Rothesay life

Smarter thinking to secure the future

Annual Report and Accounts 2016

What we do

We think originally and work intelligently to achieve long-term pension security for all policyholders. Our deep-rooted expertise and forward-thinking approach gives us the ability to create sophisticated and robust insurance solutions, tailored for every client.

Who we are

Rothesay Life is one of the leading providers of regulated insurance solutions for pensions de-risking. Established in 2007, Rothesay Life has grown to become the fourth largest annuity provider[1] in the UK market, with nearly £24bn of assets under management.

1. Analysis by NatWest Markets based on size of annuity liabilities as disclosed in 2015 year end PRA returns of UK insurers.

Strategic objectives

1 Protect the security of policyholder benefits

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

2 Grow through writing value-driven new business

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

3 Safeguard our brand and culture

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

Overview

Strategic report

Governance Report

Financial statements

MCEV statements

At a glance

Our robust capital position and cautious approach to risk management has helped us deliver another strong set of results despite economic volatility and leaves us well positioned for future growth.

Who we are

Assets Under Management

£23.7bn

We have grown to become the UK's fourth largest annuity provider

Investment in the UK economy

£14.5bn

We invest across important UK sectors such as social housing, education, transportation and infrastructure

Market Consistent Embedded Value (MCEV)

£2.2bn

The Group has achieved year-on-year MCEV growth of over 30% since 2007

Number of people insured

387,124

Relentless focus on quality means that 98% of surveyed policyholders rate our services "excellent" or "good"

Paid to policyholders in 2016

£1.3bn

We ensure the security of our policyholders' benefits through relentless focus on risk management

2016 Highlights

- Successfully completed the reinsurance of a £6.4bn block of in-force annuities from Aegon N.V. This represents the single largest transaction executed by the Group to date
- Generated IFRS pre-tax profit of £328m and increased assets under management to £23.7bn, making us the fourth largest annuity fund in the UK
- Increased the Market Consistent Embedded Value (MCEV) by 50% to £2,173m (2015YE: £1,445m), through disciplined approach to new business and cautious risk management
- Remained cautious in investment markets and focused on pro-active risk management which contributed to improving our capital position despite market volatility and substantial new business volumes. Solvency II SCR coverage at Rothesay Life Plc was 177% (1 January 2016: 158%) and economic capital coverage at year-end was 283% (2015YE: 191%)
- Recruited a number of talented senior staff to strengthen the team in line with the continuing growth of the business

Financial highlights

New business premiums (£bn)

£6.6bn

2016	6.6
2015	3.5
2014	4.1

We have delivered our largest annual new business volume to date with the reinsurance of Aegon's annuity portfolio (£6.4bn)

IFRS profit before tax (£m)

£328m

2016	328
2015	347
2014	244

IFRS profit before tax was £328m, a strong result despite volatile market conditions and initial new business strain

Assets under management (£bn)

£23.7bn

2016	23.7
2015	15.4
2014	12.8

Assets under management increased substantially, driven by the Aegon transaction and the rally in interest rates

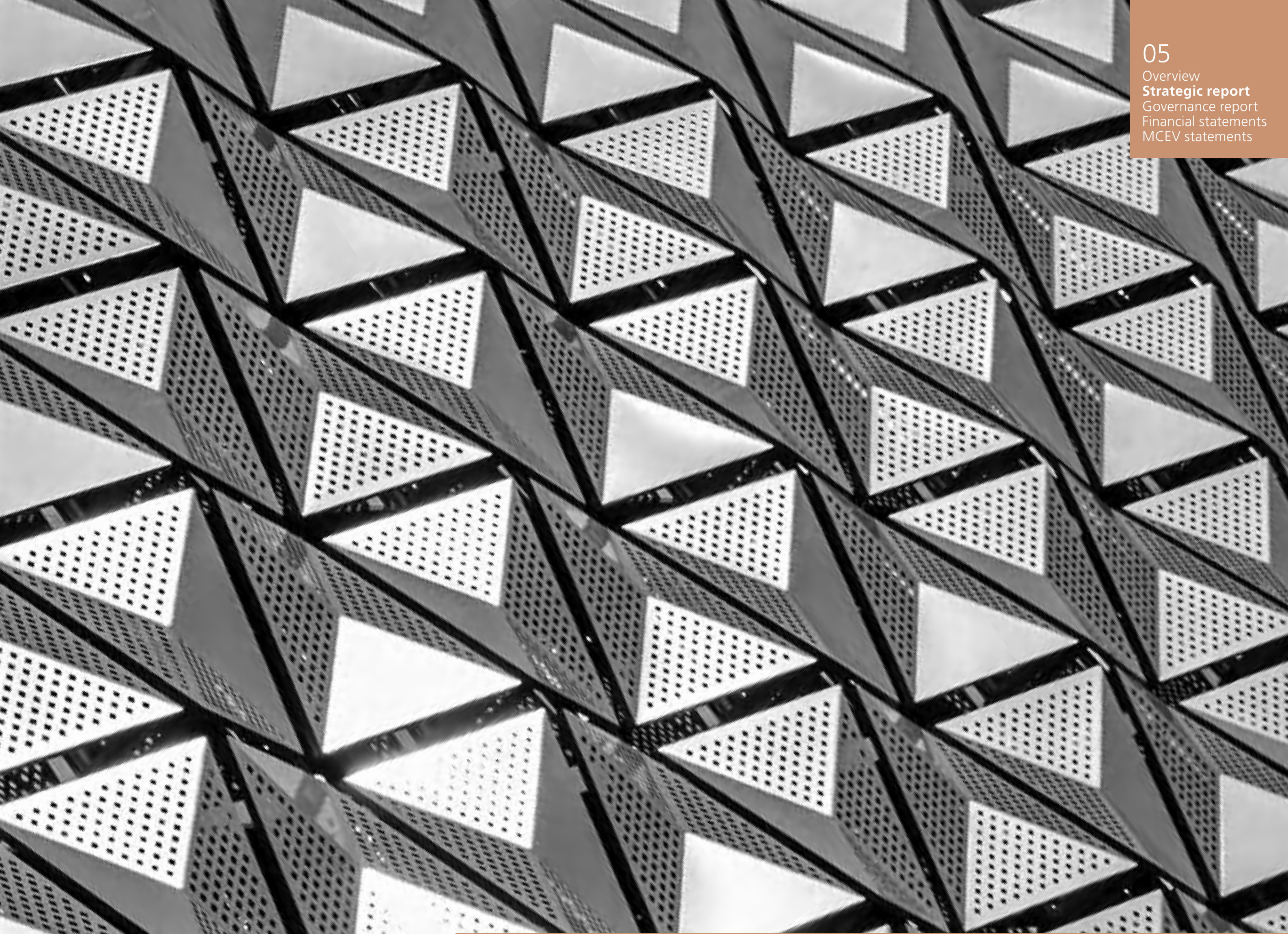
Market consistent embedded value (£bn)

£2.2bn

2016	2.2
2015	1.4
2014	1.2

The Aegon transaction was also the main driver behind the increase in market consistent embedded value

Strategic report



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

How our business works

We create bespoke solutions that secure the long-term pension obligations of our clients and strive to provide the highest levels of service to support our policyholders through their retirement.

What we do

Technology

Technology underpins all aspects of our business. We employ sector-leading systems to manage our balance sheet real-time ensuring we control risk proactively and make careful underwriting decisions.

People

Our people are our most valuable asset. We recruit carefully and have developed a culture of hard work, high standards, integrity, curiosity and dedication.

Partners

We aim to treat our clients, policyholders, counterparties and service providers as partners, cherish long-term relationships and avoid short-term opportunism.

Innovation

We continuously seek to do what we do in a better and smarter way. We pride ourselves on our ability to solve problems for our clients and set market-leading precedents.

How we do it

Our business model

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

Our existing clients include the pension schemes and members associated with high profile and blue-chip companies including Aegon, British Airways, Civil Aviation Authority, General Motors, GKN, InterContinental Hotels, Philips, Rank, RSA and Zurich.

New business origination
Rothesay Life's dedicated and experienced new business team sources new wholesale annuity business from across a broad opportunity set, promotes the Group and maintains long-term relationships.
See p.14

Underwriting
Cautious and controlled risk underwriting is combined with detailed legal and operational due diligence carried out by specialist Rothesay Life teams to achieve maximum pre-deal certainty.
See p.14

Investment management
Rothesay Life's investment team identifies long-term investments which lock-in returns to back annuities while minimising the exposure of the business to credit and market risks.
See p.16

Operations and administration
A high degree of automation and technology allows our outsourced administration platforms to interact with our risk systems to minimise discrepancies and ensure that policyholders are paid accurately and on time and that they receive the highest levels of customer service.
See p.19

Risk & Capital management
Sophisticated systems ensure daily capital and risk reporting which allow Rothesay Life's investment team to manage the balance sheet dynamically, react appropriately to evolving market conditions and maintain capital efficiency.
See p.26

Our markets

Rothesay Life is a wholesale annuity writer. We are professionals experienced in the defined benefit pensions market, the annuity reinsurance market and in corporate acquisitions.

Bulk annuity market

The £2 trillion bulk annuity and pension buy-out market represents our core organic new business growth market. The market is supported by substantial structural underpins and is projected to see annual volumes of over £15bn a year over the near term[1] with even greater flow likely as interest rates rise.

Reinsurance and M&A

Solvency constraints and the bifurcation of UK insurance into asset management and risk businesses continues to drive secondary annuity book transactions.

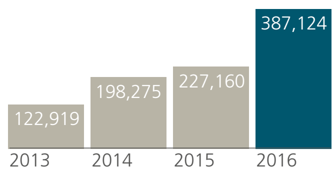
Selected clients & counterparts

How we generate and retain value for stakeholders

Policyholders

Providing security to our policyholders and insuring their future pensions is our primary concern. We look after over 380,000 people and take pride in the levels of service we provide and the strength of our capital position to ensure we can meet our future obligations whatever the market backdrop.

Total lives



RLP SCR Coverage Ratio[2]

177%

Shareholders

By focusing on protecting our balance sheet through preserving and recycling capital, we not only ensure we meet our promises to policyholders but also protect the resources we use to invest in growth. Investing these resources cautiously without ever compromising our stance on risk offers our investors stable, long-term returns.

1. LCP Pensions De-risking report 2016.
2. After amortisation of 1/16th of transitional solvency relief. SCR coverage of RHUK was 160%.

Chairman's statement

2016 has been a year of substantial growth and corporate development. The robustness of our business model has enabled continuing success in challenging market conditions.

Substantial growth

Ray King
Chairman

I am delighted to introduce Rothesay Life's Annual Report for 2016, my first year as Chairman of the Board and in the year of the Company's 10th anniversary. I would like to thank Keith Satchell for his careful stewardship of the Company over the past nine years helping to navigate remarkable growth to what is now the 4th largest annuity provider in the UK.

I take over at a time where the Company is as ambitious as it has ever been and against a sector backdrop which presents significant opportunity. 2016 was a transformative year the business having completed our biggest transaction to date and growing headcount by almost 40% while successfully navigating challenging market conditions and political turbulence which has again endorsed our meticulous approach to risk management.

Lives insured

387,124

Assets under management

£23.7bn

Our performance remains rooted in our continuing focus on meeting the needs of our policyholders, the quality of our business selection and our ability to remain flexible in the way in which we source and execute transactions. 2016 was a good example as we successfully completed the acquisition of a £6.4bn annuity portfolio from Aegon in April, helping them to exit the annuity market and providing a safe long-term home for their annuitants.

Rothesay Life has a clear strategy to deliver security and value to our policyholders and shareholders. We do this by adhering to our strong business principles and embracing an energetic, hard working and creative culture.

Our policyholders

Following the transaction this year with Aegon and a similar transaction with Zurich UK Life in 2015, we are now in the process of implementing Part VII transfers that will bring the reinsured policyholders into Rothesay as direct policyholders, and when combined with our bulk annuity business, means that we provide pensions to over 380,000 individuals.

The Board and management's main focus is and will always be to ensure that we meet our obligations to pay pensions now and in the future. We strive to ensure that we provide a market leading quality of service which is demonstrated by our low upheld complaints rate per thousand policyholders of 0.14 over the year.

Solvency II

The first full year of operation under Solvency II has been challenging for all UK insurance companies and particularly those writing insurance with long-term guarantees such as annuity business. A tremendous amount of hard work and a focus on pro-active risk management has resulted in the Group maintaining a very robust capital position throughout the year against a difficult economic backdrop finishing with SCR coverage of 160% at year end. Our cutting-edge systems offer us powerful tools to manage capital effectively and efficiently through all markets. We are well progressed in developing a Partial Internal Model which we anticipate will further align our economic capital views with solvency capital.

Financial performance

Our performance in 2016 speaks for itself – assets under management increased by 54% to £23.7bn, and our Market Consistent Embedded Value (MCEV) increased by 50% to £2,173m.

Our IFRS profit before tax of £328m was generated despite the new business strain placed by the Aegon transaction and the market volatility observed during 2016.

Rothesay won the prestigious Insurer of the Year 2016 award from Risk Magazine and also the 2016 Risk Management Provider of the Year award from Pension Age Magazine. Rothesay was selected due to its provision of innovative solutions to help pension schemes to manage or remove their risks. We are proud of these recognitions of our achievements.

As the Group enters its second decade, we will continue to pursue growth whilst ensuring that our policyholders' needs are met and will continue to focus on dynamically managing risk. Access to long-term capital to fund future growth remains important and I was delighted that all four of our shareholders demonstrated their commitment to supporting the business by subscribing capital to support the Aegon transaction.

Charitable activity

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

People

People are central to the success of Rothesay Life. We recruit the most talented individuals from the finance industry across disciplines and give them the best platform to perform. Over the past three years, we have increased the scale of our business in terms of our assets under management by 85%. In 2016 we also increased headcount by almost 40% to support the increased scale of operations in preparation for the substantial opportunities ahead of us. I am delighted to say that we have achieved this while still maintaining a low attrition rate reflecting the strong culture of the firm and the loyalty and ownership our people feel.

My congratulations to Addy and her team on another excellent year. I look forward to working with management and our Board as we try to take advantage of significant growth opportunities whilst at the same time making sure that policyholder benefits are secure now and in the future.

R King

Ray King
Chairman
30 March 2017

ageUK
Love later life

"Age UK is proud to be Rothesay Life's chosen charity. Older people often get overlooked. That is why it is so important to Age UK that Rothesay Life are supporting our work to inspire, enable and support older people." **Hannah Lee – Head of Corporate & Community fundraising – Age UK.**

Chief Executive Officer's report

Protecting policyholders' interests requires a relentless focus on risk and capital management particularly in a year that was characterised by the unexpected.

Long-term security

Addy Loudiadis
Chief Executive Officer

Rothesay Life's primary purpose is to ensure the security of our policyholders. Protecting their interests requires a relentless focus on risk and capital management particularly in a year that was characterised by the unexpected. I am proud that our investment in technology and systems continues to allow us to be pro-active and navigate even the most difficult markets with agility, ensuring we meet our obligations while preserving capital to grow and generate value for our investors.

During 2016, the EU referendum, US political upheaval and ongoing macro-economic uncertainty crossed paths with new insurance capital regulation under Solvency II which undoubtedly made for a challenging environment. For much of the year, insurance companies have had to manage volatility in capital positions in light of falling real interest rates, widening credit spreads and unstable markets. The time and resource invested over many years by our specialist teams to generate detailed real-time balance sheet and solvency data has proven to be invaluable against such a backdrop and allowed us to both manage our in-force business and achieve substantial growth through new business.

Rothesay Life's entrepreneurial culture and continued focus on being creative for our clients, setting precedents and ensuring our execution is market-leading has led to the rapid growth of the Company. In April, we acquired a £6.4bn portfolio of annuities from Aegon N.V. the first such transaction under new Solvency II regulation and which resulted in us becoming the largest specialist annuity insurer in the UK with £23.7bn of assets under management.

IFRS profit before tax

£328m

Assets Under Management

£23.7bn

Market Consistent Embedded Value

£2.2bn

RLP SCR coverage %

177%

Group performance

2016 has been another strong year for Rothesay Life. We executed our largest annuity deal to date for Aegon which contributed to record new business volume and generated IFRS profit before tax of £328m. Our capital position remains robust with a Group SCR coverage of 160%. Continued focus on value and risk in underwriting led to 50% MCEV growth up £728m to £2,173m.

We take pride in working on transactions which allow us to meet the needs of our clients whilst providing us with appropriate capital and risk adjusted returns. The margins we achieve from new business continue to reflect a disciplined origination and underwriting approach.

Risk, capital and asset management

Our specialist investment and risk management teams work together with our capital actuaries using an integrated real-time system to assess every risk management, underwriting and investment decision we make. The merits of this approach were particularly apparent in the immediate aftermath of the UK's referendum on membership of the EU when we experienced a significant market deterioration yet the Group's balance sheet remained resilient throughout due to a conservative low-risk investment strategy and an active hedging programme.

As well as supporting effective risk management, our highly quantitative approach helps us identify low risk and capital efficient investments and take advantage of relative value opportunities across the spectrum. This year we have increased our allocation to loans secured on commercial real estate both in the UK and overseas. We have also started to finance the provision of equity release mortgages to older borrowers which we believe offers a socially useful retirement product to customers and also an attractive risk adjusted return to back our annuity business.

We continue to hedge a large portion of the longevity risk associated with our business and were 86% reinsured at year end. We are pleased to have executed reinsurance swap transactions with two new counterparties, Munich Re in late 2016 and a new entrant, the MassMutual Financial Group, in early 2017. Mitigating longevity risk is efficient under the Solvency II capital regime and is also consistent with our economic view that it is prudent to hedge longevity exposure as long as it is done with robust collateral provisions to mitigate counterparty risk.

Brexit

We anticipate a period of further volatility in the financial markets over 2017 and 2018 as the politcial process of negotiating and finalising the details of the UK's exit from the EU is completed. The weakness of Sterling, low interest rates and increased market volatility are all challenges that will continue to face insurers although our primary business is domiciled in the UK. While we invest and reinsure in overseas markets we do not have material exposure to post-Brexit passporting challenges faced by other financial services businesses.

From a regulatory perspective, we expect most material elements of Solvency II will remain intact although we expect that the PRA and FCA will take advantage of some additional flexibility to adopt and amend rules specific to UK companies in the future.

Chief Executive Officer's Report continued

Defined benefit pensions market

While the bulk annuity or "buy-in" market remains robust through the market cycle, volumes of full pension scheme buyouts have been dampened as corporate pension schemes have had to contend with depressed solvency positions due to record low long term interest rates. Affordability for large portions of the £2.1trn[1] addressable market can, though, change quickly given the sensitivity to markets. The increase in interest rates experienced through Q4 had a very material effect on the solvency of a typical pension scheme and hence transaction affordability, so provides a good basis for an increase in deal volumes in 2017. Consequently the pension pipeline is strong and Rothesay Life's focus remains on large transactions and full scheme buyouts.

UK insurance landscape

The implementation of Solvency II has increased the challenge for multi-line insurance companies of efficiently managing legacy annuity liabilities alongside priority open businesses and has been a catalyst for the sale of non-core annuity books. We have now executed two large reinsurance transactions with insurers, one with Zurich Life during 2015 and £6.4bn reinsurance transaction with Aegon in April this year. There are ~£200bn[2] of in-force annuity liabilities in the UK and we believe Rothesay Life's execution experience, strong balance sheet and capital efficient approach leaves us well placed to take advantage of the further market bifurcation into "asset managers" and "risk managers" over the coming few years.

Our policyholders

Rothesay Life will soon be providing pensions to over 380,000 individual customers. We pride ourselves on the quality of service we provide to our policyholders and this is reflected in the high level of customer satisfaction and market-leading low level of upheld complaints we have enjoyed of fewer than one in 7000.

Our in-house operations team is one of our largest functions, the team continuously strives to improve our standards and work closely with our administration partners to further automate processes. Integration of our administration system with our risk management system helps ensure both seamless payments to policyholders as well as making sure risks are managed in real-time.

Our people

Rothesay Life has experienced rapid growth over the past 10 years and we remain ambitious given the significant business opportunities ahead. We benefit from a strong balance sheet, access to substantial capital resources and in 2016 grew headcount by 40% to support our objectives. This included a number of important senior hires to further develop the management team.

The efforts of our people and the breadth of the expertise within the team across insurance, pensions, actuarial, investment management, operations and technology is the defining factor in our success. Every employee is invested in the business and the culture of commitment and ownership is central.

I would like to thank our people for their contribution in 2016. I am very proud of what we have achieved in 2016 and over our first decade and look forward to building on our achievements in 2017 and beyond.

Addy Loudiadis
Chief Executive Officer
30 March 2017

1. 2016 purple book www.pensionprotectionfund.org.uk/Documents/Purple_Book_2016.pdf.
2. The £200bn is based on 2016 year end reports and Rothesay Life analysis.

Key Performance Indicators

Set out below are the Group's financial key performance indicators (KPIs). The Board and management have adopted the metrics for measuring the Group's aggregate performance and solvency.

New business premiums (£bn)

£6.6bn

2016	6.6
2015	3.5
2014	4.1

New business premiums are a key indicator of the Group's growth and realisation of its strategic objectives. New business sales include premiums written as bulk annuities, reinsurance and liabilities acquired through acquisitions.

IFRS profit before tax (£m)

£328m

2016	328
2015	347
2014	244

IFRS profit before tax is our primary measure of profitability, capturing all recurring and non-recurring items and in particular market fluctuations which have a direct impact on distributable reserves and capital. IFRS profit before tax in 2016 was £328m despite the new business strain associated with the Aegon transaction and the volatile economic backdrop.

Assets under management (£bn)

£23.7bn

2016	23.7
2015	15.4
2014	12.8

Assets under management measures the total financial investments, including cash. It provides a useful measure for the size of the business. As at 31 December 2016, the Group held assets of £23.7bn, an increase of £8.3bn.

Economic capital coverage (%)

283%

2016	283
2015	191
2014	206

Economic capital represents management's internal risk-based calculation of the capital required to remain solvent for a 99.8% confidence level over a 1-year period. The Group's economic capital coverage is surplus above best estimate liabilities divided by the economic capital requirement. As at 31 December 2016 the coverage was 283%, an increase of 92% over the year.

RLP Solvency II SCR coverage (%)

177%

2016	177
2015	158

The Solvency II SCR cover in the operating life company represents the regulatory coverage ratio of the SCR. The operating company's SCR cover as at 31 December 2016 was 177% after allowing for amortisation of 1/16th of transitional solvency relief (1 January 2016: 158%). The Group's SCR cover was 160%.

Market consistent embedded value (£bn)

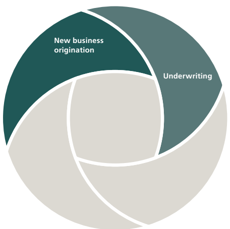
£2.2bn

2016	2.2
2015	1.4
2014	1.2

The market-consistent embedded value provides an indication of the value of business written by measuring the risk-adjusted value of the in-force business, allowing for the unwind of margins. As at 31 December 2016, the Group's MCEV was £2,173m, an increase of £728m over the year.

Operational review

Business selection is critical to the success of Rothesay Life. Our job is to find opportunities to help clients meet their objectives whilst at the same time ensuring an appropriate return taking into account the associated risks and capital required. We are not a league table-driven company and each transaction is chosen on its individual merits.



New business origination & underwriting

2016 New Business volume

£6.6bn

Selected awards

PENSIONSAge AWARDS 2016 WINNER
RISK MANAGEMENT PROVIDER OF THE YEAR

Risk.net Buy-Side Awards 2016 | Winner Insurer of the Year

We adopt a meticulous approach to underwriting which involves evaluating and quantifying the key risks associated with acquiring pension annuity liabilities ahead of completion. The underwriting team comprises actuarial, pensions, operational, trading, investment and legal expertise, all of whom have extensive experience in their respective areas.

This approach continues into extensive due diligence consistent with the highest standards in the industry in advance of execution to both quantify and mitigate operational and data-related risks.

The experienced insurance and pension professionals in our new business origination team are experts in their field and have been at the forefront of innovation. With particular focus on a solution-driven approach, Rothesay Life has now demonstrated capability to originate wholesale annuity business across the full spectrum of deal structures.

We operate an integrated asset-liability risk model and benefit from sophisticated computer systems which allow all pension liability acquisitions to be assessed real-time using prevailing market conditions and investment opportunities. This approach allows us to provide certainty of pricing for clients by locking-in the economics of a deal and also protects the Group's balance sheet by ensuring consistent quality of origination.

In 2016 Rothesay won the prestigious Insurer of the Year award from Risk Magazine and also the Risk Management Provider of the Year award from Pension Age Magazine. These awards recognise the way in which Rothesay provides innovative solutions to help pension schemes and insurers to manage or remove their risks.

Case study

Annuity portfolio purchase from Aegon NV.
In September 2015, Aegon N.V. commenced a process to de-risk its non-core UK annuity portfolio. The portfolio consisted of over £9bn of annuities originated via a range of channels including in-house vestings, bulk annuities and open market options.

On 11 April 2016, Aegon announced the sale of two-thirds of the UK annuity portfolio to Rothesay Life, for a premium of £6.4bn.

The transaction is structured initially as a reinsurance contract and is expected to lead to a Part VII transfer during 2017 of the underlying assets and liabilities to Rothesay Life (subject to regulatory and court approvals).

Highlights

- First Solvency II compliant reinsurance transaction
- Bulk of longevity risk reinsured pre-execution
- Second largest public annuity reinsurance transaction in the UK
- Long-term security and service ensured for 187,000 policyholders

Premium

£6.4bn

Number of policyholders

187,000

Longevity reinsurance

Bulk of risk reinsured pre-execution

Locked-in economic terms

Premium agreed upfront and then converted to roll-forward to lock-in terms

First Solvency II compliant transaction

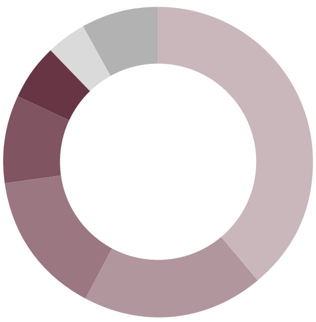
Transitional approved by the UK PRA; sets precedent for reinsurance transactions

Operational review continued

The £24bn asset portfolio of Rothesay Life is managed in-house by a specialist investment team whose primary objective is to extract value from illiquidity and secure returns by sourcing, structuring and investing in low-risk assets that benefit from collateral, hedging arrangements or other security features.

Investment management

Asset portfolio



UK Sovereign	**39%**
Secured Residential Lending	**19%**
Other Secured Lending	**15%**
Supranational and Quasi Sovereign	**9%**
Infrastructure	**6%**
Cash	**4%**
Other	**8%**

Distinct investment approach:
The Group invests in fixed income instruments which we use to back the Group's long-term annuity liabilities. Our primary focus is on ensuring that the assets we invest in are secure through both their inherent credit-worthiness and additional structural features.

We reduce credit default risk by investing in a combination of liquid, low-risk government bonds and less liquid highly-secured or collateralised investments:

- **Government and supranational bonds:** 48% of the portfolio is invested in low-risk government bonds and supranational bonds. This portion of the portfolio backs our very long-dated cashflows but is also available to meet collateral calls and cash requirements.
- **Secured investments:** 34% of the portfolio is invested in loans secured against property or other collateral. Many of these investments are bespoke where very high levels of collateral have been negotiated and returns are generated through illiquidity premium.
- **Infrastructure:** 6% of the portfolio is invested in regulated infrastructure such as water, energy and transportation. These investments are typically long-dated and backed by ring-fenced and low-risk income streams.
- **Other:** The remaining 12% of the portfolio consists of cash, fixed income instruments and equity release mortgages.

Case study

Commercial Real Estate Loan – New York

Rothesay Life provided a $200m 10-year loan secured on freehold interest in a New York flagship retail property at an attractive 45% loan-to-value. The secured property was newly-constructed and 100% let to an investment grade global sportswear company on a 15-year lease.

The investment benefits from a combination of the security provided by a class A New York property and the low risk rental yield given the long-term lease to an investment grade tenant. The loan represents Rothesay Life's first loan secured on US commercial real estate.

Case study

Commercial Ground Lease – Sydney

Rothesay Life provided a loan to the New South Wales (NSW) government, in return for a 30 year stream of low leverage "base rents" payable by the leaseholder of two recently-built office properties with 60,000 square metres of floor-space in Sydney's outer Central Business District. The office properties are sub-let to Commonwealth Bank of Australia (CBA), Australia's largest listed company and the largest bank in the southern hemisphere.

The base rent cashflows themselves reflect a small fraction of market rent paid by CBA to the leaseholder which ensures that the base rent payments could survive a very substantial reduction in market rents.

Rothesay Life is assigned the first 30 years' base rents payable under the lease in a fully-amortising pass-through structure similar to our loans secured on UK residential ground rents; the upfront investment proceeds consequently represent a low-LTV investment against the value of these office properties.

Case study

Equity Release Mortgages (ERM)

During 2016 Rothesay Life entered into funding arrangements with two market-leading firms to acquire the beneficial interest in new lifetime mortgage loans taken out by retail customers. Lifetime mortgages (also known as equity release mortgages) are mortgages extended to older customers (aged 55 and over) against their residential property at low loan to value percentage. Unlike a typical residential mortgage, no interest is paid monthly by the customer. Instead, the interest is simply added to the principal loan amount with the loan only repayable on death or entry into long-term care of the last remaining homeowner.

By providing funding to back equity release mortgages, the Group is helping pensioners to access the equity in their houses, without the need for them to move. Mortgages are written with a no negative equity guarantee which means that borrowers don't need to worry about the liability growing above the value of the house.

The Group manages the risk associated with equity release mortgages by imposing strict underwriting criteria on the mortgage origination firms covering loan to value ratios and restrictions on the characteristics of the properties against which loans can be advanced. In common with the Group's business philosophy, we use prudent assumptions in placing a value on the beneficial interest in the loans.

Operational review continued

Key principles

1
Integrate asset and liability management

2
Minimise outright credit risk through collateral, credit protection or other structural security

3
Lock-in investment return and earn illiquidity premium

4
Manage and mark collateral daily to minimise counterparty risks

5
Maintain sufficient liquidity buffer at all times

As a buy-to-hold investor, the Group is less exposed to market volatility as adverse movements in our investment portfolio are offset by movements in our insurance liabilities. Under Solvency II, the Group is exposed to risk of downgrades as capital requirements are driven by rating.

The Group adopts a market consistent approach to reserving for residual credit risks and adopts a dynamic strategy of monitoring and re-hedging these risks where possible as they arise.

Given the significant growth in the Group's assets under management, the Group has decided to include a small exposure to a diversified portfolio of corporate bonds in our investment mix.

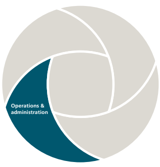
Collateral management:
The use of derivatives to hedge market risk combined with our investment in loans secured by collateral means that collateral management forms an integral part of the Group's activities. We monitor collateral closely and stress test collateral that backs investments to ensure security is not compromised due to market moves.

Liquidity management:
A large amount of the portfolio is, by design, highly secured, but less liquid. In order to manage liquidity risk, the Group holds substantial liquidity buffers at all times to protect the firm against potential liquidity calls. To achieve this, Rothesay Life operates a liquidity management framework which stress-tests and reports liquidity continually to ensure sufficient cash and liquid securities (primarily Gilts) are available at all times to meet obligations.

Industry-leading expertise:
The Rothesay Life in-house investment team consists of origination, structuring, legal, trading, risk, modelling, operations and capital expertise. We have built the team by hiring talent from the financial services industry to focus on sectors such as real estate, infrastructure, structured finance and government.

Operating the team in-house is critical to the success of the business as it ensures:
- Assets and liabilities are managed in an integrated manner.
- Regulatory capital and risk are a dynamic consideration in decision-making.
- Investment opportunities feed into new business underwriting real-time which reduces uncertainty of anticipated returns.

Rothesay Life's primary focus is making sure that we pay our policyholders accurately and on time.



Operations and administration

Service Standards

98%

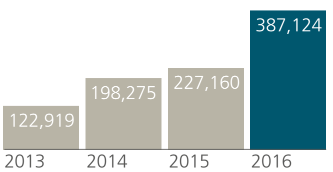
of our policyholders rated our service as 'Excellent' or 'Good'

Complaints received

0.34

Throughout 2016, we received fewer than 0.34 complaints per 1,000 policyholders

Total lives



We continue to partner with Willis Towers Watson (WTW) and Jardine Lloyd Thompson (JLT) to ensure we maintain our excellent policyholder service, manage and protect our customers' data, and guard our brand and reputation.

During 2016, we formed a new partnership with Capita Employee Benefits to administer much of the new annuity business acquired in our transactions with Zurich Assurance and Scottish Equitable (Aegon UK) which are due to undergo a Part VII Transfer in the middle of 2017. Work is ongoing to make sure that the service received by policyholders is unaffected by the transfer.

Once the Part VII transfers have taken place, the Group will have responsibility for around 204,000 new policyholders, taking the total number of policyholders to over 380,000. The chart to the left provides a summary of the number of policyholders insured by the Group and the way that this has increased over recent years.

Policyholder experience remains paramount and we continue to focus on providing best-in-class service. This experience starts with underwriting and continues as data is cleaned and the Group ultimately takes on responsibility for paying policyholders.

Our policyholder surveys in 2016 were extremely positive, with over 98% of all respondents rating the quality of our overall service as 'Good' or 'Excellent'. Our complaint levels also remain low with just 0.34 complaints per 1,000 policyholders received of which only 0.14 complaints per 1,000 policyholders were upheld. We take complaints extremely seriously with the more serious being discussed at the Customer and Conduct Committee which is chaired by a non-executive director. In addition, a full root cause analysis is carried out with process improvements implemented, where required.

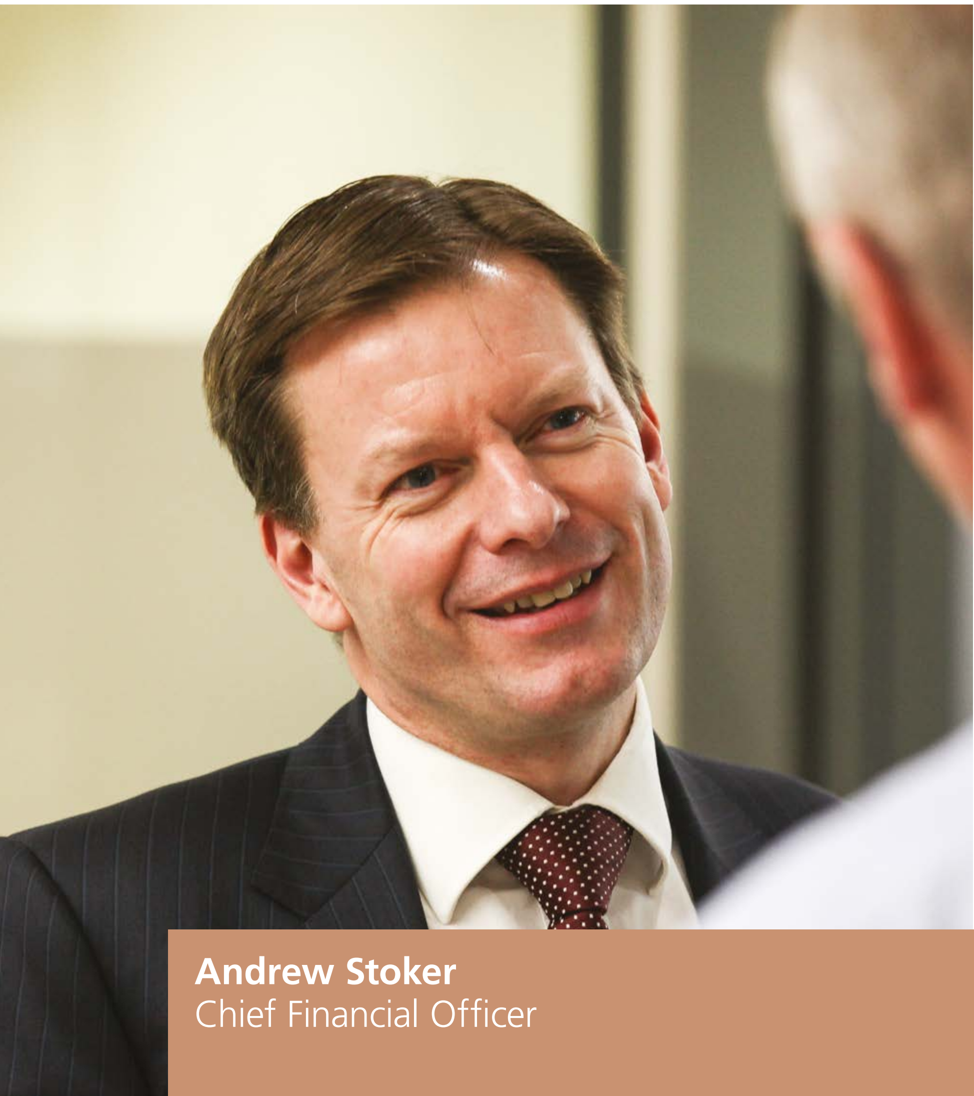
Our administrators met the agreed service level standards 96% of the time in 2016. We work closely with them, holding regular meetings and conducting on-site operational reviews, to ensure they have good governance and controls in place. We strive to continuously improve and develop our policyholder experience, as well as ensuring that best industry practices are followed.

We continue to build a robust and scalable operational model that can support the growth of the business without compromising our high service levels and our continued commitment to our policyholders.

Financial review

A successful year despite the volatile economic backdrop and our resultant caution in investing the assets received in the Aegon transaction.

Strong financial performance



Andrew Stoker
Chief Financial Officer

The results of the business
Our financial results demonstrate the Group's continuing ability to write profitable new business and deploy assets to generate strong returns whilst navigating volatile market conditions.

The financial review describes the Group's financial performance and highlights the key drivers of the movements in the Group's consolidated statement of comprehensive income and consolidated statement of financial position.

Financial performance
The Group achieved an operating profit before tax of £321m (2015: £383m) and a profit before tax of £328m (2015: £347m). The Group focuses on profit before tax as its primary measure of profitability because this metric includes recurring and non-recurring items as well as market fluctuations and has a direct impact on distributable reserves and capital. However, as other insurance companies often focus on operating profit before tax, the Group discloses a comparable result which is intended to provide a better indication of long-term profitability by adjusting profit for the impact of one-off expenses, finance costs and economic conditions in the year.

The financial performance analysis shown in the table opposite involved apportioning the items in the income statement between the various components of profit. We have therefore not provided a reconciliation between the operating profit and the income statement.

New business operating profits were £416m (2015: £174m) in line with the increase in new business premium (an increase in single premiums from £3,492m in 2015 to £6,610m in 2016). Profits are calculated assuming full investment of premiums.

As at the year end, we were overweight in gilts and cash as the premiums received in the Aegon transaction have yet to be fully deployed. The realised new business operating profit in 2016 was significantly less than the £416m shown. The difference between the realised new business profit and the fully deployed new business profit once assets are invested as planned is deducted from the management of in-force book and this leads to a net loss of £26m (2015: profit of £259m) for 2016 despite profits of over £200m being generated on the in-force book pre this adjustment. Management took the decision to delay investing the premiums received because of the volatile economic conditions following the EU Referendum and the significant rise in corporate bond indices in the second half of 2016. The Group will generate profits on these assets as it invests them according to our long-term investment strategy.

Economic profits represent the change in profit as a result of changes in market conditions. The Group has historically made relatively small profits as a result of such changes. However in 2016, the Group made £80m from changes in market conditions (2015: loss of £4m), namely movements in interest rates and credit spreads. Immediately post the EU Referendum, the Group began to hedge more dynamically to manage the balance sheet on both an IFRS and solvency basis. As the solvency balance sheet is more sensitive to interest rates than the IFRS balance sheet, IFRS profits increased as a result of falls in interest rates. As rates subsequently rose, the Group gradually returned to hedging the IFRS balance sheet. In addition, although the Group continues to mitigate credit risk where possible, the size of the balance sheet now means that the Group retains a holding of corporate bonds. As a result, the Group made a small profit from the rise in corporate bond prices.

IFRS Financial Performance

£m	2016	2015
New Business operating profit	**416**	174
Management of in-force book	**(26)**	259
Acquisition costs	**(65)**	(52)
Administration expenses	**(17)**	(14)
Experience variance[1]	**1**	10
Other	**12**	6
Operating profit before tax	**321**	383
Finance costs	**(43)**	(17)
Non-recurring and project expenditure	**(30)**	(15)
Economic profits	**80**	(4)
Profit before tax	**328**	347

1. Profits and losses arising from the difference between actual and expected longevity.

Income statement highlights

£m	2016	2015
Gross premiums written	**6,877**	3,764
Net premiums written	**6,177**	3,202
Investment return	**2,798**	(115)
Total revenue	**8,975**	3,087
Claims paid	**(791)**	(525)
Change in insurance liabilities	**(7,701)**	(2,117)
Operating expenses	**(112)**	(81)
Finance costs	**(43)**	(17)
Total claims and expenses	**(8,647)**	(2,740)
Profit before tax	**328**	347
Income tax	**(66)**	(71)
Profit after tax	**262**	276

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

Gross premiums written
The Group's gross premiums written increased significantly from £3,764m in 2015 to £6,877m in 2016.

This comprises:
- New business premiums of £6,610m (2015: £3,492m), mainly from the Aegon transaction; and
- Regular premiums of £267m (2015: £272m) generated on the in-force inwards longevity reinsurance business written in prior years.

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

Net premiums written increased from £3,202m in 2015 to £6,177m in 2016 after allowing for the increase in reinsurance over 2016.

Financial review continued

Investment return
The investment return comprises interest received on financial assets, interest payable on financial liabilities and the net gains and losses on financial assets and liabilities.

Interest received on financial assets net of interest payable on financial liabilities increased from £351m in 2015 to £530m in 2016, reflecting the growth in the size of the business.

The net movement in the fair value of assets including realised gains was a gain of £2,272m in 2016 compared to a decrease of £463m in 2015. The gain in the value of assets in 2016 was primarily due to the fall in interest rates over 2016 combined with spread tightening and was largely offset by a similar increase in insurance liabilities.

Claims paid
Claims paid represent the total payments due to policyholders during the year (£1.3bn) less the reinsurers' share of such claims (£593m).

Net claims paid increased by £266m from £525m in 2015 to £791m in 2016, an increase reflecting the growth of the in-force book.

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

The change in insurance liabilities in 2016 was an increase of £7,701m compared to an increase in insurance liabilities of £2,117m in 2015. The main drivers of the change in 2016 were new business and the impact of falling interest rates on the rate used to discount liabilities.

Acquisition costs
Acquisition costs comprise the expenses associated with the origination of new business, including incentive payments made to employees. Acquisition costs increased from £52m in 2015 to £65m in 2016.

Administration expenses
Administration expenses represent the cost of administering the in-force book of business. These increased from £14m in 2015 to £17m in 2016 broadly in line with the growth of the business.

Other expenditure
Other expenditure amounted to £30m in 2016 (2015: £15m). This includes costs relating to our Solvency II project of £12m (2015: £2m), costs associated with Part VII transfers of £5m (2015: £1m), reinsurance fees required under IFRS to be categorised as expenses of £9m (2015: £4m) and other one-off project costs of £4m (2015: £8m).

Finance costs
Finance costs mainly represent interest payable on borrowings. The interest payable increased from £17m in 2015 to £43m in 2016 as a result of additional borrowing during the year to support the Aegon transaction.

Income tax
The Group's income tax charge decreased from £71m in 2015 to £66m in 2016, as a result of the decrease in profits and the small reduction in the effective tax rate. Taxation is discussed further on page 23.

Balance sheet highlights

£m	**31 December 2016**	31 December 2015
Financial investments	**38,346**	24,592
Reinsurance assets	**437**	274
Other assets	**925**	646
Total assets	**39,708**	25,512
Share capital and share premium	**447**	268
Capital contribution reserve	**3**	5
Retained earnings	**1,035**	769
Total equity	**1,485**	1,042
Insurance contract liabilities	**22,071**	14,207
Payables	**15,532**	9,884
Borrowings	**587**	349
Other	**33**	30
Total liabilities	**38,223**	24,470
Total equity and liabilities	**39,708**	25,512

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

Assets
Total assets increased from £25.5bn as at 31 December 2015 to £39.7bn as at 31 December 2016. These aggregate numbers include derivative assets which net off against derivative liabilities and uncollateralised financing assets which net off against the associated liabilities.

Assets under management increased from £15.4bn as at 31 December 2015 to £23.7bn as at 31 December 2016 largely as a result of new business and the fall in interest rates. These numbers can be derived from the table on the next page by adjusting for reinsurance, derivatives and collateralised financing as shown:

Assets under management

£m	31 December 2016	31 December 2015
Total assets	**39,708**	25,512
Less reinsurance assets	**(437)**	(274)
Less payables and financial liabilities	**(15,532)**	(9,884)
Assets under management	**23,739**	15,354

Reinsurance assets have increased by £163m from £274m at 31 December 2015 to £437m at 31 December 2016. Reinsurance assets remain relatively low compared to insurance contract liabilities because the Group's reinsurance contracts are all longevity swap reinsurance under which the Group pays regular premiums in return for being entitled to make regular claims.

Total equity

In order to maintain financial strength in anticipation of the Aegon transaction, the Group raised £200m of new equity capital from its existing shareholders. This led to an increase in share capital (including the Employee Benefit Trust) and share premium from £268m as at 31 December 2015 to £447m as at 31 December 2016.

The rest of the increase in total equity (an increase of £443m from £1,042m at 31 December 2015 to £1,485m at 31 December 2016) was driven by the increase in retained earnings.

Liabilities

Gross Insurance contract liabilities increased from £14.2bn at 31 December 2015 to £22.1bn at 31 December 2016 largely as a result of new business and the fall in interest rates.

Payables increased by £5.6bn from £9.9bn at 31 December 2015 to £15.5bn at 31 December 2016. Payables are dominated by derivative financial instruments and collateralised financing agreements. Derivatives are used to manage market and credit risk. The derivative liability as at 31 December 2016 of £12.0bn (2015: £6.9bn) nets off against the derivative assets of £11.7bn (2015: £6.9bn).

The liabilities associated with collateralised financing agreements as at 31 December 2016 remained constant at £1.9bn (2015: £1.9bn) and can be partially netted off against the value of the associated collateralised financing assets of £6.1bn (2015: £5.1bn). Collateralised financing is used by the Group to enable investment in shorter term assets and to generate liquidity.

Borrowings have increased from £349m at 31 December 2015 to £587m at 31 December 2016 as a result of borrowing £240m from a syndicate of banks as part of the Aegon transaction. £230m of the funds raised plus the £200m of new equity referred to above were subsequently injected into Rothesay Life Plc ("RLP") as equity.

Market Consistent Embedded Value (MCEV)

The Group's MCEV has increased by 50% from £1,445m at 31 December 2015 to £2,173m at 31 December 2016. This is summarised in the table below. Adjustments allow for Group borrowings and other Group adjustments.

Market Consistent Embedded Value

£m	31 December 2016	31 December 2015
Net assets	**2,093**	1,370
Value of in force	**699**	435
Less: adjustments	**(619)**	(360)
MCEV	**2,173**	1,445

The 2016 MCEV allows for the changes required as a result of Solvency II (a £36m reduction, see page 106). Net assets include the impact of the additional £200m of equity raised during 2016 (2015: £nil).

The value on an MCEV basis of the new business written in 2016 was £330m (2015: £194m).

Taxation

The Group makes a significant tax contribution in the UK, with £111m remitted to UK tax authorities in 2016 (2015: £106m). The Group had an effective corporation tax rate of 20.2% during 2016 (2015: 20.5%). Other taxes include property taxes, employer payroll taxes and irrecoverable indirect taxes.

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

Taxes paid

£m	2016	2015
Corporation tax	**72**	67
Other tax	**2**	1
Taxes collected	**37**	38
Total remitted	**111**	106

Capital management

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

- To satisfy the requirements of our policyholders and regulators;
- To match the profile of its assets and liabilities, taking account of the risk inherent in the business;
- To maintain financial strength and allocate capital efficiently to support new business growth; and
- To retain financial flexibility by maintaining strong liquidity.

From 1 January 2016, the old solvency regime was replaced by Solvency II. Under the new solvency regime, the Group is required to hold the greater of the capital required under the new Solvency II Pillar 1 framework and the capital required under our own economic capital models, Solvency II Pillar 2.

The Group also ensures that its insurance company subsidiary, RLP, is capitalised to the greater of the economic capital requirement and the regulatory Pillar 1 position. In practice, it is the Pillar 1 requirement which is more onerous and the Group aims to maintain at least 130% of the regulatory minimum requirement in RLP.

The Group has implemented a dynamic capital management framework which targets stability of the IFRS balance sheet under normal conditions and seeks to manage both the IFRS and solvency balance sheets as conditions deteriorate. For this reason, in the immediate aftermath of the EU Referendum, the Group began to hedge more dynamically. As interest rates subsequently increased and solvency improved, the Group gradually returned to hedging the IFRS balance sheet. As a result, the solvency balance sheet is exposed to a reduction in interest rates.

Solvency II Pillar 1

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

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

Firms with illiquid liabilities such as annuity business can discount these illiquid liabilities using the risk-free rate plus what is known as the 'matching adjustment'. The matching adjustment is broadly equivalent to the illiquidity premium that can be earned on the illiquid assets held to back illiquid liabilities. The Group applies the matching adjustment in calculating the BEL for almost all of its single premium insurance business. The remaining liabilities are discounted at the risk-free rate.

Assets in excess of that required to meet the technical provisions are known as 'Own Funds.'

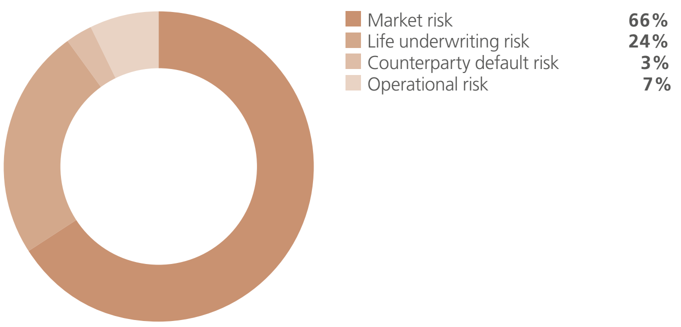
As part of the transitional arrangements in relation to the introduction of Solvency II, the Group is permitted to take credit for transitional solvency relief which amortises linearly to zero, falling by 1/16th on 1 January 2017 and again each year thereafter. An application can be made to recalculate the amount of transitional solvency relief that can be taken if the risk profile of the Group changes materially. The Group made such an application twice in 2016:

- On 11 April 2016 to allow for the additional liabilities taken on as a result of the reinsurance agreement with Aegon (since the Aegon policies were written prior to the introduction of Solvency II); and
- On 30 June 2016 to reflect the change in economic conditions over the half year.
- Such an application has not been made as at 31 December 2016.[1]

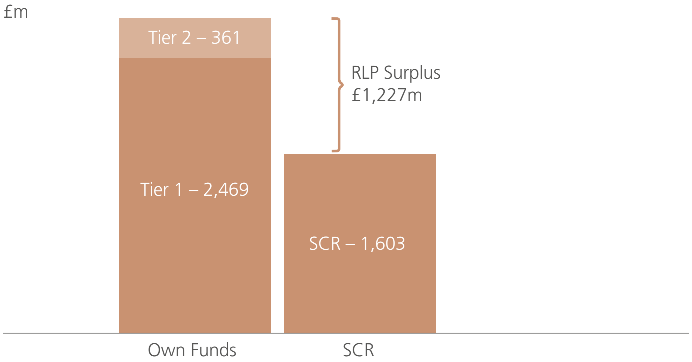
After allowing for amortisation of 1/16th of transitional solvency relief the Group's technical provisions as at 31 December 2016 were £20,736m (1 January 2016: £13,304m).

Over the 16 years of amortisation of the transitional solvency relief the risk margin associated with the business in-force on 1 January 2016 is also projected to reduce. Projections show that over 80% of the amortisation of the transitional solvency relief will be met from the release of the risk margin. It is worth noting that even without transitional solvency relief, the Group would be able to cover its Solvency II capital requirements.

SCR 31 December 2016



Own funds in RLP
£m



Insurers have the option of calculating the SCR either using the prescribed basis (the 'standard formula') or applying to use their own internal model. The Group is in the process of applying to use its own model for calculating the SCR in relation to credit and counterparty risk initially (a 'partial internal model'). The Group is applying to use a partial internal model to ensure that the allocation of capital to investment is consistent with the low risk inherent in the types of highly secured and collateralised investments which are core to the Group's investment strategy.

As at 31 December 2016, the Group's SCR calculated using the standard formula was £1,603m (1 January 2016: £1,203m). The diagram on page 24 provides a breakdown of the SCR post-diversification benefit between modules. Life underwriting relates mainly to longevity risk. Market risk is primarily spread risk, i.e. the risk that credit spreads widen. As at 31 December 2016, RLP had assets of £23,566m (1 January 2016: £15,209m), giving Own Funds of £2,830m (1 January 2016: £1,904m) and a coverage ratio of 177% (1 January 2016: 158%). The solvency position and breakdown of Own Funds for RLP is shown in the diagram on page 24.

Part of the increase in RLP's Own Funds arose from an injection of £430m of equity from RHUK to ensure that RLP remained appropriately capitalised following the Aegon transaction. This was funded by a combination of £230m of borrowings from a syndicate of banks and £200m of equity from existing shareholders. The debt does not contribute towards the Group's Own Funds. As a result, on 31 December 2016, the Group's Own Funds amounted to £2,569m (1 January 2016: £1,902m) giving a coverage ratio of 160% (1 January 2016: 158%).

Change in Solvency II Pillar 1 position

The table below provides an analysis of the movement in the Group's Own Funds over 2016. All numbers are shown net of tax. Comparatives are not provided because the new solvency regime was only effective from 1 January 2016.

Change in own funds

£m	2016 Own funds
Opening position (1 January 2016)	**1,902**
New business (on a fully deployed basis)	**288**
Management of in-force book	**175**
Acquisition costs and administration expenses	**(65)**
Other (including experience variance)	**7**
Operating surplus	**405**
Finance costs	**(36)**
Non-recurring and project expenditure[2]	**(44)**
Economic profits	**140**
Share issuance	**199**
Capital contribution	**3**
Closing position (31 December 2016)	**2,569**

1. We estimate that the impact of re-calculating transitional solvency relief as at 31 December 2016 would be to reduce the SCR coverage to 173% at RLP and 157% at RHUK.
2. Including the impact of funding the Employee Benefit Trust.

Solvency II Pillar 1 sensitivities

The table below provides a range of sensitivities as at 31 December 2016. Where applicable, allowance has been made for the impact of recalculating transitional solvency relief. Interest rates are assumed to fall progressively and hedging adjusted accordingly.

31-Dec-16	Change in assumptions	Impact on surplus £m	Impact on coverage ratio %
Annuitant mortality	+5% qx	76	6%
Annuitant mortality	-5% qx	(81)	(6%)
Interest rate	+100bps	215	26%
Interest rate	-100bps	(83)	(15%)
Inflation	+100bps	(9)	(6%)
Inflation	-100bps	58	8%
Credit spread widening[3]	+100bps	(114)	1%
Expenses	+10%	(41)	(3%)

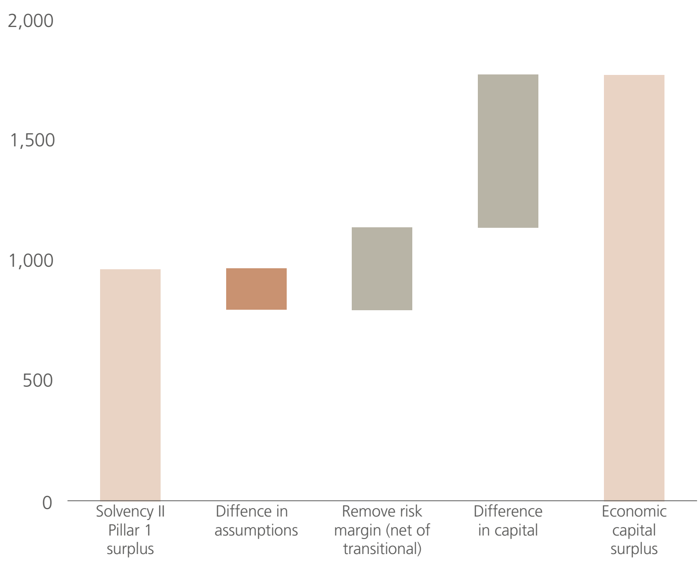
3. All non-government guaranteed assets.

Solvency II Pillar 2 (Economic capital)

The Group economic capital has increased from £2,018m as at 31 December 2015 to £2,741m as at 31 December 2016 compared to a capital requirement that has decreased from £1,054m to £967m. Economic capital requirements have reduced despite writing significant new business because reinsurance coverage has increased during 2016 and we were overweight in gilts and cash. In percentage terms, the Group's economic capital coverage has increased from 191% (Solvency I Pillar 2) to 283% (Solvency II Pillar 2).

The chart below provides a comparison of the Solvency II Pillar 1 position with the Group's own economic capital model. The Group's own economic capital model does not allow for risk margin in the base balance sheet and the capital requirement is lower than under the standard formula largely because of increased diversification benefit.

Solvency II surplus RHUK (£m)



Risk management

The management of risk is central to the success of the business. Every member of staff knows that he or she is responsible for the identification and management of risk. The Group's governance arrangements strengthen this principle by adding challenge, oversight and independent assurance from the second and third lines of defence.

Peter Shepherd
Chief Risk Officer

During 2016, the Group invested in growing the size and capabilities of the risk function commensurate with the growth of the Group's balance sheet. Such growth has ensured that the function is well equipped to challenge and support the business now and as it continues to grow in line with the Group's business plan.

Risk management framework

The Group looks to embed proactive and effective risk management across the organisation via the risk management framework ("RMF"). During the year, the Group has continued to strengthen the risk management framework to meet the growth of the business and our strategic objectives. Further detail on the components of our risk management framework is provided below. The RMF informs and is directed by Rothesay Life's business strategy. Risk management considerations are integral to setting business strategy, as we seek to optimise our risk-adjusted returns and create shareholder value whilst also meeting the expectations of our customers.

Core strategy

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

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

Board risk appetite and culture

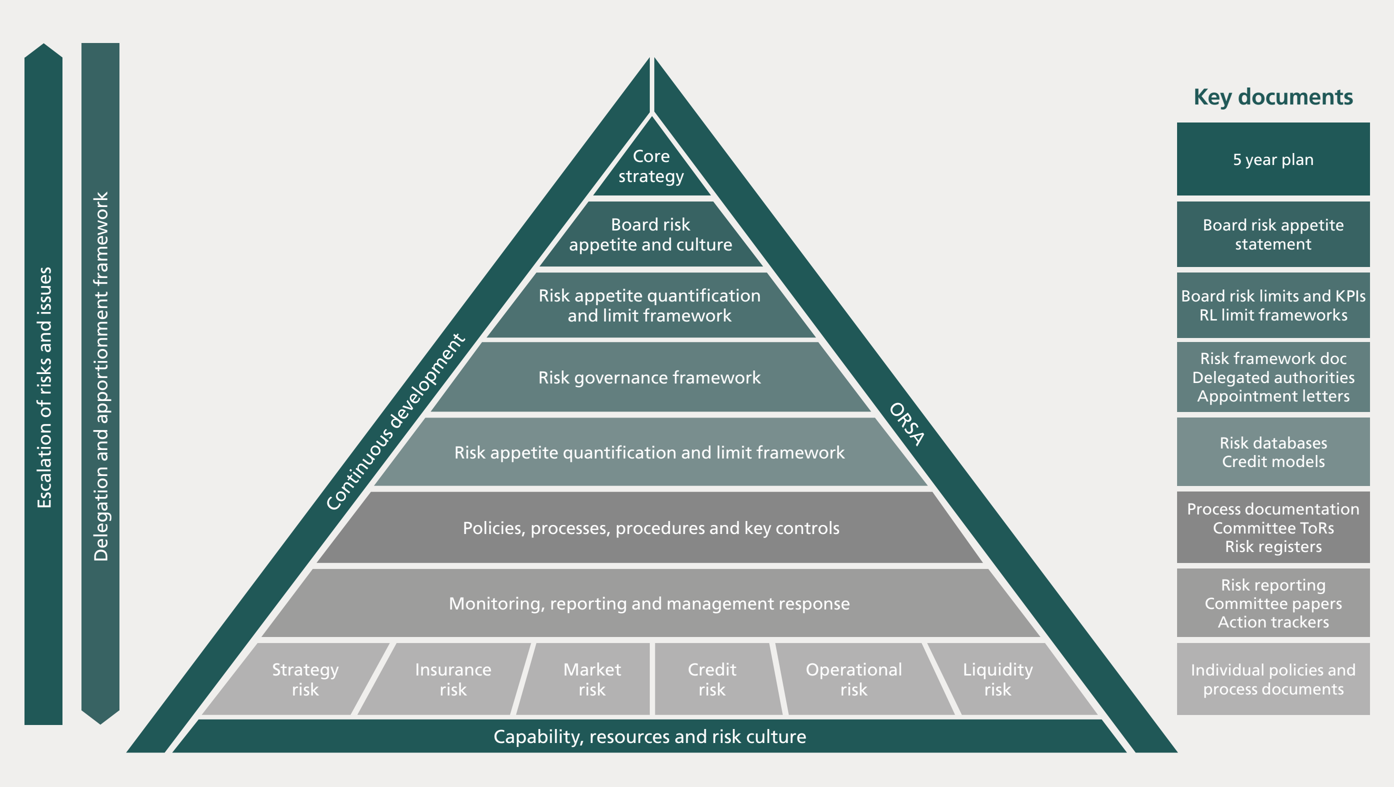
Rothesay Life's risk appetite expresses the types of risk that the Board is willing to be exposed to in pursuing strategic objectives. The Board's risk appetite sets the tone for the culture of risk management throughout the organisation.

Our strategic approach is to de-risk our business in order to achieve attractive risk-adjusted returns. We aim to protect regulatory surplus and minimise balance sheet volatility by hedging longevity risk and adopting a cautious approach to investment. Risk taking is therefore limited to circumstances where we believe that we fully understand the inherent and residual risks, where we are able to manage them within prudent, observable levels and where incurring the risks provides sufficient value to our stakeholders.

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

The risk appetite categorises risks as Desired, Tolerated or Undesired. First order risks that are core to our business model (desired), second-order risks that we incur as a result of our business model but seek to mitigate or manage to influence risk/return (tolerated) and second-order risks that we seek to fully eliminate to the extent possible (undesired).

Risk management framework



Risk management continued

Risk appetite quantification and limit framework

The risk limit framework is intended to ensure the stability of earnings and solvency position of the business. Risk appetite is translated into quantifiable limits and early warning triggers that prompt management action to avoid our risk exposures breaching the Board's risk appetite. Limits exist in relation to market, counterparty, liquidity, demographic and longevity risks and are sized with reference to our overall risk appetite and capital position.

Risk governance framework

Rothesay Life's risk governance arrangements strengthen the risk-taking and risk management of the business by adding challenge, oversight and independent assurance. Rothesay Life adopts the principles of a 'Three Lines of Defence' governance model for risk management that provides a consistent, transparent and clearly documented allocation of accountability and segregation of functional responsibilities.

- **First line:** Day-to-day risk management is delegated from the Board to the CEO and, through a system of delegated authorities, to business managers. Rothesay Life also makes the distinction between:
  - the risk-taking functions, including investment and new business origination; and
  - the control functions, whose responsibility it is to ensure the integrity of the Group's operations and reporting. These include operations, finance and legal.
- **Second line:** Risk oversight is provided by the Chief Risk Officer (CRO), his team and risk management committees. The executive level Working Level Risk Committee (WLRC) is chaired by the CRO and consists of relevant senior managers working within a delegated risk management framework. This Committee reviews all material new investment, hedging or liability transactions and is supported by a number of other committees which focus on risks arising from new activities, methodology and assumptions underlying our financial modelling and the management of third party suppliers.
- **Third line:** Independent verification of the adequacy and effectiveness of the internal risk and control management systems is provided by the Internal Audit function.

		Risk preference		
Risk type	**Definition**	**Undesired**	**Tolerated**	**Desired**
Strategy risk	The risk of loss in future earnings and capital arising from changes in the competitive, economic, legal or political environment, changing customer behaviour, or a failure to select appropriate strategic or long-term business plans.			●
Insurance risk	The risk of loss or of adverse change in the value of insurance liabilities, due to inadequate pricing and provisioning assumptions.			●
Market risk	The risk of loss or of adverse change resulting, directly or indirectly, from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments.		●	
Credit risk	The risk of loss or of adverse change in the financial situation, resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors.			●
Liquidity risk	The risk of being unable to realise investments and other assets in order to settle financial obligations when they fall due.	●		
Operational risk	The risk arising from inadequate or failed internal processes, personnel or systems, or from external events.	●		

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

Systems and infrastructure

The Group operates an integrated system infrastructure which captures all assets and liabilities centrally and provides us with the capability to report and monitor risk daily at both the portfolio and the individual transaction level. Close co-ordination of underwriting, reinsurance, investment and risk hedging functions ensures risk management is central to all aspects of the business, and that new business pricing reflects latest market conditions, hedging costs, investment opportunities as well as comprehensive liability analysis.

Policies, processes, procedures and key controls

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

Monitoring, reporting and management response

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

Capability, resources and risk culture

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

Own Risk and Solvency Assessment (ORSA)

The Own Risk and Solvency Assessment is undertaken at least annually and involves an assessment of the risks to which the business is exposed as well as solvency forecasting in a range of scenarios, including consideration of the stresses that could jeopardise the Group’s business plans. The ORSA is an important input to the Group’s strategic planning cycle.

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

Continuous development

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

Risk management continued

Principal risks and uncertainties facing the Group

The Group's primary risks are credit, insurance, liquidity, and market risk. An overview of these and other risks associated with the business including an outline of how they are each mitigated is provided in the table below:

Level 1 risk (key risk)	Level 2 risks (material risks)	Description	Mitigation
Credit	**Default risk** **Downgrade risk** **Concentration risk** **Migration risk** **Recovery risk** **Counterparty risk**	The Group's investments include government debt, government guaranteed debt, supranational debt, corporate debt, secured debt and secured loans. Therefore the Group is exposed to varying degrees of credit risk. The Group also enters into longevity reinsurance (unfunded swaps) and over-the-counter (OTC) derivative transactions (credit, interest and inflation swaps) to manage market and insurance risks. The Group is therefore exposed to the credit risk of these counterparties.	The Group strategy seeks to mitigate credit risk in a number of ways: • Investing in low-risk asset classes such as government guaranteed and other highly-rated bonds. • Investing in asset classes with security and other structural mitigation which protects Rothesay against loss in the event of a borrower default, including over-collateralisation. • Derivative contracts are subject to margining requirements to ensure changes in their fair value are appropriately collateralised. Where there is residual gap risk, the value of each contract is adjusted to reflect their credit riskiness. • Diversification of assets and counterparties. • Purchase of credit protection. • Active monitoring of assets and counterparties including for downgrade risk.
Insurance	**Longevity risk** **Expense risk** **Demographic risk**	The projection of annuity obligations used for pricing and reserving requires a number of actuarial assumptions to be made. Similar to other bulk annuity providers, the performance of the Group's business will primarily depend on the actual experience of mortality rates and longevity improvements. Systemic changes in mortality rates could arise, for example, from a cure for a major disease (e.g. cancer) being found in the near-term.	Longevity risk is mitigated through: • Strict underwriting criteria and the use of reinsurance targeting a majority of insured lives. Assumptions used in the projections are determined using recent historic experience, rating models or reinsurance pricing. Given the nature of the larger bulk annuities that the Group writes, the assumptions used can be derived specifically from the population under consideration. • All reinsurance contracts entered by the Group have been implemented through the use of unfunded longevity swaps where no initial premium outlay is required. 86% of longevity risk on an IFRS basis was hedged as at 31 December 2016.
Liquidity	**Liquidity risk** **Market function risk**	A lack of liquidity within the business may both prevent the Group from being able to pay annuity obligations as amounts fall due, and also limit the Group's ability to satisfy collateral calls on derivative contracts as they arise.	The Group has a comprehensive liquidity management framework that ensures sufficient liquidity is held to meet cash and collateral outflows in extreme market conditions. The Group models conservative instantaneous market shocks on a daily basis to a range of parameters and scenarios, measuring both the impact on asset values and movements in the value of derivatives and required collateral. The Group manages exposure to the ineffective functioning of the market via diversification of market counterparties and asset types.

Level 1 risk (key risk)	Level 2 risks (material risks)	Description	Mitigation
Market	**Interest rate risk** **Inflation rate risk** **Spread risk** **Exchange rate risk** **Property risk**	The group acquires market risk through its core activities: • Mismatches in sensitivity of assets and liabilities to the movement of future interest rate expectations. • The Group's annuity payments are linked to published inflation indices (UK RPI, UK CPI) and may be subject to caps and floors which gives rise to inflation rate and inflation volatility exposure. • A small proportion of the Group's pension obligations and investment assets are denominated in non GBP currencies. • A proportion of the Group's investments, in particular loans secured on commercial real estate and equity release financing, are exposed to property prices either in the event of the borrower defaulting (in the case of the former) or on death of the borrower (in the case of the latter).	The Group actively hedges market risks. Exposures are constructed by analysing the sensitivity of all assets and liabilities to movements in each of the underlying market risks: • Interest rate, inflation and exchange rate risks are hedged to appropriate tolerances on a continuous basis. • For interest rate risk the Group hedges the IFRS balance sheet under normal conditions, with increasing focus on the Solvency II balance sheet during times of volatility or as solvency deteriorates. • Credit spread risk is managed through active monitoring and management of the asset portfolio as well as index and single name hedges where appropriate. • Property risk is reduced through strict underwriting criteria covering, for example, the quality of the underlying real estate for commercial real estate and loan-to-value limits by age of borrower for equity release mortgages.
Operational	**General process failure risk** **Tax and financial reporting risk** **Business continuity risk** **Cyber risk** **Model risk**	The Group is exposed to operational risk, which is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. In particular, this includes the failure of key outsourcing arrangements, business disruption, cyber risk, fraud and loss of key management. The Group is reliant on the use of external parties to provide some services, for example, policyholder administration, middle and back office services and core risk management systems. The Group is therefore exposed to the potential failure of these outsourcing partners. The Group employs financial models in its day-to-day activities to inform and manage the business. Material errors in these models could expose the Group to losses and/or reputational damage. A change in regulations relating to taxation or financial reporting could result in the Group paying more taxes or being sanctioned for its approach to taxation and/or reputational damage.	The Group mitigates operational risk through its RMF and in particular: • The risk and control self-assessment process which ensures that risks are appropriately captured and controlled. • Regular reporting, monitoring and oversight of operational risk events. • A sub-committee of the WLRC monitors third party suppliers according to an annual review cycle. • Model risk is managed via a model control framework that identifies, validates and monitors models that are material to the Group. • The Group seeks to mitigate cyber risk through robust processes and controls including data protection, penetration testing and staff training. Recognising the importance of cyber risk management, the Group has recently achieved ISO27001 accreditation. • The Group seeks to mitigate taxation and financial reporting risk by focusing on compliance with relevant tax laws and financial reporting regulations. • The Group will not undertake tax planning that is contrived or artificial and the Group seeks to have an open, fair and proactive relationship with tax authorities at all times.

Risk management continued

Level 1 risk (key risk)	Level 2 risks (material risks)	Description	Mitigation
Strategic	**Business model risk** **Customer risk** **Regulatory risk** **Reputational risk**	A change in the regulatory, legal or political environment may have adverse consequences for the Group's business model, operations and financial performance. The Group is subject to UK regulation in particular the Group is required to comply with capital adequacy requirements. In addition, the UK's referendum vote to leave the EU means that there is significant uncertainty about the future regulatory framework for UK insurers. Furthermore, the Group's application to use a partial internal model is dependent on regulatory approval. Political and regulatory developments may significantly impact the business and economic environment that the Group operates in. The Group now has over 62,000 individual policyholders and is therefore exposed to conduct risk associated with unfair treatment of customers.	The Group is based in the UK and conducts almost all of its business in the UK. The Group maintains a regular dialogue with regulators in order to ensure compliance, as well as the ability to react quickly to any unanticipated developments. The Group seeks to have an open and transparent relationship with regulators at all times. The Group participates in industry bodies and consultations to ensure its interests are protected for the benefit of policyholders. A sub-committee of the Board oversees customer and conduct risk to ensure the Group meets the highest standards. The Group considers that the vote to leave the EU will have no material operational impact on the Group.

Changes in the Group's risk profile and emerging risks

2016 was characterised by substantial market volatility throughout the year, especially around the EU referendum, as well as the execution of the Aegon reinsurance transaction by the Group, increasing the size of the balance sheet considerably.

The Aegon transaction resulted in a significant increase in the asset base and total number of policyholders that the Group serves, as well as increasing the asset allocation to corporate bonds. During 2016 the Group also started investing in equity release mortgage loans, which introduces additional residential property risk to the balance sheet. The Group has identified a number of emerging risks that could impact the business over the longer-term. These principally relate to potential political and regulatory change in the UK, as well as Europe and the US, including the uncertain impacts of the UK's decision to leave the EU, risks to the stability of the Eurozone and the fiscal impacts of the ongoing political change.

The Group has navigated these changes well and as a result the risk profile of the Group has not materially changed over the course of the year. The Group has made significant progress in further building its risk management capabilities in order to prepare for future growth and the challenges these emerging risks will bring.

Viability statement

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

The Board of Directors conducted this review for a period of five years, which is consistent with the Group's strategic business plan as well as the Group's Own Risk and Solvency Assessment (ORSA). The strategic business plan is centred around the Group's projected new business targets, with assumptions about pricing, reinsurance, revenue generation, expenses and leverage based on the Group's existing business and target operating model. IFRS pre-tax profits are driven by two key sources: new business profitability and profit emergence of the Group's back-book.

The Group's own view of risk and associated capital requirements has been investigated through the ORSA process. Management has extended the analysis by considering how future changes to the Group's risk profile and also external influences, may impact on our solvency needs and ability to execute the business plan. The forward-looking scenarios test the impact of a number of stresses and scenarios that may impact Rothesay's ability to execute the business plan. The ORSA demonstrates the robustness of the Group's solvency and the way in which the business plan would need to be adapted to respond to adverse conditions. Management and the Board believe that the Group is well capitalised on both a regulatory and economic capital basis.

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

Governance report

The Board of Rothesay Life, together with management, is responsible for ensuring security of our obligations to our policyholders and generating and delivering sustainable shareholder value through the management of the Group's business. The Governance Report provides an overview of Rothesay Life's approach to governance, including how the Board oversees the business for the benefit of shareholders by promoting long-term, sustainable growth and policyholders through ensuring the risk and capital management processes remain robust.

Corporate Governance
Chairman's Introduction

I was pleased to have been appointed Chairman of the Group following the retirement of Keith Satchell in 2016. The Group takes corporate governance extremely seriously and my fellow Directors and I are committed to ensuring that robust governance remains a priority as the Group continues to grow.

Raymond (Ray) King
Chairman of the Group

Board of Directors
Our Board comprises 13 Directors – the Chairman, four shareholder Directors, five independent Non-Executive Directors and three Executive Directors.

The Board is responsible to shareholders, policyholders, the PRA and other stakeholders for the overall performance of the Group. The Board's role is to provide oversight of and direction to the senior management team and to ensure that there is an appropriate risk and control framework. The Board has a schedule of matters reserved for its consideration and approval including:

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

The Group undertook a Board Effectiveness Review during 2016 and each Director was asked to complete questionnaires for the Board and any Board Committee of which they are a member. In addition, I interviewed each Director to hear their comments first hand. Whilst I was generally satisfied by the outcome of the review, a number of areas of improvement were identified, namely an appetite to spend more time on discussion of people development and a desire to reduce duplication across committees. These findings will be addressed over the course of 2017.

The Board also spent a substantial amount of time during 2016 at various strategy days focusing on the longer-term business strategy and plan for the business. These included detailed analysis of each aspect of our business model, risks and mitigants for the business and how to ensure the business is ready and able to capitalise on future growth opportunities.

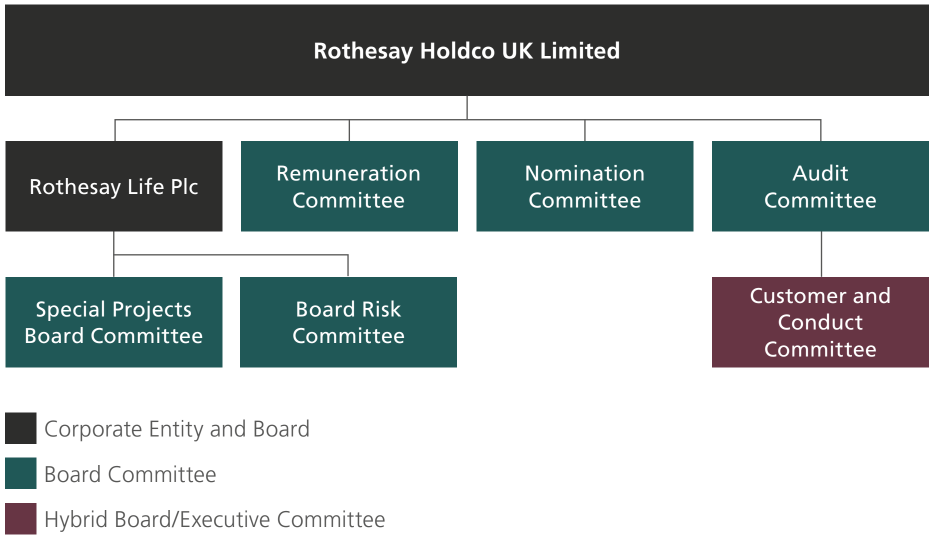
Shareholders
The ultimate holding companies of RHUK are:

- The Goldman Sachs Group, Inc.
- The Blackstone Group L.P.
- GIC Private Limited
- MassMutual Financial Group

The shareholder non-executive directors provide a valuable contribution to the overall performance of the Group and I was pleased that all four companies contributed additional equity to support the Aegon transaction (in proportion to their holdings). The shareholders also remain supportive of the Group's continuing recruitment activity and our investment in the business to build an infrastructure commensurate with the Group's ambitions.

Board Committees

A robust Board with an effective committee structure facilitates the governance framework of our Group. The Board is supported by the Audit Committee, the Board Risk Committee, the Remuneration Committee and the Nomination Committee. In the following pages, the Chairs of these committees provide a report on activity in the year.



Membership

o Chairman
+ Deputy Chairman
• Member

	Group Board	RLP Board	Audit Com	Board Risk Com	Rem Com	Nom Com
Ray King	o	o		•	o	o
Addy Loudiadis	•	•				•
Tom Pearce	•	•				
Andrew Stoker	•					
Independent Non-Executives						
Richard Berland	•	•	•		•	•
Glenn Earle	+	+		•	•	•
Naguib Kheraj	•	•		o	•	
Charles Pickup	•	•	•	•		•
Bill Robertson	•	•	o	•		
Shareholder Non-Executives						
Qasim Abbas	•	•		•	•	•
Tim Corbett	•					
Robin Jarratt	•	•	•		•	•
Dermot McDonogh	•	•	•	•	•	•

Richard Berland is the Chairman of the Customer and Conduct Committee.

Board of Directors

RAYMOND (RAY) KING
Independent Non-Executive Director, Chairman, Chairman of the Remuneration Committee and Chairman of the Nomination Committee

Ray King is currently a non-executive director and chairman of the audit committee at Saga plc and also a non-executive director of the Financial Reporting Council where he chairs the Audit and Assurance Council. Previously he has been a panel member at the Competition and Markets Authority and has held Non-Executive Directorships at Infinis Energy plc and Friends Provident plc and was a non-executive director on the board at the ABI. Ray ended his executive career as Group CEO of BUPA, having previously been Finance Director. Ray qualified as a Chartered Accountant with PricewaterhouseCoopers (PwC).

ANTIGONE (ADDY) LOUDIADIS
Chief Executive Officer

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

THOMAS (TOM) PEARCE
Managing Director

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

ANDREW STOKER
Chief Financial Officer

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

RICHARD BERLIAND
Independent Non-Executive Director and Chairman of the Customer and Conduct Committee

Richard Berliand is Deputy Chairman of Deutsche Börse AG and a member of the Boards of its Eurex subsidiaries, a non-executive Director of Man Group plc and Chairman of ITRS Global Holdings. Richard is also an adviser to the Commodity Futures Trading Commission in Washington. He was previously with J P Morgan for 23 years, most recently as global Head of the Cash Equities and Prime Services businesses.

GLENN EARLE
Senior Independent Non-Executive Director and Deputy Chairman

Glenn Earle is a member of the Board of Directors of Affiliated Managers Group, Inc. and Fiat Chrysler Automobiles N.V. and a non-executive member of the Advisory Committee of Hayfin Capital Management LLP. He is also Deputy Chairman of Teach First and a Board Member and Trustee of the Royal National Theatre. Glenn retired as Chief Operating Officer of Goldman Sachs International where he also co-chaired the firm's Capital Committee. He also previously served as a Director of Rothesay Life during 2007–2011.

NAGUIB KHERAJ
Independent Non-Executive Director and Chairman of the Board Risk Committee

Naguib Kheraj is a senior advisor to the Aga Khan Development Network and serves on the Boards of various entities within the Network. Naguib is also Deputy Chairman of Standard Chartered and a member of the investment committee of Wellcome Trust. Naguib began his career at Salomon Brothers and went on to hold a number of senior positions at leading financial institutions. He served as group finance director and vice-chairman and in various leadership positions at Barclays and was CEO of J P Morgan Cazenove.

CHARLES PICKUP
Independent Non-Executive Director

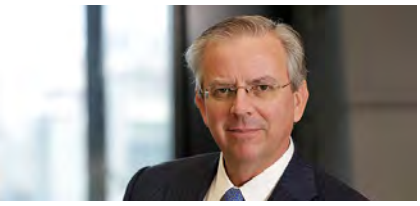
Charles Pickup is a Non-Executive Director of Rothesay Life and has served on the Board since January 2012. Charles was previously a partner in the Risk Consulting and Software division of Towers Watson (formerly Tillinghast) and acted as Actuarial Function Holder for Lucida plc, Countrywide and Blackrock. Prior to this Charles worked at Commercial Union and Prudential Bache Securities specialising in UK life insurance.

WILLIAM (BILL) ROBERTSON
Independent Non-Executive Director and Chairman of the Audit Committee

Bill Robertson is a Non-Executive Director of Rothesay Life and Chairman of the Audit Committee. Bill was previously the global life Chief Risk Officer and global life Chief Actuary for Zurich Financial Services and also held various senior positions at Aegon. Prior to this, Bill was a partner at Hymans Robertson and Head of Actuarial at Scottish Amicable.

QASIM ABBAS
Non-Executive Director

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



TIMOTHY (TIM) CORBETT
Non-Executive Director

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

ROBIN JARRATT
Non-Executive Director

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

DERMOT MCDONOGH
Non-Executive Director

Dermot McDonogh is a managing director within the Finance Division of Goldman Sachs, is the firm's International Controller, Chief Financial Officer for EMEA and a member of the European Audit Committee. Dermot joined Goldman Sachs in 1994 in New York. Dermot has been a Director of Rothesay Life since February 2009.

Audit Committee Report

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

William (Bill) Robertson
Chairman of the Audit Committee

I was pleased to have been appointed Chairman of the Audit Committee during 2016 following Ray King's appointment as Group Chairman and I now present the Audit Committee's report for the year ended 31 December 2016.

The Committee is responsible for assisting the Board of Directors in fulfilling its oversight responsibilities for the financial reporting process, the system of internal control, the internal and external audit processes and the Group's process for monitoring compliance with laws and regulations and the business principles. The Committee has unrestricted access to management and external advisors to help discharge its duties. It is satisfied that in 2016 it received adequate, reliable and timely information to perform its responsibilities effectively.

Committee membership and attendance

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

The Committee met on six occasions in 2016 at appropriate times in the financial and regulatory reporting audit cycle. The Chief Financial Officer (CFO), Chief Risk Officer (CRO), Chief Compliance Officer (CCO), Chief Operating Officer (COO), the Head of Internal Audit and representatives of PwC regularly attended committee meetings. Other members of senior management were also invited to attend as appropriate to present reports. During the year the Committee held regular private sessions with the CCO, the Head of Internal Audit and the external auditors without management present.

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

Committee responsibilities

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

- Review the effectiveness of the Group's internal controls
- Monitor and review the effectiveness of the Group's internal audit function in the context of the Group's overall risk management system
- Review the effectiveness of the system for monitoring compliance with laws and regulations
- Review the effectiveness of the system for risk governance and monitoring
- Monitor the integrity of the financial statements of the Group
- Monitor the integrity of the Group's Solvency II reporting, including quantitative reporting templates, the Solvency and Financial Condition report and the Regulatory Supervisory Report
- Consider and recommend the appointment, re-appointment and removal of external auditors of the Group
- Review the Group's arrangements for its employees to raise concerns about possible wrongdoings in financial reporting; and
- Consider and recommend to the Board the assumptions underlying the financial statements

Committee activities during 2016

The work of the Committee during 2016 fell into five main areas: financial statements and accounting policies, internal controls, regulatory compliance, oversight of the internal audit function and oversight of the external audit.

Financial statements and accounting policies

The Committee reviewed the Group's financial announcements, the Annual Report and Accounts, the PRA returns (for year end 2015), the half-year results and the going concern assumptions in relation to the Annual Report and Accounts.

The Committee also reviewed the relevant Solvency II disclosures to the PRA, including the interim Solvency and Financial Condition Report. This included oversight of the Group's applications to recalculate transitional solvency relief during the year.

The Committee reviewed the key assumptions used in calculating both the long-term insurance liabilities and the MCEV. This included the annuity mortality assumptions, the credit default allowance on the investment portfolio and the prudence requirements around the IFRS assumptions.

The Committee also reviewed the Group's Tax Policy and strategy statement.

Internal controls

The Committee received updates from the risk control self-assessment framework and discussed control improvements.

Regulatory compliance

The Committee received regular compliance updates, including:

- Updates from the Compliance function on the way in which Rothesay Life ensures compliance with relevant laws and regulations, including anti-money laundering and anti-bribery, and on the implications of changes to relevant law and regulation
- Updates on Solvency II compliance including the operation of the matching adjustment fund and calculation of transitional capital relief
- An update on the Group's compliance with the Senior Insurance Managers Regime; and
- Updates from the Group's Customer & Conduct Committee, which focuses on regulatory conduct and the fair treatment of customers and is chaired by an independent non-executive director, Richard Berliand.

Internal audit

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

The Head of Internal Audit reports directly to the Chairman of the Committee and her remuneration is approved by the Remuneration Committee. The Group operates a co-sourcing approach to internal audit using external advisors to supplement the in-house internal audit team. During 2016, the Group re-tendered these services with the result that EY was appointed. The Committee has reviewed and approved arrangements for overseeing the internal audit function whilst the Head of Internal Audit is on maternity leave.

The internal audit plan for 2016 was reviewed and approved by the Committee with internal audits being planned and prioritised following a risk-based assessment of the business. The reviews undertaken included:

- Audit of liability pricing processes
- Audit of risk management processes in relation to liquidity management and counterparty risk management
- Audit of the operation of the matching adjustment fund under Solvency II
- Audit of the Group's oversight of Northern Trust
- Audit of complaints handling
- Audit of the data security/cyber risk framework

The Committee received quarterly reports from the Head of Internal Audit on the audits that have been carried out, management's response to findings and progress in addressing identified issues.

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

In November 2016 the Committee considered and approved the internal audit plan for 2017.

External audit

As a previously wholly-owned subsidiary of Goldman Sachs, the Group's auditors were appointed by Goldman Sachs and PwC has audited the Group since its foundation in 2007.

The Committee ran a competitive tender process during 2016 and reappointed PwC as its auditors from 2017 year end. The Committee performed its annual review of the independence, effectiveness and objectivity of the external auditor by evaluating the auditor against a range of criteria and concluded that PwC remained sufficiently independent, effective and objective. It is noted that under the new Ethical Standards, Key Audit Partners are required to rotate every five years. Lee Clarke became the Group's external audit partner from the 2015 year end.

The Group's external audit contract will have to be put out to tender for 2027 year end at the latest at which point there is mandatory audit firm rotation under European Law.

The Committee has approved an External Auditor Policy (which was updated during the year to ensure adherence to the new Ethical Standards) which aims to:

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

The fees paid to PwC for the year ended 31 December 2016 are summarised in the table below:

£'000s	**Year ended 31 Dec 2016**	Year ended 31 Dec 2015
Audit of the financial statements of the Group and its subsidiaries	**470**	446
Audit-related assurance services	**487**	329
Total Audit	**957**	775
Other assurance services	**1,158**	305
Total fees	**2,115**	1,080

Other assurance services provided in 2016 include assurance in relation to the Group's Solvency II balance sheet, a review of the Group's internal credit rating function and independent validation of the Group's partial internal model. These services are all in compliance with applicable independence rules and the Group felt that the external auditor was best placed to provide these services because of its understanding of the Group and the requirement, from 2017, for audit of Solvency II disclosures.

Committee performance and effectiveness

The Group undertook a Board Effectiveness Review during 2016 which included consideration of the effectiveness of the Audit Committee. Whilst the review concluded that the Committee is generally effective, members of the Committee identified some potential improvements which will be addressed during 2017.

Board Risk Committee Report

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

Naguib Kheraj
Chairman of the Board Risk Committee

I am pleased to present the Board Risk Committee's report for the year ended 31 December 2016. I became Chairman of the Committee on 30 September 2016.

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

Committee responsibilities

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

- Monitoring the Group's overall risk appetite and tolerance
- Reviewing the Group's risk framework and risk policies, standards and limits within the overall appetite and tolerance and recommending such to the Board
- Reviewing the Group's process for determining risk appetite tolerance, monitoring compliance with approved risk tolerance levels and policies and the resultant action in respect of policy breaches
- Monitoring and analysing the Group's material risk exposures, including insurance, market, credit, operational, liquidity, reputational and economic and regulatory capital risks in the context of the Group's risk methodologies
- Commissioning management's actions to monitor and control risk exposures
- Undertaking the Group's stress-testing and monitoring management's response to such results
- Receiving notification of material breaches of risk limits and approving the proposed remedial action where such cases are escalated to the Board Risk Committee
- Reviewing and approving any new liability transaction to be executed by the Group which meets the criteria established by the Boards and applicable policies
- Reviewing and approving any new asset transaction that falls outside existing approval limits to be executed by the Group which meets the criteria established by the Boards and applicable policies
- Advising the Board on the risks inherent in strategic transactions and business plans and the impact on the Group's risk appetite and tolerance
- Reviewing the Group's capability to identify and manage new types of risk
- Considering the remit of the Group's risk function and ensuring it has adequate resources and appropriate access to information to enable it to perform its function effectively
- Evaluating whether the Group's risk function has adequate independence
- Reviewing the effectiveness of the risk function and its resourcing upon any significant one off increase in risk exposures or increase in assets under management by 20% or more
- Providing oversight to the risk function and receiving reports from the risk function in relation to solvency II requirements in respect of systems of governance and risk management
- Reviewing periodic updates from the head of compliance
- Monitoring and reviewing reports from the Working Level Risk Committee and CRO; and
- Reviewing key assumptions underlying economic capital calculations, individual capital assessments and the risk and solvency assessments and reviewing any major regulatory submissions involving capital

The Committee is supported in its duties by the WLRC which is responsible for the on-going monitoring and control of all financial risks, insurance risks and operational risks associated with the activities of the Group. The WLRC membership has 12 members and is chaired by the CRO.

Committee membership and attendance

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

The Committee met for six scheduled meetings and for three ad hoc meetings during 2016.

The Chairman, CEO, Managing Director, CRO, CFO, Chief Credit Officer, COO, the Head of Internal Audit and other Non-Executive Directors regularly attended committee meetings. Other members of senior management were also invited to attend as appropriate to present reports.

Committee activities during 2016

Risk appetite monitoring

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

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

Risk management and governance

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

- Compliance with risk limits, including in relation to liquidity
- Stress testing
- Market risk exposures
- Operational risk events
- Economic capital coverage; and
- Results of the regular risk and control self-assessment.

During 2016 and in line with the recent growth of the Group's balance sheet, the Committee oversaw a significant increase in the resourcing of the risk management function including the recruitment of a new CRO. The Committee was also involved in revamping the framework for counterparty risk management and setting of risk appetites.

New liability and asset transactions

The Committee considered the implications of the Aegon transaction from a risk management perspective, including the implications of the issuance of bank debt by RHUK and the Group's increased exposure to corporate bonds.

The Committee reviewed and approved the Group's entry into the equity release mortgage market and the decision of the Group to increase its exposure to loans secured on ground rents and commercial real estate. Some of the investments made in 2016 also necessitated amendments to risk limits which the Committee considered, challenged and approved.

The Committee reviewed the Group's approach to hedging interest rates and inflation under the Solvency II regime, including the Group's response to the EU Referendum.

Solvency II

During 2016, the Committee reviewed a number of risk-related policies, the Group's risk management framework and the Group's Own Risk and Solvency Assessment.

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

Committee performance and effectiveness

The Group undertook a Board Effectiveness Review during 2016 which included consideration of the effectiveness of the Board Risk Committee. Whilst the review concluded that the Committee is generally effective, members of the Committee identified some potential improvements which will be addressed during 2017.

Remuneration Committee Report

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

Raymond (Ray) King
Chairman of the Remuneration Committee

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

Committee membership and attendance

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

The Committee met on four occasions in 2016. The CEO, Managing Director, General Counsel and CFO also regularly attended part of committee meetings as appropriate and relevant.

Committee responsibilities

The Committee is responsible for reviewing and making recommendations to the Board regarding the remuneration policy of the Group and for reviewing compliance with the policy in so far as it relates to senior managers and other employees. Within the context of the Group's remuneration policy the Committee is specifically responsible for making recommendations for the remuneration packages of the Non-Executive Directors, Executive Directors, individuals whose remuneration is regulated under applicable regulation (including but not limited to the Solvency II regulations) and other senior managers of the Group. The Committee is further responsible for monitoring the level and structure of remuneration for the wider employees of the Group.

Committee activities during 2016

During the year, the Committee updated the remuneration policy of the Group to ensure that it is fully compliant with PS22/16, the PRA policy statement on Solvency II remuneration requirements. The remuneration policy is intended to:

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

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

The Committee made recommendations on the remuneration packages of the Chairman and other senior managers of the Group. It also reviewed the recommendations of management in relation to wider employees of the Group.

In order to ensure that all employees have equity participation in the business, the Committee approved the granting of restricted stock units (RSUs) in RHUK to all employees who were not already shareholders in RHUK. Such stock will vest and be delivered in December 2017 with delivery being conditional on employees' satisfying certain vesting and other requirements.

Committee performance and effectiveness

The Group undertook a Board effectiveness review during 2016 which included consideration of the effectiveness of the Remuneration Committee. Whilst the review concluded that the Committee is generally effective, members of the Committee identified some potential improvements which will be addressed during 2017.

Nomination Committee Report

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

Raymond (Ray) King
Chairman of the Nomination Committee

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

Committee membership and attendance

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

The Committee met or were consulted on four occasions in 2016. The CEO, Managing Director and General Counsel also regularly attended committee meetings.

Committee responsibilities

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

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

Committee activities during 2016

During 2016, the Committee approved the appointment of Peter Shepherd as Chief Risk Officer, David Hamilton as Chief Compliance Officer and Yann Samuelides as Head of Asset and Liability Management.

The Committee also undertook a skills audit evaluating the Directors' skills against the Group's requirements which concluded that the Board had an appropriate mix of skills and experience.

Committee performance and effectiveness

The Group undertook a governance review during 2015 which resulted in recommendations in relation to updating the Nomination Committee's terms of reference. The Board Effectiveness Review during 2016 did not cover the Nomination Committee and hence a review of the committee's effectiveness will be performed during 2017.

Financial statements

Report of the Directors

The Directors present their Annual Report and the audited consolidated financial statements for Rothesay Holdco UK Limited, registered number 08668809, (the 'Company or RHUK') for the year ended 31 December 2016. Comparative information has been presented for the year ended 31 December 2015.

1. Results

The consolidated results for RHUK and its subsidiaries ('the Group') for the year are set out in the consolidated statement of comprehensive income on page 52.

2. Dividends

The Directors have recommended no payment of interim dividends during the year ended 31 December 2016 (2015: £nil). The Directors have recommended no final ordinary dividend in respect of the year ended 31 December 2016 (2015: £nil).

3. Registered office

The financial statements include the financial statements of RHUK and its subsidiaries; Rothesay Pensions Management Limited, Rothesay Life Plc (formerly known as Rothesay Life Limited), Rothesay Assurance Limited (formerly known as MetLife Assurance Limited) and LT Mortgage Financing Limited. The Company and all subsidiary undertakings are registered in the United Kingdom. The registered office and principal place of business for RHUK and each of its subsidiary undertakings is Level 25, The Leadenhall Building, 122 Leadenhall Street, London, EC3V 4AB.

4. Directors

The Directors of the Company who served throughout the year and to the date of this report, except where noted, were:

Name	Appointed	Resigned
S. Q. Abbas		
R. D. A. Berliand		
M. T. Corbett		
R. A. De Beir Jarratt		
G. P. J. Earle		
N. Kheraj		
R. King		
A. Loudiadis		
D. W. McDonogh		
V. Nagarajan		20 May 2016
T. J. Pearce		
C. D. Pickup		
C. R. Pike		20 May 2016
W. J. Robertson	1 January 2016	
K. Satchell		30 March 2016
M. S. Sherwood		20 May 2016
A. M. Stoker		

5. Qualifying third party indemnities

The Articles of Association of the Company provide for the Directors and officers of the Company to be indemnified in respect of liabilities incurred as a result of their office. The Company also provides certain protections for Group Directors and senior management against personal financial exposure that they may have incurred in their capacity as such. These include qualifying third party indemnity provisions (as defined under section 234 of the Companies Act 2006) in force for the benefit of the Directors of the Group during the year.

6. Disclosure of information to auditors

In the case of each of the persons who are Directors of the Company at the date when this report was approved:

- so far as each of the Directors is aware, there is no information relevant to the audit of which the Company's auditors are unaware; and
- each of the Directors has taken all the steps that he/she ought to have taken as a Director to make himself/herself aware of any information relevant to the audit and to establish that the Company's auditors are aware of that information.

7. Independent auditors

As RLP is a public interest entity the Group is required to tender its audit every 10 years. The Group undertook a competitive tender process during 2016 interviewing three firms. PricewaterhouseCoopers LLP will continue in office as auditors of the Company pursuant to Section 487(2) of the Companies Act 2006 and paragraph 44 of Schedule 3 to the Companies Act 2006 (Commencement No. 3 Consequential Amendment, Transitional Provisions and Savings) Order 2007. Resolutions to reappoint PricewaterhouseCoopers LLP as auditor to the Group and to authorise the Directors to determine their remuneration are proposed.

8. Statement of Directors' responsibilities

The Directors are responsible for preparing the Strategic Report, Report of the Directors and the financial statements in accordance with applicable laws and regulations. Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU. Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that year. In preparing these financial statements, the Directors are required to:

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

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

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

9. Internal control and risk management systems

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

- The Risk function and management conduct checks on internal controls quarterly
- The Internal Audit function reviews and assesses controls on an ongoing basis
- Management regularly monitors and considers developments in accounting regulations and best practice in financial reporting and, where appropriate, reflects developments in the Consolidated financial statements. The Audit Committee is kept appraised of such developments
- The Group's results are subject to various levels of review by management
- The Audit Committee and the Board review the draft Consolidated financial statements, Strategic Report and Report of the Directors. The Audit Committee receives reports from management and the external auditors on significant judgements, changes in accounting policies, changes in accounting estimates and other pertinent matters relating to the consolidated financial statements
- The financial statements are subject to external audit

10. Date of authorisation of issue

The financial statements were authorised for issue by the Board of Directors on 22 March 2017.

ON BEHALF OF THE BOARD

Addy Loudiadis
Chief Executive Officer
30 March 2017

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

Report on the financial statements

Our opinion

In our opinion:

- Rothesay Holdco UK Limited's group financial statements and company financial statements (the "financial statements") give a true and fair view of the state of the group's and of the company's affairs as at 31 December 2016 and of the group's profit and the group's cash flows for the year then ended;
- the group financial statements have been properly prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union;
- the company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

What we have audited

The financial statements, included within the Annual Report and Accounts 2016 (the "Annual Report"), comprise:

- the Consolidated and Company Statement of Financial Position as at 31 December 2016;
- the Consolidated Statement of Comprehensive Income for the year then ended;
- the Consolidated and Company Cash Flow Statement for the year then ended;
- the Consolidated and Company Statement of Changes in Equity for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in the preparation of the financial statements is IFRSs as adopted by the European Union and, as regards the company financial statements, as applied in accordance with the provisions of the Companies Act 2006, and applicable law.

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the Strategic Report and the Report of the Directors for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the Strategic Report and the Report of the Directors have been prepared in accordance with applicable legal requirements.

In addition, in light of the knowledge and understanding of the group, the company and their environment obtained in the course of the audit, we are required to report if we have identified any material misstatements in the Strategic Report and the Report of the Directors. We have nothing to report in this respect.

Other matters on which we are required to report by exception

Adequacy of accounting records and information and explanations received

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

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the company, or returns adequate for our audit have not been received from branches not visited by us; or
- the company financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

As explained more fully in the Statement of Directors' Responsibilities set out on page 49, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)"). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

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

What an audit of financial statements involves

We conducted our audit in accordance with ISAs (UK & Ireland). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the group's and the company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. With respect to the Strategic Report and Report of the Directors, we consider whether those reports include the disclosures required by applicable legal requirements.

Lee Clarke

Lee Clarke (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
30 March 2017

The maintenance and integrity of the Rothesay Life website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

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

Consolidated statement of comprehensive income

For the year ended 31 December 2016

	Note	**Year ended 31 December 2016 £m**	Year ended 31 December 2015 £m
Income			
Gross premiums written	3	**6,877**	3,764
Premiums ceded to reinsurers		**(700)**	(562)
Net premiums written		**6,177**	3,202
Investment return	4	**2,798**	(115)
Total revenue		**8,975**	3,087
Expenses			
Claims and change in insurance contract liabilities	5	**(9,248)**	(3,199)
Change in the reinsurers' share of insurance contract liabilities and reinsurance recoveries	5	**756**	557
Net claims and change in insurance contract liabilities	5	**(8,492)**	(2,642)
Operating expenses	6	**(112)**	(81)
Finance costs	7	**(43)**	(17)
Total operating expenses		**(155)**	(98)
Profit before tax		**328**	347
Income tax expense	10	**(66)**	(71)
Profit for the financial year		**262**	276

All income and expenses are related to continuing operations.

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

Notes 1 – 32 form an integral part of these financial statements.

Consolidated statement of financial position

As at 31 December 2016

	Note	**31 December 2016 £m**	31 December 2015 £m
Assets			
Property, plant and equipment	14	**3**	2
Financial investments	15	**38,346**	24,592
Reinsurance assets	17	**437**	274
Accrued interest and prepayments	18	**278**	165
Receivables	19	**492**	381
Cash and cash equivalents	20	**152**	98
Total assets		**39,708**	25,512
Equity and liabilities			
Share capital	25	**2**	2
Employee benefit trust	26	**(20)**	–
Share premium	26	**465**	266
Capital contribution reserve	26	**3**	5
Other reserves	26	**1,035**	769
Total equity		**1,485**	1,042
Liabilities			
Insurance contract liabilities	21	**22,071**	14,207
Payables and financial liabilities	22	**15,532**	9,884
Borrowings	24	**587**	349
Deferred tax liabilities	23	**2**	3
Accruals and deferred income		**31**	27
Total equity and liabilities		**39,708**	25,512

Notes 1 – 32 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 22 March 2017 and signed on its behalf by:

Addy Loudiadis
Chief Executive Officer
30 March 2017
Company number 08668809

Consolidated statement of changes in equity

For the year ended 31 December 2016

	Share capital £m	Share premium £m	Capital contribution reserve £m	Profit and loss reserve £m	Reorganisation reserve £m	Employee scheme treasury shares £m	Total equity £m
As at 1 January 2016	**2**	**266**	**5**	**637**	**132**	**–**	**1,042**
Profit for the financial year	**–**	**–**	**–**	**262**	**–**	**–**	**262**
Share issuance	**–**	**199**	**–**	**–**	**–**	**–**	**199**
Employee benefit trust	**–**	**–**	**–**	**–**	**–**	**(20)**	**(20)**
Vesting of stock appreciation plan	**–**	**–**	**(4)**	**4**	**–**	**–**	**–**
Capital contribution	**–**	**–**	**2**	**–**	**–**	**–**	**2**
As at 31 December 2016	**2**	**465**	**3**	**903**	**132**	**(20)**	**1,485**

For the year ended 31 December 2015

	Share capital £m	Share premium £m	Capital contribution reserve £m	Profit and loss reserve £m	Reorganisation reserve £m	Employee scheme treasury shares £m	Total equity £m
As at 1 January 2015	2	266	5	357	132	–	762
Profit for the financial year	–	–	–	276	–	–	276
Vesting of stock appreciation plan	–	–	(4)	4	–	–	–
Capital contribution	–	–	4	–	–	–	4
As at 31 December 2015	2	266	5	637	132	–	1,042

The Reorganisation reserve reflects the impact of the Group reorganisation in 2013 which led to an increase in reserves of £132m reflecting the excess of consolidated net assets to the historical cost of investment in subsidiary entities.

Consolidated cash flow statement

For the year ended 31 December 2016

	Note	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Cash flows from operating activities			
Profit for the financial year		**262**	276
Adjustments for non cash movements in net profit for the year			
Depreciation	14	**1**	–
Share based payments	11	**3**	4
Interest income	4	**(530)**	(351)
Interest expense	7	**43**	17
Income tax expense	10	**66**	71
Net (increase)/decrease in operational assets			
Financial investments		**(13,754)**	(3,602)
Reinsurance asset		**(163)**	15
Receivables		**(133)**	(22)
Net increase/(decrease) in operational liabilities			
Insurance contract liabilities		**7,863**	2,102
Claims outstanding		**1**	–
Financial liabilities		**5,154**	1,230
Other payables		**500**	(106)
Accruals and deferred income		**5**	(11)
Net cash flows used in operating activities		**(682)**	(377)
Interest paid		**(51)**	(11)
Interest received		**423**	318
Tax paid		**(72)**	(67)
Net cash flows used in operating activities		**(382)**	(137)
Cash inflows from financing activities			
Repayment of borrowings		**–**	(125)
Proceeds from issuance of debt	24	**238**	249
Proceeds from issuance of ordinary share capital	25	**200**	–
Net cash inflows from financing activities		**438**	124
Cash outflows from Investing activities			
Acquisition of property, plant and equipment	14	**(2)**	(1)
Net cash outflows from Investing activities		**(2)**	(1)
Net increase/(decrease) in cash and cash equivalents		**54**	(14)
Cash and cash equivalent at 1 January		**98**	112
Cash and cash equivalents at 31 December	20	**152**	98

Company statement of financial position

As at 31 December 2016

	Note	31 December 2016 £m	31 December 2015 £m
Assets			
Investment in subsidiaries	31	**814**	384
Accrued interest and prepayments		**5**	–
Receivables		**22**	1
Cash and cash equivalents		**4**	9
Total assets		**845**	394
Equity			
Share capital	25	**2**	2
Share premium	26	**465**	266
Retained earnings		**107**	114
Total equity		**574**	382
Liabilities			
Other payables		**33**	12
Borrowings		**238**	–
Total equity and liabilities		**845**	394

Notes 1 – 32 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 22 March 2017 and signed on its behalf by:

Addy Loudiadis
Chief Executive Officer
30 March 2017
Company number 08668809

Company statement of changes in equity

For the year ended 31 December 2016

	Share capital £m	Share premium £m	Profit and loss reserve £m	Total equity £m
As at 1 January 2016	**2**	**266**	**114**	**382**
Loss for the financial year	**–**	**–**	**(7)**	**(7)**
Share issuance	**–**	**199**	**–**	**199**
As at 31 December 2016	**2**	**465**	**107**	**574**

For the year ended 31 December 2015

	Share capital £m	Share premium £m	Profit and loss reserve £m	Total equity £m
As at 1 January 2015	2	266	119	387
Loss for the financial year	–	–	(5)	(5)
As at 31 December 2015	2	266	114	382

Company cash flow statement
For the year ended 31 December 2016

	Note	**Year ended 31 December 2016 £m**	Year ended 31 December 2015 £m
Cash flows from operating activities			
Loss for the financial year		**(7)**	(5)
Adjustments for non cash movements in net profit for the year			
Interest expense		**7**	5
Net (Increase)/decrease in operational assets			
Receivables		**(21)**	3
Net Increase in operational liabilities			
Other payables		**21**	3
Net cash flows used in operating activities		**–**	6
Interest received		**–**	1
Interest paid		**(13)**	(4)
Net cash flows (used)/generated in operating activities		**(13)**	3
Cash inflows from financing activities			
Repayment of borrowings		**–**	(125)
Dividends received		**–**	130
Investment in subsidiary		**(430)**	–
Proceeds from issuance of debt		**238**	–
Proceeds from issuance of ordinary share capital		**200**	–
Net cash inflows from financing activities		**8**	5
Net (decrease)/increase in cash and cash equivalents		**(5)**	8
Cash and cash equivalent at 1 January		**9**	1
Cash and cash equivalents at 31 December		**4**	9

Notes to the financial statements

Note 1 – General information and basis of preparation

(a) General information

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

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

(b) Basis of preparation

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

The consolidated and separate financial statements of the Company are presented in sterling (£) rounded to the nearest million (£m) except where otherwise stated. The separate Company statement of financial position is presented on page 56.

The Group presents its statement of financial position broadly in order of liquidity. An analysis regarding recovery or settlement more than twelve months after the year end is presented in the notes.

Assets and liabilities are offset and the net amount reported in the statement of financial position only when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liability simultaneously. Income and expenses are not offset in the income statement unless required or permitted by IFRS.

(c) Basis of consolidation

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

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

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

Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if and only if the Group has:
- Power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee).
- Exposure, or rights, to variable returns from its involvement with the investee.
- The ability to use its power over the investee to affect its returns.

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

(d) Critical accounting policies and the use of estimates

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

Matters of significant judgement are considered to be:
- The assessment of whether the Group controls underlying entities and investments;
- Assessment of the significance of insurance risk transferred to the Group in determining whether a contract should be accounted for as an insurance or investment contract;
- Evaluating whether a provision or contingent liability should be recognised (see note 32);
- Calculation and recognition of deferred taxes (see note 23).

Notes to the financial statements continued

Note 1 – General information and basis of preparation continued

Estimates are based on evidence available at the accounting date and opinions provided by subject matter experts. Actual results may vary from the estimates provided. As new facts become available estimates will be updated. Items considered particularly susceptible to changes in estimates are noted below:

- Fair value of financial investments where quoted market prices are not available;
- Measurement of insurance contract liabilities (see note 21).

(e) Contract classification

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

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

(f) Foreign currencies

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

Note 2 – Company loss

The loss for the financial year of the Company was £7m (2015: loss of £5m). As permitted by section 408 of the Companies Act 2006, the Company's Statement of comprehensive income has not been included in these financial statements.

Note 3 – Segmental analysis

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

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

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

	Regular premiums		**Single premiums**	
	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m	**Year ended 31 December 2016 £m**	Year ended 31 December 2015 £m
Group pension bulk annuities	**267**	272	**21**	2,335
Assumed reinsurance premiums	**–**	–	**6,589**	1,157
Total gross premiums written	**267**	272	**6,610**	3,492

During 2016 reinsurance premiums from one insurer made up more than 10% of the Group's total gross written premium (2015: three bulk annuity and reinsurance customers), generating premiums of £6,435m (2015: £3,437m).

Note 4 – Investment return

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

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

Realised gains and losses on investments carried at fair value are calculated as the difference between net sales proceeds and purchase price. Movements in unrealised gains and losses on investments represent the difference between the fair value at the statement of financial position date and their cost.

Group	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Interest income on financial investments at fair value through profit and loss	**530**	351
Unrealised gains/(losses) on financial investments	**2,045**	(925)
Realised gains on financial investments	**227**	462
Investment expenses	**(4)**	(3)
Total investment return	**2,798**	(115)

The gain in the value of assets in 2016 was driven by the fall in interest rates over 2016 combined with spread tightening and was offset by a similar increase in insurance liabilities.

Note 5 – Net claims and change in insurance contract liabilities

Annuity payments are accounted for when they fall due for payment. Surrenders are accounted for when paid or, if earlier, on the date when the policy ceases to be included within the calculation of the insurance contract liabilities. Death claims and all other claims are accounted for when notified.

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Claims paid		
Gross claims paid	**(1,384)**	(1,056)
Reinsurance recoveries	**593**	531
Total claims paid	**(791)**	(525)
Change in insurance contract liabilities		
Gross change in insurance contract liabilities	**(7,864)**	(2,143)
Change in reinsurance recoveries	**163**	26
Total change in insurance contract liabilities	**(7,701)**	(2,117)
Net claims and change in insurance contract liabilities	**(8,492)**	(2,642)

Claims paid has increased in 2016 reflecting the growth of the in force book.

Notes to the financial statements continued

Note 6 – Operating expenses

The costs of acquiring new business are expensed during the financial year in which the premium is earned and the costs incurred.

This note gives further details of items included in the operating expenses section of the consolidated statement of comprehensive income which have been included in arriving at the profit before tax:

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Acquisition costs	**65**	52
Administration expenses – recurring	**17**	14
Administration expenses – projects and other one-off expenses	**30**	15
Total operating expenses	**112**	81

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

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Solvency II costs	**12**	2
Part VII transfers	**5**	1
Reinsurance fees	**9**	4
Other	**4**	8
	30	15

The following items have been included in operating expenses:

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Depreciation	**1**	–
Operating lease rental expense for office premises	**1**	1
	2	1

Note 7 – Finance costs

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

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Interest payable on collateral	**4**	4
Interest payable on collateralised agreements and financing	**8**	–
Interest payable on third party borrowings	**26**	8
Interest payable on borrowings from affiliates	**5**	5
Net finance costs	**43**	17

Debt issuance expenses associated with the issue of subordinated loan notes are recognised over the term of the loan.

Note 8 – Employee information

	Year ended 31 December 2016 No.	Year ended 31 December 2015 No.
Average number of staff employed during the year	**120**	89
Employees by department at year end		
Management	**9**	9
Sales and marketing	**16**	11
Investment	**31**	23
Operations	**35**	29
Technology	**6**	5
Finance and Legal	**28**	16
Risk and Compliance	**14**	7
	139	100

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

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Wages and salaries	**36**	30
Social security costs	**4**	4
Other pension costs	**1**	1
Total employee benefits expense	**41**	35

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

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

	Year ended 31 December 2016 £000s	Year ended 31 December 2015 £000s
Directors' remuneration		
Aggregate emoluments	**6,232**	6,186
Company pension contributions to money purchase schemes	**55**	54
Total Directors' remuneration	**6,287**	6,240
Highest paid director		
Total amount of emoluments	**2,664**	2,651
Company pension contributions to money purchase schemes	**13**	13
Total highest paid director	**2,677**	2,664

In accordance with the Companies Act 2006, Directors' emoluments above represent the proportion of total emoluments paid or payable in respect of qualifying services. This total does not include the value of equity awards in accordance with the provisions of Schedule 5 of SI 2008/410.

During 2016 Directors received no emoluments for non-qualifying services which are required to be disclosed.

Three Directors have been granted shares in respect of long term incentive schemes. No Directors have exercised options during the year.

Notes to the financial statements continued

Note 9 – Auditors' remuneration

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

	Year ended 31 December 2016 £000s	Year ended 31 December 2015 £000s
Remuneration receivable by the Company's auditors for the audit of the consolidated and company financial statements	**27**	17
Remuneration receivable by the Company's auditors for the audit of the financial statements of the Company's subsidiaries	**443**	429
Audit related assurance services	**487**	329
Total audit	**957**	775
Other assurance services	**1,158**	305
Total fees	**2,115**	1,080

Audit related assurance services provided in 2016 principally reflect assurance in relation to implementation of Solvency II and the audit of the Group's MCEV result.

Other assurance services provided in 2016 include assurance in relation to the Group's Solvency II balance sheet and a review of the Group's partial internal model application. These services are all in compliance with applicable independence rules and were approved by the Audit Committee.

Note 10 – Income tax expense

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

The major components of income tax expense for the years ended 31 December 2016 and 2015 are:

(a) Tax charged in the income statement

Group	**Year ended 31 December 2016 £m**	Year ended 31 December 2015 £m
Current income tax:		
UK corporation tax	**67**	72
Total current income tax	**67**	72
Deferred tax:		
Origination and reversal of temporary differences	**(1)**	(1)
Total deferred tax	**(1)**	(1)
Total expense in the consolidated statement of comprehensive income	**66**	71

(b) Reconciliation of the total tax charge

The tax expense in the consolidated statement of comprehensive income for the year and the standard rate of corporation tax in the UK of 20% (2015: 20.25%) is reconciled below:

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Profit on ordinary activities before taxation	**328**	347
Tax calculated at UK standard rate of corporation tax of 20% (2015: 20.25%)	**65**	70
Temporary differences	**1**	1
Total tax expense reported in the consolidated statement of comprehensive income	**66**	71

Note 11 – Share based payments

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

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

In the case of shares, the fair value is assumed to be the market price, and the company revises the value each reporting date. The fair value of share options is determined using stochastic and scenario based modelling techniques or an option pricing model.

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

The indirect shareholder issued SARs to the Group's employees under the RLSIP, primarily in connection with the sale of RHUK by the Goldman Sachs Group Inc. SARs were valued based on the sale price at the date of grant. Payment under SARs will be made in Goldman Sachs Group Inc. stock, cash or other marketable securities at the discretion of Goldman Sachs. Payment will be made by Goldman Sachs. The SARs vest in three equal instalments, on 31 December 2015, 31 December 2016 and 31 December 2017. Delivery of the underlying assets is conditional on the grantees satisfying certain vesting and other requirements outlined in the award agreements.

The activity related to these SARs is set forth below:

	31 December 2016 No. of SARs		31 December 2015 No. of SARs	
	No future service requirement	**Future service requirement**	No future service requirement	Future service requirement
Outstanding at the beginning of the year	**–**	**70,323**	–	103,987
Vested during the year	**–**	**(35,161)**	–	(33,664)
Outstanding at the end of the year	**–**	**35,162**	–	70,323

Expenses of £3m (2015: £4m) have been charged to the profit and loss account of the Group during the year in relation to the RLSIP.

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

The Company issued RSUs to the employees under the RHUK SIP, primarily in connection with year-end compensation. RSUs were valued based on closing value of the underlying shares at the date of the grant after taking into account a liquidity discount for any applicable post-vesting restrictions. These RSUs generally vest and deliver as outlined in the applicable RSU agreements. Employee RSU agreements generally provide that vesting is accelerated in certain circumstances, such as upon retirement, death and extended absence. Delivery of the underlying shares of common stock is conditional on the grantees satisfying certain vesting and other requirements outlined in the award agreements. On 5 April 2016, a share capital conversion took place (see Note 25) leading to the 7,964 RSUs granted during 2015 being converted into 3,243,291 new RSUs. In the table below the 31 December 2015 numbers have been adjusted to allow for this conversion. The activity related to these RSUs is set out below:

	31 December 2016 No. of RSUs		31 December 2015 No. of RSUs (adjusted for conversion)	
	No future service requirement	**Future service requirement**	No future service requirement	Future service requirement
Outstanding at the beginning of the year	**–**	**3,243,291**	–	–
Forfeited during the year		**(28,938)**	–	–
Granted during the year	**–**	**4,510,206**	–	3,243,291
Outstanding at the end of the year	**–**	**7,724,559**	–	3,243,291

The fair value of the RSUs granted in relation to the RHUK SIP during the year ended 31 December 2016 was £9.5m (31 December 2015: £5.5m). Expenses of £1.3m (2015: £nil) have been charged to profit and loss of the Group during the year in relation to the RHUK SIP.

Notes to the financial statements continued

Note 12 – Pension contributions

The Group operates a defined contribution pension scheme and contributions to the scheme are charged to the statement of comprehensive income as they accrue.

The amount charged for the financial year was £1.2m (2015: £1.1m). The outstanding contributions as at 31 December 2016 were £0.05m (2015: £0.04m) which were materially settled in January 2017.

Note 13 –Investment in unconsolidated structured entities

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

As at 31 December 2016, our total interest in such entities, reflected on the Group's consolidated statement of financial position and classified as financial investments held at fair value through profit or loss, was £4,223m (2015: £2,892m). The recorded fair value represents Rothesay's maximum loss exposure to these unconsolidated structured entities. The £1,331m increase in the balance was predominantly driven by £845m investment in collateralised financing agreements, in addition to mark-to-market movements of £486m on existing arrangements.

Note 14 – Property, plant and equipment

Equipment is stated at cost less accumulated depreciation and accumulated impairment losses. Depreciation is calculated on a straight line basis over the useful life of the following classes of assets:
– Computer Equipment: 3 years
– Furniture and Fittings: 5 years

	Computer Equipment £m	Furniture and Fittings £m	Total £m
Cost			
As at 1 January 2016	0.2	2.2	2.4
Additions	0.1	1.9	2.0
As at 31 December 2016	**0.3**	**4.1**	**4.4**
Accumulated depreciation			
As at 1 January 2016	0.1	0.4	0.5
Charge for the year	0.1	0.5	0.6
As at 31 December 2016	**0.2**	**0.9**	**1.1**
Net book value			
As at 31 December 2016	**0.1**	**3.2**	**3.3**
As at 31 December 2015	0.1	1.8	1.9

Note 15 – Financial investments

Financial investments are classified, at initial recognition, as financial investments at fair value through profit or loss, with the exception of receivables, cash, and accrued interest which are carried at amortised cost.

Financial investments at fair value through profit and loss

Financial investments at fair value through profit or loss are both financial investments held for trading and financial investments designated upon initial recognition at fair value. Financial investments at fair value through profit or loss are carried in the consolidated statement of financial position at fair value with net changes in fair value presented in investment income. Transaction costs, which are incremental costs that are directly attributable to the acquisition of a financial asset, are expensed for financial assets subsequently measured at fair value through profit or loss. Financial investments include collective investment schemes, government and agency obligations, derivative assets, corporate debt, lifetime mortgage loans and collateralised agreements and financing.

Derecognition

A financial investment (or, where applicable, a part of a financial investment or part of a group of similar financial investments) is primarily derecognised (i.e. removed from the Group's consolidated statement of financial position) when i) the rights to receive cash flows from the investment have expired; or ii) the Group has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass-through' arrangement; and either (a) the Group has transferred substantially all the risks and rewards of the asset, or (b) the Group has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the investment.

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

Collateralised agreements and financing

Collateralised agreements (securities purchased under agreements to re-sell and deposits placed as collateral for stock borrowed) and collateralised financing (securities sold under agreements to repurchase and deposits received as collateral for stock loans) are treated as collateralised financing transactions and are carried at fair value through profit and loss under the fair value option. The collateral can be in the form of cash or securities.

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

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

Financial Investments carried at fair value through profit and loss	**31 December 2016 £m**	31 December 2015 £m
Financial investments	**38,346**	24,592

This is made up of:

	31 December 2016 £m	31 December 2015 £m
Collective investment schemes	**860**	470
Government and agency obligations	**10,435**	6,137
Corporate bonds and other corporate debt	**9,035**	5,793
Derivative assets	**11,709**	6,937
Collateralised agreements and financing	**6,154**	5,135
Certificates of deposit	**153**	120
Total financial investments	**38,346**	24,592

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

Notes to the financial statements continued

Note 16 – Fair value

The fair value of a financial instrument is the amount that would be received on sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, i.e. the exit price. Financial investments are marked to bid prices and financial liabilities are marked to offer prices. Fair value measurements do not include transaction costs. Fair value gains or losses are included in investment income.

The best evidence of fair value is a quoted price in an active market. If listed prices or quotations are not available, fair value is determined by reference to prices for similar instruments, quoted prices or recent transactions in less active markets, or internally developed models that primarily use, as inputs, market based or independently sourced parameters, including but not limited to interest rates, volatilities, equity or debt prices, foreign exchange rates, credit curves and funding rates. The fair value of certain financial investments and financial liabilities require valuation adjustments for counterparty credit quality, funding risk, transfer restrictions, illiquidity and bid/offer inputs.

Cash instruments such as corporate debt securities, covered bonds, government and agency obligations and certain money market instruments are valued by verifying to quoted prices, recent trading activity for identical or similar instruments, broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. Consideration is given to the nature of the quotations (e.g. indicative or firm) and the relationship of recent market activity to the prices provided from alternative pricing sources. Valuation adjustments are typically made (i) if the cash instrument is subject to regulatory or contractual transfer restrictions and/or (ii) for other premiums and discounts that a market participant would require to arrive at fair value. Valuation adjustments are generally based on market evidence.

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

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

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

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

Determination of fair value and fair values hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:
- Level 1: inputs are unadjusted quoted prices in active markets to which the Group had access at the measurement date for identical unrestricted assets and liabilities,
- Level 2: inputs to valuation techniques are observable either directly or indirectly,
- Level 3: one or more inputs to valuation techniques are significant and unobservable.

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

Note 16 – Fair value (continued)

The following tables show an analysis of financial instruments recorded at fair value by level of the fair value hierarchy for 2016 and 2015:

31 December 2016

Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial investments:				
Collective investment schemes	**860**	**–**	**–**	**860**
Government and agency obligations	**5,695**	**4,740**	**–**	**10,435**
Corporate bonds and other corporate debt	**–**	**8,697**	**338**	**9,035**
Derivative assets	**–**	**11,709**	**–**	**11,709**
Collateralised agreements and financing	**–**	**3,243**	**2,911**	**6,154**
Certificate of deposits	**–**	**153**	**–**	**153**
Total financial investments at fair value	**6,555**	**28,542**	**3,249**	**38,346**
Financial liabilities:				
Derivative financial instruments	**–**	**12,048**	**1**	**12,049**
Collateralised financing agreements	**–**	**1,908**	**–**	**1,908**
Total financial liabilities at fair value	**–**	**13,956**	**1**	**13,957**

31 December 2015

Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial investments:				
Collective investment schemes	470	–	–	470
Government and agency obligations	3,242	2,895	–	6,137
Corporate bonds and other corporate debt	–	5,611	182	5,793
Derivative assets	–	6,934	3	6,937
Collateralised agreements and financing	–	3,196	1,939	5,135
Certificate of deposits	–	120	–	120
Total financial investments at fair value	3,712	18,756	2,124	24,592
Financial liabilities:				
Derivative financial instruments	–	6,907	11	6,918
Collateralised financing agreements	–	1,886	–	1,886
Total financial liabilities at fair value	–	8,793	11	8,804

Approximately 8% (2015: 9%) of the total financial assets recorded at fair value are based on estimates and recorded as Level 3 investments. Where estimates are used, these are based on a combination of independent third-party evidence and internally developed models, calibrated to market observable data where possible. While such valuations are sensitive to estimates, it is believed that changing one or more of the assumptions to reasonably possible alternative assumptions would not change the fair value significantly.

Notes to the financial statements continued

Note 16 – Fair value continued

The following table shows a reconciliation of the opening and closing recorded amounts in relation to the Level 3 financial instruments recorded at fair value:

Group	Corporate debt £m	Collateralised agreements £m	Derivatives £m	Total £m
At 1 January 2016	**182**	**1,939**	**(8)**	**2,113**
Total gains in the Statement of Comprehensive Income:				
Unrealised gains	**81**	**403**	**7**	**491**
Transfer into Level 3	**–**	**338**	**–**	**338**
Transfer out of Level 3	**(38)**	**–**	**–**	**(38)**
Purchases/additions	**113**	**231**	**–**	**344**
At 31 December 2016	**338**	**2,911**	**(1)**	**3,248**
At 1 January 2015	248	–	(5)	243
Total gains in the Statement of Comprehensive Income:				
Unrealised gains/(losses)	2	–	(3)	(1)
Realised gains	1	–	–	1
Transfer into Level 3	–	456	–	456
Transfer out of Level 3	(137)	–	–	(137)
Purchases/additions	68	1,483	–	1,551
At 31 December 2015	182	1,939	(8)	2,113

There have been no transfers between Level 1 and Level 2 during the year.

During the year, the Group transferred certain financial instruments between Level 2 and Level 3 of the fair value hierarchy. The recorded amount of the total assets transferred from Level 2 to Level 3 is £338m (31 December 2015: £456m) and from Level 3 to Level 2 is £38m (31 December 2015: £137m). The reason for the change is a change in the availability of observable market transactions for the same or similar instruments.

Note 16 – Fair value continued

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

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

			2016		
Impact on financial assets, liabilities and PBT	**Main assumptions**	**Sensitivity**	**Current FV £m**	**(Decrease)/ Increase in FV £m**	**(Decrease)/ Increase in PBT £m**
Financial assets					
Corporate bonds and other corporate debt	Discount rate	+50bps interest rate	**338**	**(33)**	**(9)**
		-50bps interest rate	**338**	**36**	**10**
Collateralised financing agreements	Discount rate	+25bps interest rate	**2,911**	**(192)**	**(17)**
		-25bps interest rate	**2,911**	**213**	**19**
Derivative assets	Expected defaults	+50bps credit default spread	**–**	**–**	**–**
		-50bps credit default spread	**–**	**–**	**–**
Financial liabilities					
Derivative liabilities	Expected defaults	+50bps credit default spread	**(1)**	**1**	**1**
		-50bps credit default spread	**(1)**	**(1)**	**(1)**

			2015		
Impact on financial assets, liabilities and PBT	Main assumptions	Sensitivity	Current FV £m	(Decrease)/ Increase in FV £m	(Decrease)/ Increase in PBT £m
Financial assets					
Corporate bonds and other corporate debt	Discount rate	+50bps interest rate	182	(22)	(6)
		-50bps interest rate	182	24	6
Collateralised financing agreements	Discount rate	+25bps interest rate	1,939	(144)	(14)
		-25bps interest rate	1,939	160	16
Derivative assets	Expected defaults	+50bps credit default spread	3	1	1
		-50bps credit default spread	3	(1)	(1)
Financial liabilities					
Derivative liabilities	Expected defaults	+50bps credit default spread	(11)	3	3
		-50bps credit default spread	(11)	(3)	(3)

Notes to the financial statements continued

Note 17 – Reinsurance assets

Long term business is ceded to reinsurers under contracts to transfer part of the insurance risk associated with the underlying insurance contracts. Such contracts are accounted for as insurance contracts provided the risk transfer is significant.

The amounts that will be recoverable from reinsurers are estimated based upon the gross provisions, having due regard to collectability. The recoverability of reinsurance recoveries is assessed having regard to market data on the financial strength of the reinsurance company. The reinsurers' share of claims incurred in the profit and loss account reflects the amounts received or receivable from reinsurers in respect of claims paid or incurred during the year. Reinsurance liabilities are primarily premiums payable for reinsurance contracts and are recognised in the consolidated statement of comprehensive income as 'Premiums ceded to reinsurers' when due.

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

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

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

	31 December 2016 £m	31 December 2015 £m
Reinsurance of insurance contract liabilities	**437**	274
Total reinsurance of insurance contract liabilities	**437**	274

Under the outward reinsurance contracts, the Group has committed to pay fixed cash flows to the reinsurer for each policy covered. In exchange, the reinsurers will pay cash flows that are linked to the actual longevity of the underlying policies. The contracts are generally collateralised for changes in longevity expectations and movements in market rates. Where a contract is collateralised no additional reserves are held as the expected loss on default would be expected to be covered by the collateral. For the contracts where no collateral is held an additional counterparty default allowance is held to reflect the risk of loss on default. The calculation of the allowance considers the probability of default of the counterparty along with the expected level of collateral available to be reclaimed in the event of default.

An analysis of the movement in reinsurance of insurance contract liabilities is included in Note 21.

At 31 December 2016 and 31 December 2015, the Group conducted an impairment review of the reinsurance assets and found no impairment necessary.

Note 18 – Accrued interest and prepayments

	31 December 2016 £m	31 December 2015 £m
Accrued interest	**209**	138
Prepaid expenses	**69**	27
Total accrued interest and prepayments	**278**	165

Note 19 – Receivables

	31 December 2016 £m	31 December 2015 £m
Deposits pledged as collateral to third parties	**491**	378
Other receivables	**1**	3
Total receivables	**492**	381

All receivables are due within one year. The fair value of receivables is £492m (2015: £381m).

The net exposure to certain OTC derivatives is collateralised through cash posted, as per the terms of the OTC contracts. At 31 December 2016, the total cash collateral posted was £491m (2015: £378m). Further details of the full extent of collateral usage can be found in the credit risk disclosure in Note 28.

Note 20 – Cash and cash equivalents

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

	31 December 2016 £m	31 December 2015 £m
Cash at bank and in hand	**152**	98
Total cash and cash equivalents	**152**	98

Note 21 – Insurance contract liabilities

Insurance contract liabilities are determined by the Group's actuaries using methods and assumptions recommended by the actuarial function of Rothesay Life Plc (RLP) and approved by the Board, and using recognised actuarial methods with due regard to the actuarial principles laid down in Directive 2002/83/EC. They are calculated using the statutory solvency basis required to comply with the reporting requirements under the Financial Services and Markets Act 2000 and in accordance with the SORP on Accounting for Insurance Business issued by the ABI in December 2005 and revised in December 2006. The SORP has been withdrawn with effect for accounting periods beginning on or after 1 January 2015 but the Group continues to apply the principles. The Group seeks to make prudent assumptions relating to expected future experience based on current market conditions and recent experience. The assumptions used incorporate prudent margins to reflect the inherent uncertainty that actual experience may be less favourable than our best estimate.

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

In accordance with the previous Solvency I valuation regulations, the Group recognises negative mathematical reserves on its regular premium longevity risk transfer arrangements.

Notes to the financial statements continued

Note 21 – Insurance contract liabilities continued

Key valuation assumptions

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

(a) Mortality assumptions

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

	Base mortality		
	31 December 2016		31 December 2015
	Pensions originated	Insurance originated	All
Males	**97.5% S2PMA**	**104.5% PMA08**	97.2% S2PMA
Females	**97.5% S2PFA**	**104.5% PFA08**	97.2% S2PFA

	Mortality improvements	
	31 December 2016	31 December 2015
Males	**CMI_2014_M[2.4%]**	CMI_2014_M[2.7%]
Females	**CMI_2014_F[2.4%]**	CMI_2014_F[2.2%]

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

Recent mortality experience is analysed annually for each pension scheme and reinsurance contracts (individually or grouped). The last review was carried out during 2016. The best estimate base mortality assumptions used in the valuation are based on this actual mortality experience.

For pension scheme business mortality assumptions are generally set with reference to an RLP specific suite of mortality tables. These have been expressed for reporting purposes as an equivalent to the CMI S2 series of mortality tables drawn up by the Continuous Mortality Investigation Bureau (CMIB) of the Institute and Faculty of Actuaries. The S2 tables are based on industry-wide experience.

For the reinsured blocks of insurance originated annuities the CMI 08 series of annuitant mortality tables are used to value the pension liabilities. These are expected to better reflect the shape of mortality for insured blocks.

Allowance is made for future improvements in annuitant mortality with reference to statistical analysis of historical rates of mortality improvements, expert judgement of future changes in mortality improvements, industry benchmarking and reinsurance pricing. During 2016 the long term rate was recalibrated and the female long term rate was brought in line with the male rate.

Prudent margins are then applied to the demographic basis to reflect the fact that future experience for the schemes may differ from that assumed. There are no changes to the prudent margins at 31 December 2016.

(b) Valuation rate of interest

The valuation rate of interest used to discount the cash flows for the purpose of valuing insurance contract liabilities is based on the yield obtainable on the basket of asset matching the applicable insurance contract liabilities at 31 December 2016.

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

	31 December 2016	31 December 2015
Equivalent valuation discount rate	**2.40% pa**	3.21% pa

This reflects a 2.5% prudential margin applied to the risk adjusted internal rate of return obtained on the basket of matching assets and an allowance for investment management expenses of 3bps p.a. (31 December 2015: 3bps p.a).

The asset yield used to calculate the valuation discount rate has been reduced to reflect counterparty default risk; where applicable adjusted for the prudent expected recoveries in the event of default. This reduction in yield is determined separately for each individual asset reflecting the risk to the return being achieved on the asset.

Note 21 – Insurance contract liabilities continued

The table below shows the average yield deduction at 31 December 2016 and 31 December 2015 by asset category:

Asset class	Average yield reduction 2016	2015
UK Government approved securities	**0 bps**	0 bps
Corporate bonds after allowance for covering credit default swaps	**0 bps**	0 bps
Secured lending	**9 bps**	6 bps
Supranational/other sovereign	**19 bps**	15 bps
Secured residential lending	**24 bps**	24 bps
Corporate bonds (without covering credit default swaps)	**52 bps**	N/A
Infrastructure	**84 bps**	83 bps
Other	**47 bps**	56 bps
Overall yield reduction	**19 bps**	18bps

Overall, the deduction for counterparty default risk on the assets held by the Group is generally lower than the corresponding credit default deduction on a typical unsecured credit portfolio. This is due to a significant proportion of the portfolio being invested in assets with either a low probability of default due to government guarantees or expectation of higher recovery in the event of default through collateralisation, recourse to specific assets or credit default swap protection. During 2016 the asset classes invested in were expanded to included unsecured corporate bonds.

(c) Expenses

An allowance is made for future overhead maintenance expenses following an investigation into the total costs incurred by the Group during 2016 and the projected 2017 expenses. The investigation was updated during the period to allow for the additional expected future costs including those as a result of the Aegon transaction. As part of this investigation, these costs have been split between acquisition and maintenance expenses. The long term business provisions include an allowance to provide for the expenses payable under the Third Party Administration agreements (TPA) together with the long term business overhead expenses expressed as an amount per policy. An additional short term maintenance expense overrun provision has been established to provide for expected project costs.

Within these expense provisions, an allowance for future expense inflation has been provided to cover the impact of both salary and price inflation. The future rate of expense inflation is assumed to be RPI (as implied by the RPI swap curve) plus an addition at each duration of 0.25% p.a. (31 December 2015: 0.25% p.a.) or 1.00% p.a (31 December 2015: 1.00%) for the TPA expenses depending on the TPA provider.

(d) Other assumptions

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

A number of other, less financially significant, actuarial assumptions are made in determining the provisions. These assumptions include, inter alia, the proportion of deferred and immediate annuitants assumed to have a dependant eligible for contingent benefits, dependant's age difference and the proportion of deferred annuitants opting to take a proportion or all of their benefit at retirement as a lump sum. When deferred annuitants have passed the scheme normal retirement date and have been subject to in depth tracing exercises and yet remain untraced, a prudent allowance has been made for the probability of them retiring in the future. All other individuals who have passed the scheme normal retirement date are assumed to retire immediately.

Notes to the financial statements continued

Note 21 – Insurance contract liabilities continued
Key valuation assumptions continued
(e) Movements in insurance contract liabilities

	31 December 2016			31 December 2015		
	Insurance liabilities £m	**Reinsurance assets £m**	**Net liabilities £m**	Insurance liabilities £m	Reinsurance assets £m	Net Liabilities £m
Carrying amount at 1 January	**14,207**	**274**	**13,933**	12,106	289	11,817
Increase in respect of new business	**6,503**	**117**	**6,386**	3,320	9	3,311
Release of liabilities/liabilities discharged	**(1,093)**	**1**	**(1,094)**	(617)	2	(619)
Effect of non-economic assumption changes	**(139)**	**(142)**	**3**	(83)	(103)	20
Effect of economic assumption changes	**2,599**	**187**	**2,412**	(520)	77	(597)
Other	**(6)**	**–**	**(6)**	1	–	1
Closing balance at 31 December	**22,071**	**437**	**21,634**	14,207	274	13,933

The table above details the change in the gross and net insurance contract liabilities over the year. The table below provides a further split of the net impact of the most significant assumption changes.

The release of liabilities line reflects claims paid, release of prudent margins and unwind of discounting over the year.

Effect of changes in assumptions and estimates during the year
The following table shows the impact on the insurance contract liabilities, net of reinsurance, of changes in the assumptions used:

Net Increase/(Decrease) in liabilities Change in assumptions used	**31 December 2016 £m**	31 December 2015 £m
Valuation interest rates	**2,114**	(441)
Inflation	**298**	(156)
Effect of economic assumption changes	**2,412**	(597)
Demographics	**(46)**	(24)
Expenses	**49**	44
Effect of non-economic assumption changes	**3**	20
Total change in assumptions used	**2,415**	(577)

As shown previously the valuation interest rate decreased by 0.8% over the year which led to the £2.1bn increase in the liability shown. This change was predominantly through movements in LIBOR with 30-year rates falling 75bps over the period.

The movement in the demographic assumptions shown reflects the changes to base mortality, mortality improvement and dependants' assumptions applied during the year leading to a £46m decrease in liabilities.

Note 21 – Insurance contract liabilities continued

(f) Sensitivity analysis

The schedule below provides an analysis of the reasonably possible movements in key assumptions that would have a material impact on liabilities (net of reinsurance), profit before tax (PBT) and equity. The analysis is based on a change in a single assumption whilst holding all other assumptions constant. The analysis assumes an instantaneous shock to the assumptions, other than for the interest rate sensitivities where the impact of dynamic hedging is allowed for as interest rates change. For the 31 December 2016 an adjustment has been made to the presentation of the credit default assumption sensitivity to allow for both asset and liability impacts. The 31 December 2015 comparatives are restated to be consistent.

31 December 2016	Change in assumptions	(Decrease)/ Increase in liabilities £m	Increase/ (decrease) in PBT £m	Impact on equity £m
Annuitant mortality	**+5% qx**	**(85)**	**85**	**68**
Annuitant mortality	**-5% qx**	**88**	**(88)**	**(71)**
Interest rate	**+100bps**	**(2,685)**	**32**	**25**
Interest rate	**-100bps**	**3,406**	**254**	**203**
Inflation	**+100bps**	**1,030**	**117**	**94**
Inflation	**-100bps**	**(1,026)**	**51**	**41**
Credit default assumption	**+10bps**	**(102)**	**(114)**	**(91)**
Credit default assumption	**-10bps**	**108**	**111**	**89**
Expenses	**+10%**	**58**	**(58)**	**(46)**

31 December 2015	Change in assumptions	(Decrease)/ Increase on liabilities £m	Increase/ (decrease) on PBT £m	Impact on equity £m
Annuitant mortality	+5% qx	(86)	86	68
Annuitant mortality	-5% qx	90	(90)	(72)
Interest rate	+100bps	(1,934)	29	23
Interest rate	-100bps	2,474	65	52
Inflation	+100bps	912	11	9
Inflation	-100bps	(845)	59	47
Credit default assumption – restated	+10bps	(75)	(54)	(43)
Credit default assumption – restated	-10bps	77	55	44
Expenses	+10%	29	(29)	(23)

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

The -100bp interest rate sensitivity assumes interest rates fall below zero for the period up to 6 years.

The table below shows the impact of the reinsurance on the sensitivity to mortality risk, a reduction of 86% (31 December 2015: 77%).

31 December 2016	Change in Assumptions	(Decrease)/ Increase in insurance liability £m	Increase/ (decrease) in reinsurance asset £m	Net Increase/ (Decrease) in liabilities £m
Annuitant mortality	**+5% qx**	**(577)**	**493**	**(85)**
Annuitant mortality	**-5% qx**	**618**	**(530)**	**88**

31 December 2015	Change in Assumptions	(Decrease)/ Increase on insurance liability £m	Increase/ (Decrease) on reinsurance asset £m	Net (Decrease)/ increase on liabilities £m
Annuitant mortality	+5% qx	(378)	292	(86)
Annuitant mortality	-5% qx	403	(314)	89

The annuitant mortality sensitivity is defined in terms of a qx stress where qx represents the probability of a life dying during the year. As such in the annuitant mortality stress it is assumed that in each year 5% more or fewer people survive to the end of each year than had previously been assumed.

Notes to the financial statements continued

Note 21 – Insurance contract liabilities continued
Key valuation assumptions continued
(g) Timing of cash flows
The table below shows the discounted insurance liability cash flows, which are expected to arise during each year:

Group	31 December 2016 Less than 1 year £m	 1 to 5 years £m	 Over 5 years £m	 Total £m
Insurance contract liability cash flows	**1,030**	**3,836**	**17,205**	**22,071**
Reinsurance asset cash flows	**52**	**198**	**(687)**	**(437)**
	1,082	**4,034**	**16,518**	**21,634**

	31 December 2015 Less than 1 year £m	 1 to 5 years £m	 Over 5 years £m	 Total £m
Insurance contract liability cash flows	630	2,393	11,184	14,207
Reinsurance asset cash flows	31	113	(418)	(274)
	661	2,506	10,766	13,933

Note 22 – Payables and financial liabilities

	31 December 2016 £m	31 December 2015 £m
Derivative financial instruments	**12,049**	6,918
Collateralised financing agreements	**1,908**	1,886
Deposits received as collateral from third parties	**921**	753
Deposits received as collateral for derivatives from participating interest	**547**	227
Current tax payable	**46**	52
Other taxes and social security costs	**38**	7
Other payables	**23**	41
Total payables and financial liabilities	**15,532**	9,884

Payables and financial liabilities of £2,257m (2015: £1,210m) are all due within one year.

The net exposures to certain OTC derivatives are collateralised through cash. As at 31 December 2016, the total cash collateral received was £1,468m (2015: £980m). Other OTC contracts are collateralised with fixed income securities which are not recognised on the consolidated statement of financial position for the Group.

Note 23 – Deferred tax liabilities

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

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

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

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

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

Note 23 – Deferred tax liabilities (continued)

Deferred tax balances comprise:

	31 December 2016 £m	31 December 2015 £m
Temporary differences between the financial statements financial statements and the tax deductions	**(2)**	(3)
Total temporary differences	**(2)**	(3)

The movements in the deferred tax balances were as follows:

	2016 £m	2015 £m
At 1 January	**(3)**	(3)
Transitional adjustments	**1**	–
At 31 December	**(2)**	(3)

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

The Group has unrecognised deferred tax assets in respect of:

	31 December 2016 £m	31 December 2015 £m
Temporary differences in relation to equity based compensation	**2**	3
Total temporary differences	**2**	3

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

	31 December 2016 £m	31 December 2015 £m
At 1 January	**3**	3
Temporary difference in relation to equity based compensation	**(1)**	–
At 31 December	**2**	3

Note 24 – Borrowings

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

The Group's borrowings are as follows:

	31 December 2016 £m	31 December 2015 £m
Third party syndicated loan	**238**	–
Affiliate subordinated loan	**100**	100
Subordinated loan notes	**249**	249
Total borrowed	**587**	349

Notes to the financial statements continued

Note 24 – Borrowings continued

The amounts outstanding at 31 December 2016 include £100m of floating rate perpetual callable loan notes, £249m unsecured, subordinated loan notes and £238m of third party syndicated loan notes.

On 4 April 2016 the Company entered into a £240m 3 year term loan facility agreement provided by a syndicate of third party banks. The loan is secured and the rate of interest is Sterling LIBOR plus 250bps per annum. The loan has been drawn down in three phases – £125m on 7 April 2016, £75m on 12 April 2016 and the remaining £40m on 29 June 2016. The third party syndicated loan notes were issued and initially recognised at fair value of £238m being issue proceeds of £240m less capitalised issue cost of £2m. At 31 December 2016 the notes have a carrying value of £238m which is calculated based on an amortised cost basis and a fair value of £240m.

The £100m of floating rate perpetual callable loan notes are callable at par on 21 December 2017 and every 6 months thereafter. They carry deferrable interest at sterling LIBOR plus 425bps per annum. The notes are unsecured and classified as qualifying dated Tier 2 securities for the purpose of the Group's regulatory capital requirements. The notes are issued to an affiliate. The notes have a carrying value of £100m and a fair value of £100m (31 December 2015: £100m).

The £250m subordinated loan notes mature in 2025 with a fixed 8% coupon paid annually in arrears. The notes are unsecured and classified as qualifying dated Tier 2 securities for the purpose of the Group's regulatory capital requirements. The notes were issued and initially recognised at fair value of £249m being issue proceeds of £250m less capitalised issue costs of £1m.

At 31 December 2016 the notes have a carrying value of £249m (31 December 2015: £249m) which is calculated based on an amortised cost basis, and a fair value of £258m (31 December 2015: £258m), as determined by traded levels. The notes are issued through the public debt markets.

For the year ended 31 December 2016, an interest expense of £20m (Year ended 31 December 2015: £3m) was recognised in the consolidated statement of comprehensive income in respect of these borrowings.

Note 25 – Share capital

On 5 April the Company sub-divided the A, B and C £1.00 Ordinary Shares into A, B and C ordinary shares with a nominal value of £0.001 each and the £1.00 preference shares into preference shares with a nominal value of £0.001 each. In the tables below for ease of comparison, the 31 December 2015 numbers have been adjusted to allow for this division. At 31 December 2016 and 31 December 2015 share capital comprised:

	31 December 2016		31 December 2015 (adjusted for 1000 for 1 conversion)	
	No.	**£m**	No.	£m
Ordinary share capital of £1.00 each	**30,001**	**–**	1	–
Ordinary share capital of £0.001 each	**1,034,034,369**	**1.0**	1,000,000,000	1.0
Preference share capital of £0.001 each	**1,034,034,369**	**1.0**	800,000,000	0.8
Authorised share capital	**2,068,098,739**	**2.0**	1,800,000,001	1.8

On 29 January 2016 the Company issued 30,000 £1.00 Ordinary D shares to an existing shareholder. The total cash consideration received was £30,000.

On 5 April 2016 the 200m £0.001 B Ordinary shares were converted into 81.4m new B Ordinary shares, 81.4m Preference shares and 37.1m Deferred shares. The Deferred shares were bought back by the Company on 7 April 2016 for £59.

On 11 April 2016 the Company allotted 152,607,000 Ordinary shares of £0.001 each and 152,607,000 Preference shares of £0.001 each to existing shareholders. The total cash consideration received was £200m, reflecting share premium of £199m.

All classes of shares have been fully paid.

The 12% preference shares are entitled to a preferential cumulative dividend of an amount equal to 12% per annum compounding annually and payable on wind up of the Company. The shares are non-voting but have the right to receive notice of meetings.

Note 25 – Share capital (continued)

The Ordinary shares issued are analysed into the following categories:

	31 December 2016		31 December 2015 (adjusted for 1000 for 1 conversion)	
	No.	£m	No.	£m
A £0.001 Ordinary	**789,429,000**	**0.8**	762,666,000	0.8
B £0.001 Ordinary	**–**	**–**	200,000,000	0.2
B £0.001 new Ordinary	**81,427,369**	**0.1**	–	–
C £0.001 Ordinary	**76,426,000**	**0.1**	37,334,000	–
D £1.00 Ordinary	**30,001**	**–**	1	–
E £0.001 Ordinary	**49,798,000**	**–**	–	–
F £0.001 Ordinary	**36,954,000**	**–**	–	–
Total	**1,034,064,370**	**1.0**	1,000,000,001	1.0

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

Number of shares	31 December 2016 No.	31 December 2015 (adjusted for 1000 for 1 conversion) No.
At 1 January	**1,800,000,001**	1,800,000,001
Ordinary share issuance	**34,064,369**	–
Preference share issuance	**234,034,369**	–
At 31 December	**2,068,098,739**	1,800,000,001

Employee benefit trust

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

On 19 February 2016 the Trust purchased 29,530 of the £1.00 B Ordinary Shares for consideration of £20.3m. On 5 April these along with shares received from employees who had left the Group were converted to 20,775,000 £0.001 B Ordinary shares and then converted to 13,209,560 £0.001 new B Ordinary shares, 13,209,560 £0.001 Preference shares and 6,205,880 deferred shares. As noted above, the deferred shares were bought back by the Company on 7 April 2016.

Over the remainder of 2016, the Trust acquired a further 180,361 new B Ordinary Shares and £0.001 Preference shares from employees who left the Group.

Notes to the financial statements continued

Note 26 – Share premium account and reserve

	Share premium £m	Capital contribution reserve £m	Employee scheme treasury shares £m	Profit and Loss reserve £m	Reorganisation reserve £m
At 1 January 2016	**266**	**5**	**–**	**637**	**132**
Profit for the financial year	**–**	**–**	**–**	**262**	**–**
Share issuance	**199**	**–**	**–**	**–**	**–**
Vesting of stock appreciation rights	**–**	**(4)**	**–**	**4**	**–**
Employee scheme treasury shares	**–**	**–**	**(20)**	**–**	**–**
Capital contribution	**–**	**2**	**–**	**–**	**–**
At 31 December 2016	**465**	**3**	**(20)**	**903**	**132**

	Share premium £m	Capital contribution reserve £m	Profit and Loss reserve £m	Reorganisation reserve £m
At 1 January 2015	266	5	357	132
Profit for the financial year	–	–	276	–
Vesting of stock appreciation rights	–	(4)	4	–
Capital contribution	–	4	–	–
At 31 December 2015	266	5	637	132

The capital contribution reserve arose as a result of the SARs granted in relation to the RLSIP (please see Note 11).

Note 27 – Derivatives

The Group utilises derivative financial instruments as part of its asset/liability risk management. It enters into derivative contracts to match the insurance contract liabilities arising on the insurance and reinsurance contracts that it issues.

The following table shows the fair value of derivative financial instruments, recorded as assets or liabilities, together with their notional amounts. The notional amount, recorded gross, is the amount of a derivative's underlying assets, reference rate or index and is the basis upon which changes in the value of derivatives are measured. The notional amounts indicate the volume of transactions outstanding at the year end and are indicative of neither the market risk nor the credit risk.

	31 December 2016			31 December 2015		
	Assets £m	**Liabilities £m**	**Notional amount £m**	Assets £m	Liabilities £m	Notional amount £m
Derivatives held for risk management:						
Interest rate swap	**9,891**	**(10,096)**	**101,692**	5,478	(5,256)	90,688
Inflation swap	**1,450**	**(1,496)**	**26,762**	1,321	(1,405)	27,814
Currency swap	**334**	**(379)**	**16,052**	114	(206)	10,232
Credit derivative	**23**	**(65)**	**3,028**	22	(44)	1,814
Foreign currency forwards	**11**	**(13)**	**633**	2	(7)	292
Total	**11,709**	**(12,049)**	**148,167**	6,937	(6,918)	130,840

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

The Group's exposure under derivative contracts is closely monitored as part of the overall management of the Group's market risk (see also Note 28). As of 31 December 2016, the Group had material positions in the following types of derivatives:

Note 27 – Derivatives (continued)

Interest rate swaps

Interest rate swaps are contractual agreements between two parties to exchange movements in interest rates. Typically, for an interest rate swap, a floating rate interest stream will be exchanged for a fixed rate or vice versa. The payment flows are usually netted against each other, with the difference being paid by one party to the other.

Inflation swaps

The Group uses inflation swaps and options to hedge the inflation linked benefits on the pension liabilities of the UK insurance business.

Currency swaps

In a currency swap, the Group pays a specified amount in one currency and receives a specified amount in another currency. Currency swaps are mostly gross–settled.

Credit derivatives

The Group uses credit derivatives to hedge counterparty risk on some of its assets in the event of default of corporate or sovereign bonds.

Forwards and futures

Forwards and futures contracts are contractual agreements to buy or sell a specified financial instrument at a specific price and date in the future. Forwards are customised contracts traded in the over-the-counter market. Futures contracts are transacted in standardised amounts on regulated exchanges and are subject to daily cash margin requirements. The main differences in the risk associated with forward and futures contracts are credit risk and liquidity risk. The Group has credit exposure to the counterparties of forward contracts. The credit risk related to future contracts is considered minimal because the cash margin requirements of the exchange help ensure that these contracts are always honoured. Forward contracts are settled gross and are, therefore, considered to bear a higher liquidity risk than the futures contracts which are settled on a net basis. Both types of contracts result in market risk exposure.

Interest rate swaptions

An interest rate swaption is an option contract that gives the buyer the right but not the obligation to enter into an underlying interest rate swap. The swaption buyer pays a premium to the seller at the initiation of the contract.

Note 28 – Financial risk management

The Group is exposed to financial risk through its financial assets, financial liabilities and insurance contract liabilities. These risks, described below, are managed in accordance with risk management policies and procedures established by the Group. Please see page 26 of the Strategic review for further detail on risk management arrangements and the governance framework within the Group.

Market risk

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

- Interest rate risk arises from discounting cash flow mismatches across all future dates. Profits and losses are generated through changes in the level, slope and curvature of interest rate curves. The risk is hedged by matching assets and liabilities and by using interest rate swaps.
- Inflation rate risk results from mismatches in the index linkage of annuities and assets. Profits and losses are generated through changes to the level, slope and curvature of inflation curves. The risk is hedged by matching assets and liabilities and by using inflation swaps.
- Currency rate risk results from mismatches in the denomination of annuities and assets. Profits and losses are generated due to changes in the level of foreign exchange rates. The risk is hedged using spot foreign exchange and cross currency swaps.
- Property risk results from investments that are secured on commercial or residential properties. Profits and losses may be generated by material movements in spot, or forward property prices. This risk is mitigated through strict underwriting criteria and low loan to value limits.

The Group manages market risk by diversifying exposures, controlling position sizes through limits and regular stress and scenario testing and establishing economic hedges in related securities, derivatives and insurance liabilities. The Chief Risk Officer and the risk function, which is independent of management and reports to the Chief Executive Officer, has responsibility for assessing, monitoring and managing market risk. Risks are monitored and controlled through strong oversight and independent control and support functions across the business.

Notes to the financial statements continued

Note 28 – Financial risk management continued
Market risk continued
Interest rate risk sensitivity analysis

Change in variables	31 December 2016 Impact on PBT £m	Impact on equity up to a year £m
(+) 1 basis point	**(0.6)**	**(0.5)**
(-) 1 basis point	**0.6**	**0.5**

Change in variables	31 December 2015 Impact on PBT £m	Impact on equity up to a year £m
(+) 1 basis point	0.3	0.3
(-) 1 basis point	(0.3)	(0.3)

There was no change in the method used for deriving sensitivity information and significant variables during the year.

Inflation rate risk sensitivity analysis

Change in variables	31 December 2016 Impact on PBT £m	Impact on equity up to a year £m
(+) 1 basis point	**0.04**	**0.03**
(-) 1 basis point	**(0.04)**	**(0.03)**

Change in variables	31 December 2015 Impact on PBT £m	Impact on equity up to a year £m
(+) 1 basis point	(0.4)	(0.3)
(-) 1 basis point	0.4	0.3

Credit risk
Credit risk represents the potential for loss, or solvency deterioration, due to the default or deterioration in credit quality of a counterparty or an investment we hold. Credit risk also arises from cash placed with banks and collateralised financing transactions, (i.e. resale and repurchase agreements) and receivables from customers and counterparties.

The Chief Credit Officer, who is independent from 1st line management and reports to the Chief Risk Officer, has responsibility for assessing and monitoring credit risk. All credit exposures are actively monitored by the 2nd line, including the use of a number of early warning indicators, resulting in regular reporting to the investment team and key governance bodies.

Senior management within the 1st line is responsible and accountable for managing credit risks within prescribed limits. They have in depth knowledge of the credit positions, underlying models and the instruments available to hedge the credit exposures.

Effective management of credit risk requires accurate and timely information, strong collateral management, a high level of communication and knowledge of customers, countries, industries and products.

Risk mitigants
To reduce the credit exposures on derivatives and collateralised agreement transactions, the Group enters into netting agreements with counterparties that permit it to offset receivables and payables with such counterparties that enable it to obtain collateral from them on an upfront or contingent basis and/or terminate transactions if the counterparty's credit rating falls below a specified level.

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

Note 28 – Financial risk management continued

Credit exposures

The Group's credit exposures are described further below.

Cash and cash equivalents. Cash and cash equivalents include both interest bearing and non-interest bearing deposits. To mitigate the risk of credit loss, the Group places its deposits with banks typically assigned minimum ratings in the single A rating category and central banks. Cash deposits with banks rated lower than the single A category are subject to approval by the Board Risk Committee, in line with Group's liquidity policy.

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

Collateralised agreements. The Group bears credit risk related to re-sale agreement and securities borrowed only to the extent that cash advanced to the counterparty exceeds the value of the collateral received or charges over assets. Therefore, the Group's credit exposure on the transactions is significantly lower than the amounts recorded on the balance sheet (which represents fair values or contractual value before consideration of collateral received). The Group also has credit exposure on repurchase agreements and securities loaned, which are liabilities on its consolidated statement of financial position, to the extent that the collateral pledged for these transactions exceeds the amount of cash received.

Other credit exposures. The Group is exposed to credit risk from its receivables from customers and counterparties. Receivables from counterparties are generally comprised of collateralised receivables related to customer securities transactions and have minimal credit risk due to the value of the collateral received. In addition, the Group invests in assets that are typically highly rated, or assets where there is underlying structural security in the event of a default. These assets include supranationals, sovereign bonds, subsovereign bonds, covered bonds, higher education bonds, infrastructure assets and secured residential lending.

Reinsurance. Long term business is ceded to reinsurers under contracts to transfer part of the insurance risk associated with the underlying insurance contracts. The amounts that will be recoverable from reinsurers is estimated based upon the gross provisions, having due regard to collectability. The recoverability of reinsurance recoveries is assessed having regard to market data on the financial strength of the reinsurance company.

The following table identifies the amounts covered by enforceable netting arrangements (netting under master netting agreements, cash collateral and security collateral) but do not qualify for netting under IAS32.

	31 December 2016	Related amounts not offset			
	Amounts of financial assets presented in the statement of financial position £m	Netting under master netting agreements £m	Cash collateral £m	Security collateral and charges £m	Net credit exposures £m
Exposure to credit risk by class					
Property, plant and equipment	**3**	–	–	–	**3**
Collective investment schemes	**860**	–	–	–	**860**
Government and agency obligations	**10,435**	–	–	–	**10,435**
Corporate bonds and other corporate debt	**9,035**	–	–	–	**9,035**
Derivative assets	**11,709**	**(8,485)**	**(651)**	**(2,559)**	**14**
Collateralised agreements and financing	**6,154**	**(496)**	**(260)**	**(5,398)**	–
Certificate of deposits	**153**	–	–	–	**153**
Reinsurance assets	**437**	–	–	–	**437**
Accrued income and prepayments	**278**	–	–	–	**278**
Receivables	**492**	–	–	–	**492**
Cash and cash equivalents	**152**	–	–	–	**152**
Total	**39,708**	**(8,981)**	**(911)**	**(7,957)**	**21,859**

Notes to the financial statements continued

Note 28 – Financial risk management continued
Credit risk continued

	31 December 2015 Related amounts not offset				
	Amounts of financial assets presented in the statement of financial position £m	Netting under master netting agreements £m	Cash collateral £m	Security collateral and charges £m	Net credit exposures £m
Exposure to credit risk by class					
Property, plant and equipment	2	–	–	–	2
Collective investment schemes	470	–	–	–	470
Government and agency obligations	6,137	–	–	–	6,137
Corporate bonds and other corporate debt	5,793	–	–	–	5,793
Derivative assets	6,937	(4,753)	(494)	(1,690)	–
Collateralised agreements and financing	5,135	–	(152)	(4,983)	–
Certificate of deposits	120	–	–	–	120
Reinsurance assets	274	–	–	–	274
Accrued income and prepayments	165	–	–	–	165
Receivables	381	–	–	–	381
Cash and cash equivalents	98	–	–	–	98
Total	25,512	(4,753)	(646)	(6,673)	13,440

Within the above table derivative liabilities are only included to the extent they net against derivative assets. Therefore, the amount of derivative assets shown after offsetting netting arrangements does not represent our overall derivative exposure. Our overall exposure can be seen in Note 27 Derivatives.

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

Netting under master netting agreements of £8,981m (2015: £4,753m) reflects the offsetting of derivative assets with liabilities for which the Group has a right to set off in the event of default. Cash and security collateral have been offset to the extent there are credit exposures on the balance sheet.

The Group has received total security collateral and charges of £9,229m (2015: £8,869m) of which £7,957m (2015: £6,673m) has been applied against net exposure, leaving excess of £1,272m (2015: £2,196m). Security collateral exposes the Group to further market and credit risk. This is mitigated through the use of haircuts and over collateralisation.

Credit default swaps and total return swaps (which contain credit protection) have been purchased to protect the Group from the default of corporate bonds, or counterparties. The table above does not reflect the protection provided. The Group calls margins, receivable in cash and gilt instruments, against this exposure and other derivative positions.

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

The table on page 87 shows the Group's gross and net credit exposure based on external ratings (lowest of Standard & Poor's, Moody's and Fitch ratings). In line with industry standards, Stability Ratings are used to rate the Money Market funds in which the Group invests £355m (2015: £328m) of the total net credit exposure relates to bonds held within negative basis packages, for which maturity, currency and reference obligation matched credit default swap protection is held.

Net credit exposure is primarily in 'AAA' and 'AA' bonds. AAA assets include supranational bonds, sub-sovereigns, covered bonds, US not-for-profit private universities and certificates of deposit. 'AA' assets include Gilts. Other net credit exposures rated 'A' and 'BBB' include investments in regulated infrastructure assets and English social housing bonds, which are secured on property assets.

Note 28 – Financial risk management continued

Net credit exposures rated non-investment grade are mitigated by the use of collateral or credit default swap.

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

	31 December 2016 Related amounts not offset				
	Amounts of financial assets presented in the statement of financial position £m	**Netting under master netting agreements £m**	**Cash collateral £m**	**Security collateral and charges £m**	**Net credit exposures £m**
Exposure to credit risk by rating					
AAA	**4,157**	**–**	**–**	**–**	**4,157**
AA	**12,488**	**(348)**	**–**	**–**	**12,140**
A	**13,679**	**(7,478)**	**(575)**	**(2,113)**	**3,513**
BBB	**3,075**	**(1,155)**	**(336)**	**(247)**	**1,337**
BB	**2,535**	**–**	**–**	**(2,448)**	**87**
B	**95**	**–**	**–**	**(44)**	**51**
Unrated	**3,679**	**–**	**–**	**(3,105)**	**574**
Total	**39,708**	**(8,981)**	**(911)**	**(7,957)**	**21,859**

The unrated financial assets of £3,679m (2015: £2,630m) reflect investments in issuers and issues that are not externally rated. During the year, the Group invested in unrated financial assets which are highly secured and subject to very low credit risk.

For the purpose of Solvency II, unrated assets are internally rated by the Group's independent credit risk function under a framework which has been externally reviewed.

	31 December 2015 Related amounts not offset				
	Amounts of financial assets presented in the statement of financial position £m	Netting under master netting agreements £m	Cash collateral £m	Security collateral and charges £m	Net credit exposures £m
Exposure to credit risk by rating					
AAA	3,181	–	–	–	3,181
AA	8,687	(182)	–	(1,643)	6,862
A	8,561	(3,811)	(401)	(2,485)	1,864
BBB	2,297	(760)	(244)	(225)	1,068
BB	53	–	–	–	53
B	103	–	(1)	(76)	26
Unrated	2,630	–	–	(2,244)	386
Total	25,512	(4,753)	(646)	(6,673)	13,440

Liquidity risk

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

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

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

Notes to the financial statements continued

Note 28 – Financial risk management continued
Liquidity risk continued
The liquidity management framework is designed to ensure that a prudent level of liquidity is maintained on a spot basis, but also under stressed market conditions at which time liquidity may leave the group through collateral outflows. A suite of market stresses are considered as part of the liquidity management framework, against which limits are applied by the Board.

The risk function which is independent of management and reports to the Chief Risk Officer, who reports to the Chief Executive Officer has primary responsibility for assessing, monitoring and managing liquidity risk. Risks are monitored and controlled through strong oversight and independent control and support functions across the business.

Senior management within the 1st line is responsible and accountable for managing liquidity risks within prescribed limits that are set by the Board and are overseen by the Board Risk Committee.

The following table details the Group's financial liabilities and assets by contractual maturity including interest that was accrued where the Group is entitled to repay the liability before its maturity. Financial assets and liabilities are presented at their fair value (with the exception of receivables, cash, accrued interest and borrowings) as this is consistent with the values used in the liquidity risk management of these instruments. The table excludes insurance liability cash flows and reinsurance asset cash flows which are included in Note 21.

	31 December 2016			
	Less than 1 year £m	**1 to 5 years £m**	**Over 5 years £m**	**Total £m**
Financial assets				
Financial investments	**2,246**	**3,805**	**32,295**	**38,346**
Accrued income and prepayments	**73**	**22**	**183**	**278**
Receivables	**492**	**–**	**–**	**492**
Cash and cash equivalents	**152**	**–**	**–**	**152**
	2,963	**3,827**	**32,478**	**39,268**
Financial liabilities				
Financial liabilities	**682**	**1,769**	**11,506**	**13,957**
Payables	**1,575**	**–**	**–**	**1,575**
Borrowings	**–**	**238**	**349**	**587**
Accruals and deferred income	**29**	**2**	**–**	**31**
	2,286	**2,009**	**11,855**	**16,150**
Net	**677**	**1,818**	**20,623**	**23,118**

	31 December 2015			
	Less than 1 year £m	1 to 5 years £m	Over 5 years £m	Total £m
Financial assets				
Financial investments	787	3,016	20,789	24,592
Accrued income and prepayments	134	13	18	165
Receivables	381	–	–	381
Cash and cash equivalents	98	–	–	98
	1,400	3,029	20,807	25,236
Financial liabilities				
Financial liabilities	130	2,105	6,569	8,804
Payables	1,080	–	–	1,080
Borrowings	–	–	349	349
Accruals and deferred income	23	4	–	27
	1,233	2,109	6,918	10,260
Net	167	920	13,889	14,976

Note 28 – Financial risk management continued

Collateralised agreements

Assets are transferred under repurchase and securities lending agreements with other financial institutions. The nature and carrying amounts of the assets (all carried at fair value) subject to repurchase and securities lending agreements as well as their related liabilities are as follows:

	31 December 2016		31 December 2015	
	Asset £m	**Related liability £m**	Asset £m	Related liability £m
Government and agency obligations	**2,347**	**1,908**	2,005	1,837
Corporate bonds and other corporate debt	**–**	**–**	54	49
Total collateralised agreements	**2,347**	**1,908**	2,059	1,886

As the substance of these transactions is secured borrowings and repurchase agreements the asset collateral continues to be recognised in full and the related liability reflecting the Group's obligations to repurchase the transferred assets at a future date is recognised in other liabilities. The Group remains exposed to interest rate risk and credit risk on these pledged instruments. The counterparty's recourse is not limited to the transferred assets.

The net exposures to certain OTC derivatives are collateralised through cash. As at 31 December 2016, the total cash collateral received was £1,468m (2015: £980m). Other OTC contracts are collateralised with fixed income securities which are not recognised on the balance sheet of the Group.

Note 29 – Capital management

The Group's capital resources are of critical importance. The Group's objectives in managing its capital are:

- To satisfy the requirements of its policyholders and regulators;
- To match the profile of its assets and liabilities, taking account of the risk inherent in the business;
- To maintain financial strength and allocate capital efficiently to support new business growth; and
- To retain financial flexibility by maintaining strong liquidity.

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

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

- The Group's technical provisions, being;
  - the liabilities of the Group calculated on a best estimate basis (the 'BEL'); plus
  - the risk margin; less
  - available transitional solvency relief.
- The capital required to meet a 1-in-200-year stress (calculated on a prescribed basis and known as the Solvency Capital requirement or 'SCR').

Capital in excess of that required to meet the technical provisions is known as Own Funds. As at 31 December 2016, Own Funds for the Group are £2,569m (Available capital as at 31 December 2015: £1,367m) made up as follows:

	31 December 2016 £m	31 December 2015 £m
Total IFRS equity	**1,485**	1,042
Liability valuation differences and other regulatory adjustments	**723**	–
Total Tier 1	**2,208**	1,042
SII debt valuation	**361**	–
Solvency I regulatory adjustments	**Not applicable**	325
Total Tier 2	**361**	325
Own funds/available capital	**2,569**	1,367

Notes to the financial statements continued

Note 29 – Capital management continued

The Group holds both debt and equity to optimise its capital structure and improve shareholder return. During the year ended 31 December 2016, £200m of equity was issued by the Group. The table below provides an analysis of the movement in Own Funds net of tax under Solvency II for 2016 next to the analysis of the movement in Solvency I Pillar 1 surplus for 2015. Differences between the two solvency bases mean that the movements are not directly comparable.

Movement in own funds net of tax	31 December 2016 £m	31 December 2015 £m
Opening balance	**1,367**	843
Impact of change of solvency regime	**535**	Not applicable
Opening Solvency II balance (1 January 2016)	**1,902**	843
New business	**288**	137
Management of in-force book	**175**	204
Acquisition costs and administration expenses	**(65)**	(52)
Demographic experience variance	**1**	8
Economic profits	**140**	(4)
Non recurring expenses	**(24)**	(12)
Finance costs	**(36)**	(13)
Share issuance	**199**	–
Employee based trust	**(20)**	–
Capital contribution	**3**	4
Debt issuance	**–**	250
Other	**6**	2
Closing balance as at 31 December	**2,569**	1,367

As part of the transitional arrangements in relation to the introduction of Solvency II, the Group is permitted to take credit for transitional solvency relief which amortises to zero over the next 16 years. The results make allowance for the first linear reduction in transitional. The transitional applied reflects the 30 June 2016 recalculation as approved by the PRA. The recalculation reflected the material change in economic conditions between the Aegon transaction and the recalculation date. This is allowed for in the relevant line items in the analysis above. No recalculation has been sought as at 31 December 2016.

The capital position is sensitive to changes in market conditions, due to changes in the value of the assets and the effect that changes in investment conditions may have on the value of the liabilities. The Group seeks to mitigate these risks through the use of derivative hedges and reinsurance. Management monitors market conditions and emerging longevity experience on a regular basis. As these conditions change, management will take remedial action such as adjustment of hedging strategies and redeployment of assets as appropriate.

Note 30 – Related parties disclosures

Ultimate holding companies

The companies with an economic interest in RHUK are:

- The Goldman Sachs Group, Inc.: 32.7%
- The Blackstone Group L.P.: 26.5%
- GIC Private Limited: 26.5%
- MassMutual Financial Group: 6.5%

The remaining percentage is owned by management, employees and The Trust (see Note 25). Percentages are based on economic interest in RHUK.

During the year ended 31 December 2016 the existing corporate shareholders subscribed for £200m of equity in the Group.

Note 30 – Related parties disclosures (continued)

Related party transactions

The Group entered into various transactions with fellow participating interests which are subject to common control from the same source. The fellow participating interests are all within The Goldman Sachs Group, including Goldman Sachs International, Goldman Sachs and Co, the Goldman Sachs Group Inc., Goldman Sachs Asset Management International and Rothesay Life (Cayman) Limited.

Details of transactions and balances in respect of these transactions are as follows:

	31 December 2016 £m	31 December 2015 £m
Statement of comprehensive income		
Realised/unrealised losses on financial assets and liabilities	**(936)**	(134)
Income from money market securities held in collective investment schemes	**2**	3
Interest on collateralised agreements and financing	**37**	37
Service fee charges	**(4)**	(3)
Investment management charges	**(8)**	(6)
Finance costs	**–**	(1)
Statement of financial position		
Derivative financial assets and liabilities	**(2,085)**	(1,355)
Collateralised agreements and financing	**935**	914
Collective investments schemes	**860**	470
Accrued interest	**9**	10
Amounts payable to related party	**(547)**	(227)
Capital		
Ultimate parent company	**468**	268
Capital contribution	**3**	5

During the year ended 31 December 2016 £nil (2015: £4m) of bonus payments were borne by a fellow participating interest, as part of a long term incentive arrangement. The Group was not charged for this expense in prior year.

The nominal value of derivatives contracts outstanding with related parties as at 31 December 2016 was £35,431m (2015: £36,425m).

The Group continues to develop fully independent infrastructure and computer systems. As of 1 September 2015 the Group fully migrated its middle office and back office functions to an independent third party. Any services/support which remains are provided by Goldman Sachs on an arms-length basis under a Transition Services Agreement (TSA).

Transactions with key management personnel

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

The 2016 numbers are not directly comparable to the 2015 numbers as we have amended the definition of key management personnel in line with the Solvency II regulations.

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

	31 December 2016 £m	31 December 2015 £m
Salaries, bonus and other employee benefits	**15**	9
Equity based compensation payments	**1**	–
Total transactions	**16**	9

Notes to the financial statements continued

Note 30 – Related parties disclosures continued

On 19 February 2016, eight members of key management personnel and their families sold 20,907 £1.00 B Ordinary Shares to The Trust for consideration of £14m.

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

Transactions with RPML	**31 December 2016 £m**	31 December 2015 £m
Statement of financial position		
Other receivables	**1**	1

Transactions with RLP	**31 December 2016 £m**	31 December 2015 £m
Statement of financial position		
Other payables	**30**	11
Capital	**814**	384
Dividends	**–**	130

Note 31 – Investments in subsidiaries

Subsidiaries

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

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

Group Undertakings	Country of Incorporation	Primary business operation	**2016 Held at lower of cost or net realisable value £m**	2015 Held at lower of cost or net realisable value £m	**2016 % equity interest**	2015 % equity interest
Rothesay Pensions Management Limited	UK	Service company	**–**	–	**100%**	100%
Rothesay Life Plc (formerly known as Rothesay Life Limited)	UK	Life insurance	**814**	384	**100%**	100%
Rothesay Assurance Limited (formerly known as MetLife Assurance Limited)	UK	Service Company	**3**	3	**100%**	100%
LT Mortgage Financing Limited	UK	Service company	**–**	–	**100%**	100%

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

LT Mortgage Financing Limited has remained dormant during 2016. On 3 October 2016 the PRA granted an application to cancel the permissions of Rothesay Assurance Limited. As it is now no longer needed the Group has begun proceedings to voluntarily liquidate Rothesay Assurance Limited.

Note 32 – Financial commitments and contingencies

Operating lease commitment

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

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

The future aggregate minimum lease payments under non-cancellable operating leases are as follows:

	31 December 2016 £m	31 December 2015 £m
Not later than one year	**1**	1
Later than one year and no later than five years	**8**	3
Later than five years	**6**	3
Total minimum lease payments	**15**	7

The Group signed a new lease during the year for an additional floor of The Leadenhall Building to accommodate the growth of the business.

Other commitments

During previous years the Group executed transactions to purchase partly funded bonds. The Group expects to pay a further £173m within the next 5 years (2015: £197m), £25m of this being due within 12 months of the financial reporting date (2015: £24m).

	31 December 2016 £m	31 December 2015 £m
Not later than one year	**25**	24
Later than one year and no later than five years	**148**	173
Later than five years	**–**	–
Total other commitments	**173**	197

Appendix – Changes in IFRSs

Adoption of new or amended standards

The Group has adopted the following new standards and changes to existing standards which are relevant to the Group's operations, and became effective for financial years beginning on or after 1 January 2016. These amendments have all been endorsed by the EU and are expected to have no impact on the Group financial statements.

IFRS 3 Business combinations

IFRS 3 has been amended to clarify that an obligation to pay contingent consideration which meets the definition of a financial instrument is classified as a financial liability or as equity, on the basis of the definitions of IAS 32, 'Financial instruments: Presentation'. The standard is further amended to clarify that all non-equity contingent consideration, both financial and non-financial, is measured at fair value at each reporting date, with changes in fair value recognised in profit and loss.

IFRS 13 Fair value measurement

The amendment clarifies that the IASB did not intend to remove the ability to measure short-term receivables and payables at invoice amounts following the removal of paragraphs B5.4.12 of IFRS 9 and AG79 of IAS 39.

IAS 19 Employee benefits

This amendment applies to plans that require employees or third parties to contribute towards the cost of benefits. The amendment does not affect the accounting for voluntary contributions.

IFRS 2 Share based payment

This amendment clarifies the definition of a 'vesting condition' and separately defines 'performance condition' and 'service condition'.

IAS 16 Property, plant and equipment and IAS 38 Intangible assets

Both standards have been amended to clarify how the gross carrying amount and the accumulated depreciation are treated where an entity uses the revaluation model.

IFRS 11 Joint arrangement

IFRS 11 provides specific guidance on accounting for the acquisition of an interest in a joint operation that is a business. The amendments address diversity in the practice related to the accounting for these transactions.

IAS 27 Separate financial statements

The IASB has amended IAS 27 to restore the option to use the equity method to account for investments in subsidiaries, joint ventures and associates in an entity's separate financial statements.

IFRS 10 Consolidated financial statements and IAS 28 Investments in associates

The IASB published amendments to IFRS 10 and IAS 28 which clarify the accounting treatment for sales or contribution of assets between an investor and its associates or joint ventures.

IAS 1 Presentation of financial statements

The amendments clarify guidance in IAS 1 on materiality and aggregation, the presentation of subtotals, the structure of financial statements and the disclosure of accounting policies. The amendments form a part of the IASB's Disclosure initiative, which explores how financial statement disclosures can be improved.

IFRS 8 Operating segments

The standard is amended to require disclosure of the judgements made by management in aggregating operating segments. This includes a description of the segments which have been aggregated and the economic indicators which have been assessed in determining that the aggregated segments share similar economic characteristics. The standard is further amended to require a reconciliation of segment assets to the entity's assets when segment assets are reported. The amendment has no impact on the Group financial statements because all of the Group's business is in a single segment.

IAS 24 Related party disclosures

The standard is amended to include, as a related party, an entity that provides key management personnel services to the reporting entity or the parent of the reporting entity. The reporting entity is not required to disclose the compensation paid by the management entity to the management entity's employees or directors, but it is required to disclose the amounts charged to the reporting entity by the management entity for services provided.

New or Revised Standard Not Yet Effective

The following new, revised standards, in issue, were not yet effective, or in some cases not yet endorsed by the EU. The Group has not early adopted any of these standards.

IFRS 14 Regulatory deferral accounts

IFRS 14 has been issued, an interim standard on the accounting for certain balances that arise from rate-regulated activities. IFRS 14 is only applicable to entities that apply IFRS 1 as first-time adopters of IFRS. It permits such entities, on adoption of IFRS, to continue to apply their previous GAAP accounting policies for the recognition, measurement, impairment and de-recognition of regulatory deferral accounts. The Group has already adopted IFRS and therefore the standard will not impact on the Group financial statements.

IAS 12 Income taxes

The amendments clarify the requirements for recognising deferred tax assets on unrealised losses. The amendments clarify the accounting for deferred tax where an asset is measured at fair value and that fair value is below the asset's tax base. The amendments also clarify certain other aspects of accounting for deferred tax assets. The Group does not expect the amendment to impact on the Group financial statements.

IAS 7 Cash flow statements

The amendment to IAS 7 introduce an additional disclosure that will enable users of financial statements to evaluate changes in liabilities arising from financing activities. The amendment is part of the IASB's Disclosure initiative, which continues to explore how financial statement disclosure can be improved. The Group does not expect the amendment to impact on the Group financial statements.

IFRS 9 Financial instruments (including amendments to IFRS 4 – Insurance contracts)

The final version of IFRS 9 includes requirements on the classification and measurement of financial assets and liabilities; it also includes an expected credit losses model that replaces the incurred loss impairment model used currently, in addition to the final hedging component of IFRS 9 that was issued in November 2013. IFRS 9 will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2018 and will allow early adoption. In September 2016, the IASB published amendments to IFRS 4, Insurance contracts that address the accounting consequences of the application of IFRS 9 to insurers prior to the publication of the forthcoming accounting standard for insurance contracts (IFRS 17, expected in 2017). The amendments introduce two options for insurers: the deferral approach and the overlay approach. The deferral approach provides an entity, if eligible with a temporary exemption from applying IFRS 9 until the earlier of the effective date of a new insurance contract standard or 2021. The overlay approach allows an entity to remove from profit or loss the effects of some of the accounting mismatches that may occur before the new insurance contract standard is applied. The Group has assessed the impact of the adoption of IFRS 9 and does not expect there to be material changes to the valuation of financial assets and liabilities, however the interactions with the forthcoming insurance contract standard will need to be assessed. There will be changes to the disclosures in relation to financial assets and liabilities and the Group continues to review the impact of these.

IFRS 15 Revenue from contracts with customers

IFRS 15, as issued in May 2014, establishes a new five-step model that will apply to revenue earned from a contract with a customer, regardless of the type of revenue or industry. The principles in IFRS 15 provide a more structured approach to measuring and recognising revenue and will be applied using the following five steps:

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognise revenue when (or as) the Company satisfies a performance obligation.

This new revenue standard, which is jointly issued by IASB and the United States Financial Accounting Standards Board (FASB), is applicable to all companies and will supersede the current revenue recognition requirements under IFRS. IFRS 15 will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2018 and will allow early adoption. The new standard will affect most entities that apply IFRS or US GAAP. The areas expected to provide the greatest impact are: transfer of control, variable consideration, licences, time value of money, contract costs and disclosures. As insurance is specifically excluded these changes will not impact on the Group.

IFRS 16 Leases

The standard will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after 1 January 2019. IFRS 16 replaces the current guidance in IAS 17. Under IAS 17, lessees were required to make a distinction between a finance lease (on balance sheet) and an operating lease (off balance sheet). IFRS 16 now requires lessees to recognise a lease liability reflecting future lease payments and a 'right-of-use asset' for virtually all lease contracts. The IASB has included an optional exemption for certain short-term leases and leases of low-value asset; however, this exemption can only be applied by lessees. The new standard will affect both the balance sheet and related ratios, such as debt/equity ratios. Depending on the particular industry and the number of lease contracts previously classified as operating leases under IAS 17, the new approach will result in a significant increase in debt on the balance sheet. The Group has assessed the impact of the operating leases for floors 25 and 32 of The Leadenhall Building. This is not expected to have a material impact on the financial statements of the Group.

Annual Improvements 2012–2014 Cycle

These improvements are effective from 1 January 2017 and are not expected to have a material impact on the Group. They include: IAS 12 Income taxes (recognition of deferred tax assets for unrealised losses) and Amendment to IAS 7 cashflow statements, disclosure initiative.

MCEV statements

Market Consistent Embedded Value

Supplementary financial statements

The Group has prepared supplementary financial statements on a Market Consistent Embedded Value (MCEV) basis. The results have been prepared in accordance with the European Insurance CFO Forum Market Consistent Embedded Value Principles (MCEV Principles) (Copyright © Stichting CFO Forum Foundation 2008) which were published in 2008 and revised in October 2009 and May 2016. Consistent with the MCEV Principles revision in May 2016 an explicit allowance has been made at 31 December 2016 for the new European regulatory regime (Solvency II). No allowance for Solvency II was made in comparative periods.

The Group considers that embedded value reporting provides investors with a useful measure of the future profit streams of the Group's in-force long-term business and is a valuable supplement to statutory accounts.

Group statement of financial position

As at 31 December 2016

	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Assets		
Value of in-force business	**699**	435
Financial investments and property, plant and equipment	**38,349**	24,594
Accrued interest and prepayments	**278**	165
Reinsurance assets	**437**	274
Receivables	**492**	381
Cash and cash equivalents	**152**	98
Total assets	**40,407**	25,947
Total equity	**2,173**	1,445
Liabilities		
Insurance contract liabilities	**22,071**	14,230
Payables and financial liabilities	**15,532**	9,884
Borrowings	**598**	358
Deferred tax liabilities	**2**	3
Accruals and deferred income	**31**	27
Total liabilities	**38,234**	24,502
Total equity and liabilities	**40,407**	25,947

The notes on pages 102 to 109 form an integral part of these supplementary financial statements.

Reconciliation of shareholders' equity on IFRS basis to shareholders' equity on MCEV basis

The Shareholders' equity on an MCEV basis is consistent with the sum of the Shareholders' equity on an IFRS basis, the value of in-force business ("VIF") as shown on page 105 and any debt valuation differences as shown on page 105.

The debt valuation difference arises as a result of the market value approach under MCEV which differs from amortised cost valuation under IFRS. During 2015 RLP issued £250m of subordinated debt through the public debt markets. This debt valuation was £9m higher on an MCEV basis as at 31 December 2016 (31 December 2015: £9m higher on an MCEV basis).

Prior to 1 January 2016, the MCEV was based on the Solvency I Pillar 1 balance sheet. As a result there were additional reserving differences between the IFRS balance sheet and the MCEV balance sheet which reflected an additional closure reserve held on a Pillar 1 basis which was deducted from the adjusted net worth of Rothesay Life Plc ("RLP"). This reserve is not held on an IFRS basis.

Group MCEV analysis of earnings (net of tax)

For the year ending 31 December 2016

In the table below, opening adjustments reflect the impact of adopting the revised MCEV principles as at 1 January 2016

Movement £m	Covered business (MCEV)	Non covered business (IFRS)	Total Group MCEV
Opening MCEV	**1,447**	**(2)**	**1,445**
Opening adjustments	**(36)**	**–**	**(36)**
Adjusted opening MCEV	**1,411**	**(2)**	**1,409**
Operating MCEV earnings	**357**	**–**	**357**
Non-operating MCEV earnings	**666**	**(259)**	**407**
Total MCEV earnings	**1,023**	**(259)**	**764**
Other movements in IFRS net equity	**–**	**–**	**–**
Closing MCEV	**2,434**	**(261)**	**2,173**

For the year ending 31 December 2015

Group MCEV Analysis of Earnings (net of tax) £m	Covered business (MCEV)	Non covered business (IFRS)	Total Group MCEV
Opening MCEV	1,342	(128)	1,214
Opening adjustments	–	–	–
Adjusted opening MCEV	1,342	(128)	1,214
Operating MCEV earnings	245	–	245
Non–operating MCEV earnings	(140)	126	(14)
Total MCEV earnings	105	126	231
Other movements in IFRS net equity	–	–	–
Closing MCEV	1,447	(2)	1,445

Notes to the MCEV supplementary financial statements

1. Basis of presentation
The Group's primary financial statements have been prepared in accordance with International Financial Reporting Standards. The MCEV supplementary financial statements have been prepared in accordance with the European Insurance CFO Forum Market Consistent Embedded Value Principles (MCEV Principles) (Copyright © Stichting CFO Forum Foundation 2008) which were published in 2008 and revised in October 2009 and May 2016. Consistent with the MCEV Principles revised in May 2016 an explicit allowance has been made for the new European regulatory regime (Solvency II), which became effective on 1 January 2016, and associated consequences. No allowance for Solvency II was made in the comparative periods consistent with the guidance issued by CFO Forum in 2012 and revised in October 2015.

Comparative information has been provided as at 31 December 2015.

a. Covered business
The covered business includes all business written by RLP. This business falls under the definition of long-term insurance business for UK regulatory purposes.

The adjustments applied to arrive at the Group MCEV are the market value of other entities within the Group.

At 31 December 2016 the Group adjustment included the deduction of £240m of debt from Rothesay Holdco UK Limited, which was issued during 2016.

b. New business
New business is defined as:
- premiums from the sale of new policies written throughout the year; and
- non-contractual increments on existing policies, transacted during the year.

Acquisitions are presented separately within the new business section. For the dates shown there were no acquisitions.

2. Methodology
The MCEV is the sum of the net worth of the Group companies plus the value of in-force business. For 31 December 2016 reporting, the methodology reflects the introduction of Solvency II as described below.

a. Net worth
The net worth is the market value of the shareholders' funds and the shareholders' interest in the surplus held in the long-term business funds, determined on a statutory IFRS basis at 31 December 2016 (or statutory solvency basis, with inadmissible assets included, for comparative periods).

The net worth consists of the required capital plus the free surplus of the Group. Free surplus is defined as the assets over and above the level of required capital, described below.

For the 31 December 2015 comparatives the net worth was reflecting a solvency I pillar I basis.

b. Value of in-force
The value of in-force covered business (VIF) consists of the following components:
- present value of future profits;
- time value of financial options and guarantees;
- frictional costs of required capital; and
- cost of residual non-hedgeable risks.

c. Present value of future profits
The present value of future profits (PVFP) is the present value of the distributable profits to shareholders arising from the in-force covered business projected on a best estimate basis and discounted using the risk free rate adjusted (where applicable) for the liquidity premium.

As at 31 December 2016 the PVFP reflects the distributable profits, net of tax payable, calculated on an IFRS basis rather than on a Solvency II basis. The PVFP has not been updated to reflect Solvency II technical provisions to retain consistency with the payment of tax. Solvency II allowances are made through the definition of required capital and the associated frictional costs of required capital elements of the MCEV. The alternative presentation of calculating the PVFP on a Solvency II basis would not change the total MCEV however the constituents would differ, in particular, there would be a transfer from PVFP to free surplus.

d. Time value of financial options and guarantees
There are no material financial options and guarantees, and therefore the time value is nil.

The basis for policyholder options is generally set by the Group to be profit-neutral. Where there are specific contractual clauses that diverge from this, these have been appropriately allowed for within the PVFP.

The Group currently has no guaranteed surrender terms exercisable at the unilateral discretion of the pension schemes. Some counterparties are able to surrender conditional upon certain solvency events. However for the purposes of the MCEV, it is assumed that the Group continues to meet these solvency requirements and hence no value is placed on these surrender rights.

e. Frictional costs of required capital

The additional costs to a shareholder of holding the assets backing required capital within an insurance company rather than directly in the market are known as frictional costs. The additional costs allowed for are the tax costs and any additional investment expenses on the assets backing the required capital. These costs are explicitly deducted from the PVFP.

Frictional costs are calculated by projecting forwards the future levels of required capital. Tax on investment return and investment expenses are payable on the assets backing required capital, up until the point that they are assumed to be released to shareholders.

At 31 December 2016, the level of required capital allowed for in the calculation reflects the additional capital over the IFRS reserves required to be held under the Group's capital policy, namely 130% of the Solvency Capital Requirement as set out in section 3(g).

For the 31 December 2015 comparatives the additional capital was based on 150% Solvency I capital resource requirement.

f. Cost of residual non-hedgeable risk

The cost of residual non-hedgeable risk (CNHR) covers risks not already allowed for in the time value of options and guarantees or in the PVFP. The allowance includes the impact of both non-hedgeable financial and non-financial risks. No allowance has been made within the CNHR for symmetric risks as these are diversifiable by investors. For the 31 December 2015 comparative the additional capital was based on 150% of Solvency Capital Resource requirement.

The risks which contribute to the CNHR component of MCEV are:

- Counterparty default risk: the risk of losses following the failure of counterparties, for example for longevity reinsurance and over the counter derivative transactions.
- Expense risk: the risk that the amount of expenses incurred differs from current projections.
- Operational risk: the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

These are considered to be asymmetric risks, of which operational risk is the most material element. We have allowed for diversification benefits to the extent that these are identifiable.

The Group's demographic risks exhibit no material asymmetry. Appropriate allowance has been made within the PVFP for these risks; therefore no further allowance has been made in the CNHR.

The CNHR has been presented as an equivalent average cost of capital charge across all residual non hedgeable risks considered to be asymmetric (as defined above), after allowing for diversification between these risks. The capital charge has been calculated in line with Rothesay's Own Risk and Solvency Assessment (ORSA), or Individual Capital Assessment (ICA) for comparative periods. This capital requirement has been modelled as running off in line with the cash flow profile of the best estimate liabilities excluding the longevity swap cash flows.

The resulting annual capital charge is 3.5% (31 December 2015: 3.25%).

g. Tax

The projected cash flows take into account all tax which the Group expects to pay.

	31 December 2016	31 December 2015
2016	**20.00%**	20.00%
2017	**19.25%**	19.25%
2018	**19.00%**	19.00%
2019	**19.00%**	19.00%
2020	**17.50%**	18.25%
2021 +	**17.00%**	18.00%

h. Consolidation adjustments

Group entities have been incorporated at the market value.

The Group MCEV is net of external debt.

Notes to the MCEV supplementary financial statements continued

3. Assumptions
Economic assumptions

a. Reference rates
In setting the risk-free rate a mid-price swap yield curve is used as shown in the table below:

Term (years)	1	5	10	20	30	50
31 December 2016	**0.55%**	**0.87%**	**1.26%**	**1.49%**	**1.45%**	**1.26%**
31 December 2015	0.85%	1.63%	2.07%	2.28%	2.21%	2.04%

For annuity business, swap rates are adjusted for a 'liquidity premium' in deriving the reference rates. The liquidity premium is applied as a term specific addition to the swap curve set out above. The derivation uses a target investment mix and therefore aims to consider the types of investments in which the Group invests, but does not correspond exactly to the current asset holdings.

The liquidity premium is calculated on a daily basis and considers the spread over the risk-free rate observable for various asset classes. An appropriate deduction is made to the spread for credit risk. The deductions make reference to market observable credit risk information and the resulting deduction is prudent relative to historical defaults.

The in-force liquidity premium adjustment as at 31 December 2016 was 116bps, after the deduction of investment management costs. The comparable liquidity premium adjustment as at 31 December 2015 was 111bps.

No liquidity premium is used in the valuation of longevity swap contracts.

The liquidity premium on new business is calculated at the point of sale and is determined using an approach consistent with that assumed for the in-force business.

b. Expenses
Expenses attributed to covered businesses have been included in the MCEV calculations. Future expense assumptions include an allowance for third party administration, investment management and maintenance expenses as well as project expenses.

No future productivity gains have been anticipated. Where subsidiary companies provide administration, investment management or other services to our life businesses, the value of profits or losses arising from these services have been included in the embedded value of new business.

c. Expense inflation
Internal and third party administration expenses are projected to increase at RPI, plus a margin where appropriate.

As at 31 December 2016 the assumed rate of future expense inflation is equivalent to 3.76% (31 December 2015: 3.44%).

For internal service companies the fees charged to the life company reflect the underlying expenses incurred.

d. Exchange rates
The Group has a small amount of euro denominated liabilities. These cash flows have been converted to GBP using levels implied from cross currency swap quotes.

Non-Economic assumptions
e. Demographic assumptions
Assumed future mortality has been derived from an analysis of experience with a view to giving a best estimate of future experience. Where appropriate this has been adjusted for anticipated future changes in experience, that is improvements in future policyholder longevity are allowed for.

Recent mortality experience has been analysed for each pension scheme and reinsurance contracts at the end of 2016. Where the data was considered statistically credible, the mortality assumptions used in the valuation are based on this actual mortality experience. Where the data is not statistically credible, the Group has taken into account reinsurance quotes and proprietary socio-demographic models, based on postcode and other factors. A consistent approach has been used to derive the demographic assumptions used for new business written during 2016.

f. Non-hedgeable risk

For the balance sheet a charge of 3.5% (3.3% at 31 December 2015) has been applied to the group-diversified capital required on a 1-in-200 one-year basis over the remaining lifetime of in-force business. The capital levels used are projected to be sufficient to cover non-hedgeable risks at the 99.5% confidence. The level of the diversified capital requirement to which the charge is applied is £253m (31 December 2015: £173m). The resulting cost of non-hedgeable risks is £99.5m (31 December 2015: £67.5m).

g. Required capital

The projected level of required capital to support the business is derived from the Group's capital management policy, which is to hold sufficient assets to meet the higher of:

- Solvency II Pillar 1 Technical Provisions (net of transitional measures) plus 130% of RLP's Solvency Capital Requirement (SCR). In comparative periods, this was prudent reserves plus 150% of RLP's long term insurance capital requirement (LTICR) and resilience capital requirement (RCR);
- Best estimate liabilities plus the economic capital requirement.

The economic capital requirement calculates the one year value-at-risk to a 99.8% confidence interval. The Group's capital requirement is driven by 130% of RLP's SCR. Historically the Group's capital requirement was driven by 150% of RLP's LTICR and RCR.

The Solvency II Pillar 1 transitional measures were recalculated at 30 June 2016 in response to the reduction in interest rates to 30 June 2016. Amortisation of the transitional measure is applied over 16 years on an annual basis first reducing 31 December 2016.

h. Valuation of debt

Borrowings in the MCEV Consolidated Statement of Financial Position are valued at their market value as determined by traded levels.

Movement (£m)	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Face value	**590**	350
Amortised costs	**(3)**	(1)
IFRS valuation	**587**	349
Face value	**590**	350
Effect of marking to market	**8**	8
Market value/Fair value	**598**	358

4. Group embedded value

Rothesay Life Group MCEV (£m)	Year ended 31 December 2016 £m	Year ended 31 December 2015 £m
Net worth	**2,093**	1,370
Value of in-force business		
Present value of future profits	**899**	578
Frictional cost of required capital	**(101)**	(75)
Cost of non-hedgeable risks	**(99)**	(68)
Value of in-force business	**699**	435
Sub-debt	**(358)**	(358)
MCEV of RL	**2,434**	1,447
Debt	**(240)**	–
Net assets liabilities of other Group companies	**(21)**	(2)
Group MCEV	**2,173**	1,445

Notes to the MCEV supplementary financial statements continued

5. Covered business analysis of movement in embedded value (net of tax)
For the year ending 31 December 2016

Movement £m	Net Worth	VIF	Debt	MCEV impact	Group adjustments	MCEV
Opening MCEV	1,370	435	(358)	1,447	(2)	1,445
Solvency II model adjustment	22	(58)	–	(36)	–	(36)
Adjusted Opening MCEV	1,392	377	(358)	1,411	(2)	1,409
New business value	31	299	–	330	–	330
Management of In force book	267	(194)	–	73	–	73
Expenses	(47)	–	–	(47)	–	(47)
Demographic Experience variance	1	–	–	1	–	1
Operating MCEV earnings	252	105	–	357	–	357
Economic variances	64	124	–	188	–	188
Other non-operating variances	385	93	–	478	(259)	219
Total MCEV earnings	701	322	–	1,023	(259)	764
Closing MCEV	2,093	699	(358)	2,434	(261)	2,173

The format of the analysis of movement has been updated in 2016, as permitted by the MCEV principles to be consistent with IFRS reporting given the move during the period to reflect IFRS net worth in the MCEV presentation.

Commentary

The opening adjustment shows the impact on the MCEV as at 31 December 2015 of updating the required capital to reflect the capital policy under Solvency II and of moving from a Solvency I balance sheet presentation to an IFRS balance sheet presentation. The impact is relatively small due to the existence of transitional measures which reduce the amount of additional capital required over the next 16 years.

The new business value shows the incremental MCEV, at the point of sale, from single premium bulk annuity transactions and inward reinsurance over 2016. Longevity reinsurance in place at point of sale is also allowed for in the new business value.

The management of in force book reflects assumption changes (both VIF and liability valuation) and includes profits made through the year due to asset trading activities, transacting additional reinsurance, expected returns and demographic releases, data cleanse exercises and other data movements.

Expenses reflect the actual maintenance expenses along with acquisition expenses that have not been allocated against new business profits.

Demographic experience variance represents the impact on MCEV of actual experience during the year relative to the expected assumptions at the start of the year.

Economic variances arise from market movements in credit spreads, illiquidity premium, interest rates and inflation compared to expectations. Economic conditions were significantly more volatile during 2016 than in previous years. The main contributor to the movement in MCEV due to economic variances was LIBOR where 30 year rates fell close to 75bps during the year. The impact on the MCEV balance sheet was driven by significant market movements during the year and by the decision to hedge the Solvency II balance sheet.

Other non-operating variances net worth includes £240m of loan capital borrowed by RHUK during the year. £230m of the proceeds of this loan were paid as equity to RLP. A further £200m of equity capital was injected into RHUK by existing shareholders. In addition, the movement in net worth from non operating variances also reflects debt financing costs and non-recurring expenses net of tax.

The movement in VIF from non-operating variances reflects the reduction in the long term tax rate to 17% from 18% and a methodology change to the construction of the liquidity premium used for MCEV purposes. The revision increased the liquidity premium by 3.5bps.

For the year ended 31 December 2015

Movement £m	Free surplus	Required capital	VIF & Sub-debt	RL MCEV
Opening MCEV	256	716	370	1,342
New business value	(365)	219	340	194
Expected existing business contribution	24	(1)	6	29
Transfers from VIF and required capital to free surplus	48	(21)	(27)	–
Experience variance	26	(13)	(14)	(1)
Assumption changes	(27)	4	24	1
Other operating variances	451	(40)	(391)	20
Operating MCEV earnings	**157**	**148**	**(62)**	**243**
Economic variances	17	(22)	(4)	(9)
Other non-operating variances	96	–	(227)	(131)
Total MCEV earnings	270	126	(293)	103
Closing MCEV	**526**	**842**	**77**	**1,445**

6. Value of new business over the year ended 31 December 2016

The following table sets out the after-tax value of new business for the year ended 31 December 2016, calculated at the point of sale:

Group MCEV for new business (£m)	**Year ended 31 December 2016**	Year ended 31 December 2015
Net worth	**31**	(146)
Present value of future profits	**335**	365
Frictional cost of required capital	**(14)**	(13)
Cost of non-hedgeable risks	**(22)**	(12)
Group MCEV	**330**	194

£6.6bn of new business premiums were written in the year ending 31 December 2016 (31 December 2015: £3.2bn). This excludes regular premiums generated on the in-force inwards longevity reinsurance business written in prior years.

Economic and demographic assumptions have been used at the point of sale. The MCEV modelling assumptions for new business are consistent with those used for the in-force business, as described in the basis of preparation.

The 31 December 2016 figures have been calculated on a Solvency II basis in line with the main results. At the point of sale of the Aegon transaction a transitional recalculation was performed which is reflected in the results.

The net worth does not reflect the impact of managing the new and acquired business, such as profits arising from investing assets received as premiums through the rest of the financial year.

The weighted average liquidity premium at point of sale for new business written during the year ending 31 December 2016 was 129bps (31 December 2015: 88bps). This is slightly higher than the total in-force assumption at 31 December 2016, due to the reduction in the illiquidity premium since 30 June 2016. The figure was broadly in line with the total in-force assumption at 30 June 2016.

Notes to the MCEV supplementary financial statements continued

7. Sensitivities

The following tables show the sensitivity of the total MCEV to:

- 1% increase and decrease in the risk-free rate of interest. No floor has been applied to the risk-free rate of interest in these sensitivities. The impact of dynamic hedging is allowed for as interest rates change.
- 1% increase and decrease in inflation. The covers both expense inflation and benefit inflation.
- 10 basis point increase and decrease in long term credit default assumptions. This stress has not been applied to UK government guaranteed debt or supranational bonds.
- Required capital equal to 100% of SCR (100% of LTICR and 100% of RCR in comparative year).
- No sensitivity to equity or property has been shown as the Group does not directly invest in these asset classes.
- Annuity base mortality 5% higher and lower than the central case (i.e. 105% and 95%, respectively, of the central mortality rates).
- Expenses 10% higher than the central case (i.e. 110% of the central assumption). Maintenance, third party administration, investment management and project expenses have all been subjected to the stress. There is no change to expense inflation assumption.
- No sensitivity to lapse rates has been shown as the Group is not exposed to the lapse of future premiums.
- In calculating the change in Solvency II capital required in each scenario it is assumed that the transitional has been recalculated and that the Financial Resource Requirement which underpins the liability to Solvency I pillar 1 does not bite.

Sensitivities at 31 December 2016

	Net worth	VIF	Debt & group adjustments	MCEV
As reported (£m)	**2,093**	**699**	**(619)**	**2,173**
Economic Assumptions				
interest rates +1%	**25**	**(39)**	**16**	**2**
interest rates -1%	**203**	**74**	**(18)**	**259**
inflation +1%	**94**	**23**	**–**	**117**
inflation -1%	**41**	**(66)**	**–**	**(25)**
credit default +10bps	**(91)**	**11**	**–**	**(80)**
credit default -10bps	**89**	**(8)**	**–**	**81**
Required capital equal to 100% of SCR	**–**	**30**	**–**	**30**
Non-economic assumptions				
Base mortality -5%	**(71)**	**5**	**–**	**(66)**
Base mortality +5%	**68**	**(5)**	**–**	**63**
Expenses +10%	**(46)**	**15**	**–**	**(31)**

The impact on the MCEV, including new business, has been presented as follows:

- The net worth is calculated based on the impact on IFRS profit and is consistent with Note 21 of the financial statements net of tax. The tax impact on the IFRS profit; taken by applying the current tax rate at 31 December 2016, of 20%, to the pre-tax profit figure. A simplified approach has been taken to the treatment of any potential deferred tax asset created under the shock, as it has been assumed that losses have offset profit created in the current accounting period.
- The VIF component of the MCEV; which is the sum of the PVFP, Frictional Cost of Capital and Cost of Non-hedgeable Risk.
- The debt and group adjustments include the effect of marking the debt to market in the interest sensitivities. £250m of fixed debt was issued in 2015 for which there are traded levels; therefore the valuation is sensitive to market movements.

In each sensitivity calculation all other assumptions remain unchanged unless otherwise stated.

The sensitivities above include the new business written over the year. The risk profile of the new business written was materially similar to that of the in-force business. The impact of the sensitivities applied to new business in isolation can therefore be simplified as the same proportional impacts as those shown in the previous table.

Comparative sensitivities at 31 December 2015

	Net worth	VIF	Debt & group adjustments	MCEV
As reported (£m)	1,370	435	(360)	1,445
Economic assumptions				
interest rates +1%	23	(84)	17	(44)
interest rates -1%	52	124	(19)	157
inflation +1%	9	70	–	79
inflation -1%	47	(60)	–	(13)
credit default + 10bps	(42)	–	–	(42)
credit default - 10bps	43	–	–	43
Required capital equal to 100% LTICR + 100% RCR	–	24	–	24
Non-economic assumptions				
Base mortality -5%	(72)	8	–	(64)
Base mortality +5%	68	(8)	–	60
Expenses +10%	(23)	4	–	(19)

Statement of Directors' responsibilities

In respect of the MCEV Basis Supplementary financial statements
When compliance with the MCEV Principles is stated, those principles require the Directors to prepare supplementary information in accordance with the methodology contained in the CFO Forum Principles and to disclose and explain any non-compliance with the guidance included in the CFO Forum Principles.

In preparing this supplementary information, the directors have done so in accordance with these CFO Forum Principles and have also fully complied with all the guidance included therein. Specifically, the directors have:

- determined assumptions on a realistic basis, having regard to past, current and expected future experience and to relevant external data, and then applied them consistently;
- made estimates that are reasonable and consistent;
- provided additional disclosures when compliance with the specific requirements of the CFO Forum Principles is insufficient to enable users to understand the impact of particular transactions, other events and conditions and the Group's financial position and financial performance.

The supplementary financial statements were approved by the Board of Directors on 22 March 2017 and were signed on its behalf by:

Andrew Stoker
Chief Financial Officer
30 March 2017

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

Report on the consolidated MCEV financial statements

Our opinion

In our opinion, the consolidated MCEV financial statements, defined below, for the year ended 31 December 2016 have been properly prepared, in all material respects, in accordance with the European Insurance CFO Forum MCEV Principles issued in June 2008, as amended in October 2009 and May 2016 (CFO Forum Principles), and the Basis of Preparation set out on pages 102 to 105.

This opinion is to be read in the context of what we say in the remainder of this report.

What we have audited

The consolidated MCEV financial statements, which are prepared by Rothesay Holdco UK Limited, comprise:

- the group statement of financial position as at the year ended 31 December 2016;
- the reconciliation of shareholders' equity on IFRS basis to shareholders' equity on MCEV basis as at 31 December 2016;
- the group MCEV analysis of earnings (net of tax) for the year ended 31 December 2016; and
- the notes to the consolidated MCEV financial statements.

The consolidated MCEV financial statements have been prepared in accordance with the CFO Forum Principles and the Basis of Preparation set out on pages 102 to 105.

We have reported separately on the consolidated financial statements of Rothesay Holdco UK Limited prepared on an IFRS basis for the year ended 31 December 2016. The information contained in the consolidated MCEV financial statements should be read in conjunction with the consolidated financial statements prepared on an IFRS basis, included within the Annual Report of Rothesay Holdco UK Limited for the year ended 31 December 2016 (Annual Report).

What an audit of consolidated MCEV financial statements involves

An audit involves obtaining evidence about the amounts and disclosures in the consolidated MCEV financial statements sufficient to give reasonable assurance that the consolidated MCEV financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the Group's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the consolidated MCEV financial statements.

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the other information contained in the Annual Report to identify material inconsistencies with the audited consolidated MCEV financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Independent auditors' report to the Directors of Rothesay Holdco UK Limited
continued

Responsibilities for the consolidated MCEV financial statements and the audit

Our responsibilities and those of the directors

The Directors are responsible for preparing the consolidated MCEV financial statements in accordance with the MCEV basis set out in the Basis of Preparation on pages 102 to 105. Our responsibility, as set out in our letter of engagement dated 18 July 2016, is to audit and express an opinion on the consolidated MCEV financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinion, has been prepared for and only for the Company's directors as a body in accordance with our letter of engagement dated 18 July 2016 and for no other purpose. We do not, in giving this opinion, 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.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Chartered Accountants
London
30 March 2017

Notes:
(a) The maintenance and integrity of the Rothesay website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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Rothesay life

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