100%	0%
Liverpool Victoria Life Company Limited	Life insurance	100%	0%
LV Protection Limited	Insurance	100%	0%
LV Capital PLC (Note 1)	Holding company	100%	0%
LV Equity Release Limited (Note 1)	Origination of equity release lifetime mortgages	100%	0%
Teachers Property Limited (Note 1)	Property services	100%	0%
Teachers Financial Services Limited (Note 1)	Insurance and financial intermediary	100%	0%
Teachers Assurance Company Limited	General insurance	100%	0%
Teachers Management Services Limited (Note 1)	Management services	100%	0%
Sovereign Unit Trust Managers Limited (Note 1)	Portfolio manager	100%	0%
Liverpool Victoria Banking Services Limited (Note 2)	Dormant	100%	0%
Ayresbrook Limited (Note 2)	Dormant	100%	0%
Liverpool Victoria Asset Management Limited (Note 2)	Dormant	100%	0%
Highway Corporate Capital Limited (Note 2)	Dormant	100%	0%
Ockham Corporate Limited (Note 2)	Dormant	100%	0%
NLC Name No. 1 Limited (Note 2)	Dormant	100%	0%
NLC Name No. 2 Limited (Note 2)	Dormant	100%	0%
NLC Name No. 3 Limited (Note 2)	Dormant	100%	0%
NLC Name No. 4 Limited (Note 2)	Dormant	100%	0%
NLC Name No. 5 Limited (Note 2)	Dormant	100%	0%
NLC Name No. 7 Limited (Note 2)	Dormant	100%	0%
The LV= Pension Trustee Limited (Note 2)	Dormant trustee company	Note 3	
The LV= General Trustee Limited (Note 2)	Dormant trustee company	Note 3	
The Ockham Pension Trustee Limited (Note 2)	Dormant trustee company	Note 3	
Liverpool Victoria Trustees Limited (Note 2)	Dormant trustee company	Note 3	
Liverpool Victoria Financial Services Limited (Note 1)	Active (non-trading)	Note 3	
Wealth Wizards Limited Group of Companies		70%	30%
Wealth Wizards Limited	IT software		
Wealth Wizards Benefits Limited * (Note 1)	Financial intermediary		
Wealth Wizards Advisers Limited * (Note 1)	Financial intermediary		
Liverpool Victoria General Insurance Group of Companies		51%	49%
Liverpool Victoria General Insurance Group Limited *	General insurance holding company		
Liverpool Victoria Insurance Company Limited *	General insurance		
Highway Insurance Company Limited *	General insurance		
LV Repair Services Limited * (Note 1)	Repair services		
LV Assistance Services Limited * (Note 1)	Road Rescue – Pay on use		
LV Insurance Management Limited * (Note 1)	Management services		
Highway Insurance Group Limited * (Note 1)	General insurance holding company		
Highway Group Services Limited * (Note 2)	Dormant		

* Owned by a subsidiary undertaking of the Society

Note 1 – The financial statements of these subsidiary undertakings have not been audited for the year ended 31 December 2018. These subsidiary undertakings are exempt from the requirements of the Companies Act 2006 relating to the audit of individual financial statements by virtue of Section 479A of the Companies Act 2006.

Note 2 – The financial statements of these dormant companies have not been audited for the year ended 31 December 2018. These companies were entitled to exemption from audit under section 480 of the Companies Act 2006 relating to dormant companies.

Note 3 – These companies are limited by Guarantee and have no issued share capital.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

43. Subsidiary undertakings (continued)

All the principal subsidiaries have the same year end as the Society and all have been included in the consolidation.

Non-controlling interest

Further details on the non-controlling interests in Liverpool Victoria General Insurance Group Limited and Wealth Wizards Limited are disclosed in Note 47.

Significant restrictions

Following the completion of the sale of a 49% stake in Liverpool Victoria General Insurance Group Limited to Allianz Holdings plc there are restrictions associated with this subsidiary and the subsidiaries it directly owns. The general insurance assets and liabilities identified in Note 47 are ring-fenced and distributions from these subsidiaries can only be made in accordance with the dividend policy contractually agreed with Allianz as part of the sale. Allianz has a protective veto right over any dividends paid outside of policy.

Whilst the Society retains control over the LVGIG group, the shareholders agreement includes protective veto rights for the minority investor that restricts the Society's ability to make changes to the capital structure, initiate insolvency proceedings, make a further sale of the business or enter into a merger or acquisition.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

44. Associates and joint ventures

The associates and joint ventures of the Society at 31 December 2018 are shown below. They are incorporated and domiciled in England and Wales.

Name	Class of shares	Year end	Principal activity	Percentage held
Joint ventures				
Great Victoria Partnership	*	31/03/2018	Investment property	50.0%

* The percentage held represents the share of the partnership capital and partner loans held by the Society as at 31 December 2018.

The Group holds 50% of the voting rights of its joint arrangement. The Group has joint control over this arrangement as, under the contractual agreement, unanimous consent is required from all parties to the agreement for all relevant activities.

The Group's joint arrangement is structured as a partnership and provides the Group and the other parties to the agreement with rights to the net assets of the partnership. Therefore, this arrangement is classified as a joint venture.

Commitments and contingent liabilities in respect of joint ventures

There are no commitments or contingent liabilities relating to the Group's interest in the joint venture.

Summarised financial information for joint ventures

In accordance with the provisions of IFRS 12 which states that an entity may present the summarised financial information on the basis of the joint venture's or associate's financial statements if:

- the entity measures its interest in the joint venture or associate at fair value in accordance with IAS 28; and
- the joint venture or associate does not prepare IFRS financial statements and preparation on that basis would be impracticable or cause undue cost.

The summarised financial information set out below is presented on the basis of the Great Victoria Partnership's financial statements for the year ended 31 March 2018.

Within the Group financial statements this holding is accounted for as an investment at fair value in accordance with the exemptions permitted under IAS28 applicable to investment-linked insurance funds.

Summarised Statement of Financial Position	31 March 2018 £m	31 March 2017 £m
Assets		
Non-current		
– Investment properties	**231**	229
Current		
– Other assets	**16**	15
	247	244
Liabilities		
Non-current		
– Financial liabilities	**(80)**	(79)
Current		
– Other liabilities	**(4)**	(5)
	(84)	(84)
Net assets	**163**	160
Partners' capital	**5**	6
Retained earnings	**158**	154
Total partners' funds	**163**	160

Notes to the Financial Statements (continued)

Year ended 31 December 2018

44. Associates and joint ventures (continued)

Summarised Statement of Comprehensive Income	31 March 2018 £m	31 March 2017 £m
Net rental income	**11**	12
Revaluation surplus/(deficit) on investment properties	**3**	(13)
Loss on sale of investment properties	**–**	(9)
Operating profit /(loss)	**14**	(10)
Finance costs	**(3)**	(3)
Profit /(loss) for the year	**11**	(13)

45. Investments in unconsolidated structured entities

The Group has interests in structured entities which are not consolidated as the definition of control has not been met based on the proportion of the investment of the structured entity held by the Group. As at 31 December 2018 the Group's interest in unconsolidated structured entities, which are classified as investments held at fair value through profit or loss are shown below:

Investment	2018 £m	2017 £m
Open Ended Investment Companies	**5,464**	5,430
Unit trusts	**329**	343
Liquidity funds	**655**	1,017
	6,448	6,790

Included within the above are £2,951m (2017: £2,995m) of investments held to cover linked liabilities. Other than these, the Group's exposure to financial loss from the interest in the unconsolidated structured entities is limited to the investment amount shown above. The Group is not required to provide financial support to the entities, nor does it sponsor the entities.

46. Unallocated divisible surplus

Accounting for the Unallocated divisible surplus

The Unallocated divisible surplus represents the excess of assets over and above the long-term insurance contract liabilities and other liabilities. It represents amounts that have yet to be formally declared as bonuses for the participating contract policyholders together with the free assets of the Society and Group. Any profit or loss for the year arising through the Statement of Comprehensive Income (for the Society and for the Group) is transferred to or from the Unallocated divisible surplus.

UK regulations, the Group's Principles and Practices of Financial Management, and the terms and conditions of participating contracts set out the bases for the determination of the amounts on which the participating additional discretionary contract benefits are based and within which the Group may exercise its discretion as to the quantum and timing of their payment to contract holders.

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Balance at 1 January	**1,189**	998	**1,050**	1,019
Transfer included within profit for the year	**(28)**	48	**(24)**	12
Transfer included within other comprehensive income	**(34)**	19	**(27)**	19
Gain on sale of non-controlling interest in LVGIG	**–**	124	**–**	–
Balance at 31 December	**1,127**	1,189	**999**	1,050

Notes to the Financial Statements (continued)

Year ended 31 December 2018

47. Non-controlling interest

The table below details the non-controlling interests held in subsidiaries of the Group as at 31 December:

	LVGIG Group £m	Wealth Wizards Group £m	Total £m
Balance at 1 January 2018	**376**	**(3)**	**373**
Share of profit/(loss) after tax	**38**	**(2)**	**36**
Share of movement in other comprehensive income	**(5)**	**–**	**(5)**
Balance at 31 December 2018	**409**	**(5)**	**404**
Balance at 1 January 2017	–	(1)	(1)
Initial recognition of non-controlling interest on sale of LVGIG stake	376	–	376
Share of loss after tax	–	(2)	(2)
Balance at 31 December 2017	376	(3)	373

Summarised financial information on subsidiaries with material non-controlling interests

Summarised financial information is presented in order to enable users to understand the interest that non-controlling interests have in the Group's activities and cash flows.

At 31 December 2018 the LVGIG Group of companies is a disposal group that is classified as held for sale in accordance with IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations', and has been presented as a discontinued operation – refer Note 12.

The Statement of Financial Position of the LVGIG Group is disclosed below for comparative purposes.

	2018 £m	2017 £m
Assets		
Intangible assets	**271**	264
Financial assets at fair value through income	**736**	1,437
AFS financial assets at fair value through OCI	**995**	–
Deferred acquisition costs	**86**	95
Reinsurance assets	**490**	558
Insurance receivables	**265**	279
Other assets	**188**	275
Cash and cash equivalents	**319**	540
Total assets	**3,350**	3,448
Liabilities		
Insurance contract liabilities	**2,283**	2,427
Subordinated liabilities	**11**	11
Other liabilities	**222**	242
Total liabilities	**2,516**	2,680
Equity	**834**	768
Total equity and liabilities	**3,350**	3,448

The Wealth Wizards Group of companies are not material to the Group.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

Other disclosures

This section details other disclosure matters, comprising: related party transactions, directors' emoluments, With-profits actuary details and other relevant Society information.

48. Related party transactions

a) Key management compensation

Key management personnel of the Group comprise all executive and non-executive directors and senior management. The summary of the compensation of key management personnel for the year is as follows:

	Group	
	2018 £000	2017 £000
Short-term employment benefits	**4,339**	5,815
Other long-term benefits	**380**	2,606
Post-employment benefits	**27**	44
Termination benefits	**–**	1,202
Total compensation of key management personnel	**4,746**	9,667

The aggregate premiums payable for the year by the Group Executive and Non-Executive Directors in respect of the Group's products was £17,473 (2017: £20,502).

b) Transactions between the Society and other Group companies

	2018 £m	2017 Restated* £m
Management charge by the Society (see note 11)	**58**	215
Beneficial interest of subsidiary in loans sold to the Society	**39**	33
Investment expenses charge to the Society	**(3)**	(3)
Interest income from group undertakings	**–**	18
Dividend income from group undertakings	**67**	94

* In 2017, the Beneficial interest of subsidiary in loans sold to the Society was reported as the full loan stock. This has been restated to show the loans sold in the year.

Balances outstanding between the Society and other Group companies:

	2018 £m	2017 £m
Payable by the Society	**(6)**	(21)
Receivable by the Society	**33**	25
Loans owed to the Society	**15**	10

c) Loans to related parties

Loans owed to the Society represent a loan agreement with Wealth Wizards Limited with a facility limit of £22.5m. Repayment is due by 2021 and £15m of this loan had been drawn down at 31 December 2018 (2017: £10m).

On 30 September 2017 the Society purchased 326,053,921 ordinary £1 shares in LV Capital PLC, in exchange for the cancellation of the £300m loan notes and the repayment of outstanding interest.

d) Other related party disclosure

The Society has granted a contingent loan facility to the RNPFN fund, a closed fund within the Group and a guarantee to the Trustees of the Teachers Assurance Group Pension Scheme. Further details of these, and other guarantees issued on behalf of subsidiaries, are disclosed in Note 41.

49. With-profits Actuary

The following information has been provided in accordance with section 77 of the Friendly Societies Act 1992.

a) The With-profits Actuary of the Society until 12 September 2018 was Mr A Walton, who was employed by Liverpool Victoria Friendly Society Limited. The total emoluments of Mr Walton during this period were £192,181 (2017: £297,159) including pension contributions, car allowance , LTIPs and other benefits. Mr Walton was a participant in the Society's long-term incentive plan and held one insurance policy issued by a subsidiary of the Society.

b) The With-profits Actuary of the Society from 12 September 2018 is Mrs T Abbey, a partner in Deloitte LLP. Mrs Abbey was not a member of the Society at any time in 2018. Mrs Abbey had no pecuniary interest in any transactions with the Society at any time during the year except her interest as partner in the firm of Deloitte LLP to whom fees for professional services were paid amounting to £501,608. Mrs Abbey did not receive, nor will receive any other pecuniary benefit.

Notes to the Financial Statements (continued)

Year ended 31 December 2018

50. Directors' emoluments

a) Emoluments of individual directors, including emoluments of the Chairman and highest paid director were as follows for the Society:

	Annual remuneration £000						Total remuneration £000		
	2018					2017	2018		2017
	Salary and fees	Bonus	Pension related benefits	Other benefits	Total	Total	LTIP 2016-18	Total	Total
R. Rowney	**525**	**345**	**116**	**17**	**1,003**	1,239	–	**1,003**	1,719
A. Parsons	**396**	**180**	**45**	**29**	**650**	497	–	**650**	497
W. Snow (appointed 02 July 2018) **(1)**	**168**	**200**	**19**	**7**	**394**	–	–	**394**	–
A. Cook	**250**	–	–	–	**250**	153	–	**250**	153
D. Barral	**99**	–	–	–	**99**	75	–	**99**	75
D. Neave	**90**	–	–	–	**90**	77	–	**90**	77
C. Ledlie	**73**	–	–	–	**73**	28	–	**73**	28
A. Hutchinson (appointed 1 January 2018)	**63**	–	–	–	**63**	–	–	**63**	–
L. Savage (appointed 1 February 2018)	**60**	–	–	–	**60**	–	–	**60**	–
T. Lawler (appointed 1 September 2018)	**21**	–	–	–	**21**	–	–	**21**	–
C. Burton (resigned 7 June 2018)	**35**	–	–	–	**35**	82	–	**35**	82
J. Dean (resigned 31 March 2018)	**20**	–	–	–	**20**	78	–	**20**	78
S. Treloar (resigned 28 December 2017)	–	–	–	–	–	815	–	–	815
P. Moore (resigned 29 June 2017)	–	–	–	–	–	260	–	–	599
M. Austen (resigned 20 June 2017)	–	–	–	–	–	87	–	–	87
C. Keers (resigned 20 June 2017)	–	–	–	–	–	33	–	–	33
	1,800	**725**	**180**	**53**	**2,758**	3,424	–	**2,758**	4,243

(1) Wayne Snow performed the role of chief risk officer from the date he was employed by LV= on 26 June 2018. Formal appointment to the board took place on 2 July 2018, however his full remuneration since commencing employment has been included in the table above. As part of his joining contract, the Remuneration Committee agreed that Wayne Snow would have the opportunity of being entitled to a full year's bonus.

Further details of the annual bonus awarded for the year ended 31 December 2018 are set out on pages 80 and 81.

Pension related benefits are amounts taken as cash in lieu of forgone pension contributions.

Other benefits include temporary living costs, car allowance, medical insurance, health screening, income protection cover and life cover.

The 2016-18 LTIP was below threshold and resulted in a £nil payout.

b) Pension arrangements

The LV= Employee Pension Scheme is administered at Group level and incorporates both defined benefit and defined contribution sections.

The defined benefit section was closed to future accrual in 2013 at which point existing members were eligible to join the defined contribution section.

The Society has made no contributions to personal pension arrangements during 2018 (2017: £nil).

There were no contributions to the defined contribution section in 2018 (2017: £15k).

Richard Rowney is a deferred member of the defined benefit section.

Deferred pension at end of year	2018 £000	2017 £000
Richard Rowney	**32**	31

Notes to the Financial Statements (continued)

Year ended 31 December 2018

51. Cash used in operating activities

	Group		Society	
	2018 £m	2017 £m	**2018** £m	2017 £m
(Loss)/profit before tax, mutual bonus and UDS transfer from continuing operations	**(90)**	(42)	**(29)**	62
Profit before tax, mutual bonus and UDS transfer from discontinued operations	**110**	164	**–**	–
Profit /(loss) before tax, mutual bonus and UDS transfer	**20**	122	**(29)**	62
Investment income	**(353)**	(374)	**(363)**	(430)
Other interest income	**(27)**	(32)	**–**	–
Net losses/(gains) on investments	**629**	(360)	**605**	(395)
Finance costs	**24**	24	**23**	23
Gain on sale of commercial business renewal rights	**–**	(52)	**–**	–
Net decrease/(increase) in derivatives	**7**	(20)	**13**	14
Non-cash items				
Movement in deferred acquisition costs	**9**	7	**–**	–
Amortisation of intangible assets	**20**	11	**3**	2
Depreciation of property and equipment	**5**	7	**2**	3
(Profit)/loss on disposal of property and equipment	**(3)**	1	**–**	1
Impairment of intangible assets	**–**	2	**–**	–
Increase in provisions	**5**	13	**–**	7
Increase in pension benefit asset	**(41)**	(9)	**(41)**	(9)
Impairment write-offs in subsidiaries	**–**	–	**7**	16
Mutual bonus	**(26)**	(26)	**(26)**	(26)
Changes in working capital				
(Increase)/decrease in loans and receivables	**(273)**	33	**(19)**	90
Decrease/(increase) in reinsurance assets	**77**	(1,215)	**9**	(1,146)
Decrease/(increase) in insurance receivables	**2**	(15)	**(11)**	(13)
(Increase)/decrease in prepayments	**(2)**	2	**(5)**	16
(Decrease)/increase in participating insurance contract liabilities	**(187)**	280	**(187)**	280
(Decrease)/increase in non-participating insurance contract liabilities	**(273)**	280	**(127)**	209
(Increase)/decrease in non-participating value of in-force business	**(10)**	31	**(10)**	31
(Decrease)/increase in participating investment contract liabilities	**(55)**	56	**(55)**	56
(Decrease)/increase in non-participating investment contract liabilities	**(54)**	524	**(54)**	524
Increase in subordinated liabilities	**1**	1	**–**	1
Decrease in other financial liabilities	**(3)**	(54)	**(3)**	(54)
Increase/(decrease) in insurance payables	**6**	(1)	**6**	1
Increase/(decrease) in trade and other payables	**11**	29	**(36)**	5
Cash used in operating activities	**(491)**	(735)	**(298)**	(732)

52. Solvency and Financial Condition Report

The Solvency and Financial Condition Report of the Group as at 31 December 2018 will be available on LV.com after it has been submitted to the Prudential Regulation Authority or on request from the Group Company Secretary, County Gates, Bournemouth, BH1 2NF.

53. Society information

Liverpool Victoria Friendly Society Limited is a UK-incorporated and domiciled Friendly Society registered under the Friendly Societies Act 1992.

LV= and Liverpool Victoria are trademarks of Liverpool Victoria Friendly Society Limited. LV= and LV= Liverpool Victoria are trading styles of the Liverpool Victoria group of companies. Liverpool Victoria is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority, and is a member of the Association of British Insurers and the Investment and Life Assurance Group.

Registered office:
County Gates
Bournemouth
BH1 2NF
Telephone: 01202 292333