

# CREATING A BETTER FINANCIAL TOMORROW

## ANNUAL REPORT AND ACCOUNTS 2006

# ROYAL LONDON AT A GLANCE

OUR SPECIALIST BUSINESSES HELP OUR CUSTOMERS GROW THEIR WEALTH AND CREATE A SECURE AND SAFE FINANCIAL ENVIRONMENT FOR THEIR LIVES.

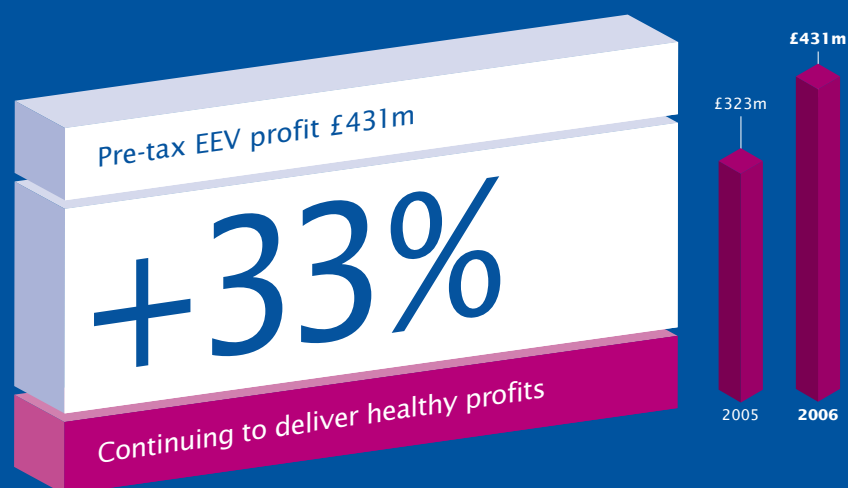
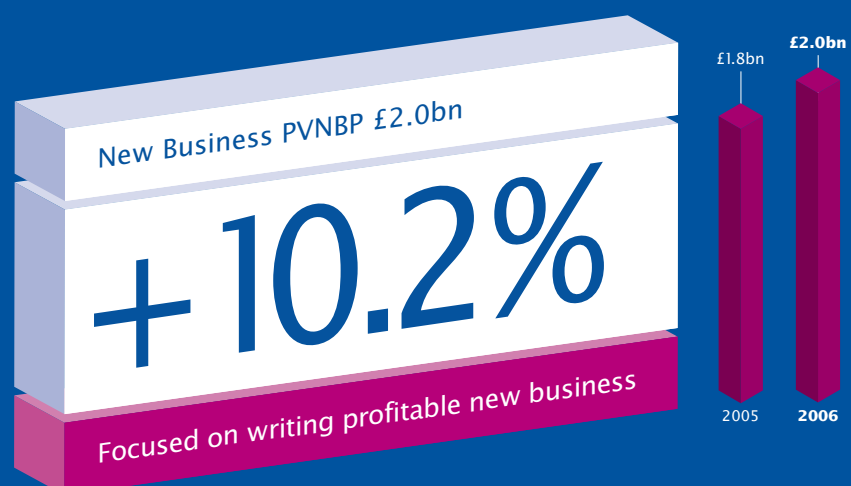
	PRINCIPAL OPERATIONS	KEY PRODUCTS	KEY POINTS FROM 2006
<p>PENSIONS</p> 	<p>Scottish Life is the specialist pensions business within the Royal London Group.</p> <p>Products are distributed in the UK through independent financial advisers (IFAs) and employee benefit consultants (EBCs).</p>	<ul style="list-style-type: none"> <li>Group personal pensions</li> <li>Defined benefit schemes</li> <li>Occupational pension scheme restructure services</li> <li>Individual personal pensions</li> <li>Self invested personal pensions (SIPP)</li> </ul>	<ul style="list-style-type: none"> <li>New business up 8% to £1,425m</li> <li>Further developed the innovative Managed Strategies investment proposition</li> <li>Launched Pension Portfolio, including an extended SIPP facility</li> </ul>
<p>PROTECTION</p> 	<p>Bright Grey, a specialist protection business, has brought a fresh approach to the market.</p> <p>Products are distributed through independent UK intermediaries.</p>	<ul style="list-style-type: none"> <li>Individual Life Protection</li> <li>Critical Illness Protection</li> <li>Income Protection</li> </ul>	<ul style="list-style-type: none"> <li>Continued to increase market share – new business totalled £154m</li> <li>Successfully launched extranet system, with over 75% of applications now made online</li> <li>Extended distribution reach with a number of new multi-tie arrangements</li> </ul>
<p>INVESTMENTS</p> 	<p>Royal London Asset Management (RLAM) manages all classes of assets on behalf of the Group and for external clients.</p> <p>Products are distributed to the institutional and wholesale sectors.</p>	<ul style="list-style-type: none"> <li>Unit trusts and OEICs</li> <li>Pooled pension funds</li> <li>Segregated investment mandates</li> <li>Cash management services</li> </ul>	<ul style="list-style-type: none"> <li>New business increased by 64% to £1,229m</li> <li>Net new cash mandates £389m</li> <li>New fund launches included UK Strategic Growth and Strategic Bond Funds</li> </ul>
<p>INTERNATIONAL</p> 	<p>Based in the Isle of Man, Scottish Life International (SLI) provides specific investment and tax efficient products.</p> <p>Products are distributed through intermediaries in the UK and overseas, in markets including Germany, the Middle East and South Africa.</p>	<ul style="list-style-type: none"> <li>Personal investment management service</li> <li>Offshore investment bonds</li> <li>Protected lifestyle life assurance</li> <li>Royal London European with-profits bonds</li> </ul>	<ul style="list-style-type: none"> <li>Increased new business by 25% to £165m</li> <li>Strengthened presence in the German market</li> <li>Granted a provisional licence to operate in Dubai</li> </ul>
<p>ADMINISTRATION</p> 	<p>Royal London deals directly with 2.3m customers through Royal London Administration Services (RLAS).</p> <p>Products are distributed through our sales contact centres.</p>	<ul style="list-style-type: none"> <li>With-profits bonds</li> <li>With-profits savings</li> <li>Individual Life Protection</li> <li>Home and Car Insurance</li> <li>Funeral Plans</li> </ul>	<ul style="list-style-type: none"> <li>New business, principally pension rebates, up 31% to £248m</li> <li>£1.8bn of annuities, including Scottish Life-branded business, transferred to Prudential Retirement Income Ltd</li> </ul>

Note: Where quoted, new business information is the present value of new business premiums (PVNBP).

## CONTENTS

- 02** Business review
  - 02** Recent history
  - 04** Chairman's statement
  - 06** Group Chief Executive's statement
  - 10** Group Finance Director's review
  - 24** Business unit review
  - 29** With-profits bonuses
  - 30** Corporate social responsibility
  - 33** Basis of preparation
- 34** Board of Directors
- 36** Directors' report
- 37** Corporate governance statement
- 41** Directors' remuneration report
- 44** Auditors' report
- 46** Consolidated income statement
- 47** Consolidated statement of recognised income and expenses
- 48** Balance sheets
- 50** Cash flow statements
- 51** Notes to the financial statements
- 129** European Embedded Value (EEV) – supplementary information
- 142** Notice of meeting
- 143** Member information
- 144** 2007 financial calendar
- 144** Contact offices

## HIGHLIGHTS



# BUSINESS REVIEW

The business review describes the main trends and factors underlying the performance of Royal London during the year ended 31 December 2006.

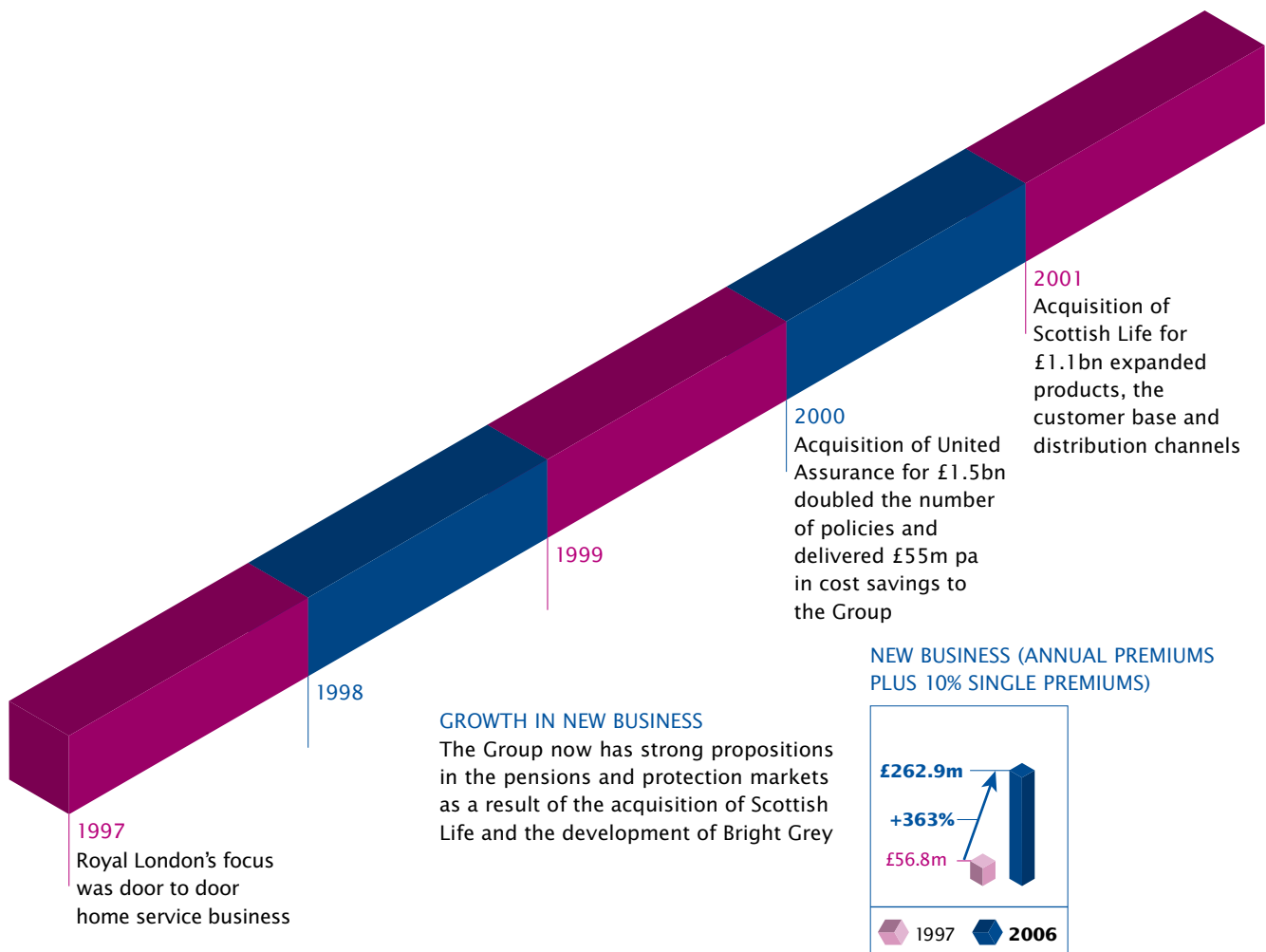
In providing this review, we aim to present a balanced and comprehensive view that is consistent with the size and complexity of our business. Royal London Group is a specialist financial services provider. Its businesses focus on those sectors of the market which value premium propositions, operating through a number of brands as detailed on the inside front cover.

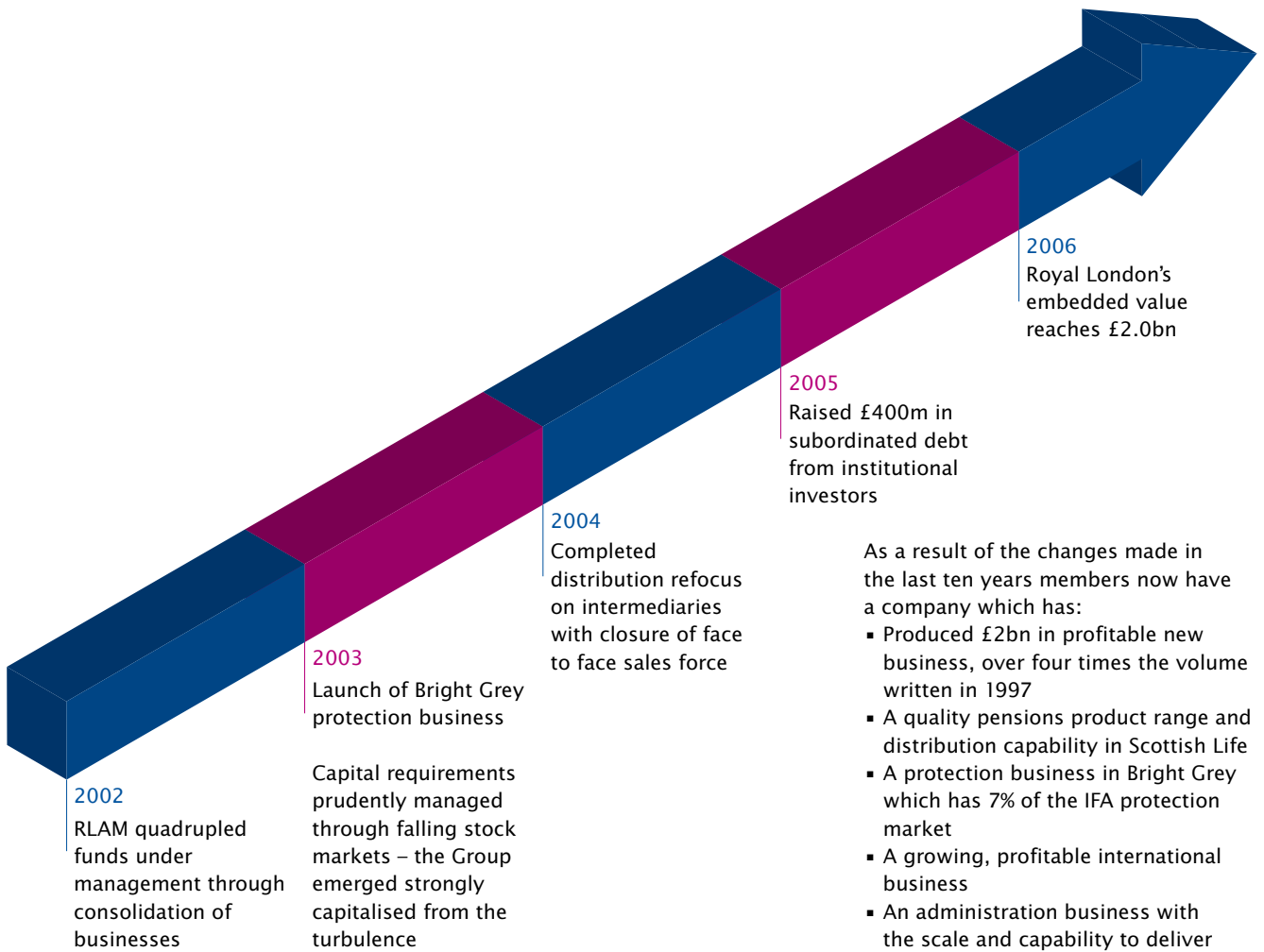
Our UK based operations are regulated by the Financial Services Authority (FSA). Scottish Life International, based in the Isle of Man, is principally regulated by the Isle of Man regulator and by authorities in the jurisdictions in which it has overseas operating licences.

This review is written in the context of the risks and uncertainties that our businesses face.

## RECENT HISTORY

The last ten years have seen major transformations for Royal London. In 1997, Royal London wrote £57m in new annualised premiums from 1,500 home service sales staff. The business was loss-making and the growing weight of regulation and limited scope and scale of the Group meant that the business model was unsustainable. Major change was required for Royal London to continue adding value for members.





Capital requirements prudently managed through falling stock markets – the Group emerged strongly capitalised from the turbulence

As a result of the changes made in the last ten years members now have a company which has:

- Produced £2bn in profitable new business, over four times the volume written in 1997
- A quality pensions product range and distribution capability in Scottish Life
- A protection business in Bright Grey which has 7% of the IFA protection market
- A growing, profitable international business
- An administration business with the scale and capability to deliver effective and efficient service to millions of customers
- An asset management business with the skills and investment record to compete in the market
- Maintained its position for market leading with-profits maturity payouts
- The ability to develop new business concepts and turn them into significant market presences
- The capability to make significant acquisitions for the Group's benefit where appropriate

**FUND MANAGEMENT BUSINESS DEVELOPED**

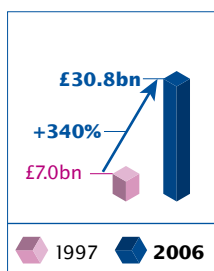
We now have an asset manager with a growing reputation for delivering sustained superior returns

**STRONG COST CONTROL**

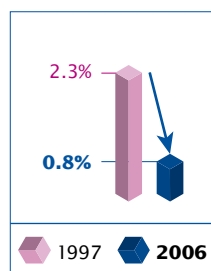
The business is now much more efficient so that returns to members are not eroded by a high cost base

**Much has been achieved and we are now in a position of greater strength to take Royal London forward, creating a better financial tomorrow for our customers.**

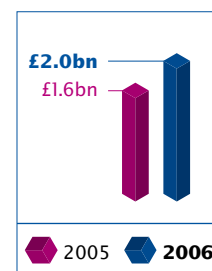
**FUNDS UNDER MANAGEMENT (FUM)**



**COSTS AS A PERCENTAGE OF FUM**



**INCREASING ROYAL LONDON'S EMBEDDED VALUE**



## CHAIRMAN'S STATEMENT



**Tim Melville-Ross**  
Chairman

I am delighted to report that the Group had another successful year in 2006. Across our businesses we concentrated on writing profitable business rather than chasing market share. By following this strategy we, once again, increased the total value of the Group for our members whilst still registering healthy growth in new business and producing strong investment returns on monies invested.

This successful result has been achieved despite a challenging market environment. Our people across the Group worked hard to introduce the changes brought about by the new simplified pensions regime (known as "A-day"). We delivered good growth during 2006 in the volume and value of new business, both in the UK and overseas, against the background of a very competitive life and pensions market. We also made significant progress in attracting third party client investment management mandates.

### LEGISLATION AND REGULATION

The Group's businesses can be significantly affected by Government developments and 2006 saw the announcement of a wide range of initiatives. Most significant was the publication by Government of its response to the Pensions Commission in the form of a new Pensions Bill (due to come into effect during 2007) and a White Paper on "Personal Accounts" as a new way to save for retirement. Given the importance of pensions to our business, we remain fully engaged with Government officials and politicians on the key issues.

As they stand, the White Paper proposals have several drawbacks. There is a significant risk that companies which currently provide good quality pension arrangements for their employees may be tempted to cut costs by closing existing arrangements and offering Personal Accounts instead. A further drawback is that many individuals may find themselves auto-enrolled into Personal Accounts and making contributions for little benefit because of the interaction between savings and the means-tested welfare benefits system.

Another important legislative development is the Financial Mutuals Arrangements Bill, which is currently before Parliament. This aims to relax the rules on transfers of business between financial mutuals. We strongly support this Bill because we believe that it will help in strengthening the sector.

### CORPORATE GOVERNANCE

Royal London is now the largest mutual insurer in the UK. I firmly believe that mutuality has served our members well over the years and that it continues to do so today. We therefore have no plans to change our corporate structure.

Any company, whether mutual or shareholder-owned, should be able to demonstrate the highest standards in corporate governance. For the first time, the Association of Mutual Insurers will be reporting formally to HM Treasury during 2007 on the sector's compliance with the new Annotated Combined Code for Mutuals. We hope this process will help build public confidence in standards of governance in mutuals.

### DISTRIBUTION DEVELOPMENTS

The FSA launched a review of distribution during 2006 looking for market-led solutions to the issues in the retail investment market, covering banks, life insurers, financial advisers, building societies and fund managers. Industry-led groups are assessing five key areas:

- Sustainability of the distribution sector
- Consumer access to financial products and services
- The impact of incentives
- Regulatory barriers and enablers
- Professionalism and reputation

With the Financial Adviser's Fee, Royal London has been at the forefront of finding ways to create a more sustainable distribution sector. I believe this to be very important for the long-term health of the industry and I am therefore very pleased that Mike Yardley has been asked to chair the 'impact of incentives' group.

### THE BOARD

In 2007 we welcome to the Board two new executive directors, Andy Carter and John Deane. Andy has been with the Group since 2001 and has been Chief Executive of Royal London Asset Management since 2003. During this time he has presided over a period of sustained growth for our asset management business. John Deane joins us from Old Mutual plc where he was Corporate Development Director. John will head up the new dedicated intermediary division, the formation of which will enable our intermediary brands of Scottish Life, Bright Grey and Scottish Life International to work together more closely. In accordance with the Articles both Andy and John will offer themselves for reappointment at the Annual General Meeting (AGM).

Brian Duffin leaves the Group after many years of service with Scottish Life, and latterly the Royal London Group. He leaves with the thanks and goodwill of the Board and all his colleagues in the Group for his tremendous contribution over the years.

### ANNUAL GENERAL MEETING

The Board remains committed to engaging with members and understanding their views. An important part of this process involves increasing the level of participation in the AGM. We would be pleased to see as many members as possible at this year's AGM which will be held in The Barbican Centre in the City of London on 22 May. This year, for the first time, we have introduced online voting to make it more convenient for members who cannot be present to exercise their vote. We believe that Royal London is the first mutual insurance company to introduce online proxy voting. I personally hope that many members will use this secure and convenient voting method.

### LOOKING FORWARD

The UK economy remains positive and customers show increasing confidence in saving. We in turn are confident that our strategy for the UK financial services sector will enable us to continue to be successful in 2007 and beyond. Our international business also has good prospects for further growth and delivery of value for the benefit of our members.



**Tim Melville-Ross**  
Chairman

“ROYAL LONDON IS  
NOW THE LARGEST  
MUTUAL INSURER  
IN THE UK.”



“WE ARE COMMITTED TO OUR STRATEGY OF WRITING PROFITABLE BUSINESS AND REMAIN DETERMINED TO AVOID LOSS-MAKING AREAS OF THE MARKET.”

## GROUP CHIEF EXECUTIVE'S STATEMENT

### ROYAL LONDON DELIVERED A STRONG SET OF RESULTS IN 2006

The year saw many developments in all parts of the Group. Once again, the Group has produced good financial results with a pre-tax European Embedded Value (EEV) profit up £108m to £431m (2005 £323m). The embedded value at the end of 2006 was £2.0bn (2005 £1.6bn) and the after tax return on the opening embedded value was 26% (2005 23%). We achieved further growth in new business and delivered healthy investment returns.

The total present value of new life and pensions business premiums (PVNBP) increased by 10% to £2.0bn (2005 £1.8bn).

These results are in line with our expectations for the year. Markets were intensely price-competitive with increasing temptation to grow new business at the expense of profitability. We have refused to be tempted and the increase we achieved in new business is a positive reflection of our reputation for innovation and quality.

Royal London Asset Management (RLAM) had an outstanding year, attracting significantly higher levels of new business from a range of institutional investors. This was driven by a strong investment track record, most notably in the UK fixed interest sector. The Royal London with-profits fund delivered a pre-tax return of 11.0%, in excess of its benchmark for the third consecutive year. Group funds under management increased during 2006 by £1.9bn to £30.8bn.

The Group continues to be well-capitalised and at the end of 2006 our regulatory capital of £3.9bn (2005 £3.3bn) was £1.8bn (2005 £1.5bn) in excess of the level required by regulators. This strong capital position has enabled us to fund business growth and to increase the proportion of our with-profits assets held in equities. In addition, in November 2006 we repaid £125m in subordinated debt issued by Scottish Life in 1996.

#### GROUP STRATEGY

Our vision for Royal London is to “**Create A Better Financial Tomorrow For Our Customers**”, which shapes our strategy for the Group. We deliver on this vision by owning and managing a number of high-performing financial services businesses, each of which is a specialist in its target market with its own unique brand.

The reputation and positioning of each of our brands is underpinned by a focus and commitment to delivering a high-quality proposition, backed by excellent service and technology, and a drive for continual innovation. Our aim is to treat our customers fairly in all we do, providing products and services which:

- Help our customers build their wealth and create a secure and safe financial environment for their lives
- Deliver good investment returns
- Are easy to use for our customers and appropriate for their changing needs

We distribute our products through independent channels, primarily in the UK but also in selected overseas markets. Our strategy is to identify and build strong trust-based relationships with good quality distributor partners in each market in which we operate. We provide them with the propositions, pricing, tools, support and service to make us both more commercially successful.

Our financial objective is to increase the value of the Group by developing profitable financial services businesses, delivering good investment performance and providing superior sustainable returns to our members.



**Mike Yardley**  
Group Chief Executive

# £431m

*pre-tax profit*

# 26%

*after-tax return on embedded value*

**10%**  
increase in new  
business premiums

**NEW BUSINESS RESULTS**

**Scottish Life** new business was £1,425m, an increase of 8% over 2005. Our focus on writing profitable new business was particularly important in the pensions market, where Scottish Life continues to use its innovative Financial Adviser's Fee (FAF). The success of FAF illustrates a growing understanding among IFAs, and the market generally, that high initial commission levels, currently available from some providers, are not sustainable in the long term.

New business at **Bright Grey** reduced, reflecting lower persistency assumptions than had been used for the previous year's figures.

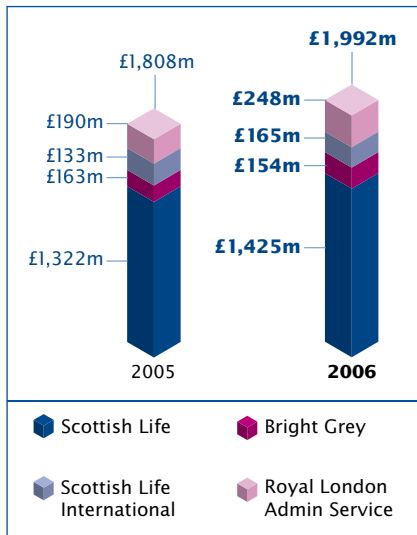
In terms of new annual premiums written, Bright Grey's performance was excellent – an increase of 15% over 2005 to £27m. This is particularly impressive in what has been a tough year for individual protection sales. In the market as a whole, new premiums were down by 2% in 2006.

**Scottish Life International** maintained its strong performance throughout the year, with an increase of 25% to £165m. Growth in new business was led by the demand for offshore portfolio bonds in the UK, the continued success of the With-Profits Bond in the German market and strong relationships with key distributors in Germany.

New business in **Royal London Administration Services** increased by 31% to £248m, principally arising from additional pension rebates.

After an excellent year in 2005, the 64% increase to £1,229m in **RLAM's** new business (excluding cash mandates) in 2006 was particularly satisfying. This continued success included new mandates from pension schemes, universities, local authorities, friendly societies and charities. The majority were for UK fixed interest, an area of recognised strength for RLAM. Royal London Cash Management produced £389m in net new business, growing their external assets under management to over £2bn.

PRESENT VALUE OF NEW BUSINESS PREMIUMS (PVNBP)



**OTHER HIGHLIGHTS OF 2006**

The use of technology for the convenience of our customers and distributors is an increasingly important differentiator of our businesses. Scottish Life's online pensions system continues to see growing usage. In addition, Bright Grey's online application service, launched in January 2006, has been rapidly accepted by intermediaries – 75% of applications are now made online.

Despite focusing much of our development resource on the delivery of Pensions A-day, we continued to develop our pensions products, launching a new defined benefit pension scheme service and our new **Pension Portfolio** proposition, which includes SIPP functionality.

RLAM launched its **UK Strategic Growth Fund** in June 2006. Performance since then has been strong: the fund has ranked in the 1st percentile since inception. January 2007 saw the launch of RLAM's **Ethical Bond Trust** for which we have high hopes. The trust offers access to RLAM's award-winning fixed interest skills in an ethically sensitive framework.

**DISTRIBUTION STRATEGY**

Distribution of our products is principally through IFAs, who dominate the market in the UK, and independent distributors in overseas markets.

The intermediary distribution sector has continued to evolve in 2006. Intermediary distributors have many different business models, although broad segments of intermediaries can be identified by their trading style and their degree of specialisation in specific markets.

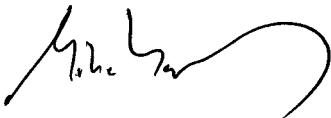
Our approach has been to align ourselves with intermediaries by creating distinct distribution "channels" within Scottish Life and Bright Grey, tailored to suit the trading style of the related segment. The channel alignment we use is shown alongside.

**OUR PEOPLE**

The Group's employees are key to the achievements of our businesses. Their efforts are the primary reason for our successful year and I would like to thank each of them for their continued contribution and commitment. Brian Duffin, Executive Director since 2001, and John Hume, Human Resources Director since 1999, both leave the Group at the end of March and I take this opportunity to thank them for their contributions to the Group's development over the years.

**OUTLOOK**

Royal London is well placed to continue to grow profitable new business in 2007, despite the competitive conditions in financial services markets. 2007 will see Royal London use its skills and competitive edge to build further on the value created for our members during 2006. The market continues to value those companies which can offer strong service, product performance and specialist expertise – Royal London is such a business.



**Mike Yardley**  
Group Chief Executive

**SCOTTISH LIFE DISTRIBUTION**

- *Employee Benefit Consultants*
- *National Accounts*
- *Regional Pension Specialists*
- *Generalist IFAs*

**BRIGHT GREY DISTRIBUTION**

- *Mortgage and protection specialists*
- *National Accounts*
- *Multi-tie firms*
- *Generalist IFAs*



“ROYAL LONDON DELIVERED HEALTHY FINANCIAL RESULTS IN 2006, OUR CAPITAL POSITION REMAINS VERY SOUND AND ALL OUR BUSINESS UNIT PROPOSITIONS ARE GETTING STRONGER. ”

## GROUP FINANCE DIRECTOR'S REVIEW

### INTRODUCTION

My review covers the Group's 2006 financial results, capital position and the measures we use to assess our performance against our objectives. Our primary responsibility is the delivery of value to our members, just as a proprietary company delivers value to its shareholders. In fulfilling this, we also have responsibilities to our other stakeholders: in particular to our customers, distributor partners and employees, and we must balance payouts with security for all our policyholders.

### MEASURING OUR PERFORMANCE

We assess our performance against our strategy and objectives through the use of qualitative assessments and through the monitoring of quantitative indicators – key performance indicators (KPIs). In the table below I show the alignment between our KPIs and primary stakeholders; many of these KPIs would also be useful for other stakeholders; such as regulatory bodies.

A number of Royal London's financial KPIs are shown overleaf and the table below indicates where other KPIs can be found in this business review. In assessing business unit performance new business profits are particularly important, though management also use a variety of other performance indicators such as new business margins. Non-financial KPIs are used for monitoring customer service. Our strategy depends upon the quality of our service and it is only by reporting regularly against our service level standards and taking appropriate action that we will match or exceed our customers' expectations.



**Stephen Shone**  
Group Finance Director

KPIs	Stakeholders					
	With-profits members	Acquired with-profits policyholders	Unit linked policyholders	Non-profit policyholders	Intermediaries	Employees
New business profits	✓					✓
Investment return on with-profits fund	✓	✓				
Table of with-profits payouts (see table on page 29)	✓	✓			✓	
EEV* profit before tax	✓					✓
Return on embedded value	✓					
Customer impact survey (see page 30)	✓	✓	✓	✓	✓	✓
Capital strength (see pages 21 to 23)	✓	✓		✓	✓	
Investment performance of unit linked funds			✓		✓	
IFA feedback and industry survey results (see Business Unit Review commentaries on pages 25 to 28)					✓	✓
Volume of new business (see page 8)					✓	✓
Employee survey results (see page 32 for a summary of results)						✓

\* European Embedded Value

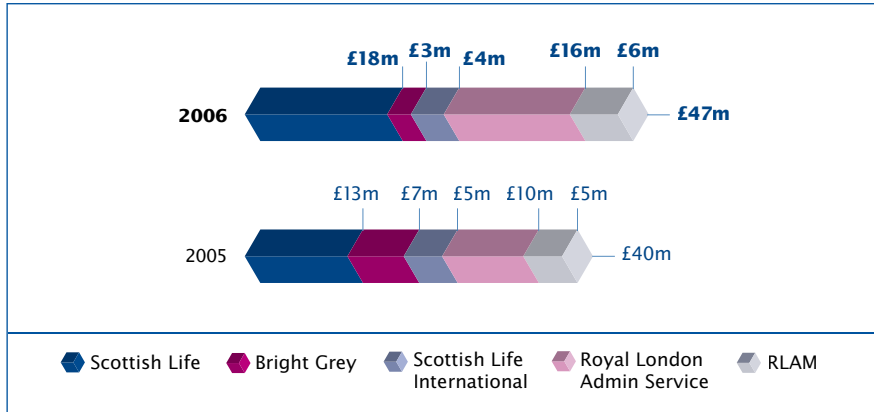
## NEW BUSINESS PROFITS UP 18%

*we have delivered new business profits from each of our brands*

### KEY PERFORMANCE INDICATORS

#### NEW BUSINESS PROFITS

Value added by new business grossed up for tax at 30%

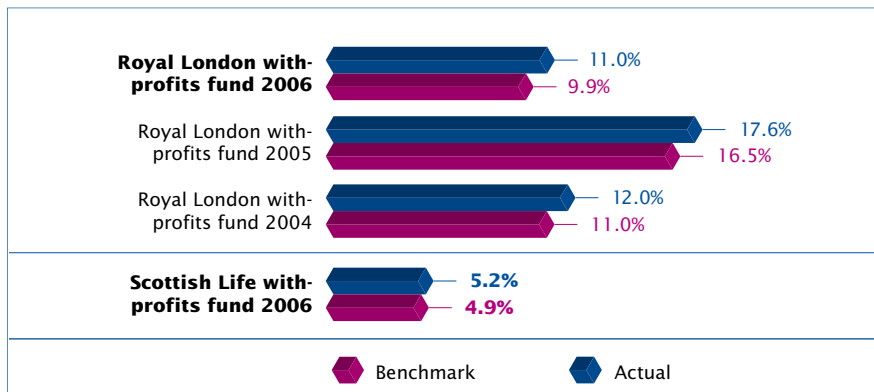


## 11% RETURN ON THE ROYAL LONDON WITH-PROFITS FUND

*consistently beating investment benchmarks*

### INVESTMENT RETURN ON WITH-PROFITS FUNDS

Royal London Fund Investment Performance for the year ended 31 December 2006

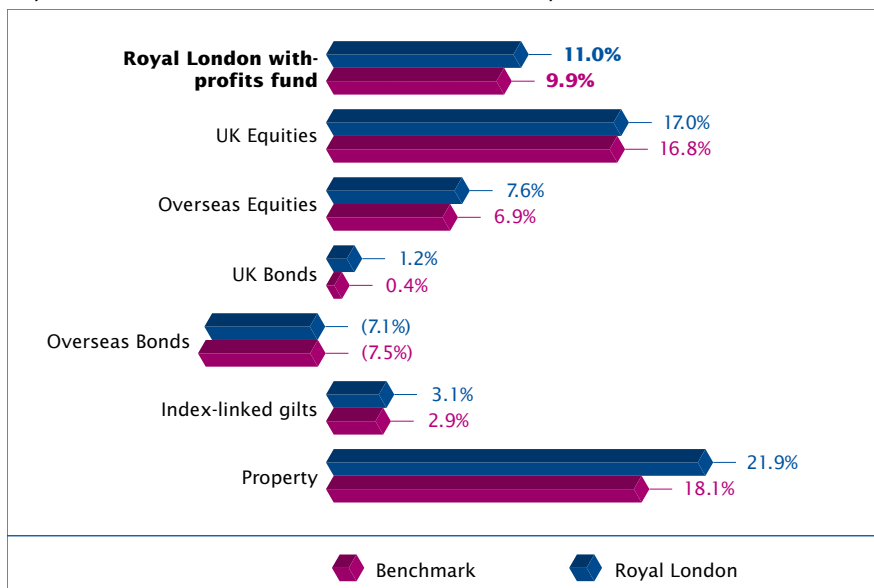


## SUPERIOR INVESTMENT PERFORMANCE

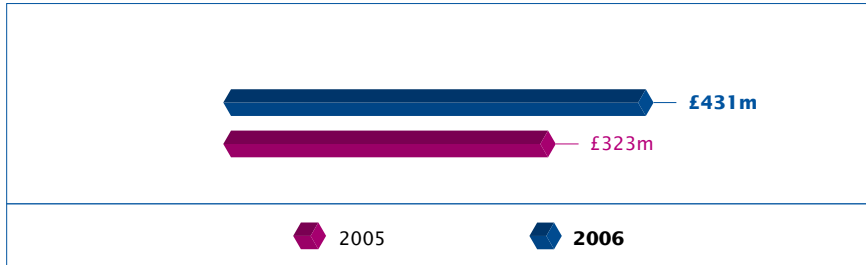
*consistent investment performance across all asset classes is fundamental to achieving leading policy payouts*

### INVESTMENT RETURN BY ASSET CLASS IN ROYAL LONDON WITH-PROFITS FUND

Royal London Fund Investment Performance for the year ended 31 December 2006



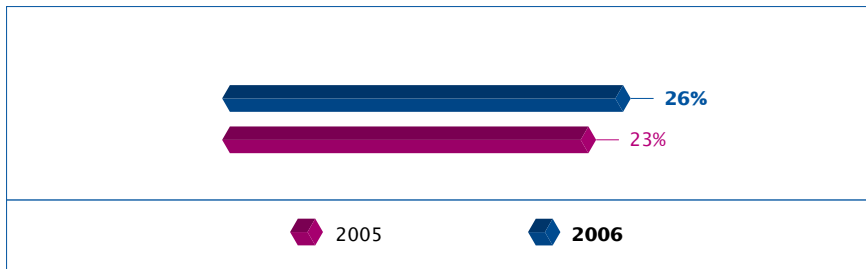
GROUP EEV PROFIT BEFORE TAX



**SIGNIFICANT VALUE ADDED**

*our businesses have developed and added significant long-term value, despite operating in a highly competitive environment particularly in the UK pensions market*

AFTER-TAX RETURN ON OPENING EMBEDDED VALUE

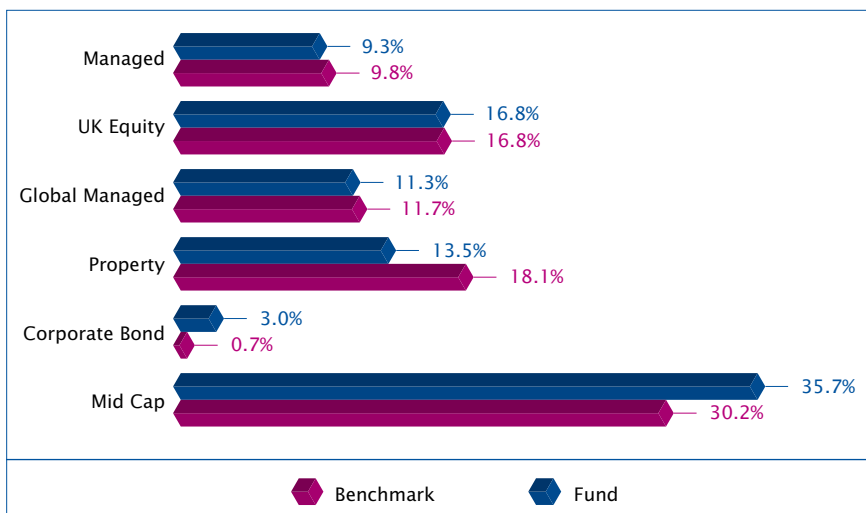


**STRONG RETURNS**

*profits generated by our business operations, as well as favourable equity and property markets*

INVESTMENT PERFORMANCE OF OUR UNIT LINKED FUNDS

Scottish Life unit linked pension fund 2006 performance (% pa – gross of fees)



**GOOD INVESTMENT PERFORMANCES**

*returns are generally in line with benchmarks; Property under-performed while Corporate Bond and Mid Cap out-performed*

## GROUP FINANCIAL RESULTS

## EEV PROFIT

Royal London is the first mutual insurer to report on an EEV basis. Our EEV operating profit before tax for 2006 increased by £16m to £116m (2005 £100m), while pre-tax profit was a satisfactory £431m (2005 £323m). The result for 2006 is analysed in the following table.

	2006 £m	2005 £m
Contribution from new business	36	31
Profit from existing business		
– expected return	99	106
– experience variances	9	6
– operating assumption changes	(48)	(34)
Expected return on opening net worth	30	15
Profit on other business (see note *)	14	10
Other items	(24)	(34)
<b>Operating profit before tax</b>	<b>116</b>	<b>100</b>
Economic experience variances	263	250
Economic assumption changes	59	8
Movement in pension scheme surplus	58	(22)
Financing costs	(25)	(1)
Enhancements to policyholder benefits	(40)	(12)
<b>EEV profit before tax</b>	<b>431</b>	<b>323</b>
Attributed tax charge	(25)	(26)
<b>EEV profit after tax</b>	<b>406</b>	<b>297</b>

Notes: (\*) Other business includes general insurance, the provision to third parties of administration services and cash management

## Embedded value

The embedded value at 31 December 2006 was £1,991m (2005 £1,585m). The majority of the embedded value comprises the Realistic Balance Sheet surplus, which was £1,809m at 31 December 2006 (2005 £1,416m).

## Contribution from new business

The contribution from, or value of, new business (VNB) is the present value of the projected stream of profits from that business. The VNB of £36m (2005 £31m) shown in the table above is the value before tax at Royal London's tax rate of 9% (2005 9%). It is common for proprietary companies to present the value of new business grossed up for tax at 30%. For comparability with results published by proprietary companies the analysis of our VNB in the following table has been similarly grossed up. The new business margin represents the ratio of the new business contribution to the present value of new business premiums (PVNBP).

Value of new business	VNB		PVNBP		VNB/PVNBP	
	2006 £m	2005 £m	2006 £m	2005 £m	2006 %	2005 %
Scottish Life	18	13	1,425	1,322	1.2	1.0
Bright Grey	3	7	154	163	1.8	4.4
Scottish Life International (SLI)	4	5	165	133	2.8	3.7
Royal London Admin Services	16	10	248	190	6.5	5.3
RLAM	6	5	1,229	751	0.5	0.6
<b>Total</b>	<b>47</b>	<b>40</b>	<b>3,221</b>	<b>2,559</b>	<b>1.5</b>	<b>1.6</b>

The Scottish Life figures illustrate the relatively low margins currently available in the pensions market, particularly from group pensions, although our actions are already improving new business profitability.

Volumes of business sold under the Bright Grey brand have continued to increase, though profitability and the PVNBP have reduced relative to 2005 as a result of a strengthening of our persistency assumptions. Bright Grey remains a relatively immature business and has yet to benefit from the economies of scale that should ultimately be achieved. As these economies are realised we expect the profitability of Bright Grey business to improve.

Offshore business written by SLI has seen reduced profitability due to a change in the mix of business written, with an increased proportion of lower margin products.

The Royal London business is predominantly incremental income to the legacy book with low attaching expenses of acquisition.

The relatively low margins shown in respect of RLAM new business reflect the nature of the external mandates won by that business.

#### Profit from existing business

Profit from existing business comprises:

1. The expected return on the value of in-force business at the start of the period, plus
2. Profits and losses caused by differences between actual experience for the period and the assumptions used to calculate the embedded value at the start of the period, plus
3. The impact of any changes in the assumptions regarding future operating experience. The charge for the year is attributable to a deterioration in persistency for certain business and an improvement in persistency for business with benefit guarantees; we have therefore strengthened our future assumptions.

#### Expected return on opening net worth

The expected return on opening net worth represents the expected investment return on the net worth over the period. The net worth has increased significantly over 2005 due to the strong profits in that year, and hence the expected return on opening net worth in 2006 is considerably larger than that in 2005.

#### Profit on other business

Profit on other business has been valued on an IFRS basis, as used in the primary financial statements. A breakdown of the profit reported on other business is shown in the table below:

	2006 £m	2005 £m
General Insurance	14	12
Administration Services	(1)	(2)
Cash management	1	–
<b>Total</b>	<b>14</b>	<b>10</b>

### Other items

Other items represent a combination of:

1. Exceptional development costs, which are typically investments made to improve future EEV profits (for example by reducing on-going expense levels or increasing new business volumes)
2. Corporate costs
3. Other exceptional items. For example, the impact of reinsuring our annuity portfolio is incorporated here.

	2006 £m	2005 £m
Exceptional development costs	(21)	(19)
Corporate costs	(17)	(15)
Reinsurance of annuity portfolio	14	–
<b>Total</b>	<b>(24)</b>	<b>(34)</b>

### Economic experience variances

This shows the effect of actual investment returns relative to those assumed. Economic experience variances impact the value of in-force (VIF) business and the net worth. The economic experience variance on the VIF arises from the increase in policy values in which Royal London has an interest. The variance on net worth represents the impact that investment returns being different to those anticipated has on the values of the:

- Opening net worth
- Financial options and guarantees (\*)
- Assets backing the financial options and guarantees (\*)

\* The value of these items above is generally more significant for Royal London, as a mutual insurance company, than would be the case for an equivalent proprietary company, whose interest in the surplus in its with-profits funds is restricted, typically to 10% of the distributable surplus.

Overall, the returns achieved on the underlying assets in 2006 were greater than those assumed. Equities performed particularly strongly. However, as interest rates increased, the market value of our fixed interest assets fell over the year. The economic experience variance contributed significantly to the overall EEV profit for the year, as it did in 2005.

### Economic assumption changes

Long-term economic assumptions were revised to take into account the financial conditions at the end of the period. As a result of movements in prevailing economic conditions, the economic assumptions adopted have been updated from those used at the end of 2005. The changes included an increase in the discount rate used to reflect the increase in risk-free rates and updated assumptions to value the cost of guarantees and options.

#### Movement in pension scheme surplus

This represents the movement in the defined benefit Royal London Group Pension Scheme. On an IFRS basis the scheme had a surplus of £60m at 31 December 2006 (2005 £2m).

#### Financing costs

In December 2005 Royal London raised £395m (after expenses) of subordinated debt, which carries a coupon of 6.125% per annum. The financing cost is calculated as the cost of servicing the debt over the year.

#### Enhancements to policyholder benefits

Whilst maturity payouts have continued to fall, primarily reflecting reduced investment returns, the Board has taken certain actions during the year to mitigate the impact. The reductions in payouts are smoothed in accordance with our Principles and Practices of Financial Management (PPFM), but the strength of our results has meant that we have been able to:

- Allocate investment return to certain asset shares in excess of the rate earned on the underlying assets
- Set policy payouts at a level in excess of those previously assumed.

	2006 £m	2005 £m
Additional returns credited to asset shares	(13)	(8)
Impact of enhancing policy payouts	(27)	(4)
<b>Total</b>	<b>(40)</b>	<b>(12)</b>

#### Attributed tax charge

EEV profits are calculated net of tax and then grossed up at an assumed tax rate of 6% (2005 8%), representing the expected long-term tax rate payable by Royal London.

#### IFRS INCOME STATEMENT

	2006 £m	2005 £m
<b>Revenues</b>		
Gross earned premiums	859	840
Amounts paid to reinsurers	(930)	(81)
Net earned premiums	(71)	759
Investment return	2,283	3,549
Other revenues	192	122
<b>Total revenues</b>	<b>2,404</b>	<b>4,430</b>
<b>Expenses</b>		
Policyholder benefits and claims	1,319	3,510
Operating expenses	573	448
Finance costs	39	16
Tax expense	44	133
<b>Total expenses</b>	<b>1,975</b>	<b>4,107</b>
<b>Transfer to the unallocated divisible surplus (UDS)</b>	<b>429</b>	<b>323</b>

Amounts paid to reinsurers in 2006 include the one-off impact of the reinsurance arrangements with Prudential Retirement Income Limited (PRIL) for the annuity business previously sold under the Royal London and United Assurance Group brands. This led to the payment of premiums to PRIL to the value of £775m. In addition, the ongoing reinsurance arrangements with PRIL for the Scottish Life branded annuity business led to the payment of premiums totalling £136m. All new pension annuities now written by the Group are either reinsured or written under direct offer by PRIL.

The year on year fall in investment returns reflects the lower returns across asset classes in 2006 – the equity benchmark return was 5% lower in 2006 and bond prices fell as interest rates rose. As a result the 2006 return on the main with-profits fund was 11.0% compared with 17.6% in 2005.

The other income movement is primarily due to the increase of £58m in 2006 in the pension scheme surplus.

Policyholder benefits and claims reduced with the Part VII transfers of the Group's annuity business to PRIL, which took place in the last quarter of 2006. This released liabilities and assets on the balance sheet of £1.8bn.

Operating expenses have increased by £125m primarily due to the external unit holders' interest in the unit trusts increasing by £69m, reflecting an increase in market value, and an increase of £49m in the amortisation of the present value of in-force business (PVIF). The increase in PVIF amortisation arose from the merger of the Refuge Ordinary Branch fund into the Royal London fund, so that its with-profits business can no longer be included as PVIF. Instead, the policyholder benefits and claims are reduced for the value of the future profits on this business so that there is no impact on the unallocated divisible surplus.

The tax charge in 2006 was lower than in 2005. No tax was payable on the long-term business in 2006 (2005 £42m), as fixed interest unrealised gains fell, and the deferred tax charge reduced to £37m (2005 £84m) due to a fall in unrealised equity gains.

#### IFRS BALANCE SHEET

	31 December 2006 £m	31 December 2005 £m
<b>Assets</b>		
Property, plant and equipment	73	111
Investment property	2,837	2,397
Intangible assets including acquired PVIF	628	698
Reinsurers' share of liabilities	302	1,259
Pension scheme asset	60	2
Financial investments	21,440	20,932
Other assets	197	145
Cash and cash equivalents	1,092	963
<b>Total assets</b>	<b>26,629</b>	<b>26,507</b>
<b>Liabilities</b>		
Unallocated divisible surplus	2,001	1,571
Insurance and investment contract liabilities (excl. UDS)	23,256	23,585
Subordinated liabilities	396	520
Other liabilities	976	831
<b>Total liabilities</b>	<b>26,629</b>	<b>26,507</b>

Key movements are:

- The increase in investment property reflects the 21.9% return on property achieved by the Royal London fund.
- The reinsurers' share of liabilities has decreased with the Part VII transfer of annuity liabilities to PRIL.
- The increase in the pension scheme asset is described on page 17.
- The increase in the UDS reflects the movement in the income statement, plus £1m (2005 £2m) of fair value gains on revaluation not recognised in the income statement.
- The decrease in the value of the subordinated debt follows the repayment in November 2006 of £125m of 9% subordinated debt issued by Scottish Life in 1996.

#### Royal London Group Pension Scheme

The Royal London Group Pension Scheme (RLGPS) was closed to new entrants on 1 September 2005 and a defined contribution arrangement was made available for new employees from that date. At 31 December 2006 RLGPS had assets of £1,782m and liabilities of £1,722m assuming future investment returns of 5.1% pa, resulting in a surplus of £60m. The pension fund is strongly capitalised and one of a few pension schemes in the UK that has a surplus on such a strong valuation basis.

#### Future accounting developments

We actively engage in the development of new accounting standards, via industry forums and working parties, reviewing and providing comment on proposals from the International Accounting Standards Board (IASB).

The most important change in the pipeline is phase II of the IASB's project on insurance contracts. The timing of this project remains uncertain, but the IASB estimates that a final standard is unlikely to be published before 2009. There is a range of possible outcomes and it is too early to assess the likely impacts of this change in accounting.

Whilst the standard is under development we will focus on EEV as the best measure of value added by our key businesses.

## CAPITAL MANAGEMENT

### GROUP CAPITAL STRUCTURE

As a mutual insurance company Royal London has no shareholder capital. Our capital structure consists of the amount by which our assets exceed our policyholder liabilities – our free assets – and subordinated debt. The structure is consistent with our risk profile and the regulatory and market requirements of our business. In managing our capital we aim to:

- Appropriately match the profile of our assets and liabilities, taking into account the risks inherent in each business and the level of accruing guarantees
- Maintain financial strength to support new business growth while satisfying the requirements of policyholders, regulators and rating agencies.

We have a number of sources of capital available to us such as debt which we use to maximise returns to members. We also consider alternative sources of capital including reinsurance and securitisation.

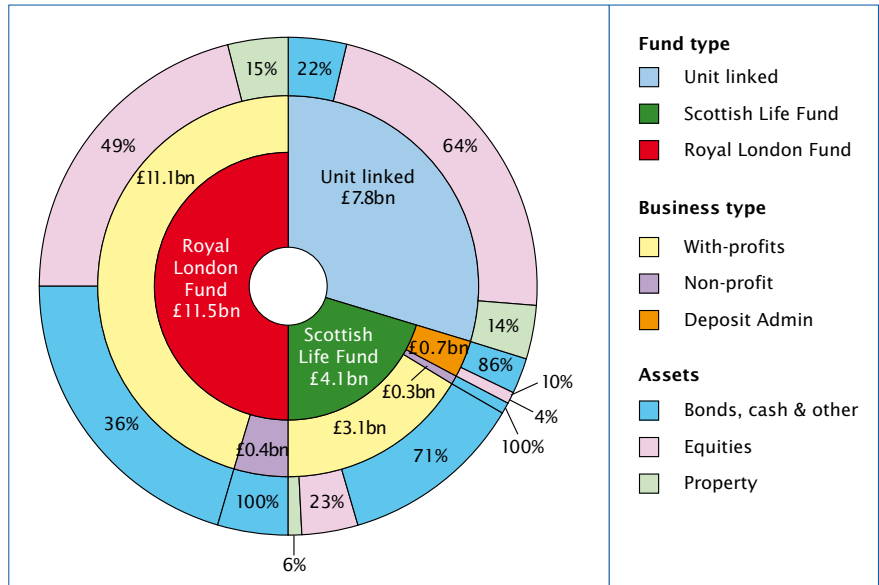
### OUR LONG-TERM FUNDS

Royal London's life and pensions funds totalled £23.4bn as at the end of 2006 (2005 £22.9bn) and are divided into three main components: the Royal London Fund, the Scottish Life Fund and our unit linked business. The chart overleaf details the structure of these funds.

The company operates two with-profits funds:

- Royal London Fund (red segment of the chart), which has assets of £11.5bn and into which all new business is written including that written under the Scottish Life and Bright Grey brands.
- Scottish Life Fund (green segment of the chart), which has assets of £4.1bn and which became a closed fund on 1 July 2001.

2006 ASSET ALLOCATION OF FUNDS (%)



CAPITAL DEVELOPMENTS DURING 2006

We manage our corporate structure to maximise the way in which we can use and access our capital. The Royal London Fund consists of various sub-funds, the open funds amounting to £8.1bn and the closed funds to £3.4bn. The closed funds comprise the Refuge Industrial Branch fund and the United Friendly funds. All new business is written in the open funds, which are the Royal London sub-fund and the Refuge Ordinary Branch sub-fund. The principal capital development during 2006 was the merger of these two open funds on 31 December 2006, which produced a reduction in the Group's capital requirement of £111m.

The Part VII transfers of the Group's annuities to PRIL reduced the Group's capital requirements by £35m.

These capital actions and our healthy financial results strengthened still further the financial resources available for the development and growth of the Group. The improvement in the capital position and the strong equity performance of the Royal London Fund enabled us to increase its with-profits equity backing ratio from 56% to 64% during 2006, an action that we expect to benefit longer-term policy returns.

**£300m**

*switched into equity holdings in the Royal London Fund, which have historically out-performed other asset classes*

## GROUP CAPITAL STRENGTH AND SOLVENCY

### Credit and financial strength ratings

Royal London has an A- long-term counterparty credit rating from Standard & Poor's and an A2 financial strength rating from Moody's Investors Service. Both are good ratings: for example, the Standard & Poor's 'A' rating is defined as "An insurer rated A has strong financial security characteristics". The indicators after the 'A' show relative standing within the major rating category.

The Group maintained regular contact with both rating agencies during the year to update them on the progress of the Group. Both ratings have remained unchanged throughout the year and the outlook is stable.

### Capital position

We believe that the FSA's 'Realistic Balance Sheet' (RBS) methodology best reflects our capital position. This can broadly be described as placing a market value on the assets and with-profits liabilities, including benefits already guaranteed and future discretionary benefits. Furthermore, the value of future profits on all acquired in-force long-term business as well as on non-participating business issued by Royal London may be included as an asset. The main component of the realistic liabilities is the asset shares of the with-profits business, although other reserving techniques have been applied where the use of asset shares is deemed inappropriate. The liabilities also include a value for the guarantees and options that have been given to policyholders. When calculating these liabilities, allowance has been made for actions that management would be expected to undertake on key assumptions, for example future bonus or investment policy in varying market conditions, in line with the Principles and Practices of Financial Management (PPFM). The asset share for a with-profits policy is essentially the premiums paid during the policy's life, less sums deducted to cover expenses, mortality charges and (where applicable) tax, plus the investment return earned on the underlying assets.

	Open funds £m	Closed funds £m	2006 Total £m	2005 Total £m
<b>Realistic Balance Sheet</b>				
Total realistic participating assets	7,646	7,163	14,809	14,590
Value of in-force business on a realistic basis	914	113	1,027	1,014
Current liabilities and subordinated liabilities	(725)	(202)	(927)	(961)
<b>Total realistic participating net assets</b>	<b>7,835</b>	<b>7,074</b>	<b>14,909</b>	<b>14,643</b>
Realistic participating liabilities				
- Participating benefit reserve	5,187	6,120	11,307	11,263
- Costs of smoothing	340	(15)	325	333
- Guarantees	264	240	504	668
- Options (guaranteed annuities)	181	400	581	555
- Other	54	(66)	(12)	23
<b>Total realistic participating liabilities (before closed fund transfer commitments)</b>	<b>6,026</b>	<b>6,679</b>	<b>12,705</b>	<b>12,842</b>
<b>Total realistic available capital (before closed fund transfer commitments)</b>	<b>1,809</b>	<b>395</b>	<b>2,204</b>	<b>1,801</b>
Closed fund transfer commitments	-	(395)	(395)	(385)
<b>Total realistic available capital</b>	<b>1,809</b>	<b>-</b>	<b>1,809</b>	<b>1,416</b>

To demonstrate the capital position of Royal London as at the end of 2006, the information above is split between those funds currently open to new business and those which are closed. The closed funds are the Refuge Industrial Branch fund, the United Friendly funds and the Scottish Life Fund, which were transferred following the acquisition by Royal London of United Assurance and Scottish Life.

For the purpose of the capital statement all excess assets associated with policies written within the closed funds, amounting to £395m (2005 £385m), are reported as liabilities because they are not available for distribution to other policyholders or for other business purposes. However, those excess assets are available to provide support to the relevant policies under stressed financial conditions before any call on the reported excess capital within the open funds need be made.

The realistic available capital disclosed in our FSA return is reconciled to the UDS in our IFRS balance sheet in the table below:

	2006 £m	2005 £m
<b>UDS at 31 December</b>	<b>2,001</b>	<b>1,571</b>
Inadmissible goodwill, pension scheme asset and deferred tax asset	(180)	(115)
Other adjustments to the value of net assets	(16)	(42)
Adjustments to liabilities on a regulatory basis	4	2
<b>Realistic available capital at 31 December</b>	<b>1,809</b>	<b>1,416</b>

The Group's minimum capital requirements are calculated on two bases – regulatory and realistic. The results of these two calculations are then compared for each with-profits fund, after applying stress tests, and the one with the highest capital requirement is then applied. This is referred to as the "Twin Peaks" test. All Royal London funds are now on the realistic peak.

<b>Regulatory Capital Statement as at 31 December 2006</b>	<b>Open funds £m</b>	<b>Closed funds £m</b>	<b>2006 Total £m</b>	<b>2005 Total £m</b>
Total Regulatory Capital*	2,669	1,256	3,925	3,325
Capital Resource Requirements				
Economic stress test requirements	-	-	-	534
EU solvency requirements	272	259	531	577
Additional with-profits requirements	589	997	1,586	688
Subsidiaries	14	-	14	14
Total Regulatory Capital Required	875	1,256	2,131	1,813
Excess Regulatory Capital	1,794	-	1,794	1,512

\* Total regulatory capital is the available assets of the Group after deducting liabilities

<b>Movements in Regulatory Capital during 2006</b>	Open funds £m	Closed funds £m	Total £m
As at 31 December 2005	2,189	1,136	3,325
Changes in valuation interest rates	72	140	212
Changes in mortality assumptions	(13)	(39)	(52)
Other valuation basis changes	(40)	7	(33)
Reduction in implicit item	(100)	–	(100)
Subordinated debt repaid	–	(125)	(125)
Investment return net of associated liability changes and subordinated debt interest	640	270	910
Surplus distributed to with-profits policyholders	(126)	(95)	(221)
Net other	47	(38)	9
As at 31 December 2006	2,669	1,256	3,925

The free asset ratio remains one of the most common approaches to assessing financial strength. At the end of 2006, Royal London's free asset ratio was a healthy 20.7% (2005 17.3%). The free asset ratio for the with-profits funds was 40.1% (2005 32.1%).

#### INDIVIDUAL CAPITAL ASSESSMENT (ICA)

Throughout 2006 the Group has continued to develop its ICA processes, taking the framework put in place in 2005 for identifying the risks that the businesses and the Group face as a whole and quantifying their impact on the capital required to be held by the Group. The ICA estimates the amount of capital required to mitigate the risk of insolvency to a 99.5% confidence level in a one-year time period against both financial and non-financial risks. This remains an ongoing process, as the Group's modelling capability is continually being improved.

During 2006 we used the results of this analysis to discuss with the FSA the target levels of capital that Royal London should maintain. These discussions were concluded towards the end of the year and the Group has assessed that its ICA remains more than twice covered by the excess of the assets over liabilities on a realistic basis at the end of 2006.

#### RISK MANAGEMENT

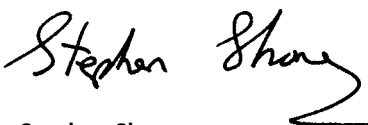
We have established a risk and financial management framework, the primary aim of which is to ensure that the sustainable achievements of the Group's performance and regulatory objectives are not undermined by unexpected events. A description of the risks we face and how they are managed is set out in note 40 to the financial statements.

#### WITH-PROFITS BONUSES

Bonuses for 2006 are commented upon on page 29.

#### CONCLUSION

Royal London delivered healthy financial results in 2006, our capital position remains very sound and all our business unit propositions are getting stronger. The UK pensions market remains challenging if we are going to generate adequate returns but we continue to focus on writing profitable business. Separately, as our current businesses have improved their performances we are now placing increased emphasis on identifying new opportunities to develop Royal London still further in 2007.



**Stephen Shone**  
Group Finance Director



“SCOTTISH LIFE REMAINS 100% COMMITTED TO THE INDEPENDENT ADVICE SECTOR AS THE BEST MEANS OF DELIVERING A COMPETITIVE, HEALTHY MARKET FOCUSED ON THE NEEDS OF CUSTOMERS.”

## BUSINESS UNIT REVIEW

# 8%

increase in new business

### SCOTTISH LIFE

2006 was a period of enormous change for the pensions industry as a result of the implementation of the new simplified pensions regime, which came into effect on A-day, 6 April 2006. The changes placed our business under significant pressure. At times during the year we were unable to provide the levels of service customers rightly expect. Our employees responded positively to this challenge, constantly striving to balance the priorities of A-day and of meeting our customers' expectations while continuing to grow new business profitably.

The achievements of our employees are shown in that the business continued to deliver on its financial targets for 2006. Focusing on writing only good quality business delivered an 8% increase in new business to £1,425m. This was a creditable performance and provides a solid platform to maximise on the launch of our expanded range of products and services supported by a rapidly improving standard of customer service in 2007.

Although much of our focus was on delivering the necessary changes for A-day, we have developed a number of important new products and services. In November we launched new services for defined benefit pension schemes. Most defined benefit schemes are now closed for new entrants, but ongoing management and service of these schemes remains an attractive market. Scottish Life is now well placed to provide a full range of services for the corporate market for both defined benefit and defined contribution business.

In April Scottish Life launched the Fund Matrix, a range of investment funds managed to tightly defined mandates by specialist external investment managers. Responsibility for the control and monitoring of these funds rests with our Investment Advisory Committee and forms part of the unique governance framework supporting this part of our investment proposition, providing transparency, clear definition and governance.

In December we launched our new Pension Portfolio proposition fulfilling our promise to customers to expand our already successful individual personal pension with a full self-investment service. Self Invested Personal Pensions (SIPPs) have rapidly become the product of choice among IFAs for individual pensions. We have partnered with Capita, which has enabled us to develop a quality online proposition with a specialist SIPP administration provider.

Technology remains a crucial element of our business. Increased use of our online facilities continued during 2006, boosted by our nationwide team of online consultants and implementation advisers who provide specialist support to IFAs and employers. In addition to our *eee* e-excellence technology rating for Corporate Pensions, our new Pension Portfolio proposition was awarded a *ee* e-excellence technology rating from *Money Marketing*. Moreover, our overall technology proposition was awarded the highest possible 5-star rating in the New Model Adviser technology ratings advised by the highly regarded firm AKG.

Scottish Life remains 100% committed to the independent advice sector as the best means of delivering a competitive, healthy market focused on the needs of customers. However, we believe it is vital that if advisers are remunerated by commission from products, then it must be completely transparent to customers. Our Financial Adviser's Fee (FAF) commission option is designed to do exactly that and we have been pleased with the growing acceptance it has received among IFAs. During 2006 around 80% of our new scheme corporate business and new individual business was written on either a FAF commission or fee basis.

**OUTLOOK**

Scottish Life is committed to its strategy of writing profitable business and remain determined to avoid loss-making areas of the market.

We are well positioned to win increasing market share for restructuring occupational pensions with a full range of products and services. The quality of our proposition in this market has enabled us to establish good business relationships with some of the highest quality IFAs and EBCs operating in this specialist market and our intention is to broaden and deepen these relationships in 2007.

We expect the at-retirement sector to be the primary driver of growth for individual pensions, now that there is more flexibility available allowing policyholders to take income from a pension fund. This is an area where IFAs are well placed to provide the help and advice that clients need. Our Pension Portfolio product is highly regarded by the market and we expect to win higher volumes of profitable business in 2007.

Scottish Life remains determined to put customers at the heart of its business. Fundamental to this is our service proposition and the primary focus continues to be to meet and exceed our customers' expectations.

**7%**

*market share of individual protection business sold through IFAs this year*

**BRIGHT GREY**

Bright Grey strengthened its position and reputation among IFAs in 2006 with record new business and application volumes, which resulted in a market share of over 7% across the product portfolio. We made particular gains in the mortgage term market resulting in a 9% market share by year end. On the PVNBP basis, Bright Grey's new business did fall by 6% reflecting lower persistency assumptions than had been used for the previous year's figures. However, in volume terms, new annual premiums were up 15% on 2005.

Bright Grey's standing among intermediaries was further evidenced by our appointment to the panels of several multi-ties during the year. The multi-tie distribution model is one where intermediaries restrict their choice to a specific panel of product providers. Sales through these channels increased strongly. This is a growth area and one that will be a key part of our distribution strategy in 2007 and beyond.

Service standards contributed strongly to sales growth with significant improvements again made in 2006. The IFA market reacted particularly positively to our online application service, launched in January 2006. Online applications had risen to 75% of all applications by year end due to the simplicity of design and speed of the service. An independent survey of protection providers showed Bright Grey to have the highest loyalty of online users measured in terms of the number of applications per user (E Benchmarkers, October 2006). Further development of our e-trading platform is underway.

Service overall received particularly favourable reviews from IFAs during 2006: 97% of our strategic IFA partners rated our service very good/excellent (ORC, May 2006). Overall, Bright Grey was voted most trusted provider of protection products by our IFA customers (NMG, May 2006).

Despite continuing pressure on price, margins held up well through effective management of underwriting and reinsurance. Sales volumes were also maintained by the identification of new product opportunities including those geared to the longer-term mortgage market.

Our Helping Hand proposition continued to provide an excellent service to clients. This offers a range of emotional and practical support in the event of a claim. This is a time when money alone is not always enough. Throughout the term of their plan, all our clients have access to a broad range of support including 24 hour helplines and advice from appropriate independent experts.

The business continued to win recognition through a variety of awards in 2006 including *Financial Adviser Life & Pensions Awards 2006*, *Money Marketing Awards 2006* and *Mortgage Next*.

#### OUTLOOK

Despite strongly competitive market conditions, prospects for Bright Grey are very positive. Application levels in the second half of the year were significantly higher than in the same period in 2005, reaching record levels by year end. Bright Grey's appointment to IFA multi-tie panel positions is additional evidence of our growing strength. Unit costs have reduced yet service standards are positively differentiating the business from our competitors.

Further development of web-based services is intended to strengthen our proposition even more. Royal London is strongly committed to the protection sector and, through Bright Grey, will continue to champion the need for protection as the solid foundation of financial planning.

#### SCOTTISH LIFE INTERNATIONAL (SLI)

SLI delivered another year of successful growth in 2006. New business was up by 25% over 2005, building on the foundation of the last two years. All areas of SLI's operations achieved or exceeded their targets, in particular the sales in Germany which, once again, increased substantially.

#### OUTLOOK

SLI will continue to develop business in the countries where we already operate. However the time is right to explore new markets. A representative office licence has already been granted to operate in Dubai and during 2007 we will begin the process of seeking a licence in Hong Kong.

A new IT platform will also be developed during 2007, which will allow us to introduce new products for the Middle East and Germany.

#### ROYAL LONDON ADMINISTRATION SERVICES

Royal London Administration Services (RLAS) focuses on administering the Royal London branded life, pensions and general insurance business, managing 4.8m policies on behalf of 2.3m customers who include the majority of Royal London members.

The large number of policies managed provides significant opportunities for economies of scale to drive business efficiencies. The deployment of new technology enables our business to deal with an increasing percentage of customer requests at point of call. Workflow planning and process simplification is also being used to improve operating performance further. Moreover, we continue to work closely with customers to offer economic premium-payment methods more suited to modern ways of life.

During 2006 RLAS successfully dealt with Pensions A-day, completed the transfer of existing Royal London annuities to Prudential Retirement Income Limited, and developed a direct-offer process for future vesting pensions.

Our sales contact centre continues to offer customers a range of products to meet their needs, underwritten by ourselves and carefully selected provider partners. During 2006, we added a new whole of life product to the range available to our customers.

#### OUTLOOK

In 2007 we will continue the transition to our new operating model to enhance the experience for our RLAS customers while continuing to drive business efficiencies.

**25%**  
*increase in new business*

**MANAGING  
4.8m POLICIES  
ON BEHALF OF  
2.3m CUSTOMERS**

## AN EXCELLENT YEAR FOR RLAM

### ROYAL LONDON ASSET MANAGEMENT (RLAM)

During the year total funds under management increased to just over £30bn. New external monies invested with RLAM were just over £1.2bn – a rise of over 60% on the previous year.

During the year we increased our institutional business revenue by 75% from £1.2m to over £2.0m. We substantially increased the number of consultants directing business to us and we have entered 2007 with a healthy pipeline of new business. We increased our number of external clients (excluding Cash Management) by 65%, from 55 to 91. These new clients accounted for 80% of the new monies in the year.

We had a very good year in the unit trust and open-ended investment companies (OEICs) sector with net sales of nearly £195m. As with our institutional business our largest inflows were into corporate bonds.

Royal London Cash Management (RLCM) is the market leader in segregated cash management services. RLCM achieved £389m of net new business in 2006, building on the successes of recent years. For the first time the team's external assets under management exceeded £2bn.

We successfully outsourced our investment administration functions to HSBC during 2006.

### DELIVERING GOOD INVESTMENT PERFORMANCE

All three of the major asset classes posted positive returns in 2006. The FTSE All Share Index returned 16.7% over the year, property returned 18% and UK gilts returned 0.7%. Of less significance, overseas bonds saw negative returns as they were impacted by the strength of sterling.

The assets used to back Royal London with-profits business generated a pre-tax return of 11.0% and those backing with-profits business in the Scottish Life Fund 5.2%. These returns exceeded their benchmarks by 1.1% and 0.3% respectively. The difference in returns reflects the greater weighting in property and equities in the assets backing the Royal London with-profits business.

The Fixed Income team continued their good performance in 2006, building on their record as one of the strongest in the UK – the reason why we have been able to attract an increasing number of external clients.

During the year we won awards as Specialist Fund Manager of the Year at the UK Pension Awards and the RL UK Equity & Income Investment Trust was awarded best high income security from *Money Observer*. In addition, we won several other awards for our Fixed Income funds from Standard & Poor's *MoneyWise* and *What Investment?*.

### OUTLOOK

External monies invested with RLAM are increasing strongly and we expect this to continue. At present just over one third of RLAM's revenues are externally generated. Our target is to have over half of its revenues generated by non-Group clients.

## WITH-PROFITS BONUSES

We aim to add value for our members and to continue to ensure that Royal London's with-profits policyholders receive competitive returns on their savings with us. This section describes the background to the bonuses for 2006 and how payouts on Royal London policies are determined.

In managing the with-profits business, including setting bonuses and maturity payouts, directors follow the Principles and Practices of Financial Management (PPFM). These were first published on 30 April 2004. The latest version was published in December 2006 and is available on the Group's website.

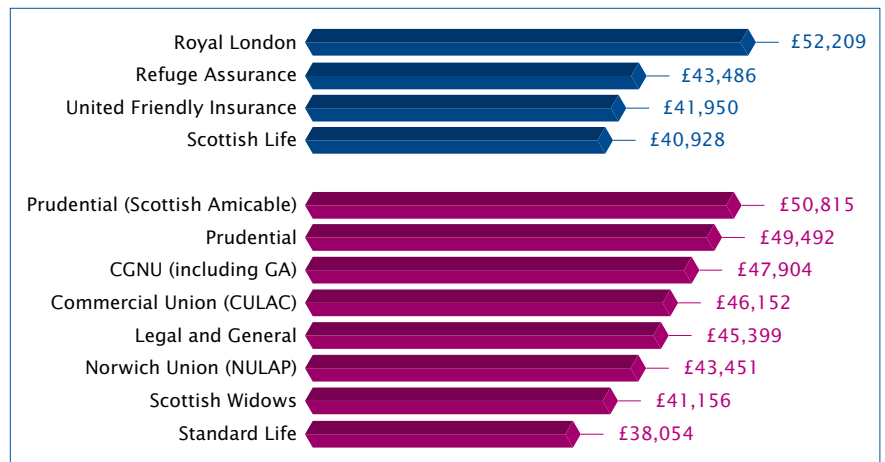
We aim to pay benefits at maturity broadly in line with a with-profits policy's underlying value, or asset share, after allowing for smoothing. The use of asset shares is the means by which we aim to ensure our payouts are treating all classes and generations of policyholder fairly. We calculate the asset shares for specimen policies by accumulating the premiums paid at the rate of return earned on the assets backing the with-profits policies, after deducting amounts to cover expenses, mortality charges and tax (where applicable).

The amount of smoothing we apply follows the approach laid out in the PPFM and depends on the strength of the fund and also on whether payouts are above or below asset shares.

Following another year of good investment returns, the Board was pleased to be able to increase final bonus rates and payouts on some shorter-term life policies. However, as explained in last year's report, payouts on many Royal London longer-term policies are still in excess of asset shares and as a result are continuing to reduce as we apply our smoothing policy to bring them more into line with asset shares. The reductions in payout that we have applied have been smaller than those seen last year, mainly due to our continued excellent investment performance and the strength of the Royal London with-profits fund.

Despite these reductions in payouts Royal London maintains strong with-profits credentials.

### WITH-PROFITS ENDOWMENTS – TERM 25 PAYOUTS



We expect future investment returns from equities and fixed interest assets to be lower than they were during the 1990s. As a result we expect asset shares on longer-term policies (for example 25-year term) maturing in the future to reduce gradually. This means that even if equity markets remain strong we are likely to reduce maturity payouts on longer-term policies to bring them more in line with asset shares. The extent of these reductions will depend on how quickly we realign maturity payouts with asset shares. However, maturity payouts on most shorter-term policies are now reasonably aligned with asset shares. So if equity markets are strong, we may increase maturity payouts on these policies.

Source: Royal London internal figures and company press releases for all companies with over £10bn funds under management.

Note: Payouts are based on a 25-year endowment policy maturing in 2007 taken out by a male aged 29 paying £50 a month. Past performance is not a guide to future performance.

## CORPORATE SOCIAL RESPONSIBILITY

As a mutual insurance company, Royal London has a long tradition of serving the community in which it operates from both an economic and social perspective. We recognise our responsibility to conduct our business in a responsible and ethical manner, taking into account our economic, social and environmental impacts. Our operations potentially affect local communities and account is taken of these in our decision making processes. To support this the Group has established a Corporate Responsibility Committee which oversees the Group's social, environmental and ethical matters. During 2006 we undertook several initiatives through the leadership of this committee, including the improvement of waste recycling and the setting up of a carbon offsetting scheme for air travel.

### MARKETPLACE

#### Treating customers fairly

Royal London is committed to the principle of treating customers fairly and this is seen as an integral part of the Group achieving its vision and strategy. As part of our policy:

- We will act with integrity and honesty in all of our dealings with customers, treating everyone with respect and dealing with requests as quickly as possible;
- Products are developed and designed with a sense of responsibility to consumers and society, and with a purpose of providing customers with the products and services they need;
- Products are designed with clear features, so that customers can easily understand the main risks of what they are being offered and will not be misled or confused;
- Communication with customers and intermediaries is clear, straightforward, balanced and easy to understand, and complies with all relevant legislation and codes of practice;
- We will handle any complaints promptly and in a fair manner; and
- Customers are kept informed about the progress of their investments in an appropriate manner that will meet their reasonable information needs.

#### Customer impact

In March 2006 the Association of British Insurers launched the Customer Impact Scheme. We agreed to join the scheme from commencement for three of our brands (Royal London, Scottish Life and Bright Grey) by resolving to ensure that the needs of our customers continue to be at the core of the way in which we run our business.

In the first year of operating under the scheme, our emphasis has been on maintaining good progress on the many customer-focused initiatives already in hand while starting to collect data which will help to measure the progress we are making. This includes participating in detailed surveys of customer attitudes administered by an independent agency for each of our brands.

It is too early to identify any trends from the information we have begun to collect. Instead, the Board reaffirms its commitment to serving the needs of our customers and notes the significance of the measures being put in place for each of our brands. Full reports on our performance and progress in delivering the commitments made as members of the scheme will be published annually on the Royal London Group website.

#### Institutional shareholder

The Group's asset management business Royal London Asset Management (RLAM), enters into a dialogue with companies in which its funds are invested, evaluates and gives due weight to the governance arrangements within these companies and makes considered use of votes at their general meetings.

Royal London subscribes to the principle of 'comply or explain' in the evaluation of companies' governance arrangements. We have also been actively involved in the development of best practice guidelines covering narrative reporting. This encourages companies to inform shareholders of the significant risks facing the business and what actions are being taken to mitigate these.

We are committed to applying appropriately the Statement of Principles as drawn up by the Institutional Shareholders' Committee. This sets out best practice for institutional shareholders in relation to their responsibilities with companies in which they have invested. In particular RLAM:

- Monitors the Group's investments and establishes an active dialogue with the Boards and senior management of major investee companies;
- Seeks the highest possible compliance with the core standards of the Combined Code which covers the largest companies in the UK;
- Evaluates the management of major investee companies to satisfy itself that their boards and committee structures are effective, and that independent directors are providing effective oversight;
- Monitors the performance of the investments so that it can exercise its votes and where necessary intervene objectively and in an informed way; and
- Reports to the Group on the impact and effectiveness of their activities.

Overall, the Group subscribes to the view that a process of constructive dialogue with companies to effect continual improvement is generally preferable to one of exclusion on, for instance, environmental or ethical grounds. We do, however, specifically monitor these issues and raise them with the management of companies in which our funds are invested where they are considered to pose significant risks.

In support of our belief that investors will increasingly seek specific investment opportunities which explicitly highlight ethical or environmental considerations we have recently launched an Ethical Bond Unit Trust. This allows for investment in the corporate bond market but in addition has a policy of abstaining from investing in companies or organisations that are involved in certain activities such as armaments. This launch has attracted favourable interest from the marketplace.

#### ENVIRONMENT

The green commuting policy at our Wilmslow site provides employees with alternatives to commuting by car and has achieved a significant reduction in single-occupancy car journeys. The Group's procurement policy aims to ensure that suppliers of goods and services consider environmental issues as part of their service provision. Environmental issues are also a major consideration in the acquisition and disposal of consumables. The Group's policy is to dispose of plastic cups, paper, light bulbs, toner cartridges and IT equipment through specialist recycling companies and to investigate energy needs with the aim of reducing consumption.

In 2007, the Group has implemented initiatives on carbon offsetting for air travel, a time-off process for employees undertaking volunteer work and an increased role in the Personal Finance Education Group.

#### CHARITY AND THE COMMUNITY

Royal London has a long history of serving the community, regularly contributing to many charities and worthwhile organisations and continues this tradition of giving something back to the local community in which we operate. Our policy is to commit to giving in kind where possible and appropriate and this allows us to provide use of our buildings and facilities for charities and community groups to hold meetings or events or for storage.

Royal London's community corporate involvement policy is called Helping Hand and includes an appointed national charity (in 2006 this was Marie Curie Cancer Care), local sponsorship support, a double-your-money employee matched-donation scheme and dress-down days which take place across the Group in aid of charities. In 2006, charitable donations by Royal London amounted to £63,259.

#### THE WORKPLACE

As at 31 December 2006 we had 2,640 employees (2005 2,885).

##### Equal opportunities

The Group is committed to providing equal opportunities to all employees irrespective of sex, marital status, creed, colour, race, religion, ethnic origin, sexual orientation, age or disability. Royal London recognises that valuing diversity brings benefits to business performance and to employee satisfaction. The Group is committed to recruiting, developing, promoting and training employees on the basis of their individual competences and performance.

If any employee becomes disabled, the Group will arrange for retraining or consider an application for retirement on disability pension, as appropriate.

The Group strives to support employees and be flexible in its approach towards work/life balance.

##### Employee involvement

Our business performance benefits if staff are motivated, informed and involved in our successes and challenges. We are committed to an ongoing dialogue with employees on all developments affecting the Group and its business. This is done by:

- Senior management road shows
- Newsletters
- Group-wide intranet communications
- Regular employee consultation forums.

Employee Committees for each business unit operated for the period under review with the aim of improving involvement and to comply with the Information and Consultation Regulations which came into effect in April 2005.

An independent Group-wide employee survey undertaken in 2006 was completed by 81% of our employees. Results of the survey were generally encouraging, placing us just outside the top quartile of companies surveyed by the research agency. Survey results were presented to all employees and specific reports produced for management teams and the Employee Committees. Addressing issues arising from the survey is a key management objective for 2007 as we continue to seek ways to maintain and further strengthen employee morale.

The 2006 Short-Term Incentive Plan for most employees was based on Group profitability and individual performance.

##### Health and safety

We strive to provide a safe environment for all employees and visitors to our premises and to comply with relevant health and safety legislation. In addition:

- We seek to protect the health of employees with suitable, specific work-based strategies, through our occupational health scheme, the promotion of 'vitality at work' and guidance on the management of road risk
- We seek to minimise the risk of injury from work activity, through staff completing display screen equipment (DSE) assessments
- We ensure that sufficient resources and information are made available and suitable management systems are in place to address health and safety matters, through dedicated health and safety personnel
- We promote a healthy workplace by only permitting smoking in certain dedicated areas.

## BASIS OF PREPARATION

The business review has been prepared in accordance with the Directors' Report Business Review requirements of the Companies Act 1985. It incorporates much of the guidance set out in the Accounting Standards Board's Reporting Statement: 'Operating and Financial Review'. It is addressed to, and written for, the members of Royal London with the intention of giving a fair review of our business development, performance and position at the present time.

### ACCOUNTING BASIS OF PREPARATION

Our results and financial position are presented on an International Financial Reporting Standards (IFRS) basis. There are no significant changes to the IFRS presentation for our 2006 Annual Report and Accounts.

In our 2005 Annual Report and Accounts we presented initial achieved profit results. During the year we have developed this methodology to enable us to present the results and financial position on a European Embedded Value (EEV) basis as supplementary information, in addition to the IFRS basis. In the Directors' opinion, EEV provides a more transparent view of the performance of the life and related operations year on year than the results presented under IFRS. The financial statements include supplementary information on EEV reporting on pages 129 to 140. Adoption of EEV has resulted in changes to the achieved profit results reported in our 2005 Annual Report and Accounts and these are restated.

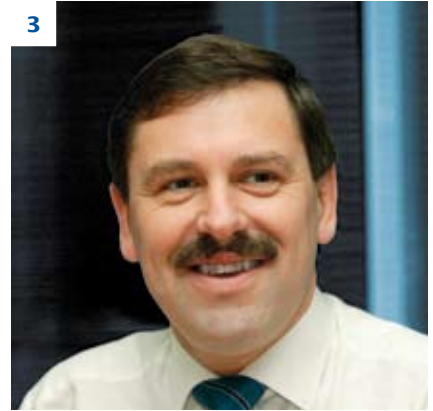
The EEV methodology adopted is in accordance with EEV principles introduced by the Chief Financial Officers' Forum in May 2004 and updated in October 2005 (so far as they can be adopted for a mutual company). Under EEV methodology, the total profit recognised over the full lifetime of a policy is the same as under IFRS reporting.

### FORWARD-LOOKING STATEMENTS

This business review contains 'forward-looking statements' with respect to certain of Royal London's plans, its current goals and expectations relating to its future financial position. By their nature, forward-looking statements involve risk and uncertainty because they relate to future events and circumstances which are beyond Royal London's control. These include, among others: UK economic and business conditions; market related risks, such as fluctuations in interest rates; the policies and actions of governmental and regulatory authorities; the impact of competition; and the timing, impact and other uncertainties of future mergers or combinations within relevant industries.

As a result, Royal London's actual future financial condition, performance and results may differ materially from the plans, goals and expectations set out in Royal London's forward-looking statements. Royal London undertakes no obligation to update the forward-looking statements contained in this document or any other forward-looking statement it may make.

# BOARD OF DIRECTORS



WITH EFFECT FROM 1 APRIL 2007

**10 John Deane (48)**  
FIA Executive Director

John Deane joins the Board, with effect from 1 April 2007, from Old Mutual plc where he was latterly Corporate Development Director and played a significant part in the successful acquisition of Skandia. John was also involved in the successful sales and product redesign in Old Mutual's South African life business to meet a changing economic environment. Prior to joining Old Mutual, John formed Adepta in 2000, an outsourcing company, which contracted with major life companies. He held senior positions within the life insurance industry at Laurentian Life and Century Life between 1987 and 2000. John is a Fellow of the Institute of Actuaries.

**1 Tim Melville-Ross (62)****CBE Chairman**

Tim Melville-Ross was appointed to the Board in June 1999 and became Non-Executive Deputy Chairman and Senior Independent Director in June 2002. He became Chairman on 1 January 2006. 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 DTZ Holdings plc, Manganese Bronze Holdings plc and Bovis Homes Group plc, and a non-executive director of Katalyst Ventures Ltd. He is also chairman of the Council of the university of Essex and president of the Chartered Management Institute.

**2 Mike Yardley (50)****FIA Group Chief Executive**

Mike Yardley has spent more than 30 years in the insurance and investment industries in the UK. He took up his current position in April 1998 having spent the previous 5 years as Executive Chairman of Royal London Asset Management. He joined Royal London in 1978 after 3 years at Pearl Assurance. In 1988 he was instrumental in forming the new asset management subsidiary of the Group that would manage third parties' assets as well as those of the Group. Mike was appointed to the Royal London Board in November 1989. He is a Fellow of the Institute of Actuaries, a member of the Life Insurance Committee of the Association of British Insurers and a founder director of the Association of Mutual Insurers.

**3 Stephen Shone (50)****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 has nearly 20 years' experience in the financial management of life companies. On leaving KPMG in 1987 he 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.

**4 Andy Carter (46)****MA Executive Director**

Andy Carter was appointed to the Board on 2 January 2007. He joined Royal London Asset Management in September 2001 as Chief Investment Officer and was promoted to Chief Executive Officer in September 2003. Andy has extensive experience of managing all of the major asset classes beginning his career in investment management in 1983 with Provident Life. Prior to joining Royal London he held a number of investment management positions at Gartmore from 1987 to 2001, leaving as head of UK equities.

**5 Brian Duffin (52)****MA FFA Executive Director**

Brian Duffin was appointed to the Board on 1 July 2001 following the acquisition of Scottish Life. He joined Scottish Life in 1976 and has significant experience of investment management and marketing. He qualified as an actuary in 1979. He was appointed to the Board of Scottish Life in 1996 and became its group chief executive on 1 January 1999. Brian steps down from the Board on 31 March 2007.

**6 Trevor Bish-Jones (46)****Non-Executive Director**

Trevor Bish-Jones was appointed to the Board as a Non-Executive Director in October 2005. He is the chief executive of Woolworths Group plc having been appointed in March 2002. Prior to that, he held various senior positions at Dixons Group plc between 1994 and January 2002, latterly as managing director of Currys, and was at Boots plc for 13 years in a number of senior retail, buying and marketing roles. He is a trustee of The Ashridge (Bonar Law Memorial) Trust, a charitable trust.

**7 Robert Jeens (53)****FCA Non-Executive Director**

Robert Jeens was appointed to the Board in May 2003. He is Chairman of the Audit Committee. He has some 30 years' experience within large financial services businesses, initially as a partner at Touche Ross & Co and latterly as Finance Director at Kleinwort Benson Group plc and Woolwich plc. He is currently a non-executive director of Bank Insinger de Beaufort N.V., Dialight plc and TR European Growth Trust plc and chairman of nCipher plc, as well as a number of private companies.

**8 Tom Ross (62)****OBE FFA****Senior Independent Director**

Tom Ross was appointed to the Board as a Non-Executive Director in July 2001 following the acquisition of Scottish Life and became Senior Independent Director on 1 January 2006. 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, the Edinburgh UK Tracker Trust plc, the Pensions Policy Institute and the trustee boards of two large pension funds. He is a past president of the Faculty of Actuaries.

**9 David Williams (60)****MSc Non-Executive Director**

David Williams was appointed to the Board on 1 March 2006. He is Chairman of the remuneration committee. He is currently an operating partner with Duke Street Capital LLP and chairman of Accantia Ltd. He is also a non-executive director of Mothercare plc and a former director of DX Services plc and Avanti Screen Media Group plc. He is a former chairman of Wyevale Garden Centres plc. He was chief executive of the Thresher Group Ltd from 2001 to 2004 and has also held a number of senior appointments with Diageo plc, PepsiCo Inc and Whitbread plc. David holds an MSc from London Graduate School of Business Studies where he is a governor.

## DIRECTORS' REPORT

for the year ended 31 December 2006

### Principal activities

The principal activity of the Company is the transaction of long-term insurance business covering life and pensions. The principal activities of the significant subsidiary undertakings are set out in note 20 to the financial statements.

### Business review and future developments

The Directors' report should be read in conjunction with the Business Review, which is incorporated in this Directors' report by reference, and includes information about the Group's business, its financial performance during the year, likely developments, and any principal risks and uncertainties associated with the business.

### Going concern

After making enquiries, the directors are satisfied that the Company and the Group have adequate resources to continue to operate as a going concern for the foreseeable future and have prepared the financial statements on that basis.

### Annual General Meeting

The Annual General Meeting (AGM) of the Company will be held at 11.00am on 22 May 2007 at the Redgrave and Mozart Suites at The Barbican Centre, Silk Street, London, EC2Y 8DS. The Notice convening the meeting together with guidance on the AGM is being sent to all members.

### Directors

Details of the current directors are set out on pages 34 and 35. All of them have held office throughout the period under review except for David Williams who joined the Board as a non-executive director on 1 March 2006, Andy Carter who joined the Board as an executive director on 2 January 2007 and John Deane who was appointed as an executive director with effect from 1 April 2007.

Fields Wicker-Miurin did not offer herself for reappointment as a director at the 2006 AGM on 25 May 2006 and Brian Duffin will retire as a director on 31 March 2007.

In accordance with the Articles of Association, Andy Carter, John Deane and Robert Jeens will retire at the AGM and, being eligible, offer themselves for reappointment.

The details of the executive directors' service contracts are set out in the Directors' remuneration report on pages 41 to 43. None of the directors has or had an interest in the shares of any Group undertaking.

### Financial instruments

The Group makes extensive use of financial instruments in the ordinary course of its business. Details of the risk management objectives and policies of the Group in relation to its financial instruments and information on the risk exposures arising from these instruments are set out in note 40 to the financial statements.

### Employees

Details of the Group's employment policies are shown on page 32.

### Corporate social responsibility

The Board recognises that the Group has a responsibility to act ethically in relation to the physical and social environment in which it operates. A summary of the Group's approach is set out on pages 30 to 32. Additionally that section sets out the Group's policy on Charitable and Community activity.

### Political Donations

No political donations were made in 2006 (2005 £nil).

### Supplier payment policy

The Group does not follow any code or standard with its suppliers, but it is the policy of the Group to agree terms of payment when orders for goods and services are placed and to pay in accordance with those terms. The ratio of the amount owed to trade creditors at the end of the year to the amounts invoiced by suppliers during the year, equates to a 22 day average payment period (2005 23).

### Auditors

A resolution for reappointment of PricewaterhouseCoopers LLP as auditors of the Company will be proposed at the AGM.

The directors who held office at the date of approval of this Directors' report confirm that so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware; and that each director has taken all steps that ought to have been taken as a director to be aware of any relevant audit information and to establish that the Group's auditors are aware of that information.

By order of the Board



**Murray Ross**

Group Legal Director and Secretary  
29 March 2007

# CORPORATE GOVERNANCE STATEMENT

for the year ended 31 December 2006

## The Combined Code

The Board is committed to a high standard of corporate governance.

The Board considers that, throughout the period under review, it has applied the relevant principles and complied with the relevant provisions of the Combined Code on Corporate Governance updated in June 2006 ('the Code'), together with the Annotated Combined Code for Mutual Insurers published in July 2005.

In this report, the term 'period under review' means the period from 1 January 2006 to the date of this report.

## The Board

### Composition and balance

The Board currently comprises the Chairman, four non-executive and four executive directors. One of the non-executive directors has been appointed Senior Independent Director. All the non-executive directors are independent and biographies of all the directors appear on pages 34 and 35 together with descriptions of their expertise, experience and qualifications, and a note of their other significant commitments. Membership of the Board Committees is set out in this statement. The Board is satisfied that this range of expertise, experience and qualifications is appropriate for the current needs of the business.

### Role

The Board determines the Group's:

- values, standards and ethics;
- strategy and objectives and approves an annual business plan and budget, and monitors the Group's performance in achieving them;
- risk appetite;
- organisational structure; and
- pension and remuneration policies.

The Board:

- reviews the most significant risks affecting the Group and the action being taken to manage or mitigate them;
- appoints directors and makes and approves many of the senior appointments including the Group Chief Executive, the executives who report directly to him, the senior actuarial appointments and the Company Secretary;
- determines the responsibilities of the Group Chief Executive and approves any delegation of his responsibilities to heads of business units or support functions;
- declares annual and final bonuses (and the basis for payment of benefits on early termination including market value adjustment factors) on with-profits policies issued by any Group company;
- approves the annual report and accounts and the significant regulatory returns;
- approves the Principles and Practices of Financial Management for the with-profits funds; and
- reserves to itself certain decisions.

These reserved decisions include:

- the acquisition or disposal of any business or major asset, the setting-up of a new business or joint venture or the merging of any part of the Group's business with a third party;
- making or guaranteeing a significant loan; and
- significant investments and transactions not at arm's length.

Beneath the Board there is in place clear and appropriate apportionment of responsibilities amongst executive directors and senior managers so that the business of the Group can be effectively managed and monitored.

### How the Board operates

The Group Chief Executive circulates to the Board on a monthly basis a report on the performance of the Group and any other material matters, both internal and external. This includes financial information provided by the Group Finance Director and reports on how the Group has performed against key indicators, and contributions from other members of the executive team who meet regularly to manage the business.

The report is reviewed at the Board meetings when the Group Chief Executive, the Group Finance Director and the other executives highlight the key issues. Additional papers on issues upon which the Board is required to make a decision are submitted as required. Where the author of these papers is not an executive director or the Company Secretary, he or she will ordinarily attend the meeting, present the paper and deal with the points raised by the Board.

### Board Committees

The Board has established Audit, Nomination and Remuneration Committees.

The members of the Audit Committee are Robert Jeens (Chairman), Trevor Bish-Jones, Tom Ross and David Williams (from March 2006). The responsibilities of the Audit Committee include:

- monitoring the integrity of the financial statements of the Company and any formal announcement relating to the Group's financial performance;
- reporting its views to the Board where it is not satisfied with any aspect of the proposed financial reporting by the Company;
- approving announcements to the London Stock Exchange by the Company on its performance;
- monitoring and reviewing the Group's internal financial controls and internal control and risk management systems;
- reviewing the external auditors' management letters and management's response to them;
- reviewing the effectiveness of Internal Audit and approving the annual Internal Audit plan;
- reviewing on an ongoing basis reports from Risk and Compliance and Internal Audit;

- making recommendations to the Board for it to put to the members for their approval in general meeting in relation to the appointment of the external auditors and approving the remuneration and terms of engagement of the external auditors;
- reviewing and monitoring the external auditors' independence and objectivity and the effectiveness of the audit process;
- developing and implementing a policy on the engagement of the external auditors to supply non-audit services;
- determining on behalf of the Board the Group's policy for employing the former employees of the external auditors; and
- reviewing arrangements by which staff may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control or otherwise.

The external auditors, the Group's Risk and Compliance Director and the Head of Internal Audit submit reports to, and attend meetings of, the Committee.

The Code states that the Board should satisfy itself that at least one member of the Audit Committee has recent and relevant financial experience. The Board takes the view that, rather than an individual or individuals, the Audit Committee as a whole should be considered and has concluded that it does have the relevant skills and experience.

A policy has been approved by the Audit Committee in relation to the provision of non-audit services by the auditors. Essentially the policy provides that the auditors may not provide certain defined services that are felt to be inconsistent with the role of the auditors. For other services, a prior authorisation procedure is in place. Any significant work has to be authorised by the chairman of the Audit Committee.

The members of the Nomination Committee are Tim Melville-Ross (Chairman), Trevor Bish-Jones, Robert Jeens, Tom Ross, David Williams (from March 2006) and Mike Yardley. The responsibilities of the Nomination Committee include:

- reviewing the structure, size and composition (including the skills, knowledge and experience) of the Board and making recommendations to the Board with regard to any changes;
- nominating for Board approval candidates to fill vacancies on the Board and Board Committees;
- succession planning – taking into account the challenges and opportunities facing the Group and skills and expertise needed on the Board in the future; and
- keeping under review the leadership needs of the organisation, both executive and non-executive, with a view to ensuring the continued ability of the organisation to compete effectively in the marketplace.

The Committee decided that, given the importance of Royal London Asset Management to the Group and his contribution to the success of that business, Andy Carter should be appointed to the Board. In addition, during 2006 the Nomination Committee evaluated the balance of skills, knowledge and experience on the Board and in the light of the evaluation set down the role and capabilities required for the appointment of one further executive director that had been identified as necessary. An external search consultancy was retained and as a result of this process John Deane was recommended to the Board for appointment.

The Remuneration Committee is composed of non-executive directors, and is chaired by David Williams. The other members are Trevor Bish-Jones, Robert Jeens, Tim Melville-Ross and Tom Ross.

The responsibilities of the Committee include determining for Board approval the policy for remunerating the executive directors and other senior executives, determining the remuneration of this group and determining the targets for performance-related pay schemes.

The terms of reference of all Board committees are available on request and are published on the Group's website in the 'Group Information' section.

Fields Wicker-Miurin was a member of the Committees until 25 May 2006, when she did not stand for reappointment as a director.

#### **Meetings and attendance**

During 2006:

- the Board met ten times and all the directors were present at each meeting;
- the Audit Committee met five times and all its members were present at each meeting;
- the Remuneration Committee met seven times and all members attended at each meeting;
- the Nomination Committee met three times and all members were present at each meeting.

#### **Evaluation**

The Board undertook a formal and rigorous evaluation of its own performance, and that of the committees and individual directors. Each director completed a questionnaire on the performance of the Board and each committee of which he or she was a member. The replies were collated with any additional comments that had been made, and discussed by the Board and the relevant committee. The Chairman evaluated the performance of the non-executive directors and the Group Chief Executive. The non-executive directors led by the Senior Independent Director evaluated the performance of the Chairman, taking into account the views of executive directors. The Group Chief Executive evaluated

the performance of the other executive directors. The Board was satisfied that each non-executive director displayed the time commitment required to properly discharge the role. Directors have continued to update their skills and knowledge, both within the Group and outside. Presentations have been given on key issues and developments within the industry.

The Chairman meets from time to time with the non-executive directors in the absence of the executive directors.

### **Succession**

It is the responsibility of the Board to ensure that plans are in place for appointments to the Board that will maintain an appropriate balance of skills and experience.

### **Internal Control**

#### ***The system of internal control***

The Group's internal control system encompasses policies, processes, tasks, behaviours and other aspects of the Group that taken together:

- facilitate the effective and efficient operation of the Group by assisting it to respond appropriately to significant business, operational, financial, compliance and other risks that could impact upon the Group's ability to meet its objectives; and
- are designed to encourage compliance with applicable laws, regulations and internal policies.

#### ***The role of the Board***

The Board is ultimately responsible for the Group's system of internal control and for reviewing its effectiveness. The system is designed to manage rather than eliminate the risks of failure to achieve business objectives, and inevitably can provide only reasonable and not absolute assurance against material misstatement or loss. The system has been in place throughout the period under review and accords with the Code. The Board is very conscious of the importance of the Group's internal controls and attaches high priority to developing them in line with best practice.

The Board has conducted a review of the effectiveness of the Group's system of internal control during the year ended 31 December 2006, taking into account matters arising up to the date of approval of this Annual Report and Accounts. This covered all material controls, including financial, operational and compliance controls and risk management systems. It was conducted in part on an ongoing basis, via the reports submitted to the Board and the Audit Committee and also by reports prepared as part of the year end process. In the event of any significant weaknesses being identified, the Board will ensure that necessary actions are taken to address them.

The Board has established an ongoing process for identifying, evaluating and managing the significant risks

faced by the Group. The management of each business unit and support function is responsible for identifying, evaluating, rating (in terms of probability of occurring and likely impact), assigning responsibility for, reporting on and managing and mitigating all risks relevant to its area of business, including the design and operation of suitable internal controls.

#### ***Element of independent oversight***

A key aspect of the Group's internal system of controls is the element of independent oversight provided by the Risk and Compliance and Internal Audit teams, and the Group Risk, Insurance and Capital Management Committees.

#### ***Risk and Compliance:***

- assists management to achieve the objective of embedding risk management throughout the Group and to manage risks within the business units and support functions;
- facilitates the risk management process;
- maintains a risk matrix that sets out all of the significant risks impacting on the Group and scores them in terms of probability and impact;
- reports and makes recommendations to the Group Chief Executive, the Group Risk Committee and the Board on, for example, the risk matrix and on the management of all categories of risk, including whether adequate risk management systems are in place, key risks are being properly managed and whether changes should be made to the Risk Appetite Statement or the overall strategy for the management of risk;
- monitors and enforces compliance with the requirements and rules of regulators;
- monitors that systems and controls are in place to counter the risk that the Group may be exposed to practices linked with financial crime;
- develops a compliance monitoring plan and undertakes work in accordance with the plan;
- co-ordinates the Group's relationships with its regulators; and
- evaluates the impact of forthcoming regulatory changes and co-ordinates the Group's responses.

#### ***Internal Audit:***

- provides management and the Audit Committee with independent and objective assurance on, and evaluation of, the overall effectiveness of the Group's internal systems and controls, and the risk management and corporate governance processes;
- develops an annual audit plan in conjunction with management and the Audit Committee;
- performs work in line with that plan and additional assignments where required; and
- includes recommendations within all audit reports and monitors the implementation of those recommendations.

The Group Risk Committee includes the Group Chief Executive, the Group Finance Director, the Executive Director responsible for risk, compliance and audit, the Group Legal Director, the With-Profits Actuary, the Group Risk and Compliance Director, the Group Actuary and the Head of Internal Audit. With effect from 1 April 2007 the newly appointed Executive Directors will become members of the Committee. The role of the Committee is to ensure that adequate risk management systems are in place, that key risks are being properly managed and that consideration of potential risks forms a part of all decision making throughout the Group. The Committee met five times during 2006.

Further information on risk management is contained in note 40 of the financial statements.

#### **Institutional shareholder**

The Group, through Royal London Asset Management, firmly believes in the use of best practice by the companies in which it invests and its approach is set out in the corporate social responsibility statement on pages 30 and 31.

#### **Directors' responsibilities**

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the parent company and Group and of the results of the Group for that period. In preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent;
- state whether applicable accounting standards 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 confirm they have complied with the above requirements in preparing the financial statements.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of Royal London and enable them to ensure that the financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

The maintenance and integrity of the Royal London Group website is the responsibility of the directors; the work carried out by 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.

By order of the Board



**Murray Ross**  
Group Legal Director and Secretary  
29 March 2007

## DIRECTORS' REMUNERATION REPORT

for the year ended 31 December 2006

This report has been prepared in accordance with the requirements of the Directors' Remuneration Report Regulations 2002. A resolution to approve the report will be proposed at the Annual General Meeting of the Company to be held on 22 May 2007.

The role and membership of the Remuneration Committee is dealt with in the Corporate Governance statement.

Hay Group provides independent advice to the Committee on the pay and benefits of executive directors and senior executives. Watson Wyatt provides specialist pension advice. Hay Group also provides the Group with remuneration data for employees outside the senior executive population.

### Policy

The Remuneration Committee decides executive directors' remuneration. It considers it is in Royal London members' interests for remuneration packages to be competitive in order to attract and retain people of the required calibre. The policy is for total remuneration to be at the median of the UK financial services market. Comparisons take account of the Group's scale and complexity compared to the comparator companies.

Bonus plans are designed to encourage and reward increases in the value of the business for the benefit of members.

### Remuneration package – executive directors

#### *Salaries*

The salaries of directors are determined by considering the individual's responsibility and performance and the remuneration paid in companies of comparable size and nature.

#### *Performance-related bonus plans*

##### ▪ Short-Term Incentive Plan (STIP)

This annual plan is designed to focus participants on the results that need to be achieved to meet Royal London's annual targets in the context of the agreed strategy. The target and cap are 50% (2005 25%) and 100% (2005 50%) respectively of salary at the end of the year except for Mike Yardley, who has a target and cap of 60% (2005 30%) and 120% (2005 60%) of salary respectively.

Payment of one third of Mike Yardley's STIP and 30% of other executive directors' STIP is deferred for three years and is dependent on the change in the value of Royal London over this time.

##### ▪ Long-Term Incentive Plan (LTIP)

The LTIP is a phantom share option plan with rewards directly related to increases in Royal London's value over the long-term on a financially equivalent basis to a share-based option plan. Payments are subject to the achievement of minimum growth targets. Allocations are fixed in new plans starting annually, the final payout under each plan being determined by the increase in the Group's value in excess of the threshold return.

Under the 2001 and 2002 plans, participants were granted options over notional units in the value of the Royal London Group and may exercise those options between the third and tenth anniversary of their grant, provided that the value of the Group has increased by at least 15% at the time of exercise.

Under the 2003 to 2006 plans, participants may exercise their options between the third and tenth anniversary of their grant, provided that the value of the Group has increased by at least 15% at the end of the third year. If this target is missed, the options will lapse.

Under the 2002 to 2006 plans, Brian Duffin, Stephen Shone and Mike Yardley were granted additional "second tier" options which only reward growth in the value of the Group of over 5% per annum compounded to the date of exercise between the third and tenth anniversaries of their grant. These second tier awards are financially equivalent to share option awards with an increasing exercise price. No further awards of second tier options will be made going forward. Instead, awards will be made under a Long-Term Relative Performance Plan which will be directly related to the development of Royal London's value compared to that of its competitors. No payments will be made unless the change in Royal London's value is at least equal to the median performance of the comparator companies. Payments will also take into account the growth of profits from new business and the absolute level of performance achieved.

No total shareholder return performance graph is provided because of the Society's mutual status.

### *Benefits*

Benefits offered are private medical insurance, medical screening, mortgage subsidy and either a company car or a cash allowance.

### *Pensions*

For each of the executive directors, the main terms applying to their final salary pensions accrued since 30 November 2001 are:

- Payable from normal retirement age of 60;
- Spouse's pension payable on death of 55% of the director's pension;
- Pensions increase in payment in line with inflation, to a maximum of 7.5% each year.

The main terms applying to final salary pensions accrued before 30 November 2001 varied by director.

In respect of service prior to 6 April 2006, the executive directors are members of the Company's pension scheme which is a funded non-contributory defined benefits arrangement.

Pension benefits for executive directors in respect of service since 5 April 2006 have been provided on an unapproved basis and 5% of salary has been sacrificed.

Stephen Shone was affected by the earnings cap on approved pension benefits prior to 6 April 2006 and the Company provided benefits above the cap on an unapproved basis.

Newly appointed executive directors who are not already members of the Company's pension scheme will be provided with benefits on a defined contribution basis.

The Company's pension scheme provides life assurance cover for death in service of four times pensionable earnings. Spouses' or dependants' pensions are payable on death, based on the number of years' service. Prior to 6 April 2006 cover for Stephen Shone was affected by the earnings cap and was increased by an individual arrangement to four times the final year's salary.

#### **Executive service contracts and termination**

All executive directors have service contracts which provide for a year's notice from the Company. The period of notice required to be given to the Company by executive directors is six months. Executive directors' contracts do not include compensation for severance as a result of a change of control.

#### **Chairman and non-executive directors' remuneration**

The remuneration of the Chairman is determined by the Remuneration Committee and that of the non-executive directors by the Board. The principles adopted by the Board in determining the fees are that they should be competitive, appropriate to attract and retain directors of the necessary calibre, and reflect the responsibilities and time involved in Royal London matters.

<b>DIRECTORS' EMOLUMENTS – AUDITED</b>	<b>2006 £000</b>	<b>2005 £000</b>
Salaries and benefits	1,177	1,101
Performance-related bonuses	1,123	496
Fees to the Chairman and non-executive directors	372	364
	<b>2,672</b>	<b>1,961</b>

	Salary or fees		Performance-related bonuses		Taxable benefits		Total	
	2006 £000	2005 £000	2006 £000	2005 £000	2006 £000	2005 £000	2006 £000	2005 £000
<b>Chairman</b>								
Tim Melville-Ross – appointed chairman 1.1.06	163	54	–	–	–	–	163	54
Hubert Reid – retired 31.12.05	–	157	–	–	–	–	–	157
<b>Executive Directors</b>								
Brian Duffin	286	270	254	115	15	15	555	400
Stephen Shone	329	305	318	135	24	25	671	465
Mike Yardley	500	463	551	246	23	23	1,074	732
<b>Non-executive Directors</b>								
Trevor Bish-Jones – appointed 1.10.05	43	11	–	–	–	–	43	11
Robert Jeens	54	52	–	–	–	–	54	52
Tom Ross	50	42	–	–	–	–	50	42
Fields Wicker-Miurin – resigned 25.5.06	20	48	–	–	–	–	20	48
David Williams – appointed 1.3.06	42	–	–	–	–	–	42	–
	<b>1,487</b>	1,402	<b>1,123</b>	496	<b>62</b>	63	<b>2,672</b>	1,961

**Long-Term Incentive Plan awards**

The exercisable LTIP awards are analysed below.

Name	Exercisable at 31.12.05 £000	Increase in exercisable awards during 2006		Paid in 2006 £000	Exercisable at 31.12.06 £000
		Transfer from provisions £000	Change in value during 2006 £000		
Brian Duffin	1,002	413	1,463	–	2,878
Stephen Shone	1,159	448	1,705	–	3,312
Mike Yardley	1,878	758	2,768	–	5,404
	4,039	1,619	5,936	–	11,594

In addition to the above exercisable awards, the following provisions have been made in respect of LTIP Plans which have not reached their third anniversary.

Name	Provision at 31.12.05 £000	Release of provision 2004 plan £000	Change in value 2005 plan £000	Change in value 2006 plan £000	Provision at 31.12.06 £000
Stephen Shone	679	(448)	442	267	940
Mike Yardley	1,148	(758)	731	451	1,572
	2,444	(1,619)	1,561	955	3,341

**Pension entitlements**

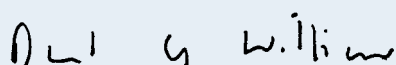
The executive directors are members of defined benefit pension arrangements. The table below sets out the disclosures of these benefits in accordance with the UKLA Listing Rules and the Directors' Remuneration Report Regulations 2002.

Name	Age at 31.12.06	Accrued pension 31.12.06 <sup>1</sup> £000 pa	Increase in accrued pension during the year £000 pa	Increase in accrued pension during the year (net of inflation) £000 pa	Transfer value of accrued pension at 31.12.05 <sup>2</sup> £000	Change in transfer value over the year £000	Transfer value of accrued pension at 31.12.06 <sup>2</sup> £000
Stephen Shone	49	72	14	13	717	257	974
Mike Yardley	50	285	33	26	2,711	611	3,322

Notes:

1. The accrued pensions are the amounts which the directors would be entitled to from normal retirement age if they left service at the relevant date.
2. The transfer values have been calculated in accordance with the guidance note 'GN11' published by the Institute of Actuaries and Faculty of Actuaries.

By order of the Board



**David Williams**  
Chairman of the Remuneration Committee  
29 March 2007

# AUDITORS' REPORT

for the year ended 31 December 2006

## Independent auditors' report to the members of The Royal London Mutual Insurance Society Limited

We have audited the Group and Parent company financial statements (the "financial statements") of The Royal London Mutual Insurance Society Limited for the year ended 31 December 2006 which comprise the Consolidated income statement, the Balance sheets, the Cash flow statements, the Consolidated statement of recognised income and expenses and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited, at the request of the directors, the information in the Directors' remuneration report that is described as having been audited.

## Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and Accounts and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union are set out in the statement of directors' responsibilities. The directors are also responsible for preparing the Directors' remuneration report (because the Company applies the requirements of Schedule 7A to the Companies Act 1985 as if it were a listed company). Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). We also, at the request of the directors, audit the part of the Directors' remuneration report to be audited (because the Company applies the requirements of Schedule 7A to the Companies Act 1985 as if it were a listed company). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 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.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the Directors' report is consistent with the financial statements. The information given in the Directors' report includes that specific information presented in the Business review that is cross referred from the Business review section of the Directors' report. In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed. We read other information contained in the Annual Report and Accounts and consider whether it is consistent with the audited financial statements. The other information comprises only the Directors' report, the Business review (incorporating the Chairman's statement, Group Chief Executive's statement and Group Finance Director's review) and the Corporate Governance statement. We consider the

implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information. We also, at the request of the directors (because the Company applies the Financial Services Authority listing rules as if it were a listed company), review whether the corporate governance statement reflects the Company's compliance with the nine provisions of the 2006 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Company's corporate governance procedures or its risk and control procedures.

## Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' remuneration report to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed. We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' remuneration report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' remuneration report to be audited.

## Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the Group's affairs as at 31 December 2006 and of its profit and cash flows for the year then ended;
- the Parent company financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the Parent company's affairs as at 31 December 2006 and of its cash flows for the year then ended;
- the financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' report is consistent with the financial statements.

## PricewaterhouseCoopers LLP

Chartered Accountants and Registered Auditors  
London  
29 March 2007

# FINANCIAL STATEMENTS

## Contents

- 46** Consolidated income statement
- 47** Consolidated statement of recognised income and expenses
- 48** Balance sheets
- 50** Cash flow statements
- 51** Notes to the financial statements
- 129** European Embedded Value (EEV) – supplementary information

## CONSOLIDATED INCOME STATEMENT

for the year ended 31 December 2006

	Notes	Group	
		2006 £m	2005 £m
<b>Revenues</b>			
Gross earned premiums	3 (a)	859	840
Amounts paid to reinsurers	3 (b)	(930)	(81)
Net earned premiums		(71)	759
Fee income from investment and fund management contracts	4	115	97
Investment return	5	2,283	3,549
Other operating income	6	77	25
<b>Total revenues</b>		<b>2,404</b>	<b>4,430</b>
<b>Policyholder benefits and claims</b>			
Claims paid, before reinsurance	7 (a)	1,453	1,422
Reinsurance recoveries	7 (a)	(135)	(83)
Claims paid, after reinsurance		1,318	1,339
(Decrease)/increase in insurance contract liabilities, before reinsurance		(1,495)	1,283
Reinsurance ceded		956	(112)
(Decrease)/increase in insurance contract liabilities, after reinsurance		(539)	1,171
Increase in non-participating value of in-force business		(150)	(94)
Increase in investment contract liabilities		690	1,094
<b>Total policyholder benefits and claims</b>		<b>1,319</b>	<b>3,510</b>
<b>Operating expenses</b>			
Administrative expenses	8,9	242	261
Investment management expenses	11	88	72
Amortisation charges and impairment losses on acquired PVIF	18	103	54
Investment return attributable to external unit holders	33	118	49
Other operating expenses	12	22	12
<b>Total operating expenses</b>		<b>573</b>	<b>448</b>
<b>Finance costs</b>	13	<b>39</b>	<b>16</b>
<b>Result before tax</b>		<b>473</b>	<b>456</b>
<b>Tax expense</b>	14 (a)	<b>44</b>	<b>133</b>
<b>Transfer to the unallocated divisible surplus</b>	28	<b>429</b>	<b>323</b>
<b>Profit for the year</b>		<b>-</b>	<b>-</b>

As a mutual company, all earnings are retained for the benefit of participating policyholders and are carried forward within the unallocated divisible surplus. Accordingly, there is no profit for the year shown in the income statement.

## CONSOLIDATED STATEMENT OF RECOGNISED INCOME AND EXPENSES

for the year ended 31 December 2006

	Notes	Group	
		2006 £m	2005 £m
Fair value gains on revaluation of property, plant and equipment	16	1	2
<b>Total income not recognised in the income statement transferred to the unallocated divisible surplus</b>	28	1	2
Net income and expense recognised in the income statement transferred to the unallocated divisible surplus		429	323
<b>Total transfer to the unallocated divisible surplus</b>		<b>430</b>	<b>325</b>

The fair value gains shown above are stated net of the related deferred tax as the tax is not material in either year.


## BALANCE SHEETS

as at 31 December 2006

	Notes	Group		Parent company	
		2006 £m	2005 £m	2006 £m	2005 £m
<b>ASSETS</b>					
<b>Property, plant and equipment</b>	16	<b>73</b>	111	<b>25</b>	9
<b>Investment property</b>	17	<b>2,837</b>	2,397	<b>2,729</b>	2,378
<b>Intangible assets</b>					
Goodwill		<b>113</b>	113	<b>113</b>	113
Acquired PVIF on investment contracts		<b>167</b>	196	<b>167</b>	196
Acquired PVIF on insurance contracts		<b>140</b>	214	<b>140</b>	214
Deferred acquisition costs on investment contracts		<b>208</b>	175	<b>195</b>	163
<b>Total intangible assets</b>	18	<b>628</b>	698	<b>615</b>	686
<b>Reinsurers' share of insurance contract liabilities</b>	23	<b>302</b>	1,259	<b>297</b>	1,254
<b>Pension scheme asset</b>	35 (a)	<b>60</b>	2	<b>60</b>	2
<b>Current tax asset</b>		<b>6</b>	–	<b>6</b>	–
<b>Financial assets</b>					
Financial investments	19 (a)	<b>21,440</b>	20,932	<b>14,992</b>	15,584
Investments in Group entities	20	–	–	<b>5,060</b>	4,420
Loans and receivables, including insurance receivables	21	<b>191</b>	145	<b>152</b>	132
Cash and cash equivalents	22	<b>1,092</b>	963	<b>756</b>	595
<b>Total financial assets</b>		<b>22,723</b>	22,040	<b>20,960</b>	20,731
<b>Total assets</b>		<b>26,629</b>	26,507	<b>24,692</b>	25,060

LIABILITIES	Notes	Group		Parent company	
		2006 £m	2005 £m	2006 £m	2005 £m
Participating insurance contract liabilities	23	11,280	11,223	11,280	11,223
Participating investment contract liabilities	25	1,880	2,064	1,880	2,064
Unallocated divisible surplus	28	2,001	1,571	2,001	1,571
Non-participating value of in-force business	24	(524)	(374)	(524)	(374)
<b>Participating contract liabilities</b>		<b>14,637</b>	14,484	<b>14,637</b>	14,484
Non-participating insurance contract liabilities	23	2,570	4,122	2,515	4,066
Non-participating investment contract liabilities	25	8,050	6,550	6,519	5,461
<b>Non-participating contract liabilities</b>		<b>10,620</b>	10,672	<b>9,034</b>	9,527
<b>Subordinated liabilities</b>	29	<b>396</b>	520	<b>396</b>	520
<b>Other financial liabilities</b>	30	<b>124</b>	43	<b>65</b>	6
<b>Provisions</b>	31	<b>73</b>	51	<b>71</b>	50
<b>Trade and other payables</b>	32	<b>363</b>	374	<b>334</b>	334
<b>Liability to external unit holders</b>	33	<b>266</b>	228	-	-
<b>Deferred tax liabilities</b>	34 (a)	<b>150</b>	113	<b>155</b>	119
<b>Current tax liabilities</b>		-	22	-	20
<b>Total liabilities</b>		<b>26,629</b>	26,507	<b>24,692</b>	25,060

The financial statements on pages 46 to 128 were approved by the Board of Directors and signed on its behalf on 29 March 2007.



**Stephen Shone**  
Group Finance Director

## CASH FLOW STATEMENTS

for the year ended 31 December 2006

	Notes	Group		Parent company	
		2006 £m	2005 £m	2006 £m	2005 £m
<b>Cash flows from operating activities</b>					
Transfer to the unallocated divisible surplus		429	323	429	325
Adjustments for non-cash items	39 (a)	102	54	(19)	21
Adjustments for non-operating items	39 (b)	39	16	(18)	-
Acquisition of investment property		(283)	(299)	(283)	(299)
Acquisition of financial investments		(24,806)	(11,448)	(18,979)	(9,912)
Proceeds from disposal of investment property		238	180	215	180
Proceeds from disposal of financial investments		24,575	10,972	18,967	9,482
Changes in operating receivables		(46)	-	(20)	4
Changes in operating payables		(11)	44	-	36
Change in liability to external unit holders		38	(55)	-	-
Net cash flows from operating activities before tax		275	(213)	292	(163)
Tax paid		(35)	(50)	(27)	(40)
<b>Net cash flows from operating activities</b>		<b>240</b>	<b>(263)</b>	<b>265</b>	<b>(203)</b>
<b>Cash flows from investing activities</b>					
Acquisition of property, plant and equipment		(24)	(51)	(15)	(18)
Acquisition of Group entities	39 (d)	-	-	(1)	(32)
Proceeds from disposal of property, plant and equipment		-	68	-	-
Proceeds from disposal of Group entities	39 (d)	-	-	15	29
Dividends received from Group entities		-	-	5	10
<b>Net cash flows from investing activities</b>		<b>(24)</b>	<b>17</b>	<b>4</b>	<b>(11)</b>
<b>Cash flows from financing activities</b>					
Proceeds from issue of subordinated liabilities		-	395	-	395
Repayment of subordinated liabilities		(125)	-	(125)	-
Proceeds from issue of other debt and finance lease liabilities		20	15	12	-
Repayments of other debt and finance lease liabilities		(1)	(53)	-	(14)
Interest paid		(39)	(16)	(38)	(14)
<b>Net cash flows from financing activities</b>		<b>(145)</b>	<b>341</b>	<b>(151)</b>	<b>367</b>
<b>Net increase in cash and cash equivalents</b>		<b>71</b>	<b>95</b>	<b>118</b>	<b>153</b>
<b>Cash and cash equivalents at 1 January</b>	22	<b>963</b>	868	<b>595</b>	442
<b>Cash and cash equivalents at 31 December</b>	22	<b>1,034</b>	963	<b>713</b>	595

An integral part of the operations of the Group is the management of a portfolio of investment assets. Cash flows relating to the purchase and sale of these assets have been treated as operating cash flows for the purposes of the cash flow statements. In the Parent company, unit trusts and other investment funds that are classified for financial reporting purposes as subsidiaries are also part of this operating portfolio of investment assets and hence cash flows in relation to these assets are also classified as operating cash flows for the Parent company cash flow statement.

# NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 December 2006

## 1. ACCOUNTING POLICIES

### (a) Basis of preparation

The financial statements of the Group and the Parent company ('the financial statements') have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) as adopted for use in the European Union. The financial statements have also been prepared in accordance with those parts of the Companies Act 1985 applicable to companies reporting under IFRS.

The financial statements have been prepared on the historical cost basis as modified by the inclusion of certain assets and liabilities at fair value as permitted or required by IFRS. The accounting policies set out below are reviewed for appropriateness each year. These policies have been applied consistently to all periods presented in these financial statements.

The Group has elected to adopt early the amendment to International Accounting Standard (IAS) 1, 'Presentation of Financial Statements: Capital Disclosures', published in August 2005. This amendment requires disclosures to be made of an entity's objectives, policies and processes for managing capital.

All amounts in the financial statements are shown in pounds sterling, which is the presentational currency of the Group and the Parent company. Unless otherwise stated, amounts are shown in millions of pounds, rounded to the nearest million.

The following standards, which have been issued but are not yet effective, have not been applied in these financial statements:

- IFRS 7, 'Financial Instruments: Disclosures', effective from 1 January 2007. The application of this standard will result in changes to the financial risk disclosures, the main differences being additional disclosures in respect of liquidity risks and the inclusion of a sensitivity analysis for market risk.
- IFRS 8, 'Operating Segments', effective from 1 January 2009. This standard requires disclosure of information about the Group's operating segments and also about the Group's products and services, the geographical areas in which it operates and its major customers. There will be no financial impact from the introduction of this standard but there will be changes to the Group's segmental disclosures.

In addition, the following interpretations have been issued, but are not yet effective and are not expected to impact on the financial statements:

- IFRIC 7, 'Applying IAS 29 for the first time'
- IFRIC 8, 'Scope of IFRS 2'
- IFRIC 9, 'Reassessment of Embedded Derivatives'
- IFRIC 10, 'Interim Financial Reporting and Impairment'
- IFRIC 11, 'IFRS 2 – Group and Treasury Share Transactions'
- IFRIC 12, 'Service Concession Arrangements'.

### (b) Basis of consolidation

The Group financial statements incorporate the assets, liabilities and results of the Parent company and its subsidiaries.

Subsidiaries are those entities (including unit trusts and other investment funds) in which the Group directly or indirectly has the power to control the operating and financial policies in order to gain economic benefits. Profits or losses of subsidiaries sold or acquired during the period are included in the consolidated results up to the date that control ceases or from the date of gaining control.

The Group applies the purchase method in accounting for business combinations. The cost of business combinations comprises the fair value of the consideration paid and of the liabilities incurred or assumed plus any directly related expenses. The excess of the cost of a business combination over the fair value of the identifiable net assets acquired is recorded as goodwill. If the cost of the business combination is less than the fair value of identifiable net assets acquired, the difference is recognised immediately in the income statement.

On transition to IFRS the Group elected not to apply IFRS 3, 'Business Combinations', retrospectively for business combinations that occurred before 1 January 2004.

The financial statements produced by subsidiaries for inclusion in the Group financial statements are prepared using accounting policies consistent with those adopted by the Group.

**1. ACCOUNTING POLICIES (CONTINUED)****(c) Classification of contracts**

The Group classifies its products for accounting purposes as insurance, investment or investment with discretionary participation features. Insurance contracts are those contracts that transfer significant insurance risk. Contracts that do not transfer significant insurance risk are investment contracts.

A discretionary participation feature is a contractual right held by a policyholder to receive additional payments as a supplement to guaranteed benefits. Such contracts are more commonly known as 'with-profits' or as 'participating' contracts.

Hybrid contracts are those where the policyholder can invest in, and switch between, both unit linked (non-participating) and unitised with-profits (participating) investment mediums at the same time. Certain hybrid contract types are treated as if they were wholly non-participating investment contracts when accounting for premiums, claims and other revenue.

**(d) Revenues****(i) Premiums**

Premiums received and reinsurance premiums paid relate to insurance and non-hybrid participating investment contracts. They are accounted for when due for payment except for recurring single premiums and premiums in respect of unit linked business, which are accounted for when the related liabilities are created.

**(ii) Fee income from investment and fund management contracts**

Management fees arising from investment and fund management contracts are recorded in the income statement in the period in which the services are provided. Initial fees which relate to the future provision of services are deferred and recognised in the income statement over the anticipated period in which the services will be provided. Such deferred fee income is shown as a liability in the balance sheet.

**(iii) Investment return**

Investment return comprises the investment income and fair value gains and losses derived from assets held at fair value through profit or loss, rental income and fair value gains and losses derived from investment property and interest income derived from cash and cash equivalents.

Investment income derived from assets held at fair value through profit or loss includes dividends and interest income. Dividends are recorded on the date on which the shares are declared ex-dividend. UK dividends are recorded net of the associated tax credits; overseas dividends are recorded gross, with the related withholding tax included within the tax expense as foreign tax. Interest income is recognised on an accruals basis. Rental income from investment property,

net of any lease incentives received or paid, is recognised on a straight-line basis over the term of the lease.

**(iv) Commission income**

The Group acts as an introducer for certain third party insurers. Commission income and profit commission received on the underwriting results of those insurers is recognised in the income statement as the related services are provided.

**(e) Claims**

Claims paid and reinsurance recoveries relate to insurance and non-hybrid participating investment contracts. For non-linked policies, maturity claims and annuities are accounted for when 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 related contract liabilities. Death claims and all other non-linked claims are accounted for when notified. For linked policies, claims are accounted for on cancellation of the associated units.

Claims payable include related claims handling costs. Reinsurance recoveries are accounted for in the same period as the related claim.

**(f) Tax expense**

Tax expense comprises current and deferred tax and is recognised in the income statement except to the extent that it relates to items recognised directly in the unallocated divisible surplus, in which case it is recognised directly in the unallocated divisible surplus. Both current and deferred tax are calculated using tax rates enacted or substantively enacted at the balance sheet date.

**(i) Current tax**

Current tax is the expected tax payable on the taxable income for the year and any adjustment to tax payable in respect of previous years.

**(ii) Deferred tax**

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities. The following temporary differences are not provided for:

- the initial recognition of goodwill not deductible for tax purposes.
- temporary differences arising on investments in subsidiaries where the Group controls the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised.

#### **(g) Property, plant and equipment**

Owner occupied land and buildings and properties under construction are carried at fair value in the balance sheet. Fair value is determined annually by independent professional valuers, who are members of the Royal Institution of Chartered Surveyors and is based on current prices in an active market for similar properties in the same location and condition. An increase in fair value is recognised directly in the unallocated divisible surplus, except to the extent that it is the reversal of a previous revaluation decrease which was recognised in the income statement. A decrease in fair value is recognised immediately in the income statement, except to the extent that it reverses a previous revaluation surplus recognised directly in the unallocated divisible surplus.

Other plant and equipment consisting of computer equipment, office equipment and vehicles are stated at cost less accumulated depreciation and impairment losses. Cost comprises the fair value of the consideration paid to acquire the asset and includes directly related expenditure.

Subsequent costs are included in an asset's carrying value only to the extent that it is probable that there will be future economic benefits associated with the item and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the income statement as an expense as incurred.

Land is not depreciated. No depreciation is provided on owner occupied buildings or properties under construction as such depreciation would be immaterial. Depreciation on other items of property, plant and equipment is charged to the income statement and is calculated so as to reduce the value of the assets to their estimated residual values on a straight line basis over the estimated useful lives of the assets concerned which range from 3 to 8 years.

The residual values and estimated useful lives are reviewed annually. Where an asset's carrying amount exceeds its recoverable amount the carrying amount is written down immediately to the recoverable amount.

Gains and losses on disposals are included in the income statement and are determined by comparing proceeds with carrying amounts.

#### **(h) Intangible assets**

##### ***(i) Goodwill***

Goodwill is tested annually for impairment and is stated at cost less accumulated impairment losses. Any gain or loss on subsequent disposal of a subsidiary will include any attributable goodwill remaining.

##### ***(ii) Acquired PVIF***

The present value of acquired in-force business (PVIF) arises on the acquisition of portfolios of investment and insurance contracts, either directly or through the acquisition of a subsidiary. It represents the net present value of the interest in the expected pre-tax cash flows of the contracts which existed at the date of acquisition and is amortised over the remaining lifetime of those contracts. The amortisation is recognised in the income statement and is calculated on a systematic basis to reflect the pattern of emergence of profits from the acquired contracts. Amortisation is stated net of any unwind of the discount rate.

The estimated lifetime of the acquired contracts ranges from 10 to 25 years for life business and 20 to 40 years for pensions business.

##### ***(iii) Deferred acquisition costs***

Deferrable acquisition costs for non-participating and hybrid participating investment contracts are capitalised as an intangible asset. Deferrable costs are restricted to directly related and incremental costs incurred for the acquisition of new contracts. This consists of commission only, including the value of future commission payable to third parties. All other acquisition costs are expensed as incurred. The deferred acquisition cost asset is amortised over the anticipated lifetime of the related contracts in the same pattern as the related fee income is recognised in the income statement.

All acquisition costs on insurance and non-hybrid participating investment contracts are recognised as an expense in the income statement when incurred.

##### **(i) Reinsurance**

The Group seeks to reduce its exposure to potential losses by reinsuring certain levels of risk with reinsurance companies. Reinsurance contracts that meet the classification requirements for insurance contracts set out above, are classified as reinsurance contracts held. Contracts that do not meet these classification requirements are classified as financial assets.

Reinsurance assets represent short-term payments due from reinsurers and longer-term receivables that are dependent on the expected claims and benefits arising under the related reinsured insurance contracts. They are measured on a consistent basis to the reinsured insurance contracts. Reinsurance liabilities represent premiums payable for reinsurance.

**1. ACCOUNTING POLICIES (CONTINUED)****(j) Investments****(i) Investment property**

Investment property is property held for rental, capital growth or both, excluding those occupied by the Group or the Parent company. Investment property includes freehold and leasehold land and buildings.

Investment property is initially measured at cost. For freehold property, cost comprises the fair value of the consideration paid plus the associated transaction costs. For leasehold property, the cost is the lower of the fair value of the property and the present value of the minimum lease payments at the inception of the lease.

Subsequent expenditure is added to the carrying value of investment property only when it is probable that future economic benefits associated with the item will flow to the Group and the cost can be measured reliably. All other repairs and maintenance are charged to the income statement during the period in which they are incurred.

All investment property is subsequently carried at fair value in the balance sheet. Fair value is determined annually by independent professional valuers based on market evidence. Any gain or loss arising from a change in fair value is recognised in the income statement.

When an owner occupied property included within property, plant and equipment becomes an investment property following a change in its use any difference arising at the date of transfer between the carrying amount of the item and its fair value is recognised directly in the unallocated divisible surplus. When a property under construction included within property, plant and equipment becomes an investment property on completion of construction, any difference arising at the date of transfer between the carrying amount of the item and its fair value is recognised in the income statement.

**(ii) Financial investments**

All investment transactions are recognised at trade date.

All financial investments are classified upon initial recognition as held at fair value through profit or loss (FVTPL). The Group does not classify any financial investments as 'available for sale' or as 'held to maturity'. The FVTPL category has two sub-categories: financial assets held for trading and those designated as FVTPL. All derivative instruments are classified as held for trading as required by IAS 39, 'Financial Instruments: Recognition and Measurement'. All other financial investments are classified as designated as FVTPL.

Financial assets that are designated as FVTPL are:

- financial assets held in the internal linked funds of the Group backing unit linked insurance and investment contract liabilities. The designation of these assets at FVTPL eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mis-match') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- financial assets managed and whose performance is evaluated on a fair value basis.

Financial assets classified as FVTPL, including derivatives classified as held for trading, are initially recognised at the fair value of the consideration paid. They are subsequently measured at fair value with any resultant gain or loss recognised in the income statement.

Fair value for quoted investments is the bid price; fair value for investments in unit trusts, OEICs and other pooled funds (including those classified as investments in Group entities) is the bid price quoted on the last day of the accounting period on which investments in such funds could be redeemed. Fair value for other unquoted investments is calculated using recognised investment valuation techniques. These include the use of recent arm's length transactions, reference to the current fair value of other instruments that are substantially the same, discounted cash flow analysis and option pricing models making maximum use of market inputs and relying as little as possible on entity specific inputs. Any difference between the fair value of the consideration paid and the initial amount determined using a valuation technique is recognised immediately in the income statement.

**(iii) Investments in Group entities**

Investments in Group entities within the Parent company financial statements are designated as FVTPL. Fair value for those entities which are not unit trusts, OEICs and other pooled funds is determined using the same valuation techniques as are used for unquoted investments, as described above.

**(k) Loans and receivables**

Loans and receivables are initially recognised at the fair value of the consideration paid. Subsequently they are measured at amortised cost.

**(l) Finance leases****(i) Group acting as lessor**

Leases under which substantially all the risks and rewards of ownership are transferred by the lessor are classified as finance leases.

The Group leases certain freehold buildings to third parties by way of finance lease. No amount is recognised for these buildings within investment property. Instead an asset is recognised within loans and receivables that represents the Group's net receivable from finance leases. This asset is initially stated at an amount equal to the present value of the minimum lease rentals receivable at the inception of the lease. As lease rentals are received, these are split between an interest element, calculated on an effective interest basis, which is credited to the income statement and a capital element, which reduces the finance lease receivable.

**(ii) Group acting as lessee**

Leases under which substantially all the risks and rewards of ownership are assumed by the lessee are classified as finance leases.

Leasehold investment property is accounted for as if it had been acquired under a finance lease. At the commencement of the lease an asset is recognised within investment property at an amount equal to the lower of the fair value of the property and the present value of the minimum lease payments. An equal liability is established to represent the financing element of the lease contract. As lease payments are made, these are split between an interest element, calculated on an effective interest basis, which is charged to the income statement and a capital element, which reduces the finance lease liability.

**(m) Operating lease payments**

Payments under operating leases, net of lease incentives received, are recognised in the income statement on a straight-line basis over the term of the lease.

**(n) Impairment**

Goodwill is tested for impairment annually. The carrying amounts of other intangible assets, property, plant and equipment and financial assets (other than those at FVTPL) are reviewed at each balance sheet date for any indication of impairment.

For non-financial assets, an impairment loss is recognised whenever the carrying amount exceeds the recoverable amount. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

For financial assets (other than those at FVTPL) an impairment loss is recognised if the present value of the estimated future cash flows arising from the asset is lower than the asset's carrying value.

For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Impairment losses are recognised in the income statement.

An impairment loss in respect of goodwill is never reversed. In respect of other non-financial assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. For financial assets (other than those at FVTPL) an impairment loss is reversed if there is a decrease in the impairment that can be related objectively to an event occurring after the impairment was recognised. An impairment loss is reversed only to the extent that after the reversal, the asset's carrying amount is no greater than the amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

**(o) De-recognition and offset of financial assets and financial liabilities**

A financial asset is de-recognised when the contractual rights to receive the cash flows from the asset have expired or where they have been transferred and the Group has also transferred substantially all of the risks and rewards of ownership.

A financial liability is de-recognised when the obligation specified in the contract is discharged or cancelled or expires.

Financial assets and liabilities are offset and the net amount presented in the balance sheet if, and only if, there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and liability simultaneously.

**(p) Cash and cash equivalents**

Cash and cash equivalents in the balance sheet comprise cash balances, deposits held at call with banks and other short-term highly liquid investments with original maturities of three months or less.

Bank overdrafts that are repayable on demand and form an integral part of cash management are included as a component of cash and cash equivalents for the purpose of the cash flow statement only.

**1. ACCOUNTING POLICIES (CONTINUED)****(q) Insurance contracts and participating investment contracts**

Under IFRS 4, 'Insurance Contracts', insurance and participating investment contract liabilities are valued using accounting policies consistent with those adopted prior to the transition to IFRS. Changes from the practices previously applied are permitted where this can be justified as an improvement. The Group has applied Financial Reporting Standard (FRS) 27 as such an improvement.

The insurance and participating investment contract liabilities are determined annually in accordance with regulatory requirements. For participating contracts the liabilities are determined on a realistic basis in accordance with FRS 27. This includes an assessment of any future options and guarantees included in this business on a market consistent basis. The calculations also take into account bonus decisions, which are consistent with the Parent company's Principles and Practices of Financial Management. In determining the realistic value of the participating liabilities the value of non-profit business written in the participating fund is accounted for as part of the calculation. The present value of future profits on this business is separately calculated and this value is deducted from the participating liabilities.

For linked insurance contracts the calculation of the liability is based upon the fund value at the valuation date plus a reserve, where on a prudent basis, it is estimated that future cash outflows cannot be covered by future cash inflows.

A liability adequacy test is then carried out on insurance liabilities to ensure that the carrying amount of the liabilities (less related intangible assets) is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all contractual cash flows are discounted and compared against the carrying value of the liability. Where a shortfall is identified it is charged immediately to the income statement.

The estimation techniques and assumptions are periodically reviewed with any changes in estimates reflected in the income statement as they occur.

**(r) Embedded derivatives**

The Group does not separately measure embedded derivatives that meet the definition of an insurance contract or embedded options to surrender insurance contracts for a fixed amount (or a fixed amount and an interest rate). All other embedded derivatives are separated and carried at fair value if they are not closely related to the host contract and they meet the definition of a derivative.

**(s) Unallocated divisible surplus**

The nature of benefits for participating contracts is such that the allocation of surpluses between participating

policyholders is uncertain. The amount not allocated at the balance sheet date is classified within liabilities as the unallocated divisible surplus.

**(t) Non-participating investment contracts**

All the non-participating investment contracts issued by the Group are unit linked. The financial liabilities for these contracts are designated at inception as at fair value through profit or loss. This classification has been used because it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mis-match') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

The fair value of a unit linked financial liability is determined using the current unit values that reflect the fair values of the financial assets contained within the Group's unitised investment funds linked to the financial liability, multiplied by the number of units attributed to the contract holder at the balance sheet date.

If the investment contract is subject to a surrender option, the fair value of the financial liability is never less than the amount payable on surrender, discounted for the required notice period, where applicable.

**(u) Deposits received and repaid on investment contracts**

For non-participating investment and hybrid participating investment contracts the amounts received as premiums are not included in the income statement but are accounted for as deposits received and are added to the value of investment contract liabilities in the balance sheet.

Amounts repaid as claims on non-participating investment and hybrid participating investment contracts are not included in the income statement but are accounted for as a deduction from investment contract liabilities.

**(v) Borrowings**

Financial instruments that contain an obligation to make interest payments or repayments of principal are classified as borrowings.

Liabilities for borrowings are recognised initially at the fair value of the proceeds received, net of any discount and less attributable transaction costs. Subsequent to initial recognition, borrowings are stated at amortised cost. The transaction costs and discount are amortised over the period to the earliest possible redemption date on an effective interest rate basis. The amortisation charge is included in the income statement within finance costs. An equivalent amount is added to the carrying value of the liability such that at the redemption date the value of the liability equals the redemption value. All borrowing costs are expensed as they are incurred.

**(w) Provisions**

A provision is recognised in the balance sheet when there is a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability. No provision is established where a reliable estimate of the obligation cannot be made.

A provision for onerous contracts is recognised when the expected benefits to be derived from a contract are less than the unavoidable costs of meeting the obligations under the contract.

**(x) Pension costs**

The Group operates a defined benefit scheme and a defined contribution arrangement.

**(i) Defined benefit scheme**

The main Group scheme is of the funded, defined benefit type. The scheme provides benefits based on final pensionable pay. The assets of the scheme are held in separate trustee administered funds. The position of the scheme is assessed annually by an independent qualified actuary using the projected unit credit method.

The aggregate pension scheme asset recognised in the balance sheet is the excess that is recoverable, of the fair value of the plan assets in the scheme over the present value of the scheme's liabilities. Plan assets exclude non-transferable financial instruments and insurance policies issued by a Group entity. Deficits in the value of scheme assets over scheme liabilities are recognised in the balance sheet as a pension liability. The net movement in the pension scheme asset or liability, including all actuarial gains and losses is included within administrative expenses or other operating income as appropriate.

When the benefits of the plan are improved, the portion of the increased benefit relating to past service by employees is recognised as an expense in the income statement on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits vest immediately, the expense is recognised immediately in the income statement.

**(ii) Defined contribution arrangement**

On 1 September 2005, a contributory, defined contribution arrangement was introduced for new employees. The Group pays contractual contributions in respect of this arrangement and such contributions are recognised as an expense as the related employee services are provided.

**(y) Foreign currency translation**

The primary economic environment in which the Group and the Parent company operate is the United Kingdom. Hence the functional currency of the Group and the Parent company is pounds sterling. Assets and liabilities denominated in foreign currencies are expressed in sterling at the exchange rate ruling on the balance sheet date. Revenue transactions and those relating to the acquisition and realisation of investments have been translated into sterling at the rates of exchange ruling at the time of the respective transactions. Any exchange differences are dealt with in the income statement under the same heading as the underlying transactions are reported.

**(z) Use of judgements, estimates and assumptions**

The preparation of financial statements requires management to make judgements in the process of applying the Group's accounting policies. In selecting accounting policies where IFRS permits a choice of policy, the Directors have applied judgement in determining the most appropriate policy as follows:

- Measurement model for certain assets. IFRS allows a choice of measurement model for financial assets, investment property, property, plant and equipment and, in the Parent company balance sheet, investments in Group entities. This is typically a choice between a cost and a fair value model. The Group and Parent company have applied a fair value model to all these assets, with the exception of loans and receivables and computers, office equipment and vehicles. The fair value model has been used in order to match asset valuations to the valuation of the related policyholder liabilities.
- Unallocated divisible surplus. The Group has chosen not to recognise any guaranteed element separately and hence the entire balance has been recognised as a liability.
- Measurement model for non-participating investment contracts. As set out in note 1(t) these liabilities have been valued at fair value in order to match their valuation to the related assets.

The preparation of financial statements also requires the use of estimates and assumptions that affect the amounts reported in the balance sheet and income statement and the disclosure of contingent assets and liabilities at the date of the financial statements. Although these estimates are based on management's best knowledge of current circumstances and expectations of future events and actions, actual results may differ from those estimates, possibly significantly. The main area involving a higher degree of judgement or where estimates and assumptions are significant is the valuation of insurance and participating investment contract liabilities and the related reinsurance assets. Further details are given in note 26.

## 2. SEGMENTAL INFORMATION

No business segmental information is presented in respect of the Group or the Parent company as the Directors consider that all of the business of the Group and the Parent company is within a single segment, life and pensions business. Also, as substantially all of the business of both the Group and the Parent company is carried on in the United Kingdom, no separate geographical analysis has been provided.

## 3. PREMIUMS

### (a) Gross earned premiums

	Group	
	2006 £m	2005 £m
Regular premiums		
- Insurance contracts	416	455
- Participating investment contracts	15	17
	431	472
Single premiums		
- Insurance contracts	377	339
- Participating investment contracts	51	29
	428	368
	859	840

### (b) Amounts paid to reinsurers and Part VII transfers

During the year, the Group continued its strategy of reducing its exposure to the longevity risk arising from its portfolio of annuities in payment. In 2004 and 2005, the Group entered into agreements with Prudential Retirement Income Limited (PRIL) to reassure a substantial proportion of the portfolio. In 2006, all remaining pension annuities in payment were reassured with PRIL under a further agreement. The premiums payable in the year in respect of these contracts totalled £911m (2005 £77m).

Subsequent to these reinsurance agreements the Group completed transfers to PRIL of substantially all of the reinsured annuities in payment by way of transfers undertaken in accordance with Part VII of the Financial Services and Markets Act 2000. The transfers had effective dates of 30 November 2006 and 31 December 2006 and had a reinsured contract value of £1,833m. No additional consideration was paid for the transfers.

During the year the Group made a gain of £14m on reinsurance arrangements with PRIL (2005 £nil).

### (c) Deposits received on investment contracts

As set out in note 1(u) the Group does not account for the amounts received as premiums in relation to non-participating and hybrid participating investment contracts as premium income in the income statement. Rather, these amounts are accounted for as deposits received and are added to the value of investment contract liabilities in the balance sheet. The amounts received by the Group during the year were £1,832m (2005 £1,045m) in respect of non-participating contracts and £37m (2005 £46m) in respect of hybrid participating contracts.

## 4. FEE INCOME FROM INVESTMENT AND FUND MANAGEMENT CONTRACTS

	Group	
	2006 £m	2005 £m
Investment contract fees receivable		
- Annual management charges applied to linked funds	66	55
- Policy administration fees	37	36
- Bid/offer spread and reduced allocation charges	10	7
- Surrender penalties	11	8
	124	106
Fund management fees receivable	9	8
	133	114
Change in deferred fee income	(18)	(17)
	115	97

**5. INVESTMENT RETURN**

	Group	
	2006 £m	2005 £m
Investment income from financial investments held at fair value through profit or loss	869	816
Fair value gains from financial investments held at fair value through profit or loss	906	2,288
Rental income from investment property	134	129
Fair value gains from investment property	325	277
Interest income from cash and cash equivalents	53	39
Net foreign exchange loss	(4)	–
	<b>2,283</b>	<b>3,549</b>

The fair value gains from financial investments held at fair value through profit or loss and from investment property include both the net fair value gain on the revaluation of assets held at the balance sheet date and the gains realised on assets disposed of during the year.

Included within fair value gains from financial investments held at fair value through profit or loss are changes in fair value of £42m (2005 £137m) estimated using a valuation technique.

**6. OTHER OPERATING INCOME**

	Group	
	2006 £m	2005 £m
Commission income	18	15
Profit on disposal of property, plant and equipment	–	7
Reversal of impairments on property, plant and equipment (note 16)	1	2
Net increase in defined benefit pension scheme asset (note 35 (d))	58	–
Other	–	1
	<b>77</b>	<b>25</b>

**7. CLAIMS****(a) Claims paid**

	Group	
	2006 £m	2005 £m
Claims paid, before reinsurance		
- Insurance contracts	1,365	1,341
- Participating investment contracts	88	81
	<b>1,453</b>	<b>1,422</b>
Reinsurance recoveries		
- Insurance contracts	(135)	(83)
Claims paid, after reinsurance		
- Insurance contracts	1,230	1,258
- Participating investment contracts	88	81
	<b>1,318</b>	<b>1,339</b>

**7. CLAIMS (CONTINUED)****(b) Deposits repaid**

As set out in note 1(u) the Group does not account for the amounts paid out as claims in relation to non-participating and hybrid participating investment contracts as a claim expense in the income statement. Rather, these amounts are accounted for as deposits repaid and are deducted from the value of investment contract liabilities in the balance sheet. The amounts repaid by the Group during the year totalled £970m (2005 £705m) in respect of non-participating investment contracts and £149m (2005 £31m) in respect of hybrid participating investment contracts.

**8. ADMINISTRATIVE EXPENSES BY TYPE**

	Group	
	2006 £m	2005 £m
Acquisition costs		
- Expenses	69	58
- Commission	99	90
Movement in deferred acquisition costs on investment contracts (note 18)		
- Additions	(57)	(59)
- Amortisation and impairment charges	24	21
	135	110
Maintenance costs		
- Operational expenses	74	73
- Renewal commission	12	12
- Restructuring expenses	3	5
- IT systems development expenses	1	4
- Movement in renewal commission liability	3	8
	93	102
Other administrative expenses		
- Defined benefit pension scheme costs	-	22
- Other, including long-term incentive plans	14	27
	14	49
	242	261

**9. ADMINISTRATIVE EXPENSES BY NATURE**

	Group	
	2006 £m	2005 £m
Staff costs (note 10 (a))	110	128
Movement in deferred acquisition costs on investment contracts	(33)	(38)
Acquisition commission	99	90
Renewal commission	12	12
Depreciation of property, plant and equipment (note 16)	5	6
Operating lease rentals	3	4
Information systems maintenance and rent	10	14
Property costs	8	13
Regulatory, professional and administration fees	15	17
Other expenses	13	15
	<b>242</b>	<b>261</b>

## Auditors' remuneration (gross of VAT):

	Group	
	2006 £000	2005 £000
Fees payable to the Company's auditor for the audit of the Parent company and consolidated financial statements:		
- The audit of the Parent company and consolidated financial statements	950	941
- Conversion to IFRS	-	306
Fees payable to the Company's auditor and its associates for other services:		
- The audit of the Company's subsidiaries pursuant to legislation	208	169
- Other services supplied pursuant to legislation – audit of regulatory returns	147	169
- Other services relating to taxation	135	210
- Other services	428	305
	<b>1,868</b>	<b>2,100</b>
Fees in respect of the Royal London Group Pension Scheme		
- Audit	38	37

**10. STAFF COSTS****(a) Analysis of staff costs**

	Group	
	2006 £m	2005 £m
Wages and salaries	101	98
Social security contributions	8	8
Other pension costs:		
- Defined benefit scheme (note 35 (d))	-	22
- Defined contribution arrangement	1	-
	<b>110</b>	<b>128</b>

The average number of persons (including executive directors) employed by the Group during the year was:

	Number	Number
Sales and sales support	479	684
Administration	2,150	2,170
	<b>2,629</b>	<b>2,854</b>

**10. STAFF COSTS (CONTINUED)**

Full details of the directors' emoluments are included in the Directors' remuneration report on pages 41 to 43. The information included therein encompasses that required by the Companies Act 1985.

No amount is shown in 2006 for defined benefit pension costs as there was a net increase in the pension scheme asset during the year, giving rise to an income item included within other operating income.

No expense is shown for 2005 in respect of the defined contribution pension arrangement as the contributions payable by the Group in that year were less than £0.5m.

**(b) Key management compensation payable**

Compensation payable to key management, including executive directors, is shown in the table below. The number of key management for the year, including executive and non-executive directors, was 33 for the Group and 28 for the Parent company (2005 32 for the Group and 27 for the Parent company).

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Salaries, short-term incentive plans and other benefits	8	6	7	5
Post employment benefits – defined contribution arrangements	1	–	1	–
Post employment benefits – defined benefit schemes	2	2	2	2
Change in amounts receivable under long-term incentive plans	11	6	11	6
	<b>22</b>	<b>14</b>	<b>21</b>	<b>13</b>

The 'Post employment benefits – defined benefit schemes' comprise the current service cost calculated in accordance with IAS 19, 'Employee Benefits'. This represents the increase in the present value of the defined benefit obligation in respect of key management arising from their service during the year.

The Group's policy for determining key management remuneration, including executive directors, is for total remuneration to be at the median. Bonus plans are designed to encourage and reward increases in the value of the business for the benefit of members. The total amount receivable by key management, including executive directors, under long-term incentive plans was £17m as at 31 December 2006 (2005 £7m). The amount of long-term incentive plans exercised by key management during the year was £1m (2005 £nil).

**11. INVESTMENT MANAGEMENT EXPENSES**

	Group	
	2006 £m	2005 £m
Property expenses	19	14
Transaction costs	26	24
Costs of in-house investment management operations	23	27
Other	20	7
	<b>88</b>	<b>72</b>

**12. OTHER OPERATING EXPENSES**

	Group	
	2006 £m	2005 £m
Impairment losses on property, plant and equipment (note 16)	–	1
Operating interest payable	8	6
Mortgage endowment review expense	10	–
Other	4	5
	<b>22</b>	<b>12</b>

**13. FINANCE COSTS**

	Group	
	2006 £m	2005 £m
Finance costs comprise interest payable arising from:		
- Subordinated liabilities	35	12
- Loans from credit institutions	-	2
- Finance lease obligations	2	1
- Other interest payable	2	1
	<b>39</b>	<b>16</b>

**14. TAX EXPENSE****(a) Tax expense in the income statement**

	Group	
	2006 £m	2005 £m
Tax has been provided as follows:		
UK corporation tax (credit)/charge		
- Current year	(3)	45
- Adjustments in respect of prior periods	2	(2)
	<b>(1)</b>	<b>43</b>
Foreign tax partially relieved against UK corporation tax	8	6
Deferred tax (note 34 (a))	37	84
	<b>44</b>	<b>133</b>

**(b) Reconciliation of the effective tax rate**

Tax on the Group's result before tax differs from the theoretical amount that would arise using the weighted average tax rate applicable to profits of the consolidated companies as follows:

	Group	
	2006 £m	2005 £m
Result before tax	473	456
Tax calculated at the standard rate of corporate tax in the UK	142	137
Due to a different basis of tax applying to UK life assurance business	(100)	(2)
Due to adjustments in respect of prior periods	2	(2)
Tax charge for the year	<b>44</b>	<b>133</b>

UK corporation tax in the income statement has been calculated at a rate of 20% (2005 20%) on the taxable profits of the long-term fund in accordance with the rate applicable to the long-term business of a mutual long-term assurance company and a rate of 30% (2005 30%) on the taxable profits of subsidiaries of the long-term fund.

**15. PARENT COMPANY INCOME STATEMENT**

The Parent company has taken advantage of the exemption under Section 230 of the Companies Act 1985 not to include a parent company income statement. The Parent company is a mutual company and consequently the profit for the year is reported as nil after a transfer to or from the unallocated divisible surplus.

**16. PROPERTY, PLANT AND EQUIPMENT**

Group – 2006				
	Owner occupied land and buildings £m	Properties under construction £m	Computers, office equipment and vehicles £m	Total £m
<b>Cost or valuation</b>				
At 1 January	56	66	63	185
Additions	–	21	3	24
Transfers to investment property	(6)	(54)	–	(60)
Revaluation gains	–	1	–	1
Disposals	–	–	(1)	(1)
<b>At 31 December</b>	<b>50</b>	<b>34</b>	<b>65</b>	<b>149</b>
<b>Accumulated depreciation and impairment losses</b>				
At 1 January	(12)	(9)	(53)	(74)
Depreciation charge	–	–	(5)	(5)
Transfers to investment property	1	–	–	1
Impairment losses	–	–	–	–
Reversal of previous impairment losses	1	–	–	1
Disposals	–	–	1	1
<b>At 31 December</b>	<b>(10)</b>	<b>(9)</b>	<b>(57)</b>	<b>(76)</b>
<b>Net book value</b>				
At 1 January	44	57	10	111
<b>At 31 December</b>	<b>40</b>	<b>25</b>	<b>8</b>	<b>73</b>
Group – 2005				
	Owner occupied land and buildings £m	Properties under construction £m	Computers, office equipment and vehicles £m	Total £m
<b>Cost or valuation</b>				
At 1 January	57	130	62	249
Additions	–	48	3	51
Transfers to investment property	(3)	(51)	–	(54)
Revaluation gains	2	–	–	2
Disposals	–	(61)	(2)	(63)
<b>At 31 December</b>	<b>56</b>	<b>66</b>	<b>63</b>	<b>185</b>
<b>Accumulated depreciation and impairment losses</b>				
At 1 January	(14)	(8)	(47)	(69)
Depreciation charge	–	–	(6)	(6)
Transfers to investment property	–	–	–	–
Impairment losses	–	(1)	–	(1)
Reversal of previous impairment losses	2	–	–	2
Disposals	–	–	–	–
<b>At 31 December</b>	<b>(12)</b>	<b>(9)</b>	<b>(53)</b>	<b>(74)</b>
<b>Net book value</b>				
At 1 January	43	122	15	180
<b>At 31 December</b>	<b>44</b>	<b>57</b>	<b>10</b>	<b>111</b>

**16. PROPERTY, PLANT AND EQUIPMENT (CONTINUED)****Parent company**

	2006 Properties under construction £m	2005 Properties under construction £m
<b>Cost or valuation</b>		
At 1 January	9	42
Additions	15	18
Transfers to investment property	-	(51)
Revaluation gains	1	-
<b>At 31 December</b>	<b>25</b>	<b>9</b>
<b>Accumulated depreciation and impairment losses</b>		
<b>At 1 January and 31 December</b>	-	-
<b>Net book value</b>		
At 1 January	9	42
<b>At 31 December</b>	<b>25</b>	<b>9</b>

For the purposes of the disclosure required by IAS 1, 'Presentation of Financial Statements', all property, plant and equipment held by the Group and the Parent company is classified as being held for more than 12 months from the balance sheet date.

Owner occupied land and buildings and properties under construction shown above are held on a freehold basis.

If owner occupied land and buildings and properties under construction were stated on a historical cost basis, the amounts would be as follows:

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
<b>Cost and net book value</b>				
Owner occupied land and buildings	43	49	-	-
Properties under construction	32	63	22	7
	<b>75</b>	<b>112</b>	<b>22</b>	<b>7</b>

**17. INVESTMENT PROPERTY**

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
<b>Fair value</b>				
At 1 January	2,397	1,950	2,378	1,935
Additions				
- Capitalised expenditure on existing properties	38	38	38	38
- Acquisition of new properties	245	261	245	261
Disposals	(198)	(160)	(198)	(160)
Net gain from fair value adjustments	296	254	266	253
Transfers from property, plant and equipment	59	54	-	51
<b>At 31 December</b>	<b>2,837</b>	<b>2,397</b>	<b>2,729</b>	<b>2,378</b>
Rental income from investment property	134	129	132	127
Direct operating expenses arising from investment property				
- Property that generated income	19	21	18	14

For the purposes of the disclosure required by IAS 1, the amount of investment property at the balance sheet date that is classified as being held for more than 12 months is £2,604m for the Group (2005 £2,311m) and £2,590m for the Parent company (2005 £2,295m).

The fair value of investment property above includes £652m (2005 £478m) for the Group and £505m (2005 £430m) for the Parent company held under finance leases.

Investment property is revalued to fair value annually with an effective date of 31 December. The fair values are determined by a registered independent valuer having an appropriate recognised professional qualification and recent experience in the location and category of the property being valued. The principal valuers used were Jones Lang LaSalle, CB Richard Ellis and AtisReal. Fair value is based on current prices in an active market for similar properties in the same location and condition. Where there is no such market, estimated future cash flows are taken into consideration. Current lease arrangements, which were entered into on an arm's length basis and which are comparable to those for similar properties in the same location, are taken into account in the valuation. The net gain from fair value adjustments shown above represents the net fair value gain on the revaluation of properties held at the balance sheet date. It does not include gains realised on properties disposed of during the year.

Investment properties are leased to third parties under operating leases. Under the terms of certain leases, the company is required to repair and maintain the related properties. At the balance sheet date the future minimum lease payments receivable under non-cancellable leases are shown in the table below. For the purposes of this table the minimum lease period has been taken as the period to the first possible date that the lease can be terminated by the lessee.

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Not later than one year	131	122	122	120
Later than one year and not later than five years	459	420	423	409
Later than five years	844	727	675	708
	<b>1,434</b>	<b>1,269</b>	<b>1,220</b>	<b>1,237</b>

**17. INVESTMENT PROPERTY (CONTINUED)**

These total future minimum lease payments receivable can be analysed as follows:

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Freehold	924	927	924	927
Leasehold	510	342	296	310
	1,434	1,269	1,220	1,237

**18. INTANGIBLE ASSETS**

The following tables show the movements in the intangible assets of the Group and the Parent company during the year. The cost and accumulated amortisation and impairment losses in respect of the deferred acquisition costs on investment contracts shown in these tables are adjusted to remove amounts that become fully amortised during a given year.

**Group - 2006**

	Goodwill £m	Acquired PVIF on investment contracts £m	Acquired PVIF on insurance contracts £m	Deferred acquisition costs on investment contracts £m	Total £m
<b>Cost</b>					
At 1 January	113	336	562	235	1,246
Additions	-	-	-	57	57
<b>At 31 December</b>	113	336	562	292	1,303
<b>Accumulated amortisation and impairment losses</b>					
At 1 January	-	(140)	(348)	(60)	(548)
Amortisation charge	-	(14)	(12)	(24)	(50)
Effect of fund merger	-	-	(57)	-	(57)
Impairment losses	-	(15)	(5)	-	(20)
<b>At 31 December</b>	-	(169)	(422)	(84)	(675)
<b>Net book value</b>					
At 1 January	113	196	214	175	698
<b>At 31 December</b>	113	167	140	208	628

The net book value of intangible assets at 31 December 2006 can be analysed between amounts expected to be amortised:

Within 12 months	-	14	11	25	50
In more than 12 months	113	153	129	183	578
	113	167	140	208	628

**18. INTANGIBLE ASSETS (CONTINUED)**

Group – 2005

	Goodwill £m	Acquired PVIF on investment contracts £m	Acquired PVIF on insurance contracts £m	Deferred acquisition costs on investment contracts £m	Total £m
<b>Cost</b>					
At 1 January	113	336	562	176	1,187
Additions	–	–	–	59	59
<b>At 31 December</b>	<b>113</b>	<b>336</b>	<b>562</b>	<b>235</b>	<b>1,246</b>
<b>Accumulated amortisation and impairment losses</b>					
At 1 January	–	(126)	(308)	(39)	(473)
Amortisation charge	–	(14)	(13)	(21)	(48)
Impairment losses	–	–	(27)	–	(27)
<b>At 31 December</b>	<b>–</b>	<b>(140)</b>	<b>(348)</b>	<b>(60)</b>	<b>(548)</b>
<b>Net book value</b>					
At 1 January	113	210	254	137	714
<b>At 31 December</b>	<b>113</b>	<b>196</b>	<b>214</b>	<b>175</b>	<b>698</b>
The net book value of intangible assets at 31 December 2005 can be analysed between amounts expected to be amortised:					
Within 12 months	–	14	12	21	47
In more than 12 months	113	182	202	154	651
	113	196	214	175	698

**18. INTANGIBLE ASSETS (CONTINUED)**

## Parent company – 2006

	Goodwill £m	Acquired PVIF on investment contracts £m	Acquired PVIF on insurance contracts £m	Deferred acquisition costs on investment contracts £m	Total £m
<b>Cost</b>					
At 1 January	113	336	562	213	1,224
Additions	-	-	-	54	54
<b>At 31 December</b>	<b>113</b>	<b>336</b>	<b>562</b>	<b>267</b>	<b>1,278</b>
<b>Accumulated amortisation and impairment losses</b>					
At 1 January	-	(140)	(348)	(50)	(538)
Amortisation charge	-	(14)	(12)	(22)	(48)
Effect of fund merger	-	-	(57)	-	(57)
Impairment losses	-	(15)	(5)	-	(20)
<b>At 31 December</b>	<b>-</b>	<b>(169)</b>	<b>(422)</b>	<b>(72)</b>	<b>(663)</b>
<b>Net book value</b>					
At 1 January	113	196	214	163	686
<b>At 31 December</b>	<b>113</b>	<b>167</b>	<b>140</b>	<b>195</b>	<b>615</b>

The net book value of intangible assets at 31 December 2006 can be analysed between amounts expected to be amortised:

Within 12 months	-	14	11	23	48
In more than 12 months	113	153	129	172	567
	<b>113</b>	<b>167</b>	<b>140</b>	<b>195</b>	<b>615</b>

**18. INTANGIBLE ASSETS (CONTINUED)**

Parent company – 2005

	Goodwill £m	Acquired PVIF on investment contracts £m	Acquired PVIF on insurance contracts £m	Deferred acquisition costs on investment contracts £m	Total £m
<b>Cost</b>					
At 1 January	113	336	562	157	1,168
Additions	–	–	–	56	56
<b>At 31 December</b>	<b>113</b>	<b>336</b>	<b>562</b>	<b>213</b>	<b>1,224</b>
<b>Accumulated amortisation and impairment losses</b>					
At 1 January	–	(126)	(308)	(32)	(466)
Amortisation charge	–	(14)	(13)	(18)	(45)
Impairment losses	–	–	(27)	–	(27)
<b>At 31 December</b>	<b>–</b>	<b>(140)</b>	<b>(348)</b>	<b>(50)</b>	<b>(538)</b>
<b>Net book value</b>					
At 1 January	113	210	254	125	702
<b>At 31 December</b>	<b>113</b>	<b>196</b>	<b>214</b>	<b>163</b>	<b>686</b>

The net book value of intangible assets at 31 December 2005 can be analysed between amounts expected to be amortised:

Within 12 months	–	14	12	20	46
In more than 12 months	113	182	202	143	640
	<b>113</b>	<b>196</b>	<b>214</b>	<b>163</b>	<b>686</b>

The amount described as 'Effect of fund merger' relates to the impact of the merger of the Refuge Assurance (RA) OB with-profits sub-fund with the Royal London IB and OB sub-fund, which took effect on 31 December 2006. Previously the acquired PVIF on insurance contracts included the value of future cost of bonus transfers from the RA OB sub-fund. As a consequence of the fund merger these future transfers are recognised as a reduction in the participating insurance contract liabilities, with an equivalent reduction in the acquired PVIF asset.

**Goodwill impairment testing**

Goodwill is the only intangible asset that has an indefinite useful life. The carrying value of £113m mainly comprises £110m in respect of the acquisition of Scottish Life in 2001. The remaining balance relates to a cash management business.

Goodwill is tested for impairment annually. The impairment test involves comparing the carrying value of the goodwill to its recoverable amount. The recoverable amount of the Scottish Life goodwill has been determined using a value in use calculation. This is determined as the present value of the expected profits arising from the future new business written by the business unit. The expected profits from future new business are based on the business plan approved by the Board of Directors, which covers a three year period. Cash flows beyond that period have been assumed to grow at a steady rate of 2.5% per annum. The cash flows have been discounted using a risk-adjusted discount rate of 7.75% (2005 7.75%).

The recoverable amount significantly exceeds the carrying amount of the goodwill and a reasonably possible change in a key assumption will not cause the carrying value of the goodwill to exceed its recoverable amount.

## 19. FINANCIAL INVESTMENTS

Due to the nature of the business of the Group, investments are held in order to be able to meet obligations to policyholders in the future. All such investments are classified as held at fair value with gains and losses being reflected in the income statement (FVTPL). In this way these gains and losses will be matched with changes in the related liabilities to policyholders, which are also reflected in the income statement. The financial investments held at FVTPL can be divided into those that are required by IAS 39 to be classified as FVTPL and those that the Group has chosen to classify as FVTPL. Those that are required to be classified as FVTPL are known as 'held for trading' and those where the Group has chosen that classification are known as 'designated as FVTPL'. All derivatives, regardless of the purpose for which they are held, are required by IAS 39 to be classified as 'held for trading'. There are no non-derivative assets classified as 'held for trading'.

### (a) Financial investments held at FVTPL

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
<b>Financial investments classified as held for trading</b>				
Derivatives (note 19 (b))				
- Quoted	8	8	-	-
- Unquoted	301	318	214	232
	<b>309</b>	<b>326</b>	<b>214</b>	<b>232</b>
<b>Financial investments designated as FVTPL</b>				
Equity securities				
- Quoted	11,017	9,658	6,309	5,495
- Unit trusts and other pooled investments	1,169	746	895	544
- Other unquoted	74	232	74	232
	<b>12,260</b>	<b>10,636</b>	<b>7,278</b>	<b>6,271</b>
Debt and fixed income securities				
- Government bonds	4,229	6,308	3,467	5,723
- Other quoted	4,444	3,428	3,843	3,134
- Loans secured by policies	24	29	24	29
- Deposits with credit institutions	112	158	104	148
- Other unquoted	62	47	62	47
	<b>8,871</b>	<b>9,970</b>	<b>7,500</b>	<b>9,081</b>
<b>Total financial investments designated as FVTPL</b>	<b>21,131</b>	<b>20,606</b>	<b>14,778</b>	<b>15,352</b>
<b>Total financial investments held at FVTPL</b>	<b>21,440</b>	<b>20,932</b>	<b>14,992</b>	<b>15,584</b>

For the purposes of the disclosure required by IAS 1, it has been assumed that financial investments will be realised in order to settle the claims expected to arise during the 12 months following the balance sheet date. On this basis, the amount of financial investments at the balance sheet date that are classified as being held for more than 12 months is £18,949m for the Group (2005 £18,694m) and £12,667m for the Parent company (2005 £13,461m).

The Parent company includes within its investment portfolio a significant holding in unit trusts and other investment funds managed by subsidiary companies. Those funds in which the Parent company holds 50% or more are classified as subsidiaries ('consolidated funds'). The Parent company's investment in these consolidated funds is shown in note 20 and is not included in the Parent company figures above. On consolidation the underlying investments of the consolidated funds are included within the appropriate investment line in the balance sheet and are therefore, included in the Group figures shown above.

## 19. FINANCIAL INVESTMENTS (CONTINUED)

### (b) Derivative financial instruments

The Group and Parent company utilise derivative instruments for efficient portfolio management purposes, to match liabilities to policyholders and for the reduction of investment risk. Derivatives are either 'exchange-traded' (regulated by an exchange), which have a quoted market price or 'over-the-counter' (individually negotiated between the parties to the contract), which are unquoted.

The derivatives used by the Group can be divided into those that are held to mitigate fair value risk and those that are held to mitigate cash flow interest rate risk. These terms are explained below.

*Fair value risk* is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all instruments traded in the market.

*Cash flow interest rate risk* is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Group is exposed to credit risk on the carrying value of derivatives in the same way as it is exposed to credit risk on other financial investments. To mitigate this risk, a portion of the fair value of the derivatives held by the Group at any point in time is matched by collateral and cash margin received from the counterparty to the transaction. Cash margin is collateral in the form of cash. Initial cash margin is exchanged at the outset of the contract. Variation margin is exchanged during the life of the contract in response to changes in the value of the derivative. Further details are given in note 19 (c). The remaining credit risk is managed within the Group's risk management framework, which is discussed further in note 40.

#### (i) Derivatives held to manage fair value risks

##### *Options*

Options are contracts under which the seller grants the buyer the right, but not the obligation, to buy or to sell a specific amount of a financial instrument at a pre-determined price, at or by a set date, or during a set period. The Group uses equity options to manage its exposure to fluctuations in equity markets by giving the Group the option to buy or sell equities at a given price.

##### *Tranche assets*

Tranche assets are contracts under which the seller agrees to pay to the buyer a return on their initial investment based on the performance of one or more stock market indices subject to an agreed minimum and maximum. These derivatives are used by the Group to back certain products where the policy return is based on the performance of a particular stock market index.

##### *Futures*

A futures contract is an agreement to buy or sell a given quantity of a financial instrument, at a specified future date at a pre-determined price. The Group uses futures to manage its exposure to fluctuations in equity markets.

##### *Inflation swaps*

An inflation swap is a contract under which inflation-indexed payments are exchanged for fixed interest payments based on an agreed principal amount. Only the interest payments are exchanged. No exchange of principal takes place. The Group uses inflation swaps to manage the inflation exposure of its inflation-indexed bonds.

**19. FINANCIAL INVESTMENTS (CONTINUED)****(b) Derivative financial instruments (continued)****(ii) Derivatives held to manage cash flow interest rate risks***Interest rate swaps*

An interest rate swap is a contract under which interest payments at a fixed interest rate are exchanged for interest payments at a variable interest rate (or vice versa) based on an agreed principal amount. Only the interest payments are exchanged.

No exchange of principal takes place.

*Swaptions*

Swaptions are options to enter into an interest rate swap at a future date, and are used to limit exposure to fluctuations in interest rates over the long-term.

Swaptions and interest rate swaps are used to mitigate the cash flow interest rate risk inherent in guaranteed annuity rates granted by the Group. The derivatives give the Group the right to swap floating rate cash receipts for fixed rate receipts in the future, enabling the Group to hedge its obligation to make annuity payments at a fixed rate to a stream of fixed rate income.

The following table shows the fair value of derivative instruments held, analysed between those designed to mitigate fair value risk and those designed to mitigate cash flow interest rate risk.

	Group					
	Contract/ notional amount £m	2006		2005		Fair values Liabilities £m
		Assets £m	Liabilities £m	Contract/ notional amount £m	Assets £m	
Derivatives relating to fair value risks						
- Options purchased	214	10	-	8	8	-
- Tranche assets	80	87	-	73	86	-
- Inflation swaps	25	-	(3)	-	-	-
		97	(3)		94	-
Derivatives relating to cash flow interest rate risks						
- Interest rate swaps	1,386	27	(1)	1,119	28	-
- Options purchased	2,373	185	-	2,461	204	-
		212	(1)		232	-
<b>Total derivative assets/(liabilities)</b>		<b>309</b>	<b>(4)</b>		<b>326</b>	<b>-</b>

**19. FINANCIAL INVESTMENTS (CONTINUED)****(b) Derivative financial instruments (continued)**

	Parent company					
	2006			2005		
	Contract/ notional amount £m	Fair values		Contract/ notional amount £m	Fair values	
	Assets £m	Liabilities £m		Assets £m	Liabilities £m	
Derivatives relating to fair value risks						
- Options purchased	60	2	-	-	-	-
- Inflation swaps	25	-	(3)	-	-	-
		2	(3)		-	-
Derivatives relating to cash flow interest rate risks						
- Interest rate swaps	1,386	27	(1)	1,119	28	-
- Options purchased	2,373	185	-	2,461	204	-
		212	(1)		232	-
<b>Total derivative assets/(liabilities)</b>		<b>214</b>	<b>(4)</b>		<b>232</b>	<b>-</b>

In addition to the above, the Group makes use of futures contracts. At 31 December 2006 the Group and Parent company did not hold any such contracts. At 31 December 2005 the Group and the Parent company had entered into equity futures trades giving exposure to equities with a notional value of £162m. The equity futures had no market value at that date because all variation margin on these contracts is settled on a daily basis.

The Group and the Parent company paid initial cash margin of £5m in respect of these trades, which was included within other receivables. Variation margin payable by the Group and the Parent company at 31 December 2005 was £1m, being the amount due for the movement on the last business day of 2005, which was settled on the first business day in 2006. Variation margin payable was included within trade and other payables.

**(c) Collateral and other arrangements**

At the balance sheet date the Group and the Parent company have pledged collateral to third parties of £5m (2005 £nil). All of this collateral was pledged in respect of derivative contracts and is in the form of US government bonds.

The following table shows the collateral received by the Group and the Parent company from third parties. This collateral was in the form of UK, US and European government bonds, certificates of deposit, letters of credit and quoted equities. It may be sold or re-pledged in the absence of default. No collateral was sold or re-pledged in the year (2005 £nil).

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Fair value of collateral received				
- In respect of stock loan agreements	2,144	2,790	1,995	2,757
- In respect of derivatives	129	136	129	136
	<b>2,273</b>	<b>2,926</b>	<b>2,124</b>	<b>2,893</b>

The market value of securities loaned under the stock lending agreements was £2,029m (2005 £2,659m) for the Group and £1,888m (2005 £2,627m) for the Parent company.

The market value of derivatives in respect of which collateral was received was £185m (2005 £204m) for both the Group and the Parent company. In addition to the collateral shown above, cash margin received in respect of derivatives was £45m (2005 £32m) for both the Group and the Parent company. Cash margin received is included within cash and cash equivalents, with an offsetting liability included within trade and other payables.

## 20. INVESTMENTS IN GROUP ENTITIES

The Parent company's investments in Group entities comprise:

	Parent company	
	2006 £m	2005 £m
Shares	175	138
Loans	29	29
Unit trusts and other investment funds	4,856	4,253
	<b>5,060</b>	<b>4,420</b>

For the purposes of the disclosure required by IAS 1, all of the investments in Group entities held at the balance sheet date are classified as being held for more than 12 months.

The unit trusts and other investment funds shown above represent the Parent company's investment in funds in which it holds 50% or more and which are managed by subsidiaries of the Group.

### (a) Significant subsidiaries

The Parent company has the following significant subsidiaries:

Name	% holding		Location	Nature of business
	2006	2005		
Royal London Asset Management Limited	100	100	UK	Investment management
Royal London Unit Trust Managers Limited	100	100	UK	Unit trust management
Royal London Savings Limited	100	100	UK	ISA management
Scottish Life International Insurance Company Limited	100	100	Isle of Man	Life assurance
Royal London Pooled Pensions Company Limited	100	100	UK	Pension fund management
RL Finance Bonds plc	100	100	UK	Finance company
Scottish Life Finance plc	100	100	UK	Finance company
Unit Trusts:				
- The Royal London Government Bond Trust (formerly The Royal London UK Fixed Interest Trust)	82.9	96.6	UK	Unit trust
- The Royal London Index Linked Trust	93.6	94.4	UK	Unit trust
- The Royal London European Growth and Income Trust (formerly The Scottish Life European Trust)	99.9	99.9	UK	Unit trust
- The Royal London Equity Income Trust	65.8	64.6	UK	Unit trust
- The Royal London European Growth Trust	68.3	67.2	UK	Unit trust
- The Royal London UK Equity Trust	98.2	98.0	UK	Unit trust
- The Royal London Japan Growth Trust	99.3	99.2	UK	Unit trust
- The Royal London North American Growth Trust	99.9	99.9	UK	Unit trust
- The Royal London Far East Growth Trust	99.4	99.6	UK	Unit trust
- The Royal London Strategic Bond Trust	97.3	-	UK	Unit trust
- The Royal London Strategic Growth Trust	96.3	-	UK	Unit trust

### (b) Investments in associates

The Group has the following investments in associates, all of which are unit trusts or other investment funds. As permitted by IAS 28, 'Investments in Associates', the Group has accounted for these investments as financial assets held at fair value through profit or loss. The fair value of these investments at 31 December 2006 was £236m (2005 £245m).

Name	Group and Parent company		Nature of business
	% holding 2006	2005	
The Royal London UK Growth Trust	43.7	43.7	Unit trust
The Royal London Cash Trust	38.0	37.8	Unit trust
The Royal London Corporate Bond Trust (formerly The Royal London Income Trust)	30.6	31.0	Unit trust
Royal London Sterling Extra Yield Bond Fund	23.9	43.0	Open ended investment company
RL Private Equity Fund LP	-	44.2	Private equity fund

**20. INVESTMENTS IN GROUP ENTITIES (CONTINUED)****(b) Investments in associates (continued)**

The investment in RL Private Equity Fund LP ('the fund') was previously treated as an associate. The Group was considered to exert a significant influence over the fund by virtue of its joint venture interest in the fund's manager, RJD Partners Limited (RJD), which controls the fund's day-to-day operation. During the year the Group disposed of the majority of its interest in RJD (see note 20 (c)). Its interest in the fund remains unchanged at 44.2%. From the date of disposal of RJD the Group ceased to exert significant influence over the fund and its investment has been treated as a financial investment from that date.

The following table shows the Group's share of the total assets, liabilities, revenues and profit for the year of its associates. The figures for revenue and profit for the year include RL Private Equity Fund LP for the period up until it ceased being treated as an associate.

	Group and Parent company	
	2006 £m	2005 £m
Total assets	238	247
Total liabilities	(2)	(2)
	236	245
Revenues	16	11
Profit for the year	14	11

**(c) Interests in joint ventures**

The Group has the following interests in joint ventures, which have been accounted for by the Group using proportional consolidation.

Name	Group and Parent company		Nature of business
	% holding 2006	2005	
Southpoint General Partner Limited	50	50	Property development
RLW Estates Limited	50	50	Property development
RJD Partners Limited	-	50	Private equity fund management

During the year, the Group disposed of the majority of its interest in RJD Partners Limited. Prior to disposal, the Group held a 50% ownership interest in RJD Partners Limited as shown above, but had a beneficial interest of 64.3%.

The following table shows the total assets, liabilities, income and expenses relating to the Group's interests in joint ventures. The income and expenses figures for 2006 include the Group's share of RJD Partners Limited's results for the period up until it ceased to be treated as a joint venture.

	Group	
	2006 £m	2005 £m
Current assets	97	3
Long-term assets	-	47
	97	50
Current liabilities	(37)	(2)
Long-term liabilities	-	(28)
	(37)	(30)
Income	2	1
Expenses	(1)	(1)

**21. LOANS AND RECEIVABLES, INCLUDING INSURANCE RECEIVABLES**

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Amounts due from customers	18	14	17	13
Receivables arising under reinsurance contracts	1	2	-	1
Investment income receivable	42	35	29	25
Amounts due from brokers	40	19	11	11
Finance lease receivables	23	19	23	19
Amounts due from other Group entities	-	-	18	20
Other receivables	67	56	54	43
	<b>191</b>	<b>145</b>	<b>152</b>	<b>132</b>
Expected to be recovered within 12 months	170	125	131	112
Expected to be recovered in more than 12 months	21	20	21	20
	<b>191</b>	<b>145</b>	<b>152</b>	<b>132</b>

Loans and receivables are carried in the balance sheet at amortised cost. Their fair values are not materially different from the values shown above.

**Finance lease receivables**

The Group and the Parent company have leased to third parties a number of properties under long-term leases, which are classified as finance leases. The terms of the finance leases entered into range from 25 to 150 years.

	Group and Parent company	
	2006 £m	2005 £m
<b>Receivables under finance leases – minimum lease receipts:</b>		
Not later than one year	2	2
Later than one year and not later than five years	8	6
Later than five years	59	57
	<b>69</b>	<b>65</b>
Less: future charges	(46)	(46)
Present value of receivables under finance leases	<b>23</b>	<b>19</b>
<b>Present value of receivables under finance leases:</b>		
Not later than one year	2	1
Later than one year and not later than five years	6	5
Later than five years	15	13
	<b>23</b>	<b>19</b>

**22. CASH AND CASH EQUIVALENTS**

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Bank balances	216	218	123	153
Short-term bank deposits	862	745	621	442
Debt instruments with original maturity of less than 3 months	14	-	12	-
	<b>1,092</b>	<b>963</b>	<b>756</b>	<b>595</b>

All cash balances are due within one year. There are no restrictions on the transferability of these balances except to the extent that some of the deposits are for fixed terms of up to 3 months. The effective interest rate on the short-term bank deposits was 5.0% (2005 4.3%) for the Group and 4.9% (2005 4.3%) for the Parent company. The average maturity of the short-term bank deposits was 42 days (2005 46 days) for the Group and 38 days (2005 39 days) for the Parent company.

**22. CASH AND CASH EQUIVALENTS (CONTINUED)**

The cash and cash equivalents for the purposes of the cash flow statement are as follows:

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Cash and cash equivalents as per prior page	1,092	963	756	595
Bank overdrafts	(58)	–	(43)	–
Cash and cash equivalents in the cash flow statement	1,034	963	713	595

**23. INSURANCE CONTRACT LIABILITIES AND REINSURANCE ASSETS**

The movement in insurance contract liabilities and reinsurance assets in the year is shown in the following tables.

	Group - 2006					
	Insurance contract liabilities, gross of reinsurance		Reinsurers' share of insurance liabilities		Insurance contract liabilities, net of reinsurance	
	Participating	Non-participating	Participating	Non-participating	Participating	Non-participating
	£m	£m	£m	£m	£m	£m
<b>At 1 January</b>	11,223	4,122	(1)	(1,258)	11,222	2,864
<b>Expected changes during the year</b>	(429)	(52)	–	42	(429)	(10)
<b>Expected closing position</b>	10,794	4,070	(1)	(1,216)	10,793	2,854
<b>New business</b>	128	260	–	(154)	128	106
<b>Experience variations</b>						
Demographic	(23)	21	–	10	(23)	31
Economic	410	70	–	–	410	70
	387	91	–	10	387	101
<b>Changes in assumptions</b>						
Demographic	33	(5)	–	16	33	11
Expense	(2)	(4)	–	(1)	(2)	(5)
Economic	(99)	(51)	–	26	(99)	(25)
Management actions	43	(1)	–	–	43	(1)
Methodology	–	–	–	–	–	–
	(25)	(61)	–	41	(25)	(20)
<b>Other movements</b>						
Part VII transfers (note 3 (b))	–	(1,833)	–	1,033	–	(800)
Guaranteed annuity options	–	–	–	–	–	–
Business reviews	–	–	–	–	–	–
Claims outstanding	–	21	–	5	–	26
Other	(4)	22	–	(20)	(4)	2
	(4)	(1,790)	–	1,018	(4)	(772)
<b>At 31 December</b>	11,280	2,570	(1)	(301)	11,279	2,269

**23. INSURANCE CONTRACT LIABILITIES AND REINSURANCE ASSETS (CONTINUED)**

	Group – 2005					
	Insurance contract liabilities, gross of reinsurance		Reinsurers' share of insurance liabilities		Insurance contract liabilities, net of reinsurance	
	Participating	Non-participating	Participating	Non-participating	Participating	Non-participating
	£m	£m	£m	£m	£m	£m
<b>At 1 January</b>	10,426	3,639	(1)	(1,147)	10,425	2,492
<b>Expected changes during the year</b>	(316)	(50)	–	19	(316)	(31)
<b>Expected closing position</b>	10,110	3,589	(1)	(1,128)	10,109	2,461
<b>New business</b>	103	240	–	(93)	103	147
<b>Experience variations</b>						
Demographic	(60)	11	–	5	(60)	16
Economic	900	125	–	–	900	125
	840	136	–	5	840	141
<b>Changes in assumptions</b>						
Demographic	13	33	–	–	13	33
Expense	(8)	(5)	–	6	(8)	1
Economic	195	90	–	(43)	195	47
Methodology	(107)	(14)	–	–	(107)	(14)
	93	104	–	(37)	93	67
<b>Other movements</b>						
Guaranteed annuity options	45	25	–	–	45	25
Business reviews	57	–	–	–	57	–
Claims outstanding	–	–	–	(2)	–	(2)
Other	(25)	28	–	(3)	(25)	25
	77	53	–	(5)	77	48
<b>At 31 December</b>	11,223	4,122	(1)	(1,258)	11,222	2,864

**23. INSURANCE CONTRACT LIABILITIES AND REINSURANCE ASSETS (CONTINUED)**

	Parent company – 2006					
	Insurance contract liabilities, gross of reinsurance		Reinsurers' share of insurance liabilities		Insurance contract liabilities, net of reinsurance	
	Participating	Non-participating	Participating	Non-participating	Participating	Non-participating
	£m	£m	£m	£m	£m	£m
<b>At 1 January</b>	11,223	4,066	(1)	(1,253)	11,222	2,813
<b>Expected changes during the year</b>	(429)	(51)	-	42	(429)	(9)
<b>Expected closing position</b>	10,794	4,015	(1)	(1,211)	10,793	2,804
<b>New business</b>	128	255	-	(154)	128	101
<b>Experience variations</b>						
Demographic	(23)	23	-	10	(23)	33
Economic	410	71	-	-	410	71
	387	94	-	10	387	104
<b>Changes in assumptions</b>						
Demographic	33	(5)	-	16	33	11
Expense	(2)	(3)	-	(1)	(2)	(4)
Economic	(99)	(51)	-	26	(99)	(25)
Management actions	43	(1)	-	(1)	43	(2)
Methodology	-	-	-	-	-	-
	(25)	(60)	-	40	(25)	(20)
<b>Other movements</b>						
Part VII transfers (note 3 (b))	-	(1,833)	-	1,033	-	(800)
Guaranteed annuity options	-	-	-	-	-	-
Business reviews	-	-	-	-	-	-
Claims outstanding	-	23	-	5	-	28
Other	(4)	21	-	(19)	(4)	2
	(4)	(1,789)	-	1,019	(4)	(770)
<b>At 31 December</b>	11,280	2,515	(1)	(296)	11,279	2,219

**23. INSURANCE CONTRACT LIABILITIES AND REINSURANCE ASSETS (CONTINUED)**

	Parent company – 2005					
	Insurance contract liabilities, gross of reinsurance		Reinsurers' share of insurance liabilities		Insurance contract liabilities, net of reinsurance	
	Participating	Non-participating	Participating	Non-participating	Participating	Non-participating
	£m	£m	£m	£m	£m	£m
<b>At 1 January</b>	10,426	3,593	(1)	(1,140)	10,425	2,453
<b>Expected changes during the year</b>	(316)	(48)	–	19	(316)	(29)
<b>Expected closing position</b>	10,110	3,545	(1)	(1,121)	10,109	2,424
<b>New business</b>	103	226	–	(93)	103	133
<b>Experience variations</b>						
Demographic	(60)	11	–	5	(60)	16
Economic	900	123	–	–	900	123
	840	134	–	5	840	139
<b>Changes in assumptions</b>						
Demographic	13	33	–	–	13	33
Expense	(8)	(6)	–	6	(8)	–
Economic	195	89	–	(43)	195	46
Methodology	(107)	(14)	–	–	(107)	(14)
	93	102	–	(37)	93	65
<b>Other movements</b>						
Guaranteed annuity options	45	25	–	–	45	25
Business reviews	57	–	–	–	57	–
Claims outstanding	–	3	–	(4)	–	(1)
Other	(25)	31	–	(3)	(25)	28
	77	59	–	(7)	77	52
<b>At 31 December</b>	11,223	4,066	(1)	(1,253)	11,222	2,813

For the purposes of the disclosure required by IAS 1, the amount of insurance contract liabilities classified as due to be settled in more than 12 months from the balance sheet date is £12,437m for the Group (2005 £13,870m) and £12,393m for the Parent company (2005 £13,828m).

The amount of the reinsurers' share of insurance liabilities classified as due to be recovered in more than 12 months from the balance sheet date is £263m (2005 £1,150m) for both the Group and the Parent company.

**24. NON-PARTICIPATING VALUE OF IN-FORCE BUSINESS**

The movement in the non-participating value of in-force business in the year is shown in the table below.

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
<b>At 1 January</b>				
Non-participating value of in-force business included within participating contract liabilities	374	280	374	280
Acquired PVIF	410	464	410	464
Deferred tax on acquired PVIF	(26)	(28)	(26)	(28)
Adjusted deferred acquisition costs arising on investment contracts	147	113	136	101
Deferred fee income on investment contracts	(72)	(54)	(68)	(49)
<b>Total value of in-force business at 1 January</b>	<b>833</b>	<b>775</b>	<b>826</b>	<b>768</b>
<b>Expected changes during the year</b>	<b>(76)</b>	<b>(60)</b>	<b>(76)</b>	<b>(60)</b>
<b>Expected closing position</b>	<b>757</b>	<b>715</b>	<b>750</b>	<b>708</b>
<b>New business</b>	<b>124</b>	<b>95</b>	<b>124</b>	<b>95</b>
<b>Experience variations</b>				
Demographic	(13)	(17)	(13)	(17)
Economic	71	64	71	64
	58	47	58	47
<b>Changes in assumptions</b>				
Demographic	(6)	(24)	(6)	(24)
Expense	(12)	12	(12)	12
Economic	(5)	25	(5)	25
Management actions	2	–	2	–
Methodology	6	(33)	6	(33)
	(15)	(20)	(15)	(20)
<b>Other movements</b>				
Transfer of annuities	15	–	15	–
RA OB fund merger	(30)	–	(30)	–
Other	(11)	(4)	(11)	(4)
	(26)	(4)	(26)	(4)
	<b>898</b>	<b>833</b>	<b>891</b>	<b>826</b>
<b>At 31 December</b>				
Non-participating value of in-force business included within participating contract liabilities	524	374	524	374
Acquired PVIF	307	410	307	410
Deferred tax on acquired PVIF	(18)	(26)	(18)	(26)
Adjusted deferred acquisition costs arising on investment contracts	176	147	165	136
Deferred fee income on investment contracts	(91)	(72)	(87)	(68)
<b>Total value of in-force business at 31 December</b>	<b>898</b>	<b>833</b>	<b>891</b>	<b>826</b>

The adjusted deferred acquisition costs arising on investment contracts shown above are equal to the deferred acquisition costs arising on investment contracts shown in note 18 less the element of those deferred acquisition costs that relates to future commission.

**24. NON-PARTICIPATING VALUE OF IN-FORCE BUSINESS (CONTINUED)**

The deferred fee income on investment contracts shown on page 82 is equal to the deferred fee income shown in note 32. For the Group only, this is adjusted to remove deferred fee income in relation to fund management contracts of £1m at 31 December 2006 (2005 £2m).

For the purposes of the disclosure required by IAS 1, the amount of the balance of £524m (2005 £374m) of non-participating value of in-force business classified as due to be recovered in more than 12 months from the balance sheet date is £425m (2005 £303m) for the Group and the Parent company.

**25. INVESTMENT CONTRACT LIABILITIES**

The movement in investment contract liabilities in the year is shown in the tables below.

	Group			
	2006		2005	
	Participating £m	Non- participating £m	Participating £m	Non- participating £m
<b>At 1 January</b>	2,064	6,550	2,063	4,833
<b>Expected changes during the year</b>	(203)	(55)	(90)	391
<b>Expected closing position</b>	1,861	6,495	1,973	5,224
<b>New business</b>	73	1,241	54	769
<b>Experience variations</b>				
Demographic	(28)	(74)	(29)	(3)
Economic	22	335	161	549
	(6)	261	132	546
<b>Changes in assumptions</b>				
Demographic	5	-	18	-
Expense	(1)	-	(4)	-
Economic	(10)	-	(5)	-
Management actions	4	-	-	-
Methodology	-	-	(47)	-
	(2)	-	(38)	-
<b>Other movements</b>	(46)	53	(57)	11
<b>At 31 December</b>	1,880	8,050	2,064	6,550

**25. INVESTMENT CONTRACT LIABILITIES (CONTINUED)**

	Parent company			
	2006		2005	
	Participating £m	Non- participating £m	Participating £m	Non- participating £m
<b>At 1 January</b>	<b>2,064</b>	<b>5,461</b>	2,063	4,225
<b>Expected changes during the year</b>	<b>(203)</b>	<b>(42)</b>	(90)	83
<b>Expected closing position</b>	<b>1,861</b>	<b>5,419</b>	1,973	4,308
<b>New business</b>	<b>73</b>	<b>767</b>	54	633
<b>Experience variations</b>				
Demographic	(28)	(55)	(29)	5
Economic	22	355	161	505
	(6)	300	132	510
<b>Changes in assumptions</b>				
Demographic	5	-	18	-
Expense	(1)	-	(4)	-
Economic	(10)	-	(5)	-
Management actions	4	-	-	-
Methodology	-	-	(47)	-
	(2)	-	(38)	-
<b>Other movements</b>	<b>(46)</b>	<b>33</b>	(57)	10
<b>At 31 December</b>	<b>1,880</b>	<b>6,519</b>	2,064	5,461

The participating investment contract liabilities include a discretionary element determined by management from time to time with regard to the returns earned on investments in the with-profits fund. These liabilities have been calculated on a basis consistent with the valuation of insurance contracts. It is not considered practicable to provide a fair value for these liabilities.

All of the non-participating investment contract liabilities arise from unit linked contracts, which are valued at fair value.

For the purposes of the disclosure required by IAS 1, the amount of investment contract liabilities classified as due to be settled in more than 12 months from the balance sheet date is £8,813m (2005 £7,742m) for the Group and £7,442m (2005 £6,759m) for the Parent company.

**26. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – VALUATION ASSUMPTIONS****(a) Assumptions**

The assumptions used to determine insurance and investment contract liabilities are set by the Board of Directors based on advice given by the Actuarial Function Holder. These assumptions are updated at least at each reporting date to reflect latest estimates. The assumptions used can be summarised as follows:

**(i) Demographic****Mortality and morbidity**

Mortality and morbidity bases are reviewed periodically to ensure that assumptions remain appropriate, taking into account recent company and industry experience for each class of business. In the case of term assurances, including those that offer critical illness benefits, an increase in mortality experience leads to increased claim levels and hence an increase in liabilities. For annuity contracts the risk is that policyholders live longer than expected. Term assurance and part of the annuity book are subject to reinsurance that mitigates these risks.

Valuation bases have been set in line with recent company experience, where it is available in sufficient volume to provide reliable results. Where company experience is not considered sufficient, bases have been set by reference to either industry experience or the terms on which the business is reinsured. A margin is included to provide against potential adverse variations in experience. In particular, a margin has been included to allow for expected future improvements in longevity.

The principal mortality rates used by the Group and the Parent company to calculate non-participating liabilities are shown in the table below. For participating liabilities and the calculation of the value of the in-force business the rates are similar but incorporate a lower (generally 2.5% less) margin of prudence.

Class of business	2006 mortality	2005 mortality
<b>Ordinary long-term non-linked assurances</b>		
Royal London Mutual	95% AM92 and 113% AF92	105% AM92 and AF92
Ex-United Assurance Group	95% AM92 and 113% AF92	105% AM92 and AF92
Ex-Scottish Life	74% AM92 and 84% AF92	80% AM92 and 100% AF92
<b>Pensions – deferred annuities</b>		
Ex-United Assurance Group (excluding DWP rebates)	85% AM92 and 87% AF92 in deferment 100% PCMA00 MC (1) and 90% PCFA00 MC (2) in payment	70% AM92 and 75% AF92 in deferment 100% PMA92 MC and PFA92 MC in payment
Ex-United Assurance Group (DWP rebates)	Not applicable	Not applicable
Ex-Scottish Life – individual	71% AM92 and 78% AF92 in deferment 100% PCMA00 MC (1) and 90% PCFA00 MC (2) in payment	70% AM92 and AF92 in deferment 95% PMA92 MC and PFA92 MC in payment
Ex-Scottish Life – group	71% AM92 and 71% AF92 in deferment 100% PCMA00 MC (1) and 90% PCFA00 MC (2) in payment	60% AM92 and AF92 in deferment  100% PMA92 MC and PFA92 MC in payment
<b>Pensions – pure endowment</b>		
Ex-United Assurance Group	Not applicable	Not applicable
<b>Pensions – individual in payment</b>		
Royal London Mutual	100% PCMA00 MC (1) and 90% PCFA00 MC (2) in payment	105% PMA92 MC and 105% PFA92 MC
Ex-United Assurance Group	100% PCMA00 MC (1) and 90% PCFA00 MC (2) in payment	105% PMA92 MC and 105% PFA92 MC
Ex-Scottish Life	100% PCMA00 MC (1) and 90% PCFA00 MC (2) in payment	100% PMA92 MC and 100% PFA92 MC
<b>Pensions – group in payment</b>		
Ex-Scottish Life	100% PCMA00 MC (1) and 90% PCFA00 MC (2) in payment	105% PMA92 MC and 105% PFA92 MC
<b>Industrial assurance</b>		
Royal London Mutual	82% ELT15 (males)	80% ELT15 (males)
Ex-United Assurance Group	82% ELT15 (males)	80% ELT15 (males)

(1) subject to a minimum improvement of 1.25% p.a. from 2001

(2) subject to a minimum improvement of 0.50% p.a. from 2001

## 26. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – VALUATION ASSUMPTIONS (CONTINUED)

### (a) Assumptions (continued)

#### (i) Demographic (continued)

##### Persistency

Persistency is the extent to which policies remain in force and are not for any reason lapsed, made paid-up, surrendered or transferred prior to maturity or expiry.

- Non-participating liabilities  
100% persistency is assumed when calculating the liability for non-participating business.
- Participating liabilities and the non-participating value of in-force business  
The rates of persistency used in the calculation of the participating business liability and the non-participating value of in-force business are based on actual experience plus a margin to provide for potential adverse variations. The rates vary by product line, sales channel and duration in force.

#### (ii) Expenses

For the main classes of business, maintenance expenses are set in accordance with management service agreements and, for business transferred to the Parent company, in accordance with the appropriate scheme of transfer. Expenses for those classes of business not covered by either a management service agreement or a scheme of transfer are based on the actual expenses incurred. During 2006 a review was undertaken of the basis for establishing the level of maintenance fees for products not covered by schemes of transfer, with the result that the fees for certain products were amended.

Expenses are assumed to inflate in line with the change in the Retail Price Index plus 1%.

Indicative renewal expense assumptions used by the Group and the Parent company are shown in the following table.

Class of business	2006				2005			
	Per policy £	Per claim £	Premium %	Reserve %	Per policy £	Per claim £	Premium %	Reserve %
<b>Ordinary long-term non-linked</b>								
<b>Royal London Mutual</b>								
Royal London branded business	12.50	–	5.00	0.09	11.88	–	5.00	0.08
Bright Grey	15.85	335.20	1.10	0.06	15.24	323.08	1.10	0.06
<b>Ex-United Assurance Group</b>								
RA OB business pre 1998	18.25	–	5.00	0.09	17.16	–	5.00	0.08
RA OB business post 1998	17.43	–	2.00	0.09	16.40	–	2.00	0.08
<b>Ex-Scottish Life</b>								
Individual pensions	27.54	–	–	0.09	29.09	–	–	0.09
Group pensions	52.02	–	–	0.09	58.68	–	–	0.09
<b>Industrial assurance</b>								
Royal London Mutual	6.26	–	10.00	0.09	5.94	–	10.00	0.08
Ex-United Assurance Group	8.16	–	17.50	0.09	7.68	–	17.50	0.08

## 26. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – VALUATION ASSUMPTIONS (CONTINUED)

### (a) Assumptions (continued)

#### (iii) Economic

- Non-participating liabilities  
The valuation interest rate for any given product group is set by reference to the market value of, and yields on, assets chosen to support that product group. The valuation interest rates used reflect the allocation of assets to the various lines of business and margins consistent with the statutory solvency basis of valuation. A reduction in interest rates increases the liabilities.
- Participating liabilities  
For participating business the majority of the liability is calculated as the aggregate asset share for the business in force. This is a retrospective calculation based on actual experience. The values of financial options (including premium rate guarantees and guaranteed annuity options) and future deductions from asset shares are calculated using market consistent techniques. Market consistency is achieved by running a large number of economically credible scenarios through a stochastic valuation model. Each scenario is discounted at a rate consistent with the individual simulation. The economic scenarios achieve market consistency by:
  - deriving the underlying risk-free rate from the forward gilt curve, with a margin of 10 basis points to reflect empirical evidence that gilt yields may understate the true risk-free rate;
  - calibrating equity and interest rate volatility to observed market data by duration and price, subject to interpolation/extrapolation where traded security prices do not exist.
- Non-participating value of in-force business  
The non-participating value of in-force business has been calculated on a market consistent basis. Future investment returns and discount rates are set by reference to risk-free yields. Risk has been allowed for through margins in the demographic and expense assumptions.

The valuation interest rates used by the Group and Parent company for non-participating liabilities are shown in the following table.

Class of business	2006 interest % per annum	2005 interest % per annum
<b>Ordinary long-term non-linked assurances</b>		
Royal London Mutual	4.000	3.500
Ex-United Assurance Group	4.000	3.500
Ex-Scottish Life	3.600	3.300
<b>Pensions – deferred annuities</b>		
Ex-United Assurance Group – in deferment	4.625	4.000
Ex-United Assurance Group – in payment	3.875	3.625
Ex-Scottish Life – individual – in deferment	4.625	4.125
Ex-Scottish Life – individual – in payment	3.875	3.625
Ex-Scottish Life – group – in deferment	4.625	4.125
Ex-Scottish Life – group – in payment	3.875	3.625
<b>Pensions – individual – in payment</b>		
Royal London Mutual	5.000	4.375
Ex-United Assurance Group	5.000	4.375
Ex-Scottish Life	5.000	4.375
<b>Pensions – group – in payment</b>		
Ex-Scottish Life	5.000	4.375
<b>Industrial assurance</b>		
Royal London Mutual	4.000	3.500
Ex-United Assurance Group	4.000	3.500

## 26. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – VALUATION ASSUMPTIONS (CONTINUED)

### (b) Changes in assumptions

The following tables show the impact of changes in the assumptions used to calculate insurance contract liabilities and reinsurance assets during the year. The tables demonstrate this effect by showing the 2006 year end liabilities as if they had been calculated using the 2005 year end assumptions.

	Group - 2006					Liability using 2006 assumptions £m
	Liability using 2005 assumptions £m	Impact of change in variable			Other £m	
		Demographic £m	Expenses £m	Economic £m		
<b>Insurance contract liabilities, gross</b>						
Participating insurance contracts	11,305	33	(2)	(99)	43	11,280
Non-participating insurance contracts						
- Unit linked	1,519	8	(2)	6	-	1,531
- Non-profit, other than annuities	756	(14)	(4)	(39)	(1)	698
- Non-profit annuities	265	1	2	(18)	-	250
- Claims outstanding	91	-	-	-	-	91
	2,631	(5)	(4)	(51)	(1)	2,570
	13,936	28	(6)	(150)	42	13,850
<b>Reinsurers' share of insurance liabilities</b>						
Participating insurance contracts	(1)	-	-	-	-	(1)
Non-participating insurance contracts						
- Non-profit, other than annuities	(132)	17	-	11	-	(104)
- Non-profit annuities	(201)	(1)	(1)	15	-	(188)
- Claims outstanding	(9)	-	-	-	-	(9)
	(342)	16	(1)	26	-	(301)
	(343)	16	(1)	26	-	(302)
<b>Insurance contract liabilities, net</b>						
Participating insurance contracts	11,304	33	(2)	(99)	43	11,279
Non-participating insurance contracts						
- Unit linked	1,519	8	(2)	6	-	1,531
- Non-profit, other than annuities	624	3	(4)	(28)	(1)	594
- Non-profit annuities	64	-	1	(3)	-	62
- Claims outstanding	82	-	-	-	-	82
	2,289	11	(5)	(25)	(1)	2,269
	13,593	44	(7)	(124)	42	13,548
<b>Non-participating value of in-force business</b>	(539)	6	12	5	(8)	(524)

## 26. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – VALUATION ASSUMPTIONS (CONTINUED)

### (b) Changes in assumptions (continued)

	Group – 2005					Liability using 2005 assumptions £m
	Liability using 2004 assumptions £m	Impact of change in variable			Other £m	
		Demographic £m	Expenses £m	Economic £m		
<b>Insurance contract liabilities, gross</b>						
Participating insurance contracts	11,130	13	(8)	195	(107)	11,223
Non-participating insurance contracts						
- Unit linked	1,399	7	–	25	–	1,431
- Non-profit, other than annuities	685	–	1	19	(15)	690
- Non-profit annuities	1,864	26	(6)	46	1	1,931
- Claims outstanding	70	–	–	–	–	70
	4,018	33	(5)	90	(14)	4,122
	15,148	46	(13)	285	(121)	15,345
<b>Reinsurers' share of insurance liabilities</b>						
Participating insurance contracts	(1)	–	–	–	–	(1)
Non-participating insurance contracts						
- Non-profit, other than annuities	(80)	–	–	–	–	(80)
- Non-profit annuities	(1,127)	–	6	(43)	–	(1,164)
- Claims outstanding	(14)	–	–	–	–	(14)
	(1,221)	–	6	(43)	–	(1,258)
	(1,222)	–	6	(43)	–	(1,259)
<b>Insurance contract liabilities, net</b>						
Participating insurance contracts	11,129	13	(8)	195	(107)	11,222
Non-participating insurance contracts						
- Unit linked	1,399	7	–	25	–	1,431
- Non-profit, other than annuities	605	–	1	19	(15)	610
- Non-profit annuities	737	26	–	3	1	767
- Claims outstanding	56	–	–	–	–	56
	2,797	33	1	47	(14)	2,864
	13,926	46	(7)	242	(121)	14,086
<b>Non-participating value of in-force business</b>	(394)	24	(12)	(25)	33	(374)

## 26. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – VALUATION ASSUMPTIONS (CONTINUED)

### (b) Changes in assumptions (continued)

	Parent company – 2006					Liability using 2006 assumptions £m
	Liability using 2005 assumptions £m	Impact of change in variable			Other £m	
		Demographic £m	Expenses £m	Economic £m		
<b>Insurance contract liabilities, gross</b>						
Participating insurance contracts	11,305	33	(2)	(99)	43	11,280
Non-participating insurance contracts						
- Unit linked	1,474	8	(2)	6	-	1,486
- Non-profit, other than annuities	751	(14)	(3)	(39)	(1)	694
- Non-profit annuities	265	1	2	(18)	-	250
- Claims outstanding	85	-	-	-	-	85
	2,575	(5)	(3)	(51)	(1)	2,515
	13,880	28	(5)	(150)	42	13,795
<b>Reinsurers' share of insurance liabilities</b>						
Participating insurance contracts	(1)	-	-	-	-	(1)
Non-participating insurance contracts						
- Non-profit, other than annuities	(131)	17	-	11	(1)	(104)
- Non-profit annuities	(201)	(1)	(1)	15	-	(188)
- Claims outstanding	(4)	-	-	-	-	(4)
	(336)	16	(1)	26	(1)	(296)
	(337)	16	(1)	26	(1)	(297)
<b>Insurance contract liabilities, net</b>						
Participating insurance contracts	11,304	33	(2)	(99)	43	11,279
Non-participating insurance contracts						
- Unit linked	1,474	9	(2)	6	-	1,487
- Non-profit, other than annuities	620	2	(3)	(28)	(2)	589
- Non-profit annuities	64	-	1	(3)	-	62
- Claims outstanding	81	-	-	-	-	81
	2,239	11	(4)	(25)	(2)	2,219
	13,543	44	(6)	(124)	41	13,498
<b>Non-participating value of in-force business</b>	(539)	6	12	5	(8)	(524)

## 26. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – VALUATION ASSUMPTIONS (CONTINUED)

### (b) Changes in assumptions (continued)

	Parent company – 2005					Liability using 2005 assumptions £m
	Liability using 2004 assumptions £m	Impact of change in variable			Other £m	
		Demographic £m	Expenses £m	Economic £m		
<b>Insurance contract liabilities, gross</b>						
Participating insurance contracts	11,130	13	(8)	195	(107)	11,223
Non-participating insurance contracts						
- Unit linked	1,355	7	–	25	–	1,387
- Non-profit, other than annuities	683	–	–	18	(15)	686
- Non-profit annuities	1,864	26	(6)	46	1	1,931
- Claims outstanding	62	–	–	–	–	62
	3,964	33	(6)	89	(14)	4,066
	15,094	46	(14)	284	(121)	15,289
<b>Reinsurers' share of insurance liabilities</b>						
Participating insurance contracts	(1)	–	–	–	–	(1)
Non-participating insurance contracts						
- Non-profit, other than annuities	(80)	–	–	–	–	(80)
- Non-profit annuities	(1,127)	–	6	(43)	–	(1,164)
- Claims outstanding	(9)	–	–	–	–	(9)
	(1,216)	–	6	(43)	–	(1,253)
	(1,217)	–	6	(43)	–	(1,254)
<b>Insurance contract liabilities, net</b>						
Participating insurance contracts	11,129	13	(8)	195	(107)	11,222
Non-participating insurance contracts						
- Unit linked	1,355	7	–	25	–	1,387
- Non-profit, other than annuities	603	–	–	18	(15)	606
- Non-profit annuities	737	26	–	3	1	767
- Claims outstanding	53	–	–	–	–	53
	2,748	33	–	46	(14)	2,813
	13,877	46	(8)	241	(121)	14,035
<b>Non-participating value of in-force business</b>	(394)	24	(12)	(25)	33	(374)

## 27. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – SENSITIVITY ANALYSIS

The following tables present the sensitivity of insurance and investment contract liabilities to movements in the assumptions used in their calculation. The CFO Forum, a group of the Chief Financial Officers of major European insurance companies, issued guidance on the disclosure of sensitivity analysis in respect of European Embedded Values (EEV) on 31 October 2005 and this guidance has been adopted for the EEV sensitivity analysis included in the EEV supplementary information note (j). For consistency, the sensitivities used by the Group in respect of its insurance and investment contract liabilities are based on this CFO Forum guidance. For both 2006 and 2005, the variable changes are shown below.

For the demographic and expenses assumptions, sensitivities are only shown in one direction as an equal and opposite movement in the variable for the majority of business would have an equal and opposite impact on the value of insurance and investment contract liabilities. For the economic assumptions, the effect of both an increase and a decrease in the variable is shown, as the impact on liabilities may not be symmetrical.

### (i) Demographic

#### *Mortality and morbidity*

5% proportionate decrease in base mortality and morbidity rates. This sensitivity demonstrates the effect of a decrease in the rate of deaths and serious illness.

The impact of such a change on the contract liabilities varies depending on the type of business written. For life assurance business, a decrease in mortality rates will typically decrease the liabilities as there will be fewer payouts for early death. However, for those policies which contain a guaranteed annuity option, the policy liability may increase as the value of the option will increase because its value depends, in part, on the length of time over which the guaranteed rate will be paid. For annuity business, a decrease in mortality rates will increase the liability as the average period over which annuity payments have to be made will be extended.

#### *Persistency*

10% proportionate decrease in lapse rates. This sensitivity reflects a single, downward movement in lapse rates. This means that fewer policies are being surrendered or terminated early, with the result that more policies are assumed to remain in force. For non-participating business, the contract liabilities are based on the assumption that there are no lapses and hence contract liabilities will be unaffected. For participating business, a decrease in lapse rates will increase the liability as more policies are assumed to remain in force.

### (ii) Expenses

10% decrease in maintenance expenses, the ongoing cost of administering contracts. This sensitivity is applied to the projected level of expenses. There is no change to the assumed rate of future expense inflation. A reduction in expenses will reduce the value of the liabilities for most classes of business. For some unit linked contracts where future charges cover expenses, however, the liability may be unaffected.

### (iii) Economic

#### *Interest rates*

100 basis point per annum reduction and increase in interest rates. This sensitivity is designed to show the impact of a sudden parallel shift in the risk-free yield curve. A reduction in interest rates increases the current market value of fixed-interest assets but reduces future reinvestment rates. The value of liabilities is also increased when interest rates fall as the discount rate used in the calculation will be reduced. An increase in rates will have the opposite effect.

#### *Equity/property capital values*

10% increase and decrease in equity and property capital values at the valuation date, without a corresponding fall or rise in dividend or rental yield. This sensitivity shows the impact of a sudden change in the market value of assets. The value of liabilities will decrease when asset values fall, but other than for unit linked business, the decrease will be less than the fall in asset values. Consequently, the unallocated divisible surplus will be reduced by a fall in asset values.

**27. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – SENSITIVITY ANALYSIS**  
 (CONTINUED)

Group – 2006								
Liability as reported	Impact of change in variable							
	Demographic			Economic				
	Mortality & Morbidity	Lapses	Expenses	Interest rates +100 bp	Interest rates -100 bp	Capital values +10%	Capital values -10%	
£m	£m	£m	£m	£m	£m	£m	£m	
<b>Insurance contract liabilities, gross</b>								
Participating insurance contracts	11,280	6	11	(5)	(679)	960	523	(479)
Non-participating insurance contracts								
- Unit linked	1,531	10	-	(2)	(110)	137	112	(112)
- Non-profit, other than annuities	698	(19)	-	(10)	(88)	114	(1)	1
- Non-profit annuities	250	3	-	(1)	(24)	29	-	-
- Claims outstanding	91	-	-	-	-	-	-	-
	2,570	(6)	-	(13)	(222)	280	111	(111)
	13,850	-	11	(18)	(901)	1,240	634	(590)
<b>Insurance contract liabilities, net</b>								
Participating insurance contracts	11,279	6	11	(5)	(679)	960	523	(479)
Non-participating insurance contracts								
- Unit linked	1,531	10	-	(2)	(110)	137	112	(112)
- Non-profit, other than annuities	594	3	-	(9)	(71)	96	(1)	1
- Non-profit annuities	62	1	-	(1)	(5)	7	-	-
- Claims outstanding	82	-	-	-	-	-	-	-
	2,269	14	-	(12)	(186)	240	111	(111)
	13,548	20	11	(17)	(865)	1,200	634	(590)
<b>Non-participating value of in-force business</b>	(524)	3	(7)	(20)	28	(56)	(70)	43
<b>Investment contract liabilities</b>								
Participating investment contracts	1,880	(9)	(7)	(3)	(87)	120	69	(70)
Non-participating investment contracts	8,050	-	-	-	(227)	277	560	(560)
	9,930	(9)	(7)	(3)	(314)	397	629	(630)

**27. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – SENSITIVITY ANALYSIS**  
 (CONTINUED)

		Group – 2005						
		Impact of change in variable						
Liability as reported	£m	Demographic			Economic			
		Mortality & Morbidity	Lapses	Expenses	Interest rates +100 bp	Interest rates –100 bp	Capital values +10%	Capital values –10%
	£m	£m	£m	£m	£m	£m	£m	
<b>Insurance contract liabilities, gross</b>								
Participating insurance contracts	11,223	2	14	(13)	(739)	899	458	(464)
Non-participating insurance contracts								
- Unit linked	1,431	–	–	–	(55)	73	99	(97)
- Non-profit, other than annuities	690	(17)	–	(9)	(64)	83	(1)	1
- Non-profit annuities	1,931	26	–	(3)	(181)	216	–	–
- Claims outstanding	70	–	–	–	–	–	–	–
	4,122	9	–	(12)	(300)	372	98	(96)
	15,345	11	14	(25)	(1,039)	1,271	556	(560)
<b>Insurance contract liabilities, net</b>								
Participating insurance contracts	11,222	2	14	(13)	(739)	899	458	(464)
Non-participating insurance contracts								
- Unit linked	1,431	–	–	–	(55)	73	99	(97)
- Non-profit, other than annuities	610	–	–	(7)	(51)	67	(1)	1
- Non-profit annuities	767	8	–	–	(72)	86	–	–
- Claims outstanding	56	–	–	–	–	–	–	–
	2,864	8	–	(7)	(178)	226	98	(96)
	14,086	10	14	(20)	(917)	1,125	556	(560)
<b>Non-participating value of in-force business</b>	(374)	4	(14)	(15)	4	(9)	(47)	46
<b>Investment contract liabilities</b>								
Participating investment contracts	2,064	(6)	(6)	–	(172)	219	79	(75)
Non-participating investment contracts	6,550	–	–	–	(160)	187	477	(477)
	8,614	(6)	(6)	–	(332)	406	556	(552)

**27. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – SENSITIVITY ANALYSIS**  
 (CONTINUED)

		Parent company – 2006							
		Impact of change in variable							
Liability as reported		Demographic			Economic				
		Mortality & Morbidity	Lapses	Expenses	Interest rates +100 bp	Interest rates -100 bp	Capital values +10%	Capital values -10%	
	£m	£m	£m	£m	£m	£m	£m	£m	
<b>Insurance contract liabilities, gross</b>									
Participating insurance contracts	11,280	6	11	(5)	(679)	960	523	(479)	
Non-participating insurance contracts									
- Unit linked	1,486	10	-	(2)	(110)	136	109	(109)	
- Non-profit, other than annuities	694	(19)	-	(8)	(87)	112	(1)	1	
- Non-profit annuities	250	3	-	(1)	(24)	29	-	-	
- Claims outstanding	85	-	-	-	-	-	-	-	
	2,515	(6)	-	(11)	(221)	277	108	(108)	
	13,795	-	11	(16)	(900)	1,237	631	(587)	
<b>Insurance contract liabilities, net</b>									
Participating insurance contracts	11,279	6	11	(5)	(679)	960	523	(479)	
Non-participating insurance contracts									
- Unit linked	1,486	10	-	(2)	(110)	136	109	(109)	
- Non-profit, other than annuities	590	3	-	(6)	(70)	94	(1)	1	
- Non-profit annuities	62	1	-	(1)	(5)	7	-	-	
- Claims outstanding	81	-	-	-	-	-	-	-	
	2,219	14	-	(9)	(185)	237	108	(108)	
	13,498	20	11	(14)	(864)	1,197	631	(587)	
<b>Non-participating value of in-force business</b>	(524)	3	(7)	(20)	28	56	(70)	43	
<b>Investment contract liabilities</b>									
Participating investment contracts	1,880	(9)	(7)	(3)	(87)	120	69	(70)	
Non-participating investment contracts	6,519	-	-	-	(122)	149	517	(517)	
	8,399	(9)	(7)	(3)	(209)	269	586	(587)	

**27. INSURANCE AND INVESTMENT CONTRACT LIABILITIES AND REINSURANCE ASSETS – SENSITIVITY ANALYSIS**  
 (CONTINUED)

	Parent company – 2005							
	Liability as reported	Impact of change in variable						
		Demographic			Economic			
£m	Mortality & Morbidity	Lapses	Expenses	Interest rates +100 bp	Interest rates –100 bp	Capital values +10%	Capital values –10%	
	£m	£m	£m	£m	£m	£m	£m	
<b>Insurance contract liabilities, gross</b>								
Participating insurance contracts	11,223	2	14	(13)	(739)	899	458	(464)
Non-participating insurance contracts								
- Unit linked	1,387	–	–	–	(54)	72	95	(93)
- Non-profit, other than annuities	686	(17)	–	(7)	(63)	82	(1)	1
- Non-profit annuities	1,931	26	–	(3)	(181)	216	–	–
- Claims outstanding	62	–	–	–	–	–	–	–
	4,066	9	–	(10)	(298)	370	94	(92)
	15,289	11	14	(23)	(1,037)	1,269	552	(556)
<b>Insurance contract liabilities, net</b>								
Participating insurance contracts	11,222	2	14	(13)	(739)	899	458	(464)
Non-participating insurance contracts								
- Unit linked	1,387	–	–	–	(54)	72	95	(93)
- Non-profit, other than annuities	606	–	–	(6)	(50)	66	(1)	1
- Non-profit annuities	767	8	–	–	(72)	86	–	–
- Claims outstanding	53	–	–	–	–	–	–	–
	2,813	8	–	(6)	(176)	224	94	(92)
	14,035	10	14	(19)	(915)	1,123	552	(556)
<b>Non-participating value of in-force business</b>	(374)	4	(14)	(15)	4	(9)	(47)	46
<b>Investment contract liabilities</b>								
Participating investment contracts	2,064	(6)	(6)	–	(172)	219	79	(75)
Non-participating investment contracts	5,461	–	–	–	(98)	115	437	(437)
	7,525	(6)	(6)	–	(270)	334	516	(512)

## 28. UNALLOCATED DIVISIBLE SURPLUS

The movement in the unallocated divisible surplus (UDS) during the year is shown in the table below.

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
At 1 January	1,571	1,246	1,571	1,246
Income not recognised in the income statement	1	2	1	–
Transfer from the income statement	429	323	429	325
<b>At 31 December</b>	<b>2,001</b>	<b>1,571</b>	<b>2,001</b>	<b>1,571</b>

The UDS represents surpluses for which the allocation between participating policyholders has yet to be determined. Therefore, for the purposes of the disclosure required by IAS 1, the whole of the UDS at the balance sheet date has been classified as a balance that will be settled after more than 12 months.

The closing balance on the UDS for both the Group and Parent company includes amounts attributable to the Royal London sub-fund only. The surpluses in the closed funds, which are the Refuge industrial branch fund, the United Friendly funds and the Scottish Life fund, are included within the participating contract liabilities because they are not available for distribution to other policyholders or for other business purposes.

## 29. SUBORDINATED LIABILITIES

	Group and Parent company			
	2006 £m	2005 £m	Effective interest rate 2006 %	2005 %
Undated Subordinated Guaranteed Bonds	–	125	9.00	9.00
Perpetual Cumulative Step-up Subordinated Guaranteed Notes	396	395	6.28	6.28
	<b>396</b>	<b>520</b>		

Of the balance shown above, £396m (2005 £395m) is expected to be settled more than 12 months after the balance sheet date.

Subordinated liabilities are carried in the balance sheet at amortised cost. Their fair value at 31 December 2006 was £390m (2005 £537m).

### *Undated Subordinated Guaranteed Bonds*

The Undated Subordinated Guaranteed Bonds were redeemed in full at their principal amount of £125m on 28 November 2006. They were originally issued on 28 November 1996 by Scottish Life Finance plc, now a wholly owned subsidiary of the Parent company. The Bonds were guaranteed by the Parent company and the proceeds of the issue were loaned to the Parent company on the same interest, repayment and subordination terms as those applicable to the Bonds. The Parent company repaid this loan immediately prior to the redemption of the Bonds.

**29. SUBORDINATED LIABILITIES (CONTINUED)*****Perpetual Cumulative Step-up Subordinated Guaranteed Notes***

On 14 December 2005, RL Finance Bonds plc, a wholly owned subsidiary of the Parent company, issued the Perpetual Cumulative Step-up Subordinated Guaranteed Notes. The issue price of the Notes was 99.676% of the principal amount of £400m. The discount of £1m and the directly related costs incurred to issue the Notes of £4m have been capitalised as part of the carrying value and are being amortised on an effective interest basis over the period to the first possible redemption date.

The Notes are guaranteed by the Parent company. The proceeds of the issue were loaned to the Parent company on the same interest, repayment and subordination terms as those applicable to the Notes.

The Notes have no maturity date but the issuer has the option to redeem all of the Notes at their principal amount on 15 December 2015 and at three monthly intervals thereafter. Interest is payable on the Notes at a fixed rate of 6.125% per annum for the period to 15 December 2015, payable annually in arrears on 15 December each year. If the Bonds are not redeemed on 15 December 2015 the interest rate will be re-set on that date and at three-monthly intervals thereafter, at a rate equal to the offered three-month sterling deposit rate quoted on the interest re-set date, plus 2.45%. Following the first interest re-set date, interest becomes payable three-monthly in arrears on 15 March, 15 June, 15 September and 15 December in each year.

**30. OTHER FINANCIAL LIABILITIES**

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Loans from credit institutions	33	25	-	-
Finance lease obligations	25	13	18	6
Loan stock	4	5	-	-
Derivative liabilities (note 19 (b))	4	-	4	-
Bank overdrafts	58	-	43	-
	<b>124</b>	<b>43</b>	<b>65</b>	<b>6</b>
Expected to be settled within 12 months	98	2	49	1
Expected to be settled in more than 12 months	26	41	16	5
	<b>124</b>	<b>43</b>	<b>65</b>	<b>6</b>

Derivative liabilities are stated at fair value. All the remaining 'other financial liabilities' are carried in the balance sheet at amortised cost. Their fair values at 31 December 2006 are not materially different from the values shown above.

**(a) Loans from credit institutions**

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Not later than one year	33	-	-	-
Later than one year but not later than two years	-	25	-	-
	<b>33</b>	<b>25</b>	<b>-</b>	<b>-</b>

Interest on the above loans is payable at floating rates. The average interest rate for the year was 6.9% for the Group (2005 7.3%).

**30. OTHER FINANCIAL LIABILITIES (CONTINUED)****(b) Finance lease obligations**

Leased investment property is accounted for as if it had been acquired under a finance lease. At the commencement of the lease a liability is established to represent the financing element of the lease contract. As lease payments are made, these are split between an interest element, calculated on an effective interest basis, which is charged to the income statement and a capital element, which reduces the finance lease liability. The average term of finance leases entered into is 105 years for the Group (2005 109 years) and 106 years for the Parent company (2005 112 years). The interest rate inherent in the leases is fixed at the start of the lease.

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
<b>Obligations under finance leases – minimum lease payments:</b>				
Not later than one year	2	1	2	1
Later than one year and not later than five years	9	4	7	2
Later than five years	125	93	78	46
	136	98	87	49
Less: future charges	(111)	(85)	(69)	(43)
Present value of obligations under finance leases	25	13	18	6
<b>Present value of obligations under finance leases:</b>				
Not later than one year	2	1	2	1
Later than one year and not later than five years	7	3	6	1
Later than five years	16	9	10	4
	25	13	18	6

**(c) Loan stock**

The loan stock was issued at par and is redeemable at par by the Group at any time. It is unsecured and interest is payable six monthly in arrears at a rate per annum of 0.75% below LIBOR at the start of each interest period. Loan note holders can only redeem the loan stock at the start of each six monthly interest period.

**31. PROVISIONS**

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Provision for future commission	33	30	32	29
Other provisions	40	21	39	21
	<b>73</b>	<b>51</b>	<b>71</b>	<b>50</b>
Expected to be settled within 12 months	34	15	33	15
Expected to be settled in more than 12 months	39	36	38	35
	<b>73</b>	<b>51</b>	<b>71</b>	<b>50</b>

The provision for future commission relates to payments that the Group is contractually committed to make in future periods for investment contracts sold as at the balance sheet date. These payments are contingent on the related policies remaining in force.

Other provisions comprise amounts in respect of the long-term incentive plan, the mortgage endowment review provision and surplus sales and administration offices which have been closed and for which the Group retains lease commitments. Sub-lease receipts on redundant property leases have been taken into account in arriving at the above provisions. For the Group and Parent company this amounts to £15m (2005 £16m).

The movement in provisions during the year is shown in the table below.

	Group		Parent company	
	Provision for future commission £m	Other provisions £m	Provision for future commission £m	Other provisions £m
At 1 January 2006	30	21	29	21
Additional provisions	7	22	7	21
Utilised during the year	(5)	(3)	(5)	(3)
Unwind of discount rate	1	–	1	–
<b>At 31 December 2006</b>	<b>33</b>	<b>40</b>	<b>32</b>	<b>39</b>

**32. TRADE AND OTHER PAYABLES**

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Amounts due to customers	79	158	77	141
Payables arising under reinsurance contracts	17	2	15	1
Deferred fee income	92	74	87	68
Accrued expenses	47	46	18	25
Amounts due to brokers	71	32	68	32
Amounts due to other Group entities	–	–	41	37
Other payables	57	62	28	30
	<b>363</b>	<b>374</b>	<b>334</b>	<b>334</b>
Expected to be settled within 12 months	264	252	245	231
Expected to be settled in more than 12 months	99	122	89	103
	<b>363</b>	<b>374</b>	<b>334</b>	<b>334</b>

**32. TRADE AND OTHER PAYABLES (CONTINUED)**

Deferred fee income is front-end fees received from investment contract holders as a prepayment for asset management and related services. These amounts are non-refundable and are released to income as the services are rendered.

Trade and other payables are carried in the balance sheet at amortised cost. Their fair values are not materially different from the values shown on the previous page.

**33. BALANCES IN RESPECT OF EXTERNAL UNIT HOLDERS*****(i) Investment return attributable to external unit holders***

The investment return attributable to external unit holders represents the portion of the investment return included within the Group income statement that relates to the Group unit trusts and other investment funds that are owned by third parties.

***(ii) Liability to external unit holders***

The liability to external unit holders represents the portion of Group managed unit trusts and other investment funds included within the Group balance sheet but which are owned by third parties. The balance is stated at fair value being the quoted bid price of the relevant fund on the last day of the accounting period on which investments in such funds could be redeemed. For the purposes of the disclosure required by IAS 1, none of the balance (2005 none) is classified as being expected to be settled in more than 12 months from the balance sheet date.

**34. DEFERRED TAX LIABILITIES****(a) Net deferred tax balance**

The tables overleaf show the movement in the net deferred tax asset or liability in the year. The deferred tax assets and liabilities are considered to be non-current. All movements are shown as recognised in the income statement as the deferred tax impact of the items taken directly to the unallocated divisible surplus is not material in either year.

**34. DEFERRED TAX LIABILITIES (CONTINUED)****(a) Net deferred tax balance (continued)**

Group – 2006			
	1 Jan £m	Recognised in the income statement £m	31 Dec £m
Deferred acquisition expenses	(33)	–	(33)
Acquired value of in-force business	26	(8)	18
Excess management expenses carried forward	–	(12)	(12)
Revaluation of investments – capital elements	62	37	99
Revaluation of investments – income elements	64	17	81
Other short-term timing differences	(6)	3	(3)
	<b>113</b>	<b>37</b>	<b>150</b>
Group – 2005			
	1 Jan £m	Recognised in the income statement £m	31 Dec £m
Deferred acquisition expenses	(32)	(1)	(33)
Acquired value of in-force business	28	(2)	26
Revaluation of investments – capital elements	(15)	77	62
Revaluation of investments – income elements	51	13	64
Other short-term timing differences	(3)	(3)	(6)
	29	84	113
Parent company – 2006			
	1 Jan £m	Recognised in the income statement £m	31 Dec £m
Deferred acquisition expenses	(33)	–	(33)
Acquired value of in-force business	26	(8)	18
Excess management expenses carried forward	–	(12)	(12)
Revaluation of investments – capital elements	62	37	99
Revaluation of investments – income elements	64	17	81
Other short-term timing differences	–	2	2
	<b>119</b>	<b>36</b>	<b>155</b>
Parent company – 2005			
	1 Jan £m	Recognised in the income statement £m	31 Dec £m
Deferred acquisition expenses	(32)	(1)	(33)
Acquired value of in-force business	28	(2)	26
Revaluation of investments – capital elements	(15)	77	62
Revaluation of investments – income elements	51	13	64
Other short-term timing differences	3	(3)	–
	35	84	119

**34. DEFERRED TAX LIABILITIES (CONTINUED)****(a) Net deferred tax balance** (continued)

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred taxes relate to the same fiscal authority.

The amount described as 'Acquired value of in-force business' is the deferred tax effect of the acquired PVIF intangible asset. This asset is calculated as the present value of future profits on acquired business based on pre-tax income and expenses. Hence a deferred tax liability is established to reflect the estimated future tax payable on the realisation of those profits.

**(b) Unrecognised deferred tax balances****(i) Unrecognised deferred tax assets**

Deferred tax assets have not been recognised in respect of the following items:

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Deductible temporary differences	(6)	(7)	-	-
Tax losses	(4)	(14)	(4)	(13)
	(10)	(21)	(4)	(13)

Deferred tax assets arising from surplus trading losses or capital allowances have not been recognised as there is insufficient evidence that an adequate amount of taxable profits will arise in the future against which to offset these items. These unused losses and allowances can be carried forward and utilised as long as the company in which they arose is active or trading.

**(ii) Unrecognised deferred tax liabilities**

Deferred tax liabilities arising from gains on subsidiary holdings have not been recognised by the Parent company as it controls the timing of any sale of a subsidiary and the repatriation of any dividend and it is not probable that a sale or repatriation will happen in the foreseeable future as the Group's intention is that these investments will be held to provide long-term returns. The potential tax liability arising is less than £1m (2005 less than £1m).

There are no other unrecognised deferred tax liabilities within the Group.

### 35. PENSION SCHEME

The Group operates one main funded defined benefit scheme, Royal London Group Pension Scheme (RLGPS). On 1 September 2005, this scheme was closed to new entrants. The Group has established a contributory, defined contribution arrangement for new employees joining the Group after that date.

The major assumptions used to calculate the pension scheme asset were:

	Group and Parent company	
	2006 %	2005 %
Discount rate	5.1	4.8
Future salary increases	4.7	4.5
Future pension increases	2.9	2.7
Price inflation	2.9	2.7
Expected return on scheme assets:		
- Fixed interest bonds	4.6	4.1
- Index-linked bonds	4.2	4.0
- Corporate bonds	5.1	4.8
- Equities	7.1	7.0
- Property	6.6	6.5
- Cash	5.0	4.5

The most significant non-financial assumption is the assumed rate of mortality. This assumption is 100% for males and 110% for females of the standard tables known as PN00 applying medium cohort improvements from 2001, based on the '92' series of mortality tables. For 2005, the mortality assumption was based on the PA92 standard tables projected to 2005, with an age rating of minus two years (minus three years for non-pensioners) applied for males and minus one year (minus two years for non-pensioners) applied for females.

The expected return on assets has been derived as the weighted average of the expected returns from each of the main asset classes (i.e. equities and bonds). The expected return for each asset class reflects a combination of historical performance analysis, the forward looking views of the financial markets (as suggested by the yields available), and the views of investment organisations.

#### (a) Amounts recognised in the balance sheet

The amounts recognised in the balance sheet are as follows:

	Group and Parent company	
	2006 £m	2005 £m
Fair value of plan assets	1,782	1,726
Pension scheme obligation	(1,722)	(1,724)
Net pension scheme asset	60	2

#### (b) Analysis of plan assets

	Group and Parent company	
	2006 £m	2005 £m
Fixed interest bonds	252	226
Index-linked bonds	388	371
Corporate bonds	284	268
Equities	746	742
Property	102	109
Cash	10	10
Fair value of plan assets	1,782	1,726

**35. PENSION SCHEME (CONTINUED)****(b) Analysis of plan assets (continued)**

Changes in the fair value of plan assets during the year can be analysed as follows:

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
At 1 January	1,726	1,171	1,726	1,546
Expected return on plan assets	95	73	95	91
Actuarial gains – excluding the impact of non-transferable assets	28	153	28	153
Actuarial gains – impact of non-transferable assets	-	393	-	-
Employee contributions	1	-	1	-
Benefits paid in year	(68)	(64)	(68)	(64)
<b>At 31 December</b>	<b>1,782</b>	<b>1,726</b>	<b>1,782</b>	<b>1,726</b>
Actual return on scheme assets – excluding the impact of non-transferable assets	123	244	123	244
Actual return on scheme assets – impact of non-transferable assets	-	375	-	-
	123	619	123	244

For financial reporting purposes, investments in non-transferable financial instruments issued by a Group entity may not be included in plan assets for the purposes of calculating the net scheme asset or liability. RLGPS holds an investment in the internal linked funds of a subsidiary of the Group. At the beginning of the comparative period 1 January 2005, the terms of this investment were such that it was considered to be non-transferable. During 2005, the terms of the investment were amended such that it became transferable. Consequently, the Group's 2005 movement in plan assets reflects the impact of this change in status.

No contributions were made by the Group or the Parent company into the scheme during the year (2005 £nil). It is anticipated that the Group and the Parent company will make no contributions to the scheme in the year to 31 December 2007.

**(c) Analysis of pension scheme obligation**

The movement in the obligation during the year can be analysed as follows:

	Group and Parent company	
	2006 £m	2005 £m
At 1 January	1,724	1,522
Current service cost	19	21
Interest on pension scheme liabilities	81	81
Benefits paid in year	(68)	(64)
Employee contributions	1	-
Actuarial (gains) / losses	(35)	164
<b>At 31 December</b>	<b>1,722</b>	<b>1,724</b>

**35. PENSION SCHEME (CONTINUED)****(d) Amounts recognised in the income statement**

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Current service cost	19	21	19	21
Interest cost on pension scheme liabilities	81	81	81	81
Expected return on plan assets	(95)	(73)	(95)	(91)
Actuarial (gains) and losses	(63)	(7)	(63)	11
Net (income)/ expense recognised in the income statement	(58)	22	(58)	22

The net income recognised in the income statement in 2006 is included within other operating income. The net expense recognised in the income statement in 2005 is included within administrative expenses.

**(e) Historic information**

Amounts for the current and previous four periods are shown in the following tables. The figures shown for the four years to 2006 have been prepared in accordance with IAS 19, 'Employee Benefits'. The figures for 2002 have been prepared under UK Generally Accepted Accounting Principles (UK GAAP) using the equivalent UK accounting standard, FRS 17, 'Retirement Benefits'.

The adjusted net obligation shown in the table is the net obligation that would be reported if the non-transferable investments in internal linked funds were to be included in plan assets.

**35. PENSION SCHEME (CONTINUED)****(e) Historic information (continued)**

	Group				
	IFRS				UK GAAP
	2006 £m	2005 £m	2004 £m	2003 £m	2002 £m
Fair value of plan assets	1,782	1,726	1,171	676	1,374
Present value of the pension scheme obligation	(1,722)	(1,724)	(1,522)	(1,436)	(1,189)
Net obligation as reported under IAS 19/FRS 17	60	2	(351)	(760)	185
Plus fair value of units in internal linked funds	-	-	375	787	-
Adjusted net obligation	60	2	24	27	185
Experience gains and (losses) on plan assets – excluding impact of non-transferable assets	28	153	55	59	(375)
Experience gains and (losses) on plan assets – impact of non-transferable assets	-	393	461	(787)	-
Experience gains on plan liabilities	35	10	10	2	48
	Parent Company				
	IFRS				UK GAAP
	2006 £m	2005 £m	2004 £m	2003 £m	2002 £m
Fair value of plan assets	1,782	1,726	1,546	1,463	1,374
Present value of the pension scheme obligation	(1,722)	(1,724)	(1,522)	(1,436)	(1,189)
Net obligation as reported under IAS 19/FRS 17	60	2	24	27	185
Experience gains/(losses) on plan assets	28	153	55	59	(375)
Experience gains on plan liabilities	35	10	10	2	48

Experience gains on plan assets are the difference between the expected and the actual return on the assets of the scheme. Similarly, experience gains on plan liabilities are the difference between the expected and the actual change in scheme liabilities in the year.

**36. CONTINGENT LIABILITIES****Regulatory reviews**

During the year, the Group and Parent company continued to address issues from past inappropriate selling practices and other regulatory matters. The directors consider that they have made prudent provision for any liabilities arising and, as and when the circumstances calling for such provision arise, that the Group and Parent company have adequate reserves to meet all reasonably foreseeable eventualities.

**Tax treatment of Schedule 2C transfer**

On 1 January 2001 the long-term businesses of Refuge Assurance and United Friendly Insurance were transferred to the Parent company under the provisions of Section 49 and Schedule 2C of the Insurance Companies Act 1982. The Parent company is corresponding with HM Revenue and Customs (HMRC) as to the correct tax treatment of the transfers in the transferor companies. Having taken appropriate professional advice the directors consider that in their view there is a very low risk that HMRC would be successful in demonstrating that the current treatment is incorrect. If a liability did arise, it is expected that it would not exceed £60m.

**37. COMMITMENTS****(a) Capital expenditure**

The Group and Parent company have the following commitments to make capital purchases as at the balance sheet date:

	Group and Parent company	
	2006 £m	2005 £m
Property, plant and equipment	41	11

**(b) Investments in private equity funds**

The Group and Parent company have a portfolio of investments in private equity funds. The structure of these funds is such that the commitment is drawn down over the investment period. The total amount committed, net of drawdown, at the balance sheet date for the Group and Parent company is £39m (2005 £23m).

**(c) Operating lease commitments**

Operating lease payments represent rentals payable by the Group for land and buildings. The total future minimum lease payments due under these arrangements net of any related sub-lease receipts is shown in the following table.

	Group and Parent company	
	2006 £m	2005 £m
<b>Total future minimum lease payments under non-cancellable leases:</b>		
Not later than one year	4	4
Later than one year and not later than five years	10	11
Later than five years	7	9
	<b>21</b>	<b>24</b>
<b>Less: total future minimum sub-lease payments under non-cancellable sub-leases expected to be received</b>	<b>(5)</b>	<b>(6)</b>
	<b>16</b>	<b>18</b>
<b>Lease and sub-lease payments recognised as an expense for the period:</b>		
Minimum lease payments	3	3
Sub-lease receipts	(2)	(2)
	<b>1</b>	<b>1</b>

### 38. RELATED PARTY TRANSACTIONS

The Parent company is the ultimate parent undertaking of the Group. The Group and Parent company carried out the following transactions with related parties.

#### (a) Related party transactions of the Group

Transactions between Group entities are eliminated on consolidation. The following are those transactions carried out by Group entities with those related parties that are outside the Group.

##### (i) Subsidiaries' transactions with unit trusts and other investment funds

The Group markets a portfolio of unit trusts and other investment funds. A number of these funds are classified as subsidiaries for the purposes of financial reporting and hence are included within the Group. For those funds not consolidated within the Group the transactions during the year were as follows:

	2006 £m	2005 £m
Management fees earned during the year	6	3

There were no amounts outstanding between the Group and the funds at the year end (2005 £nil). The total value of units held by the Parent company at 31 December 2006 in the funds that are not consolidated into the Group was £236m (2005 £245m). The acquisitions and sales of units in the funds during the year were as follows:

	2006 £m	2005 £m
Acquisition of funds	27	15
Proceeds from sale of funds	8	5

##### (ii) Subsidiaries' transactions with the Parent company's staff pension scheme

The Royal London Group Pension Scheme (RLGPS) invests in units in various internal linked funds of the Royal London Pooled Pension Company Limited (RLPPC). During the year, RLGPS invested £9m (2005 £1m), by way of single premium investment, in RLPPC units. In addition, RLGPS disinvested £nil (2005 £1m) from RLPPC.

The total market value of the units held by RLGPS in RLPPC as at 31 December 2006 was £429m (2005 £412m).

#### (b) Related party transactions of the Parent company

The significant subsidiaries of the Parent company are shown in note 20 (a). Transactions between the Parent company and its subsidiaries and other related party transactions of the Parent company are shown below.

##### (i) Administration and investment management services provided by subsidiaries

Subsidiary companies perform the administration and investment management activities of the Parent company. The Parent company is charged fees for these services under management services agreements and, for business transferred to the Parent company, in accordance with the appropriate scheme of transfer. In 2005, certain additional costs, principally commission, were incurred by subsidiaries on behalf of the Parent company and recharged. In 2006, these expenses were incurred by the Parent company directly.

The following table summarises the fees and recharges incurred by the Parent company during the year.

	Parent company	
	2006 £m	2005 £m
Administration fees	146	162
Commission recharged	-	94
Investment management fees	15	12
	161	268

**38. RELATED PARTY TRANSACTIONS (CONTINUED)****(b) Related party transactions of the Parent company (continued)****(ii) Financing transactions undertaken with subsidiaries**

The Parent company has provided loans to subsidiaries and charges interest on an arm's length basis.

As set out in note 29, two subsidiaries have issued subordinated liabilities, lending the proceeds to the Parent company on the same terms as the original debt issue. During the year, one of these loans was repaid by the Parent company.

The following table summarises the interest income and expense incurred by the Parent company during the year in relation to these transactions.

	Parent company	
	2006 £m	2005 £m
Interest income on loans to subsidiaries	3	3
Interest expense on subordinated liabilities	(35)	(12)

**(iii) Other income received from subsidiaries**

	Parent company	
	2006 £m	2005 £m
Unit trust management fee rebates	51	40
Unit trust distributions	69	16
Other dividends receivable from subsidiaries	5	10
Rental income	4	4
	129	70

The unit trust management fee rebates relate to the investment in Group unit trusts made by certain unit linked funds of the Parent company. The Parent company deducts an investment management fee from the unit linked fund. The manager of the unit trusts, which is a subsidiary of the Parent company, deducts an investment management fee from the unit trust in which the unit linked fund has invested. In order to avoid the unit linked fund bearing both these investment management fees, the subsidiary company rebates the portion of its charge relating to the internal holding of unit trusts to the unit linked fund.

Unit trust distributions are those received from unit trusts that are classified as subsidiaries for financial reporting purposes.

**38. RELATED PARTY TRANSACTIONS (CONTINUED)****(b) Related party transactions of the Parent company (continued)****(iv) Outstanding balances with Group entities at the year end**

At the year end, the following balances were outstanding with Group entities in relation to the transactions on the previous page.

	Parent company	
	2006 £m	2005 £m
Amounts due from Group entities	18	20
Loans to Group entities	29	29
	47	49
Subordinated liabilities	(396)	(520)
Amounts due to Group entities	(41)	(37)
	(437)	(557)

The amounts due to and from Group entities are due on demand and are not secured.

**(v) Other transactions of the Parent company with related parties**

As part of its portfolio of investment assets the Parent company has holdings in unit trusts and other funds, managed by subsidiaries. The Parent company's acquisitions and sales during the year of units in these funds were as follows.

	Parent company	
	2006 £m	2005 £m
Acquisition of funds	423	206
Proceeds from sale of funds	214	561

**39. ADDITIONAL CASH FLOW INFORMATION****(a) Adjustments for non-cash items**

Adjustments in the cash flow statements for non-cash items comprise the following:

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Tax expense	44	133	36	126
Profit on disposal of property, plant and equipment	-	(7)	-	-
Loss on disposal of property, plant and equipment	-	2	-	-
Reversal of impairments on property, plant and equipment	(1)	(2)	-	-
Impairment losses on property, plant and equipment	-	1	-	-
Depreciation of property, plant and equipment	5	6	-	-
Fair value gain on investment property	(325)	(277)	(274)	(276)
Amortisation and impairment charges on acquired PVIF	103	54	103	54
Change in deferred acquisition costs	(33)	(38)	(32)	(38)
Change in reinsurers' share of insurance liabilities	957	(111)	957	(113)
Change in pension scheme asset/liability	(58)	(353)	(58)	22
Fair value gain on financial investments	(906)	(2,288)	(772)	(2,202)
Net foreign exchange loss on financial investments	4	-	1	-
Change in participating insurance contract liabilities	57	797	57	797
Change in participating investment contract liabilities	(184)	1	(184)	1
Change in non-participating value of in-force business	(150)	(94)	(150)	(94)
Change in non-participating insurance contract liabilities	(1,552)	483	(1,551)	473
Change in non-participating investment contract liabilities	1,500	1,717	1,058	1,236
Change in provisions	22	15	21	17
Non-cash transfer of investments	615	-	753	-
Other non-cash items	4	15	16	18
	102	54	(19)	21

The non-cash transfer of investments in 2006 relates to the assets transferred to Prudential Retirement Income Limited (PRIL) on reinsurance of a substantial proportion of the annuities portfolio. The Parent company transfer value of £753m has been offset in the Group by £138m due to assets transferred in from external clients.

**39. ADDITIONAL CASH FLOW INFORMATION (CONTINUED)****(b) Adjustments for non-operating items**

Adjustments in the cash flow statements for non-operating items comprise the following:

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Fair value gain on investments in Group entities	-	-	(51)	(4)
Dividends received from subsidiaries	-	-	(5)	(10)
Finance costs	39	16	38	14
	39	16	(18)	-

The fair value gain on investments in Group entities and the dividends received from subsidiaries shown above exclude amounts in relation to unit trusts and other funds treated as subsidiaries for financial reporting purposes.

**(c) Dividends and interest**

Interest and dividend receipts and payments included in the cash flow statements are as follows:

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Dividends received:				
- Operating cash flows (including Group unit trusts)	355	143	225	12
- Investing cash flows	-	-	5	10
	355	143	230	22
Interest received:				
- Operating cash flows	520	499	458	480
Interest paid:				
- Operating cash flows	6	5	4	6
- Financing cash flows	39	16	38	14
	45	21	42	20

**(d) Acquisition and disposal of Group entities**

The Parent company's operating portfolio of investment assets includes unit trusts and other investment funds that are classified for financial reporting purposes as subsidiaries. Cash flows in relation to these assets are classified as operating cash flows for the Parent company cash flow statement. The amounts included within 'Acquisition of financial investments' and 'Proceeds from disposal of financial investments' relating to the acquisition and disposal of such funds were £423m and £214m (2005 £191m and £556m) respectively.

The acquisition of Group entities of £1m (2005 £32m) in the Parent company cash flow statement relates to capital injections into subsidiaries and represents the total cash consideration.

The proceeds from the disposal of Group entities of £15m relates to the disposal of a property investment subsidiary. The £29m proceeds in 2005 comprised cash received from a subsidiary in repayment of a loan of £23m and £6m from the disposal of a property investment subsidiary.

#### 40. RISK MANAGEMENT

The Group's primary objective in undertaking risk management is to ensure that the achievement of the Group's performance and regulatory objectives is not undermined by unexpected events. The Board of Directors has overall responsibility for the Group's risk management framework and for reviewing its effectiveness.

##### ***Risk Management framework***

The Group's risk management framework is built around three principal elements:

- Risk Appetite Statement;
- Risk Policies; and
- The Corporate Governance structure.

The Group's Risk Appetite Statement sets out explicitly the amount of risk that the Group is currently willing to accept. It is put into practice by the use of principles and procedures and by the setting of tolerances, limits and authority levels.

The Group's Risk policies are the high level standards and requirements which determine the way in which risks are to be managed and controlled. The Board of Directors ensures that policies are regularly reviewed to reflect the changing commercial and regulatory environment and the Group's organisational structure. Executive management has been delegated the day-to-day responsibility for establishing and implementing appropriate systems and controls and for managing the risks which impact upon their respective areas of responsibility. Business unit managers record material risks, including information on their probability and severity and the mitigating controls or actions planned. This framework allows the Group to assess its overall risk exposure and to create a risk map of major exposures. This map is continually monitored and regularly refreshed.

The Group has established a formal governance structure of committees to manage risk, reporting into the Board of Directors. Each committee has clear terms of reference and documented delegated authorities and responsibilities. These committees are described further below.

##### ***Group Risk Committee***

The role of the Group Risk Committee is to provide an oversight of the operation of the Group's risk management framework on behalf of the Board. The committee ensures that adequate risk management systems are in place, that key risks are being properly managed and that consideration of potential risks forms a part of all decision making throughout the Group. The Committee meets quarterly and is chaired by the Executive Director (who is the executive director responsible for risk, compliance and audit). The Insurance Committee and the Capital Management Committee report on risk matters into the Group Risk Committee.

##### ***Insurance Committee***

The Insurance Committee provides independent oversight of insurance risk. This Committee meets quarterly and is chaired by the Executive Director. The role of the Committee is to provide oversight of the Group's long-term insurance management, ensuring that insurance procedures are in place and operating effectively and to ensure that the control, co-ordination and monitoring of insurance and reinsurance risk is adequate and in line with the Group's risk appetite.

##### ***Capital Management Committee***

The capital position of the Group is monitored by the Capital Management Committee. This Committee meets every two months, is chaired by the Group Finance Director and reports via the Group Chief Executive to the Board of Directors. It also provides risk reports on significant credit, market and liquidity issues to the Group Risk Committee. The role of the Capital Management Committee is to monitor 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 of Directors.

##### ***Credit and Market Risk Monitoring Committee***

The Credit and Market Risk Monitoring Committee monitors credit, market and liquidity risk and reports through to the Capital Management Committee. The Committee meets six times a year, and is chaired by the Group's Chief Investment Officer. The Committee oversees the development and maintenance of the exposure limit infrastructure, authorises changes to limits and monitors, investigates and reports on breaches of limits and situations where limits are at substantial risk of being breached.

A Risk and Compliance team independent of the business areas supports these processes by providing specialist knowledge, experience and quality assurance through analysis, review and challenge as well as co-ordinating reporting to the appropriate committee.

The major risks faced by the Group can be categorised as insurance risk, market risk, credit risk, liquidity risk and operational risk. These categories and the risk mitigation undertaken by the Group are described further overleaf.

#### 40. RISK MANAGEMENT (CONTINUED)

##### (a) Insurance risk

Insurance risk arises from the uncertainty over the occurrence, amount and timing of claims payments arising under insurance contracts.

The exposure of the Group depends to a significant extent on the value of claims to be paid in the future, relative to the assets accumulated to the date of claim. The amount of such future obligations is assessed by reference to assumptions with regard to future mortality or (if applicable) morbidity rates, persistency rates, expenses, investment returns, interest rates and tax rates. Sensitivity to the main assumptions underlying insurance risk can be seen in note 27.

In addition, it is necessary for the Group to make decisions which ensure an appropriate build-up of assets and liabilities relative to one another. These decisions include the allocation of investments between asset classes, the setting of policyholder bonus rates (some of which are guaranteed) and the setting of surrender terms.

The Group manages insurance risk within the risk management framework set out above, with the primary responsibility for the setting of policy and the monitoring of the insurance risk falling to the Insurance Committee.

Insurance risks are managed through the following mechanisms:

- the use of guidelines, limits and authority levels for concluding insurance contracts, assuming insurance risks and handling insurance claims.
- reinsurance to limit the Group's exposure to large single claims and catastrophes, to reduce exposure to specific risks and to alleviate the impact of new business strain.
- the diversification of business over several classes of insurance and over large numbers of uncorrelated individual risks to reduce variability in loss experience.

These techniques are supported by the use of actuarial models to calculate premiums and monitor claims patterns. Past experience and statistical methods are also used to determine appropriate assumptions for those models.

Note 26 (b) shows a breakdown of the insurance liabilities of the Group and the Parent company, giving an indication of the concentration of insurance risk assumed by type of business. As the Group and Parent company have written substantially all of their business in the UK, results are sensitive to demographic and economic changes arising in the UK.

##### (b) Market risk

Market risk arises from the possibility that the value or cash flows of the Group's assets and liabilities fluctuate as a result of movements in market prices. The most important components of market risk are interest rate, currency and other price risks. Each of these risks is discussed in more detail below.

The Group manages market risk within the risk management framework outlined above and in accordance with the relevant regulatory requirements. The principal technique employed is asset liability matching. This involves balancing the risks relating to the liabilities under the Group's insurance and investment contracts against the risks inherent in its assets. The Group has established policies for how assets and liabilities are to be matched. Where appropriate matching cannot be achieved, policies are in place to manage the market risk resulting from the mis-match. The Capital Management Committee provides regular monitoring of these processes.

The Group is not exposed to market risk in respect of assets held to cover unit linked liabilities as these risks are borne by the holders of the contracts concerned, except to the extent that the fund based management charges levied on these contracts vary directly with the value of the underlying assets. As a result, in the tables that follow, assets and liabilities relating to unit linked policies are shown as not being subject to the risk concerned.

##### (i) Interest rate risk

Interest rate risk is the risk that the fair value or cash flows of a financial instrument will vary as market rates of interest vary. The risk of a movement in fair value is categorised as fair value interest rate risk and applies to fixed interest financial instruments. The risk of a future change in cash flows is categorised as cash flow interest rate risk and applies to floating rate financial instruments.

Movements in the fair value of the Group's fixed interest assets are broadly matched by an equivalent movement in the related policyholder liabilities. Fixed interest investments are held principally for the fixed stream of income that they provide which is matched to the expected cash outflows arising from the guaranteed policy payments of certain of the Group's non-linked liabilities.

**40. RISK MANAGEMENT (CONTINUED)****(b) Market risk (continued)****(i) Interest rate risk (continued)**

The Group's exposure to cash flow interest rate risk principally arises from the outflows required to meet guaranteed policy payments which are fixed and therefore, are not affected by changes in market rates of interest. One method that could be used to mitigate this risk would be to back these guaranteed cash outflows as closely as possible with fixed interest assets giving equivalent cash inflows. This method is used for certain product types. However, backing all policy guarantees with fixed interest assets would restrict the Group's investment choices and prevent the Group investing in other asset classes, which may be expected to provide higher investment returns over the longer term. Therefore, for most product types, including all participating contracts, the Group seeks to partially match the guaranteed payments with fixed interest bearing assets. The remaining outflow is backed by other assets, principally equities.

The table below summarises the Group's exposure to interest rate risks. Included in the tables are the undiscounted expected cash flows arising from the assets and liabilities of the Group that are subject to interest rate risk. For the purposes of the tables, undated debt securities are assumed to have a term of 60 years. The carrying amount shown in the table is the carrying amount shown in the balance sheet for the relevant item. However, for the insurance and investment contract liabilities the amount shown is the total liability and not just the guaranteed component.

The difference in expected cash flows shown in the tables will be met from the other assets backing the relevant liabilities such as equities, as noted above.

Group - 2006							
	Expected cash flows (undiscounted)					Total £m	Carrying amount £m
	0-5 years £m	5-10 years £m	10-15 years £m	15-20 years £m	>20 years £m		
Expected cash flows arising from:							
<b>Assets subject to interest rate risk</b>							
Debt securities – fixed rate	2,277	2,413	2,148	1,605	5,476	13,919	6,559
Debt securities – floating rate	106	196	156	64	347	869	741
Derivative financial instruments	99	202	339	477	1,958	3,075	212
Cash and cash equivalents	424	–	–	–	–	424	424
	<b>2,906</b>	<b>2,811</b>	<b>2,643</b>	<b>2,146</b>	<b>7,781</b>	<b>18,287</b>	<b>7,936</b>
<b>Liabilities subject to interest rate risk</b>							
Insurance contract liabilities – guaranteed component	3,301	2,669	2,016	1,964	5,629	15,579	12,319
Investment contract liabilities – guaranteed component	639	445	348	282	369	2,083	1,880
Subordinated liabilities	123	498	–	–	–	621	396
Other liabilities	65	8	7	7	81	168	62
	<b>4,128</b>	<b>3,620</b>	<b>2,371</b>	<b>2,253</b>	<b>6,079</b>	<b>18,451</b>	<b>14,657</b>
<b>Difference in expected cash flows</b>	<b>(1,222)</b>	<b>(809)</b>	<b>272</b>	<b>(107)</b>	<b>1,702</b>	<b>(164)</b>	

**40. RISK MANAGEMENT (CONTINUED)****(b) Market risk (continued)****(i) Interest rate risk (continued)**

Group – 2005							
	Expected cash flows (undiscounted)					Total £m	Carrying amount £m
	0–5 years £m	5–10 years £m	10–15 years £m	15–20 years £m	>20 years £m		
Expected cash flows arising from:							
<b>Assets subject to interest rate risk</b>							
Debt securities – fixed rate	2,384	3,323	2,584	1,948	4,235	14,474	7,854
Debt securities – floating rate	62	89	47	20	38	256	184
Derivative financial instruments	31	121	217	304	1,199	1,872	232
Cash and cash equivalents	308	–	–	–	–	308	308
	2,785	3,533	2,848	2,272	5,472	16,910	8,578
<b>Liabilities subject to interest rate risk</b>							
Insurance contract liabilities – guaranteed component	3,426	3,154	2,215	1,955	5,512	16,262	13,903
Investment contract liabilities – guaranteed component	625	515	431	340	505	2,416	2,064
Subordinated liabilities	259	523	–	–	–	782	520
Other liabilities	45	5	5	5	67	127	43
	4,355	4,197	2,651	2,300	6,084	19,587	16,530
<b>Difference in expected cash flows</b>	<b>(1,570)</b>	<b>(664)</b>	<b>197</b>	<b>(28)</b>	<b>(612)</b>	<b>(2,677)</b>	

The interest rate risk profile of the Parent company is similar to that of the Group and therefore has not been analysed separately.

**40. RISK MANAGEMENT (CONTINUED)****(b) Market risk (continued)****(ii) Currency risk**

Currency risk is defined as the risk that the fair value or future cash flows of an asset or liability will change as a result of a change in foreign exchange rates. As the Group operates principally in the UK its assets and liabilities are mainly denominated in sterling. Policyholder liabilities in particular are almost exclusively in sterling. For investment assets, the Group's investment management policies and procedures allow for a small exposure to overseas markets, via both equities and fixed interest securities. The resulting currency risk is managed by the use of exposure limits and authorisation controls operated within the Group's risk management framework. The tables below demonstrate the extent to which the assets and liabilities of the Group and the Parent company are exposed to currency risk.

	Group		Parent company	
	2006 £m	2005 £m	2006 £m	2005 £m
Non-linked assets denominated in sterling	15,724	17,133	15,399	16,822
Non-linked assets denominated in other currencies	1,324	1,393	1,288	1,391
	<b>17,048</b>	18,526	<b>16,687</b>	18,213
Linked assets not subject to currency risk	9,581	7,981	8,005	6,847
	<b>26,629</b>	26,507	<b>24,692</b>	25,060
Non-linked liabilities denominated in sterling	16,959	18,486	16,598	18,173
Non-linked liabilities denominated in other currencies	89	40	89	40
	<b>17,048</b>	18,526	<b>16,687</b>	18,213
Linked liabilities not subject to currency risk	9,581	7,981	8,005	6,847
	<b>26,629</b>	26,507	<b>24,692</b>	25,060

**(iii) Other price risk**

Other price risk is the risk that the fair value or future cash flows of an asset or liability will fluctuate because of changes in market prices, other than those arising from interest rate or currency risks. Those changes may be caused by factors specific to the asset or liability or its issuer or by factors affecting all similar assets or liabilities.

The Group's exposure to this risk arises principally from its holdings in equities and investment property. The Board of Directors sets the Group's investment policy and strategy. Day-to-day responsibility for implementation is delegated to the Group's investment management subsidiary with robust monitoring procedures in place.

Investment management agreements specify the limits for holdings in certain asset categories. In addition, asset allocation and performance benchmarks are set, which ensure that each fund has an appropriate mix of assets and is not over or under exposed to a particular asset category.

**(c) Credit risk**

Credit risk is defined as the potential loss resulting from a counterparty's failure to repay amounts in full when due.

The Group's exposure to credit risk arises principally from its investment portfolio and from its holdings in bonds, derivatives and cash in particular. The investment policies and procedures stipulate approved counterparties, permitted investments and exchanges as well as detailing specific counterparty ratings and exposure limits. For derivatives, the policy also details legal, collateral and valuation requirements. Where possible, significant counterparty exposures, particularly in respect of stock lending and derivatives, are mitigated by the use of collateral.

The Group is also exposed to credit risk in respect of its reinsurance arrangements. The credit exposures for reinsurance contracts are monitored as part of the overall credit risk policy. When selecting a reinsurer, credit risk is assessed by using rating information.

**40. RISK MANAGEMENT (CONTINUED)****(c) Credit risk (continued)**

In order to minimise its exposure to credit risk the Group invests primarily in higher graded assets, rated BBB or above, as shown in the following table. The non-linked assets not subject to credit risk comprise equities, investment property, intangible assets and property, plant and equipment.

The debt and fixed income securities which have not been rated by an external agency are subject to rigorous internal analysis to provide an internal rating, the average of which at 31 December 2006 was in excess of A. This reflects the additional security provided by asset cover for these bonds so that they are less exposed to event risk and also offer higher levels of recovery in distressed conditions.

The credit ratings in respect of derivative financial investments shown in the tables below are those of the counterparties to the derivative contracts.

	Group – 2006							Total £m
	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Not rated £m	
<b>Non-linked assets subject to credit risk:</b>								
Financial investments								
- Debt and fixed income securities	1,024	420	699	333	-	17	1,013	3,506
- Derivatives	-	212	-	-	-	-	-	212
Cash and cash equivalents	8	364	42	-	-	-	10	424
Reinsurers' share of insurance liabilities	16	265	19	2	-	-	-	302
Other assets	-	-	-	-	-	-	184	184
	1,048	1,261	760	335	-	17	1,207	4,628
<b>Non-linked assets not subject to credit risk</b>								12,420
<b>Linked assets not subject to credit risk</b>								9,581
								26,629

	Group – 2005							Total £m
	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Not rated £m	
<b>Non-linked assets subject to credit risk:</b>								
Financial investments								
- Debt and fixed income securities	567	311	796	334	10	6	709	2,733
- Derivatives	-	232	-	-	-	-	-	232
Cash and cash equivalents	-	272	36	-	-	-	-	308
Reinsurers' share of insurance liabilities	9	1,172	71	3	-	-	4	1,259
Other assets	-	242	30	-	-	-	141	413
	576	2,229	933	337	10	6	854	4,945
<b>Non-linked assets not subject to credit risk</b>								13,581
<b>Linked assets not subject to credit risk</b>								7,981
								26,507

The Parent company has a similar credit risk profile to that shown for the Group above and therefore it has not been analysed separately.

**40. RISK MANAGEMENT (CONTINUED)****(d) Liquidity risk**

All of the assets of the Group and the Parent company have exposure to liquidity risk. Liquidity risk is the risk that adequate liquid funds are not available to settle liabilities as these fall due. This is managed by maintaining forecasts of cash requirements and by adjusting investment management strategies as appropriate to meet these requirements, both in the short and longer term. In most cases liquidity risk is avoided by holding sufficient assets in investments which are readily marketable in a sufficiently short timeframe to be able to settle benefits as these fall due. Where liabilities are backed by less marketable assets, for example investment property unit linked funds, contract terms permit the company to delay settlement in order to provide the opportunity to sell investments in an orderly fashion to provide the funds required.

**(e) Operational risk**

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Operational risks include, but are not limited to, information technology, information security, human resources, project management, tax, legal, fraud and compliance. Senior management have primary responsibility for the management of operational risks through developing policies, procedures and controls across the different products, activities, processes and systems under their control and for the allocation of responsibilities.

Each part of the business is responsible for implementing and maintaining controls within its particular remit and for achieving its business objectives in accordance with the Group's operational risk methodology. This methodology assesses the operational risks the Group faces, analyses the likelihood and impact of each risk and the strength of the mitigating controls and any actions proposed.

In performing the assessment, account is taken of the Group's risk appetite with greater significance being placed on those risks that fall outside set parameters. Details of risks on an inherent (before controls) and residual (after controls) basis are maintained on a Group Risk Register, which is supported by a proprietary piece of software. This is used as a basis of review and challenge by senior management, the Group Risk Committee and the Board of Directors. Management attention is focused upon those controls identified as not working as effectively as desired and upon action plans which are put in place when any weakness is identified.

An independent Risk and Compliance function provides a degree of independent challenge to the business on the effectiveness of the risk management practices being followed, on the risks identified and the strength of the controls in place. It also provides advice and guidance on the impact of regulatory change and undertakes risk-based monitoring reviews to assess the quality of business processes and controls to meet the requirements of FSA rules, reporting the results of its findings to management.

The Group Risk Register is used to support the capital calculation process under the FSA's Individual Capital Assessment regime with risks and controls within it being stressed. In addition, separate consideration is given to the capital implications of individual scenarios.

**40. RISK MANAGEMENT (CONTINUED)****(f) Overview of insurance contracts issued by the Group**

The level of insurance, market, credit and liquidity risk assumed by the Group varies with the type of business written. Additional risks also arise from financial options and guarantees within contracts. The main insurance contract types and an overview of the financial options and guarantees are set out below. The main types of investment contracts issued by the Group are set out in note 40 (g).

**(i) Participating insurance contracts***Key terms and conditions*

Participating insurance contracts (including both conventional and unitised with-profits business) contain a guaranteed benefit on maturity or earlier death. This guaranteed benefit may be increased by the addition of annual bonuses and by a final bonus which is applied when the policy becomes a claim. The Group can vary the amount of future bonuses paid, including reducing future bonus additions to zero. The Group also has contractual discretion to vary the amount payable on early surrender of the contract. The setting of bonus rates and surrender terms are subject to the Parent company's Principles and Practices of Financial Management (PPFM). All discretionary actions must also be consistent with the overriding principle that customers must be treated fairly.

*Key risk factors*▪ **Mortality**

The guaranteed payments on death generally exceed the value of the assets held to back the policy (its asset share), giving rise to mortality risk. Assumptions regarding the rate of mortality are taken into account when determining the bonus payments to be added to participating contracts. The level of these bonus additions can be varied to mitigate differences between expected and actual mortality experience.

▪ **Guarantees**

Participating contracts are subject to the risk that the market value of assets held to back the liabilities is depressed at the time that the guaranteed payments specified in the contract fall to be paid. This risk can be mitigated by the Group's contractual right to vary future bonus additions. This is considered further in note 40 (f) (v).

▪ **Persistency**

The most significant costs associated with writing insurance contracts are the commission and other costs incurred to acquire the policy. These expenses, together with the ongoing costs of maintenance, are recovered over the policy's lifetime. If the policy is terminated early, the expense deductions made to the point of termination may be less than the costs incurred. This risk is mitigated by the Group's contractual ability to vary the amount payable on surrender.

**(ii) Non-participating insurance contracts – unit linked***Key terms and conditions*

For unit linked business, the principal benefit payable is the value of the underlying assets. The addition of further benefits, such as death benefits, over and above the fund value, incurs an additional charge. The Group generally has the right to alter these charges based on its mortality experience. For many contracts the Group also has the ability to apply penalties on early surrender or early cessation of regular premiums. The ability to increase charges or apply penalties may be constrained by regulatory or market pressures, and by the obligation to treat customers fairly.

*Key risk factors*▪ **Mortality**

The right to receive an additional amount on death in excess of the unit fund value, funded by an additional charge, gives rise to mortality risk. If the actual level of deaths is greater than that expected the Group will not have deducted enough charges to cover the additional payments. This risk is mitigated by the Group's ability to vary the charges. If the actual experience is worse than that expected (i.e. more deaths than expected) the Group can increase the charges applied to cover the additional cost.

▪ **Persistency**

Acquisition and maintenance costs are recovered by management charges deducted over the policy's lifetime. If the policy is terminated early, the expense deductions made to the point of termination may be less than the costs incurred. This risk is mitigated by the Group's ability to apply penalties on early surrender.

**40. RISK MANAGEMENT (CONTINUED)****(f) Overview of insurance contracts issued by the Group (continued)****(iii) Non-participating insurance contracts – non-profit, other than annuities***Key terms and conditions*

For non-profit business, the level of benefits payable is fixed at the start of the contract and hence the ability of the Group to reduce the level of insurance risk accepted by varying terms and conditions is limited.

*Key risk factors*

- Mortality and morbidity

These policies contain a guaranteed payment on death, disability or illness depending on the terms of the contract. The Group has mitigated these risks principally through the use of reinsurance to transfer part of the mortality and morbidity risk to third party reinsurers.

**(iv) Non-participating insurance contracts – non-profit annuities***Key terms and conditions*

For non-profit annuities, the level of annuity payments is fixed at the start of the contract and these payments continue until the death of the annuitant and, in certain cases, the later death of their dependants. Hence, the ability of the Group to reduce the level of insurance risk accepted by varying terms and conditions is limited.

*Key risk factors*

- Mortality

The contractual stream of payments made until the death of the annuitant gives rise to mortality risk. An increase in life expectancy will increase the payments that have to be made. The Group manages this risk principally through reinsurance, transferring the mortality risk to third party reinsurers.

- Cash flow interest rate risk

For those annuity contracts not covered by reinsurance, the Group seeks to match the expected cash outflows from the annuities with cash inflows from its fixed interest investments.

**(v) Financial options and guarantees within insurance contracts**

Contracts issued by the Group have two principal types of financial option and guarantee:

- Guaranteed lump sum payments due on specified dates.

These mainly comprise the sum assured together with annual bonuses added onto participating contracts. Although the Group invests in a broad spread of asset types, there is still a risk that assets held to back any individual policy (the asset share) may be depressed at the time that the guaranteed payment due at maturity falls to be paid. The potential cost of honouring these guarantees is quantified as part of the liability for participating contracts.

- Guaranteed annuities.

These primarily arise in connection with pension business and occur in one of two forms:

- a guaranteed income specified in the contract
- guaranteed terms for converting lump sum maturity benefits into an income at maturity.

These guarantees expose the Group to both insurance risk (mortality) and financial risk (cash flow interest rate). An increase in life expectancy will increase the liability arising under the guarantees as it extends the period over which the guaranteed rate must be paid. A reduction in market interest rates also increases the liability as it results in an increase in the gap between the future expected cash inflows from the Group's assets and the outflows from the guarantees, which remain fixed. This cash flow interest rate risk has been partially mitigated by derivatives, which give the Group the right to swap floating rate cash receipts for fixed rate receipts in the future. This will enable the Group to match its obligation to make annuity payments at a fixed rate to a stream of fixed rate income.

The costs of financial options and guarantees are measured using a market consistent stochastic model.

**40. RISK MANAGEMENT (CONTINUED)****(g) Overview of investment contracts issued by the Group*****(i) Participating investment contracts****Key terms and conditions*

The participating investment contracts (including both conventional and unitised with-profits business) issued by the Group are predominantly pension contracts providing a cash benefit at retirement date. These contracts contain a guaranteed benefit on maturity or earlier death. This guaranteed benefit may be increased by the addition of annual bonuses and by a final bonus which is applied when the policy becomes a claim. The Group can vary the amount of future bonuses paid, including reducing future bonus additions to zero. The Group also has contractual discretion to vary the amount payable on early surrender of the contract. The setting of bonus rates and surrender terms are subject to the Parent company's PPFM. All discretionary actions must also be consistent with the overriding principle that customers must be treated fairly.

*Key risk factors*

- Guarantees

Participating contracts are subject to the risk that the market value of assets held to back the liabilities is depressed at the time that the guaranteed payments specified in the contract fall to be paid. This risk can be mitigated by the Group's contractual right to vary future bonus additions.

- Persistency

Acquisition and maintenance costs are recovered over the policy's lifetime. If the policy is terminated early, the expense deductions made to the point of termination may be less than the costs incurred. This risk is mitigated by the Group's contractual ability to vary the amount payable on surrender.

***(ii) Non-participating investment contracts - unit linked****Key terms and conditions*

For unit linked investment business, the principal benefit payable is the value of the underlying assets. The Group generally has the ability to apply penalties on early surrender or early cessation of regular premiums. The ability to increase charges or apply penalties may be constrained by regulatory or market pressures, and by the obligation to treat customers fairly.

*Key risk factors*

- Persistency

Acquisition and maintenance costs are recovered by management charges deducted over the policy's lifetime. If the policy is terminated early, the expense deductions made to the point of termination may be less than the costs incurred. This risk is mitigated by the Group's ability to apply penalties on early surrender.

## 41. CAPITAL MANAGEMENT

### (a) Capital management policies and objectives

The Group's capital management objectives are:

- to protect the Group's financial strength, providing security to policyholders.
- to ensure that the Group's capital position is sufficient to enable it to invest in the development of the business in order to fulfil its stated core strategic objectives as determined by the Board.
- to comply with the FSA's capital requirements. The Group has not breached these requirements at any point in the current or prior year.

The capital position of the Group is monitored on a regular basis and reviewed formally by the Capital Management Committee. The Group's capital requirements are forecast on a regular basis. Those forecasts are compared against the available capital and the Group's required minimum internal rate of return. The internal rate of return forecast to be achieved on potential investments is also measured against minimum required benchmarks taking into account the risk associated with the investment.

The FSA's capital requirement is that the Group must hold capital in excess of the higher of two amounts – the pillar one and pillar two requirements. The pillar one capital requirement is reported in the publicly available FSA return. It is equal to the statutory minimum capital requirement plus an additional component for each with-profits fund for which regulatory excess assets would otherwise exceed realistic excess assets as reported in the realistic balance sheet. The statutory minimum capital requirement is based on EU directives. It is broadly equivalent to the capital needed by an 'average' life insurance company with good risk controls, to cover adverse experience likely to occur once in every two hundred years.

The pillar two capital requirement is based on the Group's Individual Capital Assessment which is reported privately to the FSA. It is broadly equivalent to the capital needed to cover the Group's actual portfolio of risks at the same 'one in two hundred year' risk level, but having regard to the Group's own risks and controls.

As the Parent company is a mutual insurance company all business, including non-participating business, is written within its with-profits fund and all the subsidiaries of the Group are owned by that fund. The capital resources and capital resource requirements of the Group's regulated subsidiaries are included within the calculation of the Parent company's capital. As a result, the capital position of the Parent company and the Group are the same and hence only the Group's figures are shown in the following tables.

### (b) Realistic balance sheet

A summary realistic balance sheet is shown opposite, split between those funds currently open to new business and those that are closed. The closed funds are the Refuge Industrial Branch fund, the United Friendly funds and the Scottish Life fund, which were transferred on the acquisitions of United Assurance and Scottish Life.

Realistic available capital for both the open and closed funds is determined in accordance with the FSA's realistic balance sheet methodology. This can be broadly described as placing a market value on both the assets and participating liabilities, including both benefits already guaranteed and future discretionary benefits. Additionally, the value of future profits on all acquired in-force long-term business as well as on non-participating business issued by the Group may be included as an asset.

Participating liabilities comprise asset shares plus the costs of smoothing plus the value of guarantees and options which have been granted to policyholders. The asset share represents the premiums received to date, together with investment return earned, less expenses and charges. Guarantees and options are discussed further in note 40 (f). When calculating the participating liabilities, allowance has been made for actions that management would be expected to undertake on key assumptions, for example future bonus or investment policy in varying market conditions, in line with the Parent company's PPFM.

For the purpose of the capital statement, all excess assets associated with policies written within the closed funds, amounting to £395m (2005 £385m), are reported as liabilities because they are not available for distribution to other policyholders or for other business purposes. However, those excess assets are available to provide support to the relevant policies under stressed financial conditions before any call on the reported excess capital within the open funds need be made.

**41. CAPITAL MANAGEMENT (CONTINUED)****(b) Realistic balance sheet (continued)**

	2006			2005		
	Open funds £m	Closed funds £m	Total £m	Open funds £m	Closed funds £m	Total £m
Total realistic participating assets	7,646	7,163	14,809	7,036	7,554	14,590
Value of in-force business on a realistic basis	914	113	1,027	931	83	1,014
Current liabilities and subordinated liabilities	(725)	(202)	(927)	(666)	(295)	(961)
<b>Total realistic participating net assets</b>	<b>7,835</b>	<b>7,074</b>	<b>14,909</b>	<b>7,301</b>	<b>7,342</b>	<b>14,643</b>
Realistic participating liabilities						
- Participating benefit reserve	5,187	6,120	11,307	4,977	6,286	11,263
- Costs of smoothing	340	(15)	325	305	28	333
- Guarantees	264	240	504	352	316	668
- Options (guaranteed annuities)	181	400	581	176	379	555
- Other	54	(66)	(12)	75	(52)	23
<b>Total realistic participating liabilities (before closed fund transfer commitments)</b>	<b>6,026</b>	<b>6,679</b>	<b>12,705</b>	<b>5,885</b>	<b>6,957</b>	<b>12,842</b>
<b>Total realistic available capital (before closed fund transfer commitments)</b>	<b>1,809</b>	<b>395</b>	<b>2,204</b>	<b>1,416</b>	<b>385</b>	<b>1,801</b>
Closed fund transfer commitments	-	(395)	(395)	-	(385)	(385)
<b>Total realistic available capital</b>	<b>1,809</b>	<b>-</b>	<b>1,809</b>	<b>1,416</b>	<b>-</b>	<b>1,416</b>

**41. CAPITAL MANAGEMENT (CONTINUED)****(c) Capital statement**

	2006 £m	2005 £m
<b>Unallocated divisible surplus</b>	<b>2,001</b>	1,571
<b>Adjustments onto a regulatory basis</b>		
- Inadmissible goodwill, pension scheme asset and deferred tax asset	(180)	(115)
- Other adjustments to the value of net assets	(16)	(42)
- Adjustments to liabilities on a regulatory basis	4	2
<b>Total available capital resources</b>	<b>1,809</b>	1,416
<b>Capital requirement</b>		
Risk Capital Margin	391	229
<b>Excess capital</b>	<b>1,418</b>	1,187
<b>Analysis of liabilities</b>		
Participating insurance contract liabilities	11,280	11,223
Participating investment contract liabilities	1,880	2,064
Unallocated divisible surplus	2,001	1,571
Non-participating value of in-force business	(524)	(374)
<b>Participating contract liabilities</b>	<b>14,637</b>	14,484
Non-participating insurance contract liabilities		
- Unit linked	1,531	1,431
- Other	1,039	2,691
Non-participating investment contract liabilities		
- Unit linked	8,050	6,550
<b>Non-participating contract liabilities</b>	<b>10,620</b>	10,672
<b>Total contract liabilities</b>	<b>25,257</b>	25,156

The capital statement sets out the financial strength of the Group and provides a reconciliation of the unallocated divisible surplus to the available capital resources. The available capital resources are determined using FSA valuation rules. The asset valuation rules are based on IFRS, adjusted to exclude certain assets not admissible for regulatory purposes and for other specific valuation differences.

The capital requirement for the Group is the Risk Capital Margin (RCM). This represents the level of capital that the Group is required to hold in a stress event. The RCM is calculated assuming that persistency improves by 32.5% (2005 32.5%), that equity markets fall by 20% (2005 20%), property values fall by 12.5% (2005 12.5%) and risk-free yields fall by 81 basis points (2005 72 basis points). Credit risk is allowed for by assuming an immediate and permanent widening in yield spreads on corporate bonds over risk-free rates, calculated on a stock-by-stock basis.

**41. CAPITAL MANAGEMENT (CONTINUED)****(d) Movement in available capital resources**

	2006			2005		
	Open funds £m	Closed funds £m	Total £m	Open funds £m	Closed funds £m	Total £m
<b>At 1 January (after closed fund transfer commitments)</b>	<b>1,416</b>	<b>-</b>	<b>1,416</b>	1,062	-	1,062
<b>Closed fund transfer commitments</b>	<b>-</b>	<b>385</b>	<b>385</b>	-	400	400
<b>At 1 January (before closed fund transfer commitments)</b>	<b>1,416</b>	<b>385</b>	<b>1,801</b>	1,062	400	1,462
Changes in assumptions	(6)	(13)	(19)	(47)	(136)	(183)
Investment performance	326	50	376	358	189	547
New business	22	-	22	14	-	14
Changes in management policy	(38)	(47)	(85)	-	-	-
Other movements	89	20	109	29	(68)	(39)
<b>Movement</b>	<b>393</b>	<b>10</b>	<b>403</b>	354	(15)	339
<b>At 31 December (before closed fund transfer commitments)</b>	<b>1,809</b>	<b>395</b>	<b>2,204</b>	1,416	385	1,801
<b>Closed fund transfer commitments</b>	<b>-</b>	<b>(395)</b>	<b>(395)</b>	-	(385)	(385)
<b>At 31 December (after closed fund transfer commitments)</b>	<b>1,809</b>	<b>-</b>	<b>1,809</b>	1,416	-	1,416

The table above shows key elements of the movement in available capital resources analysed by open and closed funds.

The impact from assumption changes includes economic, persistency, mortality, expense and regulatory valuation assumption changes and their effects on the costs of guarantees, options and smoothing, the value of in-force business and the participating benefit reserve. The dominant effect arises from changes in demographic assumptions.

The investment performance impact arises from strong investment performance, which at 11.0% for the open funds is significantly in excess of the risk-free rate anticipated. Investment performance comprises the after tax return on opening capital, including the unwind of discount rate from, and the effect of, the higher than expected return on the value of in-force business, out-performance in aggregate on assets backing liabilities in respect of guarantees, options and smoothing and other Future Policy Related Liabilities, including the swaptions held to hedge Guaranteed Annuity Rate liabilities, and the reduction in cost of guarantees caused by the increased value of underlying asset share.

Value of new business is calculated on the basis used to value liabilities within the Realistic Balance Sheet and is quoted net of development costs and tax.

Changes in management policy reflect actions taken by Royal London's Board which increase the value of liabilities set aside to meet future payments to with-profits policyholders. Other movements include experience profits over the year including those earned on non-life subsidiaries, the transfer of the annuity portfolio and opening adjustments to reflect improved modelling and residual items.

There were no significant changes in regulation or other similar external developments.

**41. CAPITAL MANAGEMENT (CONTINUED)****(e) Sensitivity of capital**

The capital position of the Group is sensitive to changes in economic conditions and financial markets both through the impact on asset values and also the effect that changes in interest rates and investment returns may have on liability valuations. The liabilities are also sensitive to the other assumptions that have been used in their calculation, such as mortality and persistency. The Group's approach to managing these risks is detailed in note 40.

**(i) Economic conditions and financial markets**

The liability valuation will include assumptions about interest rates and investment returns. An adverse change in either variable will increase liabilities and hence reduce the available capital. For example, a reduction in long-term interest rates would increase the amount of the Group's liabilities and could therefore reduce its available capital, depending upon the extent to which the liabilities are matched by assets with similar anticipated cash flows.

Similarly, an adverse change in the markets for the Group's investment assets will reduce the available capital of the Group to the extent that it cannot be reflected in reductions in payments to policyholders because of the presence of guarantees and options in the underlying contracts.

**(ii) Assumptions**

The Group monitors actual experience in mortality, morbidity and persistency rates against the assumptions used, and applies that outcome to refine its long-term assumptions. Amounts paid will inevitably differ from estimates, particularly when the expected payments do not occur until well into the future. Liabilities are evaluated at least half yearly, allowing for changes in the assumptions used, as well as for the actual claims experience. If actual claims experience is less favourable than the underlying assumptions, or it is necessary to increase provisions in anticipation of a higher rate of future claims, then available capital will be reduced.

## EUROPEAN EMBEDDED VALUE (EEV) – supplementary information

### Statement of directors' responsibilities in relation to the European Embedded Value (EEV) supplementary information

The directors of Royal London have chosen to prepare supplementary information in accordance with the European Embedded Value Principles (the EEV Principles) issued in May 2004 by the CFO Forum, as supplemented by the Additional Guidance on European Embedded Value Disclosures issued in October 2005. When compliance with the EEV Principles is stated, those principles require the directors to prepare supplementary information in accordance with the Embedded Value Methodology (EVM) contained in the EEV Principles and to disclose and explain any non-compliance with the EEV Guidance included in the EEV Principles.

In preparing the EEV supplementary information, the directors have:

- prepared the supplementary information in accordance with the EEV Principles
- identified and described the business covered by the EVM
- applied the EVM consistently to the covered business
- determined assumptions on a realistic basis, having regard to past, current and expected future experience and to any relevant external data, and then applied them consistently
- made estimates that are reasonable and consistent
- determined the basis on which business that is not covered business has been included in the supplementary information, including any material departures from the accounting framework applicable to the Group financial statements.

The maintenance and integrity of the Royal London Group website is the responsibility of the directors; the work carried out by auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the European Embedded Value (EEV) supplementary information since it was initially presented on the website.

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

## INDEPENDENT AUDITORS' REPORT TO THE ROYAL LONDON MUTUAL INSURANCE SOCIETY LIMITED ON THE EUROPEAN EMBEDDED VALUE (EEV) SUPPLEMENTARY INFORMATION

We have audited the supplementary financial statements for the year ended 31 December 2006 that comprise the Consolidated Income Statement – EEV basis and the Consolidated Balance Sheet – EEV basis on pages 131 to 132 and the relevant notes (a) to (j) ('the supplementary information') which have been prepared in accordance with the European Embedded Value (EEV) basis set out herein and which should be read in conjunction with the Group's financial statements which are on pages 46 to 128.

### Respective responsibilities of directors and auditors

The directors are responsible for preparing the supplementary information on the EEV basis in accordance with the EEV basis set out in notes (a) to (j). Our responsibilities, as independent auditors, in relation to the supplementary information are, as set out in our letter of engagement agreed with you dated 15 November 2006 to report to you our opinion as to whether the supplementary information has been properly prepared, in all material respects, in accordance with the European Embedded Value basis. We also report to you if we have not received all the information and explanations we require for our audit of the supplementary information. 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 15 November 2006 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 in to whose hands it may come save where expressly agreed by our prior consent in writing.

### Basis of opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) (ISA (UK&I)) issued by the Auditing Practices Board. Our audit included examination, on a test basis, of evidence relevant to the amounts and disclosures in the supplementary information. This evidence included an assessment of the significant estimates and judgements made by the directors in the preparation of the supplementary information, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the supplementary information is free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the supplementary information.

### Opinion

In our opinion, the supplementary information for the year ended 31 December 2006 has been properly prepared in all material respects in accordance with the European Embedded Value basis set out in notes (a) to (j).

### PricewaterhouseCoopers LLP

Chartered Accountants and Registered Auditors

London

29 March 2007

## CONSOLIDATED INCOME STATEMENT – EEV BASIS

for the year ended 31 December 2006

	Notes	2006 £m	2005 £m
Contribution from new business	(h) (i)	36	31
Profit from existing business	(h) (ii)		
- Expected return		99	106
- Experience variances		9	6
- Operating assumption changes		(48)	(34)
Expected return on opening net worth	(h) (iii)	30	15
Profit on uncovered business	(h) (iv)	14	10
Other items	(h) (v)	(24)	(34)
<b>Operating profit before tax</b>		<b>116</b>	<b>100</b>
Economic experience variances	(h) (vi)	263	250
Economic assumption changes	(h) (vii)	59	8
Movement in pension scheme surplus	(h) (viii)	58	(22)
Financing costs	(h) (ix)	(25)	(1)
Enhancements to policyholder benefits	(h) (x)	(40)	(12)
<b>EEV profit before tax</b>		<b>431</b>	<b>323</b>
Attributed tax charge	(h) (xi)	(25)	(26)
<b>EEV profit after tax</b>		<b>406</b>	<b>297</b>

## CONSOLIDATED BALANCE SHEET – EEV BASIS

as at 31 December 2006

	2006 £m	2005 £m
<b>Assets</b>		
Assets held in closed funds	7,857	8,164
Assets backing non-participating liabilities	9,487	8,767
Reinsured liabilities	302	1,259
Assets backing participating liabilities and net worth		
- UK equities	3,139	2,605
- Overseas equities	532	633
- Land and buildings	1,340	1,070
- Approved fixed interest securities	990	1,795
- Other fixed interest securities	1,398	914
- Other assets	375	245
Value of in-force business	1,016	1,002
Pension scheme surplus	60	2
<b>Total</b>	<b>26,496</b>	<b>26,456</b>
<b>Liabilities</b>		
Liabilities in closed funds	7,857	8,164
Non-participating liabilities	9,487	8,767
Reinsured liabilities	302	1,259
Participating liabilities	6,100	5,974
Current liabilities	759	707
<b>Total</b>	<b>24,505</b>	<b>24,871</b>
<b>Embedded Value</b>		
Net worth	915	581
Value of in-force business	1,016	1,002
Pension scheme surplus	60	2
<b>Total</b>	<b>1,991</b>	<b>1,585</b>

### Value of in-force business – EEV basis as at 31 December 2006

	2006 £m	2005 £m
Value of in-force business before allowance for burn-through and capital costs	1,093	1,057
Burn-through cost	(52)	(32)
Cost of capital	(25)	(23)
<b>Value of in-force business</b>	<b>1,016</b>	<b>1,002</b>

**(a) Basis of preparation**

The EEV results presented in this document have been prepared in accordance with the EEV Principles and the Additional Guidance issued in 2005. They provide supplementary information for the year ended 31 December 2006 and should be read in conjunction with the Group's IFRS results. These contain information regarding the Group's financial statements prepared in accordance with IFRS, issued by the International Accounting Standards Board, and adopted for use in the EU.

The EEV Principles and Guidance were designed for use by proprietary companies to assess the value of the firm to its shareholders. As a mutual, Royal London has no shareholders. Instead, we regard our members as the nearest equivalent to shareholders and have interpreted the EEV Principles and Guidance accordingly. With-profits policies held by members do not generally contribute to the value of in-force business. However, the liabilities associated with these contracts are deducted from total assets to arrive at net worth. Hence, any movement in liabilities not matched by a corresponding movement in assets will change the net worth and flow through the income statement. The reported embedded value provides an estimate of Royal London's value to its 'owners'.

**(b) EEV methodology****(i) Overview**

The EEV basis of reporting is designed to recognise profit as it is earned over the term of the policy. The total profit recognised over the lifetime of the policy is the same as that recognised under the IFRS basis of reporting, but the timing of recognition is different.

For the purposes of EEV reporting, the Group has adopted a market-consistent methodology. Within a market-consistent embedded value (MCEV) framework, assets and liabilities are valued in line with market prices and consistently with each other. In principle, each cash flow is valued using a discount rate consistent with that applied to such a cash flow in the capital markets.

**(ii) Covered business**

The EEV Principles require an insurance company to distinguish between covered and uncovered business according to whether the business is valued on EEV Principles. The covered business, in the case of Royal London, incorporates:

- life and pensions business defined as long-term business by UK and overseas regulators; and
- asset management business; both that derived from the life and pensions business and that arising from external clients (except that arising from cash mandates, which is treated as uncovered).

This business, which represents the vast majority of the Group's total business, is valued on an EEV basis.

**(iii) Embedded Value**

The reported embedded value provides an estimate of the value of the covered business, including future cash flows expected from the existing business but excluding any value that may be generated from future new business. For covered business, it comprises the sum of the net worth calculated on an EEV basis and the value of the in-force business. For uncovered business, it comprises the IFRS net worth.

The net worth is the market-consistent value of the net assets (excluding the value of in-force business and pension scheme surplus) over and above those required to manage the business in line with the published Principles and Practices of Financial Management (PPFM). It is based on the Realistic Balance Sheet (RBS) working capital in those funds within the Group that are open to new business. It also comprises the net worth of the uncovered businesses on an IFRS basis and allows for the value of the debt issued, which is valued on a market-consistent basis.

The value of in-force business is the present value of the projected streams of future cash flows available from the existing business at the valuation date, on a best estimate basis allowing for risk, adjusted for the cost of holding the required capital.

**(b) EEV methodology** (continued)**(iv) Allowance for risk**

The allowance for risk is a key feature of the EEV Principles. The table below summarises how each item of risk has been allowed for:

Type of risk	EEV methodology
Market related risks	Allowed for explicitly in the EEV calculations
Non-market risks which are symmetrical in terms of the impact on EEV	Allowed for within the estimates of future operating experience
Non-market risks which are asymmetrical in terms of the impact on EEV	Allowed for in the calculation of VIF and financial options by way of an additional margin in the estimates of future operating experience

- *Market risk*

The approach adopted to calculate the MCEV combines deterministic and stochastic techniques. Deterministic techniques have been used to value 'non-option cash flows'; that is cash flows whose values vary linearly with market movements. Stochastic techniques have been used to value cash flows with an asymmetric effect on profit, such as investment guarantees on with-profit products.

In principle, each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. For example, an equity cash flow is valued using an equity risk discount rate, and a bond cash flow is valued using a bond risk discount rate. If a higher return is assumed for equities, the equity cash flow is discounted at this higher rate. In practice, it is not necessary to discount each cash flow at a different rate. For cash flows that are either independent or move linearly with the market, a method known as the 'certainty equivalent approach' will achieve the same results. Under this method all assets are assumed to earn the risk-free rate of return and all cash flows are discounted using the risk-free rate. This approach has been adopted to value the 'non-option cash flows' within a deterministic model.

- *Non-market risk*

In general, the allowance for non-market risk is covered by the margin incorporated into the Group's estimates of future operating experience assumptions. However, there are certain situations in which the impact of fluctuations in experience is asymmetric, namely that adverse experience can have a higher negative impact on value than the positive impact generated by favourable experience.

In these cases, an additional margin over best estimate is incorporated into the experience assumptions. The methodology used to determine the appropriate allowance for non-market risk is based on the analyses undertaken as part of the development of the RBS and the Individual Capital Assessment.

**(c) Cost of capital**

The EEV Principles require capital allocated to the covered business to be split between required capital, the future distributions of which are restricted, and free surplus. We have defined the amount of required capital to be that necessary to meet the more onerous of the FSA Pillar 1 and Pillar 2 capital requirements, including any Individual Capital Guidance received from the FSA.

The EEV includes a deduction for the frictional cost of holding the required capital. Frictional costs, being the tangible costs of holding capital, have been allowed for on a market-consistent basis. These consist of the total taxation and investment expenses incurred on the required capital over the period it is anticipated to be required. They reflect the cost to a member of having an asset held within a mutual insurance company, rather than investing in the asset directly.

No allowance has been made for any agency costs. These represent the potential markdown to value that members might apply because they do not have direct control over their capital. Any adjustment would be subjective and different members will have their own views of what adjustment, if any, should be made.

**(d) Burn-through cost**

Under adverse conditions the funds that remain open to new business may be required to make good any deficits that arise in the closed funds. The time value cost of this potential liability, known as the burn-through cost, is modelled stochastically, as it will only occur in adverse scenarios.

The burn-through cost is calculated as the average value of the capital support supplied in a large number of market-consistent scenarios. Allowance has been made, under the different scenarios for management actions, such as altered investment strategy, consistent with the PPFM.

The stochastic model used to calculate this liability has been calibrated to market conditions at the valuation date. In addition, due to the asymmetric nature of this liability, an additional margin has been incorporated into the operating assumptions.

**(e) Taxation**

EEV profits are calculated on a net of tax basis. These are then grossed up at the appropriate rate of tax. In general, this will be 6%, the expected long-term rate of tax payable by Royal London though subsidiary companies may be subject to different rates of tax.

**(f) Expenses**

The EEV Guidance requires companies to actively review expense assumptions, and include an appropriate allowance for corporate costs and service company costs.

- *Corporate costs*

Corporate costs are those costs incurred at a corporate level that are not directly attributable to the covered businesses. Future corporate costs have not been anticipated within the EEV and instead are accounted for as they arise. The impact of corporate costs in 2006, is a reduction in the EEV profit of £17m (2005 £15m).

- *Service company costs*

An in-house management service company, that receives a fee in respect of each policy it administers, carries out Royal London's administration. A similar arrangement exists for asset management services, though the fee is applied as a percentage of assets. The value of the in-force life and pensions business has been calculated using the service company (including asset management) fees.

Costs within the administration service company have been classified as either ongoing (including an element of development expenditure) or exceptional development costs. Exceptional development costs have not been anticipated within the EEV and instead are accounted for as they arise. For 2006, £21m (2005 £19m) of development costs were classified as exceptional.

The profits expected to arise from life and pensions business within the administration service company from activities related to the maintenance of existing business and within RLAM in respect of investment management services have been capitalised within the EEV. These calculations result in the recognition of further value in the in-force business. £85m (2005 £89m) is recognised in respect of the administration service company and £26m (2005 £27m) is recognised in respect of RLAM's business arising directly from Royal London's life and pensions business.

No allowance has been made for future productivity gains except in the case of Bright Grey, a relatively new protection business. For this business, the current modest level of cost over-runs has been assumed to reduce to zero by 2010.

**(g) New business**

New covered business includes:

- premiums from the sale of new contracts;
- non-contractual increments (both regular and single premium) on existing policies;
- premiums relating to new entrants in group pension schemes; and
- rebate premiums received from the Department of Work and Pensions.

**(h) Analysis of EEV profit****(i) Contribution from new business**

The contribution from new business is calculated using economic assumptions at the end of the period. It is shown after the effect of required capital, calculated on the same basis as for in-force covered business.

New business sales are expressed on the present value of new business premiums (PVNBP) basis. PVNBP is calculated as total single premium sales received in the year plus the discounted value, at point of sale, of regular premiums expected to be received over the term of the new contracts. The premium volumes and projection assumptions used to calculate the present value of regular premiums for each product are the same as those used to calculate the new business contribution, so the components of the new business margin are on a consistent basis.

The new business contribution shown in the table below represents the net contribution from new business but grossed up at 30% to make it more comparable to results published by proprietary companies. The new business margin represents the ratio of the new business contribution to PVNBP.

2006			
	Present value of new business premiums	New business contribution	New business margin
	£m	£m	%
<b>Scottish Life</b>	1,425	17.8	1.2
<b>Bright Grey</b>	154	2.8	1.8
<b>Scottish Life International</b>	165	4.7	2.8
<b>Royal London Administration Services</b>	248	16.1	6.5
<b>Royal London Asset Management</b>	1,229	5.9	0.5
<b>Total</b>	<b>3,221</b>	<b>47.3</b>	<b>1.5</b>

2005			
	Present value of new business premiums	New business contribution	New business margin
	£m	£m	%
Scottish Life	1,322	13.4	1.0
Bright Grey	163	7.2	4.4
Scottish Life International	133	4.9	3.7
Royal London Administration Services	190	10.0	5.3
Royal London Asset Management	751	4.6	0.6
<b>Total</b>	<b>2,559</b>	<b>40.1</b>	<b>1.6</b>

The result for Scottish Life illustrates the relatively low new business margins currently available in the pensions market, particularly from group pensions, though actions taken in 2005 have already started to improve profitability in this area.

Volumes of business sold under the Bright Grey brand have continued to increase strongly, though profitability has reduced relative to 2005 as a result of a strengthening of our persistency assumptions. Bright Grey remains a relatively new business and has yet to realise the economies of scale that should ultimately be achieved. As these economies are realised we expect the profitability of Bright Grey business to improve.

In a similar vein, volumes of business sold by Scottish Life International have increased, though profitability has declined, this time as a result of changes to the mix of business sold.

**(h) Analysis of EEV profit** (continued)

The Royal London Administration Services business is largely incremental income to the legacy book, with low attaching expenses of acquisition, making it a relatively profitable business.

The volume of asset management mandates won have increased significantly, reflecting the excellent investment performance of Royal London Asset Management in recent years. The relatively low margins on this business reflect the nature of the mandates won.

**(ii) Profit from existing business**

Profit from existing business comprises:

- the expected return on the value of in-force business at the start of the period, plus
- profits and losses caused by differences between actual experience for the period and that assumed in the embedded value calculations at the start of the period, plus
- the impact of any changes in the assumptions regarding future operating experience.

	2006 £m	2005 £m
Expected return	99	106
Experience variances	9	6
Operating assumption changes	(48)	(34)
<b>Total</b>	<b>60</b>	<b>78</b>

Experience variances include the impact of the difference between demographic, expense and persistency assumptions and the actual experience incurred in the year. Although the overall impact of experience variances is relatively small there have been adverse variances in the experience for some products. Accordingly, we have reviewed our assumptions and have taken the decision to strengthen the operating assumption bases to reflect this experience.

**(iii) Expected return on opening net worth**

The expected return on opening net worth represents the expected investment return on the net worth over the period.

**(iv) Profit on uncovered business**

Profit on uncovered business has been valued on an IFRS basis, as used in the primary financial statements. A breakdown of the profit reported on uncovered business is shown in the table below:

	2006 £m	2005 £m
General Insurance	14	12
Administration Services	(1)	(2)
Cash Management	1	–
<b>Total</b>	<b>14</b>	<b>10</b>

**(v) Other items**

Other items represent a combination of:

- exceptional development costs, which are typically investments made to improve future EEV profits (for example by reducing on-going expense levels or increasing new business volumes);
- corporate costs; and
- other exceptional items. For example, during 2006 the annuity business previously sold under the Royal London and United Assurance Group brands was reinsured and subsequently transferred to PRIL. This transaction generated a one-off profit of £14m in 2006.

A breakdown of these items is shown in the table below:

	2006 £m	2005 £m
Exceptional development costs	(21)	(19)
Corporate costs	(17)	(15)
Reinsurance of annuity portfolio	14	–
<b>Total</b>	<b>(24)</b>	<b>(34)</b>

**(vi) Economic experience variances**

This shows the impact of actual investment returns relative to those assumed. Economic experience variances have an impact on the value of in-force (VIF) business and on the net worth.

The economic experience variance on the VIF arises from the increase in policy values in which Royal London has an interest. The economic experience variance on the net worth represents the impact that investment returns, being different to those anticipated, has on:

- the value of the opening net worth;
- the value of financial options and guarantees (\*); and
- the value of the assets backing the financial options and guarantees (\*).

(\*) Excluding those movements due solely to changes in the yield curve, which have been netted off against the movement in the value of assets caused by the shift in the yield curve.

The value of the second and third items above is generally far more significant for Royal London, as a mutual insurance company, than would be the case for an equivalent proprietary company, whose interest in the surplus in its with-profit funds is restricted, typically to 10% of the distributable surplus.

Overall, the returns achieved on the underlying assets in 2006 were greater than those assumed. Equities performed particularly strongly. However, as interest rates increased, the market value of our fixed interest assets fell over the year. Investment performance contributed significantly to the overall EEV profit reported for the year, as it did previously in 2005.

**(vii) Economic assumption changes**

Long-term economic assumptions were revised to take into account the financial conditions at the end of the period. As a result of movements in prevailing economic conditions, the changes included an increase in the discount rates utilised to reflect the increase in risk-free rates and updated assumptions to value the cost of guarantees and options. The combined effect of these changes contributed £59m (2005 £8m) to the pre-tax result. Further details of the economic basis used are provided in section (i).

**(viii) Pension scheme surplus**

The principal scheme is the Royal London Group Pension Scheme, a final salary scheme that is closed to new entrants. On an IAS 19 basis, the scheme had a surplus of £60m at 31 December 2006 (2005 £2m). Royal London is not currently making contributions to the scheme. Due to favourable investment experience over the year, the expected contribution holiday period has been extended. The impact of this has been incorporated as an economic experience variance.

**(ix) Financing costs**

In December 2005, Royal London raised £395m (after expenses) of subordinated debt, which carries a coupon of 6.125% per annum. The financing cost is calculated as the cost of servicing the debt over the year.

**(x) Enhancements to policyholder benefits**

The embedded value has been calculated as the value of assets in excess of those required to manage the business in line with the PPFM. Over the course of the year, Royal London's Board has taken a number of actions that directly increase the value of the liabilities set aside to meet future payments to with-profits policyholders. These actions include:

- allocating investment return to certain asset shares in excess of the rate earned on the underlying assets; and
- setting policy payouts at a level in excess of those previously assumed.

	2006 £m	2005 £m
Additional returns credited to asset shares	(13)	(8)
Impact of enhancing policy payouts	(27)	(4)
<b>Total</b>	<b>(40)</b>	<b>(12)</b>

In addition, the Board increased the equity-backing ratio in the fund and increased the proportion of fixed interest assets held in corporate bonds (rather than government securities). This should benefit long-term returns, but leads to an increase in the cost of guarantees provided to policyholders. The impact of these additional guarantee costs has been incorporated into the consolidated income statement as economic assumption changes.

**(xi) Attributed tax charge**

EEV profits are calculated net of tax and then grossed up at an appropriate tax rate. In general, this will be 6%, the expected long-term rate of tax payable by Royal London, though subsidiary companies may be subject to different rates of tax.

**(i) EEV assumptions****(i) Principal economic assumptions – deterministic**

Economic assumptions are actively reviewed and are based on the prevailing market yields on risk-free assets at the valuation date.

	2006 %	2005 %
Risk-free rate	4.60	4.10
Retail Price inflation	3.00	2.75
Expense inflation	4.00	3.75

**(ii) Principal economic assumptions – stochastic**

The value of financial options (including premium rate guarantees and guaranteed annuity options), smoothing costs and future deductions from asset shares are calculated using market-consistent techniques. Market-consistency is achieved by running a large number of economically credible scenarios through a stochastic valuation model. Each scenario is discounted at a rate consistent with the individual simulation. The economic scenarios achieve market-consistency by:

- deriving the underlying risk-free rate from the forward gilt curve, with a margin of 10 basis points to reflect empirical evidence that gilt yields may understate the true risk-free rate;
- calibrating equity and interest rate volatility to observed market data by duration and price, subject to interpolation/extrapolation where traded security prices do not exist. We attempt to achieve the best possible fit, though modelling restrictions prevent this from being perfect.

The tables below show the implied volatilities used in the modelling by asset class:

2006					
	Term (years)				
	5	10	15	20	30
15-year risk-free zero coupon bonds	5.4%	4.1%	2.8%	2.3%	3.4%
15-year AA-rated corporate bonds	5.9%	4.9%	4.0%	3.8%	4.8%
Equities	17.8%	20.3%	22.1%	23.1%	24.0%

2005					
	Term (years)				
	5	10	15	20	30
15-year risk-free zero coupon bonds	6.3%	5.0%	4.1%	3.6%	4.3%
15-year AA-rated corporate bonds	7.3%	6.4%	5.8%	5.5%	6.0%
Equities	17.1%	20.3%	22.9%	24.4%	26.2%

**(iii) Expected returns in reporting period**

For the purposes of calculating the expected returns over the period, allowance is made for a risk premium as set out in the following table:

	2006 %	2005 %
Risk premium – equities	2.50	2.50
Risk premium – property	2.00	2.00

All other assets are assumed to earn the risk-free rate.

**(iv) Other assumptions**

Demographic assumptions are regularly reviewed having regard to past, current and expected future experience, and any other relevant data. These are generally set as best estimate with an appropriate margin for adverse deviations.

**(j) Sensitivity analyses**

The table below shows the sensitivity of the embedded value at 31 December 2006 and the 2006 contribution from new business to changes in assumptions. In each sensitivity the other experience assumptions remain unchanged, except where changes in economic conditions directly affect them.

	Notes	Change in embedded value £m	Change in new business contribution £m
100 basis point increase in risk discount rates	1	-	-
100 basis point increase in equity and property returns	2	-	-
100 basis point reduction in risk-free rates		(251)	1
10% increase in market values of equities and property	3	270	-
10% proportionate decrease in lapse and paid-up rates		8	6
10% proportionate decrease in expenses		32	11
5% proportionate decrease in mortality and morbidity		(17)	1
50% increase in capital requirements		(13)	(1)

**Notes:**

1. As a market-consistent approach is used, changes in the risk discount rate would be matched by changes in the market-consistent discount rates used to value these cash flows. Therefore, there is no overall impact on the embedded value.
2. As a market-consistent approach is used, changes in the expected returns under equity and property would be matched by changes in their associated discount rates. Therefore, there is no overall impact on the embedded value.
3. The value of new business is assessed at the point of sale. Increases in the value of equities and property at this date have no impact on the value of new business.



# NOTICE OF ANNUAL GENERAL MEETING

## THE ROYAL LONDON MUTUAL INSURANCE SOCIETY LIMITED

Notice is given that the Annual General Meeting of the Company will be held at 11.00am on Tuesday 22 May 2007 at the Redgrave and Mozart Suites, The Barbican Centre, Silk Street, London, EC2Y 8DS for the following purposes:

To consider and, if thought fit, to pass the following resolutions, each of which will be proposed as an ordinary resolution:

- 1 That the audited Annual Report and Accounts for the year ended 31 December 2006 be received.
- 2 That the Directors' remuneration report be approved.
- 3 That PricewaterhouseCoopers LLP be reappointed as auditors to the Company until the conclusion of the next Annual General Meeting.
- 4 That the remuneration of PricewaterhouseCoopers LLP be determined by the directors.
- 5 That Andy Carter be reappointed a Director.
- 6 That John Deane be reappointed a Director.
- 7 That Robert Jeens be reappointed a Director.

By order of the Board



**Murray Ross**  
Group Legal Director and Secretary  
29 March 2007

Registered Office:  
55 Gracechurch Street  
London EC3V 0RL  
(Registered in England and Wales: No. 99064)

## COMMENTARY ON THE RESOLUTIONS

### RESOLUTION 1 – ANNUAL REPORT AND ACCOUNTS 2006

A company must lay before a general meeting its annual accounts, the Directors' report and the auditors' report for every financial year.

### RESOLUTION 2 – DIRECTORS' REMUNERATION REPORT

The Director's Remuneration Report Regulations 2002 require a company that is quoted on the London Stock Exchange (or in Europe or the USA) to include at the annual general meeting a resolution to approve the Directors' remuneration report. The resolution is advisory. The Regulations do not, of course, apply to the Company because it is a mutual and not a quoted company. The Board, however, believes that such a resolution has become a part of good corporate governance and accordingly has voluntarily included it on the agenda. The Directors' remuneration report appears on pages 41 to 43 of the Annual Report and Accounts 2006.

### RESOLUTIONS 3 AND 4 – APPOINTMENT AND REMUNERATION OF AUDITORS

At each general meeting at which accounts are laid, a company must appoint an auditor to hold office until the next general meeting at which accounts are laid and the general meeting must also determine the remuneration or the way in which it will be determined. PricewaterhouseCoopers LLP are the Company's existing auditors and the directors recommend that they be reappointed and their remuneration be determined by the directors.

### RESOLUTIONS 5 TO 7 – REAPPOINTMENT OF DIRECTORS

The Company's Articles of Association provide that:

- any director who is appointed by the Board to fill a vacancy or as an additional director must retire at the next AGM, and
- all directors who held office at the start of the last two AGMs and who did not retire at either of those AGMs must retire by rotation at the AGM.

In each of these cases, retiring directors are eligible for reappointment at the meeting. Andy Carter and John Deane will be retiring under the former provision at the AGM and Robert Jeens will be retiring under the latter.

Andy has been with the Group since 2001 and has been Chief Executive of Royal London Asset Management since 2003. During this time he has presided over a period of sustained growth in our asset management business. John Deane joins the Group, with effect from 1 April 2007, from Old Mutual plc where he was corporate development director and will head up the new dedicated intermediary division. John was also involved in the successful sales and product redesign in Old Mutual's South African life business. Robert Jeens was appointed to the Board in May 2003 and

is Chairman of the Audit Committee. He has some 30 years' experience within large financial services businesses and is a non-executive director of a number of companies.

Biographical details of all directors are included on pages 34 and 35 of the Annual Report and Accounts 2006.

Note: The terms and conditions of appointment of non-executive directors are available for inspection at the Company's registered office at 55 Gracechurch Street, London EC3V 0RL during business hours on any weekday (except public holidays) and will also be available for inspection at the AGM 15 minutes prior to and during the meeting.

## MEMBER INFORMATION

### ANNUAL GENERAL MEETING 2006

The 2006 Annual General Meeting was the second year in succession that voting by proxy was permitted. All 600,000 members of Royal London were mailed with an invitation to the meeting, a proxy voting form and, for the first time, the Summary Financial Statement, which allows members a high level view of the financial position of Royal London.

Over 30,000 members chose to vote by proxy at the 2006 AGM. While this is a significant number of participating members, we are actively seeking ways to increase member participation in the voting process.

### ANNUAL GENERAL MEETING 2007

Members unable to attend the meeting in person will, for the first time, be able to vote online using a secure internet site, as well as by post. We believe we are the first mutual insurance company to permit members to register their proxy voting form electronically.

### MEMBER COMMUNICATIONS

The Royal London Group website remains our primary means of delivering information to members in a timely and cost effective manner. During 2007 we will be developing the quality and content of the members' section of the website ([www.royallondongroup.co.uk/members](http://www.royallondongroup.co.uk/members)).

We will be researching the type of information members want to receive from us and the preferred method of delivery. If you are a member and have views on the type of information you would like to receive, send your views to: [memberrelations@royallondongroup.co.uk](mailto:memberrelations@royallondongroup.co.uk).

or write to:  
Member Relations  
Royal London Group  
55 Gracechurch Street  
London  
EC3V 0RL

## 2007 FINANCIAL CALENDAR

26 April	Announcement of first quarter 2007 new business figures
22 May	Annual General Meeting
31 July	Announcement of first half 2007 new business figures
27 September	Announcement of unaudited six months' interim results
31 October	Announcement of third quarter 2007 new business figures
15 December	Royal London subordinated guaranteed notes' interest payment date

## CONTACT OFFICES

### **The Royal London Mutual Insurance Society Limited**

Registered in England and Wales No. 99064

Registered Office:  
55 Gracechurch Street  
London  
EC3V 0RL

Tel: 0870 850 6070  
[www.royallondongroup.co.uk](http://www.royallondongroup.co.uk)

### **Royal London Administration Services**

Royal London House  
Alderley Road  
Wilmslow  
Cheshire  
SK9 1PF

Tel: 0870 850 6070  
[www.royal-london.co.uk](http://www.royal-london.co.uk)

### **Scottish Life**

19 St Andrew Square  
Edinburgh  
EH2 1YE

Tel: 0870 606 2000  
[www.scottishlife.co.uk](http://www.scottishlife.co.uk)

### **Bright Grey**

2 Queen Street  
Edinburgh  
EH2 1BG

Tel: 0131 247 1500  
[www.brightgrey.com](http://www.brightgrey.com)

### **Royal London Asset Management**

55 Gracechurch Street  
London  
EC3V 0UF

Tel: 0207 506 6500  
[www.rlam.co.uk](http://www.rlam.co.uk)

### **Scottish Life International**

Clarendon House  
Victoria Street  
Douglas  
Isle of Man  
IM1 2LN

Tel: 0162 461 1077  
[www.sli.co.im](http://www.sli.co.im)

Designed and produced by Wardour Publishing and Design

This report and accounts has been printed on paper which is produced using 100% de-inked post-consumer recovered fibre at a mill that has been awarded the ISO14001 certificate for environmental management. The pulp is bleached using an elemental chlorine free process.



