



Our aim is to enhance Royal London's position as a substantial force in UK financial services, providing a range of products and services to a broad spread of customers, and to continue to deliver good returns for our customers and members.

#### **Our objectives**

- Grow the value of the Group for the benefit of members
- Continue to build effective relationships with IFAs and extend the reach of our distribution through other intermediary channels
- Maintain our own direct distribution capacity to serve UK customers
- Continue to develop a focused product range, covering the areas of protection, investment and pensions
- Provide high quality, efficient servicing to our customers and use our skills to manage business from other providers
- Deliver strong investment performance
- Attract new teams and businesses in order to expand in key areas

At the end of 2002,  
the Royal London Group  
reviewed its strategy  
and business structure.

We now operate through  
four business units.



## ROYAL LONDON INTERMEDIARY

Manufactures products and  
distributes them through IFAs and  
other intermediaries under the  
Scottish Life and Bright Grey brands

IFAs provide the key interface  
between customers and ourselves

## ROYAL LONDON RETAIL

Distributes products and offers  
financial advice directly to our  
customers through a consultancy  
service and salesforce

Our consultants guide our customers  
through their financial choices



## ROYAL LONDON ASSET MANAGEMENT

Provides fund management for the  
Group and sells investment products  
to the institutional and retail markets

Focused on growing the  
value of our investors' funds

## ROYAL LONDON SERVICING

Provides servicing for customers of  
Royal London Retail and Scottish Life

Delivering high levels of  
service to our customers



## Chairman's statement

# achieving our goal of delivering value

The challenges which the Royal London Group has faced during 2002 have demonstrated the importance of the strategy which we have implemented over the last three years. As a Group we are now larger, more diverse in the products we offer and broader in the channels through which we operate. This breadth has been invaluable in a difficult operating period during which we have been able to increase new life, pensions and investment business to £239m and added £115m to the guaranteed benefits under with-profits policies.

The structure we have established provides a firm basis for delivering the Group's objectives, which are outlined at the front of this report. At the heart of the Group's goals is our drive to increase the value of the Royal London Group. In a turbulent market, the Board has concentrated on this objective, seeking the best allocation of capital across the Group and ensuring that business plans focus on delivering profitability from every Group activity.

### The external environment

The Board paid close attention throughout 2002 to the financial strength of the Group. The falls in equity markets seen in 2000 and 2001 continued and accelerated in 2002, with further deterioration at the start of 2003.

The extent of the falls required a careful response and we have actively managed our asset mix during the year. We have been steadily reducing the proportion of equities which we hold in the Royal London with-profits funds since the

summer of 2001. By switching into bonds we limited the reduction in the value of our funds and also ensured that the Group's liabilities were matched against less volatile assets. This has ensured that throughout the year the Group maintained sufficient funds to meet its liabilities, over and above the margin that our regulator, the FSA, requires us to hold.

The falls in stock markets have been reflected in lower bonuses to with-profits policyholders. While the smoothing of returns offers some protection, annual bonuses and final payouts have had to be reduced. Disappointing as it is that bonus rates have been reducing, the returns that with-profits policyholders enjoy remain attractive in comparison with many other long term investments.

### The political and regulatory framework

There were several regulatory and political proposals during the year of interest to the Group. Mike Yardley comments on some of these in his Group Chief Executive's review but I would like to highlight one aspect of particular interest for many of our members.

Our retail customer base of over three million people demonstrates how effective face-to-face financial advice was in distributing products in the last century and advice remains popular today. People have an understandable reluctance to make complex and long-term financial decisions, based only on their own research. The counsel of a financial adviser is invaluable in guiding people through their options and helping them to make provision for the future.

Over the last ten years the regulatory framework around face-to-face advice has increased costs at a time when product margins have shrunk. Consequently the number of financial advisers in the industry has reduced, particularly in the tied sector. There is a growing recognition that this is a problem which needs to be addressed. Proposals last year from the FSA included the suggestion of a less-regulated sales force. Ron Sandler's report on Savings and Long Term Investments built on some of these ideas with a stakeholder suite of products. But relaxing distribution rules while tightening margins further, by imposing an arbitrary 1% cap on product charges, is not the answer. It has been pleasing to see that the Treasury is now seeking views on the alternatives. We will certainly be pressing the case that delivering the new stakeholder products will require more flexibility in charging structures. We want to serve our customers, but we must be able to do so profitably.

### Mutuality and governance

Three members' roadshows were held in the Autumn in Brentwood, Birmingham and Glasgow. Around 200 members attended the three events and were given the chance to hear from Mike Yardley and his senior colleagues about the Group and its current activities and to raise questions of their own.

The meetings provided an opportunity to seek members' views on our Articles, and in particular matters such as postal voting. Our consultation on the Articles will continue during the year.

# £239million

We have been able to increase new life, pensions and investment business to £239m

# £115million

We have added £115m to the guaranteed benefits under with-profits policies

### The Board

Andrew Longhurst, our Deputy Chairman, retired from the Board at the end of May 2002. Andrew made a most valuable contribution to our business in his two years as Deputy Chairman, during which we achieved the successful and cost effective integration of United Assurance Group. Following Andrew's retirement, Tim Melville-Ross was appointed as Deputy Chairman. Tim has been a member of the Board since 1999.

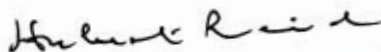
At the start of 2003 we welcomed Fields Wicker-Miurin to the Board. Fields has had a distinguished and varied career in business and public service and is at present a member of the Executive Board of the Department of Trade and Industry and Chair of its Investment Committee. From 1 May we will also welcome Robert Jeens. Robert has extensive experience as both an executive director, with Kleinwort Benson and Woolwich, and has a number of non-executive director posts. Both Fields and Robert join as non-executive directors and will bring a fresh perspective to the Board's debates.

Barry Fitzgerald will be retiring from the Board following the AGM at the end of April. Barry's contribution to Royal London has been remarkable. He joined in 1972 and held progressively more senior positions in the sales force, becoming Sales and Marketing Director in 1996 and an executive director in 1997. His intimate knowledge of the business, his depth of management experience and his warmth and humour will be much missed throughout the Group.

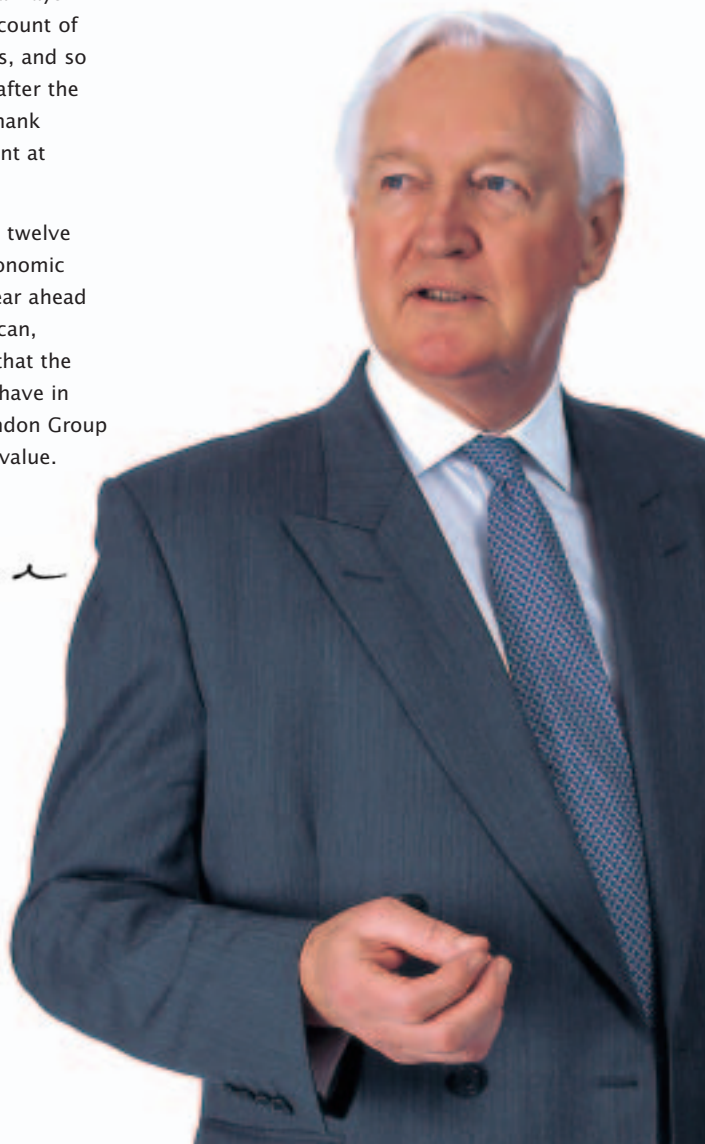
### The future

I would like to thank the employees of Royal London for their contribution during the year. Responding to the current market has required the Board to take some difficult decisions, in particular the restructuring of the Group announced last December, which led to a number of redundancies. The Board is always mindful of the need to take account of the interests of all stakeholders, and so such decisions are taken only after the most careful consideration. I thank employees for their commitment at this time.

We have been through a tough twelve month period and both the economic and political outlook for the year ahead remain difficult to predict. We can, however, say with confidence that the business plans which we now have in place will ensure the Royal London Group achieves its goal of delivering value.



**HUBERT REID**  
Chairman



## Group Chief Executive's review

2002 has been a **year of solid achievement** in very challenging markets

Positioning Royal London's business for the future shape of the financial services market has been a cornerstone of our strategy over the last three years. Our two acquisitions have transformed our scale of operations, diversifying our income streams towards the IFA sector and driving down unit costs. Royal London now generates around 75% of its new business from IFAs, but we have not forgotten our home service roots.

**MIKE YARDLEY** Group Chief Executive



## NEW BUSINESS (£m)



Figures on an annual premium equivalent (APE) basis excluding investment only mandates. 2001 figure is on a pro forma basis meaning Scottish Life included from 1 January 2001.

## PREMIUM INCOME (£m)



2001 figure on a pro forma basis.

## FUNDS UNDER MANAGEMENT (£bn)



Figures as at 31 December. The 2002 figure includes around £700m (2001 £900m) managed externally on behalf of the Group.

### A strategy for changing times

Towards the end of 2002 the Board completed a major review of Group strategy to ensure Royal London is well-positioned for the challenges ahead. Our chosen strategic direction builds on the successes of the past. As the U.K.'s second largest mutual life assurer, we will continue to be both a manufacturer and a distributor of financial services. We will distribute primarily via IFAs while retaining for our retail customers a direct distribution channel, which we regard as important for our long term future.

We will seek to maintain and develop excellence in products and services. Whether we distribute our products through intermediaries or direct to the customer, we need to supply the products our customers want, serviced in a high quality and efficient manner at a reasonable cost. Where appropriate we will seek new partnerships and alliances to improve the provision of products and services.

We have commenced implementation of plans which will make further operational savings across the Group. These plans have seen a restructuring of the Group into four business units as described at the front of this report. This will lead to improved service, performance and operating efficiencies. By identifying areas of distribution growth and tackling the

cost issues, we aim to restore rapidly all parts of the Group to profitability.

### Group performance

2002 has been a year of solid achievement in very challenging markets. It was an impressive performance to increase new business to £239m (APE). This was primarily due to strong growth of 28% in pensions sales through intermediaries. This outweighed the anticipated reduction in retail sales as our direct sales force contracted.

Significant falls in stock markets during the year resulted in funds under management declining by £2.8bn to £22.2bn. The pro forma Group operating cost base has reduced significantly as outlined in the Group Finance Director's review.

### The changing market

The external market is subject to significant change, much of it driven by regulatory developments. We anticipate greater diversity in the distribution of financial products in the future. We are supportive of many of the changes in this area and believe that a freer market, still subject to appropriate levels of regulation, will benefit the consumer by offering greater choice of products and wider access to providers.

In the pensions area, we welcome the simplification proposals from the Inland Revenue. However, the Department

for Work and Pensions Green Paper did not address many of the structural issues, particularly around suitability and the interaction between private pension savings and the Government's means tested benefits. Without addressing these issues in tandem, the scale of change in private provision can only be limited and we run the risk that the need of an ageing population to provide for itself in retirement will not be met.

It is clear from the feedback from our customers, as well as from the responses to the consultation papers, that face to face advice remains of paramount importance in providing financial products which meet customer needs. The value of face to face advice must not be under-estimated as regulation is formulated in the months to come. The Chairman has described our views on recent proposals for stakeholder products, which are of great interest to our retail business. We have also been active in the consultation on changes to the polarisation regime. We think it is right that the regulatory measures already announced have not required any fundamental change to the IFAs business model. This is important to the health of the IFA sector. We will continue to make representations on political and regulatory issues which are of importance to the Group.

we are able to offer the **full range** of pensions services



#### **ROYAL LONDON INTERMEDIARY**

Our largest intermediary business is Scottish Life, which became part of the Royal London Group in July 2001. Scottish Life specialises in pensions which now form around 75% of the Group's new business. Scottish Life is now a marketing division of Royal London. The other Scottish Life brands provide a range of products and services through intermediaries. Bright Grey will provide protection products.

#### **Investment performance**

2002 saw global equity markets suffer their worst year for nearly three decades. Markets had to contend with weaker economies, corporate accounting scandals, and the potential for armed conflict with Iraq. Over the year, the FTSE All-World US Index was down 29.8%, the FTSE All-Share UK Index by 22.7%, and the FTSE W Europe ex-UK by 27.1%.

While all major equity markets saw negative returns on the year, all major bond markets produced positive returns. Low interest rates helped underpin bond valuations. UK gilts performed well with the FTSE All Stocks Index up 9.2%. Corporate bonds also registered positive returns despite the slowdown in global economic activity. UK commercial property produced positive returns with capital values remaining firm and relatively high yields.

#### **Bonuses**

Against a background of falling equity markets we have had to make some difficult decisions. It has been necessary to reduce regular and final bonuses although our total payouts on with-profits policies are still among the industry leaders. As I stated in last year's review, the economic climate and the move towards a sustained low interest rate/low inflation period mean that the trend in maturity payouts will continue to be downward for the near future. Further details on the Group's bonus declaration are given in the Group Finance Director's review on page 13.

#### **Royal London Intermediary**

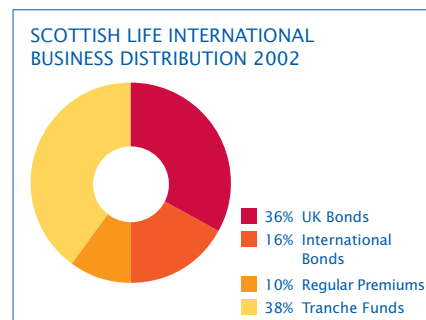
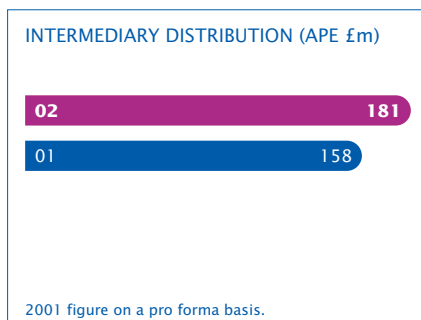
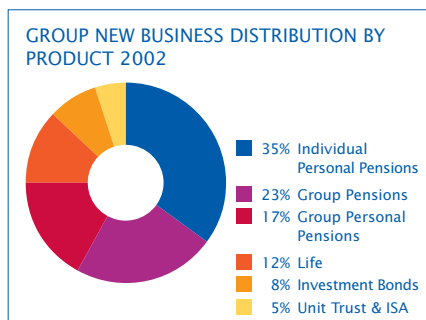
Overall, new business sold through intermediaries grew by 14% to £181m (APE). The strong sales result amply demonstrates the success of our strategy of broadening our distribution channels. Given the importance of the intermediary sector of the marketplace, building effective relationships with IFAs is a key part of our plans for the years ahead.

#### **Scottish Life**

Group pension sales were especially buoyant with growth of over 52%. Individual and group personal pensions also showed a strong growth rate of 21%.

Our ability to offer all types of defined contribution arrangements through the Retirement Solutions package launched in 2001 continues to underpin our success in this sector of the market.

Considerable product development has been going on during 2002, the fruits of which will be seen in a number of enhancements to our pensions product range during 2003. During the second quarter we plan to introduce further improvements to both our Retirement Solutions and other group pension scheme services to enable a greater degree of self-service administration for IFAs and employers. We will also be launching our new individual pension plan, replacing our older Talisman product with a modern product design. This will be followed up in the second half of the year with an income drawdown version of the new plan.



The Royal London Group is well-placed to benefit from continuing moves by employers from defined benefit to defined contribution arrangements. We are able to offer the full range of pensions services to intermediaries and employee benefit consultants – packaged pension products through Scottish Life Pensions, investment only services through Royal London Asset Management and pension administration services through Scottish Life Administration Services.

#### *Scottish Life Administration Services*

SLAS further developed its business offerings during 2002, providing specialist pension administration services to life offices and occupational schemes under the DC Solutions brand. The numbers of members of pension schemes being administered grew to some 38,000 during the year and we foresee significant further growth over the coming years, as the occupational pensions sector continues to see significant change.

#### *Scottish Life International*

The investment market in which SLI operates was extremely difficult last year, with volatile investment conditions creating a loss of consumer confidence. The impact of this was evident across the whole retail investment industry, being 40% down on last year.

SLI sales fell in line with the market to £20m (APE). Tranche products and international bonds particularly suffered. The latter was compounded by the introduction of temporary, but significant, exchange controls in one of our key markets.

However, it is pleasing to note that our UK core single premium sales actually rose by 13%. A Protected Bonus Bond was developed and launched in November, giving a late boost to tranche sales.

Distribution strategy has been reviewed in the light of current market conditions. We are building up a specialist SLI UK sales team and are refocusing our international efforts. A significant launch of our single premium products is currently taking place

  
**Scottish Life**  
 a marketing division of  
 Royal London

  
**Scottish Life**  
**INTERNATIONAL**  
 a Royal London company

**bright grey™**  
 a division of Royal London

  
**Solutions**  
 @ Scottish Life

  
**Scottish Life**  
**Mortgages**  
 a marketing division of  
 Royal London

Group Chief Executive's review continued

### ROYAL LONDON ASSET MANAGEMENT

Royal London Asset Management provides fund management for the Group and other institutions. At the end of 2002 RLAM had £21.5bn funds under management. Royal London Cash Management and Royal London Private Equity also form part of our asset management unit.



in Germany and will be followed later in the year by further product development and an extension of sales to the Austrian market.

#### *Scottish Life Mortgages*

SLM increased income levels by almost 28%. SLM packages a wide selection of mortgages for IFAs from a number of leading lenders.

Demand for this specialist service continues to grow. To support and drive this growth, in February this year SLM introduced a new front-end sourcing system supplying both online and offline facilities to IFAs, together with a variety of direct links to provider sites.

#### *Bright Grey*

Our new protection business, Bright Grey, set itself a challenging plan in early 2002 to launch an innovative service-focused business. The requirements of launching a truly differentiated business have proved considerable. Bright Grey is completing its launch at the end of the first quarter of 2003 and we are confident that it will make a substantial impression in the protection market.

### Royal London Asset Management

The Royal London Asset Management (RLAM) team demonstrated its investment capabilities in a difficult market, maintaining its strong record in fixed interest and cash, and improving its UK equity performance. The Royal London Income Unit Trust was ranked in the 17th percentile for the year by Standard & Poors Micropal, while the Scottish Life Unit-Linked Balanced Managed Pension fund ended the period in the 21st percentile.

RLAM has begun to increase the funds it manages for third party clients. New investment only mandates totalled £186m in 2002. While this was 13% below the figure for 2001, that year included £150m in respect of the launch of an investment trust. Excluding that, new mandates in 2002 almost trebled reflecting the first full year following acquisition of our cash management business.

Considerable work was done during 2000 and 2001 to integrate the fund management businesses of United Assurance Group and Scottish Life with

RLAM. This has been successfully achieved without disturbing our investment process and together with our improving performance record has enhanced RLAM's reputation. Royal London was the winner over the year in the Insurance Funds Larger Group section of the Standard & Poor's Fund Awards 2003. This reputation can only serve us well in the future as we look to grow new investment business.

We were pleased to have been awarded nine specialist fixed interest and equity mandates in 2002, the most notable being the 'best-of-breed' multi-manager programmes by Attica Asset Management and Northern Trust Global Investors for UK equity and UK fixed interest respectively. During 2002, Royal London Cash Management and Royal London Asset Management C. I. Ltd continued to increase funds under management, opening a total of 22 new accounts (compared with 16 in 2001). Our cash management businesses worked closely with the fixed interest and equity teams to explore new business opportunities.

## we were a **winner** in the Standard & Poor's Fund Awards 2003

Following approval from the Central Bank of Ireland, Royal London Asset Management International's Sterling Liquidity Fund was launched on 30 December 2002. The fund will be marketed and distributed in the UK. In addition to this, an Irish-domiciled high income bond fund will also be launched by RLAM early in 2003. These funds are evidence of the further development of our investment product range.

Royal London Private Equity continued to develop during the year. Having recently obtained FSA authorisation, the team is now in a position to commence marketing a new private equity fund, which is expected to launch shortly.

RLAM will look to maintain its strong investment performance throughout 2003, and build upon the reputation already established within the industry. We will also continue to expand our product range and funds under management, providing our institutional and retail clients with a comprehensive range of investments.

### Royal London Retail

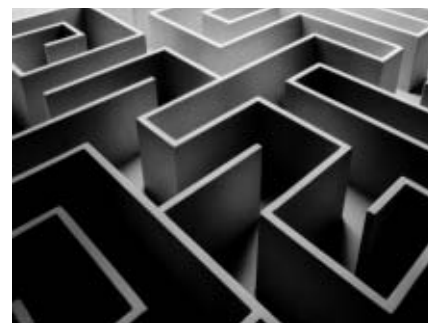
The market conditions for our retail business continued to be severe during 2002, particularly due to ongoing margin pressures. Responding to this, we progressively reduced the number of financial consultants during the year, while increasing productivity levels. Total sales levels reduced to £58m (APE) in 2002, but there was a proportionately greater reduction in the losses on new business.

It is apparent that we cannot provide to all our customers a profitable face to face full advice service on financial services products through our financial consultants. We have decided to focus our Consultancy Service on those customers who are more likely to require a full advice service, usually because they have higher levels of income or existing savings.

In anticipation of changes in the industry as part of the Sandler report and FSA depolarisation proposals, we set up pilot sales teams selling simpler, less regulated products such as general insurance and mortgages to our existing customers. In most cases these products are provided by other companies, and sold under the Royal London brand. The pilot proved successful and this sales force is now being grown in a controlled fashion during this year and next. To support this development we have been broadening the scope of our less regulated product range with the introduction of Funeral and Health Cash Plans.

Our contact centre is being developed to provide a pivotal role in integrating our distribution channels and serving our customers. It will co-ordinate a central customer management process, including all telephone and web customer contact, with new business leads either managed at the centre or directed automatically to the most appropriate channel.

### RETAIL NEW BUSINESS (£m) APE



### ROYAL LONDON RETAIL

Our retail strategy puts a strong emphasis on achieving profitable growth. While retaining our brand promise of financial advice through face to face contact, we are committed to building a profitable direct channel through better targeting our customer groups, enhanced use of technology and improved integration of distribution channels.

providing **high quality service** to all our customers



#### ROYAL LONDON SERVICING

Our servicing business manages around 6.9 million policies, handling 3.3 million letters and phone calls each year.

#### Royal London Servicing

Our servicing operations have been established as a separate business unit to provide still greater focus on profitably serving all our customers. We have significant expertise in managing existing books of business and in running collections operations. This provides us with the potential to manage these activities for third parties and we are reviewing the options for growing our servicing business in this way.

Fuelled by the increase in scale we have made over the last two years, the profitability of the business was ahead of our planned targets last year. While maintaining profitability is vital, our immediate focus is on providing high quality service to all our customers by ensuring best service practices are shared across the group. Delivery of quality service is essential to our continuing success and as a separate business unit we can ensure this receives the right level of attention.

Efficient service delivery was the cornerstone of our customer service teams in Wilmslow during last year. Improvements in key performance targets were made month on month throughout the year, with significant cost savings also being achieved.

The substantial growth in group pensions within Scottish Life last year led to the development of backlogs in parts of our customer services division. This was especially disappointing to us and we therefore established a special initiative in September, drawing in substantial resource from across the Group to improve service to our customers. Relations with our IFAs and customers are, of course, vital to us and I am pleased to say that this initiative has already gone a long way towards restoring our levels of service.

Our premium operations teams collect approximately £10m every month from some 740,000 households. Our primary aim is to provide a high quality collection service. This is inevitably quite costly and we have continued to reorganise this part of our business to maximise efficiency.

Some 20% of customers have decided to switch from cash collection to direct debit, which has helped to reduce operating costs. July 2002 also saw the successful completion of a major change programme to migrate older Royal London business onto our advanced palmtop collection devices. This programme enabled us to restructure to operate with over a third less staff than previously and without the need for an expensive office network, resulting in significant cost savings.

### Our employees

I am very pleased to offer my thanks for the way in which all Royal London employees have risen to the challenges of the year. For those employees affected by the redundancies announced at the end of the year it has, of course, been particularly difficult. We have consulted extensively on these changes and sought to ensure that the greatest possible support is given to employees who are leaving.

We have always recognised the importance of having well-trained and highly motivated employees if we are to meet our business objectives. We undertook an extensive survey of employee satisfaction levels during the year. The results of this survey, and our commitment to employee development, will help us raise further the skills of our employees and in turn, the service we provide to our customers.

### Conclusion

In what has been a difficult year, the Board has maintained a focus on enhancing the value of the Group for the benefit of members.

Value in our Group has two main components – operating performance and investment returns. We measure our operating performance by closely tracking the changes in the value of future profits emerging on business already in force and the value of new business written.

This focus on value has greatly helped us to optimise operating performances from our business units, by the early identification and correction of under-performing or loss-making areas.

The three year bear market has had a significant adverse effect on investment returns, reducing the value of the Group. Looking ahead, we foresee a more positive investment climate emerging, albeit in more modest terms than seen in the 1990's. This together with further improvements in operating performance will generate a recovery in the value of the Group over the next few years.

The adverse environment of recent years has left its mark on all life insurance companies. We can, however, take satisfaction that Royal London has been forward thinking in transforming its business. This will ensure the Group has a strong and vibrant future and will remain a substantial force in the financial services market.



**MIKE YARDLEY**  
Group Chief Executive

## Group Finance Director's review

# Royal London's with-profits policies remain amongst the **top performers**



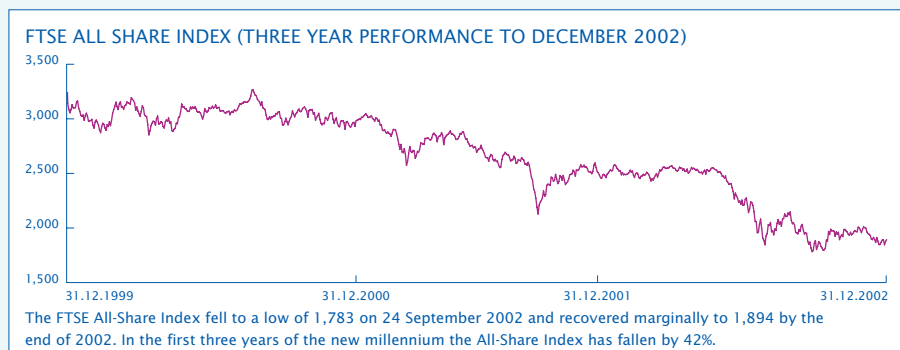
**STEPHEN SHONE**  
Group Finance Director

Financially, 2002 has been dominated by falling stock markets which have impacted on both our free assets and our ability to make bonus declarations at previously anticipated levels.

However, as discussed in the Group Chief Executive's report, we have still grown our sales and have been able to reduce operating expenses – our strategy is focused on achieving these two objectives year on year until we reach an acceptable level of profitability.

Royal London has historically benefited from a substantial level of free assets and by pre-emptive action we have managed our balance sheet effectively through dire investment markets.

The Company operates two with-profits funds: the Scottish Life fund, a closed fund established on 1 July 2001 which includes all the acquired Scottish Life non-linked, mainly with-profits business; and the Royal London Fund which includes all other non-linked business and into which all new non-linked business is written. Total assets within these funds have reduced from £20.0bn at the end of 2000 (including Scottish Life as if it was then part of the Group) to £17.0bn by 31 December 2001 and to £15.1bn at the end of 2002. During 2002 both funds experienced a negative investment performance on assets backing with-profits business. After investment income the Royal London Fund fell 12.7%. The Scottish Life fund has a higher proportion of bonds due to the mix of liabilities and had a better performance, falling 9.5%.



### Bonus declaration

In last year's accounts I stated; 'Royal London is renowned for its strong financial reserves and excellent record in relation to payouts on maturing policies. This year, however, we have been faced with some unusually difficult decisions and we have been even more mindful of the future prospects for bonus declarations and policy benefits. With-profits policies are designed to smooth out returns earned on investments but in deciding on the bonus declaration this year, the Board had to take into account the very poor stock market performance in 2001.'

At that time we did not anticipate that the investment markets would experience another negative year in 2002. Given the exceptional falls in markets over 2002, we have announced regular and final bonuses which reflect an average reduction in payouts on maturing policies of 18% compared with an average reduction of 12% declared last year.

Nevertheless, despite the fall in bonuses, returns on Royal London's with-profits policies remain amongst the top performers.

The bar charts illustrate a return of 5.0% per year over the life of a 10 year endowment policy and 12.2% per year on the life of a 25 year policy. These returns equate to 2.5% per year and 6.8% per year respectively after inflation and are net of basic rate tax. The equivalent figures for pension policies are marginally better, mainly due to their tax status.

The total surplus distributed to with-profits policyholders is detailed below:

	2002 £m	2001 £m
Regular bonuses added to policies	115	270
Final bonuses paid in the year	293	360
	408	630

Note: Regular bonuses are added to policy values each year and final bonuses are those actually paid in the year. For comparability purposes the table includes Scottish Life's figures prior to acquisition for the period 1st January to 30th June 2001.

We anticipate that final bonuses of approximately £220m will be paid during 2003 compared with £293m in 2002. Details of the bonus declarations for 2002 are set out on pages 51 to 54.

The reductions in bonuses are reflected across the whole savings industry and are a consequence of the poorer investment performance of the stock markets. Although policy payouts have been reducing in recent years and are likely to continue to reduce, it is important to recognise that real returns (i.e. returns above price inflation) have been attractive and are expected to continue to be attractive.

Note: In the tables to the right, endowment returns and yields are based on a male aged 30 next birthday paying £50 per month, with a policy maturing on 1 February for the year shown. Pension policy yields are based on a male paying £200 per month with the policy vesting on 1 January in the year shown at age 65. Figures are for policies originating in Royal London unless otherwise stated. Past performance is not necessarily a guide to future performance. The value of a policy is dependent on how profit is distributed.

### TOP PERFORMING ENDOWMENTS (£)

Red Rose	94,954
Liverpool Victoria	93,474
Wesleyan	89,732
<b>Royal London</b>	<b>87,543</b>
Children's Mutual	82,126
NFU Mutual	80,553
Ecclesiastical	77,681
Standard Life	75,984
CIS	74,265
Britannic	73,641

Note: Proposed 2003 maturity payout on 25 year regular premium with-profit endowment. Source: Money Management (April 2003) top ten out of 26 listed.

### ENDOWMENT RETURNS ON MATURITY (£)

10 year term

03 7,750

02 9,488

25 year term

03 87.543

02 107.714

### ENDOWMENT YIELDS ON MATURITY

10 year term

03 5.0%

02 8.9%

25 year term

03 12.2%

02 13.5%

### PENSION POLICY YIELDS AT VESTING

10 year term

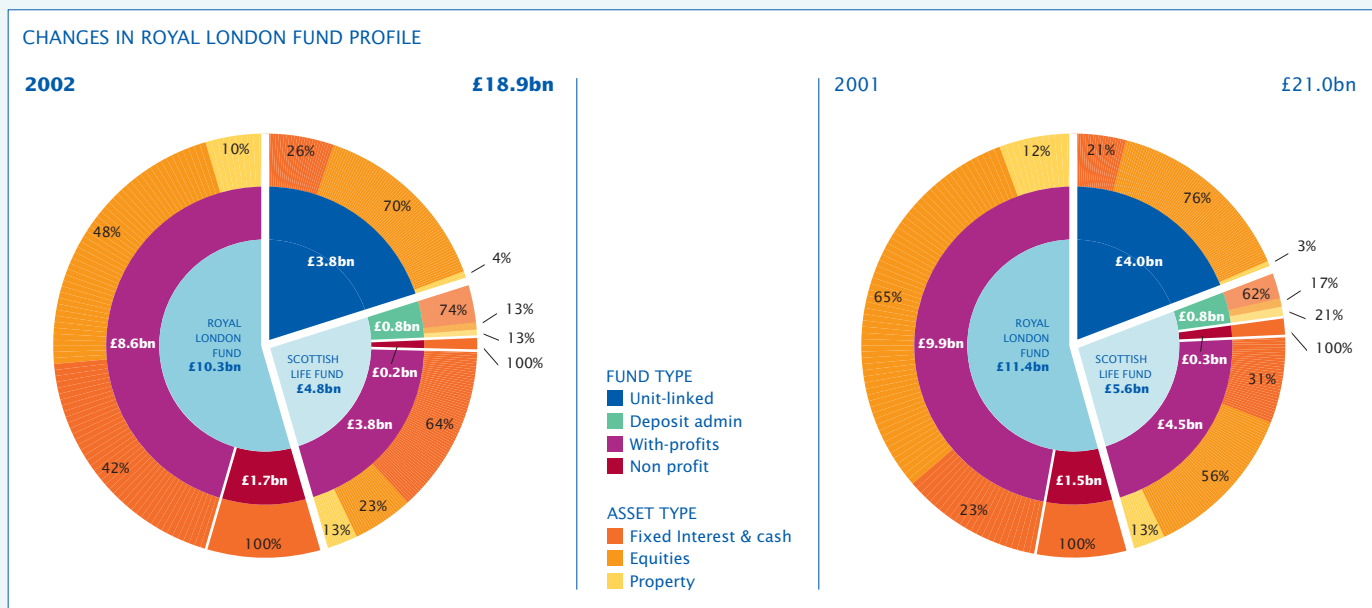
03 6.4%

02 10.1%

25 year term

03 12.7%

02 14.2%



**Fund structure**

The Group's fund structure is fairly complex. I hope the following information, together with the charts above, will be useful.

At the end of 2002, RLAM managed assets of £21.5bn of which £18.9bn (2001 £21.0bn) are assets relating to Royal London's life and pensions business. The figure includes £3.8bn (2001 £4.0bn) of unit-linked assets where the underlying investment risk lies solely with policyholders – this is the dark blue segment in the chart. There is £1.9bn (2001 £1.8bn) of non profit, predominantly annuity business – the red segment – and £0.8bn (2001 £0.8bn) of pensions deposit administration business – the green segment. The remaining £12.4bn (2001 £14.4bn) relates to the with-profits funds of which £8.6bn (2001 £9.9bn) is Royal London's with-profits fund and £3.8bn (2001 £4.5bn) is the separately managed Scottish Life fund.

The outer band in the charts shows the investment allocation between asset classes. During 2002 we have reduced the equity content of the Royal London with-profits fund from 65% to 48% and the equity content in the Scottish Life with-profits fund from 56% to 23%.

**Financial strength**

In such turbulent times there has been a great deal of focus on the financial strength of life companies.

The financial strength of Royal London has historically provided the flexibility to invest a large proportion of its assets in equities and property which have the most potential to achieve capital growth over the long term.

A priority for the Board is to make effective use of Royal London's capital by recognising the need at all times to satisfy regulatory requirements, while balancing the desire to achieve high investment returns for policyholders against an acceptable level of investment risk. We have monitored our free assets carefully over the course of the year, and took action during the last eighteen months to reduce the equity content of our investment portfolio. This action mitigated the impact of falling stock markets on our investment return.

From the end of 2003 the current regulatory system will be replaced by a system that will require each company to perform a detailed assessment of the capital needed to support the risks associated with its own business. A review of the fixed interest portfolio was completed during 2002, and

some adjustments were made to the spread of holdings, with a view to reducing capital requirements under this new regime.

Financial strength in the life assurance industry is measured by a company's 'free assets', which are the excess of its assets over liabilities. A number of commentators publish surveys showing 'free asset ratios' for the industry. These surveys usually make use of the statutory returns made by life companies to the regulators rather than the Report and Accounts.

The statutory reporting to regulators is on a cautious basis, consistent with their objective of ensuring, as far as possible, that companies can meet their liabilities as they fall due. For example, if an asset does not have a published market value or is not readily realisable then, in general, it may not be brought into account for the purpose of demonstrating solvency to the regulators. This can lead to undervaluing free assets, especially when a company has made acquisitions, making it difficult for external commentators to understand a company's true financial position.

Under current regulations the amount of capital needed to manage and continue to sell new long term insurance business is determined by complex formulae which

## MOVEMENT IN STATUTORY SURPLUS DURING 2002

	Surplus £bn	With-profits liabilities £bn	With-profits free asset ratio	Total long-term liabilities £bn	Free asset ratio
As at 31 December 2001	1.8	12.8	14.1%	19.4	9.3%
Investment return net of associated changes to liabilities	(0.9)				
Movement in the reserve for market fluctuations	0.7				
Surplus distributed to with-profits policyholders	(0.4)				
Other	0.2				
As at 31 December 2002	1.4	11.3	12.4%	17.8	7.9%

Note: Free asset ratios are stated before deducting the required minimum margin of solvency required for regulatory purposes. The required minimum margin of solvency required for regulatory purposes was £0.6bn as at 31st December 2002, which compares with the statutory surplus of £1.4bn.

## COMPONENTS OF THE FUND FOR FUTURE APPROPRIATIONS AT 31 DECEMBER 2002

	Surplus £bn	With-profits liabilities £bn	With-profits free asset ratio	Total long-term liabilities £bn	Free asset ratio
Statutory Surplus at 31 December 2002	1.4				
Reserve for market fluctuations	0.3				
Goodwill, deferred tax asset and pension scheme assets	0.4				
Implicit items in excess of acquired in-force business	(0.3)				
Net other	0.1				
Fund for future appropriations at 31 December 2002	1.9	11.1	17.1%	17.6	10.8%

are fairly prescriptive in nature and contain what are widely perceived as excessive margins of prudence. The FSA is in the process of replacing this system with a less prescriptive system that will be more tailored to the individual circumstances of each office. In preparation for introducing this new system the larger offices were asked to provide the FSA with 'realistic' valuations of their assets and liabilities, meaning valuations that exclude the excessive prudence required under the current approach. As one of the participants in this exercise Royal London was able to confirm that on a realistic basis its financial strength is considerably greater than on the present statutory basis, before including an implicit item. We welcome the initiatives the FSA are taking in this regard and hope that this will restore confidence in the insurance sector.

We have not utilised any financial reinsurance to enhance our free assets. We have subordinated debt of £125m which originates from Scottish Life and have not taken advantage of raising any further subordinated debt because we believe that the cost of this capital outweighs the benefits to our policyholders even though it could directly improve our level of reported free assets.

Royal London's free asset ratio was 7.9% (2001 9.3%) at the end of 2002. This is the ratio measuring assets against all long-term liabilities. Financial strength required for unit-linked, non-profit and deposit administration business is much less due to the closer matching of assets and liabilities and hence the free asset ratio for with-profits business only is of greater importance. This was 12.4% (2001 14.1%) at the end of 2002.

The second table reconciles our statutory free assets to the fund for future appropriations included in our published balance sheet. Statutory free assets includes an 'implicit item' of £0.8bn agreed with the regulator two years ago. This represents a prudent assessment of future profits expected to emerge. The use of this implicit item indirectly reflects the rights to future profits on the acquired business of United Assurance Group and Scottish Life, being otherwise disallowable for statutory reporting purposes.

**Profit and loss account**

In order to help the understanding of our accounts we have summarised the main components of our Profit and Loss Account in the table on page 16.

The key points to note from the results are:

- Premium income of £2,052m mainly comprises £811m of regular premiums and £1,248m of single premiums, of which £355m and £931m respectively relates to Scottish Life business. Total premiums were 4% higher in 2002 compared with 2001, including Scottish Life as part of the Royal London Group for the entire period.
- Claims of £2,186m are 11% higher than in the previous year, again including Scottish Life as part of the Group for the entire period.
- The decrease in policyholder liabilities during 2001 is partly due to the fall in stock markets, particularly in respect of unit-linked liabilities. The decrease is also due to changes to valuation bases which has reduced liabilities by approximately £350m, albeit these changes have no impact on statutory free reserves reported to the FSA.
- The investment return reflects the ongoing turmoil within the equity markets which has created significant losses, including pension scheme losses.

## Group Finance Director's review continued

## PROFIT AND LOSS ACCOUNT

	2002 £m	2001 £m
Premiums	2,052	1,392
Claims	(2,186)	(1,657)
Reduction in policyholder liabilities	917	515
Investment return	(1,979)	(2,143)
Expenses including commission	(410)	(274)
Other technical income and charges (net)	(275)	(175)
Tax credit	209	307
Pension scheme (losses)/profit	(203)	32
Movement in the year	(1,875)	(2,003)
Fund for future appropriations (FFA) on acquisition of Scottish Life	–	1,139
FFA brought forward	3,759	4,623
FFA carried forward	1,884	3,759

Note: 2001 figures only include the results of Scottish Life for six months from the date of acquisition on 1 July 2001.

- The increase in administrative expenses is driven primarily by the inclusion of Scottish Life for 12 months.
- The change in other technical income and charges (net) is due to the one-off impact on the impairment of the value of the acquired in-force business. It has been necessary to reflect a decrease in value of £205m in 2002, reflecting the fall in markets and the fact that this has had a permanent impact on the future value of the existing business.
- In both 2002 and 2001 the tax credits are driven mainly by reduced deferred tax provisions as the value of investments has decreased.
- The fund for future appropriations represents amounts not yet allocated to policyholders which provides working capital for the business, including the payment of final bonuses and provides investment flexibility.

#### Guaranteed annuity rates, mortgage endowment review and pensions review

The overall provision for potential claims in respect of guaranteed annuity rates of £0.5bn remained broadly unchanged over 2002.

Actions have been taken to limit the sensitivity of the provision to further downward movements in interest rates via the purchase of interest rate sensitive derivatives.

In common with many other insurance companies, Royal London has discussed with the FSA the historic selling practices of regulated products, including endowment policies. A £46m provision has been made for the expected costs of likely redress payments and associated expenses in respect of former UAG business.

Royal London completed the Pension Review by the FSA deadline of June 2002 and outstanding compensation was £62m at 31 December 2002.

#### Expenses

Royal London has actively managed expenses whilst investing in businesses to improve profitability and future prospects. The acquisition, administrative and exceptional cost base for the Group, on a pro forma basis (which aggregates Royal London, United Assurance Group and Scottish Life as if they had been part of the Group since 2000 and excludes certain costs such as commission payments to IFAs and non-recurring project expenditure) over four years is shown on the next page.

Employee costs are a significant part of total costs so the reduction in employee numbers in the last four years has led to reduced expenses. Cost management is a key financial objective within Royal London. Maintaining a tight control of costs is essential if we are to meet our objective of profitability across all our business units, which in turn will deliver better returns to customers.

#### Pension costs

Royal London implemented in full Financial Reporting Standard 17 – Retirement Benefits (FRS 17) in 2001.

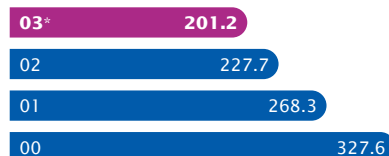
The primary purpose of the standard is to require a company to recognise on its balance sheet the pension surplus or deficit arising from its pension provision for employees. The impact of FRS 17 on the accounts to 31 December 2002 can be summarised as follows:

- The net pension asset, after deferred tax, in the Group balance sheet at 31 December 2002 was £73m (2001 £268m). This is based on the pension scheme surpluses at the year-end and restricted as necessary to take account of the ability of the Group to recover surpluses out of reduced future contributions.
- The Royal London Staff Pension Fund is shown to be in deficit by £48m (2001 £26m) on a FRS 17 basis, less than 15% of the fund's liabilities at the end of 2002. At its last full valuation at 31 December 2001, the fund was shown to be 100% funded on the minimum funding requirement basis laid down by the Pension Act 1995.

#### Exchangeable deferred shares

Under the terms of the offer to acquire United Assurance Group, holders of convertible deferred shares (CDS) were offered exchangeable deferred shares (EDS) by RLM Finance as consideration for their holding.

## LIFE AND PENSIONS ACQUISITION AND ADMINISTRATIVE COST BASE (£m)



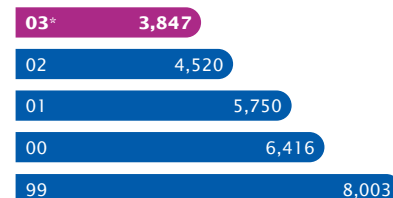
Excludes commission payments to IFAs and non-recurring project expenditure. \*anticipated

## GROUP NON-RECURRING PROJECT EXPENDITURE (£m)



\*anticipated

## GROUP HEADCOUNT



Figures as at year end. \*anticipated

Several meetings with the FSA have taken place regarding a possible re-attribution of the estate within the Refuge Assurance Ordinary Branch with-profits sub-fund. Work is ongoing and as anticipated may take some time to conclude. A letter was sent to EDS holders in December 2002 confirming the extension of the expiry date of the shares to 16 October 2004.

#### Management of financial risks

The Group has well established processes for managing financial risks.

#### Capital

The capital position of the Group is monitored by the Capital Management Committee. The committee, chaired by the Group Finance Director, meets monthly. The committee reports to the Board. Its role is to consider the Group's capital position and to ensure that it is both maintained within its target range and is sufficient to enable the Group to fulfil its stated core strategic objectives as determined by the Board from time to time.

#### Investment risk

The Investment Committee meets at least quarterly and comprises the Chairman, non-executive directors, a number of executive directors and the Appointed Actuary. Its role is to review investment performance and compliance with the management agreement between Royal London and its investment manager, RLAM. The agreement contains the broad investment policy including the approval of benchmark funds and performance against the benchmarks.

#### Insurance risk

Insurance risk is managed by having in place clear processes and limits for product pricing and underwriting. Product pricing takes into account assumptions relating to mortality and persistency rates, as well as the expenses incurred in the distribution and maintenance of products, with all these assumptions being based on past experience and anticipated trends. At the same time Royal London has clear underwriting procedures to control risk and has in place reinsurance treaties that limit the underwriting exposures. Our underwriting procedures and reinsurance treaties are reviewed by the finance department and authorised by the Appointed Actuary.

#### Counterparty risk

The Capital Management Committee has delegated operational responsibility for Group Counterparty Exposure Policy to the RLAM executive. Counterparty names are reviewed monthly by RLAM management and the performance of this control is reviewed quarterly by the Capital Management Committee.

The policy stipulates approved counterparties, permitted investments and exchanges as well as detailing specific counterparty ratings and exposure limits covering money markets, derivatives, foreign exchange, equities and fixed interest securities. In the case of derivatives, the policy also details legal, collateral, margining and valuation requirements to minimise value at risk.

#### Other financial risks

The Group Finance Director provides the Board with regular reports on the overall financial position of the Group. Processes that ensure the appropriate stewardship of the group include detailed business planning, budget approval and monitoring. In addition to this the Appointed Actuary reports to the Board on statutory valuations and bonus recommendations.

#### Conclusion

Our key financial objective is to deliver value for members. This has been difficult to achieve when equities have fallen by 42% over three years as investment performance is so key to the returns which we are able to pay. We have smoothed out the returns on policies as much as possible and as described in the section on financial strength, we have not held back excessive assets for the future. We have actively managed our balance sheet in line with our liabilities to maintain statutory solvency in an extremely volatile market. We will continue to focus on improving the performance and profitability of our business.

STEPHEN SHONE

Group Finance Director

## Board of Directors



- 1 Hubert Reid (62)**  
Chairman  
Hubert Reid was appointed to the Board as a Non-Executive Director in April 1996 and became Non-Executive Deputy Chairman in January 1997 and Chairman in July 1999. He was managing director and then chairman of the Boddington Group plc (1984-1995), and was chairman of Ibstock PLC and Bryant Group plc. He is chairman of Enterprise Inns plc, deputy chairman of Majedie Investments PLC and a non-executive director of The Taverners Trust PLC and Michael Page International plc.
- 2 Mike Yardley (46) FIA**  
Group Chief Executive  
Mike Yardley was appointed to the Board in November 1989. He joined Royal London in 1978 as a member of the investment team, was appointed Investment Manager in 1987, Chief Investment Manager in 1993, Investment and Finance Director in June 1996, Deputy Chief Executive in January 1997 and Chief Executive with effect from April 1998.
- 3 Stephen Shone (46) BSc (Econ), FCA**  
Group Finance Director  
Stephen Shone was appointed to the Board in January 1999 when he joined Royal London as Group Finance Director. He trained as a chartered accountant with KPMG and on leaving in 1987 became finance director of Prolific Group. From 1990 to 1998 he was with Irish Life plc based in Dublin and St Albans, where he held a number of posts including group chief financial officer from 1996 to 1998.
- 4 Barry Fitzgerald (58)**  
Sales Director  
Barry Fitzgerald was appointed to the Board in January 1997. He joined Royal London in 1972 and held various senior appointments in the sales force and at Colchester before being appointed General Manager, sales and marketing in 1995, Sales and Marketing Director in June 1996, and Sales Director in April 2000.
- 5 Christopher Phillips (46) BA (Hons), Oxon**  
Chief Executive, RLAM  
Christopher Phillips was appointed to the Board on 1 April 2001. He joined Royal London Asset Management Limited as Chief Executive in April 2000. He was with Morgan Grenfell and Co from 1983 and held various positions including director of strategy (business development) with Deutsche Asset Management, formerly Morgan Grenfell Asset Management. He is a Director of Royal London Growth and Income Trust plc.
- 6 Brian Duffin (48) MA, FFA**  
Chief Executive, Royal London Intermediary  
Brian Duffin was appointed to the Board on 1 July 2001 following the acquisition of Scottish Life. He joined Scottish Life in 1976 and was appointed to the board in 1996 and became group chief executive on 1 January 1999. He is a director of Heart of Midlothian plc and Pensions Advisers Support System Limited.
- 7 Fields Wicker-Miurin (44)**  
Non-Executive Director  
Fields Wicker-Miurin was appointed to the Board in January 2003. She was a partner and vice president of Strategic Planning Associates (1989-1994), director of finance and strategy at the London Stock Exchange (1994-1997), senior partner and vice president of AT Kearney Limited (1998-2000) and chief operating officer and investment partner with Vesta Capital Advisors Limited (2000-2001). She is a member of the Executive Board of the DTI (and chairs its investment committee), the Panel of Experts advising the European Parliament's Economic and Monetary Affairs Committee and of the Nasdaq Technology Advisory Council, a non-executive director of United Business Media PLC and Savills plc and an executive director of Leaders Quest.
- 8 Tom Ross (58) OBE, FFA**  
Non-Executive Director  
Tom Ross was appointed to the Board as a Non-Executive Director on 1 July 2001 following the acquisition of Scottish Life. He was a partner with Clay & Partners from 1976 to 1993 and since then has been principal and actuary with Aon Limited (formerly Alexander Clay). He was appointed to the board of Scottish Life as a non-executive director in 1996, became deputy chairman in 1998 and chairman in 1999. He is chairman of Penta Capital Partners (Holdings) Limited and of the Pensions Policy Institute and a director of the Edinburgh UK Tracker Trust plc.
- 9 Tim Melville-Ross (58)**  
Deputy Chairman  
Tim Melville-Ross was appointed to the Board in June 1999. He was chief executive of the Nationwide Building Society from 1985 to 1994 and director-general of the Institute of Directors from 1994 to 1999. He is chairman of Investors in People UK, DTZ Holdings plc, Manganese Bronze Holdings plc and Bank Insinger de Beaufort NV and a non-executive director of a number of other organisations including Bovis Homes Group plc.